IIE Chapter 19 Monetary Unions Update

Table 19.1 EMU Membership

Country	Year Joined	Original Currency	Central Government Debt as Percent of GDP, Year of Entry	Central Government Debt as Percent of GDP, Most Recent
Original Members				
Austria	1999	Austrian schilling	66	75 (2011)
Belgium	1999	Belgian franc	112	91 (2011)
Finland	1999	Finnish markka	64	48 (2011)
France	1999	French franc	61	94 (2011)
Germany	1999	Deutsche mark	40	56 (2011)
Ireland	1999	Irish pound	49	106 (2011)
Italy	1999	Italian lira	125	111 (2011)
Luxembourg	1999	Luxembourg franc	5 (2001)	17 (2011)
Netherlands	1999	Dutch guilder	58	66 (2011)
Portugal	1999	Portuguese escudo	61	93 (2011)
Spain	1999	Spanish peseta	61	55 (2011)
Subsequent Members				
Greece	2001	Greek drachma	126	107 (2011)
Slovenia	2007	Slovene tolar	NA	NA
Cyprus	2008	Cyprus pound	144	114 (2011)
Malta	2008	Maltese lira	75	87 (2011)
Slovak Republic	2009	Slovak koruna	38	46 (2011)
Estonia	2011	Estonian kroon	9 (2009)	7 (2011)
Latvia	2014 (expected)	Latvian lat		43 (2011)

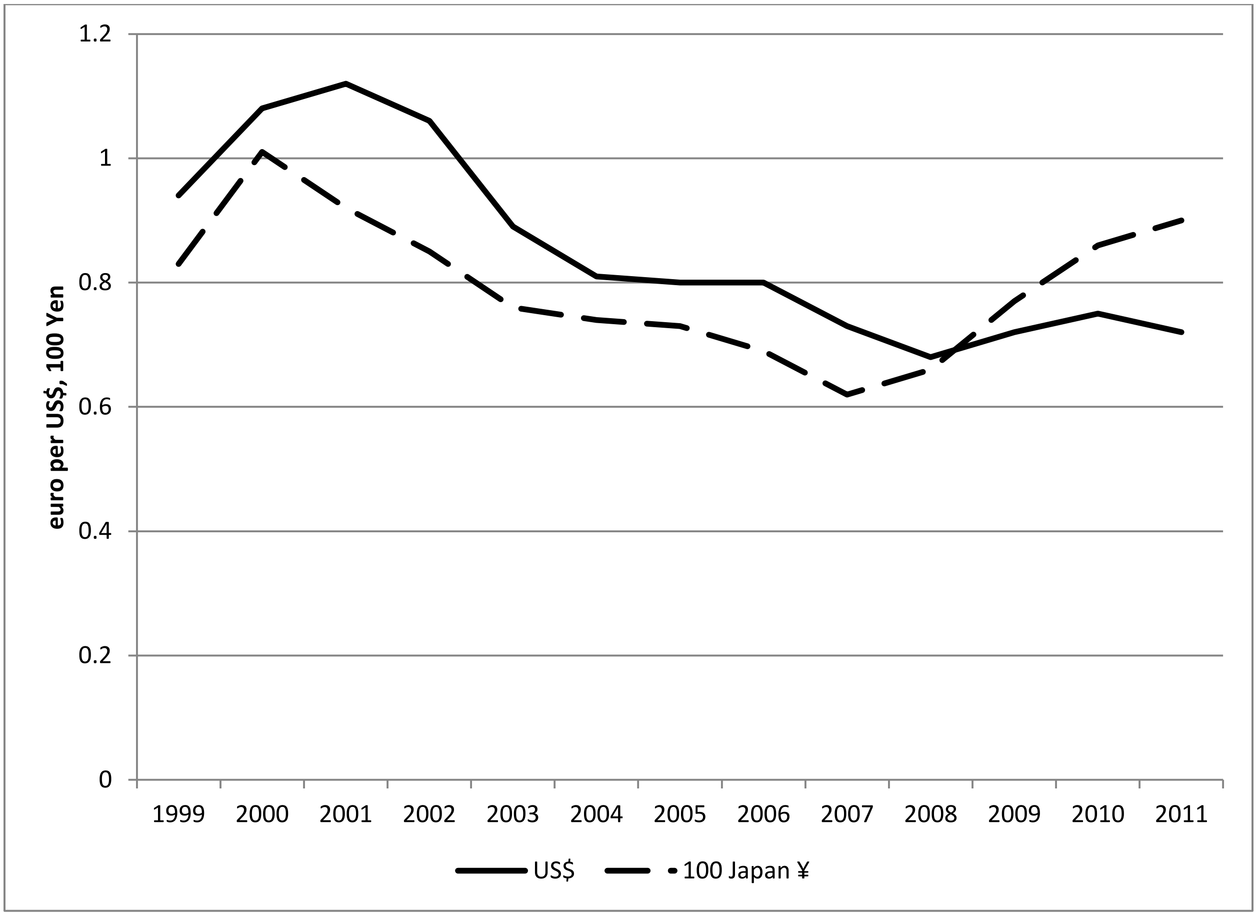
Sources: European Central Bank and World Bank, World Development Indicators Online

