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Did the euro trigger the European dept crises?

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Abstract. The European integration process has now reached the stage of economic and monetary union . European Union met the ongoing Eurozone sovereign debt crisis during this integration process. The debt crisis first emerged in Greece in 2009 and then became a Eurozone debt crisis by spreading within 2 years to Ireland, Spain, Portugal and Italy. This study will seek answers to whether the integration of uniform currency caused the European debt crises. In order to understand this, first the emergence of the European debt crises and its possible causes will be discussed and then the data and current situation of the crises will be analyzed with the help of microeconomic facts.

Keywords: European Union, Eurozone, Euro Sovereign Debt Crisis,

Jel Code: E50, O52, F34

INTRODUCTION

There is no article in Treaty of Rome establishing the European Economic Community regarding a monetary union. It is set forth in Article 105 of Treaty of Rome that a Monetary Committee with consultative status shall be established in order to promote the co-ordination of the policies in monetary matters (Gökdere, 2008: 51). It was first stated on Werner Report dated February 12th 1969 that common economy policies are needed to reach medium-term objectives. Council of Europe acknowledged Werner Report as an official objective of European Economic and Monetary Union at The Hague summit of 1969 by agreeing on most parts of Werner Report (Mundell, 1994). With help of Werner Report, they also developed a mechanism known as "snake in the tunnel" which foresees +/- 2.25% fluctuation between European currencies and 4.5% against dollar (Mundell, 1994). Snake lost most of its components within two years as a result of oil crisis, political dissidences and weakening of dollar. After this not very successful application, European Monetary System (EMS) was founded with participation of all currencies of member states excluding Pound Sterling in March 13th, 1979 (Bayar, 2014:213). The main aim of EMS is to decrease exchange rate instability which harms trade, investment and economic growth (European Commission, 2007:5). Despite oil crises, EMS has contributed to current development of monetary union by diminishing fluctuations between currencies of member countries and as a result of familiarization and coordination between economy policies of member states (Gökdere, 2008: 52).

After the introduction of the Single European Act on July 1st, 1987 and attempting, until the end of 1992 to eliminate physical, technical and financial obstacles and trying to eliminate organization of markets which harm intra community competition an absence of an important factor was shown a single currency which would act as a physical exchange instrument. A single currency would increase intra community trade and would contribute to optimum resource allocation by eliminating money changing cost and foreign exchange risk (Gökdere, 2008: 52). However, it was inevitable that releasing movement of capital entirely after July 1st, 1990 with Single European Act, EMS would create various complications with regards to the operation of the then exchange rate (Gökdere, 2008: 52). These facts led to the decision of establishing a committee under the chairmanship of the then Commission President Jacques Delors during the Madrid Summit of June 1989 to define how to actualize Economic and Monetary Union (EMU). Aim of the monetary union had been described as full liberalization of movement of capital, full integration of financial markets and replacing of national currencies with a single currency on the report submitted on April 1989 by a committee composed of central bank governors of member states under the chairmanship of President of the European Commission Jacques Delors. It was stated that an independent European Central Bank (ECB) should be established for this aim and necessity of determination of rules regarding size of national budget deficits and management of financing was also stated (European Commission, 2007:8). The transition to a single currency which would be named the EURO was decided on December 1991 with the Treaty on European Union signed at Maastricht (Bayar, 2014: 214).

In the first section of the study we will discuss the transition process to the Euro. In the second section we will provide the literature on the emergence of the European debt crises, its progress and causes.

ACCESS TO THE EURO

11 Member States (Belgium, Germany, Ireland, Spain, France, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland) established the Eurozone in 1999 in compliance with Economic and Monetary Union calendar. Denmark, England and Sweden had chosen not to join EMU in the beginning. Greece had not fulfilled the requirements.

