Financial crisis puts strains on Eurozone unity

Key points

- Ten years after the introduction of the euro, the deep recession in the Eurozone has triggered concern that the single currency might impose intolerable strains upon some members. With some countries hit hard by the impact of the credit crunch, there are mounting concerns about a possible debt default by one or more member states, which in turn might threaten the euro and even the existence of the Eurozone.
- With the Eurozone economy forecast to contract by 3.8% this year, unemployment is climbing steeply and fiscal deficits are soaring. This has raised concerns about deteriorating public finances in a number of countries, leading to sharply wider spreads on government bonds and credit rating downgrades for Greece, Spain and Portugal, with Ireland maybe facing a similar fate soon. And repercussions from the growing economic crisis in Central and Eastern Europe are adding to the problem.
- Rising bond spreads were always intended to be the mechanism that would restrain public spending by more profligate Eurozone countries. But the question now is whether the weaker economies can withstand the strains that a lengthy period of recession will impose and, at the same time, adopt credible medium-term spending plans to ward off the worst of the downturn and retain market confidence.
- With fiscal deficits already rising as a result of bank bailouts, fiscal packages and recession will push budget deficits far above the 3% of GDP target. And with rising deficits and higher bond spreads pushing up the cost of debt, countries face a sharp rise in their level of indebtedness, with Greece and Italy seeing debt/GDP ratios around 100%. This deterioration could lead to a further downward spiral if the recession is prolonged and will be a test of countries' euro commitment, which has remained strong thus far despite rising social tensions in some countries.
- Presently, the problems remain manageable and the risk of default or of countries leaving the euro is still very low. Bond spreads are still much lower than during much of the 1990s, when countries were striving to qualify for euro membership, and the currency risks attached to leaving the euro would be substantial. Moreover, EU countries that have been exposed to considerable currency strain over the past year are anxious to join the Eurozone as soon as possible, to take advantage of the benefits of a stable currency.
- While some smaller countries may experience financial difficulties, it seems inevitable that the larger Eurozone members would step in to stabilise the situation – failure to do so would risk contagion spreading to other countries, which in turn would cause even deeper problems for the euro. More policy action also seems likely to counter this threat – although the German government will probably remain reluctant to countenance the scale of expansionary fiscal policy really needed at this time.
- Current policies inevitably mean a long hard slog back towards fiscal rectitude in the years ahead, with monetary policy also tightening and growth slower than previously expected. Fiscal federalism may also have to be on the agenda. All this will undoubtedly lead to ongoing strains within the Eurozone. And any measures by governments that appear to be protectionist – will only fuel these tensions.

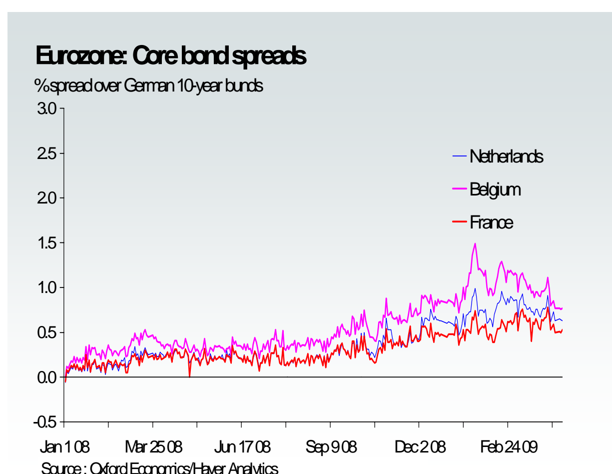
Introduction

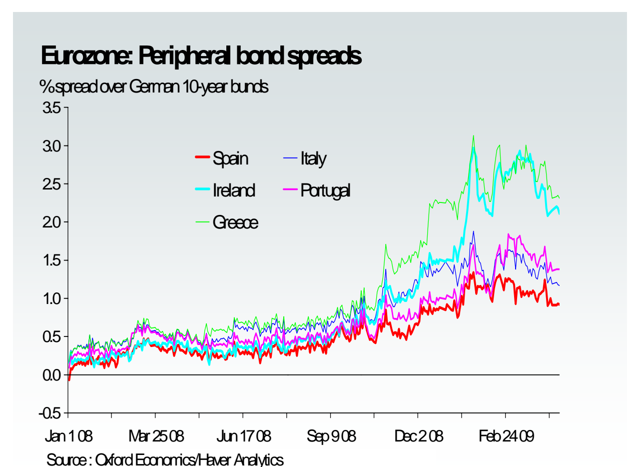
With the Eurozone having moved into recession faster than elsewhere and some member countries severely hit by the impact of the credit crunch, there are mounting concerns about a possible debt default by one or more member states, which in turn might threaten the existence of the Eurozone. This article examines the current economic strains within the Euro area and considers whether these factors, which might deter some EU members from joining, could ultimately lead to a breakdown in the euro.

