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# THE EURO CRISIS: TEN ROOTS, BUT FEWER SOLUTIONS

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## Highlights

- Many factors have contributed to the euro crisis. Some have been addressed by policymakers, even if belatedly, and European Union member states have been willing to improve the functioning of the euro area by agreeing to relinquish national sovereignty in some important areas. However, the most pressing issue threatening the integrity, even the existence, of the euro, has not been addressed: the deepening economic contraction in southern euro-area member states.
- The common interest lies in preserving the integrity of the euro area and in offering these countries improved prospects. Domestic structural reform and appropriate fiscal consolidation, wage increases and slower fiscal consolidation in economically stronger euro-area countries, a weaker euro exchange rate, debt restructuring and an investment programme should be part of the arsenal.
- In the medium term, more institutional change will be necessary to complement the planned overhaul of the euro area institutional framework. This will include the deployment of a euro-area economic stabilising tool, managing the overall fiscal stance of the euro area, some form of Eurobonds and measures to make euro-area level decision making bodies more effective and democratically legitimate.

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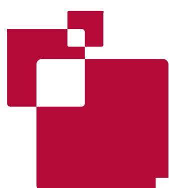


# THE EURO CRISIS: TEN ROOTS, BUT FEWER SOLUTIONS

ZSOLT DARVAS, OCTOBER 2012

## 1 INTRODUCTION

The euro faces an existential crisis. In the wake of the collapse of Lehman Brothers, the euro seemed to be a shelter for its members (Wyplosz, 2009), but attitudes changed completely following the series of events that began with the Greek fiscal crisis in early 2010. Despite attempts by various European institutions, the crisis continues and the outlook is bleak. Why is it so difficult to resolve the euro crisis?

The typical answers to this question are that the euro area does not constitute an optimum currency area or that monetary unions were traditionally combined with fiscal and political unions. These generalisations have some validity, but given the status quo and the complexity of the euro area's legal and institutional arrangements, they are not very helpful for providing solutions or determining the fate of the euro.

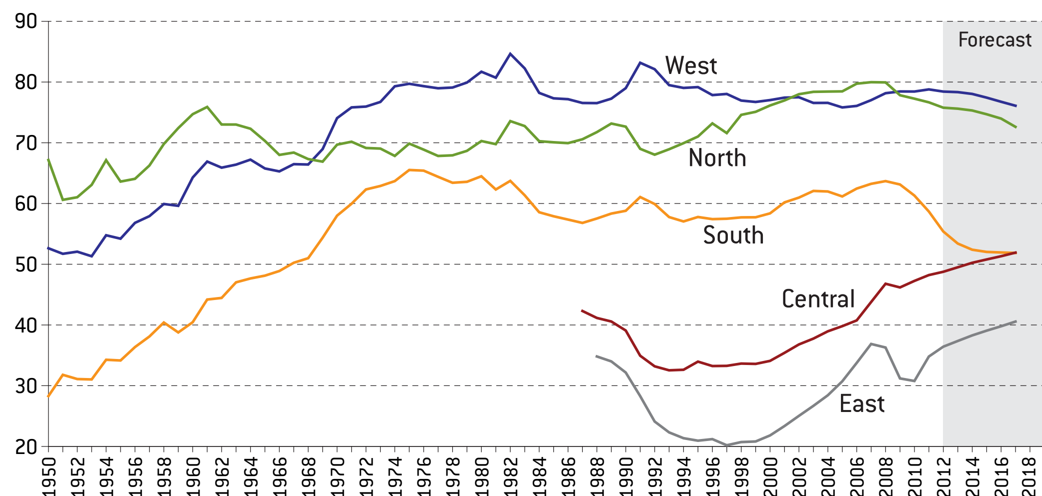
In this Policy Contribution we summarise ten major roots of the euro-crisis and assess the policy responses (if any) to these issues. We conclude that the most pressing problem, which also constitutes the most serious threat to the integrity of the euro area, is the dreary economic outlook in southern euro-area member states. As Figure 1 indicates, using data from IMF (2012), southern European members of the euro area are expected to fall behind the US in GDP per capita terms quite dramatically in the years ahead. Western and northern EU countries are also expected to experience a relative decline. And the IMF outlook must be interpreted as a baseline scenario with the risks on the downside.

We also conclude that instead of exiting or breaking-up the euro, the common interest lies in discovering ways in which these countries' prospects can be improved. A great deal of homework needs to be done by southern European countries, but other euro-area partners and European institutions will also have decisive roles to play in supporting the process. In the medium term,

1. In this section we follow Darvas (2011c) in categorising ten important issues – the first four relate to pre-crisis developments, while the other six relate to issues highlighted by the crisis.

2. The exact definition allows a small discrepancy from the three percent deficit benchmark in certain cases, and the debt may be greater than 60 percent of GDP if it *"is sufficiently diminishing and approaching the reference value at a satisfactory pace"*. To calculate the number of violations of these criteria in Darvas (2010b), we used the three percent benchmark for the deficit, and for a debt above 60 percent, we projected the average change in the debt/GDP ratio over the latest three years 20 years ahead and checked if it will lead to a ratio below 60 percent. Note that the six-pack reforms adopted in 2011 operationalised this criterion the same way: *"the gap between the debt level and the 60 percent reference should be reduced by at least 1/20th annually (on average over three years)"*; see European Commission (2011).

