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ЕВРО И АКТУЕЛНА ФИНАНСИЈСКА КРИЗА

THE EURO AND CURRENT FINANCIAL CRISIS

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Резиме

У чланку се разматрају питања везана за јединствену европску валуту у свјетлу актуелне свјетске финансијске кризе. Текст даје преглед поступака и стратегија за прелазак на Европску монетарну унију (ЕМУ) и разматра очекиване користи и негативне ефекте увођења јединствене европске валуте. Од свог увођења 1999. године евро је допринио макроекономској стабилности унутар еврозоне и створио очигледне користи за предузећа, финансијске институције и обичне грађане. Очигледно је да је у првих десет година употребе евра његов учинак био успјешан, али се сада суочава са изазовима услед актуелне финансијске кризе. Садашња криза показује слабости у способности еврозоне да контролише и управља кризама које утичу на фискалну и финансијску стабилност ЕМУ. Криза у Грчкој, која је лоше управљала својом привредом и друге чланице еврозоне довела у заблуду у погледу стварних података о свом буџету, имала је утицаја на цијело подручје у којем је у употреби евро. Мада евро обезбјеђује стабилност чланицама ЕМУ, постоје сумње у способност зоне да одговори на текуће финансијске проблеме.

Кључне ријечи: евро, актуелна финансијска криза, Европска монетарна унија, Грчка, буџетски дефицит.

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Summary

This article discusses the issues related to the European single currency in the context of the current global financial crisis. The paper gives an overview on the process and strategy for transition to the European Monetary Union (EMU) and discusses expected benefits and costs of the formation of the EMU. Since its launch in 1999 the euro has contributed to macroeconomic stability within the euro zone and produces clear benefits for companies, financial institutions and ordinary citizens. It is evident that the performance of the euro has been a success for the first ten years, but it is now faced with challenges owing to the current financial crisis. The present crisis shows that the weaknesses in the control and crisis management competence of the euro zone are affecting fiscal and financial stability in the EMU. The crisis in Greece, which mismanaged its economy and misled other the euro members about its true budget figures, has had an impact on the euro zone as a whole. Although the euro provides stability to the EMU members, there are doubts about the ability of the euro zone to respond to current financial problems.

Key words: the euro, current financial crisis, the European Monetary Union, Greece, budget deficit.

INTRODUCTION

The introduction of a single currency called the euro represents a significant financial development and a big step towards the integration of the European single market.

In early 1990s, the idea of European monetary integration became popular among EU member countries and as a result, two monetary programs were proposed, the Werner Plan and the Delors Report. The EU member countries officially agreed to implement the Economic and Monetary Union (EMU) under the Maastricht Treaty signed in 1992 (Zestos, 2006).

The process and strategy for transition to monetary union adopted by the Maastricht Summit involves a gradual transition to the euro through three stages. European countries can only become part of the currency union at the final stage if they satisfy six "convergence criteria" of which the most important are annual government borrowing (budget deficit) below 3 percent of GDP and national debt below 60 percent of GDP. On 1 January 1999, eleven countries of the European Union adopted the single currency for Europe. These eleven countries were Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain. Three other members of the EU – Denmark, Sweden and the UK – did not join the euro, while Greece did not join the first wave until it satisfied the preconditions for monetary union in

2001 (Resnick, 2001). In 2007 Slovenia joined the euro area, Malta and Cyprus likewise in 2008, while Slovakia entered in 2009.

There is strong debate over whether the Maastricht convergence criteria (budget deficit below 3%) was applied strictly or favourably for Italy, Greece, Portugal and Spain when admitting them to the euro club. Although in the beginning of 1997 German economists forecasted the possibility of the euro's failure and called for the postponing of the start of the implementation of EMU, by March 1998 Italy, Portugal and Spain had qualified for EMU. The suggestion by these economists that the single currency may be degraded through large budget deficits in these countries has proved groundless. Greece was accused of falsifying its reported deficit data to gain membership to the EMU in 2001 (Patterson, 2006).

Monetary policy is conducted by the European Central Bank (ECB) based in Frankfurt. ECB is established by the Maastricht Treaty as an independent institution which is legally obligated to conduct its monetary policy without being subject to political pressure from any member countries.

The euro as a dominant regional currency became the second most important currency after the US dollar. Its influence now extends far beyond European borders, but it still has far to go to rival the US dollar in international monetary affairs.

