The European Sovereign Debt Crisis: The Beginning of the End or the Beginning of a New and Strengthened Union?

Holland Davis
European Studies
Professor Alan Draper
13 May 2011
I. INTRODUCTION

The establishment of the European Union (EU) and the introduction of the euro have been the most significant and transforming events in recent European history. Since the inception of the EU, European integration has been on a constant trajectory of unification and expansion. The establishment and growth of the EU has completely reframed politics and economics in Europe for more than fifty years. Jean Monnet, often considered the father of the EU, asserted, “There is no real peace in Europe, if the states are reconstituted on a basis of national sovereignty…They must have larger markets. Their prosperity is impossible, unless the States of Europe form themselves in a European Federation” (“Quoting Monnet”). Up until the recent sovereign debt crisis, continued European integration seemed inevitable. Now, the future of the union looks bleak and uncertain.

If concerns and speculation about sovereign default in Europe cannot be tempered, the stability of Europe’s economies will be jeopardized and the global economic recovery may be abated. The sovereign debt crisis has suppressed growth in many EU member states and created additional risks for many international corporations. The crisis has the potential to dramatically disrupt global financial markets. If credit markets are severely impaired, a financial crisis similar to that of 2008 is a possibility. The spread of the crisis to the larger economies of Italy and Spain is particularly concerning given their regional and international economic prominence.

The most concerning consequence of the crisis has been its impact on the viability of the EU and the future of European integration. Euro-skepticism is at all-time highs. Even, Germany and France, the established leaders of European integration seem skeptical of the EU’s future. The EU and the Economic and Monetary Union (EMU) have set an example of regional political and economic integration worthy of replication; now that model is being challenged. The future
of European integration and global regional integration is dependent upon the success of the EU and the EMU.

II. HYPOTHESIS

The debt crisis has yet to be adequately addressed by the EU or the European Central Bank (ECB). This is demonstrated by high sovereign bond yields, high debt and deficit levels, non-investment grade debt ratings, and high credit default swap spreads throughout peripheral Europe. All these indicators demonstrate that investors lack confidence in the region’s ability to repay its debt. The actions of the EU and ECB have been ineffective at restoring investor confidence because none of the remedies enacted by the EU address the underlying causes of the crisis. In the present political climate, leaders of EMU member states and the citizens of EMU are unsupportive of actions that do address the underlying causes of the crisis. The European Sovereign Debt Crisis was primarily caused by a lack of political, economic, and fiscal coordination and integration within the EMU. The financial crisis of 2008 acted as the catalyst for the crisis. To restore investor confidence in the EMU, the EU should strengthen the framework of the EMU so that the union has the political power to increase economic and fiscal coordination and integration. However, increased political coordination is not supported by political leaders or the general populace of the EU.

The crisis has already affected markets and economies around the world. The EU accounts for roughly 20 percent of the world’s economy (Bird 23). Muted growth in such a prominent economic region has the potential to dampen global economic growth. The euro-zone is projected to grow by just 1.3 percent in 2011, and Portugal, Greece, Spain, and Ireland are expected to experience two or more years of negative GDP growth rates (Bird 25). Suppressed demand in the EU as a result of fiscal constraints will affect all of the union’s trading partners,
particularly the United States, a key trading partner of the union (Bird 26). The crisis also has the potential to undermine general faith in government bonds, which could potentially offset the benefits of fiscal stimulus employed by many developed nations (Bird 27). A general lack of confidence in government bonds could severely impair the economies of the US and Japan, both of which have large debt to GDP ratios. If financial markets are significantly impaired by the crisis, businesses and individuals will not be able to access necessary financing, which would lead to a decline in all sectors of the global economy. The resolution of the sovereign debt crisis is imperative for the survival of the EMU and the health of the global economy.

III. DEFINITIONS

The European Union (EU) is an economic and political supranational organization consisting of 27 member states. Each of the member states has given up various aspects of their sovereignty to the EU. The European Commission is the executive branch of the EU and yields the most political power of all the institutions within the EU. The European Parliament is the legislative branch of the union. The European Council is made up of the heads of state of the member states and determines the general agenda for the union. The European Court of Justice is responsible for ensuring that member states abide by European Community law (EUROPA).

The Economic and Monetary Union (EMU) is the currency union within the EU. The EMU consists of all 17 nations that use the euro as their sovereign currency. The United Kingdom, Denmark, and Sweden abstained from participating in the EMU, but the remaining 7 nations in the EU that have not yet joined the EMU will be required to do so once they meet the economic and financial criteria required by the Treaty of Maastricht (Treaty that established the EMU). The EMU establishes the framework that governs monetary policy, as well as limited economic and fiscal policies within the euro-zone (all nations that use the euro). The European
Central Bank (ECB) is the sole monetary authority in the union and is responsible for setting the single interest rate in the euro-zone ("Economic and Monetary Union"). The ECB’s mandate is to: “maintain the euro's purchasing power and thus price stability in the euro area” ("The European Central Bank"). All members of the EMU have conceded their monetary authority to the ECB. The Stability and Growth Pact (SGP) was established in conjunction with the EMU to ensure fiscal coordination within the union. The SGP requires that member state’s public debt not exceed 60 percent of GDP and that deficits not exceed 3 percent of GDP (Hallet 9). However, no punitive mechanisms were specified in the SGP for nations that violated the pact (Hallett 9).

IV. LITERATURE REVIEW

There are a wide spectrum of opinions regarding the actions taken by the EU and the ECB, and the best way to address the crisis. The opinions can be divided into three schools of thought. The first asserts that the actions of the EU and the ECB have not been drastic enough to calm markets and prevent future crises because of a lack of fiscal coordination. The second also considers the actions of the EU and ECB as insufficient, but supports measures focused on improving financial stabilization rather than fiscal coordination. Then, there are those groups that believe that the EMU is politically unsustainable and economically undesirable. They suggest that the monetary union cannot last in its current form and that the political will in the union is not strong enough to support further integration.

Those that think the measures taken by the EU and ECB have been ineffective because of a lack of fiscal coordination within the union suggest that the EU move towards a more centralized fiscal authority. Dominique Strauss-Kahn, a managing director at the International Monetary Fund (IMF), suggests that the EU establish “a centralized fiscal authority, with
political independence comparable to that of the ECB” (Strauss-Kahn). Mr. Strauss-Kahn argues that a monetary union without a fiscal union increases the risk of moral hazard by more profligate nations. He believes that a monetary union without a fiscal union allows for some nations to employ reckless fiscal policies at some cost to all members of the union. Increased fiscal coordination would require strong political will by the members of the EMU.

