FINANCE

"EURO CRISIS: THE FAILURE OF OPTIMUM CURRENCY AREAS"

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INTRODUCTION

In economics, an optimum currency area (OCA), also known as an optimal currency region (OCR), is a geographical region in which it would maximize economic efficiency to have the entire region share a single currency. It describes the optimal characteristics for the merger of currencies or the creation of a new currency. The theory is used often to argue whether or not a certain region is ready to become a monetary union, one of the final stages in economic integration. An optimal currency area is often larger than a country. For instance, part of the rationale behind the creation of the euro is that the individual countries of Europe do not each form an optimal currency area, but that Europe as a whole does form an optimal currency area. The creation of the euro is often cited because it provides the most modern and largest-scale case study of the engineering of an optimum currency area, and provides a comparative before-and-after model by which to test the principles of the theory. The recent crisis has exposed the hollowness of the theory as well as has given economists an opportunity in redefining the model of optimum currency areas.

ROAD TO EURO

The overarching justification for the Euro was not merely economic, but political. A single currency was perceived as a symbol of political and social integration in the post-World War II Europe and a catalyst for further integration in other spheres. At the micro level, the use of a common currency was expected to increase cross border competition, integration and efficiency in the markets for goods, services and capital.

Euro is the official currency of the euro zone: 17 of the 27 member states of the European Union.

1950: Belgium, France, Germany, Italy, Luxembourg and Netherland (6 countries) set up European Coal & Steel Community. The aim was to end the frequent and bloody war between neighbors' which cause the World War II.

1957: Six countries signed treaty of Rome and created European Economic Community or the common market. At that time monetary integration was the least important value.

The disintegration of Soviet Union followed by the end of cold war and emergence of globalization and liberalization led to a major change in the structure and functions of European Union during 1990s.

Maastricht Treaty 1992: It became the basis of European Monetary Integration. It obliges most EU member states to adopt the Euro upon meeting certain monetary and budgetary requirements.

The name Euro was officially adopted on 16 Dec 1995. The Euro was introduced to world financial markets as an accounting currency on 1st Jan 1999 (nonphysical form as travelers cheque, electronic transfers etc.) replacing the former European Currency unit.

Euro as a single currency in the form of bank notes and coins entered circulation on 1st Jan 2002.

CONDITIONS FOR JOINING EMU (CONVERGENCE CRITERIA)

Price Stability: The country must have a rate of inflation no more than 15 percentage points above the average of three countries in EU with lowest inflation rate.

Long Term Interest Rate: Nominal interest rate on long term government bonds should be no more than 2 percentage points above the average of three countries in EU with lowest inflation.

Government budget deficits should be no more than 3% of GDP.

The total government debt should be no more than 60% of GDP.

The national government cannot influence the Central bank's decision.

Exchange rate stability in member countries.

BENEFITS OF SINGLE CURRENCY

Logical component of a common market.

Price transparency

Eliminates the currency exchange cost and the Forex risk.

It facilitates smooth international trade.

Tourists travel becomes easy within EMU.

DISADVANTAGES OF A SINGLE CURRENCY

Increased potential for price wars, especially as large firms enter the local markets, previously served by smaller companies.

Lack of national monetary policy as an important tool for a member state to adjust to the economic equilibrium when it experiences an economic shock.

Public and Private institutions had to spend enormous amount of money to adjust invoices, price lists, pay rolls, bank a/c, databases etc.

Unexpected changes in the macroeconomic environment of an EU member state which may result in imbalance of production, consumption, investment, govt. spending and trade. The worst of it is asymmetric shock. Ex. Economic growth in a country affected by it goes down while in others does not. If a country which is not a member of EU can handle it using monetary and fiscal policies but a member of EU has no right to conduct national monetary policy. The remaining tools are fiscal adjustment, labor mobility and capital mobility.

EUROPEAN SOVEREIGN DEBT CRISIS

From late 2009, fears of sovereign debt crisis developed among fiscally conservative investors concerning some European states with the situation becoming tense in 2010. This included euro zone members Greece, Ireland, Spain & Portugal and also some EU countries outside the area.

