

Does the Greek debt crisis mark the beginning of the end for the Euro?

Written by Conor Slater

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<https://www.e-ir.info/2011/03/01/does-the-greek-debt-crisis-mark-the-beginning-of-the-end-for-the-euro/>

CONOR SLATER, MAR 1 2011

The Euro is the unit of currency used within 16 states (Euro zone) of the European Union (EU). Launched in 1999 and officially adopted in 2002, the monetary union is a potent symbol of integration within the EU and benefits the member states economically through being an optimum currency region (OCR); intra-member benefits include free movement of money, a free and open market, and mobility of labour throughout the region[1]. Extra-Euro zone, the Euro aids its members by making the Euro zone an attractive region in which third countries want to do business through the flexibility offered by the single currency; therefore increasing European presence within the global economy[2].

The European Commission on Economic and Financial Affairs also states that the Euro zone, with its financial and monetary policy centrally managed by the European Central Bank (ECB), is “prudently managed”[3] and that there is less risk of “sudden economic changes that may...disrupt national economies...”[4]. However, the Greek sovereign debt crisis of early 2010 presents a situation in which a Euro zone economy has been adversely effected despite the “prudent management” of the ECB.

Since 1993, Greece had been running deficits that were 100% of GDP, which was against EU rules set out for countries joining the Euro; therefore, when, in 2001, Greece joined the Euro zone, it paid Goldman Sachs and other banks millions of dollars to shield this information from the ECB[5]. This information was disclosed to the press in early 2010, which also revealed the unhealthy state of the Greek economy; cloaked by the record number of mortgages and loans brought about by the historically low interest rates of the ECB[6]. Combined with news from the previous year that the government deficit was twice as large as expected[7], fears were raised that Greece would default on its debts causing credit rating agencies to lower their credit rating to “junk”[8]. The ensuing hunt for states in a similar situation led to the downgrading of both Spain and Portugal[9], members of the “PIIGS” group of countries (Portugal, Italy, Ireland, Greece and Spain) which encountered economic problems upon joining the Euro[10], pushing them towards the same circumstances as Greece are currently in – “The Aegean Contagion”[11].

As the PIIGS teeter on the edge of financial implosion, eyes have turned towards the European Union and the role played by its institutions in the crisis. Its hesitancy to support Greece led to the worsening of the situation – potential investors that could have injected money into the country did not do so; speculation was that if the EU would not support one of its own then it would be folly for an outsider to do so[12].

Doubts are rising amongst members of the global financial community whether the, seemingly untenable, position of the Euro can be righted by the European Union; many believe that the Greek debt crisis and the issues caused by the operation and regulation of the Euro Zone mark the beginning of the end for the Euro.

The Stability and Growth Pact (SGP) was created in 1997 in order to ensure that countries joining the Euro kept their economies stable so not to disrupt the newly formed Euro zone when they joined. The criteria states must adhere to are an annual budget deficit no greater than 3% of GDP and a national debt smaller than 60%; there are penalties for those countries that exceed the figures and endanger the stability of the Euro zone. At face value, these measures are a good way of controlling the tendency of countries to put their own wellbeing before that of others, The

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Economist even went so far as to say, “[*The SGP*] is a political totem, a symbol that euro-using countries will not cheat each other.”[13]

However, in practice, the SGP has been a symbol of the weak, tentative way in which the Euro zone is governed. By 2003, most countries in the Euro zone had breached the rules of the SGP, including the two largest economies in the form of Germany and France, their promise to reach their targets as soon as possible was accepted by the European Commission, who did not impose the penalties incurred[14]. The SGP was undermined further in 2005 when the new rules introducing greater flexibility came into being; this did nothing but make it easier for countries to breach thanks to loopholes that made avoiding penalties easier. Incidentally, Germany and France only managed to correct their deficits by 2007 having successfully evaded punishment by the Commission for four years[15].

Despite not being, strictly, part of the Stability and Growth Pact, the “No Bailout Clause”, introduced in the Maastricht Treaty of 1992 and reinforced by the Lisbon Treaty of 2009, states that countries need not bailout other Euro zone countries that are in financial trouble in order to deter breaches in SGP rules. A stabilisation package was eventually formed but the delay damaged confidence in the Greek economy and its overall recovery[16].

Several of the ECB’s monetary and fiscal policies are to blame for significantly weakening the Euro and the economic stability of the Euro zone member states. To preserve the credibility of the Euro and to display its ability as effective challenger to currencies, such as the US Dollar and Pound Sterling, the ECB underwrote loans for countries, like Greece, who borrowed heavily without having sufficient economic growth to fund the reimbursement.

This heavy borrowing was further promoted through the setting of low interest rates, which encouraged countries who felt that they could easily repay their loans. Economic growth was also impacted in several countries, with the PIIGS especially feeling the effects through a negative impact on competitiveness. The result of the influx of large amounts of money through heavy borrowing is inflation; more money means that it is worth less – prices rise – a country’s standard of living will drop unless wages rise to match, the result of this being higher unit labour costs. Such is the case in the PIIGS countries where left leaning political parties have a dominant tradition and their determination to provide a better life for all is often pursued, regardless of cost[17]. Compared to Germany and Austria, the PIIGS have fallen behind in terms of competitiveness within the EU, reducing the chance that their economies will grow and the likelihood of them paying back.

This is not the first time this situation has occurred in history, however, one key circumstance is peculiar to this instance – membership of a monetary union. Countries who experience a decline in competitiveness can artificially remedy this through the devaluation of its currency, making it cheaper for other countries to buy their products. The PIIGS cannot aid themselves in this way as they are tied down to the Euro and its exchange rate which is in turn manipulated by the stronger economic powers who strongly support changes in Euro valuation in accordance to their own needs. Germany has supported exchange rate policy decisions that boost its high-quality exports outside of the European Monetary Union (EMU)[18].

There remain, nonetheless, avenues open towards a stronger, reformed EMU and Euro. Some[19] believe that the answer lies in the reform of the Stability and Growth Pact with greater intervention in national budgetary affairs and more disposed to rebuking the countries that step out of line. Talk of neutrally conducted audits of national fiscal situations and “strings-attached” deals regarding the Common Agricultural Policy is rife in academia. Applying these reforms in practice, though, will prove to be a greater task than finding the solution; electorates and the minds of key politicians need to be won over, especially when the only way to make these changes function effectively is through greater political integration[20]. The Dutch and French public’s overwhelming rejection of the 2005 European Constitution showed that the climate was not right then and one can assume that it certainly will not be now.

Milton Friedman asked, in 1992, “*How many more fiascos will it take before responsible people are finally convinced that a system of pegged exchange rates is not a satisfactory financial arrangement for a group of large countries with independent political systems and independent national policies?* [21]”. Maybe the Greek debt crisis is the fiasco.

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