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Faulty Structure and Uninspired Member States Fail the Euro
Lessons learned from the Greek crisis

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Switzerland: International Studies, Multilateral Diplomacy, and Social Justice

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Economics and International Affairs Major

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Preface

This research project in Geneva gave me the perfect occasion to develop a topic of my interest, international economics, while having access to the abundance of resources in such a global city. Considering my central position in Europe it seemed appropriate to focus on an issue as pertinent as the current Euro crisis. Studying the workings and interactions of economies is fascinating in a globalized era where the success of one currency influences the success of another. The effectiveness of mechanisms that cause an economy to function lay within the structure of the economic model. My interest in the structure of economies is why I decided to write my paper on the euro crisis. The inspiration for a single currency is ingenuous and has great potential in the world economy. Yet there were many faults in the framework and I was intrigued to write this paper to understand why the Eurozone and their interpretation of a single currency had no chance at success with the original structure, but that with specific changes and a determined effort by the Member States, the Eurozone can set the precedent for future international currencies.

Abstract

The conception of the euro was a moment that revolutionized the role of a monetary union. States no longer dealt internally with their monetary policies nor made their decisions autonomously from other nations. The euro countries in 1999 became dependent on one another's success of policymaking and proper governance. There were skeptics of this single currency theory but if it was executed properly, the Eurozone becomes one of the most important economic regions in the world. From 2002, when the euro coins were issued, up until eight months ago, the euro accomplished a level of significance rivaling the dollar and Yuan in terms of weight in the international economy. What happened in the months following when the Greek's actual inflation rate and public deficit were made public was a complete unraveling of the EMU and its validity. Month after month the Eurozone countries were exposed bare with their lack of efficiency, transparency, and effectiveness to control the damage in the Eurozone community. When dealing with such a large and significant region of the world it is essential to have a functioning and stable framework on which the monetary union is built. The paper analyzes the objectives, unravels the truths, and suggests what maintenance is needed to return credibility to the Eurozone.

Introduction

Heading into the remaining months of 2009, an eeriness of uncertainty loomed over Greece's economic future. Amidst the promises and the declarations by George Papandreou to cut the budget deficit of 12.7 percent and to decrease the public debt that reached an alarming 121 percent of GDP[1], there was still great ambiguity over the capabilities of the Greek government to manage the debt crisis on their own. Not until March was there increasing pressure put on the euro countries by the European Commission President Jose Manuel Barroso to provide potential aid packages and support mechanisms to ensure that Greece's economy does not need to default[2], which could cause a domino effect that could potentially have compounding impacts on peripheral Euro-Zone countries such as Portugal and Spain.

Before assessing the Greek crisis, and thus through association, the crisis for the entire Eurozone, and the ramifications of this fiscal and monetary hiccup, it is important to establish what constitutes an optimal currency area (OCA). This theory lays out what makes a region suitable for a single currency. Though it is not a universally accepted approach to determine whether a single currency should be used, it provides a framework to construct a successful monetary and fiscal union. The Eurozone, which is a confederation and does not have a central fiscal union, demonstrates a unique way of implementing a single currency. Presenting a few of the OCA criteria accentuates the need for the Eurozone to address the problems that can occur from creating a monetary union under a fairly different scenario.

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[1] David Cutler and Renee Maltezou, "Timeline: Greece's economic crisis," Reuters, 26 Mar. 2010, 5 Jul. 2010 <http://www.reuters.com/article/idUSTRE62P28N20100326?loomia_ow=t0:s0:a49:g43:r1:c1.000000:b31290392:z0>.

[2] Ibid.

Once the theory of an optimal currency area is illustrated, the paper analyzes how the euro area altered the theory to create its own single currency. The European Union was founded in 1957 to create a 'common market' for trade.[3] When the Maastricht Treaty was signed on February 7, 1992, which established the idea for a universal currency, the decision was considered "the most important in the history of the European Community".[4] There were various economic and political incentives to creating the euro and legislation that was established to ensure the success of the Euro-Zone. Since this momentous decision was revered by so many and seemed to carry on the end-goal objectives of the European Union, what happened between the full implementation of the euro in 1999 until the recognized collapse of the Greek economy in 2010?

At this juncture it is important to introduce the case study of Greece and evaluate where and how the monetary union failed to bring sustainable success to the Euro-Zone. Complacency, monitoring/capacity of the Economic Commission, leniency, accessibility, responsibility, all of which are due to the flaws in the Treaty and the legislation made thereafter, are the major aspects that led to the sovereign debt crisis in Europe. Each aspect will be evaluated on how it contributed to the Greece debt crisis and who is accountable for the breakdown of each category. Analyzing the major causes of the Greek crisis is essential to deciphering between what the union failed to enforce and what the sovereign state failed to correct.

Before recommending necessary changes, the important question of the controversial topic of a Greek default will be analyzed. It is important to understand what the default can do for Greece but also what the implications of this decision would have on the entire Euro-Zone.

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[3] "Why the euro," 22 Dec. 2009, 5 Jul. 2010, <http://ec.europa.eu/economy_finance/euro/why/index_en.htm>.
[4] Georges Caravelis, European Monetary Union (Hampshire: Avebury, 1994) 1.

An important aspect is the interconnected nature of this monetary union and why it is necessary to delay any default until the latest possible moment, if it needs to happen at all. The austerity measures and the policy changes that Greece will need to make are far too complex and unpredictable to analyze in this paper, but of importance is to illustrate the need to ensure a recuperation of Greece's economy because of the severity of the repercussions if it were not to recover.

The paper will conclude with the feasible structural and social changes that will create a sustainable future for the euro and the Eurozone, absent of any financial catastrophes such as the one of the present. The euro area is a unique situation in which a single currency was created with many sovereign nations of varying economic sophistication. There have been many mistakes and oversights in the creation and in the nascent years of the European Monetary Union but the situation is salvageable if progressive measures are taken to promote competitiveness, transparency, and accountability.

