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A Broad Economic Overview of the Eurozone Crisis

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This article is one of four on the theme of the Eurozone crisis and its possible implications for agriculture in different parts of the world. In this paper, we provide a broad context of the economic difficulties of the Eurozone, the effects of which were felt most severely since 2010. We set the stage for this issue by examining the mutual dependence between the United States and European Union (EU) economies, economic integration efforts among European nations and the role of the common currency therein, the origins of the multifaceted Eurozone crisis and selected responses in dealing with the crisis, as well as links to agriculture. Naturally, this summary assessment of the Eurozone crisis is far from complete due to the long history preceding the crisis, the complex nature of the difficulties, the many ongoing uncertainties, and possible future policy responses.

U.S. - EU Economic Comparison and Links

The U.S. and EU economies are comparable in size. In 2012, the Gross Domestic Product (GDP) of the EU was about $16.2 trillion, while the economic output of the U.S. was approximately $15.7 trillion (World Fact Book, 2013). By comparison, China's GDP was approximately $8.3 trillion during the same year, but China's economic output increased considerably while that of the EU declined during 2012. Jointly, the EU-27 market consists of over 500 million consumers, resulting in a per capita GDP of $34,500, compared to $49,800 in the United States. However, per capita incomes vary greatly among EU member states, from a low of $13,000 to a high of $82,000, suggesting that growth opportunities remain, particularly among relatively new member nations.

While the world's most rapid economic growth opportunities are believed to exist in parts of the world outside of Europe and the United States, the two continue to have the world's largest and most deeply integrated mutual trade and investment relationship (Office of the U.S. Trade Representative, 2013). The close ties are illustrated by the level of merchandise trade jointly contributed by the United States and the EU-27, which made up 42% of the total world exports and 52% of imports in 2011 (World Trade Organization, 2012). The close economic ties have recently led to the start of formal negotiations for the creation of a transatlantic free trade agreement.

From a U.S. perspective, bilateral U.S.-EU trade is fairly well balanced. In 2012, 21% of all U.S. goods and services exports found their way to the EU, and 19% of U.S. imports originated in the EU (Office of the U.S. Trade Representative, 2013). From the EU point of view, 18% of EU exports were destined for the United States, while 11% of EU imports originated in the United States (Eurostat, 2013).

U.S. agricultural trade with the EU is less well-balanced. The value of U.S. agricultural imports from the EU is about twice as large as U.S. agricultural exports to the EU. U.S. exports to the EU of agricultural products amounted to $8.9 billion in 2012, or about 6.5% of total U.S. agricultural exports—a decline from 2000, when the EU accepted about 15% of total U.S. agricultural exports. Nevertheless, the EU consistently ranked as the fifth most important destination for U.S. agricultural exports for the past 10 years. Key products include tree nuts, soybeans, processed fruits and vegetables, wine and beer, and animal feeds.

In 2012, the U.S. imported $16.6 billion in agricultural products, or 16.1% of total U.S. agricultural imports. The relative importance of agricultural imports from the EU decreased only slightly from 2000 levels of around 21% of total U.S. agricultural imports. Key imports include wine and beer, essential oils, snack foods, processed fruits and vegetables, and animal feeds.

U.S. Foreign Direct Investment (FDI) in the EU amounted to $2.1 trillion, and vice versa, EU FDI in the United States totaled $1.6 trillion in 2011, the latest year for which data are available (Office of the U.S. Trade Representative, 2013). U.S. FDI in the EU is mainly concentrated in nonbank companies, finance and insurance, and manufacturing, while EU FDI in the United States is clustered in manufacturing, finance and insurance, wholesale trade, and the information sector. Mutual investments in agriculture include those in land and agribusiness operations. Also, several European banks provide financing for agricultural loans in the United States.

European Integration Efforts

Fundamental to understanding the move toward increased integration among European nations is the geopolitical goal to halt historically recurrent intra-European conflicts and to stave off possible future wars. The "European project" involves an international system of checks and balances, and all EU decisions and procedures are based on a series of treaties ratified by member-nations.

The predecessor of the EU, the European Economic Community (EEC), was founded by the 1957 Treaty of Rome, which, in turn, followed the European Coal Steel Community, established by the 1951 Treaty of Paris. The latter emerged from the Organization for European and Economic Cooperation, created to oversee the implementation of the Marshall Plan. Even earlier European integration efforts took place prior to World War II, by way of the Pan-European movement led by the Austrian count Coudenhove Kalergi in 1923, and the notion of a federation of European nations raised by French Prime Minister Aristide Brian in 1929. These efforts were thwarted with the rise of fascism and the war.