The euro zone countries represent the largest economically integrated group of countries. With a population of 330 million, it constitutes 20 percent of the global economy (Ferry, 2009). Aside from Britain and Denmark, two of the EU's top ten economies, Sweden and Poland, also decided to remain outside EMU. The countries which formed the monetary union with the single currency believed that the benefits from the union would outweigh the associated costs.

1. THE BENEFITS OF ADOPTING THE EURO

The benefits of issuing a single international currency are often overestimated by policymakers, observers and politicians. Both expected costs and expected benefits from the formation of EMU are not likely to be accurately estimated, as they are not always explicit and evident.

The main benefits of adopting the euro are the elimination of transaction costs and the costs of exchange rate uncertainty, and greater price transparency.

1.1 Transactions costs

The benefit of elimination of transaction costs is that the euro cuts the costs of transferring money from one country to another. This normally arises when customers and businesses exchange currencies to buy goods and services from other countries. According to the survey undertaken by European Commission in 1990, the exchange rates and the commission charges which banks charge

for buying and selling foreign currencies are about 0.4 percent of GDP in the EU. However, for those countries with an advanced banking system like the UK, the saving for transaction costs is much lower, no more than 0.1 per cent of GDP each year (Minford, 2002).

As the huge number of currency exchange transactions operate via the banking system, the banks argue that they will lose an amount of revenue equivalent to savings in transaction costs. On the other hand, most economists disagree, as they do not consider "the banks' lost income as a true cost to the total economy" (Zestos, 2006).

1.2 Exchange rate stability: more trade and investment

It is expected that the elimination of exchange rate risks against the euro will encourage more trade among monetary union countries, increase foreign investment in Europe, and reduce the cost of capital.

Adopting the euro currency restores the confidence of everyone involved in investment or foreign trade with EU partners, because they do not incur unexpected losses due to volatility in exchange rates. There are several studies suggesting that currencies do affect trade, because separate currencies represent a serious obstacle. Due to currency uncertainly investors are often required to pay an extra interest rate called a risk premium on the securities of countries considered to be at risk of devaluation. However, EMU makes these interest rates disappear, therefore reducing the risk of investing in other countries within the Union (Huhne, 2001).

It is evident that the euro eliminates exchange rate risk from euro zone trade, but it is exposed to fluctuations against other major investment and trade currencies such as the US dollar.

1.3 Greater Price Transparency

In the EMU, expressing price in a single currency allows businesses and consumers to compare prices more easily. In terms of efficiency, making prices easy to compare across national markets represents a key advantage of monetary union. Price transparency for small items is unlikely to matter, but for large consumer durables it has a significant effect. Consumers will usually buy from the cheapest sources and thus they will apply pressure to companies to reduce prices and to increase competitiveness (Huhne, 2001).

2. COSTS OF THE MONETARY UNION

The main costs identified in the formation of the monetary union are the loss of exchange rate policies, powers over monetary and fiscal policies, and the possibility of bailing out continental countries with financial problems.

In the case of recession, an EMU country cannot depend on its monetary and exchange rate policies to counter the effects of the failed economy, while a non-EMU member can exercise its monetary policy. Thus, it can reduce interest rates to increase domestic consumption and investment. Under a flexible exchange rate policy, a non-monetary union member can depreciate its currency to improve its trade and thus to increase the value of its exports and to reduce its imports. This would increase the country's GDP (Zestos, 2006).

Fiscal policy represents an alternative instrument to monetary policy for stabilising total demand. Governments with a flexible fiscal policy can borrow money against future tax income to stimulate demand during a recession and repay the borrowings during a boom in the economy. For EMU members, there is a requirement by the Stability and Growth Pact to limit the budget deficit to 3 percent of GDP, in order to prevent irresponsible government borrowing and damaging the European Central Bank's monetary policies (Baimbridge, 2000).

The actual position is, however, that most EMU members do not comply with the Pact and the Treaty regulations. In particular, in 2009 Greece, Ireland and Spain had budget deficits of 12.7 percent, 11.7 percent and 11.4 percent respectively. The overall government deficit in the euro zone as a whole in 2009 was 6.2 percent, while the overall euro zone public debt is 78.7 percent of GDP (ECB Bulletin, March 2010).

