The Role of the Euro During and After Economical Crisis

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Abstract:
The impact of the single currency on international capital markets has been one of the most abiding features of the euro's historical development. In response to the global financial and economic crisis, governments across the world are sorting to creating national deficit levels on a virtually unprecedented scale to plug gaping holes in public finances and propel economies towards recovery. As a result, borrowing conditions on global capital markets are taking on not only an economic, but also an intensely political significance.

Keywords: capital markets, euro, global crisis, PIIGS countries[5], European Central Bank;

JEL Code: E58, E63, F42, F47;

1. Introduction

The creation of the euro has broadened and deepened European capital markets just when the Governments need to harness the world's savings in the interests of their own country's financial stability. The European Monetary Union – wide capital market is now the second biggest area for world savings and investment after US. All countries that have adopted the euro have benefited from a drop in interest rates to the law levels seen in Germany at the beginning of the single currency in 1999. Germany has had to share the traditional "stability premium" from which it profited in post-war years as a result of the Bundesbank's successful anti-inflation policy.

However, following the introduction of the euro, not all European Monetary Union members have made optimal use of these more benign capital markets conditions. Political squabbling is starting to open up among euro members about whether governments should benefit from equivalent borrowing conditions in the future. These themes are intimately linked to the debate about the style, scope and powers of international supervisory and regulatory developments. Moreover, the differences in opinion that exist offer plenty of opportunities for national rivalries in coming years.

2. Does Euro have a role in generating the crisis?

The Europeans are considering that the crisis started in other parts of the world, and they like to have this kind of justification. It is easier for them to support the idea that this phenomenon is originated and spread from America. But the true is that European financial institutions took substantial losses on mortgage-based, indicating that the shortcomings of internal controls and risk management were not an American problem only. Due to the fact that European banks were even more highly leveraged than U.S. banks, when losses were incurred and deleveraging resulted, financial distress was at least as severe as in America. How the leverage ratios of large European financial conglomerates were allowed to rise to 50 or 60 to 1 is, in retrospect, more than a little difficult to understand. Then there is the fact that, in Europe, between 1999 and 2005 housing prices in the euro area rose as strongly as in the United States, leaving them 40 percent above their

[5] **PIGS**, **PIIGS** and **PIIGGS** are acronyms that originally referred to the economies of Portugal, Italy, Greece and Spain (PIGS). Since the financial crisis of 2007–2010, Ireland (PIIGS) and, more recently, the United Kingdom (Great Britain, PIIGGS) have become associated with the term. The term became popular again during the financial crisis of 2007–2010 when the economies of Portugal, Ireland, Greece and Spain were seen as especially vulnerable due to high or rising government debt levels and a high government deficits relative to annual GDP.

30-year average. Also it should be underlined that in a number of individual euro area countries such as Ireland and Spain, the growth was faster than in the United States. In a number of European countries like Ireland and Spain residential construction as a component of GDP was more important than in the United States.

Associated with the booms in housing prices were recorded high growth in labor costs. More generous labor compensation leaded to more income, meaning that the real estate became affordable. This generated also higher export prices and larger current account deficits. Where unit labor costs euro-area wide remained flat between 2000 and 2007, they rose by 13 percent in Portugal and 15 percent in Spain. Where the ballooning of the U.S. current account deficit to 6 percent of GDP provoked widespread alarm, current account deficits were similarly 6 per cent of GDP in Ireland and even larger elsewhere in eurozone: 10 percent in Spain, 12 percent in Portugal and 15 percent in Greece. Moreover, external deficits were not randomly distributed. Gros in his article:"Bubbles in Real Estate: A Comparative Longer-Term Analysis of Housing Prices in Europe and the U.S." shows that the correlation in the change in housing prices and change in the current account across euro area countries in 1998-2004 was 0,8. Once the housing bubble burst and capital inflows to finance current account deficits dried up, very serious economic and financial difficulties eventuated.

The advent of the euro played a role in the development of these excesses and imbalances. With delegation of their national monetary policies to the ECB, previously high interest rates in countries like Ireland and Spain came down – from 4 ½ per cent in Spain and 5 ½ in Ireland in 1997, when the decision on initial membership was reached, to less than 1 per cent in 1999. In addition the change in the level of interest rates, which now converged to those prevailing in Germany, increased housing affordability and goosed demand. And strong demand fed back into relatively rapid increases in wages. With prices marked up over wages, higher inflation meant still lower real interest rates.