In an official EU Commission economic report, Andrew Hallet, an economist, argues that monetary coordination must be simultaneously integrated with greater fiscal coordination in order to avoid fiscal divergences. With regard to greater fiscal coordination, Hallet argues, “it ensures fiscal sustainability, without the need for arbitrary and easily evaded numerical rules” (Hallet 1). Hallet realizes the potential calamity that may ensue if the debt targets in the SGP are not met and enforced by the EMU. In order to prevent a debt crisis in the EMU, he suggests either replacing or improving the SGP so that it has the authority to enforce debt limits and punish violators. Hallet emphasizes the importance of integrating fiscal and monetary polices within a monetary union. He encourages the EMU to “manage the interactions that emerge between fiscal and monetary policies… in the European context, this means examining vertical coordination between the Central Bank, and the national fiscal authorities taken as a group” (Hallet 1). Debt problems will inevitably arise without greater fiscal coordination.

Those that support measures intended to cope with severe economic and fiscal imbalances through improved financial stability, encourage the establishment of a long-term, EU-wide financial stability facility. Graham Bird, an economics professor, argues that the current form of the European Financial Stability Facility (EFSF) has been ineffective because it does not establish a long term financing option for nations in undesirable fiscal situations (Bird 55). The ESFS is only intended for dealing with the current sovereign debt crisis and is not
designed to be a long-term solution. He promotes the creation of a “European Monetary Fund” which would be available for long-term financing needs, it would also have concrete conditions for gaining access to financing and the authority to reign in profligate state spending and overhaul ineffective economic policies, much like the International Monetary Fund (IMF) (Bird 55).

Another suggestion, proposed by those who believe that the EU needs to establish more effective financing options is the establishment of a euro-bond. The Bruegel Group, a leading European think tank, has proposed introducing a euro-zone backed bond. Bruegel suggests that the EMU establish a bond, which would be backed by all members of the euro-zone. Countries would be able to issue euro-bonds for up to 60 percent of their GDP. Nations could issue debt beyond the 60 percent level, but that debt would be subordinate to euro-debt and solely backed by the issuing nation.

There are also economists and scholars that believe the political will within the EU is not strong enough for increased EU integration. Some also argue that the economic consequences of the EMU are undesirable for many EMU members. These critics suggest that the EMU break up, or that it will inevitably break up. Albert Edwards, a strategist at Societe Generale argues that the EFSF will only temporarily hold off the collapse of the euro-zone. According to Edwards, "any 'help' given to Greece merely delays the inevitable break-up of the euro-zone". Edwards, like a number of other skeptical economists and bankers, argues that the single interest rate in the EMU is extremely problematic given the very different economic conditions of Western European nations like France and Germany compared to nations in the periphery such as Spain, Italy, Greece, and Portugal (Barr).
U.S. economist, Nouriel Roubini, has been an outspoken skeptic of the viability of the EMU (Barkin). According to Nouriel Roubini, a prominent economist, the break-up of the EMU is still unlikely in the short-run, but long-term divergences in economic growth rates and productivity levels make the EMU less viable and more cumbersome for member states. He believes that long-term economic trends make it likely that the EMU will eventually have to break-up, or exist in a diluted form. He argues that, for nations with laggard growth rates “the benefits of exit will increase relative to their costs” (Roubini). If struggling nations in the periphery of Europe exit the EMU, they can regain sovereign authority over their monetary policies, allowing them to employ monetary policies that reflect their unique macroeconomic circumstances.

V. METHODOLOGY

There will be three aspects to this paper. First, it will be demonstrated that the measures taken by the EU and the ECB have been ineffective. The independent variables used to demonstrate that the actions of the EU have been insufficient are: the €110 billion rescue package offered to Greece, the €750 billion EFSF, the rescue of Ireland, and the financial stability measures undertaken by the ECB. The dependent variables will be the response of European stocks, sovereign bond yields, CDS rates, and the London Inter-bank Offering Rate (LIBOR). Then, the primary causes of the crisis will be identified and remedies that address these issues will be identified. The Mundell II Model on the desirability of a monetary union will be used as the basis for determining both the causes and remedies of the crisis. According to Mundell II, the three essential criteria that should be met for a monetary union to be effectively established are symmetry of shocks (business cycle), flexibility in labor markets, and economic and fiscal integration. This paper will emphasize the integration and symmetry of shocks. A
quantitative and qualitative comparison between the US and the EU will be used to help establish
the causes and possible remedies of the crisis. The final section of the paper will evaluate the
political climate in the EU to determine whether the proposed recommendations are politically
feasible. The statements and actions of EU leaders, and public opinion polls will be used to
determine the relative levels of support for further European integration.

VI. RESPONSES OF THE EU AND THE ECB

In response to spikes in bond yields, and unsustainable debt and deficit levels for Greece
and Ireland, the ECB and the governments of the EU have had to prepare a number of rescue
packages. Greece had a debt level of around 120 percent of GDP and deficit level of 13 percent
of GDP for the fiscal year of 2010 (Mayer and Gros 1). When Greece announced that its 2009
government deficit had grown to 13 percent, investors began to question Greece’s ability to
service its debt (Berge). Between January and May 2010, the yields on 10-year Greek bonds
nearly doubled from just over 6 percent on March 15th to over 12 percent on May 15th. This
spike in bond yields further impaired Greece’s ability to repay its debts without restructuring. On
April 27th, 2010, Standard and Poor’s rating agency downgraded Greek debt to a level of BB
(junk bond level) (Berge). In order to address these issues, the first rescue package was initiated
on May 2nd, 2010, when the EMU member state’s and the International Monetary Fund (IMF)
agreed to a €110 billion loan for Greece in conjunction with stiff austerity measures. On March
5th, Greek parliament agreed to implement a number of austerity measures amounting to around
€4.8 billion in deficit reductions. The loan is expected to be enough to fund the Greek
government for the next three years and the austerity measures are expected to reduce
government spending by 5 percent of GDP. The austerity measures and the loan were larger and
more aggressive than most investors expected and at least temporarily calmed markets (Walker).
Without the rescue package and austerity measures, analysts were predicting a 25 to 90 percent chance of Greek default (Mandaro). A Greek default alone, does not pose a systemic risk to the European Market; the real concern is that a default on behalf of Greece would cause investors to loose confidence in other euro-zone nations’ debt. Greece’s economy makes up only about 2.5 percent of total euro-zone GDP. Italy and Spain pose a much greater danger of systemic risk since their economies are much larger and central to the strength of the euro-zone. The goal of the Greek rescue package was to prevent contagion to the other economies of the euro-zone. In this respect, the rescue package seems to have been ineffective. The rescue package prevented Greece from having to restructure its debt, but did little to relieve pressure on other European nations. Also, the rescue package does not guarantee that Greece will not have to restructure its debt in the future. The Greek rescue package has been ineffective in preventing contagion because it does not address the fundamental causes of the crisis. After the announcement of the Greek rescue, yields on Portuguese, Spanish and Irish debt spiked (O’Brien and Paul). This suggests that other struggling euro-zone nations may also need a Greek-style rescue.

