The EU Mediterranean Countries and the Euro Crisis

Federico Steinberg
Research Fellow
Real Instituto Elcano
Professor of Economics
Autonomous University of Madrid

Since 2010, the euro zone (EZ) has suffered a sovereign debt crisis. Although its effects have been felt by all countries that share the single currency, due to their high level of financial interdependence, the crisis has hit those in the south hardest, i.e. the countries of the Mediterranean Basin (and Portugal). All eyes have turned to Greece, Spain and Italy (and to a lesser extent Ireland) where demands are being made for cuts and reforms to be undertaken. In dealing with its solvency problem, Greece (after many delays) has opted for restructuring its government debt, thereby becoming the first developed country in history to (partially) default on its sovereign debt. Greece is also the primary source of contagion to other countries, since the gravity of its situation is far greater than any of its fellow members. A Greek euro exit, therefore, is not out of the question, and whether this happens or not, the country will have to face up to a lost decade.

Although at the time of writing Italy and Spain have not had to receive financial aid, there are concerns over their economies which lie elsewhere: these are such large countries that should they need a bailout, this could exhaust the current resources of the euro zone and International Monetary Fund's (IMF) stabilisation funds. Furthermore, if they had to restructure their debt it would endanger the very existence of the euro. This is why other EU members have been forcing them (Spain since 2010 and Italy since 2011) to balance their public accounts and undertake very unpopular structural reforms. Furthermore, in the case of Italy (like Greece), the pressure has led leaders to step down and reforms are being implemented by technocratic governments that do not enjoy democratic legitimacy (although in many cases, particularly in Italy, they do have the support of their citizens).

While severe reforms are being undertaken in its southern countries, the EZ, today led by Germany, advances slowly towards better economic governance, which aims to repair the incomplete institutional architecture of the single currency. For the time being the path is one of coordinated fiscal austerity, rather than fiscal and political Union. However, if the reforms take effect and Germany and the European Central Bank (ECB) see the Mediterranean economies of the euro becoming more orthodox and competitive, it is possible that their position may soften and they may offer greater concessions (fresh injections of liquidity to help banks, reactivation of investment and depreciation of the euro, greater resources for the rescue fund and, further down the line, eurobonds and a proper federal budget for the EU). In any case, the EZ has fallen on hard times and its future is being determined by the experiences of its Mediterranean members.

This article analyses the European response to the euro crisis and the role played by the Mediterranean countries. After outlining the steps taken at community level to ensure the stability of the single currency and guarantee its survival, the impact of the euro crisis in Greece, Spain and Italy is analysed.

Saving the Euro

The euro came into being in 1999 with incomplete governance. While its monetary pillars were robust, the coordination of the different fiscal policies that coexisted at its centre were based on fragile commitments; excessive emphasis was given to prevent-

ing inflation as almost the sole criteria of both monetary policy and the ECB's action guidelines; and the decision-making mechanisms were neither very agile nor transparent, allowing certain States to avoid sanctions when they did not comply with the agreed criteria. Furthermore, the EZ's financial regulation lacked the necessary pan-European dimension, its international role was unclear and there was no crisis resolution mechanism or rescue fund for countries or financial institutions with liquidity problems. But, since the euro was a political project, these economic deficiencies went unheeded. Like on so many occasions in the history of European integration, its creators adopted a functionalist approach: they thought that once the single currency was created, the necessary steps would be taken to improve and complete its governance. In a way they were right. The global financial crisis that erupted in 2008 and the current debt crisis that has swept the euro zone since 2010 are forcing improvements in its governance.

At the beginning of 2012, the most pressing issue is still that of breaking the hellish cycle in which public debt and the European banks feed one another. This calls for a definitive solution to the Greek issue, to halt the contagion effect of Greece's controlled default on other countries and to recapitalise the banks. Since 2010, each time that the financial markets have increased pressure on the sovereign debt of the EZ's periphery countries, the EU has been able to reach agreements that have gained it time. However, technical solutions such as expanding the rescue fund or using its resources to cover part of the debt of the likes of Italy or Spain, will not easily resolve the underlying political problem of deciding if the EZ is heading towards fiscal union, and defining the role of the ECB, which to date has not acted consistently as a lender of last resort for the States. Regulations have already been approved, throughout 2011, to avoid macroeconomic imbalances within the EZ and reinforce financial regulation.

