

THE CAUSES OF THE EUROZONE CRISIS

Karamitrou, Maria 

Technological Educational Institute of Western Macedonia, Information Applications Technology
in Business Administration and Economy, Thessaloniki, Greece
karamitroumaria90@gmail.com

Markou, Angelos

Technological Educational Institute of Western Macedonia, Information Applications Technology
in Business Administration and Economy, Thessaloniki, Greece
angelmarkou88@gmail.com

Abstract

The present research aims to present and analyze the causes that led to the crisis in the Eurozone. The 2008 financial crisis revealed the weaknesses, the chronic problems and the differences which were lurking and emerged between the member states. The disparities of the economies combined with asymmetric monetary policy and political failures of member states exacerbated the problem resulting in the loss of credibility of some member states. The most vulnerable countries were those which are facing chronic debt problems and those which have directly affected by the financial crisis. The data for this investigation were collected from the databases of Eurostat and the European Central Bank. Finally, the present research concludes that the Eurozone crisis could be avoidable if the right moves have been made before the crisis and if there was a common stance for the beginning in order to tackle the problem.

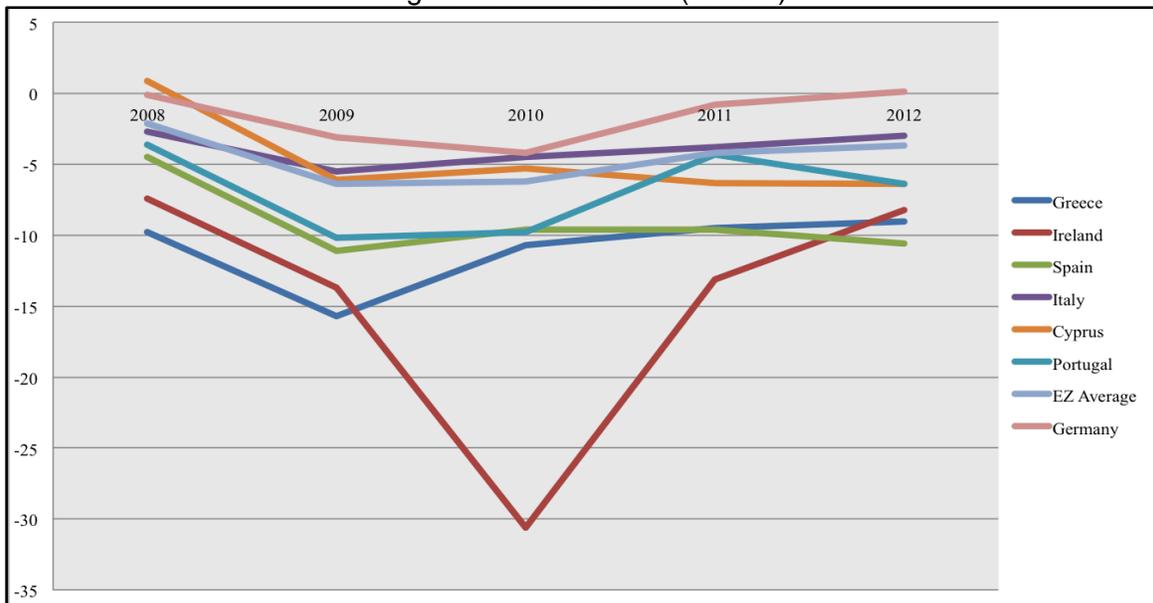
Keywords: Eurozone crisis; monetary union; banking crisis; structural distortions; sovereign debt crisis

INTRODUCTION

In 1992 the political leaders of the member states of the European Union (EU) gathered in Maastricht to sign the treaty, which would put the EU countries in the process of integration in a common monetary union. This treaty posed some goals to be achieved by the countries that had expressed a desire to join. The treaty stipulated that the inflation levels should not exceed the 1.5% benchmark, compared with the three best (in performance) countries, public debt should not exceed 60% of GDP and the fiscal deficit to reach up to 3%. The most important condition was that countries were not allowed to create money. The only way was by borrowing from the markets. Thereby the state could not implement an independent monetary policy. The

