The European Monetary Union
Fundamentally Flawed

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Over the past months, developments in the European sovereign debt crisis have filled the headlines of newspapers. Financial markets all over the world have demonstrated instability in response to the latest news, and the stronger countries in the Eurozone have been asked again and again to bail out the weaker ones. Most people did not expect this when the euro was discussed and created; they expected the euro to help Europe compete with the rest of the world. The unsound foundation of a fiat currency and the few limitations on fiscal policy in the treaties were early warning signs that the experiment might not be successful. Ultimately, the structure of a monetary union of fiat currency with independent fiscal policies created a moral hazard that enabled some countries to engage in unsustainable borrowing. The debt crisis will lead to the breakup of the euro eventually, providing the opportunity for Europe to return to a sound currency and freer markets.

The roots of the euro currency can be traced back to the pre-World War I era and beyond (Marsh 2010, p. 5). As Hans Sennholz noted, throughout the centuries, when Europe fought wars, plans for unification usually arose (p. 2). Economic conflict often started these times of turmoil. When governments intervened in the economy, increasing their spending, they typically enacted nationalistic economic policies as well with tariffs and other controls on exchange to help pay for it, leading to these conflicts (1955, p. 1). Countries felt the negative effects of government intervention even more during the wars, as governments increased their intervention even more. During the nineteenth century, however, economic progress and liberty persisted, and there were few calls for unification (1955, p. 2).

During this prosperity, particularly from 1880 to 1914, much of the Western world based their monetary systems upon a gold standard, enabling the easy exchange of currency and helping facilitate the booming trade (Sennholz, 1955, p. 2, and Bagus 2010b, p. 14). Since paper
currencies were pegged to a fixed amount of gold, gold served as a common denominator. This era demonstrated the desirability of the easy exchange of currency, although fractional reserve banking was still permitted and caused instability (Bagus 2010b, p. 14). It is important to remember that the easy exchange of currency was only one factor; liberty and the development of freer markets were key causes of the booming economic growth (Sennholz 1955, p.2). Unfortunately, this system fell apart after two world wars, an increase in government intervention and nationalistic economic policies, and in the aftermath, people once again pushed for integration (Ungerer 1997, p. 11, and Sennholz 1955, p. 2).

After World War II, Europe demonstrated a strong desire for cooperation and coordinated actions born out of its disintegration, and the goal of monetary integration formed a key part of this (Ungerer 1997, p. 1). The war had destroyed much of Europe, and governments also faced negative consequences from their increased intervention into the economy during the war and the social welfare systems they had begun to institute. Unity might help the region recover and begin to compete with other countries again (Sennholz 1955, p. 2). Starting with the Benelux Agreement in 1943, European countries created various organizations and agreements to increase unity and cooperation, particularly economic cooperation. Several of the agreements such as the Benelux Agreement, European Payments Union, and Bretton Woods system tried to increase monetary coordination (p. 137-139). In particular, leaders desired a stable exchange rate for the international monetary system in the new international order which would be created (Ungerer 1997, p. 16). They also sought international monetary cooperation in order to coordinate and perpetuate credit expansion and inflation (Sennholz 1955, p. 201). The Bretton Woods system which lasted until the 1970s demonstrated this. Discussed at Bretton Woods, New Hampshire in July 1944, the Allies agreed on monetary cooperation through the International Monetary Fund.
Though it contained a number of goals, exchange rate stability and coordination of economic and monetary growth were key as countries sought to solve the problems of credit expansion through coordination (p. 197-201). For several decades, this system served as a relatively stable foundation for European economies.

As the Bretton Woods system disintegrated, however, Europe entered a time of monetary nationalism. The relative stability of exchange rates collapsed, and several exchange rate crises actually occurred, leading the European Commission to create the Barre Plan for a monetary union and call on experts to create the Werner Report regarding implementation (Scheller 2006, p. 17). They planned a system to bring the currencies of each country into convergence, an idea termed the “snake.” This movement fell apart in the late 1970s, however (p. 18). Technically, the European Monetary System set stable exchange rates successfully, but it failed to facilitate greater economic policy cooperation (Bagus 2010b, p. 20-23, Scheller 2006, p. 19). Furthermore, because countries still enacted different monetary policies, the various currencies gained and lost value against each other. For example, the German central bank, the Bundesbank, committed to stable monetary policy, and when other countries inflated more, their currencies declined in value in comparison. Other countries therefore faced the choice of following the policy of the Bundesbank or losing respect among their citizens and other countries (Bagus 2010b, p. 23).

Southern European countries in particular liked to finance the large government deficits created by heavy welfare spending through inflation, and the comparison with the Bundesbank frustrated them (p. 37). They also accumulated large debts; by 1991 Italy’s debts comprised 103% of GDP and Belgium’s totaled 132 percent of GDP. Additionally, their interest rates indicated the higher inflation and risk premiums; in Greece, Spain, Ireland, Italy and Portugal three month rates of

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1 The process of unifying Europe was lengthy, and the many steps in the process extend beyond the purview of this paper. Only an overview of some of the more relevant developments is presented here.
interest often fluctuated between two and three times that of Germany (p. 47). The economies of Europe experienced levels of debt, inflation, and accordingly economic performance which varied widely by the early 1990s.

