

UNIVERSITY
OF MIAMI



THE CURRENT ECONOMIC CRISIS AND FINANCIAL UPROAR IN THE EU

He who blames his failure to a crisis neglects his own
talent and is more interested in problems than in
solutions

A. Einstein

Dr. Maria Lorca-Susino

Dept of Economics and Dept of International Studies

OUTLINE

- The euro: A quick overview
- The euro as a common currency
- The euro and an international and global currency
- The new monetary order
- The EU and the Eurozone:
 - The 1st economic crisis
- The current economic crisis and financial turmoil
 - Greece and the “bail-out plan”
- Final thoughts

UNIVERSITY
OF MIAMI



INTRODUCTION

The euro: an overview

The most dramatic change in the international monetary system since President Nixon took the dollar off gold in 1971.

Robert Mundell

The euro: a common currency area

- The adoption of the euro
 - The only other successful monetary union:
 - The US and the greenback after the Civil War of 1961-65
- Path to the euro:
 - Many trials from 1865 to 1971
 - An alternative in Europe:
 - The Union of Soviet Socialist Republics (USSR): from 1922-1991
 - The Werner Report → the Delors report and its 3 steps to adopt the euro:
 - Nominally on January 1999
 - Physically on January 2002

The Maastricht Treaty

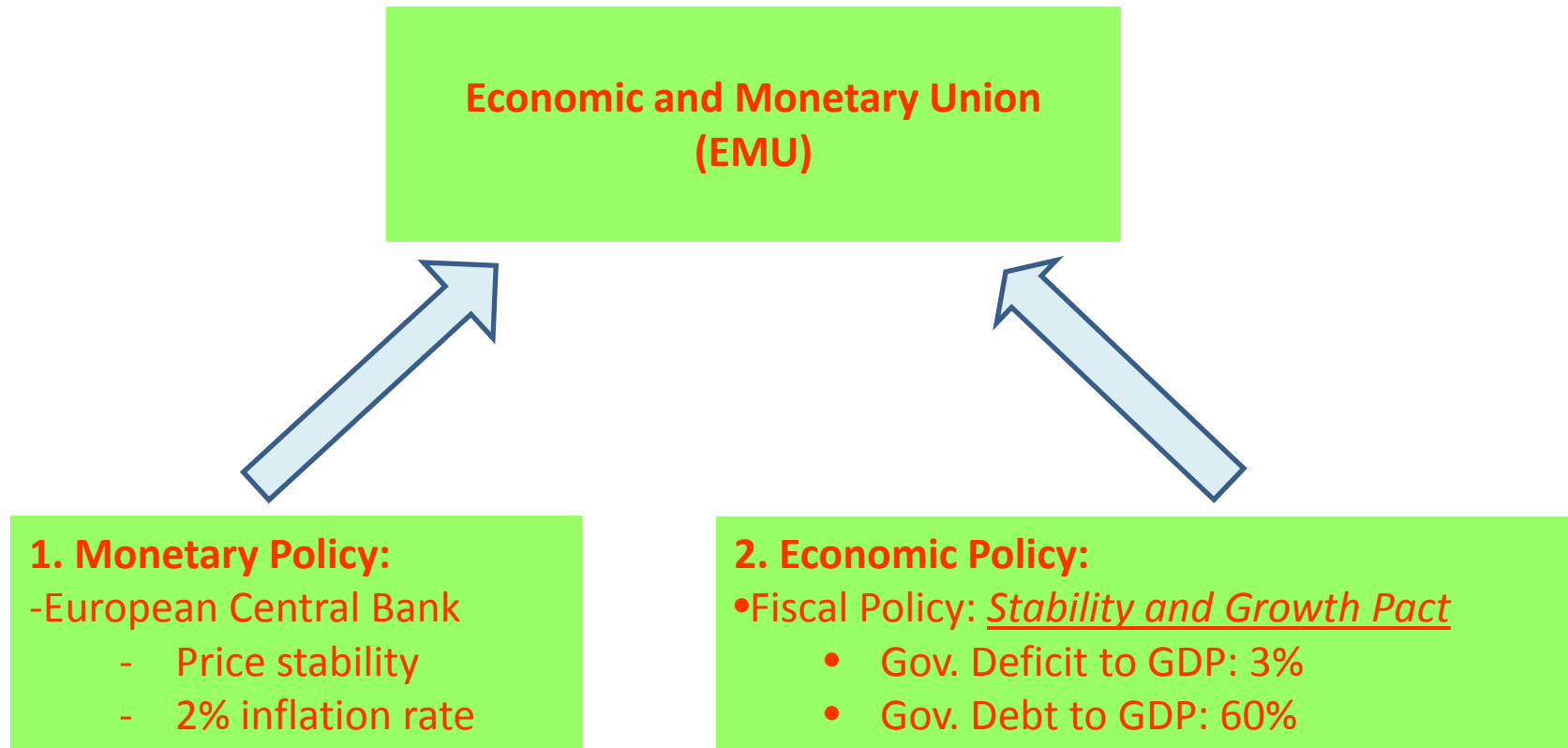
- The set of requirements that must be met to join the euro:

Target	Requirement
Inflation Rate	No more than 1.5 percentage points higher than the 3 best-performing Member States of the EU.
Public finances	The ratio of the annual government deficit to gross domestic product must not exceed 3% at the end of the preceding fiscal year.
Interest rates	The nominal long-term interest rate must not be more than 2 percentage points higher than the 3 best-performing Member States.
Exchange rate stability	Applicant countries should have joined the exchange rate mechanism under the European Monetary System for 2 consecutive years and should not have devaluated its currency during the period.

Denmark, Sweden, and the U.K.