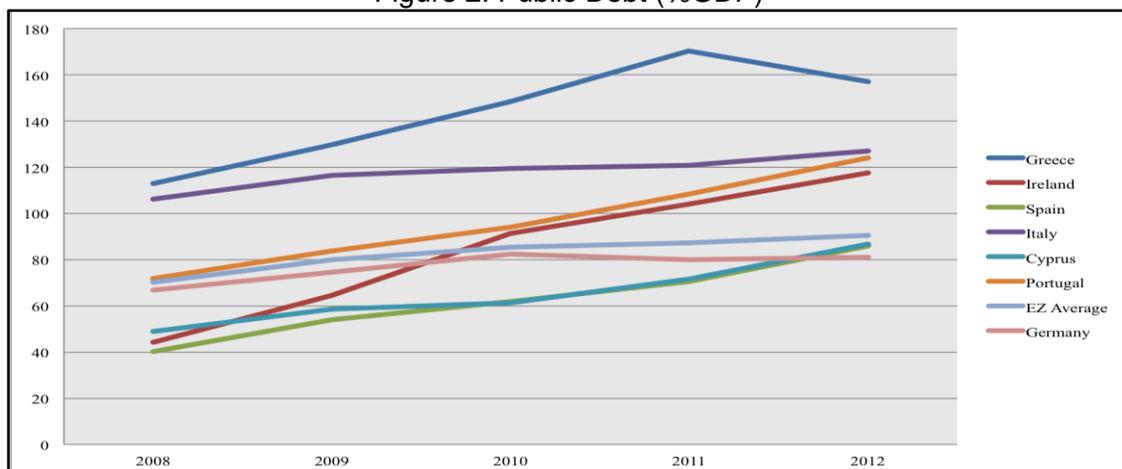
majority of countries, which have complied with the treaty, adopted the common currency known as the euro, some from 2000 and the rest from 2002. The problem was that most countries were unable to comply with the demands of the Maastricht Treaty and thus, many of these falsified financial details. The method of falsification of data is known as creative accounting. This resulted countries, which their debt was much higher from the threshold of 60% of GDP to enter the Eurozone. These countries were time bombs that would threaten to burst and break up the Eurozone. When the credit crisis broke out many member states which have as a national currency the euro rushed to support their banking systems. Financial aid which was given by the sovereigns caused the increase of public debt. In the Figure 1 Figure 2 reflect the increase of the fiscal deficit and public debt of countries that were the first "victims" of the debt crisis.

Figure 1: Fiscal Deficit (%GDP)



Source: Eurostat, General government deficit/ surplus

Figure 2: Public Debt (%GDP)

