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The Euro crisis: Solidarity and Integration or Implosion in the Euro-zone?

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As Greek citizens protest on the streets of Athens and global stock markets plunge, the economic crisis has spilled over and threatened yet more EU members, raising many questions about not only the future of the single currency but the direction of the European project as a whole. For those that can remember the original rationale for integration, solidarity is important, but fundamentally more complex and difficult to achieve given the political and social implications of endless bailouts funded by those EU Member States *that can* (mainly Germany), to those EU Member States that have clearly been exposed due to a lack of fiscal discipline and structural reform in their own domestic affairs.

The central question for Euro-zone and non-Euro zone members alike then, is how to address the debt crisis that is engulfing EU Member States; not just the likes of Greece, Portugal, Ireland and Spain, but also Italy and more recently France, which is in danger of losing its AAA credit rating following panic selling of French bank shares due to fears of being exposed to French sovereign debt. Cyprus might also be next in line for help due to its exposure to Greek debt and the economic impact of an explosion in July 2011 that destroyed its main electricity power station. On top of all this, Germany's economic growth slowdown to just 0.1 per cent in the second quarter of 2011 has only exacerbated the fears in the market (among investors) about the debt crisis and how it will be managed by EU policy makers.

The current mechanisms are clearly not adequate enough, and significant political divisions exist on how to construct a sustainable system of governance for the Euro-zone that will be both legitimate and effective. What then, are the potential solutions to these problems in the short and longer term and how viable are they politically?

On 21 July 2011, Greece's second rescue package was agreed. The funds available to the European Financial Stability Facility (EFSF) were also increased from €250 to €440. This, however, was clearly not enough to reassure the markets, and many have argued that given the amount of debt that needs to be serviced in Italy and Spain alone, such an increase is insignificant. Indeed, what would be required has been estimated at between €1-2 trillion, and even then, this is not a long term or sustainable solution to the crisis facing the Euro-zone.

What markets want is a guarantee mechanism to restore confidence; so that any amount of debt within the Euro-zone can be effectively covered by those states *that can* pay. However, this is something that Germany, the Netherlands and others *that can pay* disagree vehemently with, which is why they will not, at the moment, discuss a Euro-bond solution,

whereby, effectively, Germany and the net payer countries would essentially become liable for loans taken out by countries in the Euro-zone such as Portugal, Ireland, Greece or Spain. Chancellor Merkel of Germany does not want to countenance a Eurobond scheme as it would mean bailing out countries at any price and without any strict conditionality in place. Besides this, she also wants the market to contribute to dealing with the debt crisis.

An ECB decision to intervene to buy up government bonds has also proved controversial – and was passionately opposed by the President of the Bundesbank, Jens Wiedmann[i]. The arguments against were underpinned by fears of politicising the ECB, thus impacting negatively on its credibility, reputation and independence; it would run the risk of high inflation and effectively muddy the waters between monetary and fiscal policy and go beyond the mandate of the ECB established in the Treaties.

Those for, have argued that buying up government bonds was essential to stop the implosion of the Euro-zone; in particular if the third largest economy, in Italy, could not manage its debt which ran at 120% of its GDP (only second behind Greece –see diagram below). Indeed they argued that with Italian bonds rising to dangerously high levels, failing to act threatened to dry up lending to companies and private actors.

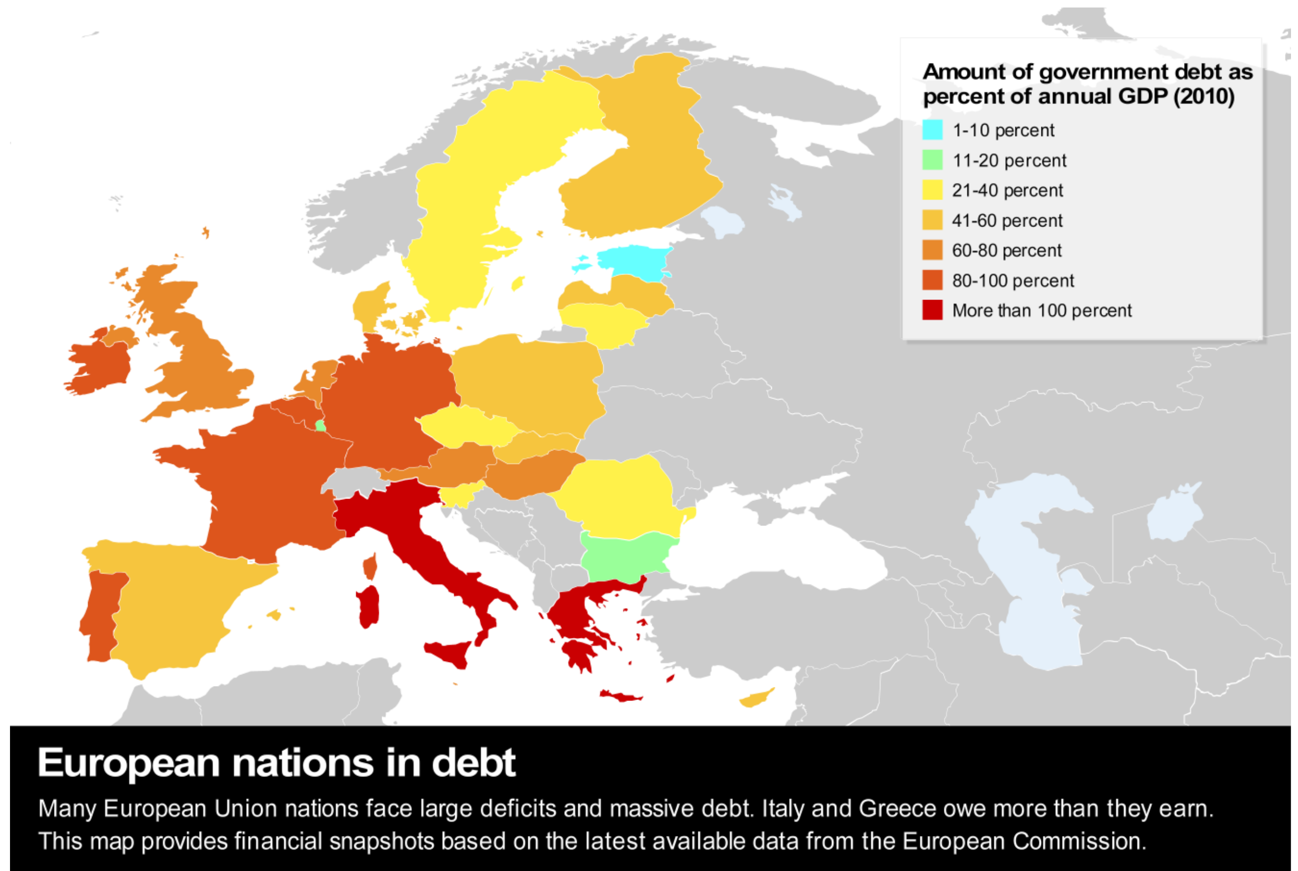
Although the purchase of Italian government bonds did come with strict conditionality and such actions did reduce interest rates on Italian bonds from six to five per cent, questions still remain as to the longer term viability of ECB policy. Indeed it raises the broader question of how far mechanisms such as this, and the EFSF, can provide the foundation for the structural reforms required in debtor countries. Moreover, it raises the question of how far injecting money into the markets can prop up confidence, especially when the markets decide that countries such as Greece, Italy, Portugal, Spain and Ireland cannot be rescued (i.e. pay back their debts). Fundamentally, such measures will only work if the countries in trouble demonstrate the ability to implement the necessary austerity measures and restructure so that they can grow themselves out of trouble; many believe that there is little prospect of this happening in the short to medium term.