The EEC was a common market, which, in contrast to a free trade agreement, requires each member nation to agree to common external tariffs. Over time, the common market evolved and additional economic integration was achieved through the use of free trade in industrial goods, a common set of prices for agricultural products within the EEC, and broadening the membership from the original six to the current 27 nations.

Formal discussions on a common currency took place as early as the 1970s, when the Werner Report outlined a plan for establishing an Economic and Monetary Union in Europe by 1980. However, these early discussions failed and were abandoned. In 1989, the Delors Report planned for the development of a common currency through gradual moves toward closer economic coordination among EU nations and toward full implementation of the European Monetary System with an independent European Central Bank (ECB).

German reunification in 1990 provided an unexpected opportunity for accelerating common currency plans and it led to the 1992 Treaty on the European Union (Maastricht Treaty). In addition to outlining the current form of the EU with its "single market" for goods, services, labor, and other inputs without international trade obstacles within the EU, the Treaty provided the legal foundation and design of the euro currency by setting "convergence criteria" that EU nations would have to meet to become members of the European Monetary System (EMU). The criteria specified in Article 104c of the Maastricht Treaty hold that a nation's actual government deficits would not exceed 3% of GDP, and that its government debt would be below 60% of GDP. The criteria also set limits on inflation, long-term interest, and national currency exchange rates.

While the criteria for joining the common currency were well-defined, in reality the threshold levels were flexible. As a result, the process involved making political compromises and sidestepped critically important economic membership criteria. For example, political necessity held that the six EU founding members would also be original Eurozone members, despite their inability to meet agreed-upon economic criteria. Furthermore, Europeans' unwillingness to pay direct taxes to fund an EU budget sufficiently large to counteract regional imbalances and economic shocks led to an absence of a central fiscal authority, essential for well-functioning currency unions.

When the euro was implemented in 1999, Eurozone nations were less integrated than prescribed by the Werner and Delors reports, and, moreover, EU leaders further weakened the financial and macroeconomic rules of the Stability and Growth Pact. The latter provides a framework for coordinating national fiscal policies in the EU, and serves to safeguard sound public finances, based on shared EU interest. Thus, while the political goal of implementing a common currency was achieved, there was no central fiscal agent, no effective budget discipline enforcement, and no clearly defined path toward further economic convergence.

The Eurozone Crisis

From its beginnings, the flaws in the design of the common currency were pointed out by a number of economists, but its inherent problems were not fully exposed until soon after the beginning of the global economic crisis set in motion by the 2008-09 recession. For example, Papadimitriou, Wray, and Nersisyan (2010), and Veron (2012) document structural design issues of the common currency. Since then, it has become increasingly clear that the problems plaguing the Eurozone are not only structural and multifaceted, but somewhat country-specific as a result of the remaining disparity within the region. Yet they are highly interconnected due to the policies built around the common currency.

Kirkegaard (2011) and others have identified distinct, but overlapping and mutually reinforcing crises. One relates to the design of euro area institutions, discussed earlier. Second, excessive debt levels among some Eurozone nations made it impossible to service their sovereign (nation-specific) debt without further increasing their financial obligations to their bond holders. The combined problems of euro-denominated sovereign debt and the inability of the ECB to guarantee the sovereign debt led to concerns that regional financial instability would be transferred to other nations, closely linked asset markets, and financial institutions within and outside of the Eurozone. To limit such "contagion" effects, financial rescue packages collectively supported by other Eurozone members and the International Monetary Fund, combined with sovereign bond purchases by the ECB and domestic policy reforms (as well as debt restructuring in the case of Greece), temporarily enabled the most deeply affected nations of Greece, Portugal, Ireland, Italy, and Spain to fulfill their international financial obligations.

Third, the Eurozone faced a banking crisis initiated by real estate booms in Ireland and Spain. The global financial crisis created a "sudden stop" of the private capital inflows once private investors recognized that risks had been underestimated and interest rates increased, which led to a collapse of real estate markets. The large size of the Eurozone banks relative to their home nations' economic output made it impossible for the heavily indebted home nations to guarantee the debt. Moreover, the banks were already highly leveraged, and much of the bank debt was issued by their home governments.

While the banking crisis had appeared to be somewhat under control, it recently manifested itself in the case of Cyprus, whose main banks had assets far exceeding that nation's annual economic output, but a significant part of the assets consisted of previously restructured Greek sovereign bonds. As in previous cases of over-leveraged financial institutions, policy makers were faced with a difficult choice of either rescuing the banks and thereby jeopardizing sovereign solvency, or refusing rescue and risking severe economic downturns. While Cyprus' economy is very small relative to that of the Eurozone as a whole, this recent manifestation of the crisis may have far-reaching consequences, in that bank creditors may be expected to bear part of the costs of bank recapitalization in addition to or instead of the European Stability Mechanism.

