THE FINANCIAL CRISIS OF THE EUROZONE*

Tuomas Hannu Aleksi Marttinen

Faculty of General Management, Siam University, Thailand
E-mail: marttinen.tuomas@gmail.com

Abstract

This study is made about the financial crisis of the eurozone. The purpose of this study is to find answers about the causes of the ongoing financial and economical crisis of the eurozone. It is also very important to find the solution to the problem that how they are going to solve these financial and economical problems in the eurozone. This study is important, because the financial and economical problems are influencing to the economies and countries in all over the world. This study is going to give answers to the reasons why there is financial and economical problems in the eurozone and what kind of solutions they have to do to be able to solve this difficult siutuation in Europe. After analyzing the data, the study found that there were many different reasons why the financial crisis started in the eurozone. There was a housing bubble in the United States in 2006, and from there the situation spreaded in all over the world. One of he America´s largest investment banks, Lehman Brothers, collapsed and that scared the banks and investors globally. The reason why there was economical and financial problems in the United States is that there was slowdown in their economy and because of that the homeowners defaulted on their mortgages. There was banks around the world which had investments that were linked to those American mortgages, and because of the difficult economic situation of the United States, they started to lose money.

The financial crisis has been affecting to the member countries of the eurozone since 2009. The reason why the crisis began in Europe was that there was a group of central and eastern European banks which were asking for bailout. The study refers that the financial and economical crisis is a combination of government debt crisis, banking crisis, and growth and competitiveness crisis. There is many structural weaknesses in the European Union and they need to improve the polcycoorination between the member countries. Because the economic governance of the European Union was so weak, countries like Greece, Spain, Ireland, Portugal, and Cyprus had very serious financial and economical problems. The study concludes that they have to improve the policy coordination, and economic and financial surveillance in the Eurozone, if they want to prevent this kind of economical and financial problems from rising again.

Keywords: European Union, Eurozone, financial crisis

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Introduction

This study is made about the financial crisis of the Eurozone which started in 2009, and that has shown that there is a need to make stronger economic governance in the European Union and the Eurozone area. Because the governance of the economics was so weak it allowed some national debt and deficit levels to develop in unsustainable way, which resulted as the sovereign debt crisis that effects many countries in the European Union. These Union countries are now obliged to pursue strict deficit reduction policies. The member countries learned very important lesson from the financial crisis, and they have to improve the economic policymaking in the European Union. The economic policymaking also needs better coordination. The governments of the European Union countries can now recognize the fact that they have to share economic and political responsibility, because their economies are very interdependent, especially in the case of the euro area countries. It is important to remember that the origins of the crisis did not develop in the short period of time, and in fact it took time for many years. The economic and financial crisis originally started from the United Sates because of the burst of the US subprime bubble, which culminated to the collapse of the Lehman Brothers investment bank in September 2008. But the reason of the crisis was not only that what happened in the United States, it was also about the imbalances which had built up over the years within the Eurozone. Many member countries in the Eurozone had a large government debts and deficits, microeconomic imbalances, coupled with increased differences in competitiveness. These issues made it very difficult for some European Union countries to effectively confront both the financial crisis and the emerging debt crisis simultaneously. This situation made also many European banks to face very serious difficulties.

Objectives

The main objective of this study is to find the solution for why did the financial crisis occur in the Eurozone, and why they have to improve the coordination of the member countries´ economical and financial policies. It is important to understand that they have to create stability, sustainable growth and jobs in the European Union so they can be able to survive from the crisis. This study should give information for others so they would be able to avoid this kind of crisis from happening again.

Theory and Related Research

Seppo Honkapohja published "The euro area crisis: A view from the north" (2013) which indicates that the financial and economical crisis has influenced strongly to the economies and some countries in the euro area. According to SeppoHonkapohja the real estate prices started to fall in Ireland and Spain, and that finally triggered a banking crisis in these two countries. Honkapohja indicates that in 2009 the government of Greece announced that their public deficits were much more higher than they have been told earlier. As the result of this situation the interest rate on Greek bonds began to rise in the high levels. Later on a similar situation occurred in other countries such as Spain, Portugal, Ireland, Italy, and Cyprus. According to Honkapohja each of these countries had very unique characteristics relating to the crisis situation. In Ireland and Spain they had real estate bubbles which finally led to the banking crisis, but it is important to remember that the government finances appeared to be in good situation before the crisis in both of these countries. Honkapohja indicates that Italy and Portugal had very weak economies which means that the growth was slow in these two countries, and they also had some overheating and debt problems. And finally Honkapohja claims that Greece had huge problems because of the high levels of deficits.