Economies of member countries should reach convergence criteria which are also referred to as Maastricht criteria to be able to enter EMU (single currency). Countries which are less outward-looking and can only achieve short term plans before European Monetary Union can be more outward-looking, can research new opportunities and apply them and can make programs for a larger foreign market with the new shared currency "Euro". Maastricht criteria which had been prepared for this aim are composed of five economic criteria (Engin ve Yeşiltepe, 2009: 16);

- Difference between annual inflation rate of related country and average of annual inflation rates of three countries which have the lowest inflation rate (which have the best performance) in the Union shall not be more than 1.5 points.
- The ratio of gross government debt of member country to Gross domestic product (GDP) must not exceed 60%
- The ratio of budget deficit of member country to GDP must not exceed 3%
- 12 month period Long-term interest rates shall be no more than 2.0% higher than 3 European Union (EU) member states with best performance in price stability
- Member state currency must not have been devalued against another member state's currency within the previous two years.

The second phase started with the establishment of European Monetary Institute on January 1st, 1994. Technical preparations regarding establishment of single currency, activities related to strengthening of fiscal discipline and activities related to convergence of economic and monetary policies of EU member countries had been performed during this phase and ECB had been established on June 1998. Exchange rate between Euro and currencies of 11 member states had been hedged on December 31st, 1998. Euro had been started to be used with last stage of EMU on January 1st, 1999. Eurosystem which is composed of ECB and central banks of Eurozone member countries took the responsibility of management of monetary policy in Eurozone. Euro bills and coins had been released to market on January 1st, 2002 (Bayar, 2014: 215). Exchange Rate Mechanism (ERM) II successor of ERM was introduced on January 1st, 1999 to prevent interruption in economic stability in single market caused by exchange rate fluctuations between Euro and other EU currencies and to help EU countries outside of Eurozone join Eurozone. Exchange rates of EU countries outside of Eurozone had been hedged against Euro and fluctuations had been allowed within pre-defined limits. A central rate between euro and the currency of a related country had been decided and it had been allowed to float within a range of 15%. An intervention to currency to keep floating of currency against Euro within the range of ±15% had been allowed. (European Commission, 2012)

Government deficits and debt criteria were the most challenging subjects for EU governments during the transition to Eurozone. Germany achieved to pull down the level of government deficit/GDP ratio to 2.7%. Italy not only reduced spending but also increased taxes. Moreover, Italy imposed an ad-hoc tax called as "Euro tax" of which 60 % is to be paid back in the coming years (Gökdere, 2008:54). Despite efforts of Alain Juppé and Jospin, government deficit was "Achilles heel" of France. However, decreasing government deficit which had been 5.7% in 1994 to 3.02% by the end of 1997 was enough to get passing grade (Gökdere, 2008: 54). However, efforts and successes of countries establishing Eurozone regarding meeting criteria cannot be denied. For example, decrease in government deficit/GDP ratio between 1994 and 1997 was impressive. This 4.4% "unweight" average rate for 11 members in 1994 decreased to 1.6% at the end of 1997 (Kava, 2005:9). Two interdependent factors apart from cut in public expenditure had played a significant role in this positive result. High conjuncture in 1997 increased the amount of aforementioned rate by increasing GDP but on the other hand it also decreased the government deficit as a result of increase in tax revenue. On the other hand, in terms of debt/GDP ratio, the situation could not be deemed as brilliant. Only Finland, Luxembourg and France met the requirements amongst 11 member states. The first wave could only decrease the ratio to 69.1% in 1997 from the ratio of 71.2% in 1994 for 11 member states (Kava, 2005:10). Moreover, ratios of 5 member countries had risen between aforementioned years.

The euro came into existence officially on the first day of 1999. Transformation to Euro in ECU had been done according to irrevocable conversion rates of national currencies of EUR-11 countries which had been announced on December 31, Thursday and equivalence of ECU to Euro was accepted. European Central Bank started using its authorities. In this context, definition and application of single currency policy dependent on Euro started. Exchange transactions and new government debts had been started to be done with the Euro.