- **Denmark's** national currency, the KROEN linked to the euro through
 - The government has met the economic convergence criteria for participating in the third phase of the (EMU), but a **September 2000 referendum rejected joining the EMU**
 - New Referendum: ?
- **Sweden: rejected the euro in a popular vote** maintains its own currency, the Swedish Krona
 - The Swedish Riksbank founded in 1668 is the oldest central bank in the world
 - Convergence problems – **Working on inflation**
- **The U.K.** The currency is the pound sterling.
 - The Bank of England is the Central Bank
 - **The UK chose not to join the euro at the currency's launch.**
 - British Prime Minister, Gordon Brown MP, has ruled out membership for the foreseeable future.
 - Former Prime Minister Tony Blair promised to hold a public referendum based on a number (five) points.
 - In 2005, more than half (55%) of the UK were against adopting the currency, while 30% were in favour.

Eurozone Member States: EMU and €



Enlargements: 2004 & 2007

Country	EMU entry date	Expected
Cyprus	January 1, 2008	
C.Republic		2013
Estonia	January 1, 2011	
Hungary		2012
Latvia		2013
Lithuania		2013
Malta	January 1, 2008	
Poland		2012
Slovenia	January 1, 2007	
Slovakia	January 1, 2009	
Bulgaria		2012
Romania		2014

Due to economic turmoil these countries will not be making this deadlines since they are far from complying with the Maastricht requirements

Non-EU countries and the euro

Country	Pegged to	Adopted Euro	Agreement signed	Seeking
Monaco	French franc	January 1, 1999	December 31, 1998	
San Marino	Italian lira	January 1, 1999	December 31, 1998	
Vatican City	Italian lira	January 1, 1999	December 31, 1998	
Andorra	French franc Spanish peseta	January 1, 1999	December 31, 1998	Agreement but not membership to EU
Montenegro	German mark	January 1, 2002	Never	Membership to EU
Kosovo	German mark	January 1, 2002	Never	Membership to EU

Existing (struggling) Monetary Union

The East Caribbean dollar: in Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, Saint Kitts and Nevis, Saint Lucia, Saint Vincent, and the Grenadines.



The Central and West CFA franc used by currency used in 12 formerly French ruled African countries plus Guinea-Bissau (Portuguese) and Equatorial Guinea (Spanish)



The East African Shilling used in the East African Community (EAC) between the Republics of Kenya, Uganda, the United Republic of Tanzania, Republic of Burundi, and Republic of Rwanda



The Facto Monetary Union

The euro	is legal tender in Andorra, Kosovo, and Montenegro.
The Hong Kong Dollar	is used in Macau
The Russian rubble	is used in Russia and the Georgian Autonomous republics of Abkhazia and South.
The Swiss franc	in Liechtenstein
The U.S. dollar	is used in Palau, Micronesia, the Marshall Islands, Panama, Ecuador, El Salvador, Timor-Lester, the British Virgin Islands, and the Turks and Caicos Islands.

Planned Monetary Union

Name	Currency	Date
West African Monetary Zone – as part of the Economic Community of West African States (ECOWAS)	Eco	December 2009
Gulf Cooperation Council (GCC)	Khaleeji	2010
Caribbean Single Market and Economy (CSME) as part of the CARICOM	Unknown	Due between 2010-2015
Southern African Development Community	Unknown	2016
Alternativa Bolivarianas para los Pueblos de América (ALBA) - Bolivarian Alternative for the Americas → Bolivia, Nicaragua, Honduras, Cuba, Venezuela, Dominica, and San Vicente-Granadinas (which have the East Caribbean Dollar) and Ecuador is not sure bc it has the US dollar	SUCRE (Sistema Unificado de Compensación Regional)	4 th quarter of 2009 (Oct/Nov/Dec)

UNIVERSITY
OF MIAMI



The euro as an International and Global currency

A global economy requires a global currency

Paul Volker

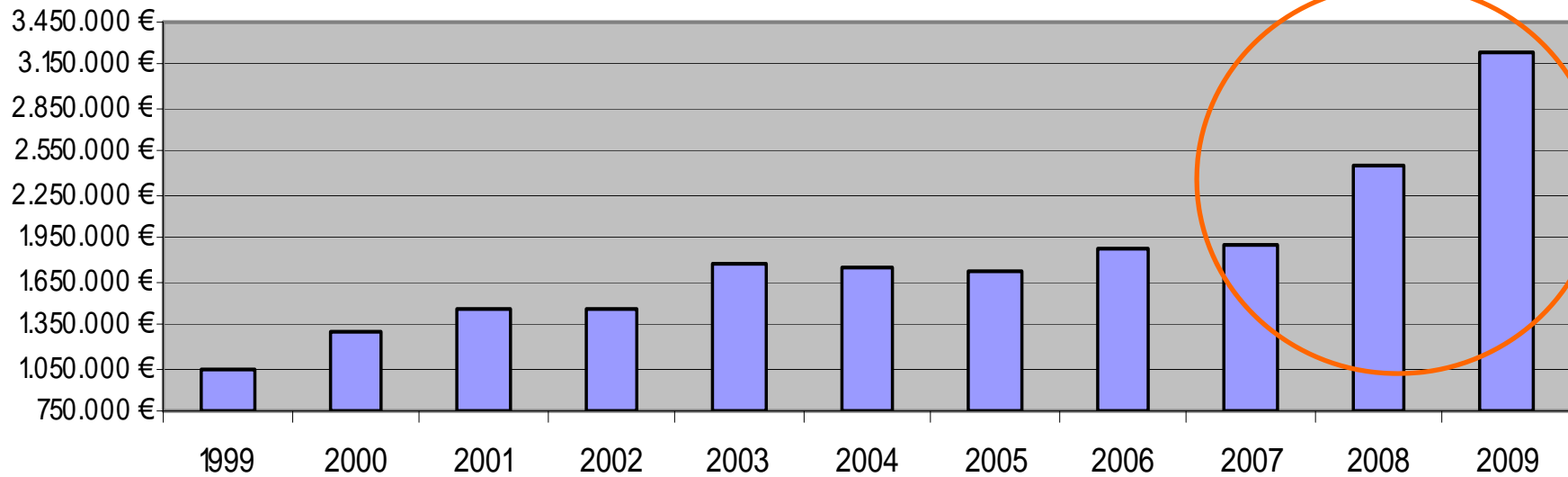
The Euro as an International currency

Function	Private Sector	Official Sector
Unit of account	Invoice	Exchange rate peg
Store of value	Financial Assets	Reserves
Medium of Exchange	Vehicle/substitution	Intervention

