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Chapter

DOOMED TO FAIL? CONVERGENCE AND THE EUROZONE CRISIS

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ABSTRACT

Keywords: EMU, convergence criteria, Greece

INTRODUCTION

Advocates of membership argued the European single currency could unleash economic potential that would increase economic growth and investment, achieve low and stable inflation and build a strong European economy through: encouraging greater trade; reducing transaction costs; increasing price transparency. In terms of new institutions, the European Central Bank (ECB) through ensuring price stability results in lower inflation and interest rates, thereby again boosting investment and economic growth. Additionally, the euro would establish itself as a major world currency conferring economic advantages and political prestige based upon the EU’s combined economic strength. Finally, arguments that eurozone membership reduces national sovereignty were rejected on the grounds that sovereignty is not absolute any more, due to the globalisation of financial markets and voluntary limitations imposed by international treaties (Baimbridge et al., 2000). However, many critics argued that the costs of entry were in fact potentially far larger, where the loss of monetary and the exchange rate policy weaken national economic management, which is further constrained by the restraints upon fiscal policy. Further, the lack of prior cyclical and structural convergence created strains such that unsynchronised business cycles and/or structural differences magnify the effects of asymmetric external shocks. This is potentially further exacerbated by the absence of any substantial fiscal redistribution mechanism to offset less competitive areas suffering declining

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incomes and persistent unemployment. Additionally, a unified monetary policy would be unable to meet the needs of all economies through concentrating upon the ‘average’ member state. In terms of rules and institutions, the ‘generous’ interpretation of the Treaty on European Union (TEU) convergence criteria implied that the majority of participants must continue to deflate their economies in order to meet the rigid financial criteria established by the Stability and Growth Pact (SGP). Finally, the ECB is fundamentally undemocratic because it is deliberately insulated from all political influence (Baimbridge et al., 2000).

There is sufficient evidence to suggest that the combination of tight fiscal policy, mandated by the SGP, and the conservatism of the ECB has already resulted in the eurozone economy suffering a decade or more of slow growth. Since the inception of the euro many commentators have argued that, despite its resilience to immediate collapse due to the volume of political, and from 2010 financial, capital invested in it by the EU establishment, it remains a fundamentally flawed creation (Minford, 2002; Baimbridge and Whyman, 2008). Therefore, the eurozone constitutes a ‘leap in the dark’ with potentially destructive implications if its participants are insufficiently cyclically and structurally convergent (Eichengreen, 1990, 1992, 1993). The reasons are varied: the eurozone fails to fulfil, or even approach, the optimum convergence criteria agreed by economists to be the minimum requirement for the efficient operation of a monetary union; crucially it lacks an adjustment mechanism to meet inevitably changing economic circumstances, both internal and external, other than price and income deflation; its governing institutions, the ECB and the European Commission, are not subject to democratic accountability, let alone control; it was adopted for essentially non-economic motives as the next stage of an integrationist European project, but without the necessary political coordination to underpin it.

THE EUROZONE AS A FLAWED MONETARY UNION

In addition to these longstanding potential problems inherent with the creation of the eurozone, its design in terms of risks emanating from spill-over and free-rider effects resulting from a lack of fiscal discipline has been relentlessly exposed following the 2008 credit crunch induced recession. Whilst theoretically fiscal policy should be used as a countercyclical tool, governments may also use the policy for purely political reasons; however, if this is the case, fiscal policy may become challenging within a monetary union such as the eurozone through the occurrence of spill-over or free-rider effects (von Hagen and Wyplosz, 2008). The former may occur if eurozone members run large budget deficits over a prolonged period of time leading to their fiscal stance being on an unsustainable path, which given its financing through the financial markets, results in ever high interest rates on sovereign debt. Additionally, with such growing recourse to the financial

market, the availability of finance may decrease and therefore further drive-up interest rates. Thus, one member's debt issue spills-over to others as financing sovereign debt becomes more expensive for all countries (Arezki et al., 2011). The potential hazard of free-rider effects materialises when a country cannot meet the repayment of its outstanding debt, with default on the horizon, it can either undertake surprise devaluation or inflation to reduce its debt's real value. However, for eurozone members without sovereign monetary policy, these methods are no longer available, thereby increasing the possibility of outright default (McKinnon, 1996). Moreover, with the integration of financial markets, one country's bonds may be widely held by other members. Thus, outright debt default harms not only domestic bond holders, but other government and private investors holding such bonds. Consequently, the pressure to bail-out troubled fellow members may increase, and, without restrictions on fiscal behaviour, a member country may allow its debt to increase continuously if they believe other governments will bail it out. Under a currency union, member countries lose not only their monetary independence, but also a central bank to back their sovereign debts; thus, eurozone governments become uniquely vulnerable to self-fulfilling panic over default. Additionally, the connection between the operation of the euro and the recent worldwide economic recession provides an illustration that national self-governance offers the potential for superior economic performance.

