Research Report

MUNISH ‘12

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Forum	Economic and Social Council (ECOSOC)
Issue:	The financial situation in the Eurozone
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Introduction

The euro was introduced as the currency of the European Union in 2002. All nations who adopted the euro form the Eurozone. While the Eurozone is a monetary union, it is far from a fiscal union; all Eurozone states have totally different rules regarding taxes, pensions, and wages. High public sector wages and unsustainable pension systems have driven up the debts of some states to such extent that in order to avoid default, the countries needed to be bailed out. These developments have sparked global debate on the future of the Eurozone. Among European leaders there is consensus that collapse of the Eurozone should by all means be prevented: solutions are sought in reforming fiscal policies. These reforms—often including fierce austerity measures—have been met with great opposition from Eurozone citizens. This has also lead to the electoral punishment of politicians associated with austerity measures, giving rise to policies aimed at increasing economic growth and employment.

Definition of Key Terms

Eurozone

Economic and Monetary Union (EMU) consisting of 17 EU Member States that have accepted the euro as their currency. The following states are currently part of the Eurozone:

Austria, Belgium, Cyprus, Estonia, Finland, France, Germany , Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.

Government Bonds

If governments need extra money, they borrow it. A bond is nothing more than a loan. Governments sell bonds and investors buy bonds. The government gets the money from the bond sale, and the investor gets the bond, a contract stating WHEN the government will pay back principal (the amount the investor bought the bond for) plus any interest.

(Budget) Deficit

A deficit occurs when a government's expenditures exceed the revenue it generates. The deficit is calculated over the course of one accounting period. (Usually one year)

Debt

Debt is the sum of all deficits that accumulated over the years.

Gross Domestic Product (GDP)

"Gross domestic product (GDP) is the market value of all officially recognized final goods and services produced within a country in a given period."

General Overview

In 1992 the Maastricht treaty was signed by the members of the European Community. The treaty called for the creation of the euro. The Maastricht criteria (also known as the euro convergence criteria), as part of the treaty, served as the entry criteria for states wishing to adopt the euro as their currency. The four main criteria are:

1. **Inflation rates**: No more than 1.5 percentage points than the three lowest inflation EU member states.
2. **Government finance**
   a. **Annual government deficit**: The annual government deficit must not exceed 3% of the Gross Domestic Product (GDP). Exceptions would only be made for exceptional and temporary situations.
   b. **Government debt**: Gross government debt must not exceed 60% of GDP. In case of a debt higher than this level, it should each year be declining towards a level below 60% of GDP.
3. **Exchange rate**: Countries should have joined the exchange-rate mechanism (ERM II) under the European Monetary System (EMS) for two consecutive years and should not have devalued their currency during that period
4. **Long-term interest rates**: Nominal long-term interest rate should not be more than 2 percent points higher than that of the three lowest inflation EU member states.

After adopting the euro, states are bound by the Stability and Growth Pact (SGP). The SGP deficit and debt criteria are similar to the euro convergence criteria. The SGP however has proven to be ineffective, penalties were never imposed, and only 6 of the 27 states monitored complied with the criteria set out by the SGP.