Development, Theories, and Legislation Leading to the Creation of the Eurozone

I. Optimal Currency Theory

The Optimal Currency Theory is a product of economist Robert Mundell who orchestrated a model to illustrate what constitutes a prime area for a single currency. The European interpretation of the OCT, or lack thereof, is a unique approach towards the implementation of a single currency. For instance, one aspect that Europe will have to deal with is the distinction between the "core" countries and the "peripheral countries." Typically in an

OCA the states have fairly homogenous economies in terms of level of development. However, in the case of the European integration, the process involves varying levels of economies.[5] In the model that explains the logic of the optimum currency, the marginal cost has a positive slope. Thus, as the area size of the currency area increases so do the costs. This is the challenge of the euro area because if they allow the region to grow to incorporate diverse economies, the marginal costs of adding another country may begin to outweigh the marginal benefits. The ideal result would be to avoid asymmetric shocks, which is when an adverse effect hurts one country causing deflation, but because they belong to the same monetary union, it has an equally bad reaction in the opposite direction, i.e., inflation. To do so, stability amongst the euro economies is essential.[6] What is important for the eurozone to succeed involves the ability of the Maastricht Treaty and Stability and Growth Pact to enforce the criteria that will implement a fiscal responsibility that is absent from the central governing power.[7]

II. The EEC until the Maastricht Treaty

When the European Economic Community was created in 1957 (eventually becoming the European Union in 1993)[8] there were strong political incentives for a union, such as promoting democracy and stability during a time when there were growing tensions between the east and the west. However, the pursuit for political stability was only a portion of the objectives;

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[5] M.J. Artis, “Reflections on the Optimal Currency Area (OCA) Criteria in the Light of EMU,” Central Bank of Chile Working Papers December 2002: 5-7.

[6] Richard Baldwin and Charles Wyplosz, The Economics of European Integration (Berkshire: McGraw-Hill, 2006) 352.

[7] M.J. Artis, “Reflections on the Optimal Currency Area (OCA) Criteria in the Light of EMU,” Central Bank of Chile Working Papers December 2002: 7-8.

[8] “Treaty of Maastricht on European Union,” 7 Oct. 2007, 5 Jul 2010, <http://europa.eu/legislation_summaries/economic_and_monetary_affairs/institutional_and_economic_framework/treaties_maastricht_en.htm>.

European economic integration was the underlying mission in the EEC. The Customs Unions of 1968 and the “Barre Memorandum” (1969) and the “Werner Report” (1970) were part of the process of creating a more integrated economic community in Europe.[9] The integration process continued with the creation of the European Monetary System and the exchange rate mechanism in 1979. Furthering the idea of an economic union came when Jacques Delors became president of the European Commission in 1985. He proposed that the “Economic Community should by the end of 1992 remove a series of barriers to free trade and free movement of capital and labour creating a "single market"”.[10] In 1987 the Single European Act was passed and declared the need for an open common market and gave more legislative power to the European Parliament furthering the understanding that a monetary union was on the horizon.

III. Economic and Political Motivations for a European Monetary Union

By 1991, the member states saw an opportunity to mature into a more interconnected, co-operative economic relationship that would help the “European economy to perform better, bringing more jobs and greater prosperity for Europeans”.[11] This collective sentiment led to the construction and formation of the Treaty on the European Union (also referred to as the Maastricht Treaty), in which it declared the intention to implement a universal currency for the European States by the turn of the century. It was done with the understanding that in order to solidify a strong economic union there needs to be one currency amongst the European States.

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[9] Georges Caravelis, 14.
[10] “A Timeline of the EU,” 12 Mar. 2007, 12 Jul 2010 < http://news.bbc.co.uk/2/hi/europe/3583801.stm>.
[11] “Why the euro,” 22 Dec. 2009, 5 Jul. 2010, <http://ec.europa.eu/economy_finance/euro/why/index_en.htm>.

Although trade, elimination of exchange rate fluctuations, and price stability are viewed as the main reasons for the Maastricht Treaty, there was a more urgent motivation to develop the euro. After the German reunification at the end of the cold war, Germany undertook a large amount of public spending that resulted in high inflation. The increasing inflation and volatility in the foreign exchange rate became a serious concern for Germany. As a result, Germany established strict monetary policy in order to avoid an inflationary spiral. This worked for the Germans because they had a strong capacity to implement fiscal policy to balance out the stagnant effects of strict monetary policy. This government decision worked well for Germany and helped stabilize the Deutsche Mark. However because countries such as France and Italy were pegged to the Deutsche Mark in the exchange market they also had to follow the strict monetary policy. Therefore, these aforementioned countries had to follow the tight monetary policy but did not have the capabilities to implement fiscal stimuli in their economy. This was extremely detrimental to economies of Italy and France, and in 1992 Italy saw a large devaluation of their currency. For these countries, the logical solution was to accept the tight monetary policy in order to avoid any large unpredictable changes in the exchange rates and further depreciation.[12] In addition to the economic incentives, politics played a just as important role in the motivating the creation of the union.