Table 1 Mean GDP growth rates (%)

| | 1993-1998 | 1999-2007 | 2008-2011 |
|----------------|------------------|------------------|------------------|
| Eurozone | 1.85 | 2.26 | -0.11 |
| European Union | 2.17 | 2.54 | -0.08 |
| USA | 3.70 | 2.85 | 0.21 |
| OECD | 2.62 | 2.56 | 0.19 |
| World | 2.89 | 3.26 | 1.55 |

To review the economic performance across the economies of the EU with particular reference to recent events, Tables.1 and 2 present an overview of mean GDP growth and unemployment rates for several key time periods: from the completion of the Single Internal Market to the fixing of exchange rates for eurozone countries (1993-1998), the operation of the eurozone prior to the Great Recession (1999-2007) and of the Great Recession itself (2008-2011). For comparative purposes the information is shown for a number of economic regions in addition to the eurozone itself. It is noticeable how relatively poorly the eurozone has performed with the slowest GDP growth and highest unemployment rate across all periods. Such stylised facts lend support to the hypotheses that the

eurozone is far from optimal through having failed to provide the ‘safety in numbers’ to weather shocks.

Table 2 Mean unemployment rate (%)

| | 1993-1998 | 1999-2007 | 2008-2011 |
|----------------|------------------|------------------|------------------|
| Eurozone | 11.26 | 8.77 | 9.25 |
| European Union | 10.65 | 8.71 | 8.74 |
| USA | 5.57 | 4.94 | 8.40 |
| OECD | 7.32 | 6.45 | 7.59 |
| World | 5.30 | 5.83 | 5.86 |

A further problematic symptom the financial crisis has highlighted within the eurozone is the balance of payments (BoP) difficulties that some members have experienced, together with the divergence of external balances between members. In relation to the rest of the world (RoW), then countries in the North (e.g. Germany, Netherlands and Austria) have persistently experienced current account surplus’, whilst those in the South/Periphery (e.g. Greece, Ireland, Portugal and Spain) have experienced persistent current account deficits despite an approximately balanced overall position (Holinski, et al., 2012). Although originally perceived to be irrelevant, with the focus being on the global balance of the eurozone, these divergences are now partially identified as sources of the eurozone crisis (Sawyer, 2012). It is therefore pertinent to review the policy options for individual eurozone members to correct such BoP disequilibria and evaluate their desirability.

Initially, following the advent of Keynesian demand management, policy prescriptions were advocated to resolve external imbalances and aid adjustment mechanisms (Crockett, 1982); however, several policies are unavailable to individual eurozone members. For example, notwithstanding their criticisms, short-term expenditure switching policies/elasticities approach that advocates changes in relative price levels between countries through either appreciations/revaluations or depreciations/devaluations (Södersten and Reed, 1994; Pilbeam, 2006). However, despite the unavailability of such policies, Jaumotte and Sodsriwiboon (2010) argue that eurozone countries could mimic this in the short-term through ‘internal devaluation’ to restore competitiveness by decreasing labour costs and hence relative price levels. Policy options include decreased social security payments, reducing indexation of wage increases, or through minimising minimum wage growth. For example, if Greece and Portugal moderated minimum wage increases to those experienced by Northern eurozone

members, this would improve current account balances by 2-2.5 percentage points (Jaumotte and Sodsriwiboon, 2010). Indeed, such measures are essentially those imposed upon bailout economies that have proved politically and socially problematic; however, it should be noted that if all Southern eurozone members adopt such policies there will be little gained in relative competitiveness (Duwicquet, et al., 2012).

Furthermore, the use of direct controls (e.g. tariffs, quotas and embargoes) are also excluded policy options; whereby trade policies are negotiated on behalf of all EU members, thus individual nations are unable to apply direct controls against the RoW (Lea, 2010). Additionally, longer-term policy options that emphasise BoP imbalances as entirely monetary phenomena are also unfeasible (Williamson and Milner, 1991); since eurozone members cannot control their narrow money supply, together with the prohibition of capital controls, then they possess no control over credit creation (Arestis and Sawyer, 2012). Therefore, members must either control their growth rate to prevent inflation, or face losing international competitiveness (McCombie and Thirlwall, 1994). Consequently, there are only a limited number of policy options available to individual eurozone members. In the short-term, the traditional approach emphasises the use of changes in the level of domestic spending, or absorption (Pilbeam, 2006). For example, in current account surplus countries, such as Germany, the policy prescription would be expansionary fiscal policy to stimulate the economy and increase imports to resolve the imbalance (Jirankova and Hnat, 2012). However, such policies may conflict with internal balance; for example, Germany has typically operated at full employment output, such that any expansionary fiscal policy to increase absorption would create inflation (Arestis and Sawyer, 2012). Furthermore, since fiscal policy is limited due to the SGP, the burden of adjustment is asymmetrically imposed on deficit countries (Ahearne, et al., 2007). Similarly in BoP deficit countries, contractionary fiscal policy is required; however, domestically these countries are experiencing low growth and high levels of unemployment (Chen, et al., 2012); thus such policies create a trade-off between internal and external balance, whereby there is a sacrifice of domestic goals (Thirlwall and Gibson, 1992). Hence, obtaining simultaneous internal and external equilibrium using only one policy is problematic; Tinbergen (1952) seminally proposed that the number of targets require at least an equal numbers of instruments, whilst Mundell (1968) advocated that policies should be assigned based on their relative effectiveness. Arguably fiscal policy has greater effects on the domestic economy, whilst monetary policy through interest rate differentials attracts capital flows and is therefore more effectively assigned to the BoP (Pilbeam, 2006). However, for eurozone countries monetary policy is controlled at the ECB supranational level, such that national governments are residually left with fiscal policy to attain simultaneous equilibrium (Holinski, et al., 2012);

therefore, the adjustment mechanism is more difficult and uncertain (Duwicquet, et al., 2012).