Imagine there are two countries, one we can think of as a rich country, the other a relatively poorer country. These countries come together and they say, "Why don't we form a currency union!" Over the course of a decade, the two countries pursue different policies towards growth and the richer country happens to be a little bit more productive than the poorer country. The wages in the poorer country don't necessary adjust and they don't have an exchange rate safety valve because now they're under the same monetary union, and then they have unemployment in the poorer country. How do we start thinking about this mess ?

Imagine a different situation in context of India. We often see confronting situations between the Finance Ministry having control of fiscal measures and RBI in control of monetary measures over debt & deficits management issues. Both blame each other on these issues. Thus even at the national level where there are sub national entities, decision making is always problematic. But since both are operating under one system, it is easy to handle the situations through cooperative efforts.

Taking cue from both the situations, the only conclusion can be drawn that even in a single democratic set up, it is challenging to monitor both monetary and fiscal policies when handled two different institutional set up. Think of another situation when different countries having different systems coming together handing their monetary power to a common central bank and alone left with fiscal powers. Currency Union is no doubt a good idea but it should be backed by strong regulatory measures and flexible and special approach towards some members if lagged behind in the race. In a monetary Union, political decisions taken in one country affect the economies of other countries. But the ECB is a central bank with a limited focus on the macro economy as the economic policies remain controlled by national governments with their own political compulsions and have different fiscal consequences. ***Thus monetary union without a fiscal union seems doubtful***. You cannot expect a fair play when two boxers in the boxing ring belong to two different weight group.

DESCRIPTION OF THE CASE

The sequence of events that led the bursting of bubble is somewhat similar among the GIIPS countries :

> The adoption of the Euro was accompanied by a large fall in the interest rates and a surge in confidence as institutions and incomes expected to converge to those of Europe's northern core economies.
>
> Larger borrowing costs and the expansion of domestic demand boosted tax revenues in the GIIPS. Instead of realizing this as temporary revenue and saving the windfall gains, GIIPS govt. increased spending. From 1997-2007, public spending per person rose by an average of 76% and government's contribution to GDP rose by 3.5 percentage points. Over the same period, per capita employee compensation rose by an average annual growth rate of 5.9% in the GIIPS, considerably faster than the EUN's average of 3.2%. These increases were not matched by improvements in productivity per employee particularly in GIIPS which grew only by 1.3% per year. Blatant fiscal mismanagement added to problems.
>
> The unemployment rates are also different for the Euro zone countries on account of differences in the labor market conditions. As compared to the other countries, Germany has the lowest rate of unemployment due to its short time working scheme and flexible time arrangements in the manufacturing sector. The fact that there has been persistence different in the unemployment levels show that labor mobility remained far more limited as compared to capital mobility despite there being a monetary union.

Domestic demand surged with accelerating domestic services, construction and government expansionary policies but exports stagnated as a share of GDP and imports and the current account deficits soared.

The result was indebtness.

Meanwhile, following reunification, Germany was undergoing a historic transformation to become the world's largest exporter and Europe's entire northern nation economies reaped the benefits of the expanding market and decreased competition offered by the GIIPS. This is only a generalized story but the details vary to some extent within each country.

EUN : Europe's northern members (Austria, Belgium, France, Germany, Netherlands)

GREECE

Prior to the establishment of the Euro, Greece was among the worst economic performers of eventual euro area members. Annual inflation rate was one of the highest in the region. The Greek government paid the highest borrowing premium and GDP growth was the slowest in Europe. The adoption of Euro appeared to solve many of these deficiencies. Inflation fell from an average of 18% from 1980-1995 to just above 3% from 2000-2007. As Greece Stabilized, it quickly became an attractive destination for foreign capital.

CAUSES

After averaging an annual GDP growth rate of 1.1% from 1980-1997, the slowest in eventual euro area members, Greece's economy expanded at an annual average rate of 4.1% over the next ten years.

As the tax revenues rose, the government rapidly expanded spending especially in social transfers and public sector wages. From 1997-2007, Greece increased govt. spending per capita by 140%, compared to 40% in the rest euro area.

Greece Public Sector per capita employee compensation grew by 112% compared to 38% in the rest of euro area.

