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THE EU CRISIS AND THE NEED FOR REFORMS

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Abstract: *Disparities, imbalances and tensions between EU members are not a new phenomenon or, solely due to the ongoing global financial and economic crisis; rather, they emerged already just after the third stage of EMU has been implemented. The first signs of imbalances could be observed in increasing current account imbalances of all EMU member countries, and increasing trade imbalances in intra-EU trade. The recent crisis added imbalanced public deficits and unsustainable debt levels in some countries. The analysis of the problems will be based on the theory of voice and exit, applied to the institutional framework of the EU. It will be argued that the current EU framework is characterized by an imbalance of voting rights and inflexibilities. This conclusion will be applied to the discussion of recent reform proposals, like an EMF, a fiscal transfer system, or a more centralized economic policy.*

Key words: *EMU, reform, public deficits.*

1. Introduction

It is now widely accepted that the severe and strengthening crisis of the European monetary union (EMU) is not a Greek but a a general crisis, in part of the institutions of the monetary union. On the search for the roots of this crisis one has to understand the institutional framework. There are few attempts to analyze the monetary union from an institutional approach. DeGrauwe (2005) argued that an optimum currency area needs to be in institutional equilibrium between symmetry, flexibility, and integration. If symmetry of shock distribution is too low, regions need flexibility to respond. More integration may improve symmetry, and institutional solutions that restrict regional flexibility – like a common currency and a single monetary policy – would work. Recent debates about solutions of the ongoing EMU crisis circle around the question whether and how Greece (or other countries) should leave the euro zone. With respect to this issue, the following discussion relates to a recent analysis by Dietrich and Klein (2010), which in turn is inspired by A. O. Hirschman's (1970) book "Exit, Voice, and Loyalty".

2. The Exit-Voice Model

Hirschman asked how organizations work and how they react to problems. His assumption is that there is an absolute or comparative deterioration in the quality of the product or service provided by an organization (a firm, a local community). Birch (1975) put it into a very simple diagram:

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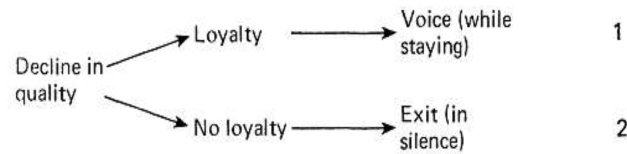

Fig. 1. *The Loyalty-Voice-Exit model*

Clients or customers react to the deterioration of products either by raising their 'voice' (criticizing the management, demanding improvements or compensation) or silently by 'exit', i.e. they change to another firm. Loyalty is an important aspect with respect to the choice of behavior. Voice is based on loyalty, exit is not. But, loyalty can turn into non-loyalty and exit, if the product or service quality does not improve. In this simple framework, there is only the alternative voice or exit, nothing in between, and it seems appropriate to simple organizations. However, a supranational organization like the European Union and its monetary union is a more complex body. Article 4 of the consolidated EU treaty distinguishes divided and exclusive competences of the Union. Hence, the complexity includes sub-organizations with low or almost no exit right – this is the case of the monetary union or competitive policies. It includes also explicit and orderly organized exit rights – for example, membership in the EU in general. And finally, there are fields where nations may or may not participate in stronger cooperation, and where they are not ready, everything belongs to national competences, which should be coordinated. Hence, the complex picture of the EU is not a simply 'yes-no' scheme of exit and voice, it is more a gradual relationship between voice or participation in governance and flexibility of participating or not-participating = flexibility). Flexibility measures the degree of exit options in the various fields of European integration. We may apply this model to the analysis of a supra-national organization like the EU: Voice (loyalty) and Exit (no loyalty) stand in inverse relations to each other (Dietrich and Klein, 2010).