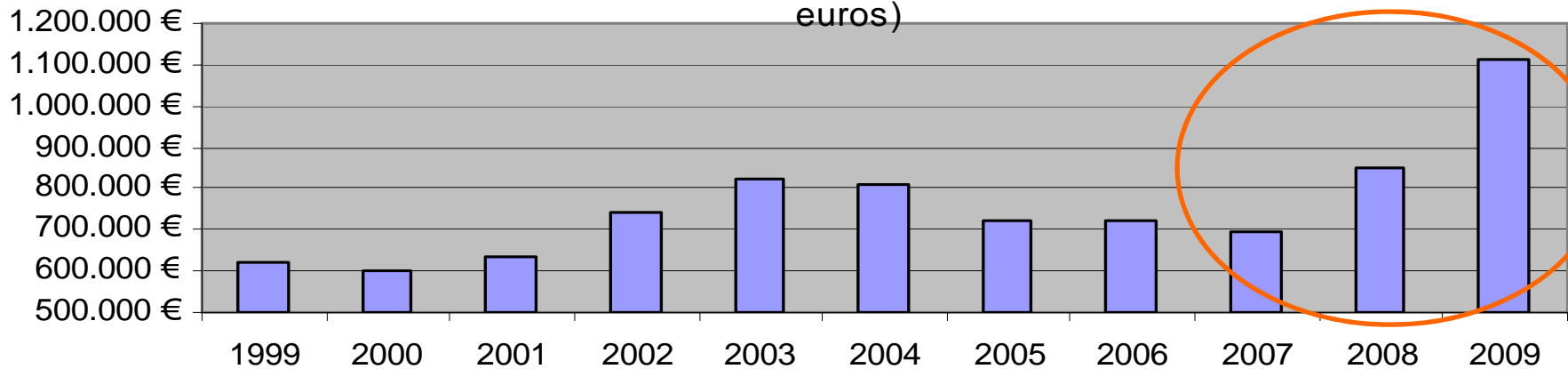
Store of value: Financial Assets

- The **purchasing power** of the euro is measured by the demand of products denominated in euros in the bond, money, and FX market
- Important: **the bond market**
 - Two conflicting patterns
 - Since the introduction of the euro → growth
 - Maastricht criteria → forces government to comply with monetary and fiscal requirements

Graph 2. Total Issuing Activity (mill of euros)



Graph 3. Evolution of Bond Issuing -Central and Local Government (mill of euros)



Governments have increased bond issuance to finance national 'bail-out' plans and increase government purchases

Sharp increase of Government issuing activity

- Jump from year 2007 to 2009
 - Consistent with breaking the requirements
- Consequence: Negative effect on quality & rating of sovereign debt
 - PIIGS or Garlic belt countries
 - S&P, Moody's, Fitch
 - Spain: August 2008 suspended an auction of 15-year bond worth €3,825 mill for LACK OF DEMAND
 - Greece: February 25, 2010 successfully raised €5 billion with a 10-year bond issuance offering higher yields
 - Yield differential with Bund increased even more

Ratings update (as of March 7, 2010)

	Moody's	S&P	Fitch
Austria	Aaa	AAA	AAA
Belgium	Aa1	AA+	AA+
Cyprus	Aa3	A+	AA-
Finland	Aaa	AAA	AAA
France	Aaa	AAA	AAA
Germany	Aaa	AAA	AAA
Greece	A2	BBB+ (*-)	BBB-
Ireland	Aa1	AA	AA-
Italy	Aa2	A+	AA-
Luxembourg	Aaa	AAA	AAA
Malta	A1	A	A+
Netherlands	Aaa	AAA	AAA
Portugal	Aa2	A+	AA
Slovakia	A1	A+	A+
Slovenia	Aa2	AA	AA
Spain	Aaa	AA+	AAA

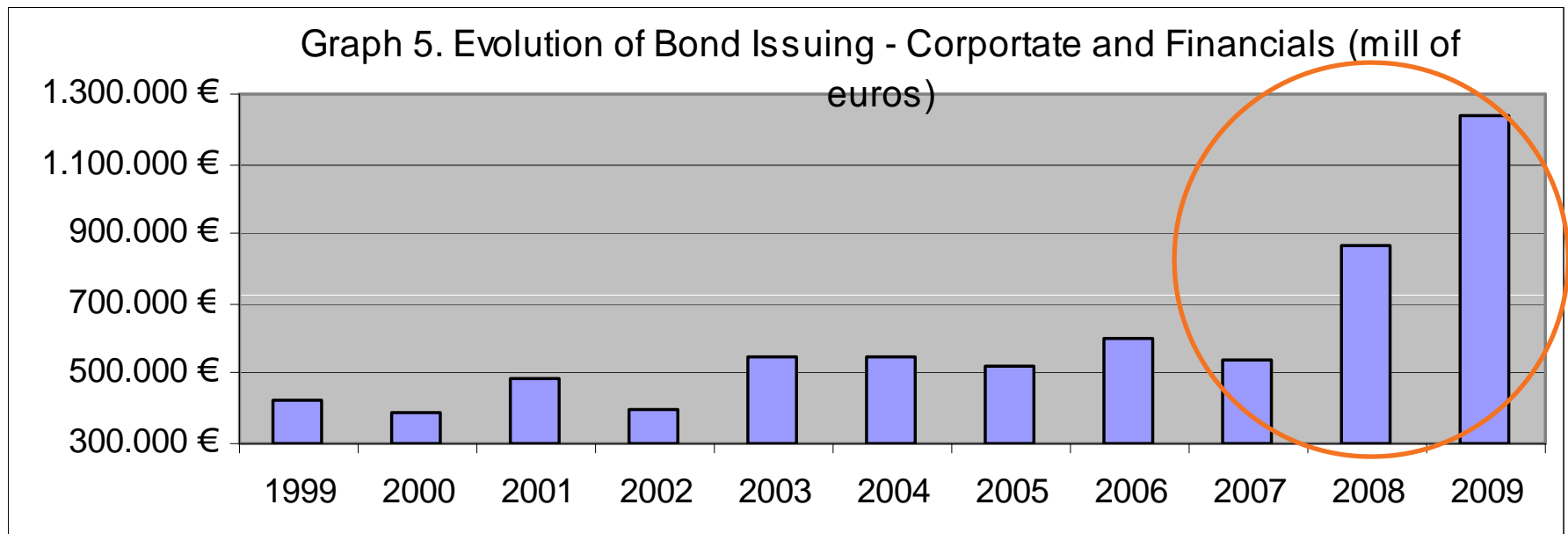
Greece:
March 7, 2011 → Moody's downgrades to B1

