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ON GOING CRISIS OF 21ST CENTURY-EUROZONE DEBT CRISIS

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Abstract :

After American Mortgage crisis of 2007-08, The International Monetary Fund (IMF) had warned that a global recession cannot be ruled out, ***as the effects of euro-zone debt crisis are spreading to more countries, banks and investors (2012).***

Euro zone crisis has threatens emerging market economies *As the euro zone's three-year-old debt worries continue to punish the global economy, there are new warnings that reduced lending by European banks mean the effects of the crisis could be most deeply felt in the developing world. This crisis is not a currency crisis in a classic sense. Rather, it is about managing economies in a currency zone and the economic and political tensions that arise from the fact that its constituents are moving at varying speeds, have dramatically different fiscal capacities and debt profiles but their feet are tied together with a single currency The Eurozone debt crisis is ongoing crisis of 21 century.*

Key Words : Eurozone Debit Crisis

Introduction :

All the **economic crises**, whether termed as economic slowdown, recession, depression or debt crisis are generally found to have **link with the greed of investors and instability in financial sector.**

Eurozone crisis is called as a "bombshell" for developing nations, a June analysis by the Overseas Development Institute, a London-based think tank, estimated that the effects of the eurozone crisis would cost the developing world 238 billion dollars in 2012 and 2013. The report singled out Mozambique, Kenya, Niger, Cameroon, Cape Verde and Paraguay among the countries most at risk. "The ability of developing countries to respond to the shock waves emanating from the euro area crisis is likely to be constrained if international finance dries up and global conditions deteriorate sharply," wrote Isabella Massa, the report's author. Indeed, European banks began closing their credit spigots to emerging economies as their attention shifted to the financial turmoil at home. Between 2000 and 2008, investors and lenders in eurozone countries were the world's chief source of private capital, and a particularly important lender to emerging markets.

The International Finance Corporation (IFC), an arm of the World Bank that promotes the private sector in developing countries, reported that capital outflows in the form of foreign direct investment (FDI), portfolio equity investments and commercial bank lending had seen significant declines.

In **2011, outflows from the eurozone to the rest of world totaled 248 billion dollars**, an amount that was about half that of the previous year. Capital inflows to emerging economies declined over the same period, according to the IFC. **This decrease in lending threatens developing economies that depend on financial backing from developed economies such as the 17-nation eurozone** (Refer 01).

The severity of the eurozone debt crisis intensified again in 2012 with weakening growth prospects, accelerating private sector capital outflows from so-called peripheral countries, elevated sovereign bond yields and a gathering political backlash against austerity. New adverse shocks centred on the eurozone are slowing the global recovery, which is creating a more difficult backdrop for sovereign credit. Fitch forecasts global GDP growth to slow from 2.7 per cent in 2011 to just 2.2 per cent in 2012, before gradually firming to 2.8 per cent in 2013 and 3.1 per cent in 2014. Risks are skewed to the downside, though lower oil prices could offer some respite. (Refer 02)

Theoretical Background :

The European sovereign debt crisis is an ongoing financial crisis that has made it difficult or impossible for some countries in the euro area to re-finance their government debt without the assistance of third parties.

From late 2009, fears of a sovereign debt crisis developed among investors as a result of the rising private and government debt levels around the world together with a wave of downgrading of government debt in some European states. Causes of the crisis varied by country. In several countries, private debts arising from a property bubble were transferred to sovereign debt as a result of banking system bailouts and government responses to slowing economies post-bubble. In Greece, unsustainable public sector wage and pension commitments drove the debt increase. The structure of the Euro zone as a monetary union (**i.e., one currency**) without fiscal union (examples: **different tax and public pension rules**) contributed to the crisis and impacted the ability of European leaders to respond. European banks own a significant amount of sovereign debt, such that concerns regarding the solvency of banking systems or sovereigns are negatively reinforcing.

Concerns intensified in early 2010 and thereafter, leading Europe's finance ministers on 9 May 2010 to approve a rescue package worth €750 billion aimed at ensuring financial stability across Europe by creating the European Financial Stability Facility (EFSF). In October 2011 and February 2012, the euro zone leaders agreed on more measures designed to prevent the collapse of member economies. This included an agreement whereby banks would accept a 53.5 per cent write-off of Greek debt owed to private creditors, increasing the EFSF to about €1 trillion, and requiring European banks to achieve 9 per cent capitalization. To restore confidence in Europe, EU leaders also agreed to create a European Fiscal Compact including the commitment of each participating country to introduce a balanced budget amendment.