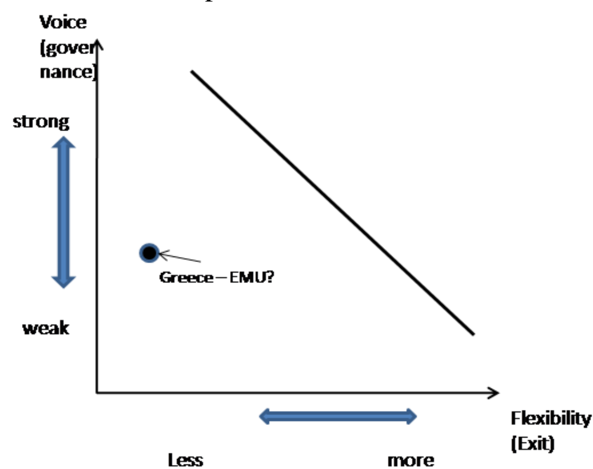

Fig. 2. *The inverse relationship of voice and exit*

The curve in Figure 2 has a negative slope, since with decreasing exit options, a member needs to have more participation (voice) rights; otherwise, loyalty would vanish. The curve depicts all combinations of voice and exit rights, where loyal conflict solution is possible. If members of the organization would recognize a decline in the organization's product quality, they needed to expect a reform either improving the quality of the product or compensating for the losses. Without reforms, conflict solution is asymmetrical. This is the field below the curve. Above the curve, the organization is characterized by too much participation at a given level of flexibility. While an example for the latter case is the period of veto rights in the EU, an example for the former case might be the EMU: the lack of exit from the common currency and single monetary policy without any compensation in case of a financial crisis ('no bail out'); hence, we would diagnose a non-optimal institutional framework with asymmetric problem solutions, if the quality of the EMU's product declines. This issue will be further discussed.

3. The Decline in the Quality of EMU 'Products'

The products the EU offers its members are described in article 2 of the consolidated EU treaty and specified in the Lisbon Agenda of 2000. They are: a high employment level, sustainable non-inflationary growth, a high degree of competitiveness and convergence of economic performance of member countries. In addition, the quality of the euro can be defined as internal and external stability for members. However, the quality of these products deteriorated after competitiveness and growth across the euro members started to diverge.

The divergent development of competitiveness and convergence finds its expression in different inflation rates, unit labour costs and current account imbalances among the members of EU and EMU (Figure 3). The dramatic rise of imbalances started immediately after the introduction of the euro. There are only few countries with a surplus in trade, among them the largest EU economy Germany. The mirrors of Germany's surplus are the deficits of Portugal and Greece, Spain, Italy and Ireland.

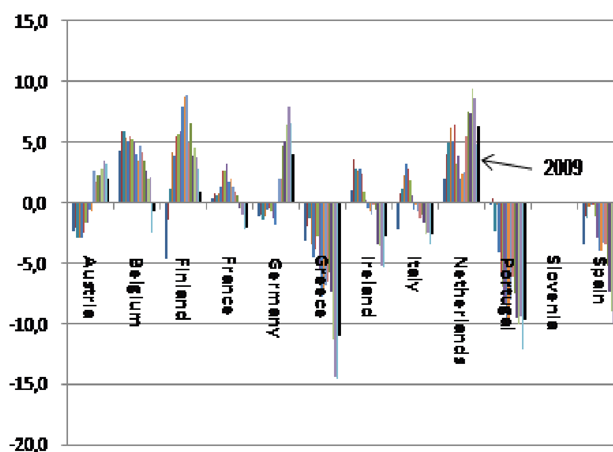

Fig. 3. *Current Account Deficits in % of GDP (1992 – 2009)*
Source: OECD; author's presentation

Long-term imbalances in the current account flows lead to emerging stocks in monetary balances. Figure 4 depicts the cumulated current account (CCA) positions as a proxy for net external debt. We compare two periods: the first includes the pre-euro period 1992-1998, the second the years 1999-2009, and we use the same scale. We may detect a very strong bias towards imbalances in the euro-period compared to the pre-euro-period. Germany, the Netherlands and Sweden recorded a huge increase in the cumulated surplus. And in this group, Greece and Portugal have severe problems with competitiveness with a real exchange rate that is too high, maybe by 50 %. Spain might follow. One finds a development that followed the pattern of the introduction of the German Mark in East Germany 10 years ago.