If Germany accepted this proposition, the creation of the universal currency carried the hope that this would be a way of, in the words of Stephen Fidler, "walking Germany into Europe and leveling out the power distribution in Europe".[13] Germany, fully aware of slight trepidation that many countries still had towards them due to their communist and hegemonic past, saw this

[12] Cedric Tille, Personal Interview, 7 Jul. 2010.
[13] Stephen Fidler, Personal Interview, 2 Jul. 2010

as an opportunity to quell the fears of fellow European states and to prove their willingness to further European integration. Alas, since Germany was aware of this perception and was willing to see the end of 'German dominance,'[14] they signed the Maastricht Treaty. Yet they were not going to let the success of their economy be determined by the recklessness of other, less developed economies. Therefore, in order to protect their economy, the Germans accepted the proposal but under a few strict conditions that were outlined in the Maastricht Treaty. German Bundesbank's influence on the Treaty marked the first time "a common policy [is] based on a sole country's institutional set-up as in the case of monetary policy". [15]

IV. The Maastricht Treaty and the European Interpretation of Single Currency Area

During the early 1990s there was stagnation because of virtually no growth, fragile markets and other aspects of the economy that would create doubt within a monetary union where each country is partially contingent on the capacity of the other countries to stay stable. The goal of launching the euro by 1999 would allow time for countries to meet the criteria. Through the three-stage process laid out by the Maastricht Treaty, the criteria is supposed to promote "sustainable and non-inflationary growth respecting the environment, a high degree of convergence of economic performance, economic and social cohesion and solidarity among Member States, etc".[16]

The five criteria laid out in the Maastricht Treaty to advance convergence of the countries account balance sheets are inflation, long-term nominal interest rate, ERM membership, budget

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[14] Marco Buti and André Sapir, eds. EMU and Economic Policy in Europe: The Challenge of the Early Years. (Chelenham: Edward Elger, 2002) 5.
[15] Ibid., pg. 3.
[16] Georges Caravelis, 3.

deficit, and public debt. Inflation has to be within 1.5 percentage points of the average of the three lowest rates of the Member States. In order to keep inflation low, interest rate cannot exceed more than 2 percentage points above that of the average rates of the three countries with the lowest rate. Countries undergo a two-year period where the countries demonstrate their ability to keep their exchange rate tied to the euro without letting the currency devalue. Since inflation is often the result of large budget deficits, the countries budget deficit cannot exceed 3 percent of GDP, which is to ensure that the countries do not have to borrow heavily to finance their deficits. The final criterion is public debt, which is supposed to keep to 60 percent of GDP.[17] These criteria show the lengthy process in which it takes to be accepted into the EMU as well as the degree of specificity that the Treaty outlines for the main objective of a stable economy.

V. Why The EMU Was Created Without A Central Fiscal Union

The creation of the EMU and the universal currency transferred the monetary control of the Member States' government's over to the European Central Bank. The European Central Bank is independent of all states, which means the head of government from the Member States cannot interfere with the ECB's policy making. What the Euro-Zone did not change is the control over the domestic fiscal policy, which still lies in the hands of each respective government. The motivation behind this decision was the always-important presence of sovereignty. The progression of European integration that led to the creation of the euro is acknowledged as a "monetary union unlike any other current or historical example of monetary unification" because there is no case in which "a group of countries with a single currency

[17] Richard Baldwin and Charles Wyplosz, The Economics of European Integration (Berkshire: McGraw-Hill, 2006) 381-2.

controlled by a single central bank, where each state retains such a large degree of political and fiscal autonomy as in the… EMU".[18] The reason for such a framework is an acknowledgement by the European Union of the necessity of walking a thin line between unification of Member States and allowing them to keep as much independence and control as possible. Without this condition no country would have entered the Eurozone because they would not willingly concede all economic control to one central European authority. States were not going to allow the central bank to have fiscal control, for not only the protection of sovereignty but also because of the occurrence of the following example: if citizens of Italy were told that some their taxes were going to be used to build a new bridge in Denmark, it is very likely that the central government would be met with a strong opposition and potentially protests.[19]

VI. The Stability and Growth Pact as a Replacement for Central Fiscal Policy

The Stability and Growth Pact, which was signed in Amsterdam on 17 June 1997, is a set of criteria that was imparted by the Council resolution to follow through with the guidelines set by the Maastricht Treaty in 1992 once members officially joined the Eurozone. The SGP is supposed to replace the need for central fiscal policy in an effort to fill the gap tin the criteria for an optimal currency area. Therefore in order to make the EMU work as intended, the Member States are supposed to treat the SGP as a set of very strict rules that need to be followed when making their own fiscal policy. This Pact is conditional on the execution by the Member States, the Council and the Commission. The Member States need to keep their government deficit to below 3% and not allow inflation to exceed 2%. They also have the responsibility, since each

[18] Marco Buti and André Sapir, eds. 3.
[19] Cedric Tille, Personal Interview, 7 Jul. 2010.

country has fiscal autonomy, to enact and proactively adjust their fiscal policies to stay within the convergence criteria. It is an integral part of the monitoring process that the Member States clearly outline for the union the direction their state is taking in domestic affairs and the ability to illustrate a plan for short-term success. The Commission acts as the overseer and monitor of the Pacts regulations on the Member States. It is their responsibility to prepare reports on countries that may be in danger of violating any guidelines. The Council is the group that enforces the implementation of the criteria and can impose sanctions on countries that fail to sustain a stable economy.[20]

The notion of the SGP, if executed correctly, is to promote price stability and low inflation, which is what mattered most to Germany, one of the principal creators of the Pact. The SGP was not created just to appease Germany's concerns; price stability is an essential factor to promoting economic success in the euroland. The European Commission strongly believed that since price stability protects from inflation many positive externalities would result. It allows for greater capital mobility among the Member States. Businesses can invest in other countries and be assured that their investment will not compromised by a fluctuating, volatile exchange market. Trade will benefit all of the states and create a market full of more choices for consumers. This is one aspect that made it easier for Germany to accept the euro because its economy is firmly based on manufacturing and rely on a large portion of their GDP to be created through exports. The financial markets are further integrated and the ability to acquire loans from other Member States without dealing with the currency exchange market becomes increasingly

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[20] "Treaty of Maastricht on European Union," 7 Oct. 2007, 5 Jul 2010, <http://europa.eu/legislation_summaries/economic_and_monetary_affairs/institutional_and_economic_framework/treaties_maastricht_en.htm>.

easier. This free flow of capital is a cornerstone for the principle of growth amongst Member States.[21]

The Crux of the Problem-How Did the Eurozone Stumble?