A fourth crisis was in the balance of payments due to competitiveness disparities and "asymmetric shocks" internal to the Eurozone. That is, Eurozone countries faced country-specific shocks, including fiscal and current account imbalances in Greece, a surge in credit and banking crises in Ireland and Spain, and productivity growth in Portugal and Italy. Over a decade prior to 2008, current account balances of both the EU, as a whole, and the Eurozone, in particular, obscured rising deficits of Greece, Ireland, Italy, Portugal, and Spain, offset by increased German surpluses. While core nations—such as Austria, Finland and Germany—improved their asset positions, countries in the periphery—Greece, Ireland, Italy, Portugal, and Spain—accumulated large net foreign liabilities. Sinn and Valentinyi (2013) note that the current account imbalances within the Eurozone were made worse by the common currency because it eliminated exchange risks, provided incentives for investors to ignore country-specific investment risks, and created unrealistic expectations about economic convergence between core and periphery nations. The artificially low interest rates in the periphery attracted capital movements from the core, and resulted in current account deficits accompanied by rapidly rising prices and so undermined these nations' competitiveness.

In their efforts to improve their competitive position without exiting the euro, periphery nations were unable to devalue their currency for the purposes of improving their current account imbalances and enhancing their competitiveness. Instead, they were forced to bring about devaluation by decreasing prices and costs (including wages) using deflationary macroeconomic policies. As described by De Grauwe (2012), such policies not only lead to long and painful periods of recession and budget deficits, but are also prone to extended periods with high unemployment, protracted deflationary spirals, possible additional sovereign debt and banking crises, and social unrest. On the other side, cost and price competitive core nations (such as Germany) that had experienced high productivity growth over the decade prior to the crisis were unable to appreciate their currency to help restore internal trade competitiveness and balance within the Eurozone.

Perhaps more important than economic features are the political aspects of the Eurozone crisis. European nations and people neither agree on the causes of the crisis nor on the path forward. The prevailing view in core nations (predominantly in northern parts of the Eurozone) links the crisis to a lack of enforcement of rules, whereas the predominant view in the periphery is that the crisis is the result of systematic flaws. Further, the core nations' dominant view is that austerity measures are the preferred policy response to the complex economic crisis, whereas the view of the periphery nations is that such policies are counterproductive and cannot be supported by the limited availability of political capital. Thus, the crisis of the common European currency appears to reflect a search for a common European purpose.

Effects of the Crisis on Other Regions

Findings by the IMF (2012) and fairly similar ones by Maplecroft (2012) indicate that if contained, a continued Eurozone crisis will likely have limited effects on areas outside of Europe. However, without economic growth, the crisis will not only linger in the Eurozone itself but also dampen economic growth in other areas of Europe and nations across the globe tied to Europe through trade and investment links. Due to the intensity of linkages, spillover effects of a possible euro collapse would likely have the most severe impacts on Europe's emerging markets, followed by the advanced economies in Europe, and nations of the Commonwealth of Independent States, while impacts on the United States and Canada would be relatively minor.

Nelson et al. (2012) stated that the implications of the Eurozone crisis for the United States and for the U.S.-EU cooperation are difficult to assess, but also suggest that United States exposure to economic events in Europe—while less than the EU's regional trading partners—is considerable due to the two economies' size and depth of integration. The authors suggest that a possible euro depreciation relative to the dollar might increase the U.S. trade deficit with the EU, and also point out that uncertainty in the Eurozone may create a "flight to safety," which might further appreciate the dollar relative to the euro, decrease U.S. Treasury yields, and increase U.S. stock market volatility.