Figure 1: GDP per capita in major geographical regions of the EU (USA = 100), 1950-2017




Source: Author's calculations using data from IMF (2012), PENN World Tables and EBRD. Note: GDP is based on purchasing power parity dollars; median values are indicated for the groups, which are as follows: West: Austria, Belgium, France, Germany, and the Netherlands; South: Greece, Italy, Portugal, and Spain; North: Denmark, Finland, Sweden, Ireland, and the UK; Central: the Czech Republic, Hungary, Poland, Slovakia, and Slovenia; East: Estonia, Latvia, Lithuania, Bulgaria, and Romania.

additional institutional changes will be necessary to complement the currently planned overhaul of the euro-area's institutional framework.

## 2 TEN MAJOR REASONS BEHIND THE EURO-AREA CRISIS AND THE EU'S RESPONSES[1]

### 2.1 The failure of the Stability and Growth Pact

The rules-based Stability and Growth Pact (SGP), which was the cornerstone of fiscal prudence in the EU, failed. In Darvas (2010b), we calculated the number of violations of the euro-entry criteria, which also include the SGP's two fiscal criteria: the three percent of GDP budget deficit criterion and the 60 percent of GDP government debt criterion[2]. We found that between 2001 and 2006, ie after the euro was introduced but before the global financial crisis erupted in 2007, approximately one-third of euro-area member states violated the SGP. Such violations greatly diminished the trust in the effectiveness of EU rules-based surveillance and resulted in high public debt, especially in Greece and Italy, at the start of the crisis.

A number of new agreements have been reached to strengthen the SGP[3]. These new agreements fundamentally reform fiscal coordination, surveillance and enforcement in the EU, and in particular, in the euro area. Fiscal rules will be stronger, will be enshrined in national constitutions, and non-compliance will be sanctioned in a quasi-automatic way. If properly implemented, these agreements could help to sustain healthy fiscal positions once the current crisis is solved. However, they are less helpful in resolving the current fiscal crisis in the euro area. Although the so-called structural budget balance (ie the budget balance excluding the impact of the economic cycle and one-time expenditures and revenue measures) will receive greater emphasis, current debates almost exclusively focus on the three percent nominal deficit target. This leads to a strong contractionary bias, ie pro-cyclical fiscal policy during the current downturn. Moreover, the current situation could only be made worse by, for example, forcing Greece or Spain to pay an immediate fine for not fulfilling the earlier nominal deficit targets[4].

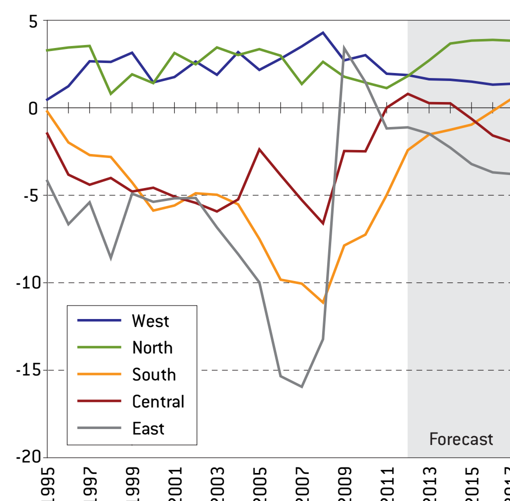
An alternative solution, a form of Eurobonds (ie pooled national bond issuances), is unfortunately not yet on the table, partly due to the mistrust between euro-area nations, and partly due to the very complex institutional framework that would be required to make the common bond issuance function properly, in the absence of an adequate level of political and fiscal integration. The proposal by Delpla and von Weizsäcker (2010) of splitting debt issuances into a senior component of up to 60 percent of a member state's GDP ('Blue bonds', guaranteed by all participating countries) and a junior component above the 60 percent threshold ('Red bonds', guaranteed by the issuing country alone), would stabilise government financing (via the Blue bonds) but would expose governments to market discipline (via the Red bonds)[5].

### 2.2 Neglect of private-sector vulnerabilities

Pre crisis, there was a sole focus on fiscal issues – and a consequent neglect of private-sector behaviour. This resulted in unsustainable credit and housing booms in countries such as Ireland and Spain[6] and the emergence of structural imbalances such as high current-account deficits (Figure 2) and eroded competitiveness.

Divergence within a monetary union, such as divergence in current account balances, is not necessarily a bad thing. Capital flows across regions and the ensuing current account deficits

**Figure 2: Current account balances in main EU geographical groups (% of GDP), 1995-2017**




Source: Author's calculations using data from IMF (2012) data. Note: median values are indicated for the groups defined in the note to Figure 1.

3. These are the following: the so-called 'six-pack' (five regulations and one directive approved by all 27 Member States and the European Parliament in October 2010), the 'Euro Plus Pact' (signed by 23 countries in March 2011), the 'Fiscal Compact' (Treaty on Stability, Coordination and Governance in the EMU, signed by 25 countries in March 2012). Furthermore, a new proposal called the 'two-pack' drafted by the European Commission in November 2011 is currently under negotiation. See Marzinotto and Sapir (2012) for an assessment of the new fiscal framework.