On May 9th, 2010 EU officials announced an emergency funding program intended to back stop the high risk debt of struggling euro-zone nations. The European Financial Stability Facility (EFSF) aimed to “shock and awe” investors with its sheer size and to prevent another Greek-style rescue (O’Brien and Paul). The EFSF will eventually raise up to €440 billion in funds through bond issuances. These funds could then be used to assist struggling euro-zone nations. The debt raised for the EFSF is backed by the European Commission. The IMF contributed an additional €250 billion in funding and the European Commission contributed €60 billion in the form of a loan, for a total of €750 billion in emergency funding (Walker). This is
on top of the €110 billion already committed to Greece. Bringing the total sovereign rescue package to €860 billion, or more than a trillion dollars (Mayer and Gros 1).

The European Central Bank has also undertaken a number of measures intended to ease the volatility of financial markets in Europe. First, it began open market purchases of government and private debt securities. Next, the ECB announced two 3-month and one 6-month full allotment of Long Term Refinancing Operations (LTRO's) (Kearns). Finally, the ECB reactivated the dollar swap lines with Federal Reserve support (Jenkins). According to the ECB, these measures are intended “to address the malfunctioning of securities markets and restore an appropriate monetary policy transmission mechanism” (Walker). The success of these measures can be evaluated based on the response of financial markets.

After the ESFS and financial stability actions of the ECB were announced stock markets around the world rallied. The Stoxx Europe 600 Index surged by 6.5 percent and the Standard and Poor’s Index increased by 4.3 percent (Walker). Credit-default swaps on the Markit iTraxx Europe Index of 125 investment-grade companies fell by 32 basis points, indicating that investors have increased confidence in markets and are less concerned about private or public default (Walker). The London Inter-bank Offering Rate (LIBOR) fell from 0.428 percent on May 7 to 0.421 percent, signaling improved liquidity in European financial markets (Walker). The euro surged to a 1.28-dollar exchange rate, indicating renewed confidence in the common currency (Walker).

However, the actions of the ECB and the EFSF were short-lived. Negative bets against the euro surged, pushing it to an eighteen month low on May 15th, 2010. This came just days after the announcement of the EFSF and actions of the ECB (Walker). Investors have turned their attention to how struggling euro-zone nations will cope with extensive austerity measures,
improve their economic competitiveness and how the EU will address the fundamental problems with its monetary union (Walker). Ireland was also forced to seek assistance from the EFSF and implement strict austerity measures as a result of its deficit soaring to an astonishing level of 32 percent of GDP in 2010.

The EFSF package and subsequent bailouts seem to have only bought time for the euro-zone. Even after utilizing the EFSF and implementing drastic austerity packages Ireland and Greece’s 10-year sovereign bond yields are at unsustainable levels of 10 percent and 13 percent, respectively, and are rising quickly (“They're Bust. Admit It.”). It is clear that investors have little faith in the measures taken thus far. What investors are really looking for is an overhaul of the system that allowed for such large disparities in fiscal policy to occur. None of the responses of the EU or the ECB have looked at addressing the significant economic and financial imbalances within the union or the structural inadequacies of the SGP and the EMU. Investors are essentially questioning the viability of a monetary union without greater fiscal and economic coordination.

It appears that investors have shifted their attention to Portugal and Spain. On March 29th, 2011 Portugal’s sovereign debt rating was reduced to Baa, just above junk bond status, and the 10-year Portuguese sovereign bond yield exceeded a paralyzing 8 percent (Richardsen). For the fourth time the Portuguese government was unable to pass an austerity package to address the government’s unsustainable debt levels (“They're Bust. Admit It.”). Portugal has agreed to a €78 billion bailout from the EU in conjunction with IMF (Moen). However, approval for the bailout requires unanimous support by all members of the euro-zone, and Finland appears unwilling to agree to the bailout plan (Moen).

**VII. CAUSES OF THE CRISIS**
The EU needs to address the underlying causes of the crisis if it wishes to restore investor confidence and prevent future crises from occurring. The debt crisis was primarily caused by fundamental problems with the structure of the EMU, and significant economic imbalances within the euro-zone. The EMU lacks the authority to coordinate fiscal policies, which is necessary for a monetary union to be successful. The ECB sets one interest rate for the entire euro-zone, which is problematic given the significant differences between the economies of the euro-zone. The financial crisis acted as a catalyst for the sovereign debt crisis.

The Theory of Optimal Currency Areas looks at the conditions necessary for an effective currency, or monetary union. The theory was developed by Robert Mundell in the Mundell II monetary model. The model looks at the criteria that should be met for a monetary union to be established. According to the model there are some macroeconomic costs to all monetary unions. For a monetary union to be worth establishing the costs should be minimized through symmetry of shocks, labor flexibility, and economic and fiscal integration. Symmetry of shocks entails ensuring that all members of the union experience similar business cycles. Labor flexibility requires that labor markets are open and that there are minimal labor barriers between nations. Finally, and most importantly, the economies of the member states should be economically and fiscally integrated. If these conditions are met the costs of entering a monetary union are minimized and the benefits of the union can be fully realized (De Grauwe 712).

Since nations in a monetary union share a central bank, and a single interest rate, it is important that the interest rate reflects the macroeconomic conditions of all states in the union. If the nations in a currency union do not have similar business cycles, they will experience increased macroeconomic costs as a result of monetary policies that do not reflect their economic needs (De Grauwe 713). Asymmetric business cycles could lead to the need for increased fiscal
policy actions to address asymmetric shocks or to counteract monetary policies that do not match domestic economic demands. Ineffective monetary policies caused by asymmetric business cycles could provoke prolonged periods of inflation, deflation, or economic contraction. Flexible labor markets are centrally important in ensuring that nations can adjust to shocks once they are in the union (De Grauwe 713). Economic and fiscal integration is essential in ensuring that nations experience similar business cycles (De Grauwe 714). This includes coordinated tax, spending, social services, and labor polices, as well as ensuring that nations have fully integrated trade policies and business regulations.

**The Financial Crisis:**

The financial crisis acted as the catalyst that exposed all the shortcoming of the EMU and led to the sovereign debt crisis. Sovereign debt crises frequently follow financial crises because of the transfer of private debt to public debt that often occurs to relieve stress in the financial sector. Central Banks or other governmental institutions must act to restore confidence in their banks by purchasing the bad assets being held by banks and inject liquidity into credit markets during severe financial crises, as occurred in 2008. EU member states cannot facilitate this transfer of debt through monetary easing because the ECB sets the euro-zone’s monetary policies, unlike nations with independent sovereign currencies.

Government budgets are further stressed by a decrease in tax revenue caused by a decrease in gross domestic product (GDP), which occurs during economic contraction. The decrease in income and employment levels may also lead to more unemployment and welfare claims, further stressing state budgets. Another stress on budget deficits may arise if the government decides to pursue an expansionary fiscal policy to mitigate the severity and length of the recession. Given that the nations of the EMU cannot independently alter monetary policies,
the only expansionary policies available to them are to reduce taxes or increase public spending,
both of which add to deficit levels.

