Munich Personal RePEc Archive

The Euro-Zone; is it the crisis ahead!

Trabelsi, Mohamed Ali

Faculty of Economics and Management of Tunis, University of Tunis El Manar

2011

Online at https://mpra.ub.uni-muenchen.de/81205/
MPRA Paper No. 81205, posted 09 Sep 2017 04:50 UTC

The Euro-Zone; is it the crisis ahead!

Mohamed Ali Trabelsi[1]

[1]*Tunis School of Business, Université de la Manouba, daly1704@yahoo.fr*

Abstract. The turmoil affecting capital markets since summer 2007 and its intensification since mid-September 2008 inflicted noticeable blows to the world economy. Although the high-risk real estate American market is believed to be the immediate source of such turmoil, these last years the euro-zone capital markets and financial institutions seem to absorb a continued credit cycle phenomenon and are seriously hit by aggravating tensions. It is the first financial crisis the Eurozone witnesses. Today, the priority for member states is to quickly find and implement solutions. In this paper, we analyse the recent developments in the Eurozone, mainly the Greek and Irish financial crises and the threats the Eurozone risks. Finally, we propose some solutions for the crises.

Keywords: Crises, Economy, Finance, Protectionism, Eurozone

1 Introduction

The international financial crisis which hit world economy now two years has been marketed as the most serious crisis that ever happened after the 1929 Great Depression [5]. Although the crisis initiated with the American subprime market bubble [1], it has progressively spread to the majority of international financial markets through derived products, a result of the securitization bank and financial institutions credits. Lack of transparency resulting from multiplying intermediaries between lenders and borrowers has quickly triggered a trust crisis. Fixing assets at market value brought about a collapse in banks rates.

2 The Financial Crisis and Protectionism

The global nature of the crisis is its most distinctive feature in that most countries were affected. Subprime credits are purely an American practice (they exist under more or less moderated forms in other countries like the UK) and it is the American institutions which are known for loans. This crisis has nevertheless quickly expanded due to the interdependence between financial institutions, of the securitization which allowed investors the access to foreign real estate markets and to risk price re-evaluation. Decrease in risky assets prices in the US influenced European banks which possess such assets, reducing thus their demand and speeding European stock markets collapse.

The crisis hit everywhere mainly Asia and Russia where unemployment figures and social difficulties are so dramatic. The current financial and economic crisis is a systematic, spectacular and particularly destructive crisis. Employees and businesses of the countries under shock called for protection from the state. The extent of the crisis and its socio-economic effects forced these governments to intervene although few of them had the intention or the means to do so [3].

No sooner, protectionism is once again hot news. It took Russia only few weeks to leverage custom duties on car importation. India followed with duties on steel importation. Indonesia responded with duties on 500 targeted products. In the US, Congress ratified the "Buy American" initiative which stipulates that public works financed by Obama's stimulus plan should exclusively use iron and steel produced in the US. In the eyes of the Europeans, this initiative is a violation of free-exchange rules and World Trade Organization (WTO) regulations. This return to protectionism may be explained partly by a rise in nationalists' slogans that call for protecting national industries and domestic employment and by governments' wishes to avoid streaming public funds towards financing foreign goods importation. These attempts show that protectionism is once again an option and some think it a solution among others.

To these protectionist initiatives, Fréderic Boccara [2] forwards some answers. For him, closing frontiers is never a solution, yet jointly establishing social and environmental norms with economic partners and imposing a control on investment-oriented public credits with very selective credit policies is required. Credits must favour investments with prospects of better salaries, additional employment and training at within-norms lower interests. He even mentioned null-approximating interest rates.

2. The Eurozone Financial Crisis

To face this crisis, the European Union (EU) undertook large scale measures setting up a financial stability plan totalling 750 billion euros in the form of loans and equities. The eurozone is able to support any member state in serious financing difficulties. The International Monetary Fund (IMF) in its turn vowed to support the Europeans with half of that amount. Finally the European Central Bank (ECB) lent its support by purchasing public and private debts accumulated by the eurozone. In return, the countries in crisis must continuously prove their solvency by credibly reorganizing their finances and by initiating reforms conducive to economic growth. Differently put, the current eurozone crisis is a public debt crisis. After Greece, Ireland is threatened and shortly other countries like Portugal, Italy, Spain and the UK await similar fate.