4. Marzinotto and Sapir (2012) also argue that since the new fiscal framework was introduced in a situation in which several euro-area countries were under an excessive deficit procedure and the growth prospect of most of them is weak, fiscal surveillance should be prioritised over the enforcement of sanctions for excessive deficits.

5. Blue bonds should be phased in through complete pooling of new issuances, in which a member state can participate until its share of the stock of Eurobonds reaches 60 percent of its GDP (Darvas, 2011b). Such a phasing-in would give struggling countries a long period to put their fiscal houses in order, while benefiting from a low interest rate.

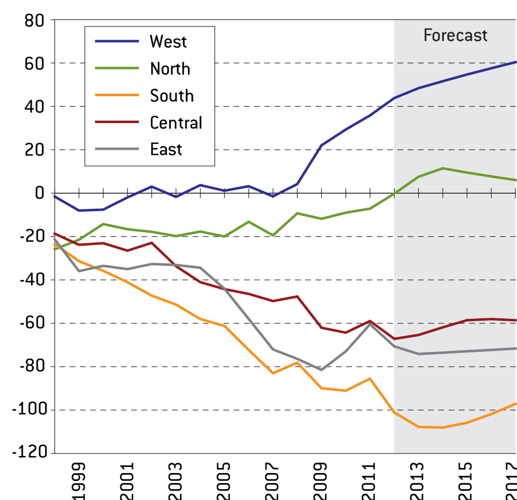
6. See for example Ahearne, Delgado and von Weizsäcker (2008).

and surpluses may reflect the improved utilisation of resources when capital moves to fast-growing regions to the benefit of the entire monetary union. However, the booms and busts in the Irish and Spanish housing sectors (see Ahearne, Delgado and von Weizsäcker, 2008) exemplify capital misallocation. Additionally the accumulation of 'excessive' regional debt is undesirable, and there are good reasons to conclude that the external debt of Greece, Portugal and Spain became excessive (Darvas, 2012b).

Looking ahead, the external debt position is even expected to worsen in southern European countries (Figure 3). The further improvements in the current account balances of southern members[7], as projected by the IMF (2012), along with GDP projections, would even imply an additional increase in net external debt[8].

The EU's response to the recognition that not only fiscal issues matter includes measures to prevent and correct private sector imbalances, such as weak competitiveness positions and high private debt[9]. A new procedure, the so called Macroeconomic Imbalance Procedure (MIP), has been introduced with the aim of assessing these private sector vulnerabilities and assisting countries in

**Figure 3: Net international investment position in main EU geographical groups (% of GDP), 1998-2017**




Source: Eurostat up to 2011. For 2012-2017 we used IMF (2012) projections for nominal GDP and current account balance and assumed that the change in the nominal value of the net IIP equals the current account balance. Note: median values are shown for the country groups defined in the note to Figure 1.

designing remedies[10]. Undoubtedly, this procedure is a major innovation in the EU's economic governance framework. However, its effectiveness needs to be tested, and in any case adjustment within the euro area could take a long time.

## 2.3 Lack of effective tools to foster structural adjustment

Even when it was recognised that certain private sector developments can lead to vulnerabilities, there were no proper mechanisms to foster structural adjustment. Structural adjustment has two main and interrelated aspects: microeconomic, such as regulations and policies that effect the business climate, flexibility of markets, banking activities, innovation and the educational system of the country, and macroeconomic, which is primarily reflected in aggregate productivity changes, price and wage competitiveness and external balances.

Some countries, such as Germany, were able to adjust within the euro area, ie Germany's competitiveness improved considerably from the mid-1990's until the onset of the crisis, and its current account deficit became a sizeable surplus[11]. But others, such as Greece, Italy, Spain and Portugal, were not able to adjust. While Germany, Italy and Portugal had the worst growth performances of euro-area member states before the crisis, Germany boosted its competitiveness during this period, but Italy and Portugal did not. Booming domestic demand contributed to rapid economic growth in Spain and Greece before the crisis, which obscured the more serious structural problems.

Following IMF (2010) and Allard and Evaraert (2010), in Darvas and Pisani-Ferry (2011) we studied aspects of growth that could be improved through structural reforms, namely labour market inefficiency, business regulation, network regulation, retail sector regulation, professional services regulation, institutions and contracts, human capital, infrastructure and innovation. We found that southern European countries are severely lagging behind on almost all criteria.

Fostering structural adjustment is one of the aims of the MIP. The European Semester, a yearly cycle

7. The difference between the adjustment patterns of eastern and southern European countries is striking. While private capital inflows halted and even reversed in both regions, in southern Europe banks received massive liquidity support from the ECB, which has offset the sudden stop in private capital flows. Such support has contributed to financial stability, but at the same time, it made it possible for these countries to delay the adjustment, as noted by Sinn (2011).

8. Note that Italy differs from Greece, Spain and Portugal, in that its current account balance remained between +/- three percent between 1982 and 2009, and its net IIP is projected to deteriorate from -21 percent of GDP in 2011 to -28 percent of GDP by 2017. For Greece, Spain and Portugal net IIP is projected to deteriorate below -100 percent of GDP during the years ahead.