Table 19.3. The Evolution of the European Union

Year	Initiative	Treaty	Members Added
1951	European Coal and Steel Community	Treaty of Paris	Belgium France Germany Italy Luxembourg Netherlands
1958	European Economic Community	Treaty of Rome	
1973	Enlargement		Denmark Ireland United Kingdom
1981	Enlargement		Greece
1986	Enlargement		Portugal Spain
1992	European Union	Treaty on European Union (TEU) or the Maastricht Treaty	
1995	Enlargement		Austria Finland Sweden
1999	European Monetary Union		United Kingdom, Sweden, and Denmark not included
2002	Common EMU currency: the euro		United Kingdom, Sweden, and Denmark not included
2004	Enlargement		Cyprus Czech Republic Estonia Hungary Latvia Lithuania Malta Poland Slovakia Slovenia
2007	Enlargement		Bulgaria Romania
2007	EU Constitution	Lisbon Treaty	
2013	Enlargement		Croatia

Sources: Dinan (2010) and europa.eu.

Figure 19.3 The Euro/US$ and Euro/100¥ Exchange Rates, 1999 to 2011



Source: www.oanda.com.

Recent Crises in the EMU

In Chapter 18, we discussed the 2007-2009 "sub-prime crisis." Interestingly, the impacts of this crisis were felt in two German banks (IKB Deutsche Industriebank and Landesbank Sachsen Girozentrale) in 2007 before they were felt by U.S. banks. As noted by James (2009), "the regulation and supervision of (European) banks remained national prerogatives, and many countries continued to insist on their national idiosyncrasies as an argument against a common supervisor and regulator. As long as there was no urgent crisis, there seemed to be no need to address this problem" (p. 122). Well, that crisis appeared.[1] As noted early on by Linnell et al. (2007), there was further

[1] Pisani-Ferry and Sapir (2010) similarly noted: "To say that the European Union (EU) was institutionally ill-prepared to manage a financial crisis, especially on involving systemic cross-border institutions, would certainly not be an overstatement. Well before the 2007-2009 crisis, many authors, both from academia

bank exposure to the U.S. sub-prime market in the United Kingdom, France, Switzerland, the Netherlands, Belgium and Ireland. The U.S. sub-prime crisis was transmitted to Europe via these exposures. The crisis began to take on a serious nature in late 2008, with the Belgian, Dutch and Luxembourg governments needing to step in to rescue the Belgian-Dutch banks Fortis and Dexia. During this time, the Irish government also announced a promise to guarantee both the deposits and debts of six Irish banks.[2] These and other development led to an emergency EU summit and a "Paris Declaration" outlining an action plan for restructuring the EU banking system with pledges of a few trillion euros to back it up.

By 2009, it was clear that the difficulties would be centered on a sub-group of countries (Portugal, Italy, Ireland, Greece and Spain) with the unfortunate acronym PIIGS. Two of the PIIGS, Ireland and Spain, had experienced housing (and construction) booms that came to a rapid end in this crisis. Greece and Ireland became caught up in fiscal crises, and Portugal and Italy suffer from long-term fiscal weakness. The ramifications of these issues on external accounts can be seen in Figure 19.4, which reports their current account balances from 1999 to 2011. As you can see in this figure, all of these countries are experiencing long-term current account deficits through 2008, some (Portugal, Greece and Spain) of large magnitudes relative to GDP. Beginning in 2009, these current account deficits began to shrink.[3]

These issues came to a head in mid 2010 when first Greece and then Ireland were caught up in market speculation of government or sovereign default of the kind we discussed in Chapter 18. Bond yield spreads widened, with Greece (at approximately 12 percent) and Ireland and Portugal (at approximately 6 percent) paying much higher rates than Germany (at approximately 2 percent) on new 10-year bond issues. To address the developing crisis that year, the EU set up the European Financial Stability Facility (EFSF) with funding of €440 billion to issue bond guarantees in order to help soothe the markets. The International Monetary Fund committed a further €250 billion to this endeavor. In the event, bond issues were successful, albeit at high interest rates. Even these efforts were not successful in addressing the case of Ireland. In late 2010, the EU and the IMF had to rescue the Irish economy with a €85 billion package, and all eyes fell on Spain as the next potential crisis. Eventually, the EFSF morphed into the European Stability Mechanism (ESM), a permanent bail-out fund.