The Greek public finances recovery plan is still awaited and a mounting fear of a contagion phenomenon within the eurozone is felt day after day. Analysts still doubt the ability of Greece to reorganize its accounts and timely meet its financial obligations (debt and interests pay-off) and subsequently revive its economy. Then Greece called for help from its European partners and the IMF which agreed to lend it 110 billion euros over three years. In return, Greece should install, under the tight supervision of its creditors, a drastic budgetary scheme. Nevertheless, this rescue plan did not shield other countries from a contagion phenomenon (Portugal, Ireland and Italy).

2.1 The Case of Greece

The Greek crisis revealed another weakness of the monetary union's budgetary scheme; lack of control of member states' budget policies. This system facilitated entry of Greece into the eurozone by providing false declaration on its public debt and budget deficit. The system could not stop the Greek government to fool Brussels again in 2009 by declaring a budget deficit between 6% and 7% on the real 13% deficit.

2.3 The Case of Ireland

Ireland's deficit is the result of the bad debts of the banks taken in charge by the state. Several raisons explain Ireland's current difficulties. First, Irish banks' rescue plan is as high as 70 billion euros, representing the highest debt/GDP ratio in the world. Moreover, growth prospects record a decrease of

(– 1.1%) instead of the predicted increase (2.5%) for 2011. Yet, economic growth is a requirement for debt pay-off.

It is to be noted as well that Irish liabilities have consequences on Europe. Spain, Portugal and Italy witnessed an increase in rates as a reaction to pressures on Ireland. In order to recover from this increase, some countries like Germany requested Ireland to accept the help of the European Union so that to avoid a worsening of the situation. Borrowing costs in Ireland reached a record during these last months following worries about a deficit which may reach this year, 32% of the GDP. This situation brought fears of a Greek scenario where budgetary problems of a country throw the whole eurozone into a crisis.

Ireland then faces a dilemma: accepting European economic rescue funds now and faces Greece's fate or wait with the hope of voting for the austerity budget in December and calm down market speculations. The Irish leaders opted for the first alternative.

3. Is the European Currency a weakness or strength?

Installing the Euro helped member states strengthen their currency across financial markets and avoid devaluating it. At the same time, the stability pact which forces governments to remain within deficit limits and to respect indebtedness thresholds came in handy. In order to respond primarily to budget deficit explosions, the Maastricht Treaty set up a procedure targeting excessive deficits. Accordingly, public debt should not exceed a 60% limit and the annual public deficit is set at 3% of GDP. Within these limits, each country was able to conserve its economic and budget policies. Some analysts even assume that the protection of the euro has favoured lax economic and budget policies for some governments at the expense of the whole eurozone.

The financial and economic crisis does in fact deepen differences among the eurozone economies. Each country has its own difficulties. Ireland is paying large amounts on its financial activities. Spain's real estate business is derailing. Greece witnesses social problems. In front of these difficulties, the stability pact rules are no longer respected. These internal difficulties are proportional to those outside the eurozone. The eurozone is protected from currencies attacks and more and more states are joining it: Finland, Sweden, Denmark, members of the European Union, wish to rejoin the union rapidly (Buiter and Sibert, 2008). Even the UK is thinking of it despite their attachment to the pound. Island, which is seriously hit by the crisis, think of submitting an admission request to the EU and the euro. Thus, the eurozone attracts the outsiders, yet paradoxically its members are unwilling to introduce solidarity mechanisms which favour them.

4. Threats to the Eurozone

Daniel Gros, director of the Centre for European Policy Studies (CEPS), highlights the worrying signs of the tensions on the interbank market. These tensions translate lack of trust in the idea that the system is restored. For him, more and more banks prefer to trust the ECB with their deposits rather than lend other banks. He forwards the following explanation: the problems surrounding the crisis, like the precarious Greek public finances and the Spanish real estate business, have not been solved although they should be with no difficulty. Greece is but 2% of the eurozone economy and its debt is just 1.5% of eurozone GDP. Spain is similar. In the worst case, the combined losses of the Spanish banks and of other banks intervening in the Spanish real estate business do not exceed 3% of the eurozone GDP. Daniel Gros is questioning the paralysis of the eurozone banking system against problems which could be easily solved.

