The Eurozone and the Greek Debt Crisis

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European Union Countries

EU Member Countries

1950: Belgium, France, Germany, Italy, Luxembourg, the Netherlands

1973: Denmark, Ireland, the United Kingdom

1981: Greece

1986: Spain and Portugal

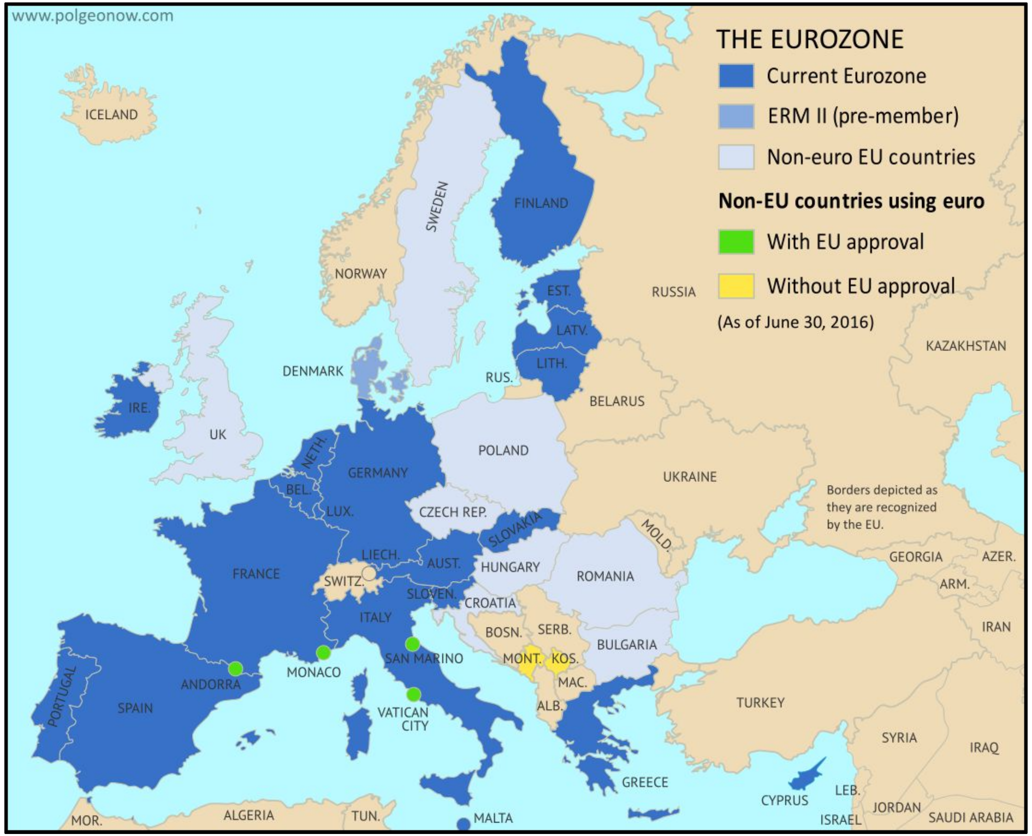
1995: Austria, Finland, Sweden

2004: ‘**Big Bang**’ Cyprus, Czechia, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia

2007: Bulgaria, Romania

2013: Croatia

Eurozone Countries (Monetary Union)



Purpose of the European Union

“The predecessor of the EU was created in the aftermath of the Second World War. The first steps were to foster economic cooperation: ***the idea being that countries that trade with one another become economically interdependent and so more likely to avoid conflict.****”* - EU Website

Establishment of the EU and Eurozone

<u>Timeline:</u>

★ **1950:** *European Coal and Steel Community* - Belgium, France, Germany, Italy, Luxembourg, and the Netherlands

★ **1957:** Treaty of Rome - goal of further economic integration among ECSC members
  - *European Economic Community* - known as the ‘Common Market’, one of two treaties forming the constitutional basis of the EU. Proposed a single market for goods, labor and services and a Customs Union.
  - *European Atomic Energy Community (Euratom)*

★ **1967:** *European Communities* **-** ECSC, EEC and Euratom merge under umbrella organization

★ **1988:** European Council confirmed the objective of an eventual Economic and Monetary Union