These aforementioned weaknesses in the design of the eurozone are permanent, but become more damaging in times of crisis. In the wake of the worldwide financial recession, the eurozone suffered a series of debt crises in individual member states. To date, the eurozone's response has been piecemeal; ad hoc loans have been provided, whilst minor revisions to the Lisbon Treaty were agreed to enable the creation of a bail-out fund, the European Financial Stability Facility (EFSF) to become the European Stability Mechanism (ESM). Such 'solutions', however, deal with the symptoms rather than the fundamental causes of the euro's structural weaknesses. The latter ensure that recurrent problems will emerge that vitiate proposed remedies once they affect a large member country. Although the immediate origin of present discontents is usually located in the collapse of the American investment bank, Lehman Brothers, in September 2008, its European antecedents lay in the bubble of speculative finance that occurred in the initial decade of the twenty-first century. This was intensified by the requirement to impose uniform interest rates in order to create an artificial monetary union amongst nations that did not always meet even their own restricted (financial not 'real') convergence criteria. Specifically, when the euro was introduced, the prevailing interest rate on 2 January 1999 stood at 3.25% for the three month Euribar (Euro Interbank Offered Rate), and, to achieve this target, nominal rates had fallen significantly in the previous nine years in France, Italy, Spain and Germany (O'Connor, 2009). Unsurprisingly massive foreign investment ensued, stock markets boomed, whilst house prices and household debt levels soared. Inevitably in such a low interest rate environment, investment banks and pension funds sought greater rates of return from alternative asset classes. Consequently 'structured products' developed becoming the norm for investment in higher yielding loan assets.

The strength of the euro until 2010 was determined by the competitive power of the German economy, which caused deflation in many other eurozone members since having the same interest rate for all countries created a 'boom-bust' cycle in a number of them. Hence, the growth rate across the zone languished, whilst unemployment as well as government budget and trade deficits multiplied. Additionally, in 2007 the German coalition increased value added tax by 3%, which financed concessions to industry so that it could compete at a higher exchange rate, but in the process intensified the problems of its eurozone 'partners'. Furthermore, the actions of the ECB, as the institution responsible for the one size fits all monetary policy in the eurozone, also contributed to the series of events contributing to the crisis. Initially, it adopted a low interest rate policy in 2002-2003, which stimulated financial speculation. However, after 2005 it changed strategy so that rates climbed until the autumn 2008 crash. Indeed, it

bowed to German pressure in June 2007 and as late as July 2008, raising interest rates to curb 'external inflation', despite an already tight monetary environment. By definition, the ECB operates monetary policy for the eurozone as a whole, typically focusing upon the 'average' member state, so that policy is often too tight for some whilst too loose for other nations. Moreover, it is more difficult for the ECB to utilise monetary policy to regulate asset prices, whether stocks or housing, in individual nation states, where bubbles may occur. Thus, whilst few would claim ECB action to be the sole cause, it would be naïve to dismiss it as irrelevant rather than a contributory influence. Although it might be argued that it is unfair to criticise the eurozone for struggling to deal with the negative consequences of the financial crisis, since it is by no means alone in this respect. Indeed, the Anglo-Saxon model was complicit in the loose regulation and speculative financial innovation which helped to precipitate the crisis in the first place. Nevertheless, the 'old' European model could have avoided the worst of these failings, through stronger financial sector regulation and a more managed economy, but it did not, and the current the eurozone framework was at least a contributory factor.

Although this series of events exacerbated the inherent problems regarding the functioning of the eurozone, such difficulties could have been tempered if it incorporated a coherent adjustment mechanism to meet inevitably changing economic circumstances. In a dynamic market economy, characterised by technological and organisational progress, change is continuous; what Schumpeter (1942) famously termed the 'gale of creative destruction'. Furthermore, since the Industrial Revolution all capitalist economies experienced a cycle of periodic booms followed by periodic depressions. Consequently, it is crucial to the health of every economy that it possesses a robust adjustment mechanism to enable it to accommodate efficiently to the inevitable transformations that will occur in its internal and external environment. However, the eurozone lacks this crucial element in its structure whilst simultaneously harbouring potentially damaging spill-over and free-rider problems. Thus, in the recent recession its members no longer possess an independent monetary policy, so that they cannot set interest rates or exchange rates to stabilise their economies. The current sovereign debt problems faced by several participating nations demonstrate the simultaneous dangers of losing control of their borrowing costs and the value of their currency to an external agency. Consequently, deflation with all its economic, political and social costs has become the eurozone's sole adjustment mechanism to the detriment of its citizens.