The Greek experience has shown that neglecting difficulties may generate a circle of risk premium increases and a decrease in investors trust. However, there is a more worrying second raison which is at the origin of financial market instability; a large number of European banking systems are undercapitalized. According to the ECB, the amount of banks liabilities (interbank debts included) is 20 times higher than their capitals and reserves. In other words, bad debts are 20 times higher than capital debts to which some banks may soon face.

Daniel Gros underlines that in the worst case Greece's and Spain's losses will not exceed 450 billion euros. However, the funds mobilized by the eurozone are 750 billion euros and proportionally they are enough to face the crisis. Nevertheless, this is not the adequate approach to follow. European rescue funds could be used to save banks but given that the ratio is 1 to 20 between the capital and the liabilities this measure needs astronomical financial packages. Consequently, to cover Spain's and Greece's losses the 450 billion euros should be 9000 billion Euros, recovering thus the Eurozone's financial sector debt and maintaining its stability. Accordingly, Europe cannot avoid its financial markets crisis if it does not remedy its banking sector.

5. The Weaknesses of the European Union's Economic Organization

With the massively spreading international crisis across Europe, the weaknesses of the European economic organization emerged again. Facing the financial crisis and economic crisis, European countries reacted in an individual fashion and without cooperation and sometimes taking opposite positions. The ECB and the European governments failed to find the appropriate combination between monetary and budget policies as the EU does not have centralized decisions on economic policy able to fix and coordinate budget policies across European states.

This is only possible through balancing the Monetary and Economic Union (MEU) by installing a European economic government and reforming competition between states. This would further push member states to implement the "2020 EU Strategy", following the failure of the "Lisbon Strategy". Certainly, the EU succeeded in devising a European Monetary Fund (EMF) which would purchase the liabilities of a country in crisis. Nevertheless, there are no synchronized projects but rather two propositions which seem to attract European attention (Financial Times Deutschland, 11 mars 2010).

A project presented by Daniel Gros and Thomas Mayer, the President of Deutsche Bank, targets the creation of a monetary fund financed by deficit penalties that countries pay when exceeding indebtedness limits specified by the Maastricht Treaty. The paying countries could then benefit from an indirect help in case of a crisis. The German minister of Finance is working on a second alternative approximating the IMF model. According to this alternative, member states contribute to the funds according to their economic power. In case of a crisis, the relevant and EMF member countries could benefit from credits if they adopt strict adjustment programs. Some ECB members have expressed serious reserves against this alternative because they think it an invitation to threatened states to borrow more. This would make EMF projects unproductive.

Jamet [4] notes that Europe's task is a difficult one. Unemployment rates are increasing within the eurozone since the crisis began. It should reach the 10.7 % in 2010 against 7.5 % in 2007. The Eurozone's public finances considerably decreased due to the stimulus plans, the increase in social expenses and the decrease in revenues. According to the European Commission, public debt of member states will represent 88.2 % of the Eurozone's GDP in 2011 against 66 % in 2007. In Ireland, public debt will exceed the 25.1 % of 2007 to reach 96.2 % of the GDP in 2011. It should reach 135 % of the GDP in Greece by 2011. This state of affairs raises serious questions about the future of the stability and growth pact. It highlights as well the opportunity to maintain the same traditional criteria on the entry of new states within the eurozone. Adding to this, the social and budget difficulties in a context of an expected economic growth relatively weak during the coming years and which approximates 1% between 2010 and 2015 against 2.5 % in the US. Another key element is the

slackening of active population growth which is explained by the weakness of innovation and investment in Europe.

5.1 The similarities between the eurozone and the US crises

Jean-Claude Trichet [6], president of the ECB insists on the differences between the Eurozone's financial structures and those of the US. The US financial system rests essentially on the market contrary to that of the eurozone which is to a large extent centred on banks. On this, he makes it clear that at the end of 2007, bank credits in favour of the private sector reached 145 % of the GDP in the eurozone against only 63 % n the US. Reversely, the direct issuing of equities represents 81 % of the GDP in the eurozone and 168 % in the US. Private credit allocation between the two blocks is then totally different. Bank credits, equities issuing not included, in the eurozone covers two thirds of external financing against only 30 % in the US. This clearly explains the approaches adopted by the two blocks. In the eurozone, in order to insure businesses' and households' normal access to credits, there must be an adequate liquidity level. Credit allocation must essentially be conducted with the contribution of banks.

