The Institute for Domestic & International Affairs, Inc.

Policy Dilemma

The European sovereign debt crisis (also known as the European financial crisis or the Eurozone crisis) is a financial crisis occurring across Europe that has substantially complicated the payment and restructuring of debt for states in the EU. Although the Maastricht Treaty established the Euro Convergence Criteria, which stipulated the yearly deficit and overall debt regulations required to join the euro currency, states within Europe engaged in economic practices that led to rising levels of debt. [1] The interconnected nature of global financial markets and European integration played a role in the spread of the crisis throughout the continent.

The origins Eurozone crisis can be traced to the early 2000s when a number of European states were not able to meet the Maastricht criteria. To hide this reality, states masked their debt levels through the process of securitization, complex accounting techniques, and off-balance sheet transactions.[2]With the global financial crisis hitting the United States in 2008, Europe was soon impacted by the banking contagion. Although Europe was not responsible for the inception of the financial crisis, the interconnected nature of global markets allowed the crisis to quickly spread across the Atlantic.[3]

Credit Ratings

Credit ratings are opinions issued by agencies that attempt to measure the ability of a state or a private entity to repay its debts. The institutions that measure credit are known as credit rating agencies. Examples of agencies include Fitch, Moody's, and Standard & Poor's (S&P). Credit ratings are measured on a scale from 'AAA' to 'D'. 'AAA' means that a state has an "extremely strong capacity" to meet its financial obligations, while D indicates that a state has defaulted on, or is unable to pay, its debt. Changes in credit ratings substantially influence investment practices and financial markets. *

By 2009, fears of an emerging sovereign debt crisis began to surface, as ratings agencies Fitch, Moody's, and Standard & Poor's downgraded the government debt of

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[1] *Ibid,* Dinan

[2] Mark Brown and Alex Chambers, "How European Governments Enronized their Debts," *EuroMoney*, September 2005, http://www.euromoney.com/Article/1000384/How-Europes-governments-have-enronized-their-debts.html (Accessed May 27, 2013)

[3] Mark Landler, "The U.S. Financial Crisis Is Spreading to Europe," *New York Times*, http://www.nytimes.com/2008/10/01/business/worldbusiness/01global.html?_r=0 (Accessed May 27, 2013)

Greece.[4] With skyrocketing debt levels in Portugal, Ireland, Italy, Greece, and Spain (collectively known as the PIIGS countries), the EU agreed to a three-year €750 billion rescue package, with assistance from the International Monetary Fund (IMF), for the Eurozone to assure investors that the weakest members of the Eurozone would not be abandoned. [5]

After delivering rescue packages to Portugal, Ireland, Greece, Spain, Cyprus, the European Union has plethora of issues to deliberate in order to mitigate the current crisis and prevent future financial crises from occurring. Actors such as the European Central Bank (ECB) may play a substantial role in the overall resolution of the crisis. With the ability to print currency and regulate the monetary policy of the Eurozone, the ECB's involvement in the Eurozone, specifically in the bond market, could improve the euro's prospects in the future. Simultaneously, members of the European Commission must be cognizant of the interests of Germany in particular, as Berlin has subsidized substantial portions of the EU-IMF rescue packages. The decisions of the German constitutional court may adversely impact the extent of aid the EU could deliver in the future to the recovering economies of the Eurozone.[6]

While the Eurozone succeeded in creating a common currency among 17 states, the experiment of the Eurozone is currently undergoing its largest test. With predictions that the euro will fall, to reaffirmations of the health of the union, there are a wide range of proposals on the table that may fundamentally alter the future of the Eurozone. The unintended effects of the Eurozone have exacerbated the crisis by allowing the financial crisis to spread quickly. Nonetheless, the nature of the union forces states to be accountable to each other in order to keep the currency afloat. As the Eurozone continues

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[4] Helena Smith and Ashley Seager, "Financial Markets Tumble after Fitch downgrades Greece Credit Rating," *The Guardian*, 8 December 2009, http://www.guardian.co.uk/world/2009/dec/08/greece-credit-rating-lowest-eurozone (Accessed May 27, 2013)
*For more info on credit ratings visit: http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us
[5] The Economist, "The PIIGS that won't fly," The Economist, 18 May 2010, http://www.economist.com/node/15838029 (Accessed May 27, 2013)
[6] Carla Bleiker, "Germany's constitutional court criticizes ECB," *DW*, 13 June 2013, http://www.dw.de/germanys-constitutional-court-criticizes-ecb/a-16877427 (Accessed June 13, 2013)

on the road to recovery, there are a number of outstanding concerns that need to be addressed through institutional changes and additional aid packages among other means. Economic development in the states of Europe is jeopardized by fiscal insecurity, so it is imperative to address these concerns in order to promote future economic development and sustainability in terms of consumption and production in Europe.