Prior to May, 2012, the European currency remained stable. As of mid - November 2011, the euro was even trading slightly higher against the bloc's major trading partners than at the beginning of the crisis. Three countries significantly affected Greece, Ireland and Portugal, collectively accounted for 6 per cent of the euro zone's gross domestic product (GDP). During June 2012, the Spanish debt crisis became a prime concern for the Euro-zone. Interest rates on Spain's debt rose significantly and its ability to access capital markets was affected, leading to a bailout of its banks and other measures.

The European sovereign debt crisis resulted from a combination of complex factors, including the globalization of finance; easy credit conditions during the 2002–2008 period that encouraged high-risk lending and borrowing practices; the 2007–2012 global financial crisis; international trade imbalances; real-estate bubbles that have since burst; the 2008–2012 global recession; fiscal policy choices related to government revenues and expenses; and approaches used by nations to bail out troubled banking industries and private bondholders, assuming private debt burdens or socializing losses.

The temptation offered by readily available savings overwhelmed the policy and regulatory control mechanisms in country after country, as lenders and borrowers put these savings to use, generating bubble after bubble across the globe. While these bubbles have burst, causing asset prices (e.g., housing and commercial property) to decline, the liabilities owed to global investors remain at full price, generating questions regarding the solvency of governments and their banking systems. How each European country involved in this crisis borrowed and invested the money varies.

Eurozone debt crisis, a situation is a far cry from the optimism and grand vision that marked the launch of the Euro in 1999 and the *relatively* smooth passage it enjoyed thereafter. While the Euro zone may be forced to do what it takes, it is unlikely that the situation will soon return to business as usual on its own.

Research :

A number of economists have suggested that the debt crisis was caused by **excessive government spending.** According to their analysis, increased debt levels were also due to the **large bailout packages provided to the financial sector during the late-2000s financial crisis, and the global economic slowdown thereafter.** The average fiscal deficit in the euro area in 2007 was only 0.6 per cent before it grew to 7 per cent during the financial crisis. In the same period, the average government debt rose from 66 per cent to 84 per cent of GDP. The authors also stressed that fiscal deficits in the euro area were stable or even shrinking since the early 1990s. US economist Paul Krugman named Greece as the only country where fiscal irresponsibility is at the heart of the crisis Either way, high debt levels alone may not explain the crisis. According to The Economist Intelligence Unit, the position of the euro area looked **"no worse and in some respects, rather better than that of the US or the UK."** The budget deficit for the euro area as a whole is much lower and the euro area's government debt/GDP ratio of 86 per cent in 2010 was about the same level as that of

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the US. Moreover, private-sector indebtedness across the euro area is markedly lower than in the highly leveraged Anglo-Saxon economies.

Commentator and ***Financial Times*** **journalist Martin Wolf** has asserted that **the root of** the **crisis was growing trade imbalances**. He notes in the **run-up to the crisis, from 1999 to 2007,** Germany had a considerably better public debt and fiscal deficit relative to GDP than the most affected euro zone members. In the same period, these countries (Portugal, Ireland, Italy and Spain) had far worse balance of payments positions. Whereas German trade surpluses increased as a percentage of GDP after 1999, the deficits of Italy, France and Spain all worsened.

Paul Krugman wrote in 2009 that a trade deficit by definition requires a corresponding **inflow of capital to fund** it, which can drive down interest rates and stimulate the creation of bubbles: "For a while, the inrush of capital created the illusion of wealth in these countries, just as it did for American homeowners: asset prices were rising, currencies were strong, and everything looked fine. But a bubble always burst sooner or later, and **yesterday's miracle economies have become today's basket cases, nations whose assets have evaporated but whose debts remain all too real**." A trade deficit can also be affected by changes in relative **labor costs**, which made southern nations less competitive and increased trade imbalances. Since 2001, Italy's unit labor costs rose 32 per cent relative to Germany's Greek unit labor costs rose much faster than Germany's during the last decade. However, most EU nations had increases in labor costs greater than Germany's. Those nations that allowed **"wages to grow faster than productivity**" lost competitiveness. Germany's restrained labor costs, while a debatable factor in trade imbalances, are an important factor for its low unemployment rate.