9. The 'six-pack' and the 'Euro Plus Pact' included such measures; see footnote 3.

10. See European Commission (2012b).

11. Ruscher and Wolff (2012) argue that there was a long process of balance sheet adjustment of non-financial corporations in Germany starting in the mid-1990s, and such balance sheet adjustment used to lead to wage moderation. Changes in labour laws and a social consensus may have also contributed to wage moderation in Germany. See Darvas (2012a) for the analysis of competitiveness changes of euro-area member states, including Germany.

of mutual assessment of fiscal and structural issues was introduced in 2010. It encompasses all new instruments, including the MIP, and is undoubtedly useful, though the jury is still out on its effectiveness. Marzinotto, Wolff and Hallerberg (2011) concluded that member states are only slowly internalising the new procedure and the European Semester so far lacks legitimacy due to the minor role assigned to the European Parliament, the marginal involvement of national parliaments and the lack of transparency at some stages of the process.

### 2.4 Lack of a crisis-resolution mechanism

There was no crisis-resolution mechanism for euro-area countries. The series of sovereign debt crises in the euro area came as a surprise and euro-area policymakers had to improvise. It is important to highlight that in other federations, such as the US, there are no crisis-resolution mechanisms for sub-central governments either (Darvas, 2010a). When studying the conditions required for a fiscal union to function smoothly and successfully, Bordo, Markiewicz and Jonung (2011) concluded: *"the first and probably the most important condition is a credible commitment to a no-bailout rule."* In the euro-area, the reluctance of citizens of economically stronger countries such as Germany, the Netherlands and Finland, to extend loans to economically weaker countries, such as Greece, highlight the validity of this conclusion. However, it also must be recognised that public debt levels in certain euro-area member states are much higher than sub-central government debt in other federations, and for the reasons discussed in the next two sections, an uncontrolled government default could be more harmful for the rest of the euro area than a similar default of a sub-central government would be in other federations[12].

The lack of a sovereign debt crisis resolution mechanism was initially addressed through some temporary arrangements: bilateral lending from euro-area partners (in partnership with the IMF) to Greece in May 2010, and the establishment of two temporary financing mechanisms, the EFSF (European Financial Stability Facility)[13] and the EFSM (European Financial Stability Mechanism)[14], with a combined firepower of €500 billion. Ireland and Portugal were granted financial assistance from these funds, as was Greece in a second programme, with IMF co-funding in each case. The scope of these facilities was widened to fund programmes related to banking only (Spain requested and granted such a programme in early summer 2012) and to purchase government securities on the secondary markets (which has not so far happened). The European Stability Mechanism (ESM)[15], a permanent rescue fund with €500 billion in resources, was inaugurated on 8 October 2012[16]. These facilities are adequate for smaller countries and perhaps Spain, but the resources, even if augmented by IMF lending, would not be sufficient if Italy were to require assistance, unless the ECB steps in with massive amounts of government-bond purchases.

The set-up of these financing facilities is justified by the current euro-area situation, but in the medium term it would be preferable to design an institutional framework in which member states do not have to lend money to each other. Such a system could be built on the basis of Blue and Red bonds (section 2.1) with a strict no bail-out rule for sovereigns, a banking union and a limited centralised fiscal capacity to help smooth out economic cycles (we discuss the latter two elements in the next sections).

### 2.5 Interdependence of banks and sovereigns

National bank resolution regimes and the home-country bias in banks' government-bond holdings imply that there is a lethal correlation between banking and sovereign debt crises. When a government gets into trouble, so does the country's banking system (eg Greece), and vice versa (eg Ireland). Merler and Pisani-Ferry (2012) demonstrated that most continental euro-area countries were characterised by the large size of their banks' portfolios of domestic government bonds, which were markedly larger than in the United Kingdom or the US. Moreover, during the crisis this vulnerability has increased, as all countries about which concerns about state solvency arose have seen a reversal in the previously steady increase of the share of government debt held by non-residents. Germany, by contrast, has seen an increase in the share held by non-residents.

12. This conclusion remains valid even though a properly designed debt restructuring inside the euro area should not cause a major contagion, as we argued in Darvas (2011a), and as the subsequent Greek experience has shown.

13. See http://www.efsf.europa.eu/about/index.htm

14. See http://ec.europa.eu/economy_finance/eu_borrower/efsm/index_en.htm

15. See European Council (2012a).

16. See Bijlsma and Vallée (2012) for an assessement of these facilities.

The lethal correlation between banking and sovereign debt crises could be best addressed with a so called 'banking federation' or 'banking union', whereby bank resolution and deposit guarantees would be centralised at the euro-area (or preferably the EU) level, which would also require the centralisation of regulation and supervision, and a fiscal backstop for the centralised resolution and deposit guarantee system. This is because when bank resolution in a given country is not the responsibility of that country's government, but bank recapitalisation, when needed, would be financed using a common fund, then banking fragility would not lead directly to sovereign debt problems for that government. The opposite case, in which the fragility of the government is transmitted to the banks of a given country, could also be better managed when regulation and supervision are centralised at the euro-area level.