Recession revives longstanding tension points…

Ten years after the euro was introduced, the onset of deep recession in the Eurozone has triggered concern that the single currency might impose intolerable strains upon some members, leading to speculation that default is possible in one or more states and that some may ultimately consider exiting the euro. Use of the common currency meant that more vulnerable members such as Ireland and Greece were spared the run on their currencies that hit countries like Iceland during the financial crisis. But despite the absence of exchange rate risk, the deepening recession is bringing to the surface the economic tensions that some had predicted would inevitably arise at some stage from the one-size-fits-all constraint of monetary and fiscal policy under a single currency. This in turn has resulted in mounting social tensions in some countries, leading to downward pressure on the euro as investors speculate about a possible fracture in the Eurozone.

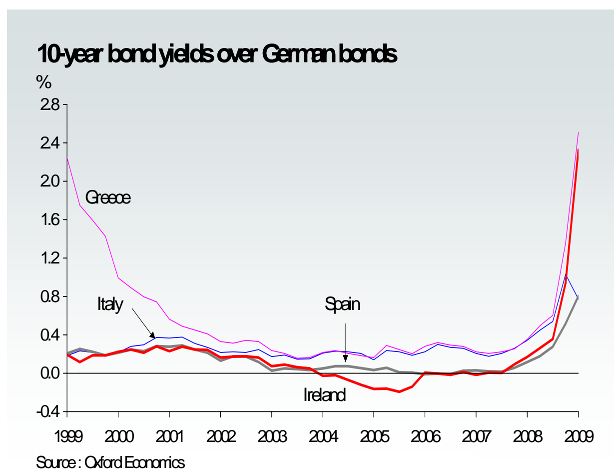
With the Eurozone economy now forecast to contract by 3.8% this year and only a very sluggish recovery seen in 2010, unemployment is set to climb steeply and fiscal deficits will soar, partly as a result of higher social spending in the downturn and partly because of the large banking bailouts and fiscal stimulus packages that are being implemented by member states. This pressure on public spending has raised concerns about deteriorating public finances in a number of countries – in particular the southern states such as Greece, Spain, Portugal and Italy, together with Ireland. In turn, this has led to credit rating downgrades for Greece (to A–), Spain (to AA+), Portugal (to A+) and Ireland (to AA+), and further downgrades are possible. Standard & Poor's has suggested that the global economic crisis has highlighted structural weaknesses that are inconsistent with the near triple-A rating accorded to Eurozone economies. Government bond spreads in these countries have widened sharply in recent months – Greek 10-year bond yields rose to 310 basis points over German bunds in February, the highest since the launch of the euro, before easing somewhat, while Irish bond yields are 220 basis points over bunds.

