

## THE ECONOMIC AND FINANCIAL CRISIS. THE EURO AREA

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### **Abstract**

*The article proposes an analysis of some European financial markets on the background of the recent crisis, markets that have become very alarmed by the increase of the Euro States' budget deficits and the possible entry of some of them in a situation of not being able to pay rates on debts contracted by the Government. Such imbalances can be avoided in general either by a correct evaluation or by a controlled devaluation of national currencies, or by means of the exchange rates of various currencies. However, in the Euro area, this is not possible due to the very existence of a single currency, a context in which the authors suggest the use of alternative solutions.*

**Keywords:** *economic crises, euro, sovereign debt problems*

**JEL Classification:** G01

### **Introduction**

Economic and financial crises have occurred since Roman times, and their degree of complexity has increased with the development of capitalist society in general and with the configuration global economy – starting with the 16<sup>th</sup> century – and the formation of relationships of interdependence between different countries of the world, reaching a point of maximum complexity in the current economic and financial crisis.

### **Theoretical background**

Modern economic theories reject the idea of general theorization of economic and financial crisis, according to which they can be included in a general valid model, considering that each financial crisis is unique, each representing in fact a historical accident, caused by specific factors, in a particular social, economic or political situation. According to these theories, crises are not predictable, so that their negative effects to be reduced to a minimum. However, history shows that, although economic and financial crises do not occur and have no effect on identical parameters, they are closely related to the cyclical nature of economic processes.

Although the causes of cyclical evolution of economic processes have not yet been strictly identified, their cyclical nature is evident. Economic cycles, whether they are short, medium or long term, consists of two phases – expansion and recession.

In the expansion phase, there is an increase of economic efficiency in business generated by the introduction of significant technological innovations, while the recession means a weakening of the springs that produced economic propulsion.

If short (lasting between 10 and 40 months) and long-term (so-called secular cycles, lasting between 40 and 60) cycles end with recession characterized by slow growth, decennial cycles (also called business cycle, which lasts from 4 to 6 years, up to 10 to 12 years) are characterized by the phenomenon of crisis, in which demand, production, employment of labor, GDP, liquidity decrease dramatically and the standard of living is getting worse.

### **Economy crisis in Member countries and the Euro Area**

At the end of 2009, when the economic crisis was already in full swing but the European banking sector seemed for the time being rather stable, a number of international investors began to raise the issue of potentially dangerous situations related to the debts of several sovereign Member States of the European Union and the Euro Area. It was the case of countries such as Greece, Ireland, Portugal, Italy and Spain, without however being alone in a particularly difficult situation. The situation became much tensed in 2010, when states within and outside the Euro Area were added on the list. It became obvious that saving the banking system had generated debt increases as well as a crisis of confidence. Financial packages were granted to Greece, Ireland and Portugal in order to avoid such a denouement, with possible catastrophic effects for the European currency.

Although the sovereign debt crisis was triggered in appearance by Greece's difficult situation, the Euro Area economy as a whole is affected, primarily, by a decreasing confidence in the economies of the acceding States because of the high level of indebtedness of their Governments. In 2010, Ireland had a deficit of € 32.4% of GDP, the United Kingdom of 10.4%; the deficit was of 9.2% in Portugal and in Spain of 9.1%, these being the countries with the highest systemic risk (Eurostat, 2010). In the same year, Greece had a huge debt of 142% of GDP, Italy of 119%, Portugal of 93%, Ireland of 96.2%, Germany of 83.2%, France of 81.7%, the United Kingdom of 80% and 53% in Spain. The need for financing of Euro Area countries in 2010 was of 1,600 billion Euros, the countries with the highest risk for payment of debts being those whose governments relied on foreign investors for funding. This situation occurred in the context of the investors' confidence in the bonds issued by the Governments of these countries being at a very low level.

At the same time, even if Greece's economy represents only 2.5% of that of the Euro Area, a possible bankruptcy of the Greek State was viewed as a source of aggravation of the situation and problems within other States and the European single currency.

## **The Greek State bankruptcy and the European currency**

The difficult situation of Greece seems to have roots in the way that this country managed the economy and budget in the last 40 years. As early as 1974, following the end of the military dictatorship, wishing to keep the movements of the left under control and the dissatisfaction of a broad part of the population with leftist orientations, successive Governments of Greece structured budgets based on high deficits, in order to get enough money that would assure the necessary funding for a relatively bulky and costly public sector that involved salaries, pension schemes and other social benefits. In this context, the Greek economy had been running since 1993, with public debt exceeding 100% of GDP.

Before joining the Euro Area, the Greek State loans had been funded through a policy of national currency devaluation, which allowed achieving substantial profits from exports and especially tourism. After the introduction of the Euro, this system was replaced with a reduced interest of Treasury bonds. However, in 2007, the beginning of the world economic crisis hit the two most powerful sectors of Greece's economy, namely tourism and shipping. Their profits had already declined by 15% by the year 2009. However, the Greek Government has hidden the real situation of the growing public debt, while continuing to practice the same system of public expenditure.