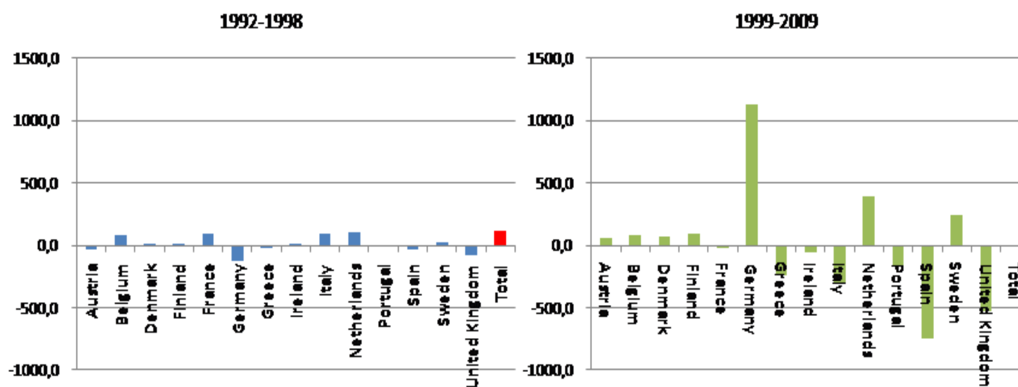

Fig. 4. *Cumulated Current Account (CCA) Positions of EU countries*
Source: OECD; author's presentation

The next figure (5) illustrates the ratio between foreign debt (CCA position) and the GDP (1998 and 2008 respectively). What we can see is a dramatic improvement of the German position from minus to plus and a sharp deterioration of Greece, Ireland, Italy, Portugal and Spain. This is the emergence of the split of the EU into a northern and a southern group since the third stage of monetary union began.

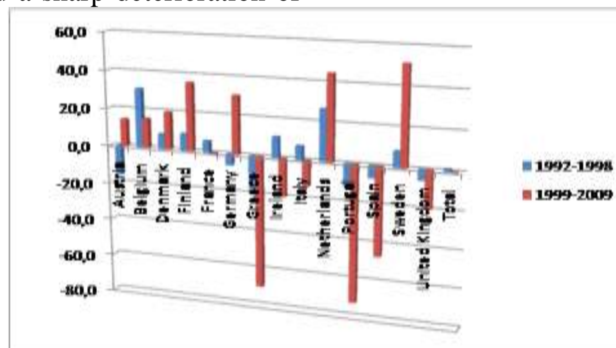

Fig. 5. *CCA Positions in % of GDP (2008 and 2009 respectively)*
Source: OECD; IMF (IFS); author's presentation

The current financial crisis added another problem to the EU economy: the threats to the quality of the euro as another major product. Financial markets assess these threats in relation to the quality of public finances in the member countries and the ability of the entire EU to solve this problem. The southern countries belong to those countries, whose public finances were in part hit by the crisis, and where public debt in terms of GDP increased strongly. The crisis elevated the government budget deficits and public debt figures above the margins the stability and growth pact sets for countries (Figure 6). Certainly, a part of increasing deficits and debt was due to the shift from private to public debt following the emergency measures of the governments of individual countries. This is a pattern Reinhart and Rogoff (2009) have revealed in their history of sovereign default.