Chronology

1992: Maastricht Treaty and the Euro Convergence Criteria

The 1992 Maastricht Treaty created the present-day European Union and set the framework for the introduction of the euro currency. In order for EU states to adopt the euro, the Maastricht Treaty stipulates that each state must meet the Euro Convergence Criteria.[7] The purpose of the criteria is to achieve price stability and prevent the Eurozone from being negatively impacted as each state adopts the currency. To monitor the progress of aspiring and current Eurozone states respectively, the European Central Bank (ECB) and European Commission each publishes a biennial Convergence Report. The Convergence Criteria are as follows:

1. The Harmonized Index of Consumer Prices (HICP) rate of each state should be lower than 1.5 *per cent* higher than the average of the 3 EU member states with the lowest HICP inflation. The HICP inflation rate, similar to the consumer price index in the United States, is the weighted average price of a basket of consumer goods across all EU member states. Its purpose is to provide the ECB an indication of inflation and price stability across the EU.
2. The annual government budget deficit of each state must be less than 3 *per cent* of its gross domestic product (GDP). Accordingly, the cumulative government debt of each state must not exceed 60 *per cent* of its GDP.
3. The long term interest rates for 10 year government bonds of a state should be no more than 2 *per cent* higher than the average of comparable bonds of the EU states with the lowest HICP. This is intended to measure the durability of a state's commitment to the Convergence Criteria.[8]
4. Applicant states must join the European Exchange Rate Mechanism (ERM), a system regulating the value of each currency, and keep its currency within a 15 *per cent* range of the value of the Euro. For instance, if the UK wanted to join the Euro, the exchange rate of the pound (GBP) to the euro (EUR) must be between 0.85 GBP to 1 EUR and 1.15 GBP to 1 EUR.

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[7] European Union, "Introducing the Euro: Convergence Criteria," European Union, 7 July 2006, http://europa.eu/legislation_summaries/other/l25014_en.htm (Accessed July 10, 2013)
[8] European Commission, "Who can join and when?" European Commission, 8 May 2013 http://ec.europa.eu/economy_finance/euro/adoption/who_can_join/ (Accessed July 10, 2013)

According to an analysis by Jan Van Gerich of Nordea Markets, none of the Eurozone states currently meet all of the criteria.[9] Likewise, Eurozone states are not forced to strictly adhere to the criteria.

2010: Greece's Debt Reaches 130 Percent of GDP

By November of 2009, the impact of the 2008 global financial crisis on Greece was apparent. The national debt of Greece increased to an estimated 262 billion EUR from 168 billion EUR in 2004. Simultaneously, Prime Minister George Papandreou's new socialist government announced projections that Greece's 2009 budget deficit would be 12.7 *per cent* of GDP. This projection was more than double previously published figures. As a result, Fitch lowered its rating of Greece's government debt from A- to BBB+.[10]

However, by mid 2010 a reevaluation of Greece's finances showed a much more dire situation. After the initial November 2009 estimate, Greece's deficit and debt levels were announced to be 13.7 *per cent* and 130 *per cent* of the state's GDP respectively in 2010.[11] To combat the state's increasing debts, the Greek government drafted a number of austerity measures, or spending reductions, that aimed to increase retirement ages, facilitate layoffs of workers, and decrease monthly payments to pension recipients. In response, many Greeks protested the spending cuts by striking and effectively shutting down a number of public services.[12] The response of the Greek citizenry to the austerity measures is indicative of the public pressures that European governments will face as they attempt to restructure their public finances.

[9] Jan Von Gerich, "All EUR countries in violation of their own convergence criteria," Nordea Markets, 18 October 2012, http://research.nordeamarkets.com/en/2012/10/18/all-eur-countries-in-violation-of-their-own-convergence-criteria/ (Accessed July 10, 2013)
[10] The Telegraph, "Timeline of a crisis: How Greece's tragedy unfolded," The Telegraph, 16 June 2011, http://www.telegraph.co.uk/finance/economics/8580720/Timeline-of-a-crisis-how-Greeces-tragedy-unfolded.html (Accessed July 10, 2013)
[11] William L. Watts, "Greece's revised 2009 deficit tops 15% of GDP Eurostat lifts reservations over Greek methodology," Market Watch, 15 November 2010, http://www.marketwatch.com/story/greeces-revised-2009-deficit-tops-15-of-gdp-2010-11-15 (Accessed July 10, 2013)
[12] Niki Kitsantonis and Matthew Saltmarsh, "Greeks Strike to Protest Austerity Plans," *New York Times*, 29 June 2010, http://www.nytimes.com/2010/06/30/world/europe/30greece.html?_r=0 (Accessed July 10, 2013)

2010: First Greece and Ireland EU-IMF Rescue Packages

With the financial crisis growing increasingly dire, Greece requested a bailout from the EU and the International Monetary Fund (IMF) on 23 April 2010. Over the next few days the international financial system was impacted by S&P's downgrade of Greece to BB+.[13] With a rating below BBB-, Greece's debt was relegated to "junk status," essentially cautioning investors that buying Greek bonds could result in losing all their money if Greece restructured their debt or defaulted.[14] After weeks of intense discussion between EU and IMF leaders, the two institutions agreed to 110 billion EUR rescue package for Greece on 2 May 2010. Accompanying the package, Prime Minister Papandreou announced a 30 million EUR measure that included further spending cuts and tax increases.[15]

When the European Commission completed its dealings with Greece, it turned its sights to Ireland's deteriorating finances. In August of 2010, S&P downgraded the sovereign debt rating of Ireland to AA-.[16] By September, worries of an Irish double-dip recession gripped the Eurozone, as Ireland's national output dropped 1.2 *per cent* during the second quarter of 2010.[17] Ireland embarked on austerity measures by cutting its budget by 6 billion EUR in response, as fears of a rescue package similar to that of Greece grew.[18] Despite its efforts, on 28 November 2010 Ireland agreed with the EU and the IMF to a 78 billion EUR rescue package.[19]

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[13] Charles Forelle and Alkman Granitsas, "Greece Asks for $60 Billion Bailout," *Wall Street Journal*, 24 April 2010, http://online.wsj.com/article/SB10001424052748703709804575201330937572258.html (Accessed July 11, 2013)