These events gave rise to a number of considerations. First, there was talk of centralized EMU bond issues, what came to be known as "blue bonds" as opposed to sovereign "red bonds."[4] Second, there were renewed discussions of whether adjustment in monetary systems should only be the responsibility of deficit countries (the PIIGS) or surplus countries (e.g., Germany and the Netherlands) as well. Finally, the crisis revealed cracks in the central project of the EU, namely political integration. For example, the idea of contributing to the EFSF/ESM did

---

and policy circles, has warned that the architecture for resolving problems within the European single financial market was deficient" (p. 343).

[2] Pisani-Ferry and Sapir (2010) analyzed the rescue of Fortis and Dexia. The Irish bailout was repeatedly criticized by Nobel Laureate economist Paul Krugman. See, for example, Krugman (2010) where he stated: "These debts were incurred, not to pay for public programs, but by private wheeler-dealers seeking nothing but their own profit. Yet ordinary Irish citizens are now bearing the burden of those debts."

[3] Figure 19.4 also reports the current account for Germany with a substantial surplus. This surplus as a percent of GDP was on the same order of magnitude as China, and has not adjusted downward.

[4] Arguments for and against are presented in *The Economist* (2010).

not sit well with the German public. Why should they "bail out" the profligate Greeks, for example? These sorts of political issues will be on the EMU and EU agenda for some time to come.

From 2010 to 2012, EU handling of what proved to be an ongoing crisis was not adept, seeming to lurch from one half-measure to another. A sampling of *Economist* headlines during this period conveys the mood: "Beware of Falling Masonry," "Is Anyone in Charge?" "Europe on the Rack," and "The Cracks Spread and Widen." During this time, a focus was on Greece, which even in 2011 had a current account deficit of approximately 10 percent of GDP (Figure 19.4). 2011 and 2012 saw very large Greek bailouts. In addition, in early 2012, holders of Greek government debt underwent a "haircut," having to exchange old bond for new worth less than half of the original value. Recall from Chapter 18 that the definition of a "debt crisis" involved sovereign default or substantial restructuring of debt. The financial press this 2012 haircut on Greek debt as the largest sovereign default in history because bondholders were in essence forced to accept this deal.

One way to appreciate the intractable nature of the euro crisis is to begin considering it in light of macroeconomic adjustment. Financial columnists who have pointed us in this direction include King (2011) and Wolf (2012). King (2011), for example, noted that reducing Germany's current account surplus as a percent of GDP requires that demand increase in Germany with potentially higher inflation there, an anathema to German sensibilities. Germany's exports could decrease substantially through a large recession in the PIIGS, but these recessions have exacerbated some of the instability behind the crisis, particularly in Greece. Very few of the individuals managing the crisis have proposed solutions to this adjustment problem. Wolf (2012) points out that having removed one macroeconomic adjustment mechanism (currencies and exchange rates), the eurozone has made credit crises all the more likely.

In September 2012, events seemed to take a turn for the better. Germany's constitutional court gave its long-awaited approval of the ESM. The European Commission set out its plan for a long-called-for, EU-wide banking union.[5] In addition, Mario Draghi, head of the ECB, announced that it would begin to purchase the bonds of the PIIGS to aid in their adjustment and thus begin to act as a lender of last resort. Bond yields consequently began to decline. This initially seemed to have been a point at which the euro crisis began to resolve itself.

