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IS THIS ALL “GREEK” IN EUROPE?

Critical Evaluation of the Eurozone Policy Response to Debt Crises

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Abstract: *Eurozone is going through the worst ever crises since the adoption of the common currency in 1999. In the aftermath of financial crises of 2007, many EU governments due to their own fragile banking system and imbalanced economic structures pursued a debt-spending financing which resulted in a full-fledged sovereign debt crisis. Though indebtedness increased in all members of the union to overcome the recession but some states became more vulnerable. EU tried different measures to check the contagion but lack of an adequate institutional setup, poor coordination and the absence of a permanent mechanism to cope with such crises made the situation worse. Many options have been tried so far to get out of the mess but these have failed to address the underlying causes of the catastrophe. The systemic policy failure has not only exposed the union to the risks of breakup but also rendered the future of Euro as a reserve currency more uncertain. Nevertheless, the challenge in the current situation demands a very well carved policy which ensures the integration of the union and stability of the Euro as the reserve currency. This challenging situation underpins the necessity to move further with a strong political will. Improving the euro area's fiscal woes by a balanced economic growth and overhaul of the regulatory architecture are the few areas that call for the serious attention of authorities.*

JEL Codes: G01, H12, H63, E44, E62, F36

Keywords: *Debt Crises, Financial Stability, Policy Coordination, Financial Integration*

1: Introduction

Economic prosperity and the European unity are the most cherished goals of the Europeans since decades. Creation of the monetary union and introduction of the common currency in 1999 were the steps taken to achieve these goals. The very idea of creation a single market was to have more economic and financial stability but the financial crises of the 2007 and current debt crises have put both these cherished goals at stake. EU is trying hard to cope with the enormous debt crises since the fall of 2009. Some weaker links of the union like Greece and Portugal have suffered the insolvency and some other like Spain and Ireland are punished by the bursting of housing bubble of 2007 which eventually paved the way of the debt crises in the union. Now this crisis is posing risks to the EU's integration efforts and the future of the Euro as a reserve currency. However the Euro zone debt crises is not exception, available historical evidence suggests that episodes of financial instability are frequently associated with subsequent sovereign debt crises, mainly because bursting of a financial bubble leads to years of weak economic activity resulting in low tax revenues and high spending, this is how it happened in the EU in the aftermath of the 2007 meltdown. Gravity of the current situation demands a carefully carved and well-thought out exit strategy that ensures the financial stability in the short run and addresses the root causes of this catastrophe.

My PhD work investigates the genesis of the financial crises of 2007 and shape of the regulatory framework required to have more stable financial markets. In this aim analyzing the causes of the current debt crises in European Union (EU), critical assessment of the policy response and the long run challenges of this financial catastrophe for the EU seems very pertinent to dig out. The paper is divided into four sections. First section identifies the underlying causes of the debt crises. In the second section a very detailed analysis is presented about the different policies EU has tried so far to get out of this mess. Long term implications of these policies for the integration of the EU and future of Euro as Reserve currency are discussed at length in the fourth section. Last section offers some suggestions followed by the conclusion the paper.

2: Underlying Causes of the Debt Crises in European Union (EU)

Following section discussed at length the root causes of the problem. However it's not just a one factor which can be pointed out as the base of this mess. It can be called an array of a systemic failure of EU policy framework. Fiscal deficits and imbalances were unsustainable in many EU members long before the financial crises of 2007 which latter on transformed into a recession; but the full-fledged debt crises started only when the confidence in the financial markets of the union eroded on sensing the insolvency of the Greece. The extent and depth of Greeks problem was not highlighted until the threats of the default Dubai world took the radar screens of the media in the last quarter of 2009. This was the second time when credit rating agencies failed to predict and assess the situation just like the failure of the Bear Sterns and Lehman collapses. EU was in denial in the start about any possibility of debt crises like situation and practically had no strategy in case if any member country required to be rescued. With this hindsight it was very difficult to imagine the bankruptcy of the sovereign governments.

