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One for All and All for One: The Global Financial Crisis and the European Integration Project

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Partenaire financier

One for All and All for One: The Global Financial Crisis and the European Integration Project [*]

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Abstract

When the global financial crisis hit the shores of Europe, after crossing the Atlantic, the Eurozone was considered a safe haven. After the first Greek bailout in May 2010, the discourse had now changed completely; the debt crisis was the euro's fault. As a result, some argued that Greece and eventually other bailed-out member states should abandon the euro and reintroduce their national currencies. If they did not, then countries such as Germany and the Netherlands would give up on supporting them financially, forcing them to abandon the euro anyway. Yet, no such thing has happened. The euro and the European Union are still with us. In fact, European integration has been deepened as a result of the debt crisis. This paper explains why the doomsayers have been wrong on durability of the Eurozone.

Mots clés : Debt crisis, Euro, European integration, European Monetary Union, European Union, Financial crisis.

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Introduction

When the global financial crisis hit the shores of Europe, after crossing the Atlantic, the Eurozone was considered a safe haven (Jones, 2009; Wyplosz, 2009). Although there were concerns about how the euro would face up to its first major crisis (Feldstein, 2008; Münchau, 2009), the European Union's (EU) single currency was generally viewed as a protective force against the financial storm shaking the world. For instance, *The Economist* concluded that 'the Euro has proved a haven in the economic crisis—so much so that no country seriously wants to leave it and plenty want to join' (*The Economist*, 2009). Such a view was also shared by sovereign bond investors since, according to Attinasi et al. (2010a, p. 35), there was a 'flight to safety' towards the Eurozone between September 2008 (when Lehman Brothers failed) and March 2009 (when financial markets began to stabilize). During that period, most Eurozone countries saw their sovereign bond yields decline.

By the spring of 2010, when the Greek debt crisis reached its (first) apex, the discourse had changed completely. The euro was now blamed for the debt crisis propagating itself through the so-called 'PIIGS' (Portugal, Ireland, Italy, Greece and Spain) and requiring the financial intervention of the EU and the International Monetary Fund (IMF). It is the euro's same protective shield that was now declared at fault because it allowed Member States such as Greece to indulge in a feast of fiscal deficits. Increasingly, the Eurozone came to be seen as something unsustainable, which is exemplified by *Financial Times* columnist Gideon Rachman's conclusion: 'Increasingly the Euro looks less like an indissoluble union, and more and more like an unhappy marriage between incompatible partners' (Rachman,

2010). Presumably, the end of the Eurozone and the EU would unfold like this: the domino effect that has already hit Greece, Ireland and Portugal would reach Italy and Spain; some Member States would eventually be forced to default; ultimately Germany and its northern neighbours would dump their southern EU partners and form a new, more stable and prosperous union.

More than one year after the first Greek bailout, the EU and the Eurozone are still intact. In fact, there is now more integration of fiscal affairs in the EU and the Eurozone than there was back in the spring of 2010. For instance, the Eurozone has now created what is for all intents and purposes a European monetary fund, something that was considered impossible only a few years back. In fact, those who saw the Eurozone as a safe haven at the beginning of the global financial crisis were right to do so. Things would surely have been worse for countries like Greece, Ireland and Portugal if they had been outside the euro to deal with their plight. Furthermore, the major complaint so far amongst pundits is that Eurozone leaders have not done enough to quell the crisis, meaning that there should be more Europe, not less. The two most common solutions invoked are a common Eurobond and more money for the European Financial Stability Facility (EFSF) and its future replacement, the European Stability Mechanism (ESM).

So, how do we explain the Eurozone's (and the EU's) resilience? Why have the doomsayers proved wrong? Given that at the time of writing, the European debt crisis was still in full swing, pessimists might say that it was still only a question of time before the euro falls into the abyss. However, nothing indicates that any Eurozone Member State has

the intention to give up the integrity of the euro. On the contrary, with every new instance of financial market pressure (or panic), Eurozone leaders come together to calm things down, even if they often only manage to do so for a while. The process might not be pretty but politics rarely is.[1] Nevertheless, the end result has always been to find a European solution and push integration forward.

