UNIVERSITY OF ECONOMICS, PRAGUE

FACULTY OF INTERNATIONAL RELATIONS

MASTER'S THESIS

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UNIVERSITY OF ECONOMICS, PRAGUE

FACULTY OF INTERNATIONAL RELATIONS

Programme: International and Diplomatic Studies

European Imbalances and the Debt Crisis in Europe

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Declaration:

Herewith I declare that I have written the Master's Thesis on my own and I have cited all sources.

Prague, 4 May 2014 …………………

Student's Signature

List of Abbreviations

CAB – Current Account Balance (CA – Current Account)

EC – the European Commission

ECB – the European Central Bank

EDP – Excessive Deficit Procedure

EFSF - European Financial Stability Facility

EIP – Excessive Imbalance Procedure

EMU – the European Monetary Union

ESM – the European Stability Mechanism

EU – the European Union

GCI – the Global Competitiveness Index

GCR – the Global Competitiveness Report

GDP –Gross Domestic Product

ICT – Information and Communication Technologies

IMF – the International Monetary Fund

MIP – Macroeconomic Imbalances Procedure

OECD – the Organization for Economic Co-operation and Development

OMT – Outright Monetary Transactions

R&D – Research and Development

SGP – Stability and Growth Pact

TEU – Treaty establishing the European Union

WEF – the World Economic Forum

Table of Contents

Introduction

The global financial crisis that began in the second half of 2008 has grown into a full-blown economic crisis affecting almost four fifths of the world economy. The crisis that started as a mortgage crisis in the U.S. in 2007, was quick to spread around the globe, and by the fall of 2008 extended not only to banking and financial sphere, but also plagued the sector of real economy. Particularly it hit the Euro-zone. The combination of these crises in the European Union has led to the outburst of another type of crisis – sovereign debt crisis. The Euro-zone debt burden has risen to a new historic maximum despite the austerity policies imposed on the main debtor-states. The increase in public debt was worsened by the recession in the real economy sector, meanwhile large budget deficits and the austerity prevented governments to provide stimulus for the real economy. Therefore, the Euro-zone got stuck in a vicious circle of the three interrelated crises - balance-of-payments crisis, sovereign debt crisis and banking crisis.

Relatively recently there has come the understanding that financial, economic and debt crises are not just directly connected, but also mutually reinforcing. The sovereign debt crisis has led to the deepening of the fragmentation of the European region which boiled over into the massive capital outflow from the so-called "periphery" to more stable economies.

Although the initially gloomy OECD estimates did not prove true, the continuing growth of the indebtedness of the Euro-zone, indicates that the measures taken to overcome the debt crisis have proved to be insufficient, therefore the necessity to study and analyze the deep-seated reasons for the crisis and work out new solutions still remains. Moreover, highly deregulated global financial economy has increased the risk of sovereign debt crises, which potentially might lead to a new wave of corporate debt crises in Europe, as well as in other countries, especially in the banking sector. This, in turn, can lead to the collapse of the Euro-zone and the collapse of the international monetary system as a whole, followed by deep political and social crises. (Heifets 2012)

The aim of this thesis is to analyze the main reasons for the sovereign debt crisis in Europe that has encompassed southern states of the Euro-zone and give recommendations that would help encourage the recovery process, and avoid the repetition of the current scenario. The main thesis of the paper is that imbalances within the Euro-zone were the main reasons of the crisis that had led to the growing budget deficits in the Southern Europe resulting in the accumulation of unsustainable debt.

The imbalances were caused by the declining competitiveness of the South vis-s-vis the North. The main causes of the declining competitiveness are the differences in unit labor costs invoked by different regulations concerning the labor markets in the Euro-zone countries and the diverging levels of productivity, which is liked with the different levels of technological advancement. The contributing factor is the institutional imperfections of the EMU, that did not allow the countries in Southern Europe to restore their competitiveness by traditional means without providing them with alternatives.

The first part will represent the theories regarding sovereign debt, current account balance and competitiveness, and I will try to prove that all these notions are inseparably connected with each other, and must be dealt with in a single package.

Second and third chapters will be empirical, and the theory from the first chapter will be applied to analyze the reasons of the crisis and suggest the way out of it on the example of the five Euro-zone, and one EU, member states, namely Finland, Germany, Sweden, Greece, Spain, Portugal, three of which can be called best performing, and the other three – among worst performing. Sweden is included to underline the significance of failures of the single currency union, since it opted for keeping its own currency, and benefitted from it. Thus, this set of countries is quite representative, and conclusions made on the analysis of these states can be applied to other EU members showing similar performance.

The third chapter will deal with the imbalances after the crisis, as well as the analysis of the policies implemented to level-off this differences. It will also focus of the institutional flaws of the monetary union, and the recommendations for making improvements in this field.

In the conclusion I will sum up the findings and recommendations in all the three chapters, and try to give forecast for the future of the Euro-zone.

Chapter 1. Theoretical part: Sovereign debt, imbalances and competitiveness

1.1 The connection between sovereign debt, private debt, budget deficit and current account balance

Modern economic theory and practice pay much attention to the problems of sovereign debt and the reasons for its unsustainable growth. One of the key factors of the accumulation of public debt is budget deficit. At the same time, the increase of public debt can also become the determining factor of the growth of budget deficit, which is used to service and repay the debt. Therefore, budget deficit and public debt are usually interdependent.

In general, public debt was viewed by the representatives of classical political economy as a negative phenomenon. In their opinion, growing public debt brought a manifold increase in consumer demand, which inevitably led to higher prices. Its negative impact is enhanced by the fact that it not just withdraws funds from the production, but also falls as a burden on the population by way of interest payments.

Keynesianism, however, brought the new approach to this issue. John Keynes did not believe in the self-regulation of market economy, and insisted that government spending can and should stimulate the economy, encourage business investment and increased business activity in private sector. (Kireev 1997, p. 37) Therefore, if government spending and borrowings were used wisely and stimulated economic growth, moderate indebtedness level would be the natural outcome of such policies, and consequently permissible.

Today, all countries resort to borrowing to cover their budget deficits and stimulate economies. Government spending is mostly directed into the public sector to fund government operations to finance state enterprises and activities that produce public goods, such as defence, healthcare and education, law enforcement, scientific research, arts, culture etc. Other items on a budget include unemployment benefits, pensions, support to vulnerable social groups, grants to talented students and some others. State budget can also be used for the levelling-off of regional socio-economic disproportions, overcoming of the excessive differentiation of incomes and stimulation of the economy during economic recession. However, one must remember that the ultimate goal of the government spending is to ensure sustainable economic development. If it fails to achieve this goal, it will eventually lead to the increase of deficit, and consequently of debt in the form of borrowings taken to finance the deficit. Conversely, the growing deficit will not allow a state to serve its debt and fulfill debt obligations in time, which will result in increased indebtedness. As a result, a country is likely to find itself in a vicious circle of endless borrowing, and will have to turn to credit organizations and/or international banks, such as the World Bank or the International Monetary Fund. These banks, however, provide credits under certain conditions, for instance, the imposition of austerity measures, minimization of budget deficit, promotion of competition etc. A country bogged down in debt usually has no other choice but to accept the conditions, which can have an ambiguous effect on its economy, and lead to the contrary results.

Already back in 1930s John Keynes came to the realization that the imposition of austerity measures, i.e. cutting of government spending and increasing taxes, in a depressed economy leads to even greater depression, and that the reduction of taxes in such situation can bring better results in the long-run. (Keynes 1933, p.7) The example of Greece and Portugal that were forced to impose fiscal austerity measures as a precondition for receiving emergency loans, and have suffered even greater economic recession accompanied by the increasing public debt speaks for the correctness of Keynes' statement. The cutting down of government spending and the increase of taxes leads to the decrease of spending, which inevitably provokes the decline in production, and as a result economic recession and withdrawal of investment, accompanied by growing unemployment and often social unrest. On the contrary, experience of many countries shows that the increase of government spending and reduction of taxes during an economic downturn can increase aggregate demand, which in turn can slow down the economic recession.

Such policy, in fact, corresponds to the theory of the **cyclical balancing of budget**, in particular, that provides for the balancing of budget throughout a business cycle (period of several years). **Pro-cyclical policies** provide for fiscal tightening, meanwhile **countercyclical policy** implies that government should reduce taxes and increase spending. During the current sovereign debt crisis in Europe the indebted countries were forced into fiscal tightening (pro-cyclical policy), meanwhile countries with a budget surplus could implement more fiscal stimulus (countercyclical policy). (OECD 2010) However, as the crisis has revealed, such policies have had quite a controversial effect, and reinforced the thinking that countercyclical policy can be more productive in times of crisis, implying that government should provide fiscal incentives during a recession, and raise taxes and reduce spending during the period of economic growth to compensate for the previously accumulated deficit. This approach is supported by Krugman and Keynes, who believe that "austerity should wait until a strong recovery is well under way".[1] However, this approach has two drawbacks. Firstly, it is not always easy to distinguish a cycle of economic development and its phases. Secondly, crises and growth periods in a business cycle vary in depth and duration.

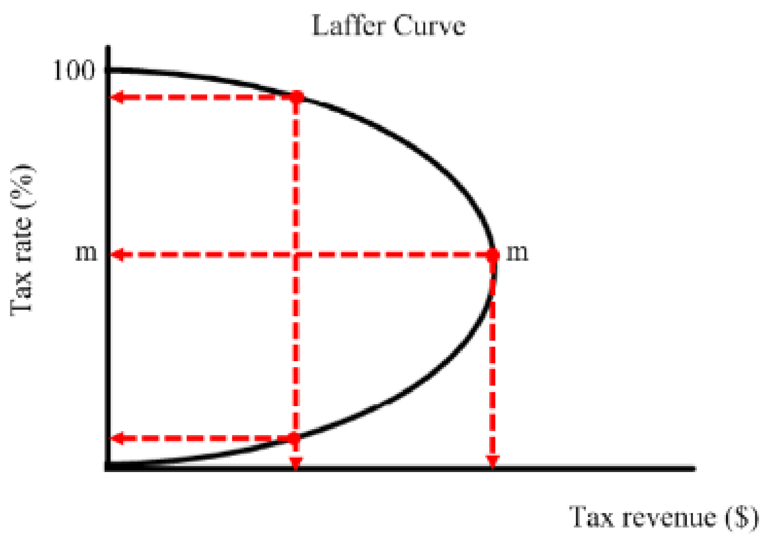
There is also another alternative of financing budget deficit without increasing borrowings – **monetization of deficits**, i.e. the government can finance the deficit through direct currency

[1] *The New York Times*, 'Keynes was right' by P. Krugman

issue, but in practice this method leads to the unwinding of the inflationary consequences in the economy. Theoretically, this strategy can be implemented. The increase of the money supply will not only help cover the deficit, but will also lead to the devaluation of currency, consequently increasing the amount of exports from the country by making them cheaper. Naturally, higher exports will result, first of all, in higher tax revenues, secondly, in the inflow of investment, and as a result of the recovery of the economy. However, in the Euro-zone it is not that easy. Firstly, since all Euro-zone countries have single currency and monetary system, currency \issue will affect all of its members. Secondly, an individual state cannot decide on it unilaterally, since only the European Central Bank can make such decision. Hence, such decision will require the official consent of the ECB, and implied consent of other Euro-zone member states.

Another measure that has already been mentioned is increase in taxes. In practice, however, this method is feasible only in the long run, since it requires a whole complex of tax reforms. Moreover, such policies can lead to the increase of the budget deficit in accordance with the laws described by the Laffer curve (Figure 1). The Laffer curve is based on the assumption that an increase in tax rates up to the point *m* will produce the increase in tax revenues. But further increase in tax rates will lead only to the reduction in tax revenues, since people will either have no incentive to work or find a way to avoid paying taxes. However, it must be mentioned that is no single revenue maximizing point and it differs from country to country depending on a number of factors, such as overall economic situation, income levels, government spending on social welfare etc. As it has been discussed earlier, such policies during an economic recession or a crisis are likely to deteriorate the situation, and lead to even greater recession and, logically, to the reduction of tax revenues.

Figure 1. The Laffer Curve



Source: http://econfix.wordpress.com/2012/01/17/laffer-curve/

Another alternative is to issue **government bonds**. Government bonds are considered to be reliable financial instruments with medium and low levels of profitability. Investor demand for such bonds depends on a number of factors, such as yield factors, or revenue generating capacity (through interest, dividends or growth in market value); reliability, i.e. probability of incurring losses (risk of loan default); and liquidity, i.e. the ability to quickly convert an asset into cash. Government bonds are considered a low-risk investment; however, they are not completely risk-free. Although the probability that government will not be able to return a loan and interest is very low, inflation risk remains. Therefore, financial, economic and political stability are key factors defining reliability of government bonds, and eventually the demand for them. Furthermore, turbulent economic situation and/or negative economic forecasts can undermine investors' trust and lead to the decrease of demand for country's bonds and/or the demands to increase interest rates on newly issued bonds. Accordingly, high interest rates indicate that investors' trust is low, and that a country is facing economic and/or political instability. It also implies that a country's debt will increase even more, since it will have to pay higher interest on its borrowings.

Experience of many countries, such as the US and Japan, shows that budget deficit and public debt are not negative factors by itself, as they help solve economic difficulties at certain stages of economic development. Government loans increase financial opportunities, help in accelerating the pace of social and economic development, and in overcoming economic and financial crises. By attracting more money, externally, as well as internally, with the issuing of government bonds, government receives new opportunities to stimulate or enhance economic growth, improve economic efficiency and decrease the gap with more developed countries.

At the same time, running unjustified deficits and public debt accumulation, and the choice of unsuitable forms and means of financing budget deficits have a destabilizing effect on the economy. If the growth rate of government debt significantly outpaces the GDP growth, the debt can become unsustainable, and lead to a severe financial, economic and political crises. In the case of the EU, debt crisis can undermine the viability of the Euro and result in the collapse of the Euro-zone. In worst-case situation, the collapse of the Euro-zone will not only cost its members millions and decrease real incomes of the population, but may start other EU members thinking that the EU was not such a good idea after all.

Therefore, **debt sustainability** should be one of the priority policies of a state, and at this point especially of the EU. However, strengthening the ability to withstand debt risks escalating under the influence of the growing financial instability is impossible without taking into account the macroeconomic development of a country. Thus, it is important to choose appropriate macroeconomic strategies and instruments, overlook that loans are used not only to cover “holes” in the budget, but that they are drawn on the creation of a stronger economy that will be able to attract investors and provide for the wellbeing of citizens without invoking excessive borrowing.

However, in practice budget deficits and unreasonable government spending often cannot fully explain the accumulation of huge government debt that leads to a sovereign debt crisis. Studies show that it is the extraordinary growth of **private sector debt** that is mainly responsible for the strong increase of total liabilities in Western economies. It can be explained by the fact that public sector often assumes private-sector debts to prevent the outbreak of a full-scale financial and economic crisis. This argument is supported by the finding that in advanced economies risks to financial stability primarily originate in the private sector, and not in the public sector. Further studies suggest that growing public debt is not usually predictive of financial crises in advanced economies; meanwhile private credit boom raises the odds of a financial crisis. (Jordà, Schularick, Taylor March, 2014).

High volumes of private debt do not just contribute to the public debt, and increase the likelihood of the outbreak of the crisis, but also have a negative impact on the recovery process. Private credit boom results in much slower growth of the post-recession output. (Jordà, Schularick, Taylor February, 2014). Studies also confirm that a credit boom prior to the outbreak of a crisis causes deeper recession and slows down the recovery process regardless of the behaviour of the public-sector debt. By contrast, low levels of private debt make recession less painful and a recovery much faster. (Jordà, Schularick, Taylor March, 2014)

Further evidence from the EU experience supports this view, as the only sector that did not experience significant increase in its debt levels (as % of GDP) prior the crisis, was the government sector. It was the private debt accumulation in the Euro-zone that created booms and bubbles that eventually burst out, leaving a large number of banks, firms and households in debt that they were unable to pay. (De Grauwe 2013, pp. 11-15) In order to avoid further economic deterioration, European governments had no other choice but to take over the private debt, which led to the increase of their own debt. As a result, the government debt/GDP ratios started to increase rapidly after the eruption of the financial crisis, therefore confirming the supposition that the primary cause of the sovereign debt problems in the Euro-zone is the unsustainable debt accumulation by the private sector in many Euro-zone economies, and not the profligacy of their governments, as it had been assumed earlier. These findings explain why the imposed budgetary austerity has failed to produce positive changes in debt levels, and encourage recovery in the Euro-zone countries marred with high sovereign debt.

IMF research has also confirmed that German-inspired austerity programs have had little effect, since high private debt is more detrimental to growth than high public debt, and that fiscal tightening will only lead to the increase in spreads, thus making it even harder for a country to repay its debt. (Cottarelli, IMF 2011) IMF studies have also provided evidence that excessive sovereign debt reduces growth only when household and corporate sectors are heavily indebted too, since amid financial and economic crisis overleveraged firms avoid investing, and banks become more reluctant to lend. Thus, these trends reinforce each other, slowing down recovery and growth.[2] Furthermore, loose credit conditions and the associated rapid accumulation of private-sector debt increased the vulnerability of the European states to the sudden stop of capital inflows, thus contributing to the severity of the crisis. (Liu, Rosenberg 2013)

In spite of private debt being the prevailing cause of a financial crisis, and the reason for the accumulation of huge sovereign debt, **government spending** should not be completely disregarded. Research also shows that keeping public debt low is a good insurance policy in the case of the outburst of a financial crisis. When the credit boom is unwound, high levels of public debt can weaken state's capability to rescue private financial sector by taking over its debt; meanwhile a low level of public debt gives a government more latitude to compensate for the fall in demand which inevitably happens with the outbreak of a financial crisis. (Jordà, Schularick, Taylor February, 2014) Besides, the ability of the public sector to provide fiscal stimulus during a crisis is also critical for the "mitigation" of the recession and rapid recovery, as it has been already discussed.

Although the relation between the sovereign debt and private debt looks quite clear, it still does not explain what causes a crisis, what underlying reasons lead to the unsustainable accumulation of private debt and the subsequent burst of the credit bubble. To answer this question, one must ask why some countries accumulate huge debt and why others do not. Of course, no one can give an easy explanation applicable to all countries or cases. Each country, as well as each crisis, has its own particularities, and in each case there might be some additional factors. The same applies to the debt crisis in the Euro-zone; however, there are some common factors that can explain this phenomenon.