3. The Euro's future after crisis

Now nearly 11 years old, the euro has certainly come of age. But it is clear that some of the basic policy differences between euro states have been merely masked rather than eliminated by the achievement of a single currency. The global economic downturn has brought to the surface of some powerful, if uncomfortable, truths about Europe's fixed exchange rate mechanism. On the positive side, the EMU's current total of 16 members has endured the repercussions of the financial and economic crisis, with less disruptions than of individual currencies were still circulating. On the negative side, the contradictions and strains of shackling together nations at different stages of development with a single currency and monetary policy have become more apparent.

Still, more importantly, the recession in Europe and across the world is an exacting test for the historically unusual position of a single monetary policy, combined with continuation of individual economic and budgetary policies in 16 politically separate member states. This combination of circumstances brings a cluster of challenges on both the home and international fronts. There is now general agreement that, through the euro was weathered some important storms in its first ten years and finished the decade acclaimed as a success story, the next 10 years will be much more difficult.

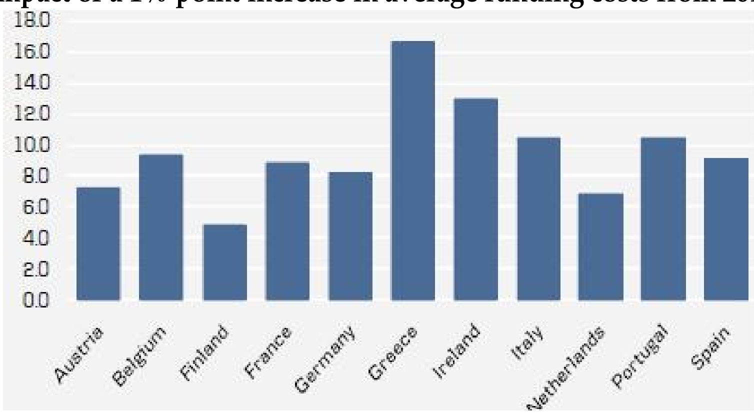
The current debt problems in Greece, and uncertainties about whether the same situation which is repeated now in larger countries such as Spain and Italy, have cast a spotlight on the European Union's need for a new supervisory model with more forceful economic measures. Along the way, the euro has lost strength versus the dollar, the differentials between the various debt levels in Europe have increased significantly, and some experts are saying that the worst problems have yet to occur.

Large deterioration in fiscal situation in PIIGS countries

Source: European Commission

There is a measure of the euro's success that many of its achievements were not universally expected. The Frankfurt based European Central Bank (ECB) has become an institution of world-wide renown. The ECB's achievements in supplying vast quantities of much-needed liquidity to international banks in the wake of the subprime mortgage crisis in August 2007 earned the respect of many previous critics. Although the ECB made a mistake in raising interest rates in response to short-lived inflationary pressures in July 2008 (when the euro area was already in recession), it quickly moved to ease credit policy after the collapse of Lehman Brothers in September 2008 – although its rates cuts were less aggressive than those of the Federal Reserve and Bank of England. As the world grappled with the fall-out of the credit crisis, in addition to the interlinked challenges of the 2008 explosion in oil prices and then, in 2009, the worst economic contraction since 1930s, the ECB appeared, to many, as a safe harbor in a storm. The present phase of deep economic downturn has been difficult enough, but following the European Central Bank's initial indecision about its credit policies in summer 2008, the Europe wide policy response has been relatively straightforward: cutting interest rates aggressively (in line with action in the US and UK) and allowing a major short-term deterioration in budget deficits to prevent the recession from turning into a depression. The true test of the euro's mettle will come when European economies start to recover, towards the end of these years. Recent European Commission statistics on euro area competitiveness paint an extremely bleak picture of EMU imbalances – in spite of an expected upturn – possibly intensifying the trap affecting the weaker southern and western CADs. The most difficult scenario for the EMU would come if, driven by export-led recovery in Germany and other traditionally stability minded countries in northern Europe, the European Central Bank was to increase interest rates early this year. The ECB will be influenced by worries about the potential inflationary impact of high government borrowing and massive injections of liquidity into financial markets. If borrowing costs start to rise, this will disproportionately hit the sluggishly – recovering CADs.