This chapter argues that there are two reasons why the Eurozone did not implode as a result of the debt crisis. First, although economically and politically painful, bailing out Greece, Ireland and Portugal (and maybe even Italy and Spain), putting in place a temporary EFSF that will be replaced by a permanent ESM in 2013, cutting down fiscal deficits and public debts, undertaking market-liberalizing reforms as well as reforming the Stability and Growth Pact (SGP) all represent a better policy option than the alternative of a euro (and EU) failure. Second, in spite of its weaknesses, the euro has so far been a tremendous political and economic success. The doomsayers' scenario would mean throwing away all these accomplishments, not to mention the probable end of the EU itself. In sum, the Eurozone debt crisis has been an opportunity for more EU, not less. This means that the European integration project will continue to move forward, with the Member States in the lead and European institutions in a supporting role. If regional economic integration is seen as generally beneficial to countries, then it seems logical to conclude that it is better to be one for all and all for one than to be none for all and all for none.

[1] In comparison, the politics of the United States debt crisis makes European leaders look very reasonable and clear-headed.

The end is nigh: the doomsayers' reasoning

Although some concerns were initially expressed with regards to the euro's ability to withstand the global financial crisis, it is not until the Greek debt crisis got going in late 2009 that the doomsayers' arguments about the euro and its future (and by extension the EU), gained credence in the media and the public. Their reasoning is based primarily on the idea that the euro, because of its inherent flaws, is responsible for the debt crisis. However, it is also predicated on the expectation that Greece will eventually default on its debt and, through contagion in financial markets, force other Mediterranean countries to do the same. In such a scenario, these countries would have to leave the Eurozone and possibly the EU. Should the euro continue to exist, it would do so with only a few countries concentrated around a Franco-German core.

Critics who blame the euro for the debt crisis in Europe rest their argument on the fact that, when they adopted the single currency, Euro-Med countries like Greece, Italy and Spain could no longer devalue their currencies in order to maintain their competitiveness vis-à-vis their Eurozone partners, as they had done in the past.[2] Consequently, the only way for these countries to improve their economies' competitiveness was by undertaking labour and product market reforms that would improve productivity and reduce relative prices. Unfortunately, that is not what happened. They took advantage of the lower interest rates that joining the Eurozone offered them as well as the general good health of the European

[2] Ireland's situation is different from that of the Euro-Med countries since its fiscal problems arise solely from the failure of its banking system, which was bailed out with public funds. It should also be mentioned that Spain's fiscal difficulties also stem in good part from failures in its banking system, which like Ireland also arose because of a collapse in the real estate market. For more information on the housing booms experienced by Ireland and Spain, see Hibers et al. (2008).

economy to avoid making the necessary reforms. Governments also continued to run fiscal deficits, which sometimes ran afoul of the SGP rules (that is, a maximum deficit of 3% of GDP). However, overall public debt did not necessarily increase since economic growth was strong. A lot of private investment and consumption, which contributed to fueling growth, were financed with indebtedness rather than savings, since credit was cheap and abundant. The end result was that prices and wages increased without productivity following suit. Because governments could no longer devalue their currencies, their economy's goods became less and less competitive internationally while foreign goods became relatively cheaper. Thus, the current account surpluses that these countries were running before joining the euro turned into significant deficits, which mean that the economies were now consuming more than they were producing. Current account deficits are financed by (often foreign) investors, who buy financial securities issued by governments (sovereign bonds) and corporations (shares and bonds). In the case of the Euro-Med countries, the Germans and their northern European neighbours, through banks and other financial institutions, were the ones that provided most of the financing. This is because northern European countries were running current account surpluses that needed investing abroad. Germans in particular had done what the Greeks, the Italians, the Portuguese, the Spaniards and even the Irish should have done: they increased their economy's international competitiveness by keeping wage rises low and improving productivity while maintaining their relatively high savings rate to finance investment domestically. This allowed them to produce large current account surpluses that were invested in southern and eastern EU partners.[3]

[3] The situation in central and Eastern Europe was no different in general, which is why many of them have

Although one could argue that the above-mentioned situation was ultimately allowed to arise because Euro-Med governments adopted national economic policies that were inadequate in the context of a common currency, the European monetary union itself was not inconsequential. At the heart of the matter is the fact that the Eurozone is (still) not an optimal currency area (OCA). An OCA is deemed to exist if its members (countries or sub-national regions) possess at least one of three characteristics. First, they must face similar shocks to their economies and react to these shocks in the same way. Second, in the absence of such symmetry, an OCA occurs if the Member States have sufficient labour and capital mobility between them so that factors of production can move from one country experiencing an economic downturn to another enjoying an upturn. Finally, if both symmetry and factors of production mobility are inexistent, then an OCA exists if there is a high level of price flexibility (especially wages) in member states.[4] The reason why these OCA criteria are important is because in a monetary union member states have effectively relinquished control over their national monetary policy.[5] Therefore, the common monetary policy may not be well adapted to all or any of the member states' economic situation.