Euro zone countries with sustained trade surpluses (i.e., Germany) do not see their currency appreciate relative to the other Euro zone nations due to a common currency, keeping their exports artificially cheap. Germany's trade surplus within the Euro zone declined in 2011 as its trading partners were less able to find financing necessary to fund their trade deficits, but Germany's trade surplus outside the Euro zone has soared as the Euro declined in value relative to the dollar and other currencies.

From late 2009, fears of a sovereign debt crisis developed among investors as a result of the rising private and government debt levels around the world together with a wave of downgrading of government debt in some European states. Causes of the crisis varied by country. In several countries, private debts arising from a property bubble were transferred to sovereign debt as a result of banking system bailouts and government

In the first few weeks of 2010, there was renewed anxiety about excessive national debt, with lenders demanding ever higher interest rates from several countries with higher debt levels, deficits and current account deficits. This in turn made it difficult for some **governments to finance further budget deficits and service existing debt**, particularly when economic growth rates were low, and when a high percentage of debt was in the hands of foreign creditors, as in the case of Greece and Portugal. Some governments have focused on austerity measures (e.g., higher taxes and lower expenses) which has contributing to social unrest and significant debate among economists, many of whom advocate greater deficits when economies are struggling. Especially in countries where budget deficits and sovereign debts have increased sharply, a crisis of confidence has emerged with the widening of bond yield spreads and risk insurance on CDS between these countries and other EU member states, most importantly Germany. By the end of 2011, Germany was estimated to have made more than €9 billion out of the crisis as investors flocked to safer but near zero interest rate German federal government bonds (*bunds)* While Switzerland equally benefited from lower interest rates, the crisis also harmed its export sector due to a substantial influx of foreign capital and the resulting rise of the Swiss franc. In September 2011 the Swiss National Bank surprised currency traders by pledging that "it will no longer tolerate a euro-franc exchange rate below the minimum rate of 1.20 francs", effectively weakening the Swiss franc. This is the biggest Swiss intervention since 1978.

One of the central concerns prior to the bailout was that the crisis could spread to several other countries after reducing confidence in other European economies. According to the UK Financial Policy Committee **"Market concerns remain over fiscal positions in a number of euro area countries and the potential for contagion to banking systems."**

Findings :

Fitch Ratings says in its latest bi-annual global Sovereign Review and Outlook report that the systemic crisis engulfing the eurozone and downward pressure on eurozone sovereign ratings is unlikely to diminish until European leaders articulate a credible and substantive road-map towards greater fiscal, financial and political integration.

Regardless of the corrective measures chosen to solve the current predicament, as long as **cross border capital flows remain unregulated in the euro area, current account imbalances are likely to continue**. A country that runs a large current account or trade deficit (i.e., importing more than it exports) must ultimately be a net importer of capital; this is a mathematical identity called the balance of payments. In other words, a country that imports more than it exports must either decrease its savings reserves or borrow to pay for those imports. Conversely, **Germany's large trade surplus** (net export position) means that it must either increase its savings reserves or be a net exporter of capital, lending money to other countries to allow them to buy German goods.

Suggestions :

The Economist wrote in June 2012: "Outside Germany, a consensus has developed on what Mrs. Merkel must do to preserve the single currency. It includes shifting from austerity to a far greater focus on economic growth; complementing the single currency with a banking union (with euro-wide deposit insurance, bank oversight and joint means for the recapitalization or resolution of failing banks); and embracing a limited form of debt mutualization to create a joint safe asset and allow peripheral economies the room gradually to reduce their debt burdens. This is the refrain from Washington, Beijing, London and indeed most of the capitals of the euro zone. Why?

The crisis is not merely of sovereign debt and bank financials but also rooted in the real economy with structural problems. The stage is set for a change in the manner in which the eurozone will have to manage its monetary, fiscal and financial system.

Conclusion :

Stability in financial sector, particularly the banking sector is the call of the day for restoring the confidence and creditability in the financial markets.

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