Conventional wisdom is that these contemporary crises are the product of deficient policy-making in the suffering countries, often expressed in moral terms as 'indiscipline' (Mills, 2011). In particular, budgetary policy has been too expansive and economies are too competitively inflexible. The consequences of

such errors are public expenditure cuts, increases in taxation and/or declining real wages. Additionally, the conventional wisdom declares that once fiscal consolidation has occurred and labour market flexibility introduced, the countries concerned can return to non-inflationary growth, as Germany did after 2003. However, such conventional wisdom is misplaced, subjecting the eurozone to inefficient and ultimately unsustainable tensions. So long as the ECB tolerates weak demand in the eurozone as a whole and so long as the EU's founder members (especially Germany) run trade surpluses, it will prove impossible for less competitive nations to avoid insolvency. Their problems cannot be resolved by fiscal austerity alone, but only by a large rise in the external demand for their output. However, in a eurozone without monetary or exchange rate offsets, any reduction in public expenditure generates at least an equivalent reduction in output. For example, an attempt to cut a fiscal deficit by 10% of GDP through falls in spending would involve an actual reduction of 15% in GDP once declining tax revenues are taken into account (Holland, 1995). A diminution in purchasing power of this magnitude will create a spiral of debt deflation in which the cost of meeting unpaid debts leads to low growth, falling prices, loss of jobs and declining living standards (Minsky, 2008). This 'perfect storm' increases the risk of default and therefore is likely to cause long-term interest rates to rise, the very thing that the adjustment policy was designed to avoid. Such a scenario carries dire consequences for future productive potential, political dislocation and social distress (Baimbridge et al., 1994).

Almunia et al. (2010) compared the operation of the interwar Gold Standard with that of the euro, arguing that both systems are undermined as much by persistent surplus, as by persistent deficit, countries. Indeed, more so because those in surplus are under no compulsion to change and are unwilling to contemplate this scenario. However, Germany now needs to reconsider its position, because the only way for other eurozone countries to lower fiscal deficits without their economies collapsing is through a huge net export expansion, based upon both improved productivity and crucially buoyant external demand. Currently neither is forthcoming, so that it is difficult to regain competitiveness when the euro is strong, partly because Germany is so competitive and partly also because eurozone inflation is low. Furthermore, the financial markets are correct in questioning the willingness of governments, and societies as a whole, to suffer the enormous deflationary burden imposed by euro membership. Indeed, the most direct method for eurozone nations to avoid the consequent deflationary effects of the eurozone is by dismantling or, at the very least, reconstructing its entire mode of operation.

Attainment of the TEU convergence criteria

Most academic social science literature either accepts that closer EU integration is desirable, or more usually, given the political will of EU leaders, that it is inevitable. Therefore economists, political scientists and sociologists frequently devote their research to the dynamics of EMU, the political institutions fostering 'ever closer union' and the social implications of these momentous changes. However, whilst such detailed analyses generate important policy proposals, they tend by their weight to obscure the crucial strategic issue: is EMU beneficial or not for the EU *as a whole*? The purpose of this chapter is to analyse this issue. More specifically, it seeks to evaluate the criteria that have been advanced by different authorities to assess whether or not membership of the single currency would prove beneficial.

Over the last 20 years, economists have studied the potential impact of monetary union between countries under the rubric of optimum currency area theory. It concludes that a single currency boosts participants' living standards when they possess similar economic structures and international trading patterns, but proves detrimental where these diverge. The danger of locking a country's currency within an international regime ill-suited to meeting domestic and external economic goals is illustrated by mass unemployment under the Gold Standard of the 1920s. Consequently, to avoid making a potentially costly mistake, especially since single currency membership is intended to be permanent and irrevocable with no exit clause negotiated in the TEU, there is an obvious need for a series of measurements to determine whether an individual economy is prepared for the demands of membership (EC Commission, 1992). These indicators must incontrovertibly demonstrate the existence of prior, sustainable 'real' convergence between participating economies, before the formation of a single currency between these countries is in their economic interests. However, despite the critical importance of such indicators in establishing whether or not membership of EMU is 'good' or 'bad' for a particular country, their construction has been paid relatively scant attention.

Indeed, the convergence criteria contained within the TEU are more concerned with examining transitory *cyclical* movements in *financial* indicators, rather than concentrating upon *structural* convergence in the real economy (EC Commission, 1992). Thus the only questions asked are those concerning the levels of price inflation, interest rates, exchange rate stability, public debt and annual budget deficits. The TEU focused upon 'nominal' convergence, measured by reference values (e.g. 60% debt; 3% deficit) that largely reflect historical levels of debt and deficit in the 'core' EU countries. Their relevance to future conditions is unclear. In contrast, the TEU contained no similar tests to compare the wealth of the different countries, their unemployment, productivity and growth rates, nor the sectoral composition of economic activity. Perhaps this is not entirely surprising as the EMU project was designed by a committee dominated by central bankers,

whose particular concern was to devise rules restraining potentially profligate national governments from destabilising the monetary system. However, whilst these matters are important, it is problematic that EMU is designed to proceed from such a narrow, theoretically questionable foundation. Such concerns are magnified by the fact that EMU possesses no historical precedents. No monetary union has existed independently of political union and no independent country has ever unilaterally abandoned its own currency (Goodhart, 1995). EMU is therefore a 'leap in the dark' that has potentially destructive implications if its participants are not sufficiently converged prior to its establishment (Eichengreen, 1992 and 1993).