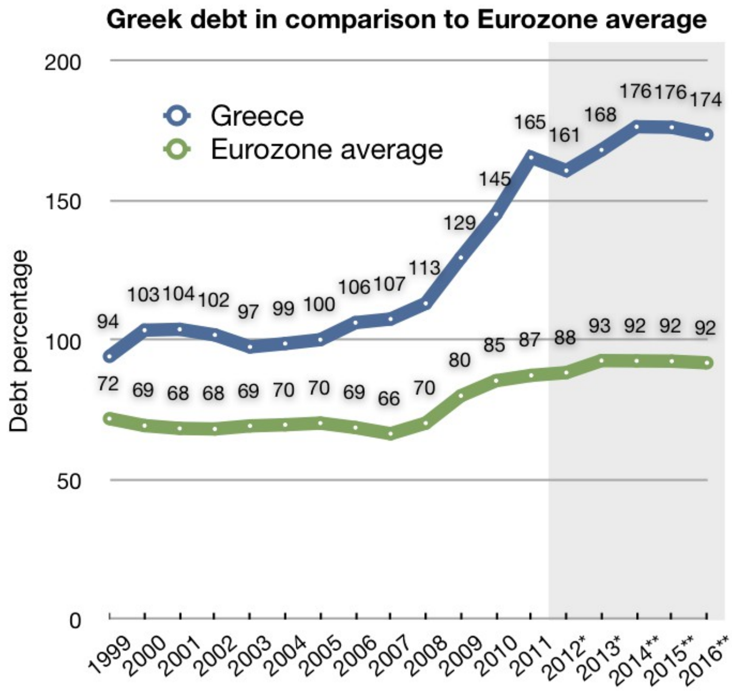
SGP compliance by country

Fiscal data for 2011	Budget deficit to GDP[21]	Debt-to-GDP ratio[21]	Breaches of the deficit/debt rule (since 1998)[21]	Deadline for compliance with SGP[22]
Reference value	max. 3.0%	max. 60.0% (or if above: declining towards 60%)		
Austria	2.6%	72.2% (increasing)	1998-99, 2001, 2004, 2008–current	2013
Belgium	3.7%	98.0% (increasing)	2008–current	2012
Bulgaria	2.1%	16.3%	2009–10	**Comply**
Cyprus	6.3%	71.6% (increasing)	1998-99, 2001-04, 2009-current	2012
Czech Republic	3.1%	41.2%	1998-2003, 2005, 2009-current	2012
Denmark	1.8%	46.5%	**No breaches**[1]	2013
Estonia	-1.0% (surplus)	6.0%	1999	**Comply**
Finland	0.5%	48.6%	**No breaches**[1]	**Comply**
France	5.2%	85.8% (increasing)	2002-05, 2007-current	2013
Germany	1.0%	81.2% (declining)	1998-99, 2002-05, 2008-10	**Comply**
Greece	9.1%	165.3% (increasing)	1998-current	2014
Hungary	-4.3% (surplus)	80.6% (declining)	1998-99, 2001-10	2012
Ireland	13.1%	108.2% (increasing)	2008-current	2015
Italy	3.9%	120.1% (increasing)	2001-06, 2008-current	2012
Latvia	3.5%	42.6%	1999, 2008-current	2012
Lithuania	5.5%	38.5%	2000-01, 2008-current	2012
Luxembourg	0.6%	18.2%	**No breaches**	**Comply**
Malta	2.7%	72.0% (increasing)	1998-2004, 2008-current	2011
Netherlands	4.7%	65.2% (increasing)	2003, 2009-current	2013
Poland	5.1%	56.3%	1998, 2001-06, 2008-current	2012
Portugal	4.2%	107.8% (increasing)	1998-current	2013
Romania	5.2%	33.3%	1998-2001, 2008-current	2012
Slovakia	4.8%	43.3%	1998-2002, 2006, 2009-current	2013
Slovenia	6.4%	47.6%	2000-01, 2009-current	2013
Spain	8.5%	68.5% (increasing)	2008-current	2014
Sweden	-0.3% (surplus)	38.4%	**No breaches**	**Comply**
United Kingdom	8.3%	85.7% (increasing)	2003-05, 2008-current	2014 (FY)
Eurozone 17	4.1%	88.0% (increasing)	2003-05, 2008-current	N/A
EU27	4.5%	83.0% (increasing)	2003-05, 2008-current	N/A

