Evaluating the Euro: An exploration of the Euro’s impacts on the European Monetary Union

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ABSTRACT
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Evaluating the Euro: An exploration of the Euro’s impacts on the European Monetary Union
(Under the direction of Douglas Elvers)

The question of whether or not the Euro’s implementation has had a positive impact on the Eurozone remains frequently debated. The purpose of my research is to provide a holistic view of the Euro’s impact on the Eurozone. Shortly after the Euro’s implementation, Eurozone nations experienced an increase in economic and financial growth that they otherwise would not have. However, the Eurozone’s economic heterogeneity and lack of timely integration set the Eurozone on a path of economic divergence, culminating the Eurozone Debt Crisis. Since the debt crisis, European leaders have striven toward increased Eurozone integration in an effort to strengthen the European Monetary Union; but, due to economic and political factors, will most likely fail to do so in a timely manner. As a result, the Eurozone will continue, at least in the short-run, to experience a continued economic divergence and a resulting decrease in lack of popular support for the Euro.
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INTRODUCTION

Originally implemented in 1999, the Euro has become a modern example of the economic effects of a monetary union. Eleven countries initially discontinued the use of their traditional national currency in favor of the Euro, thus establishing the European Monetary Union (EMU). Since 1999, the EMU has grown to include nineteen total member nations, with a growing number of other European nations expressing interest in joining the union.

However, the debate as to whether the implementation of the Euro has had a positive or negative effect on the Eurozone countries is more contentious than ever. Supporters of the Euro argue that monetary integration has led to increased trade and a more integrated European economy, while critics point to the lack of substantial European economic growth and the multi-year debt crisis that has strained the EMU. Both sides of the debate present various, substantiated arguments that make the Euro’s efficacy even harder to judge.

Additionally, the lack of established criteria by which the Euro can be judged further complicates the matter. Definitive metrics to measure the Euro’s success were never set, and there is no timetable with regular intervals at which EMU members can evaluate their economic position and choose whether or not to continue with the Euro. Withdrawal from the EMU would be next to impossible, and legally controversial (Athanassiou, 2009). In short, the implementation of the Euro set the EMU on a course of monetary integration that is, at least in the short term, irreversible.

This thesis aims to present a holistic view of the Euro’s impact on the Eurozone’s original eleven countries, focusing on both economic and financial effects as well as cultural and political considerations. Because the Eurozone is a political and economic union, political and social considerations must be made in order to effectively analyze the Euro’s impact.
Nations that implemented the Euro have experienced economic and financial benefits at times, and serious hardships in others. Furthermore, the heterogeneity of EMU nations – both economically and culturally – makes for a complex and nuanced union. Because the Eurozone is so politically and economically diverse, what is good for one nation may not necessarily be beneficial to the rest. A large governing body, made up of representatives from each EMU nation and charged with governing the Eurozone, is generally slow to act because of the immensely difficult task of building consensus due to the varying interests of the member states. This complication has been particularly present in the last few years because of the strain the debt crisis put on the EMU.

In general, the majority of the Eurozone countries can be grouped into one of two economic groups – the Northern Eurozone Area (NEA) and the Southern Eurozone Area (SEA). I have chosen to use this grouping because it provides a solid basis for analysis of the Eurozone as a whole. The Northern Eurozone Area includes: Germany, Netherlands, Belgium, Austria, Finland, and Luxembourg. The Southern Eurozone Area includes: Spain, Portugal and Italy. This grouping is in line with several economists’ analysis, and is based on the economic models of the respective regions (Hall 2014; Hope 2016; Jaumotte & Sodsriwiboon 2010; Hassel 2014; Lane 2006). Simply put, the NEA economies tend to emphasize growth driven by exports and tight fiscal policies; the SEA economies tend to emphasize growth led by increased demand and generally have looser fiscal policies. Although each individual country’s economy is by no means identical to another in its group, the economic models are similar enough to warrant such a grouping. France and Ireland, although discussed in the thesis, have been left out of the two groupings because they do not necessarily fit the criteria of either group.
Although this methodology excludes two countries from specific consideration, it allows for an effective structure by which the overall effect of the Euro on the Eurozone can be discussed. Additionally, 9 of the original 11 Eurozone nations fit into either the NEA or SEA grouping criteria, allowing for the vast majority of the Eurozone to be represented in the analysis.

Additionally, I have singled out Germany for additional discussion because of the pivotal role it has played throughout the Euro’s life. In the years between the signing of the Maastricht Treaty and the Euro’s implementation, the Germans had significant say in the vision of the Euro. Furthermore, particularly during and after the Euro crisis, Germany emerged as the leading voice in the Eurozone, both politically and economically.

LITERATURE REVIEW

Current literature on the topic of the Euro’s impacts generally focuses on one specific economic area or consequence (e.g. the Euro’s effect on Real Interest Rates or Current Account Balances). These relatively narrow approaches fail to present a holistic picture of the Euro’s overall impact on the Eurozone, thus making it harder to judge the Euro’s overall success or failure. My research aims to tie in both sides of the Euro debate to illustrate the Euro’s overall impact, making it easier to project the short and long-term economic effects EMU countries will face.

Analyzing the Euro’s overall historic trends, successes, and failures allows for a more informed projection of the future, as opposed to using any one particular data point (such as a month or one year’s worth of economic data). Thus, it is important to establish a timeline to contextualize the Euro’s progression through the 21\(^{st}\) century. The timeline that I will focus on will include: the goals of establishing the Euro (1992-1999), the Euro’s impacts in its first decade (1999-2009), the Eurozone Debt Crisis (2009-2014), the Euro since the debt crisis (2014-present) and what the future of the Euro might entail.

Establishing the Euro (1992-1999)

In 1992, twelve European nations signed the Maastricht Treaty in response to European economic instability. A key goal of the Maastricht Treaty was to establish a single currency within Europe in order to strengthen the single market within the EU. This singular currency, the Euro, was set to start circulating in 1999, given that member nations met a set of economic criteria.\(^1\)

\(^1\) The full Maastricht Treaty can be found at https://europa.eu/european-union/sites/europaeu/files/docs/body/treaty_on_european_union_en.pdf
At the time, a monetary union with such size and scope had never been attempted before, effectively making the move toward a common European currency unprecedented. As a result, the supporters of the Euro needed to build a strong case in support of the common currency; one that aligned with Europe’s economic and political goals.

The Euro was established under the assumptions that it would: “bring Europe ever closer together, and was the next step in Europe’s integration; that the closer economic integration would lead to faster economic growth; and that this greater economic integration and the consequent greater political integration would ensure a peaceful Europe” (Stiglitz, 2016). Since the Maastricht Treaty was signed in 1992, it gave member nations seven years to prepare, both economically and politically, for the Euro.

Given the macroeconomic instability throughout Europe at the time, the promise of economic integration and stability was attractive. A key advantage of implementing the Euro would be the removal of foreign exchange risk, which “would cut transaction costs, and increase planning security for transborder trade and investment…” (Regling, Deroose, Felke & Kutos, 2010). Advocates of the Euro argued that the removal of foreign exchange risk would greatly benefit an economically active, yet geographically small area such as Europe.

For example, before the Euro, German long-term investment in Italy could be discouraged by fluctuating exchange rates between the Deutschmark and the Lira. German investors would be unsure that the value they invested would produce their expected return given the difference in exchange rates between the time of investment and the time of return. The introduction of the Euro effectively removed this risk, thereby making foreign investment within the Eurozone less risky and more attractive to European investors.
Furthermore, advocates argued that an integrated monetary policy would bring about macroeconomic stability in the region and lead to stable inflation rates that would not be heavily affected by single-country economic shocks, and would disallow currency devaluation as a means of emergency economic alignment (Regling et al., 2010). Advocates made the case that the Eurozone economy would, in theory, behave similarly to that of a single nation, with the traditional economic boundaries erased and integration encouraged.

However, many on the other side of the debate were skeptical of the Euro’s potential advantages. Critics of the Euro were primarily concerned about “the ability of the single monetary policy to address country-specific shocks and about the interaction between centralized monetary policy and decentralized fiscal policy” (Regling et al, 2010). A singular Eurozone monetary policy coupled with individual countries’ fiscal policies could lead to economic divergence among member nations, particularly given the varying economic tendencies among Eurozone nations.

A singular currency would mean that individual countries would not have the ability to nominally devalue their national currency. Devaluing currency is an economic strategy often used by countries seeking to boost exports or foreign investment. While advocates of the Euro argued that the removal of this option in the Eurozone would lead to more stable interest rates and macroeconomic trends, critics insisted that the inability to devalue the national currency could hurt nations that struggle economically in relation to their neighbors.

Ultimately, the Euro came into effect in 1999 in 11 countries (Denmark, Sweden, and the United Kingdom opted not to implement the Euro): Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain. Significantly, no contractual provisions were written for a country wanting to exit the Eurozone. The Euro was not seen as an
experiment that could be scrapped if it did not accomplish its goals; rather, it was seen as a European economic and political project that understandably needed reevaluation and reform in the future (Juncker, Tusk, Dijsselbloem, Draghi & Schulz, 2014).

**After the Euro’s Implementation (1999-2009)**

Since no definitive criteria for success were set at the Euro’s inception, economists and politicians generally tend to analyze the Euro’s effects in relation to the goals in originally establishing the single currency. Economic metrics such as Current Account Balances and Interest Rates have commonly been analyzed in order to judge the Euro’s impacts on the Eurozone economies (De Grauwe 2013; Hall 2014; Hope 2016).

The debate among economists and politicians as to the Euro being a beneficial economic implementation remains contentious. Economists on both sides of the issue analyze economic data in varying ways in order to substantiate their view on the Euro. Because the Euro is a union of economics and politics, it is important to contextualize economic data, as well as to factor in external and internal political movements when analyzing the Euro. Many economic papers regarding the Euro fail to do so, opting instead to crunch raw data and present a conclusion based simply on econometrics.

Many economists have argued that the Euro has had a positive impact on the Eurozone economies. One important argument for establishing the Euro was the supposed increase in trade flow among Eurozone countries. Theoretically, the removal of the foreign exchange risk due to the Euro’s implementation and the benefits of the EU’s open borders would facilitate a larger volume of trade within the Eurozone. Economic analysis done by Glick and Rose (2006) verifies this idea. Glick and Rose have found that international trade between two economies is nearly twice as much when the two countries are part of the same currency unit versus when they
have separate currencies (Glick & Rose, 2016). The Euro, along with a lack of foreign exchange risk, effective price comparison, and the advantages of a single market has proved to be effective in increasing trade volume within the Eurozone.

These findings are further substantiated by Mongelli and Vega (2006), who found that, “After the start of EMU, the [e]uro has already boosted intra-euro area trade by five to ten percent, and without trade diversion vis-à-vis the rest of the world (i.e., no ‘fortress Europe’)” (p.5). The consideration of trade diversion is an important one because it contextualizes European trade within the broader scope of world trade. Mongelli and Vega’s findings show that intra-European trade has increased independently from EU countries’ increase in global trade.

However, some economists remain skeptical of the Euro’s direct involvement in increasing trade flow within the Eurozone. Critics of the Euro argue that when contextualizing European trade patterns, trade between European countries had been trending upwards over the course of the second half of the 20th century. Furthermore, several key policy changes were made before the introduction of the Euro that boosted inter-European trade. The result of these policies was closer European integration, and increased trade flow was the logical conclusion of nearly fifty years of increasingly closer economic ties (Berger & Nitsch, 2008).

In addition to an increase in trade volume, the Euro has had a substantial effect on Eurozone countries’ Current Account Balances. A Current Account Balance is defined as the net of a country’s exports and imports. If a country exports more than it imports, it is said to have a Current Account surplus. Conversely, if a country imports more than it exports, it is said to have a Current Account deficit. Generally, Current Account Balances correspond with a country’s fiscal policy in running either a surplus or a deficit.
Since the Euro’s introduction, there has been a divergence in Current Account Balances within the Eurozone. Varying fiscal policies contribute to this divergence, as each Eurozone member nation has autonomy in determining its own fiscal policy. Critics’ worry that a singular monetary policy coupled with independent fiscal policy has been validated in that several Eurozone countries have run Current Account deficits for the majority of the Euro’s life (Regling et al., 2010). In addition, the lack of ability to devalue currency to boost foreign investment (theoretically driving Current Account Balances upward) accelerates the deterioration of a country’s Current Account Balance.

According to research gathered by Hope (2016), in general, countries in the Southern Euro Area (SEA) have trended downward in terms of Current Account Balance, while countries in Northern Europe and Scandinavia have trended upward. In particular, France, Greece, Italy, and Spain have seen a significant downward trend in Current Account Balances, while Germany and Austria have seen improvement. A negative Current Account Balance can be problematic over time because it forces a country to run a budgetary deficit in order to compensate for the lack of revenue from exports.

Additionally, budgetary deficits and negative Current Account Balances can have a snowball effect from year to year. A common strategy used to combat long-term negative Current Account Balances is the devaluation of currency to attract foreign investment, which, as previously mentioned, has been rendered a non-option by the Euro’s introduction. Furthermore, SEA countries felt more comfortable running up Current Account and budgetary deficits after the introduction of the Euro because of the comfort and stability of being in an otherwise strong monetary union. Because of this confidence in the Euro, SEA economies, since joining the
EMU, began to run higher deficits than their respective historical norms. (Jaumotte & Sodsriwiboon, 2010).

