European Crisis Brought about by the Single Currency Euro

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The European debt sovereign crisis is becoming a growing problem. With Greece deemed as having plunged itself into debt default by the markets, there are concerns that it will pose the risk of contagion to other EU countries.

Titled "European crisis brought about by the single currency Euro," this report is an analysis of the European economy in the "short-term economic forecast" produced by Hitachi Research Institute quarterly. Taking into consideration the current situation of the European debt sovereign crisis, this paper points out that the present crisis is not a fiscal balance crisis caused by the loose economy of peripheral countries in the Eurozone, such as Greece and Portugal. In the past decade or so, after the Euro was introduced, there has been a growing disparity in competitiveness between the core countries of the Eurozone, including Germany and France, with the peripheral ones. A capital account crisis was triggered when this imbalance was no longer sustainable, and capital flows into the peripheral countries came to a sudden stop. Based on this reason, the peripheral countries, which gave up their local currency and independent monetary policies to participate in the single currency, were subject to the "original sin" by foreign investors for being incapable of raising funds in their local currency. With domestic liquidity drained, there is a likelihood that they will be driven into debt default.

1. Current Situation of European Debt Sovereign Crisis

Currently, there are worries that debt default (default of government bonds) may occur in Greece, Ireland, and Portugal. Further government interest rates continue to rise in Spain and Italy, which are considered solvent countries (Figure 1). In addition to Greece, which is seen to have gone into de fact debt default, if the price of government bonds were to fall drastically in countries like Spain and Italy, with nominal GDP shares of 11.6% and 16.9%, respectively, in the Eurozone (as of 2010), then the contagion may spread to financial institutions in the core countries, which are holders of the government bonds of these peripheral countries, thus developing into a European financial crisis.

The EU is planning to implement measures to avert such a situation. One of the solutions is to enhance the functions of the European Financial Stability Facility (EFSF), including purchase of the government bonds of EU participating countries, and inject public funds into the financial institutions in Europe. Yet another measure is to bring forward the launch of the European Stability Mechanism (ESM), which is scheduled to succeed the role of the EFSF from 2013. However, these are merely temporary measures, and are a far cry from addressing the true cause of the issue.

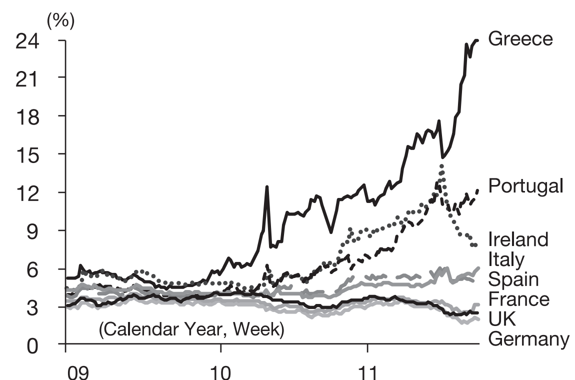

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Figure 1: 10-year Government Bond Yields of Eurozone Countries and UK

2. The Single Currency, Euro – Cause of the Crisis

2.1 The European Debt Sovereign Crisis is a Capital Account Crisis

There are arguments that attribute the cause of the European debt sovereign crisis to the escalating budget deficits in the peripheral countries, or, in other words, their lack of fiscal discipline. Specifically, due to the excessive fiscal deficits, investors became concerned with the financial solvency of the peripheral countries after the financial crisis in 2008, which in turn led to capital flight from these countries. As a result, besides Greece, which is on the verge

of debt default due to lack of fiscal discipline(note), there is also a strong tendency for the core countries to adopt austerity measures such as cuts in expenditures and higher taxes. These actions should not be necessary under normal circumstances, but there is fear that they would plunge into the same situation as Greece if actions were not taken to reduce budget deficits.

However, the present crisis is not a fiscal balance crisis due to failure of the peripheral countries sustaining budget deficits. In fact, countries such as Spain and Ireland, for which the danger of debt default has been a concern, had fiscal surpluses prior to the financial crisis in 2008 (Figure 2). In the Maastricht Treaty that took effect in 1993, one of the "Maastricht Convergence Criteria" for participating countries to realize a single currency is "to maintain budget deficits within 3% of nominal GDP, and for the government's total cumulative debt to be within 60% of nominal GDP." If we look at the average ratio of fiscal balance to nominal GDP in Spain and Ireland over the eight years from 2000 to 2007 before the financial crisis, both were in the black, with a rate of 0.3% for Spain and 1.5% for Ireland. Also, the ratio of total cumulative debt to GDP for both countries was also kept below 60%, with 54.5% for the former and 33.6% for the latter. The reason that the fiscal balance for both countries swung into the red after 2008 is attributable to the drastic drop in tax revenue due to the recession after the financial crisis.

