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Pandora box: The eurozone and the euro crisis

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Abstract: The global economy has experienced considerable turbulence since 2007. The financial crisis has been viewed as the trigger for a prolonged period of economic decline. This decline remains an issue for all member states of the European Union, the eurozone and beyond. We argue genesis of this crisis lies in the integration negotiations of 1991, ratified in 1992. These produced a flawed economic model within the eurozone. Given the seeds of decay were planted at origin; we argue the solution can be found through a reconstructed eurozone via looser integration, where countries less equipped to deal with the realities of closer integration will be economically independent.

Subjects: Economic Theory & Philosophy; International Economics; Macroeconomics

Keywords: currency union; current account surpluses; euro; eurozone; financial crisis; public finances

1. Introduction

> Panics do not destroy capital; they merely reveal the extent to which it has been destroyed by its betrayal into hopelessly unproductive works. (John Stuart Mill)

The eurozone is the aggregate of the world's second largest economy, similar in size to the United States (US) in terms of financial scope. Its currency, the euro, is the world's second most important reserve asset. It accounts for a quarter of the world's currency reserve, indicating its high significance as a global currency. Its economic impact cannot be underestimated. The affect of the eurozone

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PUBLIC INTEREST STATEMENT

The European debt crisis is an ongoing financial crisis that has made it difficult or impossible for some countries in the euro area to repay or re-finance their government debt without the assistance of third parties.
The European sovereign debt crisis resulted from a combination of complex factors, including the globalisation of finance; easy credit conditions during the 2002–2008 period that encouraged high-risk lending and borrowing practices; the 2007–2012 global financial crisis; international trade imbalances; real-estate bubbles that have since burst; the 2008–2012 global recession; fiscal policy choices related to government revenues and expenses; and approaches used by nations to bail out troubled banking industries and private bondholders, assuming private debt burdens or socialising losses. In this paper, we discuss this crisis and the long-term solution to it.

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banking system within the Union is significantly larger than those felt within the United States, with certain states having balance sheets which "… are very large relative to the size of their country's economy" (Artus, 2010, p. 3). Then threats of the Euros collapse therefore represent a catastrophic financial and economic problem of unparalleled global significance, impacting upon economic confidence and fiscal stabilities well beyond the narrow confines of its predetermined arena.

The creation of the European Union (EU) which includes the onset of currency union—was a significant part of a series of economic and political integration projects in post-war Europe:

> Between 1945 and 1950, a handful of courageous statesmen including Robert Schuman, Konrad Adenauer, Alcide de Gasperi and Winston Churchill set about persuading their peoples to enter a new era. New structures would be created in Western Europe, based on shared interests and founded upon treaties guaranteeing the rule of law and equality between all countries. (Gil, 2006)

It was established as a political response to the catastrophic events of the first half of the twentieth century vis-a-vis the social impacts of the depression and the two world wars. Economically, it was also a response to the threats of Soviet expansionism in Europe, retarded in part through such US fiscal interventions as the Marshall Plan. Established as a means of ensuring peace, it has now shifted character over the course of the latter part of the twentieth century towards ensuring the power of individual nations to compete in a globalised market comprised of larger trading blocs. This is confirmed by Tony Blair, who argues that "the 21st Century case for Europe is about power versus irrelevance" (Blair, 2012). The EU can be viewed as a political and economic project, designed to compete in the ever-increasing globalised world.

However, today the EU is challenged by the integration of states that are, arguably, unprepared for succession either economically or politically into the trading bloc. The EU was and is designed for mature economic liberal democracies with a welfare ethos. This was challenged by the inclusion of less developed eastern European economies, some of which are still recovering from the legacies of communism. This notwithstanding the "European Project" the European project has been perceived by some as a cataclysmic error which has presented tremendous economic problems. This is due to the economic disparities which lie between the states. In trying to bind these states together all that has been created is political and economic frictions. The challenge of creating prosperous integration has been problematic.

In this paper, we will develop this proposition, arguing the European project is too large in its current form to continue, and that without massive reconstruction of the relationship between eurozone states and the broader EU membership, it is unlikely to emerge as a strong economic bloc, arguably negating its *raison d'être*. To do this, we will first discuss the background and symptoms of the crisis, drawing from post-crisis events in our analysis. This is necessary to contextualise any proposed solutions, which we advance in the latter part of the paper to determine whether and how the eurozone can and will survive the crisis.