Country's largest industries are tourism and shipping, both badly affected by the down turn with revenues falling by 15% in 2009 due to financial crisis.

The government misreported the country's official economic statistics to keep within monetary union guidelines. Govt. hid the actual level of borrowing.

Reflecting the economy's rapid growth, public sector deficits remained within what appeared to be reasonable bounds- average 5% of GDP from 2000 to 2007. The picture changed markedly with the financial crisis and when markets realized Greece's chronic failure to report accurate statistics. GDP expanded by only 2% in 2008 and contracted by 2% in 2009 pushing down tax revenues and driving the deficits to the level of 15% by the end of 2009.

With debt ballooning from 96% of GDP in 2007 to 115% in 2009 and the IMF projecting it to reach nearly 150% by 2012. The worry part is that Greece would not be able to repay its loans and the crisis would quickly infect other troubled European nations if necessary actions will not be taken by the Global financial institutions and the leaders.

BEST POLICY RESPONSE

At the moment, as the Greece is a member of the Euro zone, it cannot unilaterally stimulate its economy with monetary policy in the same way as the Federal Reserve of USA expanded its balance sheets by over $ 1.3 tn. by printing new money and injecting in to the system by purchasing outstanding debt. At this moment abandonment of euro and default, though an extraordinarily painful course may eventually prove to be a less costly option for Greece if its adjustment does not succeed and help is not forthcoming. Devaluation and default would shift some of the burden on to foreign creditors, avoid further debt

build up in the bail out and establish conditions for resumed growth much more rapidly than the policies of austerity and adjustment.

What may be a less costly option for Greece may be much worse for its euro area partners. Devaluation and default would lead to losses for the banks, unpredictable contagion effects on other countries and a hit below the waterline on the euro project. There would also be global implications.

Thus in such difficult situations, it is in Europe's and the international community's interest to support Greece and facilitate its adjustment.

IRELAND

Government deficit in 2010 was 32.4% of GDP. The economy expanded rapidly during 1997-2007 due to low corporate tax rates. With low interest rates, there was rapid expansion of credit and property valuations from 2002-2007. The rise in mortgages was accompanied by banks relying heavily on whole sale external borrowing. As property prices showed a downward movement from 2007 Irish banks stood exposed and came under severe pressure. Thus it was not based on government over spending, but from the state guaranteeing the six main Irish based banks that had financed a property bubble. The Government issued a one year guarantee to the bank's depositors and bondholders in 2008 and renewed it for another year in 2009. In November 2010, the government decided to seek an 85 bn. Euro bailout from the ECB and the IMF. But the Banking Crisis turned in to a fiscal problem. In terms of unemployment, Ireland with an unemployment rate of 13.7% is among the worst affected, after Spain which also witnessed a collapse in the property sector.

PORTUGAL

Portuguese republic government have encouraged over expenditure and investment bubbles through unclear public private partnerships and funding of numerous ineffective and unnecessary external consultancy and advisory of committees and firms. It inflated top management bonuses and wages. Though its Public debt and deficit is lower than Greece, it has a significantly large external current account deficit and external debt fuelled largely by private sector borrowing. The Euro zone leaders officially approved a 78 bn. euro bailout package for Portugal. As a part of the bailout, Portugal agreed to eliminate its golden share in Portugal Telecom to pave the way for Privatization.

