MEIJI INSTITUTE FOR GLOBAL AFFAIRS

MIGA Column Global Diagnosis

December 13, 2013

Naoaki Okabe

Fellow, Meiji Institute for Global Affairs, Meiji University

Short Curriculum Vitae) Naoaki Okabe
Graduated from the School of Political Science and Economics, Waseda University in 1969. Joined the *Nihon Keizai Shimbun* that same year, and after serving in roles such as reporter in the economics section held successive posts as a correspondent in Brussels, head of the New York branch office, executive director of the editorial board, special executive director, and columnist. Has held his current post since 2012. His major works have included *A Leaderless World*, *A Primer to the Japanese Economy*, and *Reciprocity: The Political Dynamics of the Yen and Dollar*.

The Euro Is Tossed by the Waves but Does Not Sink

The euro crisis is now in a temporary lull. The slump in business conditions has been halted, and even the ranking of Greece’s national debt that suffered from the crisis has been elevated. Moves are also being taken over reforms such as a banking union, while drastic measures are being taken for the structural contradictions of the euro. Of course, this is not to imply that the crisis has returned to normal because of these. This has further distinctly revealed that Germany is Europe’s sole winner, as disparity has only just widened with the southern countries. The unemployment problem centered mainly around young people remains as severe as ever, and could potentially lead to social unrest. The fear of touching off a chain-reaction of debt crises and bank crises has not been dispelled. However, it would be misguided to predict the collapse of the euro and the dissolution of the European Union (EU). Europe’s heavy history of having experienced two world wars has produced Europe’s wisdom in not giving up on its march towards integration. “*Fluctuat nec mergitur*” (it is tossed by the waves but does not sink) is the underlying spirit of the EU.

Why Did the Crisis Occur?

The euro fell into crisis due to a variety of overlapping causes. The first one that must be pointed out is the “cost of success.” The euro that was born from the conclusion of the Cold War was wreathed in “euro-phoria” (a sense of euphoria created by the euro), and there was even a misplaced sense of overconfidence that it could become a currency that would rival the US dollar.

Even Germany and France, which are the main axes of the euro, failed to uphold the financial standard of keeping their budget deficits to within 3% of their gross domestic product (GDP), and this looseness in financial affairs spread to the Southern European countries. Then the financial crisis precipitated by the collapse of Lehman Brothers came in the fall of 2008, and exposed the structural contradiction in the euro in that it has a single currency and monetary policy, but separate fiscal policies and financial administration.

The crisis primarily spread to the PIIGS (Portugal, Ireland, Italy, Greece, and Spain). A “dangerous tango” in which sovereign crises (national debt crises) and bank crises were interlinked started here and there. This was also the unpaid bill from having the euro expand too much and vastly exceeding the “optimal currency area” spoken of by Professor Robert Mundell.

The response to the crisis came a day late and a dollar short. There was an enormous disparity between the “market time” that demands an instantaneous response and the “political time,” which must be grounded in the democratic procedures of each of the euro member countries. Despite the fact that the euro crisis was on the verge of becoming a global economic crisis it took far too long to form the troika structure for overcoming the euro crisis consisting of the International Monetary Fund (IMF), the EU, and the European Central Bank (ECB). Above all else, the greatest causal factor in delaying the response was the reluctance of Germany, as the leading power in the euro, to offer aid to Southern Europe.

Reforms Pushing towards Reunification

Even so, reforms have been set in motion. These are moves that attempt to revise the structural contradiction of the euro in that there is a single currency and monetary policy but separate fiscal policies and financial administration. The notion for a banking union is at the forefront of this. It consists of three main pillars: the centralization of financial oversight under the ECB, the centralization of financial liquidation procedures, and the consolidation of deposit insurance systems. Audits of assets of European banks have already begun for the sake of transitioning over to a banking union. Of course, Germany has some complaints that the centralization of liquidation procedures could potentially lead to an increase in costs, but the fact that reforms have taken a step forward should be regarded as a momentous change.

It is possible that debates over financial integration will grow in fervor. The idea of a ministry of finance for the euro zone that was proposed by former President Trichet of the ECB is one plan for financial integration. The idea of joint euro debt demonstrates the possibility of the response to the crisis serving as an entryway to financial integration. Naturally, there are objections to both ideas, as they raise questions over striking a balance between financial sovereignty. However, the basic principal of the EU has intrinsically been "shared sovereignty" surpassing that of an ordinary sovereign nation. If restoring the euro is taken as the overriding imperative, then Europe cannot shy from the path of financial integration.

The euro zone also has "three arrows" that resemble those found in Abenomics. Right now falling into deflation and turning into another Japan are the biggest worries in the euro zone. The concern is that sliding into deflation the way Japan did would set them on a course towards a "lost era."

President Draghi of the ECB has declared that the ECB will do whatever it takes to overcome the euro crisis and has gotten it under control, and even recently he has taken the plunge of reducing interest rates and demonstrated a stance of monetary easing. This has risen to the level of a doctrine of negative interest rates, and as things currently stand the ECB does not seem to have an exit strategy from its easing in mind.

In terms of fiscal management, what is needed is for the countries to rigorously apply the financial criteria for the euro, as criticism has been observed coming from President Hollande of France and others of the single-minded devotion to austerity in the euro zone. They assert that the emphasis should shift from austerity to growth strategies. There are a number of different growth strategies for the EU, such as Europe 2020, and one hears self-mockery to the effect that, “If it’s papers you want we’ve got stacks of them.” What will most likely serve as the determining factor in the EU’s growth strategy will be its global market strategy in the form of a free trade agreement (FTA) with the United States and an economic partnership agreement (EPA) with Japan.

