Fiscal union or bust

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ABSTRACT:

Today the Euro and its crisis are invoked in all major financial newspapers and business news. This paper gives some basic background on the history of the Euro, and illustrates the financial discrepancies of the member countries that lead to the current crisis. Additionally, the paper discusses a possible solution that may keep the member countries from going bust.

Keywords: Euro, Fiscal policy, Monetary Policy.

INTRODUCTION

The European Union (EU) is a partnership between 27 European Countries. Of these 27 European countries, seventeen have adopted the Euro as their currency. The Euro was launched in 1999 and, according to the European Commission, the 17 Countries are:

Adopted in 1999: Belgium (BE), Germany (DE), Ireland (IE), Spain (ES), France (FR), Italy (IT), Luxembourg (LU), the Netherlands (NL), Austria (AT), Portugal (PT) and Finland (FI)
Adopted in 2001: Greece (GR)
Adopted in 2007: Slovenia (SI)
Adopted in 2008: Cyprus (CY) and Malta (MT)
Adopted in 2009: Slovakia (SK)
Adopted in 2011: Estonia (EE)

The Euro is today used by 330 million European Citizens. The institution in charge of monetary policy for these 17 countries is the European Central Bank (ECB). The fiscal policy is left to each country with guidance and standards set out by the Stability and Growth Pact (SGP). According to the European Commission, the countries in the economic and monetary union (EMU) are coordinating their national fiscal policies utilizing the SGP. "The Stability and Growth Pact has preventive and a dissuasive arm." With the preventive arm "the member states " must submit annual stability or convergence programmes showing how they intend to achieve or safeguard sound fiscal positions in the medium term taking into account the impending budgetary impact of population aging. The Commission assesses these programmes and the Council gives its Opinion on them". With the dissuasive arm, an Excessive Deficit Procedure (EDP) is triggered when the deficit of a country in the EMU is deemed too high by the Council of the Member States. The Council issues recommendations on how to bring the deficit down. In the case of non-compliance, the Council can impose sanctions.

Today, many economists think that the Euro and the Euro zone was an ill conceived idea. Alan Greenspan (2011), the former Chairman of the Federal Reserve, told CNBC that the "euro zone is doomed to fail because the divide between the northern and southern countries is just too great". For many economists like Nobel winner Christopher Sims (2011), the path to save the Euro zone is to create a Fiscal Union. Lydia Prieg (2011) states that Europe should have a fiscal union similar to the one used in the United States "where individual states still enjoy significant tax autonomy." The Federal government imposes federal income tax but states are free to set state and sales taxes according to their state and local fiscal needs.

THE EURO ZONE AND ITS DEBT CRISIS

There is a big discrepancy among the GDP per person of the 17 countries that have adopted the Euro. According to Table C, in 2011 Luxembourg had the largest GDP per capita with € 82,000 and Estonia the smallest with € 11,900. The size of the GDP is different among countries as well. Table B shows Germany with the largest GDP in Europe in 2012 with € 2,568,480 (Millions of euro) and Malta the smallest with € 6,335 (Millions of euro). In 2012 the seventeen countries had a combined GDP of € 9,264,019 (Millions of euro), second only to the United States. The euro allowed countries in the euro areas to borrow heavily at very low interest rates. According to Robin Emmott (2011) "Bonds issued by southern European nations were taken to be as safe as German ones." However, over the past three years the euro-zone debt crisis is threatening the survival of the euro.