The key factor contributing to the global financial crisis are **global imbalances**. Current account surpluses in several emerging market economies have helped fuel the credit booms in the major advanced deficit countries by simply financing those booms. Different economic policies and structures served as an additional factor that has led to the division of the biggest world

[2] *The Economist,* 'Debtors' prison', October 2013

economies to the ones with current account surplus (such as China, Japan, oil exporting countries, Germany, Scandinavian countries) and the others with current account deficit (the USA, the UK, southern countries of the EU). The situation within the EU is a "miniature" mirror image of the global imbalances. According to the Global Competitiveness Report 2012, the growing divide between a strong northern Europe and a weak southern Europe continues to threaten not only the economic stability of the EU, but worldwide economic stability as well. The unequal development in Euro-zone member countries is viewed as the main reason for the crisis, and for the sovereign debt crisis in the Southern Europe. This belief has led many to place responsibility for the crisis on the northern countries of the EU, the majority of which have current account surpluses. Some scholars, such as Schmidt, base their argument on the assumption that current account deficits of one country are matched by respective surpluses of other countries, which means that doing business within the EU is practically a zero-sum game. Powerful European economies put weaker economies under competitive pressure through the export-orientation of many of their companies, causing deficits in those countries. (Schmidt 2010, pp. 73-75). However, before accepting or rejecting this assumption, one should ask the question why these countries are economically stronger, what allows them to run surpluses and put weaker economies under competitive pressure. In order to answer these questions, two notions mentioned by Schmidt must be clarified: current account balance and competitiveness.

Since the outbreak of the crisis **the balancing of the current account** has become one the major tasks of economic policy makers, and in countries with current account deficits even a source of worry for ordinary people. Running a current account deficit has become, at the very minimum, undesirable, meanwhile the concept itself is much trickier than it seems. Firstly, there are several ways to measure current account balance. Secondly, there is more than one variant what a deficit or a surplus can mean, i.e. current account surplus is not always good, and current account deficit is not always bad.

The **current account** is usually expressed as the difference between the value of exports of goods and services and the value of imports of goods and services, or $CA = EX - IM$. If CAB is measured this way, a deficit means that a country is importing more than it is exporting. Although the current account also includes net income (such as interest and dividends) and transfers from abroad (such as foreign aid), they usually constitute a small fraction of the total. When this indicator is measured this way, this may have a strong influence of budget deficit and government debt. To show this connection, we should look at the following equation:

$$Y = C + I + G + NX,$$

where Y – national income or GNP,

C – consumption,

G – government spending,

NX – net exports, or $EX – IM$, which equals CAB

If we analyse this equation, we can come to the obvious conclusion, that CAB has a direct impact on national income, and if it is negative, it can diminish national income, or, if positive – increase it. In the first case, reduction can be avoided by decreasing consumption, or investment, or government expenditure, or all of them. However, if this adjustment does not happen, it will lead to the reduction of national income, which means that, in order to support consumption, government spending and investment at the previous level, a country will have to borrow from external sources, i.e. other countries, foreign banks or international institutions. It is important to keep in mind that a country will have to pay back with interest rate; therefore, persistent current account deficits can lead to the accumulation of a huge debt. If the deficit reflects an excess of imports over exports, it may point at low competitiveness of a state, a concept that will be discussed later.

The current account can also be expressed as the difference between national (both public and private) savings and investment. In this case CAB can be expressed by the following equation:

$CAB = (Sh-Ih) + (Se-Ie) + (Sg-Ig)$, or, put differently, $NX = S - I$

where Sh stands for households' saving,

Ih – households' investment,

Se – savings of enterprises (firms),

Ie – investment by enterprises,

Sg – government saving,

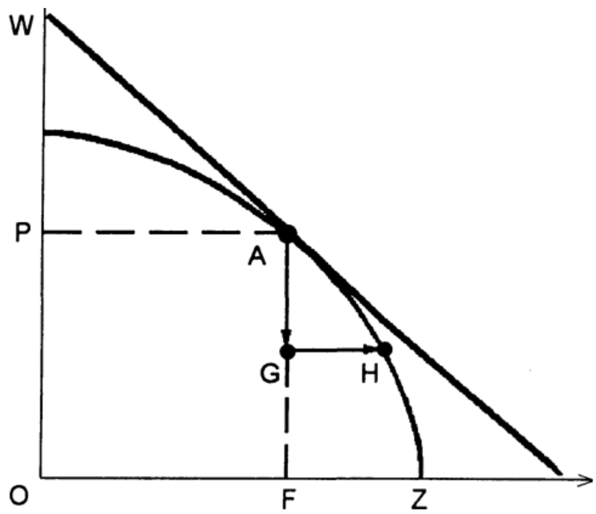
Ig – government investment.

A current account deficit may therefore reflect a low level of **national savings** relative to **investment** or a high rate of investment or both. Since the current account deficit can also signal the excess of investment over savings, it could equally be pointing to a highly productive growing economy. If the deficit reflects low savings rather than high investment, it can be the sign of the incautious fiscal policy or a boom of consumption prone to turn into a bubble. There can be one more sensible explanation: temporary shock or shifting demographics. (Ghosh, Ramakrishnan)

Trade surplus is not always a positive sign as well. For example, a state can have high exports due to its weak currency and/or cheap labour, and have a surplus, but it has to import sophisticated goods from other countries. In the end, it has negative influence on living standards, discourages people from investing into their own economy, and prevents them from creating competitive advantage (of their economy) for the future. (Porter 1990) This view is shared by Krugman who suggests that trade balance is not the bottom line of a national economy. Trade surplus can be a sign of national weakness, while a deficit a sign of strength. Mexico, for example, was forced to run huge trade surpluses in the 1980s in order to pay the interest on its foreign debt since international investors refused to lend it any more money. It began to run large trade deficits after 1990 as foreign investors recovered their confidence and began to pour in new funds. (Krugman 1994) Therefore, deficits reflect underlying economic trends, which may be desirable or undesirable for a country at a particular point in time (Ghosh, Ramakrishnan), and before grieving at the deficit or celebrating the surplus, one should identify and analyse these trends.

The third way to look at the current account is in terms of the timing of trade, i.e. **intertemporal trade** that, simply speaking, means increased current consumption in return for reducing consumption in the future, or understated current consumption in favor of greater consumption in the future. This paradigm is depicted in Figure 2, where *OW* reflects current consumption and *OZ* – future consumption, showing that the more a country consumes today, the less it will have to consume in the future. If country's production equals *A*, it can currently consume *OP*, and in the future – *OF*. If a country reduces its consumption to *AG*, it will be able to consume more in the future, *GH*. Put differently, a country borrows to finance its consumption, but later it will have to repay a loan with interest. Such policy can follow at least two basic scenarios. Firstly, a country can borrow to import goods today, thus running a current account deficit, in order to be able to export goods in the future, thus running a current account surplus then. If that is the case, and the deficit is a temporary measure, it might not be a signal to worry. However, a country should remember that when running a current account deficit, it is building up liabilities for the future. (Kireev 1997, pp. 313-315). This brings us back to the argument that if borrowings are not used to generate long-term productive gains, which is a second scenario, country's solvency might come into question. Therefore, if a country chooses to run a current account deficit consciously, it should be willing and able to eventually generate sufficient current account surpluses to repay for the past current account deficits. Nevertheless, even if a country is intertemporally solvent, its current account deficit may still become unsustainable, for instance, if private financing withdraws abruptly. Such reversals can be very painful because they imply that private consumption, investment, and government expenditure must be cut abruptly, and a country is forced to run large surpluses to repay what it borrowed in the past. In this case more flexible policy framework, such as export diversification, a higher degree of openness, and coherent fiscal and monetary policies could help by making a country less vulnerable to foreign capital outflows and by providing greater room for shock absorption. (Ghosh, Ramakrishnan) At the same time, if a current account deficit is the result of imports prevailing over exports, and this trend is not intended by a state, as in the case of intertemporal trade, it is the indication of competitiveness issues that need to be addressed to avoid greater deficits in the future and prevent them from becoming unsustainable, thus increasing public, as well as private debt.

Figure 2. Consumption alternatives in intertemporal trade

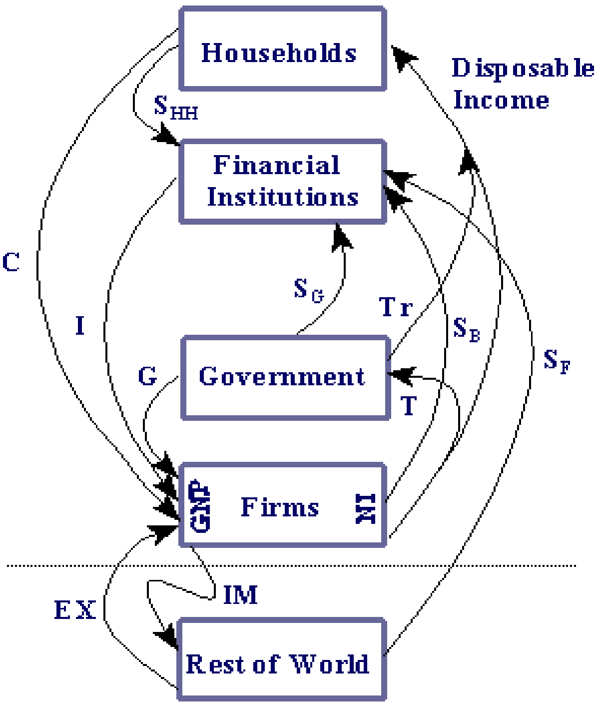


Source: Kireev (1997) *International Economics*, p. 313

The evidence suggests that a surplus or a deficit do not always point to a success or a trouble correspondingly, however, large and persistent deficits, regardless of why a country has them, are a cause for worry and should be avoided. This argument is supported by the Twin Deficit Identity, which is shown graphically in Figure 3. This figure basically reflects the conclusions derived from the above mentioned equations, namely, $Y = C + I + G + NX$ and $NX = S – I$, but it also underlines the role of financial institution within a country, that can serve as depositories of savings of households (*Shh*), government (*Sb*), firms (*Sf*) and other countries or foreign financial institutions (*Sf*), and/or a source of investment for private enterprises, i.e. be a borrower or a lender. Therefore, their activities also should be taken into account when dealing with distortions in national income. In the case of foreign savings (*Sf*), a foreign country or a bank plays the role of a lender that expects to receive an interest on its loan, which is not reflected in the equations, but has played a huge role in the sovereign debt crisis in southern Europe. It also depicts the source of government revenue, taxes (*T*) which later can be used for government spending (*G*), like buying uniforms for an army, or paying salaries to civil servants etc., or transfer payments (*Tr*) that are injected into households income in the form of unemployment benefits, social security payments etc. Although this division of government spending into "pure" government spending and transfer payment is not reflected in the equations, it can be useful, since it can point more accurately to where adjustments should be made when an excessive budgetary deficit or excessive public debt occurs.

Summing up, we can make several important conclusions. Firstly, **government debt and budget deficit** are often interconnected and reinforce each other. Secondly, government debt can budget deficit can be the result not of **government profligacy**, but of high private debt that government consumes to save its economy from falling into a deep recession. Thirdly, private debt is much more dangerous, and has a negative impact on recovery process and makes it more painful. Fourthly, although current account deficit is not always a sign for worry or an indicator that economy is doing badly, large and persistent deficits, regardless of the cause, are likely to become a trouble and lead to increased borrowing, thus increasing government debt, and, accordingly, budget deficit. Fifthly, there can be different causes for running current account deficits, varying from consumption boom to improper fiscal policies and lack of competitiveness. The latter issue will be addressed in the second section of the chapter.

Figure 3. Twin Deficit Identity



Source: S. Suranovic, *International Finance Theory and Policy* at: http://internationalecon.com/Finance/Fch5/F5-9.php

1.2 Competitiveness

The problem of determining the level of **competitiveness** of the national economy and the development of measures to increase it have become particularly acute after the global financial and economic crisis has brought fundamental changes in the economic development of the vast number of countries, including major world economies, in turn, affecting the development of the world economy. Even more scholars and policy-makers have come to the understanding that competitiveness is inextricably intertwined with a country's overall economic performance, and has significant impact on its balance of trade, investment attractiveness, growth rate of economy and ultimately on the wellbeing of common people. In addition, the effects of the crisis brought about the process of adjustment of methods for calculating the index of competitiveness.

Despite the fact that the study of issues of international competition has a long history, interest to this problem has increased quite recently, as most economies around the world found themselves involved in fierce competition. EU member states are no exception, and despite belonging to the same economic and political bloc, also have to compete among each other. Currently, renowned economists and major international institutions are involved in researching in what competitiveness is, what factors define it, how to measure it, and what relation it has to a country's economy and wellbeing of its citizens.

It might be surprising to know that there is no final and single definition of international competitiveness, qualitative and quantitative, accepted in economic literature. The simplest, quantitative assessment of competitiveness at the macro level is the amount of products sold by a country in the global market, and logically country's competitiveness is determined by its **market share** on the world markets. However, this definition hardly seems sufficient.

The observed continuous changes concerning the essence of the concept of "international competitiveness", or competitiveness of a state, and the methods of calculating this indicator are due to the fact that active development of the theory of competitiveness at the macro level has been taking place in the last 35-40 years. At the moment there is not much research on the methodological problems of measuring international competitiveness and on determining the factors defining it. Rather, there are works on specific aspects of national competitiveness and strategies of improving it. Nevertheless, economic foundations of the theory of competition and competitiveness were laid in the days of mercantilism and developed by the classical political economists Adam Smith and David Ricardo. More recently, a number of foreign experts, such as Eli Heckscher, Bertil Olin, Joseph Schumpeter and some others have addressed specific issues of international competitiveness. However, one of the fundamental works in this sphere belongs to the renowned economist Michael Porter whose "diamond" model of national competitiveness and its stages have been to a large extent implemented by the World Economic Forum in compiling Global Competitiveness Index, which will be described later. For the sake of greater objectivity, the work will also include key arguments of another influential economist Paul Krugman, who is a well-known critic of the whole concept of international competitiveness.

Today the definition of competitiveness and competitive advantage management is based on a complex **multi-factor approach**. This approach involves the assessment of economic, social and political aspects of economic development, including the impact of such processes in the world economy, as globalization and technological advancement. The multi-factor approach reflects the complexity of today's competition on the global markets, helps in the assessment of the prospects of the development of national economy, and helps to reveal weak spots that require improvement. These indicators are critical for the making of forecasts and development of effective national strategies.

Previous attempts to give a definition to the international competitiveness of a state have failed to stand the test of time, and have shown that approach based on the advantages of external trade and/or labor productivity and one/two-factor models could not adequately reflect this complex phenomenon. However, these definitions also deserve attention, since they became the basis and paved the way for the further development of the notion, and have made significant contribution into the economic theory.

Adam Smith, for instance, identified factors affecting competitiveness of economy: labor efficiency, transition to a more advanced production, freedom of competition and the abolition of customs duties. Another important pillar of his theory concerned advantages in international trade. He believed that a country, in order to gain from international trade, should produce and sell goods in which it has absolute advantage, i.e. which it can produce cheaper than other countries. Only then a country can be competitive in international markets and profit from trade.

Another renowned economist, David Ricardo, developed the concept of Adam Smith, showing that a country can win from international trade even if it does not have absolute advantage, and introduced the concept of comparative advantage. Ricardo substantiated the idea virtually every country has goods, the production of which will be more effective than others at a ratio of production costs in different countries. Therefore, a country should specialize in production and export of such goods to other countries. (Krugman, Obstfeld 1997 pp. 14-15) Studies of Ricardo also contributed to the realization that the main factors affecting prices of manufactured goods, and hence determine the degree of competitiveness, are the location of the country, its natural and human resources.

Further consideration of the concept of competitiveness is associated with the names of Swedish scientists Eli Heckscher and Bertil Ohlin. They determined that a country can be endowed with the following factors of production: land, labor and capital. Countries have comparative advantages in producing and exporting those goods, for which the required factors of production are relatively abundant locally. (Krugman, Obstfeld 1997 pp. 65-66) This concept is based on the assumption that cheaper goods will be more competitive on the international markets, and they can be cheaper only if their production requires relatively abundant factors of production. (Krugman, Obstfeld 1997 p. 74) It should be noted that this model presupposes that each country itself decides which production factors are redundant or scarce in correlation between these factors domestically, as well as globally.

Completely new way of looking at the problems of competitiveness was proposed by the Austrian economist Joseph Schumpeter, who started studying the influence of innovation and the role of entrepreneurship in the economy in contrast to the (neo) classical school of economic thought, which concentrated on macro-economic changes in the production processes and distribution of wealth. He was one of the first scholars to view entrepreneurs as innovators and the driving force behind the economic development of a country. Schumpeter distinguished the following types of **innovation**: production of new goods; implementation of new methods of production; development of new sources of raw materials; changes in the organization of production; and development of new markets. According to Schumpeter, innovations and entrepreneurial initiative and skills contribute to the creation of new products or improve existing analogues, reduce production costs, and increase trade volumes. These processes result in the growing competitiveness of companies and enterprises, which subsequently leads to the increased competitiveness of a country's economy as a whole.

Although Schumpeter's view was quite innovative, it does not sufficiently capture the variety of factors which define modern competitiveness. Nowadays, the most widely known definition of a nation's competitiveness is the one given in the report of the Presidential Commission on U.S. competitiveness "Global competition: the new reality" in 1987, in which competitiveness is determined by how the nation can produce goods and services that meet the needs of international markets in a free and fair competition, maintaining at the same time stable or increasing real incomes of its citizens. Although this definition is considered to be classical and seems all-encompassing, it mainly anticipated further transformation of the theory of international economic competitiveness, where the starting point has become the understanding of the source of prosperity of the nation and its sustainability.

Nevertheless, it should be noted that such factor as **productivity** has not lost its relevance in the contemporary theory. High productivity still remains one of the sources of a nation's competitiveness and prosperity allowing a state to support high wages, strong currency and relatively high return on investment. However, today, due to the rapid technological development and increased pace of globalization, the term "productivity" has become more complex, and depends not only on the efficiency of production of goods and services, but also on their value in prices installed in open international markets.

