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Crisis Developments in the Euro Area

SUMMARY: This paper will discuss the 2010 euro area crisis and its management. The crisis started with the Greek debt crisis and ended with the Irish one. In this process even the existence of the Euro itself was put into question. Therefore, in this paper I will try to present the economic performance of the Member States. The success of all debt management efforts depends on economic growth. It is a serious problem of this crisis that unemployment rates are on the rise for the long term in every EMU Member State as compared to previously registered levels. If the unfavourable effects of growth are coupled with high unemployment then every fiscal indicator can only be improved at a serious cost to society. Presumably fiscal solidarity and the forms and content of the European semester presented so far will be insufficient to maintain the stability of the euro area, if the debt crisis proves to be prolonged. Integration as a whole will be rattled, if the lasting community instruments of long-term stability are not created in 2011.

KEYWORDS: crisis, euro area, EMU member states, crisis management, stability

JEL-CODES: E62, F15, F42

INTRODUCTORY REMARKS

Since the 1999 introduction of the Euro, or to say during its first decade, no crisis erupted that would have required the rethinking of the regulations set forth by the convergence criteria and the Stability and Growth Pact. What happened in 2010 with the eruption of the Greek crisis necessitated the rethinking and re-regulation of the concept contained in the Maastricht Treaty.

By November 2010, we were able to draw an approximate picture of possible new regulations. In terms of economic performance, we can safely say that we did not have too many things to be happy about this year either. As we all know, the year began with the Greek crisis and ended with the Irish crisis accompanied by horrendous general government deficit. The public deficit and the resulting significant general government deficit in certain countries is of serious concern in the mid-term. Unemployment rates in all Member States have increased compared to pre-

vious levels. Based on current projections, we cannot expect any massive economic growth in 2011 that would allow us to hope for the resolution of these two considerable economic problems. 2010, therefore, has shown us the bleak economic consequences of the transition period from the financial crisis to the real economic crisis, which consequences might be resolved in the mid-term.

It is my opinion that the euro area will survive this crisis, even if further EMU Member States have to be rescued from sovereign default. (The IMF might have also been thinking about how to manage this possible future threat when it took a stand in favour of an increase in capital.) During the year more and more people began to recall that they had already warned everyone back in 1998 that the new currency expected a year from then would not last a decade and the very first great crisis would blow it to pieces.

While monetary policy is now at a supranational level in the euro area, fiscal policy, in

essence, continues to remain within a national framework. The only “small” difference is that the European Commission and the ECOFIN Council constantly supervised and monitored the current deficit, and within the framework of the so-called excessive deficit procedure attempted to guide Member States to the current deficit level determined by the relevant convergence criterion. This worked to a limited extent until 2008, and apart from increased attention Member States received no sanctions whatsoever.

This article will attempt to present 2010 developments, from Member State performances to the outlining of EU regulations.

THE ECONOMIC PERFORMANCE OF EURO AREA MEMBER STATES IN 2010

The Greek crisis at the beginning of 2010 and the Irish crisis at the end of the year emphatically call attention to the fact that on the one

hand the euro area can still expect its share of difficult surprises, while on the other hand, the issue of fiscal solidarity will remain on the agenda in the long-term.

If the conditions of sustainable GDP growth were established, all fiscal problems accentuated as the result of the crisis would become significantly more manageable. This is the reason it is worth taking a look at what opportunities for growth there are in euro area Member States. (See Table 1)

Examination of growth data from the last three years paints a rather pessimistic picture. This is visible not only when comparing euro area and US growth data, but also if we examine the time series data of Member States on growth. Economic growth for the euro area has been below that of the US in all three years. This, in itself, would be nothing new. It is, however, remarkable that the growth of the American economy is not particularly dynamic either, while its current general government deficit is still considered high in 2011.

Table 1

GDP GROWTH AND PUBLIC FINANCE POSITIONS IN EURO AREA MEMBER STATES

(GDP change expressed as a percentage of the previous year, public finance position as a percentage of GDP)

	GDP, %			General government deficit, %		
	2009	2010F	2011F	2009	2010F	2011F
Germany	-4.7	3.4	1.7	-3.1	-3.9	-3.0
France	-2.5	1.5	1.0	-7.5	-7.6	-6.2
Italy	-5.1	1.1	0.9	-5.3	-4.9	-3.3
Spain	-3.7	-0.5	0.0	-11.2	-9.0	-7.1
Netherlands	-3.9	1.8	1.2	-5.3	-5.8	-4.8
Belgium	-2.7	1.8	1.2	-6.0	-4.7	-3.9
Austria	-3.8	1.6	1.3	-3.5	-4.4	-3.7
Finland	-8.1	2.4	2.0	-2.1	-3.2	-2.5
Greece	-2.0	-4.3	-2.7	-13.6	-8.0	-7.6
Portugal	-2.6	1.6	0.0	-9.2	-7.5	-6.0
Ireland	-7.6	-0.5	1.2	-14.3	-29.2	-9.8
Euro area	-4.0	1.5	1.0	-6.3	-6.0	-4.7
USA	-2.6	2.8	3.1	-10.2	-6.6	-6.3

Source: Deutsche Bank: Research Bureau Frankfurt, Prognosetabelle, 11 November 2010

F = forecast

Together with the moderate economic growth of the euro area general government deficit reduction is more dynamic than in the US, not to mention that its levels have been lower in all three years.