Likewise, at the request of Germany, in 2012 a new Fiscal Agreement was approved, which has taken the form of a 25-state intergovernmental treaty – the United Kingdom and the Czech Republic refused to sign it. According to this agreement, all countries must incorporate the golden rule into their national legislation, which requires a balance between revenue and public spending throughout the cycle – something which Germany and Spain have already achieved – setting the structural public deficit ceiling at 0.5% above GDP. Furthermore, the budgets and the structural reform policies will be overseen by the Commission, which could veto the annual public accounts if the countries are receiving financial aid from the European rescue fund.

So in actual fact, everything that has been decided in recent European summits goes no further than to take seriously what was already decided in June 1997 in the Stability and Growth Pact. Moreover, what has been agreed now implies the same problems as the pact made fifteen years ago: all measures aimed at achieving stability, with no allusion to "growth." While greater efforts towards achieving stability are welcomed, it is of much greater importance that the EU also creates growth directly. Otherwise, following a recipe of almost exclusive austerity could increase unemployment and social unrest and intensify problems in the financial sector, even causing citizens from certain southern countries (starting with Greece) to contemplate whether it is worth remaining in the euro.

The Mediterranean Countries and the Euro Crisis

Greece, Spain and Italy are in the spotlight of international markets and European institutions because their future economic development will determine the progress of the euro (Ireland and Portugal are also focuses of attention, but the former is fast improving its competitiveness and the latter, although still suffering serious problems regarding growth, deficit and debt, could receive a second bailout without significantly damaging the lending capacity of the European rescue fund and that of the IMF). If the Mediterranean countries manage to reduce their deficits, stabilising levels of debt (preferably without recourse to partial defaults of said debts), reduce their risk premiums, relaunch their exports and generate growth, the euro zone would remain stabilised, and would come out stronger thanks to the improvement in its economic governance, outlined above. However, since they can no longer devalue their currencies, which would have been recession policy before the arrival of the euro, the Mediterranean countries must carry out severe cuts. And since these measures are deeply unpopular, they may not be undertaken, thereby endangering the integrity and future of the Monetary Union.

Greece

Greece is a special case within the euro. Possibly, if it were not a member of the EZ, the collective problems of the Monetary Union would be far less serious, since a large part of Europe's financial instability since 2010 owes to the contagion effect Greece (that represents less than 2% of the EZ's GDP) has had on other countries. During the years before the financial crisis, Greece lied about its public accounts, accumulated the highest levels of debt and deficit of the EZ, lost a lot of competitiveness and permitted significant levels of corruption. Since it received its first bailout in 2010, the world has seen its economy steadily weakened year after year, while the authorities have shown themselves to be incapable of meeting the commitments made with the Troika (European Commission, ECB and IMF). The continued decline of its GDP and its incapacity to reduce its deficit and stabilise its levels of public debt (forcing it, in 2012, to partially default on its payment commitments with the aim of taking the GDP/debt ratio to 120% in 2020, which is believed to be sustainable, although it may not be) responds both to the vicious circle generated by the cuts and low growth, and the State's incapacity to implement the necessary reforms. This makes Greece a unique case, since its institutional problems appear to be extremely serious for the State to have to control the economy; a situation which is not happening in any other developed country.

The severity of the Greek case has given the country cause to consider leaving the euro. However, since the European Treaties do not contemplate a country's expulsion from the Monetary Union, as long as Greece continues to tighten its belt, funds will eventually be released for future rescues if need be.

Alternatively, the Greek government could decide that it would prefer not to accept the conditions demanded of it and opt for a massive default on its debt, which would undoubtedly be followed by a euro exit. This would spark a currency crisis, with a significant devaluation of the new drachma with respect to the euro, thus allowing Greece to adjust its real salaries accordingly, making exports much more competitive and opening the road to recovery. Simultaneously, there would be a collapse in its financial system and a banking crisis, which would be accompanied by a capital outflow that would force an Argentinean style *corralito*. The country would be left without any sources of external financing, which would send it back into the dark ages financially, making it much harder to initiate short-term growth. The most probable outcome, therefore, is that the authorities continue to try to avoid this apocalyptic scenario, as long as the "people on the street" allow it to.

Spain and Italy

Spain and Italy are similar to one another in certain significant aspects and are very different cases to Greece. Neither has needed to be rescued (yet). Additionally, both have carried out major fiscal adjustments and structural reforms which have allowed them to calm the nervousness of investors in the short term and spur growth in their economies in the long term (in Spain under governments with strong electoral support and in Italy under the Presidency of Mario Monti, a technocrat without democratic legitimacy). The other shared characteristic is their size. Italy represents 17% of the EZ and Spain 11% (respectively they are the third and fourth economies of the Monetary Union), which makes them systemic countries, whose difficulties could lead to contagion within the Union serious enough to reach Belgium and France, seen as part of the euro's core. This is the scenario which must be avoided, since failing to do so may endanger the viability of the euro.