2. Methodology

The methodology applied within this paper was built upon critical review of the secondary literature. The systematic review provided an exhaustive summary of literature relevant to the financial crisis in Europe.

The first step of the review was a thorough search of the literature for relevant publications. Publications were assigned an objective assessment of methodological quality using a rating system. The researchers kept a log of the search strings used and the results. The search string yielded more than 100 references. Additional terms (keywords) were added to the string to focus the search more accurately. Next, the titles and the abstracts of the identified articles were checked against pre-determined criteria for eligibility and relevance. To ensure that the searches undertaken were consistent and comparable, the method applied involved keywords and phrases derived from the research topic. These were then placed into categories and assigned keyword numbers to allow their strategic combination according to researcher impressions from a preliminary literature trawl: keyword 1 words were to be paired with every keyword 2 word once. These were "euro" and "eurozone", respectively.

The initial search returned a high number of references (70 or more), the second search was further refined by adding keyword 3 ("outcomes") to the search string. Search logs were compared between researchers to ensure that the terms had been applied consistently (Saunders, Lewis, & Thornhill, 2007). This research was refined to 35 articles which directly addressed the topic under consideration.

3. Analysis of the crisis

Causal factors of the crisis are *international credit*, *public finances*, *current account surpluses*, their *interdependent relationship* and *net exports as capital*. The alignment of each of these issues stripped away the credibility of the eurozone and its capacity to recover. For the countries now in difficulty, their inability to apply fiscal policies as a remedy to localised recessions causes significant internal and external strain.

However, on an even more fundamental level, the crisis is one of balance of payments and financing. Wolf (2012a) notes when countries start lending across the frontiers to other countries the economies adapt in complex ways. When financing ceases, it creates "a sudden stop". It is this which helped lead to the collapse of Lehman Brothers, acting as a trigger at the start of the economic crisis. Its impact was exacerbated by internal capital flows from creditor nations in northern Europe to the deficit nations in the south. These current accounting imbalances between income and trade deficits occurred due to the flow of capital generated by a superficial but sustained boom in the decade previous to the crisis. During this time, private sector lenders advanced funds to high risk entities, principally governments and/or banks. The implosion of the financial sector produced a major downturn in countries' revenue base, collapsing the broader economy and producing the economic crisis. This resulted in governments becoming insolvent and needing to be bailed out by the central institutions of global governance, such as the International Monetary Fund (IMF). Moreover, as these countries did not have effective independent central banks to govern their own economies, they did not have the ability to adjust domestic exchange rates to deal with the localised economic conditions in their sovereign territory. This implosion should be seen as a symptom of the economic integration crisis, rather than a cause.

The financial crisis shone light upon lenders who disregarded the accepted principles of sound lending. In the boom years before 2007, lenders advanced funds to those who, had normal underwriting procedures been applied, would have no realistic chance of repaying the loan on the terms agreed. This point is supported by the public debt positions, and is a simple measure of fiscal stress relative to Gross Domestic Product (GDP). The consequences of such major divergences of competitiveness are demonstrated by their scope, such as the economic collapse of Ireland, Spain, Portugal, Italy and Greece, each of which generated major divergences in competitiveness within the single currency area. There was no exchange rate adjustment available to national economies, thus such countries became very uncompetitive whilst simultaneously running up bad debts.

Moreover, the aggregate balance of payments for the eurozone has been imbalanced throughout its history. With the onset of the eurozone project, more prosperous states such as Germany have become an increasingly dominant player in the broader EU. Combined with the Netherlands, both can justly be reasonably described as "surplus countries", who have led the bailouts to countries such as Greece. As a result of this domination defined by comparative wealth, the poorer nations have become less significant in terms of been able to determine their own economic future, with dominant actors emerging as the greater capital exporters, garnering a much higher share of the eurozone GDP. Given the fiscal importance of balancing national budgets, the imbalance in the eurozone as a single unit was placed under increasing pressure from the *dearth nations*. Capital flows were exported from the wealthier nations towards the poorer, making economic instability even greater.

