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Eurocrisis

Before we start heading towards crisis, first let us know what SOVEREIGN DEFAULT is. A sovereign default is the failure or refusal of the government to pay back its debt in full. It may be a formal declaration of a government not to pay or only partially pay its debts. The next question in the queue is ñwhat is EURO and EUROZONE?ò. The **euro** (sign: ú; code: **EUR**) is the official currency of the Eurozone: 17 of the 27 member states of the European Union. It is the currency used by the Institutions of the European Union. The Eurozone consists of Austria, Belgium, Cyprus, Estonia, Finland, France,Germany,Greece,Ireland,Italy, Luxembourg , Malta,the Netherlands, Portugal, Slovakia, Slovenia,and Spain. Euro coins and banknotes entere d circulation on 1 January 2002. As most of the state members were declining financially in late 2009 and deepening their debt levels, members of Eurozone formed European Financial Stability Facility (EFSF) on 9 May 2010, with the objective of preserving financial stability in Europe by providing financial assistance to Eurozone states in economic difficulty.

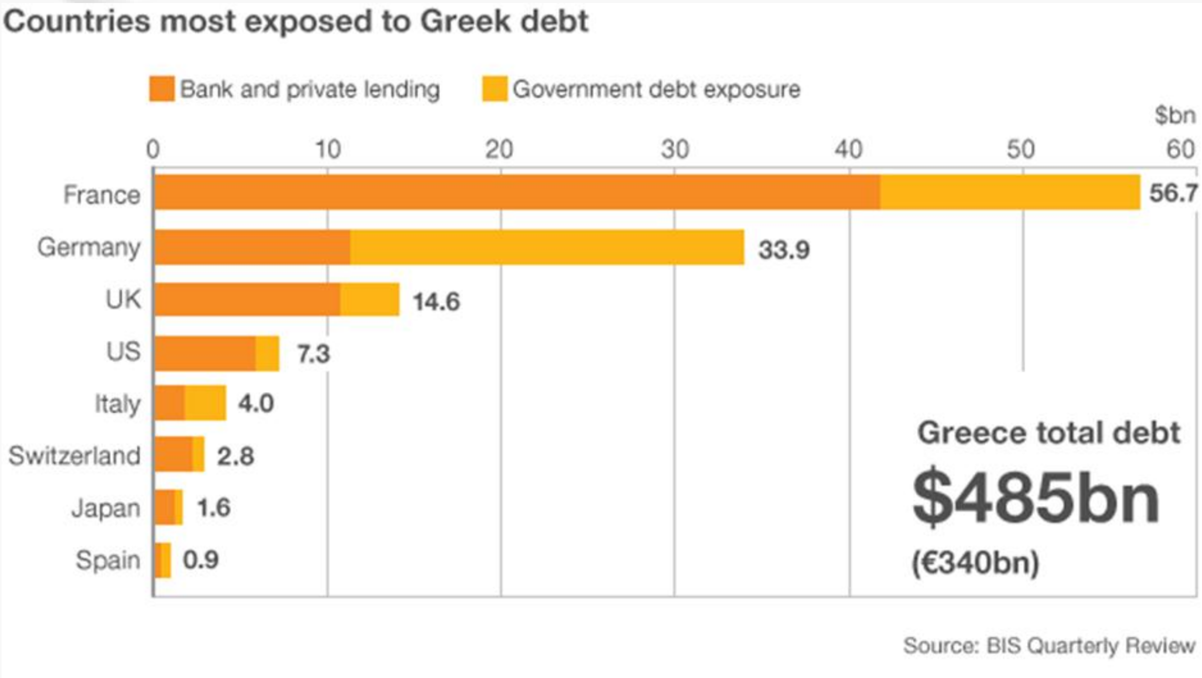
There are many causes for the crisis namely easy credit policies when in 2000-2007, high risk lending and borrowing practices , real estate bubbles , slow economic growth in 2008 , high rise in savings available for investment in 2007 , rising government debt levels as nations like Greece and Ireland used complex currency and credit derivatives to mask their debts , inflexible monetary policies as it was not under the control of individual nations, loss of confidence because of rising sovereign CDS prices.

Now lets have a look at how individual euro countries were responsible for crisis.

Lets take a look at what happened when **Greece** accepted the Euro as their currency. The advent of the European Single Currency in 1999 removed the exchange rate between Greece and the rest of Europe. In simple terms, what this means is that one Euro is worth the same in any country in the Eurozone, whereas before the introduction of the Euro Grecce had a very weak currency and Germany had a very strong currency, which meant that large amounts of Drachma (the former Greek currency) had to be converted to small amounts of Deutschmarks (the former German currency). This meant that it was comparatively expensive for Greek businesses and consumers to import German goods. With the removal of this exchange rate differential, Greek and other Southern European consumers had far more money in their pockets without the relative strength or productivity of their economies changing at all. This, predictably, led to a massive export boom. German exports to Greece alone increased by 130% in ten years.

