Teacher's Attachment B: A Brief History of the Eurozone Crisis

- The Eurozone crisis has been ongoing since 2010. It has affected a number of the Eurozone countries and resulted in a general economic downturn in the European Union member states.
- The Eurozone crisis has long-term and short-term causes.
- **Long-term causes** include structural problems with certain European economies, such as a lack of competitiveness or bloated public sectors, as well as the nature of the common currency system. Many have argued that this common currency system was not 'complete', and therefore unable to withstand massive external shocks.
- **Short-term causes** are related to external shocks to the European financial markets that resulted from the 2008-09 financial crisis that originated in the United States.
- The **global financial crisis** started with the bursting of the housing bubble in the US, where people had been able to get mortgages on their houses at very low interest rates even if they had low credit ratings and poor prospects for being able to pay back their loans. This meant that even people who had trouble paying their credit card bills were trusted with borrowing large sums of money. Many ended up being unable to pay off these subprime mortgages and the housing bubble burst.[1] In the summer of 2007, several hedge funds, including European ones that were invested in subprime mortgages in the US, collapsed. Many European banks had to cut back on their lending, which reduced consumption and investment. Likewise, the housing boom was reversed in most developed countries. The financial crisis led to a global economic recession.
- In 2008, the cost of lending between banks was very high and central banks, including the European Central Bank, had to intervene. At the same time, some member state governments had to borrow money in order to bail out their banks and stimulate their economies, since the higher unemployment and the lower profitability of businesses during the recession had lowered their tax revenues. Because these governments had to run fiscal deficits to pay for this, **their public (sovereign) debt increased**.
- At first, one Eurozone country, **Greece, could not borrow money on the capital markets as** the Greek debt was seen as unsustainable and, thus, interest rates were increased.
- Greece has been passing austerity measures periodically since early 2010 in order to curb its deficit and receive bailout loan packages from the Eurozone and the **International Monetary Fund (IMF).** This austerity has sparked strikes, riots, and a failed attempt to form an anti-austerity government.
- A **contagion** effect led to investors demanding higher returns on Italian and Spanish sovereign debts, meaning that these countries had to pay higher interest on loans, which in turn caused them to adopt fiscal austerity measures and structural reforms in order to reduce budget deficits and improve economic competitiveness.
- The EU and IMF also agreed to a **bailout package** to Ireland in November 2010 and to Portugal in May 2011. Since June 2012, Spain has been talking of requesting a bailout,

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[1] Jeff Holt (2009), "A Summary of the Primary Causes of the Housing Bubble and the Resulting Credit Crisis: A Non-Technical Paper," *The Journal of Business Inquiry* 8, no. 1: 120. http://www.uvu.edu/woodbury/jbi/volume8/journals/SummaryofthePrimaryCauseoftheHousingBubble.pdf.

and one is on track for its banks.[2] As well, in February 2011, Eurozone finance ministers set up a permanent bailout fund, called the European Stability Mechanism, worth about €500B. Finally, in 2012, the EU (except for the UK and the Czech Republic) signed an intergovernmental **"fiscal pact"** for new rules that would make it harder to break budget deficits.[3]

Why were these countries in need of bailouts?

- In the case of Ireland, the country has a competitive economy. The Irish government guaranteed bank liabilities and this resulted in high public debt. there
- By contrast, Greece, Portugal, and Italy had experienced little growth for a decade, and suffered from a lack of competitiveness. Being in the Eurozone had allowed them to borrow at the low interest rates of more competitive Eurozone members. Furthermore, the creation of the euro had encouraged a massive capital movement from Europe's core – mainly Germany, but also the Netherlands – to its periphery, causing an economic boom and higher inflation rates in peripheral countries such as Spain.
- In Greece especially, the government had borrowed large sums of money in the 2000's which were used very inefficiently in the public sector. There has also been debate as to whether Greece actually met the criteria for joining the Eurozone in 2001.
- Most countries ignored the Eurozone rules on spending. Two of the main architects of the euro, Germany and France, had themselves undermined the SGP in 2003 by running budget deficits above 3% of their GDP and then getting Italy to help them veto the sanctions that the Commission and other member states would have ordered. This meant that France and Germany could not later use sanctions to encourage Portugal and Greece to lower their deficits during good economic times. In fact, in the Eurozone, only Luxembourg, Sweden, and Finland had deficits below the pact's limit of 3% and only Spain, Luxembourg, Finland, Slovenia, Slovakia, and Cyprus had a debt level below the pact's limit of 60%.[4]
- Despite breaking the SGP, Germany has performed well during the crisis. Why might this be? First of all, Germany has undertaken structural reforms and became more competitive in recent years. Secondly, the German economy gets a lot of its strength from exporting goods around the world. The euro made it easier for Germany to sell goods to countries on the periphery of Europe, both by making German goods cheaper for people in those countries, and by making it easier for people in those countries to borrow money to buy goods from Germany.[5] Comparing numbers across the entire EU, it was only in Germany that unemployment rates decreased from 2009 to 2011. You can read more about the German economy here.
- To read a timeline with clickable links to more in-depth stories during each stage of the crisis, click here.