In fact, value of goods expressed in price, is considered to be one of the key factors influencing competitiveness of a firm or a state as a whole, i.e. the ability of a state to produce cheaper goods compared to other states makes it more competitive, since the demand for its goods on the international markets will be higher. Thus, a country will be able to sell more goods that is likely to ensure its current account surplus. In turn, the price on goods is defined by multiple factors, such as **unit labor costs**, the level of competition on the market, the supply and demand etc. One of the most important variables is wage paid to a worker, which can be a sufficient proportion of unit labor costs, although not necessarily. It is logical to suppose that the higher a wage is, the higher unit labor costs will be, and consequently the goods will be more expensive, and vice versa. Here comes the question which factors define wages. This question, in fact, is even more complex. The size of wages depends on a number of factors varying from productivity of workers to the role and the relationship of labor unions with the government, and the government's policy towards labor market. Standard microeconomic theory identifies a clear link between wages and productivity. If the growth of wages in a country exceeds the growth of productivity, it will lead to the decrease in output and increase in unemployment, which will be the necessary conditions for the survival of a company. Accordingly, in order to maintain or increase output and employment wages must be kept in line with the rate of productivity growth. Conversely, the combination of the growth in productivity and moderate wage increases can stimulate output growth, and higher employment levels. This combination will result in the GDP growth, but also in lower unit labor costs, which are detrimental for the determination of price that will be lower, thus enhancing the competitiveness of a company or a state and keeping it safe from the current account deficits. Therefore, we can conclude that productivity, wages and unit labor costs are inextricably interconnected and can have a major effect on the competitiveness of a country.

Significant contribution to the evolution of modern theory of competitiveness of states has been made by Michael Porter in his study "The Competitive Advantage of Nations" published in 1990. His concept of **the "diamond of national advantage"** and the stages of development of competitive advantages have contributed to a qualitative leap in the method of calculating the level of international competitiveness, and provided the basis for the methods used by the World Economic Forum for classification of states according to their competitiveness.

The essence of Porter's thesis is that countries, like companies, compete in international markets for their fair share of the world markets. In his study, Porter does not ignore the quantitative factor, but goes further examining the sources of national advantage that drive up country's competitiveness. He repudiates the key assumption of the classical school that such criteria as factors of production, like labor, capital, or land, labor costs, interest and exchange rates, or the achievement of economies of scale determine competitiveness. Porter claims that in modern advanced economies with sophisticated industries **advantages can be created**, for instance a country can "raise" skilled labor force, and disadvantages can be turned into advantages. He uses Japan as good example, where the lack of land stimulated Japanese companies to create just-in-time production. He also rightly stresses that it is not only the factors that matter, but also the ability of a country to make use of them. For instance, a country can create good scientific base and have skilled labor able to create innovations, but does not offer sufficient funding or lacks production capacity to commercialize innovations, or there are strong institutional barriers; as a result, it cannot gain competitive advantage in particular industries.

The corner stone of Porter's theory of national competitiveness, however, is the ability and capacity of its industries to **innovate and upgrade**. By innovation Porter means not only technical inventions, but also new strategies, innovative labor management, marketing or use of ideas or concepts that were for some reasons disregarded. In his understanding of innovation Porter is very close to Schumpeter's views. Porter also makes one interesting observation: domestic rivalry can be a positive factor for increasing country's competitiveness, since they create pressure to innovate. Such factors as national values, culture, and historical development can also be additional factors to stimulate innovation.

Although Porter published his work more than 20 years ago, innovation factor is a relatively new factor in the theory of competitiveness. At the same time, this factor is the most dynamic, and its weight in the evaluation of national competitiveness is steadily reaching up to 30%. It is a logical consequence of the increasing number of "innovative" economies. Besides, it has already become obvious that competitive economies of today are the ones that have superior technology which allows them to produce more sophisticated products and services.

Porter does not exclude the involvement of the government. On the contrary, government can and should "intervene" by creating environment that will encourage innovation, and stimulating **domestic rivalry**. Government should encourage or finance research at universities that are connected with certain industries, and set strict product, safety, and environmental standards. This would again stimulate domestic competition, consumers' demands, and eventually lead to higher competitiveness through improved quality. This can also give domestic companies benefits, since quite often such tough regulations anticipate trends that will later spread internationally. Its role, however, should not be excessive or protective, as it is likely to undermine domestic competition and will not encourage change and innovation, especially in the long run. In Porter's view, deregulation of competition and pursuing of strong anti-trust policy would be the best option. (Porter 1990)

Basing on the factors mentioned above, Porter has created the so-called **"diamond of national advantage"** which represents four basic groups of factors determining the competitiveness of the economy. It consist of: factor conditions, such as skilled labor and infrastructure; demand conditions, such as sophistication of consumers; related and supporting industries, such as supplier companies and research institutions; firm strategy, structure and rivalry characterised by the nature of rivalry, institutional and legislative conditions for creating and managing a company etc. This "diamond" represents a system whose elements are mutually reinforcing, and thereby contributing to the improving competitiveness of companies and eventually of the whole country.

Another contribution of Porter into contemporary competition theory is the introduction of the **four stages of competitiveness** depending on the main driving factors behind it:

- stage of production factors;
- 2) stage of investment;
- 3) stage of innovation;
- 4) wealth.

Each stage is characterised by a different set of sources of competitive advantage of a company or a country. Growth of the competitiveness of national economy takes place during the first three stages, and is usually accompanied by the growth of national wealth. The fourth stage represents a gradual slowdown and eventually the decline of competitiveness.

At the first stage, basic factors of production, such as natural resources and unskilled labor, are the main source of the competitive advantage. Factor conditions of the “diamond” are the only ones utilized, while the others remain underdeveloped.

The second stage is driven by investments. At this stage, national competitive advantage is based on the willingness and the ability of the country and its companies to actively invest in technology. Usually this technology is bought from other countries, and is a generation behind the world leaders, since few companies or states would want to share their know-how with their competitors. However, at this stage, foreign technology and methods are not only utilized, but also improved. This ability to absorb and improve foreign technology represents the major distinction from the factor stage. Acute domestic competition in competitive industries forces companies to continuously invest in order to reduce costs, improve product quality, introduce new models, upgrade processes, and give preference to most skilled workers. At this stage national companies begin to establish their own distribution channels, as well as direct contacts with end-customers, and sell products under their own brands.

At the third stage, driven by innovation, the full “diamond” is activated in a variety of industries, and all the determinants of the “diamond” interact. This stage is called “innovation-driven” since companies not only adopt experience and technologies of other countries, but also create their own innovations. Factor conditions become a very rare source of the competitive advantage; meanwhile the lack of individual factors stimulates innovation, and the creation of new advanced and specialized factors and their continuous improvement. National companies at this stage compete internationally. They compete not only on price, but also on the basis of high productivity.

The fourth stage, driven by wealth, is the beginning of the decline. Its driving force - the wealth - is already achieved. It is characterised by a tendency to increase taxes on wealth, which eventually reduces incentives to invest in industry. Investment in financial assets becomes more common, and increasingly commonplace mergers and acquisitions of companies create the illusion of progress, which does not encourage new businesses, but very often slows down innovation even more. Visible signals that economy enters this stage appear slowly due to the inertia of established customer loyalty and still enough strong market position.

It should be mentioned that economic progress is not inevitable, and many countries for a variety of reasons cannot move from one stage to the other, or can “degrade” to a lower stage. Therefore, the enhancement of competitiveness requires constant attention and continuous effort.

Although Porter’s “diamond” and his stages of competitiveness have revolutionized the theory of national competitiveness and were translated by the WEF into a measured index, not all scholars support his concept, as well as the whole concept of competitiveness of a state. Among such critics is a world-famous economist Paul Krugman. Krugman does not believe in the concept of national **competitiveness,** and views it purely **as the replacement for the term “productivity”.** He denounced the belief that countries compete with each other as corporations do, claiming that major industrial countries are not only competitors, but also trade partners, and are each other’s export markets and main suppliers of useful imports. Although this is certainly true, it does not annihilate the fact that they are rivals competing for the market share in the global markets. Even though strong and competitive European economy is not necessarily bad news for the American economy, the growing number of strong actors, such as China and other developing Asian economies, significantly increases the competitive pressure. Besides, trade liberalization and competition regulation, also within the EU, leaves individual states exposed to the global competition without providing them any protection. In other words, in the contemporary world dominated by market economy each country stands for itself.

Although all major economic problems cannot be attributed solely to low competitiveness, Krugman’s claim that the quest for competitiveness can result in the declining standard of living does not stand the test of time. Modern notion of competitiveness, as it was already mentioned, includes, among other criteria, maintenance or even the increase of real incomes of citizens. Furthermore, one of the main sources of nation’s competitiveness must be derived not from the devaluation of its currency, but from the ability of its companies to create and apply innovations supported by government policy.

Krugman’s fears about the calamitous consequences of the “obsession” with competitiveness also seem groundless. Modern theory of competitiveness opposes the reinforcement of protectionism, and advocates for investment in the factors that would inevitably increase domestic productivity along with the enhancement of national competitiveness, which will allow avoiding “wasteful government spending”.

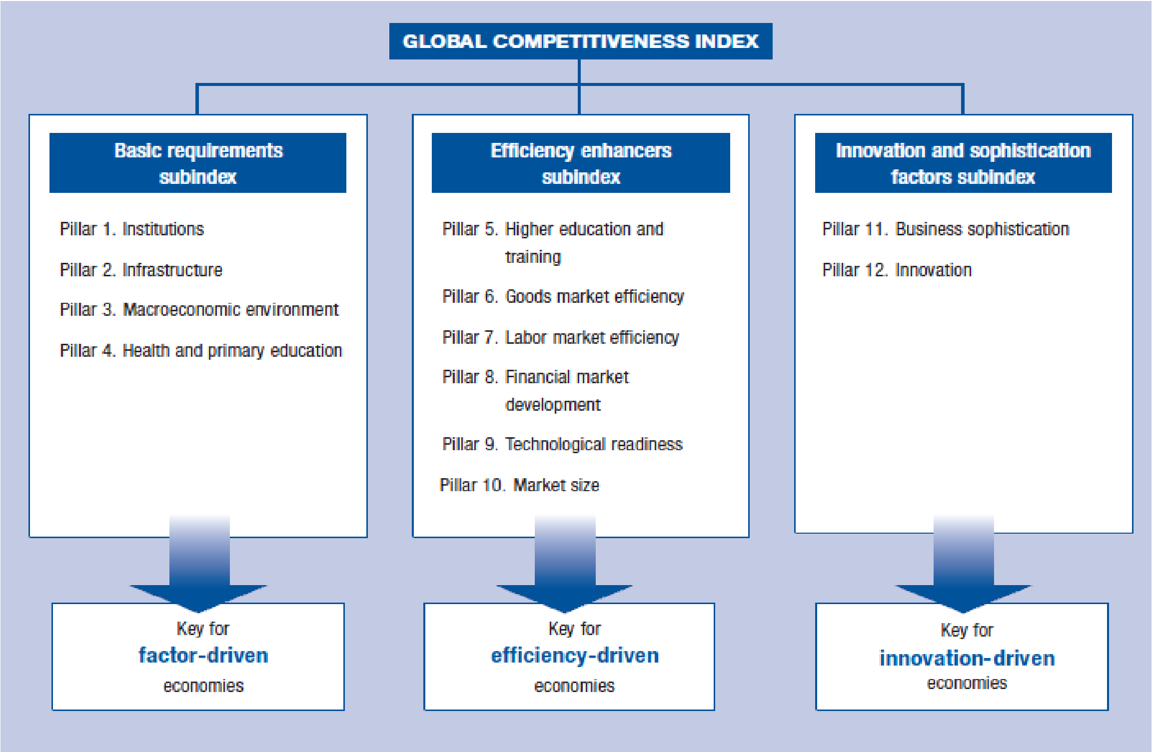
Since the analysis of the competitiveness will be conducted with the use of the research base of the World Economic Forum and its annual Global Competitiveness Report, it is worth mentioning their understanding of the notion and the methodology they use.

For more than three decades, the World Economic Forum has studied a variety of factors and indicators that define and underpin national competitiveness. The WEF defines national competitiveness “as the set of institutions, policies, and factors that determine the level of productivity of a country”. The level of productivity is critical since it determines returns on investment into economy, which is one of the key factors driving up economy’s growth and allowing sustaining a high level of income.

By now, annual Global Competitiveness Report covers more than 140 economies, and since 2005, the World Economic Forum has based its analysis on the Global Competitiveness Index (GCI), which is a comprehensive tool for measuring microeconomic and macroeconomic foundations of national competitiveness. The GCI is based on the 12 pillars, which measure different aspects of competitiveness. In their turn, they are comprised on the basis of multiple weighed economic, social, political and legislative indicators. Although each pillar is presented separately, they are not independent since a weakness in one area tends to reinforce weaknesses in the others. However, the reason behind presenting them separately is that it demonstrably shows which areas are lagging behind and require improvement.

For greater credibility, the GCI distributes countries over the three main stages of development of competitiveness also taking into consideration the level of GDP per capita and the share of commodity exports in total exports of the country. Basing on such classification, it attributes higher or lower relative weight to those pillars that are more or less relevant for a particular economy.

Figure 4. The Global Competitiveness Index Framework



Source: Global Competitiveness Report 2012-2013

Chapter 2. Imbalances before the crisis. The comparison of Germany, Finland, Sweden, Portugal, Spain and Greece

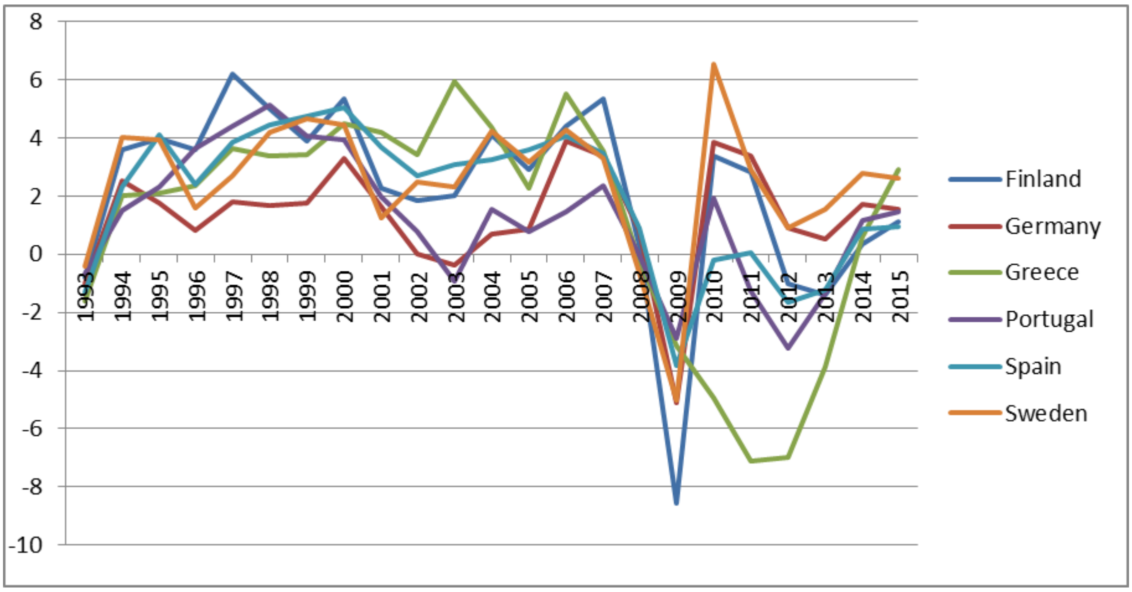
Until the outbreak of the financial crisis in Europe in 2008, that subsequently grew into a **sovereign debt crisis** in Southern Europe, the European Union was seen by its members and states outside the EU as a bulwark of economic prosperity, and elite club of developed economies. Portuguese, Greek and Spanish citizens regarded their membership in the European Union as a guarantee of democratic stability, and participation in the monetary union that was followed by the supply of **cheap credit** – as a way to secure their prosperity. However, with the beginning of a prolonged recession accompanied by unsustainable debt accumulation, these perceptions changed drastically. The “winners” and the “losers” started to point fingers at each other, each party blaming the other. It is clear that such tactic is leading nowhere at best, and to the disintegration of the Euro-zone and/or the EU at worst. Therefore, instead of tackling the immediate causes of the crisis, such high public deficits and debt, there is the need to analyze and address the deep-seated reasons of the crisis, and implement structural reforms oriented at producing long-term growth and convergence.

The analysis will be conducted on the example and the comparison of the six EU members, three among the best performing - Germany, Sweden, Finland, and three main debtor states – Portugal, Spain and Greece. I will analyze the reasons for the success/setback of a respective state, and the conclusions made will serve as the base for further analysis and recommendations on the resolution of the crisis in the concluding chapter.

Over the last ten years, Germany has become one of the major world exporters that also allowed it to enter the top ten of the biggest world economies[3], and become the biggest one in the European Union. Germany also managed to preserve relative stability and growth during the crisis, and according to the estimates, Germany’s GDP growth is going to reach the mark of 1.9% in 2014 (Figure 5). It also became the country that took leadership in dragging indebted European states out of the crisis. Nevertheless, instead of gratitude it has received wide criticism for its selfish view of trade imbalances, neo-mercantilist policy, cheap labor, and the imposition of austerity on the Euro-zone countries marred by high sovereign debt.