Jeff Cox (2012) from CNBC is reporting that Nouriel Roubini, famous for having predicted the collapse of the United States housing market, sees only problems ahead for the eurozone, "where peripheral nations are struggling with the inability to pay their debts." According to Wood (2012), Greece, Spain, Italy, Portugal, Ireland and Belgium were not ready to be part of a single currency zone. According to the Excessive Deficit Procedure (2012) of the European Commission, "Member States must avoid excessive budgetary deficits. Under the provisions of the Stability and Growth Pact, they agree to respect two criteria: a deficit-to-GDP ratio of 3% and a debt-to-GDP ratio of 60%". From Table A and D we can see that countries did not follow these criteria. Niels Thygesen, a member of the committee that drafted the European Monetary Union, told CNBC in an interview June 7th, 2012 that countries drifted away "from policies embedded in the original rules of the currency union." Antionio Martino (2012) added that "it should have been obvious from the beginning that the threat of high fines to countries not meeting the standard was not credible." Some of the 17 countries, including Germany, were able to violate the two criteria and have not being punished.

MONETARY POLICY IN THE EURO ZONE

The mandate of the European Central Bank is to maintain price stability. According to the ECB's own webpage, the objective of ECB monetary policy is: "the Eurosystem shall also support the economic policies in the Union with a view to contributing to the achievement of the objectives of the Union. These include inter alia full employment and balanced economic growth." The editorial of the Economist (2011) states, "If the ECB is to fulfill its mandate of price stability, it must prevent prices falling. That means cutting short-term rates and embarking on quantitative easing (buying government bonds) on a large scale." This is exactly what the Federal Reserve did. Bernanke stated in his testimony to Congress during his Semiannual Monetary Policy Report in July 2009 that "since December, the targeted funds rate has been effectively at its zero lower bound (more precisely, in a range between 0 and 25 basis points), eliminating the possibility of further stimulating the economy through cuts in the target rate." In the same speech, Bernanke continues to say the nonconventional tools of credit easing was full and center now at the Federal Reserve because of "substantial economic slack and limited inflation pressures, monetary policy remains focused on fostering economic recovering."

The ECB is still not a lender of last resort like the Federal Reserve and has not been as aggressive as the Federal Reserve. The ECB has the benchmark interest rate set at 1% and in December 2011, according to Mario Draghi (2011), the ECB is conducting a form of Quantitative Easing with Long Term Refinancing Operations (LTROs) which gives European banks access to cheap money from the ECB for up to three years. For Gros (2012), the big difference between the two approaches is that "The Fed buys almost exclusively risk-free asset (such as government bonds), whereas the ECB has bought (much smaller quantities of) risky assets for which the markets was drying up. Moreover, the Fed lends very little to banks, whereas the ECB has lent massive amounts to weak banks that could not obtain funding from the market." Even with all of these efforts the borrowing costs of Spain and Italy, fourth and third largest economy of the euro-zone respectively, soared to unsustainable levels (Armitstead, 2012). Mark Zendi, Packard and Cheng are reporting that according to Moody's Analytics, interest rates on government debt above 7% are considered unsustainable.