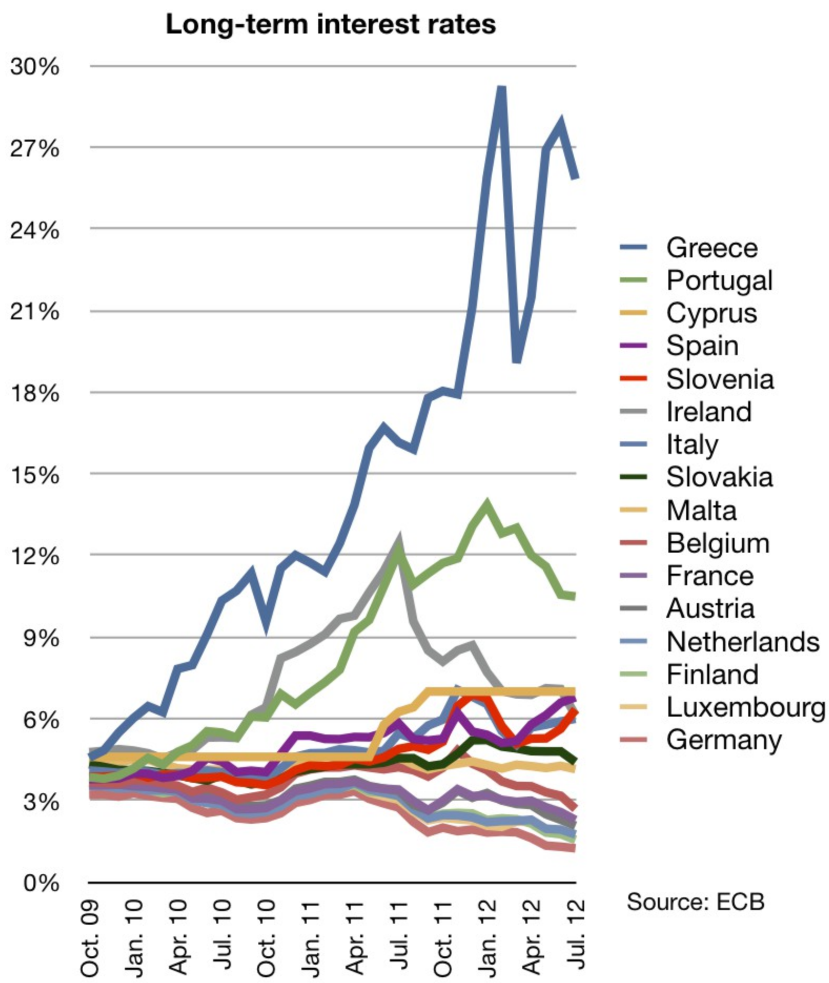
In response to the failure of the SGP, European leaders came up with the ESM. Please read more about the ESM under “Evaluation of previous attempts to solve the issue”.

The European sovereign debt crisis, how did it originate?

Most analysts trace the start of the European sovereign debt crisis back to late 2009; Greece revealed that its debt reached €300bn, the highest debt level in the country's modern history. It was also revealed that Greece had lied about its financial situation; for many years it had pretended to run way lower deficits than it actually was running. Statistical bodies and accounting institutes were not independent from the ministry of finance, which possibly lead to the false figures being presented. Fears of Greece not being able to meet its debt obligations developed among investors and rating agencies started downgrading Greek debt. As a consequence, Greece would no longer find itself able to borrow money from investors at a low interest rate. The high interest payments would then again add up to Greece its total debt, resulting in an unsustainable build-up of debt and even higher interest rates.



Source: Eurostat
* estimates from Eurostat (spring 2012)
**estimates from Ernst & Young using data from Oxford Economics



Source: ECB

In May 2010, on the brink of Greece's default, the IMF and Eurozone states agreed on a rescue package for Greece; a €110bn bailout package. Many more bailouts followed on condition that Greece would implement reforms to curb its annual deficits. As austerity plans were passed in Greek parliament, great anger developed among Greek citizens, leading to riots and other forms of social unrest.

Why doesn't Eurozone just let Greece go?

Some argue that letting Greece default would be a good plan. After sending all the bailout money, Greece's financial situation hasn't shown any significant sign of improvement, and it is uncertain whether sending more money will increase the likelihood of Greece ever being able to repay its debts. Default would allow the Greek government to lower taxes and increase spending in order to stimulate the economy. A new currency would allow the government to devalue, which would increase export of Greek goods and services.

So why isn't this path chosen? First of all it would lead to massive loss of confidence in countries with similar bond yields, think of Portugal and Ireland. This could trigger a domino effect, which would tear apart the whole Eurozone. Furthermore it is predicted that a Greek exit from the EMU would likely cause a global liquidity freeze more severe than the one witnessed after the bankruptcy of Lehman Brothers in 2008.

Other countries in trouble

Spain

While Spain's debt in 2010 was relatively low with just 60% of GDP, its deficits have raised concerns among other European states as well as the IMF. To earn trust from investors, Spain implemented austerity measures and amended its constitution to require a balanced budget by 2020. The amendment states that debt may never exceed 60% of GDP, though exceptions would be made in cases of emergency (e.g. natural disasters, economic crises). Spain managed to cut its deficit from 11.2% in 2009 to 9.2% in 2010 and 8.5% in 2011.

While the public debt in Spain is under control, private mortgage debts have resulted in a housing bubble, leading to many government bailouts of private banks. When interest on Spain's 10 year bonds reached the 7%, Spain received a €100bn aid package to bailout its banks. The announcement of the ECB its "unlimited bond-buying plan" immediately lead to the 10 year bond yield to fall from 7.7% to 6.6%.