The notion of a banking union was not on the agenda until late spring 2012, despite numerous calls by economists (see eg Véron, 2011). However, the intensification of the euro-crisis brought euro-area policymakers back to reality, and perhaps the call for a banking union seemed a politically more acceptable alternative compared to the issuance of Eurobonds and a more rapid move towards a full-fledged fiscal union. Consequently, the European Council on 28-29 June 2012 called for a banking union and the European Commission proposed its first element, a single supervisory mechanism for banks on 12 September 2012. It was agreed that once banks come under the control of the joint supervisor, the ESM would be able to recapitalise banks directly. The willingness of member states to relinquish national sovereignty over major banking issues is clearly an important development in crisis management. Yet the formation of the banking union will be extremely complex, and many open issues need to be negotiated and agreed, as discussed by Pisani-Ferry *et al* (2012). These include the means of providing financing for the banking union, which is studied by Pisani-Ferry and Wolff (2012).

### 2.6 Interdependence of countries

The interdependence of countries is much stronger than was generally perceived during the good years before the crisis. Government and private sector defaults in a small country can lead to contagion, while the default of a large country would lead to meltdown. Italy, for example, cannot be allowed to go bankrupt, as it would bankrupt the Italian banking system, which in turn would cause a meltdown in the rest of the euro-area banking system and would also have disruptive effects outside the euro area. This channel would remain important even if financial integration were to be reversed to a significant extent, as argued by the ECB (2012a).

The strong interdependence of countries should primarily be addressed by limiting the scope of the fiscal and private sector vulnerabilities of member states in three main areas: (a) structural, (b) banking, and (c) public finances. The European Semester – to the extent that it proves to be effective – could help address structural vulnerabilities. Banking interdependence could be best addressed with a properly designed banking union, as discussed above. Fiscal vulnerabilities are supposed to be kept under control by the EU's revised fiscal architecture, yet a type of Eurobond, such as the previously discussed Blue bond, would further help to limit the spread of a sovereign debt crisis from one country to another.

### 2.7 Lack of a lender of last resort for sovereigns

The strict prohibition of ECB/Eurosystem monetary financing means that euro-area governments borrow as if they were borrowing in a foreign currency, as highlighted by De Grauwe (2011). This is because a central bank can in principle act as a lender of last resort for the sovereign, ie print money and buy government bonds (as the Federal Reserve, the Bank of England and the Bank of Japan did during the crisis). The lack of a lender of last resort for sovereigns of individual states of a monetary

*'In the medium term it would be preferable to design an institutional framework based on Blue and Red bonds with a strict no bail-out rule for sovereigns, a banking union and a limited centralised fiscal capacity to help smooth out economic cycles.'*

union is not a substantial problem when the level of debt is low. For example, in the US, the Federal Reserve does not buy the debt of states such as California or New York, but buys only federal bonds. Although California has been in deep financial trouble since 2007, its eventual default would not cause a major disruption to the US banking system: the State of California's debt is small, approximately 7 percent of California's GDP (the debt of local governments in California represents an additional 13 percent of the state's GDP); moreover, this debt is not held by banks, but mainly by individuals. However an Italian default would be a game changer for Europe.

The lack of a lender of last resort for sovereigns could be remedied by establishing a stronger political and fiscal union that could provide the basis for changing the ECB's statutes. Without such a change, the ECB must act within its current mandate. On the secondary markets, the ECB has already purchased the sovereign bonds of member states under the so-called Securities Market Programme (SMP), which began in May 2010 and was terminated on 6 September 2012, replaced by the Outright Monetary Transactions (OMT) programme[17].

The SMP had only temporary effects on government bond yields for a number of reasons, but the OMT differs from the SMP in several respects. It will be in principle unlimited, the ECB will not claim senior creditor status with respect to other bondholders, and the major condition for OMT has been clarified, ie compliance with a full or a precautionary macroeconomic adjustment programme by the EFSF or the ESM.

The initial reactions of the markets (up to the time of writing) to the OMT were positive. For example, the 2-year Spanish government bond yield fell from a 15-year record high of 6.9 percent in late July 2012 to below 3 percent in early September 2012. Longer maturity yields have also fallen somewhat.

It was wise for the ECB to introduce the OMT, as otherwise the euro-crisis may have escalated in mid-2012[18]. By preventing a self-fulfilling crisis, the OMT may help to reduce government bond yields, and thereby also lower private sector yields, which will help the economy. However, the OMT operations can only buy precious time, but cannot solve the euro crisis and cannot fully eliminate the risk of an eventual euro-area exit, as these would be dependent on the answers given to the other more fundamental problems of the euro area, in particular the growth question that we discuss next.

## 2.8 Downward spiral and negative feedback between the crisis and growth

There is a downward spiral in the adjusting countries of southern Europe, where fiscal accounts are extremely hard-pressed, ie fiscal adjustment is leading to a weaker economy, thereby reducing public revenues and creating additional fiscal adjustment needs. It is extremely difficult to break this vicious circle in the absence of a stand-alone currency. In the US, automatic stabilisers, such as unemployment insurance, are operated by the federal government, which also invests more in distressed states – but in Europe such instruments do not exist. An economic stabilisation tool is badly needed for the euro area, which should work as automatically as possible and ideally be financed from a euro-area wide tax. It should be confined to economic stabilisation only, and not be a platform for permanent transfers between euro-area member states.