Both Greece and Ireland were hit particularly hard by the financial crisis. Prior to the
crisis, Greece had the highest GDP growth rates in the euro-zone at 4 percent annually. After the
financial crisis Greece’s growth rates crept into negative levels. Greece had to fund particularly
large welfare programs with less tax revenues after the crisis ("Greece GDP Growth Rate").
Ireland on the other hand, had a housing bubble much like that of the United State’s and a large
financial sector relative to the size of its economy. The financial crisis and housing bubble
forced the Irish government to rescue its struggling banks. On September 30th, 2008 Ireland was
forced to pass The Credit Institutions (Financial Support) Act, to prevent the collapse of its
financial institutions “(Credit Institutions”). The act pledged €440 billion to guarantee six of the
largest Irish banks’ deposits (“Credit Institutions”). As the financial condition of theses banks
worsened this backstop became a growing burden on the Irish budget. This led to Ireland’s 2010
budget deficit ballooning to 32 percent of its GDP ("Credit Institutions"). At the time of the
 crisis, the total assets held by Irish banks exceeded the size of the Irish economy by a factor of
ten placing a massive financial burden on the small European nation.

The financial crisis severely strained the budgets of EMU member states, but it was not
the underlying cause of the sovereign debt crisis. The United States and the United Kingdom
were also forced to take drastic measures to restore faith in their financial markets and spur
economic growth, but they have not had the same lack of investor confidence in their sovereign
debt. If Ireland or Greece were not in the EMU they could have used monetary policy to ease
pressure on their budgets by monetizing their debt through currency depreciation. This also
would have improved their competitiveness in international trade because of a decrease in
domestic costs relative to their trading partners. Also, there would be no uncertainty as to how a sovereign default would occur if they were not in a monetary union. The real causes of the crisis can be attributed to a lack of integration.

**Structural and Political Inadequacies:**

When the EMU was established in the late nineties, the SGP was the only mechanism capable of ensuring fiscal responsibility and coordination within the euro-zone. The SGP requires that member state’s public debt not exceed 60 percent of GDP and that deficits not exceed 3 percent of GDP (Hallet 9). Unfortunately, there are no punitive mechanisms for those nations that violate the SGP. As a result, many euro-zone nations have violated the SGP, including France and Germany. This has rendered the SGP relatively ineffective since so many member states have routinely and continually infringed on it without any repercussions.

The SGP pact is unenforceable because it lacks the authority to implement sanctions. The Amsterdam Treaty, the treaty that established the SGP, states that a deficit is too high if “that country’s fiscal deficit exceeds 3 percent of its gross domestic output, and if the Council of Ministers judges it to be so” (Hallett 9). Technically, an EMU member state would only be in violation of the SGP if its deficit exceeds the 3 percent level and the Council of Ministers rules that it is too high. The Council of Ministers is comprised of one representative from each EU member state and requires unanimity to rule on issues pertaining to taxation and fiscal policy. Given that the Council of Ministers is made up of ministers from every member state, it seems very unlikely that the council could unanimously agree to sanction a member for violating the SGP (Hallett 9).

The abovementioned inadequacies in the SGP allowed for Greece to pursue a policy of repeated and continual profligate fiscal spending. The sovereign debt crisis essentially began
with Greece and quickly spread to other struggling EMU member states. Greece’s public debt levels have exceeded 100 percent of GDP since 1993 (Berge). Prior to joining the euro, Greece funded government overspending by deflating its currency relative to its trading partners. After joining the euro, currency manipulation was no longer an option for Greece since it relinquished its monetary authority to the ECB. In the years following Greece’s ascension into the euro-zone, Greek politicians continued to fund large welfare programs and continually violated the SGP without any repercussions (Berge). Had there been a fiscal authority with the ability to reprimand profligate member states, it seems unlikely that Greece’s public debt levels would have grown to their current levels and other EMU member states would have prevented their debt levels from rising above 60 percent if they knew that they would be held accountable for violating the SGP.

In addition to the EMU lacking effective disincentives for profligate fiscal practices by member states, the structure of the EMU has incentivised nations to employ fiscal deficits in certain situations. Since the ECB is independent and seeks to maintain the stability of the EMU as a whole, it is sometimes not responsive to domestic member states macroeconomic conditions. If the monetary policies employed by the ECB do not match the macroeconomic conditions of an EMU member state, the government is encouraged to employ fiscal policies to offset the divergence in policy actions of the ECB. This is problematic when the ECB employs contractionary monetary policies (high interest rates) during a time when the economy of a single member state is experiencing a contraction. To offset the actions of the ECB, the member state would need to employ expansionary fiscal policies (increased public spending or decreased taxes). This causes both fiscal and monetary measures to be less effective and adds pressure to domestic state budgets. In situations of asymmetric economic contraction, member states’ only
available expansionary tools are tax decreases or public spending increases, which add to public deficits.

Investors have been particularly skittish about a possible sovereign default by one nation such as Greece or Ireland because there is so much ambiguity over what a sovereign default within the EMU would entail. Investors are unsure of how a default by one nation in the EMU would affect the euro and the EMU as a whole. When the EMU was created there was no mechanism for an orderly sovereign default, nor was there any mention of the possibility of a nation leaving the EMU. So a default by one nation could have disastrous consequences for the entire euro-zone if mechanisms are not implemented to reduce the uncertainty of a sovereign default ("OECD Economic Survey"). An official Center for European Policy Studies brief, by Daniel Gros and Thomas Mayer emphasizes the importance of establishing a mechanism for an orderly default in conjunction with any fiscal reforms or increased financial support.

It is crucial to create mechanisms to minimize the unavoidable disruptions resulting from a default. Market discipline can only be established if default is possible because its cost can be contained. A default creates ripple effects throughout the financial system because all debt instruments of a defaulting country become, at least upon impact, worthless and illiquid. However, with an exchange à la Brady bonds [orderly default mechanism], the losses to financial institutions would be limited. (Mayer and Gros 4)

Eliminating the ambiguity of a default by one nation would reduce contagion to other EMU member states in the event of a default. A mechanism for an orderly default would also allow for more accurate risk analysis and more efficient market responses.

**Economic Imbalances:**

Beyond the shortcomings of the structure of the EMU and the SGP, there are significant economic imbalances within the euro-zone, particularly between Southern European nations, such as Greece, Spain, Italy and Portugal, and northern nations like Germany, France and the
Netherlands. In particular, there are significant divergences between nation’s current account balances. Export oriented countries like Germany have large current account surpluses while less competitive southern nations like Greece have large current account deficits. According to the OECD, prohibitive market regulations and large current account deficits and surpluses allowed divergences on public debt levels to manifest (“OECD Economic Survey”). Without market deregulation goods and people cannot move freely and adjust to economic imbalances. These regulatory and current account divergences have manifested in the form of domestic asymmetric shocks and alternating business cycles within the EU.