Portugal

As a result of decades-long public overspending, Portugal has received a €78bn bailout package. As part of the package, Portugal agreed to cut its deficit back to 3% in 2013. Credit rating agency Moody's has brought down Portugal's credit rating to "junk status".

Ireland

The Irish crisis was not caused by public overspending, but by government bailouts of banks that had invested in a property bubble. It is estimated that Irish banks lost about €100bn related to the property bubble. Ireland received €67.5bn bailout package in November 2010. As part of the deal Ireland would reduce its budget deficit to fewer than three percent by 2015. Just like Portugal, Ireland got its credit rating reduced to junk status by Moody's.

In July 2011 European leaders agreed to lower the interest rate of Ireland's bailout from ±6% to 3.5-4.0%. The duration set for the loan was also doubled to 15 years. Ireland managed to bring down the cost of its 10-year government bonds from 12% in July 2011 to 6.3% in July 2012.

Major Parties Involved and Their Views

European Central Bank (ECB)

A key task of the ECB is to define and implement monetary policies for the Eurozone. On the 6th of September 2012, the ECB announced its "unlimited bond-buying plan", meaning that the ECB will make large-scale purchases of short-term government bonds in order to reduce interest rates.

International Monetary Fund (IMF)

The IMF helps finance government bailouts. It is also involved in the design of monetary policy for the Eurozone.

Credit rating agencies

Credit rating agencies assign ratings to Eurozone governments. The agencies take into account a government's ability to pay back loans. Investors to determine risk, and thus affect interest rates using ratings.

Timeline of Events

Date	Description of event
1992	Signing of the Maastricht Treaty
1999	A new currency, the “euro”, officially comes into existence.
2001	Greece joins the euro
2002, 1st of January	Notes and coins are introduced
2008, December	The global financial crisis; a 200bn-euro stimulus plan is agreed on by EU leaders
2009, April	The EU orders Spain, France, Greece and the Irish Republic to reduce their budget deficits
2009, December	Greece admits that it debts have reached 300bn euros (113% of GDP), the highest debt in the country’s modern history and nearly double the Eurozone limit of 60% of GDP
2009	Eurostat indicates that Greece submitted incorrect data with regards to its deficits and debts
2010, February	Greece introduces austerity measures aimed at minimizing the deficit, strikes and riots follow.
2010	Concern is expressed about all the highly indebted European countries: Portugal, Spain, Ireland, Greece
2010	A safety net of 22bn euros to help Greece is established by the Eurozone and IMF
2010, April	Eurozone countries provide up to 30bn euros in emergency loans
2010	After review by the EU it is announced that Greek deficit is even higher than thought: 13.6% of GDP instead of 12,7% of GDP
2010, 2nd of May	A 110bn-euro bailout package to rescue Greece is agreed on by Eurozone members and the IMF
2010, November	Ireland receives a 85bn-euros bailout from the EU and IMF
2011, February	Eurozone finance ministers agree on a 500bn permanent bailout fund; the European Stability Mechanism (ESM)
2011, April	Portugal ask the EU for help with its finances
2011, May	Portugal receives a 78bn-euro bailout
2011, June	Eurozone ministers require Greece to adopt new austerity measures before it can attain the next trance of its loan.
2011, July	The latest 12bn trance of the loan to Greece is approved by the EU after Greek parliament voted in favour of new austerity measures
2011	A comprehensive second bailout of 109bn for Greece--designed to resolve the Greek situation and prevent spread to other European economies-- is agreed on.
2011, 7th of August	The ECB announces that it will buy Spanish and Italian government bonds in an effort to lower borrowing costs for the respective countries.
2011, September	Spain passes a constitutional amendment to strictly limit future deficits
2011, 6th of October	Bank of England injects £75bn into the UK economy
2011, 6th of October	The ECB announces emergency loans measures for banks
2012, 13th of January	Standard & Poor’s, a credit rating agency, downgrades nine Eurozone countries, including France, for their failure to deal with the debt crisis
2012, 16th of January	Standard & Poor’s downgrades the European Financial Stability Facility (EFSF)
2012, January	The “fiscal pact” is signed by all members except the UK and Czech Republic.[1]
2012, 6th of September	ECB announces "unlimited bond-buying plan"