Ireland:
April 5, 2011 → Moody's downgrades to Baa1

Portugal:
April 15, 2011 → Moody's downgrades to Baa1

Spain:
March 10, 2011 → Moody's downgrades to Aa1

Corporate and Financial



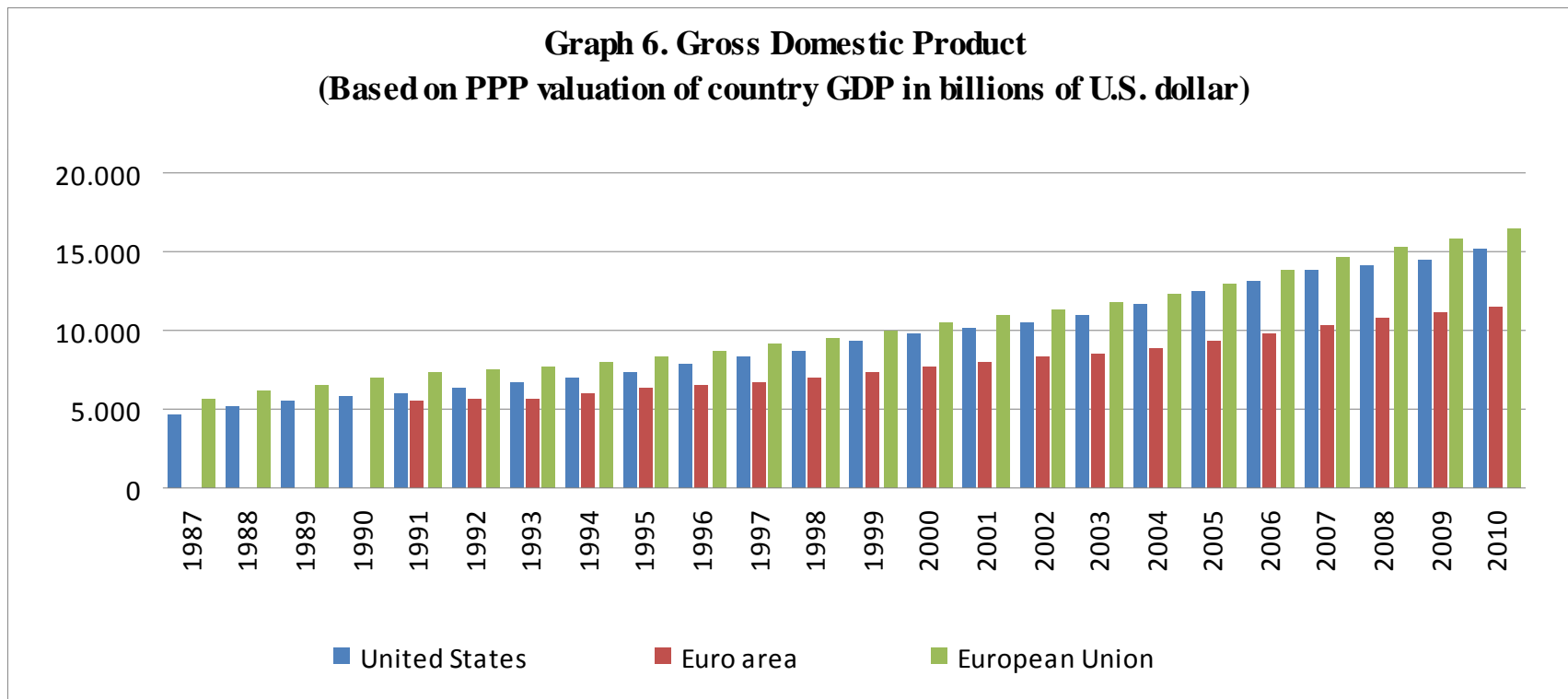
- The rise in corporate and financial bond issuance proves:
 - 1). Euro has facilitated corporations and financial institutions access to market capital
 - 2). Before the euro, government enjoyed a “crowding out effect”
 - 3). Sharp increase from 2007 to 2008 and 2009 due to financing needs

Official Sector: Reserve currency

	1995	1999	2000	2002	2007	2008	2010
Total FX holdings	\$1,3trill	\$1,7trill	\$1,9trill	\$2,4trill	\$6,4trill	\$6,6trill	\$9.2 tri
US\$%	43,92%	54,98%	55,77%	50%	40,64%	40,62%	33,96%
€%	6,35%	13,86%	14,35%	17,74%	16,83%	16,79%	14,55%
Industrial countries							
US%	44,43%					59,6%	56,1%
€%	9,6%					19,9%	21,5%
Emerging and developing countries							
US%	42,91%					29,49%	22,8%
€%	0,36%					14,95%	11,07%

