Euro and the Eurozone

- Compared to Brexit, and even the migrant issue, the Euro and the Eurozone debt crisis have receded into the background
  - But last Friday, April 7, European finance ministers agreed that talks for a fourth bailout package for Greece since 2010 could resume
  - Greece faces July due date to pay €7.5 billion of debt
  - Greek debt remains at 180 percent of GDP
  - After years of grinding austerity, standard of living has fallen and unemployment rate remains at 23.5 percent

- Even Euro itself remains in news
  - May 2016, European Central Bank announced that it intended to stop producing €500 note
    - Largest denomination note generally in circulation of the world’s primary currencies
    - A 2010 student indicated that the €500 note was used primarily by criminals
  - Last Tuesday, April 4, the new series €50 note went into circulation
    - New anti-counterfeiting measures, because €50 note is the most counterfeited in Eurozone
    - New series is animal fat free, thus vegan £5 note, which was issued with tallow content, offending vegans, Hindus, and Muslims
Euro and the Eurozone

- How did we get here, and what do the challenges of the Eurozone sovereign debt crisis portend for the future of the EU?
- Today will address three topics
  - Origins and structures of 2002 introduction of unified currency, and structure for its governance, the Eurozone
  - Causes and contours of crisis that has arisen since 2008
  - Some possible, and I think likeliest, outcomes of the crisis for the EU

Euro and the Eurozone

- Idea of common market pregnant with need for a common currency
  - Two of “Four Freedoms” are 1) free movement of goods and 2) free movement of capital;
  - Goods that move freely must be paid for; exposes traders to two risks;
    - Fluctuations of relative value;
    - Transaction costs, fees and commissions to buy and sell foreign exchange
  - Capital that moves freely, to be invested at greatest return, is also subject to these frictional and transaction costs
  - Much more efficient in liberal economic terms to eliminate these costs

Euro and the Eurozone

- **Gold Standard**
  - Before World War I and in interwar era, governed system of foreign exchange
  - Each currency pegged at a fixed weight of gold, and thus relative values of currency were fixed and known
  - Heyday was 1870-1914, but massive spending of World War I destroyed ability of most states, except U.S., to stay on it
  - Great Depression killed Gold Standard; U.K. abandoned 1931, U.S. 1933
Euro and the Eurozone

- **Gold Standard**
  - German Foreign Minister Gustav Stresemann in 1929 called on League of Nations to establish a European common currency to promote trade and economic well-being
Euro and the Eurozone

- Bretton Woods Conference, July 1944
  - 730 delegates from 44 Allied powers, calling selves the “United Nations”
  - Created International Monetary Fund and International Bank for Reconstruction and Development
  - Set up system whereby all other states pegged their currencies to the U.S. dollar, and the U.S. pegged the dollar to $35.00 per troy ounce of gold
  - Possible because U.S. held 60 percent of all gold in the world, and had a huge balance of payments surplus, a surplus of current account

- Bretton Woods system, 1944-71
  - Great stability into late 1960s
  - So initially little need for Europe to consider common currency, focus on eliminating tariffs by 1968
  - But U.S. balance of payments deficit forced Nixon to abandon Bretton Woods on August 15, 1971, and end convertibility of U.S. dollar to gold
  - New international system of “fiat money” and floating currency rates
  - Currencies each backed by “full faith and credit” of issuing government, and value determined by calculations of traders and speculators
Euro and the Eurozone

• Discussions of Monetary Union
  – Europe had begun discussions in 1969, but of a single currency within Bretton Woods
  – “Nixon shock” rendered this first effort moot
  – In 1972, Member States agreed to peg their currencies to each other within a range of ±2.25 percent; called the “Snake in the tunnel”
  – Oil shocks in 1973 and 1979 (and oil discoveries), as well as inflation, forced most Member States to withdraw, leaving a “Deutsche Mark” group of Germany, Denmark, and Benelux

• European Monetary System, 1979
  – Led by Commission President Roy Jenkins
  – Created European Currency Unit (ECU), a “basket” of currencies of Member States based on a weighted average of currencies (based upon size of economies)
  – Exchange Rate Mechanism (ERM I), allowed fluctuations of ±2.25 percent (±6.00 percent for Italy, Spain, Portugal, and U.K.)
  – Supplemented by intervention tool and credit mechanism backed by Member State central banks
  – Created European Monetary Cooperation Fund (EMCF) to allocate ECUs to Member State central banks in exchange for deposits of gold and U.S. dollars

• Economic and Monetary Union, 1988 onward
  – Single European Act of 1985 and determination to complete Single Market increased need to cure friction and transaction costs
  – Delors Report of 1989 set out three stages to accomplish EMU
    • Stage 1 (1990-94): Complete internal market and remove restrictions on further financial integration
    • Stage 2 (1994-99): Establish European Monetary Institute to strengthen central bank cooperation and prepare for European System of Central Banks (ESCB); plan transition to new currency and name it; define criteria for membership (Stability and Growth Pact); achieve economic convergence among Member States
    • Stage 3 (1999 onward): Fix final exchange rates and transition to common currency; establish European Central Bank and ESCB with independent monetary policy-making power; implement binding budget rules in Member States