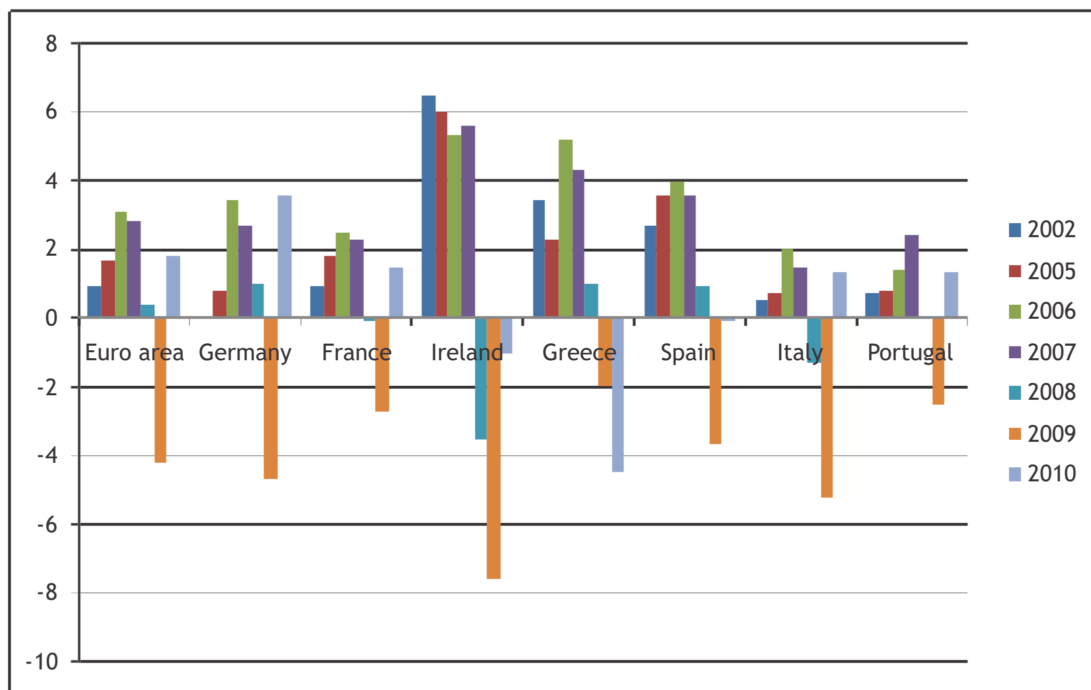
SPAIN

Since Spain joined the European Union in the 1986, the biggest European countries such as France, Germany and the United Kingdom have invested in the Iberian economy. From 1986 to 2009, Spain has received fresh money without real counterparts. This has contributed in the acceleration of its economy. Indeed, when we look back at the case of Spain, we find out that this country had in 2006 a surplus of around 18 billion euros about 1.8% of its GDP. But in 2009 the public deficit was already 11.4% of its GDP. In 2006, the European subvention program to Spain was pulled up. It is therefore no coincidence that the weakest countries in the euro area, are those who have benefited from this fund, since 1986. Moreover, Spain was the largest recipient of EU funds. Indeed, between 1986 and 2006, it received 200 billion euros in the funds. Then, from January 2007, it only received 1.2 billion a year. This reduction of subsidies will cause a contraction in aggregate demand in this country. This will materialize in the real estate crisis, starting in March 2007. Currently there are over one million homes for sale.

MARCO INDICATORS : ANALYSIS

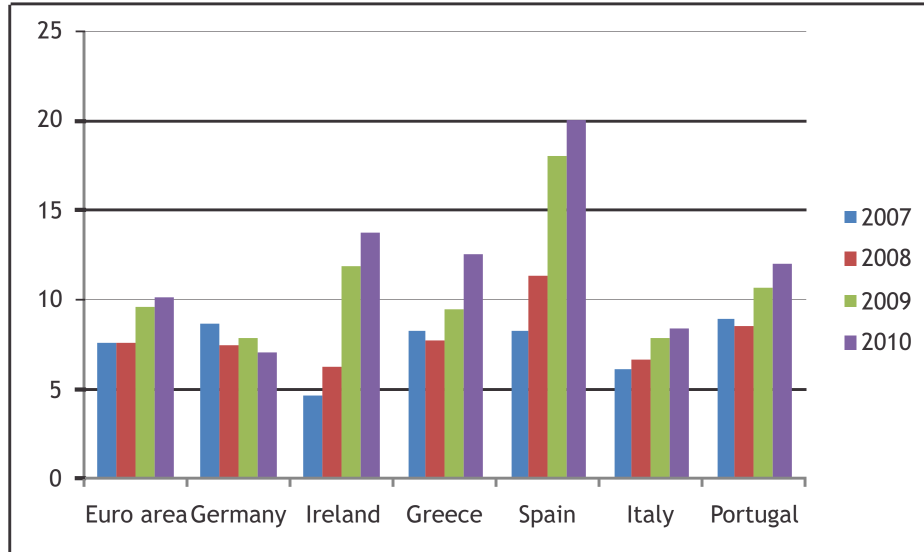
1. GDP Growth (%) (Source: Euro stat)