If we take a look at the Member States, we can see that in 2011 there are only two countries that have avoided having excessive deficit procedures initiated against them (Germany and France). According to the projection, all the other countries will, to varying degrees, produce significant deficits in 2011 as well. In most EMU Member States, GDP growth in 2011 will fall off compared to 2010 values. This in itself points to the fact that feasibility of the current deficit related convergence criterion will be delayed. This constitutes a serious problem — beyond breaching the relevant regulations — because the deficit must be financed somehow. This, in turn, could increase the vulnerability and dependence of the euro area to external financing, which could endanger the international success of the Euro.

The problem of deficit financing is different for the various euro area Member States. At this point it is still impossible to precisely determine which EMU Member States will require external financing in the future to avoid public debt. Greece and Ireland two of the most pressing cases in this regard, however, the Spanish and Portuguese general government deficit is also a source of concern. If we examine the development of the general government deficit of France, we might presume the prolongation of the existence of similarly grave problems as well as the creation of new ones. In the euro area, currently consisting of 16 Member States, there are at least five members where the level of general government deficit could still prove to be a serious risk factor in 2011. It is also still unsure whether debt financing problems in Italy will escalate over time.

The fact that Greece, Spain and Portugal are considered countries at risk calls attention to

the fact that the developmental heterogeneity measured in per capita GDP — amid the world economic crisis which broke out in the autumn of 2008 — led to less developed EMU Member States not being able to meet the current deficit related fiscal criterion following the first good (almost) decade.¹

The fact that the development of the public finance position of France is not very reassuring or that the general government of the United Kingdom (which though not a member of the EMU, is still considered developed) is a cause for serious concern all prove that high general government deficit cannot simply be blamed on developmental heterogeneity. Naturally, countries which are poorer in comparison will have a harder time managing the deficit created. In this sense, developmental heterogeneity can indeed be considered a veritable risk factor in terms of the future of the euro area as well. (*See Table 2*)

Between 2000–2009 six new countries were added to the euro area. None of these countries were considered to be richer EU Member States. According to time series data, the GDP per capita reflects a definite decline. Compared to the US, the euro area is significantly poorer, however, relative GDP of the US compared to 2000 shows a marked drop, and the rate of decrease is greater than that of the euro area. Luxembourg is the only country in which the rate of GDP per capita examined within the EU-27 is higher than levels recorded in the US. In 2000, the indicator was above 100 in 9 of the 16 EMU Member States; by 2009 this was true for 10 countries (Spain was next to join the club). Between 2000 and 2009 remarkably commendable convergence could be observed in Slovakia.

In Belgium, Germany, Ireland, France, Italy, the Netherlands and Austria the 2009 indicator is lower than in the initial year. The relative impoverishment did not clearly result in the convergence of all lesser developed countries.

Table 2

PER CAPITA GDP IN EMU MEMBER STATES

(EU-27 = 100)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Belgium	126	124	125	123	121	120	118	115	115	116
Germany	118	117	115	116	116	117	116	116	115	116
Ireland	131	132	138	141	142	144	145	147	134	128
Greece	84	86	90	93	94	91	93	92	93	93
Spain	97	98	100	101	101	102	104	105	103	104
Finland	117	115	115	112	116	114	114	118	117	111
France	115	116	116	112	110	111	109	108	108	108
Italy	117	118	112	111	107	105	104	103	102	102
Cyprus	89	91	89	89	90	91	91	93	96	98
Luxembourg	245	234	240	247	253	255	270	275	279	271
Malta	84	78	79	78	77	78	77	77	77	78
Netherlands	134	234	133	129	129	131	131	133	134	130
Austria	131	125	126	127	127	124	125	123	124	122
Portugal	81	80	80	79	77	79	79	78	79	79
Slovenia	80	80	82	83	86	87	88	88	91	87
Slovakia	50	52	54	55	57	60	63	67	72	71
Euro area	112	112	111	111	109	110	109	109	108	108
USA	161	156	154	156	157	159	154	151	147	147

Source: Eurostat.ec.europa.eu

By the end of the period, Malta and Portugal became poorer compared to 2000. Based on the development indicator measured in GDP per capita, some sort of reorganisation did occur during the first decade after 2000. This period, however, was not characterised by convincing convergence. It was, however, typical at the start as well as in 2009 that richer, larger and more developed countries were able to dominate the average data of the community now counting 16 members purely on their statistical weight.