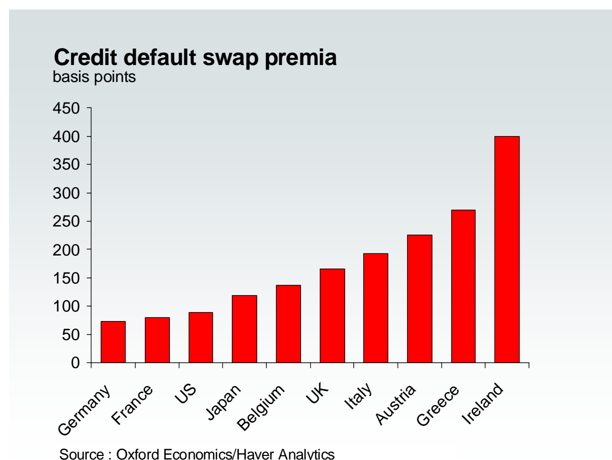




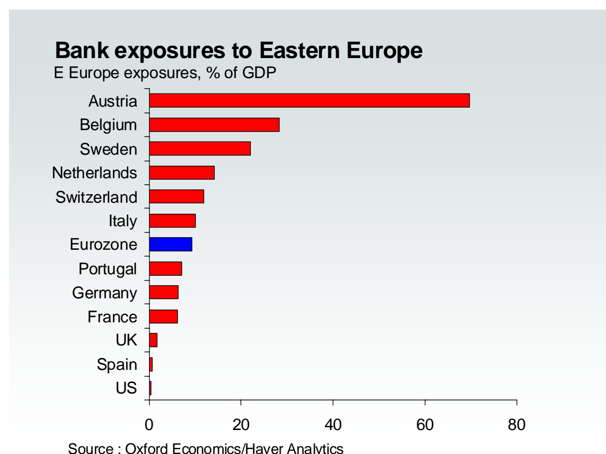
…as countries face rising funding costs

As economies weaken and inflation rapidly heads towards zero, with deflation possible in the coming months, governments in some countries face a very difficult period. Under the Stability and Growth Pact, countries are able to run fiscal deficits of over 3% of GDP in exceptional circumstances and most of them are likely to exceed this target in the next two years. But political pressures demand stronger action, and hence higher deficits. Single currency rules do not permit the printing of money, so governments in some countries now face the prospect of having to pay high real rates of interest on new borrowing to fund the extra spending, which in turn will exacerbate the pressures on public finances. This has raised fears of possible default by one or more member states, also raising question marks about whether some might exit the euro – either of these eventualities would cast considerable doubt over the credibility of the single currency. This in turn has led to a sharp widening of credit default swap premia – the price investors have to pay to insure against the risk of default on a country's debt. These have risen steeply for those Eurozone countries most exposed, such as Ireland and Greece, but the most striking change has been shown by Austria, where CDS spreads have risen to 230bp compared with 100bp in mid-January and just 10bp a year ago as a result of its banks' exposure to increasingly troubled countries in Central and Eastern Europe.





But although the situation is worrying, it is worth remembering that changes in bond yields were always intended to be the mechanism that would limit public spending in the more profligate countries. The fact that bond yields in most countries in 2003-07 had converged to (or in some cases like Ireland gone below) German bunds, the benchmark for the Eurozone, did not reflect economic reality given the relative economic strengths of the member states. The markets had become increasingly complacent about potential problems in recent years, but the depth of the downturn now under way has highlighted the underlying weaknesses of some economies. And these problems are being exacerbated by the deepening crisis in Central and Eastern Europe (CEE), which have been hit by the downturn in demand for their exports to the main Eurozone economies and the drying up of credit lines, in turn making it difficult to roll over short-term debt falling due. It seems very likely that the deepening problems in the CEE region will have a major impact on banks in some Eurozone countries, with Austria in particular (with its banks' exposure to the CEE equal to 75% of GDP), Belgium, Sweden and the Netherlands the most vulnerable.



The cornerstone of the Eurozone against which all other countries have to be judged is, of course, Germany. And being the largest member, the German economy, along with that of France, tends to dictate the course of both fiscal and monetary policy, as well as the speed of policy response to economic developments. One result of this was that as recently as July last year, the ECB was still raising interest rates in order to combat above-target inflation, almost a year after the US had started its easing policy – this probably contributed to the surprising speed of the Eurozone's descent into recession.

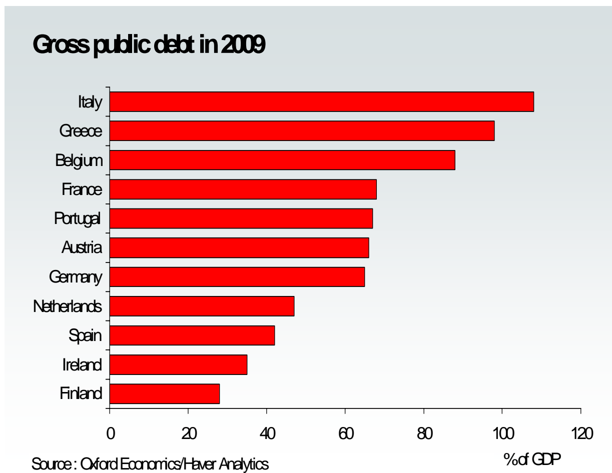
The question now is whether the Eurozone economies can withstand the strains that the period of deep recession will impose, or whether some will succumb to the pressure and move towards default or be tempted to withdraw from the euro in order to regain the option of currency devaluation – the method of combating downturns traditionally used by countries such as Italy, Spain and Greece (and of course the UK) that have suffered a serious loss of competitiveness. At the heart of this debate will be the strengths and structures of the member states' economies, their fiscal and current account balances and their levels of indebtedness. These relative strengths will have a major bearing on which countries are best able to both withstand the fiscal squeeze that is coming and adopt credible medium-term spending plans. Yet equally importantly, the need for fiscal stringency will test political commitment to the single currency, especially in Greece and Ireland, where there have been political tensions in recent months. A protracted slump would inevitably undermine the currently strong public support for the euro.