★ **1990:** All restrictions on the movement of capital between Member States were abolished → economic convergence

★ **1991:** Intergovernmental Conference on Economic and Monetary Union and Intergovernmental Conference on Political Union were held simultaneously

★ **1993:** Maastricht Treaty- ratified agreements made in 1991 conferences, establishes the ‘*European Union*’, amends treaties of the European Communities
  - Laid more concrete plans for economic convergence and the introduction of the Monetary Union i.e. the Euro
  - Single Market completed including four freedoms: **movement of goods, services, people and money**

Establishment of the EU and Eurozone

Timeline

- **1994:** Establishment of European Monetary Institute to strengthen central bank cooperation and prepare for the introduction of the European System of Central Banks (ESCB)
- **1995:** *Schengen Area* opened, abolished internal border controls, allowed free movement of travelers and workers
- **1997:** *Stability Growth Pact*- a set of rules designed to ensure that EU countries pursue sound public finances and coordinated fiscal policies, i.e. try to prevent excessive budget deficit or excessive public debts. *Enforceable?*
- **1998:** The European Central Bank is established in Frankfurt ahead of the introduction of the Euro
- **1999:** Fixed exchange rates of the 11 member states deemed ready to enter the EMU, Euro introduced as a virtual currency for cashless payments and accounting purposes
- **1999** Treaty of Amsterdam, amends the Maastricht Treaty, including increased power of the European Parliament
- **2001:** Greece becomes eligible to enter the EMU
- **2002:** Euro banknotes and coins become the sole currency of EU members
- EU members that have joined the Eurozone since are Slovenia, Cyprus, Malta, Slovakia, Estonia, Malta and Lithuania

Intro: The Euro

"The Economic and Monetary Union involves the coordination of economic and fiscal policies, a common monetary policy and the Euro as the common currency" - EU Website

Three Stages of preparation and convergence:

1. **Stage 1, 1990:** Complete freedom for capital transactions, increased cooperation between central banks, improvement of economic convergence
2. **Stage 2, 1994:** Establishment of the European Monetary Institute, increased cooperation of monetary policies, strengthening of economic convergence, preparatory work for the establishment of European System of Central Banks
3. **Stage 3, 1999:** Irrevocable fixing of conversion rates, introduction of the euro, opening of the European System of Central Banks, Stability Growth Pact goes into effect

Currently, 19 of 28 EU members are part of the Eurozone, all EU countries not on the Euro now are required to join the Eurozone in the foreseeable future *excluding the UK and Denmark*

Requirements for Adoption

Before a country is allowed to join the Eurozone:

- ➔ Its annual budget deficit must not exceed 3% of its gross domestic product
- ➔ Its public debt must be under 60% of its gross domestic product
- ➔ It must have stable exchange rates
- ➔ Its inflation rates must be within 1.5% of the three EU countries with the lowest inflation rates
- ➔ Its long-term interest rates must be within 2% of the three lowest interest rates in the EU

These are known as the '<u>convergence criteria</u>' (or 'Maastricht criteria'). They were agreed to by the EU Member States in 1991 as part of the preparations for the introduction of the Euro.

There is no official timetable for when EU countries must adopt the Euro, and some countries are far from meeting this criteria, we will return to the issue of compliance later

Delayed adoption of the Euro in 1996 when only 3 of the 15 states were completely compliant

The first two countries to break the criteria were Germany and France (originally the sticklers), which has made these criteria difficult to enforce

Why might a country want to adopt the Euro?

Why might a country want to adopt the Euro?

- Facilitates cross-border trade by eliminating fluctuating exchange rates and exchange costs
- Encourages travel and travel spending, both from tourists in the Eurozone and outside
- Consumers generally have more choice
- Provides EU and thus the adoptive country higher prestige, as the EU is the world's second most important currency
- Supranational ethos
- Reduced risk of damage from currency speculation and currency crises in less developed countries
- Prevents highly irresponsible printing of currency by politicians
- Desire to be in the EU for other political and economic gain / aid
- **Peace**

Why might a country **not** want to adopt the Euro?

Why might a country **not** want to adopt the Euro?