In the Economic and Monetary Union's case, Member States have delegated monetary policy to the European Central Bank (ECB). Because the Eurozone is not an OCA, the ECB's monetary policy contributed to fueling the imbalances between the north and the

required financial assistance from the EU and the IMF. For details, see ECB (2010).

[4] For details on OCA theory and its evolution, see Kenen and Meade (2008).

[5] This is the famous trilemma identified by Robert Mundell (1963) and Marcus Fleming (1962), whereby no country can have simultaneously the following three things: internationally mobile capital, fixed exchange rates and an autonomous monetary policy. They can only two of those three elements at once. For details, see Obstfeld *et al.* (2005).

south that developed after the euro's inception. In fact, as Bayoumi and Eichengreen (1997) concluded more than a decade ago, the Eurozone is constituted of two core OCAs, one centered on France and Germany (with Austria, the Benelux countries and Slovenia) and another involving southern European countries. Contrary to what Frankel and Rose (1998) argued, an OCA for the Eurozone did not arise endogenously following the introduction of the single currency (Willett et al., 2010). Thus, given that the ECB's monetary policy is targeted to the entire Eurozone rather than specific countries and given that the Franco-German core is the most significant part of the Eurozone economy, then the common monetary policy was better suited to the economic situation of northern countries rather than the Euro-Med ones. For instance, between 2001 and 2005 the German economy pretty much stagnated, with an average annual real GDP growth rate of less than 0.5 per cent. At the same time, Greece, Ireland and Spain were experiencing rates of growth above three per cent of GDP. Hence, for them the Eurozone's monetary policy should have been much stricter than it actually was. Interest rates should have been much higher in order slow down growth and inflation, which was running at over three per cent annually, compared to less than two per cent in Germany.[6] Thus, the ECB's monetary policy was inadequate to deal with growth disparities between Eurozone members.

The only option left for countries facing inflationary pressures and a common monetary policy that is too loose is to use fiscal policy to cool the economy down. However, this is politically difficult to justify: how can a government raise taxes and decrease public spending when the economy is booming, especially if public debt is itself declining? In

[6] Real GDP growth and inflation data are from Eurostat.

fact, Ireland and Spain were already running budget surpluses during that period. Nevertheless, they should technically have done more. The Greek case is the most conspicuous since fiscal deficits were averaging five per cent of GDP at a time when the economy was booming. Clearly, the government was adding fuel on the fire when it should have been trying to put it out, which explains why Greece's public finances exploded when the global financial crisis hit. In a way, the Greek situation is one that the SGP was supposed to prevent but did not, although the fact that Greece underreported its public finance statistics made it more difficult to undertake the right procedures at the right time.[7] Nonetheless, the SGP's main weakness has always been that it is politically difficult to enforce (Heipertz and Verdun, 2010), which is why financial markets were counted on to exercise the necessary pressures on governments whose finances were not sustainable (Leblond, 2006). It is not until early 2009 – when the global financial crisis had reached its apex – that sovereign bond yield spreads and credit-default swap premiums began to reflect the diverging states of Eurozone members' public finances.[8] Until then, sovereign bond investors were happy to treat Eurozone countries as a single bond market (Pagano and von Thadden, 2004).

Increasingly, investors began to worry that sovereign debt in Greece, Ireland and Portugal was growing too rapidly and to levels that would become unsustainable in the absence of some major reforms to reverse the trend. The only way to stabilize government debt, if not

[7] The poor quality of Greek government finance statistics was already in the public domain in 2004 (Eurostat, 2004).