These legislations, pacts, and establishments created the framework for the monetary union and the Euro-Zone. There was a clear structure and purpose in the creation of the universal currency, of which seemed conducive to a successful future for the Euro-Zone. However, jumping forward ten years after its establishment, the euroland finds itself confronted with a major debt crisis in Greece, which is subsequently affecting every Member State. As the storyline progresses, the public and the EMU founders are realizing the faults in the foundation of the monetary union and the execution of its objectives. However, by analyzing the growth of the EMU in the first decade leading up to the crisis helps make it potently obvious where the EMU lost its focus and integrity.

I. Complacency In the Subsequent Years Following the Adoption of the Euro

Along with the many promises for Eurozone success, come equally as many setbacks in the foundation. One of the biggest problems was sheer complacency by the countries and the commission. During the time frame of 2003-2007, Europe was economically stable, and not only stable but had a strong presence in the world market. In 2004, the European Commission developed a public opinion analysis to understand the general sentiments towards the new currency. Two years after its introduction to the Eurozone, "the euro seems to be more and more

[21] "Why the euro," 22 Dec. 2009, 5 Jul. 2010, <http://ec.europa.eu/economy_finance/euro/why/index_en.htm>.

accepted by the public" and "the feeling that the euro has already become an international currency is largely accepted by the public".[22] The euro was strong and it had favorable purchasing power for trading overseas. In addition, even though some countries had to inhibit growth because of limited capabilities with their fiscal policy and the guideline restrictions established by the Stability and Growth Pact, the trade within the Eurozone had also increased and the ability to borrow at low interest rates helped countries stimulate their economies. Greece was one of the countries that were thriving from the EMU. Their economy was growing by nearly 4% per year from 2003 through 2007 with help of infrastructural spending due to the Athens Olympic Games and the availability of credit throughout the Eurozone.[23] The circumstances in the Eurozone appeared promising, and it seemed like the visionaries behind the euro had gotten the framework right, and the guidelines that needed to be followed in order to enter the Eurozone looked sufficient. The complacency and laissez-fair approach, however, would end up being one of the biggest demises for the euro. Since the founders of the Treaty were unaware of the structural faults, it led to poor monitoring and complacency, exposure of the European Community's incapacity to enforce, too much leniency, and to the unexpected harm of accessibility.

A. Flawed Theories that Led to Complacency

There was too much trust in the theories of the EMU and there was a failure to account for potential pitfalls. The EMU was not a union that limited itself to the core states with fully developed economies. It instead made the decision to incorporate peripheral countries, which

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[22] European Commission, Flash Eurobarometer, The €uro, two years later (European Commission: EOS Gallup Group, 2003) 73.
[23] "The World Factbook: Greece," 10 Jul. 2010 <https://www.cia.gov/library/publications/the-world-factbook/geos/gr.html>.

presented the risk of spreading the scope of the EMU too wide, accounting for countries that were only just becoming global actors. This was an area that strays from the OCA criteria. However, the Union believed that the Stability and Growth Pact would create price stability and convergence as long as the criteria were enforced. Greece, which has the twenty-eighth largest economy in the world and high inflation, in comparison to Germany who has the fifth largest economy and low inflation, is expected to grow with the same restrictions that Germany abides by.[24] As has become strikingly evident, the SGP was not enough to close the gap between said economies, especially when the criteria is loosely enforced. Yet because the EMU did not forecast the incongruity of states to be a factor, they were not terribly concerned about conquering this obstacle.

Even the benefit from a common market that stimulates trade would not help to close the gap. Greece, whose exports and imports only make up 25% of their economy, compared to Germany where they account for around two-thirds of GDP, the opening of trade barriers does not do very much for their economy. In addition, Greece's public sector constitutes 40% of their economy.[25] The service and retail jobs cannot benefit greatly from an opening of markets. In order to keep up with growth in the Eurozone it required excessive public debt to spur consumption in the economy, which, when the financial crisis hit Europe, Greece realized the enormity of paying back their debt.

II. Lacking the Capabilities to Enforce the Treaty and the Pact

A. Sovereignty Rules All, Transparency Means Little

[24] Ibid.

[25] "The World Factbook," 10 Jul. 2010 <https://www.cia.gov/library/publications/the-world-factbook/geos/gr.html>.

Regardless of the strict rules imparted by the Maastricht Treaty, these countries made the necessary adjustments to meet the criteria. It is important to note, though, that many countries were not following the pact from the moment they entered the Eurozone. Greece violated the criterion of no more than a 3% budget deficit from 2001 through 2006, to only meet the criterion for the next two years before violating the rule again in 2009. The Commission and Council are the two institutional bodies that assume the role of monitoring and enforcement as well as the oversight of the European Parliament. Among other things, there was very little transparency that allowed the Council and Commission to evaluate the situations of each country's economy. Greece was cooking their numbers for years, under cutting how much debt and government deficit they actually had.[26] By doing so, this made it very difficult to put sanctions on Greece. This could easily be interpreted as solely the responsibility of Greece and full blame should be directed towards it. However at the outset of the EMU there was meant to be strict enforcement by the European Commission and Council on the Member States set in place when the Stability and Growth pact was created; "This Resolution provides the Member States, the Council and the Commission with firm policy guidelines for the timely and rigorous implementation of the Stability and Growth Pact".[27] However, the governing bodies started to realize the difficulty in doing so. This is due to two factors: sovereignty and leniency. When entering into this union, every country exercised full control over all aspects of their economy, fiscally and monetarily. The Council and Commission's power relative to the power of the states is meager and they are aware that their capabilities are limited.