These imbalances are significant because EMU member states share a central bank that employs a single monetary policy for the entire union. The ECB is responsible for setting interest rates that reflect the macroeconomic conditions of all EMU member states. The goal of any central bank is, essentially, to moderate the business cycle by employing contractionary monetary policies (increasing interest rates and reducing the money supply) during economic expansions and expansionary monetary policies (reducing interest rates and increasing the money supply) during economic contractions. Unfortunately, EMU member states do not experience the same business cycles (Hallet 3). Any sort of asymmetric shock experienced by a single member of the EMU cannot be addressed using monetary policy. Since the macroeconomic targets used by the ECB are based on the average of EMU member states, the ECB’s policies do not always reflect the economic conditions of individual member states. A change in a single nation’s macroeconomic performance may not be reflected in the averages of the EMU (Hallet 8). In certain situations asymmetric shocks in member states may be exaggerated depending on the actions of the ECB (Hallet 8).
Another problem with ECB’s policy of using the average of EMU macroeconomic indicators to set policy targets is that it does not account for long-term divergences between nations. The primary macroeconomic target utilized by the ECB is the inflation rate throughout the EMU. Andrew Hallet, an economics professor, articulates this dilemma:

In an inflationary period, those with below average inflation are penalized and forced to tighten as much as those with above average inflation. Similarly, in a recession, those with above average inflation must loosen just as much as those below average. (Hallet 8)

Long-term discrepancies between nations’ macroeconomic performance have the potential to severely disrupt output levels if the ECB’s monetary policies do not match the macroeconomic conditions of those nations.

The Fed faces challenges similar to the ECB, but the economic divergences within the US are not as severe as in the EMU, and the Federal Government of the US has more tools to address economic imbalances. Within the EMU there are significant differences in GDP per capita, a good measure of the relative prosperity of a nation. For example, according to statistics provided by Eurostat, Ireland, the Netherlands, and the Germany have GDPs per capita of €40,500, €36,600, and €30,200, respectively ("Regional GDP per Inhabitant in 2008"). While Estonia has a GDP per capita of just €12,000 and Portugal has a GDP per capita of €16,200 ("Regional GDP per Inhabitant in 2008"). Comparatively the GDP per capita of Delaware, the wealthiest state by real GDP per capita was $62,800, 48 percent above the national average. Mississippi, the poorest state on a per capita basis, has a GDP per capita of $29,634, 29 percent below the national average. By comparison Ireland's GDP per capita was 61 percent above the EU average and Estonia's GDP per capita was 52 percent below the EU average ("Regional GDP per Inhabitant in 2008").
There may be greater economic differences within the euro-zone compared to the US, but the real problem is that the EMU lacks a centralized fiscal authority to address asymmetric shocks. The EU's budget is only 1.23 percent of the EU's total gross national product (The Budget Explained). The US federal budget, on the other hand has historically been around 20 percent of GDP (Historical Budget Data). In the US, when one state experiences a more severe economic contraction compared to the rest of the nation, fiscal stabilizers in the form of unemployment insurance, welfare support, and increased fiscal spending are employed (Krugman 3). For example, if one state experiences high unemployment, or a significant decrease in wages, the Federal Government will still provide unemployment insurance and welfare support to that state (Krugman 3). In Europe, the responsibility of providing welfare, unemployment, and retirement support rests entirely within the independent nation. EMU member states can independently deploy expansionary fiscal policies to mitigate asymmetric economic shocks, but if they face large budget deficits and strict austerity measures, expansionary fiscal policies are not an option (Krugman 3). Paul Krugman, a Nobel Prize winning economist, uses the comparison of Ireland and Nevada to demonstrate this paradigm.

Budgets in both Ireland and Nevada have been hit extremely hard by the slump. But much of the spending Nevada residents depend on comes from federal, not state, programs. In particular, retirees who moved to Nevada for the sunshine don’t have to worry that the state’s reduced tax take will endanger their Social Security checks or their Medicare coverage. In Ireland, by contrast, both pensions and health spending are on the cutting block. (Krugman 3)

In addition, largely because of a common language, worker mobility has historically been higher in the US than it is in Europe (Krugman 3). Workers in states with high unemployment rates can emigrate to other states with better employment prospects leaving the workers that remain with less competition, which results in a reduction in unemployment levels and reduces the severity of asymmetric shocks.
Currently, the ECB is in a particularly precarious situation. Germany is experiencing economic expansion while Ireland, Greece, and Portugal are facing economic contraction. In addition, the fiscal policy tools of Ireland, Greece, and Portugal are paralyzed due to strict austerity measures. On April 7th, 2011 the ECB announced that it would raise interest rates for the first time in nearly three years (Blackstone). This is largely because the inflation rate in the euro-zone reached 2.6 percent, which exceeds the 2 percent target set by the ECB. This is amidst negative GDP growth rates in Greece and Ireland as they cope with drastic austerity measures. Raising interest rates to cope with rising inflation rates, presents a quagmire for the ECB in addressing the economic concerns of the debt burdened nations in the euro-zone’s periphery. Raising interest rates acts as a contractionary economic policy making it more difficult for struggling nations to return to economic growth (They’re Bust. Admit it.” 14). However, if the ECB were to allow inflation to rise, so too would interest rates, which would include sovereign bond yields making it even more difficult for debt burdened peripheral nations to repay their debts (They’re Bust. Admit it.” 14). If Ireland or Greece were not in the EMU, they could monetize their debt through significant monetary growth, or they could restructure their debt to more sustainable levels.

There may be significant differences in the economies of European nations, but prior to the crisis, many of the key economic indicators were converging and were not significant enough to entirely account for the inadequacies of the EMU. Also, the EU has moved towards increased labor market coordination since the founding of the union. The real hurdle for labor flexibility in Europe are the numerous language barriers. Of Mundell's three principles for creating an optimal currency union, the clear shortcoming of the EMU is the lack of integrated fiscal policies. The lack of a central fiscal authority is the reason that asymmetric shocks cannot be
mitigated as they can in the US. A centralized fiscal authority would not have allowed for such large discrepancies between nations' public debt levels. The establishment of an effective fiscal authority first requires increased political and economic integration. Increased political integration is required so that policies of increased fiscal coordination can be established.

Increased economic coordination is needed for fiscal coordination to be effective, because social service, labor, and business regulation policies are directly linked to tax and spending policies.

VIII. POLICY RECOMMENDATIONS

The EFSF has temporarily provided a safety net to protect debt burdened nations from bankruptcy. But, the fear that under-performing markets and unstable economies would have to be rescued by more responsible euro-zone nations, specifically Germany and France, has become a reality. Although the actions of the ECB and most recently, the assistance provided to Ireland, have bolstered confidence in the euro and yield hikes in Greece and other troubled countries, this is not the solution to creating long-term growth and stability across the euro-zone. Depressed countries will continue to pose a threat to the overall strength of the euro. Economists have offered a wide variety of solutions for managing risk and increasing the strength of the euro.