Methods

This is a qualitative research study which focuses on the publications of the European Union, the European Commission, the eurozone, and some online journails. I compared the information from the different sources and after that I build my study for relying to that information. After that I analyzed the data and used it in my study. The data is collected from internet sites and from various online books which are related to the financial crisis of the eurozone.

Results

According to the European Union the financial crisis spreaded in Europe from the United States of America. In 2006, there was a slowdown in the United States economy and because of that the local homeowners defaulted on their mortgages. Many banks in all over the world had investments which were linked to those mortgages, and because of that they started to lose money. Because of the bad investments, one of the largest banks in the United States collapsed. The collapse of Lehman Brothers caused fear between banks and investors around the world, because they had common businesses with each other. Soon after that, the financial and economical problems spreaded in Europe, because some European governments wanted to rescue several banks from collapsing.

The financial crisis has been affecting to the member countries of the eurozone since 2009, when a group of central and eastern European banks asked for bailout. According to the European Union the member countries of the European Union agreed to control their deficit spendings and debt levels in the Treaty of Maastricht, but some of them didn´t follow these rules and regulations. Many governments in the eurozone borrowed a lot of money to finance their budgets. These governments also wanted to finance their debts, because the money was easily available for them. The investors ignored the problems of the economy and they borrowed more money for the troubled countries. The economies of these countries lost their competitiveness against the other member states.

There was also property bubbles and economic imbalances in some countries in the European Union. The financial and economical crisis is a combination of government debt crisis, banking crisis, and growth and competitiveness crisis. The economic governance of the European Union focused too much on deficits when they should have focused more on the government debt levels. There was not enough surveillance of competitiveness and that is the reason why there was macroeconomic imbalances in the eurozone. Because there was not enough surveillance it caused debts to the private sectors, the financial institutions to be unfunctional, and inflation to the housing markets. The European Union had weak enforcement against the countries which had financial and economical problems and when the problems occurred, they did not solve these problems soon enough. And finally there was no mechanism that would have provided financial support for countries which had financial and economical difficulties.

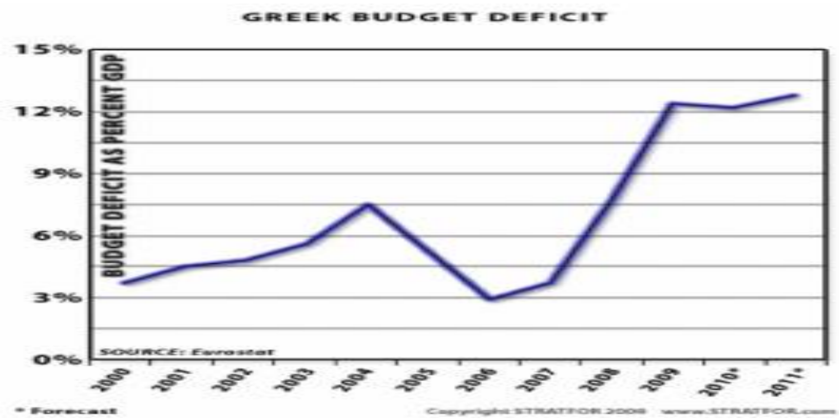

Figure 1. This chart describes the Budget Deficit of Greece, Stratfor 2009

The government of Greece reported false data about their budgets for many years. The bond spreads rose in extremely high levels. The investors lost their confidence because of the high deficit levels, and that affected directly to bond spreads. Greece was spending too much money for many years even before the financial crisis, and their government did not receive enough incomes. Because of the overspending their budget deficit levels went out of control, and they were not able to handle the situation anymore. Greece was not able to pay back their loans, and that is the reason why they needed to borrow money from the European Union and the International Monetary Fund. Greece received a bailout loan of 110 billion euros from the European Union and the International Monetary Fund. But soon they discovered that this amount of loan was not enough to bail them out from the critical situation. The European Union and the International Monetary Fund gave 165 billion euros more so they would be able to cover their debts. The European Union and the International Monetary Fund insisted that Greece have to reform their labour market and pensions, rise taxes, and to control their spendings more accurately.