The identification of those individual EU member states that have demonstrated their suitability for single currency membership is officially determined by their attainment of the five TEU convergence criteria that are denominated exclusively in terms of 'nominal' rather than 'real' convergence targets. Nominal values as represented here concentrate upon specific financial ratios rather than measurements of productivity and output growth, changes in the level of employment and other indicators from the real economy.

The initial two criteria regarding inflation and interest rates have a clear rationale with respect to the establishment of a single currency area based upon the achievement of prior cyclical convergence. The similarity of inflation rates denotes a low probability of a sudden loss of competitiveness inside a single currency that might lead to unemployment blackspots and a growing inequality at the heart of the monetary union. Moreover, comparable interest rates indicate a relatively straightforward transition to a common monetary policy that does not require dramatic changes in the national strategies formally pursued by the nation states. However, whilst these two convergence criteria are theoretically sound, the latter three have generated both analytical and empirical controversy.

The third criteria regarding 'normal' ERM fluctuation bands was interpreted until 1992 as the relatively narrow margins of $\pm 2.25\%$ around the central parity. However, following the 1992-93 exchange rate crises, the bands were widened to $\pm 15\%$ for an indefinite period in order to reduce the speculative pressure upon the ERM, whilst Italy and the UK were forced to withdraw from the system entirely. As a result, the third convergence criteria was relaxed in order to adapt to this new reality, so that member states only had to achieve the looser measure of currency stability required by the ERM (Aglietta and Uctum, 1996). However, the re-definition significantly reduced this indicator's utility, because the looser arrangement allowed for a currency to fluctuate by a potential of 30% and still be considered stable. During any period other than an economic crisis or massive competitive misalignment, it would be unlikely that a currency would threaten to breach such a lax target, so that the criteria becomes increasingly difficult to

defend. Indeed, at their June 1996 meeting EU Finance Ministers agreed to ignore the ERM membership precondition entirely. The decision was particularly fortuitous, since a significant number of countries still failed to meet such modest standards. The UK and Sweden have not rejoined the ERM, whilst Spain and Ireland realigned their central parity rates; thus they failed to meet the original principle of successively reducing exchange rate fluctuations, whilst preventing realignments prior to the establishment of a single currency in order to minimise adjustment costs.

The inclusion of the final two targets concerning the budget deficit and national debt as means to establish the compatibility of potential participants within a monetary union raises further problems. The justifications for their use are, firstly, that they would result in a stable debt ratio in a steady-state economy with 2% inflation and 3% real growth (Trades Union Congress, 1993); and secondly, advocacy of the 'golden-rule' that current government expenditure and revenue should be equated, together with an estimate that EU public investment approximately averaged 3% over the period 1974-91, indicates adoption of the convergence criteria (Buiter *et al.*, 1993). However, the first justification fails to provide a convincing case for the specific values chosen for maximum government borrowing as a proportion of GDP, since the fiscal reference values are compatible with any combination of inflation and growth which sum to 5% per annum. Moreover, there is no evidence that attainment of these criteria would result in a steady-state economy (Arestis and Sawyer, 1996). Consequently the justification for the last two convergence criteria is far from secure and the case for their reliability must rest upon the second justification. However, it appears to be based upon the simplifying and unlikely assumption of zero inflation, otherwise inflation accounting must be included into the calculation. The 60% national debt criterion is of doubtful use in any case, because it is primarily a consequence of the *prior* accretion of debt, reflecting past fiscal activities rather than current policy (Goodhart, 1992). Whilst it is important to avoid a country joining a monetary union so over-burdened by the results of poor previous macroeconomic management that it is susceptible to current repayment crises, the adoption of a 60% maximum figure appears somewhat arbitrary and unnecessarily harsh.

Despite the problematic nature of the convergence criteria, the architects of EMU believed that their attainment would indicate the compatibility of potential participants, together with providing a guide to their subsequent maintenance in both favourable and unfavourable economic conditions (Baimbridge, 1997). The prerequisite of prior convergence is significant over each stage of the economic cycle, if EMU is to prove robust against symmetric and asymmetric shocks (Eichengreen, 1992; Bayoumi and Eichengreen, 1993). However, examining the extent to which EU member states have actually met the convergence criteria over

the period 1992-2002 following the signing of the TEU encapsulates both a recession and recovery makes difficult reading for supporters of European monetary integration. Only in 1998, the crucial year prior to the irrevocable fixing of national exchange rates did compliance with the convergence criteria begin to approach that necessary for a sustainable monetary union. Even then, however, only six EU member states achieved strict adherence to all five convergence criteria.

The attainment of all five criteria was fulfilled on only 29 out of a possible 165 occasions over the 1992-2002 period. A record of achievement of approximately 18% is a particularly poor reflection of the prior convergence of the EU economies, as measured by the convergence criteria, particularly manifested in the period preceding EMU, when member states retained considerable control over their economies. Indeed, only Luxembourg, a country atypical of other EU members' economies in terms of its size, industrial base, and the fact that it does not possess its own central bank (allowing Belgium to operate its monetary policy) appears able to consistently meet the 5 criteria. Of the remaining fourteen EU member states, only seven have ever secured total compliance with the convergence indicators with key euro zone countries such as Austria, Belgium, Italy and Greece failing to achieve all five criteria. Moreover, the number attaining all five convergence criteria peaked in the period 1998-2001, but thereafter declined (at least temporarily, before policy instruments were used to force a greater degree of convergence) thereby illustrating the difficulties in maintaining political willpower after the commencement of EMU and adherence in light of an economic slowdown. Whilst the Stability and Growth Pact (SGP) was designed to reinforce the former, the latter is a consequence of the convergence criteria's inherent design faults and questionable *a priori* convergence between EMU candidates.

