The Eurozone Crisis: An Update

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Introduction

Resolution of the eurozone crisis is widely seen as needing resolution of several different but linked issues, reflecting the complex, multifaceted nature of the crisis. These can be listed as follows:

- Greek debt and threat of default;
- remove risk of contagion by (1) recapitalisation of and greater stability for banks exposed by any Greek settlement or default and by the possibility of default from other countries;
- by (2) deficit reduction, economic reform and increased competitiveness in vulnerable eurozone members;
- establishment of eurozone rescue funds large enough to support eurozone countries coming under speculative attack;
- agreement on measures to ensure fiscal discipline in the eurozone;
- restoration of growth in eurozone economies without which other measures are mere palliatives.

This paper covers developments since 2011 excluding the fiscal compact treaty, which is covered in a separate paper. It starts with a short background and then moves on to discuss each of the above points.

Background

The global financial crisis of 2008 onwards triggered a crisis of confidence in the eurozone banking system. A House of Lords Select Committee report in early 2012 crisply summed up the consequences for the eurozone:

> An asymmetry between a centralised monetary policy and decentralised fiscal and supply-side policies, combined with a build-up of competitiveness imbalances among Member States, had left the future stability of the euro area in doubt.[1]

As the Select Committee went on to say, these problems were exacerbated by the failure of the markets (and eurozone countries) to understand fully the implications of the way the eurozone had been established. This meant that banks treated the eurozone as a single entity and failed to take account of the economic health of individual eurozone countries. This enabled, for

[1] House of Lords European Union Committee, *25th Report of Session 2010-2012: The euro area crisis*, HL 260, 14 February 2012, p. 7

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example, the Greek government to sell large amounts of debt at very keen interest rates despite the absence of demonstrable capacity to pay off the debt in the medium-term.

The fear by the autumn of 2011 was that eurozone governments were incapable of coming up with the necessary measures to reassure the markets. Some countries were finding it difficult to sell debt at affordable rates, (contributing to the political a crisis in Italy, where the Berlusconi Government was replaced by an all-party supported administration in November led by the former European Commissioner Mario Monti). Fears of contagion – that Greece would default on its sovereign debt, triggering similar crises in other vulnerable eurozone countries leading to a widespread banking collapse and recession – reached crisis levels.

By October 2011 the eurozone countries had held many meetings but had failed to resolve three key issues: how the Greek debt was to be managed, given that the first bailout to Greece had proved insufficient; how eurozone banks were to be recapitalised; and how European rescue funds could be adequately resourced to reassure the markets that the eurozone had the capital to provide any further bailouts. Agreement was reached on these three points at the October 2011 summit but it was criticised for being short on detail and afterwards for its slow implementation.

Greek Debt

A loan package had been agreed between the EU and Greece in May 2010 which provided finance to enable Greece to meet its debt obligations in return for significant public spending cuts and other measures by Greece. Part of this money was released to Greece after the Greek Parliament had agreed to further austerity measures in July 2011 but on-going difficulties in getting Greek compliance with the 2010 agreement and the lack of political and public support within Greece for austerity measures raised concerns about the likely effectiveness of further support.

At the October 2011 eurozone summit a new package for Greece was agreed in principle, backed by the troika of the European Commission, the ECB and the IMF. In return, the private sector banks agreed to consider reducing Greece's debt obligations by 50 per cent (a so-called "haircut"). The Greek Government surprised the rest of the EU by announcing plans to hold a referendum on this package; this triggered a demand from the French and German Governments that Greece decide whether it wished to stay in the euro or not. Mr Papandreou withdrew his referendum proposal and his administration was replaced by a government of national unity led by a former Governor of the Bank of Greece, Mr Lucas Papademos.

Finally, in February 2012, after long and difficult negotiations, agreement was reached on a second financial package for Greece of up to €130 billion in support. Private sector holders of Greek bonds will take a cut of around 70 per cent and receive new bonds in exchange, the interest on Greece's debt will be reduced and an enhanced monitoring programme will ensure Greek Government compliance with the agreement beyond the expected parliamentary elections in the spring of 2012.

The package needed to be approved by eurozone governments, and in some cases their parliaments. The most difficult such ratification was thought to be in Germany but in the event

the necessary motion was approved by a large majority in the Bundestag despite the German Chancellor saying that there was no 100 per cent guarantee that the package would save Greece.

Bank Recapitalisation

While there was wide agreement that eurozone banks needed to be recapitalised in order to strengthen their balance sheets there was disagreement, notably between France and Germany, as to how this was to be done. At the October 2011 summit it was agreed that European banks should be better protected from the risk of contagion by being required to raise €106 billion in new capital by June 2012 (to ensure a ratio of 9 per cent of high quality capital to their loans). If this could not be done entirely by the banks themselves, then central banks were to provide support and if necessary there would be loans to eurozone banks from the European Financial Stability Facility.

Commentators queried whether this approach would provide the resources required and suggested that it was likely to lead to a loss of liquidity in the banking system which would impact adversely on the real economy as banks restricted their lending. In the event, the ECB, under its new president, intervened with two tranches, in December 2011 and February 2012, of lending to European banks worth over €1 trillion. The purpose of these loans was to ensure that liquidity is maintained in the European banking system. This action received a very positive reaction from the markets but ECB President has made it clear that there are no plans for further tranches.