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[26] Ibid.

[27] "Treaty of Maastricht on European Union," 7 Oct. 2007, 5 Jul 2010, <http://europa.eu/legislation_summaries/economic_and_monetary_affairs/institutional_and_economic_framework/treaties_maastricht_en.htm>.

Without this central control, the SGP holds very little power and undermines the purpose of the Eurozone. The Treaty was intended to keep strict criteria but when the country that demanded this rigidity fails to follow the rules themselves, it only further reduces the value of the Pact. Germany and France both had troubles keeping to the inflation rate of the 3%, but economies that are as developed and important as Germany can ignore the Pact because of political power. This crisis again becomes a target of political implications. The whole construction of the Eurozone is a struggle between political and economic goals, and of which the political side usually wins. There is an obvious reluctance to provide all the necessary means for a successful monetary union because that would involve such an astronomical shift of power to a central European government that no state government could fathom it occurring.

B. Leniency by the Commission and ECB

Leniency is the other factor that became an issue with enforcement. Even before the euro was introduced, exceptions were being made. Under the Maastricht Treaty all signatories were supposed to keep their public debt under 60 per cent of their GDP. Belgium, however, made the case that even though their public debt was at 120 per cent of GDP they were "committed to adhere to a strict budgetary discipline".[28] As a result, the guidelines were altered to say 60 per cent or moving in that direction. Courtesy of the Belgians, when Greece was finally admitted in 2001 after failing to meet the criteria for the first admission of states in 1999, it was allowed to have a public debt of over 100 per cent of its GDP.[29] In addition, as the Eurozone aged, it once again dealt with embarrassment of failing to enforce its own treaty; inflation was rising in the

[28] Baldwin and Wyplosz, 382.
[29] Baldwin and Wyplosz, 384.

early 21st century due to the oil shock and rising import prices, which caused most countries to violate the inflation criterion in the SGP. What was done instead of enforcing the rules was for the Eurosystem, which is the coined term to refer to the ECB and the national central banks, to restructure the inflation clause to have an inflation of near 2 per cent.[30]

The leniency in some ways is a mature way of allowing the countries to not suffer a double whammy, in which not only are they dealing with increased oil prices but also sanctions by the Eurosystem. But in the same respect, countries that have debts and need to pay back loans look at inflation as a positive occurrence. And with the Eurosystem failing to take action allows them to readjust their mindset to a more exploitative approach when dealing with Eurozone. The SGP was created to provide price stability but also help to mollify any worries of the Germans that the signatories will take advantage of the system, leading to price instability and therefore negatively impacting Germany's domestic economy. These leniencies provided by the EMU are step towards validating this notion that SGP is only a façade that appeases Germans fears.[31]

III. The Unexpected Negative Impact of Accessibility

The accessibility of markets is one the most influential aspects that lends its hand to the Euro crisis. When the EMU was created, one of the most alluring features of the single currency would be the access to low interest rates throughout Europe and no penalty of exchange rate markets when paying back the loans. However, this gift was also a curse; as result of this market accessibility there was excessive borrowing. Countries such as Greece were borrowing from private banks around the Eurozone in order to stimulate consumption, but did so without a strict

[30] Baldwin and Wyplosz, 383-91.
[31] Renee Schwok, Personal Interview, 8 Jul. 2010.

plan for repayment. European banks "have funneled $2.5 trillion into the five shakiest eurozone economies: Greece, Ireland, Belgium, Portugal and Spain".[32] Countries lent money to unstable economies without concern of how the money would be paid back. This was less a problem of the framework of the EMU than it was the irresponsibility of the countries to keep their banks accountable for their transactions. What can be blamed on the structure of the EMU is the lack of pressure to be transparent in their operations. The European commission did not have the power to make the states more accountable for their action.

The euro countries and the Union underestimated the level of interconnectedness in the euro area. Now with Greece in economic turmoil and the potential of a Greece default and a restructuring of its debt, a substantial amount of the private banks around Europe would not be able to withstand such a cut in how much Greece pay back. As a consequence, private banks holding Greece's debt, such as in Spain, France, and Germany, run the risk of failing, which in turn could worsen the economic situation around Europe. The default of Greece would cause a domino effect primarily on the periphery of the Eurozone, in countries such as Spain who hold a considerable amount of Greece's debt. If Spain is impacted deeply by Greece, Germany will be doubly affected from the loans they provided for both Greece and Spain. So what starts out with a problem involving a fraction of the eurozone GDP (2.5%), all of sudden creates a domino effect that throws the entire euro area into recession. Yet the impacts can be curbed by effective reserves and planning by the ECB; unfortunately, the treaty did not foresee the need for a reserve fund.

IV. No One In Charge of Saving the Day

[32] Stefan Theil "Worse Than Wall Street," Newsweek, 12 Jul. 2010 28-32.

Now that all the European countries helped push the euro region into further crisis by intentionally exploiting a weak EMU structure, the importance of giving Greece outside help is more pressing. Greece, who rigged its books, and with the help of other countries by providing sketchy loans, drove the country so far into debt, 120 per cent of GDP, and as high 13.6 per cent public deficit (after reporting a 6-8 per cent) that austerity measures would not be the only changes needed to help Greece out of its' debt crisis, which is consequently becoming the Euro crisis.[33] However, under the framework of the Treaty, if Greece goes into a deep economic recession, there will be no centralized aid to intervene.