[8] For studies analysing the determinants of bond yield spreads in Europe, especially during the crisis, see Attinasi *et al.* (2010b), Barrios et al. (2009), Manganelli and Wolswijk (2009), and Sgherri and Zoli (2009).

to reduce it, is to restore fiscal balance between revenues and expenditures. This requires cutting down government spending and raising revenues through higher taxes, a larger tax base and/or enhanced economic growth. This is very difficult to do in the context of a deep recession. In fact, the latter was one of the main reasons why fiscal deficits were booming in the Eurozone: in an economic slowdown, tax revenues normally decrease as a result of lower economic activity while social expenditures increase as there are more people who are unemployed and, thus, require some form of financial assistance. If one adds the need for the government to bailout banks in particular and the financial system in general in order to prevent the recession from turning into a depression, as in Ireland and Spain, then the mix becomes an explosive cocktail for public debt.

This is why it was extremely difficult for governments in the PIIGS to begin restoring fiscal balance before the crisis had passed and economic growth had resumed. The problem is that investors understood this predicament as well. So the longer the crisis lasted and the more governments' debt increased, the more investors became worried. As a result, yields on sovereign bond ultimately reached a point where they became a self-fulfilling prophecy; that is, the returns demanded by investors to cover the heightened risk of default ended up reaching levels that made servicing the debt unsustainable when it came to refinancing.[9]

This is when EU-IMF bailouts became necessary, because they provided governments with an alternative source of financing that is cheaper than what financial markets offered. That

[9] Self-fulfilling behaviour by financial market participants is a common feature of financial crises (Kindleberger and Aliber, 2005).

way, default could actually be avoided. Such financial assistance, however, needs to be accompanied by a credible and rigorous adjustment programme to reduce fiscal deficits and restructure the economy to make it grow faster in the future. As such, public bailouts buy a government time to effectively put in place the required fiscal and economic reforms that will bring the economy back on the path of lasting prosperity, which in return will allow it to finance public debt privately once again.

The doomsayers' view of such a situation is that the level of commitment by both parties to the bailouts is insufficient. On the side of the countries receiving financial assistance, governments in Greece, Ireland and Portugal will not have the staying power to impose in full the fiscal and economic adjustments to bring back the public debt to a sustainable level. The domestic political pressures from the general population as well as vested interest groups will become so intense that the government (or its replacement, following an election) will either water down the reforms in order to spread the adjustment over a longer period or abandon them altogether. In the latter case, it means that the government would default on its debt and leave the euro. In the former case, it implies that the bailouts have to last for longer than originally anticipated. The problem here, according to the doomsayers, is that governments in financially-solid Germany, France and the Netherlands, which are the ultimate guarantors of the bailouts, will not want to continue providing 'profligate' Member States with financial aid if the necessary fiscal and structural reforms are not put into place effectively. This is because the domestic political pressure against supporting Euro-Med 'laziness' with 'hard-earned' northern savings would eventually become too

strong to overcome unless there is clear evidence that bailout recipients are actually imposing the required austerity on themselves.

Basically, the doomsayers believe that the politics of austerity in the Eurozone are not sustainable: either bailed-out countries default and leave the euro on their own (because they cannot sustain the necessary austerity) or they are forced to default and leave the euro because Germany & co. will no longer willing to stand by them as they restructure their economy and public finances. As such, they share with sovereign bond investors the same lack of confidence in the ability and willingness of EU institutions and Member State's governments to resolve effectively the current debt crisis.

Euro failure is not an option

For pessimists, it is only a question of time before the Eurozone unravels, one way or the other. For optimists, however, Eurozone failure is not an option, because it would actually not solve the Member States' fiscal and economic predicament. It would just make things worse, both in the short and long term. Moreover, it would risk undermining the entire European integration project and the political and economic benefits that have accrued from it.

For Eurozone countries like Greece or Portugal that are experiencing a severe fiscal crisis, abandoning the euro in order to reintroduce the national currency is not the solution. The economic and social consequences would be even worse than those caused by the current austerity measures. Reintroducing the national currency would lead to a sharp devaluation

of the exchange rate, which would be the sole reason for giving up the European currency. Devaluation would restore some degree of competitiveness for exports, which in turn would help fuel economic growth.[10] However, it would also lead to a massive flight of capital outside the country, as holders of financial assets try to salvage the value of their wealth before the devaluation. This would seriously limit investment in the economy, because the national savings base would no longer be available to provide financing while any form of foreign borrowing would have become impossible as a result of debt defaults.