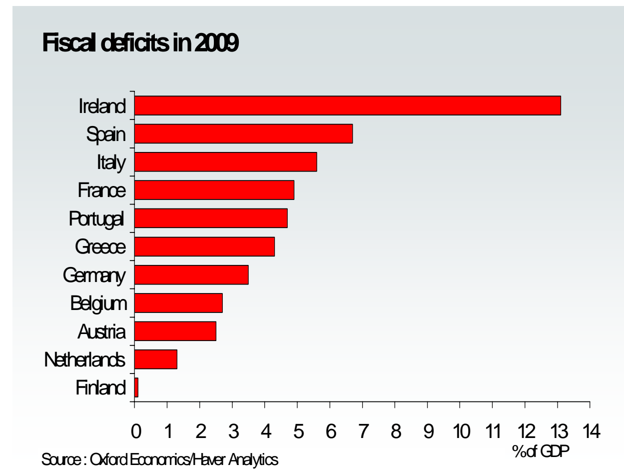
Sharply higher deficits and debt ratios…

The period of slower growth will inevitably mean lower tax revenues and higher spending on social welfare. At the same time, most governments are implementing rescue packages for the banks and introducing fiscal stimulus programmes to mitigate the impact of recession. As a result, budget deficits are set to rise above the Maastricht target of 3% of GDP – in some cases well above the target. Ireland, for example, will see its deficit in double digits as a % of GDP, perhaps as high as 13% and for several years, as its revenues are falling by around 20% on a year ago, while Spain is likely to run a deficit of about 7% of GDP. Italy's deficit is heading above 6% and, given their weak economies, deficits in Greece and Portugal will be rising to around 5%. Even Germany is now expected to post a deficit of 4.7% in 2010, after 3.5% this year.

Rising fiscal deficits will in turn result in higher levels of debt, which in some countries has remained well above the Eurozone target of 60% of GDP for many years. Italy's debt, for example, could be equal to 110% of GDP this year, Belgium's is likely to be back up to around 90% of GDP and Greece could see a ratio of close to 100% of GDP. All these levels would be well above the Eurozone average of about 70%. In contrast, Germany's debt/GDP level is significantly lower, albeit it is forecast to rise towards 70% of GDP this year from 65% in 2008, while France is expected to be posting slightly higher levels of close to 70%. Interestingly, Ireland's debt/GDP ratio was only around 30% in 2008, but this is likely to climb steeply to well over 40% in the next few years.

At the same time, a number of Eurozone countries are running very large current account deficits, which are a reflection of years of loss of competitiveness. Spain, for example, posted deficits of around 10% of GDP in the last two years, the third highest deficit in the world in cash terms after the US and the UK, and Greece's deficit is close to 16% of GDP. Although the adoption of the single currency eliminated any immediate currency risk for those member states running large external deficits, there are clear medium- to long-term risks from falling exports, heavy job losses and shifting patterns of investment, in turn leading to mounting social and political pressures. There have already been protests on a significant scale in Greece and Ireland about the mounting economic problems, and these can be expected to escalate as the problems intensify over the next year.





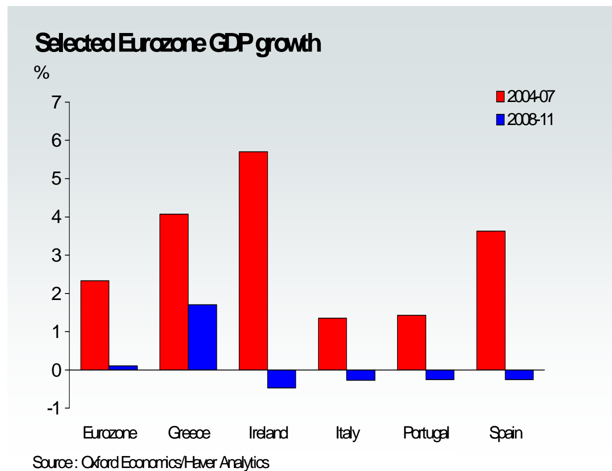
A weaker euro would help, but only with regard to exports to non-Eurozone countries – competitiveness of these countries would still lag within the Eurozone, making it a difficult and slow process for them to restore positive growth. With the previous option of currency depreciation no longer available, the way to improve competitiveness for countries such as Spain, Greece, Portugal and Ireland is either via faster productivity growth, which will probably take many years to achieve, or lower nominal wages, which will be politically hazardous.

