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Chapter 1: Europe at a Crossroads

The European Union is beset with problems, chief of which are the crises in the Eurozone, its inability to promote economic growth in the wider single market and more recently the refugee migration disaster posing an existential threat to its survival.

In order to appreciate the origins of its multiplicity of on-going crises, we need to look back at the economic and political foundations, which crystallised in the Maastricht Treaty (MT) of 1991. The Maastricht resolution to the inconsistent quarter of macroeconomic policy, that of:

i) free trade in goods and services,

ii) free capital and labour movements,

iii) fixed exchange rates;

iv) and independent monetary policy

has effectively led to the emergence of a two-tier European Union. The first tier consists of those countries that joined the Euro; the second a tier of nations that did not, but which instead sought specific exchange rate arrangements with the single currency bloc. The UK, Denmark, Sweden and Poland all opted for retaining monetary independence as a feature of their EU membership. This has rendered the single market effectively incomplete, as London is the strongest financial market in the EU capital markets, and as result capital markets are subject to the £-Sterling/Euro exchange rate volatility. Nevertheless, the status quo was effectively maintained, primarily due to favourable European and international macroeconomic conditions, and the absence of systemic international financial shocks from 1999 to 2008: circumstances conducive to relative exchange rate stability between the pound and the euro.

The onset of the Euro debt crisis in the second half of 2009 set in motion processes that could potentially undermine the effective functioning of one of the key pillars of the EU, the Single Market: the enhancement and effective functioning of which the single currency was supposed to facilitate. Currently, less than 40% of EU markets are regulated entirely by Single Market guidelines, with the remaining subjected to national law. The (Single Market) guidelines include common external tariffs and quotas with the rest of the world, such as £common regulations governing industrial production and environmental standards. Broad coordination of macroeconomic policy reduces exchange rate volatility among EU currencies and in doing so facilitating enhancement in the volumes of intra-EU trade. At the same time, the Euro zone debt crisis has led to a de facto economic spilt in the Eurozone: the Euro-North comprising of primarily Germany, Austria, the Netherlands and Finland, and the Euro-South consisting of Greece, Cyprus, Spain, Italy, Portugal and Ireland. France and Belgium are difficult to integrate in the two groups, as they have not been directly involved in the debt crisis, in terms of punitive interest rates or heavy austerity programmes. However, their economies are highly indebted, and subject to poor growth.

<u>Background to EU Debt Crisis</u>

The Eurozone debt crisis must be seen in the context of the global economic downturn, which was triggered by the US subprime mortgage crisis of 2007-8 but had its origins in the macroeconomic policies of at least the past decade.[1] As we shall see, a broad-based consumer boom coupled with ultra-loose monetary policy by central banks in the US and Europe fed a global speculative bubble in real estate and equity markets.[2] The fallout of this gigantic credit bust took its time to unwind across the Eurozone; emerging as an on-going sovereign debt crisis that owes its origin as much to the structural problems of the single currency,[3] and state spending in the Eurozone, as it does to banking leverage, global finance, and the securitisation of toxic debt.

It is commonplace to assume that the countries engulfed in the Eurozone debt crisis, most prominently Greece, Ireland, Portugal, Spain (the so-called "PIGS") and Cyprus, are victims of their own economic mismanagement: and, as a result, invite the view that they are alone to blame for their economic and social hardships experienced. Balancing their budgets through tough austerity policies, without the palliative of currency devaluation, is the associated policy prescription to secure their continued place in the single currency.