Suffused with Structural Problems

While it has gotten started with reforms, the euro zone is suffused with a variety of structural problems. That Germany is the sole winner in the region has cast a shadow over the euro’s management. The creation of the euro came about as a result of the end of the Cold War. The fall of the Berlin Wall led directly into the integration of East and West Germany. But the restoration of a strong Germany caused major anxiety in Europe, and so Germany was pressed into choosing to become “Europe’s Germany” instead of it being “Germany’s Europe.” As a token of this, Germany dispensed with the strongest currency in the region, the mark, for the creation of the single European currency of the euro. This was the consensus reached by President Mitterrand of France and Chancellor Kohl of Germany.

The historical irony is that the euro was created in order to avoid having a strong Germany, but on the contrary it gave rise to this very thing. Germany has received the greatest benefit from the dividends of the euro. The eastward expansion of the EU has significantly widened the market for German companies, which have a competitive edge. These disparities in developmental stages have conversely served as a source for growth. The depreciation of the euro as a result of the crisis has led to a further expansion in exports. Germany has currently surpassed China to become the country with the greatest current account surplus, and its unemployment rate has fallen significantly as well. Naturally its financial affairs are also in sound order.

The disparity between a strong Germany and the embattled Southern European countries just grows wider. This has thrust forward fundamental doubts about what would constitute integration for the polarization of the euro zone.

The greatest problem is that major disparities are arising between Germany and France, which have shouldered the euro. To date the EU has harnessed Germany's economic might and France's diplomatic strength as the sources of its power. Yet whereas the iron lady of Chancellor Merkel is a global leader surpassing the bounds of the EU, President Hollande of France is a virtual non-entity. There are fears that cracks are appearing in the German-French axis that has sustained both the EU and the euro.

The question is one of whether or not Germany can transform itself. It will not be easy to mobilize the people of Germany, who have been reluctant to provide aid to Southern Europe. However, there is the possibility of bringing about a turning point by adding the Social Democratic Party of Germany (SPD), emphasizing the restoration of the euro as well as having similar thoughts as President Hollande of France when it comes to growth strategies, to Germany's grand coalition. Transforming Germany holds the key to restoring the euro.

Though Europe has weathered the worst of it, the crises in the Southern European countries remain severe. The reason that current account balances are taking a turn for the better in heavily indebted nations is because their domestic demand is cooling down, while bad debt is ballooning at Italian and Spanish banks.

The most serious problem is the issue of unemployment. The structural youth unemployment in which one in four people are unemployed in particular could potentially produce a new impoverished underclass and lead to significant social unrest. The expansion of this "lost generation" (NEET) is casting a dark shadow over the future of Europe.

There is the contradiction that due to their financial limitations the countries with high unemployment cannot set to work on drastic measures to stimulate employment. The EU as a whole must promote employment and growth strategies and movements of labor. Once again, the key here lies in whether Germany and the winners can promote financial adjustment within the euro zone.

Nevertheless, the Euro Will Prevail

Even though the euro is beset by a host of challenges, the theory that the euro would collapse found in the height of the crisis has largely disappeared. The theory that it would collapse is no longer to be seen among the major media outlets in the United Kingdom, which had been alluding to the possibility of a collapse. There are no withdrawal provisions from the euro, so when they speak of withdrawal they mean withdrawal from the EU. The price to be paid from this would be overly large. Even Germany, which has been reluctant to come to the aid of Southern Europe, is unyielding in its stance of protecting the euro. The euro has put everyone in the same boat together.

The reason that this theory of the euro's collapse gained currency throughout the world for a time was because the British media, which has a powerful ability to get its message out and has been skeptical of the euro from the very beginning, led international public opinion. Media outlets on the European continent viewed a collapse as inconceivable even during the euro crisis, but compared to the British media their ability to convey their message internationally was weak. There is no denying the fact that this disparity in the medias' abilities to convey their opinions served to amplify the crisis.

The dissolution of the EU is also unimaginable. The United Kingdom is planning a national referendum to ask whether it should remain in the EU, but there is no other option but for it but to remain. The depth of their mutually interdependent relationship is such that the United Kingdom could not exist without the EU. First off, the City of London is the largest euro center. If the United Kingdom were to withdraw from the EU then foreign investment would almost certainly be pulled out all at once. The United Kingdom's worst nightmare would be if it were to withdraw from the EU and then Scotland were to become independent from the United Kingdom and join the EU and the euro.

The EU and the euro will most likely continue with their gradual expansion in the future. The other Balkan states will probably follow Croatia in joining the EU. Ukraine's participation could potentially deepen the rift between it and Russia, and so for the time being its joining is unthinkable. It will be difficult for Turkey to join the EU, which is also a "cultural community." Even despite the crisis there are EU member states that aspire to join the euro, with the euro being a major objective of the late-joining countries.

As former Chancellor Kohl of Germany has pointed out, the euro currency is "a matter of war and peace." When viewed against the history of Europe, which made it through two world wars, there is no denying the fact that the EU and the euro will take the next step forward even as they are beset by problems. Therein lies the wisdom and perseverance of Europe, which have their roots in its history.