

## The “Euro Crisis”: Implications for Wider Europe

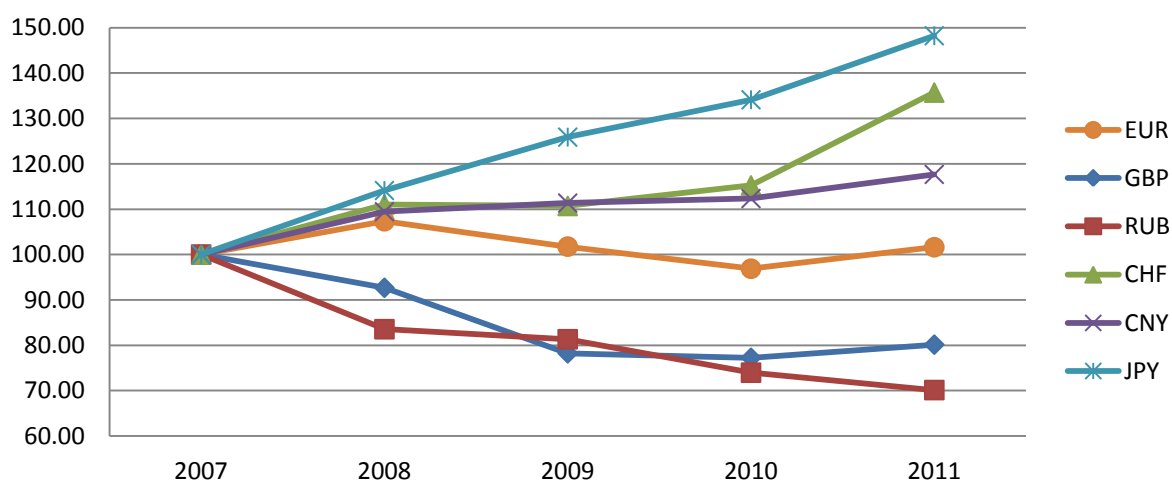
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Euro-pessimism has been a feature of the global financial crisis, particularly since Greece and Ireland’s fiscal meltdowns in 2009 and 2010 respectively. This was followed by the debt crises in Portugal, Ireland, Italy, Greece and Spain (the so called “PIIGS”), and most recently by the downgrade of the triple A sovereign debt qualifications of France and Austria by Standard & Poor’s on January 13<sup>th</sup> 2012, bringing additional uncertainty to the eurozone. The fear of further repercussions on the other countries in the entire union is growing stronger. These are indeed trying times for the EU and constructing scenarios in which things worsen hardly requires the imagination of a novelist. However, some of this criticism is perhaps misguided as a [recent presentation](#) from the UNDP senior economist’s office in Bratislava suggests.

### The Good, the Bad and the Misunderstood

Despite the alarmism, a scenario in which dissolving the euro is best practice still seems unlikely. The euro will most probably survive, because the alternative option would be significantly more painful for all countries involved. On the contrary, there could be positive outcomes from the current crisis including the benefits of a weaker euro and the now inevitable fiscal reforms. That said, Europe still remains in serious economic trouble with medium term stagnation if not recession the forecast. And while improbable, the risk of a serious financial crisis leading to the breakup of the EU is non-trivial. In spite of this, the euro has not behaved like a currency in crisis (significant depreciation against main trading partners), as demonstrated below.

**The Euro, other major currencies' exchange rates against the dollar  
(2007-2011)**



Source: OANDA and Central Bank of Russia. EUR: Euro, GBP: British Pound, RUB: Russian Rouble, CHF: Swiss Franc, CNY: Chinese Yuan Renminbi, JPY: Japanese Yen.

The financial instability experienced by eurozone countries during 2009-2010 was the result of violations to the EU's Stability and Growth Pact and despite some progress in reducing budget deficits, public debts expanded further in 2010. This should not however be demonized as long as it is a reflection of countercyclical expansionary fiscal activity, says [this paper on the Euro crisis](#) written by the UNDP BRC senior economist.