Fiscal Integration:

Creating new rules for fiscal discipline throughout the EU is essential in preventing a similar crisis. Germany, whose economy has seen its largest growth since reunification, has already adopted new rules for itself on fiscal discipline and provides a good example for the rest of the EU ("Fixing Europe's Single Currency"). Stronger nations like Germany can become a role model in this area and should attempt to persuade countries like Greece to follow suit ("Fixing Europe's Single Currency"). The EU has lacked a centralized fiscal authority, allowing countries to create dangerously high amounts of debt compared to GDP. Even the stable
countries of Germany and France broke the initial limits on debt and deficit levels and simply rewrote the rules when they were breached ("Fixing Europe's Single Currency"). Different countries implementing varying policies under the same currency allowed for huge imbalances and runaway debt fueled by spending booms. Without a centralized authority, reigning in these countries has proven difficult and now their crises have rippled throughout the EU, forcing their peers to bail them out and stabilize their markets.

Increased fiscal coordination would either strictly regulate deficit and debt levels of EMU member states, or coordinate fiscal revenue and expenditures at the EU level. This would eliminate the potential for large divergences in deficits and debts to emerge within EMU member states. The real problem however is that without increased fiscal coordination similar to that of the US, EMU member states will still have to cope with differing macroeconomic circumstances without the stabilizing abilities of a centralized fiscal authority. A large part of the reason that the monetary system in the US has not suffered a similar crisis is due to the ability of the federal government to absorb asymmetric shocks experienced by individual states through fiscal actions. A report by Sachs and Sala-i-Martin found that over 40 percent of the asymmetric shocks suffered by US states are absorbed by federal fiscal actions. The US also has economic divergences between states, but many of the asymmetric shocks are absorbed by federal fiscal actions, a highly mobile work force, and well integrated economies. The real shortcoming of the EMU compared to the US is the lack of fiscal authority (Hrebenciuc 54).

**Political and Economic Integration:**

If Europe were to integrate its fiscal policies at the EMU level, then the EMU would be capable of absorbing shocks such as the financial crisis through fiscal mechanisms. However, this route has numerous obstacles. Fiscal coordination would require increased political and
economic policy integration (Hrebenciuc 60). Before fiscal or economic policies can be coordinated, the political union of the EMU must be strengthened.

A strong, federal-like, political system is necessary to establish policies that allow for fiscal transfers from one member state to another to address asymmetric shocks. This would require a centralized political power similar to that of the Federal Government of the US. One significant obstacle to increased political coordination within the EMU is that any member state can secede from the EMU if it feels that the benefits from being a member of the union no longer outweigh the costs (De Grauwe 721). In the US independent states cannot feasibly secede from the nation. If the union does not have the ability to prevent nations from exiting the union, a nation experiencing a negative shock (Greece), or a contributing nation in a fiscal transfer (Germany) may find it in their best interest to exit the union. Because of immense pressure from the electorate, German and Greek politicians have found it challenging to make political decisions that may be difficult to stomach in the short-run, but beneficial for the long-run stability of the EMU. If the political institutions of the EMU had a greater degree of coercive power over the member states, policies that are in the best interest of the union as a whole could be negotiated at the EMU level (De Grauwe 720).

A coordinated political union would also be capable of preventing asymmetric shocks caused by political decisions. Tax, spending, welfare, and employment policies determined by individual member states have the potential to cause shocks and disrupt economic integration (De Grauwe 721). In an extensive study on the conditions necessary for an ideal currency union, the economist Paul De Grauwe discussed some of the shortcomings of the absence of a political union in the EU.

Unilateral decisions to lower (or to increase) taxes creates an asymmetric shock. Similarly, social security and wage policies are decided at the national level.
Again this creates the scope for asymmetric shocks in the euro area, like in the case of France when that country decided alone to lower the working week to 35 hours. (De Grauwe 720)

There are significant divergences on tax, salary, and employment policies within the EMU. Germany for example has a corporate tax rate of 30 percent while Ireland has corporate tax rate of just 12.5 percent ("OECD Tax Database"). Coordinating tax policies would have to be the first step in a move towards greater fiscal coordination. It would be difficult for Germany to stomach large fiscal transfers if Ireland can maintain a competitive advantage in corporate tax policy. There are also divergences in salary and employment policies that would have to be resolved for a fiscal union to be possible. Integrating spending on social services, public pensions, public infrastructure projects, and public wage policies would also have to be coordinated to certain degree for fiscal integration to be effective (Hrebenciuc 55).

According to the Mundell II model an Optimal Currency Area, nations in a monetary union “should have sufficient flexibility in the labour markets to be able to adjust to asymmetric shocks once they are in the union” (De Grauwe 712). America has, historically, had a more dynamic job market than Europe. However, one of the biggest obstacles to worker mobility in the EU is not regulations, but language and cultural differences between nations, which makes it much more difficult for workers to emigrate to more productive regions (Daily).

There is however ample room for improvement in some of the less productive regions in Europe’s periphery. Greece is a prime example of labor market rigidity. Their recent crisis is not a direct result of an inflexible job market, but it is an example of how deregulation and integration could improve market dynamics within the EU. Greece has around 70 inaccessible professions, which include pharmacies, lawyers, and a myriad of others (Daily). A complex system of rules and regulations has prevented entry into these professions and prevented growth. Simply buying a license to be a commercial driver can cost as much as $500,000 and finding a
license for a pharmacy from a retiring pharmacist will cost around $400,000 (Daily). These types of barriers prevent competition and efficiency. Simply opening up these markets would allow them to grow by up to $35 billion, or 10 percent, over the course of 5-years, according to a study from the Greek IOBE (Daily).

Another key component of a successful monetary union is for the nations of the union to be economically competitive with one another. A good measure of the relative competitiveness and productivity levels between nations is their unit labor costs. The unit labor cost is a ratio of total compensation over real output levels. A higher unit labor cost indicates that the cost of doing business in that nation is high compared to other nations for the same level of output. Since the inception of the EMU, the unit labor costs in France, Finland, Austria, and Germany have decreased substantially (De Grauwe 717). In Europe’s periphery unit labor costs have increased even more dramatically. Portugal, Greece, Italy, and Ireland have all seen sharp increases in unit labor costs over the past decade (De Grauwe 717). Unit labor costs do indicate that compensation levels are increasing, which is a good for the employed. However, when the pace of labor costs increase more quickly than productivity levels, these nations are left at a competitive disadvantage.

A sharp divergence in labor costs is particularly problematic for a monetary union because the member states share a central bank that targets inflation averages. If labor costs are decreasing in Germany, but increasing in Portugal, Greece, and Italy, the price increases will not be captured by the inflation average. In this situation the only way for nations with increasing unit labor costs to regain competitiveness is through domestic wage deflation. This is an extremely painful process for the nations with high labor costs (De Grauwe 717). Wage deflation can really only occur with high levels of unemployment, which suppresses wage
demands (De Grauwe 717). This situation drastically decreases the benefit of remaining in a monetary union for nations experiencing wage deflation.