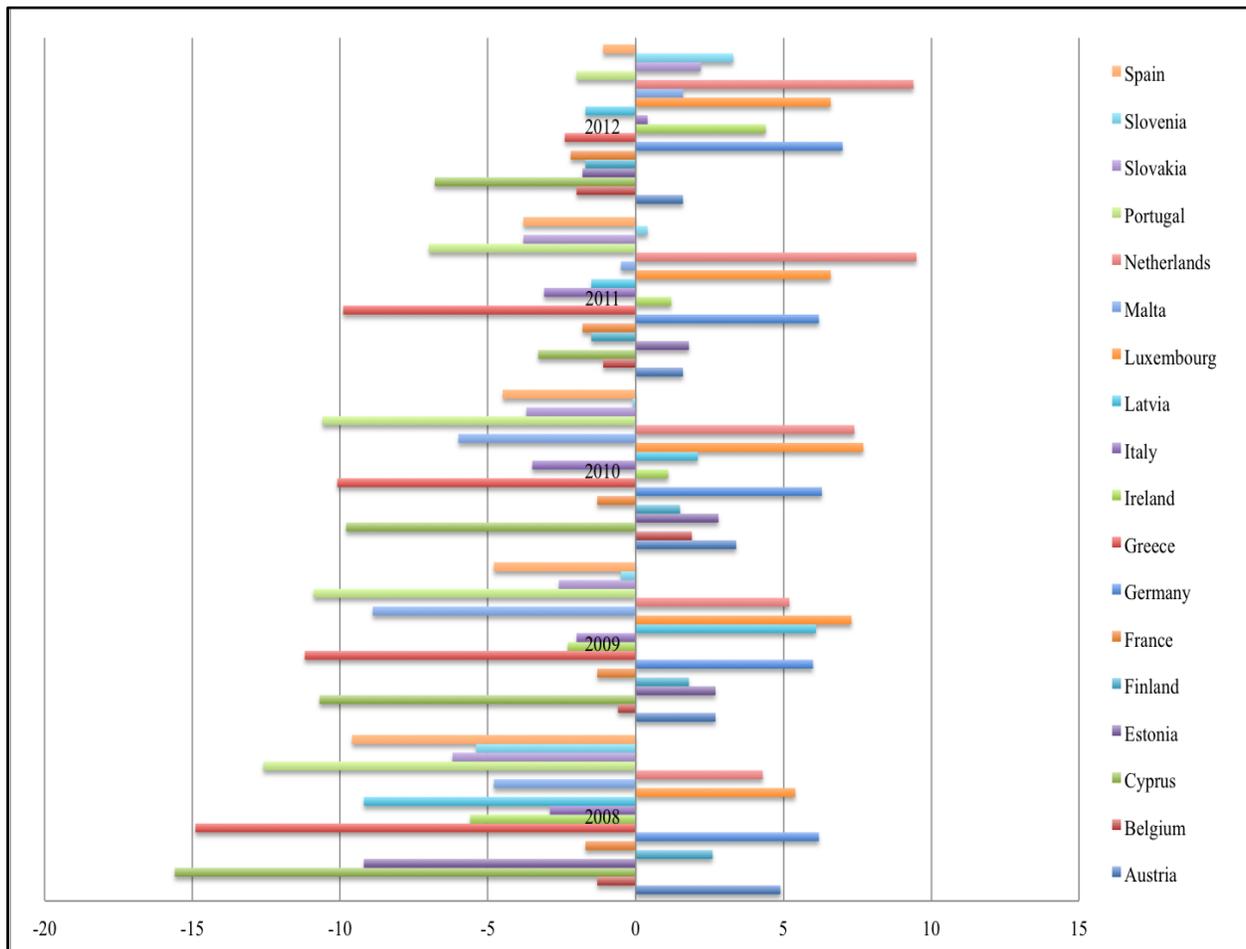


Source: Eurostat, General government gross debt

THE DISPARITIES OF ECONOMIES

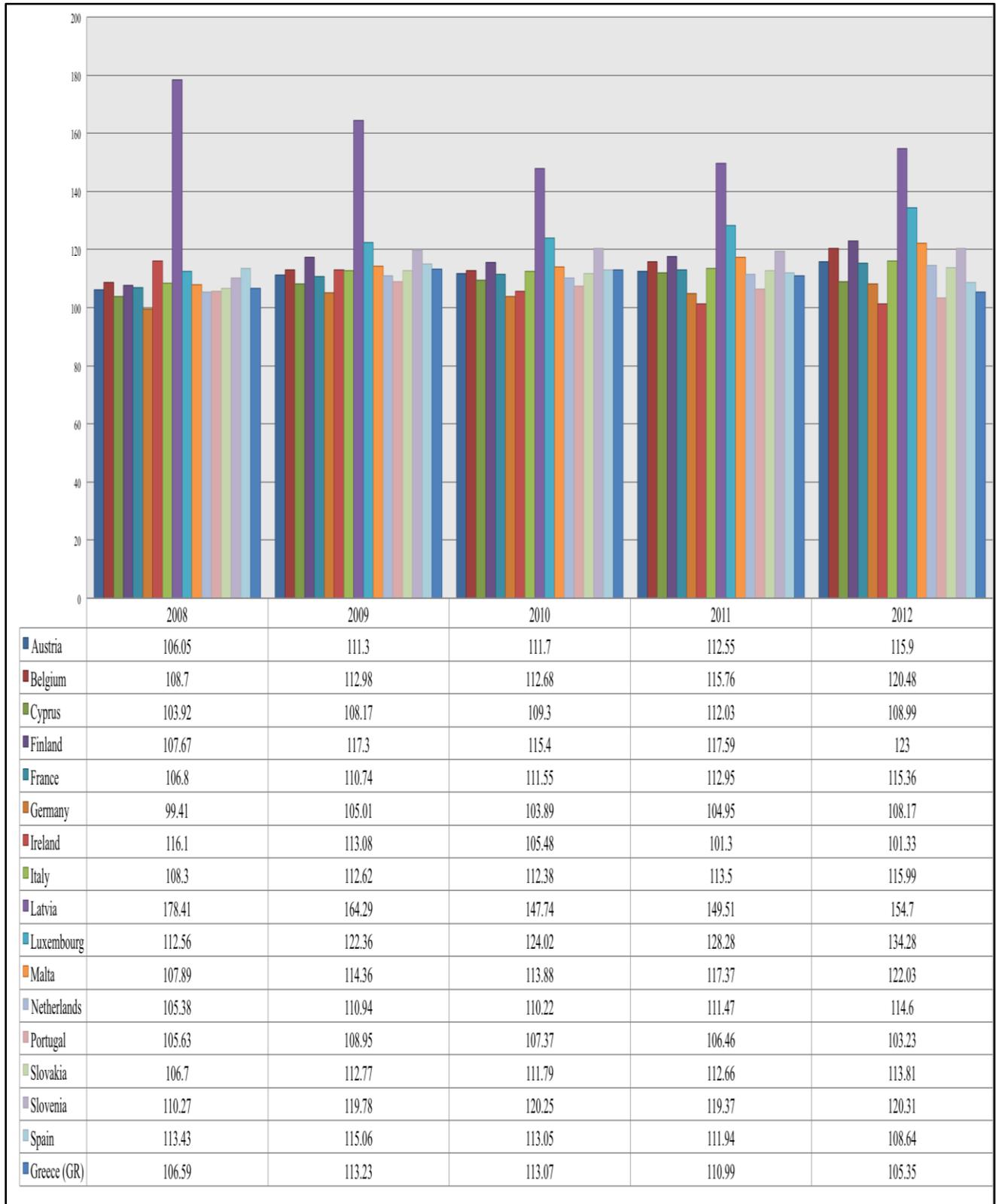
The members, which consist the Eurozone, are countries, that, due to the specificities of each have, they exhibit significant differences. The differences beyond cultural (language, culture, etc.) are also economical. Since the establishment of the Eurozone it was evident that the economies of some countries predominated compared with others. Increased competitiveness that some countries had, compared with others, made labor cost to differ from country to country in conjunction with the legislative regime. Several countries did not have the appropriate structures in order to absorb the "shock" of the adoption of a stronger currency. Thus countries with trade surpluses, exploiting the free market that offered them the Eurozone benefited at the expense of other countries (exported their products to them) that lacked productive development. The continuation of these moves led to the creation of a two tier Eurozone. These kinds of disparities have paved the way for the coming crisis in the Eurozone. Figure 3 shows the current account balance while Figure 4 shows the labor costs of the Eurozone countries, two indicators that are a representative criterion for measuring the competitiveness of an economy.

