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Is the Eurozone doomed to fail?

by Jacques Sapir

The eurozone is currently undergoing a crisis of historic importance, which results in the accumulation of sovereign debt in eurozone countries and reveals the internal defects of the eurozone.

Since the beginning of 2010, the crisis in several EU countries has resulted in a faster growth of interest rates compared to those of Germany. This is known as interest rate "spreads" and has challenged the single real accomplishment of the eurozone: the relative convergence between countries on the debt market that began in 2000. This has been fuelled by the huge growth of sovereign debts in the wake of the 2007 crisis. But even this development could be linked to the euro as prior to the crisis it allowed a downturn of interest rates, which then facilitated the build-up of the large debt, both private and public, in most eurozone countries.

Table 1: Situation at the beginning of the crisis (December 31 2009)

	Spain	Portugal	Greece
Total debt (euro billions)	5,315	783	703
Total debt (% GDP)	506%	479%	296%
Amount of total debt held by non-residents	33%	49%	51%
Debt by issuer (euro billions)			
Government	676	121	293
Financial corporations	1669	238	120
Non-financial corporations	2053	246	165
Households	918	178	123

Source: C Lapavitsas et alii, "The Eurozone Between Austerity and Default", *RMF-Research on Money and Finance*, occasional report, September 2010, available at www.researchonmoneyandfinance.org

When the difference between the interest rates of one country and those of Germany exceeded 300 points (the Irish debt reached its peak at 399 points[1]), it was clear that the eurozone had entered troubled waters. The homogenization process had been suspended, and the rates in Greece remained very high. The growth of the rate spread was actually caused by the deterioration of the debt situation in Greece followed by Spain, Portugal and Ireland[2].

Beyond the "at risk" countries, we can see the process of interest rates divergence going one step further. For example, Italy resumed issuing futures on government bonds in September 2009 (a practice that was suspended in 1999 when the euro was introduced). This shows operators are seeking to prevent new problems in this segment of the government securities market[3]. The fact that Italy reverted to this type of emission indicates that the euro is fast losing its protective role. The same can be said about worries now openly voiced on Belgium.

Yet, advocates of the euro stressed this role during the crisis. They argued that the euro helped member countries to avoid the consequences of their currencies fluctuating violently against one another. Nevertheless, these fluctuations have been possible because of the long standing decision to move to complete convertibility (capital-account convertibility). Note also that the speculation on exchange rates has been replaced by speculation on interest rates. One wonders what would have been the outcome had capital controls been introduced. But capital controls have been strictly prohibited under the provision of Article 63 of the Lisbon Treaty.

However, it is important to note that the introduction of capital controls is recommended by the IMF[4] to fight speculation. They could have helped avoid currency swings while giving eurozone countries the possibility to adapt their exchange rate to the massive divergence in the real cost of labour experienced in Europe since 2002.

This openness has made countries totally dependent on the eurozone. The adoption of a single exchange rate and the overvaluation that has characterised the euro since 2003 has also increased the economic pressure on certain members.

The rigid pressure of the single currency "noose" forces some eurozone countries to resort to ongoing growth of their budget deficits[5], which raises questions on the competitive deflationary policy of the Stability and Growth Pact within the Treaty of Maastricht (1992) and might have serious recessionary consequences for Europe. We cannot exclude the possibility that some countries may leave the eurozone[6]. Even the withdrawal of one country would cause a strong speculative movement, which would make the participation of others ever more expensive and eventually impossible.

When the euro crisis broke in April 2010[7], it had two dimensions: momentary dimension (the debt crisis in Greece, Portugal, Spain and Italy) and a more important structural dimension. The crisis was triggered by the growing lack of confidence among financial markets that countries with large debts were going to be able to repay them. The crisis began in Greece and then attacked Ireland, Portugal and Spain. It is now obvious that Italy will be next, as it was already the target of speculative attacks in July.

The plan adopted on May 9–10 2010 was supposed to put an end to the crisis. However, the market response shows that the lack of confidence has increased. The plan has been revamped several times, but each modification has only served to push back problems for one or two months. Market speculation reveals the following:

(1) This plan does not announce a clear commitment by donor countries as a large part of the funds are just a credit guarantee.
(2) The total sum is not enough to cover the estimated financial needs of 900–1000 billion euro for the three countries already targeted by the plan (Greece, Ireland, and Portugal). This amount is clearly short of what would be needed if Spain were to be rescued too. The default rate on bank credit has already reached 6.2% of the credit amount. With the planned end of the unemployment benefit package by December 2011, the default rate is likely to surge even higher, maybe to 10%.
(3) Some countries, such as Germany, are not ready to commit to obligations.

This plan has clearly been designed as an attempt to gain time. The only relevant action has been the ECB's decision to buy out government and private debt, but even this is not completely satisfactory: only monetization of some part of the debt could give real breathing space. In early May Greece asked for more money, and Portugal and Ireland are asking for a renegotiation of their interest rates.

What options are left?

Fiscal austerity plans are pushing some countries to their limits. The fiscal adjustment needed to stabilize the sovereign debt is too great to be swallowed by different countries. What is more, the deflationary spill over effect has not been computed nor introduced in various forecasts presented by governments or independent research centres.

The cumulative effect of these different fiscal adjustment plans is likely to plunge the eurozone into a previously unknown depression.

The only possible solution would be a default on the sovereign debt for some countries (Greece and Portugal and maybe Ireland). But the economic competitiveness of these countries cannot be rebuilt without a strong devaluation. On the other hand, the Russian experience of 1998 is showing that long-term benefits can outweigh short-term pain.

Table 2: Fiscal adjustment needed to keep the sovereign debt at its 2010 level

	Sovereign debt at end 2010 in % GDP	Amount of budget deficit in % GDP (2010)	Primary deficit (-) or surplus (+) needed to keep the sovereign debt at its end 2010 level	Revised results from growth figures published by independent research centres.	Minimal fiscal adjustment (in % GDP)	Maximal fiscal adjustment (in % GDP)
Germany	**77%**	-4,2%	-1,9%	-1,6%	-2,3%	**-2,6%**
Belgium	**102%**	-4,9%	-1,6%	-0,9%	-3,3%	**-4,0%**
France	**82,7%**	-7,6%	-1,1%	-0,6%	-6,5%	**-7,5%**
Italy	**118%**	-5,1%	-0,1%	1,9%	-5,0%	**-7,0%**
Spain	**66%**	-9,3%	1,1%	2,6%	-10,4%	**-11,9%**
Portugal	**86%**	-7,3%	2,7%	5,0%	-10,0%	**-12,3%**
Ireland	**78%**	-17,7%	2,2%	4,7%	-19,9%	**-22,4%**
Greece	**142,5%**	-7,9%	12,0%	15,1%	-19,9%	**-23,0%**
Greece with IMF funding	**142,5%**	-7,9%	6,3%	9,3%	-14,2%	**-17,2%**

Source: Author's computations and CEMI-EHESS database.

However, such devaluation could not be obtained within the eurozone: these countries are then bound to leave it, maybe momentarily.

Problems will not stop with Greece and Portugal. While some of the eurozone countries would not benefit from a possible devaluation (Germany, Netherlands, Finland), others would, such as Ireland, France or Italy. Large budget transfers have not backed the single currency system adopted for the euro. Germany continues strongly opposing the very principle of turning the single currency into a transfer zone. But, as the single currency has prevented adjustments of the exchange rate, this left fiscal adjustment as the only way open. Fiscal adjustments will not be sustainable.

The coming crisis could mean the beginning of the end for the euro.

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