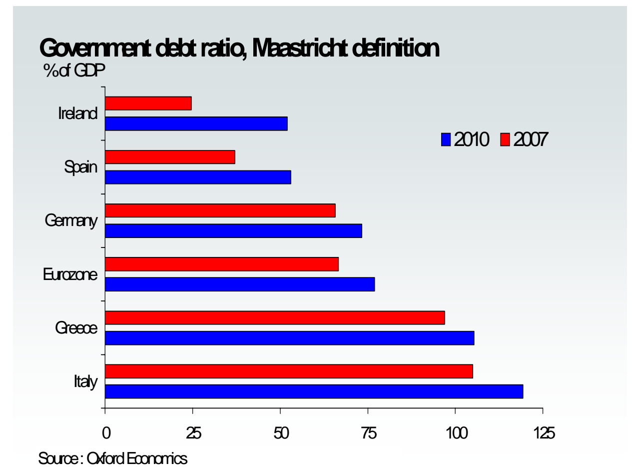
Which countries are most at risk? The biggest debtor countries (as a % of GDP) are Italy and Greece (both expected to be around 100% of GDP in 2009), and Belgium, followed by France, Portugal and Germany. Those with the largest current account deficits (again as a % of GDP) are Greece, Portugal, Spain, Ireland and Italy. And in terms of the fiscal accounts, Ireland (at 13% of GDP in 2009), Spain, Italy, France, Portugal and Greece are expected to run the heaviest budget deficits. Although other factors clearly come into play, on these three measures alone, the countries most at risk are Greece, Ireland, Portugal, Spain and Italy.

…could result in a downward spiral

The deepening recession will place an even greater focus on these strains over the next year, with most Eurozone countries facing the depressing prospect of falling GDP, rising public sector deficits and worsening balance of payments positions. The collapse in growth that is projected for the period 2008-2011, compared with the preceding four-year period, will put an increasing strain on government finances, with tax revenues plunging and unemployment and social spending climbing, thereby further pushing up deficits in the absence of new measures to boost revenues.

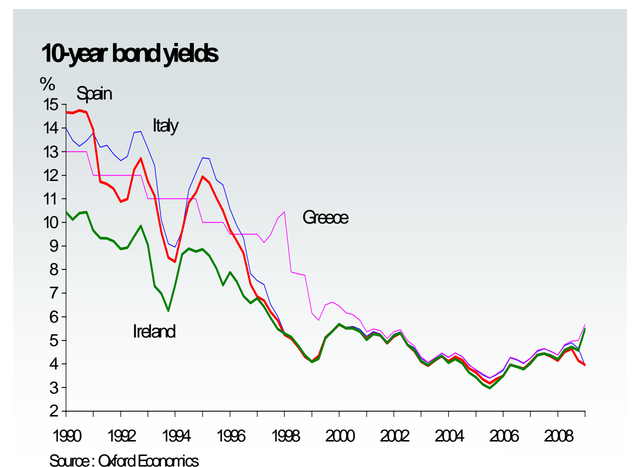
With monetary policy in the hands of the ECB and hence unable to match the needs of all zone members, the recent sharp rise in international borrowing costs facing some governments will exacerbate fears of possible default given their inability to inflate away public debt or to finance budget deficits via the issue of additional currency. In these circumstances, the strong political commitment to the euro that has been evident for the past decade will inevitably come under scrutiny in some countries, especially as levels of unemployment start to climb more rapidly and long-term borrowing rates remain high.





But perspective is necessary – default looks unlikely…

However, although the situation appears bleak, it is important to put recent events into perspective. The market response to the rising tensions has seen bond spreads widen quite sharply, but in historical terms the move has been quite small. Back in the mid-1990s, when there were fears that the Italian lira would break from the European Monetary System because of its domestic problems, the spread on Italian bonds over German bunds rose to some 600-700 basis points, way in excess of current spreads even for Greek bonds. And as noted earlier, rising bond spreads were always intended to be the main method by which Eurozone governments would be 'punished' for failing to consolidate their public finances during the years of favourable economic performance. Moreover, long-term rates are still relatively low in an historical context – for example, the yield on Spanish 10-years bonds is around 4.2%, compared with the average of 4.4% for the last ten years – and nor are they yet at particularly onerous levels in real terms. Belgian 10-year yields are significantly lower than they were back in the 1990s, when its government was striving to bring down its deficit and debt levels in order to qualify for the single currency.



As a result, the current situation is not as dire as some commentators have suggested – the real issue is whether the current economic downturn proves to be prolonged. In the near term, even the worst hit of the peripheral Eurozone members such as Greece and Ireland should be able to withstand the pressures of higher borrowing costs, as long as the EU Commission accepts that the current situation will lead to members overshooting the Maastricht targets by quite a large margin and for a number of years. In the near term, no country appears to be in any danger of imminent default – indeed, any default would more likely be the result of a loss of market confidence following a political decision to leave the single currency. Yet there is no evidence of any move in this direction. Any move by a member country to exit the currency zone would be seen by the markets as a sign of serious weakness, which in turn would accelerate and exacerbate the problems that the move was designed to avoid.