As a result of the crisis and with the passing of time, developmental heterogeneity could cause increasingly serious problems within the euro area. Some of the problems will be of a fiscal nature. Others will be long-term problems surfacing in the real economy. One such problem that is difficult to manage is unemployment. (See Table 3)

The unemployment figures clearly prove that this will be one of the most serious challenges the euro area and the EU will have to face in the second decade of the millennium. The Netherlands, Austria and Slovenia are the only three EMU Member States where unemployment remained manageable during the crisis. German figures are also remarkable in that, according to the projections, unemployment is not increasing in the country. This is also interesting because following strong GDP growth in 2010, projections agree that growth will significantly slow down in Germany in 2011. The two countries (Greece and Ireland) where serious fiscal situations developed in 2010 are battling severe unemployment as unemployment grew in both countries in the last three years and is currently above 10 per cent. The same is true for Portugal from 2010, at least with regard to unemployment. Unemployment could also

Table 3

UNEMPLOYMENT IN EURO AREA MEMBER STATES BETWEEN 2000 AND 2009

(%)

	2009	2010F	2011F
Euro area	9.4	10.0	10.6
Germany	7.5	7.7	7.4
France	9.5	9.8	10.1
Italy	7.8	8.6	8.7
Spain	18.0	20.3	21.3
Netherlands	3.4	4.6	4.1
Belgium	7.9	9.0	9.7
Austria	4.8	5.0	4.8
Finland	8.2	9.6	9.9
Greece	9.5	12.6	13.2
Ireland	11.9	13.7	14.0
Portugal	9.6	10.9	11.2
Slovenia	5.9	6.4	6.5
Slovakia	12.0	14.3	13.9

Source: Ifo Schnelldienst, December 2010

F = forecast

cause grave problems in one of the poorest EMU Member States, Slovakia. However, all previous problems pale in comparison to the sight of Spanish unemployment figures.

After viewing this data it is not particularly surprising that the two EMU Member States of the Iberian Peninsula are considered countries where serious fiscal problems could be anticipated in the future.

In the future, the economic success of the EU may also be judged by examining the successes achieved (or not achieved) over the next two or three years in managing unemployment. The Lisbon Strategy contained employment objectives, however, the open coordination associated with it included no obligations whatsoever for any of the Member States. EU objectives until 2020 build on open cooperation. This means that from here on we cannot expect Member States to learn from each other how to resolve employment problems. Even more so, because as a result of developmental heterogeneity, these employment problems could have very different components. We

might presume that gradually turning certain areas into the domain of common policy might improve the implementation of decreasing unemployment.

This is a grave problem, even if 2010 began with the Greek debt crisis and ended with the Irish financial crisis. These reflect the problems of the Maastricht system, which consciously integrated the lack of fiscal solidarity into regulations. But the management of this issue does not lead to the abatement of employment problems. This is why we can surely expect more problems related to “crisis consequences” in the period after the end of the crisis.

A FEW FACTORS IMPACTING FISCAL REGULATION IN THE EURO AREA

As of 2010, the crisis which erupted in 2008 requires the rethinking of the regulation of the euro area from several aspects. The EU and, in this respect, the euro area as well react late and after the fact to each and every problem. If the

problem is related to money, we can surely say that a resolution requires more money than what would have been required had action been taken more swiftly. If we are talking about new regulations, then based on the experiences of the 2000s we can almost surely presume that — for various reasons and aspirations — for each document requiring national ratification there is a serious counter-movement to hinder the ratification process. The crisis demanded the establishment of fiscal solidarity, however, Member States were not ready for this from a legal point of view. The amendment of regulation poses a constant challenge, and after this crisis long-term security in the euro area cannot be achieved without the reestablishment of institutional frameworks.

With all this in mind, we should take a look at the development of public debt. Of the fiscal convergence criteria, the regulatory system considered the current general government deficit as relevant. Public debt was treated as an attribute which over time can be reduced to levels set out by the criterion along with the development of the current public finance posi-

tion. The crisis, however, resulted in current deficits that point to the fact that the first few years of the decade beginning with 2010 would be about debt management. (See Table 4)

In December of 1991 at the debate of the draft of the Maastricht Treaty, there were three Member States where the size of public debt exceeded 100 per cent of GDP. These countries were the following: Belgium, Italy and Greece. Belgium and Italy went on to become the founding members of the euro area, which was established on 1 January 1999. Greece was admitted to the euro area (based on falsified public finance data as we now know) in 2001. It could partly be due to this problem that the rate of public debt was handled more loosely than the current deficit. All the more so, as it was common knowledge that a debt pile this large cannot be reduced quickly.

