

THE GREEK DEBT CRISIS, GERMANY AND THE EURO

Yiannis Tirkides

Research Fellow, Cyprus Center for European and International Affairs, Cyprus

Angela Merkel called the current economic crisis the 'the greatest test Europe has faced since 1990, if not in the 53 years since the passage of the Treaties of Rome'. The survival of the eurozone and the single currency are at stake. The euro has dropped more than 20% against the dollar in less than six months to levels not seen since late 2008. Interest rates across the eurozone are diverging and spreads against German bunds are increasing.

The past couple of months have seen considerable turmoil in Europe over the Greek debt crisis and the risk that it would spread to other countries. Despite an initial stalling, EU countries put together a €110 billion aid package for Greece and a €750 billion stabilisation fund to support other weak members of the eurozone if contagion spreads. Both packages include about one third of IMF contributions. At the same time the European Central Bank in an unprecedented move announced that it will be able to intervene directly to buy sovereign debt. The bailout packages and the ECB intervention are against the rules of the eurozone and Germany now wants to reform its institutions to make sure that such a crisis never happens again

What comes next?

Near term risks may have lessened and pressure on Eurozone banks and counterparties should ease for now at least. Greece should be able to meet its short-term funding needs without a major problem but the country's debt profile is difficult to manage. At the end of the three years of the bailout package Greece will have accumulated considerably more debt with a significantly higher service burden. The economy will be caught into turmoil in the medium term and real GDP is expected to contract in 2010 and 2011. Even with tough austerity measures being implemented Greece's public debt will rise to about 150% of GDP by 2012.

Greece therefore will remain under the investor spotlight. The implementation of the austerity programme and fiscal policy generally will be subject to IMF quarterly reviews. If public discontent and rioting escalate in the future this might lead to economic disruption and political instability.

At the same time in the eurozone as a whole, there is an obvious need for almost all members to undertake some serious fiscal restructuring in order to get their deficits under control and reduce their public debt. As countries will be undertaking restructuring measures, growth prospects will be tepid. The European Commission anticipates real GDP growth of 0,9% and 1,5% respectively in the eurozone in 2010 and 2011.

The longer term problem however, is uncompetitive economies across the southern part of the eurozone. There is a fundamental North-South divide in Europe that is now being highlighted as the crisis unfolds.

The collapse of the euro would undermine the entire project of European integration. The current crisis therefore should serve as an opportunity to reform the way the Eurozone works. If none of the mechanisms in place designed to ensure the stability of the euro worked to prevent a fiscal crisis, then surely the eurozone is in need of some major overhaul.

In this context the European Commission on 12 May proposed a set of reforms for the Eurozone, intended to strengthen its institutions and reinforce economic governance. Specifically the Commission proposes: stricter punishment rules for members that break the fiscal rules; a broadening of economic surveillance to member states macroeconomic and competitive imbalances; early peer review of fiscal policies and budgets before implementation. Whilst reform may be necessary, it will not be easy as it will be against member inclinations against further encroachment of their sovereignty.

Can the euro break up?

If history is any guide a collapse of the euro would lead to a political crisis that would threaten the foundations of European Union itself. Reversing integration has far wider implications than the process of integration in the first place. A break up of the euro would mean that the eurozone would disintegrate to the individual nation states that compose it. None of these nations individually, Germany included, has the geopolitical mass to be of any relevance in a global context.

In economic terms the eurozone has been beneficial to its members in different but not symmetrical ways. German exports for instance received considerable boost since the launching of the single currency. But the problem for low productivity countries was that they could not use currency devaluation as a competitive weapon which led to their amassing large payments and fiscal imbalances. If nations inside the eurozone cannot compete via devaluations and if they can no longer borrow to fund their imbalances, they will have to take the painful and difficult road to restructuring.

The first ten years of the euro were boom years. The next ten years will certainly be far more challenging. The euro may be the only way for the Europeans to be of any global relevance, but its survival in its current form is uncertain.