…and the Eurozone remains united for now…

Furthermore, rather than Eurozone numbers dwindling, the EBRD[1] has indicated that some of the recent EU entrants are likely to want to join the euro soon, as inflation moves rapidly lower despite recent sharp plunges in their currencies. Notwithstanding the outward signs of stress within the Eurozone, those countries that have fixed their currencies against the euro under the ERM-II arrangement are anxious to join as soon possible – in these states, there has been substantial external borrowing in euros and the threat of a forced currency devaluation could spell real trouble, in terms of debt servicing, for both the public and private sectors. But given the signs of potential financial problems among existing members, it is now doubtful whether the Eurozone will welcome new members until the situation settles. This will add to the devaluation pressures facing some countries in Eastern Europe.

At this stage, talk of countries defaulting or a break-up of the euro appears well wide of the mark. Any country that was in any real danger of default would certainly not even contemplate exiting the euro – in addition to a debt crisis, such a move would almost inevitably result in a currency slide and a banking sector crisis as euros shift out of the country. One of the underlying reasons for joining the single currency in the first place was to benefit from the stability offered by currency union – one of these benefits would be the support of other members at times of crisis. And this is what would happen in the unlikely event of one or a number of the smaller countries threatening to default on its debt; other member states would step in to bail out the potential defaulter. For example, it would cost just 0.6% of German GDP to cover Ireland's projected 2009 budget deficit.

Even though the core members such as Germany, France and the Netherlands might be reluctant to go down this path, failure to do so would inevitably lead to contagion, spreading default to other countries and bringing down banks and financial institutions throughout Europe, wreaking incalculable havoc. Inaction would not be an option in such circumstances. But Germany has made it clear that any EU bailouts of member states facing difficulty would be only as a last resort and would come attached with tough conditions, along the lines of previous IMF packages. For example, Ireland might be forced to raise its currently low corporate tax rates, which in the past attracted large inflows of foreign investment. There is a strong feeling in Germany that some countries now facing difficulties have been living beyond their means in recent years, relying upon the growth of credit and borrowing to finance GDP growth rather than solid expansion of productive capacity. The German government is clearly very reluctant to ask its taxpayers to foot the bill to help such countries unless more prudent policies are adopted.

…with more policy action likely

What form might this support action take? Firstly, there is likely to be further coordinated fiscal measures to try to get the economy going again. The fiscal packages announced so far – equal to about 1.7% of GDP – are well below of the scale of programmes announced in the US and elsewhere. And there is also scope for further monetary easing. Although the ECB was slow to start cutting rates – and even slower to recognise the scale of the mounting threats to the Eurozone economy – its benchmark refi rate is now down to 1.25%. The ECB has been wary about bringing rates down too rapidly (although they are now below the 2% seen in the aftermath of the dotcom bust), but further cuts seem likely as the recession bites; we expect rates to fall to 1% later this year.

And there is increasing talk of a need for quantitative easing – essentially expanding the money supply by creating money to buy assets – which is already under way in the US and UK and appears likely in Japan. Yet the ECB will be cautious about proceeding down this route. One such "unconventional" method of monetary stimulus would be for the ECB to buy up government bonds of member countries, specifically those

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[1] *EBRD – European Bank for Reconstruction and Development*

facing financial problems. Although the Maastricht Treaty appears to prevent the ECB from making direct purchase of member government debt, it is allowed to operate freely in the financial markets, buying or selling assets or by lending or borrowing claims and marketable instruments. And the possibility of financial losses incurred by the ECB resulting from possible monetary policy stimulus is explicitly covered by the treaty – in this event, the ECB's general reserve fund can be tapped and, if this is insufficient, then national central banks have to step in. Eurozone member central banks are ECB shareholders, and profits, as well as losses, are distributed according to a scale based on GDP and population. In any event, national governments can be lenders of last resort through their ownership of national central banks, or they can back the ECB against losses by direct capital injections.

Although some ECB governing council members may have some misgivings about such a course of action, there are others who favour more aggressive policy measures in order to try to ward off the risks. Acquisition of private sector debt by the ECB could be more contentious, given the potential losses for the ECB in holding such debt. Unlike the US, the UK and Japan, where the national governments stand behind the central banks, the ultimate financial backing for any ECB losses is less clear. These issues highlight the complex nature of the Eurozone, in terms of control over fiscal and monetary policy and the independence of individual member states.