[3] The Global Competitiveness Report 2011-2012

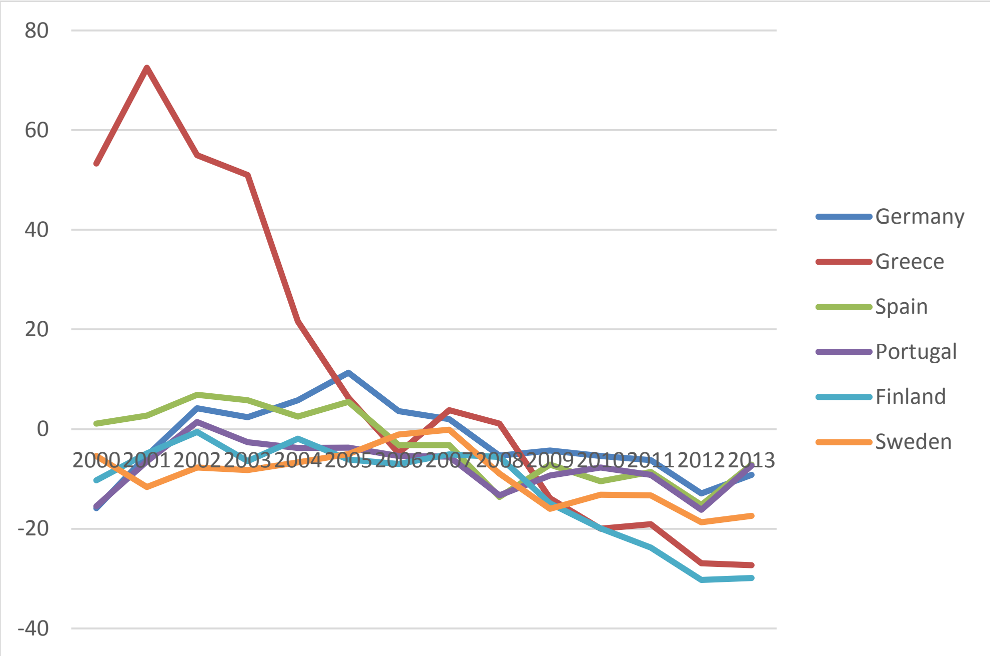
Figure 5. GDP growth, %



Source: IMF World Outlook 2014

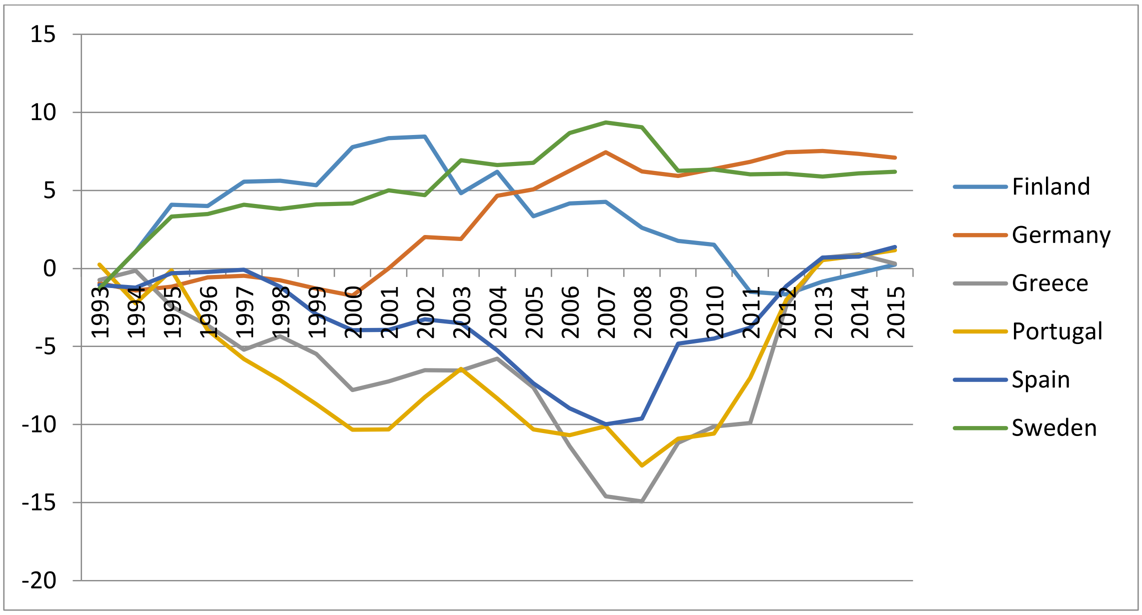
For several years, Germany was the world leader in **export** in absolute monetary terms, benefitting from the introduction of the single currency. German exports of total goods and services, including those to other European nations, were steadily rising from 2000 until 2005, and experienced a mild reduction, regaining growth in 2013. Greece's share in the world exports, on the contrary, fell dramatically in 2001 and despite slight recovery in 2006-2008, continued to shrink amid the sovereign debt crisis. It is important to stress that Greece experienced the bigger reduction of its export share before and not after the crisis, signaling that the problem had already been there for a number of years. Portugal, Spain, Sweden and Finland generally followed the German trend prior the crisis. (Figure 6) However, Spain and Portugal also continued to accumulate **current account deficits**, restoring positive trend only after the outbreak of the crisis. (Figure 7) Meanwhile, Sweden was benefitting from the favorable **exchange rate** of its local currency, krona, to the Euro, and for a period of 2003-2009 outran even Germany in terms of surpluses. Although Finnish CAB was steadily declining, thanks to the moderate growth of **labor costs**, it managed to retain surpluses until 2010. Such developments have resulted in the deepening of imbalances within the EU and the Euro-zone, with Germany, Sweden and Finland accumulating large surpluses, and Spain, Portugal and Greece running current account deficits. (Figure 7)

Figure 6. Share of world exports, % change



Source: Eurostat

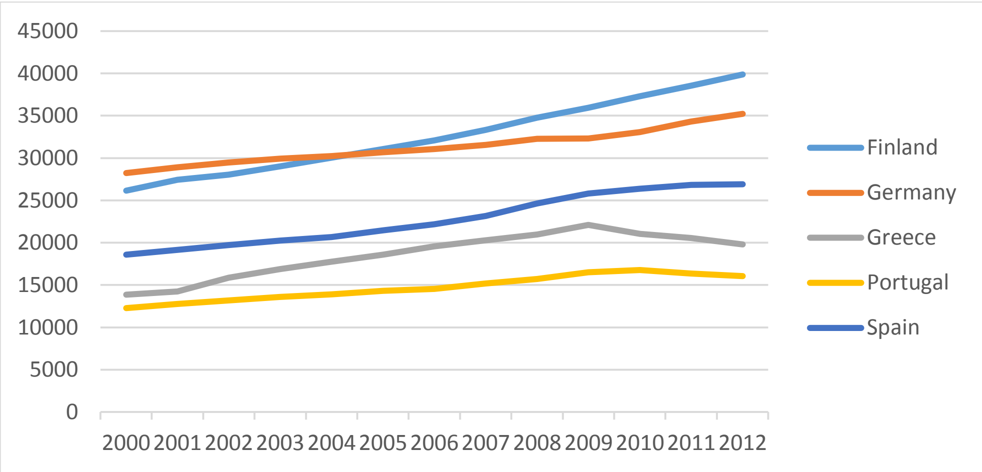
Figure 7. Current account balance, % to GDP



Source: IMF World Economic Outlook Databese, April 2014

One of the main reasons that allowed Germany to run **trade surpluses** and support its **competitiveness** is lower prices of German goods achieved through **wage moderation**. From 2000 to 2008, wages in Germany grew by around 14%, while in Finland this indicator grew by around 35%, in Spain – 39%, in Portugal – 23%, in Greece – 50%. (Figure 8) Important factor is that wages in Germany were growing more or less in line with labor productivity that did not experience drastic change from 2000 until 2006, while in other Euro-zone nations, wages growth did not go in line with **labor productivity**, or in other words were unjustified. (Figures 8, 9), Despite the fact that labor productivity in Greece has been rising faster than in Germany, and Portugal generally did not lag behind the EU giant, German workers still remain more productive, which indicates that these countries had a lower starting point upon their accession to the **monetary union**.

Figure 8. Average annual wages, national currency unit



Source: OECD Database

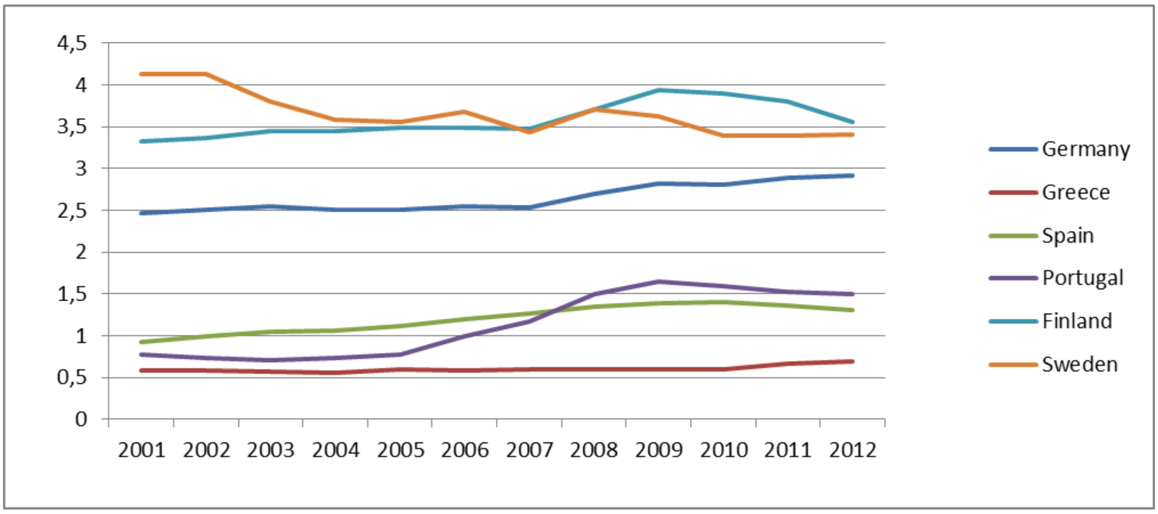
Figure 9. Labor productivity, % change

Source: Eurostat

However, Germany became a leading exporter not only because of its wage policies. This claim can be supported by the fact that Germany, along with Sweden and Finland, is among the most competitive countries in the world not only in terms of prices, but also in terms of **innovation**, which explains why German workers can produce more goods in less time, and of better **quality**. Germany's economy is truly innovative, since German companies are among the most innovative in the world, which is achieved through heavy spending on **research and development**, and the country's well-developed ability to absorb the latest technologies at the firm level. Higher productivity is also supported by **high-quality infrastructure**, and the **sophistication of its business sector**. Another significant factor is intense local competition and low market dominance by large companies. It is important for the stimulation of productivity and the enhancement of Germany's international competitiveness, since German companies constantly have to face **high domestic competition**, and find ways to increase their efficiency, reduce costs or/and produce innovative goods/services that can be consumed within or outside the country. With Sweden and Finland the picture is more or less the same. Both countries are also highly innovative, with Sweden being one of the world's **leading innovators**. Both countries can boast sophisticated business culture, efficient goods and financial markets, high-quality public institutions and a high level of technological readiness. (GCR 2012-2013/2013-2014)

However, we have a dramatically different picture, if we look at the countries representing southern periphery, Spain, Portugal and Greece. These countries lag behind their northern neighbors in terms of productivity due to their **lower levels of innovativeness**. Lower levels if investment in research and development (Figure 10) hinder the growth of productivity and continue to hold back the capacity of their local companies to innovate, and therefore compete successfully with cheaper high-quality German, Finnish and Swedish goods. (GCR 2013, pp. 26-28) In such case an option for these countries could be to specialize in their **traditional industries**, such as textiles, shoe production or agriculture, however, the increased competitive pressure from the **developing countries**, especially China, has significantly limited their market share in these industries, beating them in terms of price. The sovereign debt crisis has put an even greater strain on the ability of these countries to increase productivity, since all of them lost access to cheap credit and were offered **financial assistance** from the Troika in return for spending cuts, and austerity that further depressed investment.

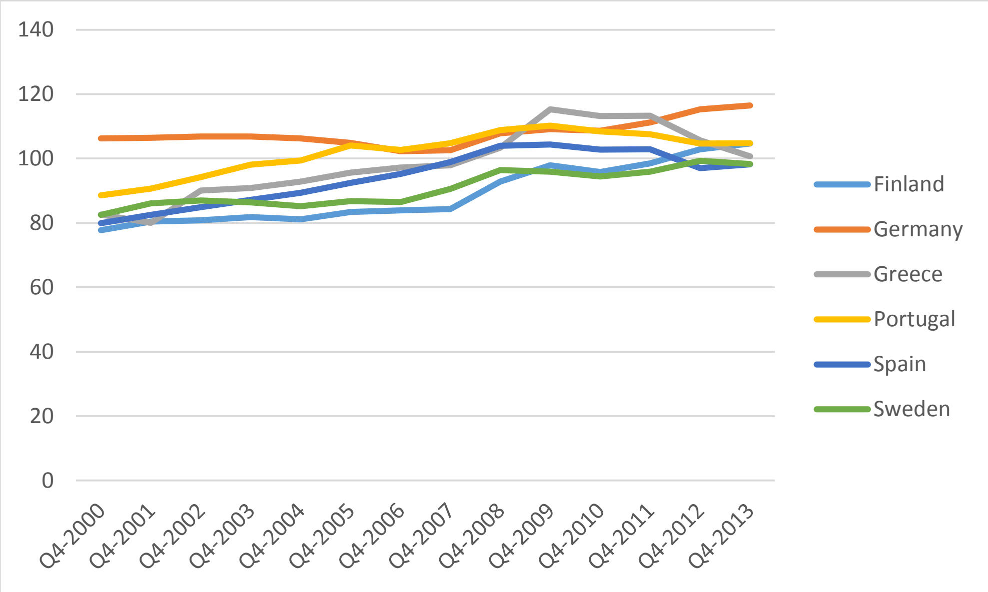
Figure 10. Investment in research and development, % of GDP



Source: Eurostat

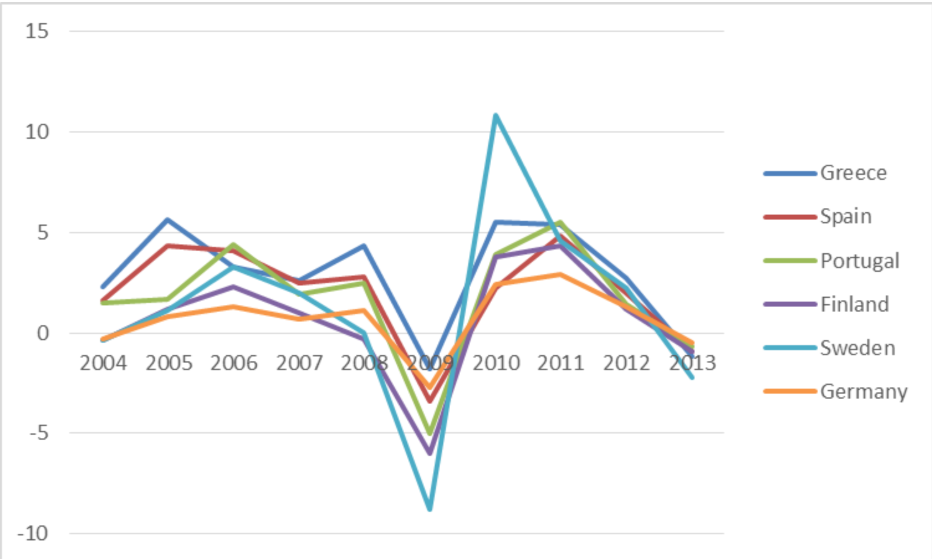
High productivity of German workers combined with **wage moderation** has resulted in that **unit labor costs** in Germany were practically not changing prior the crisis, and even fell slightly in 2005, thus remaining among the lowest in the Euro-zone. At the same time, unit labor costs in Spain, Portugal and Spain were steadily growing, with Greece taking the "first place" among the six countries in 2008. (Figure 11) The result was that German, Swedish and Finnish **exports value** growth was lower, than that of Spain, Portugal and Greece. (Figure 12) Therefore, prior the crisis Spanish, Portuguese and Greek goods continued to lose competitiveness, thus fuelling German, Swedish and Finnish exports within and outside the Euro-zone. As a result, Germany and Finland have been gaining from the **single currency** in the Euro-zone, and Sweden – from its lower-value **local currency**. All the three northern states were "outplaying" southern states in terms of exports value through greater productivity, but still the case of Germany with its high productivity, but low wages stands out.

Figure 11. Unit labor costs, % change, 2010=100 index



Source: OECD Database

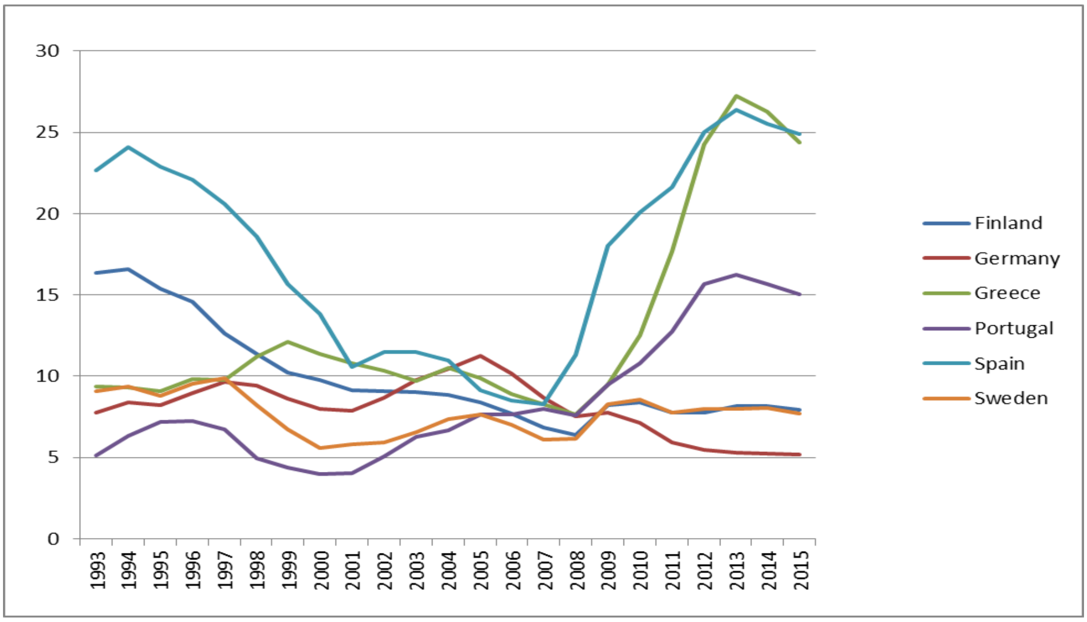
Figure 12. Price index (exports of goods and services), % change on previous period



Source: Eurostat

It was a combination of factors that led German labour unions to accept modest wage increases during 2000-2008. (Figure 8) Firstly, steep economic growth and **rising unemployment** during 2000-2005 (Figure 13) raised fears of job layoffs. It was accompanied by the reforms that reduced unemployment benefits,[4] which encouraged people to accept **lower-paid jobs**, and made German **labour unions** accept modest wage increases in exchange for job security. This, in turn, led to the increased reliance of German enterprises on **part-time workers**, and the **outsourcing** of a large part of the production to Eastern Europe.[5] Employing part-time workers brought double benefit to German employers. Outsourcing to less developed countries reduced the cost of labor, and employing more part-time workers decreased social security contributions made by employers.

