

3. Their annual budget deficit should be below 3% of their gross domestic product (GDP - the total output of their economy).

4. The total amount of money owed by the state, known as public debt, has to be less than 60% of GDP. (At the end of 2010, only 2 countries using Euro met this criterion!)

- All new EU member states have to join the Euro once they fulfill the necessary monetary and budgetary conditions, except Denmark and the UK which have negotiated an 'opt-out' clause.

Euro Crisis: What went wrong?

VatsalaShreeti

2012 is said to be the make or break year for the wounded Euro zone. Economists and politicians worldwide seem to be in a fix. Finding a permanent solution to a problem this complicated is nothing short of a gruesome and tedious task. Before we even get close to finding a solution, we need to answer some pressing questions. What has led to this global mess? Is the notion of a single monetary authority operating with numerous fiscal authorities feasible? Are the efforts by the ECB to get things back on track having a positive effect? And finally, is the disintegration of the European Union imminent?

Adoption of Euro and the beginning of the Crisis

The euro was adopted on 16 December 1995 and was introduced to world financial markets as an accounting currency on 1 January 1999, replacing the former European Currency Unit. Doubts regarding the feasibility of a common currency for the entire euro zone were raised even back then but its adoption got a green signal based on the argument that a common currency would enable firms to invest freely across the borders in Europe without worrying about exchange rate fluctuations and related risks and costs thus facilitating growth consistent throughout the continent.

Although the currency fared well initially with trade and investment in the continent rising by an estimated 5-10% and 5% respectively, things began to take a different course when Greece faltered in 2009. The sovereign debt for Greece reached 120% of the country's GDP, bond yields began to rise and the Greek government bonds were downgraded to junk status. Portugal, Ireland and Spain soon followed suit and the situation turned into a full-fledged Sovereign Debt Crisis.

Probable Cause

The basic reason why things turned ugly is the irresponsibility on the part of European governments. Massive over spending over the last decade by these countries raised public debt beyond sustainable levels. To expect from the popular Keynesian mechanism that this spending would lead to higher growth is incorrect. Empirical evidence suggests that beyond a certain limit, debt stunts growth. (The negative or counter multiplier effect as

increased debt leads to loss of private investment due investors fearing default by the government). This limit has been set at around 85% of the GDP for government debt. Many of the European countries are way past this ratio of debt versus GDP. These countries cannot finance their deficit as they have no control over their monetary policy and rely on a reluctant European Central Bank for this purpose. Other causes include easy credit conditions in the last decade, high risk lending practices which led to formation of asset bubbles.

The severity of the situation compels us to dig deeper and to try to identify the root of the problem. Recent events call for a review of the basic foundation of the European Union. The very idea of a single monetary authority working with different fiscal authorities is flawed. When countries enter a monetary union, they change the nature of their sovereign debt in a fundamental way as they lose control over the currency in which their debt is issued. The reason why it has been so difficult to control the contagion is that government bond markets in a monetary union are very vulnerable to financial market risks.

In a recent paper by Paul de Grauwe (The Governance of a Fragile Euro zone, May 2011), the situations in UK (nonmember) and Spain (member) are compared. Even though since the start of the financial crisis the government debt ratio of UK has increased more than that of Spain yet the yield on Spanish bonds has risen strongly relative to UK bonds. This suggests that markets put a significantly higher default risk on Spain than on UK. This can be explained as follows: In case of UK, if investors fear that the government might default on its

debt, they would sell government bonds thus driving up the interest rates. Even if the UK government cannot find the funds to roll over its debt at reasonable interest rates, it would certainly force the Bank of England to buy up the government securities. Thus the UK government is ensured that the liquidity is around to fund its debt. This means that investors cannot precipitate a liquidity crisis in the UK that could force the UK government into default. Moreover, as investors sell UK bonds, the pound depreciates and the economy is given boost. All this is absent in Spain. It does not enjoy the luxury of having a superior force of last resort in the form of a central bank nor a depreciating national currency. In a similar situation the Spanish government cannot force the ECB to buy its bonds as it has no control over it. The financial markets force Spain into a liquidity crisis which soon turns into a solvency crisis as bond yields rise. Thus, in a monetary union, financial markets acquire tremendous power and can force members to default.

Response of the ECB and Effects of the Solutions Offered

Contagion between sovereign bond markets can be stopped only if there is a central bank willing to be the lender of last resort. Even though the ECB has performed this role by buying government bonds it has always expressed its reluctance to do so. This, along with misplaced political interests has worsened the situation. Even though this function of the ECB is essential, one must not forget the moral hazard that is involved. Fiscal imprudence could be encouraged if countries take liquidity provision for granted. Moreover, the establishment of European Financial Stability Facility (EFSF) followed by the establishment of

European Financial Stabilization Mechanism (EFSM) has not seen much success. These rescue funds are not big enough and lack the credibility needed to assure the investors. While doubts can be raised on the commitment of Greece, Ireland and other affected countries in imposing fiscal austerity measures, investors also fear that in case these measures are implemented, the economies would slowdown further and enough revenue would not be raised by the state to pay the debt.

More recently, the ECB has committed to provide three year liquidity to banks to deal with the situation. Despite this liquidity injection, banks seem reluctant to buy many government bonds. As per The Economist, Italy and Spain alone need to roll over €150 billion (\$195 billion) of debt in the first three months of this year. This means intensification of the crisis as the entire continent is trapped in the vicious cycle of slow growth, austerity and bigger budget deficits.

The Future of the Euro

The Euro could collapse if one of the weak links were to step out to devalue their currency or if Germany were to step out of the mess it finds itself in. This would mean high political and economic costs and a huge setback for the entire Euro Zone. For the countries that step out, it would mean tedious work in printing and circulation of old currency which would incur huge costs. Moreover, as pointed out by Barry Eichengreen of Berkeley any euro-zone country that even hinted at leaving the currency would trigger a devastating run on its banks, as depositors rushed to move their funds to safer places.

What will happen in the future depends a lot on the stronger economies. Whether they let the dreams of a unified and strong European Union shatter or act as shields for their neighbors remains to be seen. The rest of the world will have to wait and watch. And more importantly, learn.

References :

1. The world economy, Self-induced sluggishness- The Economist, Jan 2012
2. Only an active ECB can solve the Euro crisis- Paul De Grauwe, 2011
3. Governance of a fragile Euro zone, Paul De Grauwe, 2011

WORLD AFFAIRS

The U.S. Debt Crisis: Lessons learned

Aastha Gupta

The debt crisis in the U.S. during mid-2011 had President Barack Obama and the Americans on their toes since in the absence of an increase in the debt ceiling, the US government would have defaulted on its payments, leading to a tremendous blow to business and investor confidence –raising interest rates for everyone who borrows, undermining the value of the dollar and roiling stock and bond market. To deal with this, a framework for a budget deal was struck that would cut trillions of dollars in