Additionally, the ability of each EU member state to participate in monetary union, through examining the average number of criteria met in a given year and by a given country, indicates that only Luxembourg, Denmark, France, Germany, Belgium, the Netherlands and Ireland come close to satisfying the convergence indicators on a permanent basis; although even their record raises significant doubts about their long term ability to achieve the convergence criteria. Thus the available evidence provides little support for the ability of member states to both achieve, and maintain, the stipulated convergence criteria for more than momentary periods. To the extent that the convergence criteria satisfactorily indicate 'fitness' of entry for EMU, the failure of EU member states to consistently meet these criteria raises the prospect of the single currency becoming unsustainable in the medium- to long-term.

The degree of variability in the attainment of the five convergence criteria over the 1992-2002 period is measured by their standard deviation where Luxembourg was the best performing member state in this regard closely followed by France, Ireland, Belgium, Germany and the Netherlands. However, the more disturbing finding is the significant level of variability of countries such as Finland, Spain, Greece, Portugal and Italy where the figure exceeds either 1 or 2 convergence criteria. Although their movement towards fuller compliance in more recent years offsets this, such historical instability regarding the adherence of the convergence criteria highlights the potentially fragile nature of the euro project as presently conceived.

The conclusions reached from this analysis diverge significantly with the examination of the progress towards convergence and sustainability of the monetary union completed by the EU Commission (1998). Indeed, the Commission concluded that eleven EU member states have “achieved a high degree of sustainable convergence”, with the UK, Sweden and Denmark utilising their opt-outs from membership and only Greece deemed incompatible with EMU. However, its conclusion conflicts with the economic data; for example, Belgium, Germany, Greece, Spain, Italy, the Netherlands, Austria and Sweden all possessed a government debt ratio exceeding 60% in 1999. Even assuming that the economic climate is favourable to reducing previous debt burdens, it is most improbable that Italy and Belgium will be able to meet these criteria since both have government debt ratios in excess of twice the convergence criteria limit. Indeed, their government debt share of GDP is significantly higher than that of Greece, although Italy and Belgium were passed as ‘fit’ for monetary union membership whereas Greece was initially rejected.

The variance between the historical evidence that a large number of EU member states will not consistently meet the convergence criteria by the establishment of EMU, and that their participation in the monetary union has already been endorsed by the Commission, may indicate that the decision as to which countries qualify has been taken on political rather than economic grounds. The problem with undermining a rigorous interpretation of the convergence criteria is that, to the extent that they reflect necessary prerequisites for a sustainable EMU, failure to comply could create a potentially weakened single currency which will suffer from a higher degree of inherent tension than would otherwise have been the case. The experience of those countries that narrowly comply with the convergence criteria for only a minority of the period since the TEU was adopted, suggests that they are not permanently converged, but only achieve the necessary conditions in the most favourable economic circumstances. The implication is that, once a recession occurs, the majority of EMU participants will demonstrate a significant divergence from the established criteria, thereby increasing the potential for destabilisation at the heart of the single currency.

Greece: accession, growth and crisis

In January 2000, the ECB and the Bank of Greece resumed a policy of exchange rate stability around the central parity, which was revised to ECU 1 = Drachma 340.75, reflecting some 3.5% revaluation of the currency vis-à-vis the euro and 2.0% above its ERM-II central rate (ECB, 2001; Anastasatos and Manou, 2008). It was expected that this revaluation would enter EMU at a strong exchange rate, while ensuring that the rate of inflation remained low in the long-term, even if this resulted in a further decline in export competitiveness. Moreover, it was projected that the inflationary impact of the depreciation of the drachma towards its conversion rate on import prices will disappear by the end of 2001 (ECB, 2000).

Although Greece vigorously implemented policies aimed at achieving a high degree of sustainable economic convergence in order to meet the terms of the TEU, the post-2000 the Greek deficit levels have remained higher than the 3% level, hence the country was not fully adhering to the government deficit requirement under the SGP. Similarly, even though Greece did not meet the public debt criteria, the European Council decided that it has fulfilled most of the conditions for the adoption of the single currency, thus the country became the 12th member of the EMU on January 1, 2001¹.

Following Greece's accession, the economic situation remained relatively positive: the rate of economic growth in Greece was significantly above the average growth of 2.2% recorded in the euro zone, and the rate of unemployment remained relatively stable, at around 10% in the same year. Meanwhile, consumer-price inflation in Greece was 3.6% which is significantly higher than the ECB target rate of 2.0% and is primarily due to the increase in petroleum prices over the year. On the other hand, the general government debt was between 100-107% of GDP, hence the government's assertion that the outstanding public debt would be equivalent to its target of 60% of GDP by the end of 2000, therefore appeared overly optimistic.