[14] Jack Ewing and Jack Healy, "Cuts to Debt Rating Stir Anxiety in Europe," *New York Times*, 27 August 2010, http://www.nytimes.com/2010/04/28/business/global/28drachma.html (Accessed July 11, 2013)

[15] Lefteris Papadimas and Jan Strupczewski, "EU, IMF agree $147 billion bailout for Greece," *Reuters*, 2 May 2010, http://www.reuters.com/article/2010/05/02/us-eurozone-idUSTRE6400PJ20100502 (Accessed July 12, 2013)

[16] Lisa O'Carroll, "Ireland highly rated by Newsweek, but not S&P," *The Guardian*, 25 August 2010, http://www.guardian.co.uk/business/2010/aug/25/ireland-newsweek-ranking-standard-and-poorshttp://www.guardian.co.uk/business/2010/aug/25/ireland-newsweek-ranking-standard-and-poors (Accessed July 12, 2013)

[17] Larry Elliot, "Irish economy faces double dip recession," *The Guardian*, 23 September 2010, http://www.guardian.co.uk/world/2010/sep/23/irish-economy-double-dip-recession (Accessed July 12, 2013)

[18] The Economist, "Ireland's Economy: Threadbare," The Economist, http://www.economist.com/node/17522578 (Accessed July 12, 2013)

[19] Rich Barbiera, "EU Unveils Irish Bailout," *CNN Money*, 2 December 2010 http://money.cnn.com/2010/11/28/news/international/ireland_bailout/index.htm (Accessed July 12, 2013)

27 September 2012: European Stability Mechanism Created

In light of rescue packages for Portugal, Spain, and Greece, European governments discussed the need for a permanent fund to provide immediate financial assistance to members of the Eurozone. On 27 September 2012, the European Stability Mechanism (ESM) was created and replaced the two earlier temporary Eurozone funding programs, the European Financial Stability Facility, and the European Financial Stabilization Mechanism. The ESM is authorized to directly contribute funds to states and private banks and is funded by states of the European Union. [20]

For a state to receive funding from the ESM, it must first sign a Memorandum of Understanding (MoU). A MoU expresses the needs of a state including fiscal reforms required to restore the state's financial stability. State's applying for an ESM rescue package must also have ratified the European Fiscal Compact. The treaty is explicit in its balanced budget requirements by defining a balanced budget as a deficit less than 3 *per cent* of GDP. If a state that has ratified the treaty fails to pass a domestic implementation law that will self-correct deficit spending, the European Court of Justice can fine the state. These stringent requirements are intended to dissuade states from acquiring large deficits and debts in the future. [21]

The ESM was met with substantial resistance across Europe, particularly from Germany, Finland, Austria, and the Netherlands. [22] Furthermore, the ESM's implementation was delayed because the German Constitutional Court had to evaluate its legality under German law. The German Constitutional Court allowed the ESM to be

[20] European Union, "European Stability Mechanism (ESM)," European Union, http://www.esm.europa.eu/pdf/FAQ%20ESM%20041020121.pdf (Accessed July 14, 2013)
[21] Ireland Citizens Information Board, "Summary of the Fiscal Stability Treaty," Ireland Citizens Information Board, http://www.citizensinformation.ie/en/government_in_ireland/european_government/fiscal_stability_treaty/fiscal_treaty_summary.html (Accessed July 14, 2013)
[22] Julien Toyer and Luke Baker, "Exclusive: Euro zone may drop bondholder losses from ESM bailout," *Reuters*, 25 November 2011, http://www.reuters.com/article/2011/11/25/us-eurozone-treaty-esm-idUSTRE7AO1NF20111125 (Accessed July 14, 2013)

signed into law with restrictions, limiting Germany's contribution to the fund to 190 billion EUR.[23]

6 September 2012: European Central Bank Announces Bond Buying Initiative

With the credit ratings of Eurozone states continually deteriorating, the European Central Bank's (ECB) announcement to buy unlimited bonds in September 2012 was welcomed by international markets. The move, intended to ensure investors that the Eurozone governments would not default, immediately sent stocks in the global market soaring. Likewise, borrowing costs for Spain and Italy in particular were significantly reduced in anticipation of the ECB's program.[24] As the supply of bonds is reduced by the purchase of bonds by the ECB, the hope is that the demand for investors will increase and will cause interests rates on the bonds to decrease.

ECB President Mario Draghi defended the measure stating that buying bonds from heavily indebted states "is even more essential now as we see potential changes in the monetary policy stance, with associated uncertainty, in other jurisdictions of the global economy." Draghi also ensured the international community that states would only get assistance from the bond buying program if they committed to reforms.[25]

The ECB's bond buying program also was met with a challenge in the German Constitutional Court. President of the German Constitutional Court Andreas Vosskuhle stated, "Whether they've been successful in the largest sense will not play a role in the constitutionality of the measures," and that the judges will determine whether the ECB is engaging beyond the powers prescribed to it in European law, as well as the German constitution. Since the court does not have jurisdiction over EU institutions it cannot

[23] Matthew Sparkes, "German Constitutional Court ratifies ESM with conditions," *The Telegraph*, 12 September 2012, http://www.telegraph.co.uk/finance/financialcrisis/9537638/German-Constitutional-Court-ratifies-ESM-with-conditions.html

[24] Howard Schnieder, "ECB loads the 'big bazooka,' agrees to buy government bonds, if needed," *The Washington Post*, 6 September 2012, http://www.washingtonpost.com/business/economy/ecb-loads-the-big-bazooka/2012/09/06/a4ff5a2a-f814-11e1-8b93-c4f4ab1c8d13_story.html (Accessed July 16, 2013)

[25] Associated Press, "E.C.B Chief Defends Bond Buying Program," Associated Press, 25 June 2013, http://www.nytimes.com/2013/06/26/business/global/ecb-chief-defends-bond-buying-program.html (Accessed July 16 2013)

shutdown the program outright.[26] However, as with the ESM, the court can limit Germany's participation in the ECB's initiatives.