By the early 1990s, many European countries needed reform to stay viable fiscally, and a monetary union seemed to be the best option (Bagus 2010b, p. 47). In 1995, public opinion in France, Italy, Belgium, Greece, Ireland, Luxembourg, the Netherlands, Portugal and Spain solidly favored the euro, while the public in more conservative countries such as Germany, Denmark, Finland, Austria, Sweden and Great Britain remained more skeptical (Gärtner, p. 488). While the countries cannot be separated perfectly, it is telling that the countries with higher inflation and larger debts tended to support the introduction of a European currency (p. 496). While many factors influenced these opinions, clearly the public of some higher inflation countries expected to benefit from the Euro. Some commentators believe that these countries believed a single monetary system would allow them to avoid the check on inflation provided by the harder currencies of Germany and other Northern European Countries in addition to other benefits. Each country would receive the same vote in the European Central Bank (ECB) council, and the Southern countries outnumbered the conservative northern countries (Bagus, 2010b, p. 37). The proposed structure of the ECB, however, resembled the Bundesbank, giving the impression that it would enact stable monetary policy. More concretely, the euro promised to lower interest rates if the system was perceived to be stable and lasting because the inflation and risk premiums would fall (p. 40-41). A number of economic factors led European countries to desire to introduce a common monetary system in addition to many political considerations.

At the end of the 1980s, Europe took key steps in the process of unification. In 1986, the European Commission passed the Single European Act, a move in the direction of political union
that also affirmed the need for a monetary union (Bagus 2010b, p. 25, Scheller 2006, p. 20). The European Council then appointed a committee to study and recommend concrete steps toward an economic and monetary union (Ungerer 1997, p. 199). Led by European Commission president Jacques Delors, it included the central bank governors of countries in the European Community, other members of the European Commission, and three independent experts on monetary policy (p. 199). Delors, a French socialist, wanted Europe to integrate politically and saw monetary integration as a catalyst for this, a warning sign in hindsight (Bagus 2010b, p. 25). Submitted in April 1989 and accepted in December 1990, the Delors Report named three stages that would guide the process of monetary integration and shape the monetary union (Bagus 2010b, p. 26; Scheller 2006, p. 21). First, the countries should “converge” in their economic performance, enacting similar policies (Ungerer 1997, p. 202). This stage began in July 1990, before the European Commission even officially accepted the report (Bagus 2010b, p. 26). Next, a European System of Central Banks would be created to direct the convergence of monetary policies. In the last stage, the countries would fix exchange rates, further coordinate policy and make the rules binding (Ungerer 1997, p. 203). This framework seemed sound, but later agreements failed to create strong enforcement mechanisms.

The countries later amended the Delors Report, but the basic framework remained the same. At the important Intergovernmental Conference on Economic and Monetary Union, leaders decided to appoint a Monetary Committee to plan the European Central Banks’ role in monetary policy. This committee decided that monetary policy should not finance public deficits. Furthermore, this conference decided that the monetary union would not bail out individual states when they faced difficulty, that countries should reduce and avoid large deficits, and that Europe should create an institution to ensure compliance with the rules (Ungerer 1997, p. 213-
These provisions, however, sparked considerable debate and resistance. Politically, centralized economic policy was unpopular; countries hesitated to give up their autonomy in decision-making (p. 214). Even more importantly, the European Commission decided to enforce the provisions through binding procedures rather than binding rules, allowing considerable leniency when countries failed to meet the requirements (p. 215). Some of these considerations were wise, but the concessions on the centralization of policy and the enforcement of rules weakened the resulting monetary union.

Finally, the Maastricht Treaty combined all the reports and discussions over the previous three years. Signed on February 7, 1992, it was intended to complete the integration and create a single currency with a single monetary policy and closely coordinated economic policies (Ungerer 1997, p. 229). Countries which signed the treaty were required to join the monetary union when all the transitional stages were completed, a provision which sought to skirt future public disapproval of the monetary union (Bagus 2010b, p. 26). The treaty stipulated that the European System of Central Banks and later the European central bank would be legally independent, governed by a governing council and Executive Board with the primary goal of price stability in mind (Ungerer 1997, p. 231). Furthermore, the European Central Bank would play a large role in controlling the exchange rate because of its price stability mandate (p. 232). Additionally, Article 103, Paragraph 1 of the treaty stated “Member states shall regard their economic policies as a matter of common concern and shall coordinate them within the Council” (Qtd. in Ungerer, p. 233).

The treaty contained weak enforcement for this coordination, however. As mentioned above, the treaty defined rules focused on budgetary policies and procedures with a goal of avoiding large budget deficits, but the rules were not automatically binding (p. 233). An
excessive budget deficit as defined by the treaty was measured as more than three percent of GDP unless the deficit was clearly temporary and declining (p. 230). Sanctions for offenders included requiring offenders to release additional information before selling more bonds and securities, ‘invit[ing]” the European Investment Bank to alter its lending policy for the offender, and requiring the offender to deposit a sizeable amount of money with the European Commission until it reduced the deficit, and levying fines on states whose deficits exceeded the limit (p. 235). These sanctions proved to be inadequate deterrents against liberal fiscal policy.