Thus, there are no simple solutions to the problems that currently face the Euro-zone members (and non-Euro-zone countries given the loans that they have provided to banks in indebted countries). Whilst solidarity is important in the coming weeks to, essentially, stop (or temporarily delay depending on your perspective) the implosion of the Euro-zone, the balance that has to be struck by leading EU Member States and the ECB to restore confidence and credibility, ensure that the markets and investors remain calm and that indebted Euro-zone states implement measures to help themselves, is a difficult one.

Ongoing discussions to resolve the crisis between Chancellor Merkel and Presidency Sarkozy have excluded the idea of a Eurobond scheme, and have focused on reviving proposals for a tax on financial transactions as well as ensuring all countries in the Euro-zone write into their constitutions rules on balanced budgets. The former is an idea that has, not surprisingly, been opposed by banking associations in the UK and Germany and the Association for Financial Markets in Europe which represents large banks; the main fear being that any such tax introduced simply for Eurozone members and not globally, would distort markets, and increase costs for European industry, thus having a further negative effect on growth. Clearly such a tax could be beneficial in terms of shifting some liability to the market and putting off short term speculation, as well as providing additional revenue for

the EU's annual budget. However, it is clear that this idea in its current form needs to be thought through further if it is to induce long term positive rather than short to medium term negative effects.

Clearly the above objectives are unlikely to be achieved in the short-term. In addition, even if the EFSF takes over the ECB's role in buying up government bonds after September 2011 as planned, it is questionable whether this will



- Fourteen out of 27 European Union countries in the European Union had public debt exceeding 60% of their GDP
- Greece and Italy had debt exceeding 100% of their GDP
- Government debt for all 27 member states increased from 74.4% in 2009 to 80.0% of GDP in 2010

Source: http://edition.cnn.com/2011/BUSINESS/06/19/europe.debt.explainer/index.html .
See also Eurostat at: http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home

satisfy the markets or provide a sustainable platform for long term recovery given the funds available.

What the EFSF might do in the short to medium term, at the very least, is provide additional breathing space for indebted states (although this is questionable for Italy and Spain if funds are not increased) to restore their own credibility, and in turn investors' faith in their ability to service their own debt. However, this does not address the problem of how weak Eurozone

members secure funding in the medium to long term, and thus it can only be one part of a more comprehensive solution that is needed to address the crisis in the Euro-zone.

Many see the Eurobond scheme, with strict conditionality, as an inevitability in this sense, and this might be an idea that Germany and France will eventually have to consider if they still value the idea of 'solidarity through integration' in the European project, even if it does come at a short term political and financial cost. Merkel and Sarkozy have argued for greater fiscal integration, and a Eurobond scheme would provide for exactly that in the Eurozone, addressing what has been seen by many analysts over the years as one of the major weaknesses in the governance of Economic and Monetary Union.

The alternative, especially if the markets and investors cannot be convinced that European governments can recover and grow (i.e. that they are not a liquidity risk), is a Euro-zone that at the very minimum will become more differentiated, and in the worse- case scenario, slowly start to disband and disintegrate. Such a scenario will have serious ramifications for the European and global political economy, as well as the nature of the European integration project in the years to come.

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[i] Others that opposed such a move were Luxembourg and the Netherlands as well as ECB Chief Economist, Jürgen Stark.