The second major effect of the introduction of the Euro was to make it much cheaper for the Greek government to borrow. Essentially, because all Euro members would be borrowing money in the same currency but each Eurozone member would be issuing its own sovereign debt, Greece overnight was taken from having a poor credit rating to having a credit rating equal with that of Northern European economies, the market assumption being that, should Southern European economies like Greece ever find themselves in trouble, Northern Europe would in effect be forced into a position of long-term subsidy to prevent a run on the Euro and an undermining of their own economies.

At the time of the Euroôs founding, it was hoped that this access to cheap, public and private credit would allow not only for rising standards across Southern Europe but also that, as a result of rising living standards, governments across Southern Europe would have a shield behind which they could correct long-term stumbling blocks to economic growth, such as inefficient tax systems, bloated public sectors and weak infrastructures, all of which have led, for the past fifty years, to much weaker rates of growth for the Southern half of the European Union as opposed to the Northern half.



However, this optimistic scenario of increased living standards providing the political space for long-term structural reform has not happened. According to research by the London School of Economics, tax evasion in Greece in the period 2004-5 resulted in the government taking 26.1% less in tax than it was actually due to collect, farmers being the group most likely to dodge paying income tax. On average, Greek farmers only reported 47.1% of their taxable income. This persistent shortfall in government revenue has led to a situation effectively where Greece was borrowing increasing amounts of money simply to fill a gap created by the governmentôs inability to collect the tax revenue it was due.

Causes behind the people of Greece unwilling to accept the European bailout:-
In exchange of foreign aid Greece would have to implement draconian austerity measures. The large scale decrease in the government spending would mean still greater unemployment. The economy of Greece would shrink further resulting in probably great socio-political unrests. A lot many Greeks, if not most, see themselves as being the victims of designs of the richer countires and thus resent the consequences of the bail-out package. This is the reason why Papandroeu, the PM of Greece had proposed the referendum on accepting the package. But he had to ultimately back out because of heavy pressure from other EU leaders.

Now, if Greece were to default on her debts, stock markets across the world from America to Japan, the European Union would crash causing wide spread havoc. Other countries like Spain, Italy , Portugal might follow suit. Banks of France, Germany would be in the need of massive bailouts. In short the world would enter another great mess.

Portugal : Risky credit, public debt creation, and European structural and cohesion funds were mismanaged across almost four decades. and later it was incapable to improve the situation when the country was on the verge of bankruptcy by 2011 . On 16 May 2011 the Eurozone leaders officially approved a ú78 billion bailout package for Portugal, which became the third Eurozone country, after Ireland and Greece, to receive emergency funds. The bailout loan will be equally split between the European Financial Stabilization Mechanism, the European Financial Stability Facility, and the International Monetary Fund. As part of the deal, the country agreed to cut its budget deficit from 9.8 percent of GDP in 2010 to 5.9 percent in 2011, 4.5 percent in 2012 and 3 percent in 2013. Because of privatization all public servants had already seen an average wage cut of 20% relative to their 2010 baseline, with cuts reaching 25% for those earning more than 1,500 Euro .On 6 July 2011 the ratings agency Moody's had cut Portugal's credit rating to junk status

Italy : The lack of competitiveness weaker growth and low inflation are main reasons.. Lenders were demanding a much higher interest rate. And Italian 10 years bond yield > 7% interest.

Spain : When Spain joined the euro, interest rates fell to the much lower levels typical in Germany. The country experienced a long boom, underpinned by a housing bubble, as Spanish households took on bigger and bigger mortgages. House prices rose 44% from 2004 to 2008, at the tail end of a housing boom, according to ministry of housing data. Since the bubble burst, they have fallen 17%.During the boom years, Spaniards earned more and spent more. That helped to flatter the government's finances. More economic activity means more tax revenues. But it also helped push Spanish wages up to uncompetitive levels. Overpriced workers. Construction sector - bloated during the building boom - has collapsed. Households are cutting their spending as they struggle to repay their debts. Jump in unemployment and collapse in tax revenues Banks exposed to the housing collapse thanks to all the mortgages they have lent.

France and **Germany** wants a balanced budget; automatic sanctions if deficits >3% GDP; harmonization of euro zone corporation taxes a tax on financial transactions. France is averse to Brusselô s power over national budget. Germany is against ECB Intervention to buy bonds.

Portugal, Italy, Ireland Spain and Greece wants The EU/IMF bailouts. Greece**,** Ireland and Portugal were all conditional on stringent austerity measures. Italy and Spain are both urged to slash their deficits with recent austerity budgets All five are against surrendering budget decisions to Brussels and adamant about staying in the euro.