Figure 13. Unemployment, % change



Source: IMF World Economic Outlook Database, April 2014

It should be mentioned that, although for now Germany is doing great compared to other Euro-zone members, the stable excess of exports over imports has attracted criticism not only from outside but also from within Germany as German economists also see danger in the stable surpluses. Pumping of exports by artificial wage restraints and through massive lending to foreign consumers leads only to short-term growth, whereas in the longer term it will lead to the impoverishment of the German population, and severe financial and economic difficulties in the neighboring economies, which is already happening. If Germany continues to increase its market share within the Union, especially on the market of industrial goods, in the end it will have to

[4] OECD Employment Outlook, 2005

[5] ‘Enlargement: The New Face of the EU’ by The European Association of Craft, Small and Medium-sized Enterprises

credit its neighbors so that they could pay for German exports. Germany's aggressive exporting to these countries generally weakens their economies, and again arises the need to support the weaker states, especially in the times of crises, within the framework of European mutual assistance mechanisms. Germany will have to carry the financial burden of the Euro-zone, however, the prospects of taking it down will become more and more dim.

It can be concluded that Germany's, Sweden's and Finland surpluses, and deficits of the southern European states are interconnected. Germany has managed to accumulate current account surpluses by enhancing its competitiveness by reducing labor costs through high productivity and wage moderation. Sweden has benefitted from a **low exchange rate** of krona and high level of innovation of its economy, and Finland managed to stay afloat also thanks to its innovation potential and moderate unit labor costs relative to southern states.

Although productivity in southern states, especially in Greece, was growing more than in Germany, the growth of wages in these countries still outran the growth of productivity, which resulted in higher unit labor costs and prices as a consequence compared to Germany, Finland or Sweden. This is a clear indicator that these economies were initially much weaker than that of Germany, Finland or Sweden, and that the decision to join the Euro-zone might have been premature, since by adhering to the monetary union the states have deprived themselves of the possibility to restore competitiveness by **devaluating** their currencies.

The experience of Sweden and Finland deserves separate examination, since in the early 1990s they already contracted a similar crisis, although on a much smaller scale. The so-called **Nordic crisis** of the early 1990s was the first systemic crisis in industrialized countries since the 1930s, not counting the banking problems directly related to World War II. Certainly, that crisis cannot be compared with the current crisis in terms of complexity, geographical coverage and multidimensionality, however, there are a lot of similarities, and some of the answers to the current crisis can be found in the Swedish, and to a lesser extent in the Finnish experience in the overcoming of that crisis. (Ingves, Lind 2008)

In the early 1990s, Sweden and Finland experienced a deep **financial and real estate crisis** accompanied by **escalating unemployment**, huge deficits, and a sudden **loss of market confidence** that raised the cost of **sovereign borrowing**. The crisis of 1990s strongly resembles the situation in Ireland and Spain, which has led these countries to economic downturn, high unemployment and sovereign debt crisis.

The Swedish crisis originated in the **banking sector**. **Financial deregulation** in 1980s removed the lending ceiling of the commercial banks, which contributed to the **expansion of**

credits, and led to the credit boom, fuelled by **rising inflation and tax system** that favoured borrowing. Before the liberalization of the Swedish credit market, legislation forced banks to allocate a substantial share of their resources to fund **housing** and other real estate projects. De facto public guarantees were provided for **mortgage loans** and for investment in residential real estate, similar to those of the U.S. mortgage giants Fannie Mae and Freddie Mac. Consequently, prices in real estate and financial assets increased which generated a **speculative bubble** that burst in 1991 and entailed a real estate crisis. Huge credit losses and non-performing loans, in turn, resulted in the banking crisis. (Franke 2009) Compared with the current crisis, the Swedish crisis was more of a "pure" credit crisis in its nature, however, its speedy recovery indicates that there are a few lessons that can be learned, and applied by Euro-zone countries struck by the 2008 crisis. (Ingves, Lind 2008)

Firstly, strong fiscal tightening was implemented to regain **fiscal sustainability** and market confidence. Sweden reduced **public expenditures** by 20% of its GDP, slashing social transfers such as unemployment benefits and sick-leave compensation, therefore managing to cut its public debt in half. Furthermore, all handouts, including disability benefits, have not only become less generous, but also more short-lived and harder to qualify for. Nevertheless, Swedish government did not opt for "pure" **austerity**, which would have led only to the severance of the crisis, as it has been reflected in the theoretical part of the paper. On the contrary, Sweden has cut **taxes on labor**, especially for the low-skilled. The combination of lower taxes and fewer benefits did not only help to reduce the public debt, and secure larger funds for the support of the affected banking sector and companies, but also encouraged employment which prevented the growth of inequality and the outbreak of social unrest. In addition, the Swedish government also adopted **macroeconomic and structural reforms** to enhance efficiency of the public sector by privatizing many of the educational and medical services. For instance, now many schools in Sweden are independently run, and in health care private management is becoming more and more common. As the consequence, these structural reforms have raised Sweden's competitiveness, long-term growth rates, and real wages.[6]

Another important step in stabilizing financial sector was to restore confidence in the financial system by enforcing greater **transparency**. The government forced the banks to disclose their true financial situation. Another critical measure was that the Swedish government provided an unlimited guarantee of bank deposits and liabilities. This combination helped quickly restore confidence in the Swedish banks both from domestic and from foreign depositors in the form of

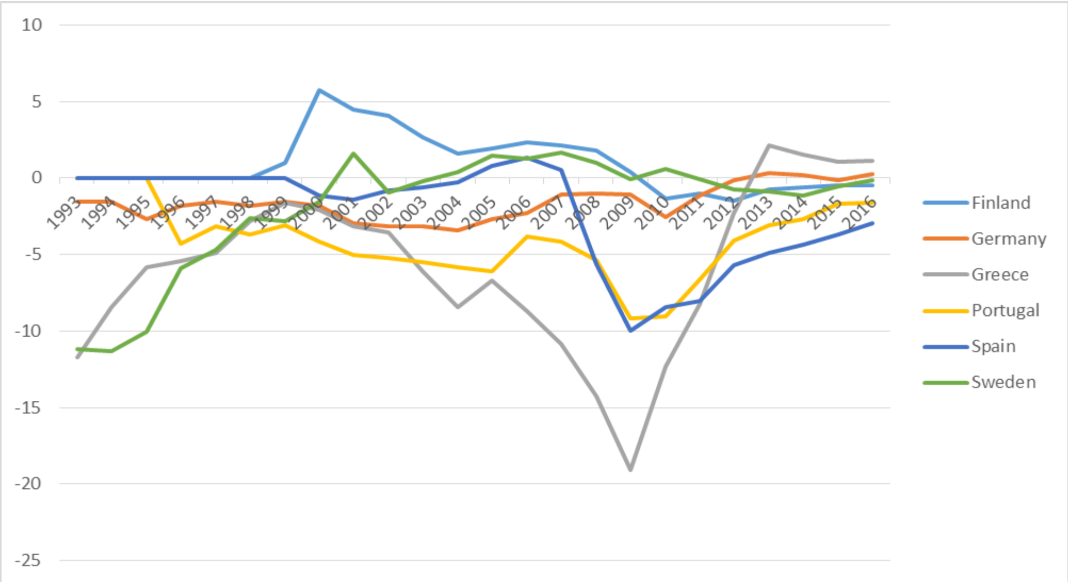
[6] *The Economist* 'The new model: A bit more unequal, a lot more efficient' (October 2012)

renewed interbank credit lines with foreign banks, and the country did not experience abrupt capital outflows, as some European countries today, such as Ireland, Spain and Greece.

Political consensus was also an important precondition for the imposition of such measures. In Sweden, all main political parties agreed on the framework for the crisis resolution, and furthermore, the government also managed to get the tacit consent of the Swedish population by conducting transparent and reasonable policies in crisis management. (Franke 2009)

It should be noted that, although government intervention and political consent played an important role in the overcoming of the 1990s crisis, the implementation of these measures would not have been possible without the weighed fiscal policies that go in line with the findings in the theoretical part. The government allowed budget surpluses to accumulate during the run-up to the crisis and huge deficits to develop during the crisis. Since 2006, the Swedish government have introduced another series of tax cuts and the reduction of unemployment and sick leave benefits as it was doing throughout the 1990s. (IMF Country Report: Sweden, 2013, p.44) These reforms have insured a general government surplus averaging above 1% since 2006. (Figure 14) Budgetary surplus before the outbreak of the crisis gave the Swedish government room for maneuver in tackling the crisis allowing it not to impose severe fiscal tightening that could have had devastating consequences for the economy. All this contributed to a relatively rapid recovery and significantly decreased the costs for the taxpayers.

Figure 14. Budget balance, % of GDP



Source: IMF World Economic Outlook Database, April 2014

The **depreciation** of the Swedish krona was also an important driving force behind the recovery which started in 1993. The depreciation contributed to the increase of competitiveness of Swedish exports which have become the engine of the Swedish economy. Between 1992 and 2008, exports roughly doubled as a share of GDP. (Jonung 2009) This stable growth have resulted in the steady increase of a **current account surplus** allowing Sweden to reduce the volume of foreign debt held by the public and private sectors. The exposure to international competition, in its turn, helped Sweden to create a long-lasting competitive advantage, and resulted in the increased productivity and the rise of Sweden as an innovation-driven country.

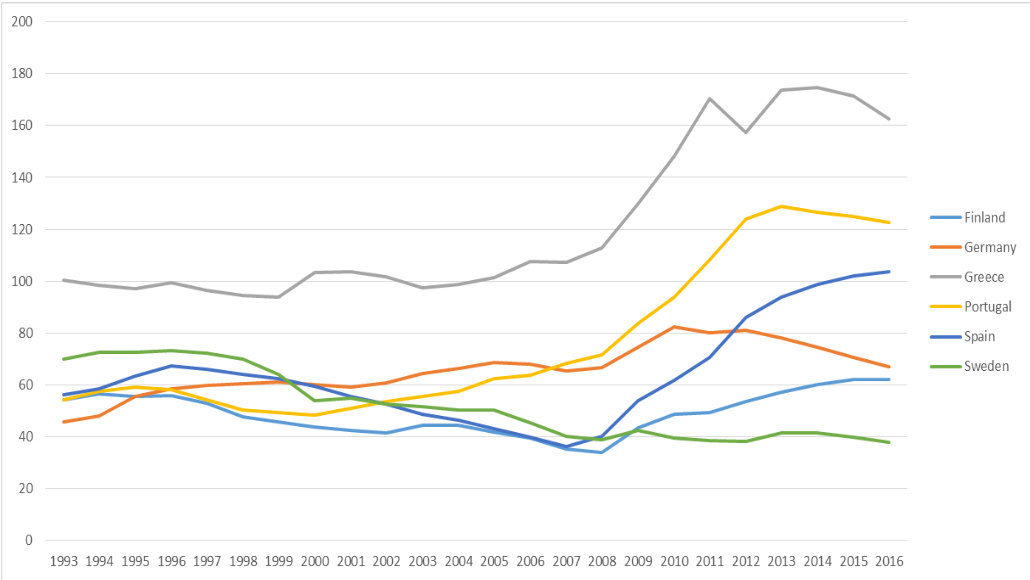
In order to ensure future financial stability the Swedish government also introduced the so-called **Covered Bonds** in 2004. Covered bonds, unlike traditional bonds, assure that a bondholder has a claim both on the issuer and on the specially selected collateral in cover pool. Besides, covered bonds are regulated by the state law, and not just by an agreement between an issuer and a holder. Furthermore, cover pool is dynamic, which means that bad assets must be removed timely, while new assets must be added. At the same time, issuing of covered bonds prevents the potential growth of a credit bubble by encouraging issuers to give preference to less risky loans as credit risks remain on the balance sheet of the issuer. (IMF Country Report: Sweden, 2013, p.38)

The crisis in Finland was basically a **twin crisis**, invoked by the similar reasons. Finland's recovery was also greatly supported by the depreciation of the markka (Finland's former national currency), and strong growth in productivity, as well as wage cuts agreed upon by the government and labor market parties and supported by tax reductions. As a result, the volume of Finnish exports in 2000 more than doubled compared to the pre-crisis level. This led to the strong improvement in the current account, which went quickly from a deficit to a surplus of 6% (Figure 14).

Finland has also succeeded in **restructuring** its resource-based economy dominated by heavy industries, and switched to innovation-led economic growth, mostly focusing on the ICT industries. Inefficient companies were closed, and labor shifted to the more productive enterprises. Productivity growth was supported by public and private **investment in R&D**, machinery and equipment, as well as training and education. As the result of these efforts, Finland's Nokia Group became the world's biggest manufacturer of mobile phones in 2000. (Jonung, Kiander, Vartia 2008)

Although both countries have contracted similar crises, and implemented similar measures, initially Finland was doing better than Sweden. However, in 2008-2009 Finland experienced a much sharper recession, with GDP falling by 8%. (Figure 5) Finland's recovery has also been less speedy. During the crisis Sweden also continued to run a current account surplus, whereas Finland slithered into deficit in 2011 for the first time since 1993 (Figure 7), and its public debt is now higher than the Swedish one, although it used to be lower before the crisis (Figure 15). The reason for that is that Finnish competitiveness have been declining. Despite unit labor costs were growing not as rapidly, as in southern states, their growth was still outpacing the German ones, and in the end Finland also fell victim to German wage policies. One of its main competitors, Sweden, has also been putting Finland under competitive pressure, especially after its currency weakened after 2008. Therefore, even for Finland the costs of the monetary union turned out to be not that low.

Figure 15. Government gross debt, % of GDP



Source: IMF World Economic Outlook Database, April 2014

The situation is also severed by a rapidly **ageing population**, which puts significant pressure on the budget, and consequently on the taxpayers, who have to limit their **consumption**, thus leading to the **decline in output**. Since this trend was not followed by wage reduction or, at least, slower growth of wages, Finnish goods also started losing in competitiveness to Germany and Sweden. Another factor is the shrinking of the Nokia, Finnish economic giant that once was a leader in mobile phones manufacturing. According to the Research Institute of the Finnish Economy, from 1998 to 2007 Nokia was contributing up to a quarter of Finnish growth.[7] Now, its share of Finnish GDP has significantly shriveled, and the completion of the sale of its subsidiaries engaged in the production of mobile phones to the U.S. Microsoft scheduled for April, will reduce

[7] The Economist, 'Finland's fortunes are affected by one firm. What about other countries?' , August 2012

Nokia's share even more, which contributes to the decline in output and slower GDP recovery during the crisis.

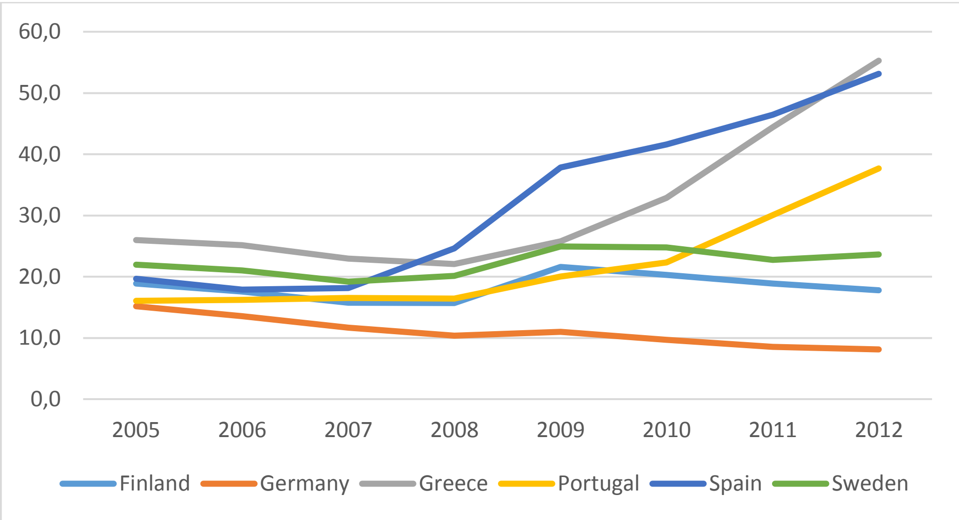
The experience of these two states can be very helpful for Spain, which has contracted similar problems after the abrupt stop of the **housing boom** and related banking problem. Spain used to be a telling story of economic success upon its accession to the European Union. It continued to flourish after the adoption of Euro as well. It could boast high economic growth, and right before the outbreak of the crisis, in 2007, became one the fastest growing in the Eurozone - 3,8% (Figure 5). The driving forces behind Spain's economic success were the liberalization of economy, and the diminishing role of the state; inflow of foreign investment; tourism boom and a building boom that had led to the formation of a property bubble that eventually crashed, and dragged Spanish economy into prolonged recession.

In fact, the **inflow of cheap foreign capital** largely contributed to expansive housing construction and consequent **mortgage lending**. The share of the construction industry in Spanish GDP reached the mark of 16% in 2007. Between 1996 and 2007, Spanish property prices almost tripled.[8] This situation strongly resembles the 1990s in Sweden and Finland, however, the situation for Spain was even more dangerous, since both Nordic states had the benefit of their local currencies, which they could devaluate, as they had done. Even before the burst of the housing bubble, economists repeatedly warned about the inadmissibility of such one-sided development of the economy, and stressed the need to diversify the economy, especially in the view of the declining traditional industries such as shoe industry and agriculture, and the growing competitive pressure in industrial sector from other European countries and China. Besides, the construction boom pushed up **wages**, and during the boom years, **unit labor costs** in Spain rose by around 22%, precede only by Greece. (Figure 11) This resulted in the increase of value of Spanish exports, consequently leading to the loss of competitiveness.