	2002	2005	2006	2007	2008	2009	2010
Euro area	0.9	1.7	3.1	2.8	0.4	-4.2	1.8
Germany	0.0	0.8	3.4	2.7	1.0	-4.7	3.6
France	0.9	1.8	2.5	2.3	-0.1	-2.7	1.5
Ireland	6.5	6.0	5.3	5.6	-3.5	-7.6	-1.0
Greece	3.4	2.3	5.2	4.3	1.0	-2.0	-4.5
Spain	2.7	3.6	4.0	3.6	0.9	-3.7	-0.1
Italy	0.5	0.7	2.0	1.5	-1.3	-5.2	1.3
Portugal	0.7	0.8	1.4	2.4	0.0	-2.5	1.3



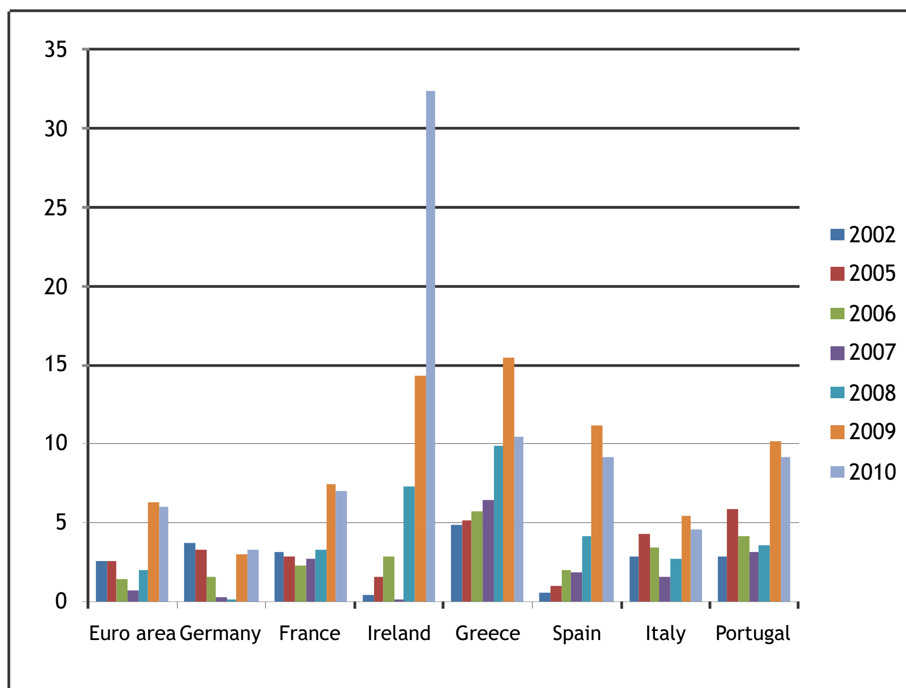
2.0 UNEMPLOYMENT RATE, ANNUAL AVERAGE (%) SOURCE: EURO STAT

	2007	2008	2009	2010
Euro area	7.6	7.6	9.6	10.1
Germany	8.7	7.5	7.8	7.1
Ireland	4.6	6.3	11.9	13.7
Greece	8.3	7.7	9.5	12.6
Spain	8.3	11.3	18.0	20.1
Italy	6.1	6.7	7.8	8.4
Portugal	8.9	8.5	10.6	12.0