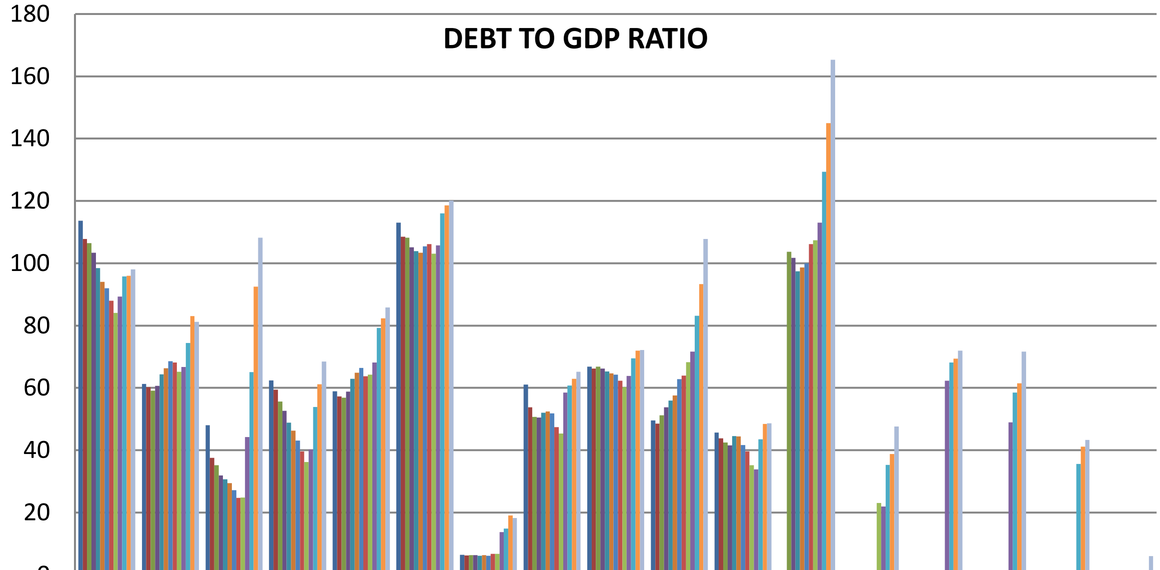
THE NEED FOR FISCAL UNION IN THE EUROZONE

Without a strong intervention of the ECB in the form of heavily buying government bonds, Italy, Spain, Portugal, Ireland and Greece (PIIGS) or any combination of these could be forced to abandon the Euro. Simms (2012) thinks that it is impossible to run a common currency without a fiscal union. The proposal that could stop the soaring borrowing costs for the so called PIIGS could be the introduction of Eurobonds. From the pages of the Wall Street Journal, Walker (2011) is reporting that "members of the currency bloc would sell joint bonds to investors, guaranteeing them collectively. The money raised would be split up among Euro members to cover each nation's borrowing needs, which would have to be collectively approved in advanced". According to Arestis and Sawyer (2011b) "The EMU would need tax-raising powers to be able to service the bonds, and there would have to be EMU fiscal and financial policies." Bagus (2011) stated that "Government deficits must be controlled and effectively restricted by credible sanctions and penalties." This would require a fiscal union stronger than the one adopted by the European Union in the Stability and Growth Pact, where currently the European Commission only tries to prevent excessive deficit, and are doing it unsuccessfully according to the data on Tables A and D. In his summary remarks, Le Cacheux (2010) stated "As abundantly illustrated by vicissitudes of the Stability and Growth Pact and by the poor performance of the economies of the Euro zone over the past few years, fiscal policy coordination is still embryonic and not very satisfactory in the European monetary union, after more than ten years of existence of the European currency."

CONCLUSIONS;

Is the Euro zone worth saving? Ultimately this is the question the 17 countries of the Euro zone must answer. If the answer is affirmative, the Euro zone must work toward lowering the borrowing costs of some of its members. Creating the Eurobonds is only the first step toward a more full integration. According to Farrell (2011) the Stability and Growth Pact should be incorporated into the EU's treaties. In doing so it "would allow the European Court of Justice to adjudicate disputes between EU bodies and member states and help with the pact's enforcement." This would also require a more stringent coordination with the ECB. The ECB has to become the lender of last resort for the member countries that follow the fiscal rules. Arestis and Sawyer (2011a) summarize their position by affirming "The independent European Central Bank which has largely preclude the necessary co-ordination of fiscal and monetary policy, has also disabled the central banking system from providing sufficient support to national governments and their budget deficits." The Euro zone has reached a point in its history where it either comes up with a credible solution to the current crisis or, according to the Editorial of June 9th 2012 of the Economist, "not coming up with a solution guarantees an economic tragedy." What form this "economic tragedy" will take, no one knows and only time will tell. But it is clear that some action would be better than in-action.

