Limitations of Monetary Unions for Peripheral Countries

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Introduction
In order to adopt the euro as its national currency, each member state of the European Monetary Union (EMU) agreed to relinquish independent control of its monetary policy. Thus, EMU countries no longer maintain the ability to issue their own currency, manipulate the money supply, or alter interest rates. The global economic crisis (GEC) resulted in varying degrees of economic downturn for countries both in and out of the EMU. For example, in 2009, at the height of the economic crisis, the United States had a growth rate of -2.8, while Australia had a growth rate of 1.7 (World Bank). The countries that appear to have been affected most severely, however, were members of the EMU. Portugal, Ireland, Greece, and Spain (PIGS) have experienced persistent negative growth rates since the onset of the GEC. Unsustainable increases in public debt led to the sovereign debt crisis that has primarily been held responsible for the lack of recovery and damaging economic conditions in PIGS. These countries have maintained huge levels of public debt with increasingly large deficits - conditions that have lead to liquidity problems and potential solvency issues.

De Grauwe (2012) tests the theory that monetary unions leave all member countries more vulnerable to liquidity crises than stand-alone countries. He points out that although economic conditions before the GEC in the Eurozone as a whole were better than those in the US and UK, the latter managed to recover much
more effectively than the Eurozone. The disparity in duration and effectiveness of economic recovery since the GEC is more complex than the notion of all countries in a monetary being at risk for liquidity crises. Comparisons between the Eurozone as a whole and stand-alone countries do not provide enough information to explore why some countries within the Eurozone recovered relatively quickly from the GEC while others appear to be in a perpetual state of downturn. This paper builds on De Grauwe’s theory to determine why PIGS have experienced consistent negative growth rates since the onset of the GEC.

**Literature Review**

While there exists an extensive body of research on the effects of the GEC on the Eurozone, none consider the possibility of an inherent disadvantage of peripheral Eurozone countries for recovery. It is very clear that peripheral Eurozone countries experienced the most severe economic shocks resulting from the GEC. This paper argues that the deteriorating economic conditions in peripheral countries are the result of the membership stipulations in the EMU.

The effects of the GEC in peripheral Eurozone countries, specifically the debt crises, are more alike than previously realized. The circumstances leading to macroeconomic imbalances in each peripheral country were not idiosyncratic events leading to a simultaneous, independent, yet somehow similar outcomes; that is, unsustainable growth of government debt (Bagnai 2012).

A synchronic study of the Eurozone neglects to consider the true causal factors of the Eurozone debt crisis. The large debts incurred by each of these countries were not the result of independent anomalies; rather the boom and bust cycle experienced within the peripheral countries indicates a common cause. In such countries, government bonds became risky as the federal governments issued large amounts of bonds (incurring debt) without
any real GDP growth. In addition, the threat of default became a reality for such countries because they relinquished their ability to issue their own currency.

Financial markets and consumer confidence played a substantial role in the creation of the financial crisis. Financial markets maintain the power to cause countries in a monetary union to default on their debt (De Grauwe 2012). When investor confidence in a country’s ability to service its debt is shaken, investors remove their money from that country’s system and invest elsewhere. The reduction of cash in the national economy decreases the amount of liquidity in the system, increases interest rates in the bond market, and increases budget deficits, all of which can increase the severity of an economic downturn. Thus, the perception of solvency can become self-fulfilling. Expectations by financial markets lead to action by firms in such markets, which often creates the very situation firms intended to avoid (De Grauwe 2012).

Some researchers argue that Germany was at least partially responsible for the severity of the debt crisis. Citing Germany’s delayed response to the financial crisis, Angela Merkel’s inaction in the creation of the rescue package proposed to aid peripheral countries, and her rejection of jointly guaranteed Eurobonds designed to increase the bond ratings in peripheral countries, and subsequently help finance their debt, Young and Semmler (2011) question Germany’s commitment to the successful recovery of other Eurozone countries. In addition, Germany’s sudden change in current account surplus created instability in the Eurozone by failing to offset the current account deficits in peripheral Eurozone countries (Young and Semmler 2011).

Bond ratings affect the ability, or inability as the case may be, of a country to finance its debt. Many Eurozone bond markets experienced a bubble in their bond markets, which led to extremely low interest rates and a glut of new bonds being introduced into the
system (De Grauwe 2010). When the asset bubble burst, the massive amount of debt incurred by these countries through the issuance of their bonds caused them to fall into a recessionary period. De Grauwe (2010) argues that the formation of the bubble was perpetuated by the ratings agencies and intensified by their overreaction to the resulting economic conditions.

