

## **The State of the European Union**

Eamonn Butler  
Adam Smith Institute

“Europe” can mean many things

- A geographical area, from the Mediterranean to Iceland and from the Atlantic to Russia – including the countries of Western Europe, Eastern Europe and Scandinavia
- The European Economic Area – an free trade alliance of 30 countries, including 27 European Union countries plus Switzerland, Iceland and Norway
- The European Union (EU) – a confederation of 27 countries, from Cyprus to Ireland and from the Mediterranean to Finland
- The eurozone – the 17 EU countries that use the common currency, the euro (€)

The European debt crisis is principally a eurozone crisis

- akin to an old-fashioned balance of payments problem
- some countries highly productive, others with falling productivity
- hence tensions in their fixed exchange rate system

The euro was created in 1999, led by the Western countries including Germany and France. Greece joined in 2001. Malta, Cyprus, Slovenia and Slovakia have also joined. Several other EU countries operate an Exchange Rate Mechanism by which their own currency tracks the euro.

We now know that the economic data on which the accession of Greece was granted were in fact deeply flawed or even deliberately misleading. It is the poor economic performance of Greece, its default on around half of its sovereign debt, and its seeming inability to reduce corruption and featherbedding and thus to improve its productivity, that has been the main driver of the euro crisis.

In 2009, following the financial crisis, the Dubai sovereign debt crisis, worries about the security of sovereign debt and strains within the euro area, the EU ordered France, Spain, Ireland and Greece to reduce their budget deficits. (In fact only Ireland, which suffered a deep banking crisis, has made significant budget cuts, and partly as a result is recovering better than the others.)

In late 2009, Greek voters rejected the EU austerity package, voting in the Socialist Party. Greece’s debts stood at €300 billion, a record and equivalent to 113% of GDP – nearly twice the official eurozone maximum of 60% of GDP.

In early 2010, the EU criticised Greece’s national accounts, revising the annual deficit figure up to 12.7%, three times the previous official statistic. Concern mounted that with a huge debt and a huge deficit, Greece might have to leave the euro, but this was headed off by a new austerity plan drawn up by Greece.

People now started to talk about the weaker PIGS or PIIGS countries – Portugal, Ireland, Italy, Greece and Spain – as potentially destabilising the common

currency. The EU demanded further public spending cuts in Greece, which precipitated riots and strikes.

The EU now facing significant downward pressure on the value of the euro, embarked on a string of measures to shore up the government finances of the weaker nations. It announced a €22bn 'safety net' for Greece. Following yet more riots and strikes, the eurozone and the International Monetary Fund agreed on €30bn emergency loans. But the Greek debt continued to rise, and the deficit figure was revised upwards again to 13.7%, a dangerously high level. In May 2010 eurozone countries and the IMF agreed a €110bn bailout package.

With the Greek problem temporarily averted, attention then turned to the other PIIGS, particularly Ireland, which was thrown into crisis. At the end of 2010, Ireland introduced a stringent budget, and the EU and IMF agreed a bailout of €85bn.

In early 2011, the eurozone set up a permanent bailout fund, the European Stability Mechanism, as a way of dealing with future country crises without needing protracted talks. This fund was projected as worth €500bn, though most of that came as pledges from eurozone countries rather than as hard cash. The question of whether this money could be realised in the face of a general crisis was raised, particularly in the UK – which is not in the euro – but eurozone finance ministers and prime ministers reiterated their confidence in the plan.

The spotlight then turned onto the weak public finances of Portugal, forcing another round of bailout talks, culminating in a €78bn rescue package. Greece, however, continued to have problems in repaying its debts, and with a default looking imminent, eurozone ministers demanded a new budget austerity plan from Greece as a condition of receiving the next tranche of its loan. Although the euro is seen as a symbol of the 'ever closer union' that drives the idea of the European Union, and although most European governments are deeply committed to it, ministers in some countries began to talk openly about the possibility of Greece leaving the euro. Nevertheless, it was (and remains) obvious that this would be a shocking prospect for most EU governments and ministers, motivating them to do everything in their power to keep the euro intact.