There is also a negative feedback loop between the crisis and growth in economically stronger euro-area countries. In addition to the direct impact of crisis in southern euro members through trade and financial links, uncertainty over the future of the euro means that corporations and households are more hesitant to invest and consume in the economically stronger countries as well. Furthermore, funding constraints in the banking sector, increasing credit risks for banks because of the weakening economic outlook, and the efforts to raise banks' capital ratios are leading to a reduction in credit supply throughout the euro area, further dampening economic growth. Without effective solutions to address the crisis, growth is unlikely to resume.

The EU did not have a powerful response to the growth crisis. The main goals of the 'Compact for Growth and Jobs' agreed to at the 29 June 2012

17. See ECB (2010) and ECB (2012b).

18. In Darvas (2012c) we assessed the various criticisms of the OMT and concluded that they are largely unjustified.

summit[19], such as structural reforms, completing the restructuring of the banking sector, growth-friendly fiscal consolidations, addressing the social consequences of the crisis and deepening the single market, are all correct. However, few new tools were mobilised to achieve these goals. Providing fresh capital to the European Investment Bank (EIB) (€10 billion, which would increase lending capacity by €60 billion) and launching a pilot phase for Project Bonds up to €4.5 billion are welcome, but these would have a limited impact on growth in the EU. Moreover, while mobilising idle Structural Funds (also agreed at the summit) is also crucial, it does not constitute new funding and progresses very slowly.

## 2.9 Lack of a euro-area fiscal policy

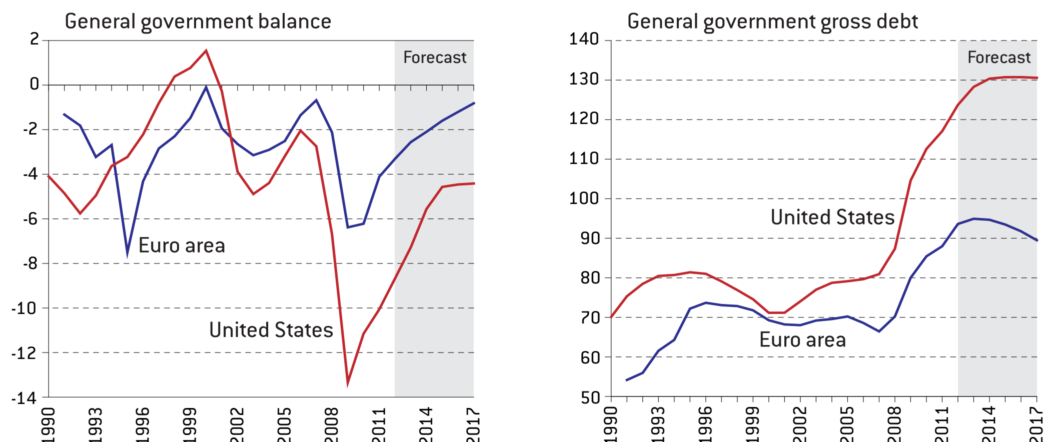
No institution is responsible for managing the overall fiscal stance of the euro area. Member states implement the policy deemed appropriate for their own economies, subject to the constraints of the European fiscal governance framework. However, the aggregate of such decentralised fiscal policy is unlikely to produce optimal fiscal policy for the euro area as a whole. For example, while the aggregate fiscal position of the euro area is much better than that of the US (Figure 4), and while the economic outlook is arguably more fragile in the euro area, there is a much stronger consolidation bias in the euro area as a whole than in the US. Certainly, states in the US are also independent in setting state-level fiscal policies (all but one has a balanced-budget constitutional rule), and *"a degree of revenue and expenditure independence of the members of the fiscal union reflecting their preferences"* is arguably necessary for a fiscal union to function successfully (Bordo, Markewicz and Jonung, 2011). However in the US the federal government dispenses more than half of total tax revenues and considers the US economy as a whole when setting fiscal policy targets (Darvas, 2010a). In other federations, such as Canada or Switzerland, the circumstances are similar.

The euro area has not yet reached a point where a discussion can be begun on the overall fiscal stance of the euro area and the way it could be aligned to the situation of the euro area as a whole.

## 2.10 Executive and democratic deficit

The crisis is not just a sovereign debt, banking and growth crisis, but also a governance crisis. In most cases the response of European policymakers has been partial, inadequate and belated, undermining their credability to resolve the crisis. Some observers have concluded that agreeing a comprehensive solution is technically and politically out of reach. Compounded with the lack of democratic accountability of various European decision-making bodies, Véron (2012) places the "executive and democratic deficit" at the centre of

Figure 4: The aggregate fiscal positions of the euro area and the USA (% of GDP), 1990-2017




Sources: Euro area balance and debt: IMF (2012); US balance: Ameco up to 2000 and IMF (2012) for 2001-17; US debt: http://www.usgovernmentspending.com/federal_state_local_debt_chart.html up to 2012, for 2013-17 we assumed that state and local government debt will remain at the 2012 value as a percent of GDP and federal debt increases as projected by IMF (2012). Note: US general government debt also includes the debts of states and local governments (IMF and European Commission data only report federal debt, even though they call it, erroneously, 'general government gross debt').

