Preserving the Eurozone

Europe works to solve Greek debt crisis

By *per Concordiam* Staff
Photos by Agence France-Presse

Two years into an economic recovery from one of the worst recessions of the postwar era, the European Union continues to search for solutions to the debt crisis that plagues some of its members. Following the announcement in October 2011 that Greece would be allowed to engage in an "orderly" default on its government debts, EU leaders strove to prevent such an event from causing widespread harm to economies across the continent. The crisis has sparked protests in Greece, and some against austerity measures have turned violent. In Germany and other richer EU member states, popular sentiment remains set against enlarging taxpayer-funded bailouts, forcing national leaders to find creative ways to stabilize their economies.

The logo of the Euro stands in front of the European Central Bank in Frankfurt am Main, Germany. The ECB sets interest rates for the 17-member European Monetary Union.

Amid the frenzy of street protests and emergency meetings by central bankers and government officials, some economists have called the future of the euro into question. Progress towards a more politically and economically integrated EU could also be at stake. As austerity measures are incorporated, defense spending has been targeted across Europe by budget cutters in both richer and poorer countries, leading to concerns that Europe's already tightfisted military spending will be insufficient to meet current and future obligations.

How it started

The 2008 financial crisis is commonly viewed as the beginning of serious troubles for Greece and the European Monetary Union, commonly referred to as the "eurozone." Many observers, however, see the origins of the crisis in the creation of the euro itself. "The monetary union is a fair-weather construct, as a number of economists said from the beginning," *Der Spiegel* reported in June 2011. The magazine also pointed out that Nobel laureate economist Milton Friedman predicted that the euro wouldn't survive the first crisis and said in 2002, "Euroland will collapse in five to 15 years."

The core of the problem, economists say, is that the euro project cobbled together widely divergent economies unable to agree on spending, saving and taxation. According to *The Telegraph*, "monetary union itself can only flourish on the basis of a high degree of political and fiscal integration. One interest rate and one exchange rate cannot possibly fit all the members of a group of nations with widely different industrial and financial strengths, tax regimes and political cultures."

Richer countries need stable monetary policy, while poorer countries need more flexibility in order to encourage economic growth. The European Central Bank (ECB) set uniform interest rates across the zone while fiscal policy remained under the control of each government, hampering coordination between fiscal and monetary policies. The euro was essentially a political project, according to *Der Spiegel*, intended to embed reunified Germany into Europe, and it relied on hopes that "the underlying problem of the euro's design would resolve itself."

But low ECB interest rates increased the flow of money in weaker eurozone countries like Greece, Portugal, Ireland and Spain. That easy money was designed to spur growth and alleviate economic imbalances. While there was growth, the easy availability of credit caused real estate bubbles in Ireland and Spain while, as *Der Spiegel* puts it, "Greeks and Portuguese were able to live shamelessly beyond their means," borrowing to cover their consumption. When the recession hit, the housing bubbles burst, tax revenues dropped and social payments increased. The party was suddenly over.

German Chancellor Angela Merkel and French President Nicolas Sarkozy, leaders of the eurozone's largest economies, shake hands during a joint press conference at the Chancellery in Berlin in June 2011.

According to *Der Spiegel*, the Greeks "were forced to admit that their debts were much higher than they had ever disclosed before."

Risks abound

When Greece formally defaults on its bonds – the securities sold to investors to help finance public spending – some fear it could pull other overextended eurozone counties into default. Portugal, which already received a bailout, is in particular danger. Like Greece, the cheap euro masked declining competitiveness in Portugal and the financial crisis left it overextended, without access to normal lines of

credit. Ireland, another bailout recipient, and Spain also indulged during the boom years and remain at risk if the economic recovery stalls. Investors have also questioned if Italy, possessing one of the world's largest economies, should also be grouped within the group of "sick" economies. The sheer num-ber of ailing economies has forced European leaders to search for a unified path out of the quagmire of debt. Clearly, there are no easy choices, nor cheap ones. As of October 2011, EU members had revealed plans for a controlled default of Greek debt to a more manageable level. Private holders of Greek bonds, which most conspicuously include European banks, would have to write off at least 50 percent of their investment in the Aegean nation. At the same time, in an attempt to bolster investor confidence in places like Italy, EU officials proposed using taxpayer money to insure part of the value of government bonds in case of default.