The mismanagement of the Portuguese and Greek public finances is beyond dispute. Chronic debt accumulation and sizeable public sectors date back to the late 1970s.[4] It has to be noted though that the social programmes of the time were following from the policies of these countries' dictatorial past.[5] Greece had been living beyond its means even before it joined the Euro.[6] The country was only allowed to join the Euro by inaccurately - registering the equivalent of €10 billion in debt. In a now notorious financial manoeuvre, Goldman Sachs helped the country hide the true extent of its debt - limited by Maastricht treaty rules to 60% of GDP, and a 3% deficit - through a credit swap scheme that engineered a public deficit within the maximum entry criteria.[7] After the country joined the single currency, public spending soared. Wages in the public sector rose by over 50% between 1999 and 2008. The 2004 Olympic Games in Athens cost around €10 billion. As money flowed out of government coffers, tax revenues were hit by an endemic culture of tax evasion on an extraordinary scale; one that is estimated by the OECD to account for at least €20 billion in lost revenues each year.[8]

The Greek economy had grown steadily throughout most of the 2000s in an apparent economic boom, but the financial crisis meant the gaping hole in the country's budget could no longer be contained - or concealed. In January 2010, the European statistics agency, Eurostat, issued a report on the debt statistics of the Greek government, pointing to "severe irregularities" and "institutional weaknesses" in the way the data had been collected, and suggested political interference in the process.[9]

A month later, the government of George Papandreou (elected October 2009) admitted a flawed statistical procedure existed. In April, the official measure of the deficit was raised from a prior estimate of 6-8% to 13.6% of GDP - the second highest in the world behind Iceland.[10] This move rang alarm bells in international markets. Greek bonds began their rapid slide to junk status as yields soared, and USA and European stock indices plunged as a Greek default and widespread debt contagion appeared to be drawing near.[11]

By contrast, Spain and Ireland had no such problems.[12] Both countries experienced low deficits and debts, and were cited by the EC as examples of sound public finances (see chapter-3).[13] However, the substantial increases in both countries' deficits and debts post-2010 led to the view that systemic and long-term mismanagement was the root cause of their problems. This has added to confusion over the origins of the crisis, and led to growing scepticism over the solutions put in place.

Much of the worst of the Eurozone debt crisis was stimulated by credit-financed wage and public spending increases over the last decade. The euro brought the nations of Southern Europe low interest rates and easy credit: and they borrowed to finance increased public spending, government wages, and real estate programmes. Both the wage increases of the construction workers and the government employees were largely credit financed. Low interest rates in Southern Europe meant that these countries could borrow very easily but failed to add to their productivity.[14] Prices increased with this inflationary credit bubble, which had the knock-on effect of depriving these countries of their competitiveness. The decline in profits in the productive sectors of the economy was counterbalanced by the increase in profits in the unproductive, and highly protected, sectors fuelled by the explosion of cheap credit in the Euro's early years.[15] A process, which was not only an EU phenomenon, which would itself lead to the credit crunch and worldwide recession. Until 2008, credit markets did not substantially reflect the economic differences between the countries of the Eurozone. This resulted in a reduced interest rate spread on debt servicing, as reflected by the spread on the 10-year bonds. This apparent 'convergence' of Eurozone nations' interest rates, reversed itself from 2008 onwards.

The competitiveness issue was exacerbated when the post 2004 Accession states of Eastern European, with significantly lower wages, were absorbed into the EU. For comparison, Poland has wage costs of about €7 per hour – less than a third of (now unemployment-wracked) Spain, where they are at €23. No dream of any politician in Europe can overcome this fundamental problem of such wage discrepancies. This is a fundamental long-term structural problem, - as opposed to a purely cyclical one of boom-and-bust finances, that can (potentially) be suppressed or mitigated by tempering regulation and economic policy.

The cost of debt servicing came at the heart of the economic debate in the European Commission. The lack of a fiscal union, that is, the lack of a union with the power to tax and spend on a pan-European level, or, alternative institutional arrangements combined with the Maastricht Treaty's clause not permitting the ECB to provide lender of last resort facilities (articles 101 and 103) prevented the bailing out of Greece, Portugal, Ireland, Spain and Cyprus. This led to mounting speculation during 2011 to 13, as to whether countries were in danger of imminent departure from the single currency.[16] A vicious cycle of financial instability and interest rate increases was created.