a; *Misaligned Economic Structures within EU;* can be stated as the fundamental to the debt crises. Due to these misalignments, many EU members lost their competitiveness. After the creation of single currency, a spending and borrowing frenzy in some members took place exploiting the prevailing interest scenarios. Declined interest rates environment resulted in rise in wages relative to the productivity and some domestic sectors like construction expanded at a ballooning speed, lagging behind the sectors like manufacturing. Lack of innovation and the nonresponsive rigid labor and product markets made it impossible for periphery to compete the

export engines of the Union like Germany. Lost competitiveness of these countries resulted in eroding the earning capacities. Existing structural misalignments were enhanced further by the loose monetary policy of the ECB which only contributed to the housing boom in the Greece, Ireland, and Spain, and an unprecedented banking sector expansion in Ireland.

b; Government's financing Patterns: Many EU nations like other modern governments relies heavily on the debt financing option to run the economy. It seems easier to borrow the deficit amount from financial markets instead to scale back the government spending to the collected revenues (a standard recipe of financing the government). For investors government bonds are always secure and stable options because of the general belief of the markets that government would not default on its outstanding debts and hence bonds are backed by sovereign guarantees. But the problem arises when governments borrow more than they could repay. Greek's public sector debt ballooned to 12.5% of GDP in November 2009. Bond rating agencies ignored the projections about its further rise over 135% of the GDP in 2011. Macroeconomic fundamentals showed that Greece was one of the fastest growing economies of the EU during 2000-07 and this fact made it very easy to ignore the skyrocketing structural debt. Trouble began when the bonds issued by the Greek government declared as junk by investors and some fortune hunters stopped buying making it impossible for Greece to finance its spending permanently and continuously through debt instruments. Now Portugal is going through the same scenario , despite the fact that its debt level are lower then Greece and it tried hard to manage it self in the past few months but now its borrowings costs are increasing day by say. Each spike in the Portugal's bond yield is making the Spain and Italy even more vulnerable.

c; Extraordinarily large budget & external deficits: Stability and Growth pact allowed the members of the EU to have budget deficits not more then 3 percent of the GDP. But many members of the periphery were allowed to enter after a smart financial engineering with the macroeconomic fundamentals which resulted in the development of large budget deficits and external imbalances over the past decade. In 2009 Greece's budget deficit was more then 15 percent of GDP followed by Ireland and Spain; both exceeded the 11 percent of GDP. Ratios of external account deficit to GDP were more then 10 percent for both Greece and Ireland. Ratios of gross external debt to GDP of Portugal and Spain were alarming i.e. 230 percent and 140 percent of GDP, respectively. Due to artificially high exchange rate large unsustainable trade balances developed among the southern countries and Ireland. This complete failure of deficit discipline shows clearly that almost half the Eurozone nations entered the crisis period (2007-10) with high debt ratios. Irresponsible spending and budgetary gaps in some members of the EU eventually resulted in the difficulties of the whole block.

d; lack of Institutions and Legal Framework. EU does not have adequate institutions or mechanisms to deal with such a crisis. Present legal framework of the union excludes the insolvent members to access the required financial support automatically. In the wake of debt crises like situation when the private investors halt the bond purchases of vulnerable economies, the only way out left is the either IMF or the EU governments. This happened in the case of bailout packages approved for the rescue of Greece and Ireland. Lack of a common framework and the institutional depth required to fight against the challenging debt crises has really hit hard the union both economically and politically.

e; Fragile banking & Weak regulatory architecture of the Union: large current account imbalance was financed mainly by the banks in the EU core economies. Build up of debt crises in the periphery resulted in threatening the stability of these institutions. Government debts and the bank crises were as interconnected as were policy failures. Banks in the core economies were highly leveraged due to weak regulatory framework in the union before the financial crises of

2007 and balance sheets of these fragile institutions were not cleaned up properly in the run up of the financial meltdown, so these institutions were a standing threat waiting for a spark for further instability in the union.