The divergence in Current Account Balances between the SEA and the rest of the Eurozone corresponds to a divergence in fiscal policy as well. As the SEA began to run deficits, countries like Germany and Austria began to run surpluses (Regling et al, 2010).

**The Eurozone Debt Crisis (2009-2014)**

These fiscal divergences began to threaten the continued existence of the Euro during the global financial crisis of 2008 and the ensuing Eurozone crisis of 2009. Continued movement toward financial integration was always a large part of the Euro’s agenda, but the debt crisis that many Eurozone (particularly SEA) economies faced proved that the planned financial integration had not been quick enough. The external, country-specific shocks that critics had long worried about began to strain the foundation of the Eurozone.

As Eurozone countries such as Spain, Italy and Portugal began to run the risk of defaulting on government debt, the Eurozone began to split on the issue of what caused the SEA Current Account deficits and the increased risk of SEA governments defaulting on debt. Germany, in particular, pointed toward the SEA’s fiscal irresponsibility in running up massive Current Account deficits. Conversely, SEA countries pointed toward Germany’s insistence on low inflation rates and export-heavy tendencies as the reason why SEA economies could not compete enough to grow at a reasonable pace (Trautwein & Körner, 2014). Again, the inability to devalue currency hurt the SEA economies, and Germany’s tendency to run a Current Account surplus meant that another country had to run a correlating Current Account deficit.

The Eurozone crisis illustrated many of the critiques of the Euro’s implementation, as well as the extremity of the Eurozone’s economic divergence. Throughout the period during and
after the Eurozone crisis, critics of the Euro attacked the previous successes of the Euro, as well as the lack of foresight of European economic leaders. A general consensus reached by the Euro’s supporters and critics alike was increased financial integration and fiscal structure was necessary in order to shield the Eurozone’s vulnerabilities and prevent another debt crisis.

**The Future of the Euro**

Although the Eurozone has stabilized since the Eurozone debt crisis, the call for reform is still prevalent among EMU nations (Juncker et al., 2014). The economic divergence between Germany and the SEA continues to grow, and political tensions have arisen from economic disagreements on how to continue on with the Euro. Since the Eurozone debt crisis, the question has been posed of whether or not the Eurozone would benefit by some members withdrawing. Additionally, the British referendum to leave the European Union established a sort of precedent for a EU member leaving the EU.

The future of the Eurozone is relatively uncertain, but European countries are pushing hard in order to improve the monetary union. Because of the Euro’s benefits, and resulting tight-knit economic integration of the Eurozone, getting rid of the Euro would be such a gargantuan economic and legal task, that no Eurozone country is seriously considering it. Even one of the harshest critics of the Euro, a Nobel Prize winner, Joseph Stiglitz, concludes that the Euro “can and must be saved” (Stiglitz, 2016).

The consensus among European economic leaders is that there must be a push toward increased financial integration. Increased economic and financial integration would, theoretically, alleviate some of the economic divergence between Northern and Southern Europe, and stabilize economic metrics in the Eurozone such as Real Interest Rates (Lin & Yeh, 2016).
While the leaders of the Eurozone are not pushing for such radical short-term reform, they agree that structural economic reform is needed. As a result, the European Commission has put forth a 3-stage plan for “Completing Europe’s Economic and Monetary Union” (Juncker et al, 2014). The plan calls for establishing benchmarks for integration and a tiered approach on how to reach them. Overall, the call for structural reform and economic integration within the Eurozone is widespread, and being readily enacted by Eurozone leaders.

Much of the literature surrounding the future of the Eurozone revolves around a particular economic metric, or centers around one country’s economic stability (or lack thereof). The goal of my thesis is to illustrate the Euro’s impacts on the Eurozone on a broad scale and use historic patterns in order to project the future of the Eurozone as a whole. In particular, the question of whether or not it is reasonable to project that historical economic trends will continue within specific areas of the Eurozone is central to my thesis. In theory, increased economic integration will lead to the Eurozone being less susceptible to external shocks, making it more likely that economic trends will continue in the short term.
METHODOLOGY

In order to approach the question of whether or not the Euro has had a positive impact on the original Eurozone countries, I have structured my research into two categories. The first category is comprised of primary raw data analysis. The second category is comprised of secondary research, both qualitative and quantitative.

I have decided to separate my research into these two buckets in order to gain a more holistic understanding of my research question. The secondary research allows me to utilize economic data analysis that has already been performed, as well as find qualitative historical data that will help contextualize the economic analysis. On the other hand, the primary research serves to illustrate several key economic trends and will supplement the secondary analysis that I find.

Primary Research and Data Analysis

In order to analyze the impact of the Euro on the original Eurozone, I have found economic data that pertains to the original 11 countries that implemented the Euro in 1999 - Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain. Specifically, I examine macro-economic indicators such as: GDP, Current Account Balances, and bond yields within the Eurozone. These indicators are standard macroeconomic measurements that allow for a holistic view of a nation’s overall economy. Examining these indicators within the Eurozone allows for a big-picture examination of the Euro’s impacts. In order to make the data analysis as effective as it can be, I examine these indicators over a long period of time and look for patterns, as opposed to taking them as separate data points and comparing one to another.
GDP is one of the most commonly used indicators when looking at a nation’s economic health. Therefore, GDP trends are an important consideration to make when analyzing the impact of a monetary union such as the EMU.

Current Account Balances, simply, are the net sum of a country’s exports and imports. Since one of the main goals of the Euro’s implementation was to boost trade among the EMU, the analysis of Current Account Balances of Eurozone nations is critical in researching the effects of the Euro. Furthermore, analyzing the historical trends of the Current Account Balances will serve to illustrate whether or not the Euro’s impacts (whether positive or negative) have been constant since its implementation.

Finally, the bond yields of a particular country indicate the health and confidence of the government’s credit. Higher bond yields typically indicate a riskier investment, with the government offering a higher yield in order to compensate for the increased risk. Examining the bond yields of Eurozone nations over time will serve to illustrate how well or poorly individual governments are able to repay their debts and stave off financial instability.

In order to set a historical context, I aim to limit my time horizon to 1992 to the present. My reasoning is that starting the time horizon at 1992 allows for almost a decade of historical context before the Euro’s implementation, and is the point at which most future Eurozone countries became the modern economic versions of themselves (particularly Germany with its 1990 reunification).

**Secondary Qualitative and Quantitative research**

Since my research question is multi-faceted, numerous secondary sources from top economists that have analyzed the effects of the Euro’s implementation serve to bolster my analysis. In my research, I have found that analysis of the Euro tends to focus on a particular
issue or geographic area, rather than attempting to tackle the question of its overall impact. As a result, tying these sources together in conversation with one another, particularly when their conclusions conflict provides a more holistic view of the Euro’s impact.

Similar to my primary research goals, when researching secondary economic analysis focus on macro-economic indicators and broad historical trends. My reasoning is two-fold. First, since my research question is targeted at analyzing the impacts of the Euro on the entirety of the Eurozone, I believe looking at broader economic indicators are more effective in illustrating the progression of the Eurozone as a whole throughout the period since the Euro’s implementation. Secondly, I believe incorporating analysis that factors in historical trends is important because it contextualizes the analysis over the given time period and could explain certain patterns (or lack thereof) in the Eurozone’s economic trends.

Since these secondary sources come from top economists, they are generally very detailed in their analysis of their particular topic. For example, an economic paper covering the GDP growth of a particular Eurozone nation over time can dissect the actual GDP numbers down into their root causes, whether it be a lowering level of unemployment or increased trade flows with surrounding nations. This analysis supplements my primary research and provide a deeper understanding of the economic trends that I have found.

Additionally, research qualitative factors such as: shifts in political/economic ideology, government turnover, and cultural considerations. I believe these qualitative factors serve to contextualize economic patterns, leading to a more holistic view of the Euro’s impacts, as opposed to presenting exclusively economic analysis. For example, the high turnover rate of Prime Ministers in Italy over the last decade could have played a role in its economic instability. This consideration would be important when tackling my research question because the
argument could be made that economic instability – given the frequent change of governments – was inevitable, regardless of whether Italy implemented the Euro or retained the Lira.

Overall, I aim to tie my own economic analysis and historical and cultural context with that of top economists in order to present a holistic view of the impact of the Euro on the Eurozone. Through my research plenty of disagreement among economists and politicians as to whether or not the EMU has been a positive step or not. Therefore, incorporating sources from both perspectives in conversation with one another and supplementing that conversation with my own research and perspective presents a broad view of the Euro’s economic impacts.
NORTHERN EUROZONE AREA (NEA)

Northern Eurozone Area economies are centered around tight fiscal policy, high levels of wage coordination and restraint, and an export-led economic growth model (Hall, 2014; Hope, 2016; Lane, 2012). As the eleven nations that signed the Maastricht Treaty prepared to enter the European Monetary Union, Hall (2014) argues that NEA countries were particularly well-positioned to benefit from the Euro because, “They could continue to pursue export-led growth strategies in a more favourable context in which their principal trading partners could no longer devalue in order to increase the competitiveness of their own products against those exports.”

As will be discussed, after the Euro was implemented, the NEA countries saw a Current Account Balance increase, and began to run a continued surplus. In particular, NEA countries benefited from the SEA’s lack of ability to devalue currency. Additionally, tight wage coordination and restrained led to relatively lower labor costs, resulting in increased competitiveness with the SEA (Hall, 2014). This led to a large flow of credit from the NEA countries to the SEA, allowing for constant budgetary surpluses and relatively low levels of debt within the NEA (Gros, 2012).

When the debt levels and Current Account Deficits of the SEA eventually culminated in the Eurozone debt crisis, the NEA countries (particularly Germany) emerged as the main drivers of policy aimed at mitigating the debt crisis and preventing future crises. Consequently, the power dynamic in the Eurozone began to shift heavily in the NEA’s favor (Bulmer, 2014). As a result, the implemented policies were heavily centered around bringing the SEA to a level of fiscal discipline similar to that of the NEA. These policies did not have the desired effect, and the NEA continues to run Current Account and budgetary surpluses, resulting in a continually divergent Eurozone.
The NEA Pre-Euro Implementation (1992-1999)

After the signing of the Maastricht Treaty, the NEA countries, as a whole, had relatively balanced Current Accounts. In fact, only two of the NEA countries (Belgium and Netherlands) ran Current Account Surpluses in the 1990s. This trend would later reverse, as the entire NEA would run a Current Account Surplus for a number of years in the 2000s. However, before the implementation of the single currency, NEA Current Account Balances remained relatively balanced throughout the NEA. Figure 4.1 shows the Current Account Balances of NEA countries from 1992-1999.

Figure 4.1. NEA Current Account Balances as Percent of GDP 1992-1999*

Source: Knoema
*Luxembourg not included because of a lack of available data
Apart from Finland, no NEA country experienced a significant amount of fluctuation in its Current Account Balance, indicating that, for the most part, the period between the signing of the Maastricht Treaty and the Euro’s implementation was business as usual.

In addition to stable trends in Current Accounts, the NEA also went through a period of fiscal tightening in the 1990s in preparation for the Euro’s launch. Several NEA countries were well below the Maastricht Criterion of 3% government deficit in 1992, and began to implement stricter fiscal policies. Figure 4.2 shows the government surpluses/deficits of NEA countries from 1992-1999.

**Figure 4.2.** NEA Government Surplus/Deficit as Percent of GDP 1992-1999

![Graph showing government surpluses/deficits of NEA countries from 1992-1999.](image)

*Source: Federal Reserve Bank of St. Louis*

As seen in Figure 4.2, all six NEA nations were within the 3% deficit mark by 1997. Unlike the SEA, the Northern Eurozone Area’s fiscal tightening was complimented by increasing or stable Current Account Balances. This correlation between increased fiscal discipline and stable Current Account Balances meant that the NEA was more prepared for the Euro’s implementation. By 1999, all NEA countries had either met all five Maastricht criteria, or were judged as being on a reasonable path to attain them.
NEA Post-Euro implementation (1999-2009)

Once the Euro was launched in 1999, the NEA began to see the benefits of its entrance into the EMU. Specifically, the lowered foreign exchange risk, focus on exports and restrained wage growth led the NEA to experience steady economic growth (Hall 2014; Hope 2016). Furthermore, the NEA, as a whole began to run substantial Current Account surpluses, along with increased credit flow to the Southern Eurozone nations (Gros, 2013). These two factors set the stage for the economic divergence that would ultimately call the Eurozone’s existence into question in the late 2000s.

