Abstract:

r states of the Euro zone will secede from it, while others will join.

an states, while Eastern and Central European states are expected to join.

l the Greek temptation: large amounts of cheap credit as a result of successful policy without suitable development of micro-economic reform

Senat 399 for political and social issues:

The credit crisis in the Euro zone: implications for Israel

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The Euro zone: structural problems

The Euro zone was launched in 1999 with 11 member states, and by 2009 another five EU states joined it. The main dilemma which occupied the founders of the zone was the temptation of the governments in member states to develop large deficits, with the interest rate at the same level for all the zone's countries and therefore not serving to punish a spendthrift government. Two solutions to this problem were first the prohibition in the Maastricht Treaty (the legal basis of the Euro zone) of the rescue of governments from their deficits, and second the signing of a Stability and Growth Pact (SGP) which restricts the amount of public deficits. Another significant challenge to the zone's members is contending with asymmetrical shocks, that is, shocks which have a differential impact on the various members. For example, if Germany is in a period of growth while Italy is in depression, and as Italy cannot devalue its currency or reduce the interest rate (since it is part of the Euro zone), Italy can expand the deficit in the state's budget or rely on market forces such as price and wage reductions and immigration of workers. In times of growth Italy can reduce the deficit, or rely on the raising of prices and wages and the influx of foreign workers.

In the states of Western Europe there is usually some inflexibility of prices and especially of wages. Furthermore, the movement of workers between (and even inside) the member states is in practice quite curtailed (there are some exceptions), despite the legal liberty to do so. Concerning the fiscal instrument, the SGP does not retain suitable space for anti-cyclic fiscal policy, especially because even in times of growth budgets are not balanced, since it is politically easier to expand the deficit than to reduce it.

The EU is aware of the need for greater dynamism in the European economy. However, reform comes very slowly, and many of the zone's members have not completed the needed reforms for growth inside the zone.

The result is that in times of depression, the restrictions of the SGP for government deficits were breached, together with a rise in unemployment (especially among young and unskilled workers), and in times of growth it was politically convenient to raise wages (especially among associated workers in the public sector).

Theoretically, it could be expected that capital markets would punish governments with a high deficit with higher yields for their bonds, but until 2008 there weren't significant differences to be found between these yields. This phenomenon can be explained by the common belief that despite all the rules, the financial inter-dependence of economies in banks in Europe would necessitate interference to prevent the insolvency of a member state. The anchoring of policy inherent in Euro-zone membership (that is, the rise of expectations that membership will bring significant change to the economic and political systems of the member state to match the conditions of the zone) also contributed to the cheap interest rate for deficient governments. To all this we must add the international financial bubble, which led to norms of credit provision without suitable attention to the ability of the borrower to return the loan.

The Euro zone: the beginning of a new period

The burst of the bubble and the heavy debt incurred by many governments in an attempt to prevent the financial crisis from becoming a global economic crisis directed the attention of investors to the financial situation of governments and their ability to stand behind their promises. The credit rating of some governments was undermined, and the yields on their bonds began to vary. Europe was in the center of attention because of the problems we detailed earlier. Speculative attacks against the debts of Greece, Portugal, Spain and Ireland severely tested the prohibition on rescuing governments from debt. Indeed, in May 2010 the members of the EU decided upon an assistance package of half a billion Euros for three years for members with credit problems, so buying some more time; but without micro-economic reform, sustainable growth is impossible. Without growth governments cannot return their debt, and with many countries in trouble, not all of them could be rescued (in addition, the assistance has to overcome legal obstacles).