f; Inherently Flawed Construction of the EU: Buiter and Ebrahim (2010) has argued that the rise in the government borrowings in the aftermath of financial crises is a quite normal phenomenon. Perhaps there are some structural flaws in the EU which has manifested in the present catastrophe. Putting together dozens of economies that had visibly differing levels of economic productivity and efficiency into a single currency was a flawed construction. Financial crises of the 2007 and current debt crises has only exposed these uneven economic efficiency levels across the union. Majority of the economies of the union are earning less while spending more. Southern European economies of Greece, Spain, Italy and Portugal are not at comparable with Germany who still has a strong export base. There was lots of skepticism on the introduction of the euro in 1999 about the mismatch between the EU's core economies and monetary union with an incomplete framework of a political union. Member states peruse and focus more on he national agenda then to coordinate with some EU wide economic strategy. Economic divide between Northern and the Southern States of the EU is much more invisible now. Critics argued since long that this arrangement is prone to problems and imbalances that would ultimately threaten the viability of having a common currency

g; Policies of the European Central Bank: policies and actions of the ECB also have its share in the financial mess the Europe is going through. A centralised monetary policy with lowered interest rates administer through the ECB resulted in detrimental effects for the all in the union. This may be pointed out as the real tragedy of the union and the euro currency that one monetary policy has to coordinate with more then dozen fiscal policies. Recent events have undermined very badly the hard earned credibility of the ECB.

3: Critical Evaluation of Policy Response

There are two views about the institutional response to the debt crises. People at the helm of economic policy posit that response has been swift, strong and resolute while the critics argued that it was lax, half hearted and EU took much time to recognize the severity of the situation. Initially EU's adhoc and hesitant strategy consisted of putting up rescue funds, demanding reforms in affected economies and then hoping these steps would automatically rebuild confidence of the financial markets and ensure the debt repayments. Lack of systemic approach and contingency plans and bad timings of some initiatives made further contribution to the already unstable financial market. Union has tried different options like European bailout funds, European Financial Stability Facility (EFSF), EU and IMF backed rescue scheme, purchases by ECB, sharing of bailout costs by bondholders and the latest to set up a permanent eurozone rescue fund. Bailouts failed completely because this measure does nothing to address concerns of investors that the affected countries will be able to fix their finances and pay their creditors. In fact, the bailout-mandated cuts, by suppressing growth, may make it even harder for affected economies to repair their financial position. Bond purchases by the ECB have also failed to halt the increase in periphery bond spreads. A critical assessment of different policy options and their failure is analyzed below.

Package for Greece by the IMF/EU/EC: insolvency of the Greek government and liquidity shortage in its financial institutions led the EU and the International Monetary Fund to cobble together a €110bn rescue package for Greece in May 2010 in lieu of certain commitments. Greece promised to introduce large spending cuts and tax rises. Rigorous implementation of the structural and financial sector reforms to improve its competitiveness, improvement in fiscal data collection and provision for public sector were also included in the terms of the agreement. In return it received loans in various tranches implying that it would not need to access markets until 2013 as long as it complied with the agreed adjustment programme. It's seemed all fixed on paper; core

economies also lectured Greece about its irresponsible behaviour but in reality, all the austerity measures combined with other reforms have failed to solve the problems of the Greece. These policies failed to save Greece and then Ireland and they would definitely fail to stop further contagion to Portugal, Italy, and Spain.

The Irish Package: Greeks package only bought few months for the union and soon it has to rescue the Ireland. On 28 November 2010, the Irish government and the EU/IMF announced the €85bn support programme. €50bn was earmarked for the budgetary support, while €35bn would be spending to recapitalize and restructure the banking sector. Obviously, the package was tied with some commitments and Conditionalities. Ireland promised its banking sector restructuring and full implementation of the four-year budget austerity plan. Increase in corporate taxes would not be included in the program despite the fact that 12.5 percent is lowest in EU as compared to some core economies. Although high corporate tax rate countries like Germany and France had pressurized the Ireland to raise corporate tax rates as a pre- condition for a bail-out but Ireland showed resistance because it would materially hinder its FDI-led recovery, the most likely prospective source of growth for the Irish economy during the next few years.