Following yet more deep austerity measures in Greece, designed to improve tax revenues (since evasion and avoidance are common) and reduce public expenditures (on over-generous pensions and public service contracts), the eurozone agreed a €109bn rescue. This was thought to be large enough to contain the Greek crisis and prevent 'contagion' to other countries in the area. However, worries about the reliability of eurozone sovereign debt continued to grow. Sovereign bond yields in Spain and Italy spiked sharply. While borrowing costs in these countries remained much lower than Greece's (which currently pays around 23% to anyone trusting enough to lend to it), it was enough to put these countries' finances into the 'danger zone' in which debt interest payments grow so large that they eat deeply into the public finances and make it increasingly hard to actually repay debt.

While Greece is a very small country in economic terms, and one that could be bailed out with discomfort but without real difficulty, Spain and Italy are much bigger. The GDP of Greece is currently around \$300bn while that of Spain is five times larger at \$1.5trn and Italy's is over seven times larger at \$2.2trn. These are, plainly, not countries whose finances could be bailed out if they got into trouble.

As the main creditor country, German in any case remained sceptical about the policy of providing crutches for the lame ducks. Germany is an oddity among the generally indebted eurozone countries. It runs a large current account surplus, its competitiveness and productivity have improved and continue to improve, it is a net saver rather than a borrower, it has seen deflation rather than inflation. Germany has benefited from the fact that the falling value of the euro has helped its huge export sector. So it has an interest in keeping the euro together. And its government, like those of most other eurozone countries, is deeply committed to the euro as a symbol of European unity. However, its workers – who have raised their productivity at great cost, and have gone through years of tight budgets and wage restraint to make Germany the power-house it is today – really have little in common (economically or culturally) with those of the ‘Club Med’ countries of Greece, Portugal, Spain and indeed southern Italy. They do not see why they should pay to bail out people who have overindulged themselves and seem incapable of reining in their costs.

But unless something was done to help Italy and Spain, the prospect was that the euro could split apart. So in summer 2011 the European Central Bank, the eurozone’s Fed, announced that it would buy Spanish and Italian government bonds in the attempt to keep down those countries’ interest payments. In response, Spain adopted a new constitutional amendment that would keep its budget deficits within strict limits. This helped reassure investors. (However, such reassurance might be misplaced. When the euro itself was created, the member countries agreed to strict rules on government debt and deficits. As soon as the banking crisis struck, however, these were quickly forgotten.)

For its part, after a long period of national argument, Italy adopted its own austerity budget, projecting savings of €50bn. However, these projected savings were trimmed after fierce public disagreement. Standard & Poor’s subsequently cut Italy’s credit rating, which pushed up its borrowing costs once again.

One argument against ‘austerity’ budgets is that they can make it harder to get out of the hole you are in, at least in the short term. When pensions or public-sector wages are cut, people have less money to spend, so business shrinks. The unemployment caused by this, and by the reduction in the number of civil servants, means that even more has to be spent on welfare benefits, making it even harder for a government to balance its books.

This may be one reason why growth in the eurozone came to pretty much of a standstill. Overall, the area grew at just 0.2% in the second half of 2011 – and that is an average of reasonable growth in Germany and a few others, balanced against large contractions in many others. Similarly, the statistic disguised the fact that while governments continued to expand, the private sector across the eurozone, the thing that creates wealth for those governments to spend, was actually shrinking.

With alarms being raised by the UK, the US and the IMF, a meeting of finance ministers and central bankers in Washington DC called for urgent action, but no specific policies were proposed. Eurozone and EU ministers continued to try to create some more credible stability mechanism and (with rumours of imminent failures abounding) to pump more capital into eurozone banks. Though there was little in the way of specific policies, a large bailout given to the Franco-Belgian bank Dexia

reassured the markets that ministers were serious about not letting eurozone banks fail.

Crisis talks continued almost constantly. Again, the fear of a new Greek default triggered a further €8bn of loans. But the news was not all good. Many European banks had invested in Greek debt – indeed, under the Basle banking regulations, sovereign debt was classed as a ‘safe’ asset and banks were encouraged to hold it: as a eurozone nation, which the eurozone would presumably stand behind, Greek debt might have seemed safe enough. But in fact, facing the prospect of a default on their loans, it turned out that many banks had accepted a 50% loss instead. Greek banks, meanwhile, faced increasing pressure on their revenues as thousands of Greeks started to open accounts in Germany and other countries, putting their euro savings into these more secure places.