Based on the data indicated in the table, of the three countries concerned only Belgium could be considered truly successful in reducing its public debt, as this particular indicator has not exceeded 100 per cent in the country since 2003. Of course this is still a long way

Table 4

PUBLIC DEBT IN EURO AREA MEMBER STATES AND THE USA

(expressed as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Germany	58.4	59.7	60.3	60.9	59.7	58.8	60.4	63.9	65.8	68.0	67.6	65.0	66.0	73.2
France	58.0	59.2	59.4	58.9	57.3	56.9	58.8	62.9	64.9	66.4	63.7	63.8	67.5	77.6
Italy	120.9	118.1	114.9	113.7	109.2	108.8	105.7	104.4	103.8	105.8	106.5	103.5	106.1	115.8
Spain	67.4	66.1	64.1	62.3	59.3	55.5	52.5	48.7	46.2	43.0	39.6	36.2	39.7	53.2
Netherlands	74.1	68.2	65.7	61.1	53.8	50.7	50.5	52.0	52.4	51.8	47.4	45.5	58.2	60.9
Belgium	127.3	122.7	117.4	113.7	107.9	106.6	103.5	98.5	94.2	92.1	98.1	84.2	89.8	96.7
Austria	68.3	64.4	64.8	67.2	66.5	67.1	66.5	65.5	64.8	63.9	62.2	59.5	62.6	66.5
Finland	57.0	53.9	48.4	45.7	43.8	42.5	41.5	44.5	44.4	41.7	39.7	35.2	34.2	44.0
Greece	99.4	96.6	94.5	94.0	103.4	103.7	101.7	97.4	98.6	100.0	97.8	95.7	99.2	115.1
Portugal	59.9	56.1	52.1	51.4	50.5	52.9	55.6	56.9	58.3	63.6	64.7	63.6	66.3	76.8
Ireland	73.5	64.3	53.6	48.5	37.8	35.6	32.2	31.0	29.7	27.4	24.9	25.0	43.9	64.0
Euro area	73.8	73.3	72.9	71.7	69.2	68.2	68.0	69.1	69.5	70.1	68.3	66.0	69.4	78.7
USA	73.4	70.9	67.7	64.1	58.2	57.9	60.2	62.5	63.4	–	–	–	–	–

Source: Eurostat (<http://epp.eurostat.ec.europa.eu>)

from 60 per cent of GDP. The Greek indicator started to drop very nicely, however, in 2009, as a result of the crisis, the deficit jumped back past 100 per cent of the GDP. Between 1996 and 2009, the indicator was never under 100 per cent of GDP in Italy. Overall, in the case of two of the three countries we can still state that, timewise, more than a decade was still insufficient to achieve two-digit, decreasing public debt as expressed as percentage of GDP.

In the EMU Member States where public debt was low — that is to say lower than the level required by the criterion — debt did increase during the crisis, but still meets criterion requirements. One such country is Spain, whose ratings have been downgraded several times due to current public general government deficit. In fact, the public debt of the other Mediterranean country, Portugal is not remarkably high either (in 2009 the indicator for Portugal was lower than that of France). This may explain why the two EMU Member States of the Iberian Peninsula are still not in need of EU funds to finance their debts.

In 2006, Ireland's public debt did not reach 25 per cent of GDP. A significant increase began in 2008, and in 2009 it already surpassed the 60 per cent threshold. According to the Commission, in 2010 Irish public debt will reach 77.3 per cent of GDP, while Barclays Capital estimates it might climb as high as 98 per cent this year.²

In EMU Member States where the stabilisation of public finances requires significant external financing, it will be increasingly difficult to turn to market financing. That is because the premiums on their government bonds are so high that it could all but lead these countries into a debt trap. That is why it is necessary to establish a prudent system of tools and instruments for managing debt that can be applied quickly and smoothly in real life.

The situation has different explanations in EMU Member States battling general govern-

ment deficit and government debt financing problems. However, the real estate bubble is among the leading causes underlying the financial crisis. That is why it is useful to look at the weight of real estate investments in each affected country. (*See Chart 1*)

The data clearly shows that Ireland follows Great Britain and the United States in terms of the high ratio of investment in real estate. This ratio is much higher than in the other EU Member States presented. Therefore, it is no coincidence then that the three largest Irish commercial banks started to run into serious problems at the end of 2010 precisely because of their excessive exposure to the housing market. Not entirely as a direct result of inter-bank securities trading, but due to the toxic securities generated from its own investments.

Problems like this give rise to the desire to create international regulations based on the experiences of a financial crisis that has become global in its reach and effects. As time passes, and as we get farther and farther away from 2008 the possibility of creating such regulations seems to be slipping away.