To exacerbate this crisis, poorer countries were running current account deficits. Over an 11-year period, Portugal ran a deficit of 9% of GDP, Greece 8% and Spain 6%. These countries, at the end of 2007, had a net asset position representing in excess of minus 100% of GDP. Inevitably, this produced a loss of confidence and a flight of capital from those countries. This created a situation where the markets stopped functioning and the affected countries did not have the capacity to raise any new income through conventional taxation. An important part of this narrative is when capital was flowing more freely, these countries were spending beyond their income. There was a pronounced neglect of traditional industry and competitiveness because foreign capital was providing them with a significant part of their imports, financed by artificial capital. As such their export sectors were squeezed and real wages rose. During the "boom" years, the export sector was tightened through real wage increases rising faster than productivity, the result of which was growing labour costs, reducing competitiveness.

Moreover, in the years prior to the debt crisis, western governments failed to adequately regulate their banks because they bought into the opportune view that the "… problem of depression prevention had been solved" (Lucas, 2003). Added to this were the non-conventional underwriting methods in lending which led to large volumes of capital being advanced to sub-prime individuals, groups and governments. This was particularly evident in the US sub-prime mortgage market. This lack of fiscal prudence and regulation enabled their drive for profit to dominate policy formulation, leading to lax investments in unproductive works. Efforts were promoted with monetary imprudence, regulatory forbearance and government tax incentives that marginalised investment. This enabled markets to become fragmented through off-exchange trading and derivatives that no longer performed the economically critical function of capital allocation and price transparently. The results of which were serial bubbles such as debt financed speculation in real estate, investments and commodities. Since August 2007, there has been a steady constriction of credit markets, starting with the aforementioned subprime mortgage bank securities, spreading to interbank credit, bond markets and securities more generally. Prior to the crisis, a period of high regulatory imprudence dominated.

This is the critical argument. Viewed from this perspective, the Western world may face decades of under-production, over-consumption, under-investment and over-spending, each tending to a greater imbalance in debt. This may, if combined with oscillations induced by disturbances, take the eurozone economies beyond the point where they could right themselves into a *deflationary spiral*. The support from the European central bank as a lender of last resort has been somewhat important in offsetting the worse symptoms of the recession. However, this is not as effective as having bank that can target the regional decline. As an evaluation, when Spain is contrasted with the United Kingdom (UK), both have similar fiscal situations; however, they diverge in that both have different interest rates on public debt. Such interest rates contribute towards the credit rating of a state's economy. Spain remains more vulnerable to currency liquidity and default risk, to which the UK is not as exposed. Yet Spain's net public debt is lower than in the UK; however, Spain has a much less mature financial sector. The UK is currently trading on a 10 year debt with 10 years government bonds. These bonds are trading at 1.6%, which is the lowest yield on UK government bonds in the history of its 300 year bond trading. Spain on the other hand is trading at between 6 and 7%, which is unsustainable in the long term. Its 10 year bond yield listed at 2.1% UK is at 2.3% currently. Ireland supposedly one of the PIGS has a 10 year yield of 1.63%. UK growth rates are much lower than Ireland Spain's debt interest rates are higher because the British treasury is not expected to default. In part, the fiscal rebalancing generates more confidence in the markets, and the City of London ensures the British economy remains locked out of the fiscal catastrophe of other eurozone nations. In part, this is also due to the greater credibility and stability of the broader British economy, but the icing on the cake is the all-important central bank. Britain has more control over its finances through its central bank, and it is outside of the eurozone. It can be concluded that given no two economies in the EU

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are alike, solutions for one will be different to another, and that high income countries embedded inside a currency union are more vulnerable to balance of payments in a financial crisis than countries with floating exchange rates and their own central banks. The crisis has demonstrated that ever closer union is inadequate; however, given those in the eurozone have chosen to participate in such an undertaking, it is now a reality from which Britain and the rest of the EU simply cannot hide. “Ever closer Union” in the original 1956 Treaty of Six is only a vague aspiration. Without political union, monetary union will be a crisis-prone shambles every time there is an economic shock?