Greece, who is the most willing to participate in ECU amongst other 4 EU member states who chose not to use Euro as national currency, submitted application to be the 12th member. Greece who did not meet any Maastricht criteria at the beginning came to a position swiftly with a tremendous effort in which she fulfilled all conditions. Ratio of budget deficit/GDP had been dropped to 1.7% which is much below than the reference value. According to harmonized consumer price index of EU, annual inflation rate is 2.1% by February. Average of annual price increase of 3 members of Eurozone who have the lowest inflation rate is 0.6% (Gökdere, 2008:55). According to Maastricht criteria, a country can pass this ratio at maximum of 1.5% and for this reason Greece meets the inflation criteria just barely. Only ratio of public debt/GDP is

100%. However, according to Treaty establishing the European Community Article 104c Paragraph 2b, this is not a problem because "sufficient diminish in this ratio and reaching to reference value at a satisfactory pace" can be considered sufficient. Belgium and Italy had benefited from this provision although their ratios were between 120% and 130%. Participation of Greece to Eurozone at the start of 2001 had been decided on Lisbon Summit on June 19 and 20.

THE EMERGENCE OF THE EUROPEAN DEPT CRISES, ITS PROGRESS AND CAUSES

It is seen that problems in coordination of economic (monetary and financial) policies and structural reasons are behind the crisis when debt crisis in Eurozone is assessed. There are significant differences between development levels and competence powers of economies, especially in the Purchasing Power Parity, of Eurozone countries.

Table 1

Purchasing Power Parity in Some European Countries (GDP 27=100)

Countries	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Luxemburg	245	234	240	248	253	255	270	275	279	266	271
Netherlands	134	134	133	129	129	131	131	132	134	132	133
Austria	132	126	127	128	128	125	126	124	124	125	126
Belgium	126	124	125	123	121	120	118	116	116	118	119
Germany	118	116	114	116	115	116	115	116	116	116	118
Finland	117	115	115	113	116	114	114	118	119	115	115
Ireland	132	134	139	142	143	145	146	148	133	128	128
France	115	115	115	111	110	110	108	108	107	108	108
Italy	118	118	112	111	107	105	105	104	104	104	101
Spain	97	98	100	101	101	102	105	105	104	103	100
Greece	84	86	90	93	94	91	92	90	92	94	90
Malta	85	79	81	80	78	78	76	76	79	82	83
Portugal	81	80	80	79	77	79	79	79	78	80	80
Slovenia	80	80	82	84	87	87	88	88	91	87	85
Slovakia	50	52	54	55	57	60	63	68	73	73	74
Estonia	45	46	50	55	57	62	66	70	69	64	64

Source: Eurostat.

There are important differences between GDP per capita in Eurozone countries. While GDP per capita is very high in developed economies such as Luxembourg, Holland, Austria, Belgium, Germany and Finland on the other hand GDP per capita in countries where debt crisis is seen such as Spain, Greece and Portugal is below EU average. It is seen that there are significant differences between other Eurozone countries considering global competition index. Differences in both development and competence power between countries in Eurozone make following an efficient and coherent economy policy harder (Table 2). Because of these differences desired environment for monetary union couldn't be established and brought about compliance problems between countries as a result of application of multiple fiscal policies against a single currency policy. While ECB performs monetary policy by itself, application of fiscal policies had been entitled to governments of countries. On the other hand, ECB only focused on low inflation and could not apply different policies against different developments in member countries (Brok and Langen, 2012:192). Moreover, different fiscal policies in countries increased inconsistency between countries by ignoring existing rules. Although many precautions had been taken to realize harmony in economy policies between countries, hesitations about effectiveness and authority of these precautions arose. Thus, debt crisis also showed that harmonization of economy policies had not been very effective. (Wood, 2012: 33).

Table 2

Global Competitiveness Index of Some European Countries

Countries	2009–2010	2010–2011	2011–2012
	(range/point)	(range/point)	(range/point)
Finland	6/5,43	7/5,37	4/5,47
Germany	7/5,37	5/5,39	6/5,41
Netherlands	10/5,32	8/5,33	7/5,41
Belgium	18/5,09	19/5,07	15/5,20
France	16/5,13	15/5,13	18/5,14
Austria	17/5,13	18/5,09	19/5,14
Luxemburg	21/4,96	20/5,05	23/5,03
Ireland	25/4,84	29/4,74	29/4,77
Estonia	35/4,56	33/4,61	33/4,62
Spain	33/4,59	42/4,49	36/4,54
Italy	48/4,31	48/4,37	43/4,43
Portugal	43/4,40	46/4,38	45/4,40
South Cyprus	34/4,57	40/4,50	47/4,36
Malta	52/4,30	50/4,34	51/4,33
Slovenia	37/4,55	45/4,42	57/4,30
Slovakia	47/4,31	60/4,25	69/4,19
Greece	71/4,04	83/3,99	90/3,92

Source: World Economic Forum.