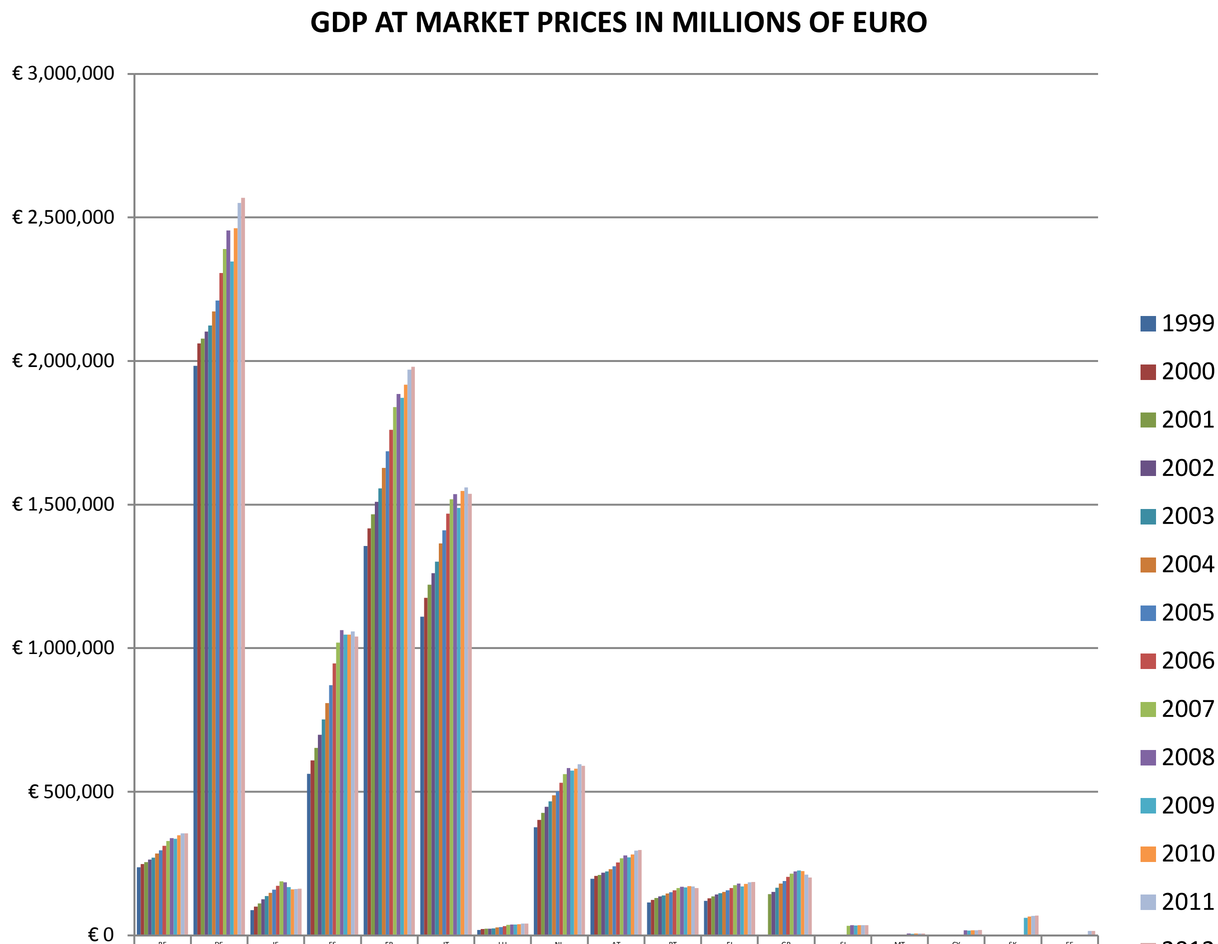
APPENDIX



	BE	DE	IE	ES	FR	IT	LU	NL	AT	PT	FI	GR	SI	MT	CY	SK	EE
1999	114	61.3	48	62.4	58.9	113	6.4	61.1	66.8	49.6	45.7						
2000	108	60.2	37.5	59.4	57.3	109	6.2	53.8	66.2	48.5	43.8						
2001	107	59.1	35.2	55.6	56.9	108	6.3	50.7	66.8	51.2	42.5	104					
2002	103	60.7	31.9	52.6	58.8	105	6.3	50.5	66.2	53.8	41.5	102					
2003	98.4	64.4	30.7	48.8	62.9	104	6.1	52	65.3	55.9	44.5	97.4					
2004	94	66.3	29.4	46.3	64.9	103	6.3	52.4	64.7	57.6	44.4	98.6					
2005	92	68.6	27.2	43.1	66.4	105	6.1	51.8	64.2	62.8	41.7	100					
2006	88	68.1	24.7	39.6	63.7	106	6.7	47.4	62.3	63.9	39.6	106					
2007	84.1	65.2	24.8	36.2	64.2	103	6.7	45.3	60.2	68.3	35.2	107	23.1				
2008	89.3	66.7	44.2	40.2	68.2	106	13.7	58.5	63.8	71.6	33.9	113	21.9	62.3	48.9		
2009	95.8	74.4	65.1	53.9	79.2	116	14.8	60.8	69.5	83.1	43.5	129	35.3	68.1	58.5	35.6	
2010	96	83	92.5	61.2	82.3	119	19.1	62.9	71.9	93.3	48.4	145	38.8	69.4	61.5	41.1	
2011	98	81.2	108	68.5	85.8	120	18.2	65.2	72.2	108	48.6	165	47.6	72	71.6	43.3	6