• Stage 1, 1990-94
  – Directives governing financial matters that promoted completion of single market, especially with respect to free movement of capital
  – Directive on capital movement implemented in all Member States in July 1990

• Stage 2, 1994-99
  – European Monetary Institute replaced EMCF
    • Prepared for creation of ESCB, to include all Member State central banks, not just those of States inside common currency
    • Along with council, chose name “Euro” and designated symbol €
    • Germans opposed calling it the euro, because of French coin, écu
  – Growth and Stability Pact, 1997 set “convergence criteria”
    • Annual budget deficit of no more than 3 percent of GDP, including all levels of government
    • National debt no higher than 60 percent of GDP
    • Enforcement mechanisms for excessive deficits
    • Added to 1993 Copenhagen Criteria for accession to EU, so Euro mandatory for all states that acceded after 1995
Euro and the Eurozone

- Stage 2, 1994-99
  - Harmonization of financial and capital laws of Member States by EU Regulation
    - Prohibition of privileged access, obliging financial institutions to hold any public debt
    - Prohibition of central banks giving credit facilities to public authorities and undertakings, which would mask total debt
    - Deregulatory, neo-liberal thrust, freeing market for cross-border capital transfers
  - Eleven (11) Member States certified on May 3, 1998 as eligible to join common currency on January 1, 1999
    - Few actually met standards; Germany met by sale of assets, non-recurrent credits to offset recurrent expenses
    - Proven in 2011 that Italy was nowhere near convergence criteria in 1998

Euro and the Eurozone

- Eurotower, Frankfurt
  - European Central Bank (ECB)

- Stage 2, 1994-99
  - European Central Bank, June 1, 1998, seat in Frankfurt a.M.
    - Three presidents since then, all former central bank heads
      - Wim Duisenberg, 1998-2003
      - Jean-Claude Trichet, 2003-11
      - Mario Draghi, 2011-present
      - No German yet!
    - Primary objective is to maintain price stability, TFEU Article 127, defined as increase of CPI of 2 percent or less
  - December 1, 1998, EMI fixed exchange rates for 11 countries
    - Deutsche Mark, 1.05885
    - French Franc, 6.55957
    - Italian Lira, 1.93627
Euro and the Eurozone

- **Stage 2, 1994-99**
  - U.K. decided to stay within ERM but outside of EMU, negotiated derogation
  - Sweden has no derogation, obligated to join EMU, but to do that must be member of ERM for 2 years, has never joined ERM, and it is not required to join; so avoids Euro by not joining ERM
  - Denmark had held referendum on whether to join, which failed; so negotiated derogation with option to join later (Treaty of Lisbon Protocol 16)

- **Stage 3, 1999-onward**
  - January 1, 2002, Euro notes and coins introduced
  - Transition exceptionally smooth
  - National currencies withdrawn February 28
  - Convertibility determined by Member State law; indefinite in Germany, ended in France February 17, 2012, after 10 years

Euro and the Eurozone

- **Stage 3 began January 1, 1999**
  - Euro became currency of account, three year transition to circulation
  - Prices in stores appeared in national currencies and Euros, paid in national currencies
  - Eliminated exchange rate fluctuations but not transaction commissions
  - January 1, 2001, Greece, which had been rejected in 1998, now certified, clearly another political decision, nobody believed it met criteria

Eurozone Enlargement

- **January 1, 1999**, 11 Member States
  - Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain
  - January 1, 2001
    - Greece
  - January 1, 2007
    - Slovenia
  - January 1, 2008
    - Cyprus, Malta
  - January 1, 2009
    - Slovakia
  - January 1, 2011
    - Estonia
Euro and the Eurozone

- Eurozone Enlargement
  - January 1, 2014
    - Latvia
  - January 1, 2015
    - Lithuania

- Eurozone Enlargement
  - Obligated to Join
    - Bulgaria
    - Croatia
    - Czech Republic
    - Hungary
    - Poland
    - Romania
Euro and the Eurozone

- Impact of EMU largely salutary after introduction of Euro notes and coins in 2002
  - New governmental group emerged, Eurogroup
  - Formalized in Treaty of Lisbon in 2009
  - Has its own President
    - First was Jean-Claude Juncker
    - Now Jeroen Dijsselbloem

Euro and the Eurozone

- Intra-Union grade grew, with Germany as largest single exporter
Euro and the Eurozone

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- Euro became a reserve currency and appreciated against US dollar
Euro and the Eurozone

- Intra-Union grade grew, with Germany as largest single exporter
- Euro became a reserve currency and appreciated against US dollar
- Interest rates on sovereign debt fell throughout Eurozone

Euro and the Eurozone

- Competed on worldwide basis with US dollar

Euro and the Eurozone

- Governance of Eurozone
  - Early criticisms argued that monetary union without fiscal union, and in view of the chicaneries of accession, mis-perceived risk in peripheral countries
  - Also argued that low interest rates and “huge pool of money” promoted speculative bubbles, especially in real estate
  - First sign of trouble, though, came in recession of 2001-05, when German and France violated SGP criteria for more than 3 years, but escaped sanctions by changing the rules in 2005
Euro and the Eurozone