The truth is that fiscal policies in many European countries are neither sustainable nor credible. The events in Italy that prompted the fall of Berlusconi's government, the installation of a technical government and the peak in the cost of refinancing Italian debt in the fall of 2011, and the subsequent volatility in this cost is a clear reflection of the uncertainty in capital markets. In addition to short term debt and deficit strains generated by the fiscal response to the crisis most European countries face longer-term fiscal challenges, driven by the high debt over GDP ratios and the economics of shrinking, aging populations (which imply rising pension and public health care costs). These fiscal problems cannot be laid at the door of the Euro; they existed long before the EU couldn't agree what picture belonged on the €100 bill. Europe will be a source of financial instability and contagion for years to come.

### **A Non-Fiscal Monetary Union**

The benefits of a monetary union in Europe have included the abolition of exchange rate risk within member countries which has helped to promote trade as well as lower transaction costs, which reduces uncertainty and therefore induces economic activity.

There is of course no such thing as a free lunch, and the quagmires of a monetary union without fiscal unity are painfully apparent in hindsight. Perhaps most significantly, the Stability and Growth Pact has created a European Central Bank but not a European Ministry of Finance, there are weak sanctions for violators and due to a lack of a common fiscal policy, the burden of policy making is placed almost exclusively on monetary policy. Couple this with trying to solve competitiveness issues via non-monetary tools such as fiscal transfers and the limitations of the euro are apparent.

### **Where do we go from Here?**

The current challenges facing the eurozone are debts, deficits and weak competitiveness. The reality is that these challenges are not facing the eurozone as a whole; they are problems with member countries (PIIGS) that are transferred to other EU countries via the eurozone.

Greece, Ireland and Portugal have all lost access to international capital markets and have therefore required bailouts by the International Monetary Fund (IMF) and European Financial Stability Facility ([EFSF](#)). If Spain and/or Italy also lose their ability to access capital markets it is unclear whether the IMF or EFSF have the depth to act as a lender of last resort. Whatever the outcome, there is limited chance of expansionary fiscal policy in the foreseeable future owing to the strict limits on financing.

Many financial institutions that own Greek debt are negotiating "haircuts" on Greek debt<sup>1</sup>, they have already suffered heavy losses during the real estate collapse of 2008 and now need to raise capital for their own sustainability – an unenviable position given recessionary conditions and generally tight credit markets. Unemployment has been 50% higher than pre-crises levels for around 2 years now, leading many to predict that a double dip recession is on its way (if it hasn't already arrived).

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<sup>1</sup> At the time this brief was posted, on January 24<sup>th</sup> 2012, Greek talks with bondholders over debt 'haircut' deal are still ongoing.

## **The implications for Wider Europe<sup>2</sup>**

Eastern Europe's new members, even those whose economies rebounded in 2010 such as Poland, Czech Republic and Slovakia, will suffer from a slowdown in external demand for their main export products and foreign direct investments (FDIs). Also, short term foreign capital inflows are unlikely to fully recover anytime soon. This will also impact the Baltic economies. The Balkan countries that still have not recovered from the hit of the 2009 crisis - such as Croatia - will be further penalized by the slowdown in export demand and the consequent wider trade and current account deficits now financed at higher rates. Stagnation in Europe and high unemployment will have an impact also on remittances with potential repercussions on countries in the region highly dependent on these flows such as Kosovo, Albania, Bosnia and Serbia.

### **Take it or Leave it**

If things are so bad why not leave the eurozone? Legally it is virtually impossible and you can't leave the eurozone without leaving the EU. Perhaps the Greeks could dance to their own beat (as they often have) and just leave anyway, reintroduce a national currency and devalue to restore competitiveness. Or Perhaps the Germans leave (with other northern Europeans) and create a "northern euro" that appreciates against the euro helping to restore eurozone competitiveness.

Whatever the scenario, a country leaving the eurozone would face massive capital outflows, huge devaluations, high inflation and bankruptcies. Add to this a multi-year legal nightmare, global contagion and it seems an unlikely a nation can ever view this as a best response to the eurozone crisis.

The choice is quite clear – bad or worse? The optimistic scenario calls for 2-3 years of limited to zero economic growth, financial instability and socio-economic tensions. The pessimistic scenario is that of a financial collapse and global financial contagion – highly improbable, but not impossible.

– 24 January 2012

*This piece does not constitute an official statement of UNDP, the United Nations, or its member states.*

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<sup>2</sup> The term "Wider Europe" is used here to indicate European Union 27 countries plus the EU candidates and other European countries [http://europa.eu/about-eu/countries/index\\_en.htm](http://europa.eu/about-eu/countries/index_en.htm).