The NEA’s export led growth model and tight fiscal policies complimented the SEA’s demand-led growth model and looser fiscal policies. After the Euro’s implementation, SEA growth was primarily driven by the credit that NEA countries were more than willing to provide (Gros, 2013; Holinski et al., 2012). As a result, the NEA was able to settle into its preferred economic pattern of Current Account and budgetary surpluses, while maintaining restrained wage growth in order to retain a competitive edge. Figure 4.3 shows the Current Account Balances of the Northern Eurozone Area from 1999-2009.
Figure 4.3. NEA Current Account Balance as Percent of GDP 1999-2009

As shown in Figure 4.3, each of the NEA countries was running a Current Account Surplus by 2002, indicating that the NEA’s export-led economic model came into full fruition in the early 2000s. When considered individually, a nation’s Current Account surplus can point to stable and sustainable economic growth. Additionally, a continued Current Account surplus indicates a level of fiscal and economic discipline that can facilitate long-term economic and financial sustainability.

However, as Stiglitz (2016) points out, when a nation in a currency union runs a Current Account surplus, another nation must run a corresponding Current Account deficit. In the case of the Eurozone, the entirety of the NEA was running Current Account surpluses, meaning that the SEA was left with little choice but to run corresponding deficits. Additionally, the NEA’s (particularly Germany’s) emphasis on high export levels and fiscal discipline allowed for little downward flexibility when it came to Current Account and budgetary surpluses. As a result, the NEA systematically forced the SEA to run continued Current Account and budgetary deficits.

Unlike the booming SEA, the NEA experienced slower but steadier growth during the period after the Euro’s implementation. Figure 4.4 displays the annual percentage GDP growth of the NEA from 1999-2008

**Figure 4.4.** NEA Yearly Percentage GDP Growth 1999-2008

![Graph showing NEA Yearly Percentage GDP Growth 1999-2008](image)

*Source: Federal Reserve Bank of St. Louis*

As evident in Figure 4.4, apart from Luxembourg, no NEA country experienced explosive GDP growth during the period following the Euro’s implementation. Hall (2014) argues that a lack of explosive growth in the NEA can be attributed to the tight fiscal policies implemented in the region. By running budgetary and Current Account surpluses, NEA nations kept internal demand restrained. Particularly in Germany, the emphasis on Stability Culture played a large role in keeping demand growth relatively low and exports relatively high. For a more detailed discussion of Stability Culture, see Chapter 5. Again, the Euro played a beneficial
role in the development of the NEA economies during this time period because it allowed the NEA to supply the demand growth of the SEA with its own credit and exports.

However, as discussed in Chapter 7, the divergence caused by the heterogeneity of the EMU economies and distinctly contrasting styles of the NEA and SEA culminated in the Eurozone debt crisis.

**NEA during the Eurozone Debt Crisis (2009-2014)**

Once the Eurozone debt crisis set in, the NEA was the only region of the two financially capable of putting forth the resources needed to save the whole Eurozone. In particular, Germany led the charge from a resource and policy perspective. In general, the rest of the NEA followed Germany’s lead in terms of backing policy proposals (Bulmer, 2014). As a result, I discuss Germany’s approach toward the debt crisis in the Germany section, which can apply to the NEA policy approach as well.

**NEA Since the Eurozone Debt Crisis**

A more detailed analysis of the NEA’s economic developments within the context of the Eurozone can be found in Chapter 7. This section will focus on general economic development in the NEA since the debt crisis, as well as the level of public support for the Euro from the crisis up to the present time.

As German-led policies were enacted in an effort to save the Eurozone, the entirety of the Eurozone suffered from the global financial crisis and Eurozone debt crisis. In the NEA, the tempered economic growth slowed to a standstill amid concerns of the Eurozone’s continued existence. Figure 2.5 shows the NEA GDP percentage growth from 2008-2015
As seen in Figure 4.5, the global financial crisis and ensuing Eurozone crisis led to negative growth in the entirety of the NEA area from 2009-2010. After that, unlike the SEA, the NEA was able to return to positive GDP growth because NEA nations did not require major economic policy changes like the SEA that caused short-term economic pain. As a result, the NEA was able to pull out of the debt crisis and begin to trend toward positive yearly economic growth.

Overall, the NEA was well-positioned to take advantage of the Euro’s implementation and did so. The NEA saw steady growth during the first decade after the Euro was implemented, and was able to expand on its export-led growth model by allowing it to compliment the SEA’s willingness to increase demand. However, the sustained Current Account Balance surpluses and willingness to provide credit to the SEA was a major factor in the Eurozone Debt Crisis. Once the crisis set in, the NEA was essentially tasked with pulling the Eurozone out of it, resulting in slowed economic growth as resources began to flow South in order to save the EMU. As a result,
the Euro hindered the NEA during that time period. Since the crisis, the NEA has generally recovered, and remains the region in which public support for the Euro is stronger.
GERMANY

A founding member state of the Eurozone, Germany has emerged as the EMU’s strongest economy, and, therefore, maintains the most policy influence regarding the single currency. Overall, the Euro has benefited the German economically, and, arguably, politically. The German economy has steadily grown since the Euro’s implementation due to increased trade flow and disciplined fiscal policy. Additionally, Germany has become a European political powerhouse as a result of its economic standing. As a result, Germany currently wields the most political and economic influence in the Eurozone (Bulmer, 2014; Howarth & Rommerskirchen, 2013).

However, Germany’s economic success has come at the expense of other Eurozone countries that have been unable to maintain the same level of steady growth or fiscal discipline. Moreover, the seemingly unwavering German insistence on the consistent monetary policy of low inflation leaves little flexibility for other Eurozone countries. Germany’s considerable economic and political power within the Eurozone suggest that this preferred policy will not change any time soon, which I argue will lead to a perpetual economic tension between Germany and SEA countries.

Despite Germany benefiting from the Euro, and the current majority of German citizens supporting the continued use of the currency (Eurobarometer, 2016), there was initial public opposition to the implementation of the currency. This opposition stemmed from a concept central to understanding German political and economic policy – the Stability Culture (Howarth & Rommerskirchen, 2013).

The idea of German Stability Culture is centered on low inflation rates, price stability, and steady economic growth. Stability Culture also refers to a German cultural aversion to high
levels of debt and focus on fiscal responsibility. Among the German public, low inflation was among the most important of policy goals, regardless of political party. The term emerged in the early 1990s in reference to public opposition of the Euro. Germans saw the move away from the Deutschmark as a potential inflation-inducing risk because of the integration with other European economies that were seen as less disciplined. Moreover, the move toward the Euro meant the German government would relinquish control of the country’s monetary policy, and link its economy permanently to other European nations (Howarth & Rommerskirchen, 2013). Ultimately, as discussed in Chapter 3, the Maastricht Treaty was ratified despite the German public’s opposition.

After the Euro was introduced, the term Stability Culture was politically pivoted to describe the Euro and the low inflation rates brought about by European economic integration. German politicians were able to successfully integrate the idea of the Euro with the continuation of the Stability Culture, and Germans began to believe that, “Germany was not surrendering its currency culture, but rather exporting it throughout the Eurozone” (Howarth & Rommerskirchen, 2013). Howarth and Rommerskirchen conclude that, presently, inflation aversion (Stability Culture) remains a top priority for German voters, regardless of political party or demographic. Because of this insistence of stability, it is safe to assume that regardless of which political party is in power in Germany, the insistence of Stability Culture will remain strong as ever. Voters’ preference for this economic tendency will ensure that Germany’s economic policy will reflect its desire to maintain the Stability Culture.

To this point, the German desire for low inflation rates has largely been fulfilled, and the German economy has been able to maintain some level of predictability. As a result, popular
support for the Euro has increased in the last decade. Currently, 61% of the German population believes the Euro is beneficial to Germany (Eurobarometer, 2016).

**Germany’s Role in Establishing the Euro (1992-1999)**

As one of Europe’s strongest economies at the time, Germany played an integral role in the foundation and implementation of the Euro. Helmut Kohl, Germany’s chancellor at the time, was one of the primary champions of the Euro. The motivation for establishing the EMU, however, was not purely economic. De Grauwe (2013) argues that, “the ultimate objective was to permanently link the fates of Germany and France and thereby make future wars in Europe impossible.” If the ultimate objective was, in fact, political, it is not unreasonable to assume that economic shortcomings were overlooked in order to push the Maastricht Treaty through. Moreover, Kohl faced significant opposition from the German population, who were reluctant to trade in the stability and independence of the Deutschmark for the untested Euro (De Grauwe, 2013).

European economic integration was a longstanding goal before the introduction of the Euro through the European Monetary System (EMS), in which European currencies were linked in a system of currency pegging. In the EMS, Germans viewed Stability Culture as a political, economic, and culture fixture. The fate of Germany’s economy was in the hands of Germans, even though the EMS pushed for continuing integration.

Furthermore, with Germany being one of Europe’s strongest economies, the country essentially led the system of currency pegging, with other European nations choosing to peg their currency to the Deutschmark. As a result, monetary policy enacted by the German central bank (Bundesbank) dictated other European nations’ monetary policy. Thus, Germany became the de
facto economic leader of Europe leading up to the Maastricht treaty (De Grauwe 2013). Because the German economy was at the forefront of European economic policy and maintained monetary and fiscal autonomy, “with the [Deutschmark] as the anchor of the system, the asymmetrical nature of the EMS therefore did not challenge German stability culture” (Bulmer, 2014). The move toward the Euro meant giving up the leading role in the European economic system in exchange for an equal seat at the table with other European nations that were not as economically disciplined as Germany. As a result, the Germans heavily influenced conditions for the founding of the EMU.

In particular, the central values of the Stability Culture were implemented in the EMU. This entailed keeping inflation levels low and maintaining price stability – a policy identical to the traditional monetary policy of the Bundesbank (Bulmer, 2014). Furthermore, Germans sought to depoliticize the common monetary policy in order to ensure an objective structure that would be better suited to achieve its Stability Culture goals (Enderlein, Gnath & Haas, 2016).

As one of Europe’s strongest economies at the time, Germany was in a strong position to satisfy the criteria at the time of the Euro’s implementation in 1999. Therefore, the German financial and economic house was in order, and was ready to undertake the implementation of the Euro. German readiness for the Euro stood in stark contrast to other European nations, such as Italy, who were not as economically prepared for the Euro, and did not satisfy the Maastricht criteria. As a result, the path toward divergence was set, and the Germans held the economic upper hand because of the nation’s higher level of fiscal organization.
After the Euro’s Implementation (1999-2009)

As the Euro came into circulation in the Eurozone, Germany continued its economic and monetary policy trends of low inflation and price stability. Politicians such as Angela Merkel and her CDU party began to use the term Stability Culture in reference to the Euro and the pan-European stability it facilitated (Howarth & Rommerskirchen 2011). As a result, German public support for the Euro steadily increased, and Merkel, a champion of the Euro, has remained in power since 2005.

Furthermore, Germany began to run a Current Account Balance surplus, with the first net positive Current Account Balance coming in 2002 (Federal Reserve Bank St. Louis). As fiscal and budgetary conservatism continued to dominate German policy, the nation began running Current Account Balance surpluses every year since. Figure 5.1 shows Germany’s Current Account Balance since 1999.

**Figure 5.1. German Current Account Balance 1999-2013**

![Graph showing German Current Account Balance 1999-2013](image)

Source: Federal Reserve Bank of St. Louis

As evident in Figure 5.1, Germany began to run a Current Account surplus that remained consistent after 2002. Combined with its fiscal conservatism, Germany achieved its Current
Account Balance surpluses by being in a better economic position than other Eurozone countries. For example, the population in Germany is the highest among the Eurozone nations, and its unit labor cost the lowest in the Eurozone (Bulmer, 2014).

Economic advantages such as low unit labor cost and a large labor force coupled with the Euro’s removal of foreign exchange risk and trade barriers served to significantly benefit Germany’s economic growth since the introduction of the Euro. Additionally, institutionalized strategies and economic mindsets have proved imperative in Germany’s ability to significantly boost exports (and, therefore, Current Account Balances). Such strategies include: “central bank independence and monetary policy, universal banking with long-term engagement in industries, and openness to international trade” (Trautwein & Korner, 2014).

Central bank independence and monetary policy ensure that, barring a major shift in economic mindset or circumstance, monetary policy would remain fairly consistent. Additionally, the German economic model is centered around minimal government interference (Bulmer, 2014). Coupled with Germans’ emphasis on low inflation and price stability, the German central bank has maintained a steady policy in line with the idea of the Stability Culture.

The policy of low inflation rates and price stability also contributed heavily to Germany’s increasing net Current Account Balance. Analysis done by Björksten and Syrjänen (2000) shows that the ideal rise in interest rates for Germany would be significantly less than that of other Eurozone countries such as Portugal and Ireland, and less than the weighted average of the entire Eurozone’s output. The analysis is based on the Taylor rule, a reduced-form equation used to determine the ideal percentage interest rate increase for every percent increase in inflation.

Björksten and Syrjänen (2000) show that Germany’s optimal interest rate increase for every percentage inflationary increase would be 1.4, as compared to other Eurozone nations such
as Portugal (4.9) and Spain (4.6). Factoring in weighted averages of GDP, the optimal Taylor Rule interest rate for the Eurozone in 2000 would have been 2.4.

This difference optimal interest rate hikes illustrates a clear divergence in optimal monetary policy. In other words, a one-size-fits-all approach would be detrimental to several Eurozone economies’ long-term growth. For example, a higher optimal interest rate indicates that taking on debt should become more expensive, thus disincentivizing a nation from doing so.

