

*On the European Sovereign Debt Crisis,
or Why not Leave the Euro Area
O evropské dluhové krizi
aneb proč neopouštět eurozónu*

MOJMÍR HELÍSEK

Jean Pisani-Ferry: *The Euro Crisis and its Aftermath*. Oxford University Press, Oxford 2014. 206 pp.

The book will grab your attention with the title "The Euro Crisis" alone. What is the crisis all about? Is the euro going through a period of crisis? How is the crisis manifesting itself? Are investors showing distrust in the euro; are they getting rid of the euro? As the reader will learn in the very first pages, it is not a "euro crisis" in the sense of a "currency crisis". By the "euro crisis", the author means the "European sovereign debt crisis".

The book consists of four parts. The first part primarily deals with the creation of the euro, with the first chapter dealing with the emergence of the debt crisis itself. The second part describes the first decade of existence of the European currency and the emergence of the imbalances leading to the crisis. The third part discusses the response of policy-makers to the crisis since 2010, and describes, among other matters, why the indebted countries should not leave the euro area. The fourth part offers options on how to reform the euro area and put an end to the crisis.

The title of the first part, "Bare-Bones Utopia", signals the author's unbiased attitude towards a single European currency. The first chapter of this part describes the growing difference between the Northern and Southern regions of the euro area. While the Northern states have been increasing savings, the Southern states have been increasing debt. This resulted in the debt crisis, to which the euro area responded by introducing safety mechanisms. The following chapter starts with the following: 'The euro was the last utopia of the 20th century... It was something that had never been created before: a currency that did not rely on a state or on a commodity'. The euro was implemented despite the warnings of academic economists that Europe is not an optimal currency area. Why? For three reasons. First, exchange rate volatility ceased to exist and competitive devaluations with it. Second, a single monetary policy with single interest rates resulted in reduced strong movements of capital between countries. The third reason was a political one, being the condition that German unification (and making Germany stronger as a result) could only happen if European integration was made closer by introducing a single currency.

The next chapter of this part explains the conditions under which the European Central Bank (ECB) was established. Germany agreed that it would only share the single currency on condition that this currency was subject to the German model of monetary policy. The first requirement was that the ECB, following the example of the Bundesbank, would be fully independent, as opposed to, for example, the Banque de France, which was merely a branch

of the Ministry of Finance. The second requirement was the determination of the monetary policy objective as price stability, and not for example exchange rate regulation on top of that, as proposed by France.

The remaining chapters of this part deal with the discussions held before the introduction of the euro. What should the political arrangement of the future euro area be? Should it be a federation of nation-states or a political union? The euro was eventually created without significant political foundations. It was logically bereft of any mechanism for solidarity between countries. Nor was the creation of the euro accompanied by improved economic cooperation. Therefore, the author calls the euro "the orphan currency".

The second part of the book has the title "Crises Foretold, Unexpected Crises". The opening chapter of the book describes the economic development of Germany in the first ten years following the introduction of the euro. In the beginning, Germany was a country with a sharp current account deficit in the balance of payments, while France posted a strong surplus. At the end of the period, it was the other way around, the reason being internal structural changes. Germany adopted a drastic reform of the labour market (Agenda 2010); consumption grew slowly and savings posted fast growth. The introduction of the euro and removal of the foreign exchange risk facilitated the circulation of these savings in the euro area (from the North to the South) and the emergence of external deficits and surpluses as a result. The German economy also influenced the anti-inflationary monetary policy of the European Central Bank. The low German inflation, which had a significant impact on average inflation in the euro area, led to the ECB's low interest rates. With low interest rates, credit in the South (particularly Greece, Spain and Portugal) was not held in check.

The debt crisis sprang up in spring 2010 when the negotiations started between Greece and three major players (the "Troika"), the European Commission, International Monetary Fund (IMF) and ECB regarding the provision of debt relief to the Greek government. The crisis exposed other two dangers. First, it was not only about public debt. In the case of Ireland and Spain, the private sector, more specifically, the default of banks, was the main reason behind the debt. Second, a debt crisis can emerge quickly, as was the case with these two countries which had posted low public finance deficits for many years. In Spain (which is dealt with in a separate chapter), low interest rates resulted in an increased demand for mortgage loans and a bubble in the real estate market.

