Eurozone Debt Crisis

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For

CECN 606: International Monetary Economics

Date:

Name:

Summary

The Eurozone, officially known as the Euro area, is a monetary union involving 19 of the 28 countries that are part of the European Union. The 19 countries adopted the Euro € as their currency and legal tender. The Eurozone Debt Crisis is an ongoing multi-year debt crisis that began near the end of 2009. The Eurozone states members such as Greece, Portugal, Spain, and Cyprus were unable to repay their government debt which led to multiple consequences within the European Union.

In this case study, we will introduce our topic and the importance of it along with the outcomes that arise from the debt crisis to not only the countries in question, but to the rest of the global economies. Using the various data collected in relation to the European Union as a whole as well as specific EU states members, we will analyze and find the connections between their results.

The research objective is to find the leading cause of the Eurozone debt crisis, focusing on countries with high debt, how it accumulated, and how that resulted in the depreciation of the Euro. The Maastricht Treaty, also known as the Treaty on European Union, was a treaty signed on February 1992 that established the European Union. It became effective on November 1, 1993, therefore making trading among borders easier, but the Euro was not adopted until January 1, 1999. It was created so that when countries within the European Union trade with each other, they no longer have to deal with exchange fees when having different currencies.

1. Introduction

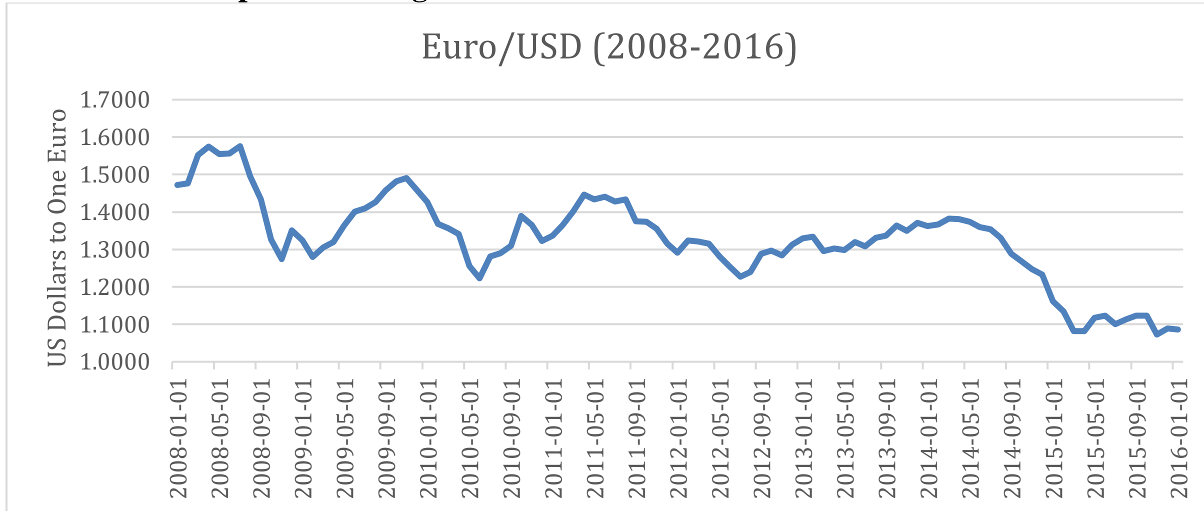
When the Euro was launched, the countries within the Euro Area discontinued their own currencies and adopted the Euro, as well as discontinuing their own monetary policies handing control of it to the European Central Bank (ECB). However, fiscal policies were not discontinued, which is the key reason that created the debt crisis. It is important to understand the difference between Monetary Policy and Fiscal Policy. Monetary Policy controls the money supply; the amount of money that circulates in the economy, as well as determining the interest rates for borrowing money. Fiscal Policy, on the other hand, controls how much money a country's government collects in taxes and the government spending. When a government spends more money than they collect in taxes, they have to borrow money, creating a deficit spending. With the smaller countries now being a part of the Euro Area, they had access to more borrowing and lower interests than previously. We will later discuss how this eventually created the Eurozone debt crisis.

First, we begin by looking at the exchange rate of the Euro against the US Dollar. We found three major dips in the Euro's value; 2009 to 2010, 2011 to 2012, and 2014 to 2015. We will now take a look at each of these periods, locate the cause of the depreciation, what actions were implemented to combat it, and how it eventually appreciated or stagnated.