Rather, it was the core countries that failed to observe fiscal discipline. Between 2002 and 2005, the ratio of fiscal balance to GDP in Germany and France fell below the critical value of -3%, while the average budget deficit from 2000 to 2007 was also in the red, with -2.2% in the case of Germany and -2.7% for France. The ratio of total cumulative debt to GDP for the same period was 65.3% for the former and 70.2% for the latter, both exceeding the 60% critical value.

Meanwhile, the current account deficit of the peripheral countries continued to widen after the introduction of Euro in 1999 and conditions up to the 2008 financial crisis (Figure 3). This can be accounted for by the large capital flows from the core countries into the peripheral countries, which have a higher investment return (though, in retrospect, this was a reflection of higher risks).

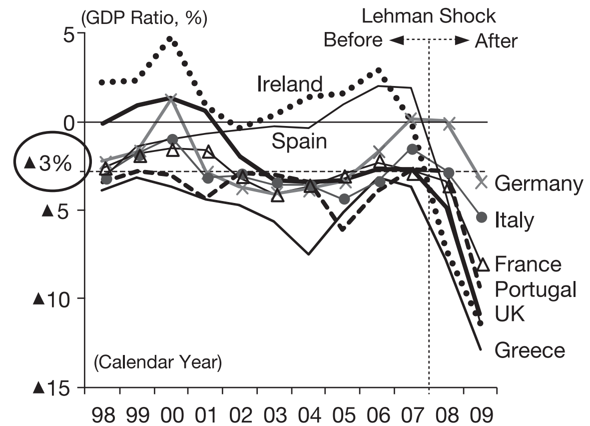

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Figure 2: Fiscal Balance of Eurozone Countries and UK

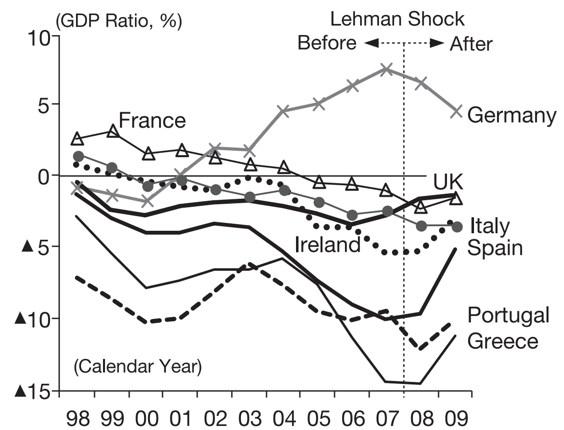

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Figure 3: Current Account Balance of Eurozone Countries and UK

With the growing disparity between the current balance deficit in the peripheral countries and surplus in the core countries of the Eurozone, this imbalance became unsustainable, which resulted in the sudden stop of capital flow into the peripheral countries. This is the true cause of the European sovereign debt crisis, which can be considered a capital account crisis.

2.2 "One Size Fits All" Monetary Policy Led to Disparity in Euro Area

Next, we will consider the background to the capital account crisis in the peripheral countries. The European Central Bank (henceforth ECB) and the National Central Banks (henceforth NCB) of the respective nations act as the central banks for the 17 Euro participating countries. Authority is divided between the two bodies, with the primary authority in the hands of the ECB. The authority

of the ECB includes determination of monetary policies for the Eurozone, such as adjustment of policy interest rates; determination, adjustment and monitoring of open-market operations, planning, adjustment and monitoring the issuance of Euro notes (central bank notes), and foreign exchange operation through intervention (in joint effort with individual NCBs in some cases). Meanwhile, NCBs are responsible for executing decisions made by the ECB, such as by performing open market operation, placing print order for as well as managing and supervising Euro notes, and managing foreign reserves on their own or for the ECB. The principle difference between the two entities lies in whether they are authorized to adjust money supply in the Eurozone or within the country through monetary policies and issuing of Euro notes: the ECB is authorized to make adjustments in the Eurozone, while NCBs do not have the authority to make adjustments in their own country.

Although the ECB plays the key role as the central bank of Eurozone, its monetary policies are biased toward the core countries. It is clearly stated in the Maastricht Treaty that the policy objective of the ECB is "to maintain price stability," with the "Harmonized Index of Consumer Prices (HICP)" used as the benchmark. HICP is a consumer price index for the entire Eurozone, and the monetary policy is managed to control the year-on-year increase of HICP to within 2% in the medium term. It is compiled by weighting the consumer price index measured by the individual Euro member countries based on the household consumption expenditure of each country with respect to the entire Eurozone. Since Germany has the largest household consumption expenditure in the zone (27% of at 2010, with France in the second place at 21%), HICP is therefore most susceptible to the influence of price fluctuations in Germany. In fact, the ECB has adopted a clear stance that does not tolerate inflation in Germany by raising the policy interest rate once the inflation rate in Germany exceeds 2% (interest raise in April and July) (Figure 4). In other words, the monetary policy of the Eurozone can be said to be targeted at the core countries.