The European Financial Stability Facility (EFSF) & European Financial Stabilisation Mechanism (EFSM): as the part of the total rescue package amounting €750 bn, EFSF can issue bonds guaranteed up to € 440 bn. Contributions are from all member states. In addition to the EFSF, another €60bn made immediately available from EFSM which can be drawn from the EU budget. The IMF also declared to provide loans equivalent to up to 50% of the contribution of the EU. The European Stability Mechanism (ESM) shall be the successor to the EFSF when it expires in 2013. The ESM will provide conditional financial assistance to ailing member countries in the same fashion as EFSF has done. However these two facilities collectively remained unsuccessful to cap the future uncertainties and financial markets expected more money and analysts also calling for increase in the funds.

Failure of the Bail-Out Plans for Greece and Ireland: to safeguard against national bankruptcies and to strengthen the value of the euro, EU opted for the bail out strategy; clearly a measure of last resort. The bail out packages for the Greece and Ireland has some fundamental flaws; the recipe fails to acknowledge and address that both of these severely indebted economies would not grow until these crushing levels of public debt are reduced. Growth could be supportive in raising tax revenues and cutting the ratio of debt to G.D.P but unfortunately neither Greece nor Ireland is growing. Ireland's external debt is 10 times bigger then the total size of its economy and the bank losses have already jeopardized the governments solvency, in this situation the draconian austerity budget measures introduced seemed a very high price for the bail out and would make the things even worse. It seems that EU is throwing money at debt without addressing the problem of wealth creation and the structural imbalances in periphery and this would eventually deepens the crises. In nutshell the EU's bailout program ended in utter failure due to its inability in solving the underlying causes of the problem. With the passage of the bailouts become more expensive, deepening the crises even more. EU has tried to appease the financial markets by extending the financial support in the form of an enlargement of the EFSF and the purchases of sovereign debt by the ECB. But unfortunately these efforts too failed to save Ireland; the likelihood of Portugal being next in the queue is increasing each day

The Role of the European Central Bank: The ECB is clearly the key to any effective response to the sovereign debt and banking sector turmoil in Europe. In the event of debt crises in Greece, the ECB faced one of its most critical times since its creation. It has to make a difficult decision about buying the Greek papers which essentially means printing more money or not to buy and let the Greece at the hands of ruthless financial markets. EU leadership remained indecisive

about the precise mechanism to save the Greece and the ECB made a tough choice of buying the Greek papers on May 9, 2009 the ECB decided to buy Greek papers. The markets responded positively, and the Greek economy was pulled back from the brink. This decision created a moral hazard and the hard earned credibility of the CB was eroded deeply. As this decision was not fully applauded for many it was a mistake by the ECB which tarnished the credibility of the EU nation's central bank. ECB's multiple roles as central bank also creates conflicts of interest, while prose and cones of sovereign debt restructuring are assessed ,this would thus potentially expose the ECB to losses.

Need of a Permanent Crises Response Mechanism (PCRM): permanent crises response mechanism is agreed on principle though the details are yet remained to be specified. Markets and analysts were expecting the announcement “comprehensive long-term solution” in the meeting of February 2011. Leaders showed their resolve to present the blue print of this mechanism in the meeting of March 2011. Absence of such mechanism is providing easy targets for speculation, and destabilizing the markets in Portugal Spain, Italy.

Options about Debt Re-Structuring: Debt restructuring is one of the options aimed to limit the crises. Those who opposed the idea argue that it could easily trigger a big banking and governance crisis (Bini-Smaghi 2010)¹. Leaders of the affected economies fear that this would led them to a financial penalty box ultimately denying any access to funding requirements. Thus a generally held view is that the debt restructuring in EU's periphery would constitute a major blow to the European banking system and might ushered into another whole sale financial catastrophe since the major part of the periphery's US\$2 trillion in sovereign debt is held by the banking system of the core countries

All above discussed proposals has merit but practically all these fail to address the fundamental causes of the crisis. Essentially stopping the debt crises and its spill over require an entire rethink of how the Eurozone is approaching the problem. Europe has to address the problem by acting proactively and getting ahead of the markets and putting in place comprehensive reform-based mechanism and addressing the inherent imbalances between full centralization of monetary policy and the maintenance of almost all other economic policy instruments at the national level. Affected governments are trying to strengthen the rules for fiscal and broader economic policy coordination to fix the fiscal and macroeconomic imbalances. The core economies have created and are refining facilities that can provide external financial support to those facing the most intense pressures in sovereign debt.