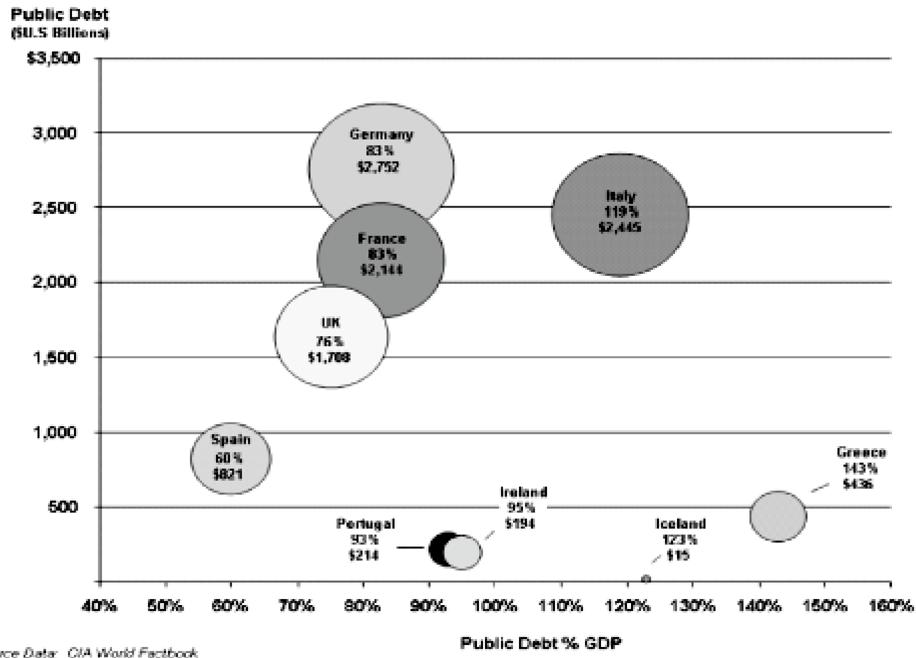
3.0 FISCAL DEFICIT AS % OF GDP (SOURCE: EURO STAT)

	2002	2005	2006	2007	2008	2009	2010
Euro area	2.6	2.5	1.4	0.7	2.0	6.3	6.0
Germany	3.7	3.3	1.6	0.3	0.1	3.0	3.3
France	3.1	2.9	2.3	2.7	3.3	7.5	7.0
Ireland	0.4	1.6	2.9	0.1	7.3	14.3	32.4
Greece	4.8	5.2	5.7	6.4	9.8	15.4	10.5
Spain	0.5	1.0	2.0	1.9	4.2	11.1	9.2
Italy	2.9	4.3	3.4	1.5	2.7	5.4	4.6
Portugal	2.9	5.9	4.1	3.1	3.5	10.1	9.1



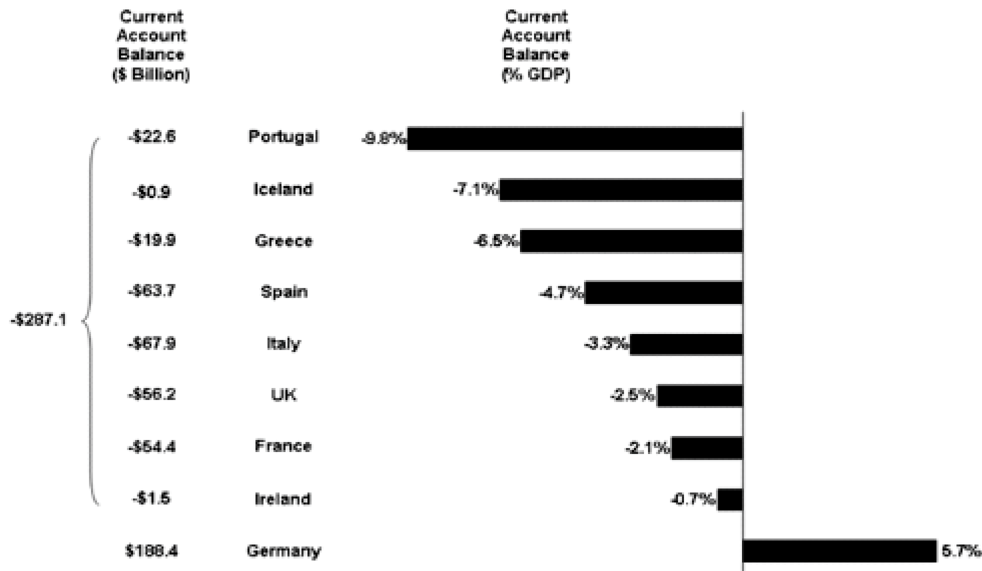
4.0 PUBLIC DEBT

Public Debt and Debt to GDP - 2010



5.0 CURRENT ACCOUNT DEFICITS

Current Account Balances - 2010



Source Data: CIA World Factbook

Current account balances refer to the net import or export activity of a country. A trade surplus is when exports exceed imports. A trade deficit is when imports exceed exports. Germany has a significant trade surplus, meaning it is a net exporter. The other countries often mentioned in this crisis all have trade deficits.