19. See European Council (2012b).

the lingering euro crisis and argues that some of the most important problems, such as Europe's banking crisis, the Greek sovereign debt saga, and the weak growth outlook of southern European member states, could have been addressed earlier and in a decisive way had proper European decision-making processes existed. Overcoming executive and democratic deficiencies is a truly fundamental issue, yet because of political constraints, any progress will be, at best, piecemeal.

## 3 SOUTHERN EUROPE AND THE EURO'S FUTURE

The combined impact of the 'ten roots' is to depress the economic outlook in the euro area, and in particular, in southern Europe (Figure 1).

There is a view that southern euro members have no hope for growth inside the euro area and an exit from the euro is their only viable option. While undoubtedly it would be much easier for southern euro members to solve their problems outside the euro area, I disagree on both counts: there is some hope, at least in some southern members, and an exit would likely be so disastrous that it would take a very long time to recoup the output that would be lost during the exit process. An exit would cause devastating consequences for economically stronger countries as well, fundamentally threatening the euro, with severe implications for the whole EU.

- **Hope:** Since 2008, Spanish exporters have been the best performers among the EU15 countries, ie the pre-2004 members of the EU (Darvas, 2012a). Spain is followed by Germany, Ireland and Portugal. Spain and Portugal even outperform the UK and Sweden, two countries that benefited from significant currency depreciation during the crisis[20]. While the Portuguese and Spanish tradable sectors remain small, solid export performance is an indication that the tradable sector has scope for expansion. Additionally, the World Bank (2012) found that large and internationalised firms in southern Europe are as productive as large firms in western and northern Europe, and the main issue is that there are far fewer large firms in southern Europe, because of various barriers. Altomonte, Aquilante and Ottaviano (2012) arrived at a similar conclusion. This suggests that while the business conditions are unfavourable and there are barriers to firm growth, properly managed firms are able to achieve a high level of efficiency even in southern Europe.

- **Disastrous exit:** It is impossible to provide an accurate estimate of the cost of an exit from the euro, but it would most likely be huge. UBS (2012) have concluded that an economically weak country leaving the euro area would lose approximately one half of its GDP in the first year. If they are correct, it is unclear how many years it would take to compensate for the lost output, even if growth were to increase from this halved level of output. The huge decline in output would necessitate even harsher fiscal austerity, as it is not very likely that, in the event of a messy exit from the euro, other euro-area partners would be happy to lend to the departing country. Without such support, the government could spend only tax revenues, which would be dramatically reduced by the collapse in GDP and a likely increase in tax evasion. Moreover, there would be longer-term consequences. The low credibility of the newly stand-alone central bank of the exiting country would likely lead to much higher real interest rates and a period of high inflation, which are bad for growth. Additionally, a euro exit may be accompanied by an EU exit, depriving the country of transfers from the EU. It is also in the best interest of euro-area partners to keep these countries in the union, and not just because of the direct losses that would arise from financial and trade relationships with the exiting country. Even more importantly, in the case of an exit, it would be very difficult to safeguard other economically weaker countries and a wave of exits would be even more disastrous for the economically stronger euro-area countries[21].

Notwithstanding positive export performance in some countries, and the fear of disaster which provides the incentive to find solutions, the deep economic slump in southern countries will not end any time soon. If the recession continues to deepen, social tensions could escalate, which may lead to domestic political paralysis. Under

20. However, the export performance of Greece is very weak.

21. And the euro is not just about economics but has major historical and political roots as well.

such circumstances, cooperation between euro-area partners and the country in question, including financial assistance that has already been granted to some southern euro members, could come to an end, leading to an accelerated and possibly uncontrolled exit from the euro area, with all the consequences we described above.

Therefore, the single most pressing threat to the integrity, and perhaps also the existence, of the euro is the depth of the recession in southern European member states and their bleak economic outlook.

Solid economic growth in southern Europe would help to ameliorate many other aspects of the euro crisis. It would gradually help to improve the employment situation and ease social tensions. It would help to improve public finances, thereby reducing the need for fiscal consolidation. It would help to stabilise asset prices, and in particular, housing prices, which in turn would improve bank balance sheets, thereby also reducing recapitalisation needs. Increased trust in banks and the hope of an economic recovery would slow or even reverse capital outflows from these counties. As a consequence, economic growth in southern Europe would greatly diminish the exit risk that some southern euro-members face.

But economic growth in southern Europe would also reduce the political risk in creditor countries. Because of domestic political developments, a creditor country may unilaterally decide to stop granting further loans to southern European countries (Darvas, 2011a) and instead decide to leave the euro area. That may start a chain reaction with other economically stronger countries following. Economic growth in southern Europe would reduce the need for bailouts, thereby reducing this external political risk.

Without the problems of the economically weaker southern countries (for which economically stronger members also bear responsibility[22]), economically stronger euro-area members would be able to overcome their banking difficulties, and the other issues we identified as the roots of the euro crisis would be much less pressing.