Eurozone Rescue Funds

During the early stages of the eurozone crisis two financial support mechanisms were established: the EFSF and the European Financial Stability Mechanism. In December 2010 the European Council had agreed that these were stop-gap measures and a permanent fund was needed. The necessary amendment to the EU treaties was agreed at the March 2011 European Council.

Article 136 of the TFEU had the following paragraph added to it:

> The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality.

The eurozone countries then negotiated an agreement amongst themselves which was signed as a treaty outside the EU treaties in February 2012. The text of the European Stability Mechanism Treaty links it explicitly to the Fiscal Compact Treaty; no eurozone country will be able to receive support from the European Stability Mechanism unless it has ratified the Fiscal Compact Treaty and written the requirement for a balanced budget rule in that treaty into its national law. This new arrangement is due to come into force in July 2012.

The amount of funds available to the European Stability Mechanism is set in the Treaty at €500 billion but with a commitment that that will be reviewed before the Treaty comes into force.

Establishing the ESM was an important step but the urgent issue in the autumn of 2011 was the fear that the €250 billion left in the EFSF was inadequate given on-going market concern about the sovereign debt levels of several eurozone countries. This perception was not assisted by unsuccessful attempts to persuade China to back the EFSF and by the admission of the Eurogroup president that plans to enable the funds in the EFSF to be leveraged in order to increase their value four-fold were unlikely to be successful.

At the December 2011 meeting of eurozone heads of state or government they agreed to bring forward implementation of the ESM and to keep the EFSF in being until mid-2013. They also agreed to make pledges to provide additional funds to the IMF and encouraged other EU Member States to do so. The IMF later launched, on 19 January 2012, a call for a further $500 billion of support from its member countries in order for it to be able to support eurozone countries. The UK Government has indicated its willingness to support the IMF call for funds provided that other EU Member States do the same.

Outstanding Questions

After two years of effort to prevent defaults by Greece and other heavily indebted eurozone countries, questions remain about the effectiveness of the measures taken and about the ability of eurozone to recover from this crisis. In this section we set out some of the remaining questions.

Contagion

For a few weeks in the autumn of 2011 there was a serious prospect that the eurozone crisis might spin out of control. The action taken then, combined with the changes of government in Greece and in Italy, reduced market anxiety and prevented meltdown.

The particularly vulnerable eurozone countries, Ireland, Portugal, Spain and Italy, are all at various stages of austerity measures but it would take time for them to reduce their debt burden to sustainable levels. In the meantime, is the ESM big enough to hold back the markets? Further action to strengthen the balance sheet of the ESM is likely to be needed because the markets are still vulnerable to sudden shocks and because of uncertainties about the pace (and in the case of Greece, the likelihood) of economic recovery in the medium-term. Some countries have significant corruption and tax avoidance problems; these will need to be tackled effectively as well.

Competitiveness

The measures taken so far do not tackle one of the big dilemmas for the eurozone – the difference in competitiveness between the northern and southern members. This is a critical question because countries not in a currency union have the ability to devalue their currency in order to become more competitive (as has happened with sterling against the euro).

Countries like Greece, Portugal and Spain, whose unit labour costs, for example, are significantly higher than those in other eurozone countries such as Germany would have to take drastic measures to force down wages and prices in order to become truly competitive. Such a strategy would be difficult to implement in practice and would need to show swift results in order to maintain public confidence. At the present time, there is little evidence that the imbalance in competitiveness is likely to be corrected nor is it clear how this can be done.

Recapitalisation & Banking Stability

Bank recapitalisation remains highly uncertain, with commentators concerned that even the radical action taken by the ECB in December 2011 and February 2012 will be insufficient to maintain liquidity in the system. Critics of the ECB's loans to banks ask what will happen when they become due for repayment in three years' time. But the ECB's action has averted a sudden loss of liquidity in the system like that which occurred in the autumn of 2008 and which had disastrous consequences for businesses in many countries.

Political Stability

Can European citizens cope with much more austerity? There has been aggressive hostility towards austerity measures in Greece, which may well become more acute; and the fear remains that this concern may spread more widely in the eurozone. The very high levels of unemployment in parts of the eurozone – especially among young people – are deeply troubling and no immediate cure is in sight.

The eurozone countries were criticised throughout 2011 for being too slow and too cautious in their response to the crisis. By the end, they had seized back the initiative and the successful signing of the Fiscal Compact and ESM treaties, together with the finally realised Greek debt package, showed that they could deliver on their collective commitments even if the process was slow and, at times, messy. But these successes were hard won and could quickly be undermined if, for example, there were problems over the ratification of the two treaties. A further complication will arise if Francois Hollande wins the French Presidential election as he said he will not support ratification of the treaty unless it is altered to include measures to stimulate growth.

Economic Growth

No amount of technical fixes can get round the urgent need for economic growth in Europe, without which the competitiveness and deficit problems cannot improve. While some commentators are optimistic that growth will return to the eurozone in the second half of 2012, measures needed to revive European economic growth are needed outside as well as inside the eurozone. Without economic growth political and social unrest may return and support for austerity measures will fall. Prolonged recession would threaten free trade and the single market as national governments would come under further pressure to defend jobs and businesses in their own countries by breaking EU rules.

Future Developments

Further measures are likely to be necessary but the most immediate challenge will be for eurozone countries to live up to the commitments they have already made, notably in respect of balanced budgets and levels of national debt.

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The Senior European Experts Group is an independent body consisting of former high-ranking British diplomats and civil servants, including several former UK ambassadors to the EU, and former officials of the institutions of the EU.

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