The euro as a global currency to dethrone the US dollar hegemony

- 1. The size of the underlying economy and global trade



In terms of trade 5 of the Eurozone member states are in the top 10 nets exporters

Rank	Exporters	Value €bn	Rank	Importers	Value €bn
1	Germany	1461,9	1	US	2169,5
2	China	1428,3	2	Germany	1203,8
3	US	1287,4	3	China	1132,5
4	Japan	783	4	Japan	763,6
5	Netherlands	633	5	France	705,6
6	France	605,4	6	UK	633
7	Italy	538	7	Netherlands	573,2
8	Belgium	475,6	8	Italy	554,9
9	Russian Fed	471,6	9	Belgium	469,5
10	UK	458,6	10	Rep of Korea	435,3
11	Canada	456,5	11	Canada	418,3
12	Rep of Korea	422	12	Spain	401,4

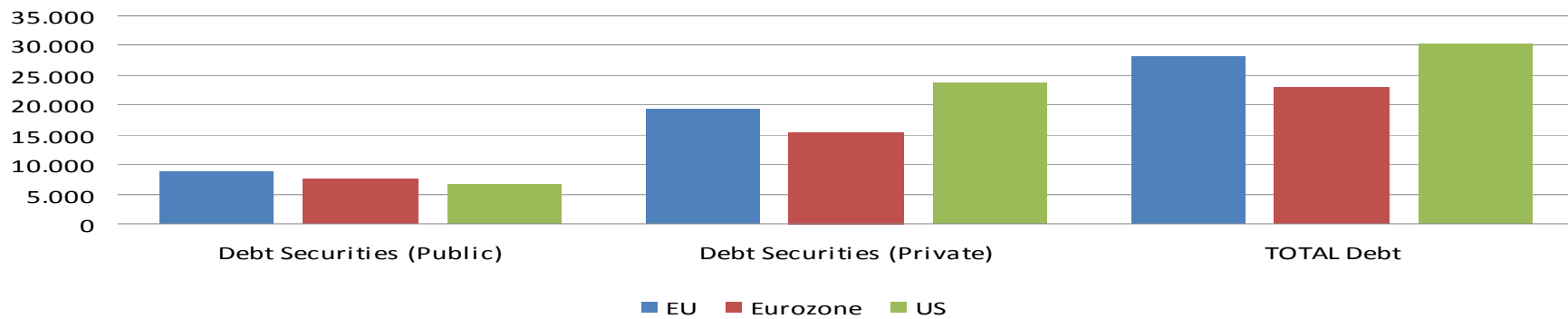
December 2009 → China overtook Germany as the world's top exporter – in 2009 it reached US1.2tr