Impact of a 1%-point increase in average funding costs from 2010 on debt in 2020



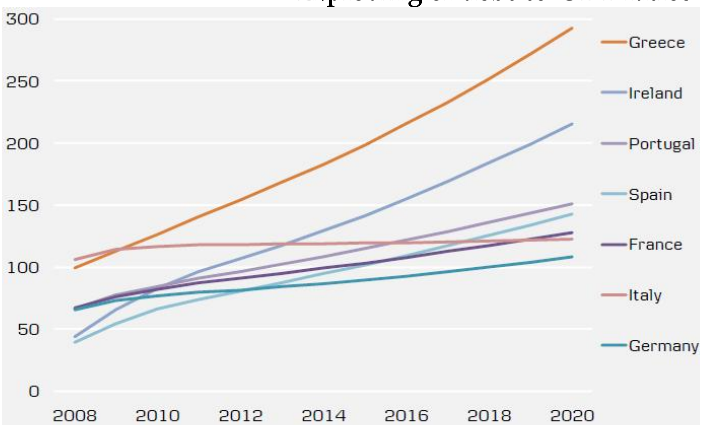
Source: Danske Markets calculation (higher nominal rates and/or lower nominal growth can speed up the "snowball effect")

In this scenario, interest rates on government bonds issued by the weaker EMU members can be expected to rise appreciably, especially if the yield "spreads" over German government paper start to widen again. The borrowing problems would be compounded if, in these countries, growth remains very low, unemployment rises (adding further to public sector deficits) and inflation stays around 1% - for then the real (inflation adjusted) value of debt would start to rise with exceptional rapidity.

All this would coincide with persistent financial strains. The European commission's report on euro's members' competitiveness says widely – varying price and productivity developments throughout the euro area, combined with the pegging of exchange rates since 1999, have produced a 10% to 15% over-valuation of the effective exchange rate for the CADs and an undervaluation of 5% to 15% for the current account surplus countries, principally Germany and the Netherlands.

In particular, this has led to a sharp rise in net external liabilities for Greece, Portugal and Spain, close to 100% of GDP in 2007 compared with near – balance in 1995. The Commission's report says adjustment to euro area imbalances is taking place "only partially and at a high cost "in terms of unemployment and underutilization of capital". It goes on to say that in 2007 to 2010, "most countries with overvalued real exchange rates are expected to lose further competitiveness while undervalued economies will continue to gain competitiveness".

Exploding of debt-to-GDP ratios

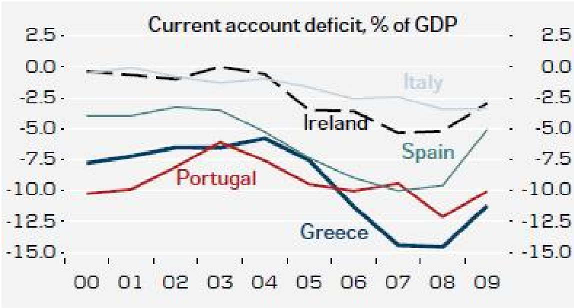


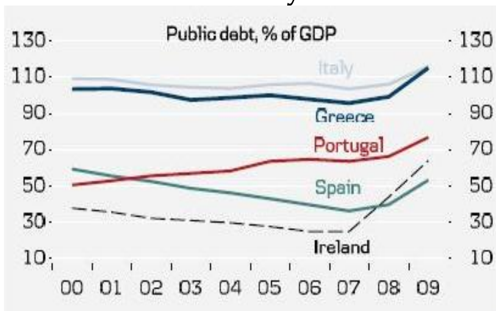
Source: European Commission, IMF, Reuters Ecowin

The Commission has sounded the alarm on the financing of the CADs' liabilities. Greece and Portugal have financed more than half their increases in net external liabilities since 1998 by currency and deposits, rather than longer term sources of finance such as bonds, while for Spain, currency and deposits account for 25% of the increase. The Commission notes that "cross-border deposits are easy to withdraw and can be considered a more volatile source of finance" – an ominous warning of EMU strains ahead.

Concern about financing these imbalances is one of the reasons why the ECB has declared it will not adopt large –scale purchases of government bonds as decided by the Federal Reserve and Bank of England. The ECB is plainly worried about the scale of financing needed to offset some of the very large imbalances building up within the euro area as a result of differences in prices and productivity within the fixed currency system. As the EMU is composed of 16 sovereign countries with individual government debt-issuing departments, quantitative easing would have to be applied in a GDP weighted manner to bonds of 16 countries. However, it would have a disproportionately large and positive impact on the bond markets of the most heavily indebted countries – and could be seen as granting privileged access to better borrowing conditions for the worse-off members. This is precisely the effect that weaker southern and eastern euro members running current account deficits wish to bring about. But the idea that the ECB could act as a government bond purchaser of last resort for hard-pressed nations is also something that the ECB wishes to avoid at all costs.

Vulnerability of PIIGS countries





Source: Reuters Ecowin

The EU has been unable to overcome a principal conundrum that has dogged it ever since the first stirrings of life in the single currency. Without political union, monetary union will remain a degenerated half-construct, a headless torso that will possibly become unstable and topple. Especially as a result of widening of the EU to 27 states, the idea of a genuine political union across Europe now seems as a remote as any time over the past 50 years.