Rather than pinning the blame for the crisis on national governments, we suggest blame lies in the wider context of the growth of the fiscal and political institutions of the EU.[17] When the Maastricht Treaty came into force in January 1992, there were four countries with excessive debt levels in relation to the 60% of GDP benchmark, as set by the treaty. These were Italy, with a debt ratio of 130% of GDP, Belgium with a ratio of 128%, Ireland at 115%, and Greece at 105%. Therefore, when the Maastricht Treaty agreement was signed it was widely expected that these four countries would not meet the conditions necessary to join the European Monetary Union (EMU) due to commence on January 1st, 1999. In other words, only the creation of a 'small' EMU was apparently attainable. However, it was the flexible interpretation of the debt criterion by the European Commission, according to which countries would be allowed to participate in the single currency provided their national debt was converging at a satisfactory pace towards the 60 *per cent* benchmark, which allowed these countries to join the

EMU.[18] A flexible interpretation was introduced to pave the way for Italy to join the Eurozone.[19] Such a generous interpretation of the Maastricht Treaty debt criterion allowed Italy and Belgium to join with the first wave of eleven countries that acceded on January 1st, 1999 – despite their debt-to-GDP ratios of 121.6% and 122.2% respectively in 1997. The debt data of these different nations in relation to the accession criteria is presented in the table below criteria. Greece joined the Euro in 2001.

Table-1

QUALIFICATION FOR ECONOMIC AND MONETARY UNION						
MT Criteria	**Inflation Rate 1997(%)**	**Interest Rates (%)**	**Government Budgetary Position**			**Exchange Rate (in ERM, March 1998)**
			Deficit, 1997 (% of GDP)	**Debt (% of GDP) 1997 Change from 95**		
Target	**2.7**	**7.8**	**<3**	**<60**		**Yes**
Members of EMU						
Luxemb.	1.4	5.6	-1.7	6.7	1	Yes
Finland	1.3	5.9	0.9	55.8	-3.7	Yes
France	1.2	5.5	3	58	9.5	Yes
Germany	1.4	5.6	2.7	**(61.3)**	11	Yes
Portugal	**1.8**	**6.2**	**2.5**	**(62)**	**-1.8**	**Yes**
Austria	1.1	5.6	2.5	(66.1)	0.7	Yes
Ireland	**1.2**	**6.2**	**-0.9**	**(66.3)**	**-22.8**	**Yes**
Spain	**1.8**	**6.3**	**2.6**	**(68.8)**	**6.2**	**Yes**
Netherlands	1.8	5.5	1.4	**(72.1)**	-5.7	Yes
Italy	**1.8**	**6.7**	**2.7**	**(121.6)**	**-3.3**	**Yes**
Belgium	**1.4**	**5.7**	**2.1**	**(122.2)**	**-11.2**	**Yes**
Did not qualify for EMU						
Greece	**(5.2)**	**(9.8)**	**(4)**	**(108)**	**-0.7**	**Yes**
Political decision not to join EMU						
UK	1.8	7	1.9	53.4	3	No
Denmark	1.9	6.2	-0.7	(65.1)	-13.1	Yes
Sweden	1.9	6.5	0.8	(76.6)	-2.4	No

Notes: Figures in brackets indicate that a member state did not meet the convergence criteria as set out in the Maastricht Treaty. Belgium and Italy convinced their EU partners that their debt ratios were converging to the target at a sufficient rate in order to qualify for the single currency.
Source: European Commission (1998).

Convergence (Maastricht Treaty) Criteria

The Maastricht Treaty criteria, presented below, are a mixture of tight macroeconomic conditions on monetary convergence (criteria 1 and 2), fiscal performance (criteria 3 and 4) and exchange rate stability (criterion 5).