However, in the Eurozone, there is a singular monetary policy, and therefore a singular interest rate that was lower than optimal for several Eurozone nations. As a result, nations such as Spain and Portugal were incentivized to take on relatively cheap debt (that they otherwise probably would not have) in order to spur short-term economic growth. Conversely, Germany’s optimal interest rate fell below the Eurozone’s, therefore making excessive borrowing unattractive, leading to budgetary and Current Account surpluses.

Germany’s export-minded economy was further boosted by the increased trade flow resulting in the Euro’s implementation. Empirical analysis performed by Micco et al. (2003) suggests that the impact of the single currency boosted trade among Eurozone members by a statistically significant range of 7-10%. This increased trade flow benefited Germany in particular, both in the short and long terms. In the short term, the Euro’s removal of trade risks and barriers, coupled with German economic advantages such as low unit labor costs, quickly increased German Current Account Balances and GDP. In the long run, German social and political insistence on fiscal discipline set the country on a course of increased economic growth. As a result, the German economy retained its position at the forefront of the Eurozone.
Germany’s Policies Set Path to Divergence

However, there are many who argue that Germany’s insistence on this particular economic model was a key factor in the development of the Euro crisis. For example, Dulien and Guerot (2012) argue that German economic and political policies in the years leading up to the Eurozone crisis were almost exclusively focused inward, resulting in a lack of timely economic integration; “from a German point of view, no co-ordination [was] needed as long as everyone has the correct policies.” In other words, German policy in the 2000s largely ignored the increasing divergence in the Eurozone, and believed that institutional safeguards such as the Stability and Growth Pact would ensure that divergence would be restrained to a manageable level. Increasing divergence would therefore be seen as a nation’s lack of discipline in following the Stability and Growth Pact (Hall, 2014).

Furthermore, Enderlein et al. (2016) argue that, “Germany’s original idea of stability was too narrow for the monetary union.” The one-size-fits-all monetary policy of the ECB benefited Germany in particular, but ended up hindering competitiveness of other Eurozone countries. The original German effort to de-politicize the ECB and its policies ensured that the Eurozone’s monetary policy remained fairly constant, and immune to the pressures of struggling economies’ political and economic leaders.

The divergence between Germany and other key Eurozone nations is particularly clear in the widening gap between Current Account Balances. Figure 5.2 shows the Current Account Balances of Germany, Italy, Spain and Portugal.
As seen in Figure 5.2, Germany’s consistent Current Account surplus (and corresponding budgetary surplus) meant that other Eurozone countries had to run corresponding Current Account (and budgetary) deficits. Over time, these deficits added on growing debt levels and reduced competitiveness for Southern Euro Areas. Coupled with Germany’s insistence on an export-led economic system, the divergence in Current Account Balances was essentially inevitable.

Throughout the early 2000s, Germany experienced steady economic growth due to the Euro’s implementation because of its emphasis on Stability Culture, export-minded economic system, and fiscal discipline. However, these strategies also began to set Germany on a course of divergence with other Eurozone countries that were conversely taking on relatively cheap debt in order to boost short-term economic growth. In the years leading up to the global financial and
Eurozone debt crises, this divergence played a key role in establishing Germany’s current position among Eurozone economies.

**Germany in the Eurozone Debt Crisis (2009-2014)**

Because of Germany’s economic strength and influence on the ECB, it emerged as the de facto head of the effort to save the Euro, and dictated many of the resulting conditions (Bulmer, 2014). This ascension to the lead role was the result of the strength of Germany’s economic model, as well as the large amount of credit German banks had issued other Eurozone institutions in the years leading up to the Euro crisis (Morisse-Schilbach, 2011). Furthermore, German shares of the ECB total 27%, more than any other Eurozone nation (Schild, 2013).

This economic leadership did not always result in proactivity, or even immediate reaction. Additionally, as an equal member of the Eurozone, Germany did not have unilateral authority to enact its proposed remedies to the Euro crisis. Other EMU nations such as France pushed their economic agenda as well, leading to both political and economic standoffs between Germany and other Eurozone nations. German culture places emphasis on careful dialogue preceding policy decisions and a relatively even balance of power (Bohn & de Jong, 2011). As a result, Germany’s longtime Chancellor, Angela Merkel, avoided rash action during the crisis in favor of a more cautious approach.

Regardless, as the leader of the decision-making process, Germany maintained its traditional economic view and the Germans applied it to their view of the crisis. Furthermore, “…the German mainstream [saw] current account imbalances in the [E]urozone as a consequence of a loss of competitiveness and excessive consumption in the deficit countries…” (Dullien & Guerot, 2011). In the eyes of many Germans, the debt crisis was the result of
undisciplined fiscal policy in Southern Eurozone countries, and the only remedy was to impose a system of fiscal discipline analogous to the German system of Stability Culture (Bulmer, 2014).

Consequently, Germany pushed for a solution to the crisis that involved the necessary bailouts of nations about to crack under the weight of their debt in exchange for strict austerity measures. The austerity measures would, theoretically, ensure that the countries receiving the financial aid would be set on a path toward fiscal discipline, and thus be less likely to find themselves in the same position in the future (Truger, 2013). The German push for austerity measures (the effects of which are hotly debated among economists and politicians) is unsurprising given the Germans’ historic emphasis on financial discipline. Although Germany did not have unilateral decision making power, it carried a lot of weight, and was able to enact a lot of its desired policy points.

Given Germany’s superior economic position, it, along with France, often reached compromises in the nick of time, and pulled other nations into a sort of coalition in order to approve the agreed-upon deal (Jovanovic & Damnjanovic, 2013). This manner of political leadership often frustrated other Eurozone leaders. For example, in 2010, Italy’s Foreign Minister, Franco Frattini, referred to these kinds of deals as “pre-cooked decisions” (Dinmore, 2010).

Unsurprisingly, the German desired economic remedy to the crisis contrasted significantly with other Eurozone nations, most notably France. As a result, the Eurozone crisis had a lack of a definitively agreed-upon structure by which ailing countries can begin to close the economic gap. Instead, last-second arrangements were generally made as the result of a Franco-German compromise and the ensuing process of hastily bringing other Eurozone members on board in a take-it-or-leave it fashion (Schild, 2013). Irrespective of the seeming exclusivity of
the policy process during the debt crisis, however, the bailout of struggling Eurozone nations showed a German willingness and determination to keep the Euro alive.

Additionally, Germany further ingrained its fiscal responsibility on a domestic level by instituting a constitutional Schuldenbremse, or Debt Brake in 2009. This constitutional amendment stipulates that, starting in 2016, there would be a federal borrowing cap of 0.35% of GDP (Howarth and Rommerskirchen 2013). The Debt Brake serves as a sort of doubling-down on fiscal discipline, and, since it is a constitutional amendment, will likely remain in place for the foreseeable future.

**Germany Since the Debt (2014-present)**

The German economic mindset has changed little since the implementation of the Euro. Given how ingrained this mindset is in the German public, it is unlikely that future German economic policy will differ greatly from its historical trend. Unfortunately for some of the other Eurozone countries, particularly those in the south, this consistent policy will likely mean continuing economic hardship. Because of German insistence on running Current Account and budgetary surpluses, and the self-imposed Debt Brake, Southern European countries will continue to be externally pushed toward running Current Account deficits. Without the ability to devalue the local currency, Southern Eurozone Area nations will continue to lack price competitiveness, meaning almost certain short-term economic hardship.

However, overall, the German determination to keep the Euro afloat has meant taking action that went against the prevailing German economic mindset of minimal government interference (both fiscal and monetary) in the economy (Dullien & Guerot, 2013). Also, the Eurozone appears to have pulled out of the deepest depths of the Euro crisis, indicating that the German-led policies were sufficient to keep the Euro alive. Already proving willing and capable
to prevent the Euro from failing, Germany will likely continue to pursue a path of steady European integration. However, the Germans will continue to insist that this path of integration remain in line with the staple German economic tenants of fiscal responsibility, as evidenced by the push for austerity.

As a result, the Euro will continue to survive, but will most likely continue to experience a wide range of diversion between the Eurozone economies. Since all signs point to Germany being set in its ways economically, struggling Eurozone countries will find it difficult to close the gap without traditional strategies such as currency devaluation. Germany’s continued Current Account surpluses, Debt Brake and cultural insistence on a tight fiscal policy will mean other Eurozone nations will continue to endure the same relative economic disadvantages as they have since the Euro’s implementation.

Finally, Germany’s continued position at the forefront of European policy making and its role as the Eurozone’s chief creditor will mean that Eurozone policy will also likely change very little in the short-term. The only instance in which Germany would lose its leadership in Eurozone policy making (barring a widespread financial emergency) would be one in which a coalition of economically like-minded Eurozone nations emerges in a unified manner with a clear vision of how the Eurozone should be best integrated. Given that several northern Eurozone countries share similar economic values with Germany, such a coalition is unlikely, and the Eurozone will likely continue to be sluggishly integrated.
SOUTHERN EUROZONE AREA

As previously mentioned, I have defined the Southern Eurozone Area (SEA) as: Italy, Spain and Portugal. In general, SEA countries have relatively limited power in coordinating wage growth, have a low emphasis on training the workforce (and therefore rely heavily on unskilled labor), and have generally loose fiscal policies (Hall 2014). The reliance on unskilled labor and low coordination of wage growth has led to a lack of competitiveness with the Northern Eurozone Area (Hall, 2014; Hassel, 2014). As will be discussed, the low levels of wage restraint led to a decreasing level of competitiveness (Hassel, 2014). Because of a lack of sustainable competitiveness with the NEA, the SEA economies are centered around demand-driven growth (i.e. high levels of imports) (Hall, 2014).

In the years before the Euro’s implementation, SEA countries made an economic push to satisfy the Maastricht Criteria. By 1999, the three SEA nations had satisfied 4 of 5 criteria, and were deemed to be sufficiently on the way to satisfying the fifth. However, the satisfaction of the majority of the Maastricht Criteria did not necessarily mean that the SEA was prepared to enter the EMU. In particular, the national debt levels of the SEA nations were substantially higher than the 60% requirement, and would continue to grow after the Euro’s implementation, eventually leading to the Eurozone debt crisis.

In the short-term, the SEA economies’ demand-driven growth complimented the NEA economies’ export-led growth models. Additionally, membership in the single currency union meant a singular interest rate that was lower than it would have been had the SEA nations remained independent. Lower interest rates made borrowing more attractive for SEA nations (Björksten & Syrjänen, 2000). Lowered transaction costs and the removal of foreign exchange risk helped to facilitate trade, with a heavy increase of imports.
As a result, SEA Current Account Balances (and budgets) began to deteriorate and diverge significantly from the NEA (Hope, 2016). In the long-term, this meant an unsustainable level of debt in the SEA and culminated in the Eurozone debt crisis. Because of the economically weak position of Southern Eurozone nations, they had little opportunity to influence the Eurozone policy decisions that sought to pull the EMU out of the crisis. In order to receive the necessary financial assistance from the rest of the EMU, the SEA was forced to implement austerity measures that pushed their economies into a recession.

The result has been declining public support for the Euro in the SEA countries and sluggish economic growth because of the austerity measures. In the short-term, the SEA will likely continue to experience sluggish growth, in addition to a growing debate within nations about continued membership in the EMU.

The SEA Pre-Euro Implementation (1992-1999)

Before the Euro’s implementation, the SEA countries experienced two economic trends that began to trend in the opposite direction after the signing of the Maastricht Treaty and before the Euro went into effect in 1999 – Current Account balances relatively close to zero and high budgetary deficits.

Once the Maastricht Criteria was implemented, the SEA economies began to reduce their budgetary deficits in preparation for the Euro’s implementation. Theoretically, lower fiscal deficits should serve to improve Current Account Balances. Additionally, interest rates in the SEA began to decline, giving SEA governments access to cheaper debt than they had before (Jaumotte & Sodsriwiboon, 2010).

The ultimate goal of this fiscal tightening was the Maastricht Criterion of less than a 3% deficit by 1999. All three SEA countries were able to achieve this target goal by the time the
Euro was implemented. Theoretically, this fiscal tightening signaled that the SEA countries were able to get their financial houses in order, and would be able to maintain an acceptable fiscal budget.

However, the fiscal budgetary improvements in the SEA in the lead up to the Euro’s implementation were not necessarily beneficial to the SEA’s long-term economic health. As confidence in the EMU began to drive down interest rates, SEA countries gained access to cheaper credit, and were able to fuel their demand-driven growth. As a result, prices and unit labor costs in the SEA countries began to increase significantly. As unit labor costs increase across the board, a nation begins to lose its competitiveness with its trading partners, because its products cost more to make. Because the competitiveness of SEA economies was driven significantly by low-cost labor, the rising unit labor costs began to take a toll on SEA competitiveness. The area most affected by the decreased competitiveness was the Current Account Balance of SEA nations (Hall, 2014).