March 2011 → China hit record high exports in April 2011

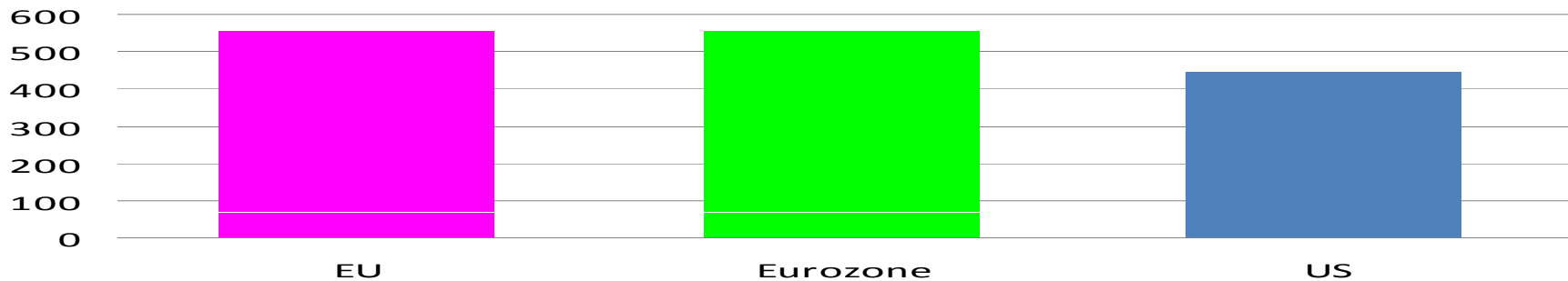
The breadth and depth

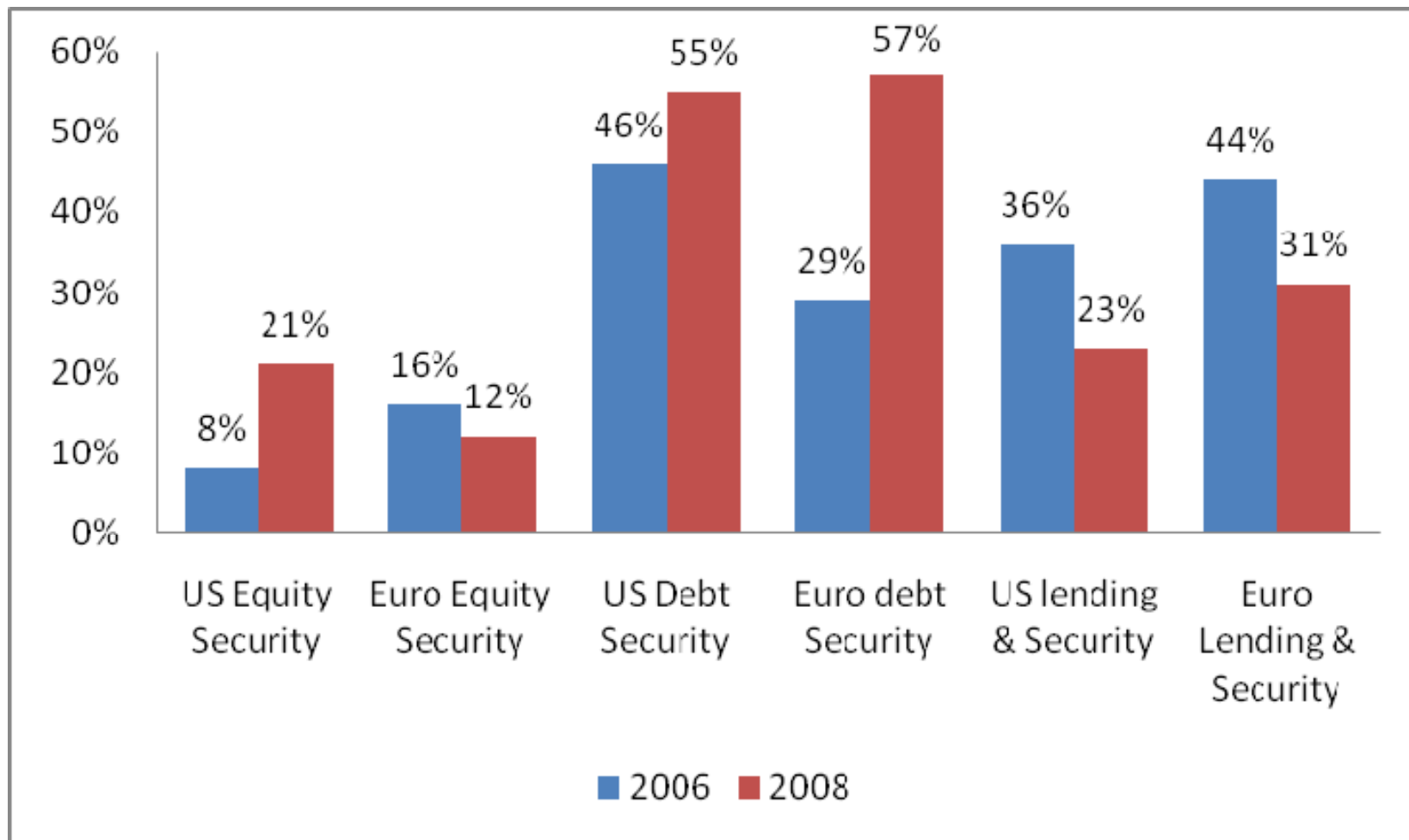
- Breadth of the economy → measures the behavior of capital market
- Depth of the economy → measures by the ration of the financial assets to GDP

Graph 8. Size of the Captial Market, 2007



Graph 9. Bond, Equities & Bank Assets (in % of GDP) (2007)





UNIVERSITY
OF MIAMI



Greece and market instability

The stability of the international monetary system can't hinge on the currency of one single country, even though that is the largest economy in the world

Zhou Ziaochuan

Introduction

- The past two years have been very dramatic for the EU, particularly for the Eurozone.
- In 2010 a sovereign debt problem unfolded in Greece.
 - solving this problem and avoiding contagion: a challenge.
- March 2011 was a decisive month: two dramatic but necessary financial and economic agreements:
 - reinforce the Stability and Growth Pact by automatically implementing harsher financial sanctions for rule breakers.
 - agree, after two years of debate, on establishing the European Stability Mechanism (ESM).

-
- On Nov , 2010 → European Finance Ministers → approve a detailed agreement establishing a permanent crisis mechanism: EMS
 - The purpose → safeguard financial stability in the euro area by expanding the mandate of the European Financial Stability Facility (EFSF).
 - Why? after Greece received the rescue package in May 2010, however, the situation in Greece has not improved, and other countries have shown the need for economic support.
 - The EMS is ready to lend around €500bn, or about \$710bn
 - Supposed to operate in 2013 to replace the current EFSF.

Structure

- 1. Summary Greek situation by analyzing the two rescue plans
- 2. reviews and compares default cases such as Asia and Argentina
- 3. actions that have been taken to save the rest of the euro area countries
- 4. pinpoints the measures taken are not enough to settle the financial markets.

Understanding the Greek Conundrum: Two Rescue Plans and One Mission

- In May 2010 → bankruptcy with a country debt expected to reach about €350bn by 2014.
- Greece has not respected the Stability and Growth Pact
- Greece used “creative accounting” to work out the numbers on its national accounts in 2009, which led to the budget crisis in 2010.
 - in 2008 Greece presented budget deficit estimates for 2009, which stood at about 6.7% of GDP
 - in October 2008 the newly elected Greek government revised the estimate: from 6.7% of the gross domestic product (GDP) to 12.7% of GDP
 - It was then explained that Goldman Sachs helped Greece → obscure billions in debt from the budget overseers in Brussels.

The First Bail-Out

- The FIRST lending facility, or bailout, of €110bn (\$146.2Bn) on May 2, 2010
 - €30bn in standby agreement with the IMF and €80bn from euro area member states in the form of bilateral loans
- The terms of the bail-out : three year bailout plan that Greece would have to repay with an interest of 7.5%.
- The first loan, worth €30bn, was given before May 19, 2010 → the date by which Greece had to make debt repayment and avoid defaulting on its massive debt.
- IN RETURN: Greece was sked to take some extreme austerity measures: cut €30bn over the next three years → reduce public debt from 13.6% in May 2010 to less than 3% by 2014.
 - Some of these austerity measures:
 - scraping bonus payments for public sector workers,
 - capping annual holiday bonuses,
 - increasing the Value Added Tax from 21% to 23%,
 - raising taxes on fuel, alcohol, and tobacco by 10%
 - and taxing illegal construction



One year later....