When the property bubble crushed, hundreds of thousands of people found themselves out of work. The **unemployment** level spiked to almost 14% by the end of 2008, and during 2009, the unemployment rate in the Spanish economy reached a record high of 18.1%, crossing out government's successful efforts to reduce the unemployment that had fallen to only 8% in 2007. The level of youth unemployment also became unprecedented, breaking the 50% mark in 2011. (Figure 13, 16)

[8] Knight 'Spanish Economy: What Is to Blame for Its Problems?', May 2012 for BBC News Business

Figure 16. Youth uemployment, %



Source: OECD

If Spain had looked at the experience of Sweden and Finland, it could have found some remedies that could have made the recession less painful and contain rapidly rising unemployment. Such measures as cutting unemployment benefits and other social transfers, and cutting taxes for low-paid jobs would have stimulated employment, and secured larger funds for the support of the affected banking sector and companies. However, such measures were hard to implement without conducting reforms of the labor market. **Rigid labor market** regulations forced employers to reduce working staff and cut-down hiring, instead of cutting their wages, and overly generous unemployment benefits, as well as their "accessibility" and "duration", were a contributing factor. Thus, the postponed liberalization of the labor market resulted in the **unresponsiveness of wages** to high unemployment levels and recession, consequently affecting the country's competitiveness.

Unlike Spain, Portugal did not go through the burst of the property bubble. In fact, Portugal used to be one of the fastest-growing countries in the world, and in the decade following Portugal's accession to the European Free Trade Association, its income per capita nearly doubled. The years after joining the European Community in 1986 were also marked by steady growth. (Reis 2013, p.

145) However, the start of the monetary union and the adoption of Euro opened a new chapter in Portugal's economic history.

The period of the fast growth turned out to be short-lived, and was followed by an abrupt and prolonged **recession** since 2000. In the mid-2000s, economic growth was marked with some improvement, which was again followed by a recession with the outbreak of the crisis. (Figure 5) At the same time, the amount of exports was slightly, but steadily declining, and throughout the second half of the 1990s and the 2000s the country was steadily accumulating **current account deficits** with a record low of -18% to GDP in 2008. (Figure 7) At it was already discussed, its unit labor costs were steadily rising, and by 2008 it had risen by 18%, meanwhile Germany experienced a 5% decline in this indicator. (Figure 11). The productivity was low, but the wages continued to rise, and its competitiveness was declining. The Euro made Portugal too expensive, and crossed out its advantage of being a relatively cheap European country, attracting tourists from all over the world. As Spain, Portugal could not compete with relatively cheap and high-quality goods. However, there is one more explanation.

Portuguese economy was also crumbling because it has failed to adapt to the **new realities of the global economy** and implement timely structural reforms. Until now, textile, tailoring and shoe industries remain the key industries in Portugal. However, the outsourcing of production by more developed countries to "cheap" Eastern Europe and China's accession to the World Trade Organization have adversely affected Portugal's textile and shoe industries.

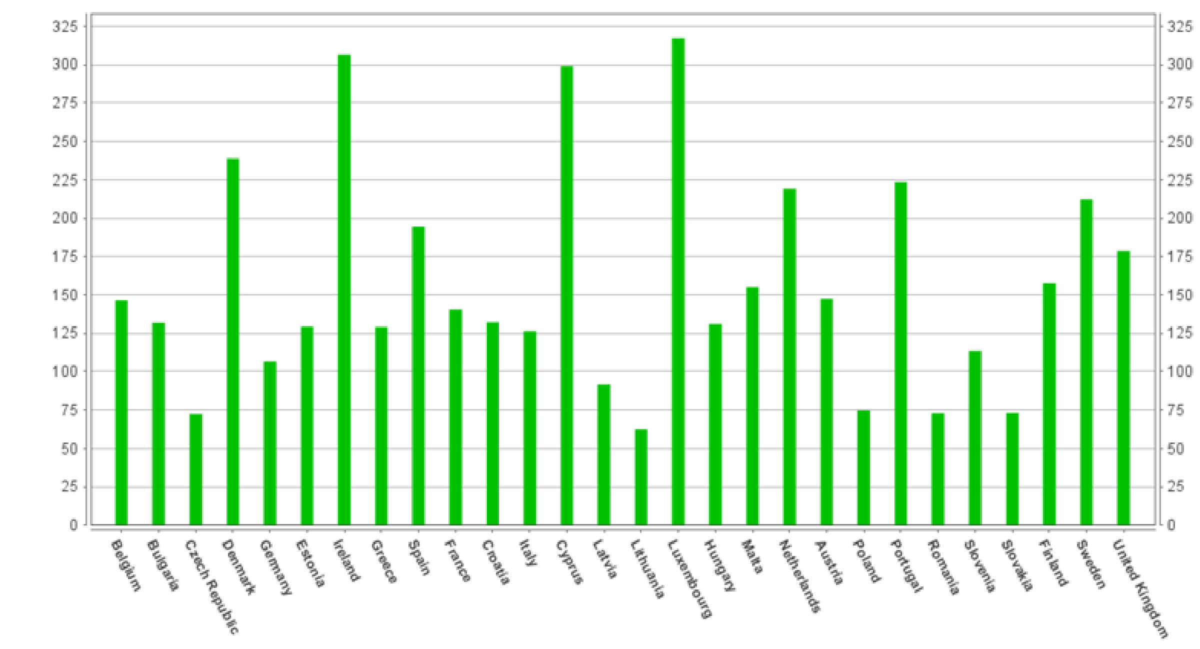
This, together with the soaring oil prices, resulted in the ever growing current account deficit (Figure 7) which forced the country to constantly increase borrowing. The decline of these industries and the rigidity of the Portuguese labor market also contributed to the growing unemployment in the country, which also affected domestic consumption. Consequently, this combination of factors has led to a **sharp drop in tax revenues** and the expansion of the budget deficit and public debt. (Figures 14, 15)

The reasons that put Greece on the brink of financial catastrophe, i.e. bankruptcy, and raised the question of Greece leaving the Euro-zone, are even more complex and multiple than those of Spain and Portugal. Greece was running **current account deficits** for a number of years, hitting the bottom low in 2008. (Figure 7) The declining world export share has long been a cause of worry for the Greek economy. Thus, the economy had to rely on tourism, loans from the EU as well as remittances from expatriates for filling the gap. Opening its market and adopting Euro as its currency despite positive expectations only worsened the situation making Greek goods more expensive and therefore less competitive. In eight years forestalling the crisis, **unit labor costs** in the country had grown by around 38%, which is the biggest increase among the six. (Figure 11)

As in the case of Spain and Portugal, it led to the increasing value of Greek goods and services, which were losing the competition to Germany, Finland and Sweden for a number of years before the outbreak of the crisis. (Higgins, Klitgaard 2010)

However, it is only one side of the coin. Another factor that has led to the outbreak of the sovereign debt crisis was that the Greek government was regularly blinding the real state of affairs tampering with financial statistics. In fact, the situation in Greece has triggered the crisis that later spilled on the territory of the rest of Southern Europe, namely when the story about financial fraud at of the Prime Minister Papandreou office came out. Greece is only states (among the states of the Southern Europe), whose government profligacy can be blamed for the painful situation the country is experiencing. Meanwhile in Spain and Portugal the excessive budget deficit and government debt was accumulated after the outbreak of the crisis and due to the absorption of the private debt, the private debt of Greek population equaled 125% of GDP, which is significantly smaller than the same indicator in Spain and Portugal (well above 200% in 2012). (Figure 17)

Figure 17. Private debt, % of GDP, 2012



Source: Eurostat

When the real state of government finances in Greece came out, it led investors to believe that Greece would not be able to repay interest on loans, which led to the rapid expansion of spreads on long-term government bonds. (Figure 18) However, it is a big question whether their fears were justified. If during the pre-crisis years the markets underestimated the risks, believing that Euro would secure their investments no matter what country they were invested in, at that time they were overreacting. (Lisin, Shurakov , 2011) Unfortunately, this tendency was quick to spill to the other countries of the Euro-zone periphery, Spain and Portugal, which also started experiencing liquidity problems.

Figure 18. European Bond Spreads, basis points, 10-year bond spread to German bonds

Source: The Economist. Available at: http://www.economist.com/blogs/freeexchange/2010/04/sovereign_debt

For several years prior 2010, Greece, along with other states of Southern Europe, engaged in heavy borrowing from foreign private investors. (Figure 19) Borrowing was facilitated by low interest rates, which were offered to Greece upon its accession to the Monetary Union. (Figure 20) Once Greece introduced Euro, investors gained confidence in the Greek economy, since there was no risk of Greece depreciating its currency; therefore, Greek bonds were seen practically as safe as any other European bonds. However, when it became clear that Greek budget deficit was far larger than previously thought, investors raised concerns about the ability of Greece's to pay back its debt, and responded by demanding much higher yields on Greek bonds. Although this was the moment when the sovereign debt crisis took off, the build-up had been formed much earlier.

Already by 2007, the Greek debt had reached the mark above 100% of the GDP.(Figure 15) The budget deficit in 2009 reached a record high -18% of the GDP. (Figure 14) Greece was forced to constantly make new debt, reaching the point when it became unsustainable, and the country had no other choice, but ask for help. The inability to service its debt had led to a decrease of its credit rating to BB+ and financial markets started to demand double or even triple interest rates compared to 2007-2008, making borrowing extremely costly for Greece, and thus pushing the country into a deeper debt pit and further recession.

Already by the end of 2010, spreads on newly issued 10-year Greek government bonds reached a 9% mark. Interest rates on Portuguese bonds rose to 7%, on Spanish - 5-6%, whereas interest rates on German bonds did not exceed 3 %. (European Commission 2012, p. 14) Therefore, these countries have experienced an abrupt outflow of investment, and could not continue borrowing at such high rates. Since the debt of Greece was already huge, and its budget deficit well below the Maastricht criteria, it had no other option but to turn for financial assistance.

A little bit later, in January 2011 Portugal was recommended to turn for financial support to the European Union. Although the Portuguese government was trying to resist and cope with the situation on its own, after the reduction of its credit rating Lisbon had to accept financial assistance from the EU.

However, there is one more significant factor that explains the outbreak of the crisis on the territory of the Euro-zone. The crisis in the EU and the Euro-zone broke out in 2009, and was preceded by the mortgage crisis that broke out on the territory of the US. The crisis in the US started with the collapse of the “Lehman Brothers”, and the largest US mortgage agencies “Fannie Mae” and “Freddie Mac” had to be taken under state control, which marked the beginning of the global systemic crisis. The turmoil on the US financial markets was then broadcast on the European Union through the financial markets. American banks, that found themselves in a difficult situation, refused to give loans to its European partners. The exhaustion of financial channels had a devastating effect on the European banking sector, and European banks, faced with the lack of liquidity, began to increase liabilities and limit the growth of assets. This led to the sharp drop in the volume of interbank loans in the Euro area, and from mid- 2008 to mid- 2010 this volume fell by 106 billion Euros. (Allen, Moessner, 2012) Furthermore, the crisis in Europe turned out to be deeper and more prolonged, than in the US, since banks in Europe are the main source of finance, whereas in the US this role is played by the stock market. Therefore, the mortgage crisis in the US was a trigger and a contributing factor to the crisis in the Euro-zone.

Summing up the evidence, it can be concluded that the accumulation of the **current account deficits** in southern states of the Euro-zone was due to the **declining competitiveness**, caused by a number of interrelated factors. Spain, Greece and Portugal were lagging behind the northern European states in terms of **productivity**, and, upon joining the EMU, could not hold the competition with strong **innovative economies**, where much higher **investment in research and development** ensured their greater productivity. The growth of wages in the South did not go in line with the productivity of their labor, and this situation persisted for a number of years due to the **inflexibility of their labor markets**, in the end resulting in **soaring unemployment**. Thus, **exports value** of these countries exceeded this indicator in the more developed northern countries, and led to the decrease of their exports, especially the Greek ones, thus leading to the accumulation of the current account deficits.

If we look at the budget balance of the these countries, we can clearly see that the accumulation of current account deficits in the South was accompanied by the growing budget deficits in two out of the three states of Southern Europe – Portugal and Greece, thus representing the Twin Deficit Identity discussed in the first chapter. Decreasing of exports was not accompanied by **adjustment in consumption**, that should have followed as described in Figure 2 (consumption alternatives in intertemporal trade), and the countries continued to borrow **increasing public debt**. (Figure 15) Furthermore, the borrowed sums were not channeled to the investment in research and development that could generate **long-term productive gains** that would help to repay **interest on foreign loans**, and create competitive advantage for the future. The case of Greece is quite outstanding, since the situation there was severed by financial, which revelation triggered the sovereign debt crisis in Europe.

The budget surplus in Spain until 2008 and its sharp drop after the outbreak of the crisis is a clear indicator that the primary reason for the crisis in Spain was the **consumption boom** rather than the current account deficit, i.e. high investment combined with low savings. The situation in all three states was severed by high unemployment, and high unemployment benefits that did not stimulate its reduction and put strain on the budget balance. The accumulation of large budget deficits forced the southern states to turn to even more borrowing, thus creating the ever-growing liabilities for the future, and increasing budget deficits even more instead of decreasing it.

Certainly, the situation in each country is unique to some extent, and is the result of a combination of multiple factors. Nevertheless, having examined the experience of the six European states, we can identify a number of common patterns in their economic performance. Firstly, despite the offensive PIIGS concept has discredited itself, the division of Europe into the rich North and poor South is, unfortunately, still relevant. The key common feature that lies at the heart of the current situation in southern European states is that their economies lack competitiveness. Low levels of productivity coupled with the increased unit labor costs in these countries have made them unable to compete with northern European states at an appropriate level. The role of labor markets must also not be underestimated. The empirical analysis has revealed that the rigidity of labor markets can be a crucial factor in hindering country's competitiveness by suppressing productivity growth, increasing unemployment, and thus creating additional pressure on a state budget. Conversely, flexible labor market favors competitiveness, is more immune to high unemployment, and can be better managed in times of crisis compared to rigid labor market. The declining competitiveness has led to the ever-growing current account and public deficits and consequent unsustainable debt accumulation. Their failure to implement structural reforms that had long been waiting have led to the loss of investors' confidence, outflow of investment and rising bond yields, which has created a vicious circle of the steadily increasing indebtedness of southern countries.

Meanwhile, countries in northern Europe have benefited from increasingly low, and sometimes negative, real interest rates, indirectly pulling investment out the indebted states. In part, this can be explained by traditionally sound pro-cyclical fiscal policies in those states. At the same time, their focus on innovation has stipulated their greater competitiveness, thus creating high value-added goods and services and securing current account surpluses.

Chapter 3. The European states after the crisis and the institutional flaws of the EMU

3.1. Imbalances after the crisis

Although the debt crisis has broken out majorly in the south of Europe, it has impacted all of the Union, and citizens all over the EU. Many people lost their jobs or part of their income. However, the crisis did not only have a purely economic impact, but it has also led to the **growing political and social tensions**, put in question the whole idea of the **viability of Euro** and the Union itself. It has taken the form of the increasing lack of confidence and trust in the governance of financial institutions, companies and the free market, as well as democratic institutions and politics at the European and national levels.

Such developments were largely provoked by the **austerity** measures imposed as a precondition for the financial assistance from the Troika. Their rationale was that the indebted countries had to decrease budget deficits through government spending cuts e.g. wage cuts for civil servants, reduction of unemployment and other social benefits etc. The implementation of **structural reforms** and the decrease of the current account deficits were also necessary.

In fact, some improvements started already in 2009, when all the five countries with the exception of Greece regained growth. However, this trend was short-lived, and already 2011-2012 Spain and Portugal experienced the decline in GDP. Surprisingly, they were also joined by Finland. (Figure 5) The reduction of the current account deficits turned out to the more persistent tendency, and in 2012 Spain and Portugal experienced current account surpluses for the first time in many years. Greece followed in 2013. (Figure 7) The budget deficits of the debtor states also started to decrease rapidly in 2009 in Greece and Spain, while in Portugal the deficit started to decrease only in 2011after holding on the same level for two years. (Figure 14)

These improvements came as a result of the structural reforms conducted by the debtor states to enhance competitiveness, and financial assistance provided by the Troika. In Greece wages started to decrease since 2009 (Figure 8), and it was the only one out of the three southern states to increase investment in research and development since 2010 (Figure 10), which resulted in short-term growth of productivity (Figure 9). The country has managed to reduce labor costs in 2011 (Figure 11), which helped decrease the value of Greek exports (Figure 12), and ultimately achieve a current account surplus in 2013. (Figure 7)

Nevertheless, such successes came at a high price. Years of austerity, two **bail-outs**, and a deep recession has made the Greek economy shrink by more than a quarter. The soaring unemployment reached a record high of 27% in 2013 and more than 50% among the youth (Figure

13, 16), as well as the public debt also reaching a record high of 178% of GDP in 2013. (Figure 15) In fact, since the outbreak of the crisis it has been growing at increased pace, because Greece had to ask for a series of bail-outs, by now totaling 240 billion Euros[9]. In 2010, the Greek government signed an agreement to obtain a loan of €110 billion over the next three years.[10] However, this agreement sparked a **wave of mass protests**, and put the country on the edge of a political crisis. The imposed austerity, which was the condition for the financial assistance, was vigorously opposed by opposition parties. Most of them have been contesting the government's claims of the success, potentially undermining the countries reform efforts by arguing that the economy is far from recovering and the human crisis is spreading.

Although the country's **political situation** is turbulent, it is steadily moving ahead with structural reforms aimed at decreasing its debt and increasing country's competitiveness, such as the **liberalization** of various sectors of the economy, overhaul of the **civil service** and a new **tax code**. Besides, Greece has the most ambitious **privatization program** among the European debtor states hat should help to reduce its debt, and enhance efficiency.