[1] http://www.european-council.europa.eu/media/579087/treaty.pdf

UN involvement, Relevant Resolutions, Treaties and Events

- Euro zone debt crisis: a danger for the global economy (7 June 2012) (/)
- ESM Treaty (25 March 2011)

Evaluation of Previous Attempts to Resolve the Issue

European Stability Mechanism (ESM)

The European Stability Mechanism (ESM) is a suggested intergovernmental organization. All member states of the Eurozone can join. The ESM would be located in Luxembourg and led by a Board of Governors. Each member state can appoint a governor. According to plan the ESM would succeed the temporary emergency funds (EFSF and EFSM) by mid-2013. If established, the ESM would help Eurozone members in financial difficulty. EU Member States would be required to put in the same share they keep in the ECB. The ESM would have an authorized capital of €700bn and would be able to approve bailout deals at a maximum of €500bn. The amount of capital can be increased at any moment by the ESM Board of Governors.

The ESM is heavily criticized for its claimed violations of sovereignty; it would give excessive powers and forms of immunity to its Board of Governors without subjecting them to any form of parliamentary control. The ESM has also raised many constitutional challenges, in at least Austria, Estonia, Germany, and Ireland, the legality of the ESM has also been challenged.

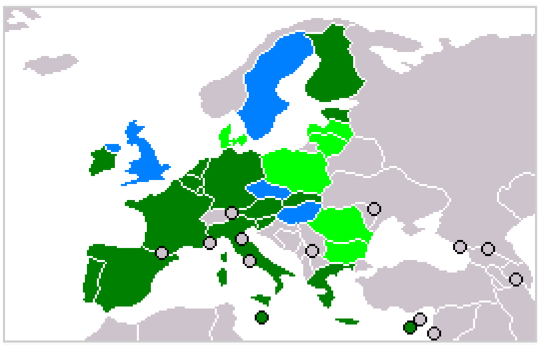
EU emergency measures

The European Financial Stability Facility (EFSF) and the European Financial Stabilization Mechanism (EFSM) are temporary funding programs. Both programs will expire in 2013 and are planned to be succeeded by the ESM.

ECB Bond Buying

The ECB makes large-scale purchases of short-term government bonds in order to reduce interest rates.

Euro Plus Pact



Euro-Plus Pact participants members of the Eurozone
Euro-Plus Pact participants not members of the Eurozone
other EU members

The Euro Plus Pact is a plan drawn up in 2011 in which EU Member States made agreements on series of political reforms meant to improve the fiscal strength and competitiveness of each member state. The plan was drafted by the French and German governments, the same nations that later on advocated the implementation of the plan in all Eurozone states. The Euro Plus Pact was designed as a stricter successor of the Stability and Growth Pact (SGP), which was never enforced consistently. The Euro Plus Pact is controversial; it has often been criticized for infringing sovereignty too much, as well as it being too harsh.

The goals of the euro plus pact are:

Increasing competitiveness
This is to be achieved by reducing labour costs and increasing productivity. Ways of increasing productivity are deregulation, education, as well as improving infrastructure.

Employment
This goal is measured by looking at long term and youth unemployment rates, as well as labour participation rates. According to the Pact the goal is to be achieved by inter alia “lowering taxes on labour" and "taking measures to facilitate the participation of second earners in the work force"

Public finances
This is indicated as being the most important part of the Pact. The pact aims to "increase the sustainability of pensions, health care and social benefits". The Pact attempts to increase the sustainability of pensions by limiting early retirement as well as "schemes and using targeted incentives to employ older workers".
The most strict rule however: "Participating Member States commit to translating EU fiscal rules as set out in the Stability and Growth Pact into national legislation."

Financial stability
"Level of private debt for banks, households and non-financial firms."

Tax policy coordination
This is mostly about developing common tax systems. It also aims to share best practices for tackling fraud and tax evasion.

Possible Solutions

Government burden sharing (Eurobonds): the Eurozone would collectively issue one type of government bond. It would allow indebted states to borrow money at better conditions than they normally would be to.

Sharing favourable interest rates[2]: letting Eurozone states with lower borrowing costs share some of the money they save as compared to Eurozone members with higher borrowing costs. Just as with the Eurobonds, borrowing becomes less expensive for the indebted states, however this idea is easier to implement.

Establishing the ESM: as mentioned under “Evaluation of Previous Attempts to Resolve the Issue”

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[2] http://www.youtube.com/watch?v=RSHrW6pLKGY

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