Moreover, the public deficit faced by Greece at the start of the economic crisis was approximately 100%. During the course of the crisis, this increased dramatically to over 160%. GDP will be falling in the current paralysis as debt grows. The deficit faced by Italy has also dramatically increased to approximately 100%. Although this is not as substantial as Greece, it is certainly a substantial increase. Also, we must consider what has happened in Spain and Ireland to better understand possible solutions. As the financial crisis struck, these countries had strong fiscal positions and low net public debt. Ireland’s deficit was approximately 11%, yet this has risen to over 100% in the four years since the start of the crisis. This can justly be described, therefore as the largest fiscal catastrophe following a financial crisis witnessed in recent history. The main causal factors for these increases are the bailing out the banks, coupled with more conventional consequences of a recession vis-à-vis unemployment and declining living standards. Sudden and immense rises in credit spreads, and the differences between interest rates on these governments, created disparity in the impacts felt by the countries concerned. When countries are facing such dramatically increased spreads, they are typically paying interest rates of 5, 6, or 7% per annum. This compounds the debt position for those countries, contracting their economy. The real level of debt explodes because of the cost of rolling over the debt year to year. Moreover, the collapse of the integration of the eurozone financial market and the increased reliance of these governments on domestic credit means that if a country goes bankrupt, they wipe out their economies, taking their banking system with them, and needing further external intervention. Lack of confidence also leads to foreign investors abandoning the economy. Foreign ownership has declined in some eurozone countries from 15 to 80%, which is projected to continue as financial integration declines. As a result of this, enormous recessions risk becoming the norm, with a return to prosperity permanently elusive as an example, Ireland’s GDP has collapsed to 10%, remaining static at that approximate percentage since external measures were introduced. Greece, for reasons which are seemingly obvious, has simply stopped publishing GPD figures in 2012 entirely, but it is reasonable to conclude that their GDP is significantly lower than other EU nations, given they are in a deep depression. Italy, which is more significantly tapped into the eurozone economy, was also collapsing along with Spain. Wage reductions and unemployment rates of approximately 25% compound the problem, with Greece having a youth unemployment rate of approximately 60%. It is anticipated that the unemployment rates in each of the affected eurozone nations under discussion will continue to rise over the coming years, with the eurozone economy also contracting. Indeed, as recently as February 2013, the contraction continues at 0.6%.

In sum, the eurozone is now in extreme debt and needing similar intervention. Political and economic proponents of the eurozone were arguably unaware of these dangers of cross-border financial flows and current account imbalances because they were blinded, in part, by their ethos of ever closer union. They also thought these flows were the purpose of the exercise, seeing the aim as to get the capital to flow using any means possible. These nation states appear to consider that currency risk was the only danger to these capital flows, a risk they believed had been eliminated. The recent evidence strongly indicates they were unambiguously wrong. Regardless of this, however, we can present some potential solutions to the economic crisis in the eurozone, based on the evidence we have advanced thus far.

4. Analysis of solutions

It is not possible to review non-existent regional currency. With the euro dominating, measuring the strength of a regional national currency has become impossible. It is, however, possible to consider an existent regional public sector debt. This acts as an effective proxy for measuring national prosperity in a given state. Wolf (2012a) has argued, *currency risk* becomes a *credit risk* in a national economy. This is where some nations within the eurozone have ended up. Granted, regions within sovereign countries can also suffer the consequences of current account imbalances, showing as localised recessions, however, the measures taken by national governments can either contain or exacerbate their effects.

Most developed countries have ways of transferring capital from the richer members of society and towards the poorest members in depressed regions. This functions effectively in Britain given it has a mature welfare state; however, some eurozone countries—certainly the less developed former Soviet countries—simply do not have such advanced mechanisms of social support. By improving on such sources, economic productivity may be stimulated through a Keynesian-style investment strategy across the EU, targeting areas most in need of a kick start, triggering economic growth whilst safeguarding against the threat of future regional downturns.