Slowly, but steadily the Greek efforts are starting to yield fruit. Another sign of the **improvement** is that Greece has finally returned to the global capital markets with the sale of five-year bonds, and is now able to borrow independently from the Troika. There have been other signs signalling the end of the recession. Eurostat forecast points to a mild recovery of real GDP in 2014, followed by a substantial growth of 2.0-3.0%% in 2015. (Figure 5)

Despite Greece's indisputable success, much still needs to be done to sustain its **economic recovery**, including further structural reforms that will support **investors' confidence**, encourage **domestic and foreign direct investment**, and increase exports. However, in order to proceed with further reforms, Greece needs to stabilize not only its finances, but its turbulent political and social environment, which threatens its nascent recovery.

Spanish economy has also been showing signs of improvement, but, despite the recent decrease in unemployment level, it still continues to threat the recovery of the Spanish economy. According to the EU Commissioner for Economic and Monetary Affairs Olli Rehn, unemployment in Spain would fall to the pre-crisis levels not earlier than 10 years later. Findings of the International Monetary Fund also suggest that **unemployment** will remain at the level of **above 25%** for at least for another five years, unless the Spanish government undertakes further reforms

[9] *The New York Times*, 'Greece Passes Economic Measures, Clearing The Way For Bailout Money'.

[10] *IMF Survey Magazine*: Countries and Regions, Europe And Imf Agree €110 Billion Financing Plan With Greece

of the labor market. Furthermore, Spain also has to face problems similar to Greece, i.e. the opposition to privatization programs and painful **labor reforms**, such as making **unemployment benefits** less accessible, the freeze of civil-service wages, and allowing **employers and unions** to opt for wage moderation rather than firing, which has helped to boost productivity.[11] The current government, headed by Mariano Rajoy, that is implementing these reforms, has been losing support with the forthcoming of the **elections** in 2016. This has to do not only with the labor reforms, but also with the cuts on financial support of the Spanish autonomies, which is also a requisite measure to reduce spending and enhance competitiveness by making autonomies more self-reliant and efficient. In order to proceed with these reforms, Spain must ensure a stable government, and even if the its composition changes after the elections, new ruling coalition must remain committed to the reforms initiated by the Rajoy government.

However, Spain has something to rely on in paving the way out of the crisis, and compared to its "fellows in misery", Greece and Portugal, has a significant advantage, namely one of the best infrastructures in Europe, ranging from high-speed trains to the most modern environmentally friendly electricity networks. Besides, with the returning investor confidence, its real estate market has recently seen some improvement, and desolated houses, erected during the housing boom, are being slowly inhabited by new owners.

The conditions in global financial markets also look good for Spain. The **interest rates on Spanish 10-year bonds** have drastically reduced to only 3.2%, compared with 7.6% back in 2012.[12] Although banks are still preoccupied with reducing debt, credit is already flowing to healthy businesses. This is largely the result of the financial assistance granted to Spain by the ESM and which expired in December 2013. The ESM disbursed a total of 41.3 billion Euros to the Spanish government for the recapitalisation of the country's banking sector. The ESM financial assistance for Spain was conditional, however, its conditionality focused on the banking sector, and not the public spending. The conditionality consisted of in-depth bank restructuring plans and reforms concerning the governance, supervision and regulation of the financial sector.

If we look at the figures, we can conclude that the situation in Portugal is getting better as well, and for the first time in the past few years, Portuguese economy is showing growth and not decline, but not all Portuguese people are sharing the optimism of the authorities. Furthermore, the forecasts for Portugal are not as promising as for Spain and Greece, and its successes seem highly controversial. Portugal's economy is expected to grow around 0.4% in 2014, and between 1-2%

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[11] *The Economist*, 'The Worst May Be Over', (October 2013)

[12] *The Wall Street Journal*, 'Bonds Of Italy, Spain Narrow Gap With U.S., German Yields'

in 2015. (Figure 5) Although the country has been successful in **reducing its debt** (Figure 14), it still is miles away from the 60%-target, and its debt remains above 100% of its GDP. (Figure 15) The unemployment rate has also been going down, from around 17% in 2013 to around 15.5% early this year. (Figure 13) Besides, its current account deficit had been steadily decreasing, and in 2012 it finally became positive. (Figure 7) Nevertheless, the cost of these adjustments has also been high.

In order to get **financial assistance** from the Troika, Portugal had to adopt **harsh austerity measures** and implement numerous reforms that have deteriorated living standards of the population, since the emphasis was placed on the reduction of public spending. More precisely, the government has cut wages of civil servants, has put a three-year wage freeze of clerks, reduced spending on healthcare costs and certain benefits. It has also committed to freeze pensions, and impose taxation on pensions above 500 Euros. Portugal is also conducting privatization of state property and enterprises. However, austerity will also concern the private sector in the form of the increased taxation of the rich. Wages of bankers will be subject to a special tax of 50%, and **corporate tax** will increase as well. The government has introduced changes in relation to the corporate surtax. Prior to 2013, profits exceeding 1.5 million Euros were additionally taxed at the rate of 3%, profits exceeding 10 million Euros – 5%. Starting in 2013, Portuguese government decreased the minimum taxable income threshold to which the 5% rate applies from 10 to 7.5 million Euros.[13]

Naturally, these changes were not met enthusiastically by the population. Although they have contributed to the country's economic growth, common people do not feel this recovery. These reforms have also been heavily criticized by the **opposition parties** who believe that Portugal should abandon austerity, and see dangers in the privatization of public administration. Furthermore, Portugal's competitiveness does not seem to be too responsive to these reforms. The country's competitiveness continues to be shadowed by its unstable macroeconomic environment and government inefficiency, and the reforms concerning the **liberalization of the markets and the labor market** are expected to bear fruit only in the **medium term**, which means that the much awaited relief for the population will follow within the course of five, or maybe even ten years. In addition, Portugal must undertake further reforms to strengthen its **innovation potential** by in investing in science and technology, which will demand more borrowing. (GCR 2013-2014) In order to proceed with these reforms, Portugal must reach political stability, which is impossible without the commitment of the population, a great proportion of which is stricken with poverty.

[13] Neves, Graç, 'Portugal – Recent corporate tax developments', *Tax Directors Handbook 2014,*

Therefore, the result of the austerity remains controversial, and economic prospects are not very rosy.

The growing indebtedness has also resulted in **spending cuts of households** that depressed the economy even further. Debt-ridden banks have also cut back on giving loans and credits that are essential for the support economic activity in the country. Citizens of the debtor states have held mass protests against the on-going austerity programs, some of the northern states have demonstrated the unwillingness to pay for their less lucky neighbours, which took the form of the rise of nationalistic right wing parties, especially in the Scandinavian countries. For example, Finland went as far as demanding collateral for the provision of financial help to Southern states. Moreover, political forces advocating for the exit from the Euro-area have gained popularity.

Nevertheless, **2014** has brought a **wind of change**. Finally, the efforts of the debtor countries, supported by the Troika, to decrease debt levels and resume growth have started to yield fruit, and economic forecasts for the Union have become positive, predicting slow, but **steady growth**. (Figure 5) **Euro-skeptics** have quietened down a bit, and Finland is no longer planning to leave the Euro-zone. However, it should be understood that today's successes are rather a sign of successful management of the short-term symptoms of the crisis, and the long-term challenge remains. (Moravcsik 2012) The the revival of the sustained economic development of Germany and high dynamics of the domestic market might also contribute to positive forecasts for the Euro-zone. High domestic consumer demand, along with the construction boom are expected to decrease the amount of German exports, and therefore level-off the imbalances within the Euro-zone. However, no adjustment regarding the wages has been made, therefore this positive trend is lokely to be occasional and short-lived.

As it has been identified in Chapter 2, the **main challenge** for the EU remains the **convergence** of the European economies that must result in the increase of competitiveness of debtor states that would allow them to reduce their current account deficits, and regain investors' confidence. Although much of the adjustment should be made by the debtor states, such as conducting structural reforms of financial and labor markets, it is not enough to assure their convergence with the rest of the Euro-zone and EU, as well as to avoid future severe recessions. For this to happen, both debtor countries, such as Greece, Spain, Portugal, and creditor countries, such as Germany, must **align their trends in public spending, inflation, and other areas**. (Moravcsik 2012)

Despite the fact that debtor countries have provided their "input" to the debt crisis in their own countries, both public and private sectors, they cannot be fully blamed for it. Nor can Germany, which is dumping wages of its workers and being one of the main lenders to indebted states, be held completely responsible. The severance of the current debt crisis of the Euro-zone can be explained by a tricky entwinement of economic, political and institutional failures that can be attributed not only to individual/a group of states, but to the **monetary union** as a whole. Therefore, crisis resolution requires critical analysis of the provisions of the monetary union and its flaws that have exacerbated the current crisis.

3.2. Institutional failures of the monetary union

When it became clear, that austerity alone was not working, European authorities, together with the ECB and the IMF, and many scholars came to the realization that to a great extent fault lies with the **institutional design failure** of the monetary union, and the crisis is rather the result of a fundamental **disequilibrium within the single currency zone**, which enforces single monetary policy and applies single exchange rate to a very diverse group of countries.

The main problem is that the countries that joined the Euro-zone had to give away the tools they used to have to reduce their debt levels and compensate for the lack of competitiveness. Such tools were the unilateral control over money supply, and interest rates. In times of crisis, government could force its central bank to print more money, so it could partially repay its debt. At the same time, this also served as insurance for investors, who did not face the risk of not getting their money back. The increase of the money supply would also lead to the depreciation of a local currency that would make goods from this country cheaper, and therefore more competitive. It would also result in the increased demand for domestic goods within the country, since imports would become more expensive. The outcome would be the "relaunch" of country's economic growth, return of investment, and ultimately the decrease of a country's debt.

When Euro was introduced, authority over monetary policy was vested in **European Central Bank** that is essentially independent from political control of member states. It took the role of central banks of the countries that have adopted Euro, thus leaving those countries no tools to protect themselves from inferior competitive pressure and increased uncertainty. At the same time, the ECB was forbidden to issue debt to subsidize national governments, i.e. no provisions were made for the ECB becoming **the lender of last resort**. (De Grauwe, p. 3) Thus, the ECB has taken away the lender of last resort function from central banks without providing any "compensation". As a result, the governments of debtor countries could no longer guarantee that the cash would always be available to roll over the government debt. As described in Chapter 2, this led to the sales of **government bonds** of these states, and money obtained from these sales were invested in "safe" creditor countries, like Germany. Therefore, with the massive **outflow of**

liquidity, the only remaining policy options for the deficit countries were to increase taxes, cut wages, and decrease government spending. As the crisis has revealed, such policies do little good.

To compensate this failure and save the indebted Euro-zone countries the **European Stability Mechanism** was created in October 2012. This institution is entrusted with providing **financial assistance** for Euro-zone member states that face severe financial difficulties. It has replaced another institution, the European Financial Stability Facility that used to be entrusted with similar tasks. The EFSF will cease to exist once all loans outstanding under EFSF assistance programmes have been reimbursed and all funding instruments issued by the EFSF have been repaid in full. The ESM raises funds by issuing money market instruments as well as medium and long-term debt with maturities of up to 30 years. The unconditional obligation of an ESM member states that wants to be entitled for financial assistance from the fund, which can reach up to 80 million Euros, is to provide its contribution to the ESM authorised capital stock, in accordance with the contribution key annexed to the ESM Treaty.

The ESM has also received its portion of criticism. Firstly, it has limited resources and cannot credibly commit to the aim of pulling the indebted states out of the crisis. Secondly, apart from contributions of the member states, the ECB has also imposed another condition in the form of the **“Outright Monetary Transactions” (OMT) program**, introduced in 2012, which promises to buy unlimited amounts of sovereign bonds during crises. On the one hand, that is the answer to the “prayers” for the ECB taking the role of lender of last resort. On the other hand, the ECB attached a number of **conditions to its OMT-program** that might reduce its effectiveness. The first condition is that the ECB will restrict its bond purchases to bonds with a maturity of 3 years or less. This may potentially result in the incentive of the countries in trouble to issue bonds with shorter maturities than they would have done otherwise, making them more vulnerable to liquidity crises. (De Grauwe 2013) Secondly, countries applying to the ESM through the OMT can be subjected to certain conditions, such as economic reforms or further fiscal austerity, in order to qualify for financial assistance. Potentially it might push applicant countries into further recession, which would make providing loans under this mechanism senseless. At the same time, this provision makes sense, since the essence of the ESM is not just to provide immediate relief to debtor states, but also not take away the motivation for reforms. Despite this criticism, these mechanisms have shown good results, and although the OMT has not been used so far, its mere existence has been enough to send bond yields sinking in debtor states.

Another failure is that the creation of the monetary union was not accompanied by the introduction of **coordinated fiscal policy**. Certainly, the EMU did have some provisions concerning fiscal coordination. These are the so-called Maastricht criteria, or criteria of convergence, introduced to secure the single currency. There are four main criteria, that help the ECB and the EC decide whether a country is ready for the introduction of a single currency. These entry conditions are designed to ensure that a country's economy is prepared for the adoption of the single currency and can integrate into the monetary union without the risk of disruption for a country and for the Euro-zone as a whole. These criteria are:

- Price stability;
- Soundness and sustainability of public finances;
- Exchange-rate stability, through participation in the Exchange Rate Mechanism (ERM II) for at least two years without strong deviations from the ERM II central rate;
- Long-term interest rates.

The first and the last criteria are called moving targets, because they take into account developments in other EU countries, so their value is constantly changing. As for coordination of fiscal policy, the second criterion stipulates that there is a ceiling for a budget deficit and for and for public debt. Budget deficit must not exceed 3% of GDP, and public debt must not exceed 60% of GDP. Compliance with these criteria, however, must not be the result of one-off measures, but a slong-term outcome of sound fiscal, monetary and macroeconomic policies. However, deviations from these criteria have been frequent (Figure 19), and in case a country was making significant progress in reducing budget deficit and public debt, it could be accepted despite not being formally qualified for the introduction of a single currency. The same criteria are applied to countries that are already members of the Euro-zone. However, if we look at Figure 19, the excessive debt of Greece clearly stands out, and right after the introduction of the Euro it started growing at an increased pace. We can trace the same pattern in Portugal, but only regarding the budget deficit. Upon Portugal's admission, its deficit continued to grow, and more surprisingly the was no even a small improvement from 1998 to 1999. (Figure 20) This fact leads to one important consideration that the major flaw of this system was the lack of the enforcement or sanction mechanism that could call the "breacher" to order. On the example of Greece Europe, and Greece itself had to learn in the end such uncontrolled "deviations" come at high price, both for the breacher and for the Euro-zone as a whole.

Figure 19. Public debt, % of GDP

Country	1998	1999	2000
Finland	47,619	45,664	43,793
Germany	60,491	61,257	60,183
Greece	94,532	93,998	103,441
Portugal	50,272	49,432	48,359
Spain	64,165	62,417	59,379
Sweden	69,895	64,207	53,896

Source: IMF World Economic Outlook Database, April 2014

Figure 20. Public deficit, % of GDP

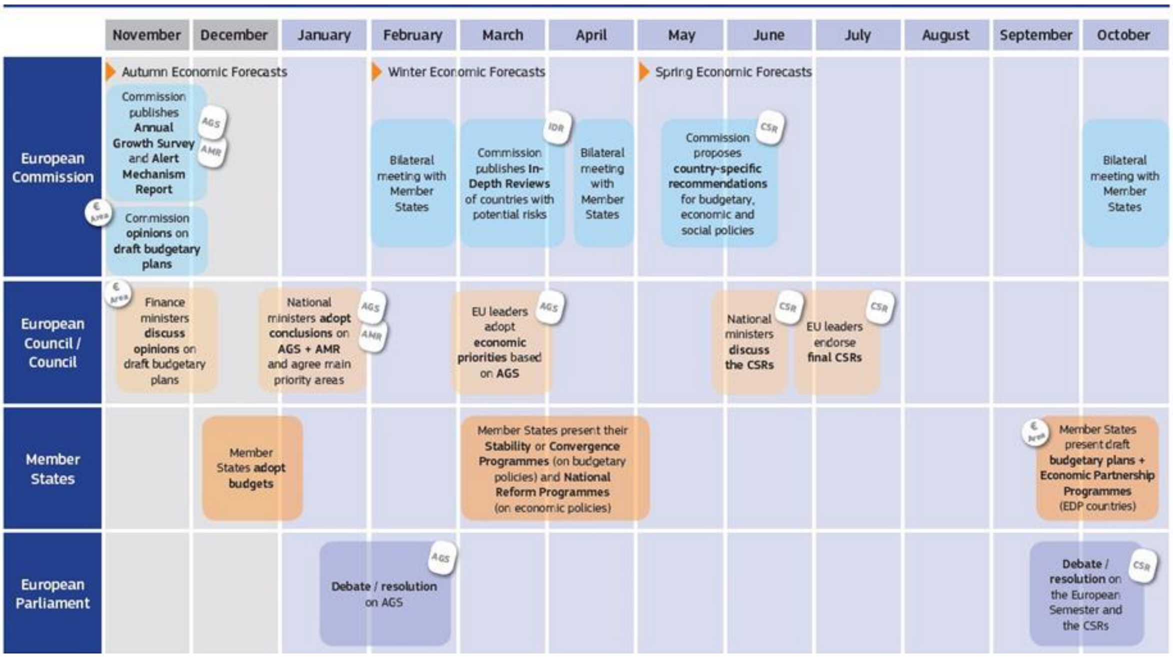
Country	1998	1999	2000	2001
Finland	n/a	1	5,763	4,482
Germany	-1,8	-1,53	-1,82	-2,97
Greece	-2,8	-1,63	-2,08	-3,154
Portugal	-3,6	-3,08	-4,17	-4,993
Spain	n/a	n/a	-1,11	-1,445
Sweden	-2,6	-2,84	-1,51	1,576

Source: IMF World Economic Outlook Database, April 2014

There are also additional provisions concerning admissibility, namely a Euro-area candidate must make changes to national laws and regulations, such as governing its national central bank and other monetary issues, in order to make them compatible with the Treaty. In particular, national central banks must be independent. In order to enhance convergence, Euro-zone candidates also signed The Stability and Growth Pact (SGP) in 1997, which is a rule-based framework for the coordination of national fiscal policies in the European Union. Basically ,the SGP reaffirmed fiscal criteria set out under the TEU, however, it was amended several times to encourage greater compliance with the criteria. Changes have been introduced within the framework of the so-called “Six-Pack” legislation, which reinforced economic and fiscal governance in the EU and the Euro area. Currently the SGP contains two arms – the so-called **preventive arm** and the **corrective arm**. The purpose of the preventive is to ensure that fiscal policy is conducted in a sustainable manner, meanwhile the corrective gives recommendations in they face an excessive deficits.