Maastricht Criteria and its revised version Stability and Growth Pact and the Broad Economic Policy Guidelines (BEPG) must be taken into consideration by countries in EU. However BEPG has only directive and advisory characteristics. On the other hand, Lisbon Strategy which gave place to Europe 2020 Strategy in 2010 had aimed coordination of economy policies between countries. However, these coordination efforts had only met with an advisory response in EU and had been ignored by countries. For this reason, efforts which restrain individual policies of countries either had been ignored or stayed as advisory recommendations (Begg, 2012:108).

Another reason of crisis in Eurozone is the fiscal structure and liabilities of Eurozone. After conversion to a single currency, significant decreases in borrowing costs had been seen in countries which accepted Euro as national currency and also investors believed that there would be a convergence between countries in Eurozone. This belief had been fortified with policy aims (such as restriction to ratio of budget deficit to GDP by 3% and public debt to GDP by 60%) which have to be met to join Eurozone (European Council, 1997). Factors such as economically developed countries like Germany and France acting as anchor in common currency policy and management of monetary policy by European Central Bank discreetly generated trust of investors for Eurozone countries which have rather weaker economic foundations compared to countries such as Germany, France and Holland. Many European countries followed stimulus policies for economy to prevent unemployment during the global economic crisis and this situation led to increase in public debts and thus formed a basis for crisis.

European Central Bank kept interest rate of national debt for Portugal, Italy, Ireland, Greece and Spain (PIIGS) and this enabled and encouraged these countries to overspend. This situation shows that deficiencies in systematical and organizational structure have a great importance on the basis of crisis in Eurozone. With the decrease in borrowing costs, received funds had been used to fund current expenditure instead of being lead to productive investments which would create new resources to pay debts and investments which would create growth and increase competitiveness of the country. This situation caused continuous increase in debt stock.

One of the reasons which contributed to existence of crisis is mispricing of risk and ineffective capital distribution. Economic and monetary union caused convergence of interest rate of countries joined in Eurozone. Difference between interest rate of bonds of Germany and PIIGS countries had decreased after these countries joined EU and disappeared in time. As soon as Greece joined the Eurozone in 2001, interest rate of 10-year bond had decreased to 5% from 25% (Yahya, 2015:217). Risks of all Eurozone countries including PIIGS countries had been priced almost at the same level of Germany's risk. Investors, especially with trust in monetary union, had not assessed borrowing to PIIGS countries as risky. For this reason, risk in pricing of commodities had been ignored. For this reason cheap credit was more reachable and this along with unsustainable private sector debts in Ireland, Portugal and Spain caused increase in public debts in Portugal and Greece (Table 3). Cheap credits which countries received after joining Eurozone caused housing price inflation in Spain and an increase in public debts in Greece. This situation led way to close current account deficit with cheap credit and diminished pressure on reforms which need to be done to increase competition (Volz, 2012: 8-9).

Table 3

The public debt ratio of some European Countries (GDP%)

Countries	2006	2007	2008	2009	2010	2011
EU 17	68,5	66,3	70,1	79,9	85,3	87,2
EU 27	61,5	59,0	62,5	74,8	80,0	82,5
Greece	106,1	107,4	113	129,4	145,0	165,3
Italy	106,1	103,1	105,7	116,0	118,6	120,1
Portugal	63,9	98,3	71,6	83,1	93,3	107,8
Belgium	88,0	84,1	89,3	95,8	96,0	98,0
France	63,7	64,2	68,2	79,2	82,3	85,8
England	43,4	44,4	54,8	69,6	79,6	85,7
Germany	68,1	65,2	66,7	74,4	83,0	81,2
Hungary	65,9	67,0	73,0	79,8	81,4	80,6
Austria	62,3	60,2	63,8	69,5	71,9	72,2
Spain	39,6	36,2	40,2	53,9	61,2	68,5
Netherlands	47,4	45,3	58,5	60,8	62,9	65,2

Source: The Turkey Undersecretariat of Treasury.