1. National **inflation rates** were not to exceed **1.5%** of the average rate of the three best performing countries.
2. **Interest rate differentials** were not to exceed **2%** of the average of the three countries with **lowest inflation rates**.
3. **Budget deficits** were not to exceed **3%** of GDP.
4. The **public debt** was not to exceed **60%** of GDP.
5. The exchange rate parity had to remain within the narrow band of the Exchange Rate Mechanism (ERM) of 2.25% for at least two years before admission to the final stage was granted.

Upon signing of the Maastricht Treaty, countries seeking to join the Eurozone placed emphasis on meeting the first two criteria relating to monetary conditions, namely inflation differentials and interest rates differentials. These two criteria were of competitive nature as they were basing a country’s performance in relation to that of the others. However, the long-term consequences of sustained divergence in inflation – even small divergence – was not considered.

By the mid-1990s, after registering improvement with inflation and interest rate convergence, countries also aimed at either meeting or improving their fiscal conditions concerning criteria 3 and 4, depending on their starting positions in 1992. As a result, criteria 3 and 4 were of an absolute nature, as countries either met them or not, and progress was registered against their past performance. The criteria were applicable from 1993 to 1998 for the Eurozone countries that joined with the first wave in 1999 and for countries that have joined since. They are also still applicable to non-Eurozone countries that have (and wish) to join e.g. Poland, Bulgaria etc. Given that criteria 1 and 5 cannot apply to Eurozone countries, as the Eurozone's interest rate is set for the entire area by the ECB, and there is no exchange rate volatility, only the fiscal criteria are still applicable under the Stability and Growth Pact (SGP).

As a result, of the flexible interpretation of the debt criterion, the reduction of 3.3% of the Italian debt-to-GDP ratio, from 1995 to 1998, made it impossible to refuse entry to Belgium, as it successfully managed to reduce its debt-to-GDP ratio by 11.2% in the same period (Table-1). Likewise, the remarkable reduction of the Irish debt-to-GDP ratio by 22.8 percentage points, to 66.3%, justified the moniker of 'Celtic tiger' that was commonly used to describe the Irish economy in the second half of the 1990s.[20] Quite remarkably, both Germany and the Netherlands failed to meet the 60% debt criterion in 1997, albeit at narrow rates of 61.3 percent and 72.1 percent respectively. Overall, out of eleven countries that joined in 1999, only three - namely Luxemburg, Finland and France - met the debt criterion. Germany, Portugal, Austria, Ireland and Spain maintained a debt-to-GDP ratio below 70 percent. These countries, together with the Netherlands, could form a 'small' Euro (Euro-9), as envisaged by Germany. Indeed, in 1992 Germany anticipated that only six countries would satisfy the MT criteria, as Portugal, Spain and Ireland were not expected to meet them. This would have made the management of the Euro much easier, and would provide an incentive for other countries to join once they reduced their debt-to-GDP ratios below a threshold to be decided at a later stage, e.g. 75 percent.[21]

The flexible interpretation of the 60% debt-to-GDP criterion therefore set a precedent for high debt countries to join the single currency. The underlying assumption behind this was that countries with high debts would keep servicing them successfully, as they had done prior to joining the EMU, by taking advantage both of the low interest rates set by the ECB and the reserve currency status acquired by the newly formed currency. Given that this was not the case, and in the absence of debt mutualisation, the EMU has been running the risk of stagnation and a sustained debt crisis – while also rendering it politically impossible for some countries to maintain their place in it. The origins of the EMU debt problem therefore goes back, at least in part, to the flexible interpretation of the 60% debt criterion of the Maastricht Treaty. Had such an interpretation not been adopted, Belgium, Italy and Greece and possibly Ireland, Spain and Portugal would not have been able to join. In essence, a 'small' Euro-zone would have been created, as envisaged by Germany. This was, ardently advocated by the German authorities, in the mid-1990s prior to assigning Eurozone accession status to countries. It is in this framework that the current stringent stance of the German authorities must also be evaluated.