Public position

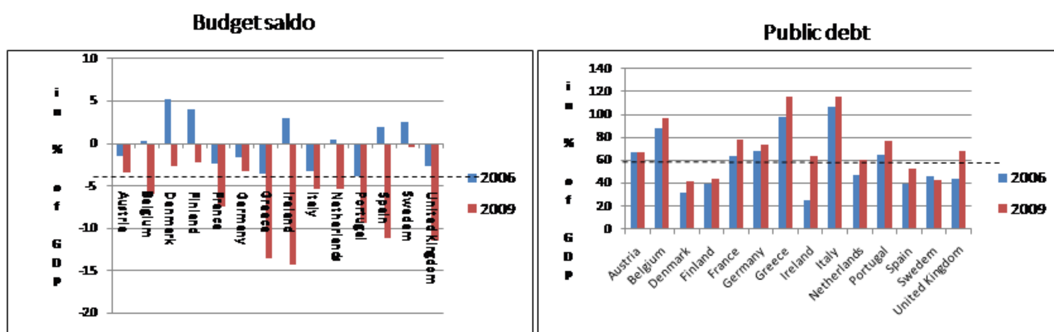

Fig. 6. *Public positions in % of GDP*
Source: Eurostat

4. The Dilemma of Asymmetrical Solutions

A closer look into the figures reveals that the lack of competitiveness of Greece and other deficit countries is not one of weak productivity progress or laziness. On the contrary hourly labor productivity increased more than twice as fast in Greece than Germany during the ten years of the euro since 1999. Nor do frequent claims in the media of Greek 'laziness' stand up to scrutiny: average annual working hours are the longest in Europe. The problem has been with diverging wage and price setting. Surplus countries' wage formation institutions (trade unions, employers' federations, and the government) were able to moderate nominal wage increases below productivity progress, while this way was not followed in Greece and other countries. With own currency, the nominal exchange rate would correct for such attempts to obtain competitive advantages. With euro adoption, member countries like Greece lost this instrument. This statement requires a closer look to the changes in behavior in members. Take Germany: like in all countries, nominal wages followed productivity progress plus the inflation rate

until 1999, which was about 2 % a year and became the official inflation target of the European central bank. This productivity plus 2 % target is still the official formula in the macro-economic guidelines for wage policy of the EU commission. Also, the German council of economic advisers sees this formula as the condition for euro stability However, with the start of the euro, Germany changed the wage formula: nominal wages fell below the sum of productivity and inflation while most of the other countries followed the informal rule.

This is the major difference to currency areas with a strong fiscal institution that can help to mitigate the shocks for some regions. Ample examples are Germany with its Western and Eastern parts, and also the United States. It has been stressed in the literature, that one of pre-requisites of an optimal currency area is a mechanism for inter-regional transfers. Hence, there is no orderly exit and no orderly compensation for the deterioration in the quality of the product in terms of output stability. It was mainly Germany that, in dispute with France pleading for a strong fiscal player in the monetary union, forced the institutional framework we have in the EU today. The introduction of the German Mark in East Germany was coupled with an implicit devaluation of the German Mark, followed by massive exports to East Germany. While net exports to weaker EMU members were financed by credit, they were financed by transfers to East Germany. Germany wanted and wants to avoid the EU to become a transfer union – but there is no free lunch. Accumulated trade surpluses and increasing Greek debt are unsustainable, and sooner or later the borrower has to pay – in our case by huge public money in Germany and other countries to guarantee repayments of Greek and other countries' public debt. So, all solutions are asymmetrical: Greece has to accept a harsh austerity program with deflation; Germany has to accept de facto transfers via Greece to the private banks.

Instead of implanting a single fiscal policy by strong coordination, the monetary union installed a rule for binding fiscal policies – the stability and growth pact. However, this pact failed to function properly. Certainly, Greece has obtained by trickery and support by Goldman & Sachs EMU membership and has to accept harsh remedies. But, the stability and growth pact is not able to deliver the expected product. The weak position of stability and growth pact is revealed by the fact that 20 out of the 27 EU members (among them most new members), and 12 out of 16 euro-zone members violate the pact's stipulations. The commission is desperately trying to force the governments back to the path of virtue and threatening with sanctions, without any consideration of the effects on the real economy, which is only weakly recovering from the impacts of the global financial crisis. It would be cleverer to ask, where a law's virtue and value is, when it declares 70 % of the population of a country to be criminals.