2. Data

The Eurozone debt crisis focused mainly on the debt that countries accumulated, the data sets we use include the central government debt for several European Union countries, in a percentage of GDP, long term government bond yields for various countries, and the exchange rate data for the Euro against the US Dollar.

Graph 1: exchange rate of Euro to US Dollars from 2008 to 2016.



Source: Data retrieved from FRED.

3. The period from 2008 to 2010

Near the end of 2009, 1 Euro equated to 1.51 USD, but by mid-2010, the Euro plummeted to 1.19 USD. Greece was at the heart of this drop due to a number of reasons. Greece was considered a smaller country compared to other EU countries, so prior to joining the EU, they faced high-interest rates when borrowing money which led to less spendable capital. Once they joined the EU however, they suddenly had access to more money at lower interest rates. As a result, Greece adjusted its fiscal policy and government spending increased substantially.

Graph 2 : Greece Government Spending (2000-2016)

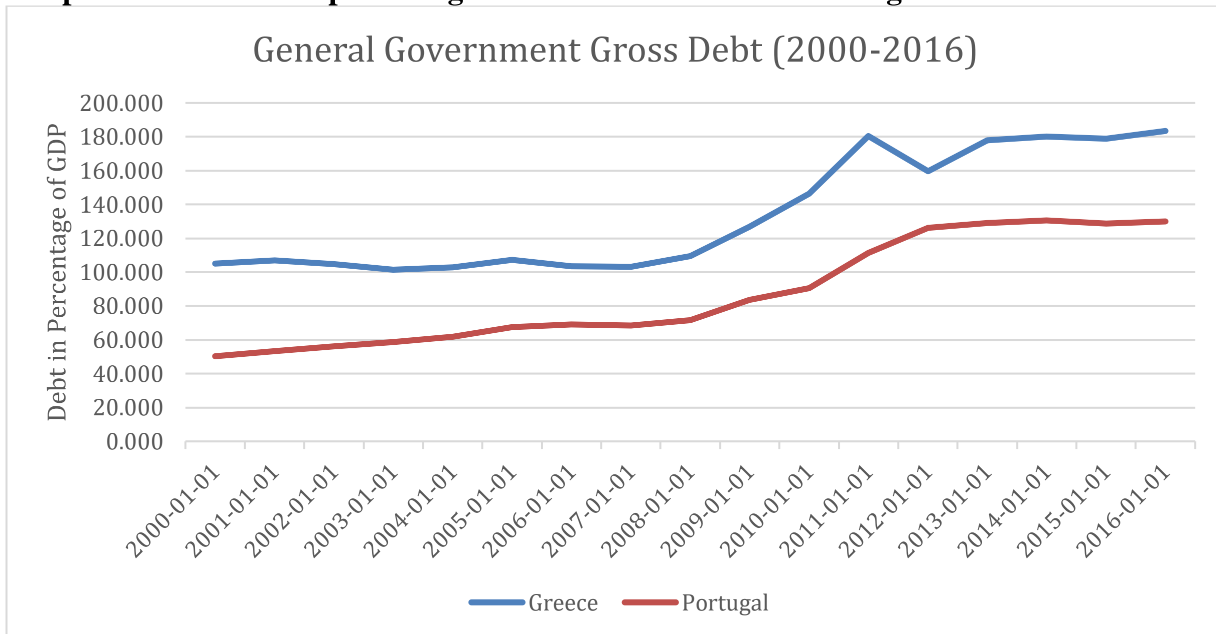
Source: tradingeconomics.com

When Greece began using the Euro, its government spending increased dramatically from 2002 to 2008, which is when the Eurozone debt crisis started. In 2002, Greece had an average government spending of $9.5 billion Euro, but by 2008, they reached a peak of $14 billion Euro. The debt began to accumulate and the countries within the EU became more intertwined. It was only until 2008 when credit was available for the countries within EU to help smaller countries repay their debt, so once the 2008 housing market in the United States took place, it created a credit crisis shockwave around the globe, affecting Europe and brought borrowing of money to a standstill. Countries such as Greece were now unable to borrow money and found themselves in a position where they cannot repay their debts. In December of 2009, Greece had reached $300 billion Euros in debt, which amounts to 146% of their GDP, which is more than double the Eurozone limit of 60%.