‘Monetarists’ versus ‘Economists’

The conflict between a ‘small’ and a ‘large’ Euro currency reflects the long-standing dispute between strict ‘monetarists’ and ‘economists’ within EU, concerning the process of European monetary integration in the 1970s and 1980s. According to ‘monetarists’, led by France, the creation of a ‘large’ European Monetary Union would provide the necessary macroeconomic framework for less wealthy European countries to achieve high growth rates, facilitated by EU’s regional funds, and catch up with the richer ones.[22] Italy, Spain and Belgium supported this approach to monetary union. On the other hand, 'economists' led by Germany have maintained that countries should be allowed to join the single currency only after they have undergone protracted fiscal consolidation. Not surprisingly, the Netherlands, Austria, Sweden, Denmark and Finland have formed the ‘economists’ group. In summary, then, the argument focused on whether or not economic integration, is a necessary pre-condition for a successful monetary union.[23]

Monetary Union: Stability or Systemic Weakness?

The Stability Pact (renamed to Stability and Growth Pact) was agreed in the second half of 1996 made effective in 1997. The Pact ensured the application of the 3% deficit-to-GDP and the 60% debt-to-GDP criteria respectively, in the Eurozone countries. Overall, the Euro was created in accordance with the monetarist positon, with eleven countries joining in the first wave in 1999, and another eight countries joining from 2002 to 2014. No particularly strong and certainly no measurable *real economic* convergence was registered for the countries joining. The crucial nation, in this perspective, is Italy. With Germany being the main export market for both France and Italy, and many Italian and French products homogenous and price sensitive, a 'small' Euro, that would have excluded Italy, would have provided her with an immense competitive advantage over France in case of a European recession.[24] The potential loss to French companies of their market share in Germany would have rendered the task of reducing unemployment in France almost impossible. As such, Italian participation to the single currency was vital not only for Italy but for France as well. A very strong Italian desire to join the single currency (with the exception of the President of Banco d' Italia for this very reason), the compression of the Italian debt-to-GDP from 1993 to 1999, and the reduction of the country's deficit, increased the chances of her joining. The only remaining obstacle was the country's debt-to-GDP ratio, which despite its reduction, still far exceeded the 60 percent benchmark imposed by the Maastricht Treaty. The flexible interpretation of the debt criterion saw Italy joining the Euro.

This decision had far-reaching implications that dramatically shaped the single currency's current form. Italy joining effectively meant that Belgium and Ireland could accede, as they managed to reduce their debt-to-GDP ratio in the second half of the 1990s. Low debt (but high deficit) Spain and Portugal could have not be refused entry either, as they achieved a remarkable reduction of their deficit as a percentage of their GDP. Reducing the deficit was seen as the central step to ensuring a sustainable debt-to-GDP, and thus providing a solid foundation for a successful performance in a monetary union, even according to the 'economists'. However, the potential creation of a 'large' Euro, as was clear by 1997, meant that a number of countries formerly planning to participate changed their attitudes. Denmark in particular, following the flexible interpretation of the 60% debt criterion, decided not to join followed by Sweden: though both countries maintain a fixed exchange rate regime with the Euro, and in this respect differ from the UK, the only EU country in a flexible exchange rate regime with the single currency. In order for Germany to acquiesce to the creation of a 'large' Euro, the application and adherence to fiscal discipline by all Eurozone countries was essential.