5. Leave or Vote?

Now, Greece and Portugal have two severe economic problems that stress the loyalty in the Union. So then, leaving the euro zone: would it be a reasonable solution for countries that are not able to comply with the rules or are not willing to accept asymmetrical solutions? It is true, the new constitutional treaty imposed the first time in the community's history exit rights and an exit procedure – but this new rights are related to the exit from the EU. However, there is no rule that regulates an

exit from EMU. Neither Greece nor any other country in a similar position could sensibly leave or could be forced to leave the euro zone. Indeed, any sniff of thinking about that would cause an immediate banking crisis (Goodhart, 2010). Apart from the prompt effects on wages, prices and interest rates, existing debts are denominated in Euros and any attempt to renege on that would, very likely, result in seizure of Greek assets abroad and expulsion from the euro zone, in addition to a cessation of European Union net transfers. Greece or the entire Southern group can leave the euro zone only if it left also the EU. The massive speculation against the new currencies would force the governments to impose protective measures we know from the past, hence, the imposition of trade controls, and this finally threatened all achievements in the European integration process since the early 1950s.

So then, are there still grounds for loyalty and believe in reforms of the EU? Historically, the ongoing crisis is not a single event. Remember the euro-pessimism in the 1970s, after the first enlargement wave including the United Kingdom, Ireland and Denmark 1973 revealed severe institutional defects. New members had to realize a loss of flexibility, and the existing institutions did not offer more participation and voice to deal with the specific problems of the newcomers. Remember the well-known veto-right of each member. The decade of euro-pessimism ended with the Single European Act in 1987, after Greece, Portugal and Spain joined the Union. The member countries opted for more governance and more integration to overcome a critical situation.

Now, the political attempt is directed towards more control rights on public finances for Eurostat and the EU commission and improving the stability and growth pact. But this would not change very much. What is needed is a mechanism that sets disincentives for countries to record current account deficits and surpluses by more coordination of sensible national policies (wages, taxes) and establish a fund for financial assistance in case of asymmetric shocks, financed by both deficit and surplus countries.

6. Summary and Conclusions for Euro Candidates

There remains one thing to say: Greece is a lesson for new EU members eagerly expecting adoption of the Euro. Among the 15 'old' EU members, the GDP per capita in terms of PPP was 94 % of the average in 2008. Hence, Greece was the country with the lowest income, but with a high share of employment in the public sphere. It is well known that low income and a high public share in employment are correlated with corruption. Transparency International identifies Greece as highly corrupt among all EU members. Romania with a GDP per capita level of 47 % and Bulgaria of 41 % show the same intensity of corruption. The Corruption Perception Index 2009 was at about 8.0 on average for 10 EMU countries, it was 3.8 for Greece, Romania and Bulgaria (the lower the corruption perception index, the higher corruption). There seems to be clear correlation between the level of corruption and the level of GDP per capita (Figure 7).

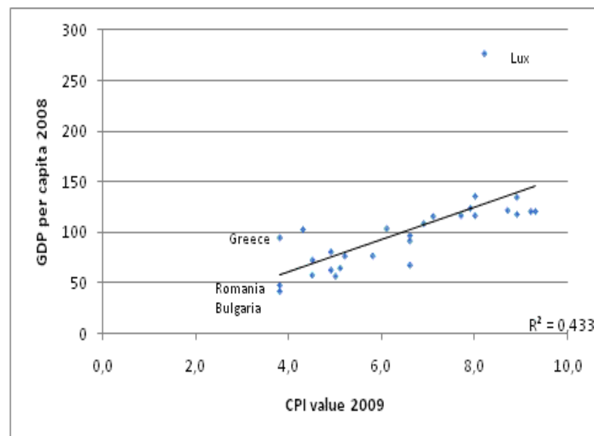

Fig. 7.
Note: The higher the corruption perception index, the lower corruption

Greece has obtained by trickery EMU membership. This is the lesson for non-EMU countries like Romania and Bulgaria: if one cannot effectively fight against corruption, improve institutions and transparency in general, than a country will not be able to compete with countries with low corruption and high income where all important players – government, trade unions and employers' associations – are unified to pursue a competitive income policy for gaining a competitive advantage over other countries. Then, the country should keep its own currency.

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