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Is Europe Heading towards Another Euro Crisis?

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The World Health Organisation has declared that the Coronavirus outbreak is a pandemic and, outside China, its epicentre is Europe. Right now, the European country most affected is Italy, which is also a prominent member of the Eurozone. Italy is a country which has already experienced a period of stagnation and soaring indebtedness since the introduction of the euro. The Coronavirus crisis may prove to be the straw that breaks the camel's back by leading to a flurry of bankruptcies. Italy's banking system is weak and may soon encounter serious difficulties. An unprecedently large rescue operation may have to be undertaken by the European Central Bank (ECB) and the Eurozone members.

In the meanwhile, the UK is at the forefront of government intervention to stave off the economic consequences of the Coronavirus having introduced a massive fiscal stimulus programme. The Bank of England has also cut its rate and introduced measures that stimulate lending. The US Federal Reserve has reacted very strongly by cutting interest rates to almost zero and launching a $700bn stimulus programme. The US Congress is on the verge of approving a fiscal stimulus package of nearly USD 1 trillion. By contrast, the Eurozone has been so far unable to take any coordinated fiscal measures, whilst the ECB has introduced a package of weak monetary measures. Why is the Eurozone so slow and so ineffectual in addressing what is likely to be a euro crisis of massive proportions? Why do crises in the Eurozone seem the inevitable result of factors built into the system rather than accidents?

Basic economic principles show that for a monetary union to be successful it has to be applied to an optimal currency area (OCA). Some of the conditions that define an OCA are labour mobility, wage flexibility and a fiscal mechanism that redistributes resources from the regions with a trade surplus to those with a trade deficit. Further, fiscal transfers usually take place in the context of a political union.

The founders of the Eurozone monetary union were well aware that the countries involved did not meet all the OCA conditions. They decided to go ahead nonetheless, guided by the idea that crises will force eventually a political union that would allow fiscal transfers. The founders stood the process on its head. Instead of creating the political union that could support a monetary union, they imposed the monetary union on a non-optimal currency area in the hope that this will lead to further political integration.

If and until that time comes, in the absence of a mechanism for fiscal transfers, Target2 -- the payment system operated by the ECB -- has become by stealth a bailout system for the Eurozone. Whilst other payment systems clear at the end of the day, this is not the case with Target2, which allows credit and debit balances to accumulate without limit. At this time Italy's debit balance in Target2 is about EUR 400 billion, whereas Germany's credit balance is in excess of EUR 800 billion. There are debates about how significant these credit and debit balances are. Some argue that since these are funds owed to and by the ECB, there is nothing to worry about. The ECB has recently admitted, however, that should a country wish to leave the Eurozone the debit balance would have to be repaid. What is important is that the balances in Target2 represent real transfers of wealth from one country to another and may become at any time subject to political scrutiny, especially if credits and debits explode in the midst of the Coronavirus crisis.

The euro is underpinned by the Stability and Growth Pact, which imposes strict limits on government spending and has a strong deflationary bias. Indeed, since the introduction of the euro, GDP growth has slowed down and unemployment has gone up across the Eurozone. Unable to use fiscal tools for economic management, the Eurozone relies an on a one-size-fits-all monetary policy, currently defined by negative interest rates. Negative rates have many detrimental side effects and are not very useful in the context of the Coronavirus crisis. The European Commission has suspended some of the limits on fiscal spending for the duration of the Coronavirus crisis, but this is of little use to countries who are already heavily indebted.

Once the euro was introduced national governments in the Eurozone lost the ability to issue debt in their national currency and their outstanding debt was converted into euros. By the stroke of a pen, their debt became foreign debt and riskier since national central banks could not issue currency to redeem it. Instead of recognising this new reality, market participants were encouraged by various authorities to believe that all national debt should be viewed as Eurozone sovereign risk, although there was no legal basis for this perception. As a result, a period of interest-rate convergence followed, whereby the high interest rates of the countries in the Southern tier of the Eurozone declined drastically towards the level of those of the countries in Northern tier.

Stimulated by suddenly very low interest rates related to the introduction of the euro, loan demand soared. Given the perceived sovereign Eurozone guarantee, there were also plenty of willing lenders. Not surprisingly, a borrowing binge ensued leading to levels of indebtedness difficult to sustain. When the first major Eurozone crisis erupted in Greece in 2009, it became painfully evident that national debt did not benefit from a supranational guarantee. It was entirely at the discretion of the Eurozone members to organise a bailout and to impose conditionality. Moreover, they felt the need to bring in the IMF, which would be equivalent to the US Government asking the IMF for help in the rescue of a US state.

The rescue package for Greece was designed primarily to bailout lenders and not to help Greece. The package became known as "extend and pretend", i.e. payment terms were extended far in the future, when presumably Greece will be able to pay back the loans, but only a small part of the debt was written off. Had Greece not been a member of the Eurozone, it would have been allowed to default and write off a major part of the debt. Instead, the country remained heavily indebted and had to accept draconian austerity conditions -- introduced under the threat of ECB shutting down the banking system -- that led to economic depression and mass unemployment. The resolution mechanism on display during the Greek crisis had the opposite result to that of furthering the political union. It revived old animosities between Northern and Southern Europe and gave rise to nationalist populist movements both in debtor and creditor countries.

The Eurozone is composed of countries which are structurally diverse and with different levels of development. Labour markets diverge in terms of flexibility and industrial relations, which results in significant differences in international competitiveness. Prior to the introduction of the euro, some countries – such as Italy – resolved this issue through periodic currency devaluations. Once this tool was removed, the only way to restore competitiveness is through internal devaluations, which is a euphemism for wage reductions. As these are very difficult to achieve, the Italian economy has lost its competitive edge and has stagnated since the introduction of the euro.

By contrast, Germany that has been able to introduce labour reforms and control wage growth has become exceptionally competitive. It is the world's most successful exporter with the largest trade surplus as a percentage of the GDP. Prior to the introduction of the euro, Germany's currency would have appreciated reducing this structural imbalance. Instead, Germany has an implicitly undervalued currency, which along with advantages has significant drawbacks. There are few incentives to innovate and Germany is relying increasingly on obsolete industries, such as the automobile industry. Its economy has become also excessively dependent on exports to China, a vulnerability highlighted by the current Coronavirus crisis. But, probably the most significant weakness of the German economy is the vast amount of credit extended to by German exporters to foreign customers with doubtful ability to repay. This partly explains the paradox that an economic powerhouse like Germany has a fragile financial system.

Will the Eurozone authorities make the same mistakes in the rescue of Italy, if one is required, as they made in the case of Greece? Will the next Eurozone crisis lead to the collapse of the euro? Not necessarily. As the founders intended, a crisis may prompt some constructive reforms such as a partial banking union and some form of joint-and-several responsibility for bonds issued by member countries. The political will of the leaders to keep the Eurozone together is still very strong and should not be underestimated. Maintaining the Eurozone, however, will continue to inflict pain – economic sclerosis and high unemployment. This may well result in increased populism, nationalism and an electoral disaster for the mainstream political parties, which is a high price to pay for saving the euro.

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