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# The Eurozone Crisis: Origins and Implications

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**ABSTRACT** *The sovereign debt problems in the peripheral economies of the euro zone has started to pose a serious threat to the main economies of the Europe and perhaps to the future of the 'euro' itself. Such a situation is a far cry from the optimism and grand vision that marked its launch. For several years prior to 2010, countries in the euro area periphery engaged in heavy borrowing from foreign private investors, allowing domestic spending to outpace incomes. Now these countries face debt crises reflecting a loss of investor confidence in the sustainability of their finances. The result has been an abrupt halt in private foreign lending to these economies. This study reviewed how the periphery countries became dependent on foreign borrowing and considers the challenges they face reigniting growth while adjusting to greatly reduced access to foreign capital.*

**Introduction**

The year 2009 was the tenth anniversary of the creation of the euro. Throughout the year, academic conferences were held to celebrate what at that time was widely considered to be the success of the boldest attempt ever by diverse sovereign states to reap the efficiency gains of a single currency. Despite the earlier misgivings of some economists about the feasibility of a common currency in Europe (e.g., Feldstein, 1997; Friedman, 2007), by 2009 evidence of the euro's success was plentiful. The euro had created a low-inflation, low-interest-rate environment (even for formerly high-inflation countries) conducive to sustainable growth. It had fostered trade integration and the integration of financial (and, to some extent, labor and commodity) markets among the members of the euro area. The number of participating countries had risen from eleven in 1999 to sixteen in 2009. Notwithstanding the eruption of the global financial crisis in August 2007 and its intensification in September 2008 with the collapse of Lehman Brothers, the euro area had been relatively unscathed by the effects of that crisis. To mark the euro's tenth anniversary, at the end of 2009 the European Commission published a study that sought to explain the reasons the skeptics of the single currency could have been so misled in their assessment of the euro's feasibility (Jonung and Drea, 2009).

Yet, amidst the celebrations in 2009, in Greece a shock was unfolding that, by the end of the year, would materialize into a full-blown financial crisis. Krugman (2012, p. 4) would later characterize that shock as "the mother of all asymmetric shocks - a shock that was, in a bitter irony, caused by the creation of the euro itself." During the ensuing years, the euro crisis broadened and deepened, threatening the sustainability of Europe's common currency. What had started as a sovereign-debt crisis in Greece spilled over to that country's banking system, creating twin crises. In other euro-area countries, including Ireland, Spain and Cyprus, the crises originated in the banking systems and spilled over to the sovereign debt. While at the time of this writing (August 2013) the euro-area crisis is by no means over (although it has subsided considerably), the events of the past four years provide the opportunity to take stock of what went wrong and what can be done to prevent future crises in the euro area.

In order to gain a better understanding of the issues involved, this study reviewed how the periphery countries became dependent on foreign borrowing and considers the challenges they face reigniting growth while adjusting to greatly reduced access to foreign capital.

**Why is the literature reviewed?**

A literature review discusses published information in a particular subject area, and sometimes information in a particular subject area within a certain time period. Literature reviews provide a handy guide to a particular topic. For professionals, they are useful reports that keep them up to date with what is current in the field. For Scholars, the depth and breadth of the literature review emphasizes the credibility of the writer in his or her field. Literature reviews also proved a solid background for the research topic under investigation. And depending on the situation, the literature review may evaluate the sources and advise the reader on the most pertinent or relevant. Comprehensive knowledge of the literature of the field is essential to most researches.

Until recently many researchers have shown interest in the field of the Eurozone Crisis. They have carried out numerous field observations to illuminate the darkness of this field. Their findings and suggestions are reviewed here:

Sprčić, Danijela Miloš (2007) analysed financial risk management practices and derivative usage in large Croatian and Slovenian non-financial companies and explores if the decision to use derivatives as risk management instruments in the analyzed companies is a function of several firm's characteristics that have been proven as relevant in making financial risk management decisions. On the basis of the research results the researcher concluded that forwards and swaps are by far the most important derivative instruments in both countries.