Table A

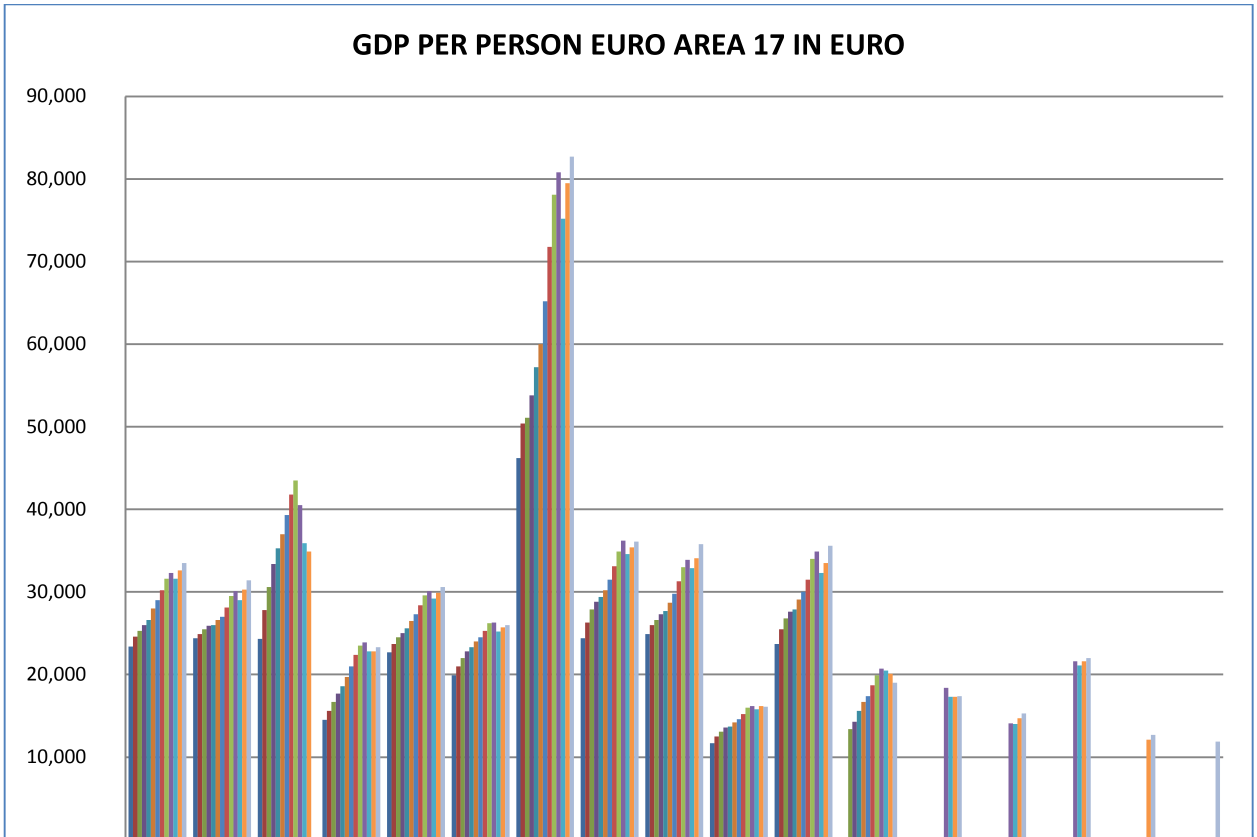
SOURCE: Eurostat



	BE	DE	IE	ES	FR	IT	LU	NL	AT	PT	FI	GR	SI	MT	CY	SK	EE
1999	€ 236,483	€ 1,982,918	€ 87,346	€ 562,399	€ 1,355,945	€ 1,109,788	€ 18,750	€ 376,716	€ 197,353	€ 114,193	€ 120,444						
2000	€ 247,643	€ 2,061,440	€ 99,888	€ 609,228	€ 1,417,311	€ 1,175,430	€ 21,566	€ 401,413	€ 206,575	€ 123,335	€ 128,833						
2001	€ 254,582	€ 2,078,590	€ 110,927	€ 653,021	€ 1,466,031	€ 1,220,612	€ 22,554	€ 426,009	€ 210,261	€ 129,837	€ 135,214	€ 143,719					
2002	€ 263,336	€ 2,102,200	€ 125,059	€ 698,837	€ 1,509,445	€ 1,261,407	€ 23,499	€ 448,073	€ 217,829	€ 135,509	€ 141,843	€ 151,464					
2003	€ 270,787	€ 2,124,270	€ 136,799	€ 751,788	€ 1,556,806	€ 1,301,267	€ 24,364	€ 466,775	€ 222,439	€ 139,291	€ 146,537	€ 165,924					
2004	€ 285,185	€ 2,172,480	€ 147,336	€ 808,605	€ 1,628,310	€ 1,365,073	€ 26,971	€ 487,612	€ 230,822	€ 145,710	€ 151,534	€ 179,962					
2005	€ 296,336	€ 2,210,630	€ 158,600	€ 871,443	€ 1,685,811	€ 1,410,745	€ 28,947	€ 501,236	€ 240,342	€ 150,470	€ 156,706	€ 189,490					