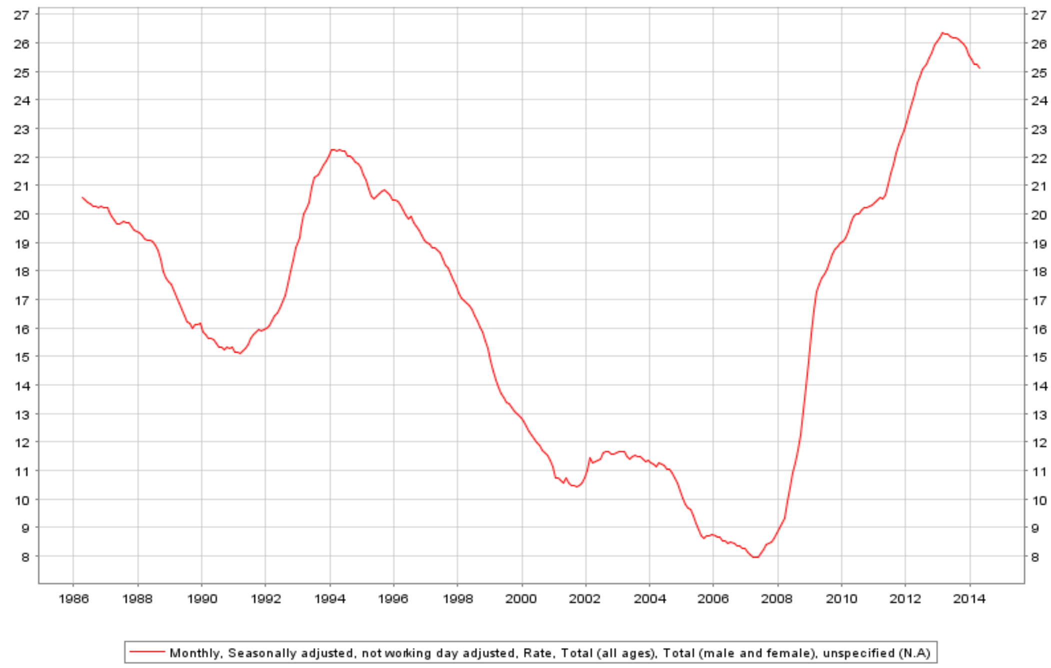

Figure 2. The Unimployment Rate of Spain, Statistical Office of the European Commission (Eurostat)

The situation was totally different in Spain than it was in Greece. There was a housing boom in Spain, but later on it turned out to be a housing bubble. The Spanish banks gave cheap loans to the homebuyers and builders, but these people were not able to pay back their loans. The Spanish banks are struggling because they have massive loans, and that is why they needed to reconstruct their banking sector. The value of the properties collapsed, they had a recession, and the unemployment rate was very high. They received a bailout loan of 100 billion euros from the European Financial Stability Facility and the European Stability Mechanism, and it was targeted to the banking sector. But this loan is not solving all the problems that they haveing in their economy, because they are suffering from recession and they have a lot of unimployment in their country.