Furthermore, after Greece joined the EMU, the country accumulated many macroeconomic and financial vulnerabilities, due to easy access to international funds at low borrowing costs and high economic growth that lead to the real value of debt thus stimulating increased borrowing by the government in order to finance fiscal deficits which further worsened current account deficit. Thus, during 2003 when Greece posted GDP growth of 6%, a deficit of 7.8% on the

¹ In the Greek case as elsewhere, the EMU nominal convergence criteria excluded the debt to GDP ratio, the rate of which by the end of 2000 was over 100 percent.

country's current account was recorded while a deterioration in the budget deficit was witnessed, breaching the 3% of GDP limit, and as a result the country was subjected to the Excessive Deficit Procedure, as envisaged in the framework set by the SGP.

Having had levels of debt and deficit exceeding reference values even before entering the Eurozone, the European Commission issued a report in June 2004 reviewing the problem of excessive deficits in Greece as part of the surveillance system of the preventive arm² (Ngai, 2012). Moreover, the Commission emphasized that the quality of public data was unsatisfactory, noting that the EU's statistical office (Eurostat) had not certified or had unilaterally amended data provided by the National Statistics Service of Greece since 2000³ (Belkin, 2010). Subsequent statistical revisions during 2004-07 revealed that Greece had violated the 3% limit in every year since 2000, with its budget deficit topping out at 8.8% of GDP in 2004. The Commission also noted that Greece's gross debt had been above 100% of GDP since before Greece joined the euro, and that the statistical revisions had pushed the debt number up as well (Belkin, 2010). It is also believed that the deficit originated mainly from the spending side (e.g. transfers and public wages) and as a result, the debt to GDP ratio was already as high as 103% of GDP at the outset of the crisis.

Meanwhile, during 2004 there was an early election in Greece in which the incumbent party of New Democracy won, but with a marginal majority and stayed in office until the end of 2000. One of the main goals of this newly elected Greek government was to improve the negative trend in the economy as well as to deal with tampering with statistics of the previous government. Fiscal policy therefore was procyclical, providing a stimulus to disposable income and consumption, on top of the impetus provided by private credit growth (Riedl, Silgoner and Knollmayer, 2015). Nonetheless, the achieved adjustment relied on one-off measures and was thus unsustainable. The combination of high economic growth, the persistent fiscal imbalances and the deterioration of the competitiveness over the past decade worsened the external balance of the Greek economy, with the current account deficit peaking at 15.2% of the country's GDP in 2007. The widening of the external imbalances happened mainly due to a growing deficit of trade, which reached approximately 17% of GDP in 2008 (Magoulios and Athianos, 2013). However, even before the crisis the openness of the Greek economy was low, whereby the export sector represented only 22.5% of GDP in

² Since then the country received six reports from the Commission and, Economic and Financial Affairs Council (ECOFIN) regarding its fiscal situation.

³ European Commission, Report from the Commission: Greece, Brussels, May 19, 2004, http://ec.europa.eu/economy_finance/sgp/pdf/30_edps/104-03/2004-05-19_el_104-3_en.pdf

2007 as compared to 43% in Germany. Thus, despite several years of prosperous economic growth, Greece started the crisis with adverse fiscal conditions.

In the meantime, the Council of the European Union, based on the European Commission's recommendation that the public deficit had been brought below the 3% to GDP reference value in a sustainable way, decided that the excessive deficit had been corrected and brought the excessive deficit procedure to an end (Kaplanoglou and Rapanos, 2011). Nevertheless, by the end of 2007, the general government deficit had once more surpassed the 3% limit and a current account deficit ran at over 15% of GDP. Furthermore, it had become clear that the economy was extremely vulnerable to potential negative developments, such as a rise in interest rates in government borrowing or difficulties in public debt refinancing. It was clear that the economy lacked both the resilience and the institutional apparatus that would make possible appropriate policy responses to a sudden macroeconomic deterioration (Bank of Greece, 2014).

The global financial crisis in 2008 and the subsequent worldwide economic recession had a marked negative impact on the fiscal positions of euro area countries. At the onset of the financial crisis, Greece mainly relied on running a foreign capital surplus whilst it ran both a current account and a budget deficit after high spending by successive governments relative to revenues raised. However, as the foreign capital surplus is very responsive to risk and uncertainty, the outbreak of the worldwide financial crisis was the starting point for a sudden stop in capital inflow which decreased the foreign financial surplus, forcing Greece to lower its deficits. Since currency devaluation is not an option in a monetary union, Greek wages fell and GDP was reduced through internal devaluation resulting in a recession which increased the debt to GDP ratio.

Furthermore, the Greek government's reliance on borrowing from international capital markets to pay for budget deficits and trade deficits left it vulnerable to shift in investor confidence. If investors lost confidence in the Greek government's ability or willingness to repay its debt, they would stop lending to the government or charge interest rates that were higher than what the Greek government could afford. Lack of access to new funds would make it difficult for the government to roll over its debt, meaning that the government would have to implement austerity measures quickly or risk defaulting on its debt (Belkin, 2010). Therefore, starting from 2009, investor confidence in Greece's ability to service its debt dropped significantly, hence increasing borrowing costs and raised the spreads on sovereign bonds. Moreover, the global financial crisis of 2008-2009 and the related economic downturn strained Greece's public finances, as government spending on programs, such as unemployment benefits, increased and tax revenues weakened. Greece's reported public debt rose from 104% of GDP in 2006 to 127% of GDP in 2009.