Table 2.1: Budget balance and Public Debt, as % of GDP

	Budget surplus (+)/deficit (-)			Public debt		
Country	2007	2008	2009	2007	2008	2009
Belgium	-0.2	-1.2	-5.9	84.2	89.8	97.9
Germany	0.2	0.0	-3.2	65.0	65.9	72.5
Ireland	0.3	-7.2	-11.7	25.1	44.1	64.5
Greece	-3.7	-7.7	-12.7	95.6	99.2	113.4
Spain	1.9	-4.1	-11.4	36.1	39.7	55.2
France	-2.7	-3.4	-7.9	63.8	67.4	77.4
Italy	-1.5	-2.7	-5.3	103.5	105.8	115.1
Cyprus	3.4	1.0	-0.8	58.3	49.3	46.8
Luxemburg	3.7	2.5	-1.1	6.6	13.5	14.9
Malta	-2.2	-4.7	-3.8	62.0	63.6	66.8
Netherlands	0.2	0.7	-4.9	45.5	58.2	62.3
Austria	-0.6	-0.4	-3.5	59.5	62.6	66.5
Portugal	-2.6	-2.7	-9.3	63.6	65.9	75.2
Slovenia	0.0	-1.8	-5.7	23.3	22.5	34.4
Slovakia	-1.9	-2.3	-6.3	29.9	27.7	37.1
Finland	5.2	4.4	-2.2	35.2	34.2	41.8
Euro area	0.0	-2.0	-6.2	53.6	69.4	78.7

Source: ECB Bulletin, March 2010

There is an argument that a collapse of the Pact may lead to the collapse of the euro. Some economists propose that is not possible to control a system where fiscal policy is decentralised, while the monetary policy is centralised. The Keynesian economists argue that the initial rules of the Stability Pact were flawed and may result in damaging fiscal policies (requiring EMU countries to cut public spending and to raise taxes during a recession) (Patterson, 2006).

3. CURRENT FINANCIAL CRISIS AND IMPACT ON THE EURO

The euro contributed to macroeconomic stability within the euro zone, but the global financial crisis shows the weaknesses of the control and management capabilities of the EMU. Although the euro provides stability to its members and served to protect some of them against the effects of the financial crisis, there are doubts about the ability of the euro zone to respond to global banking problems.

The euro area has faced an existential crisis since the single currency was launched. This apparently "vindicates the sceptics who have long regarded the euro zone as unsuitable for a single monetary policy given the divergence of its members" (Garnham, 2010). Although the UK and the US have financial problems, the market has mainly focused on the euro rather than on the sterling or the dollar. The UK and the US are in a more favourable position than recently afflicted EMU countries with large deficits because they have the independent options to devalue or print money.

At present, Greece, Ireland, Spain, Portugal and Italy are the EMU members with largest budget deficits and government debts, representing the major breach of the euro area regulations on deficit management. In particular, Greece's national debt of 300 billion euros (113.4 percent of GDP) is bigger than the country's economy, with predictions that it will reach 120 percent of GDP in 2010 (ECB Bulletin, March 2010).

Due to irresponsible borrowing, years of uncontrolled spending, lack of financial reforms, and incompetence, Greece is badly exposed to the global financial downturn. Greece is an EMU country which was struggling to comply with the Maastricht convergence criteria in 1999 when the euro was launched, but by falsifying its budget deficit statistics the country joined the euro in 2001. A year after adoption of the euro, Greece received from Goldman Sachs $1 billion through a swap on $10 billion of debt. The transaction consisted of a cross-currency swap of $10 billion debt issued by Greece in dollars and yen that was swapped into euros at the historical exchange rate. The swap reduced the country's debt and generated $1 billion of funding. The contracts, which allowed Greece to delay payments and shrink its reported budget deficit, present the question of whether Greece used the swap to mask its true debt (Martinuzzi,

2010). In previous years, Italy used a similar trick to mask the true extent of its deficit with the assistance of a US bank (Balzli, 2010).

The financial crisis made some of the euro's weaknesses more apparent, indicating the need for an immediate response. Country risk differentiation is a reality within the euro area where governments are solely responsible for their own debt. Greece's deficit put the credibility of monetary union at risk. Leaving the euro zone is not a rational option for Greece and other troubled economies, but to fail to intervene and rescue them would have a severe effect on the euro and the global financial system.

After months of political negotiations, on 11 of April 2010 a rescue package was announced by the EU leaders, 30 billion euros in funds from Europe and the IMF. Sceptics raise the prospect that the loan may be nothing more than a "bandage on a wound that shows little sign of healing". Some analysts believe that the package may have a long-term damaging effect. An economist at Morgan Stanley J. Fels states that "now there will be more fiscal profligacy in Europe, more political fractures and ultimately the possibility that some countries might want to leave the Euro zone" (Thomas, 2010).