- In July 2011 → Greece asked for more money
 - Important: Greece was still entitled to the last payment of the first bail-out plan
 - €12bn payment due on June 29, 2011
 - The IMF asked for even more austerity
 - Greece promised: €14.32bn of public spending cuts and €14.09bn of tax increases for 5 years
- The second bail out: €109bn in new loans
- In return: Greece agreed to about €78bn in additional austerity measures and asset sales through 2015.
 - €6.4 billion spending cut from June 2011 to December 2011,
 - another €22 billion up to 2015,
 - and €50 billion in sales of assets.
 - This time some sacrifice on the bondholders' side.

Greece is NOT alone

- Default: Greece should be left to default and self-organize: Argentina.
- “Default”:
 - Mexico first country which had difficulties.
 - the US provided funding with about \$50bn in loans.
 - The East Asian crisis was different.
 - Those countries helped either by the IMF, the World Bank, G7 countries, or a combination.
 - Thailand—the first country in the area which ran into financial difficulties → the US did not rush to save it → this country was regarded as insignificant → The 1997 East
 - This lack of response on the part of the US has been blamed and used to explain the spillover effect to the rest of the area.
 - Years later, Russia ran into sovereign debt difficulties and defaulted selectively after receiving some help.
- Alternatives to Greece:
 - No restructuring
 - Voluntary restructuring
 - Forced restructuring

Not alone in Europe

Country	Amount in euros
Greece	110bn in May 2010
Ireland	85bn in November 2010
Portugal	78bn in April 2011
Greece 2 nd bail out still under debate	102bn in July 2011

The EFSF has already committed about €256 billion out of the €440bn available to help Greece, Portugal and Ireland.

ESM and EFSF: the No Bailout rule

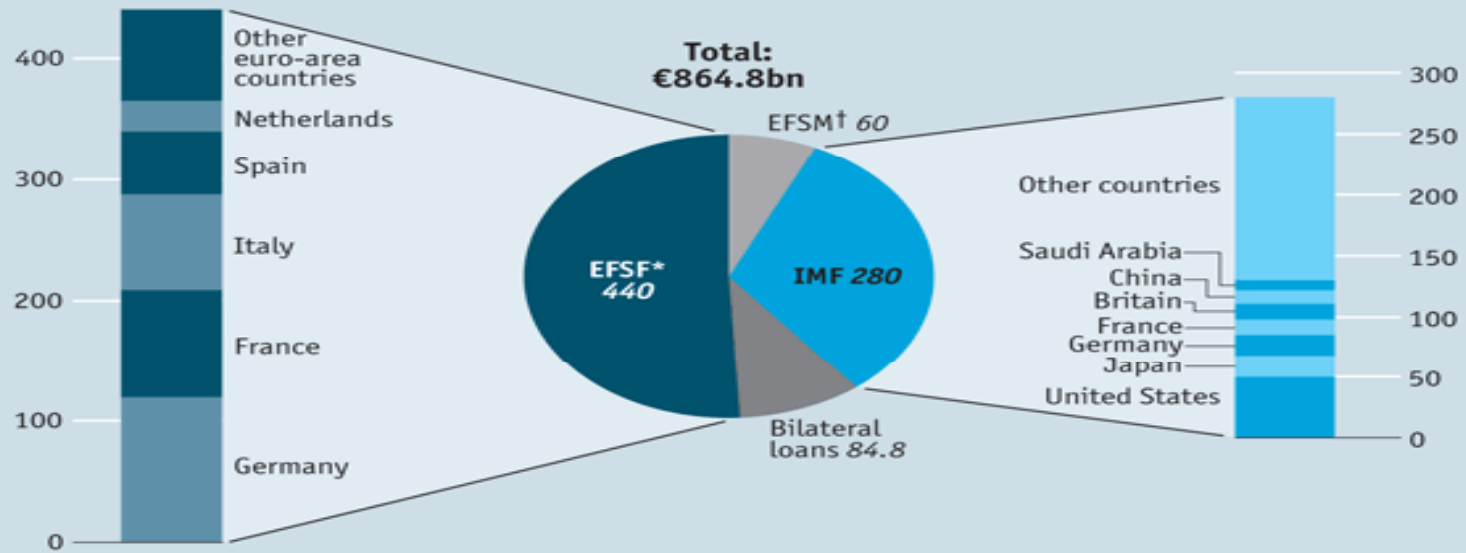
- EU approved 3 lending facilities in May 2010 to deal with Greek sovereign debt crisis and stop it might spread to other countries.
 - Deal with the no bail-out rule and art 125:
 - Article 12531 (ex Article 103 TEC) states that neither the EU nor a member state should be liable or assume the commitment of any public body or entity of any member state.
 - This article directly bans any direct fiscal transfers from one member state to another and also seems to ban purchases of sovereign debt in the primary market
- On May 11, 2010: the Council of the European Union approved the Council Regulation (EU) No 407/2010, which established the European financial stabilization mechanism
 - the No-Bail out rule of Article 125 was bypassed using Article 122(2) of the Treaty.

EFSM

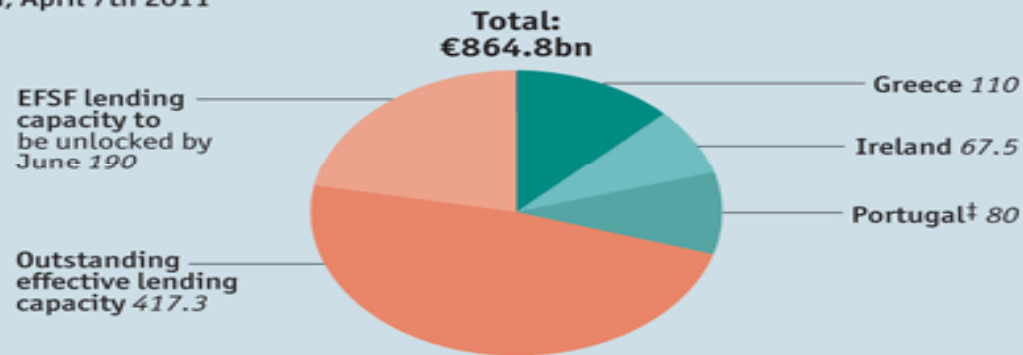
- On May 9, 2010, the EU's finance ministers adopted a regulation establishing a European Financial Stabilization Mechanism (EFSM)
 - 2nd Facility: maximum total lending capacity of €60bn from the EU budget and administered by the European Commission
 - 3rd Facility: the capacity to issue bonds guaranteed by EAMS for up to €440 billion for on-lending to euro area member states (EAMS) in difficulty, subject to conditions negotiated with the European Commission, and in liaison with the European Central Bank and International Monetary Fund, and to be approved by the Eurogroup.
 - International Monetary Fund: €250bn