2006	€ 311,554	€ 2,306,660	€ 172,144	€ 946,363	€ 1,760,430	€ 1,467,964	€ 31,788	€ 530,833	€ 254,243	€ 156,488	€ 164,373	€ 203,750					
2007	€ 327,939	€ 2,389,590	€ 187,537	€ 1,019,836	€ 1,839,210	€ 1,518,160	€ 36,172	€ 561,396	€ 268,634	€ 164,660	€ 174,609	€ 215,152	€ 33,184				
2008	€ 338,822	€ 2,454,890	€ 184,288	€ 1,062,520	€ 1,885,270	€ 1,536,229	€ 37,773	€ 582,088	€ 277,846	€ 169,305	€ 180,358	€ 222,423	€ 35,803	€ 5,758	€ 17,157		
2009	€ 336,297	€ 2,346,900	€ 167,400	€ 1,047,059	€ 1,872,356	€ 1,488,599	€ 37,347	€ 573,456	€ 271,974	€ 166,981	€ 170,159	€ 225,351	€ 34,294	€ 5,699	€ 16,854	€ 61,237	
2010	€ 348,110	€ 2,462,100	€ 159,906	€ 1,047,103	€ 1,917,124	€ 1,547,117	€ 38,394	€ 580,795	€ 281,179	€ 170,865	€ 178,955	€ 223,495	€ 35,798	€ 5,865	€ 17,334	€ 65,422	
2011	€ 354,700	€ 2,551,050	€ 161,034	€ 1,058,785	€ 1,970,150	€ 1,559,862	€ 40,893	€ 595,318	€ 295,091	€ 169,890	€ 184,852	€ 211,619	€ 35,354	€ 6,258	€ 17,761	€ 67,945	€ 15,398
2012	€ 354,635	€ 2,568,480	€ 161,894	€ 1,040,121	€ 1,979,470	€ 1,537,921	€ 41,327	€ 590,035	€ 297,384	€ 164,348	€ 186,252	€ 201,589	€ 34,858	€ 6,335	€ 18,018	€ 69,178	€ 15,646