Instabilities which came to surface at the end of 2009 as a result of global financial crisis represent deep imbalances in Eurozone (Table 4). In addition to this, a debt crisis has emerged in Europe. Arising domestic demand increased the price of non-traded goods and services regarding traded goods and services and also increased fees regarding productivity. While there were not any improvements in exports and mports and the current deficit had increased as a result of abundant foreign capital. Growth had been maintained with domestic services, construction and increasing public expenditure.

Table 4

The Economic Growth Rate of Some European Countries

Countries	Years											
	2001	2003	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Euro Zone	2,0	0,7	1,7	3,2	2,9	0,4	-4,4	2,0	1,6	-0,7	0,2	0,3
Germany	1,5	-0,4	0,7	3,7	3,3	1,1	-5,1	4,0	3,3	0,7	0,1	0,7
France	1,8	0,9	1,8	2,5	2,3	-0,1	-3,1	1,7	2,1	0,3	0,3	0,1
Greece	4,2	5,9	2,3	5,5	3,5	-0,2	-3,1	-4,9	-7,1	-6,6	-3,3	0,2
Ireland	5,0	3,7	6,1	5,5	5,0	-2,2	-6,4	-1,1	2,2	-0,3	0,2	4,1
Portugal	2,0	-0,9	0,8	1,4	2,4	0,0	-2,9	1,9	-1,3	-3,2	-1,4	1,4
Italy	1,9	0	0,9	2,2	1,7	-1,2	-5,5	1,7	0,5	-2,5	-1,9	-0,2
Spain	3,7	3,1	3,6	4,1	3,5	0,9	-3,8	-0,2	0,1	-1,6	-1,2	2,7

Sorce: Eurostat, Worldbank.

As a result, public debt increased in these countries and one of the criteria for conversion to Euro which sets the ratio for GDP as 60% was passed. Ratio of public debts to GDP had reached to 129.4% in Greece, 116% in Italy and 83.1% in Portugal in 2009 (Overbeek, 2012: 38). Mentioned increase in loans caused decreases in credit notes by credit rating agencies and increases in borrowing costs by increasing concerns about these countries.

CONCLUSION

The economic integration of the European Union gained a different aspect with harmonization of national economy policies, establishing a monetary union called "Eurozone" between specific countries by accepting common (single) currency (Euro) and with accepting single monetary policy. However, there were differences between countries in Eurozone regarding development levels and competence powers of their economies. Convergence criteria called as Maastricht Criteria (regarding inflation, capital budget deficit, public debt ratio, interest rates and exchange rate conversion) and monetary union (1999-2002), which had been established after fiscal harmonization between 1994 and 1997 within the scope of macro-economic framework to minimize differences between exchange rates of countries to be able to converge into single currency, confronted European Union countries with a deeper macro-economic problems.

Decreasing interests after using Euro as a single currency increased the chance to reach cost-effective and abundant capital. Within this period both the public and private sector reached to considerably high levels. Countries under a high debt burden reached cost-effective and abundant loans and this caused tax reductions and increase in public expenditures in these countries. Investments which were to be done on areas to increase economic efficiency and competence were limited. Increasing economic boom increased tax revenue in many countries and this caused higher levels of public expenditures in countries. Maastricht criteria had been ignored, breached by many countries and for this reason macro-economic imbalances between countries came to surface.

Banks in countries such as Spain and Ireland became more fragile because of high-risk loans given to the housing industry. Financialization increased and properties which the banks owned reached considerably high levels. With the help of financial integration, most of the European banks possessed high-risked assets which were based on the U.S. mortgage market. Capital outflow began because of financial crisis and investors started to look for safer harbors. Many banks were affected by this financial crisis because of problems created because of loan repayments as a result of sudden decline in housing prices in countries such as Spain, and because of risky assets which banks owned; in fact, many European banks came to the point of bankruptcy.

Using Euro as a single currency in member countries of Eurozone and handling monetary policy in these countries by European Central Bank (ECB) caused the economies of these countries to be interrelated and adverse events in a Eurozone country spread to other Eurozone countries in a short period of time.

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