A short history of the eurozone crisis

SUMMARY *Monetary union without fiscal union may be the seed of the current difficulties. This structure, from the launch of the euro in 1999, along with readily available and cheap credit, encouraged deficit spending. As a result, when the economic crisis started in 2008, a number of eurozone Member States (MS) had growing budget deficits and government debts, along with competiveness problems.*

From late 2009 to the present, the most indebted of these MS have found themselves progressively unable to fund their borrowing needs. Starting with Greece, then Ireland and Portugal, these eurozone (EZ) countries have moved towards defaulting on their debts.

The EZ bailed out Greece in May 2010, Ireland in November 2010 and Portugal in May 2011. Greece had a second bailout in February 2012, along with the largest debt default in history.

The bailouts are mainly funded by the EZ, with some participation by the IMF and other MS. Funds are supplied subject to implementation of austerity policies, restructuring and repayment programmes, with the aim to move to a sustainable budgetary position.

During these past two-three years, the EZ has built up structures to deal with these new needs, from a temporary to permanent bailout fund, to agreements to establish sustainable debt situations and prevent a reoccurrence.

The current situation remains of concern, in particular whether the plans can be effectively implemented and contagion avoided.

In this briefing:

Abbreviations

EFSF: European Financial Stability Facility

EFSM: European Financial Stabilisation Mechanism

ESM: European Stability Mechanism

SGP: Stability and Growth Pact

Context: The eurozone before the crisis

The 1990s brought monetary union (the euro and European Central Bank) but no economic union: no fiscal union, no effective economic governance institutions and no meaningful coordination of structural economic policies. Some warned that this structure could lead to the problems now being felt.

The euro officially came into existence on 1 January 1999. Notes and coins were introduced on 1 January 2002. Two of the main criteria for joining the euro are a limit of 60% debt to GDP and 3% budget deficit. Greece joined in 2001and the last (Estonia) in January 2011, making 17 EZ MS.

More than ten years after its introduction, the euro has gained an international reserve currency status and is the world's second most exchanged currency.

Some EZ members, who had previously paid more for their debt, reflecting their history and economic risk, were able to borrow at lower rates because it was expected that repayment of their euro debt was guaranteed, if not from the MS itself then

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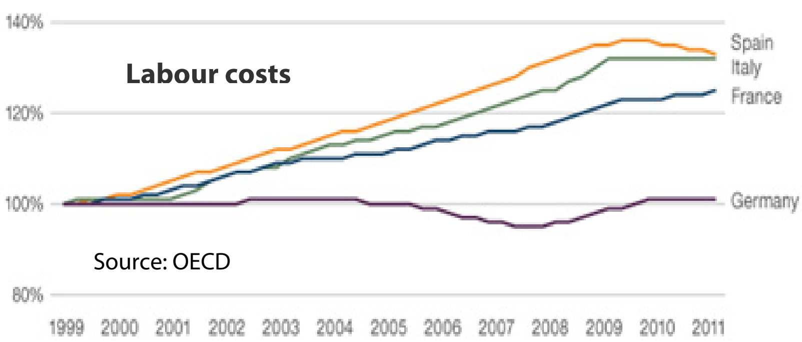
from other (stronger) EZ MS. This view held until Greece defaulted in July 2011.

Credit was freely available and some MS over-borrowed for consumption and government expenditure. Moreover, Greece, Ireland, Italy, Portugal and Spain lost competitiveness (estimated at 20-30% relative to Germany) through rising labour costs and lower productivity. This reduced their economic growth and - with much trade being intra-EU - led to negative trade balances.



As EZ MS cannot devalue their currency, reducing domestic prices and costs is required to restore competitiveness.

A weak competitive position and budgetary deficits were not a problem, so long as there was access to credit. However, the 2008 financial crisis and rising concern over debt levels led to the drying up of liquidity access on the financial markets between the autumn of 2009 and the spring of 2010.

2009 to 2012

2009

The European Commission (EC) told France, Spain, Ireland and Greece to reduce their budget deficits (the difference between spending and tax receipts) in April as concerns rose about some MS' debts.

> Greece, with a troubled financial history normally reflected in higher bond yields, benefited from EZ lower borrowing costs and 'easy' credit. So, despite heavy debts and a record deficit in 2008, borrowing costs remained close to Germany's.

Worries over Greece's fiscal position accelerated when its new finance minister said in October 2009 that the budget deficit was not 3.6% as previously reported but 12.8% of GDP (increased to 13.6% in April 2010).