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[2] http://www.telegraph.co.uk/finance/financialcrisis/9719875/Spain-requests-39.5bn-bank-bail-out-but-no-state-rescue.html

[3] "Timeline: The unfolding eurozone crisis," 2012, *BBC News*, http://www.bbc.co.uk/news/business-13856580.

[4] Mary L. Lo Re (2011), "Impact of the Global Financial Crisis on the EU and Euro Area vs. the USA," *China-USA Business Review* 10, no. 7: 536-7.

[5] Jacob Goldstein (2012), "The Crisis In Europe, Explained," *National Public Radio*, http://www.npr.org/blogs/money/2012/06/04/154282337/the-crisis-in-europe-explained.

Austerity and growth

- As a response to the recession and financial crisis, many countries, including EU states, have implemented austerity measures, i.e., cutting government spending. Critics of austerity say that lowering government demand in a depression environment reduces economic growth and tax revenues. While austerity measures aim to decrease the level of debt, restructuring the economy aims to make the economy more competitive, for instance through labour market policies, business support, and investment. Lowering the debt while simultaneously increasing competitiveness is very difficult because of the negative relationship between austerity and economic growth. Furthermore, the tendency to bailout banks but not the unemployed and to be so strongly against inflation has been criticized.[6] However, except for Greece, high debt-to-GDP ratios were not the main reason for the debt crisis in the Eurozone. In fact, many countries, such as Spain and Italy, were decreasing or stabilizing their debts prior to the banking crisis. Hence, private rather than public debt was the cause of the crisis. Despite this, some politicians in Europe and North America have mistakenly blamed the Eurozone crisis on high European welfare spending.

Possible Solutions

The EU may consider some of the following options:

Fiscal Integration

- Some believe that only a fiscal union can save the euro. This means that not only monetary policy (e.g., currency, interest rates) would be controlled at the European level, but also fiscal policy (e.g. taxes and expenditures).
- A fiscal union could involve a European finance minister with the power to veto national budgets and to approve levels of new borrowing. The individual countries could still decide how to spend the approved funds, e.g. on families or on road construction.[7]
- A European-wide coordination of wage policy could close the gap between low German wages and inflated Southern European ones.[8]
- The EU would need strong powers to sanction states that break the fiscal rules. Would these states listen? Well, the European Commission has been able to regulate competition in the EU.
- In Canada, we leave decisions about monetary policy to our central bank. However, fiscal policy is decided by the elected government and is usually one of the main questions in any election. Citizens in the EU are also interested in their countries' fiscal policies. Because the European Parliament and other democratic measures at the European level are not as strong as member states' national democratic standards, a fiscal policy controlled at the European level would require improved democratic measures. Perhaps the European Parliament could gain the power to enact bills, alongside a new body

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6 Paul Krugman (2012), "Another Bank Bailout," *The New York Times*, http://www.nytimes.com/2012/06/11/opinion/krugman-another-bank-bailout.html?_r=3&hp.

7 Schäuble, "'We Certainly Don't Want to Divide Europe,'" 2.

8 Heiner Flassbeck and Friederike Spiecker (2011), "The Euro – a Story of Misunderstanding," *Intereconomics*, 180, http://www.nachdenkseiten.de/upload/pdf/110812_Flassbeck_Intereconomics.pdf

similar to the US Senate with each country dispatching a certain number of representatives to this body.[9] Of course, democratic accountability has already been lacking in the EU's response to the crisis. The European Central Bank and the European Council (led by Germany and France) have been forced to make decisions quickly and without much democratic consultation.

Countries default on their debt and exit the Eurozone.

- This option would leave the banks from wealthier countries, such as Germany, with large unenforceable claims against the periphery countries and cause considerable turmoil in the whole Eurozone. It could undermine the credibility of and confidence in the euro.

Rather than further integration, is the opposite (disintegration) possible? Will the euro survive? Will the EU survive?

- Economic problems, especially those caused by the way the euro is structured, discredit what has always been the strongest justification for giving power to the EU: that it is good for the European economies.
- The crisis has given rise to some xenophobic sentiments such as stereotypes of Germans controlling Europe and Greeks demanding Germans' money. The countries at the heart of the crisis, Portugal, Italy, Ireland, Greece, and Spain, are being called by the unflattering acronym "PIIGS."
- If austerity goes too far, some Southern states could demand to leave the Eurozone.
- The euro was the EU's flagship project.

<u>How is Canada affected by the Eurozone crisis?</u>

- Demand for our exports from Europe might grow only slowly or even decrease.
- Fortunately, our banks do not hold risky sovereign bonds in many of the worst affected countries.
- In January 2010, one euro was worth 1.4882 Canadian dollars. By July 2012, this had fallen to 1.2445. If you want to buy European goods or go on vacation to Europe, now is a good time![10]

[9] Schäuble, "'We Certainly Don't Want to Divide Europe,'" 1-2.
[10] Bank of Canada (2012), "Monthly average exchange rates: 10-year lookup," http://www.bankofcanada.ca/rates/exchange/monthly-average-lookup/.