Afonso, António et.al. (2010) examined how and to what extent these crisis-related interventions, as well as the fall-out from the recession, have had an impact on fiscal positions and endangered the longer-term sustainability of public finances in the euro area and its member countries. The researchers also discussed the appropriate design of fiscal exit and consolidation strategies in the context of the Stability and Growth Pact to ensure a rapid return to sound and sustainable budget positions. And concluded that Once the recovery is evident, governments need to start exiting from the fiscal stimulus and shift to substantial fiscal consolidation in order to return to sound and sustainable fiscal positions.

Wyplosz, Charles (2010) contrasted the United States (US) and European situations during the crisis and examined how much of the crisis has been imported by Europe from the US. The researchers also argued that Europe never had a chance to avoid contagion from the US. It also documents the relatively limited reaction of both monetary and fiscal authorities. Muted fiscal policy actions may well be a consequence of the Stability and Growth Pact despite its having been de facto suspended. While the European Central Bank (ECB) intervened promptly and massively to attempt to maintain liquidity in the money market, it has been slow in dealing with the upcoming recession. The concluding remarks consider the differences that the monetary union has

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made and their relevance.

Grauwe, Paul De (2010) discussed about how to impose more convergence among member states of the eurozone has focused on what national governments should do to avoid divergent developments in a number of macroeconomic variables (competitiveness, current account imbalances). Without denying that national governments have their part of responsibilities, the role of these governments has been overemphasized. Conversely the role of the monetary authorities, in particular the ECB, has been under-emphasized. The conclusion was derived from the diagnosis of the causes or the present crisis. This is that the divergences between member- states of the eurozone have been driven mainly by what researcher called "national animal spirits", i.e. waves of optimism and pessimism that continue to have a strong national basis in the eurozone. There were no animal spirits gripping the eurozone as a whole.

Paloviita, Maritta and Kinnunen, Helvi (2011) explored euro area fiscal policies since the late 1990s using real time data from the OECD and fiscal policy reaction functions. Both discretionary plans for the budget year and policy changes during budget implementation stages are investigated. The main focus is on the fiscal adjustment to the recent financial and economic crisis. The results suggested that during the monetary union (EMU) euro area planned fiscal policies have been long-term oriented and counter-cyclical. In the implementation stages new policy decisions have been made as a response to unexpected economics developments. They had provided evidence that the crisis had a clear impact on discretionary policies. Due to the increased uncertainty, the crisis emphasized the impact of cyclical developments on fiscal planning. In the implementation stages, huge forecast errors made in budget planning were observed. As a consequence, new decisions were made in order to alleviate negative impacts of the crisis on the euro area economies.

Wignall, Adrian Blundell (2011) examined the policies that have been proposed to solve the financial and sovereign debt crisis in Europe, against the backdrop of what the real underlying problems are: extreme differences in competitiveness; the absence of a growth strategy; sovereign, household and corporate debt at high levels in the very countries that are least competitive; and banks that have become too large, driven by dangerous trends in 'capital markets banking'. The researcher explained how counterparty risk spreads between banks and how the sovereign and banking crises are serving to exacerbate each other. Of all the policies proposed, the researcher highlighted those that are coherent and the magnitudes involved if the euro is not to fracture.

Dreger, Christian and Wolters, Jürgen (2011) explored the stability of the relation between money demand for M3 and inflation in the euro area by including the recent period of the financial crisis. Evidence wass based on a cointegration analysis, where inflation and asset prices are allowed to enter the long run relationship. By restricting the cointegrating space, equations for money and inflation are identified. The results indicated that the equilibrium evolution of M3 is still in line with money demand. In the long run, inflation is affected by asset prices and detrended output. Excess liquidity plays an important role for inflation dynamics. While the hypothesis of weak exogeneity is rejected for real money balances and inflation, real income, real asset prices and the term structure do not respond to deviations from the long run equilibria.