Countries not sharing a single currency normally combat decreased competitiveness and rising Current Account Balances by devaluing their currency in order to make their products relatively cheaper (Regling et al., 2010). However, because of their coming entrance into the Eurozone and the Maastricht Criterion forbidding currency devaluation, SEA countries were unable to devalue their national currency. As a result, SEA Current Account Balances began trending downward in the mid-1990s. Figure 6.1 shows the Current Account Balances for the SEA area from 1990-1999.
As seen in Figure 6.1, SEA Current Account Balances began to rapidly deteriorate in the mid 1990s in the lead up to the Euro’s implementation. This trend would remain constant throughout the Euro’s lifetime, as SEA countries ran Current Account Balance deficits that corresponded with the NEA’s Current Account surpluses. Although the SEA’s fiscal deficits were moving toward zero, the Current Accounts were decreasing, signaling that the SEA was not as well-prepared for the Euro as it might have seemed.

As mentioned, once the Maastricht was signed, interest rates in the SEA began to fall. Figure 6.2. depicts the long-term government bond yields of the SEA nations.
Figure 6.2. Italy, Spain and Portugal 1992-1999 Long-Term Bond Yields 1992-1999

Source: Federal Reserve Bank of St. Louis

As seen in Figure 6.2, bond rates in the SEA dropped significantly in the mid-1990s, allowing for the governments in those nations to issue cheaper debt. The issuance of cheaper debt by SEA countries further contributed to the increasing Current Account deficit. Kosteletou (2012) finds that a sudden increase or decrease in interest rates will have a deteriorating effect on Current Account Balances. As shown in Figure 6.2, interest rates in the SEA quickly dropped after 1995, leading to a negative effect on SEA Current Account Balances. Intuitively, as credit becomes cheaper, a nation is incentivized to borrow more. In the demand-led growth model of the SEA, this increased credit was spent to drive demand up, resulting in a higher level of imports, and thus a deteriorating Current Account Balance.

Furthermore, Jaumotte and Sodsriwiboon (2010) point out that SEA countries began to finance their Current Accounts with debt instead of Foreign Direct Investment (FDI). In other words, SEA economic growth in the lead up to the Euro’s implementation was fueled significantly by increased leverage instead of sustainable economic and financial practice.
SEA After the Euro’s Implementation (1999-2009)

Once the Euro was implemented, the economic trends from the mid-1990s continued. SEA Current Account Balances continued to diverge from the NEA, and SEA national debt continued to increase. However, the GDP of SEA nations began to increase as the result of the increased trade flow and removal of foreign exchange risk within the Eurozone. Figure 6.3 shows the GDP percentage growth from 1999-2008.

**Figure 6.3.** Italy, Spain and Portugal Percent Change in GDP 1999-2008

As shown in Figure 6.3, SEA countries’ GDPs increased significantly after the Euro was implemented in 1999 (with the exception of an economic contraction in Spain and Portugal in 2000). Key advantages of the Euro such as: removal of foreign exchange risk, the European single market, and stable interest rates led to short-term economic growth (Regling et al., 2010).

Thus, in terms of short-term economic growth, the Euro was beneficial to the SEA countries once it was originally implemented. As will be discussed, the increased trade flow the
Euro brought about benefited SEA economies. Had the Euro not been implemented, it is doubtful that SEA economies would have seen such an increase in growth (Baldwin, 2006).

However, amid the economic growth, underlying economic problems in the SEA began to grow. In particular, SEA countries’ competitiveness relative to their northern neighbors did not increase (Hall, 2014). As Hassel points out, loss of competitiveness in SEA countries put pressure to increase compensation for labor. Increased compensation would, in turn, lower competitiveness because of a higher unit labor cost. In a single currency union, lowered competitiveness is an acute problem because of the lack of the most effective tool to combat a loss in competitiveness – the ability to devalue currency (Regling et al., 2010).

Thus, after the Euro’s implementation, the SEA’s lack of competitiveness in relation to the NEA began to grow (Hassel, 2014). Without the ability to devalue the currency, and with the NEA’s trend of running Current Account Surpluses, it is no surprise that the SEA’s Current Account Balance began to deteriorate at an increasing rate once the Euro was implemented.

Deteriorating Current Account Balances and a widening gap in competitiveness with the NEA set the stage for economic hardship in the SEA once the global financial and Eurozone crises set in. As Hope (2016) concludes, the EMU played an integral role in the SEA’s Current Account Balance deterioration, and SEA Current Accounts would not have decreased at such a pace if the Euro had not been implemented. Furthermore, without the ability to devalue currency, the SEA countries had little choice but to continue to finance their economic growth with leverage (Jaumotte & Sodsriwiboon, 2010). The result of the growing divergence in Current Account Balances and growing debt in the SEA was the Eurozone debt crisis, during which SEA countries required assistance from the rest of the Eurozone in order to economically stay afloat (Hassel, 2014).
The SEA During the Eurozone Debt Crisis (2009-2014)

After the global financial crisis of 2008, the Eurozone (particularly the SEA) endured an ensuing financial shock as investors lost confidence in the SEA countries’ ability to repay their debts. Apart from economic downturn, the SEA also experienced political turmoil, as sudden shifts in government took place (Hassel, 2014). In Italy, then-Prime Minister, Silvio Berlusconi resigned. In Portugal and Spain, both incumbent Prime Ministers were defeated in elections. The ousting of incumbent governments indicated that the SEA public lost faith in their governments’ ability to deal with the crisis, and incumbents were replaced with new coalitions tasked with pulling their nations out of the Eurozone crisis.

As Bosco and Verney (2012) point out, SEA politicians were put in a particularly difficult situation in having to deal with both Eurozone leaders (many of whom saw the SEA as primarily responsible for the debt crisis), and their respective electorates that wanted a solution that would be least painful for their own countries. Consequently, SEA leaders were caught between working with other Eurozone leaders in a lopsided power dynamic (which would be unpopular with their electorate) or making a more unrealistic push to get a better deal for their country (which would make them seem less credible to other Eurozone leaders). Ultimately, SEA governments turned toward the latter option, and began to implement austerity measures in an effort to mitigate the effects of the debt crisis.

In Portugal, these austerity measures were particularly difficult because they compounded with the already weak growth of the Portuguese economy. From 2008-2011, the Portuguese economy experienced only one year of positive growth, and ran a budgetary deficit much higher than the 3% required by the Stability and Growth Pact (Bosco & Verney 2012).
the time the Portuguese government received a bailout in 2011, the budgetary deficit stood at -11.2 percent of GDP (Eurostat, 2016). In exchange for the 2011 bailout package, Portugal was forced to implement austerity measures, which further slowed down economic growth. Bosco and Verney (2012) point out that, unlike Portugal, Italy and Spain did not require a bailout packages, but were nonetheless hit hard by the Eurozone debt crisis. In Italy, a decade of loose fiscal policy and relatively slow growth resulted in speculative attacks on Italian bonds after an overall loss of investor confidence in the Southern Euro Area. High levels of existing government debt and low growth patterns made Italy a prime target for a lack of investor confidence. Furthermore, as the increase in bond spreads rose along with the government debt and deficit, increased government spending to pull the economy out of the Eurozone crisis was rendered a non-option. In Spain, a 2008 housing bubble burst and the effects of a global financial crisis sent the economy into a downward spiral. GDP growth and budgetary surpluses were replaced with negative growth and budgetary deficits. Notably, the unemployment rate among Spanish workers under 25 years old reached almost 50% in 2011.

Table 6.1.

*SEA Real GDP Growth, Government Surplus (Deficit) and Government Debt 2008-2012*

<table>
<thead>
<tr>
<th>Portugal</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP Growth (Decline) as a %</td>
<td>0.2</td>
<td>(3.0)</td>
<td>1.9</td>
<td>(1.8)</td>
<td>(4.0)</td>
</tr>
<tr>
<td>Government Surplus (Deficit) as % of GDP</td>
<td>(3.8)</td>
<td>(9.8)</td>
<td>(11.2)</td>
<td>(7.4)</td>
<td>(5.7)</td>
</tr>
<tr>
<td>Government Debt as % of GDP</td>
<td>71.7</td>
<td>83.6</td>
<td>96.2</td>
<td>111.4</td>
<td>126.2</td>
</tr>
<tr>
<td>Italy</td>
<td>2008</td>
<td>2009</td>
<td>2010</td>
<td>2011</td>
<td>2012</td>
</tr>
<tr>
<td>------</td>
<td>------</td>
<td>------</td>
<td>------</td>
<td>------</td>
<td>------</td>
</tr>
<tr>
<td>Real GDP Growth (Decline) as a %</td>
<td>(1.1)</td>
<td>(5.5)</td>
<td>1.7</td>
<td>0.6</td>
<td>(2.8)</td>
</tr>
<tr>
<td>Government Surplus (Deficit) as % of GDP</td>
<td>(2.7)</td>
<td>(5.3)</td>
<td>(4.2)</td>
<td>(3.7)</td>
<td>(2.9)</td>
</tr>
<tr>
<td>Government Debt as % of GDP</td>
<td>102.4</td>
<td>112.5</td>
<td>115.4</td>
<td>116.5</td>
<td>123.3</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Spain</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP Growth (Decline) as a %</td>
<td>1.1</td>
<td>(3.6)</td>
<td>0.0</td>
<td>(1.0)</td>
<td>(2.9)</td>
</tr>
<tr>
<td>Government Surplus (Deficit) as % of GDP</td>
<td>(3.8)</td>
<td>(9.8)</td>
<td>(11.2)</td>
<td>(7.4)</td>
<td>(5.7)</td>
</tr>
<tr>
<td>Government Debt as % of GDP</td>
<td>39.4</td>
<td>52.7</td>
<td>60.1</td>
<td>69.5</td>
<td>85.7</td>
</tr>
</tbody>
</table>

Source: Eurostat

As seen from Table 6.1, all SEA countries experienced a sharp decline in Real GDP, along with a surge in government debt and deficit during the debt crisis. Austerity programs implemented in the SEA countries during the crisis also served to reduce economic growth as government debt levels rose. As De Grauwe (2013) argues, there is little evidence to suggest that austerity benefited SEA countries in any way, and severely limited SEA economic growth amid growing government debt. In the years following the most extreme points of the debt crisis (2014-present) the SEA has continued to struggle economically and politically, resulting in decreasing public support for the Euro.
The SEA Since the Debt Crisis (2014-Present)

As discussed in Chapter 7, several policy decisions were implemented by the Eurozone in order to pull the EMU out of the debt crisis. The majority of these policies were aimed at providing immediate financial aid to SEA countries under the condition that the SEA countries repay their debt and implement programs geared toward swift fiscal consolidation. As a result, public support for the Euro in the SEA has fallen considerably after the debt crisis. Not surprisingly, austerity programs implemented in the SEA led to economic downturn, much to the frustration of the populations living in SEA nations. Table 5.2 shows key economic indicators for the SEA during and after the debt crisis.

Table 6.2.

*SEA Real GDP Growth, Government Surplus (Deficit) and Government Debt 2012-2015*

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP Growth (Decline) as a %</td>
<td>(4.0)</td>
<td>(1.1)</td>
<td>0.9</td>
<td>1.6</td>
</tr>
<tr>
<td>Government Surplus (Deficit) as % of GDP</td>
<td>(7.4)</td>
<td>(5.7)</td>
<td>(4.8)</td>
<td>(7.2)</td>
</tr>
<tr>
<td>Government Debt as % of GDP</td>
<td>126.2</td>
<td>129.0</td>
<td>130.6</td>
<td>129.0</td>
</tr>
</tbody>
</table>
As seen in table 6.2, sluggish (at times negative) GDP growth, high deficits and increasing debt levels continued in Southern Europe after the debt crisis was over. After austerity measures were implemented in the SEA, Lane (2012) and De Grauwe (2013) argued that austerity measures would only add to the government debt, while keeping economic growth to a minimal level. Table 6.2 provides affirmative evidence of their predictions. All three SEA countries have seen their government debt levels increase far above the mandated level of 60%.

Perhaps the hardest hit economy in terms of government debt increase has been Spain. Before the Eurozone debt crisis, the Spanish government maintained a debt level under 60%. After the onset of the crisis, and in the years following, the Spanish debt-to-GDP ratio has
increased significantly as the result of austerity measures and continued lack of competitiveness with the rest of the Eurozone.

Moreover, the economic turmoil during the debt crisis has facilitated a political shift in Southern Europe toward parties that oppose austerity reforms (Hall, 2014). Frequent government turnover (particularly in Italy) has led to growing instability within the SEA as individual countries have yet to form a definitive political and economic long-term plan to deal with sluggish growth. Thus, the SEA is caught between an increasing number of voters who are Eurosceptic, and the political elite of the Eurozone calling for increased financial and political integration.

In the years after the debt crisis, continued membership in the EMU has had significant economic and political drawbacks to the Southern Eurozone Area. A decade’s worth of inflating debt levels and deteriorating Current Account Balances left the SEA in a particularly vulnerable position once the global and Eurozone financial crises hit. The austerity measures that the SEA was forced to impose in order to pull out of the crisis only served to further hamstring economic growth. As a result, the SEA public support for the Euro has dropped in some cases to below 50%, indicating that the majority of the electorate is no longer under the impression that the Euro has been beneficial to their nation (European Commission, 2016).
THE EUROZONE

Before the Euro’s Implementation (1992-1999)

The European Monetary Union, established in 1992 by the Maastricht Treaty to be implemented in 1999, was, at the time, the next step toward greater European integration. Many European politicians believed that it would not only bring about increased integration, but also ensure political peace and cooperation throughout the Eurozone (Stiglitz, 2016). Thus, the motivation for establishing the EMU was not purely economical – the process also had important political implications.