In addition to defining the role of the European Central Bank, the goal of coordination and the sanctions for offenders, the Maastricht Treaty planned the final stages of monetary integration. It created the European Monetary Institute to help monetary policy converge and oversee the monetary system until the ECB came into being (Ungerer 1997, p. 235). Additionally, it contained an agreement for all countries meeting the criteria to move to the last stage in the beginning of 1999, regardless of the situation (p. 237). Lastly, it defined the criteria for moving to the final stage and joining the euro. Countries must decrease price inflation below a certain limit, lower their government deficits to three percent of GDP or less, reduce their public debts to sixty percent of GDP or less, bring their long term interest rates under a limit and meet the exchange rate criteria of the European Monetary System (Bagus 2010b, p. 27). These provisions of the Maastricht Treaty proved to be critical in the future performance of the euro; in order to meet the 1999 deadline, European authorities used a lenient standard for meeting the criteria Maastricht required.

As detailed above, the Maastricht treaty laid out criteria for merging into the monetary union (Marsh 2010, p. 147). The United Kingdom received an exemption from the treaty; the country could choose whether to proceed with the union and notify the European Council, and
Denmark later asked for an exemption as well since the Danish Constitution required a separate referendum (Ungerer 1997, p. 239-240). Once the treaty was signed, however, numerous negotiations over further details took place, particularly between France and Germany. The French wanted more political control over the union while the Germans sought stricter rules to be enforced regardless of politics (Marsh 2010, p. 201). For instance, France sought for a ‘Euro-Group’ to work with the European Central Bank on exchange rates and add more political considerations, and Germany conceded this provision (p. 199). Germany, on the other hand, took great concern over the provisions regarding debt and deficits (p. 191). As a result, it pushed for a stability pact in addition to the Maastricht treaty in 1995, and the push almost halted the monetary union (Ungerer 1997, p. 280). As Horst Ungerer explains,

“The underlying issues were, on the one hand, how to shield the common monetary policy from profligate budgetary policies of individual countries, and, on the other hand, how to protect national sovereignty against the prevalence of automatic, technocratic rules. More precisely, the question was whether sanctions should be imposed on the basis of quantitative and automatically applicable criteria without regard to the economic circumstances of a case, and what role the Council of Ministers, the main political body representing member states, should play.” (p. 280).

The results of these debates over enforcement and the role of politics played a critical role in the success of the European Monetary Union.

In 1995, German Finance Minister Theo Waigel proposed a stability pact with automatic sanctions of deposits of 0.25 percent of GDP for “each full or partial percentage point transgression of the deficit limit” (Ungerer 1997, p. 279). These deposits would be repaid if the country lowered its deficit to the accepted amount over the next two years, but if the country failed in this, the deposit would become fine (p. 279). Eventually, Europe agreed on the Stability and Growth Pact in December 1996 which satisfied Germany and contained enough concessions
for France (Ungerer 1997, p. 280; Marsh 2010, p. 192). This pact termed a deficit over three percent “exceptional” if GDP declined more than two percent in a year or if there was an unusual event such as a national disaster that affected the government and the sanctions would not apply in that case. Furthermore, the European Monetary Union could determine if a deficit was “exceptional if GDP fell more than .75% annually” (Ungerer, p. 280). However, if a country did not take “action” within four months and reduce the deficit within the next year, sanctions similar to those Waigel proposed would take effect (p. 280). Though this agreement seemed to be a healthy compromise, it contained a moral hazard in its structure: states more prone to deficits would be more lenient in determining if a deficit was “exceptional” (p. 281). The political control in the final pact weakened it, leaving little power to discipline (Marsh 2010, p. 195; Bagus 2010b, p. 31).

Additional turmoil developed as countries attempted to meet the necessary conditions to enter the European Monetary Union (Marsh 2010, p. 176-205). Even France and Germany experienced difficulty in meeting the criteria (p. 196). Much of Europe grew slowly in the mid-1990s; even France acquired a five percent budget deficit in 1995 (p. 191). Across the continent, governments worked hard to reduce budget deficits, but they used some one-time measures which should have concerned many (p. 192). The Bundesbank lowered the discount and Lombard rates from 1996 through 1998, leading to lower borrowing costs which assisted in lowering budget deficits. Furthermore, interest rates began to mirror the German rate as investors expected that the union would indeed occur in a significant number of countries. In particular, Italy and Spain benefitted from reduced borrowing costs, enabling them to lower their deficits (p. 192). Italy took measures further and even instituted a one-time tax in 1997 to meet its budget goals (p. 196). Furthermore, France used pension funds to reduce its deficit, and even some
German politicians recognized that Germany would need “creative accounting” to meet the standards, so they did not attempt to enforce the requirements strictly (p. 196). Ultimately, in March 1998, eleven countries qualified for the monetary union, even if temporary provisions such as the lower rates of the Bundesbank allowed them to meet the criteria (p. 201, 205).