A country with a large trade surplus would generally see the value of its currency appreciate relative to other currencies; which would reduce the imbalance as the relative price of its exports increases. Trade Surplus can drive capital in to other countries but trade deficits, artificially lowering interest rates and creating asset bubbles.

STEPS TAKEN

On May 2010, 27 member states of EU agreed to create the European Financial Stability Facility (EFSF), a legal instrument to provide financial stability. The facility is devised in the form of Special Purpose Vehicle (SPV) that will sell bonds and use the money it raises to make loans up to a maximum of 440 bn. euro in Euro zone nations in need. The bonds were to be backed by guarantees given by the European Commission representing the whole EU, the euro zone member states and the IMF. The measures taken in 2010 had negative effects on the market. Serious doubts remained on the ability of Greece to service its debts. Moody's lowered Greece's credit rating to junk status on June 1, 2011.

An extraordinary summit was again convened on 21 July 2011 in Brussels. The leaders decided to take measures to stop the risk of contagion. They agreed on a further bailout for Greece for 109 billion euros with the participation of the IMF and voluntary contribution from the private sector in order to cover the financial gap. Since this has a contagious effect, even the global leaders have shown their commitment in order to solve the crisis by buying the Euro bonds. But all these measures have so far failed to satisfy the financial markets.

IMPLICATIONS

Since the creation of European Union and Euro Zone has both political and economic motives, its break up would be painful both in economic terms and political fallout. The banks of Germany and France face large exposures. America is one of the trusted trading partners. American banks have over $600 bn. of exposure in the troubled economies.

As far as India is concerned, the EU is a major trading partner and accounted for as much as 20.2% of India's exports and 13.3% of India's imports (2009-10). Bilateral trade between the two has been growing on an average of 9.6% during 2006-10. The total FDI from EU during 2010 amounted to 3 bn. euro while India also invested about 0.6 bn. euro in the EU. In other words a slowdown in the euro zone and the EU is likely to have adverse impact on India's exports.

The current situation provides China an opportunity to gain political mileage by simply offering to hold troubled assets of the euro zone states. These assets could be in the form of sovereign debt as well as real assets like interest in public sector units that may be privatized.

The major impact will be global as the global banking system played a crucial role in transmitting the crisis from the advanced economies to various parts of the world including the emerging markets.

POSSIBLE SOLUTIONS

Fiscal consolidation through austerity measures: Austerity measures no doubt will decrease the expenditure but at the same time, it may further deepen the crisis increasing social costs in the form of unemployment. The growth is already stagnating and prospects of exports leading growth appear dim. Thus austerity measures do not seem to solve the problem but it will no doubt restrict the unnecessary expenditures and force the government to work on its priorities.

FISCAL UNION:

This solution does not seem to work in the short run but no doubt it is must for a successful monetary union. A substantially enlarged European Budget, a common form of

protection of employment on the German lines with more flexibility, greater cross border investment even if this implies takeover of sick public sector units by richer euro zone states or by privatization will be fruitful.

BREAKING THE EURO ZONE :

This seems to be a very costly proposition. The worst affected countries may be helped out but the spillover effect of this will cross boundaries and could lead to insolvency of several euro zone countries.

CONCLUSION

Now, the world is already experiencing the outcome of the crisis. At the moment no any policy options seem to work efficiently. Status quo is also not an option. The situation is either to love it or leave it. Both has its own pros and cons. The situation is so critical that if you love it, be ready to face the bullet and if you leave it, there is a ditch 100ft. depth which will lead you to your natural sad demise. So, it's a high time that the international community understands this and come out with bullet proof jackets to save the Euro from its fall.

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