16 March 2013: Cyprus EU-IMF Rescue Package

By January 2013, the debt-to-GDP ratio of Cyprus was reported to be 84 *per cent.*[27] In 2012, Cyprus had received a 2.5 billion EUR loan from Russia to help it refinance its debt and close its budget deficit.[28] Despite Russia's financial assistance, Cyprus was far below its estimated borrowing need of 15 billion EUR and subsequently required aid from the EU and the IMF.[29] Investors and credit agencies were progressively losing confidence in Cyprus as Moody's, Fitch, and S&P downgraded Cyprus' credit rating to junk status.[30] With Cyprus' financial situation becoming increasingly dire, the state requested for assistance from the European Union in June 2012.[31]

After months of negotiations, the EU and IMF agreed to a 10 billion EUR deal with Cyprus, making it the fifth state in the Eurozone to receive funds from the EU-IMF.[32] Initially, it was announced that the deal would include a 6.7 *per cent* bank deposit levy for deposits up to 100,000 EUR and 9.9 *per cent* levy for higher deposits on all existing domestic bank accounts to pay for a portion of the loan. After domestic protests and rejection from the Cypriot parliament, the idea of the bank levy was dropped for

[26] Brian Blackstone, Christopher Lawton, and Friedrich Geiger, "Berlin Defends ECB Bond-Buying Plan," *The Wall Street Journal,* 11 June 2013, http://online.wsj.com/article/SB10001424127887323949904578538792901788324.html (Accessed July 16 2013).
[27] Eurostat, "Third quarter of 2012 compared with second quarter of 2012 Euro area and EU27 government debt nearly stable at 90.0% and 85.1% of GDP respectively," Eurostat, *23 January 2013,* http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-23012013-AP/EN/2-23012013-AP-EN.PDF (Accessed July 17, 2013)
[28] Reuters, "Russia Loans Cyprus 2.5 billion," Reuters, 10 October 2011, http://archive.is/uZa4 (Accessed July 17, 2013)
[29] Lidia Kelly and Darya Korsunskaya, "Russia to coordinate Cyprus loan decision with EU," Reuters, 28 September 2012, http://www.reuters.com/article/2012/09/28/us-russia-summit-cyprus-siluanov-idUSBRE88R0BL20120928 (Accessed July 17, 2013)
[30] Sheyna Steiner, "Ratings of euro countries by S&P, Moody's, Fitch," Yahoo Finance, 29 October 2012, http://finance.yahoo.com/news/ratings-euro-countries-p-moodys-070122514.html (Accessed July 17, 2013)
[31] Al Jazeera, "Cyprus asks EU for Financial Bailout," Al Jazeera, 25 June 2012, http://www.aljazeera.com/news/europe/2012/06/201262517189248721.html (Accessed July 17, 2013)
[32] Jan Strupczewski and Annika Breidthardt "Euro ministers back 10 billion Euro Cyprus bailout," *Reuters*, 12 April 2013, http://www.reuters.com/article/2013/04/12/us-eurozone-cyprus-idUSBRE93B0BY20130412 (Accessed July 17, 2013)

incomes below 100,000 EUR.[33] When providing funds to states, the austerity measures proposed by the EU-IMF partnership are difficult to implement and tend to be met with considerable domestic unrest.

Actors and Interests

The PIIGS and Cyprus

The states impacted most severely by the Eurozone crisis are Portugal, Ireland, Italy, Greece, Spain, and Cyprus. After Banco Português de Negócios (BPN) and Banco Privado Português (BPP) suffered substantial losses in the 2008-2009 financial crisis, the Portuguese government provided them with a bailout at the expense of taxpayers. After facing substantial pressure from the international bond markets, Portugal enacted a number of austerity measures in 2010 in an attempt to ease concerns that the state would ask for aid from the EU and IMF.[34] By 2011, Portugal capitulated to pressures from the EU and IMF and accepted a 78 billion EUR rescue package.[35] More recently, difficulties over the extent of austerity measures have caused considerable political turmoil in the Portugal.[36] This is a consistent theme among the PIIGS states as austerity has a considerable political price.

Despite being the eighth largest economy in the world, Italy has compiled a substantial debt that has exacerbated the Eurozone crisis. Italy's debt-to-GDP ratio is 130.4 *per cent*, which is second worse in the Eurozone behind Greece.[37] However, as opposed to debt, weak investment, poor regulation, an ageing population, and overall

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[33] Marcus Bennasson, "Cyprus Loses EU6 Billion in Deposits as Levy Imposed on Savers," *Bloomberg BusinessWeek*, 29 May 2013, http://www.businessweek.com/news/2013-05-29/cyprus-loses-eu6-billion-in-deposits-as-levy-imposed-on-savers (Accessed July 17 2013).