The European Central Bank opened June 1, 1998, before the European Monetary Union finally took place in January 1999 with eleven members (Marsh 2010, p. 207). The European Central Bank was independent, controlled by the directors and presidents of each central bank. Given the historically different monetary policy of the member nations, however, conflict was natural. Germany, Netherlands, Belgium and Luxembourg favored hard currency and lower inflation, but Italy, Portugal, Greece, Spain, France, and others outnumbered them (Bagus 2010b, p. 37). Even in 1992, some Frenchmen saw that inflation could be masked “finally put[ting] an end to the monetary supremacy of Germany” (p. 38). Initially, the European Central Bank remained pretty independent from politics under the presidency of Wim Duisenberg from the Netherlands, but this began to change during the presidency of Frenchman Jean-Claude Trichet which began in October 2003 (Marsh 2010, p. 207, Bagus 2010b, p. 33).

Whereas the ECB initially mirrored the Bundesbank’s focus only on price stability, the European Central Bank soon had to “support the general economic policies in the Community” as well (Bagus 2010b, p. 34). Unlike the Bundesbank which always corrected any change in inflation, the European Central Bank could justify inflation for economic reasons (p. 35). Initially the ECB set a target between zero and two percent inflation, but in May 2003, the ECB raised its goal to just under two percent (Bagus 2010b, p. 34, Scheller 2006, p. 81). It met this and other policy goals through “changes in minimum reserves, open market operations, and standing facilities (Bagus 2010b, p. 71). The ECB rarely employed the first mechanism, relying
mainly on open market operations and standing facilities. The ECB did initiate open market purchases, mainly repurchase agreements where it purchased assets and sold them back at a specified time for a profit and collateralized loans in which banks received loans using assets as collateral and paid interest on that loan (p. 73). Its standing facilities consisted mainly of the marginal lending facility and the deposit facility. In the former, banks provided collateral for loans from the European Central Bank in exchange for new money, and the European Central Bank applied a haircut to the value of that collateral based on its categorization of the asset in case the bank failed to repay the loan. The deposit facility took a much shorter duration; banks deposited money at the European Central Bank overnight and received interest (Bagus 2010b, p. 72; ECB 2011, p. 73). These mechanisms compared to those of the United States Federal Reserve bank, but the European Central Bank applied much lower standards for collateral than the Federal Reserve. For instance, the ECB allowed banks to buy government bonds, funding government debt and used a smaller coupon for this debt even if the rating was low, making central government debt preferred collateral (Bagus 2010b, p. 74-75; ECB 2011, p. 73). These standards partially enabled the buildup of debt which led to the sovereign debt crisis in Europe, and the further lowering of standards during the financial crisis only worsened the expansion of debt (Bagus 2010b, p. 74-75).

On the fiscal side, Europe suffered from slow growth from 2000 to 2005, so countries ran larger deficits and increased their borrowing (Marsh 2010, p. 212). Even Germany failed to expand from 2002 to 2004, so it accumulated high budget deficits. Naturally, Germany did not enforce the Stability and Growth Pact it had sought when its own deficits were large, and this enabled other countries to spend heavily as well. France assisted, and in November 2003, Germany and France jointly stopped the sanctions which should have occurred under the
Stability and Growth Pact (p. 212). In 2005, Germany reduced its deficits, partly because of a new finance minister, but the damage was done; enforcement of the sanctions for fiscal irresponsibility did not take place (p. 225).

Despite developments which should have concerned investors and politicians, Europe still experienced a boom prompted by the formation of the European Monetary Union. Even before countries officially adopted the euro, interest rates fell in anticipation. Italy’s interest payments, for instance, fell from €110 billion in 1996 to €79 billion in 1999. Italy did not take action to cause this; investor expectations of a less inflationary policy by a European Central Bank modeled after the Bundesbank prompted this (Bagus 2010b, p. 40). Furthermore, people did not expect the European Monetary to break apart, risk premiums fell. Investors assumed that other countries would bail out those who did accumulate too much debt, an assumption which proved to be accurate (p. 40-41). Overall, interest rates moved closer to those of Germany as early as 1995, a huge boon to countries which had traditionally faced higher borrowing costs (p. 41). Rather than using the lower interest rates to reduce their debt, however, they chose to increase their borrowing (Bagus 2011, Marsh 2010, p. 228).

This increased borrowing caused an unsustainable boom. Fiat money and the credit cycle enabled the boom rather than an increase in saving and investing, capital accumulation and productivity (Rockwell, 2011). Countries like Spain, Greece, Ireland and Finland grew, but they accumulated large amounts of government debt in the process (Marsh 2010, p. 228). Banks purchased the debt of such governments financing their deficits which was preferred collateral with the ECB. In fact, the European Central Bank applied a smaller haircut to government bond than for other types of collateral (Bagus 2010b, p. 90; ECB 2011, p. 73). The Bank then created new reserves which it exchanged for the bonds for varying amounts of time. The banks used the
reserves to expand credit, a practice accepted and encouraged in system of fiat money, but with very negative consequences in the future (Bagus, 2011; Rockwell, 2011).