The decision to have a no-bailout clause in the Maastricht Treaty may appear to be a considerable mistake and a gap in the structural framework; however, this is was an intentional move by countries such as Germany when the Treaty was created. When the no bailout clause was included in the Treaty, it was meant to alarm each country that the Eurozone was not created to give gifts of money to those who could not operate their economy. Countries were not willing to loan to states if a country spent and borrowed recklessly. In the Brown Brothers Harriman FX report, they aptly refer to it as the way to avoid a moral hazard. It would create a situation where countries "end up having limited incentive to keep their public finances in order as they know they would always end up being 'bailed out'".[34] The chief flaw in this mentality is that without a central fund to help bailout a country, not only can they not bailout a country but they cannot provide efficient assistance when the time truly presents itself for some sort of intervention.

As Joerg Bibow points out, not understanding what would happen without a support system proves lack of prudence to predict these failures. Their oversight had to do more with

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[33] Charles Forelle**, "**EU Sees Wider Greek Deficit, Roiling Markets," The Wall Street Journal**,** 23 Apr. 2010, 10 Jul. 2010 <http://online.wsj.com/article/SB10001424052748703876404575199520197362174.html>.

[34] Foreign Exchange 2010 Second Quarter Report: The Road to Recovery (Brown Brothers Harriman) 15.

their false assurance in the theories of which the Treaty was based on then it was a neglect to see it coming.[35] Back in January European Central Bank member Juergen Stark was quoted saying, "Whoever believes that, at the end, the European Union state member will put their hands in their pockets to save Greece, will end up deluded".[36] It was to the belief of the ECB that Greece was under complete control of their debt crisis. The lack of reserves and the resistant approach towards intervention hurt the economic situation more severely than if the EMU and Member States were proactive with the Greece crisis.

V. Slow-Response Time by the Eurozone Countries Exacerbates the Crisis

Since the ECB and Member States significantly delayed in giving aid to Greece the aid that eventually was provided was much greater than if given in December or January. Not only did the ECB and Member States end up going against their word and intervene, but they also agreed to allow the IMF to provide loans for Greece, after originally claiming that this was a European problem and should not involve outside sources. The IMF was willing to help all the way back in the beginning of January but the Eurozone was not ready to commit to such intervention.[37]

The ECB, IMF, and the Eurozone governments did not officially agree on a bailout until May 3, 2010, seven months after Greece's true debt and deficit numbers were revealed. Cedric Tille, a professor at Graduate Institute of Geneva, believes that if the Member States agreed to the IMF's aid back in late December/early January, it could have helped restructure Greece's

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[35] Joerg Bibow, Personal Interview, 30 Jun. 2010.

[36] William Watts, "ECB's Stark warns no bailout for Greece," MarketWatch, 6 Jan 2010, 9 Jul. 2010 <http://www.marketwatch.com/story/ecbs-stark-warns-no-bailout-for-greece-2010-01-06>.

[37] Edward Hugh, "The IMF is ready to help Greece if asked- so why not ask them?" A Fistful of Euros, 5 Jan. 2010, 8 Jul. 2010 <http://fistfulofeuros.net/afoe/economics-and-demography/the-imf-is-ready-to-help-greece-if-asked-so-why-not-ask-them/>.

debt by "possibly including a 'haircut' on holders of Greek bonds".[38] Doing so would consolidate potential losses for the private banks in Europe and provide an immediate alleviation on Greece's economy. Due to the reluctance of the Eurosystem, the future of a Greece's default is still uncertain. However, since ECB and IMF did eventually combine in a joint effort for a bailout loan to Greece, it buys Greece time to improve their economy before a likely restructuring of their debt, which will hopefully have lessened impacts on the whole Eurozone because of the bailout.

Structural and Social Attitude Changes that Channel Feasibility

The many facets of a breakdown in the structure and the EMU mentioned above paints a gloomy picture of the euro and its validity. Although it may seem like there are insurmountable challenges, the truth is quite the contrary. After breaking down the problems that occurred over the past ten years, some of the problems were due to the structure of the EMU and parts of it can be attributed directly to the actions of the Member States. With a better understanding of the flaws that caused this crisis, it makes it considerably easier to make the necessary changes for a stronger economic union. The following will illustrate first what is in the process of changing for the better and then the following section will deal with the changes that are yet to be made but are critical to the longevity of the euro.

I. Changes That Are Being Made

A. Giving More Monitoring Power to the ECB and European Commission

[38] Cedric Tille, Personal Interview, 7 Jul. 2010.

One of the most essential changes that will need to take place, which is a feasible measure, will be the increasing role of ECB and European Commission in monitoring the economic status of each country. Tommaso Padoa-Schioppa, a former Board Member and the European Central Bank, feels strongly that if there was not such a lack of peer pressure by the Member States to enforce the rules of the Treaty, then there would have been a much greater chance at avoiding the crisis. He also puts blame on the reluctance of the Eurozone states to give the European Commission more power and control. If states allow this it would create a centralized, noticeable body that is responsible for monitoring the economic conditions and conducting on-site inspections in the Member States. Without the presence of a centralized symbol in the Eurozone and without the enforcement capacity, countries will take advantage of the Treaty criteria, as is the case with Greece that leads to absolute economic turmoil. Mr. Padoa-Schioppa points out the irony in Germany resisting the proposition of giving the European Commission more power when it was proposed a few years back; Germany, who ignored this proposition, ended up having to come to the rescue of Greece.[39] If they had allowed the EC to expand their capacity to conduct investigations, it is very likely Germany would not have had to provide so much assistance to Greece.