4. HAS THE EURO BEEN A SUCCESS?

The performance of the euro since its launching in 1999 is relatively impressive. The euro provided price stability to previously inflation-prone countries, and increased foreign investment from companies trading mostly outside of Europe. It has been valuable for consumers because of the reduction in transaction costs, and in addition for companies because they no longer have to cope with exchange rate fluctuations. The key area where the euro has driven greater banking efficiency and productivity has been in wholesale banking. Thus, it has produced evident benefits for big companies and large investment institutions, rather than for ordinary citizens (Marsh, 2009).

It is difficult to determine whether the advantages outweigh the disadvantages. The criteria for evaluating the performance of the euro need to be specified according to the situation – whether in normal times or in financial crises when the euro faces severe challenges. During financial crises financial stability has been at risk in the euro zone.

The benefits and costs of the EMU are different from the perspective of each country within the euro zone. Some euro members such as France and Germany have been afforded significant economic benefits from the euro, while certain other states' reward has been limited. For Ireland, EMU membership has not proved particularly beneficial, because the country mainly trades with a non-euro zone member, the UK. A CESifo report by German experts said the large fall in the value of sterling against the euro could be the key fac-

tor in Ireland being the EMU member where "the recession has been the most severe" (Lyons, 2010). It is argued that this country represents a significant risk of a default or exit from the euro area.

Portugal is the other euro zone member that did not enjoy the benefits of low interest rates as it did not evidence the positive outcome of a long period of growth. Since adopting the single currency, Portuguese exporters have been losing market share to competitors. Therefore, the government has been pushed to borrow funds to finance the current accounts deficit which built up debt to its current level. However, Portugal and Greece, as members of the euro area, do not have flexible monetary policy with the power to print money or depreciate their currencies and consequently to find their way to recovery (Thomas, 2010). Evidently, competitiveness imbalance was illustrated by significant changes in EMU countries' current account balance of payments – an increase of deficits in Greece, Spain and Italy, and large surpluses in Germany and Netherlands.

The euro is currently going through a difficult period, mainly because of the financial crisis in Greece. Greece, with a budget deficit of 12.7 percent and debt 113.4 percent of GDP, is not able to pay its loans and could default on its debts if not bailed out by the euro zone states and IMF (Wray, 2010). The strongest euro zone economies of Germany and France were the prime movers in pushing the rescue plan forward in order to solve this failing economy's problem.

There are further concerns that if the euro members bail-out Greece, they may need to rescue other weak economies as well, such as Portugal, Spain, Ireland and Italy. Thus, it might have an effect on the entire market that may require a major financial support which could in turn result in harm to the stronger euro zone economies.

CONCLUSION

The euro has been a success for the first ten years. It has contributed to macroeconomic stability within the euro zone and has brought low inflation and interest rates. It is evident that the EMU has protected the euro zone economies from instability over the last ten years of the euro's existence, and it can be reasonably assumed that the current crisis would have had a more severe impact without the euro.

During the next decade, the euro is however faced with challenges owing to the current financial crisis and economic recession. The present crisis shows the weaknesses in the control and crises management competence of the euro zone. In order to forestall a negative impact of the crisis, the large account im-

balances in deficit countries need to be managed by spending reductions and relative costs deflation.

The current financial crisis is affecting fiscal and financial stability in the whole euro zone. As the crisis deepens, fiscal discipline comes under scrutiny, and financial instability may have severe negative effects when weaker euro zone governments are overwhelmed by the costs of the financial crisis.

The crisis in Greece, which mismanaged its economy and misled other states about true budget figures, has an impact on the whole euro area. Greece, with its huge budget deficit, is not able to repay its loans and may default on them. Because allowing Greece to default would affect the euro and the financial stability of the euro zone, the other euro zone members agreed to bail out the failed economy. However, there is a big concern that after rescuing Greece, the euro states may need to bail out other weak economies such as Portugal, Spain, Ireland and Italy. This would require a significant financial commitment by the strong euro economies and may see them suffer too.

The euro is going through a difficult time and it is suffering from uncertainty. The pessimistic interpretation of "the Euro's speedily-won status is that pride goes before a fall" (Marsh, 2009). It is definitely too early to say whether the single currency will end in success or failure.

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