Rather surprisingly, the author claims that France is the country to "celebrate" most the introduction of the euro, for three reasons. First, the euro put France on par with Germany; second, the euro helped to weaken the international role of the US dollar, which had been systematically criticised by France; third, it was the success of a ten-year French diplomatic effort. However, neither France nor Italy could keep public debt down. The final chapter of this section deals with the financial markets. It has an apt title: "The Dogs that Did Not Bark". Market judgement could still be expressed by interest rates on long-term government bonds. Interest rates should have continued to reflect risk. However, this was not the case, for three reasons. First, the euro's first decade was dominated by the search for yield. Second, assessing a state's long-term solvency is costly. Third, investors believed that in the unlikely event of crisis, the euro area's member states would put together some type of rescue operation.

The third part of the book, entitled "Agonies of Choice", deals with responses to debt crisis. First, it describes the debt relief provided to Greece by the IMF and via EU mechanisms (the European Financial Stability Facility and European Stability Mechanism). The author explains the reasons for this aid: 'The leaders were aware that the stability of their own financial systems ... crucially depended on the fate of countries that, until then, had seemed economically insignificant'. Thus the aid continued. Ireland, Portugal, Cyprus and Spain followed. One can only agree with Pisani-Ferry's explanation.

In the next phase of the debt crisis, when aid had been provided by both the IMF and the EU, the following issue arose at the turn of 2010/2011: should private creditors (banks) also be involved in the financial aid by writing-off a portion of government debts? The so-called debt restructuring (also referred to as "private-sector involvement") was declined, mostly, under the influence of the ECB. The ECB's arguments were threefold: government bonds must be considered more reliable than private bonds; fear of contagion – Ireland, Portugal and other countries would proceed in the same manner; debt restructuring is a developing-country syndrome – it must not be connected with a serious state. In the case of Greece, a compromise in the form of reducing interest rates from official loans, the provision of further loans and a call to private creditors to extend the maturity of loans was adopted. A partial write-off of receivables in the private sector (banks) occurred in 2013 with regard to the state debt of Cyprus.

The following chapter describes the spread of the debt crisis into other countries, particularly France and Italy. By "debt crisis" the author means the development of interest rates: spreads vis-à-vis interest rates on German bonds were on the rise. In addition, a massive capital outflow from banks in the South of Europe occurred; banks from the North preferred to deposit their surplus liquidity in the ECB. In the chapter "Redemption Through Austerity", the author goes on to describe further steps aiming to resolve the debt crisis. More specifically, he means the "Fiscal Compact" of 2011 (with the UK and the Czech Republic being the only states not to join) and the long-term refinancing operations (LTRO) programme announced by the ECB.

The final chapter of this section reflects on so-called "internal devaluation". Countries with high production costs (Greece, Ireland, Portugal, Spain, Italy and France to name a few) may not compete with Germany and other Northern European countries. If they had their own national currency, they could devalue it. However, this is not possible now. If they want to improve their competitiveness, there must be a drop in prices and wages in their economies. Both Latvia and Ireland employed this method successfully. But they are small open economies. However, Greece and Portugal are closed economies. In addition, large economies such as Spain, Italy and France have a low share of export to GDP.