The reintroduction of a much devalued national currency would lead to an upward explosion in the value of public and private debts, since the latter are denominated in EUR. With incomes generated in the national currency, it would then become impossible for the government and individuals to repay their debts in euros. Thus, massive public and private defaults would have to take place, which would bring down the domestic financial system.[11] With a collapsed financial system and a government that is no longer able to borrow, at home or abroad, the economy would suffer not a recession but a depression. Because credit would become pretty much inexistent, it would become very difficult for firms and households to go about their business. Firms would no longer be able to borrow to buy inputs for production, let alone invest in plants, machinery and equipment. As such, many of them would collapse, leaving their workers unemployed. For those households whose breadwinners would still be fortunate enough to have a job, they would have to

[10] Eichengreen (2007) points out that such an outcome depends on how workers and other economic agents react to the devaluation. If, for example, workers manage to negotiate higher wages to compensate for their loss of purchasing power as a result of the devaluation, then there may be little or no gain in competitiveness.
[11] In fact, there would be a run on the banks with any expectation that the national currency would be reintroduced as depositors would want to withdraw their high-valued euros before they are turned into devalued drachmas or pesetas (Blejer and Levy-Yeyati, 2010; Eichengreen, 2010).

postpone any purchase of housing and durable goods until they had saved up the money. This would put an additional damper on consumption. Finally, government spending would also have to fall drastically as tax revenues would collapse and borrowing would be unavailable. Public sector workers would also lose their jobs and social programmes would have to be cut. The only option for the government to sustain some kind of spending would be to force the central bank to buy government bonds with newly printed money; if this were done to an extent whereby the government tried to keep spending at current levels, then inflation would rise significantly and economic growth would be hurt as a result.

It is also worth mentioning that reintroducing the national currency is fraught with technical difficulties (Eichengreen, 2007; 2010). It could not be done overnight without severe disruptions to basic economic activities. After all, it took three years after the creation of the euro in 1999 to introduce notes and coins. The introduction of a national currency in a developed economy would require long and detailed planning since computers and software would have to be reprogrammed, payment and vending machines modified, notes and coins designed, produced and distributed, etc. So one can only imagine how disruptive for individuals and firms an unplanned reintroduction of the national currency would be. Economic growth would be negatively affected. Moreover, social unrest would likely break out if people could not pay for anything with their bank cards or access cash.

So any positive effect that the reintroduction of the national currency would have on net exports would be more than nullified by a sharp decline in consumption, investment and government spending. Furthermore, the absence of credit in the economy would probably

also make export transactions very difficult to conclude as firms would be unlikely to secure the necessary financing for producing the goods and services while awaiting payment from customers. Hence, abandoning the euro and reintroducing the national currency would lead to a massive economic shock that would be much worse than any adjustment programme accompanying the EU/IMF bailouts. In addition, the negative economic effects of abandoning the euro would be immediate while adjustment programmes are spread over several years.

If a country like Greece or Portugal decided to abandon the Eurozone, it would also likely have to give up its membership of the EU. This is because the euro is an intrinsic part of the EU and there is no legal means to withdraw from the euro without also withdrawing from the EU (Athanassiou, 2009). Such a scenario would amount to a post hoc renegotiation of the Member State's accession to the EU, which would be hard to manage politically. [12] In addition, withdrawal from the euro would mean the imposition of strict restrictions on the movement of capital in order to prevent massive capital flight, as mentioned above.[13] This would also require that the movement of people in and out of the country be restricted, in order to prevent people from taking suitcases full of cash out of the country (Eichengreen 2007). Controlling capital movements these ways would contravene other key elements of

[12] Other than Denmark and the United Kingdom, which negotiated legal opt-outs when the Maastricht Treaty was agreed to in the early 1990s, all the other EU Member States are legally bound to adopt the euro once they have satisfied the Maastricht criteria for admission. The EU Treaty does not allow Member States to opt unilaterally out of certain clauses or legal commitments. The only option would be to negotiate an official opting out agreement with the other EU members, which the existing Eurozone Member States would most probably not accept as there would little interest in negotiating any membership adjustment for a Member State that wished to abandon the euro and inflict severe economic casualties on its EU partners.

[13] This is what Argentina had to do when it abandoned its currency board in 2002 (Blejer and Levy-Yeyati, 2010).

the EU's *acquis communautaire*, two of the four freedoms that underpin the single market: free movement of capital and labour Under such circumstances, it becomes difficult to see how a country could remain a member of the EU while contravening several of its legal obligations. Therefore, in addition to the economic implications of reintroducing the national currency, a country would find that its free access to its largest export market may no longer available. Surely, this would severely undermine any benefit to exports that a devaluation of the exchange rate could possibly provide. It would also hurt investment by domestic and foreign firms, which would further affect the economy's future prospects. Again, it appears that working out debt problems from within the Eurozone and the EU is a better (or less bad) solution than abandoning the euro and reintroducing national currencies.