The dream of the architects of European monetary union was the creation of an island of stability in an economically and financially turbulent world. Whatever the debateable achievements or blunders of the single currency experiment, it is undeniable that the existence of a single currency, without the corresponding fiscal integration or political union normally underpinning a currency union, has introduced massive new sources of strain to the region.[25] It has given the European arena of the global crisis its own particular flavour of financial trouble. Countries crippled by the burden of sovereign debt, such as Greece, have not been able to devalue their currency to reduce the load in real terms. Indeed, surges in strength in the Euro at critical junctures, most notably 2009 and late 2010, have wreaked havoc on their ability to service their debt, triggering repeated fears of impending default.[26]

At the heart of the financial infrastructure of the Eurozone lies the European Central Bank (ECB): an institution whose primary task is to keep inflation under control, and whose scope of monetary policy is defined almost exclusively as "maintaining an environment of stable prices."[27] The ECB explicitly makes the objective of employment and growth contingent to maintaining inflation below but close to 2 percent. This implies that it would not give priority to other objectives, or permit any trade-offs among them.[28] The strong currency stance of the Eurozone's institutions and in particular, the ECB, reflects the member countries' need to erase their external imbalances.

The EU elites of course, hoped that the SGP criteria would not be violated by any Eurozone country. But we know, this was not the case, and indeed the elites knew this as they massaged the Eurozone countries statistical financial regimes prior to joining the single currency.

The anti-inflationary reputation of the Euro relied on tight monetary policy - so lack of budgetary control was bound to bring problems. Keeping price stability was a key principle for the ECB to control inflation. But the ECB failed to cope with the wider implications of this policy on the global financial system relating to international exchange rates: in particular, the impact of the fluctuating exchange rate with the weak dollar, which ultimately made most Eurozone countries bar Germany and the Netherlands uncompetitive in world markets and key export industries.

Germany has been the main beneficiary of the Euro prospering at the expense of its southern Eurozone neighbours.[29] It is because of exceptionally low interest rates that Greeks, Spaniards and Cypriots have bought German good and cars, fueling a massive credit boom in their countries. Before 1999, Germans may have complained about the loss of the Deutschmark: but they stopped when cheap credit skyrocketed its exports to these countries - its Eurozone partners - that now are paying the price for profligacy. Germany has also kept a tight grip on wages. Its GDP is driven by its massive export market representing nearly 50% of GDP so remaining competitive was vital to its domestic economic policies. Indeed, Germany is so competitive *for the same reason* that southern Europe is now uncompetitive – because, in the credit inflation of the 2000s, the Southern Eurozone increased their prices relative to Germany. The South did not follow Germany's example and allowed wage inflation to rise, and coupled this with a spending boom largely centred on the commercial and retail property markets (Spain, Portugal, Cyprus and Greece). With the global recession, these countries found the level of debt they had acquired unsustainable - with an equally unmanageable rise in borrowing costs. As a result, they faced austerity through the bail-out provisions *and* internal devaluations causing cuts in wages, benefits and overall living standards. Greece provides the best illustration of how devastatingly the level of spending and salary cuts has affected the everyday lives of its citizens.[30] As a result of those, Greek unemployment stands at over 25%, with youth unemployment closer to 40%, wages, welfare benefits and in turn living standards have plummeted by up to 50% and public debt increasing to 175% of GDP. It stood at 120% before the first austerity programme of 2010, and rose to over 175% by 2015. While not all economic malaise in Greece can be attributed to austerity, what is certain is that the austerity agenda failed to provide a viable economic solution.

While Germany's post-crisis recovery is presented as an example of a country that made the short-term sacrifices necessary for long-term success, Germany did not apply to its economy the harsh, pro-cyclical austerity measures that fell on countries like Greece – even as it has benefitted from the low interest rates facilitated its thriving export markets in manufactured goods.[31]

From this perspective, Euro's debt crisis is far more complex in nature than simple conflict of management of the Euro area between France and Germany, or even the debate between the monetarist and economist positions. This is the case as all Eurozone countries have different and specific stakes in the successful performance of the single currency. France's position in the Euro is sustainable only to the extent that Italy maintains its place in it. Italy in turn is sensitive to developments in Greece as it is the second most indebted Euro area country. Portugal is closely, attuned to developments in Greece and Italy. The Eurozone debt crisis has evolved to a much broader disagreement, or even 'conflict' concerning the direction the EMU and the EU need or ought to take. The United Kingdom referendum forms part of this debate: whichever direction EU takes, it would have to be without the UK.