Bond markets, like other financial markets, are not immune to volatility caused by changes in consumer confidence. Greece, for example, experienced a loss of consumer confidence concerning debt service stemming from its bond prices in what Argyrou and Tsoukalas call a self fulfilling currency crisis. When investors in bond markets believe that interest rates are going to increase, the demand to hold bonds decreases, making it more difficult for a government in this situation to finance its debt.

Naturally, the most obvious causes of the debt crisis were fiscal. Tax revenues declined as a result of the GEC, causing governments to increase the amount of borrowing in order to maintain their levels of government spending (Fernandes and Paulo 2011). Similar to the financial climate in the United States, the banking crisis in the Eurozone necessitated large bank bailouts and economic stimulus through even more government spending (Overbeek 2012). In addition, rising unemployment rates and the lack of competitiveness resulting from structural imbalances, caused GDP growth rates to slow. Without realizing the implications, peripheral Eurozone countries chose to adopt similar fiscal policies to those of the core countries. Peripheral countries enacted policies that included large-scale spending. Ordinarily, this would be the prescribed method for recovery from an economic downturn; however, without a similar increase in GDP growth, peripheral countries were forced to continue borrowing to finance their spending programs. As mentioned earlier, investor faith began to weaken as information concerning government borrowing, output (real GDP), and tax
revenues were released. Thus, the replications of core countries’ fiscal policies exacerbated the debt crisis in peripheral countries.

**Argument**

Current work concerning the Eurozone and the GEC focuses on the causes and effects of the crisis, primarily the sovereign debt crises and the reaction of the ECB, EU, and various member states. The effects of the GEC on each Eurozone country are clearly observable. There is an obvious disparity between the length and severity of recovery in some of the peripheral countries and the core countries. Most notable are the high unemployment rates and unsustainable debt accumulation in the countries often referred to as PIGS – Portugal, Ireland, Greece, and Spain.

This disparity naturally raises the question of why some countries would be more negatively affected by the GEC than others. It would be erroneous to assume that the difference in duration and severity can be explained by the differences in economic conditions at the start of the financial crisis or size of an economy. A quick look at the recoveries for each individual country in the Eurozone indicates that other countries within the Eurozone with similar economic conditions as PIGS at the onset of the GEC were able to recover relatively quickly – at the same rate as the core countries.

Why then would PIGS economies not recover in the same way? This paper seeks to determine why the GEC affected some peripheral Eurozone countries differently than core countries. Researchers have focused on the fiscal causes of persistent negative growth rates in PIGS, but many have neglected the monetary causes. This paper argues that membership in the EMU created circumstances that left peripheral Eurozone countries ill equipped and unprepared to effectively manage their economic institutions during an economic downturn. The fiscal factors contributing to the perpetuation of the downturn are clear; however, the stipulations of
the monetary union are what allowed these factors to have such a damaging effect on PIGS recovery from the GEC.

**Research Design**
In this paper, I argue that there were both fiscal and monetary causes of the slow recovery form the GEC. In order to demonstrate the differences in economic recovery, I am going to examine three periods of economic downturn. The first period will be the 1973-75 recession. The 1973-75 recession was similar to the GEC in the way that it negatively affected international financial markets and slowed economic growth. The second period will be the early 1990s recession. This period is used to show recovery periods from economic downturn in fairly modern economies. Both of these periods will be compared to the GEC and the subsequent ongoing recovery. This period demonstrates the changes in severity and duration of recovery periods for these countries since joining the EMU.

As mentioned earlier, financial markets have a great deal of influence in generating national economic conditions. The effects of fluctuations in financial markets, however, can be mitigated through the effective use of monetary policy. Manipulating the money supply, altering interest rates, and creating non-conventional monetary policy tools to remedy problems caused by very specific markets are methods that have been used effectively to correct imbalances caused by specific markets. For example, the Federal Reserve’s policy initiatives during the late 1970s were explicitly designed to combat the results of the supply shocks that led to the period known as the great stagflation.

Chairman Volker’s policies in the late 1970s were designed to focus on monetary aggregates, specifically non-borrowed reserves. The period before Paul Volcker’s tenure in office was marked by wild fluctuations in inflation and general instability in business cycles. In
1979, inflation reached 11.2% and in 1980, inflation rates climbed to an alarming 13.5% (U.S. Bureau of Labor Statistics). During this time, the U.S. economy faced severe stagflation. This means that inflation was increasing without proportionate levels of growth in aggregate output (Mishkin 2007). Volcker’s new policy initiatives were implemented to remedy these extreme hikes in inflation. The focus on the money supply rather than interest rates was successful in creating disinflation (Bailey 2008).