[34] Fiona Govan, "Portugal approves austerity measures," *The Telegraph*, 26 November 2010, http://www.telegraph.co.uk/finance/financialcrisis/8163146/Portugal-approves-austerity-measures.html (Accessed July 20, 2013)

[35] Patricia Kowsmann, "Portugal Banks Push for Bailout Changes," *Wall Street Journal*, 26 July 2011 http://online.wsj.com/article/SB10001424053111903999904576469991876291306.html (Accessed July 20, 2013)

[36] Associated Press, "Portugal's president extends talks on government's future after resignations trigger crisis," 9 July 2013, http://www.foxnews.com/world/2013/07/09/portugal-president-extends-talks-on-government-future-after-resignations/#ixzz2agQgf4WY (Accessed July 21, 2013)

[37] Andrew Davis and Lorenzo Totaro, "Italy's Debt to Rise to Record in 2013 as Recession Lingers," *Bloomberg*, 10 April 2013, http://www.bloomberg.com/news/2013-04-10/italy-s-debt-to-rise-to-record-this-year-as-recession-lingers.html (Accessed July 22, 2013)

small growth characterize Italy's crisis. Additionally, Italy's wages grew too quickly during the pre-crisis years, which currently puts Italy at a disadvantage against German workers whose wages are not as inflated.[38]

Overall the PIIGS and Cyprus are hopeful that aid from the EU-IMF will make the recovery process substantially easier. Simultaneously, they would prefer that the austerity measures required of them by any rescue package would not be politically infeasible. Nonetheless, in order to receive aid, the EU-IMF will require austerity measures in hopes of ensuring that the recipient state will not accumulate substantial debts in the future.

Germany

Germany is continually the primary benefactor of the rescue packages proposed by the EU-IMF. As the largest economy in the Eurozone and the 4th largest economy by nominal GDP, German approval is crucial for any aid package to be enacted.[39] Likewise, key EU programs such as the ESM required the approval of the German constitutional court before they were implemented.[40]

During the Eurozone crisis, the German economy has remained relatively steady.[41] However, German exports have shrunk substantially within the Eurozone, as the beleaguered governments of Southern Europe do not have the finances to import more goods.[42] Germany's interest, accordingly, lies in the Eurozone economies returning to a proper financial state. The predominant fear among the German populace is that Germany will continue to fund the Eurozone crisis at the expense of German taxpayers. As the owner of many Greek, Spanish, and Italian bonds, Germany has played a large

[38] Laurence Knight, "What's the matter with Italy?" *BBC*, 28 December 2011, http://www.bbc.co.uk/news/business-15429057 (Accessed July 22, 2013)
[39] CNN Money, "World's Largest Economies," CNN Money, http://money.cnn.com/news/economy/world_economies_gdp/ (Accessed July 22, 2013)
[40] A.K, "The euro zone looks anxiously to Karlsruhe," *Economist*, 12 June 2013, http://www.economist.com/blogs/charlemagne/2013/06/germany-and-euro (Accessed July 22, 2013)
[41] EUObserver, "German growth too weak to lift eurozone from recession," EuObserver, 15 May 2013, http://euobserver.com/economic/120135 (Accessed July 22, 2013)
[42] Martin Walker, "Germany Falters," *UPI*, July 15 2013, http://www.upi.com/Top_News/Analysis/Walker/2013/07/15/Walkers-World-Germany-falters/UPI-69761373861100/ (Accessed July 22, 2013)

role in financing the deficits of states that have built up large debts.[43] Therefore, Germany's interest must be kept in mind when future rescue packages or programs are considered.

France

Since the onset of the Eurozone crisis, France has played an extensive role alongside Germany in providing economic assistance. As the two largest economies in the Eurozone, France and Germany have cooperated with each other when creating plans for the future of the common market. German Chancellor Angela Merkel and then French President Nicolas Sarkozy agreed in December 2011 to push a new treaty that would result in automatic sanctions for states that breach the budget deficit restrictions outlined in the Convergence Criteria.[44]

After the election of French President François Hollande in May of 2012, France sought a policy shift towards growth and jobs. This stood at odds to Germany's preference for austerity as a response to the crisis. Following a year of discussions, Chancellor Merkel and President Hollande agreed to push for jobs, growth, and reforms. The two leaders also called for a full-time Eurozone chief to manage the currency and the EU oversight of the area. Hollande explained, "We want (Europe) to pay more attention to jobs, notably youth jobs, to move more quickly to put in place a banking union, to have more efficient economic governance, to have more harmonious tax systems and to implement policies for growth and competitiveness" [45] In the meantime, France has

[43] Reuters, "Rival accuses Germany's Merkel of deceit over euro zone bailouts," Reuters, http://www.reuters.com/article/2013/07/20/us-eurozone-germany-spd-idUSBRE96J06Y20130720 (Accessed July 22, 2013)
[44] Martin Strydom, "Merkel and Sarkozy demand tough new Eurozone treaty," *Telegraph*, 5 December 2011, http://www.telegraph.co.uk/finance/financialcrisis/8936358/Merkel-and-Sarkozy-demand-tough-new-eurozone-treaty.html (Accessed July 22, 2013)
[45] Michael Mainville, "Hollande, Merkel vow united front on eurozone recovery," *AFP*, 30 May 2013, http://www.google.com/hostednews/afp/article/ALeqM5hqIzRo8VKXX_NVi5Cw8QDITN2uJQ?docId=CNG.79f0b30ac48999cac1e6ab07eb788023.151 (Accessed July 23, 2013)

pledged to reduce its deficit to 3 *per cent* of GDP by 2015. Like many of the other states in the Eurozone, France is still operating at a trade deficit.[46]

European Central Bank (ECB)