5.2 How can the Eurozone bypass the crisis?

In order to define common policies to bypass the crisis, the analysts propose two strategies:

- Reforming the Eurozone's governance according to the following foundations; controlling private indebtedness, internalizing budget regulations within member states laws and the adoption of common positions on international economic disequilibrium.
- Defining a common structural reform program in view of replacing the Lisbon Strategy.

In the same context, Jamet [4] gives much importance to the role of France and Germany. According to him, France and Germany must set themselves seven objectives:

- Increase investment contribution in the economy by strengthening investment in public expenses in a way to increase financing targeting education and research.
- Improve employment of active population by improving the efficiency of the training system and favouring women and youth employability.
- Preserving the reliability of health and retirement schemes.
- Improve environmental regulations and competition of businesses through facilitating their access to financing.
- Reconciling the French and German fiscal system at the level of Value Added Tax (VAT) and taxes on businesses.
- Adopt common investment and energy supply objectives.
- Define industrial priorities on financing environmental innovation.

6 Conclusion

The financial crisis causes are attributed to markets and essentially to the regulations targeting customer protection and financial transparency and to products derived from the securitization of credits following the Basle II system. This crisis is revealing of the failure of the governance model and the regulating institutions like the IMF and the World Bank which call for reforming regulating organizations, abolishing fiscal paradises, re-evaluation of credit rating agency (CRA) and creating a new economic order. This crisis led public authorities to intervene in the form of liquidity injections as debts or capital and a partial or total nationalisation. This intervention gave birth to a debate on the return of protectionism and the role of the State. This return to protectionism, explained in part by the

rise of popular slogans targeting the protection of national industries and domestic employment and by governments' willingness to avoid using public funds in financing foreign goods importation, is judged to be a danger by most experts.

In this context and following the G20 summit (November 2010), there was a unanimous denunciation of all forms of protectionism which according to Angela Merkel would bring catastrophic results for all countries. The final communiqué mentioned the firm intention of the states to implement the Basle III framework.

We should insist as well on the fact that public authorities, governments and central banks must act to win, preserve and reinforce households' and businesses' trust in order to open the path for durable wealth. The trust of economic agents depends today on the judgement of central banks determination to maintain prices stability.

It is time now to think of a social transformation project passing by financial markets regulation and economic growth to fight unemployment and to improve services. To this effect, two solutions will be possible: a unique authority of financial control for the EU or a system of European authorities of financial supervision including a central organism which coordinates between local organisms. Each of these solutions will improve supervision and help eliminate systematic risks in a European capital market which is growing and more and more integrated. This systematic crisis needs a systematic response.

The European Union must take advantage from the Greek crisis in order to repair the structural defects of the economic and monetary union issued from the Maastricht Treaty by installing an economic European government. Not only does the creation of such institution allow avoiding the debt crisis, but also it gives the EU a budget policy instrument which allows it to conduct coherent up-to-date politics. Thinking about eliminating some financial instruments like the credit default swaps (CDS) so as to limit financial markets speculation should be on the agenda. Finally, creating a European IMF may help fight indebtedness crises.

7 References

Bénard V. (2008). Crise des subprimes, un désastre engendré par l'état, Objectif Liberté, (18 aout 2008).
Boccara F. (2009). Le protectionnisme, une réponse à la crise ? Entretiens croisés, (voir l'Humanité du 14 Février 2009).
Borrell J. (2009), L'Europe face à la crise, Alternatives Economiques, (voir N°81, avril 2009).
Buiter W. and Sibert A. (2008). The Icelandic banking crisis and what to do about it: the lender of last resort theory of optimal currency areas, CEPR Policy Insight, N°26.
Jamet J-F. (2008), Quelle peut-être la réponse européenne face à la crise financière ?, Revue d'Economie Financière, pp. 449-454.
Trabelsi M.A. (2011). The impact of the financial crisis on the global economy:
Can the islamic financial system help?, Journal of Risk Finance, 12 (1), pp. 15-25.
Trichet J-C. (2008), Réflexions sur les turbulences récentes sur les marchés de capitaux mondiaux, Revue d'Economie Financière, pp. 417-426.