So far we have examined why it would not be in the interest of a Member State suffering a severe debt crisis to abandon the euro and reintroduce the national currency. However, what if Germany and others decided that they were no longer willing to support those Eurozone partners experiencing debt crises because, for example, it would take them too long to implement the required fiscal and structural reforms? Again, the costs would be substantially larger than the benefits. To begin with, it would entail an immediate loss for Eurozone governments, the EFSF, the ECB as well as private banks and financial institutions that hold Greek, Irish and Portuguese sovereign bonds. Given that these countries are currently unable to finance their public debt on financial markets, the removal of bailout money from the EU would cause their governments to immediately default on their debt. Given that, at the end of 2010, the outstanding sovereign debt of these three countries was about 560 billion EUR (Standard and Poor's, 2011, p.17), even a partial

default would represent a substantial loss for European public and private investors, including the German government and German banks. Furthermore, a default in Greece, Ireland and Portugal would immediately have a contagious effect on Italy and Spain, whose combined sovereign debt at the end of 2010 was 2,113 billion EUR (ibid.). Already in the summer of 2011, yields on Italian and Spanish sovereign bonds were reaching levels that many considered close to unsustainable, thereby forcing the Italian and Spanish governments to adopt new austerity measures to rapidly reduce their fiscal deficits and, hopefully, reassure investors that default was out of the question. Should Italy and Spain be forced to default, it would be catastrophic for the EU and its financial system.

According to the European Banking Authority's stress test exercise in the spring of 2011, European banks held about one third of the sovereign debt of Greece, Ireland and Portugal as of 2010 (European Banking Authority, 2011, p,28). The total exposure of Belgian, German, French and Dutch banks to the debt of public and private institutions in the PIIGS was on average over 120 per cent of the home country's banking system capital and reserves in the fall of 2010 (TD Economics, 2011, p.5). This means that a complete default of public and private debt in the these countries would bankrupt the banks in Belgium, Germany, France and the Netherlands, unless their governments intervened to recapitalise (that is, bail out) them. Although a complete default by the PIIGS is highly unlikely (scenarios plan for a 30 or 50 per cent 'haircut'), this amount of exposure by the banks in the EU's key debt-backer countries would cause significant disruptions in the proper functioning of financial markets and force governments whose finances are themselves already strained to intervene to keep the system going.

But the costs of giving up the provision of financial assistance to the Euro-Med countries and possibly Ireland would be more than just the loss on the value of holdings of sovereign bonds and the bailout of the financial sector in the so-called 'core' Eurozone around Germany. It would undoubtedly lead to the break-up of the Eurozone (and also likely the EU) itself, with the euro probably remaining the common currency of the core countries. Such a scenario would hurt the medium- and long-term prospects of the core economies. First, they would see the relative value of the euro appreciate significantly (Posen 2011; Wolf 2010), which would hurt their exports not only to the Euro-Med countries but also to the rest of the world. One just needs to take a look at what has been happening to the Swiss Franc during the crisis; for example, in the year or so that followed Greece's first bailout, in May 2010, the Swiss Franc gained close to 15 per cent on the euro and 30 per cent on the US dollar. With the break-up of the Eurozone, in addition to bringing back exchange rate risk, the core countries would lose the other benefits associated with a common currency in their economic exchanges with the Euro-Med countries and Ireland (Posen 2011). For instance, Baldwin et al. (2008) calculate that, in aggregate, the euro has increased trade by 5% during the 1999-2006 period, over and above other factors such as the single market. They also conclude that the euro had a positive effect on foreign direct investments. For their part, Barrell et al. (2008, p.52) find that the 'common currency has had a direct positive impact on growth in the core Euro Area countries'.[14] They estimate that the euro will end up increasing economic output by approximately 2 per cent in these core countries.

[14] The authors' analysis includes Italy as part of the Euro Area core countries.