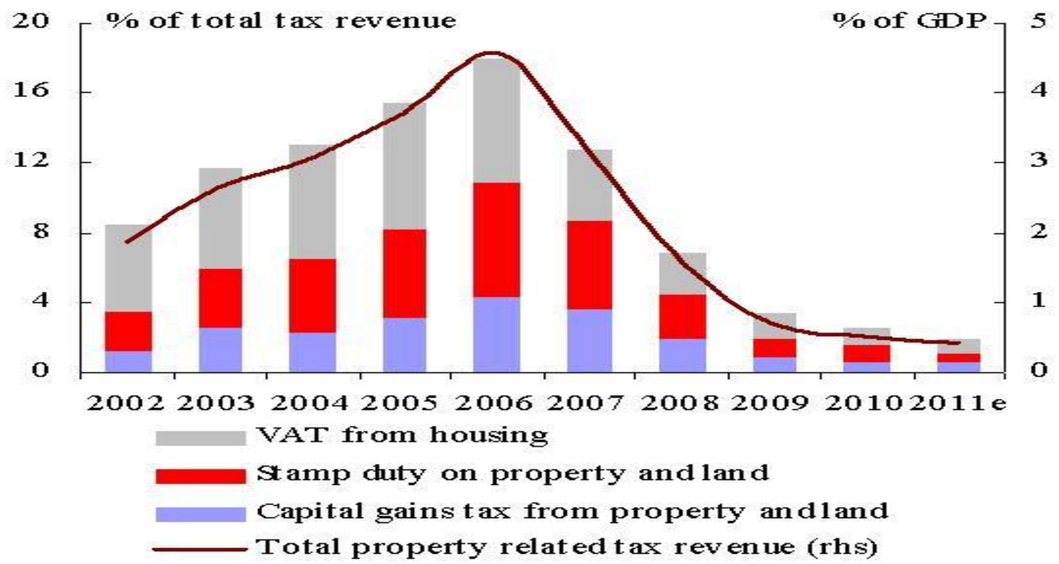

Figure 3. The collapse in property related tax revenue which caused the fiscal crisis in Ireland, European Commission

Ireland had a very good position in the European markets before the financial crisis. Ireland had strong fiscal position, the unemployment rate was very low, they had an educated workforce, and their economy was growing rapidly. The property bubble bursted in 2007, and that is the reason why the economy collapsed in Ireland. People were not able to pay their loans to the Irish banks, and the Irish banks lost about 100 billion euros to the defaulted loans, which were taken by property developers and homeowners. The European Union and the International Monetary Fund covered a financial assistance package to Ireland which was worth of 85 billion euros. It is important that Ireland creates stronger banking sector, improves ther fiscal sustainability, and have sustainable growth. Ireland is the first eurozone country which succesfully emerged from the macroeconomic assistance programme, and they are no longer dependent on international financial assistance.