Poland, Sweden, Latvia, Lithuania Czech Republic, Hungary Romania and Bulgaria wants to avoid a twotier EU. Want a say in euro zone Decisions. They are opposed to the threat to its 10% corporate tax and wary of centralized budget control.

UK says the more it is asked for, the more it will ask in return - and any treaty agreed by the UK would have to go through parliament. Denmark wants speedy resolution to crisis with minimum treaty change and UK wants to avoid major treaty change Denmark wants to avoid change that would trigger referendum.

Austria, Netherlands, Finland, Luxembourg All four are alarmed by warnings of possible credit-rating downgrade that would affect cost of borrowing. They also Argue for a Brussels commissioner to have power to expel member states from the euro zone. And they are reluctant to have treaty change.

Belgium, Estonia, Cyprus, Malta, Slovakia, Slovenia want low borrowing costs. And also want to be among the decision-makers. And they are against major treaty change.

How will the Euro Crisis end?

Phoenix from the Ashes : Least Bad Outcome is all Eurozone governments agree and stick to the strict new borrowing rules. Italy and Spain get bailouts financed by the European Central Bank. Most importantly, confidence returns. Europe suffers only a light recession, but then recovers, and slowly but painfully grows its way out of its debt problem.

Union : The European Union turns into a political federation As the financial malaise keeps doggedly returning, so the Eurozone governments call more and more summits and come up with more and more proposals for closer union. Eventually they agree a complete political union - a democratically-elected government in Brussels that can borrow with the backing of all 17 member countries, and can spend money wherever needed - rescuing banks, paying unemployment benefits, financing investment in the more recession-mired countries. The UK and other EU countries not signed up to joining the euro are asked to exit the EU altogether and join a looser free trade area with much less political influence.

Inflation : The ECB prints money, prices rise, debts and savings wither away The euro plummets, The European Central Bank prints money to pay for one government or bank bailout after another. The ECB tolerates higher inflation - They also want to see wages rise rapidly in Germany, so that workers in struggling southern European countries can regain a competitive edge. But governments continue to spend freely, expecting the ECB to keep lending them newly-printed euros. When a big government breaks the borrowing rules, the rules are simply abandoned. And so the inflation gets out of control.

Depression : The Eurozone stays together, but the price is years of economic hell Governments cut spending will lead to a deep recession. Consumers and businesses lose confidence and cut back their own spending.The European Central Bank cuts rates to zero, but still finds it almost impossible to stimulate the economy.The recession makes it very hard for governments to actually cut their borrowing, because they are spending more on unemployment benefits and earning less in income tax. Companies and mortgage borrowers find it harder to pay their debts, putting the banks in trouble, who cut back their lending even more, undermining the economy further. Eventually borrowers, including governments, have to write off their debts, and many banks and businesses go bust.

Unraveling : The weaker countries drop out one-by-one Fearing exit from the euro, ordinary Greeks empty their bank accounts in droves. The European Central Bank insists that Athens freezes people's accounts, or else it will pull the plug on the Greek banks. The Greek government falls, and its replacement decides enough is enough, announces a stop to all debt payments and a unilateral exit from the euro. The newly reintroduced drachma plunges in value. With widespread anger at spending cuts and recession, there are growing calls in other, bigger, southern European countries, At best a rump euro zone of Germany and France - and possibly Finland, the Netherlands and Austria - is all that remains.

Meltdown : 2008 again, but without the last-minute bailouts Financial markets lose confidence that the Eurozone's problems are solvable. The Eurozone's plan - stricter controls on government borrowing - is not credible. Anyway, government borrowing wasn't the real reason the euro got into trouble. It was all the private-sector borrowing that did the real damage. Workable solutions to the economic problems are not politically acceptable. And politically acceptable solutions make no economic sense. Investors stop lending to all Eurozone banks and governments alike - except perhaps Germany. Banks collapse. Governments run out of money. Stock markets and the euro plummet. And the politicians run out of ideas and time.

Divorce : The Eurozone decides break-up is the only option. Any solution that might save the euro proves impossible to agree. Irish voters would block any treaty change put to them in a referendum. Along with the southern Europeans, they want to escape the seemingly endless cycle of spending cuts, tax rises, wage freezes and recession. They are angry at the seeming lack of solidarity from the northern Europeans. Meanwhile, voters in Germany, the Netherlands, Finland and elsewhere are incensed by the spectacle of their tax money being used to rescue southern Europeans from the consequences of what they see as laziness and overspending. Governments eventually agree this cannot continue, and negotiate a controlled break-up of the Eurozone - perhaps a split into northern and southern European currencies.