Table A shows the index of compatibility of EU members for a monetary union with Germany, and for indicative purposes, also Israel's index.[1] This index is built on economic and political factors, and reflects the amount of changes needed in the long term, according to the conditions of membership in the Euro zone (under the assumption that Germany's membership is a condition for the zone's existence). A high index reflects a need for broad and deep use of fiscal instruments, large-scale immigration of workers, or large wage and price changes in order to maintain zone membership. According to European experience, a high index reflects large debt and/or high unemployment. The table demonstrates that there are basic reasons making Euro membership especially difficult for Greece and other Mediterranean countries, and also for Ireland. On the other hand, Sweden, the Czech Republic, Hungary and Bulgaria can easily maintain their membership in the Euro zone, if and when they join it. Of course, a country exiting the Euro zone will incur heavy costs, but some of these costs will start to be realized for incompatible members even before the exit, making the formal decision easier. On the other hand, joining the zone is dependent on complex political factors. Therefore the table shouldn't be seen as forecasting the entrance or secession of a certain country. However, the table does clearly show that the Euro zone consists of a core and a periphery, and the current Euro crisis demonstrates that this issue cannot be ignored forever. It is probable that in the coming decade, some Euro zone countries will leave it, while new members will join.

Table A: Index of compatibility for monetary union with Germany (average for 2003-2009)

Not in the Euro Zone as of 2010		In the Euro Zone as of 2010	
Sweden	2.4	Slovenia	3.9
Czech Rep.	3.3	Finland	3.9

1 According to the method of Sadeh (2006) and the author's calculations.

Hungary	3.3	Italy	4.2
Denmark	6.6	Austria	4.5
Bulgaria†	7.3	Belgium	5.5
UK	7.3	Slovakia	6.7
Israel	***8.7***	France	6.9
Estonia†	10.1	Netherlands	7.4
Poland	10.1	Spain	7.5
Romania†	14.0	Portugal	8.1
Lithuania†	17.2	Ireland	8.5
Latvia†	18.1	Cyprus†	8.7
		Malta†	9.5
		Greece	12.2

†= the datum is biased upwards due to the data series used. The real datum is lower, but cannot be calculated.

Implications for Israel

The main lesson for Israel from the crisis is the need to avoid the Greek temptation: large amounts of cheap credit as a result of successful policy, without suitable development of micro-economic reforms. Israel's medium-high index in Table A is a result mostly of the short duration of governmental coalitions (shorter in the period studied than any of the EU members). Frequent changes in the coalition destabilize the government's agenda and make long-term support of a project such as Euro zone membership much more difficult. On the other hand, the Israeli index reflects low inflation in the period studied, and the dynamic effects of the stabilization of its exchange rate versus the Euro zone if it becomes a member. Apparently, Israel's index is similar to that of the other Mediterranean countries, and it indicates the difficulties it would be in if it joined the Euro.

Table B contains a labor market liberalization index. A high index reflects a flexible labor market and the ability to react to economic shifts by wage and employment changes. A country with a high compatibility index and a low liberalization index is expected to accumulate high debt as a Euro zone member. That is indeed the situation in Greece, Cyprus, Portugal and Spain. Israel is also characterized by this combination of indexes. Therefore Israel was right not to attempt to adopt the Euro as its policy anchor.

Table B: The labor market liberalization index (2007 data)

Not in the Euro Zone as of 2010		In the Euro Zone as of 2010	
Denmark	7.7	Malta	6.9
UK	7.2	Slovakia	6.5
Bulgaria	7.1	Ireland	6.5
Latvia	6.8	Netherlands	6.3
Romania	6.4	Slovenia	5.9
Czech Rep.	6.2	Italy	5.7
Hungary	5.9	France	5.6
Poland	5.7	Belgium	5.4
Estonia	5.0	Spain	5.1
Lithuania	5.0	Portugal	4.9
Israel	***4.7***	Austria	4.8
Sweden	4.7	Finland	4.5
		Greece	4.4
		Germany	4.0
		Cyprus	3.2

Index from 0 to 10. High index = high liberalization.

Taken from the Frazer Institute for Economic Freedom. _

However, the European crisis can provide a lesson concerning all policy anchoring: Israel's

membership in the OECD is a kind of policy anchoring as well, as it nurtures expectations that Israel will become a dynamic economy, which draws investment and grows quickly. Israel seemingly performed many reforms in order to join the OECD; but as demonstrated in Table B, membership in the OECD does not ensure economic dynamism. If the expected expansion of capital flow to Israel is not accompanied by the required reforms, Israel may also be exposed to strong shocks.