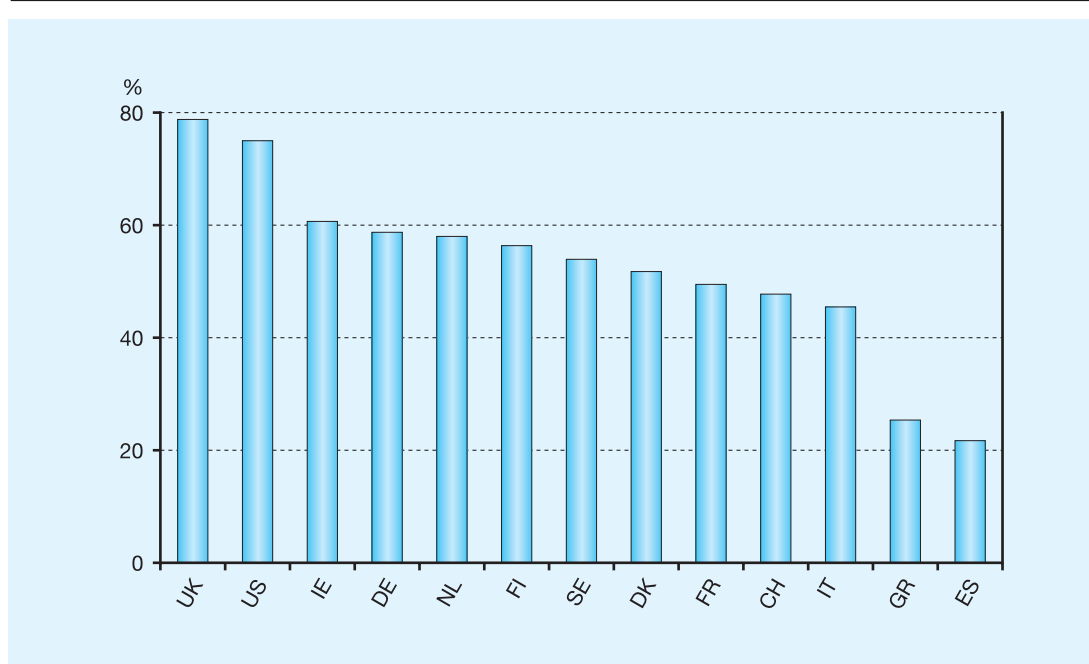
The debt crisis that was created in the euro zone has country-specific characteristics. That means that this crisis has different causes and different options for treatment in every country. In terms of the latter it is naturally a better situation if internal indebtedness is not accompanied by external deficit, that is, if there is no twin deficit. That is why it is interesting to see how the current accounts of the euro area Member States have been shaping up recently. (*See Table 5*)

The data show marked differences between the various member states of the euro area. There are two countries, Greece and Portugal, with negative double-digit data. In this regard, the picture for Ireland is much better. The results for Spain are also more positive in that its deficit as a percentage of GDP has been abating, even if only slightly, year on year.

Chart 1

OWNERSHIP STRUCTURE

(institutional real estate investments expressed as a percentage of total investments)



Source: Neue IFRS-Standards verändern Immobilieninvestmentmärkte = Deutsche Bank Research: Aktuelle Themen 500., 2010, p 6

Table 5

CURRENT ACCOUNT IN CERTAIN EMU MEMBER STATES

(expressed as a percentage of GDP)

	2009	2010F	2011F
Germany	4.9	5.4	5.0
France	-2.0	-1.7	-2.0
Italy	-3.2	-3.6	-3.2
Spain	-5.5	-5.0	-4.5
Netherlands	3.9	4.5	4.5
Belgium	2.0	2.5	2.0
Austria	2.9	3.5	3.0
Finland	1.5	2.5	2.0
Greece	-13.1	-8.0	-7.0
Portugal	-10.5	-10.5	-8.0
Ireland	-2.9	-1.0	0.0
Euro area	-0.6	-0.4	0.0
USA	-2.7	-3.7	-4.2

Source: Prognosetabelle = Deutsche Bank, 24 November 2010

F = forecast

Moreover, Spain's original deficit levels are lower than in the two countries described above.

It is thus noteworthy that the honour of the largest balance of payments surplus goes to Germany. The Netherlands, Belgium and Finland have all produced positive balances of payment in all three years examined, but the extent of the surplus is much lower than in Germany. In the often less than objective debates further exacerbated by the crisis, Germany was frequently accused of relying too heavily on exports and keeping its consumption rates low in comparison. Nevertheless, the trade balance, the driving force of the current account, shows a permanent export surplus in Germany. The usual counter-arguments run along the lines of needing to improve competitiveness, which would then nudge other countries in the same direction, towards a positive current account. Changes in unit wage costs seem to be a good indicator of where spending changes and the competitiveness of a given country stands. (See Table 6)

Between 2004 and 2006 negative indicators can be seen for all presented EMU Member States. That means that unit wage costs are

declining. In this three-year period the German indicator is among the lowest and continues to drop in 2007 as well. If compared with the indicators for Greece, Portugal, Spain and Ireland in the same period it becomes obvious that the consistent cost cutting measures that took place in Germany did not occur in those countries. Starting in 2008 all countries described as well as the euro area as a whole only present positive indicators. 2009 was a peak year in terms of these indicators. These data reflect the demand-stimulating activities of these states geared towards mitigating the recession of their real economies. Indicators for 2010 and 2011 are projected indicators. However, there are no signs of negative data in any of the countries examined. This seems to suggest that although demand incentives are losing their intensity, they have not been completely eradicated. Of the countries presented Germany seems to show one of the lowest positive values.

Nonetheless, between 2004 and 2007 the possibility of dynamic exports has been established in the wake of cost reductions. It is important to note here that this export surplus is not exclusive to EU or EMU Member States.