Table B

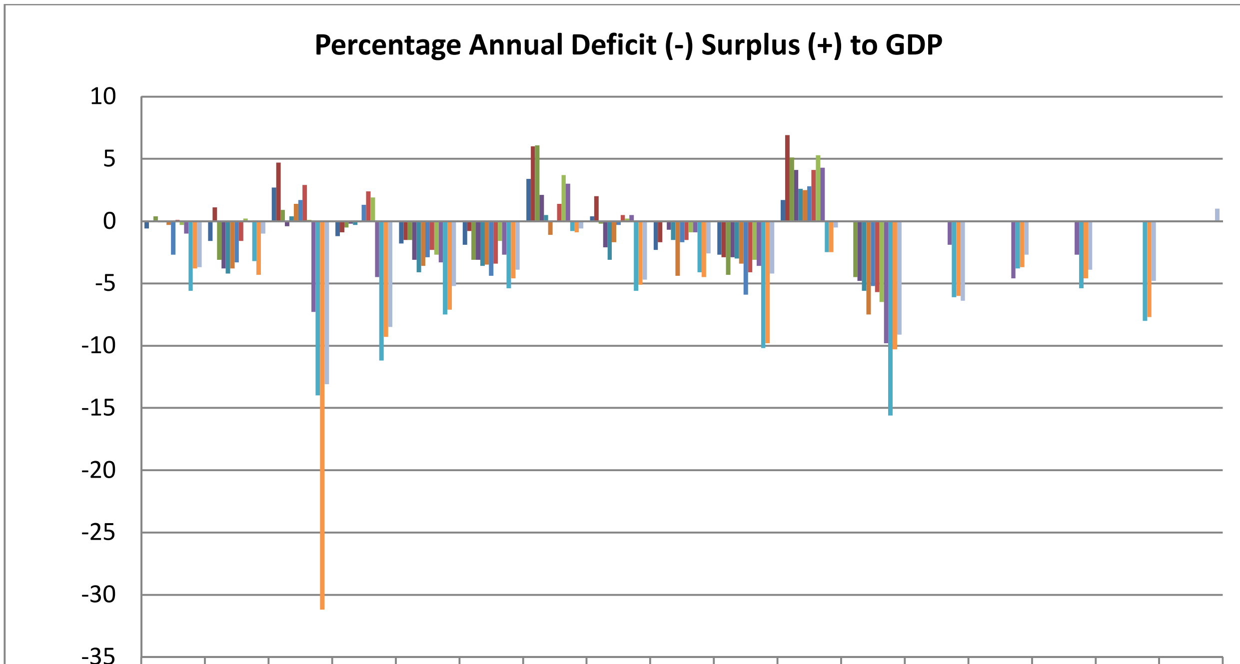
SOURCE: Eurostat



	BE	DE	IE	ES	FR	IT	LU	NL	AT	PT	FI	GR	SI	MT	CY	SK	EE
1999	23,400	24,400	24,300	14,500	22,700	19,900	46,200	24,400	24,900	11,700	23,700						
2000	24,600	24,900	27,800	15,600	23,700	21,000	50,400	26,300	26,000	12,500	25,500						
2001	25,300	25,500	30,600	16,700	24,500	22,000	51,100	27,900	26,600	13,100	26,800	13,400					
2002	26,000	25,900	33,400	17,700	25,000	22,800	53,800	28,800	27,300	13,600	27,600	14,300					
2003	26,600	26,000	35,300	18,600	25,600	23,300	57,200	29,400	27,700	13,700	27,900	15,600					
2004	28,000	26,600	37,000	19,700	26,500	24,000	60,000	30,200	28,700	14,200	29,100	16,700					
2005	29,000	27,000	39,300	21,000	27,300	24,500	65,200	31,500	29,800	14,600	30,000	17,400					
2006	30,200	28,100	41,800	22,400	28,400	25,300	71,800	33,100	31,300	15,200	31,500	18,700					
2007	31,600	29,500	43,500	23,500	29,600	26,200	78,100	34,900	33,000	16,000	34,000	19,900					
2008	32,299	30,100	40,500	23,900	30,100	26,300	80,800	36,200	33,900	16,200	34,900	20,700	18,400	14,100	21,600		
2009	31,600	29,000	35,900	22,800	29,200	25,200	75,200	34,600	32,900	15,800	32,299	20,500	17,300	14,000	21,100		