The most important mechanism of the preventive arm is the country-specific medium-term budgetary objective (MTO), under which Euro-zone member states outline their medium-term budgetary plans in stability and convergence programs (SCP), which are annually assessed within the framework of multilateral fiscal surveillance under the European Semester (Figure 20) that is the first phase of the EU’s annual cycle of economic policy guidance and surveillance.

Figure 20. European Semester Framework



Source: European Commission, *Economic and Financial Affairs*

The corrective arm is used to make member-states to take appropriate measures to correct excessive deficits through the implementation of the Excessive Deficit Procedure (EDP). The EDP, in its essence, does not represent any radical change. It simply restates the Maastricht criteria regarding the fiscal convergence, that the deficit must not exceed 3% of GDP and public debt must not exceed 60% of GDP, however, it provides for punitive actions that can be applied to a member state that does not comply with recommendations of the Commission. Under a standard EDP procedure, countries are given a deadline of six months, and three months in case of serious breach, to comply with recommendations and reduce its **excessive deficit** within a set timeframe. Once the deadline has passed, the Commission and the Council assess the measures taken by the state and conclude whether they were sufficient and whether the country actually did take some measures. This does not contribute to the effectiveness of the procedure, since the mere procedure already implies that a member state can take no measures at all, and continue breaching the criteria and not complying with recommendations. The sanction mechanism can also be called weak. The strictest **sanctions** under the amended SGP come in the form of a non-interest-bearing deposit of 0.2% of GDP, or possible suspension of Cohesion Fund financing until the excessive deficit is corrected.

However, this is only one aspect of the six-pack. Having realized that there are serious gaps in competitiveness and major macroeconomic imbalances within the Euro-zone and the EU, the Commission also introduced the Macroeconomic Imbalance Procedure, which represents a new surveillance system for economic policy aimed at providing clearer rules and better coordination of national policies to secure financial and economic stability of the Euro-zone.

The aim of the Macroeconomic Imbalance Procedure (MIP) is to identify potential risks in advance, prevent the emergence and growth of excessive macroeconomic imbalances and level-off the imbalances that are already in place. As well as the newly amended SGP, the MIP also has a preventive and a corrective arm. The latter can be applied through the Excessive Imbalance Procedure, which is similar to EDP, but concerns macroeconomic indicators. This mechanism also envisages the implementation of sanctions in case of non-compliance.

In order to avoid the repetition of the current scenario, the MIP is "equipped" with an early warning system that is based on a scoreboard consisting of a set of eleven indicators that cover the major sources of macroeconomic imbalances:

- 3 year backward moving average of the current account balance as percent of GDP, with thresholds of +6% and -4% ;
- net international investment position as percent of GDP, with a threshold of -35%;
- 5 years percentage change of export market shares measured in values, with a threshold of -6%;
- 3 years percentage change in nominal unit labour cost, with thresholds of +9% for Euro-zone countries and +12% for non-Euro-zone countries;

- 3 years percentage change of the real effective exchange rates based on HICP/CPI deflators, relative to 41 other industrial countries, with thresholds of -/+5% for Euro-zone countries and -/+11% for non-Euro-zone countries;
- private sector debt (consolidated) in % of GDP with a threshold of 133%;
- private sector credit flow in % of GDP with a threshold of 15%;
- year-on-year changes in house prices relative to a Eurostat consumption deflator, with a threshold of 6%;
- general government sector debt in % of GDP with a threshold of 60%;
- 3-year backward moving average of unemployment rate, with a threshold of 10%;
- year-on-year changes in total financial sector liabilities, with a threshold of 16.5%.

For each indicator there is an alert threshold that might signal about the dangerous tendencies in a Euro-area country that are likely to lead to the widening of the gap in current account balances. The aim of the scoreboard is to "separate" countries in order to determine whether the potential imbalances identified in the early-warning system pose a threat to the Euro-zone and the country, and whether they need to be addressed by conducting an in-depth review. For the sake of greater transparency, and in order to avoid accusations in not being impartial, the Commission makes in-depth reviews public.

The mechanisms of the preventive and corrective arms of the MIP are quite similar to the SGP. The MIP allows the Commission and the Council to adopt preventive recommendations that are embedded in the package of country-specific recommendations.

Under the corrective arm, in case of an Excessive Imbalance Procedure (EIP), a member state that is facing difficulties must submit a **corrective action plan** with a clear roadmap and deadlines for implementing corrective measures. If a state fails to submit this plan, refuses to implement recommendations or does not fulfil its commitments, the Commission can use sanctions in the form of imposing an interest-bearing deposit, or, in the worst case of non-compliance, this interest-bearing deposit can be converted into a fine (up to 0.1% of GDP).

Therefore, the MIP is basically identical in its institutional provisions to the SGP mechanisms, and, as is the case with the SGP, the punitive measures under the MIP corrective arm are quite limited. However, it should be noted that making in-depth reviews public might produce positive change, since it will increase transparency and credibility of the procedure, and will not allow the guilty party to "get away" with its imbalances. It is also a positive change that the EU and Euro-zone countries in particular have realized that it is impossible to conduct common monetary policy without at least some coordination in fiscal and macroeconomic policies, since they are inextricably entwined. Still, the adopted measures do not solve the deep-seated problems of the Euro-zone, but rather try to smooth them.

Despite multiple adopted legislation, procedures etc., there were no institutional provisions regarding medium-term coordination of fiscal policy, which would enact a risk sharing system that envisages **automatic fiscal transfers** to countries/areas facing fiscal deficits. In other words, such system requires taxation redistribution to less developed areas. In fact, this is one of the main conditions for the existence of a common currency area that ideally should be met by the Euro-zone countries. However, more than ten years after the adoption of a common currency, Europe has still not become an optimal currency area. Instead, the single currency in Europe only exaggerates existing differences, having eliminated policy instruments required to overcome them.

Of course, these problems are not easy to solve since it requires both, political and social consensus and solidarity. The introduction of a fiscal union that would provide for the fairer distribution of the costs of convergence and single currency will demand certain sacrifices on the part of the surplus countries and their population. However, without shifting the burden from the deficit countries to surplus economies, the viability of Euro will continue to be called into question that can result in the collapse of the Euro-zone. Meanwhile, according to the estimates of Swiss experts, the **collapse of the Euro area** would cost 9.5-11.5 thousand Euros per each European inhabitant only in the first year, and about 3-4 thousand Euros over the next few years. In total, within the course of five years, each European citizen would become poorer by at least 21 thousand Euros. However, this is only the top of the iceberg, and these numbers are hardly significant compared to losses that would follow large **government and corporate defaults** that would be also inevitable if the Euro-zone collapses. In addition, the collapse of the Euro-zone will lead to. Thus, actual losses may be much more pronounced.[14] Therefore, despite the high price already paid by the Euro-zone, Euro is still worth saving.

Despite the Euro-zone now appears to be in much better health, the ECB is taking the role of lender of last resort, and Euro-zone countries are making small steps on the way of coordinating their fiscal policies, this is only part of the solution. The main challenge, economic imbalances provoked by different levels of competitiveness, still needs to be addressed by member states. In fact, addressing this challenge might be even more difficult, since it is less clear how national governments can encourage reforms of wage and business practices. Besides, the implementation of such reforms requires political stability and consistency, something that can become an issue

[14] Chuvakhina 2012, pp. 19–28

for the indebted states that are now marked with political instability, and the growing social discontent with the high costs of staying in the Euro-zone.

Although southern debtor states have been mostly complying with the imposed austerity measures, their success varies from country to country, and especially in Portugal it has been ambiguous. Furthermore, it has fuelled social unrest in Greece and Portugal, and has put their political stability that is essential for implementing structural reforms in danger. Besides, despite some reforms implemented at the level of the monetary union, the core issues, such as the need to create fiscal union, remain unaddressed. Besides, as it has already been mentioned, tackling imbalances that are at the heart of the crisis requires action not only on the part of the debt-laden states, but also on the part of the surplus countries as well.

Despite **interest rates on sovereign bonds** of southern periphery of the EU have fallen to record low, some economist are convinced that so far little has been done to "put the Euro-zone on a viable footing". (Moravcsik 2012) The speed of the recovery in these states remains low, and the already implemented structural reforms are not enough to enhance their competitiveness and decrease their deficits in the long-term vis-a-vis the surplus states. It is too early to celebrate the achievement of primary budget surpluses by some debtor states, which includes Greece, since their success might be short-lived, as it is mostly the result of big loans from the Troika and fiscal tightening which cannot last forever. Furthermore, if Troika continues to impose austerity and postpone fiscal reforms within the Euro-area, this might cross out the current improvements that have been reached at high cost.

Certain adjustments should be made on the part of the biggest EU economy, Germany. As it has been identified in Chapter 2, the current imbalances cannot be smoothed out without Germany giving up part of its surpluses, therefore, the country needs to finally decide whether it is ready to sacrifice its export-driven growth, or let the Euro-zone fall apart. Furthermore, it also has to decide whether it is ready to take the path of further **integration** by agreeing to **fiscal transfers**, i.e. the creation of a **fiscal union**, and if so, translate words into deeds. Finally, Germany must accept that it has to continue to play the leading role in driving it Euro-zone neighbours out of the crisis.

Another Euro-zone leader, Finland, has to fight its own "demons". Although it has survived the crisis with relatively small losses, the prospects for the Scandinavian country are not that bright. Finland is expected to grow below 1% this year, and in 2015 the growth is expected to reach up to 2%. (Figure 5) Despite the fact that the current crisis had its share in the decline, it is not the main cause. Ironically, the main problem of the most competitive country of the Euro-zone is its declining competitiveness that is provoked by the **recession in its traditional industries**, such as wood and electronics industry. These difficulties are the result of the outward competitive pressure from the developing countries, such as China and Brazil, but also South Korea and the U.S. that have taken the leadership in smart phones production, and contributed to the decline of the Finnish giant Nokia. Finland needs to address these challenges by increasing investment in innovation-driven industries, and intensify efforts to **diversify its economy** to counter new challenges.

For Sweden, the prospects look much better. The country goes ahead of the majority of the EU countries in terms of economic growth, as in 2015 it is forecast to break the 3% mark (Figure 5), and its debt level, as well as budget deficit do not exceed the newly reaffirmed criteria of convergence. Apparently, this is the result of the lessons learned after the 1990s crisis, combined with the country's decision not join the Euro-zone. Sweden's economic model has managed to combine global competitiveness with reasonable fiscal policies without undermining the **welfare state**, but it should not become complacent. No country is immune to crises, and in order to avoid the reiteration of the 1990s scenario, it should keep in check its monetary policy to avoid the increase of its already high **household debt**.

The recent developments have revealed that **unilateral efforts** of the debtor states are not efficient enough to overcome the sovereign debt crisis in Europe that is still far from being completely resolved. The long-term solution will also include adjustments on the part of Germany. The austerity measures, which have been praised and pushed by Germany, must also be abandoned, partially because they have run out of steam, and partially because they have turned out to be not the best solution for some member states. These measures have been pulling out resources from the southern states that they need to proceed with structural reforms, without which all the sacrifices made by the debtor countries can turn out senseless. Another part of the long-term solution should be the creation of a fiscal union, and the commitment of all member states to introduce the system of fiscal transfers in the nearest future. If these measures are not implemented, it is likely to lead to the collapse of the Euro-zone, and all EU citizens will have to bear the cost.

Conclusion

The sovereign debt crisis in Europe has had a devastating effect on the economies of the European southern periphery. It has resulted in record unemployment, economic recession, depressed disposable incomes and high indebtedeness of the Southern Europe. Although the crisis had a strong impact mostly on the southern periphery of the Euro-zone, it has affected the Union as whole. The prolonged crisis have affected the countries in the Northern Europe as well, since they had to become the rescuers of the indebted countries to support the integrity of the Euro-zone by providing financial assistance.

Basing on the theoretical data from the first chapter and the empirical data in the second chapter, we can conclude that the current crisis is not a unique phenomenon in the world economic history, although its scale and depth can be called unprecedented.

The conclusions derived from the theory have provided a base for the analysis carried out in the empirical chapters. Having examined the economic theory, I have come to several assumptions, which were later confirmed by the empirical data. Firstly, it was identified that government debt and budget deficit can be the result not of government profligacy, but of high private debt, which is, in fact, more dangerous and has a negative impact on the recovery process and makes it more painful.

Secondly, the reason that lies at the heart of private debt is current account deficit that can be the result of several factors. A current account deficit may be the result of low level of national savings relative to investment, or a high rate of investment or both. If it is the result of the excess of investment over savings, it can be pointing to a highly productive growing economy. If, however, the deficit reflects low savings rather than high investment, it can be the sign of the incautious fiscal policy or a boom of consumption prone to turn into a bubble, which was the case in Spain. When this is the case, it means that certain adjustments should be made on behalf of the state, more precisely, it should limit consumption in order not to get into a debt pitch, since in this situation a state usually resorts to borrowing to finance consumption instead of investing money to produce long-term gains. If such adjustment is not made, the result is going to be precarious. It will lead to the reduction of national income, and, in order to support consumption, government spending and investment at previous levels, a country will have to borrow from external sources, such as other countries, foreign banks or international institutions. It is important to keep in mind that a country will have to pay back with interest rate. In such situation persists for a long time, country's debt can become unsustainable, as it happened in the states of the Euro-zone periphery.

Current account deficit can also be the result of imports prevailing over exports, which can signal weak or declining competitiveness of a state. It can also mean that a country is importing more goods today, thus running a current account deficit, in order to be able to export goods in the future, thus running a current account surplus then, for instance by purchasing new technologies and equipment to produce more sophisticated good In the future. If that is the case, then deficit is not a signal to worry. However, in any case a country should remember that when it is running current account deficit, it is building up liabilities for the future.

The most dangerous situation is when current account deficits are the result of the lack of competitiveness. Low competitiveness is usually caused by low productivity of labor. Low productivity is usually typical for developing countries, however, they can compensate it will low value of their goods due to low wages paid to the workers and weak currencies of their states. However, everything’s relative. Southern European countries, having joined the common market and later the EMU, had to face strong competition from the side of more technologically advanced northern states. Unlike other “stand-alone” countries, they no longer had the benefit of enhancing their competitiveness through currency devaluations, therefore, the options were limited. They could either increase investment in research and development to increase productivity, or decrease unit labor costs through wage cuts or wage growth moderation, as Germany did. Nevertheless, they opted for none of the solutions. The result was the loss of competitiveness, and subsequent accumulation of current account deficits.

In Portugal and Greece the accumulation of current account deficits in the South was accompanied by the growing budget deficits that represented the Twin Deficit Identity. The decrease of exports from these countries was not accompanied by the adjustment in consumption, that should have followed, and the countries continued to borrow increasing public debt. Furthermore, the borrowed sums were not channeled to the investment in research and development that would have helped them to generate long-term productive gains, which would allow them to repay interest on foreign loans, and create competitive advantage for the future.

The budget surplus in Spain until 2008 and its abrupt drop after the outbreak of the crisis indicates that the primary reason for the crisis in Spain was the consumption boom. Although Spain’s government spending was in line with the Maastricht criteria, and the accusations of the government profligacy cannot be applied to this country, it still has at least one thing in common with Portugal and Greece: it is also characterized by low rate of investment in research and development, which was a contributing factor to its current account deficit, and high borrowings.

The situation in all the three states was severed by high unemployment, and high unemployment benefits that put an even bigger strain on the budget balance. The accumulation of large budget deficits forced the southern states to turn to even more borrowing, thus creating the ever-growing liabilities for the future, and increasing budget deficits even more instead of decreasing it. Besides, the rigidity of labor markets in these states forced employers to reduce working personnel and cut-down hiring, instead of cutting their wages, which continued to hold back competitiveness. Thus, the postponed liberalization of the labor markets resulted in the unresponsiveness of wages to high unemployment levels and recession.

If these countries ad looked at the experience of Sweden and Finland, that had to pass through a similar crisis back in 1990s, they could have found some solutions suitable for their situation. Such measures as cutting unemployment benefits and other social transfers, and cutting taxes for low-paid jobs that were implemented in Sweden and Finland would have stimulated employment, and secured more money for the support of the affected companies and the banking sector affected by the crisis. However, such measures demanded reforms of the labor market that until very recently had been postponed.

Therefore, the Southern states found themselves in the web of current account deficits that contributed to budget deficits in the form of lower taxes, and which led to the increase in borrowing with ever-growing interest rates. Since their investments were not channeled into the increase of productivity gains, they found themselves unable to pay the debt, and had to turn to financial institutions for assistance, namely the Troika, which imposed a number of conditions in return for help. These were the implementation of structural reforms and cuts in budget deficits, including severe austerity measures. Although some of these measures were necessary, the process turned out to be painful for the population, and did not bring the expected results. Although some improvements started to show in 2009, they were not sufficient, the public debt in the southern countries continued to grow, and the change only came in 2014.

Furthermore, the recent developments have shown that unilateral efforts of the debtor states are not sufficient to overcome the sovereign debt crisis in Europe, since the uncertainty about the growth prospects, still high levels of government and corporate debt continues to shadow the recovery perspectives of the Euro-zone periphery. Therefore, the crisis resolution requires effort also from the side of the other Euro-zone members.

Certain improvements should be made at the level of the monetary union. Despite the fact that some reforms have already been or are being implemented, the core issue, such as the need to create fiscal union, remains unaddressed. It is also hardly possible to overcome the crisis and build safeguards for the future without Germany agreeing to give up part of its surpluses and sacrifice part of its export-driven economy. The EU leader must finally decide whether it is ready to pay the full price for rescuing the Euro-zone, being its main beneficiary, or let the Euro-zone fall apart. Furthermore, it must also decide whether it is ready to commit to further integration by agreeing to fiscal transfers, i.e. the creation of a fiscal union, and if so, translate words into deeds.

Certainly, these sacrifices of Germany should be matched by some sacrifices in Southern Europe as well, and although austerity should be abandoned, they should proceed with labor reforms, and increase their investment in research and development to enhance their competitiveness.

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