- Complete loss of control over monetary policy
  - Central bank no longer prints currency
  - *Can't to use currency manipulation in case of crisis* - just like US states
- 'Have' to abide by the fiscal restrictions of the Maastricht criteria, no room for discretion
- National pride, distrust of the EU, rejection of globalization and supranational ethos
- Expensive for businesses, the government, and individuals alike to implement
- Contagion effect i.e. correlated risk if the banking sector becomes corrupted, especially as member countries still have control of their own fiscal policies, national debts, etc. **potential bank run situation**
- Concern that business cycles will not converge, causing economic friction
- Fear of the unknown
- <u>Bonus question:</u> Why would Germany *want* to be on the Euro?

European Central Bank (ECB)

The European Central Bank is the central bank of all of the countries that have adopted the Euro

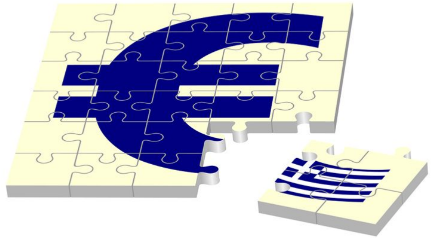
The ECB is responsible for maintaining price stability of the Euro:

- Defines and implements monetary policy
- Conducts foreign exchange operations
- Holds and manages the Eurozone's foreign currency reserves
- Promotes smooth operation of payment systems

Run by the Governing Council which consists of six executive board members and the heads of the central banks of each Eurozone member

Under the original ECB charter, the ECB was not supposed to bail out any individual member country, but it did under Draghi's 'whatever it takes' motto. Thich is what we will touch upon next.

The Greek Debt Crisis: An Overview



- Greek Debt Crisis Began in 2009
  - Government Unable to Repay Debts without Assistance
- Financial Institutions Rallied to Save Greece
  - Involved a Series of Bailouts for the Country
- Ripple Effects Throughout Europe
- Implementation of Austerity Measures
  - Massive Public Backlash
  - Continued to Shrink Economy
- Bailouts Concluded, Greek Debt Problem Has Not

Systemic Problems in Greece

- Decrease in Government Revenue
  - Pervasive Tax Evasion
- Increase in Government Outlays
  - Generous Retirement Packages
  - Excessive Employee Benefits
- Decrease in Competitiveness within International Markets
  - Increase in Prices and Minimum Wage
- High Rates of Foreign Debt
  - Loaned 4.1% of GDP during 1990s and 10.2% during 2000s
  - Used for Consumption Instead of Structural Reforms
- Current Account Balance
  - Declined to -15% of GDP in 2008

Effects of the Financial Crisis

- Unemployment Increases Dramatically
  - Increase in Government Outlays
- Government Revenue Declines as Economy Slumps
  - Budget Deficit is Exacerbated by Decrease in Revenue and Increase in Outlays
- Need to Undertake More Debt as Deficit Rises
- Borrowing Costs Rise, Financing Unavailable
  - Unable to Service Their Debts

Revelations About Debt

- New Government Elected in 2009
  - Revealed that Previous Government Lied About Deficit
  - Revised Projection from 6.7% to 12.6% Then Later Over 15%
- Asked for Six-Month Loan Postponement
  - Owed Money to Dubai World (essentially the Gulf Emirate)
- Debt-Holders Immediately Sell-Off Debt
  - Trying to Reduce Exposure to Greek Debt
  - Demand Higher Yields to Take Risk
- Investor Demands Worsens Greek Debt Problem
  - Becomes Cycle of Requesting Higher Yields, Leading to Worse Debt Situation and so on
- Shut Out from Borrowing in Financial Markets
- Sovereign Debt Downgraded to “Junk Status”

Effects Throughout Europe

- General Loss of Investor Confidence For Greek Debt
- Contagion Effect Seen in Similar Markets Within Europe
    - Bond Yields Skyrocketed in Other Heavily Indebted Countries
    - Includes Spain, Italy, Ireland, and Cyprus
- Higher Bond Yields Increase Difficulty of Financing Budget Deficit
- Yields for Germany and United States’ Debt Fall
    - Seen as a Safe Haven for Investors Who are Worried About Debt Crisis

European Institutions Come Together

- Creation of the “Troika”
    - Comprised of the IMF, ECB, and European Commision
    - Funded Bailouts for Countries Across the Continents
- The European Central Bank Buys Government Bonds to Support Fractured Markets
    - Intended to Provide Liquidity to Dysfunctional Markets
- ECB President Announces that It Will Do “Whatever It Takes” to Keep the Eurozone Together
- ECB Engages in Quantitative Easing Program
    - Spur Inflation and Growth

Why Should Greece Be Saved?