European bail-out funds

Sources, €bn, April 7th 2011



Allocation, €bn, April 7th 2011



Sources: EFSF; European Commission; IMF; *The Economist*

*European Financial Stability Facility
 †European Financial Stabilisation Mechanism ‡Estimate

Where is this money coming from?

Country	Amount
Germany	119,390.07 (27%)
France	89,657.45 (20%)
PIIGS	161,562.71 (36%)
Portugal	11,035.38
Ireland	7,002.40
Italy	78,784.72
Greece	12,387.70
Spain	52,352.51

The European Banking System: The Stress Tests of Europe

- On July 16, 2011, Europe presented to the world the result of the —stress test on the strength of the banking system.
- The purpose: to measure the resistance of European banks during economic instability.
 - to study and report publicly on the —health situation of the European banking system to calm the markets and reassure investors that the European banking system is solid.
- The idea: inspired by the US banking crisis and, particularly, due to the difficult situation of Greece.
- The institution: Committee of European Bank Supervisors (CEBS)
 - to create scenarios, analyze the exposure and make projections.

How Many??

- To date there have been three stress tests.
- The first: in September 2009 when the CEBS ran a very limited stress test on 22 banks that went almost unnoticed because the results were not made public.
- The second: in July 2010, pressured by the events that unfolded in Greece and the exposure of European banks to a possible Greek default.
 - 90 banks were tested.
- The third: published on July 16, 2011.
 - approximate 65% of the European banking sector and 50% of the sector in each country

BASEL

- Banks are now forced to implement Basel III
- Basel III : helped estimate exposure of the banks tested to Greece's financial difficulties is €98.2bn (\$138bn)
 - €10bn less than during the second stress test in July 2010.41
 - If Greece goes under, European banks will lose \$138bn
- Basel I: deliberations and agreements among central bankers from around the world who met in Basel (Switzerland) in 1988 to set the minimal capital requirements needed for the proper functioning of banks to reduce credit risk.
 - This agreement, the 1988 Basel Accord, had to be enforced by 1992.
- Basel II: expanded the requirements and guidelines of Basel I
 - Introduced the three pillars : minimum capital requirement, supervisory review and market discipline.
 - Guidelines in Basel II were the norm in 2004,
- Basel III: the need to put together a better banking system after the financial crisis of 2007 and would apply to more than 8,000 banks in the EU alone but also in the US.
- It has been defined by the Bank of International Settlements as: a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision to strengthen the regulation, supervision and risk management of the banking sector and it is based on the need to improve the banking sector's ability to absorb shocks arising from economic and financial stress, improve risk management and governance, and strengthen the transparency and disclosure of banks.

Where is the problem with Basel III

- The EU has become the first area where these —rules have become law and the so-called Capital Requirement Directive 4, which forced large banks to have bigger and better levels of capital ready in order to face a crisis,
- Capital requirements:
 - 1. the common equity tier one (CET1) is increasing from 2% to 4% of risk-weighted assets, but the problem is that there are 14 strict criteria to determine what can be counted as CET1.
 - 2. implement a —Capital Conservation Buffer—which should account for 2.5% of risk weighted assets.
 - PROBLEM: a total capital requirement of 7% that must be taken into account.
 - This extra reserve requirement poses two intertwined threats to the system.
 - First, banks have to put more money —away to comply with this requirement which, in turn, will mean that there might be less money available for the banks to lend; this will reduce the liquidity available.
 - Second, if the EU is the only area or country to implement these requirements, the EU would be at a disadvantage with less capital available.
- Altogether, banks in the EU must come up with €84bn of CET1 capital by 2015 and €460bn by 2019, and reduce their risk and balance sheets substantially.



UNIVERSITY
OF MIAMI



THE OUTCOME: A SOUP OF LETTER

Churchill once said:

you can always count on the Americas to do the right things---after they have tried everything else.

THE BAILOUTS

- Two vehicles to save the Eurozone:
 - 1) The European Financial Stability Facility (EFSF) → €440 bn in loans from plus the IMF, the European Commission and other → \$622 bn
 - 2) The European Stability Mechanism (ESM) → will take effect in 2013 → \$996bn
- Bailouts so far:
 - Greece → 110bn
 - Ireland → 67.5bn
 - Portugal → 80bn

UNIVERSITY
OF MIAMI



Final Thoughts

That which does not 'kill' us makes us stronger
Friedrich Nietzsche

-
- The EU and the Eurozone are in serious danger
 - Lack of supervision (see no evil, hear no evil, speak no evil)
 - This shows negligence → EU politicians should be held accountable
 - Common fiscal policy → not viable
 - Budget will be imposed → fiscal sovereignty
 - Politicians are not longer needed...
 - If PIIGS are asked to leave:
 - Currency devaluation with lack of comp → immediate bankruptcy
 - What about Germany leaving the EU?
 - Best economy in the area and record high export rate despite euro
 - FX vendors still maintain the DEM as a currency
 - Solution is not:
 - The European Monetary Fund
 - Institution to supervise financial activity

Thank you