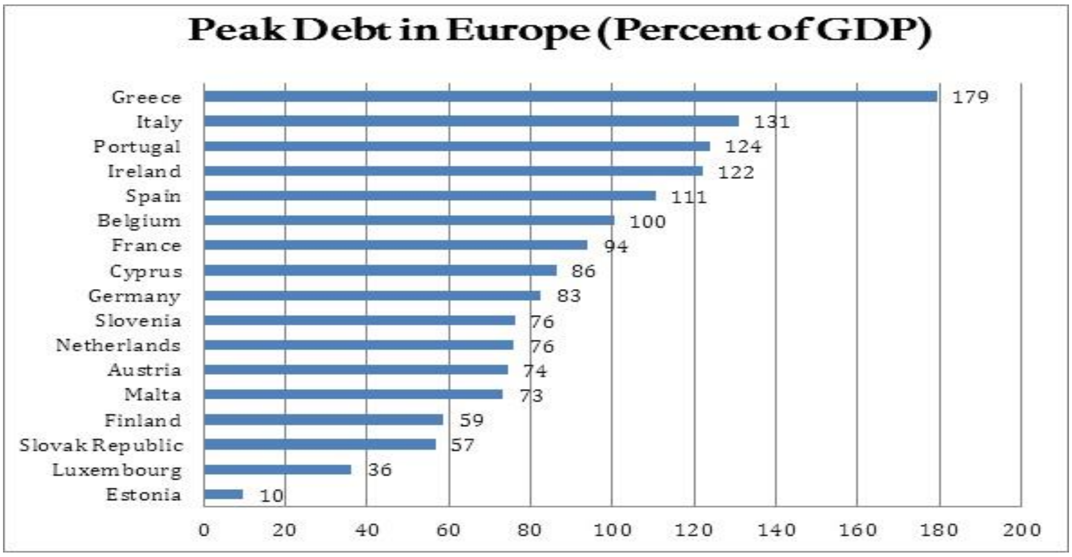

Figure 4. Gross government debt in Europe, using IMF data released in April 2013

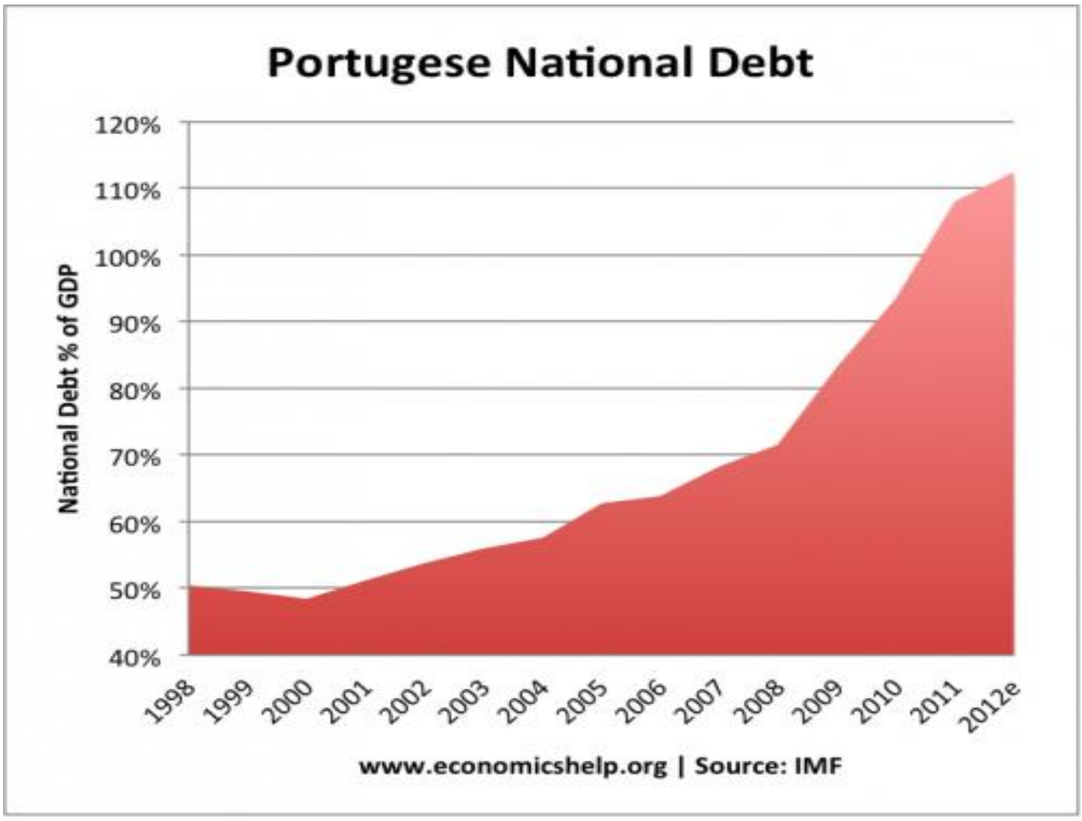

Figure 5. Portugese national debt, Statistica/Eurostat/Global Finance est 2012

The economy of Portugal has suffered from deep recession and unemployment for many years. Their government used a lot of credit, created a public debt, and they mismanaged their structural and cohesion funds. Portugal had very serious problems with their public finances and they requested a bailout package of 78 billion euros from the European Union and the International Monetary Fund. If Portugal wants to meet the targets of their deficit reduction, they need to increase their tax incomes and cut their spendings. Portugal needs to boost their growth and create more jobs. They also need to improve their competitiveness. The situation is still very challenging in Portugal, but they have improved their finances and economy.

In 2009, the tourism and shipping sectors shrank in Cyprus, and that is the reason why their economy went into recession. The global financial crisis was the main reason why their economical sectors shrank so rapidly. These difficulties caused a lot of unemployment in their country. The commercial property values declined in Cyprus, and people were not able to pay their loans to the banks. Because the banks were not able to receive their loans, the pressure increased against their banking system. Cyprus was not able to recapitalize their financial sector. Their credit rating went in the ”junk” status and they needed to request a bailout money from the European Financial Stability Facility and the European Stability Mechanism. Finally after many investigations Cyprus received a bailout package of 10 billion euros from the European Union and the International Monetary Fund so they would be able to rebuild their economy.