This credit expansion was particularly noteworthy in Southern Europe (Huerta de Soto 2010, vii). Interest rates fell as a result of the abundance of newly-created credit in addition to the lower rates caused by the creation of the euro. Private parties then misinterpreted the low interest rates and mistakenly lengthened the structure of production (Bagus 2011; Rockwell 2011; Howden 2011). In Spain, this malinvestment occurred largely in a housing industry which built 700,000 new houses in 2006 and in imports such as automobiles. Other countries followed similar trends, financing consumption with cheap credit (Huerta de Soto 2010, vii, Bagus 2010b, p. 49). Furthermore, since these countries spent the new money on consumption rather than saving, they failed to become more competitive. Italy’s competitiveness, for instance, worsened by thirty-four percent between 1998 and 2007 while Germany’s increased ten percent (Marsh 2010, p. 229). Southern European countries in particular seemed to enjoy considerable prosperity, but it was a façade, soon to fall.

As mentioned above, southern European countries such as Italy, Greece and Spain spent the newly-created credit on imports, causing large increases in consumption. Moving to a higher-valued currency such as the euro had caused real prices of imports to drop, and credit was cheap (Howden 2011). German exports became more competitive throughout Europe, and this increased demand for its goods and a led to record trade surplus (Marsh 2010, p. 3). Spain, France, Italy, Greece and others, however, accumulated large trade deficits (p. 230). Without a monetary union, exchange rates would have changed as economies grew, causing the trade deficits and surpluses to balance. In this case, however, German currency could not appreciate and lower the costs of imports for its people while raising the cost of exports for other countries

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2 For more on the Austrian Business Cycle Theory, see Huerta DeSoto 2009.
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(Bagus 2010b, p. 42). This also prevented industries in countries with large trade deficits from becoming more competitive (Huerta de Soto 2010, ix-x). Exemplifying this, Germany increased its competitiveness by 13.7 percent between 1999 and 2010 while Greece, Ireland, Spain, Italy declined in competition by around ten percent (Bagus 2010b, 43-44). Adding to this problem, new money went to southern Europe at a higher rate, increasing wages, so productivity increases occurred slowly (p. 42-43). Foreign banks financed these ongoing trade deficits in Greece and Spain, leaving them subject to the banks’ willingness to continue financing the debt, a factor that was subject to changing economic and financial conditions (p. 45-46).

Naturally, the boom lasted only temporarily, and a painful bust occurred with the onset of the financial crisis which exacerbated Europe’s debt situation until a sovereign debt crisis developed. Across the Eurozone, slow growth spread, particularly in countries whose economic expansion had been founded on low interest rates (Marsh 2010, p. 218). Countries like Italy had not lowered their spending and debt or increased taxes during the first part of the twenty-first century, so they experienced immediate fiscal difficulty when the crisis hit (p. 230). As a result of the slow growth, countries faced increased budget deficits due to lower tax revenues while increasing spending to ease the pain of the bust (Kelly 2011). Governments subsidized car purchases, infrastructure improvements in order to help the construction industry and helped banks. This response caused the sovereign debt situation to reach a crisis (Huerta de Soto 2010, viii).

By 2009, the effects of years of borrowing and the recent financial crisis were clear. Overall, the recession and resulting policies increased debt in Europe between fifteen and forty percentage points of GDP (International Monetary Fund 2011, p. 3). The Greek budget deficit had climbed to 12.7 percent of GDP in 2009, and the gross debt to GDP ratio totaled 113 percent
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(Bagus 2010a). The rest of the Eurozone became concerned by the large deficits run by countries like Greece and preached austerity. Fortunately, Greece could not devalue its currency and decimate the price structure as they had in previous decades, so they were forced to cut spending (Huerta de Soto 2010, viii-ix). Still, Greece faced a huge burden of debt which even large spending cuts could not bring under control. Since strong and weak countries alike faced the crises and experienced a growth in deficits, people began to question the commitment of countries like Germany to bail out the weakest. Because of this investors began to question the bonds of deeply indebted countries, and the difference in yields between strong and weak increased (Bagus 2010a). It became clear that significant malinvestment and an unwise increase in debt had occurred, leading to a crisis.