Second, should the Eurozone break-up also lead the Euro-Med countries to leave the EU, then Germany and company would lose their 'free' access to these markets, which would further hurt exports, a significant portion of these countries' GDP. The contribution to EU-wide GDP by the single or internal market is not insignificant. Ilzkovitz et al. (2007) estimate that the single market increased overall EU GDP by 2.2% and total employment by 1.4% during the 1999-2006 period. They also claim that these gains could be doubled if the remaining market barriers were eliminated. Hence, removing a substantial portion of the EU's single market by jettisoning the PIIGS would also cost the Eurozone core countries as it would further lower their GDP and employment.

If it is economically (and socially) costly for the PIIGS to abandon the Eurozone and for the core countries to abandon the PIIGS, there is an added benefit of keeping the Eurozone together and continuing with the bailouts and other means to support economically troubled countries. It is a unique chance for countries like Greece, Italy, Portugal and Spain to undertake long overdue fiscal and/or structural reforms.[15] Otherwise, with default, the countries will be back where they started, without any real improvements to their microeconomic and fiscal structures. Argentina is a case in point. Growth may have restarted quickly after its default but that is mainly because of rising commodity prices in international markets (Cavallo 2011). Otherwise, the underlying structure of the Argentine economy and the government's macroeconomic policies do not seem to have changed much. For instance, inflation is now running at 10% officially, although private surveys

[15] Once again, the case of Ireland is different since its fiscal crisis is solely due to its bailout of the Irish banking system. Just before its financial meltdown, Ireland had a low level of debt to GDP and its economy was deemed to be competitive.

indicate that the true rate of inflation is more around 20-25% (Economist Intelligence Unit, 2011). Moreover, producer prices are increasing at an even faster rate than consumer prices, which is likely to hurt the competitiveness of exports in the medium and long term. In terms of fiscal policy, the government is forecast to run a fiscal deficit in 2011, in spite of the economy being expected to grow at an astonishing rate of 8.5% (ibid.). This is because government spending is growing at a faster rate than the economy. Surprisingly perhaps, there has also been a large amount of capital flight away from Argentina since 2006, indicating a certain lack of confidence in the long term prospects of the economy (ibid.). It is also noteworthy that the IMF's Executive Board issued a statement on 13 July 2011 indicating that there were concerns with the quality of Argentina's statistics for inflation and GDP.

Such behaviour by the Argentine government may look similar to that of Greek governments after the country joined the Eurozone in 2001: they lied about the true state of the country's public finances. In fact, as already mentioned, many Euro-Med countries relaxed the pace of fiscal and structural adjustments to their economies once they joined the Eurozone. Thanks to much lower interest rates on debt, it became easier to finance budget deficits and sustain higher levels of debt, which fuelled consumption and investment, especially in real estate (in Spain, for example). There is thus a strong chance that once outside the Eurozone, Euro-Med countries would go back to their old ways of maintaining export competitiveness and growth by devaluing their national currency and refraining from adopting difficult reforms that would make their economies more productive. With the current adjustment programmes under the various bailout initiatives as well as the

newly improved EU institutional mechanisms for monitoring and enforcing sounder fiscal policies, these countries stand a much better chance of coming out of the current debt crisis with stronger, more competitive economies than if they let go of the euro or are abandoned by their Eurozone partners.[16] For sure, the adjustment will not be easy. However, taking the so-called 'easy' way out will only result in even more short-term pain while actually undermining future growth prospects for all those involved, the PIIGS and the Eurozone core countries. The solution to the debt crisis is therefore not less but more Europe.

Conclusion

It should be clear by now that, in spite of the fact that the Eurozone is still not an optimal currency area, the solution to the euro's present difficulties is not to abandon it, one way or another. Since the beginning of the global financial crisis, which transformed itself into a debt crisis, EU leaders and institutions have shown that they understand this crucial point. The approach has been characterised as 'muddling through' rather than 'decisive' but, as Mario Telò (forthcoming) reminds us, the EU tries very hard to strike a 'relatively stable balance between efficiency and legitimacy'. Crisis management in the EU may look messy, given its structure and the nature of its institutions, but it nevertheless ends up getting the job done (Kirkegaard 2010; 2011). And as the EU has gotten the job done in the context of the financial and fiscal crises, it has become gradually more integrated (see also Grossman and Leblond, 2011). Effective cooperation, coordination and burden-sharing, whether regional or global, still remain a better way to deal with cross-border problems.

[16] For an assessment of the adjustment programmes for Greece, Ireland and Portugal, see Leblond (2011).

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