- Prevent Contagions in Similar Countries
    - Contagion Effect: Sell Off Debt for Countries in Similar Situation
    - Could Put Italy, Spain, Ireland, and Cyprus at Risk
- Prevent Contagion to Financial Institutions
    - Banks Who Held the Debt Would Lose Significant Assets
    - If a Country Defaults, Bond Values Plunge, Decreasing Assets Which Could Cause Insolvency
    - Most Importantly, Save French and German Banks which Held Significant Greek Assets
- Maintain the Eurozone
    - Greece Leaving Would Hurt the Trust in the Eurozone
    - Could Put the Entire Region at Risk

First Round of Bailouts

- First Bailout Provided by EU and IMF
  - Agree to 110bn Euro Bailout Package
  - Germany Provides Almost 22bn Euros of EU's 80bn
- Aid Package Includes 45bn Euros in Year 1 with More Aid Over Next Two Years
- In Exchange, PM Papandreou Agrees to Austerity Measures
- Analysts Warn that Fundamental Problems Have Not Been Solved

"The immediate impact may be soothing, but the inflammation will soon show up again. My feeling is the rot has now gone too far." - Edward Hugh

Austerity Measures

“We will be in recession for the next few years, which means that we have to run faster to reduce the deficit,” - PM Papandreou

- To Secure Bailout Money, Austerity Measures Needed to be Passed
- Increased Taxes
  - Value-Added Tax Increase from 21 to 23%
  - Increase Taxes on Fuel, Tobacco, and Alcohol
- Pay Freezes and Cut Bonuses
  - All Civil Servants’ Wages Were Frozen
  - Civil Servants Annual Bonuses (2 Months Pay) and Parliament’s Bonuses Cut
- Austerity Measures Take Their Toll on Economy
  - Sharp Increase in Number of Unemployed
  - Increase Outlays and Decrease Revenue for Government

Political Backlash

- Protest Marches Within the Capital
  - Athens Brings Out Riot Police to Contain Violence
- Strikes Across the Nation
  - 2-day Strike by Public Sector Workers Union
  - Bus, Metro, and Rail Workers Hold 24-hour Strike
- Farmers Barricaded Roads, Demanding Greater Subsidies During Economic Strife

Second Round of Bailouts

- Greater Concern Across the World that “Grexit” Will Occur
- Agree to 109bn Euro Package
  - $30bn to Incentivize Bond Swaps
  - $23bn to Recapitalize Greek Banks
  - $35bn to Finance Buying Bonds Back
- Private Creditors Accept a Writedown of 53.5%
  - Around 100 billion euros of debt will be written off as banks and insurers swap bonds for longer-dated securities with a lower coupon
- New Expectations for Greece
  - Greek Debt Needs to Hit 120.5% of GDP by 2020

Political Problems Continue

- PM Papandreou Proposes to Hold a Referendum on the Second Bailout
  - Shocked European Leaders and Put Success of Greek Debt Crisis in question
  - Eventually Backs Down and Nixes the Referendum
- In May 2012, Popularity of Fringe Parties Grows
  - Majority of Greeks Vote for Parties Opposed to Troika Bailout
  - Center-Right Narrowly Earns a Plurality
- Protests Resurface Within the Capital
  - Union-Backed Strikes Manifest
  - Some Protestors Throwing Rocks and Molotovs at Police

Revised Terms for Bailouts

- Revised the Target Debt-to-GDP Ratio to 124% by 2020
    - In Exchange, Committed to Reducing Debt Below 110% by 2022
- Included Four Other Key Elements
    - Interest Rate Cut on Debt From First Bailout
        - Reduced from 1.5 points over Euribor to 0.9 then 0.5
    - Received 10-year Interest Rate Deferral on Debt from Second Bailout
    - Offer Voluntary Debt Buyback of Greek Debt
        - Given 35 Cents for Each Euro of Bonds They Hold
    - Promise to Hand Back 11bn in Profits from Buying Greek Bonds
- After Everything, Debt is Still Rising
    - Approaching 190% of GDP