Before the EMU, the European Monetary System (EMS), a system in which European countries pegged their currencies to each other was the prevailing monetary arrangement. Germany, reunified in the early 1990s, had a strong, export-led economy, and the Deutschmark served as the lead currency to which other countries pegged their currencies. This meant that the German central bank (Bundesbank) had significant power in dictating monetary policy that would resonate throughout Europe. Therefore, for countries such as France, the implementation of the Euro - a system that would follow a mutually agreed-upon monetary policy - would mean an equal seat at the table and an increase in their economic power. Conversely, for Germany, the Euro would mean tying the economic fate of Germany to that of other European nations that were less fiscally and financially disciplined. However, since the economic and political fates of Europe would be so closely linked, the possibility of another European war declined almost completely (De Grauwé, 2011).
At the signing of the Maastricht Treaty in 1992, definitive criteria (known as the Maastricht Criteria, were implemented. These criteria were agreed upon by the nations signing the treaty. The understanding was that by the Euro’s 1999 implementation, each nation seeking to enter the European Monetary Union (EMU) would meet the following criteria:

1. The inflation rate cannot be higher than 1.5% above the 3 nations with the lowest inflation rate
2. Government deficit cannot be higher than 3% of GDP
3. The government debt to GDP ratio cannot be higher than 60%
4. The nation must have participated in the European Exchange Rate Mechanism (ERM) for at least two years without significantly devaluing its currency against the Euro
5. The interest rate of the nation’s 10-year bond must be less than 2% above the three countries with the lowest long term interest rates (European Council of the EU)³

If one of the nations did not entirely meet all five criteria, membership would still be allowed if the nation was able to show that it was on a reasonable path to attaining the Maastricht Criteria.

Furthermore, in 1997, the nations that signed the Maastricht Treaty also implemented a mandate of fiscal responsibility known as the Stability and Growth Pact (SGP). Similar to the Maastricht Criteria, the SGP mandated that deficit levels be kept fewer than 3% and the debt to GDP ratio kept under 60%. The SGP also created a council to monitor Eurozone nations and issue sanctions if necessary. However, “It also included no formal requirements for fiscal policy coordination across member states and took no steps toward establishing a centralized Eurozone fiscal authority” (Iversen et al., 2016). Although, notably, the SGP did have the effect of some fiscal tightening in southern Euro countries in order to meet its criteria (Jaumotte and Sodsriwiboon 2010).

³ The Maastricht Treaty is available online at https://europa.eu/european-union/law_en
In the decades before the signing of the Maastricht Treaty, economists developed a theory known as the Optimal Currency Area (OCA Theory). This theory stipulated the purely economic conditions that should be satisfied in order to have an effective monetary union. One of the most important of these conditions was that any economic divergence of the currency union not be allowed to become too large, as convergence would be difficult and painful. An important domestic tool to prevent significant divergence is the ability to push wages and prices down in order to restore competitiveness, thus indicating flexibility in the local labor market. Several Eurozone countries did not possess this flexibility, and were thus setting themselves up for potential divergence (De Grauwe, 2011).

Perhaps the most important criteria for OCA theory is the existence of a budgetary union that could help to deal with shocks to the system. For example, the established budgetary union could transfer funds to a struggling nation in times of hardship. A budgetary union would require fiscal integration beyond the level of which the Eurozone was capable, thus leaving out an important institutional instrument to battle potential financial shocks to the monetary union (De Grauwe 2013; Iversen et al 2016).

At the time of the Euro’s implementation, several Eurozone nations had not met the Maastricht Criteria, and did not meet the OCA Theory’s condition of flexible labor markets in order to prevent divergence, and were thus less likely to converge with the rest of the Eurozone (Bayoumi & Eichengreen 1997; Beine 2003). Table 7.1 shows the EMU nations’ economic indicators in relation to the five Maastricht Criteria.
Table 7.1.

*EMU Nations’ Maastricht Criteria Metrics 1998*

<table>
<thead>
<tr>
<th>Country</th>
<th>Inflation Rate (%)</th>
<th>Long Term Government Bond Yield (%)</th>
<th>Budget Surplus (Deficit) (% of GDP)</th>
<th>Public Debt (% of GDP)</th>
<th>Currency Devalued in Last Two Years?</th>
<th>Number of Maastricht Criteria Satisfied</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>1.1</td>
<td>5.6</td>
<td>(2.3)</td>
<td>64.7*</td>
<td>No</td>
<td>4</td>
</tr>
<tr>
<td>Belgium</td>
<td>1.4</td>
<td>5.7</td>
<td>(1.7)</td>
<td>118.1*</td>
<td>No</td>
<td>4</td>
</tr>
<tr>
<td>Finland</td>
<td>1.3</td>
<td>5.9</td>
<td>0.3</td>
<td>53.6</td>
<td>No</td>
<td>5</td>
</tr>
<tr>
<td>France</td>
<td>1.2</td>
<td>5.5</td>
<td>(2.9)</td>
<td>58.1</td>
<td>No</td>
<td>5</td>
</tr>
<tr>
<td>Germany</td>
<td>1.4</td>
<td>5.6</td>
<td>(2.7)</td>
<td>61.2*</td>
<td>No</td>
<td>4</td>
</tr>
<tr>
<td>Ireland</td>
<td>1.2</td>
<td>6.2</td>
<td>1.1</td>
<td>59.5</td>
<td>No</td>
<td>5</td>
</tr>
<tr>
<td>Italy</td>
<td>1.8</td>
<td>6.7</td>
<td>(2.5)</td>
<td>118.1*</td>
<td>No</td>
<td>4</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>1.4</td>
<td>5.6</td>
<td>1.0</td>
<td>7.1</td>
<td>No</td>
<td>5</td>
</tr>
<tr>
<td>Netherlands</td>
<td>1.8</td>
<td>5.5</td>
<td>(1.6)</td>
<td>70.0*</td>
<td>No</td>
<td>4</td>
</tr>
<tr>
<td>Portugal</td>
<td>1.8</td>
<td>6.2</td>
<td>(2.2)</td>
<td>62.0*</td>
<td>No</td>
<td>4</td>
</tr>
<tr>
<td>Spain</td>
<td>1.8</td>
<td>6.3</td>
<td>(2.2)</td>
<td>67.4*</td>
<td>No</td>
<td>4</td>
</tr>
</tbody>
</table>

Source: European Monetary Institute (1998)

*Indicates specific Maastricht Criterion not satisfied

As evident in Table 7.1, only four of the eleven EMU nations were able to satisfy all Maastricht Criteria. In particular, the national debt level of several Eurozone nations was substantially higher than the required 60%. The fact that the Euro was implemented regardless of several nations being economically unprepared indicates that political motivations were more important at the time, and that economic shortcomings were overlooked in order to push the Maastricht Treaty through.

As previously discussed, the economic unpreparedness of several nations with which the Eurozone implemented the Euro would lead to a divergence (particularly in Current Account Balances) that almost dissolved the Eurozone. European leaders at the time of the Maastricht
Treaty were neither ignorant nor uninformed of the economic risks of the project and the unpreparedness of several nations. However, the political goals of France and Germany in particular trumped these economic shortcomings and the Euro was pushed through (De Grauwe, 2013).

Southern European economies were not institutionally inclined to promote an export-led system; rather, economic growth was based on domestic demand. As a result, Northern European countries stood to benefit significantly from the EMU because they could continue their export-led growth model while other EMU nations lost their ability to devalue their local currency to boost competitiveness. On the other hand, Southern European countries, with relatively loose wage coordination, would be put into a tough position in the event of economic divergence or loss of competitiveness without the ability to devalue their currency (Hall, 2014).

These economic differences and lack of preparedness set the stage for significant divergence in the years following the Euro’s implementation. Critics at the time also worried about the potential for contagion in the monetary union if a financial shock were to hit one country. Furthermore, the singular monetary policy of the Eurozone coupled with each country maintaining its own fiscal policy was another serious cause for concern, as varying fiscal policies could lead to significant divergence (Regling et al., 2010). Ultimately, European politicians at the time largely overlooked these concerns and the EMU was established (De Grauwe 2011).

After the Euro’s Implementation (1999-2009)

Once the Euro was implemented, the Eurozone experienced short-term economic growth because of the very advantages that Euro advocates preached. The elimination of foreign exchange risk played a major role in increasing trade flow among European nations. Additionally, Glick and Rose (2002; 2016) found in their analysis that the lowered transaction
cost and lack of foreign exchange risk is associated with inter-currency union trade, and results in an increase in trade flow by as much as a factor of two. These findings are not Eurozone-specific, but substantiate the argument that a currency union significantly boosts trade among the participating nations.

Analysis done by Baldwin (2006) applies currency union research to the Eurozone and Baldwin concludes that the Euro’s introduction did, in fact, significantly boost inter-Eurozone trade. His findings are substantiated by Micco, Stein and Ordoñez (2003) who found that inter-Eurozone trade increased by a magnitude more than can be attributed to regular growth or other external factors.

Critics of the Euro have argued that the increased trade flow was inevitable given the increasing European integration in the decades leading up to the Euro’s implementation. For example, Berger and Nitsch (2008) conclude that, when accounting for the increasing European integration and trade flows immediately after World War II, the trade benefit of the Euro essentially disappears. While it is true that European trade had been gradually increasing in the decades leading up to the Euro’s implementation, the spike in trade after 1999 cannot be attributed simply to inevitability. Rather, the powerful advantages of the removal of foreign exchange risk and transaction costs contributed to the significant rise in Eurozone trade in the years following the Euro’s implementation.

As a result of the increased trade flow, the Eurozone enjoyed substantial economic growth in the first decade after the Euro’s implementation, and the Euro was labeled as a “resounding success” in its first decade (European Commission, 2008). From a monetary policy perspective, the European Central Bank (ECB) was successful in keeping inflation near its stated target level (2.2% actual average inflation versus the ECB’s 2% target) (IMF, 2015).
Additionally, “Intra-Eurozone trade in goods increased from 26% of GDP in 1998 to 33% of GDP in 2008” (Iversen et al., 2016), signaling a significant increase in trade among Eurozone countries. Furthermore, in the Euro’s first decade, the differing economic systems of the northern and southern Eurozone seemed to complement each other – the northern Eurozone’s export-led model coupled well with the southern Eurozone’s demand-led model (Iversen et al, 2016). The increased trade flow as a result of the EMU could only have contributed to the rise in growth of Eurozone trade.

However, unsurprisingly, the increased trade flow in the aftermath of the Euro’s introduction led to a divergence in Current Account Balances (Carlin, 2013; Hall, 2016; Lane, 2006). This divergence was led primarily by the difference in economic models, with the export-heavy northern European countries benefiting from their southern neighbors’ lack of currency devaluing power. However, Iversen et al. (2016) point out that, “the [southern Eurozone nations] were able to grow rapidly because of access to low real interest rates (the low real interest rates under the euro were further lowered by expected inflation in the south exceeding that in the north).” Given their demand-led growth model, Southern Eurozone nations had incentive to borrow at a relatively lower interest rate than they otherwise would have had.

These conclusions are preceded by Björksten and Syrjänen (2000), who conducted analysis about the Taylor Rule and its application to the Eurozone. They concluded that, when taking the weighted average of the Eurozone economies, the ideal interest rate for the newly formed Eurozone in 2000 would be 2.4%. There was significant variation among the individual nations in what their optimal interest rate should be. Every Southern European country (with the

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4 The Taylor Rule is an approximation of the ideal percentage interest rate increase for each percentage increase in inflation
exception of Italy) had an optimal interest rate that was at least 2% higher than the convergent rate.

Thus, southern European countries could borrow at a lower rate than they otherwise could have. This new incentive, coupled with their demand-led growth models set the stage for what became excessive borrowing. Excessive borrowing is generally considered unsustainable over a long period of time. However, over time, Southern Eurozone countries arguably had no choice but to continue borrowing as the divergence in Current Account Balances began to increase (Jaumotte and Sodsriwiboon 2010).

The result of differing economic mindsets, along with incentivized borrowing, loose fiscal policy and lack of competitiveness quickly led the Eurozone to Current Account Balance diversion. Figure 7.1 shows the Current Account Balances major Eurozone economies as a percentage of their respective GDPs.

**Figure 7.1.** Current Account Balances in Germany, Italy, Portugal and Spain 1999-2008

Source: Federal Reserve Bank of St. Louis
As evident in Figure 7.1, Germany (a representative NEA country) ran rising Current Account surpluses, while the southern Eurozone ran increasing Current Account deficits. Interestingly, Italy was the only SEA country to run a Current Account surplus at the time of the Euro’s implementation. After the Euro was introduced, Italy’s Current Account Balance began to steadily decline, perhaps as a result in its lack of competitiveness over time and lack of ability to devalue its currency. As mentioned, these two factors were a major issue for the entirety of the SEA, and trade flows began to significantly favor the northern European nations. As the Current Account Balances began to diverge to unmanageable levels, and the resulting SEA debt to GDP ratios spiraled out of control, the Eurozone was ultimately led to the Euro crisis in 2009.