Table 6

CHANGES IN UNIT WAGE COSTS IN SOME EMU MEMBER STATES
(%)

	2004	2005	2006	2007	2008	2009	2010F	2011F
Germany	-1.4	-1.6	-2.0	-1.9	1.3	3.7	1.1	1.5
France	-0.5	-0.2	-0.3	-0.9	0.3	2.4	1.2	1.0
Italy	-0.5	0.7	0.3	-0.6	1.7	2.1	0.8	1.1
Spain	-1.5	-0.9	-0.9	0.7	2.4	0.2	1.3	0.7
Netherlands	-0.5	-2.8	-1.1	-0.2	0.6	5.3	2.1	1.9
Belgium	-2.7	-0.9	-0.5	-0.2	2.4	3.2	2.1	1.0
Austria	-1.8	-0.7	-1.0	-0.9	0.9	4.2	0.5	1.0
Finland	-0.5	1.7	-0.5	-2.4	3.9	6.8	5.3	1.6
Greece	-0.7	0.9	-0.8	0.6	2.4	2.7	2.6	1.6
Portugal	-1.4	1.0	-1.8	-1.6	1.1	3.3	0.5	0.7
Ireland	1.9	2.5	0.0	2.3	2.5	3.6	1.4	2.5
Euro area	-1.1	-0.7	-0.9	-0.9	1.4	2.9	1.2	1.2

Source: Reales Wachstum der Lohnstückkosten = <http://epp.eurostat.ec.europa.eu>

F = forecast

Table 7 clearly illustrates Asia’s prevalence in terms of growth opportunities.

The data in the table shows with a high degree of clarity that economically Germany is closely linked to EU Member States, but at the time of the crisis it also achieved outstanding export growth in China, Brazil and East-Asian countries in general. If this attribute becomes a long-term characteristic of the world economy, the Euro will not be the common currency of the single market, rather the common currency that holds together the integration where economic growth for Member States or certain Member States is primarily brought on through export and capital export to Asia. It will be a strange situation.

In 2010, the debt crisis deepened within the euro area. The most difficult public finance situations were most typically observed in the less developed EMU Member States. In spite of all this, these countries profited and are still profiting from EMU membership. The debt situation which intensified due to the outbreak of the crisis in 2008 became more manageable because of the existence of the euro area. The debt trap generated in countries on the developmental periphery of the euro area points to the fact that with low growth and high unemployment these relatively poorer countries cannot bear the costs of crisis management from state funds.

The main component of growth is export. The devaluation of the Euro in itself, therefore, can be considered more growth-friendly than problematic. (See Chart 2)

The diagram shows that in 2008–2010 the US dollar exchange rate of the Euro underwent substantial devaluation and appreciation. Nevertheless, the 2010 exchange rate changes are good for the exports of all of EMU Member States outside the euro area.

The intensification of debt financing in certain Member States of the euro area is also linked to the fact that the EMU Member States concerned have only been able to sell their government bonds with increasingly higher yields. That is why the market financing of their debt became more and more expensive over time. This problem on its own should justify the establishment of a European institution specifically for the purpose of government debt financing. However, until such an institution is created, the role of the IMF will be reinforced.

Chart 3 demonstrates the yields of long-term government bonds in the individual Member States.

While certain macro-economic figures put Spain in the “danger zone” when it comes to public financing, the perception of the markets seems to paint an entirely different picture. After the Irish debt crisis, markets considered