In January 2010, the EU agreed to repay Greece's debt as long as Greece agrees to implement strict Austerity Measures, which included cutting down on government spending, decreased borrowing, and paying back more debt. On January 14, 2010, Greece announced its *Stability and Grown Programme* which aimed towards cutting their deficit from 12.7% in 2009 to

2.8% in 2012. The Euro continued to depreciate as EU countries come under harsh scrutiny on handling of debt. The ECB's interest rate plummeted from around 4.5% in 2008 to just under 1% in 2010. In May of 2010, a €110 billion financing package was agreed on to help Greece out of sovereign default and to handle their finances up until June of 2013. The Agreement was launched by the European Commission, the European Central Bank (ECB), and the International Monetary Fund (IMF). Negotiations were made within the financing package, which included having Greece to cut budgets, freeze wages and pensions for three years, and increase taxes to address the country's problems with their debt and fiscal policies. Reforms were also created to revitalize economic growth with Greece as well as strengthen their competitiveness. With the increasing sight of solutions being implemented to handle's Greece's debt, confidence was regained which resulted in the Euro to appreciate starting in June of 2010. In July of 2010, a 41.8% reduction of central government cash deficit was announced by the Bank of Greece. Greece's GDP fell 6.9% in 2011 as a result of failing jobs and company bankruptcies from lowered government spending. Between June 2010 to January 2011, the Euro appreciated from 1.19 USD to 1.33 USD.

Graph 3. Gross debt in percentage of GDP for Greece and Portugal from 2000 to 2016

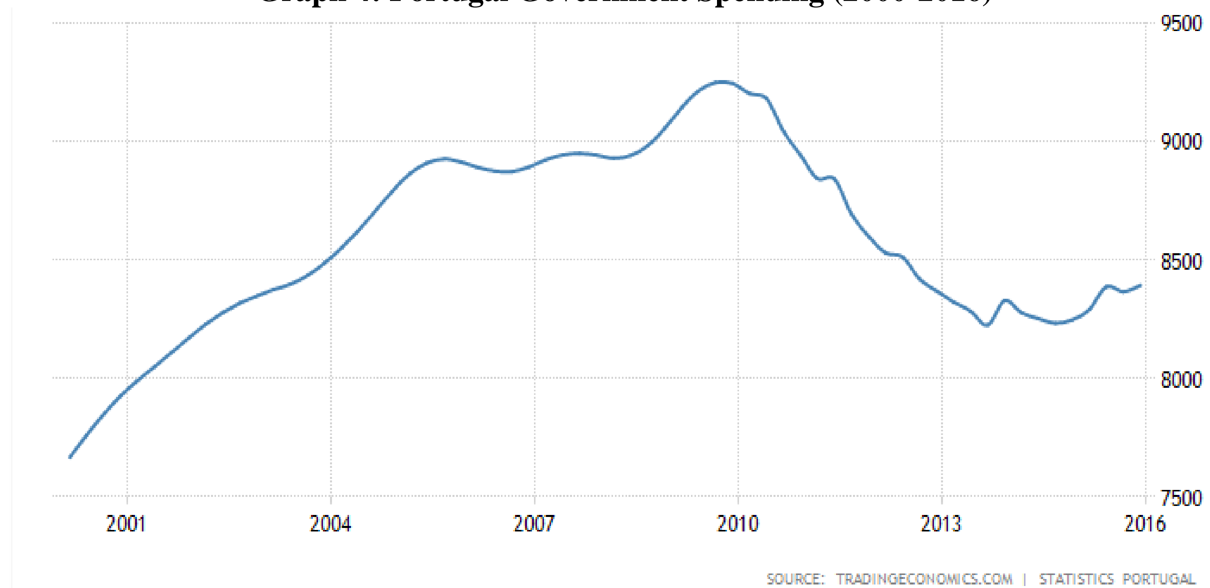


Source: Data retrieved from FRED.

4. The period from 2011 to 2012

During the first half of 2011, many bailout funds were set up and approved to help the Eurozone with repaying their debt. In February of 2011, a bailout fund of 500 billion Euros was established. This was called the *European Stability Mechanism*, and it was set up by the Eurozone finance ministers. The ESM is an EU agency that provides financial assistance to Eurozone countries that need financial assistance. Countries like Portugal and Greece needed these bailout funds in order to keep afloat otherwise they would default. In April 2011, Portugal joined the list of EU countries sovereign debtors list and needed the European Union's help to repay their debt. Portugal had a gross debt of 115% of its GDP. Portuguese debt skyrocketed during the beginning of the Eurozone debt crisis.