A number of actions could be taken to improve the economic prospects for southern euro members:

- The southern euro-countries should engage in a number of efforts: we have highlighted that they suffer from vast structural weaknesses, which are impediments to growth. Moreover, while productivity has improved and unit labour costs have fallen, for example in Spain since 2008, this was mainly the consequence of reduced employment, which has adverse social consequences. Wages proved to be downwardly rigid (Darvas, 2012a)[23]. Structural reform to improve the functioning of labour markets is also inevitable, as are reforms to intensify competition in the non-tradable sector, which should increase productivity and reduce prices. However, it will take a long time for these reforms to take effect.

- The southern euro-countries should also continue fiscal consolidation at an appropriate pace, but the structural deficit criterion, which is central to the euro area's new fiscal framework (see section 2.1), should finally receive full attention. When fiscal targets are not met due to weakened economic performance, responding with additional austerity measures just deepens the recession (see section 2.8)[24]. Instead of the setting of nominal fiscal targets, such as the critical three percent of GDP deficit target, the debates and the deadlines should refer to the structural deficit.

- There is a strong case for calling for unit labour cost (ULC) increases in economically stronger euro-area trading partners (see for example Wolff, 2012; and Merler and Pisani-Ferry, 2012). To some extent wage growth has accelerated in Germany, but in any case this process will take a long time[25].

*'The single most pressing threat to the integrity, and perhaps also to the existence, of the euro is the depth of the recession in southern European member states, and their bleak economic outlook.'*

22. The economically stronger are responsible for designing an improper institutional framework for the euro area, for letting certain southern countries join though they did not meet entry criteria (Darvas, 2010b), for being the first to flout the SGP rules in the early 2000s (France and Germany), for not being forceful in preventing pre-crisis developments that resulted in southern euro members' major vulnerabilities, and for ineffectively addressing the escalating euro-crisis from 2010.

23. Eventual wage decline in southern Europe would improve the competitiveness of companies, but would worsen debt sustainability and reduce domestic demand. Therefore, fostering downward wage adjustment should be just one element of the policy mix and should be supplemented with the other polices we list.

24. Unfortunately, the deep recession that southern euro members are facing has not been very instrumental in lowering prices and wages, thereby increasing the competitiveness of those economies. While structural reforms may increase the responsiveness of prices and wages to the business cycle, as argued by Merler and Pisani-Ferry (2012), further fiscal consolidation does not seem to be the best tool to address the southern competitiveness problems.

25. Higher average inflation in the euro area as a whole would also help to correct pre-crisis intra-euro divergences in prices and wages, but such a policy would be clearly unacceptable to the economically stronger countries of the euro area.

- Fiscal expansion in economically stronger euro-area members, or at least a significant slowdown in the pace of fiscal consolidation, would facilitate the economic adjustment of the southern members (Merler and Pisani-Ferry, 2012). Unfortunately, however, the relaxation of fiscal targets in stronger countries does not seem to be on the agenda.

- A weaker euro would also greatly facilitate adjustment in southern euro-area members (Darvas, 2012b). It could be fostered by further interest rate cuts and quantitative easing by the ECB. A weaker euro would help southern economies to improve their trade balances with non-euro countries and would also boost German exports. This in turn would help to address intra-euro imbalances, since increased exports would likely translate into greater wage increases in Germany, because of its tight labour market, but not in Spain, because of its high unemployment. Thus, Spain's competitiveness relative to Germany would also improve. Without a weaker euro, Spain would need to enter a deflationary period, which is difficult to achieve and would worsen both the public and private debt situation even more.

- Bad assets in the banking system should be recognised and dealt with promptly, to support both deleveraging in the non-financial private sector and the restoration of credit provision, as argued by Aherne and Wolff (2012).

- Euro-area partners should also recognise that public debt, at least in Greece, is still too high. Even if the austerity programme is implemented as planned, it is very unlikely that Greece will be able to repay all of its public debt. Prolonging the recognition of this issue simply prolongs the uncertainty about Greece's future, thereby also negatively impacting the economy. However, as European partners have loaned money to Greece to repay private lenders and therefore have 'socialised' a large share of Greek public debt, further significant public debt reduction cannot be accomplished without some involvement by the official sector. This is the price that euro-area partners have to pay for their mistakes in managing the Greek crisis in 2010 and 2011.

- Finally, to help break out of the downward economic spiral that southern euro-area member states face, a very significant European investment programme is needed for southern members. The EIB seems to be the best institution to carry out such an investment programme, and therefore further capital should be provided to the EIB beyond the €10 billion agreed at the 29 June 2012 European Council. Note that investments are different from aid and lending.

## 4 CONCLUDING REMARKS

The euro has many flaws, which were cast into stark relief during the crisis. For some of these flaws, solutions have been provided, even if belatedly, and member states have shown a willingness to improve the functioning of the euro area by agreeing to relinquish national sovereignty in some important respects. However, the single most pressing issue, which threatens the integrity and perhaps the existence of the euro, has not yet been well addressed: the deepening economic contraction in southern member states. Most of the major policy measures that would help to stop the economic misery in these countries and offer the prospect for improved economic conditions are not yet on the agenda. In the absence of the implementation of these measures, there are very serious risks in the economic and political developments taking place in southern member states. While some progress has been made in tackling some of the roots of the crisis, there is still a long way to go to address all of them fully.

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