Figure 3: Current Account Balance



Source: Eurostat, Balance of payments, current and capital account, quarterly data

Figure 4: Labor Cost of Eurozone Countries 2008-2012



Source: European Central Bank - Statistical Data Warehouse

ASYMMETRIC MONETARY POLICY

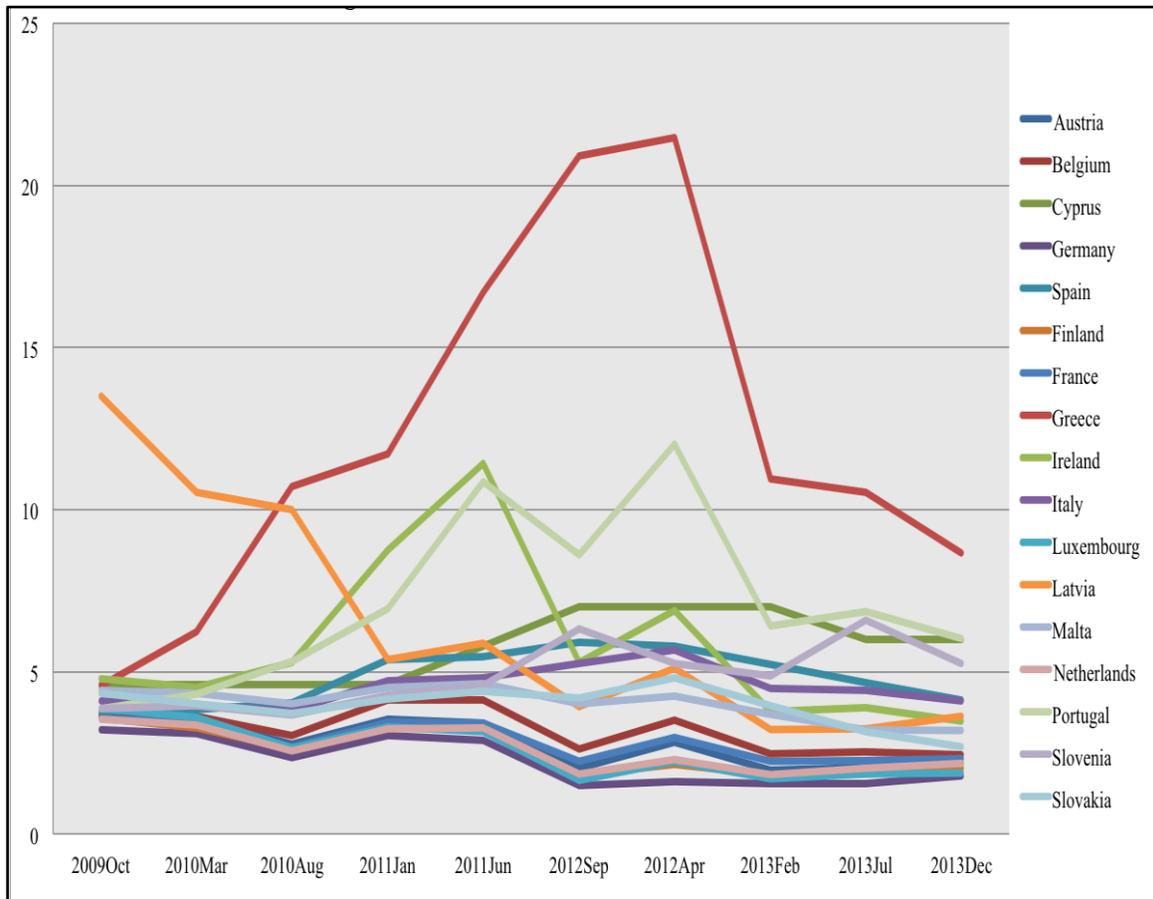
When the euro monetary union was established, it was introduced a common monetary policy which will be determined by the European Central Bank (ECB). The move prohibits member states of the euro zone to act autonomously printing money and confounded the role of the central banks of the Eurozone countries. Furthermore, the legal framework that defines the existence and the functions of the ECB limits the institution for acting at issues related to monetary policy. In other monetary unions such as the United States, the Federal Reserve may be used as emergency lender and fund states with debt problems. Additionally, if any of the States defaults, the pensions and the wages provided by the state will be covered by the Fed. E.C.B. does not have these features. Jurisdictions are limited to borrowing the European banks and the establishment of the interest rate. A further disadvantage is the autonomy of fiscal policy. The Eurozone has single monetary policy without having a common fiscal policy. Member states while are obliged to follow fiscal rules, there is not any official body which implements these rules and regulations. This enabled the Eurozone countries to borrow brazenly and increase their public debt, canceling in practice the Maastricht Treaty. Countries with debt problems which could pay its creditors by printing money found themselves threatened with default. In which case the only way to repay their creditors was that of internal devaluation. As internal devaluation define a series of activities such as spending cuts, wage cuts and pension, increases in indirect taxes and easing of labor relations. The lack of independent monetary policy, the trade deficits that several countries had in conjunction with the internal devaluation made the debt crisis in the euro area to be impenetrable.

THE LOSS OF CREDIBILITY

Several European banks have bonds in their portfolio of various Eurozone countries. Before the crisis, regulatory authorities and rating agencies considered the bonds of countries with high public debt safe (as they were equal members of the Eurozone). When it was found that the image presented regarding the levels of public debt in Greece was quite different from the reality, country's credibility collapsed. Rating agencies had continuously degraded the creditworthiness of Greece, resulting the interest rates to rise and borrowing became prohibitive. This fact contributed to other Eurozone countries with high public debt having problems of borrowing. The situation became even more adverse with the stance of the European partners, without taking immediate actions to resolve the debt crisis in Greece and later on in rest of the Eurozone. The solution of the European Financial Stability Fund (EFSF) came up when Greece came close to default. Even then, the measures which implemented as a result of the lending from EFSF have not been able to convince that this solution on the debt problem is likely to

bring stability. Figure reflects the loss of credibility with interest rates of the Eurozone countries which facing debt problems to have an upward trend during the critical period.

Figure 5: Long-Term Interest Rates of all Eurozone Countries



Source: European Central Bank - Statistical Data Warehouse

CONCLUSIONS

In Europe, the lack of insight and solidarity among member states of the Eurozone made euro look weak and stripped in front of the challenges of the financial markets. The funding of countries that have a debt problem from the EFSF exacerbated the situation and was seen as a short-lived embankment. The insistence of austerity made countries which have debt problem sinking into recession, without any apparent prospect for growth.

The Eurozone debt crisis could have been avoided if except for the common monetary policy and there was a common fiscal policy. The lack of a common fiscal policy made (at some extent) the euro to be vulnerable to any endogenous problem of a member state. Noteworthy is also the lack of political will of several Eurozone governments to make appropriate reforms in the economy of their countries. If they had done the appropriate moves before the credit crisis the economies within the Eurozone would have the adequate structures to withstand and

overcome the crisis. In this period with the recession dominating on a permanent basis is very difficult to implement the needed reforms but also to be efficient in order the countries to become more competitive.

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