Table 7

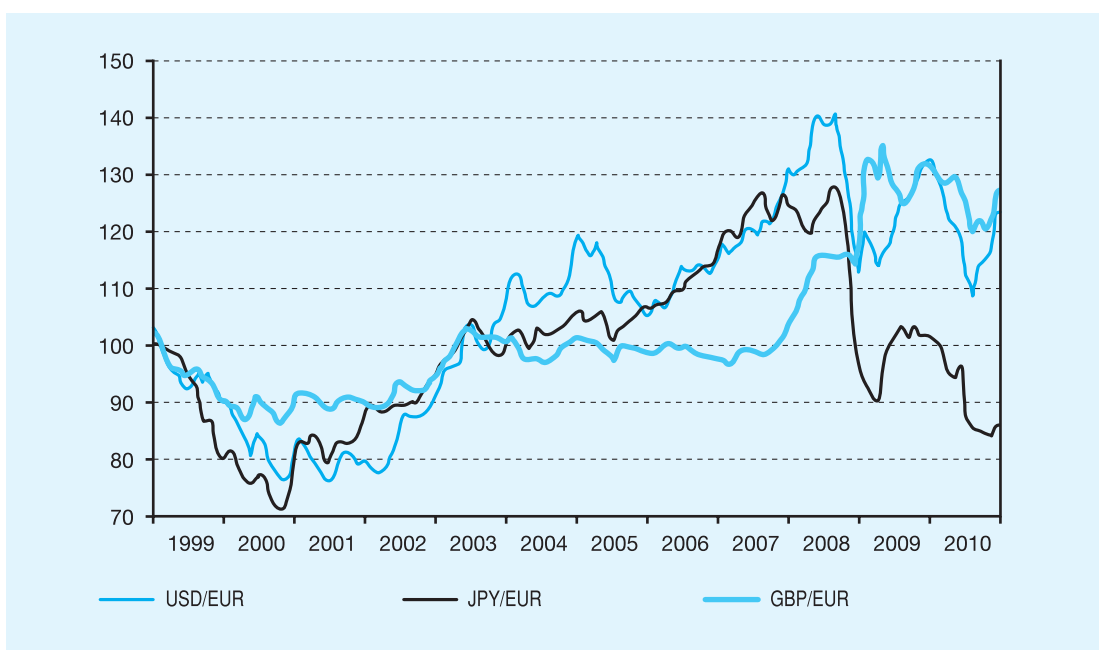
GEOGRAPHICAL DISTRIBUTION OF GERMAN EXPORT

	Total export for 2010 = 100	Rate in 2009
China	52.1	4.5
Brazil	50.7	0.9
East Asian countries	38.7	3.5
Japan	22.2	1.3
Russia	20.5	2.5
USA	15.7	6.7
Non-EMU EU Member States	14.0	20.0
Great Britain	11.7	6.6
EMU Member States	11.3	43.3

Source: IWD, 2010, 40, p. 5

Chart 2

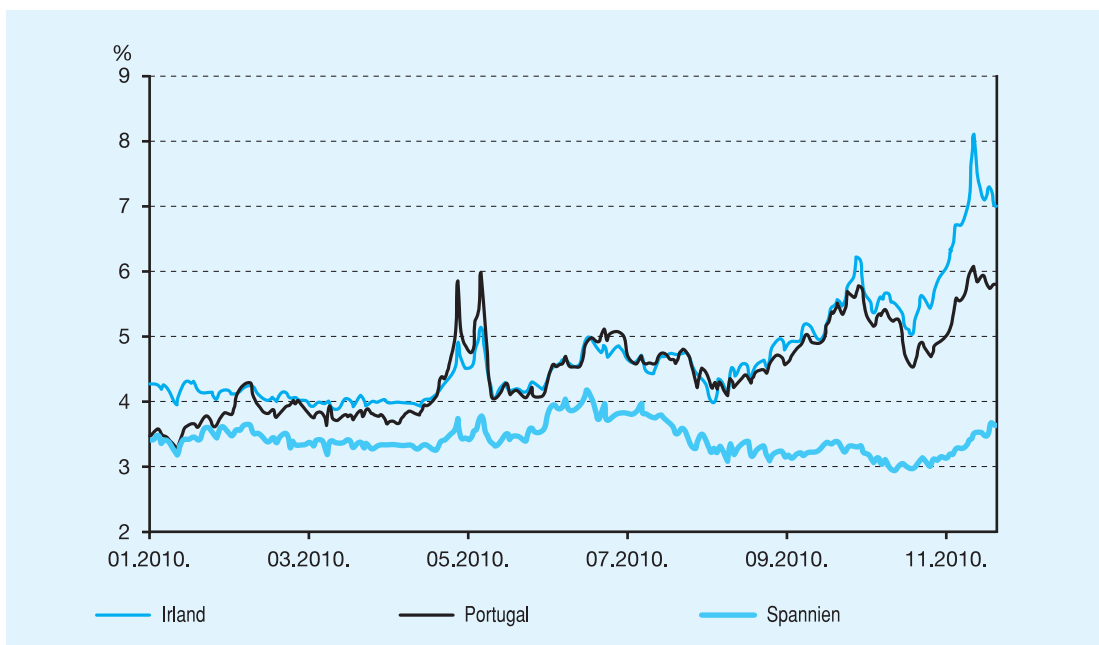
EURO EXCHANGE RATES AGAINST THE US DOLLAR, YEN, AND BRITISH POUND STERLING



Source: ECB Monthly Bulletin, 2010. 11. p. 73

Chart 3

TEN-YEAR GOVERNMENT BOND YIELDS IN CERTAIN EMU MEMBER STATES (%)



Source: Ausblick: Konjunktur & Märkte = Economic Research Bureau Frankfurt, 2010. 48. p. 1

the Portuguese economy the weakest link. Based on the yields, the Portuguese curve is very similar to the Irish curve. Obviously, this is the trend that predicts Portugal as the next country that will fall into the abyss of a crisis. Markets, however, regard Spain completely differently. One can even implicitly derive a positive outlook from this, namely that Portugal can still be saved (as yields have been decidedly lower recently than in the case of Ireland). Spain, on the other hand, will not even come close to facing such an emergency.

POSSIBLE CHANGES OF FISCAL REGULATION OF THE EURO AREA

Today we can unequivocally state that the system of regulations contained in the Maastricht convergence criteria and the Stability and Growth Pact regarding the fiscal activities of Member States participating in monetary integration can be considered insufficient and invalid based on the consequences of the crisis which broke out in 2008.