Ratings agencies - their opinions highly influential before and after the crisis - downgraded Greek debt to speculative grade. As a solution for Greece was being sought, concern started to spread about Portugal, Ireland, Greece and Spain.

2010

Greece I

An EU report noting severe irregularities in Greek accounting procedures was produced in January, and in February Greece unveiled austerity measures to control the deficit. The EZ and IMF provided a €22 billion safety net (no loans) in March and the EZ added €30 billion of emergency loans in April. With its borrowing costs continuing to rise and doubt about its ability to raise funds to pay debts falling due in May 2010, Greece formally requested financial assistance on 23 April 2010.

> The Greek government's external borrowing cost on new ten-year debt rose from 4.9% in December 2009 to 7% in April 2010. *(December 2009 debt: €300 billion - 113% of GDP).*

A three-year €110 billion bailout package including an economic adjustment programme was finalised on 2 May. The EZ funding was via bilateral loans.

In May and June 2010 the EC published Reinforcing economic policy coordination and Enhancing economic policy coordination covering:

- The high level of public debt and safeguarding long-term fiscal viability.
- Incentives and sanctions to ensure compliance with the SGP rules.
- Control of EZ macroeconomic trends.

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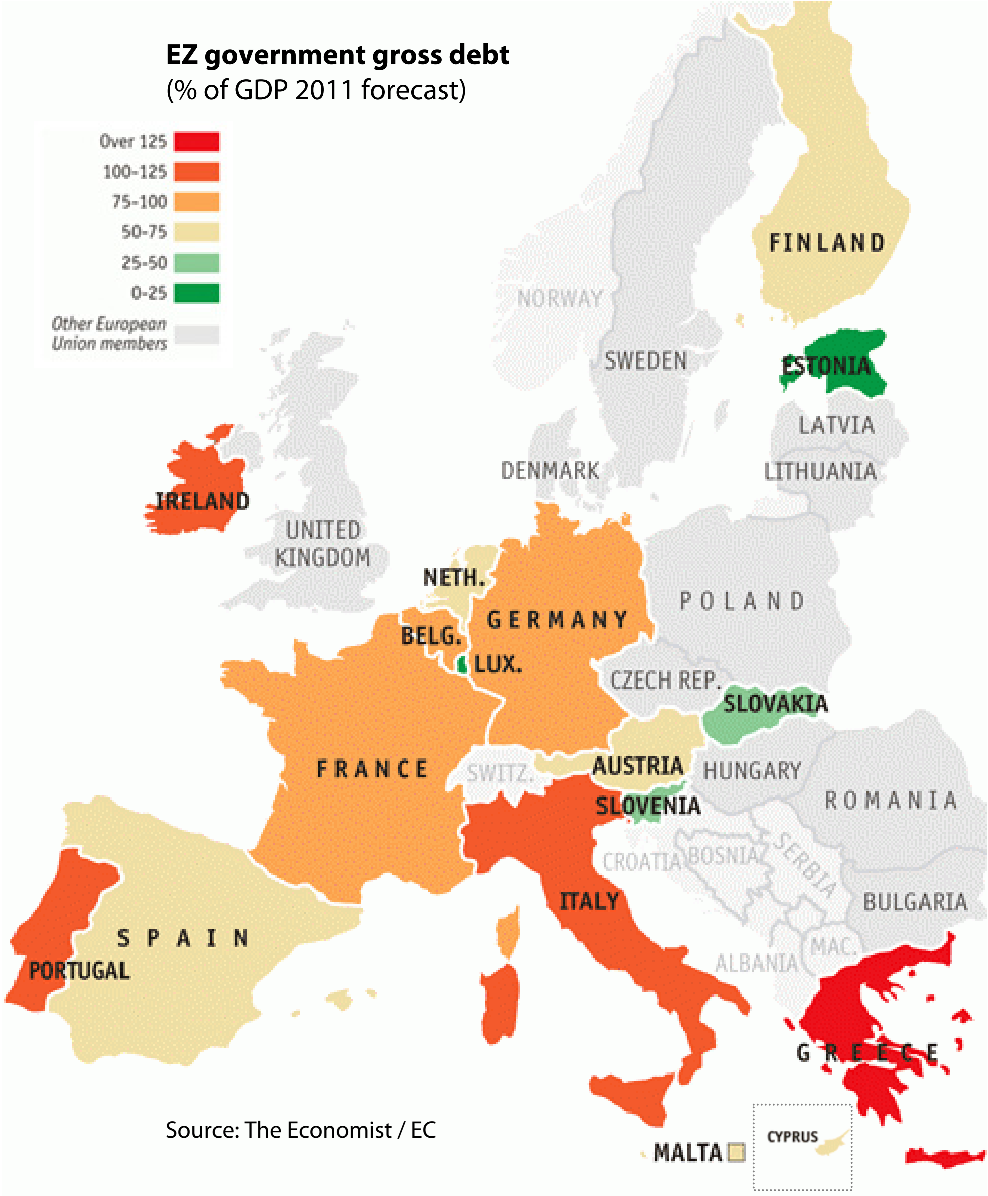
- More integrated budgetary policy coordination ("European semester").

