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Can the Eurozone Survive and Be Prosperous?

The introduction of the euro went smoothly, and even though economic performance was sluggish and widening current account deficits and surpluses were clearly evident, it appeared to be functioning well through the early years. Although there had been occasional rumblings in opposition to it, there had not been, until the past three years or so, any serious contemplation of the withdrawal of a country from the euro or of the break-up of the eurozone. The budgetary crises, the high levels of unemployment and the imposition of austerity have not only spawned the eurozone crisis; they have also led to serious doubts on the future of the euro and whether its continued existence with the present policies is compatible with prosperity in the Economic and Monetary Union (EMU).

The Great Recession highlighted a range of problems with the "euro project", but these problems and difficulties are related to some fundamental weaknesses of the construction of the euro. The convergence criteria established by the Maastricht Treaty focused on nominal rather than real variables and failed to incorporate issues such as current account positions. There are well-known difficulties stemming from the macroeconomic policies imposed by the Stability and Growth Pact (SGP), including their deflationary nature and the one-size-fits-all problem of imposing common deficit requirements on all countries. Similar problems with the EMU monetary policy have also been evident. There are also problems with divergences in competitiveness and current account deficits, and the implications of these divergences for the future of economic performance within the euro area, and for the future of the euro itself, are troubling. The political limits and the ideological constraints are also serious, which leads to the unfortunate conclusion that the needed reforms are extremely urgent but will not be undertaken. This conclusion also includes consideration of the role for a substantial EMU-level fiscal policy and other aspects of political integration. Thus, the problems of the eurozone are deep-seated and unlikely to be resolved, casting a dark shadow over the future of the euro.

The economic performance of the eurozone countries since the euro's introduction had been rather lacklustre even before the financial crisis struck. Over this period, economic growth has been sluggish, inflation has remained low, though often breaking the inflation target, and unemployment has remained high. Disparities in economic performance among countries in terms of unemployment and standards of living have been persistent, and the framework of the euro area has little capability to address them. For the future operation – and indeed the survival – of the eurozone, the differences in inflation levels, in budget deficits and in current account positions are highly significant.

The Great Recession has highlighted many of the economic problems for the eurozone countries. The sharp increases in budget deficits as the economies slowed and tax revenues plummeted meant that the limits of the SGP were breached. Fortunately, the immediate response was generally to accept those breaches, but it was not long before the calls for concerted action in terms of budget deficit reduction and fiscal consolidation emerged. The danger now is that attempts by countries to cut their budget deficits will have cumulative negative effects on employment and growth and have little actual effect on budget deficits.

European leaders agreed in principle at their meeting in Brussels on 8-9 December 2011 to adopt tougher sanctions on eurozone countries that break the "new" rules of the SGP. Now known as the Fiscal Compact, it is embedded in the intergovernmental Treaty on Stability, Coordination and Governance, which includes some countries currently outside the eurozone. Its three main ingredients are as follows: first, a firm commitment to "balanced structural budgets" for the eurozone countries, defined as a structural deficit of no greater than 0.5 per cent of gross domestic product, written into the national constitutions or equivalent; second, automatic sanctions for any eurozone country whose deficit exceeds three per cent of GDP; third, a requirement to submit national budgets to the European Commission, which will have the power to request that they be revised.

In effect, the Fiscal Compact retains the principles of the previous fiscal pact versions but with the addition that countries that break the deficit rules may actually be punished. If a eurozone member state is in breach of the three per cent deficit ceiling, there will be automatic consequences, including possible sanctions, unless a qualified majority of the euro area states opposes it. The old SGP rule setting a debt-to-GDP ratio limit of 60 per cent is also retained. Any excess should be eliminated at an average rate of one-twentieth of the excess each year. Clearly the Fiscal Compact treaty reflects the notion that the euro crisis was due to fiscal indiscipline; consequently, more discipline is the only solution. Such principle is clearly misleading. The Fiscal Compact also seeks to impose without any justification a balanced budget and poses restrictions on the use of fiscal policy in the face of economic crises.

The focus of attention under the Fiscal Compact has been to impose fiscal austerity in pursuit of balanced budgets. The harshness of these austerity programmes imposed through the troika on countries such as Greece and Portugal is all too evident. These measures, however, do not and cannot set up the conditions for a return to prosperity. What is required is a series of measures to support investment and exports in the depressed economies. Many countries suffer from current account difficulties, and whilst the current account deficits have fallen in the past couple of years, this has come through the savage depression of internal demand and reduction of imports; there is little to suggest improvements in the underlying current account position. Higher levels of investment and increased exports would make a major contribution to reducing budget deficits.

Can the euro survive under such conditions? In the absence of economic integration, monetary unions without political integration have generally not had a good record of long-term survival. It could be argued, though, that the monetary union has one feature of political integration in the sense that it is the governments which determine what is treated as legal tender and accepted as payment of taxes. However, there is a need for a significant EMU fiscal policy with a budget of at least five per cent of GDP and the ability to run deficits and surpluses. The implementation of such a policy does require that the levels of tax revenues and of public expenditure, which come within the scope of EMU fiscal policy, and the balance between them are settled at the EMU level.

It is remarkable how little attention the EMU has paid to the promotion of economic integration, which would enhance convergence of economic conditions within the eurozone, whether with respect to unemployment, positions in the business cycle, common inflation developments or changes in competitiveness. A first step along this road could be the development of an EU unemployment insurance scheme, followed by the development of a common social security system.

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