It is also important to note the eurozone operates on a form of "gold standard fiscal transfer mechanism". This was, stylistically, a nineteenth century arrangement for which countries had irrevocably fixed exchange rates and the adjustment mechanisms. This is essentially one of the major causal factors of the current recession, and so remedying it can act as a gateway to returning stability and future prosperity. David Hume advanced a proposition of a *price-specie flow mechanism* in his work "The Theory of Money". He argued:

> It is the proportion between the circulating money, and the commodities in the market, which determines the prices. Goods, that are consumed at home, or exchanged with other goods in the neighbourhood, never come to market; they affect not in the least the current specie; with regard to it they are as if totally annihilated; and consequently this method of using them sinks the proportion on the side of the commodities, and increases the prices (*sic*). But after money enters into all contracts and sales, and is everywhere the measure of exchange, the same national cash has a much greater task to perform; all commodities are then in the market; the sphere of circulation is enlarged; it is the same case as if that individual sum were to serve a larger kingdom; and therefore, the proportion being here lessened on the side of the money, everything must become cheaper, and the prices gradually fall. (Hume, 1752, p. 43)

An economy with a positive balance of trade would be in receipt of more capital, whilst an economy with a negative balance of trade would see the inverse. Those economies with rising levels of trade would see increases to inflation and prices, whilst those with declining levels would see deflation and declining prices. Hume's theory, of course assumes the absence of a central bank. In the modern EU, such a thing exists; however, this does not detract from the overall thesis and possible value in better understanding solutions to fixing the eurozone's economic structure.

As stated earlier, most EU nations have a commitment to a broadly social democratic welfare system, the existence of which compels nations to believe they are more developed economically and, therefore, in no need of a structural adjustment programme. State welfare is, broadly speaking, an indicator of a prosperous society sufficient to invest in social enterprises. Inversely, structural adjustment programmes are mostly used to develop emerging economies that lack a mature economy and such social enterprises. Wolf argues the dependent nations in the eurozone "… have become emerging economies" which is "… a crisis for them. Their banking sectors have essentially been destroyed, and in the case of Ireland massively so" (Wolf, 2012a, p. 12). Structural adjustment programmes enable neoliberal economics to dominate, such as demanding the retreat of the state in favour of the free market. Such programmes have, in some form, already been applied to Greece carrying with them that transformative ideology. It must be noted, however, that as Hay (2013) reminds us neo-liberalism is not the sole capitalist model.

So, succinctly, the starting point for economic union was a mistake. The ideology underpinning it, the economic philosophy and the incorporation of less developed countries into the project laid the foundations for the crisis. This led to bankruptcies, private retrenchment, collapsing GPDs, soaring unemployment, exorbitant bond yields in deficit countries, tightening links between domestic banks and their governments and rising political friction as seen in Greece. Interventions by the European Central Bank have increased to try and stem the declines, but these are hardly enough to offset the blockage to the flow of capital. The institutions of global governance are acting as gatekeepers, and have taken the position that the net flow of credit should be forced into an external surplus to maintain the eurozone. As a result of these pressures, countries that did not have fiscal crisis before are starting to show those signs now.

The central question therefore must be how do you resolve a crisis of this magnitude? How is the eurozone crisis going to be resolved, and can it be done in a sustainable manner? The catastrophic outcome is the possible break-up of the eurozone. Despite being imprudently established, it is something which must be worked with. We cannot see any means by which its breakup would not tear the eurozone economy apart, with worse political consequences to follow. Fouskas and Dimoulas (2012, pp. 5–6) argue that "... a return to national currencies entails a step backwards to national self-reliancy, thus spelling isolation and even authoritarianism and dictatorships à la the 1930s on this scenario, protectionism, authoritarianism and even war are just around the corner". Simply, maintaining the eurozone leviathan may be difficult, costly and expensive, but its splintering would be even more catastrophic. The reasons it has stayed together, and most likely will continue to stay together, is few can think of a way of breaking it up without causing such turmoil. We described this as the "bad marriage scenario". You are in a bad marriage in which you cannot even imagine how to divide the property and the children, so it becomes impossible to countenance. This is not good for relations between the member states, and is disastrous in finding some way through it, so we advance the following as solutions and ways forward.

Firstly, there needs to be internal fiscal readjustments if a government is borrowing more than it can maintain. However, although rebalancing the economy is essential, the lack of a strong private sector makes austerity highly problematic: "I think fiscal austerity is too fast and it's too one-sided—particularly when the external sector, competitiveness, and the private sector is weak" (Wolf, 2012a, p. 13). The private sector simply cannot obtain the funds needed from domestic banks in order to finance its operations. Given this, mistimed austerity risks entrenching the economy, driving down wages and causing a depression. A return of competitiveness to prevent this is vital, with domestic markets having access to finance and continued state-investment to prevent that outcome (Wolf, 2012a).