But there are longer-term dangers…

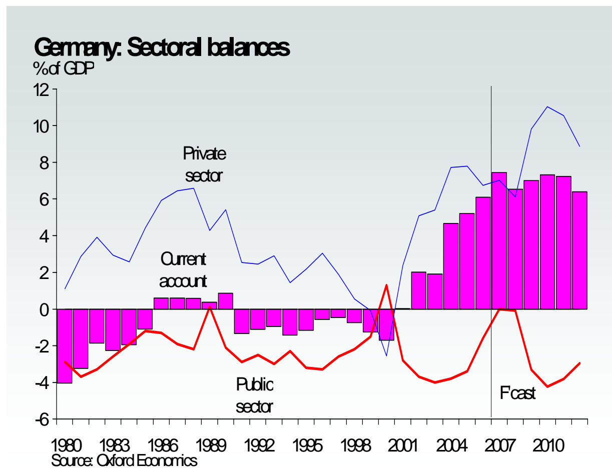
The response of Germany, France and other core Eurozone members to the threat of default in other countries will obviously be critical. But, as argued above, there can be little doubt that they would respond to crises in a number of the smaller countries that threatened the euro. And in financial terms, the larger countries would certainly be able to bail out the smaller members, with the IMF also likely to weigh in with its support given its expanded resources after the G20 summit.

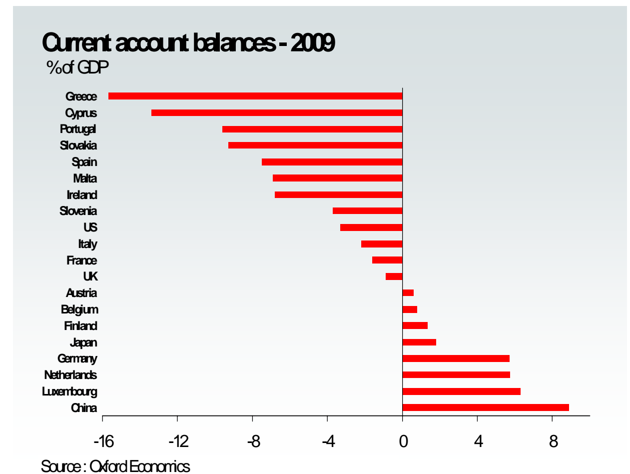
But what would happen in the event that the recession proves much more prolonged than currently envisaged and the threat of default spreads to a number of larger Eurozone countries such as Italy and Spain? In this situation, the ability and, more importantly, the willingness of the major countries to stave off default would be called into question. But prior to this, it is very likely that there would have been further developments affecting the operation of the single currency. Indeed, if the situation appeared to pose a risk to the whole of the Eurozone, then it seems likely that the single currency could begin to unravel. This in turn would spark widespread panic in financial markets, depreciation of newly reissued national currencies, sharply higher spreads among the weaker European countries and a further flight of capital to the US dollar, adding to the woes facing Europe. The chances of this happening are slim, but given the train of events over the past 18 months it cannot be ruled out completely.

…and Germany's role will be key

And there remains an underlying concern about the role of Germany within the monetary union, given its inability/unwillingness to boost domestic demand sufficiently to curb its large current account surplus, which in effect is exporting unemployment to other less competitive Eurozone countries. Although it is prepared to tolerate a budget deficit for now, it is talking of returning to a surplus as soon as possible. While its surplus is still perhaps not perceived to be a problem in Germany itself, it nevertheless poses one of the fundamental strains for the weaker members that will continue to cast a shadow over the Eurozone's long-term viability. However, in return for more expansive domestic policy in order to assist with rebalancing the Eurozone economy, Germany would probably demand more prudent fiscal policy from other member states in the future. This would involve countries running higher budget surpluses in the good times in order to leave them in a better state to handle crisis periods such as is being experienced at the moment. It is clear that the improvement in public finances during the 1990s, which entailed tough policy decisions by a number of

countries, have not really been followed through during the easier years of the last decade.





In the current situation, for those countries facing the worst problems, such as Greece, Portugal and Spain, stabilising GDP growth will mean much bigger public deficits as an offset to the expected retrenchment as the private sector tries to move back into financial surplus. One solution to this would be for Germany to run a significantly higher public deficit, which in turn would mean a lower current account surplus, as this would allow other Eurozone countries to see an improvement in their net trade positions. Germany's reluctance to go down this route, while understandable from a domestic standpoint, is less tenable given its lead role in the Eurozone as it makes other member countries' growth rates lower than they need to be and aggravates tensions noted above.