The increases in unit labor costs in much of Europe’s periphery were caused by ascension into the union without adequate fiscal and economic integration. When the monetary union was established, nations like Greece, Ireland, and Portugal were able to borrow at much lower costs because of faith in the single currency, and the establishment of a common interest rate. In Greece this led to a public borrowing boom to fund unsustainable wage and pension programs. This artificially inflated wages and increased public debts. In Ireland, Spain, and Portugal lower interest rates translated into housing and lending booms. This inflated real estate and wage levels to keep up with demand for mortgages and cheap credit. Ultimately this ended in massive bank rescues and the collapse of the real estate and construction markets (Hrebenciuc 58).

To increase member state convergence in unit labor costs, economic and fiscal policies need to be coordinated within the EU. In Greece, a large part of the causes of increases in unit labor costs can be attributed to wage and labor policies, and expensive public pensions and salaries funded through public debt. Ireland saw wage increases because of loose credit policies and a runaway housing boom. If tax, labor, social service, and pension policies are coordinated many of the conditions that allowed for divergences in unit labor costs could be avoided. Business regulations should also be coordinated to reduce the likelihood of productivity divergences (Beyond Austerity 4-5).

Financial Stability Facility:

A less politically divisive, potential remedy to the sovereign debt crisis is increased financial coordination through the establishment of an EMU financial stability facility. One example of such a remedy is a collective EMU bond. A collective bond would allow the EMU
to mitigate borrowing risks of countries like Greece and Ireland by pooling risk with more credit-worthy nations such as Germany. A euro-bond would also be more liquid than individual countries' bonds, which would further reduce yields. A euro-bond option would be similar to a centralized treasury style bond in risk. Countries would be able to issue euro-bonds of up to 60 percent of their GDP. These would be backed by the entire euro-zone. Nations could issue debt over the 60 percent level, but it would only be backed by that nation and subordinate to euro-bonds (Bruegel). The creation of an oversight group, the Independent Stability Council (ISC) would oversee all allocations of euro-bonds (Bruegel). The creation of euro-bond would allow for all nations within the EMU to take advantage of lower yields as a result of pooled risk and increased liquidity. The market for euro-bonds would be similar to that of US Treasuries in size, liquidity, and risk.

High bond yields are problematic for debtor countries, but they serve as an early warning sign that a country is having trouble servicing its debt. The euro-bond proposal allows individual countries to limit their risk by issuing EMU backed euro-bonds, which pools risk across the EU. At the same time, countries forced to issue bonds above the 60 percent mark would have to suffer the higher yields of potentially riskier bonds. The drawback to issuing high yield bonds does not change with the euro-bond, but it does make promoting fiscal responsibility look more appealing since all EU countries are sharing risk and domestic bonds above the 60 percent level would have a much higher yield than the euro-bonds. The higher yields incurred by nations that issue debt beyond the 60 percent level would act as a punitive mechanism for nations that violate the SGP (Bruegel).

An additional component of the euro-bond initiative is to establish sovereign bankruptcy measures for EMU countries. The EFSF was established because allowing Greece to default
would have been far too risky for the EMU to allow. Within the EMU there is currently an unknown component to sovereign bankruptcy, which makes accurately evaluating risk impossible. Outlining what measures would be taken in the event of a sovereign bankruptcy does not necessarily reduce the risk of default, but it does prevent widespread contagion. If nations could default on subordinate domestic debt without jeopardizing the euro, or the solvency of euro-bonds there would be much less volatility in financial markets in the event of a sovereign default.

Remedies such as the euro-bond would be a step in the right direction towards greater integration, but financial measures alone may not be enough to revive the union. Nations like Greece, Ireland, Portugal and Spain would still have to address issues of labor costs and labor productivity independently through wage deflation. Asymmetric shocks would still be a problem that could not be remedied through fiscal limits. These measures would help to improve fiscal coordination but without a central fiscal authority, stability and uniformity could not be guaranteed. Anything short of improved political coordination means that nations could still leave the union if they feel the benefit of the union no longer outweighs the costs, which severely undermines the EMU’s ability to act decisively and boldly. Without increased political integration substantial fiscal and economic reforms are unlikely. In the absence of increased integration nations will face increased costs as a result of being in the union and the likelihood that the costs will eventually outweigh the benefits becomes an increasing reality.

**IX. OBSTACLES TO REFORM**

Increased political, economic, and fiscal integration will restore investor confidence in the euro and the EMU. Increased fiscal coordination or regulation, and the introduction of a euro-bond address the inadequacies of the SGP and the EMU, which allowed for such large
divergences between EMU nations’ fiscal policies. Increased economic integration through wage, labor, tax, and social services policy coordination would reduce economic imbalances between nations of the EMU and improve the competitiveness of the union as whole. However, all of these proposals face significant political and logistical obstacles to being effectively enacted.

The European project has been one of continued growth toward an unknown end result. The union has continually expanded membership and gradually increased economic and political integration of members. It has expanded from a union of just 7 nations to one comprised of 27 member states. Economically, it has advanced from a trade bloc to a monetary union. And politically, the union has established legislative, executive, and judicial branches to enact, execute, and enforce EU legislation ("The History of the European Union"). The union has reached a real crossroads as to where to go from here; towards further integration, a two speed Europe, or the disassembly of the union. This uncertainty makes decision making particularly difficult for both EU officials and the national leaders of EU member states. This uncertain progression is demonstrated by the EU’s inability to promote political integration at the same rate as it has with economic integration.

Member states have never been able to agree on the finalité politique, making the European experiment a journey to an unknown destination…The EU, however, has proved unable to strengthen its political institutions at a pace and with a depth consistent with the needs of its integration, as well as the number and heterogeneity of its membership. (Cameron 4)

The Failure of the EU to coordinate political issues at the same rate that it has coordinated economic policies is why the EMU exists as a monetary union without a fiscal union.

It seems that the political and popular will for increased and coordinated integration is even worse than it has been in the past. Public opinion in the member states of the EU has
become increasingly skeptical of the European project. According to a recent poll by TNS Opinion and Social research group for the European Commission conducted in the summer of 2010, public support for membership in the EU has fallen to 49 percent (Grajewski). This is the lowest level of public support for the EU in nine years. Most disconcerting for the future of the Union is Germany’s increasing Euro-skepticism. Largely as a result of the recent bailouts of Greece and Ireland, German public support for EU membership fell by 10 percent to just 50 percent in 2010 (Grajewski).

The lack of public support for the union has translated into less pro-European national leaders and domestic policies. Furthermore, the prior leaders of European integration, Germany and France, are divided and uncertain of the future of the EU (Cameron 4). The largest obstacle to increased integration is the lack of political will on the part of member states and, in particular, the lack of public support for increased EU integration. In an official EU report, Sony Kapoor, a Managing Director with Re-Define, articulates some of the most daunting political obstacles facing further EU integration.

The problem is that significant groups of citizens, stakeholders and Member States remain opposed to various elements of this grand bargain. For example, German opposition to Eurobonds, Luxembourg’s opposition to further tax harmonization, the opposition of worker groups to more services liberalization and of business groups to higher levels of social protection etc. are highly entrenched and potentially intractable. (Kapoor 10)

Essentially, there are objections from some group or nation within the EU for every suggested policy recommendation intended to rectify the sovereign debt crisis.