2010	32,600	30,300	34,900	22,800	29,900	25,700	79,500	35,400	34,100	16,200	33,500	20,100	17,300	14,700	21,600	12,100	
2011	33,500	31,400	-	23,300	30,600	26,000	82,700	36,100	35,800	16,100	35,600	19,000	17,400	15,300	22,000	12,700	11,900

Table C

SOURCE: Eurostat



	BE	DE	IE	ES	FR	IT	LU	NL	AT	PT	FI	GR	SI	MT	CY	SK	EE
1999	-0.6	-1.6	2.7	-1.2	-1.8	-1.9	3.4	0.4	-2.3	-2.7	1.7						
2000	0	1.1	4.7	-0.9	-1.5	-0.8	6	2	-1.7	-2.9	6.9						
2001	0.4	-3.1	0.9	-0.5	-1.5	-3.1	6.1	-0.2	0	-4.3	5.1	-4.5					
2002	-0.1	-3.8	-0.4	-0.2	-3.1	-3.1	2.1	-2.1	-0.7	-2.9	4.1	-4.8					
2003	-0.1	-4.2	0.4	-0.3	-4.1	-3.6	0.5	-3.1	-1.5	-3	2.6	-5.6					
2004	-0.3	-3.8	1.4	-0.1	-3.6	-3.5	-1.1	-1.7	-4.4	-3.4	2.5	-7.5					
2005	-2.7	-3.3	1.7	1.3	-2.9	-4.4	0	-0.3	-1.7	-5.9	2.8	-5.2					
2006	0.1	-1.6	2.9	2.4	-2.3	-3.4	1.4	0.5	-1.5	-4.1	4.1	-5.7					
2007	-0.3	0.2	0.1	1.9	-2.7	-1.6	3.7	0.2	-0.9	-3.1	5.3	-6.5	0				
2008	-1	-0.1	-7.3	-4.5	-3.3	-2.7	3	0.5	-0.9	-3.6	4.3	-9.8	-1.9	-4.6	-2.7		
2009	-5.6	-3.2	-14	-11	-7.5	-5.4	-0.8	-5.6	-4.1	-10	-2.5	-16	-6.1	-3.8	-5.4	-8	
2010	-3.8	-4.3	-31	-9.3	-7.1	-4.6	-0.9	-5.1	-4.5	-9.8	-2.5	-10	-6	-3.7	-4.6	-7.7	
2011	-3.7	-1	-13	-8.5	-5.2	-3.9	-0.6	-4.7	-2.6	-4.2	-0.5	-9.1	-6.4	-2.7	-3.9	-4.8	1

Table D

SOURCE: Eurostat

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