Policy Responses to the Eurozone Crisis

Policymakers have mainly focused their responses to the Eurozone crisis on efforts to develop solutions for sovereign (nation-specific) debt and banking crises, and, more recently, to strengthen the institutional setting of the EU and Eurozone. Increased funding for and the consolidation of temporary institutions into the permanent European Stability Mechanism in 2012 have improved the financial stability of the most indebted Eurozone nations. Also, as a step toward the creation of a banking union, the ECB has a new supervisory role over Eurozone banks. However, most important for dramatically reducing the fear of a Eurozone collapse was the ECB's long-anticipated decision to commit itself to supporting sovereign bond markets. For example, De Grauwe (2011a; and 2001b) suggested earlier that market confidence would be improved by the ECB commitment to buy sovereign bonds. Similar calls were made by Wolf (2011). By announcing itself as a lender of last resort, bond yield spreads (the interest rates on a government bond compared to that of very solid status benchmark bonds, such as German bonds) among Eurozone nations that had emerged since the start of the Eurozone crisis dramatically reduced. One of the most intractable problems—the large, internal imbalances within the Eurozone—has thus far not been dealt with in an adequate manner. As mentioned, efforts to regain competitiveness have focused on devaluing through lowering prices, wages, and production costs in periphery nations and less on conducting the reverse in core nations. Sinn and Valentinyi (2013) noted that these policies have had only minimal effects on bridging the competitiveness gap between periphery and core nations. Furthermore, there appears to be an increasingly widespread realization that the controversial austerity policies consisting of spending cuts and tax increases may have worsened and prolonged the Eurozone crisis by dampening economic growth and causing historically high unemployment levels in many Eurozone nations, and thereby further increased debt burdens among households, firms, and governments. Various economists have proposed alternative solutions to the austerity policies and have suggested ways to help enable nations in the periphery to regain competitiveness. For example, Wyplosz (2013) and others proposed a combination of prioritizing economic growth, restoring the banks' ability to lend, and replacing the current austerity policies.

EU Agriculture

A key component of the European project has centered on the Common Agricultural Policy (CAP) with its multifold objectives to increase agricultural productivity, ensure a fair standard of living for farmers, stabilize markets, guarantee regular food supplies, and assure reasonable prices for consumers. While these objectives have evolved to include broader objectives such as those affecting the environment and rural development, agriculture is perhaps the most integrated sector in the EU as a result of the longstanding EU-wide agricultural policy.

Because the agricultural sector is heavily influenced by global market conditions, sector-specific implications of the ongoing crisis are difficult to assess on the basis of conditions prevailing within the Eurozone only. Global demand for agricultural products is strongly affected by market conditions in especially rapidly growing economies such as China. However, China's ability to export its own products is also deeply affected by European consumers' purchasing power and their ability to import Chinese products.

Since the start of the crisis in late 2008, the Eurozone as a whole has maintained its global competitiveness due to some depreciation of the euro relative to other major currencies such as the U.S. dollar. Also, economic contraction in the EU has placed pressures on the overall EU budget (amounting to about $78 billion in 2013), and has provided opportunities for reducing the costs and improving the efficiency of the CAP (which uses 40% of the total budget), as proposed by, for example, Tangermann (2011). However, attempts to reform the CAP have been overshadowed by the Eurozone crisis itself. The EU budget represents only 1% of the EU's national income, and it pales in comparison to funds needed to stabilize economic conditions in the Eurozone following the crisis. Efforts to reduce CAP funding are further undermined by conflicts over the internal distribution of CAP funds allocated to new and old EU members. Also, unlike in the United States, the EU remains committed to its system of de-coupled direct government payments as agricultural commodity supports. In the EU, the direct payments are viewed not only as stabilizing farm incomes, but also encouraging producers to comply with environmental programs. An additional uncertainty is how the European Parliament will allocate funds for the CAP in its new role of co-decision maker, jointly with the Council of Ministers which, heretofore, was the only entity controlling the CAP budget. The implications of the co-decision are unclear. On the one hand, it affords improved transparency; but, on the other hand, it complicates the political process.

Last but not least are poor credit conditions affecting the agricultural sector in Europe. Increased capital requirements for banks associated with the prolonged difficulties in the EU's banking sector have affected the ability among agricultural producers and agribusinesses to access credit. Similar to other industries, the number of bankruptcies in the agricultural sector in the EU appears to have increased.

Continuing Challenges to EU Agriculture

One of the purposes for the development of the common European currency was to integrate the economies of the EU through encouraging trade and advancing economic growth. Yet the ongoing difficulties in the Eurozone may undermine further European unity. The threat of an immediate disintegration of the euro has declined due in part to an agreement among European leaders to embark on a banking union and because of the ECB's stated commitment to support sovereign bond markets. However, economic growth prospects remain dim throughout the EU, and economic and social conditions in the periphery nations are dire. Further, there is no agreement on the most appropriate policies needed for further improvement in economic conditions and for making the euro more resilient to possible further set-backs.

To an extent, the European agricultural sector reflects broader problems within the Eurozone and the EU overall. The CAP long served successfully as a tangible element of a common European purpose, but it may not be able to escape budget cuts as a result of the economic difficulties. Further, policymakers remain divided over the future direction of the CAP as well as over the geographical distribution of funds associated with the CAP. Finally, agricultural producers' access to credit has been limited due to the banking crisis. While agricultural market cycles may not necessarily coincide with macroeconomics cycles, the crisis in the Eurozone is expected to continue to be a problem for agriculture within Europe and the economies of its trading partners.

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