The Eurozone finds itself in a weakened position, which opens up the opportunity for the Commission to retain more power and demand more transparency. The euro is weakening, the flaws are exposed, and change needs to occur. The European Commission and the ECB should use this opening to make the strong case that the Eurozone could be much more successful if they were allowed more enforcement control. One step to show that the Commission is taking

[39] Tommaso Padoa-Schioppa, "Will bail-out rescue Europe?" Financial Times, 28 Mar. 2010, 7 Jul. 2010 <http://www.ft.com/cms/885d7916-e3aa-11dc-8799-0000779fd2ac.html?_i_referralObject=15690268&fromSearch=n>.

advantage of this window of opportunity is the decision to have stricter stress tests on banks around Europe.

B. More Powerful Bank Stress Tests

In the past, banks have provided loans to different countries in the euro zone without considering the credibility of the borrower. The Member States did not realize the magnitude to which countries were interdependent in the new Union. Because of that, many private banks have been hit extremely hard by Greece, which could get worse if Greece defaults in the near future. The heat these banks are starting to feel is creating a noticeable paradigm shift in the attention of the Member States to providing solutions for the future. Towards the end of June, the Member States collectively agreed to bank stress tests that would be more vigorous and cover more banks than in the past. Germany, at first reluctant about making the results public because they felt the results could be misinterpreted and cause unnecessary concern, acquiesced when it saw that Spain was willing to publish their results. Germany gave in for fear that it would look like the country has something to hide.[40] The stress tests will put the private banks all around the European continent under the microscope for risky loans and hopefully allow for investor assurance worldwide and also preventing, which is a vital part of the European economic re-growth. The stress tests that are now more transparent are sign of the governments' maturity, understanding that they cannot protect banks that are making poor decisions.

C. Joint Responsibility

[40] Charles Forelle, et al., "Europe agrees on stress tests for banks," The Wall Street Journal, 18 Jun. 2010, 4 Jul. 2010 < http://online.wsj.com/article/SB10001424052748704289504575312332885606398.html>.

Although extremely delayed, the plans for immediate intervention appear to be beneficial. The 110 billion euro rescue package seemed a far cry five months ago, but now Greece sees glimmers of hope for their economic future as well as the future of the euro. Thirty billion euro will come from the IMF while the countries in Europe through bilateral loans will provide the other 80 billion euro. These loans provided by the other members of the euro currency are taken by Greece as three-year loans and are to be repaid with 5% interest. In addition to this package the "Governing Council of the European Central Bank has agreed to suspend the application of the minimum credit rating threshold to the country's debt".[41] This means that even though the bond rating of Greece's debt is at "junk" status, they will not have to pay the penalty of increased collateral, essentially making the credit drop ineffective. However, Greece will not have as much access to loans as will Germany. The austerity measures taken by the Greek government will ambitiously look to cut the fiscal deficit to below 3% of GDP by 2014 and a turnaround in the public debt-to-GDP ratio by 2013.[42] These measures are important to see a return to price stability in the Eurozone. The actions that are currently underway were delayed for too long, which will draw out the process of recovery. However, the light and the end of the tunnel is close to being seen and the EMU seems to be realizing what changes need to be made.

D. Future Assistance

Another aspect that the Member States are addressing is their ability to respond to a similar disaster in the future. Back in May the sixteen countries in the euro area came to the

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[41] James Langton, "IMF, ECB agree to Greece bailout," 3 May 2010, 8 Jul. 2010 <http://www.investmentexecutive.com/client/en/News/DetailNews.asp?IdSection=148&cat=148&Id=53436>.
[42] Ibid.

agreement for a bailout fund of 750 billion euro that would provide immediate assistance as well as assistance for any arising economic problems in the Eurozone. The EU Monetary Affairs Commissioner Olli Rehn "The fiscal efforts of the EU member states, the financial assistance by the commission and by the member states, actions taken today by the ECB prove we shall defend the euro whatever it takes".[43] This declaration came as a surprise to many analysts, one of whom was Mario Annunziata at UniCredit bank who said "this truly is overwhelming force, and should be more than sufficient to stabilise markets in the near term, prevent panic and contain the risk of contagion". [44]It comes as such a surprise considering there was a no bailout clause in the Maastricht Treaty and the sentiment towards helping Greece back in January 2010 was glum. However, the wording in the Maastricht Treaty does allow for Member States to provide aid to countries that are extremely difficult situations caused by “exceptional occurrences”.[45]

E. Where Should the Assistance Come From?

The decision to intervene in Greece shows that a backbone does exist in the Eurozone and that there is an ability to create effective agreements in times of need. Even though the member countries may not realize now, but the joint actions they are taking (bailout plans and stress bank tests) shows that there is a transformation from a decentralized to a more centralized union. This is not to say that the center is gaining too much control, although allowing a close monitoring of banks is a progressive step, but the understanding of the interdependence and the willingness to work cooperatively helps to create a less fragmented union. This is why there is no

[43] “EU ministers offer 750bn-euro plan to support currency,” BBC, 10 May 2010, 8 Jul. 2010 <http://news.bbc.co.uk/2/hi/business/8671632.stm>.

[44] Ibid.

[45] Tony Barber, “EU possesses the legal power to rescue Greece if necessary,” 26 Jan. 2010, 9 Jul. 2010 <http://blogs.ft.com/brusselsblog/2010/01/eu-possesses-the-legal-power-to-rescue-greece-if-necessary/>.

need to create a European Monetary Fund that emulates the process of the IMF. Creating an EMF could potentially give the Eurozone countries too much breathing room when it comes to structuring their finances and their economy. But at least through the example of the current crisis, if the eurozone finds it necessary to intervene, it will. Since there is no guarantee of a bailout, it will stress the importance of not falling asleep on their economic credibility. What the Eurozone can do on top of creating last minute bailout packages in time of need is to utilize the IMF in a timelier manner. By doing so, the Member States will then have more time to make a prudent decision on the issue of assistance.

