



ORIGINAL RESEARCH PAPER

Economics

Various Dimensions of the Euro Zone Crisis

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ABSTRACT

The European Monetary Union was formed with the primary objective of increasing the productivity of member states by eliminating the escape route of exchange rate devaluation. Other objectives existed such as fall in borrowing costs on attaining reserve currency status. After the formation of Eurozone, the borrowing costs of economies converged. Some periphery economies failed to utilise this window of opportunity to borrow cheap and invest in productivity enhancement. After the global financial crisis exposed the weak economies, a number of measures have been announced to help. A major demand of assistance providers has been that such economies cut down on the benefits they provide to public sector workers and general public at large. The need of the situation is that assistance providers back down from such demand and share some of the pain of the weak economies and also share their experience in institution building with the weak economies.

Introduction

The European continent is uniquely placed in terms of composition of countries, their shared history and faces unique problems. There is a core set of countries which have very high per capita income, human development indicators, robust and evolved institutions and have had a history of democratic setup. There is a periphery which aspires to possess all these features. There is an ocean on the west of the continent and friendly countries across it. On the east, European region borders with a militarily powerful Eurasian nation which has huge ambition. After the Second World War, European nations, with a history of hostilities started contemplating cooperation in the economic arena. The result was European Coal and Steel Community, which was formed in 1951 through the Treaty of Paris, to regulate industrial production in six member countries viz. Belgium, France, West Germany, Italy, the Netherlands and Luxembourg. The next landmark was the formation of the European Economic Community in 1958 through the Treaty of Rome. A number of developments over the years have led to the formation of "the European Union" and "the Eurozone" within the Union. The global financial crisis exposed the economic cracks in the Eurozone and since then, European Monetary Union has been struggling to handle the home grown troubles, which, on a number of occasions have threatened to dismantle it.

Idea behind the Monetary Union

European Union had been world's largest common market by the 1990s with seamless movement of labour and commodities across state borders. But national differences in productivity could still be tackled with exchange rate devaluation. The basic idea behind forming a monetary union and adopting a single currency was that, those states that have been lagging behind others in productivity improvement would not be able to resort to exchange rate devaluation and would have to come up with serious measures to improve productivity. This competition of productivity improvement will be good for the union as a whole. Apart from this, there were other considerations like potential status of reserve currency allowing the members to borrow at a lower cost.

The forming of the problem

After the formation of the monetary union, the borrowing costs of the periphery countries quickly fell to the German and French levels. This gave a window of opportunity to the periphery countries to borrow cheap and invest in productivity improvement measures. However, the opportunity was squandered by countries like Greece which borrowed heavily and used the proceeds to cover current consumption and provide generous benefits to public sector employees without any corresponding increase in their productivity. Moreover, the fall in borrowing costs provided an escape route to enforcement of rule of law in tax collection. Rampant tax evasion continued and public services continued to be financed by borrowing.

The Maastricht Treaty curtailed the fiscal deficit to be no more than

3 percent of the Gross Domestic Product of a nation and the combined public debt to be no more than 60 percent of the Gross Domestic Product. The rules have been flouted by even the most prosperous countries. However, Greece went as far as using accounting tools to hide its heavy fiscal deficit and accompanying large public debt from the scrutiny of the European commission.

The Troubles

By 2006, borrowing costs for members of the Monetary Union started to diverge, marking trouble for the weak as the cost of servicing debt started increasing. The weak economies were marked from the strong. Then came the global financial crisis and all the governments and the supra national institutions of the European Union announced emergency measures to counter it. Although the measures announced averted immediate financial crises by supporting short term aggregate demand, problems of excessive deficits and debt remained. Moreover, the crises exposed the weak economies as their borrowing costs increased further. In late 2009, Greece admitted that its fiscal deficit was understated (12.7 percent of GDP, as against 3.7 percent stated earlier) prompting the rating agencies to downgrade Greek debt and Greek companies. In late 2009, Greek public debt was over 113 percent of GDP, just under twice the euro zone limit of 60 percent. By 2010, a sovereign debt crisis was looming large over the European Monetary Union with Greece right in the middle of it. The problems of Ireland, Portugal and Spain were also out in the open. The Crisis in Ireland was not on account of government borrowing and overspending and hence accumulating public debt. Irish banks had made enormous amount of loans for financing real estate purchases. When the real estate market collapsed, banks made losses amounting to about 100 billion euros. The economy was on the verge of collapsing and the government decided to guarantee the six major banks which had financed the property bubble. Ultimately, the government had to take over the property related loans of the failing banks. These toxic assets on the government balance sheet created yet another debt scare for the European Monetary Union. Portugal allowed considerable slippage in government managed infrastructure and provided extremely generous salaries and perks to the management of public firms from mid-1970s right up to the financial crisis. Public firms were consistently overstaffed and when the crisis hit the monetary Union, Portugal was one of the first economies to show signs of stress. Spain also experienced a property bubble prior to the crises. The crisis caused the bubble to burst and the Spanish government had to spend considerable amount of money to keep the banks afloat. Spain has been a prime concern for Europe because of its relative size. Cyprus, although being relatively small in size, had an inflated banking sector. The assets of the banking sector relative to the size of the economy were the largest in Cyprus and a component of that asset base was Greek government bonds. As borrowing costs increased for Greece, the value of Greek government bonds collapsed leaving a large hole on the asset side of the Cypriot Bank's balance sheets which led to a crisis for the Cypriot economy.

The Aftermath

Although the combination of fiscal deficit, public debt, private debt and bank lending was considerably different in the periphery economies, the financial markets treated them similarly, increasing the borrowing cost for the countries and companies in these countries. On 2 May 2010, to reassure investors' confidence, the EU and IMF put together a 110 billion Euro bailout package for Greece conditional on implementation of austerity measures. This was followed on 9 May 2010 by a decision by 27 member states of the European Union to create the European Financial Stability Facility (EFSF), a special purpose vehicle to provide financial assistance to European Monetary Union countries in financial difficulty. Apart from these, the Union took several measures to overcome the crisis. The main issue of contention between the countries in trouble and the assistance providers has been the benefits provided to the public sector employees. The assistance providers have been insisting on increases in length of the workweek and in the age of retirement and a decrease in pension and other benefits while the governments owing to domestic pressures have been resisting such measures.

Conclusion

The primary objective of forming the monetary union, viz. the improvement in productivity of the countries via competition after eliminating the escape route of exchange rate devaluation was bound to fail without the core countries providing support with respect to education, health and most importantly institution building. Had tax evasion been controlled in Greece, the government would not have required to finance public services by borrowing. Moreover, the insistence of the assistance providers that all the pain should be borne by periphery countries is going to lead to a prolong recession, further shrinking their GDP base and increasing their debt burden relative to it. The need of the hour is that the core countries share some of the pain and also share their own experiences with the periphery countries with respect to institution building.

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