Not even France escaped the market pressure. In January 2012, With out-of-balance public finances, large debts and the prospect of a socialist government coming to power, and no sign of a coherent plan to save the euro, Standard & Poor’s downgraded France (along with half the other eurozone countries). It even downgraded the eurozone bailout fund, the European Financial Stability Facility.

Greece had to continue negotiating with its creditors, hoping they would take a haircut on their loans, in order to reduce its indebtedness and qualify the next tranche of the eurozone loan. The European Commission, the European Central Bank and the IMF continued to put pressure on Greece to honour its agreements to cut costs, but the prospect of yet more ‘austerity’ triggered yet more protests in Greece. Once again, the international lenders indicated that even then, they did not believe the country’s national accounts, demanding €325m further cuts and causing further political turmoil in Greece.

As 2012 wore on, the eurozone’s doldrums deepened. The European Commission forecast negative growth, and unemployment (now a shocking 23% in Greece and 25% in Spain) continued to grow. Greece did not help again, when its General Election in May returned parties who rejected the bailout and austerity package. But they went to the polls again in June, giving most votes to the pro-reform New Democracy party. That would mean that Greece was once again committed to stay in the euro and accept the austerity forced on it by eurozone ministers; though of course that in turn might simply have increased the headache that those ministers faced.

Meanwhile, Italy’s borrowing costs spiked to nearly 4% amid fresh concerns about its competitiveness and forecasts of a significant downturn in GDP, while Spain’s went up to 6%, near the ‘danger zone’ where investors start to desert. Fears for the solvency of Spain’s troubled banks rose when the fourth largest, Bankia, applied for a €19bn government loan. Spain announced it would apply for a €100bn bailout from the eurozone to shore up Bankia and other banks. German objections that the European Central Bank should not simply print money to bail out whole countries were finessed by the compromise that the Bank could indeed bail out particular banks – handing the money to Spain for it in turn to pass on to banks in trouble.

With the summer now over – mainland Europeans take long summer holidays, particularly their politicians and officials – the eurozone debt turmoil is slowly cranking up again. Greece faces yet more loan deadlines, but the eurozone authorities

have decided to hold off and see what happens before firming up the general future policy that everyone has been demanding of them, especially people in the UK and US, whose banks are heavily invested in the eurozone.

The sticking point is Germany. The Weimar era hyperinflation is still prominent in the minds of Germans, as is the spectacular stability of the postwar Deutsche Mark that they created, before giving it up for the euro. They are reluctant to see the euro debased by the Central Bank printing more money to shore up banks and indeed countries that Germans think should sort out their own problems. So as is routine in the horse-trading area that is the European Union, some kind of compromise – the British call it a ‘fudge’ – will have to be cobbled together. How far any such agreement will pacify the markets, however, is another question: the whole eurozone debt crisis has been a story of countries teetering on the edge of bankruptcy, followed by hasty crisis measures aimed more to keep the show on the road than to effect any long-term repairs.

The trouble, though, is that this continuing fudge and indecision is trying to keep on the road a currency system that could explode at any moment. Indeed, the longer that this economically dysfunctional system is kept running, and the more money that is ‘invested’ trying to save it, the larger is the ultimate explosion likely to be and the greater the amount of money that will have been wasted. Unless, of course, you think that a long-term future of repeated crisis talks and repeated policy fudges will actually keep the single currency together. It might, of course: there seems to be no limit to the resource that eurozone ministers are prepared to throw at the problem to keep the system on the road and to save the face of the principle of ‘ever closer union’. The euro – for all its past benefits, bringing transparency to European price differentials, forcing labour-market reforms, and expanding the single market – may be a deeply flawed economic idea, but it is seen as an absolutely crucial political idea. It cannot be abandoned, at least not without a fight.

The question is how bloody the fight will be. US and UK banks are deeply invested in the euro area. Most of them have radically cut back their exposure to sovereign debt, of course – it is countries that are bust now, not just banks. But the UK is a huge trading partner with the eurozone countries, as is the US. The eurozone’s stagnating or even shrinking economy is bad for that trade, which we each need as we struggle to grow and pay off our own debts. And if a messy break-up of the euro, and the failure of European and other banks with large euro holdings, were to occur, the downturn would be even greater – though arguably it would clear the air and enable a long-term recovery based on sound monetary principles to start up. But for some time, at least, things would be tough and turbulent, and a lot of savers, investors and those relying on government pensions and salaries would suddenly find themselves much worse off.