Using the Oxford Economics' model, the following table shows the scale of additional public spending, and hence the size of budget deficit, that Germany might be faced with if it were to boost its domestic demand growth sufficiently to offset the lower growth rates elsewhere implied by other smaller member countries reining back their public spending. The Eurozone GDP growth rate is broadly unchanged from our base forecast, but German GDP falls only slightly in 2009 before recovering quite strongly in 2010-11 as it expands government spending by 5% of GDP. But its growth prospects for 2012 onwards are weakened as it then has to tighten fiscal policy sharply to bring its budget deficit under control. Under this scenario, the fiscal expansion required to support Eurozone growth and enable other members to bring down their deficits closer to the Maastricht goal of 3% of GDP would see the German budget deficit rise to about 8% of GDP in 2010-11. At the same time, less expansionary fiscal policy in other countries would see much weaker GDP results, with Ireland for example posting a double-digit GDP decline this year and Italy's GDP contracting by just over 6.5% – although the subsequent recoveries would be stronger.

	Eurozone		Germany		Italy		Greece		Ireland		Portugal		Spain	
	GDP growth %	Budget % of GDP	GDP growth %	Budget % of GDP	GDP growth %	Budget % of GDP	GDP growth %	Budget % of GDP	GDP growth %	Budget % of GDP	GDP growth %	Budget % of GDP	GDP growth %	Budget % of GDP
2008	0.7	-1.7	1.0	-0.1	-0.9	-2.8	3.0	-3.2	-1.0	-5.5	0.0	-2.2	1.2	-2.8
2009	-3.8	-4.8	-0.1	-7.0	-6.6	-2.9	-2.4	-3.3	-11.2	-2.9	-4.4	-3.4	-6.7	-3.2
2010	0.3	-5.1	0.7	-8.0	0.1	-3.7	0.8	-3.4	2.4	-3.2	-0.1	-3.8	0.2	-3.6
2011	2.0	-4.9	1.5	-7.6	2.4	-3.9	4.8	-3.5	6.8	-3.3	2.8	-3.7	1.8	-3.6
2012	2.4	-4.0	0.4	-6.0	4.6	-3.8	5.9	-3.6	8.7	-3.3	3.4	-3.6	3.0	-3.3
2013	2.4	-3.2	-0.1	-4.5	4.8	-3.3	4.7	-3.1	8.2	-3.0	3.6	-3.4	4.2	-2.9

But it seems highly unlikely that the German government would be willing to countenance budget deficits as high as 8% of GDP in order to support growth in the Eurozone and help other member countries run lower fiscal deficits. The memories of the cost of German re-unification – and pledges not to repeat this burden on taxpayers – will make the government reluctant to run a deficit much higher than the level of around 4.5% of GDP that is currently expected for 2010. Equally, it is difficult to envisage governments in countries such as Ireland and Italy agreeing to curb public spending to get their deficits back down towards 3% of GDP if this were to result in such steep declines in GDP and accompanying hefty rises in unemployment.

Slower growth over the next 10 years…

In conclusion, the current situation facing the Eurozone is undoubtedly severe, but our forecasts showing growth beginning to recover in 2010 should mean that the deficit and debt problems should remain manageable for most member countries. The more robust the recovery, when it comes, the lower the risks facing the Eurozone economies, although at this stage there is an increasing danger that the recovery may take longer to emerge than we currently expect.

But even if the recovery does start later this year, the combination of banking bailouts, fiscal packages and possible financial support for troubled member states will impose a heavy fiscal burden for the next four or five years. This implies a long hard slog for many countries as they try to return to the path of fiscal rectitude. And monetary policy is almost certainly going to have to be tighter than currently envisaged as the authorities reverse the recent and ongoing sharp monetary relaxation in order to ward off the threat of a possible pick-up in inflation in the years ahead. Together with slower growth in the emerging markets over the next couple of years, this almost certainly means that trend GDP growth in the Eurozone is going to be below the pace seen in the last ten years or so.

…and calls for fiscal federalism?

In the event that the recession proves more prolonged than we expect, with GDP falling for the next two years and deflation threatening to take hold, which could jeopardise the prospects of some of the larger Eurozone countries, then the implications for the euro would be much more fraught. The political commitment to the euro project would be called into doubt and, even if there were to be a move to a narrower currency union based around the core countries where deficits, debt and debt spreads are more closely correlated, it is questionable whether a new arrangement could survive given the likely political, economic and financial pressures that would ensue.

In these circumstances, one alternative to the threat of a break-up of the single currency area might be a move to fiscal federalism – centralised fiscal policy – which would reduce the risk of member countries going into default. The head of the IMF has suggested that the euro could prove unworkable unless member states surrender some control over fiscal policy. Currently, this is clearly not politically acceptable to most countries, but the concept may gain support if the next few years prove increasingly difficult. Indeed, it can readily be argued that this is a natural progression from centralised monetary policy control.