Despite their similarities, both countries have different problems. The level of Italian debt (120% above GDP) is much greater than that of Spain (70%), but the public deficit of Spain (8.5% of GDP in 2011) more than doubles that of Italy (it should be noted though, that Italy has the advantage that most of its debt is in the hands of its residents, which would enable it to undertake a "disguised" partial default on its debt through taxation, which Spain cannot do since it largely depends on non-taxable foreign capital). Also, while both countries have lost competitiveness, with price levels in recent years higher than those of their EZ business partners, Italy has a large export base (particularly in the north) and its "country brand" is more solid.

The aim of both countries is to stabilise their financial situation and improve their growth prospects, which is the only formula to dissipate doubts concerning their capacity to deal with their debts and deficits. However, the speed of the fiscal adjustment demanded by their EU partners is leading both countries, particularly Spain, into the vicious circle that Greece is stuck in, where the cuts intensify the re-

cession, reduce tax revenue and then force fresh cuts. The good news is that the three-year loans at 1% that the ECB began to offer European banks in December 2011 safeguard the banks, allowing the States to avoid generating fresh debt to bailout their financial institutions. The ECB, however, has also made it clear that it will not act as a lender of last resort for the States, so speculative attacks on the Italian or Spanish debt may reappear.

In any case, the need for a financial rescue should not be ruled out, and – as is particularly the case for Italy – they may even be forced to restructure part of their debt. The question to which no one has the answer is whether or not this will mean the end of the EZ. In all likelihood, once the new Fiscal Compact is signed, Germany will agree to increase the resources of the EZ's permanent rescue fund. Furthermore, the IMF could channel additional resources towards the EZ, contributed by emerging countries in exchange for greater power in the institution. This means that while generating financial instability, an eventual rescue would probably not break the euro. It would be another matter altogether if Italy or Spain partially defaulted on their debts. This situation would constitute the acid test for the single currency. If the euro were able to survive debt restructuring in one of its systemic countries, it could be said that it has passed the acid test. But to know if this is the case – and we hope never to have to put it to the test – we will have to wait sometime yet.

Conclusion

The agreements adopted by the EU in recent months to defend the euro and strengthen economic coordination within the EU – essentially through fiscal stability – are a step towards preserving the single currency, improving its economic governance and increasing European integration. However, under the German leadership, all emphasis has been placed on stability, without regard to growth. During the euro's first ten years, thanks to the boom years, the lack of a European policy on growth was not so serious. However in the current economic climate, it is far more important that the EU also stimulates growth directly, especially in the southern countries, which can only stabilise and reduce their debts if they begin to grow. Otherwise, following a recipe of almost exclusive austerity could increase unemployment and social unrest and intensify problems in the financial sector, even causing citizens from certain southern countries (starting with Greece) to contemplate whether it is worth remaining in the euro.

In the medium and long term the euro crisis may advance the federalisation process which, for pro-Europeans, would mean a happy ending to this turbulent period for the Union. But for the citizens, this greater European integration may not be very attractive, both for its lack of democracy and transparency, and because it represents a particular ideological tendency, which places fiscal austerity and social cuts (aimed at increasing competitiveness) as supreme values, resorting to the use of fiscal policy as a stabiliser of the economic cycle.

The key to clarifying where Europe is heading will be in the development of the EZ's Mediterranean economies during 2012 and 2013. Greece will continue to be an ongoing source of instability, but the Union is equipped with sufficient instruments to be able to manage the financial contagion. Even so, if Greece decides to abandon the single currency, it is impossible to predict how the markets would react. Italy and Spain are, for the moment, solvent economies with problems of liquidity. But if their growth prospects do no improve in the medium term and if the ECB continues to refuse to act as its lender of last resort (it already does so for their banking systems, but not for the States), a financial bailout, or even a debt restructuring, is a possible eventuality. If that moment arrives, the EZ would find itself once again on the edge of the abyss.

References

De Grauwe, P. "The Governance of a Fragile Eurozone", *Working Document* 346, Centre For European Policy Studies, May, 2011.

Sapir, A.; B. Marzinotto and G. Wolff. "What Kind of Fiscal Union?" *Policy Brief*, Issue 2011/06, Bruegel, November, 2011.

Steinberg, Federico and Ignacio Molina. "Un renovado pacto de estabilidad (¿sin crecimiento?) para la UE". *Research journal* of the Real Instituto Elcano. No. 93, January, 2012, pp. 4-11.

Wyplosz, C. "La zona euro y España durante 2011". *Política Exterior*, No. 140, March-April, 2011.