In September 2010 the EC put forward [six legislative proposals](#) ("six pack") to reform the SGP through additional surveillance of fiscal policies, along with a more systematic and earlier application of measures to ensure budgetary and macroeconomic imbalance compliance. The EP argued in favour of strengthening the proposals and only approved the package in September 2011 following lengthy negotiations and a compromise with the Council. The final [package](#) entered into force in December 2011.

Ireland
An EU / IMF [bailout package to Ireland](#) totalling €67.5 billion was negotiated in November 2010. EU financing comes via the EFSF and the EFSM, supplemented by bilateral loans from EU MS (e.g. the United Kingdom and Sweden). The Irish [overall](#) and detailed [economic adjustment programme](#) targets a 3% budget deficit by 2014.

EZ government gross debt
(% of GDP 2011 forecast)



Source: The Economist / EC

Financial Assistance for EZ Governments

	Date agreed	European	IMF	Total
		€'billion	€'billion	€'billion
Greece	May 2010	80	30	110
Ireland	December 2010	45	22.5	67.5
Portugal	May 2011	52	26	78
Greece	July '11 to Feb '12	113	17	130

Source: International Monetary Fund

2011
[The Pact for the Euro](#) (Euro Plus Pact) was agreed in March 2011 by EZ members and Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania and aims to strengthen the EU's economic governance:

- Encourage competitiveness and its convergence in MS.
- Respecting the rules of the internal market.
- Strengthening financial stability.

Portugal
Following a request in April, Portugal received a €78 billion bailout in May with a detailed economic adjustment programme. There is equal EFSM, EFSF and IMF financing.

In September, Italy passed a €50 billion austerity budget but it had its debt rating cut by Standard & Poor's, a ratings agency. On 26 October European leaders agreed to boost the EZ bailout fund (EFSF) and for banks to raise more capital and accept a 50% loss on Greek debt.

2012

In January, the credit ratings of nine EZ countries and the EFSF were downgraded.

Greece II
In March 2011, in return for lower interest rates and a longer repayment schedule Greece had agreed to sell off €50 billion of public-sector assets, to be completed by 2015. However, though it voted in additional austerity measures in July 2011, its deteriorating economic performance meant it would not be able to borrow on the open market in 2012. This led to a second financial support programme. First discussed at a July 2011 summit of leaders and agreed in February 2012, Greece's imminent default on some debts and the passing of an austerity bill helped. It was approved on 14 March by the Eurogroup. The Greek government now has access to finance until at least 2014.

More complicated than the first bailout, it is hoped that the measures will bring Greece's debt-to-GDP ratio down to a (barely) sustainable 120% by 2020.

It consists of an EZ/IMF €130 billion package (€117bn in loans from EZ MS through the EFSF and €13bn from the IMF). In addition, the private sector owners of €177 billion of Greek debt lose 53.5% in value. For the remaining 46.5% they get 15% in cash and new, longer-term Greek debt. The EFSF loans repayment is lengthened up to 30 years with a grace period of ten years. This is the largest restructuring of government debt in history.

EP's President Schulz addressed the Hellenic Parliament in February 2012. Expressing solidarity and understanding with the position that they find themselves in, he said that Greece must remain in the euro.

Financing facilities and conditions

There are three facilities:

- **EFSF**: This was created following the 9 May 2010 ECOFIN Council as a temporary, three-year facility to provide financial assistance to EZ MS. Financed through new bond issues, it is backed by €780 billion of EZ MS guarantee commitments and has a €440 billion lending capacity. It can provide assistance to governments, finance bank recapitalisation, or purchase government bonds on secondary markets in exceptional market circumstances.
- **EFSM:** Established by a May 2010 Regulation, the EC can borrow up to €60 billion for lending to MS. The beneficiary MS pays the loan principal and all interest.
- **ESM**: Originally it was agreed by EZ finance ministers in November 2010 and February 2011 that this permanent, €500 billion, EFSF replacement bailout fund start in 2013. Market jitters led to a December 2011 decision to start it in July 2012, with the treaty signed in February.