Around the world, banks began to doubt that the European Central Bank would accept Greek bonds as collateral, sending the markets into turmoil and forcing governments to face the reality that they could not borrow endlessly (Bagus 2010b, p. 76). Banks only purchase bonds at appealing yield rates, and as uncertainty increased, governments such as Greece were forced to offer higher interest rates (p. 88). In Greece, ten-year yields increased from 3.7 percent in January 2010 to 6.2% in May 2010 (Shostak, 2010). Banks could then profit on the difference in the interest rate paid to the ECB and the high interest rate received from the Greek government, making the risk worthwhile (Bagus, 2010a). Furthermore, banks began to consider the high default risk on the bonds of heavily-indebted governments, but they were still satisfied by the implicit guarantee that the rest of the Eurozone would bail out troubled governments in order to preserve the currency, a guarantee that soon became explicit in 2010 with the introduction of various bailout funds, bailouts which violated the Maastricht Treaty (Bagus 2010b, p. 88, 92).
A key factor, however, was the ECB’s minimum credit rating requirement for collateral, an A- when the crisis began. Ratings agencies downgraded Greek government bonds several times, and on April 27, 2010, Standard and Poors classified Greek bond as junk, leading to continuing turmoil in the markets (Howden 2011). Concerned, the ECB lowered the requirement from A- to BBB- and ultimately to junk status as Greek bond ratings fell in order to ensure that demand would continue for the Greek debt and lower borrowing costs for a Greek government in crisis (Bagus 2010b, p. 89). These provisions in the midst of crisis created many consequences that will appear in future years, but the ECB, responding to the pressure of politicians and the market, decided that further action was needed. In May 2010, the ECB no longer limited its actions to lending; it began to purchase government bonds directly from banks in violation of the Maastricht Treaty’s requirement that the ECB not monetize debt, removing the limitations banks concerns had placed on borrowing in order to “stabilize financial markets” (Bagus 2010b, p. 90; Shostak 2010). As a result, the ECB balance sheet grew at a rate of 11.5 percent during the first week of May in comparison with the negative 6.8 percent rate at the start of the year. The ECB’s standards helped create the debt crisis, and in order to prevent the bankruptcy of a member state of the Eurozone, it violated its own treaty, a move which will weaken the monetary union further.

Although investors and politicians desired such a response to relieve the effects of the crisis, it can only alleviate the symptoms. As Austrian economist Frank Shostak notes, “any monetary pumping sooner or later will lead to an exchange of nothing for something, which will weaken the real-wealth-generation process” (Shostak 2010). Increasing the money supply “out of thin air” shifts real savings to bubbles during the credit expansion process (Shostak 2010). The ECB’s actions may temporarily help those hurt by the market turmoil, but monetary pumping
can only redistribute income; it cannot create the growth Europe needs to overcome its past mistakes and pay off its debt (Shostak 2010). Furthermore, the government stimulus packages will only shift savings from productive private use to unproductive government spending, resulting in capital consumption damaging to growth (Shostak 2010). The Eurozone has made many mistakes which enabled its members to borrow beyond their means, and the emergency actions by European governments and the European Central Bank delay the liquidation of the bad assets.

Unfortunately, it is unlikely that Europe will be able to grow its way out of the sovereign debt crisis. The International Monetary Fund projects lower growth for Europe, thinking real GDP growth would slow in the Eurozone from 1.6% in 2011 to 1.3% in 2012 (International Monetary Fund 2011, p. 10). The debt has reached a level where even a high rate of economic growth would not sufficiently enable the countries to reduce their debt quickly. As a result, the countries have no option but to improve their fiscal position. Additionally, The European Central Bank might intervene to give politicians more time, but monetary intervention is only a short-term solution. The central bank can lower borrowing costs with extensive bond purchases, but these low rates cannot last (Blackstone and Gauthier-Villars 2011). The ECB cannot finance government debt, but it has acted in a similar vein under the guise of responding to fears of deflation (Blackstone and Gauthier-Villars 2011).

The standard advice for reducing deficits and improving growth, however, has not solved Greece’s problems. Greece cut its government spending, decreasing public pensions and government wages. They also attempted to increase economic growth and tax income by changing overtime pay and termination laws, becoming more competitive with other countries. The government raised taxes in order to increase its revenue, a provision negatively affecting
growth. Lastly, Greece sought to grow by deregulation and privatized two-thirds of publicly owned companies (Howden 2011; Bagus 2010b). These solutions may take more time to affect growth, and Greece may need to make more reforms to increase their competitiveness, but in the meantime, Greece has sought aid from the European Union in order to meet its obligations.

The crisis is complicated by the interconnectedness of Europe, making it difficult to forecast the outcome. First, it is difficult to tell how many banks and financial institutions carry significant exposure to sovereign debt. Merrill Lynch estimates that European banks hold €3 trillion of “periphery debt” and are leveraged at a 30:1 ratio, twice the ratio of banks in the United States (Merrill Lynch 2011). Furthermore, banks in Europe have been swapping assets to improve borrowing from the European Central Bank and stay afloat. Banks receive the assets which meet the ECB’s rules for collateral and investment banks or insurers take the “non-investment-grade loans to corporations or to finance public-infrastructure projects” (Enrich 2011). This gives banks more liquidity and spreads risk among many institutions, but it also might become a “transmission mechanism” for risk throughout the financial system (Enrich 2011). Some companies have expressed their lack of confidence in the banking system; Norfolk Southern Corp, for instance, chose not to refinance with European banks (Enrich 2011). As Wall Street Journal reporter David Enrich notes, “traditional sources of bank funding, including institutional investors and fellow banks, have largely fled amid concerns that many lenders are sitting on huge piles of risky government bonds and loans to shaky borrowers” (Enrich 2011). Given this situation, it is natural that the governments of France and Germany, countries with banks heavily exposed to the debt, have promoted bailouts of debtor nations and banks.