4: Implications and the Challenges for European Union:

Current challenge is not just economic but has multidimensional facets, understandably having deep social and political implications. Strengthening the week institutions and the speeding up the expansion of the EU were the widely agreed objectives of the union. The euro was thought to be source and symbol of unity of the union but has unfortunately bred discord that has led the states into a blame game from the core to periphery and vice versa. Some proponents of deeper integration has used the current situation of crisis to launch a discussion about moving towards a more integrated EU-wide fiscal policy. How the integration efforts suffered a blow and the future of euro as the currency become more uncertain is discussed below.

Challenges for the Integration of the Union: The rescue packages negotiated for Greece and Ireland were aimed to contain the fallout of the crises. It was an attempt to establish the fact that EU can deal with its financial problems. No doubt the rescue packages approved by the union showed the audacity of the members as the trio- Portugal, Spain, and Italy are themselves heavily indebted economies and rumoured to be the candidates for such packages. Core economies like Germany and France also have unusual high debt ratios³. Stabilizing the economies of the affected members and preventing the dis-integration seems a test of its cohesiveness. Europe today seems

standing at the crossroads. Fragile treasuries of some members can be instrumental in pulling them apart. If the fiscal problems are not come to halt, continuous bailout demands together with unsought economic reforms will surely lead to dent the EU's attempts at unity. Response and responsibility of the Germany is very important and vital. Market's perception about the timid political will of Germany would simply erode the efforts of the other members. Perhaps EU is suffering from an integration fatigue resulted due to member countries tendency to exploit the benefits of the single currency, and their reluctance to surrender national powers over public finances. EU integration process advanced quite amazingly since the Treaty of Rome was signed in 1957. Now with 27 members, it is the world's largest single market and trading bloc. The introduction of common currency in 1999 was giant leap forward in European integration and symbol of the gradual transfer of national sovereignty to the EU in essence. However over the years as the integration went deeper EU member states were become more hesitant to shed sovereign powers and policies. On the political front this fatigue translated more visibly, a good example is the failure of the EU's Constitutional Treaty in 2005. The Lisbon treaty came into force as the successor of the EU's Constitutional Treaty with the objective of streamline the EU decision-making process, but unfortunately debt crisis exposed the divide and showed the clear lack of coordination in important decisions and policy making. National interests overshadowed despite the Lisbon Treaty's mission for deeper economic and political integration. As crises unfolded, the break up of Euro is again subject of debates. However EU break-up remains extremely unlikely; *"exit is effectively impossible"* (Barry Eichengreen) as it involves huge economic and political costs besides the insurmountable procedural obstacles. But the likelihood may ascend steeply in the absence of required institutional setup. Efforts about the expansion of the union to Scandinavian region, Eastern Europe and United Kingdom got a heavy blow and now it seems quite far off. The message for all potential entrants is to leave their baggage before entry.

Future of EURO as Reserve Currency; Euro is one of the world's two leading currencies. Since its launch on 1st January 1999, it has consistently captured a significant market share as a reserve currency from its competitor US dollar. However when crises erupted euro immediately faced the pressures of loosing value but ECB's plan to backstop European debt was a clear signal to the financial markets that EU will protect its currency at all costs. As the uncertainty have not sized in the euro area and the fears of contagion are hovering around, the efforts by the ECB and other steps taken by the union has done little to stabilize it. The current situation has undermined deeply the possibility of the euro surpassing the US dollar to take the position of a reserve currency. As a matter of fact the likelihood of the euro's revaluation and its continued slide toward low versus the U.S. dollar has increased. But if this crisis is taken as an opportunity by the periphery to address the fiscal imbalances it would surely regain its position. Essentially a stronger European union at the back of Euro would be a source of its strength in the financial markets. It is obvious that members sharing the common currency are obliged to cooperate for the adjustment of the imbalances and to prevent contagion that would destabilize the currency further and so far EU response shows that how union is serious to protect the currency which is symbol of its political and economic unity. But the bill for saving the euro looks costly even more in the wake of possible defaults of Spain and Portugal. Ireland's financial support package has buy time apparently, but fundamental insolvency issues regarding the sovereign debt and banking system remain unaddressed. Until and unless these trends are capped, Euro would remain at the merci of ruthless markets.