Mody, Ashoka and Sandri, Damiano (2011) used the rise and dispersion of sovereign spreads to tell the story of the emergence and escalation of financial tensions within the eurozone. This process evolved through three stages. Following the onset of the Subprime crisis in July 2007, spreads rose but mainly due to common global factors. The rescue of Bear Stearns in March 2008 marked the start of a distinctively European banking crisis. During this key phase, sovereign spreads tended to rise with the growing demand for support by weakening domestic financial sectors, especially in countries with lower growth prospects and higher debt burdens. As the constraint of continued fiscal commitments became clearer, and coinciding with the nationalization of Anglo Irish in January 2009, the separation between the sovereign and the financial sector disappeared.

Kulms, Rainer (2012) reviewed the European trajectory from makeshift to more comprehensive strategies with rescue mechanisms for countries in distress, including an assessment of the role of the European Central Bank and the conflicting interests of the Member States. A section on the Spanish Recapitalization Schemes of 2012 and the EU's policies on recapitalizing banks demonstrate the interface between the sovereign debt and banking crises.

Shambaugh, Jay C. (2012) detailed the three crises (i.e. banking crisis: banks are undercapitalized and have faced liquidity problems. There is a sovereign debt crisis: a number of countries have faced rising bond yields and challenges funding themselves. Lastly, there is a growth crisis: economic growth is slow in the euro area overall and unequally distributed across countries), their interconnections, and possible policy solutions. Policy responses that fail to take into account the interdependent nature of the problems will likely be incomplete or even counterproductive. A broader point also becomes clear: a currency union may not need a fiscal union, but it does likely need both a financial union and some way to adjust for unbalanced economic conditions across countries.

Kennan, Jane et. al (2012) analyzed the vulnerability of developing countries to the euro zone crisis, looking at differences across countries and groups of countries. In addition to this, the researchers simulated the potential effects of trade shocks due to the crisis on lower-income economies, and established a set of stylized facts on the actual impacts of the European debt crisis on poor countries. Policy responses at the country and international level were also discussed.

Research Report (2012) suggested that among senior finance professionals in the UK many expect a continued worsening of the eurozone crisis to have a detrimental impact on the turnover of their business over the next 12 months.

Chinn, Menzie D. and Frieden, Jeffry A. (2012) reviewed the origins of the euro project and recounted the ideas that underpinned the project and explain why some economists were skeptical. The current state of debate over possible solutions was next and concluded with some views on the likely path forward which include early recognition of the need for North-South transfers, recapitalization of the banking system, and accelerated inflation.

Anand, M R et. al. (2012) attempted to understand the implications of the ongoing euro zone crisis and the factors that make it somewhat unique as the contradictions of a monetary union without a fiscal union are coming to fore. They concluded that the crisis is not merely related to sovereign debt and bank financials but also rooted in the real economy with structural problems. The manner in which the crisis is dealt is likely to be of far reaching significance to Europe and to the rest of the world. The stage seems set for a change in the way in which the euro zone will need to manage its monetary, fiscal and financial system.

Cencig, Elisa (2012) outlined Italy's economic situation in the midst of the cur- rent crisis and the challenges ahead and discusses the current government's reform agenda. The researcher argued that the technocratic government led by Monti is undertaking comprehensive reforms which address a wide range of structural weaknesses, yet economic recession and political factors both at a national and European level make the outlook all but safe. In addition, a number of issues remain high on the agenda, notably the weakness of the justice system, inefficiency in PA and corruption, which hinder Italy's economic growth. Although something has been done to deal with them, more courage is needed to address these weakening factors.

Lane, Philip R. (2012) analyzed the sovereign debt crisis is deeply intertwined with the banking crisis and macroeconomic imbalances that afflict the euro area. Shambaugh (2012) provided an accessible overview of the euro's broader economic crisis. Even if the crisis was not originally fiscal in nature, it was a full-blown sovereign debt crisis and the researcher focus was on understanding the fiscal a full-blown sovereign debt crisis.

Stracca, Livio (2013) conducted an event study focusing on the global effects of the euro debt crisis in 2010-2013. After identifying 18 key exogenous crisis events, researcher analyzed the impact on equity returns, exchange rates and government bond yields in 12 advanced and 13 emerging countries. The main effect of euro debt crisis events was a rise in global risk aversion accompanied by fall in equity returns, in particular in the financial sector, in advanced countries (but not in emerging countries). The effect on bond yields is not statistically significant for the whole set of countries, but is significant and negative for key advanced countries such as the US and the UK.