European Council March 2011 Decision amends Article 136 of the Treaty (TFEU) so that EZ MS can set up a permanent stability instrument.

The ESM will provide assistance to EZ MS in a liquidity crisis (identified via a debt sustainability analysis) subject to the implementation of an economic programme.
With insolvency, the MS must first determine a plan with its private creditors and then ESM liquidity assistance may be provided.

Parliament passed a resolution noting that it has no role in the EFSF and EFSM processes despite the potential significant budgetary consequences. However, it was agreed that the Euro Summit president would inform the EP about the results of the meetings and there is close contact between EFSF and EP committees.

The EP was consulted in respect of the (intergovernmental) ESM and backed the connected limited Treaty change following discussions with MS.

All new EZ sovereign bonds will have Collective Action Clauses.

The existing bailout loans come with conditions: highly specific programmes of economic reform with a quarterly timetable. Aside from additional austerity measures, more fundamental structural reforms such as dealing with 'inflexibilities' in the labour and product market, improved tax collection, reducing macroeconomic imbalances and privatisation of state assets are covered.

Each new tranche of money released needs the approval of the 'Troika' (the EC, ECB and IMF) after a review of the success in meeting the loan conditions.

The role of the ECB

Since May 2010 the ECB has kept liquidity - and stopped the freezing up - of public and private euro debt markets through its Securities Markets Programme.

By August 2011 the ECB made purchases of Italian and Spanish debt to bring down prices when concerns spread to these markets and borrowing costs rose sharply.

It makes purchases of national debt on the secondary market, since Article 123 of the TFEU forbids direct purchases. The ECB may be the biggest holder of Greek bonds.

From December 2011 it significantly increased its activities with long-term refinancing operations (LTRO): providing cheap loans to EZ banks. This liquidity may have saved some banks from failing.

New control structures

The European semester is an EU agreement to coordinate budgetary and economic policies, following MS approval in September 2010 of the May and June 2010 EC proposals. Specifically it includes greater EC surveillance of national budgets, and an early warning mechanism to tackle macroeconomic imbalances within and between MS.

The EP expressed its concern at the lack of democratic legitimacy in the European semester in a December 2011 resolution. The EP considers that its president should participate in the relevant European Council meeting and that the EP should provide the overall evaluation.

25 EU leaders (not the UK and Czech Republic) signed the intergovernmental Treaty on Stability, Coordination and Governance ("fiscal pact") on 2 March 2012. It is a renewed version of the failed SGP. It aims to make it harder to break budget deficit limits through EC approvals requirements and financial penalties, though they could be overridden by a qualified majority vote. Other MS would be able to launch infringement proceedings at the Court of Justice.

An intergovernmental agreement means no automatic role for the EP and a weakening of the EU institutions and community method. However, to address this, the EP had three MEPs invited to participate the working group that drafted the Treaty. The resulting agreed treaty contained significant modifications to the early draft. It now recognises the primacy of EU law and implementation by the institutions.

MS should keep their structural budget deficits to a maximum of 0.5% of GDP, their overall deficits to 3% of GDP and have these rules in their national constitutions.

Spain passed a constitutional amendment to limit budget deficits in September 2011.

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The EU mechanism to achieve these new structures has been criticised as needing (too) many EU crisis meetings (the 9 December 2011 meeting was the 15th in 22 months) and being preoccupied with short-term goals, which left responsibilities unclear. The policy response has been consistently viewed as delivering too little, too late, reflecting disagreements between Germany, France, and the European Central Bank (ECB), and the (complex) EU policy-making process. A longer-standing observation is that the ECOFIN Council has never applied sanctions despite some MS being over the 3% / 60% public deficit / debt targets in the Treaty's Excessive Deficit Procedure.

The status in early 2012

The many austerity plans may not be fully implemented because of public resistance and government's lack of capacity to deliver. Allied to limited economic growth, high unemployment and weak competitiveness, the risk of debt default remains. In the meantime, fundamental trade imbalances indicate a continuing need for funding transfers from stronger EZ countries.

Contagion concern, where one MS' default leads to another, also remains. This can be avoided if there is a big enough fund to support EZ MS, particularly if they are solvent and only have a temporary liquidity crisis.

> European banks may be the largest holders of EZ government bonds. Already considered undercapitalised, a default could lead to some collapses.

However, the current structures do not have enough funds to deal with a default by major indebted EZ MS, so discussions are continuing on an increase.

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