According to the European Union the economic coordination was not strong enough in the eurozone, and that is the reason why they had macroeconomic and fiscal imbalances in that area. I totally agree with this claim, because there was many structural weaknesses in the European Union which they have to reorganize. The European Union have to increase their growth and to create more jobs. The countries in the eurozone area have to follow the common governance rules if they want to correct these financial and economical problems. The Stability and Growth Pact creates stability and fiscal discipline to the European Union, but they needed to make this pact even stronger because of the eurozone crisis. That is why they increased the budgetary surveillance in the eurozone. Now they can observe if some nations in the eurozone have high levels of government debt. The launch of the excessive deficit procedure makes it possible that now they can monitor both, the government deficits and debts. The study agrees that it is very important that they monitor the debt levels in the eurozone, because the situation of Greece points out that there is a need for stronger fiscal surveillance in this area. Because there is financial and economical problems in the eurozone, the member countries have to present their draft budgets for the following year to the European Commission. Now the European Commission can follow the draft budgets and they can see if they do not fill the requirements of the Stability and Growth Pact and the European Semester. The credible sanction mechanism is going to increase the enforcement of the fiscal rules. The credible sanction mechanism is a very good thing, because before there were countries which did not follow the rules and regulations in the euro area. If the countries are able follow these rules, they can prevent a similar crisis from happening again.

The European Union also have to increase the surveillance of macroeconomic imbalances, because they have to avoid risky developments from occurring in the euro area. Real estate bubbles and weak competitiveness are serious threats for the stability of the euro area and that is the main reason why they have to increase the surveillance of the macroeconomic imbalances. The important thing is that now they regularly monitor indicators that are related to potential macroeconomic imbalances.

Finally, the European Union have to boost their growth. The European Union created the Europe 2020 Growth Strategy which is going to help the member countries to deliver high levels of employment, productivity and social cohesion.

Conclusion

The study concludes that there were many different reasons which caused the financial and economical crisis in the Eurozone. The financial crisis started to spread from the United States, because there was a slowdown in their economy caused by the homeowners who defaulted in their mortgages. Several banks around the world were linked to those mortgages and that eventually caused serious financial difficulties for them. The collapse of the Lehman Brothers, which was one of the largest banks in the United States, caused fear among banks and investors around the world. Soon the problems started to spread in Europe, because European governments wanted to rescue several banks, that were linked to those events, from collapsing. There was easy credit conditions in the Eurozone which encouraged some European countries to do risky borrowing practices. These countries did not control their deficit spending and debt levels well enough, which caused the collapse of their economies. As the result of the reckless borrowing practices in the European Union, these countries lost their competitiveness in markets around the world. The situation was different in countries like Spain and Ireland which had property bubbles and economic imbalances. The Eurozone crisis is a combination of government debt crisis, banking crisis, and competitiveness crisis. These problems reveal that the economic governance and the economic coordination were not strong enough in the European Union and the Eurozone. Now the member countries have to follow the common rules of governance if they are want to survive from the crisis. The European Union created new and more better fiscal rules to the Eurozone area, and they are monitoring the member countries in regular basis. It is a very important thing that they increased the budgetary surveillance in the euro area, because it helps them to observe if some nations have high levels of government debt. The crisis exposed that there is also a need for the better surveillance of macroeconomic imbalances, because real estate bubbles and weak competitiveness are serious threats for the stability of the euro area. The European Union have to increase their competitiveness and growth by creating more jobs, productivity, and social cohesion to the whole area.

The European Union will be more functional society if they can follow the new rules and regulations. The European Union has now stricter monitoring of public debt levels, macroeconomic surveillance, and stricter enforcement of the fiscal rules. The study indicates that these are the factors that are going to create more stability to the Eurozone and help them to survive from the crisis. The important thing is that I could find the solution that what were main causes why the financial crisis began in the Eurozone. The member countries have to be able to solve these financial and economical problems in the euro area by creating stronger economic governance and to improve the structural weaknesses in the European Union. They have to improve the policy coordination between the member states. The stronger cooperation between the member countries is very important in the Eurozone so they can be able to survive from the crisis.

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