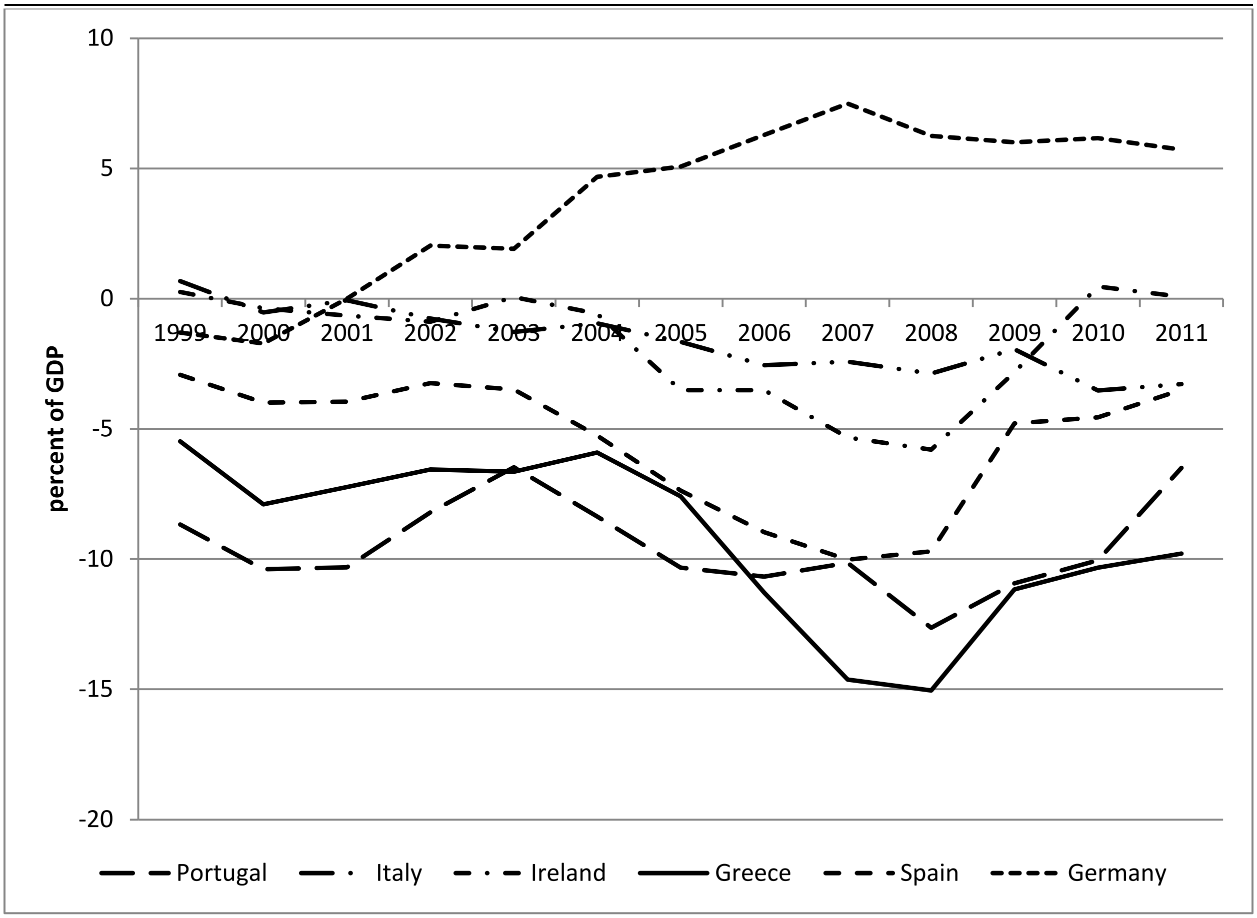
The crisis reasserted itself in March 2013 with a banking crisis in Cyprus. As it turned out, Cypriot banks had assets worth 8 times the county's GDP in 2011. Much of this total was owned by foreigners, including Russians who distrusted economic and legal conditions back at home. The government initially hoped to raise funds by imposing a levy on depositors (9.9% on deposits of over €100,000 but controversially also 6.75 % on deposits below this threshold). In the face of protests and a bank shut-down, this initial proposal was modified and controls on capital outflows introduced. This event shed light on the role of banking within the EU, particularly since Cyprus was not the only country with banking deposits out of proportion to GDP (Luxembourg and Malta also fall into this league).

[5] James (2009) noted: "Although banks were active across national frontiers in a single capital and money market, regulation and supervision remained national. Bank support operations, because they were so expensive, were also national affairs. The consequence of this national focus was heightened uncertainty when there was a need to unravel complex cross-national institutions" (p. 183).

To get a sense of the impacts of these crises on the ground, let's return to the case of Greece. *The Economist* (2013) reported: "the crisis has left a terrible legacy. Five-and-a-half years of recession have wiped out over 25% of output and more than a million private-sector jobs. Tens of thousands of retailers and small manufacturers have gone under. Unemployment is above 27%, a record; for youths it is over 60%."

One major question is how France will play into this evolving crisis in the EMU. Note from Table 19.1 that France's central government debt is of the same order of magnitude as in the PIIGS. France, however is a "core" EMU country, not a peripheral one. If there is one country that could sink the euro in a crisis, France would be it.

Figure 19.4 Current Account Balance in the PIIGS and Germany, 1999 to 2011 (percent of GDP)



Source: World Bank, World Development Indicators Online

New References

The Economist (2013) "Greece's Government: Up, But Not Out," May 25.

James, H. (2009) *The Creation and Destruction of Value: The Globalization Cycle*, Harvard University Press.

King, S. (2011) "Why the Eurozone Deal Will Fail," *The Financial Times*, December 12.

Krugman, P. (2010) "Eating the Irish," *New York Times*, November 25.

Linnell, I., G. Scott, M.-J. Lokerbie and G. Rawcliffe (2007) "European Bank Exposure to Subprime Risk," Fitch Ratings Special Report.

Pisani-Ferry, J. and A. Sapir (2010) "Banking Crisis Management in the EU: An Early Assessment," *Economic Policy*, 25:62, 341-373.

Wolf, M. (2012) "Can One Have Balance of Payments Crises in a Currency Union?" *Financial Times*, February 16.