Such monetary policies have created a gap between the competitiveness of the core and peripheral countries. As a result of introducing a single currency in the Eurozone, a "one size fits all" monetary policy is introduced in both the core and peripheral countries. When there is a gap in the interest level, this is almost evened out by capital flowing from the core countries into the peripheral ones. While this interest may be an appropriate level for maintaining price stability in the core countries, it is too low for the peripheral economies, which are in the phase of catching up with their core counterparts. This causes economic overheating, and the housing bubble in the case of Spain. While commodity prices (wages) in the peripheral countries are rising with respect to the core countries, the increase was not significant in Germany, where the economy has been sluggish due partly to the reunification of the country. In the past decade or so after the introduction of Euro, labor costs in the peripheral countries have risen sharply compared to Germany, and thus they have been losing their export competitiveness against the core countries (Figure 5).

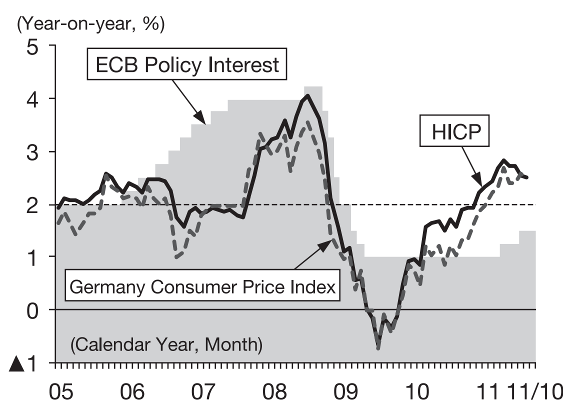

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Figure 4: Policy Rate of ECB, HICP, and Consumer Price Index of Germany

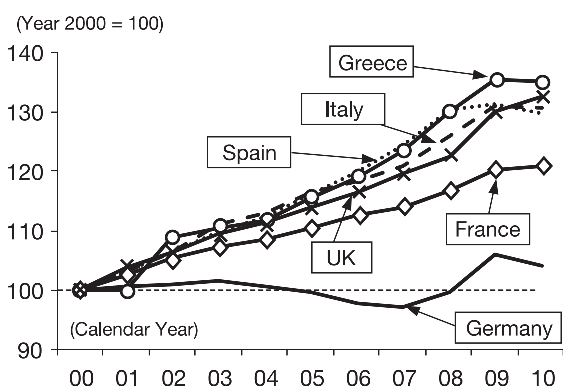

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Figure 5: Wage per Unit Produced in Major European Countries

If labor in the Eurozone were as mobile as that between the states in the US, wage increase could be curtailed by moving to the country with a higher wage. However, the truth is otherwise, and the peripheral countries have lost their competitiveness in export markets as a result. This alone has already failed to satisfy the "optimal currency

area" criteria ((1) free flow of labor, (2) fiscal integration, (3) free flow of goods, services and capital, (4) similarity in economic structure).

2.3 Peripheral Countries Subject to Original Sin

Disparity in the competitiveness between the core and peripheral countries takes the form of growing current account deficit in the peripheral countries through capital inflow from the core countries. However, with the imbalance between the current account deficit in the peripheral countries and the current account surplus in the core counterparts becoming unsustainable, the ongoing capital flow into the peripheral countries suddenly stopped, thus giving rise to the European debt sovereign crisis.

Even if there was a sudden stop of the inflow of capital, the peripheral countries would not have a problem getting loans in their own currency if they had retained their own currency and implemented independent monetary policies. However, by participating in a single currency, Euro, and giving up their local currency, the NCBs of the peripheral countries are not authorized to make adjustments to the domestic money supply even when capital flight occurs. This is likely to drain the domestic liquidity, and drive the countries into debt default. The rising concern that even countries such as Spain and Italy, which are solvent countries, may be driven into debt default stems from fears among investors that liquidity of the peripheral countries may be drained.

When a country, or an emerging country in particular, borrows funds from foreign investors while being subject to the constraint of not being able to borrow in its domestic currency, this situation is referred to as the "original sin." The largest issue of the European debt sovereign crisis is the sudden stop of capital flow into the peripheral countries that are subject to the original sin. In the following, we will show that Euro participating countries subject to the original sin may go into debt default due to the inability to counteract the sudden stop of capital inflow by making a comparison between Spain and the UK, the former being a Euro participating country and the latter a non-member.