While the exposure of banks throughout Europe and the commitment of all the governments to the single currency testify to the interconnectedness of Europe, some
commentators fear contagion. For contagion to truly describe the situation, however, only one or two countries would be at fault. Economist David Howden cites Anna Schwartz’s definition: “contagion, if the term is used accurately, occurs only in circumstances in which other countries are free of the problems of the country that first experienced trouble and yet suffered unwarranted investor disaffection” (Howden 2011). In the case of Europe, however, the monetary policy of the Eurozone contributed to the crisis, enabling the poor fiscal policy of several countries. The interconnectedness is undeniable, but Greece and its counterparts alone did not cause the crisis.

Because of its interconnectedness, individual countries and the whole Eurozone must solve the crisis, but many factors complicate this. The root of the crisis lies in fiscal policy, a political decision. Debtor nations have implemented austerity measures amid much political uproar. The Greek prime minister was forced to step down due to the unpopular policies, and Greece will now hold a referendum on the austerity measure (Granitsas and Paris 2011). In Italy, Prime Minister Berlusconi faced tremendous pressure as he tried to restore the fiscal situation, eventually stepping down as well (Galloni and Meichtry 2011). These countries must also implement pro-growth reforms which will allow them to compete with the rest of the world and grow economically.

Furthermore, the political situation in the strong countries has posed difficulties for those continuing in efforts to bail out Greece and its counterparts. Germany and France will not bail out the other countries forever, transferring their wealth to those who have made very unwise decisions. In June 2010, fifty-six percent of Germans opposed bailout measures, and most Germans want to bring back the Deutschmark (Bagus 2010b, xvi). In Finland, a country traditionally favoring conservative monetary policy, citizens voted out the ruling party in spring
2011, largely because of the party’s support for the European Union bailout (Rockwell 2011). As the crisis continues and further bailouts are requested, the pro-bailout governments will lose support.

Despite initial boosts following Europe’s actions aimed at stopping the sovereign debt crisis, the market continued to react negatively to the debt crisis. A July 2011 summit in the Eurozone helped ease market fears temporarily, resulting in an increased line of credit, lengthened loans and lowered interest rates, but the fears of investors have been resurgent (International Monetary Fund 2011, p. 9). By October 2011, however, the situation again required action. Greece, hampered by high borrowing costs, large debt, and continuing deficits despite austerity measures, needed to restructure its debt or face default. On October 27, 2011, “European leaders secured an agreement from Eurozone banks to take a 50 percent loss on the face value of their Greek debt” (Shostak 2011). Furthermore, the leaders announced that banks must increase their capital reserves to 9% by June 30, 2012, a move which should improve banks’ ability to weather defaults on debt (Shostak 2011). Banks must deleverage in order to meet this requirement, creating a risk that asset values will fall. This would be difficult, but credit expansion will be slowed, however, and perhaps the debt bubble will finally burst and enable Europe to restructure and grow. Additionally, leaders agreed to more than double the size of the emergency bailout, improving Europe’s ability to guarantee bonds in Italy, Spain and other countries burdened by large debts (Shostak 2011).

Negotiations continued throughout the rest of 2011 as politicians sought to reach more permanent solutions. Recognizing that the fiscal policies of several countries had led to a crisis affecting the entire Eurozone and world, leaders sought to craft a fiscal compact. The process will be lengthy, but a pact reached in early December made some progress. First, automatic
penalties will finally occur for countries running large deficits, a structure that should have been in place from the start of the monetary union. Additionally, Euro members must adopt balanced-budget procedures in their laws. The market responded positively to this announcement, but government bond yields did not change, a crucial issue for the heavily indebted nations (Forelle and Fidler 2010). Still, investors such as Merrill Lynch thought that Europe made some progress towards resolving the crisis, but they said that quick political solutions are essential. They believe Europe must grow in order to overcome the crisis, so pro-growth reforms must take place in addition to austerity measures (Merrill Lynch 2011). The situation remains fluid, and policy decisions will be critical in shaping the future growth of Europe and the success of the euro.

Overall, it is unlikely that the countries of Europe can stick to the fiscal reforms needed to satisfy creditors and return to financial health. Standard and Poors expressed its doubt of the the political will of Europe by threatening to downgrade the debt of fifteen of the seventeen nations in the monetary union (Smith 2011). Moritz Kraemer, Standard and Poors’ head of European Sovereign ratings, said “our experience with previous summits suggests that it is far from certain” that the agreements will be enforced and improve the debt crisis (Smith 2011). Some think binding rules could bring a permanent solution to the fiscal issues, but these could not be enacted without tightening the political union, an option discussed at a December summit (Smith 2011).