Furthermore, as most advanced economies went into deep recession and economic activity in emerging economies slowed down considerably, Greece recorded negative rates of change in GDP of 4.4 percent. Moreover, the Commission opened a new excessive deficit procedure in 2009 when Greece's 2007 deficit was reported at 7% of GDP, and that procedure is ongoing in the context of the existing situation (Nelson, Belkin, and Mix, 2010). Consequently, new revisions about Greek debt and primary deficits were made and published by the newly elected government led by Prime Minister Georgios Papandreou (PASOK). As the country's economy started to come under closer scrutiny, credit rating agencies repeatedly downgraded Greece's rating and borrowing costs from markets started rising: the long-term interest rates increased to 5.2% by the end of 2009 (Economou et al., 2014).

CONCLUSION

Although the issue of monetary union is merely a step along a theoretical road of exchange rate regimes its adoption is not a decision for any country to take lightly given that its practical consequences in terms of both economic and political national sovereignty are substantial and therefore require deep analysis. This calculation is required by eurozone member states; however, there are complications in that the various cost and benefits need to be assessed within the context of both the potential partner country and in relation to the already established monetary union, or the other prospective members. Each economy is unique in its blend of sectoral strengths and weaknesses and comparative advantage, therefore the national interest will be distinctively different for each potential participant. Further, there is no set rule in which to weigh the relative merits of the arguments associated with membership of a monetary union. Although economic theory suggests that a monetary union will prove generally beneficial if the participants are sufficiently converged, it is necessary to establish an unambiguous, comprehensive and theoretically sound set of convergence criteria; however, it is questionable whether the current convergence criteria fulfil this role.

Consequently, the sustainability of EMU in the medium- and long-term will partly depend upon the implementation of a fiscal policy initiative, located at the federal rather than national level, which is sufficiently well resourced and targeted to stabilise member state economies in the face of asymmetric external shocks. In the absence of exchange rate or monetary autonomy and with insufficient labour mobility and wage flexibility, individual regions may become characterised by persistent unemployment, low per capita income and ensuing social tension. The EU leadership's priority is to prevent the single currency collapsing, but such a stance creates immense danger since the EU possesses only a limited volume of

borrowing and political will. For example, the EFSF and ESM were established with a capital base of €80bn to provide a lending ceiling of €500bn, but should a country such as Italy require a bailout, then even the combined might of the ESM and IMF would be severely tested. If these become exhausted, insufficient financial firepower may remain to prevent bank defaults when a number of countries decide to leave the single currency and devalue. This risk has been intensified by EU encouragement of cross-border loans within its jurisdiction, thus leaving European banks more exposed than they would otherwise have been.

Although such efforts may lead to economic remedies, a potentially more significant outcome from the eurozone crisis is to the body-politic of the EU with greater long-term damage emerging through the imposition of 1930s style austerity policies. In terms of the flawed economics of austerity, Blyth (2013) provides an account of how this has reared its head at moments of crisis only to persistently exacerbate the situation in the overwhelming majority of cases. In the contemporary context of the eurozone crisis a number of studies (Alesina and Tabellini, 1987; Persson and Svensson, 1989; Giavazzi and Pagano, 1990; Alesina and Ardagna, 2010) were the touchstone of the shift towards so-called expansionary fiscal consolidation; subsequently, their findings have been rebutted by a further series of studies (Jayadev and Konczal, 2010; Leigh et al., 2010; Gravelle and Hungerford, 2011; Perotti, 2011; Guajardo et al., 2011; Battini et al., 2012; Jordà and Taylor, 2013). Overall, research on the effects of austerity on macroeconomic indicators remains problematic and complicated by the difficulty of identifying multipliers; however, the consensus has now shifted in favour of the latter studies refuting the applicability of fiscal consolidation. Moreover, they indicate that fiscal contraction prolongs the pain when an economy is weak compared to when the economy is strong; in other words precisely not the policy to pursue in times of crisis.

In addition to a return to austerity-orientated economics and political discourse, a further aspect of the EU's response to the eurozone crisis has arguably been a weakening of the bonds of social cohesion through increasing internal and external discrimination, together with the rising spectre of racism in Europe. The twin concepts of internal and external discrimination are centred on the notion that in contrast to EU integrationalist developments, for third country nationals there is a danger of Europe increasingly becoming a 'fortress', whilst internal discrimination occurs through the differences in the way individual member states treat their minority populations that are partially explicable in terms of their differing histories and patterns of migration. In terms of the extreme right in contemporary Europe the conventional view has been that their rise in popularity is largely explained by the individual fortunes of political parties, as opposed to a particular phenomenon occurring. However, evidence suggests that the diminution of social cohesion/rise of racism as exemplified by support for the

extreme right is a pan-EU phenomenon exacerbated by neoliberal deflationary policies as espoused by EMU and now austerity (Baimbridge et al., 1994).

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