This situation became public in 2009 with the change of Government which reviewed the budget deficit from 6% of the official amount at 12%. This amount had increased by the year 2010 at 13.6% of GDP, one of the largest in the world, with a debt estimated in January 2010 at 216 billion Euros. At that time, 70% of the bonds issued by the Greek State were held by foreign investors. The indebtedness of the Greek State was aggravated by domestic tax evasion estimated at about 20 billion dollars annually.

It should be noted that despite this context, in 2010, the state bonds issued by the Government of Greece were purchased for a total of 20 billion Euros, with a fixed rate term of 5 years which is worth 5 times more than anticipated by the Greek Government, five billion Euros for a period of 10 years with additional requests 3 times higher, for this category of bonds.

In this context, as a result of the decrease in the level of descriptions provided loans to Greece by international independent agencies, interest on bonds issued by the Government of Greece grew initially with a percentage of up to 15%, a phenomenon that generated concerns regarding the ability of this country to pay its debts. As a result, Greece asked for external financial assistance from the IMF and the European Commission, which called for the implementation of an austerity plan in 2010 with the purpose to reduce governmental expenses and to increase confidence in its ability to pay rates on debts accumulated and long-term loans granted by the two institutions.

In the absence of the financial package, there is a risk that Greece might not be able to pay a part of its huge foreign debt. The probability that this theoretical

situation should become real was estimated to be between 25 and 90%. More problematic, however, were the features and results of such a situation.

Very likely, the Greek State bankruptcy might have taken the form of a financial and economic restructuring with a partial payment of the accumulated debts, estimated at 25-50%. The most important consequence might have been Greece's coming out of the Euro Area, a particularly dangerous situation for the European currency consisting primarily in the loss of investors' confidence in it. However, viewed from the opposite angle, the solutions suggested by the EU officials may turn out to have possible long-term adverse effects. Very tight fiscal constraints and damaged social situation could have a negative impact especially on the economic recovery effort. This is generally the most criticized aspect of the IMF's lending policies.

### **Ireland, Portugal and Spain and the European financial package of measures**

As far as Ireland is concerned, in December 2008, following the discovery of unreported loans made by the Anglo Irish Bank, it was nationalized in 2009 through a legislative act. In this way, the Irish took over not only the ownership of assets of the Bank but also its liabilities. In addition to the Anglo Irish Bank nationalization, the Irish State in general took over the majority of the national banking system debt in an attempt to save it from collapse. However, even if in 2010 the Government of Ireland announced that the support for debt of the banking system did not generate serious problems, in 2011, due to a sudden decline in confidence in the creditors' ability to pay those debts, it was forced to negotiate a financing agreement with the IMF and the European Commission. The agreement was accompanied by a package of measures intended to reduce public expenditure and to increase the collection of money from the national budget. As a result, Ireland, one of the countries with the strongest economic growth in the European Union before the crisis, entered practically in a recession period.

The difficult financial situation of Portugal seems to have originated in a longstanding policy of excessive government spending and investment, by means of partnerships of public-private type. These would be added to high-risk loans contracted by the Portuguese Government and non-efficient management of European funds. In this context, as a result of the global financial crisis, Portugal is currently in a situation almost as difficult as that of Greece.

Although at the beginning of 2010, Portugal had one of the best economic recovery rates in the EU, in May of the same year, the leaders of the Euro Area countries approved a 78 billion Euros funding package for this country. The loan was given by European Financial Stabilization Mechanism, the European system of Financial Stabilization and the IMF and has an interest rate of 5.1%. As part of the funding program, Portugal was obliged to privatize the national telecommunications company Portugal Telecom. In this way, Portugal was the third country after Greece and Ireland which received a refinancing package.

In Spain, shortly after the announcement of the European Union to establish an “Emergency Fund” for the Euro Area countries, in May 2010, the Government announced, in turn the adoption of austerity measures intended to reduce the budget deficit of the country. That measure was due to weak economic growth and rising domestic and foreign pressure, especially from the United States of America, the IMF, the European Commission and some of the Euro Area countries. These pressures took a more aggressive approach of the budgetary economies (Pop V., 2010).

With these measures, the Government of Spain succeeded in reducing the budget deficit from 11.2% in 2009, to 9.2% in 2010 (Johnson M., 2011). At the same time, it should be recalled that the public debt of Spain was at the beginning of the crisis in the Euro Area much smaller than that of Greece, Portugal and Ireland, but superior to that of some countries such as Germany or France.

### **Ensuring the long-term fiscal stability of the Euro Area countries – some measures**

In May 2010, the EU member countries approved the establishment of a European Financial Stability Body (EFSB). It is a legal instrument which aims at providing financial assistance of the Euro area in difficulty (European Commission, 2010). In order to achieve this aim, EFSB operates on the basis of a special fund that sells bonds to finance loans of up to 440 billion Euros, granted to countries in need of urgent interest. The bonds are guaranteed by the European Commission, as a representative of all the Community countries, and the IMF. The new body will act only at the request of countries in need of refinancing (Stearns J., 2010). EFSB funds will be added, on the one hand, a credit of 60 billion Euros granted by the European stabilization mechanism, guaranteed by the European Commission under the Community budget and on the other hand an IMF loan worth 250 billion Euros, while pursuing the creation of a fund safety deposit worth 750 billion Euros (Barber T., 2010). An agreement on the basis of these two additional credits allows the European Central Bank (ECB) to buy the loans contracted by Euro Area Governments which in the end to push down the interest on debt securities issued by them (Flanders S., 2010).