The ECB has the primary role of implementing monetary policy in the Eurozone, conducting foreign exchange operations, and to promote efficient operation of the financial system within the Eurozone. It also maintains the privilege to issue euro banknotes, while member states may only issue euro coins with permission from ECB beforehand.[47] The ECB has unprecedented power over monetary policy, interest rates, and exchange rates, which have direct implications on the health of the Eurozone economy.[48]

The ECB's role in the Eurozone crisis has expanded considerably since President Mario Draghi's declaration on 26 June 2012 that "within our mandate, the ECB is ready to do whatever it takes to preserve the euro."[49] The ECB's bond-buying program, called Outright Monetary Transactions (OMT), gave credence to Draghi's declaration about the ECB's commitment to the health of the Euro. However, the ECB's program could be considerably diminished if there are restrictions on Germany's participation in the OMT.[50] The ECB's commitment to the OMT is encouraging to investors and the states suffering the most from the crisis.

[46] Holly Ellyatt, "France Likely to Miss Deficit Target, Auditors Warn," *CNBC*, 27 June 2013, http://www.cnbc.com/id/100848263 (Accessed July 23, 2013)
[47] Hanspeter K. Scheller, "The European Central Bank: History, Role And Functions," European Central Bank, 2004, http://www.ecb.int/pub/pdf/other/ecbhistoryrolefunctions2004en.pdf
[48] Franziska Richter and Peter Wahl, ""The Role of the European Central Bank in the Financial Crash and the Crisis of the Euro-Zone," World Economy, Ecology & Development, http://www.globalmarshallplan.org/sites/default/files/media/ecb_report_by_weed.pdf (Accessed July 24. 2013)
[49] Jeff Black and Jana Randow, "Draghi Says ECB Will Do What's Needed to Preserve Euro: Economy," *Bloomberg*, http://www.bloomberg.com/news/2012-07-26/draghi-says-ecb-to-do-whatever-needed-as-yields-threaten-europe.html (Accessed July 24, 2013)
[50] Brian Blackston, "Measuring Mario Draghi's Promises," *Wall Street Journal*, 26 July 2013, http://blogs.wsj.com/moneybeat/2013/07/26/measuring-mario-draghis-promises-one-year-on/ (Accessed July 25, 2013)

International Monetary Fund (IMF)

The IMF is the last of the troika of institutions including the European Commission, and the ECB. As an organization of 188 states around the world, the IMF works to secure financial stability, facilitate international trade, encourage global monetary cooperation, reduce poverty, and promote high employment and sustainable growth.[51] It is committed to the resolution of the crisis as the 30 billion EUR the IMF gave to Greece, and the sizeable loans it extended to Ireland and Portugal were among the largest loans it has ever given out.[52] The IMF will continue to play a considerable role in the Eurozone crisis if more aid is requested, as the loans the IMF provides in resolving the crisis fall directly in line with the organization's mission.

Possible Causes

Increasing Government and Private Debt Levels

Although the Euro Convergence Criteria in the Maastricht Treaty establish strict parameters for budget deficits and outstanding debts, states in the Eurozone did not adhere to the treaty's spending limits. Greece and Italy in particular were allowed into the Eurozone despite not falling in line with the debt and deficit criteria. As opposed to increasing taxes or cutting spending, Greece and Italy artificially reduced their deficits through derivatives.[53] In the case of Greece, by swapping the floating exchange rate of the US dollar and Japanese yen, two of the largest holders of Greek debt, with a fixed exchange rate based on historical projections provided by Goldman Sachs, the state's debt did not increase despite the value of the dollar and the yen appreciating against the

[51] International Monetary Fund, "About the IMF," International Monetary Fund, https://www.imf.org/external/about.htm (Accessed July 25, 2013)
[52] The Economist, "Less Cash, more impact," The Economist, 6 October 2012 http://www.economist.com/node/21564254 (Accessed July 25, 2013)
[53] Louise Story, Landon Thomas Jr. and Nelson D. Schwartz, "Wall St. Helped to Mask Debt Fueling Europe's Crisis," *New York Times*, 13 February 2010, http://www.nytimes.com/2010/02/14/business/global/14debt.html?pagewanted=all (Accessed July 18, 2013)

Euro.[54] Effectively, Greece and Italy masked their increasing debts by extensively involving themselves in these financial transactions.[55]

In the private sector, the adoption of the euro led to very low interest rates across the Eurozone in states that had historically different levels of credit-worthiness. Likewise, states that had weaker currencies before they adopted the euro immediately experienced more promising credit.[56] Low interest rates and increasing credit led to substantial spending in both the public and private sectors, leading to an economic boom. However, in states such as Ireland and Spain, the low interest rates resulted in a housing bubble, or a market in which demand substantially exceeds supply and houses are quickly bought and sold by speculators in hopes of making a profit. After these housing bubbles burst, meaning that prices in the housing market dramatically decreased, Ireland and Spain both moved to save their banks. Ireland nationalized, or took over, a number of banks in order to ensure their solvency.[57] Conversely, Spain infused large sums of money into its struggling banks.[58] By using public money to cover private debts, both Spain and Ireland were eventually forced to ask for rescue packages from the EU-IMF.[59] Actions to stabilize domestic industry across the Eurozone subsequently exacerbated the financial crises of the public sector and forced governments to reach out for aid in combatting rising debt levels.