4. Current state of research. Euro predictions of experts.

"Warton" University of Pennsylvania described in the article *"Crisis in the EU: Is the Future of the Euro at Stake?"* published in 10 March 2010, a summary of the most important points of view regarding euro's future. For example, George Soros, one of the most influential investors in the world and the twenty-ninth richest man in the world, believes that the future of the euro is at risk. The owner of Soros Fund Management argued recently in an article in the *Financial Times* that Europe needs "a more active process of supervision as well as institutional mechanisms for conditional support." According to Soros, "a well-organized market of euro bonds would be desirable; the question is if the political will can be created to adopt such measures." For Soros, "the survival of Greece" does not resolve the debate over the future of the euro, since the true battlefields are Europe's other weakest economies - including Portugal, Italy, Ireland and Spain. In an article in the *Wall Street Journal*, Nobel Prize-winning economist Paul Krugman wrote that the problems these countries are facing stem from "the arrogance of elites; specifically, the political elites who urged Europe to adopt a single currency long before the continent was ready for an experiment of this sort."

One the most widespread currents of thought attributes these problems to the fiscal independence of each member state of the EU. "The eurozone cannot have one monetary union with 27 different fiscal policies" notes Robert Tornabell, professor of finance at the Esade business school in Spain and author of a recent book titled, *The Day after the Crisis*. The United States "has a single currency, with a single monetary policy and, of course, an identical fiscal policy for all of the states of the Union - including Alaska, Hawaii, etc." Another sort of debate has been attracting greater attention in recent months: Some countries may be thinking about getting out of the eurozone. Those countries that are suffering the most from the crisis could be motivated by the temptation to return to the days when each country had its own currency and could therefore devalue its currency when it wanted to, lower interest rates on its own, and/or issue more currency to promote domestic consumption. However, Rafael Pampillón, director of the economics department at the IE Business School, discounts the possibility that countries will abandon the euro. "Nobody wants to get out of the euro," he says. "But if a country has excessive debt and cannot repay its loans now, it can declare a competition among its creditors."

Beyond that, it would not be a simple process to abandon the euro because, as credit agency Standard & Poor's warned recently, if a country moves out of the eurozone, that would mean an enormous devaluation of its new currency, and higher costs for financing. "Although it is possible to negotiate leaving the euro, a unilateral withdrawal would be controversial from a political point of view," the agency said in a statement. According to Juan Mascareñas, professor of financial economics at the Complutense University of Madrid (UCM), "The image of the euro would be weakened if any member of the eurozone abandoned it. In addition, in the case of Spain and, I believe, any other country as well, the psychological impact on the population would be great."

Another factor contributing to the eurozone's woes is that its institutions do not have strong enough mechanisms for sustaining member countries during times of trouble. One possible way to deal with this would be to establish conditional assistance, proposes Soros. "The most efficient solution would consist in issuing euro bonds that are guaranteed in a collective and particular way to refinance, for example, the 75% of the Greek debt that is in the process of expiring, under the condition that Greece fulfills its goals; while leaving the remaining 25% for Greece to finance as it can." However, current EU regulations do not take into account any option to undertake rescue operations for its member countries, and the European Central Bank literally rejects such ideas. The only possibility at the moment would be if some countries were to rescue other countries, or if the International Monetary Fund provided help. Mascareñas suggests that those states that have problems should resolve them at whatever cost it takes, but they should not be allowed to involve themselves with those who have figured out how to do a better job of managing their own growth - thus sending a message of responsibility. "German people must be tired of using their own savings to pay for other people's fiestas. Countries that are rescued in order to stay within the euro club must pay a cost" for their rescue, he adds.

5. Conclusion

The eventual full magnitude of the crisis and its consequences depends on the response of the affected countries. Sometimes, well-intentioned reforms can backfire, unleashing a revolution that sweeps away the change agents. Leaders must be extremely careful not to repeat mistakes. Given the excessive leverage, for example, was one of the reasons for subprime crisis. Policy makers should not take on more debt to launch giant economic stimulus programs. For the member countries which required a common monetary policy, they should have similar levels of national debt, or else they may struggle to attract enough buyers of national debt. This is a growing phenomenon in Mediterranean countries like Italy, Greece and Spain who have large national debts. In the absence of an integrated European fiscal policy, member countries find loopholes to avoid proper scrutiny by EU institutions. This may weaken the single European monetary policy over time. Smart regulation is not enough though. To decrease the likelihood of future crises, above all, governments have to reassert their basic belief in business leaders and nurture leadership talent from the cradle to the grave.

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