**Eurozone Debt Crisis (2009-2014)**

*Effect on Bond Yields*

When the debt levels of several Eurozone nations reached unmanageable heights, a sovereign debt crisis emerged in Europe. The debt crisis served to realize a major concern of Eurosceptics at the time of the Euro’s implementation – the worry that a significant financial shock within a country or region of the Eurozone would spill over to the rest of the EMU. Since bond yields are an indicator of a country’s perceived credit-worthiness (and thus overall financial health), an examination of bond yields can serve to help examine how the Eurozone as a whole pulled through the debt crisis.

Several economists argue that a major factor in the emergence of the debt crisis was the lack of fiscal integration between member states (De Grauwe, 2013; Hall, 2014; Stiglitz, 2016). At the time of the crisis, the Eurozone lacked an institutional method of providing aid to struggling countries. A budgetary union, one of the theoretical necessities of a currency union was all but absent – the Eurozone’s overall budget stood at around 1% of GDP at the time of the
crisis (Iversen et al., 2016; Stiglitz, 2016). Furthermore, the Eurozone lacked a creditor of last resort, an institution that would buy up risky government bonds in order to prevent that nation from issuing more risky debt (De Grauwe, 2012). A massive divergence and lack of institutional support put the Southern Euro Area in particular in a particularly painful position.

During the beginning years of the Euro, Eurozone government bonds converged significantly as investors perceived entrance into the monetary union as a sort of collective risk-sharing approach. In particular, southern Eurozone nations benefited from this convergence because it allowed them to issue cheaper debt than they otherwise would have (Mäkelä, 2016). Regardless, Eurozone bond yields before 2008 remained relatively converged.

However, in 2009, the Euro crisis, triggered in part by the US financial crisis, began to call the credit-worthiness of several Eurozone countries (particularly Greece) into question, culminating in reasonable doubt that the Eurozone could continue to exist (Bibow, 2012; Darvas, Piasni-Ferry & Sapir, 2011; Lane, 2012; Stiglitz, 2016). Several economists attribute a major cause of the debt crisis to the lack of institutional safeguards, such as a lender of last resort and closer fiscal union (Darvas, Piasni-Ferry & Sapir, 2011; De Grauwe, 2012; Ehrmann and Fratzscher, 2016; Stiglitz, 2016). Without a lender of last resort, each individual nation within the EMU would essentially be on its own in terms of paying back its debts.

The divergence that caused the crisis in the first place then served to diverge the Eurozone even more, particularly in the area of bond yields. As the debt crisis became full-fledged in 2009, bond rates for southern European nations (and Ireland) spiked considerably, as investors began to doubt the credit-worthiness of those nations. Furthermore, the pre-Euro concern for financial contagion was seemingly realized.
Ehrmann and Fratzscher (2016) provide comprehensive analysis on the shift in Eurozone bond yields after the debt crisis and the worry of financial contagion. Before 2008, EMU bond yields were generally converged, and Germany, with the lowest interest rate, acted as the leader that other interest rates followed.\(^5\) Any country-specific shocks generally only affected that particular country. Ehrmann and Fratzscher find that there was fragmentation in bond yields after the Euro debt crisis, with a significant flight to quality in the beginning stages of the crisis. This flight to quality is unsurprising, given that the Euro crisis coincided with a global financial crisis. At a time of high risk and instability, many investors would naturally gravitate toward a safer investment (the safer investment being a bond with a relatively low yield, indicating higher levels of credit-worthiness).

Ehrmann and Fratzscher (2016) also determine that the level of spillover and contagion during the Euro crisis was surprisingly low. In fact, “there is generally no evidence of contagion.”\(^6\) However, the co-movement of Eurozone countries’ bond yields that was present before the crisis was significantly reduced during and after the crisis. The weakening of the co-movement resulted in fragmentation. Italy and Spain serve as an exception as their respective bond yields became heavily reliant on one another. Ultimately, the Euro crisis had not raised the risk of contagion among the Eurozone. These findings substantiate earlier results found by Caporin et al., (2013) and Claeys and Vašíček (2014), who also conclude that there is little evidence of contagion, and that any significant movements in bond yields were the result of larger shocks outside the Eurozone.

Although there is evidence that there was a lack of contagion among the Eurozone, the

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\(^{5}\) Theoretically, a lower bond yield (interest rate) signals a higher level of the government’s credit-worthiness. A higher bond yields indicates a higher payout at maturity in exchange for assumption of greater risk.

\(^{6}\) Ehrmann and Fratzscher (2017) define contagion as “a strengthening in the transmission of [financial] shocks”
variance of bond yields increased significantly after 2009, with SEA countries exhibiting the highest yields. The rising bond yields of SEA economies also began to rise in a self-fulfilling manner; rising bond yields lead to a weaker fiscal position, which, in turn, leads to a reduction of perceived credit-worthiness (and thus even higher yields) (Mäkelä, 2014). A significant reduction in the perceived credit-worthiness of a significant portion of the Eurozone would likely lead to a loss of confidence in the entire union. Therefore, the ECB introduced the Outright Monetary Transaction (OMT) program, aiming to reestablish a convergence in Euro area bond yields.

The OMT is a policy geared toward the ECB acting as a lender of last resort – an economic institution that, as previously mentioned, many argued was necessary for a monetary union. Instituted in 2012, the OMT was the ECB’s policy of having the option of buying a Eurozone government’s bonds on the secondary market with a maturity date of up to three years on the condition that the government in question be set on a path toward fiscal consolidation (European Central Bank, 2012). The OMT program is an important step toward increased EMU fiscal integration because it provides a sort of safety net that will theoretically ensure that countries willing to put in the effort to get their financial house in order won’t default on their credit.

Also, leaders at the ECB, such as Benoit Coeuré, argued that the OMT was necessary because, “the transmission of monetary policy was severely impaired [by the debt crisis]” (Coeuré, 2013). Furthermore, Coeuré pointed out that, “Investors required an interest rate premium as a compensation for the risk that the euro might not remain the irreversible currency of the euro area – at least in its current composition.” These developments were unacceptable to the ECB, and the introduction of the OMT was seen as a remedy to the deteriorating economic
situation in 2012. On the day the OMT was announced, Mario Draghi, the head of the ECB stated, “Within our mandate, the ECB is ready to do whatever it takes to preserve the euro” (European Central Bank, 2012), signaling a willingness from the Eurozone leadership to speed up financial integration in order to get the Euro back on its feet.

The OMT program’s announcement had an immediate effect in the reduction of SEA bond yields, as evidenced by Altavilla and Giannone (2014), even though the program has never been put into effect (Altavilla and Giannone, 2014; Ehrmann & Fratzscher, 2016; Stiglitz, 2016). In particular, Atavilla and Giannone find that Italy and Spain’s bond yields went down by as much as 200 basis points after the announcement of the OMT, indicating a reestablishing of perceived credit-worthiness.

Although the program has never actually been utilized, it remains an important part of Europe’s integration because it signals a Eurozone willingness to provide common support to an individual nation through the ECB. In a way, it is a step in the direction of the “all for one and one for all” mentality that some European leaders at the time of the Maastricht Treaty were hoping to facilitate.

However, I argue that, especially given that the OMT program was never enacted and only served to restore public confidence in Eurozone solvency, it is a reactive policy instead of a proactive one. It is an example of the Eurozone introducing a measure that could potentially save the Euro were it ever to fall into another crisis, but does not make any strides toward immediately and directly assisting struggling economies. Additionally, the ECB promised that all OMT funds would be fully “sterilized” (European Central Bank, 2012), meaning that the European Central Bank intends to collect any debt it is owed through the OMT. This, in effect, ensures that the OMT assistance will only be temporary, and the country receiving the aid will
owe, in full, the amount of bonds the ECB bought through the program.

Although, given that the announcement of the OMT program did re-converge Eurozone bond yields and has never been put into effect, it is possible that it was never meant to be enacted. It is not irrational to think that Eurozone policy makers knew that the announcement of another safety net would boost investors’ perception of the Eurozone’s credit-worthiness, and felt that no direct monetary action was necessary at the time. As a result, the OMT program is another tool that the ECB can keep in its back pocket without overstepping its mandate. Ultimately, the OMT program served as an important step by Eurozone leadership to restore confidence in the Euro, but makes little forward progress in terms of continued integration.

Policy Decisions and Push Toward Austerity

As the debt crisis emerged, decisive action was needed within the Eurozone to address the situation, resulting in a call for strong leadership. This leadership came primarily from the two Eurozone nations with the most resources and experience in policy leadership – Germany and France (Schild, 2013). The Franco-German leadership and resulting Eurozone policies have shaped the Eurozone since the debt crisis, and are critical to the examination of the Euro’s overall effect.

In 2010, immediate and decisive action was needed in order to keep Greece from insolvency and, as many thought, to keep the Euro alive (Valiante, 2011). However, at the time, the question of how to deal with the crisis from a policy perspective was contested throughout the Eurozone. In order to answer the question of how to deal with the crisis, one must first answer the question of how it came about in the first place.

Two opposing perspectives on the origin of the debt crisis emerged between the two
Eurozone leaders. In the German view, the crisis was the result of a lack of fiscal discipline in the SEA. Conversely, the French believed that the debt crisis stemmed from economic imbalances. Regardless of the differing views, however, both countries firmly believed that the Euro must be saved at any cost, and used this common goal as a foundation for policy compromise (Schild, 2013). Although France played a significant role in the policy leadership during the crisis, Germany was undoubtedly the main driver of policy decisions, and became the leading voice in the Eurozone (Bulmer, 2014). As a result, many of the Eurozone responses to the debt crisis reflected the German mentality that fiscal irresponsibility was a root cause of the problem in the first place. However, Eurozone’s reaction to the debt crisis nevertheless sought to address the crisis head-on and save the Euro.

In 2009-11, Greece, Ireland and Portugal required immediate financial assistance in the form of bailouts in order to stay afloat. To address these financial needs, the Eurozone approved bailout packages for Greece in 2009, for Ireland in 2010, and for Portugal in 2011. These bailouts were made possible by establishing the European Financial Stability Facility (EFSF) and the European Financial Stabilization Mechanism (EFSM). The EFSF and EFSM are funds backed by all Eurozone nations and use different financial vehicles through which they can act as a lender of last resort to Eurozone nations in desperate need of financial assistance (Closa & Maatsch, 2014). The bailouts also, “violated a core principle of the Maastricht Treaty, the no bail-out clause (Art. 125 TFEU)”7 (Schild, 2013). The willingness to violate a key provision the Treaty on the Functioning of the European Union (TFEU) signals that Eurozone leaders believed that the Euro must be saved by any means necessary. In fact, in 2011, Angela Merkel stated, “If

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the Euro fails, then Europe fails” (Spiegel, 2011).

However, in return for the immediate bailouts, the countries receiving financial assistance were forced to implement strict fiscal tightening (austerity). For example, Portugal was forced to reduce its budgetary deficit by 6% of GDP within three years, while Greece was required to reduce its budgetary deficit by 11% of GDP in three years (Hall, 2014). This call for austerity was backed primarily by the German government, and underscores the German government’s views of the root of the crisis. Countries such as Portugal and Ireland announced their own austerity measures in order to preemptively convince investors that they were committed to becoming increasingly credit-worthy (Theodoropoulou & Watt, 2011).

In effect, these strict austerity measures for countries in need signal that Eurozone leaders were willing to go to great lengths to keep the Euro alive in the long-term, even if the proposed solutions cause a great deal of short-term economic pain. This stance marked the next iteration of the Eurozone’s mindset about the Euro. Before the debt crisis, the Eurozone countries enjoyed relatively smooth sailing. At the onset of the debt crisis, the dynamic of the Eurozone shifted as Germany, in particular, seized the reigns and began directing the path forward. The German push for austerity, in particular, has facilitated a sudden reversal of over a decade of loose fiscal policy in the SEA.

In theory, austerity measures impose a reduction in government spending and an increase in taxes to move toward budgetary stimulus. However, these measures often lead to a decrease in output and economic growth (De Grauwe & Ji, 2013). Figure 7.2 displays the GDP growth of the three countries that received Eurozone bailout packages and implemented strict austerity measures - Portugal, Ireland, and Greece.
As seen in Figure 7.2, all three countries experienced at least two years of negative GDP growth, signaling a sharp decrease in economic output. Additionally, as De Grauwe and Ji (2013) point out, implementing austerity measures in a group of countries can only be effective if the countries with which they trade run budgetary deficits. In the ideal situation, more trade flows to the debtor countries and the budgetary divergence begins to narrow. Applying this ideal scenario to the Eurozone would mean that SEA countries such as Greece and Portugal would implement austerity measures and move toward budgetary surpluses by cutting spending and increasing taxes, while NEA countries such as Germany would run budgetary deficits. In reality, NEA countries continued to run budgetary and trade surpluses, making austerity measures in SEA countries painfully ineffective (De Grauwe & Ji, 2013; Truger, 2014).