Secondly, financing new on-going spending in the short to medium term is important. In the immediacy, this is to maintain the eurozone economies through the period of adjustments whilst avoiding a deeper depression. In this, the IMF would be instrumental in preventing the mass bankruptcy of eurozone states. Strong emphasis must be placed on a state's ability to maintain a working financial system and manageable costs of government expenditure. In terms of paying back the funds advanced to indebted states, there is "... no doubt that they have to write down the debt. Portugal also will have to, and that may be true of Ireland" (Wolf, 2012a, p. 13).

Finally there has to be real adjustments to the model of competitiveness. Structural reforms, divergence deflation across the eurozone and stronger final demand in the core countries can help frame a recovery. "Comparative political economy as a field of study has long understood that, even within a globalised economy, different 'models of capitalism' can exist" (Hay, 2013, pp. 1–2). It is anticipated that new models of capitalism will take approximately a decade of state-led direction to emerge. Such may be built on a looser relationship between states, reflecting the differences in models of capitalism, but held together by a minimal federal and banking union within the eurozone. Political aspirations to create a United States of Europe are unrealistic at this point because the neoliberal model of capitalism has failed fiscally (Hay, 2013); however, a looser form of federal union inspired by the US 80 years ago may be more likely to keep the eurozone together, with the strong caveat that comparisons between the eurozone and the US are often asymmetrical vis-à-vis the eurozone is not a country

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(Wolf, 2012b). Essentially, this would entail a banking union with responsibility for resolving the flaws in domestic banks and supporting such institutions through central direction rather than by individual states.

Such states are, at the moment, insolvent and do not have the capital to rescue declining banks. It would, for example, be problematic to compel Spain to bail out its banks when it lacks the solvency required to do so. The eurozone banking sector needs an adequate safety net so that countries can continue to function. The collective issuing of Euro-bonds is one way to do this, which would require an enhanced European stability mechanism which exceeds the existing 500,000 billion euros. Whilst some have postured the idea of a transfer union, we agree with the Germans that it is undesirable because a return to prosperity would be held back by turning the weaker countries of the union into permanently dependent regions.

Making these adjustments to the financial sector will be a significant undertaking, due to the complexities of integrating 19 multi-sided national economies. Simply achieving federal or fiscal union may also not automatically lead to prosperity. Moreover, the ideological differences in economic perspectives remain very large, and regional competitiveness between state actors will retard the possibility of even closer union. Culturally, some may not identify with one another, bringing to the table different perspectives and economic needs.

5. Discussion and conclusions

The principal political force is the commitment to the ideal of an integrated Europe, along with the huge investment of the elite in that project. This enormously important motivation is often underestimated by outsiders. While the eurozone is not a country, it is much more than a currency union. For Germany, much the most important member, the eurozone is the capstone of a process of integration with its neighbours that has helped bring stability and prosperity after the disasters of the first half of the twentieth century. The choices facing the eurozone are bleak, the determination to keep it together should not be underestimated. The road ahead remains difficult because the economic crisis has not been a normal recession. Its trigger, the financial crisis, has made measuring recovery highly problematic. These are problems eurozone elite members are willing to navigate. Thus, the eurozone will continue as a miserable marriage, but one which can and most likely will endure. More broadly, some may take lessons from the strategies of the 1930s, yet the composition of the European economy is, of course, very different. However, as Fisher argues, the propensity towards disregarding catastrophes and an over-confidence in the prior economic model can, in part, be attributed for both. As Hay (2013) argues, alternative models remain open to assist in the emergence of a new workable economic theory. Such new theories have recently been called for by Crines and McIntosh (2013), arguing "… a new economic model is likely to be needed to return the west to prosperity. When such emerges, our political leaders must be receptive to new ideas". Such new ideas will also need to be communicated to the electorate in a manner likely to ensure a receptive audience. This presents the eurozone elites with an opportunity to go beyond the free market form of capitalism, and to consider new ideas for capitalist expansion. Such ideas are worthy of development in further scholarship.

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