Suggestions

Debt crises do not happened accidentally so it will be resolved only with some real political will and serious sole searching to address the roots of the problem. A systemic failure as it is manifested, it require a systemic solution. Barry Eichengreen predicted this crisis in January 2009, writes: *"To avoid similar crises in the future, Europe will have to build out the institutions of its monetary union."* Co-ordination between monetary authority of the Union and the national fiscal authorities is

the unanimous solution on which almost all analysts and policy makers are agreed. Leaders must be aware that they are dealing with at least a five-year problem any step taken in haste or for a temporary gain would only add up to prevalent uncertainties. EU need an array of institutional arrangements to deal with the enormous economic and financial challenges it is facing. The smooth functioning of such institutional set up without frequent recourse on the interpretation and the amendment of its Treaty would go a long way to stabilize the region. This is also the time about the precision on the economic governance because only fiscal consolidation alone would not solve the structural problems

- The periphery must show increased fiscal discipline ensuring that are achieving progress on competitiveness, export led economic growth. The core must recognise that a depreciated euro and increase in the demand in core economies will help the both and greatly facilitate adjustment in the periphery.
- Crises management is very important. The union's toolkit is empty of necessary firefighting arsenal. Current stability facility does not work if the sovereign debt crisis should spread to major countries like Spain or Italy. So liquidity support facility must be enhanced to at least €2,000bn
- EU lacks the required banking and financial market regulation. While its banks remain a mess, every shock has the potential to create a systemic crisis. Improved transparency may be a step in the right direction to clean up the banks.
- National approach goes a head than the European approach in the current crises. Berlin, Paris and London remained the decision seat instead of Brussels. To manage an integrated economy, a strengthened European approach is needed rightly pointed out by Jose Manuel Barroso5 "*either swim together, or sink separately*"
- One monetary policy and 17 fiscal policies is problem that needs to be fixed up. Each member of the union must set up national institutions for guaranteed fiscal discipline. Many authors have put forward the idea of setting up domestic "*Independent Fiscal Councils*"
- The ECB's "*securities purchase programme*" must be an emergency time measure in an extraordinary situation. Member countries have to be clear that it would not be possible to forever buy the bad debts. Obvious implications of this are the balance-sheet risks for the central bank and complications in the conduct of monetary policy.
- For the orderly resolution of sovereign debt defaults EU must devise a new mechanism. An IMF-style sovereign debt restructuring mechanism or sovereign default resolution mechanism can be one of the options. The sovereign debt restructuring mechanism could be part of the liquidity facility, thus forming a kind of European Monetary Fund (Gros and Mayer 2010).

Conclusion

Capping the debt crises is not an easy job. Financial markets are judging the resilience of EU authorities. Initially the EU took much time to realize the gravity of the situation and then the lack of a comprehensive strategy and weak institutional framework added further to the problems. However EU's willingness and ability is manifested by the different policy measures taken so far. Provision of liquidity is ensured for the fragile financial structure and governments are trying hard to overcome fiscal imbalances. But these measures have and would fail until or unless inherent imbalances are fixed. A permanent crises management mechanism is the need of hour and proper implementation of such mechanism in letter and spirit need more coordination and must be backed by the strong political will of the core members. Thinking beyond the stability and growth pact, and possibility of new institutional arrangements can go a long way to support adjustment processes of indebted member states. Bottom line is that anti-debt crisis measures need to be supplemented by stronger economic co-ordination to render the Union able to reduce the probability of future financial instabilities.

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