France has long desired a closer political union, and French President Nicolas Sarkozy proposed a tighter union with binding economic policy in December 2011. “There cannot be a single currency without economic convergence,” he said 1 December (Blackstone and Guathier-Villars 2011). United fiscal policy in addition to monetary policy would solve a moral hazard of the monetary union, but it would require further treaties and lengthy negotiations. The European
Union took first steps in early December, agreeing on a fiscal compact with automatic sanctions (Forelle and Fidler 2011). German Chancellor Angela Merkel sought a treaty to improve enforcement, but this required the unanimous consent of all members of the European Union (Walker 2011). Ireland and the Czech Republic hesitated, and the United Kingdom vetoed the treaty, leaving Europe with only an intergovernmental agreement which will be difficult to enforce. More details must be decided over the next several months which will have implications for its enforcement (Forelle and Fidler 2011). In its current form, Eurozone countries with large deficits will incur automatic penalties and all Eurozone governments must enact balanced budget laws. Additionally, only a small bailout accompanied the agreement, demonstrating Germany’s reluctance to continue wealth transfers (Forelle and Fidler 2011).

Default and bankruptcy is the best option for Greece and possibly other nations in similar circumstances such as Italy, although many fear the results. The International Monetary Fund believes default can be avoided even though the needed fiscal adjustments are very large with countries relying on the International Monetary Fund and European Union to lower interest rates. The IMF particularly fears the effect default would have on banks and the economic recovery (International Monetary Fund 2010). The large losses banks would take would force some out of business, so the money supply would contract and the purchasing power of money rise (Kelly 2011). Greece would probably need to leave the euro and return to its own currency, but the European Central Bank could still control the supply of euros, swapping euros for the country’s new money. The exit of Greece and other weak nations could actually raise the value of the euro, though many fear the consequences of such deflation (Kelly 2011). Stronger countries, however, would feel economic pain from a default because of the heavy exposure of their banks to Greek debt (Bagus 2010a). The example of Iceland demonstrates the positive elements for Greece.
Iceland’s stock market dropped 95 percent and its currency 60 percent in the wake of its own bankruptcy. The new exchange rate, however, let Iceland accumulate a trade surplus. Furthermore, bankruptcy forced the government to cut back spending, and now Iceland has run budget surpluses (Howden 2011). Bankruptcy was painful, but it allowed Ireland to quickly regain competitiveness. A similar process would allow Greece to recover from its mistakes and prosper economically once again, but it is unlikely that the stronger European countries will allow this or that Greece would choose this path.

It is far more likely that governments will attempt to inflate their way out of the crisis. Already, countries have refused to stick with their deficit reduction plans, plans which are extremely unpopular (Bagus 2010a). Countries would need to leave the euro to be able to inflate their way out of the crisis, and the consequences would be disastrous. Sovereign debt would either remain in euros, leaving the inflating country with even higher borrowing costs due to a weak currency. If the country chose to denominate their debt in the weaker new currency, they would lower the real amount paid but destroy their credibility and increase interest charges (Marsh 2010, p. 255). Both solutions fail to solve the debt problem and leave a foundation for future borrowing. Additionally, the inflation would harm the economy considerably, destroying savings which form the foundation for capital creation and productivity increases. In the short run, however, inflation masks the malinvestments which must be liquidated and provides a veneer of prosperity, so it is likely that politicians concerned with keeping their offices will choose this option.

The success and continued existence of the euro depends on the ability of political leaders to handle the crisis, but it seems likely that the Euro will break up in the future (Enrich, Ball and MacDonald 2011). There is a moral hazard inherent in the structure of the euro; countries have
separate fiscal but joint monetary policy, allowing for externalities (Bagus 2010a). Individual
governments have financed their debt through the joint bank, and the banks continue to purchase
government bonds because the European Central Bank accepts them as collateral (Bagus 2010,
p. 85). The first users of the newly-created money, often southern European countries, have
benefitted at the expense of less-indebted countries. Furthermore, interest rates have risen for all
borrowers because of the increased demand for loans (p. 87). Unless the Eurozone can join more
closely together and remove the moral hazard, it seems likely that the strong countries will tire of
bailing out the weak and choose to leave the euro. Countries have already begun preparing for
this, even though they do not expect it to occur. Central banks in several member countries have
researched printing measures in case they have to return to their old currencies, and other
countries such as Switzerland have researched possible alternatives against which to peg their
currency (Enrich, Ball and MacDonald 2011). Eventually, the European Monetary Union will
fall apart; whether strong countries leave the euro, quickly ending it or they force the weaker
countries out and try to hold on, the tensions created by the problems of fiat money will
eventually drive the countries apart.

The European Monetary Union is fundamentally flawed, as the recent sovereign debt
crisis has revealed. Moral hazards exist within the system which allowed some countries to
become overly-indebted. Unless Europe can enforce a united fiscal policy, however, the
problems will persist. A Europe brought into closer political union, however, would become
increasingly centralized, full of bureaucratic rules and regulations which would hamper the free
market. In order to maximize growth and benefit from easy trade with neighboring nations,
Europe should return to a hard currency, ending the system of fiat money which disguises the
fundamental bankruptcy of the region (Rockwell 2011). Governments should remove regulations
and allow the liberty needed for a truly free market. Under this system, exchange rates would remain stable, countries would prosper economically without the destructive boom and bust cycle created by credit expansion, and trade between nations could flourish through liberty and a lack of tariffs rather than bureaucratic unity. The sovereign debt crisis in Europe continues to unfurl, but Europe should take the opportunity to examine the flaws in the system and return to sound economic practices.
Bibliography