Furthermore, as NEA countries contributed significant sums to SEA bailout packages and bond-buying programs, the amount of SEA debt held by NEA banks began to significantly increase. Table 7.2 shows the increase in SEA debt held by NEA banks from 1999-2009.
Table 7.2.

*Southern Eurozone Area Debt Held by Core Eurozone Banks in Billions of Euros*

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2009</th>
<th>Percent Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portugal</td>
<td>26</td>
<td>110</td>
<td>320%</td>
</tr>
<tr>
<td>Ireland</td>
<td>60</td>
<td>348</td>
<td>481%</td>
</tr>
<tr>
<td>Greece</td>
<td>24</td>
<td>141</td>
<td>491%</td>
</tr>
<tr>
<td>Spain</td>
<td>94</td>
<td>613</td>
<td>554%</td>
</tr>
<tr>
<td>Italy</td>
<td>259</td>
<td>822</td>
<td>217%</td>
</tr>
<tr>
<td>Total</td>
<td>463</td>
<td>2033</td>
<td>340%</td>
</tr>
</tbody>
</table>

*Core Eurozone Countries are: Germany, France, Austria, Belgium and the Netherlands*

*Source: Baldwin et al. (2010)*

As seen in Table 7.2, NEA have accumulated a significant increase in SEA debt, with the majority of the increase coming during the debt crisis. This credit imbalance serves to strain the economic and political relationships by the NEA and SEA. Because SEA countries are so heavily indebted to the North, NEA countries (particularly Germany) have assumed a dominant role in the Eurozone decision making process since the onset of the debt crisis.

**The Euro Since the Debt Crisis (2014-Present)**

With policy decisions, such as the EFSF and EFSM bailouts, and the OMT program, the Eurozone was able to pull out of the debt crisis and remain intact. As mentioned, the bond yields of Eurozone countries began to reconverge as investors began to regain confidence in the credit worthiness of Eurozone countries. However, several SEA countries have experienced recent periods of economic decline. This decline has been accompanied by sluggish growth in the NEA as well, leaving many citizens in the Eurozone dissatisfied with the single currency, and some political parties calling for an exit from the currency (Stiglitz, 2016).

Regardless, Eurozone governments have worked to preserve the Euro through structural reform and fiscal discipline, because both NEA and SEA governments realize that exiting the Euro would be extremely economically painful, at least in the short term (Hall, 2014). For the
SEA, exiting the Euro could mean imminent failure of financial institutions, and most likely a large recession. For the NEA, a Eurozone exit could mean having to absorb large amounts of losses on debt issued to Southern Europe (McKinsey Germany, 2012).

As previously discussed, a constant relationship throughout and since the debt crisis has been the NEA running of Current Account surpluses. Consistent NEA Current Account surpluses have hindered SEA economic growth and competitiveness, and the imposed austerity measures only magnify the economic hardship. The result has been sluggish - and at times negative - GDP growth in the SEA.

Nevertheless, the Euro has maintained majority public support in the Eurozone as a whole (European Commission, 2016). Many Eurozone leaders have repeatedly voiced their support for the Euro’s preservation, and have worked to implement structural reforms and integration to bolster the Euro’s future. For example, in Germany, Stability Culture used to refer to the Deutschmark, but now is used in reference to the Euro (Howarth & Rommerskirchen, 2013). In France, Francois Hollande, stated that, “What threatens us is not an excess of Europe, but an insufficiency [of Europe]” (BBC, 2015). This top-level support has been reflected in the Eurozone public’s support for the Euro.

However, in the SEA, public support for the Euro is significantly lower than in the NEA. For example, only 41% of Italians believe the Euro is a good thing, while 47% believe it to be a bad thing (with 12% undecided). This lack of approval is in stark contrast to Germany’s 64% approval rating (European Commission, 2016).

The differing levels in support likely stem largely from the economic downturn SEA countries have faced over the last few years, and is unlikely to significantly rise without economic growth. As a result, I argue that, in the coming years, lack of popular support and
increased political uncertainty across the Eurozone will be the Euro’s biggest non-economic challenges.

The Future of the Eurozone

As economic growth in the Eurozone remains sluggish, and support for the Euro falls in several Eurozone nations, the future of the Euro remains uncertain and volatile. In particular, decreasing support for the Euro in SEA countries could lead to electoral pressure on SEA governments to begin to take action to pull out of the Eurozone. Moreover, without proactive economic and financial integration, the Eurozone remains vulnerable to similar kinds of economic divergences that were seen before the debt crisis.

Political and Social Uncertainty in the Eurozone

Several key political developments inside and outside the Eurozone have put pressure on the status quo, and will play a role in determining the future of the Euro. First, the United Kingdom’s decision to leave the European Union marks the first time an EU nation has decided to leave the union. Although the UK is not part of the Eurozone, the process will no doubt affect the workings of the EMU.

British Prime Minister, Theresa May, is set to invoke Article 50 of the Lisbon Treaty in March 2017, thereby launching negotiations with EU leaders as to the terms with which the UK will exit the EU (BBC, 2016). The central question of the negotiations is whether or not Britain will have a clean break from the EU and become an entirely separate nation, or retain some benefits (and drawbacks) of EU membership, such as access to the single market (De Grauwe, 2016). Furthermore, the precedent set by the UK in leaving the EU could trigger similar referendums in other European nations (NBC, 2016). If other EU/Eurozone members were to
decide to leave the EU, it could mean the start of the unraveling of the entire union.

Within the Eurozone itself, political instability has established an increasing presence. For example, Italy has had six Prime Ministers in the last decade, with the previous Prime Minister, Matteo Renzi, stepping down in late 2016 after losing a referendum on constitutional reform (Wall Street Journal, 2016). Aisen and Vega (2013) and Jong-A-Pin (2009), in their analysis of the economic effects of political instability, conclude that political instability serves as a detriment to economic growth, particularly because it shortens policy makers’ time horizon and long-term macroeconomic policies are rarely successfully implemented. Italy has experienced slow, often negative, GDP growth since the debt crisis, resulting in a popular support for the Euro dropping to 41% in 2016 (European Commission, 2016). Additionally, Matteo Renzi’s defeat in his constitutional referendum has been called by some as a victory for Eurosceptics (Washington Post, 2016). While Renzi’s referendum defeat and Italy’s political turnover do not necessarily mean that Italy is headed toward exiting the Eurozone, they are nonetheless indications of economic and political instability that could end up threatening the Euro.

Elsewhere in the Eurozone, France is set for its presidential election in 2017. Among the frontrunners is Marine Le Pen, the leader of the far-right National Front. One of Le Pen’s key platforms is to follow in the UK’s footsteps and remove France from the European Union (and thus the EMU) (Time, 2016). While there is certainly no guarantee that Le Pen will secure the presidency, she currently is ahead in the polls leading up to the first-round elections in April (CNBC, 2017). Her popularity in France signals the French electorate’s desire for a shift from the current policies of the leftist Francois Hollande. At the very least, Le Pen’s populist appeal underscores a growing French Euroscepticism that could be damaging to the Eurozone in the
coming years.

Although it is impossible to predict the future of the Eurozone, many significant challenges have become increasingly present in EMU countries. With declining public support for the Euro and an increasing probability that the political status-quo will be reshuffled, the Eurozone must deal with problems that are not purely economic. How willing and well-equipped the EMU is to do so will depend heavily on elections in influential Eurozone countries such as: Germany, France, and the Netherlands.

Regardless, in the short term, it is hard to be too optimistic about the Euro’s future success from a social perspective. As a populist wave begins to sweep over Europe, Euroscepticism is on the rise. The Eurozone public’s current majority approval of the Euro is underscored by rising bottom-up Euroscepticism. If the populist wave continues its trajectory toward high political offices in Europe, the top-level support the Eurozone has seen since its inception could quickly evaporate. Whether the increased Euroscepticism will be short-lived will likely depend on the outcome of the political elections; but, what is certain is that the already fragile Euro, apart from its economic and financial struggles, will also have to endure mounting social and political pressure against it.

*Economic Uncertainty of the Euro*

Apart from the social and political uncertainties facing the Euro, economic worries will also play a key role in the Eurozone’s future. As previously discussed, Eurozone policy makers sped up the financial and fiscal integration process during and after the Eurozone crisis. However, the majority of these policies, such as the OMT program, the EFSF, and EFSM are reactionary instead of proactive, meaning that they serve to address a past crisis instead of
necessarily preventing one in the future. Furthermore, the majority of these safeguards against the Euro’s failure require that any monetary assistance be repaid, or that strict fiscal tightening be implemented.

These policies will likely lead to a Eurozone that is increasingly two-tiered, with countries heavily in debt (the SEA) subordinate both politically and economically to the creditor nations (the NEA). Germany will also most likely increase its standing as the leading voice among the Eurozone because of the sheer amount of resources and leadership it has already contributed to keeping the Euro alive.

Nonetheless, European leaders still maintain a strong desire to preserve the Euro through increased integration (Juncker, Tusk, Dijsselbloem, Draghi & Schulz, 2014). Joseph Stiglitz, a Nobel laureate and outspoken critic of the Euro, agrees that an effort should be made to save the Euro and proposes some solutions for doing so. Stiglitz’s remedies center around heavy structural integration in the form of a banking union with a common depository insurance, and the mutualization of debt within the Eurozone in addition to a budgetary union (Stiglitz, 2016). From an economic and financial perspective, these solutions are logical – mutualization of debt and a common depository insurance would strengthen the Eurozone’s credit worthiness and serve to diversify financial risk in a way similar to a stock portfolio. A budgetary union would serve as an internal safeguard against government default, with struggling EMU nations being able to receive immediate financial assistance. The budgetary union, too, would spread financial risk relatively evenly across the Eurozone, instead of it being concentrated in one region.

However, Stiglitz’s proposed reforms, while economically sound, will most likely, at least in the short-term, never be implemented. Such a high level of risk sharing would go against NEA countries’ view of the Eurozone. In particular, Germany’s cultural emphasis on Stability
Culture is a direct antithesis to the idea of taking on a much higher level of risk by way of a budgetary union or mutualization of debt. Also, France’s growing Euroscepticism and populism suggest that the French would starkly oppose a move as radical as a budgetary union.

In fact, with upcoming elections and existing political turmoil within the Eurozone, it is unlikely that any moves toward significantly increased integration will be made in the short-term. On the other hand, because of the high cost of abandoning the Euro, EMU nations will also likely not make a significant push to leave the Eurozone. The most likely exception is France under a President Le Pen, who has promised to hold a referendum similar to the UK’s on France’s status in the EU. As a result, the Euro will likely endure, but continue to face sluggish growth and constant tension between nations as debt levels remain high and economic mindsets remain divergent.
CONCLUSION

At the time of the Maastricht Treaty’s signing, eleven European countries linked their fates to each other and established the economically and politically heterogeneous European Monetary Union. The nations allowed themselves a seven-year grace period before the Euro’s implementation, during which they needed to work toward the Maastricht Criteria in order to ensure the success of the monetary union. Even though each Eurozone nation showed improvements in working toward the criteria, only a handful were able to satisfy all five, signaling an overall unpreparedness to launch the single currency.

Once the Euro was launched, the EMU nations experienced overall growth as the result of the Euro’s economic benefits. However, underlying imbalances between the SEA and NEA began to surface, and the two regions began to diverge in terms of their Current Account Balances and levels of debt. This divergence benefited the NEA in particular, as budgetary and Current Account surpluses facilitated stable economic growth.

As the global financial crisis set in and triggered the Eurozone Debt Crisis, the economic divergence in the Eurozone was so severe that it threatened the continued existence of the Euro. Furthermore, the debt crisis facilitated a lopsided power dynamic, with the heavily indebted SEA having to acquiesce to the NEA’s demands for austerity and quick reversal of decades of SEA economic trends. The austerity measures and overall slow recovery of the global economy were particularly harmful to the SEA nations, which have experienced sluggish growth to the present day. As a result, popular support for the Euro in the SEA has dwindled, and politicians are caught between trying to please their electorate and catering to the rest of the Eurozone.
The NEA, on the other hand, has emerged from the debt crisis as the clear leading region of the EMU, both politically and economically. Consequently, the NEA nations have had to undergo few changes in terms of their economic models, and have been able to slowly pull out of the crisis. This consistency is heavily contrasted in the SEA, where immediate and painful fiscal changes have been made in order to stay in the EMU.

In the future, the lopsided power dynamic within the Eurozone, as well as the continued divergence between the NEA and SEA will most likely lead to sluggish growth, and continued tension between EMU nations. However, as has been proved several times, Eurozone leaders are willing to go to great lengths in order to keep the Euro alive, indicating that, barring some sort of financial catastrophe, the Euro will most likely live on despite its hardships and shortcomings.

A major threat to its continued existence, however, is the possibility that Europe’s current rise in populism ends up staffing the Eurozone’s highest offices with Eurosceptics. Referendums similar to the United Kingdom’s are a possibility within the Eurozone depending on the outcome of key elections in member states. This social and political uncertainty further complicates the Euro’s future, rendering a variety of political and economic outcomes possible.
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