In the April 2011 elections in Finland, a populist, anti-EU party made significant political gains. The True Finns party received about 19 percent of the vote on a platform of anti-Europeanism. In the last election in 2007, prior to the surge of Euro-skepticism, the True Finns received just 4.1 percent of the vote. The True Finns have vowed to block any future bailouts
including a bailout of Portugal. Any sovereign bailout within the EU requires unanimous support by all member states, so a veto by Finland would paralyze the union’s ability to offer support. If Portugal does not receive aid, the prospect of a default or a disorderly exit from the union becomes increasingly likely (Ward). The recent vote in Finland highlights a sense of growing antagonism between the wealthier nations of the EMU and the peripheral nations of the EMU that are struggling to reign in their finances. This conflict will make further EMU integration more difficult.

EU countries have always been wary of granting too much power to a centralized authority, be it fiscal or political. The current skeptical and uncertain political climate makes increased fiscal coordination extremely doubtful. The creation of a fiscal authority similar to the United State's has been proposed on several occasions. The switch to a centralized fiscal authority would undoubtedly be difficult and find much opposition throughout the EU. For example, Sweden’s Prime minister, Fredrik Reinfeldt, responded to the suggestion of increased fiscal coordination, saying “We are a shining exception with good public finances and don't even come close to the limits [under euro-zone rules] one is not permitted to surpass…It is not fair to treat us the same way [as some other countries]” (Quinn). This articulates the fears of the frugal and economically competitive Northern European nations, which makes increased fiscal coordination an extremely unlikely option. The additional political and economic coordination that would be needed for effective fiscal coordination makes fiscal coordination even less likely.

Increased economic coordination comes with numerous political and functional obstacles. Centralizing social services, tax policies, and employment regulations and benefits comes with drawbacks for EU countries. For instance, countries with high current unemployment levels would potentially remain at high unemployment levels if European employment insurance was
centralized. Productive countries would end up subsidizing these countries' unemployment. Additionally, Europeans are unsupportive of creating a central authority, which would require increased powers to legislate and punish countries that do not follow new EU standards (Economist). Increased economic coordination also has the potential to disrupt the European welfare model (Cameron 3).

Even less politically controversial measures like the euro-bond proposal seem improbable in the current political climate of the EU. Pooling risk through an EU wide financial stability facility would be difficult to enforce, and if countries such as Greece continue to practice fiscal irresponsibility, then the productive countries would continually be forced to supplement them financially. The EU is currently depending on a minority of financially responsible countries. The current average debt to GDP of EU countries is around 84 percent, far above the 60 percent proposed in the SGP or the euro-bond initiative (Bruegel).

There are, however, some optimists that have more faith in the future and stability of the European project. Nicolas Sarkozy and Guy Verhofstad, the former Belgian prime minister, believe the EU is capable of moving towards increased integration (Cameron 4). In the 2010 EU Heads of State Declaration, the leaders of the EU committed that they were “ready to do whatever it takes” to maintain the union (Llewellyn and Westaway 2). As critical as some European leaders may be towards further integration, they do not want to be responsible for the demise of the EU or the euro (Llewellyn and Westaway 2).

There are some optimists that argue that the EU will survive without the loss of any members or any major changes to the structure, or authority of the union. They argue that Europe has the resources to address their public and private budget issues. The euro-zone has a debt to GDP ratio of 84 percent and a 2010 deficit equal to 6 percent compared to a debt of 90 percent
and deficit of 11 percent of GDP, in 2010, for the US. They also argue that there is a great deal of political will in retaining the union, even if that means rescuing struggling member states.

Even optimists realize that there are still some significant risks regarding the EMU’s future. Italy and Spain present a much greater risk to the future of the EMU. They are the 4th and 5th largest economies in the EU. If financial troubles spill over into Spain or Italy, the EMU may not have the resources to prevent a serious financial crisis. Based on Sovereign bond yields, Spain may be targeted by investors after Portugal. If Portugal does not receive a rescue package troubles may spread to Spain even sooner. Spain’s economy is about twice the size of Greece, Ireland and Portugal’s economies combined. To avoid such a risk, economists suggest recapitalizing Spanish banks, which would cost the EU between €43 and €80 billion. Optimists also concede that Greece, Portugal, and Ireland will have to sustain economic contraction and stiff austerity packages for some time into the future (Llewellyn and Westaway 2).

The EU will survive as a trade and loose political and economic union regardless of what happens to the euro and the EMU. The real concern is whether the EMU will survive in its current form as a monetary union. As discussed in the Mundell II monetary model, nations enter into, and remain in currency unions so long as the macroeconomic benefits of the union outweigh the costs. The survival of the EMU is dependent upon nations remaining in the monetary union because it is in their best interest to do so. If the costs for Greece and Ireland become too great they will have no incentive remain in the union. If they are forced to sustain years of strict austerity, economic contraction, and deflation it will be difficult for the public or their political leaders to justify remaining in the monetary union. If German voters tire of rescuing their more profligate peers they may also find it appealing to exit the union and return to the Deutschmark.
The reason that US sovereigns have not been targeted by investors is that investors are confident that the US has the political power and will to address its debt issues. The US has a strong federal government with an independent monetary authority, and both of which have powerful tools to deal with issues related to rising debt levels. American politicians may posture over raising the debt ceiling, or how to address the rising debt levels in the long run, but there is little concern that the US will actually default on its debt, or that the monetary and fiscal union of the US will collapse. There are, however, real and legitimate concerns that nations in the EMU will have to restructure their debt and nations may find it in their best interest to exit the EMU.

X. CONCLUSION

The actions of the EU and ECB have been ineffective because they do not address the underlying causes of the sovereign debt crisis. The EMU faces significant challenges, but if EU officials are willing to take decisive and bold actions, confidence in the union can be restored. The EMU must address the fundamental causes of the sovereign debt crisis by increasing political, economic, and fiscal coordination. However, it seems that political will and public opinion within the EU is not supportive of increased integration. The situation may have to worsen to the point where the consequences of inaction are so great that the very survival of the euro and the EMU are put into question. Then, EU leaders may be willing to take bold actions to revive the union. If the EU fails to take decisive action it is doubtful that the EMU can survive in its current form given the significant challenges facing the union.

There are clear and proven economic benefits to monetary unions, but there are also costs and those costs increase if nations in the union are not sufficiently politically, economically, and fiscally integrated. No nation will have any incentive to remain in the monetary union if the costs of doing so are more significant than the benefits. The current will not completely derail
the European project, but it has certainly created a significant detour. It is hard to say what the future is, but inaction and stagnation are not an option. Some peripheral nations may find it in their best interest to exit the EMU, and the situation may worsen before any meaningful reforms are made. However, the EU and the EMU will not disappear, and at some point and in some form, the EU will continue on a path of expansion and integration.

WORK CITED