Greer, Scott L. (2013) argued that the Economic Adjustment Programmes (EAPs) that came with loans to peripheral Eurozone members Greece, Ireland, and Portugal are very similar to the loans with conditionality, also known as Structural Adjustment Programs that international financial institutions used as a policy tool during the 1980s and 1990s. The researcher defined structural adjustment programs and then shows how Eurozone rules plus the Economic Adjustment Programmes resemble them and then canvassed the literature evaluating structural adjustment in the developing world in order to formulate expectations for its performance in Europe. The conclusions from the large literature on structural adjustment policies suggested that the EAPs will: be badly implemented; be neutral or bad for growth; be bad for equity and the poor; have unpredictable policy consequences; and will allow incumbent elites to preserve their positions.

Fidrmuc, Jarko et. al. (2013) argued that Slovakia joined the euro area after a period of unprecedented real appreciation, which generated a threat for competitiveness of its export-oriented manufacturing industry. The response combined internal devaluation with productivity increasing measures, including capital deepening and laying off low productivity workers. While this strategy was successfully restoring an external equilibrium, its consequences for domestic demand and employment are less positive. This development is compared with Estonia and Slovenia, two other small and very open economies, recently entered the euro area.

Rana, Pradumna B and Blomenhofer, Michael (2013) used root cause analysis to identify the root causes of the eurozone crisis and compares it with the causes of the Latin American, the Asian, and the sub-prime mortgage crisis in the US. Similarities and differences are identified. The researchers argued that the root causes of the eurozone crisis were overleveraging, and the flaws in the design of the economic and monetary union. Although the crisis began over three years ago, it is only recently (July 2012) that actions have been initiated to fix the design flaws and deepen integration. Implementing these reforms will require strong political will on the part of member countries as they involve handing over authority to supranational institutions. The researchers also examined the various channels through which the eurozone crisis has impacted Asia and concluded that the overall adverse impacts have been manageable so far, but cautions that it could be more serious in the future.

Fennell, Shailaja et. al. (2013) focused on the interaction between Eurozone and India with a particular focus on the relationship between changes and economic conditions in these two jurisdictions. In the pre liberalization world, India and the Eurozone were regarded a priori as having little interaction with each other. This story changes with globalization and relatively free capital movements. The researchers highlighted some of the important changes which have occurred in the Eurozone and Indian economies and discuss the implications for other regions and countries. They set out a number of hypotheses and uses broad- brush data to provide the intellectual foundations for our analysis.

Rixtel, Adrian van and Gasperini, Gabriele (2013) provided an overview of bank funding trends in the euro area following the 2007–09 global financial crisis and the euro area crisis. It showed that funding has become segmented along national borders and that secured instruments are much more prevalent than previously. Rising debt retention by euro area banks has accompanied greater dependence on liquidity provided by the ECB.

Eriksen, Erik Oddvar (2014) studied that European citizens are humiliated by the way in which European institutions treat them in handling the Eurozone crisis. Social and political exclusion and technocratic rule contradict the normative thrust of the European integration process. Non-domination is the crux of justice and goes to the core of EU normativity. Through lock-ins and normative commitments, the EU's member states and in particular the Eurozone members have accidently moved themselves into a situation of collectivized risks and shared sovereignty. Establishing a European political union has become both a duty and a strategy for solving the crisis.

**Conclusion**

The paper shows that the crisis is not merely related to sovereign debt and bank financials but also rooted in the real economy with structural problems. The manner in which the crisis is dealt is likely to be of far reaching significance to Europe and to the rest of the world. The stage seems set for a change in the way in which the euro zone will need to manage its monetary, fiscal and financial system. Now the question is what should be done to make the Eurozone sustainable in the long run. The survival of the Eurozone hinges on the capacity of its leaders to improve the eurozone's governance.

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