It is not my intention to suggest that central banks have historically been exclusively beneficial to economic recovery. During the Great Depression, for example, the Federal Reserve’s policy preferences indicated a very non-activist strategy that ultimately proved to be harmful to the recovery. However, I am suggesting that there are policy tools available to central banks that could have mitigated the effects of the GEC in PIGS, which would have led to a much quicker and more effective recovery.

Central Banks also have the ability to assist in correcting macroeconomic imbalances. One of the primary problems in PIGS, and the fiscal factor that is most often studied as the cause of the slow recovery, is the massive amount of debt accumulated by federal governments. In what has become known as the sovereign debt crisis, many of these countries face the prospect of insolvency as they inch closer towards debt default. A nation’s debt is not too high if its debt GDP ratio is stable over time. PIGS have rapidly borrowed large sums of money in order to maintain their levels of government spending, which is a primary component of GDP. This practice of rapidly borrowing large sums of money by these countries has made economists, investors, and the public question PIGS ability to service their debt. Here is the point where monetary policy can relieve the federal government from the pressures of stimulating economic growth alone – which has lead to dangerous levels of borrowing. Central banks also have the capability to foster economic growth.
Any easy money policy is designed to increase the public’s access to money and credit, allowing the money multiplier to work, thus increasing consumption spending and investment spending, which subsequently leads to economic growth. The growth in GDP will work to offset the money borrowed to finance government spending during the downturn and the increase in GDP, or income, will result in higher tax revenues.

I will test three hypotheses in order to demonstrate the reliability of my argument. Three hypotheses are necessary because there are three possible explanations for the slow recovery from the financial crisis. One explanation is that the slow recovery was caused by irresponsible fiscal policies enacted by the federal government. It is reasonable to assume that this could be the case when one considers the prominence of the debt crises in Greece, which has long-term interest rates that are nearly fifteen times higher than Germany (ECB and European Commission). The second explanation is that the slow recovery is caused by the lack of control over monetary policy alone. This is likely not to be the case, since the fiscal factors are obvious contributors to the state of economic conditions in PIGS. The third hypothesis is that fiscal policies and lack of monetary control caused the slow recovery from the GEC. Fiscal policy and monetary policy are both responsible for generating business cycles. When the two do not complement each other, or at the very least work together, the results can be damaging to the economy.

Results
In order to demonstrate PIGS recovery from previous recessionary periods, I have compiled growth rates from two other recessions similar to the GEC and compared the recovery periods to the time since the GEC (2009-2013). Table 1 shows the growth rates for the 1973-75 recession, Table 2 shows growth rates for the early 1990s’
recession and Table 3 shows growth rates for the GEC. The comparisons clearly indicate that the recovery period from the GEC is abnormal. Following the 1973-75 recession, all of the countries listed had positive growth rates by 1976.

During the early 1990s’ recession, all but one of the countries listed had negative growth rates during the height of the recession. The largest losses in GDP growth rates were in 1993. By 1994, however, each of the countries had positive growth with rates at least three percent higher than the previous year.

The period since the GEC, however, shows persistent negative growth rates for all but one country listed. Ireland appeared to be recovering as it had a positive growth rate in 2011. However, by 2012, Ireland’s growth had dropped down to zero and has yet to improve. No other country in the Eurozone has experienced negative growth since 2009.

Conclusion
Fiscal policies have undoubtedly had a role in the continuation of negative growth in real GDP; however, fiscal policies alone do not appear to be responsible for the growth rates in PIGS. Federal governments often utilize fiscal programs that create temporary increases in government spending during recessionary periods in order to stimulate economic activity and facilitate recovery. Unfortunately for PIGS during the GEC, increases in government spending had the opposite effect – such programs contributed to the severity of the downturn and perpetuated its continuation. Thus, the results are consistent with hypothesis three alone. Without a central bank working specifically to complement fiscal policies in individual states, some countries were left defenseless against the GEC.
References


US. Bureau of Economic Analysis, Gross Private Domestic Investment [GPDI], retrieved from FRED, Federal Reserve Bank of St. Louis. November 1, 2014

Appendices

Table 1 – GDP Growth Rates for 1973-75 Recession

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Table 2 – GDP Growth Rates for early 1990's Recession

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Table 3 – GDP Growth Rates for GEC

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