Bailout proposals have run into opposition both in Germany and Greece. Germans, who pay higher taxes and work longer, are resentful that they are being asked to bail out the "spendthrift" Greeks once again. Throughout much of 2011, a majority of Germans opposed more aid to Greece. German Chancellor Angela Merkel criticized Greece and other heavily indebted countries for their early retirement ages and extensive vacation time, saying, "We can't have a currency where some get lots of vacation time and others very little." Meanwhile, the Greeks are angry about the austerity measures demanded by the European Central Banks and the International Monetary Fund to receive aid. Some Greeks view the demands as a "new economic colonialism." Unions and students have rioted, and a 2011 poll showed that 30 percent of Greeks wanted to leave the eurozone immediately.

In response to domestic pressures, Germany has demanded that private investors share the pain with the EU taxpayers, resulting in the 50 percent voluntary "haircut" demanded of Greek bond holders. But some fear even such a controlled default could

Protestors attack Greek riot police during violent demonstrations near the Greek parliament in Athens in June 2011.

trigger further crisis in places like Portugal and Ireland if their bonds are viewed as too risky to attract investors. Another option would be to leave Greece (and potentially others) to their own devices. Such an option is unlikely. Countries recognize that a refusal of further aid would almost certainly result in rapid insolvency and carry heavy risks that the "contagion" could spread.

The remaining options are the partial dissolution of the eurozone, or the transition of the eurozone into a transfer union, with the richer countries providing permanent subsidies to the poorer. Since creation of a transfer union would require EU members to hand over much of their sovereignty to Brussels, dissolution of the eurozone is something an increasing number of economists see as a foregone conclusion. One scenario has Greece and other weaker economies leaving the euro and reintroducing domestic currencies. Despite the perils of this approach, it would provide monetary flexibility, allowing countries to devalue their currencies and improve their balance of trade.

Eurozone spending cuts are necessary to manage debt. But security experts worry budget cutters could sacrifice too much of their nations' militaries in the name of austerity. As Europe and its NATO partners face a new generation of threats and expanded responsibilities, including battling pirates and global terror networks, European governments are cutting their already lean militaries. Pooling of resources can counter some capacity loss, but excessive cuts could leave Europe militarily irrelevant and its interests unprotected.

End of the eurozone?

The eurozone, as currently constructed, is under threat. *The Telegraph* says: "The unthinkable idea that the eurozone might break up is now being thought. And the version of break up gathering ground in people's minds is not that the poor, indebted countries would fall out, but that Germany would rise up like Gulliver, snap the insubstantial euro-ropes tied round its body, and walk away." The newspaper also noted that Borsenews, a German stock market website, began "pricing shares in Deutschmarks as well as euros."

In a June 2011 report, the United Kingdom's Centre for Economics and Business Research predicted the "break up" of the eurozone by 2013, saying that Southern European countries would have no choice but to withdraw, or face economic stagnation. The centre projects low growth rates and poor competitiveness for Greece, Portugal, Spain and Italy, but thinks Ireland has a chance to get its financial house in order and remain in the monetary union.

Mario Monti, appointed prime minister of Italy in late 2011, has promised to stabilize his country's economy.

The eurozone debt crisis also has the po-tential to turn Europe in the other direction, towards more complete economic and political integration. In June 2011, former ECB President Jean-Claude Trichet proposed creating a central finance ministry with substantial control over national budgets. Supporters of increased European integration admit the idea has little chance in the current political climate but argue that stronger EU governance is preferable to the breakup of the current monetary union.

Europe and the eurozone are at a crossroads, faced by the first serious crisis since the common currency entered circulation in 2002. It is still to be seen if the euro will survive the crisis in its current form or shrink to being the currency of the stronger, core European economies.

The currency's detractors are growing and many would rather see the euro go away than surrender sovereign taxing and spending authority to a centralized EU treasury. But euro supporters argue that it must be saved despite the costs.

As *Der Spiegel* said: "The euro, created with the aim of permanently uniting Europe, has become the greatest threat to the continent's future. A collapse of the monetary union would set Europe back by decades, dealing it a blow from which it might never recover." ◻