Assume there are fears in the UK for the default of gilts, and investors are selling gilts to purchase German government bonds. In order to purchase German bonds, it is necessary to sell Sterling in the foreign exchange market and buy Euro. Sterling that is acquired by the counterparty is bottled up in the UK bank system. Total money supply in the UK remains unchanged because of these investors, and under the control of the Bank of England, the central bank. Thus, the government will not lose the ability to pay for the gilts due to its inability to acquire liquidity in terms of Sterling.

Meanwhile, assume that investors decide to sell Spanish government bonds and purchase German government bonds due to concerns in Spain about the default of Spanish government bonds. Payment for this purchase results in an outflow of Euro from the bank system in Spain to that in Germany. While total money supply in the Eurozone remains unchanged in this case, it has decreased in Spain. Without instruction from the ECB, the Central Bank of Spain is not authorized to increase the reserve deposit through open market operation, or issue orders for the printing of new Euro notes. Consequently, the Spanish government would fail to pay for the Spanish government bonds, which are issued in Euro, due to its inability to acquire liquidity in terms of Euro. If the government interest rate rises in response to fear of such liquidity, the country may be driven into debt default by the high interest rate even if it used to be a solvent country (Figure 6).

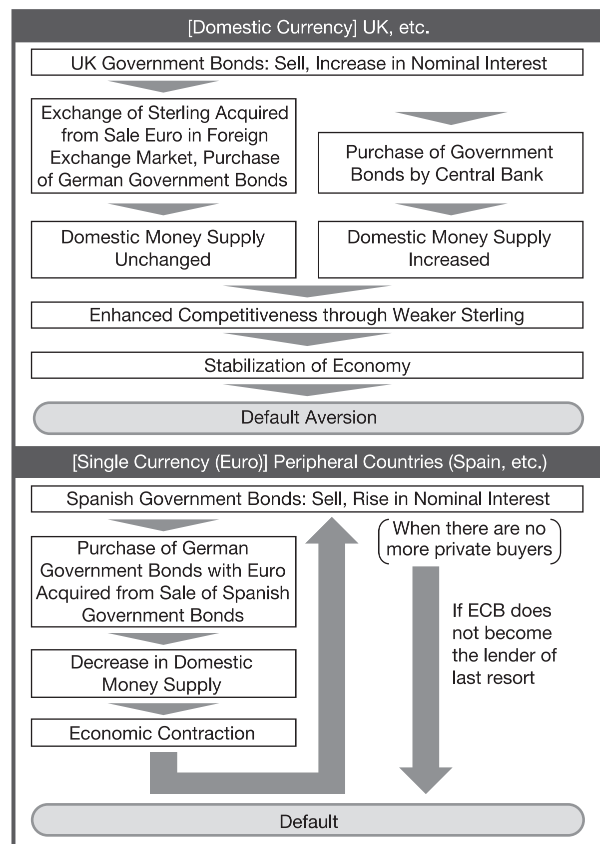

Figure 6: Differences in impact of fears for default between UK (with a domestic currency) and other Eurozone countries (without a domestic currency)

3. Eurozone Faces Challenge on Formation of Optimal Currency Area

In August 2011, the ECB purchased a large amount of Spanish and Italian government bonds from the market to counter concerns for liquidity. This led to a drop in the government bond interest rate in both countries. However, seen as an act of protest against the ECB's hidden fiscal transfers, Jürgen Stark from Germany resigned from his post as an executive board member of the ECB on 9 September, suggesting that the Eurozone countries are unable to take actions as a monolithic organization.

One of the possible short-term measures is to function as the "lender of last resort," such as for the ECB, which holds the authority capable of countering concerns for liquidity, to provide liquidity. Meanwhile, disparity in competitiveness with the core countries should be rectified through lowering of wages and deflation (internal devaluation) in the peripheral countries. But they are also required to increase productivity through structural reforms during the process. The core countries, which have a relatively better fiscal balance, should, instead of opting for austerity measures, increase public spending to stimulate the sluggish Eurozone economy.

As part of the medium, to long-term measures, efforts should be made to break away from the current situation of having common monetary policies and independent fiscal policies, and work toward fiscal integration of the entire Eurozone. If liquidity were to be provided to counter sudden stops in capital flows, it is desirable to procure public funds by issuing Eurobonds based on the credibility of the entire Eurozone. In addition, efforts toward the formation of an optimal currency area will be necessary to facilitate the mobility of labor within the zone.

Note: After the change in the governing party from New Democracy to Panhellenic Socialist Movement in October 2009, a significant downward revision was made to the published data about the budget deficit (ratio of budget deficit to GDP: -5.0% → -7.7% in 2008; -3.7% → -12.5% in 2009).

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