Austerity and Bond Market Return

- July 2013 Greece Approves New Set of Austerity Measures
  - Needed to Secure the Next Tranche of Funding
  - Includes Thousands of Layoffs and Wage Cuts
- Thousands of Greeks Protest Outside of Parliament
- General Strike Takes Place Across the Country
  - Questions Linger About Ability to Enforce Cuts Amid Greece's Tenuous Coalition
- April 2014 Greece Returns to International Bond Market
  - Raise $3bn in its First Bond Sale
  - Strong Demand Pushed the Yield on 5-year bonds below 5% (Better Than Expected)

On the Brink of “Grexit”

- January 2015 Syriza wins in the Elections
    - PM Alexis Tsipras Wants Renegotiation of Bailout Terms, Debt Cancellation
    - Raises International Tensions and Likelihood of “Grexit”
- Rejected the Conditions Set Out by IMF and Europe for Remaining Bailout Money
    - Decided by a Decisive 60% “No” to 40% “Yes”
    - Own Its Own and Running Out of Money
- June 2015 Greek Bailout Expires and Default on Payment to IMF
    - Cut Off From Access to IMF Resources
- Greek Banks in Financial Straits
    - €60 Daily Cash Withdraw
    - Greek Banks Prevent Bank Runs With Extended Three-week Bank Holiday

The Third Bailout

- August 2015 Eurozone Finance Ministers Approve an €86bn Bailout
    - €26bn dispersed in the first tranche
    - Most Used to Pay Back IMF and European Institutions, Rest to Recapitalize Greek Banks
- February 2017 Revise the Budget Targets for Greece
- Serious Reforms Needed Within Greece to Meet Targets
    - Reducing Allowances and Perks for State Staff
    - End Fuel Tax Benefits for Farmers
    - Overhaul Social Welfare
    - Deregulate Natural Gas Market
    - Sell Off Government-Owned Facilities (e.g. Regional Airports)

Aftermath

- August 2018 Greek Received the Last of Its Bailout Funds
    - Received Their Final €15bn in Loans
    - Now Financially Independent After 8 Years
- The Economy is Still Battered From the Debt Crisis
    - One-Fifth of Greeks are Still Unemployed
    - Household Incomes have Lost One-Third of Their Value
    - Pension Cuts and Tax Increases Still Loom
    - Economy Lost 25% of Value, Only Growing at 1.4% Year
- Debt for Generations to Come
    - Now Owe the EU and IMF €290bn
    - Public Debt is Around 180% of GDP
    - Must Run a Budget Surplus for 40 Years to Finance This Debt

Why is Greek Debt Situation Different?

In Short, Being a Part of the Eurozone.

- Unlike Other Countries, Cannot Print Money to Pay Off Debts
  - This Responsibility was Conceded When They Joined the Eurozone
  - Makes Investors Worried Since Cannot Simply Create Money Like Other Countries
- When in a Recession, Their Currency Maintains Its Value
  - Maintaining Value Hurts Their Ability to Attract Travelers/Encourage Spending By Lowering the Value of Their Currency Relative to Others

Is Greece/EU Still at Risk?

Absolutely

If we experience another worldwide recession, and the Greek Economy slumps again, the budget surplus could become a budget deficit, requiring Greece to take on more loans while being unable to service the ones they currently have.

Additionally, when the 10-year loan deferrals run their course, Greece may not be able to service these debts without borrowing, and they could find themselves in a similar position as before.

Conclusion

"This crisis has exposed a fundamental structural problem- divergent productivity growth across the eurozone economies and the lack of an effective enforcement mechanism for fiscal discipline, obviously complicated by the absence of an intra-zone monetary policy adjustment mechanism"-Eswar Prasad, Brookings Institute

The motivations for the European Union and the Eurozone, while seemingly economic, were mostly political. The point was to cultivate mutual dependence and thereby **prevent war**.

Through the cultivation of mutual dependence, the Eurozone put the entire continent at risk of putting the entire continent at risk of financial collapse during the Greek Debt Crisis due to the interconnectedness of its institutions.

Thus, while the EU system has many benefits, it also has significant drawbacks that contribute to financial fragility both in Europe and elsewhere.

Questions?

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