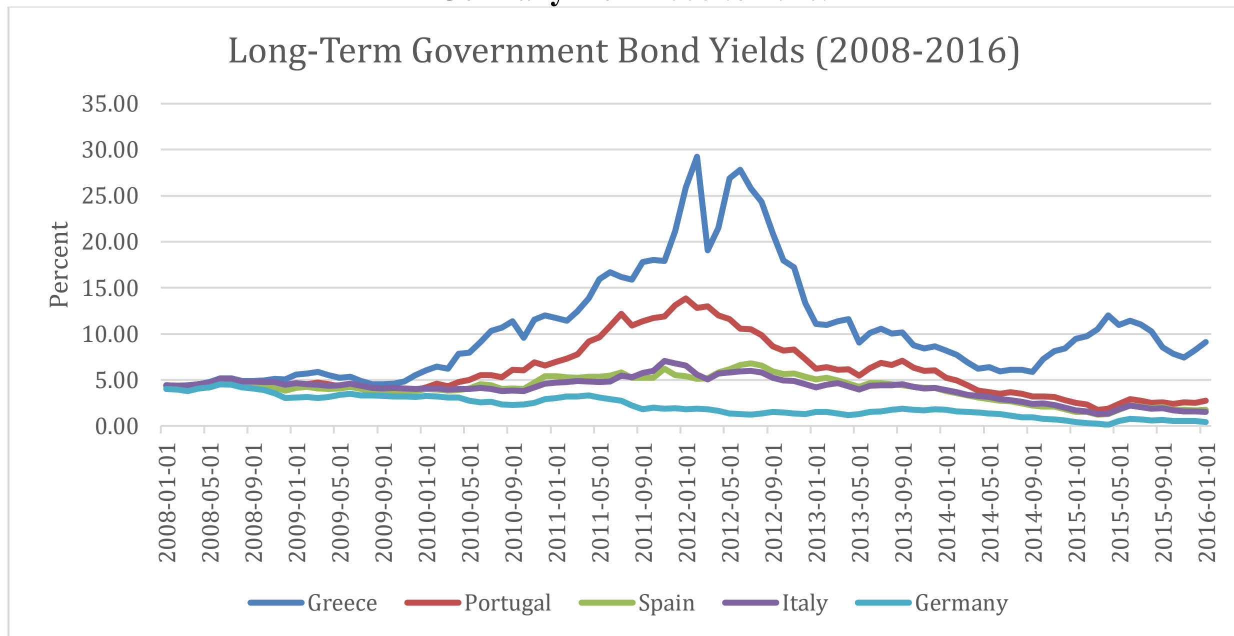
Graph 4: Portugal Government Spending (2000-2016)



Source: tradingeconomics.com

Portugal reached their peak government spending in 2011, with an amount close to 9.25 billion Euro. In May 2011, a $78 billion Euro bailout was approved, in exchange for Portugal agreeing to certain reforms and austerity measures such as cutting back the public sector wage bill by setting a limitation on job promotions and freezing wages, increasing sales tax, privatization of stakes in national energy companies, cutting back on certain state pensions while freezing others entirely, and the length of unemployment benefits to be cut back as well. Since then, government spending reduced to around 8.5 billion Euro and had since then stabilized. With all these bailouts set in stone, the Euro was relatively stable between April to August 2011. During that same period, a second bailout was agreed upon for Greece, being worth 109 billion Euros. The Euro did dip slightly following the announcement. The Euro dipped from $1.44 USD to $1.43 USD, which is not substantial considering how Greece at that time was considered to be in “restricted default”. Long-term government bond yields for Greece skyrocketed from 2010 to 2012.

Graph 5. Long-Term Government Bond Yields for Greece, Portugal, Spain, Italy and Germany from 2008 to 2016.