This raises the issue as to whether it would not be better for some countries to leave the euro area. Pisani-Ferry explains four obstacles to leaving the euro area. First, there are *legal obstacles*.¹ The Treaty of Lisbon specifies conditions for leaving the European Union, not

¹ Since the 19th century, 67 monetary unions have collapsed. In this connection, the author also mentions Slovakia, which was in union with the Czech Republic 'until Czech prime minister Vaclav Klaus pushed them out'.

the euro area. It is not clear whether a country that has left the euro area may continue to be a member of the EU. Second, there are *technical obstacles*, such as printing new bank notes, the reconfiguration of IT systems and so on. Third, the *economic obstacles* of leaving the euro area are the most critical ones. A country that introduced a new national currency would have an intention to perform controlled devaluation. However, the credibility of such a currency would be extremely low, and its significant devaluation may occur. This would result in price increases and the massive impoverishment of households and firms, and also a strong rise in interest rates. Fourth, there are *financial obstacles*. As of now, all existing assets and liabilities are denominated in euro. Newly, they would be redenominated in the new currency – or not. There are no established legal principles for converting financial assets into another currency. If debts are still payable in euro, and the devaluation of the new currency will take place, debts will grow unbearably. In my view, these four explanations for why not to leave the euro area are the greatest contribution of the reviewed book. The author also does not recommend splitting the euro area in two parts – “neuro” and “sудо”. The collapse of the euro area would result in the greatest turmoil since the end of World War Two.

The fourth and last part of the book offers “The Repair Agenda”. The first chapter of this part deals with the unequal development of countries from the North and South (including France). The countries in the South are less competitive, more indebted (both with regard to public and private debt) and produce less added value. What should the monetary policy of the ECB be? An expansive policy would depreciate the euro exchange rate and support export from the countries in the South. However, at the same time, this would result in investors’ distrust towards European assets. Fiscal policy seeks a solution on how to deal with the requirements of low deficit and debt on one side and the support of the private sector on the other. Transfers through “Structural and Cohesion Funds” from the EU budget may be one potential solution. Funds from the European Investment Bank and European Bank for Reconstruction and Development that may help with for example privatisation programmes can also be used to support development in countries in the South.

A description of two models for reducing the unemployment and external deficit of Southern countries is also worth noting. The first model is the *agglomeration model*. This consists of the concentration of manufacturing and other economic activities in certain areas to which people would move for work. This would have to be accompanied by the unification of social rights (particularly pension protection), free movement of capital, and finalisation of a full banking union. This would naturally lead to big differences in GDP per capita. The *rebalancing model* is the second model. In this case, the work would move to the people. Structural Funds would be used to revitalise the South. There would be a convergence in GDP per capita, and at the same time a lower average GDP per capita across the entire euro area. The author concludes that regardless of the current financial problems, the euro area is confronted with deeper choices about its type of economy.

The next chapter deals with a description of how the banking union (which should reduce the risk of banking crises) was created. The author also deals with an option to issue “eurobonds”. These are government bonds that would be issued and guaranteed by a debt agency, the liabilities of which would be guaranteed collectively by the euro area countries. This is followed by an analysis of the EU budget, to which member states make

a contribution of 1% of GDP. This budget has no stabilisation function, as opposed to the US federal budget. The author notes that the attitude of European leaders is unclear in this regard. A short chapter deals with the international position of the euro. The last chapter ("Governance Reform") notes that Europe's governance is ineffective. It is not an executive, but an institutional problem, as the Maastricht Treaty was not drafted to deal with crises. The author also asks the question: should the euro area have a federative arrangement? Answer: In the long run this would certainly be the most fitting solution.

In the Conclusion, the author formulates questions addressed (implicitly) to European leaders. First: is the euro area willing to extend the integration of labour, product and capital markets? Second: is the euro area willing to fundamentally redesign its fiscal system and introduce risk sharing? Third: is it willing to allow redistribution through a transfer mechanism? Fourth: is the euro area willing to implement an institutional reform that would result in more effective decision-making? These questions were raised by the euro crisis. The future of the euro area is dependent on how they are resolved.

The former minister of finance of the USA, Larry Summers, evaluates the book using the following words: 'This is must-reading for anyone who cares about Europe's future'. We may fully agree with his opinion.

Contact address

prof. Ing. Mojmír Helisek, CSc.

University of Finance and Administration / Vysoká škola finanční a správní

Department of Economics and International Relations / Katedra ekonomie a mezinárodních vztahů

(mojmir.helisek@vsfs.cz)