II. Changes Yet To Be Made

A. Competitiveness

Even though this bailout will provide Greece, and other countries such as Spain, time to weather the debt issues, these corrective measures will not solve the debt crisis in the long term. The time that the bailout provides, however, will be essential for periphery countries to re-stabilize their economies so that they can develop a more competitive market. The Growth and Stability Pact, as Jim O'Neill expresses, who is a chief economist at Goldman Sachs, did not work. The Germanic approach to low growth and price stability was not an effective fiscal policy framework for all the countries in the Eurozone.[46] Not allowing countries to stimulate growth by focusing on becoming more competitive in the external European market is severely hurting the Eurozone countries. Nouriel Roubini, a professor at New York University, explains the current problems of a lot of the periphery countries, such as Greece, as a problem of competitiveness,

[46] Jim O'Neill, "Roubini & O'Neill on Greece and China," Financial Times, 26 Mar. 2010, 8 Jul. 2010 <http://www.ft.com/cms/885d7916-e3aa-11dc-8799-0000779fd2ac.html?_i_referralObject=15690268&fromSearch=n>.

which is due to a loss of market shares to India and China a decade ago. He indicates that with efforts taken to increase productivity, no fiscal measures will have the desired effect.[47]

Stephen Fidler of the Wall Street Journal also mentions the emphasis for the same corrective structural changes. In addition to the fixing the fiscal and banking problems, the third aspect is that of competitiveness.[48] With such low productivity growth there cannot be the expectation of a stable currency in many of the Member States. Roubini believes in order to return to a competitive economic structure there needs to be real depreciation. One way of achieving that is through deflation, which is associated with recession and it is difficult to deal with deflation over an extended period of time. The other option, which Roubini proposes and is the structural change that really needs to happen to ensure stability in the future, is do what Germany did after the Cold War: restructure faster, keep wage growth low, and increase productivity. Using this platform could take the better side of a decade, which is a small price to pay if it steers Greece away from another economic crisis.[49]

Understanding the importance of the long term and making sure that the EMU focuses more on the future than the short term will play an integral role in avoiding further crises from developing. Fidler and Roubini both emphasize the importance of long-term growth and increase in exporting competitiveness. If Greece can listen to this very sensible strategy, there is a much brighter forecast for their economy. Tourism accounts for 15% per cent of their economy, but the expansion of its shipping industry, the development of its manufacturing industry, and the

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[47] Nouriel Roubini, "Roubini & O'Neill on Greece and China," Financial Times, 26 Mar. 2010, 8 Jul. 2010 <http://www.ft.com/cms/885d7916-e3aa-11dc-8799-0000779fd2ac.html?_i_referralObject=15690268&fromSearch=n>.

[48] Stephen Fidler, Personal Interview, 2 Jul. 2010

[49] Nouriel Roubini, "Roubini & O'Neill on Greece and China," Financial Times, 26 Mar. 2010, 8 Jul. 2010 <http://www.ft.com/cms/885d7916-e3aa-11dc-8799-0000779fd2ac.html?_i_referralObject=15690268&fromSearch=n>.

shrinking of the service sector would be a progressive step to ensure a more competitive market, thus strengthening their economy and eliminating the need to rely so heavily on loans from European banks. It is worth mentioning that Greek population will take often severe measures to curtail the efforts of the government, as has already been seen expressed through riots and strikes, but there are no clear alternatives to a stable economic future.

B. Independently Funded Institution that Provides the Budgetary Analysis

One way to improve the transparency of government's budgets and fiscal policies is to take the power out of the government's hands and empower a constituency that has long term-interests and independent funding. European government's dishonesty in displaying their account balance sheets and budgetary projections are two major reasons why the crisis went undetected. If the state loses control of issuing the updates, and instead the responsibilities for the analysis and outlooks are given to a private institution there will be a perceptible change in the government's efforts to present their numbers accurately. This organization will essentially have the same role as the Congressional Budgetary Office does in the United States. This office, which is a branch of the government, was created in 1974 to keep a closer eye on the policy making and spending of Congress.[50] If each eurozone state has a similar office that has independent funding and the power to name and shame, the problems of Greece issuing inaccurate numbers for their budgetary spending can be resolved. Even if the institution is a subsidiary of the government, as long as it is given the credibility to act as an effective watchdog

[50] "CBO's Role in the Budget Process," Congressional Budget Office, 12 Jul. 2010, May 2010 <http://www.cbo.gov/aboutcbo/budgetprocess.cfm>.

over the eurozone governments and cannot have its' funding rescinded, then the Member States will finally be held accountable for their fiscal policy decisions and spending.[51]

Conclusion

The many deficiencies in the Eurozone structure that were exposed by the Greek crisis are plentiful. The past ten years have been deceitful by projecting a success story when it was actually only surviving from false assurances. Although the euro does not epitomize a perfect optimal currency area, it has found a way to last ten years and have a significant role in the international economy. The idea is formidable, but the weakness of the SGP cannot continue and there needs to be a cooperative effort by the Member States to adopt a public peer pressure that will help to coerce the governments into making the necessary changes mentioned in the above sections. In the past, the political force outweighed the economic needs and the theories and propositions were never executed fully. In order for the Union to survive, the concepts need to become realities. The recent efforts by the Member States governments to let down their guards and allow greater transparency is a positive sign of a growing mutual relationship between the economic and political initiatives. The countries are maturing, and the crisis has refreshingly united a very decentralized union. Yet the most necessary improvement for the Eurozone is to adjust their goals to encapsulate long-term goals and growth. The Treaty focuses narrowly on the accounting sheets from year-to-year and often overlooks the importance for development towards the future. Fortunately in the case of this crisis the lessons learned are quite clear and viable and if the EMU can execute the appropriate changes, the Eurozone is in a position to control history from repeating itself.

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[51] Cedric Tille, Personal Interview, 7 Jul. 2010.

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