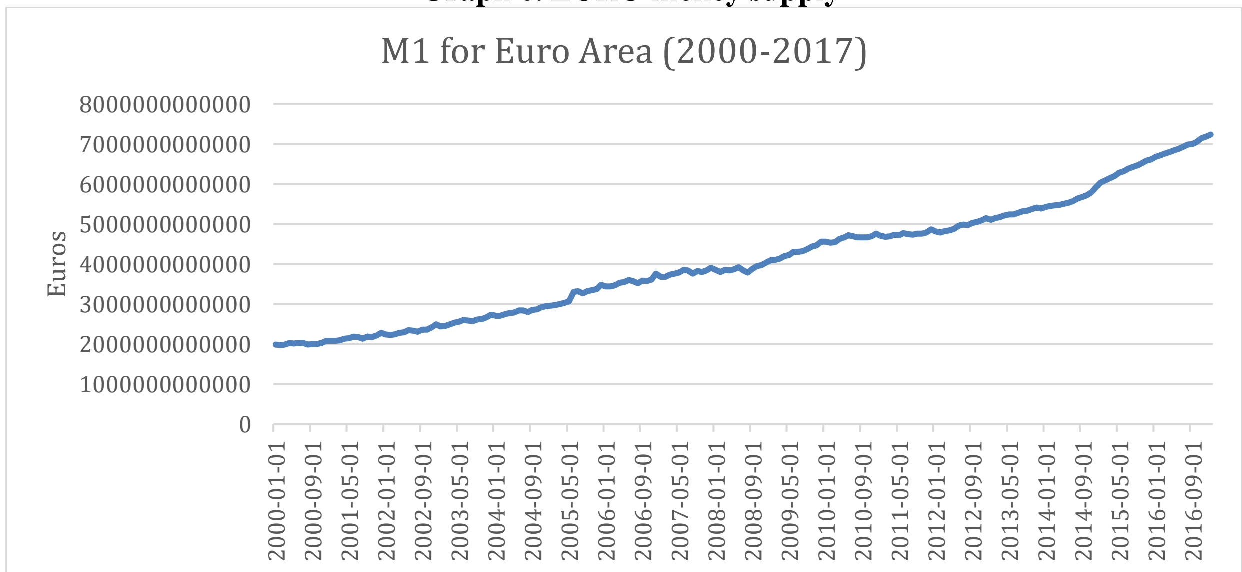
Source: Data retrieved from FRED.

It was at 6.02% rate in January 2010 but was at 29.24% by February 2012. This was due to the lack of confidence by investors in Greece paying back on their government bonds during the heart of the Eurozone debt crisis. At the same time, countries such as Portugal, Spain, and Italy also suffered spikes in government bond yields, while Germany fell to record lows. August 7, 2011, the ECB announced that they would purchase government bonds from Italy and Spain to lower borrowing costs, but this only sparked concerns that the debt crisis is now spreading towards larger economies within the European Union. This, along with the European Commission predicting a standstill on economic growth for the second half of 2011, and with the IMF cutting growth forecasts, created a wave of concerns which led to the Euro plummeting in September 2011 from $1.45 USD to $1.31 USD in October 2011.

5. The period from 2014-2015

Between mid-2014 to mid-2015 is where we see a record fall in the Euro. In March 2014, the Euro was $1.39 USD, but in March 2015, it was at a record low of $1.04 USD. One of the leading causes for it is the European Central Bank's preparation of performing a big Quantitative Easing (QE) Program. Quantitative Easing is when a central bank purchases a massive amount of government bonds as a way of increasing the money supply and lowering interest rates. In the case of the ECB, their goal is to pump 1 trillion Euros into Europe's economy. 60 billion Euros each month for the next 18 months. This is also done so the ECB can hit their desired inflation rate target of 2% in order to help increase economic growth. The problem with increasing the money supply is that it depreciates the Euro because more is circulating in the economy. With a weaker Euro, European exports are now cheaper helping boost the economy by selling more goods, which is especially helpful to smaller countries. An issue with lowering interest rates however is that it would cause investors to invest elsewhere, such as the United States causing money to flow out of Europe and in depreciating the currency further.

Graph 6. EURO money supply



Source: Data retrieved from FRED.

6. Conclusion

There were many variables that played a big role in the Eurozone debt crisis. However, it was mainly the fault of the European Central Bank not taking control of every member states fiscal policy that eventually led to a wave of problems. Had the ECB taken control over the European Union's monetary policy and fiscal policy, Greece and Portugal's debt crisis could have been avoided. Having control of Greece and Portugal's fiscal policy, the ECB would have seen their dangerously high borrowing rates, which is what led to their behemoth size debt accumulation. Since the EU countries are heavily intertwined, Greece and Portugal's debt crisis becomes everyone's debt crisis. There is only so much that the larger countries can support, therefore once Germany is no longer able to repay Greece's debt from its high government spending, it created a shockwave of problems that not only causes problems to Greece and Portugal, but to the entire Eurozone economy as well. The Euro suffered tremendously during the Eurozone debt crisis, having faced three large depreciations against the US Dollar, and having to create many bailout campaigns, establishing the European Stability Mechanism, and performing a Quantitative Easing just to stay afloat. Had they not implemented them, there is a very high likelihood that Greece, Portugal, and other small countries would have defaulted on their debt, which would create a shockwave to the lenders having to default due to not getting the money they leaned back, which may have shattered the European economy.

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