In terms of the future the weight at which solidarity, austerity and penalties will factor into the fiscal regulations of the future poses an interesting question. 2010 saw the launching of multi-lateral regulations, which means that the directions can already be outlined today.

- ▶ Even the *de Larosière report* contains references to creating two types of new institutions, which could help predict macro and micro-level financial crises before they are fully formed. The European Systemic Risk Council (ESRC) will be created to forecast macro-economic level risks with the participation of the Ministers of Finance and an ECB representative. In fact, internationally renowned experts will also be invited. In order to forecast micro-level risks, a new supervisory system was established with the participation of the

financial supervisory authorities of the Member States. (Three institutions have been established on an experimental basis in order to supervise banks, insurance companies and the stock market. Based on experiences, this arrangement might be upheld, but the three institutions could also be merged.)

- ▶ In the first half of 2011, within the framework of the so-called European semester, national budgets will be discussed before the ECOFIN Council prior to adoption by Parliament. The discussion will not only concern the balance, but the competitiveness of the given Member State as a result of the measures taken will also be examined.
- ▶ As a result of the 2010 debt crises — and of the Greek crisis in particular — new financing frameworks have been established in the spirit of fiscal solidarity. Firstly, a EUR 110 billion crisis fund was created from the contributions of the Member States, the common budget and the IMF to solve the Greek debt crisis. Funds can only be drawn from the fund to implement structural reforms of public finances. This is verified by IMF experts. The financing of the Greek crisis in this manner did not calm the financial markets, which is why a crisis fund of 750 billion Euros was established which is financed from the markets, but Member States issue guarantees in relation to it. When this mechanism was established (the agency drawing funds from the market was indeed established) there were no signs that Ireland would fall into a debt trap in the last quarter of 2010. Ireland receives funding of 85 billion Euros and in return will generate 15 billion Euros of savings within its own general government.
- ▶ As of the beginning of the fiscal crisis, Germany once again moved into the lime-

light. At the time the Maastricht Treaty was being drafted and preparation for the introduction of the euro area was underway, it was general practice to have Germany propose something, which the other Member States simply wanted to dilute. It is exactly this “Member State game” we can see emerging with regard to the management of the 2010 crisis. German Chancellor *Angela Merkel* made two demands in connection with the crisis fund and has been consistently adhering to them ever since. On the one hand funds have been reallocated from the German budget to finance the Greek debt crisis. The German constitution prohibits such monetary movements. It is, therefore, of elementary interest for the German Chancellor to have some sort of regulatory mechanism established that would eliminate this direct financial transfer. One such solution could be the European Monetary Fund. On the other hand, Germany has taken a resolute stand on actually sanctioning Member States that exercised loose fiscal policy after the crisis. They originally wanted to make financial penalties automatic, but later abandoned the idea. The German chancellor also frequently emphasises that as a consequence of sustained, loose fiscal policy, the Member State in question should be excluded from the EU’s decision making mechanism until consolidation has been completed. For the moment we are still unaware of the details of the above sanctions, or the circumstances of the establishment of the European Monetary Fund. This issue is, as yet, undecided, but the money markets are already rather unsettled by the fact that

based on the “polluter pays” principle, the financial institution which is both a victim and cause of the crisis will have to pay back more than the original subsidy amount.

There is no use debating the fact that after the crisis other tools must be used to facilitate fiscal cooperation between the countries participating in monetary integration. It is also unquestionable that in 2010 several significant steps have been taken to achieve this and objectives have been formulated. However, fiscal regulations, including the specifics of solidarity and austerity, have not been formulated precisely enough.

The deepening of European integration over the course of the last fifty years has generally been the result of outside pressures. 2011 will most likely still pass in the spirit of the crisis. If GDP growth will be lower than this year, we can most likely expect further intensification of fiscal problems. This means that the whole of the crisis management mechanism will require constant fine-tuning. The European semester will begin, during which examination of general governments will be extended. Early warning and strict penalties could gain new meaning in this context.

The single market suffered serious damage as a consequence of the crisis and the company subsidies applied as a result. During his press conference, *Joaquin Almunia*, European Commissioner for Competition, emphasised the requirement whereby EU Member States should gradually repeal the measures taken to counter the financial crisis, and voiced his hopes of being able to apply the competition regulations in 2012. This suggests that in 2011 the applicability of common competition policy will be still restrained by restrictions originating from crisis financing.³

NOTES

- ¹ In December of 1991 at the debate of the draft of the Maastricht Treaty, Spanish Prime Minister Felipe Gonzalez specifically emphasised that this fiscal austerity would slow down the real economy convergence of converging Member States. This was the reason the President of the Commission at the time, Jacques Delors initiated the establishment of the Cohesion Fund within the common EU budget. Looking back from 2010, it seems that using this policy for one decade was not enough to achieve real convergence.
- ² Is Portugal next? *Világgazdaság (World Economy)*, 23 November 2010, p. 5
- ³ EU to Continue Programme Facilitating State Aid of Banks Next Year MTI (Hungarian News Agency) news, 1 December 2010

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