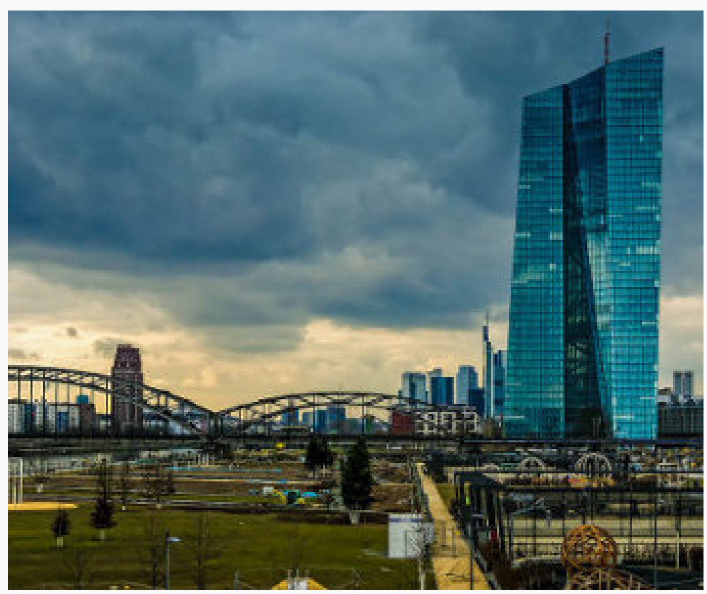
Greece shows the flaws in pursuing a common monetary policy response to economic shocks across the EU

To what extent is the Greek debt crisis a function of wider flaws in the design of the single currency? **Bruce Morley** *writes that while Greece's debt already exceeded 100 per cent of GDP in the 1990s, it is not simply the size of a country's debt that determines whether it is sustainable. He argues that the real problems illustrated by Greece stem from the application of a common monetary policy across the Eurozone despite key structural differences between individual Eurozone economies.*

Following protracted negotiations between Greece and the Troika, an agreement was finally reached on a bailout package for the country worth approximately 86 billion euros. However this came at a high price in both economic and political respects. In political terms, Euclid Tsakalotos replaced Yanis Varoufakis in July as the coordinator of the bailout negotiations. More recently substantial differences developed within the governing Syriza party, culminating in a further general election being called for later this month and the splitting of the party into those that support the bailout and those that oppose it. Once again the future for Greece and the wider Eurozone economy has become undermined by the uncertainty surrounding the political makeup of the country and its consequent economic policies.

The current crisis follows years of financial problems in Greece, which have arguably been developing over a protracted period of time. There have been a number of explanations suggested for the current economic predicament in Greece, many relating to the inherent uncompetitiveness of the Greek economy with respect to that of Germany and other Eurozone members. Some have argued that Greece should never have been allowed to join the euro in the first place. In some respects today's problems began when Greece joined the euro, initially failing to meet the Maastricht criteria, but subsequently being allowed to join in 2001.



ECB building, Credit: Jonas M Luster (CC-BY-SA-3.0)

In order to join the single currency all potential members first needed to pass the Maastricht criteria. There were five criteria in all relating to interest rates, inflation, government debt and deficits as well as the need for European Exchange Rate Mechanism (ERM) membership for at least two years prior to joining the euro. These criteria were meant to ensure convergence across the member state's economies to encourage stability across the Eurozone. All those who applied to join passed these criteria, except Greece.

In particular Greece had a problem with their fiscal stance, with their budget deficit exceeding more than the then stipulated maximum of 3 per cent of annual GDP; while their outstanding debt already exceeded 100 per cent of annual GDP in 1998. Although this situation didn't change much during the years after 1998, Greece was subsequently allowed to join the euro. However supporters of Greek membership could point out that other countries also failed the criteria, in some cases to a greater extent than Greece. Although high levels of debt are often given as an underlying cause of the current crisis, Greece has not been a stranger to high debt levels in previous years prior to the crisis.

A particular aspect of this bailout has been the debate over whether Greece's overall public debt is sustainable. The International Monetary Fund (IMF) recently published a report questioning whether current levels of debt could be sustained in the long-run. However the level of debt can't be the only problem, as Greece's debt to GDP ratio is substantially below that of Japan. There appears to be very little concern over Japan's debt sustainability. If it is not sustainable, then it may be that its creditors have to accept part of the debt will have to be written down. A previous write down of Greek sovereign debt in 2012 involved private investors in Greek government debts having to accept a 50 per cent write down in the value of the debt, known as a haircut.

However none of the bailouts or financial strategies used so far are really confronting the fundamental problems in the Greek economy or the Eurozone as a whole. In particular the structural differences in the economies across the Eurozone, which mean that a common monetary policy is not always appropriate. These differences cover many aspects of the economy including labour markets and aggregate consumption levels.

For instance a study published in 1999 by Euclid Tsakalotos (co-authored with Alan Carruth and Heather Gibson) found substantial differences in consumption patterns across the member states. The findings indicate a common policy response to shocks across the EU may not be appropriate, even when the core states alone are considered. This did not mean that when the euro was in place, there wouldn't then subsequently be some convergence towards more common economic behaviour, although there is little evidence that this has happened over recent years.

The recent problems in Greece and the Eurozone have had a severe impact on the value of the euro, which has suffered increased volatility and a loss of value against other major currencies over the last year, falling by about 10 per cent against the UK pound since the beginning of the year. One reason for the fall in value is the increased likelihood of the Eurozone breaking up following Greece's exit.

For instance studies by Stefan Eichler among others have found strong evidence that the euro depreciates when the risk of a Eurozone breakup increases. In addition it also created increased volatility in the currency. Using the credit default swap premia on sovereign bonds in the Eurozone to measure the riskiness of the euro provided evidence that as the probability of a euro breakup increased, so the euro depreciated against the dollar and other currencies. This may be because as the Eurozone crisis has erupted investors have lost faith in the single currency, leading to significant capital outflows from the euro area, and causing the euro's exchange rate to fall.

The devalued euro is not necessarily all bad news for the Eurozone, as it can encourage exports and economic growth, although on the other side, countries that rely on exporting to the Eurozone, such as the UK, will potentially suffer. This has become increasingly apparent in the UK agricultural sector, as farm payments are based on the value of the euro: hence as the pound has appreciated against the euro, payments have fallen.

The crisis has again highlighted the need for a long term solution, possibly involving greater fiscal integration within the Monetary Union. Many economists, such as Alan Greenspan (former head of the US Federal Reserve), have gone as far to say that a fiscal union should be formed in order to prevent future crises and that even this may not be enough as a political union could also be required. However when the euro was formed, it was felt that the retention of fiscal policy was necessary as a mechanism for individual members to stabilise their own economies in the event of asymmetric shocks to the Eurozone, so fiscal union may not be popular across the EU.

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