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[54] Reuters, "Goldman Sachs details 2001 Greek derivative trades," Reuters, http://www.reuters.com/article/2010/02/22/goldman-sachs-greece-derivatives-idUSLDE61L1KH20100222 (Accessed July 18, 2013)

[55] *Ibid,* Story, Thomas Jr., Schwartz

[56] National Public Radio, "How the Financial Crisis Created a 'New Third World'," National Public Radio, 30 September 2011, http://www.npr.org/templates/transcript/transcript.php?storyId=140948138 (Accessed July 18, 2013)

[57] Eamon Quinn, "Ireland Bank Nationalization Moves Ahead," *Wall Street Journal*, 26 July 2011, http://online.wsj.com/article/SB10001424053111903999904576470264248494884.html (Accessed July 16, 2013)

[58] Christopher Bjork, Jonathan House, and Sara Schaefer Muñoz, "Spain Bails Out Its Third-Largest Bank," *Wall Street Journal,* 28 May 2012, http://online.wsj.com/article/SB10001424052702303395604577430341319668750.html (Accessed July 16, 2013)

[59] Julien Toyer and Sam Cage, "IMF praises Spain, Ireland reforms but warns of risks," *Reuters*, 19 June 2013, http://www.reuters.com/article/2013/06/19/us-spain-ireland-imf-idUSBRE95I1C620130619 (July 16, 2013)

Inflexibility of Monetary Policy

By virtue of having a common currency, states within the Eurozone share a single monetary policy. More specifically, individual states do not have the ability to create Euros for banking purposes. Other operations that are usually controlled by a state with an independent currency such as devaluation cannot be done in the Eurozone as well. States that have control over their monetary policy have the ability to adjust its value in order to decrease the price of its exports.

As a result of having an inflexible monetary policy, states in the Eurozone could not use monetary controls to mitigate the effects of the crisis. Although the smaller economies in the Eurozone with traditionally lower credit benefit from the Euro, the trade off of having the currency places all instruments of monetary policy in the hands of the ECB.[60]

Fiscal Independence and Eurozone Structure

Despite having a common monetary policy, the Eurozone states are each responsible for managing their fiscal affairs. While the Euro Convergence Criteria may have strict standards for fiscal policy, there is not a treasury in the EU to enforce it. States are able to ignore the criteria once they become a part of the Eurozone.[61] Simultaneously, in times of crisis, it is difficult for Eurozone states to have a hasty response, as the decision-making process requires unanimous agreement among the 17 states.[62]

A mix of fiscal mismanagement and the Eurozone's structure brought about Greece's financial turmoil. From 2000 to 2007 Greece was one of the fastest growing states in Eurozone with a GDP growth rate of 4.2 *per cent*. Concurrently, Greece recorded high budget deficits each year.[63] Greece was unable to control primary

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[60] Mario Draghi, "The role of monetary policy in addressing the crisis in the euro area," European Central Bank, https://www.ecb.int/press/key/date/2013/html/sp130415.en.html (Accessed July 16, 2013)
[61] *Ibid*
[62] Christopher Alessi, "The Eurozone in Crisis," Council on Foreign Relations, 3 April 2013, http://www.cfr.org/world/eurozone-crisis/p22055 (Accessed 16 July 2013)
[63] Organization for Economic Co-Operation and Development, "Economic Survey of Greece, 2007," Organization for Economic Co-Operation and Development, May 2007, http://glotta.ntua.gr/posdep/concrete/OECD/2007-OECD-38665552.pdf (Accessed 16 July 2013)

government expenditure on local authorities, the health sector, and social security.[64] Initially, currency devaluation was the preferred method of the Greeks to help finance borrowing for its domestic programs.[65] However, after the introduction of the Euro, the devaluation tool disappeared. Despite this reality, Greece continued borrowing due to lower interest rates across the Eurozone.[66] This culminated into a large debt once Greece's true financial situation was revealed, and exposed the fiscal mismanagement of the state's funds.[67]

Trade Imbalances

Since the adoption of the euro in 1999, a majority of Eurozone states have suffered from trade imbalances, or deficits resulting from importing more goods than are exported. Although Germany experienced trade surpluses as percentage of GDP between 1999 and 2007, the trade deficits of France, Italy, Ireland, Portugal, Greece, and Spain increased substantially.[68] The largest trade deficits belong to the PIIGS and contributed to the financial crisis. Since the deficits were overwhelmingly owed to Germany, the PIIGS trade imbalance largely escaped public attention as the deficits were paid out in euros as opposed to foreign exchange.[69]

With the aforementioned monetary controls of the Eurozone, states such as Germany that are sustaining trade surpluses do not see their currency appreciate. Normally, a state with a floating currency would see their currency appreciate relative to other currencies, thus making its exports more expensive. In the Eurozone arrangement,

[64] George Alogoskoufis, "Greece's Sovereign Debt Crisis: Retrospect and Prospect," *Hellenic Observatory 54*, January 2012, http://eprints.lse.ac.uk/42848/1/GreeSE%20No54.pdf (Accessed 17 July 2013)
[65] *Ibid*
[66] Agustino Fontevecchia, "Greek Euro Exit: 60% Currency Devaluation, Default, Banking Sector Collapse," Forbes, 3 November 2011, http://www.forbes.com/sites/afontevecchia/2011/11/03/greek-euro-exit-60-currency-devaluation-default-banking-sector-collapse-2/ (Accessed 17 July 2013)
[67] *Ibid*
[68] The Economist, "State of the union: Can the euro zone survive its debt crisis," The Economist, March 2011, http://pages.eiu.com/rs/eiu2/images/EuroDebtPaperMarch2011.pdf (Accessed July 19, 2013)
[69] Swaminathan S Anklesaria Aiyar, "Eurozone: Fiscal or Trade Crisis," *Economic Times*, 18 January 2012, http://articles.economictimes.indiatimes.com/2012-01-18/news/30639118_1_fiscal-deficits-trade-deficit-eurozone (Accessed July, 19 2013)