At present, the functioning of the Eurozone post-2009 seems to vindicate economists' aversion to the creation of a 'large' Euro. From this perspective, the policies put forward, based on bailouts, are part of the old 'large' Euro approach that is simply not sustainable without prior economic convergence, or, even worse, an economic convergence based on unsustainable policies. And the contrast between the condition of North and South illuminates the key weaknesses at the heart of an austerity-driven scheme for recovery. The whole point of the structural reforms enforced under the terms of the Troika - the triad of institutions that includes the International Monetary Fund (IMF), the European Central Bank (ECB), and the European Commission (EC) - is to make these troubled, debt-ridden Eurozone economies leaner and more competitive. But what makes an economy competitive in an international marketplace? After all the term is relative.[32] Ultimately and finally, it is prices for a product or service which are not higher than elsewhere. The southern countries of the EU inflated under the credit bubble that the Euro brought them. Undoing this inflation is a very different matter. Cutting nominal wages in a safe manner is extraordinarily difficult: as the example of Greece proves, it puts armies of protestors in the streets, destroys confidence, and shatters the social cohesion necessary to maintain a functioning socio-economic order. It is in essence, the same policy prescription pursued in the UK in the aftermath of WWI. In particular from 1920 to 1925 when the then Chancellor of the Exchequer, Winston Churchill insisted that the UK should return to the fixed exchange rate regime of the time, namely the Gold Standard, at the pre-war parity of 4.86 dollars to the pound. Massive unemployment ensued.[33]

Conversely, the very existence of the euro makes currency devaluation impossible for individual nations. This removes the main policy instrument for correcting these competitive variations. Underpinning the rationale of these policies, therefore, has been the notion that Greece - as well as Ireland, Spain and Portugal – must instead recover by means of an internal pricing devaluation to replace the currency devaluation that a single currency straitjackets away as an option. This means increasing unemployment so much that wages fall enough to make the country more internationally competitive. The social costs of such a move, however, are extremely high: and the evidence it works thin. Unemployment has doubled in Greece (to 25%), more than doubled in Spain (to 21%) and more than tripled in Ireland (to 15%). The biggest problem facing a government in an austerity-driven economic spiral is how it can service debt repayments from an ever-dwindling source of revenue instead of investing in infrastructure and economic development. In Greece, small businesses (SMEs), the main drivers of a modern economy, have been down at a rate of 5000 per month, not to mention the 100,000 which have gone bankrupt since 2008. Those SMEs businesses that are actually able to trade and do business cannot grow as interest rates on loans are so prohibitively high in Greece and the Mediterranean, in contrast to what are effective ‘negative’ interest rates in Germany: a scenario in which German banks are in effect paying the debtor to borrow. These circumstances are rather ironic, considering the EU’s treasured ambition to enable the private sector to regenerate employment in Europe.

Whether in fact it would have been easier for Greece to exit the single currency – aside from the crisis in the Eurozone, and its likely contagion effect – and devalue its new currency, is an important question to ask when looking at the calamitous effect of a single currency on the Southern states of post-financial crisis Europe. EU ministers warned of a sharp increase in Greek debt from such devaluation if it were to have left Eurozone.[34] But the fact is that Greece could not pay this debt, as Argentina did not pay two-thirds of its foreign debt after its devaluation and default in 2001-2.

Clearly, the Argentinean experience is of relevance. The 1-to-1 fixed exchange rate between the Argentinean peso and the US dollar from 1991 to 2001 provides an excellent case for judging the costs and benefits of a potential exit of Greece from EMU. Argentina and Greece faced significant differences in their economies. In Argentina for example, the agricultural sector is quite important whereas in Greece services (e.g. tourism) and the shipping industry are significant in terms of growth and employment. However, both countries share striking similarities in terms of their experience from participating in fixed exchange rate regimes.