In the same context, the ECB has taken a series of measures aimed at reducing the volatility of financial markets and improving the liquidity situation. Of these, the most important are the acquisition of debt obligations of public and private sectors, a rescheduling at intervals of 3 and 6 months of longer-term refinancing operations and reactivation of monetary exchange lines with the Federal Reserve of the United States of America (European Central Bank, 2010). At the same time, the banks which are members of the European system of central banks started to buy government debt.

However, despite these measures, the European Commissioner for economic and Financial Affairs, Olli Rehn, called for Spain and Portugal to take measures for an “absolutely necessary” decrease of their budgetary deficits. However, although the European financial package of measures managed to overcome the momentary

panic on the markets, the credit rating agencies still consider that countries in the Euro Area will continue to have difficulties.

Two important decisions were taken by European leaders for the purpose of ensuring the long-term fiscal stability of the Euro Area countries. The first one consisted in the creation of the already mentioned European Financial Stabilization Fund financially backed by the IMF. The second consisted in starting the process of creating a single authority responsible for the supervision and coordination of fiscal policies of the Government expenditure of the European Union member countries, called the temporary Single European Tresoreria (Crespo). This body may be supported by the European Parliament, the European Council, and especially by the European Commission. However, external monitoring and in-depth tax and budget policies, as well as associated national implementation mechanisms, are considered as a potential violation of the sovereignty of the Euro Area countries.

Irrespective of the measures taken at the level of a country or another to prevent the reappearance of overvaluation of capital assets and current account imbalances, settlement and regulation measures are to be adopted in the area of cross-border movement of capital in order to maintain the balance of payments of the Euro Area countries. This implies that countries importing goods mainly should also produce and import comparable amounts of capital in order to pay for those imports. The converse works for the exporting countries which should predominantly be exporting net capital as well, most often to the countries importing goods. Risks can arise when exports of capital tend to grow faster than supply, leading to an increase in the indebtedness of the importing countries over their real needs and purchase more than the real reimbursement capacity, which may ultimately lead to an overvaluation of capital goods.

Such imbalances can be avoided in general either by evaluating a controlled devaluation of national currencies, or by means of the exchange rates of various currencies. However, in the Euro area, this is not possible due to the very existence of a single currency, the context in which alternative solutions must be found. The first solution would be consumption policies in importing countries, to increase savings and reduce the trade deficit. A second solution could be to reduce budget deficits in order to increase the degree of power-saving state. A third solution could be the control of trans-boundary movements of capital by charging or restriction, in order to reduce the balance of payments imbalances. A fourth solution may be to increase interest rates for encouraging savings deposits, but it has the disadvantage of slow development of the economy and leads to higher interest rates that Governments must pay.

Finally, there is also the already applied solution of austerity, being implemented in most countries of the community. Beyond any argument, the solution may be criticized by some specialists. There is an increasing feeling that such a management solution for the crisis is unfair to the majority of the working population obliged to bear the costs of a crisis triggered by serious errors of economic management of bankers, investors and economists. While so far, in the European Union, 23 million workers have lost their jobs, hundreds of bankers, in

the same country, have become millionaires, despite the collapse or nationalization (supported all by the contributors) of the banks who worked during the crisis (European cities hit by anti-austerity protests, 2010). This situation has caused both from specialists and some European leaders to call for the establishment of a European and global system of regulations and control of the activities performed by private financial institutions.

### **Conclusions**

In the last two years, leaders of the European Union Member States met increasingly often and have spent even more time for a decisive struggle with economic crisis which swallows the Euro Area and, widespread, the entire European economy. Undoubtedly, the global economic crisis has become a dominant international life (Chirimbu, Murariu, Dorînga, Barbu, 2011, p.23). Could that be seen as a clear indication of imminent failure of the EU political system?

At the beginning of last year, most countries in the European Union were optimistic about overcoming the crisis in the foreseeable future, further there was a considerable change of thinking. Given the economies of most European countries began to emerge from the deepest recession recorded in the Second World War, the economic results of 2012 indicate the beginning of the year for the first time in several EU countries, a slightly upward trend.

For further EU economic recovery, it is essential that the member countries to reduce their debt quickly and with lasting results. A total of 25 European Union countries, including Romania, but not the UK and Czech Republic have signed the European fiscal pact, which provides primarily tax rules for balancing budgets and economic policy coordination at European level. The way EU countries deal with any crisis and the cost of it to various countries will certainly influence in a decisive way, if and how quickly European citizens and economic analysts will begin to believe again in Europe's economic recovery.

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