- Impact of Global Financial Crisis 2007-Present
  - Collapse of housing market in U.S. hit Union for three reasons
    - European banks deeply invested in AAA-rated collateralized debt obligations backed by U.S. mortgages, or in credit default swaps insuring risk
    - Ireland, Portugal, and Spain had had their own real estate bubbles, financed by European banks, and those bubbles now burst; Member States assumed and made sovereign debt
    - As U.S. economy seized up, Union’s export-oriented economy lost a very valuable market
  - Point of spear was Greece, but also Portugal, Ireland, Spain, and perhaps even Italy, “PIGS” or “PIIGS”
Euro and the Eurozone

- Greece
  - Audit in 2004 revealed Greeks had falsified their 1999 deficit to enter Euro in 2001
  - End of 2009: restated deficit from 3.7 percent of GDP, to 6 percent, to 12.7 percent; in May 2010 restated to 13.6 percent
  - Total debt rose to 120 percent of GDP in 2010, now 170 percent before haircut
  - Greek sovereign debt held by other Eurozone Member State banks, as well as credit default swaps; so Greek problem is a Eurozone problem
Euro and the Eurozone

- **Avalanche of Bailout Mechanisms**
  - May 2010, European Financial Stability Facility (EFSF)
  - May 2010, European Financial Stability Mechanism (EFSM)
  - February 2012, European Stability Mechanism (ESM)
  - March 2012, European Fiscal Compact (EFC)

- **European Financial Stability Facility (May 2010)**
  - Eurozone only
  - Can borrow up to €440 billion, backed by Eurozone Member States (Germany 27 percent)
  - Have borrowed €190 million, bailed out Ireland
  - IMF also contributed

- **European Financial Stability Mechanism (May 2010)**
  - Run by Commission, so backed by all 27 Member States
  - €60 billion
  - Operates in concert with EFSF and IMF
Euro and the Eurozone

• European Stability Mechanism
  – Effective January 1, 2013
  – Paid in capital of €80 billion, total capacity of €700 billion
  – Supplemented and then succeeded EFSF
  – Challenge in German Constitutional Court decided on September 12, 2012, dismissed in May 2014

Euro and the Eurozone

• Austerity and Fiscal Orthodoxy
  – Deep budget cuts in Ireland, Greece
  – High unemployment in Spain

Euro and the Eurozone

• European Fiscal Compact
  – Signed by 25 Member States in March 2012, effective January 1, 2013
  – Requires each Member State to enact constitutional requirement of balanced or surplus budget (excluding capital budgets)
    • Court of Justice can fine up to 1 percent of GDP if Member State found in violation
    • Permits 0.5 percent structural deficit; variation for economic cycle
  – Really puts teeth into enforcement of SGP
  – No amendment to TEU or TFEU, torpedoed by David Cameron over financial transaction tax
  – U.K. and Czech Republic outside

<table>
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<tr>
<th>ESM member state</th>
<th>Percentage of contributions</th>
<th>Paid in capital (million €)</th>
<th>Number of shares</th>
<th>Capital subscription (million €)</th>
<th>Nominal GDP 2010 (million €)</th>
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Euro and the Eurozone

- **Other Measures**
  - Direct loans to banks by ECB rather than only to central banks
  - Increased banking regulation by ECB
  - Calls for targeted investments, “Marshall Plan” for the Union
  - Neo-liberal reforms to increase competitiveness
    - Abolish wage indexation
    - Liberalize labor regulations
    - Place pension plans on stable footing, adequately funded
    - Coordinate tax policy to combat fraud and tax evasion

- **Possible Outcomes**
  - Collapse of European Union
  - Debt default and national exits from Eurozone
    - “Grexit” “Hellexodus”
    - Eurobonds
    - European Monetary Fund
    - Europe-wide system of banking regulation and transparency
      - Union located deposit insurance system
      - Union located system of bank examiners
      - Union determined system of capital requirements
      - European credit rating agency
    - Union located deposit insurance system
    - Union system of bank examiners
    - Union determined system of capital requirements
    - European credit rating agency

- **My Prediction**
  - Greatly harmonized banking system
  - Union level examiners and deposit insurance, reduced role for Member State central banks
  - Fiscal union steps in a major treaty revision
  - Greater political role for Parliament and move toward higher profile
  - Union chief executive
  - Perhaps Greek exit, but no other states

- **Flexibility and “Enhanced Cooperation”**
  - Until Treaty of Maastricht (1991-93), taken for granted that Union law and policy would apply equally in all Member States
  - But some Member States reluctant to participate in expansion of competence into new fields, especially monetary union
  - Idea arose of a “two-tier” European Union
Euro and the Eurozone

- Flexibility and “Enhanced Cooperation”
  - Treaty of Lisbon provides general scheme for Enhanced Cooperation, TEU Article 20
  - Requires:
    • Minimum of 9 Member States
    • Deals with a sphere of non-exclusive competence
    • Cooperation must “further the objectives of the Union, protect its interests, and reinforce the integration process”
    • Must be “last resort”
    • TFEU Articles 326-334 provide detailed rules to govern enhanced cooperation