Both Argentina and Greece defaulted on their debts after participating in a fixed exchange rate regime for a period of ten years, from 1991 to 2001, and from 2001 to 2011 respectively. The participation of both countries' economies on fixed exchange rate regimes had a very positive impact on their macroeconomic performance in the early stages, followed by catastrophic consequences in the latter stages. Indeed, reductions in inflation and interest rates and prolonged growth rates were the key features of both economies from 1991 to 1997 and from 2000 to 2007 respectively. However, both countries' faced severe recessions after participating in these regimes for a period of seven years. At which point, both countries' participation in the fixed exchange rate regimes under perspective and their inability to devalue became a major obstacle in restoring their balance of payments deficits. Eventually, inability to meet debt repayments effectively led to disorderly default in Argentina in December 2001 and in an orderly Greece in July-October 2011.

Indeed, a reason for Argentina's rapid recovery was that it was finally, freed from adhering to fiscal and monetary policies that stifled growth. For more than three and a half years, Argentina had suffered through one of the deepest recessions of the 20th century by losing almost 20 percent of its 1999 output. The Argentines took loans from the IMF and cut spending as poverty and unemployment soared. Then Argentina defaulted on its foreign debt and cut loose from the dollar. It then grew 63% over the next six years, albeit in an inflationary environment and received a substantial boost from the devaluation's effect on the trade balance, making its exports far more competitive.[35]

Of course, the infrastructure of the single currency renders the Argentine option impossible for member states such as Greece. The nature of the fixed peg was different in the fixed peso-to-dollar exchange rate regime, involving only two countries that maintained their national currencies. In contrast, the Eurozone involved 17 countries (in 2010) that had replaced their national monies with the single currency, and no one could predict the outcome of a disorderly Grexit, for either Greece or the entire Eurozone. However, notwithstanding the different international context of both crises, the Argentinean experience demonstrated the short-term help that can be provided by devaluation.

In the long-run, the second Argentinean default of 2014, reflects the long-standing implications of reneging in international agreements and the inflationary pressures arising from devaluations/depreciations.

The lesson from both the Argentinean and the Greek experience, demonstrates that austerity leads to a severe contraction of economic output: which compromises both a nation's ability to both function as an economy, and to pay the very debts such cuts are meant to facilitate. The realignment of relative prices that Greece and perhaps other countries need, cannot really be achieved within the Euro, because it would either, mean significantly higher inflation in the core and/or deflation in Southern Europe.[36] According to the economics department of Goldman Sachs a German inflation of 70% would be needed to make southern Europe competitive without price cuts there. That is 5.5% annual inflation for ten years in Germany or an average inflation of 3.6% for the Eurozone. Both scenarios are incompatible with the mandate of the ECB. It may be that a true recovery in the Eurozone requires an eventual realignment of relative prices – meaning inflation in Germany, and/or deflation in southern Europe.[37] Yet the entire region is now, faced with deflation as a universal and homogenous economic threat.

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[31] A Bloomberg editorial entitled cast the role and responsibility of Germany in the debt crisis in this light: In the millions of words written about Europe's debt crisis, Germany is typically cast as the responsible adult and Greece as the profligate child. Prudent Germany, the narrative goes, is loath to bail out freeloading Greece, which borrowed more than it could afford and now must suffer the consequences… By December 2009, according to the Bank for International Settlements, German banks had amassed claims of $704 billion on Greece, Ireland, Italy, Portugal and Spain, much more than the German banks' aggregate net capital. In other words, they lent more than they could afford… Irresponsible borrowers can't exist without irresponsible lenders. Germany's banks were Greece's enablers." It concluded that "Europe's taxpayers have provided as much financial support to Germany as they have to Greece."
http://www.bloombergview.com/articles/2012-05-23/merkel-should-know-her-country-has-been-bailed-out-too

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