Germany's use of the euro keeps its goods artificially cheap, as the value of the euro is a reflection of all the states that use it.[70]

Due to the large discrepancy in balance of payments among Eurozone states, many economists have argued that trade deficits have played a larger role in the financial crisis than rising public debt levels. Economist Matthew O'Brien contends that increasing current account deficits increase interest rates, subsequently augmenting borrowing costs and debt.[71] This cycle contributed to the financial calamities experienced by the PIIGS and culminated in larger public debts that cannot be explained by government spending alone.[72] Irrespective of the primary cause, each factor in the Eurozone crisis contributed to this economic contagion that spread across the continent.

Projections and Implications

The European sovereign debt crisis was the first major test for the Eurozone. Consequently, there are a number of projections for the future of the Eurozone. Some have predicted a collapse of the euro and a return to the previous currencies. This scenario would result in unparalleled global financial calamity, as the second largest reserve currency in the world would no longer be in circulation.[73] Another proposal is the creation of a two-tier Eurozone in which the stronger economies would be separated from the weaker ones. A European official explained, "The philosophy is the stronger countries might need to move away from countries they can't afford to bail-out. As a way

[70] Floyd Norris, "Outside Europe, German Trade Surplus Soars," *New York Times*, 11 May 2012, http://www.nytimes.com/2012/05/12/business/economy/outside-europe-german-trade-surplus-soars-off-the-charts.html (Accessed July 19, 2013)
[71] Matthew O'Brien, "No, the United States Will Never, Ever Turn Into Greece," *The Atlantic*, 7 March 2013, http://www.theatlantic.com/business/archive/2013/03/no-the-united-states-will-never-ever-turn-into-greece/273748/ (Accessed July 19, 2013)
[72] Paul Krugman, "Fatal Fiscal Attractions," *New York Times*, 8 March 2013, http://krugman.blogs.nytimes.com/2013/03/08/fatal-fiscal-attractions/ (Accessed July 19, 2013)
[73] The Economist, "The Euro Zone: Is this really the End," The Economist, 26 November 2011, http://www.economist.com/node/21540255 (Accessed July 25, 2013)

of containing the damage, they may have to do something dramatic, though obviously in the short term implementation is difficult."[74]

Others, such as IMF managing director Christine Lagarde, have a much more positive outlook for the Eurozone's future. During a panel discussion Largarde contested, "I think that there is a bright future for Europe, and there is a bright future for the Eurozone and for the euro. This is predicated on continuation of the structural reforms, the strengthening of the European architecture, particularly with the European banking union project."[75] Likewise, the Eurozone has a number of avenues that it can pursue in order to mitigate the financial crisis' impact on Europe, such as pursuing common bonds, or Eurobonds. Since the remedies range from fundamentally altering the Eurozone altogether to making simple adjustments to restore investor confidence, the Eurozone will continue to be heavily scrutinized.

[74] Alex Spillius and Bruno Waterfield, "Germany and France examine 'two-tier' euro," *The Telegraph*, 19 June 2010, http://www.telegraph.co.uk/news/worldnews/europe/7837874/Germany-and-France-examine-two-tier-euro.html (Accessed July 25, 2013)
[75] EU Business, "IMF's Lagarde sees 'bright future' for Eurozone," EU Business, 18 July 2013, http://www.eubusiness.com/news-eu/finance-public-debt.pxu (Accessed July 25, 2013)

Conclusion

The Eurozone crisis has elicited a wide variety of responses and suggestions from the broader international and European community. Although states have received rescue packages to prevent the crisis from worsening, there is still considerable room for the European Commission to act in order to preserve the future of the Eurozone. Throughout the Eurozone's history, its member states have not abided by the Convergence Criteria that it was founded upon. Subsequently, the European Commission is charged with enacting the necessary reforms to ensure that the states that are participating in the Eurozone are in a mutually beneficial partnership. Irrespective of the solutions, it is imperative that the European Commission thoroughly examines the Eurozone's institutions and postulates how to ameliorate the current crisis and prevent future financial calamity from occurring.

As the most integrated regional body in the world, the sustainable development of the EU as a whole and the Eurozone more specifically is paramount to success of its member states. As explained previously, with a common monetary policy in place, the Euro can be adversely affected by the economic booms and busts of each state. Likewise, it is important for these factors to be taken into consideration when evaluating the sustainability of the union and its long term prospects. The EU can serve as a model for future regional integration globally, or could stand alone with its unique supranational institutions. If the EU wishes to persevere through economic hardship, it must outline a sustainable path by which all of its member states can prosper.

Discussion Questions

- Does the Eurozone need greater fiscal controls?
- Is monetary policy in the Eurozone too inflexible?
- Should the debts of states be written off?
- Are greater austerity measures needed to prevent a crisis in the future?
- Is a two-tier Eurozone system a feasible option?
- If states continue to pile up debts, should they be forced to exit the Eurozone?
- Are Eurozone wide bonds, or Eurobonds, a viable option to curb volatility in the bond market?
- What institutional changes can be made to prevent a future crisis?

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Dinan's "Ever Closer Union" is a comprehensive overview of the history, institutions, and policies of the European Union. This book provides a great basis for anyone that would like to understand the functions of the EU.

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