The euro zone crisis
Its dimensions and implications

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Foreword

In the rush to produce urgent policy documents and briefing notes that any government has to do, it is easy to let matters that may not be quite as urgent to go unattended. However, the not-so-urgent often includes matters of great importance for the long-run well-being of the nation and its citizenry. Research papers on topics of strategic economic policy fall in this category. The Economic Division in the Department of Economic Affairs, Ministry of Finance, has initiated this Working Paper series to make available to the Indian policymaker, as well as the academic and research community interested in the Indian economy, papers that are based on research done in the Ministry of Finance and address matters that may or may not be of immediate concern but address topics of importance for India's sustained and inclusive development. It is hoped that this series will serve as a forum that gives shape to new ideas and provides space to discuss, debate and disseminate them.

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Disclaimer and Acknowledgements

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Abstract

The sovereign debt problems in the peripheral economies of the euro zone has started to pose a serious threat to the main economies of the Europe and perhaps to the future of the 'euro' itself. Such a situation is a far cry from the optimism and grand vision that marked its launch. This paper is an attempt to understand the implications of the ongoing euro zone crisis and the factors that make it somewhat unique as the contradictions of a monetary union without a fiscal union are coming to fore. The paper shows that the crisis is not merely related to sovereign debt and bank financials but also rooted in the real economy with structural problems. The manner in which the crisis is dealt is likely to be of far reaching significance to Europe and to the rest of the world. The stage seems set for a change in the way in which the euro zone will need to manage its monetary, fiscal and financial system.

The euro zone crisis
Its dimensions and implications

Over the last two years, the euro zone has been going through an agonizing debate over the handling of its own home grown crisis, now the 'euro zone crisis'. Starting from Greece, Ireland, Portugal, Spain and more recently Italy, these euro zone economies have witnessed a downgrade of the rating of their sovereign debt, fears of default and a dramatic rise in borrowing costs. These developments threaten other Euro zone economies and even the future of the Euro.

Such a situation is a far cry from the optimism and grand vision that marked the launch of the Euro in 1999 and the *relatively* smooth passage it enjoyed thereafter. While the Euro zone may be forced to do what it takes, it is unlikely that the situation will soon return to business as usual on its own. Yet, this crisis is not a currency crisis in a classic sense. Rather, it is about managing economies in a currency zone and the economic and political tensions that arise from the fact that its constituents are moving at varying speeds, have dramatically different fiscal capacities and debt profiles but their feet are tied together with a single currency.

Given the large economic weight of the euro zone in the globe, and regularity with which the crisis is spreading from one euro zone economy to the next, the stage for palliatives is over. The manner, in which the euro zone crisis is dealt this point onwards, is likely to be of far reaching significance to the world. This paper shows that the crisis is not merely of sovereign debt and bank financials but also rooted in the real economy with structural problems. The stage is set for a change in the manner in which the euro zone will have to manage its monetary, fiscal and financial system.

This paper is an attempt to understand the implications of the euro zone crisis in the light of the developments subsequent to the creation of the euro. Starting with a background in section 2, the paper analyses the factors that make the euro zone crisis unique in section 3. Section 4 delineates the significance of the ongoing developments which is followed by a few concluding observations.

Section 2
The Euro Zone: A background

On January 1, 1999 eleven European countries decided to denominate their currencies into a single currency. The European monetary union (EMU) was conceived earlier in 1988–89 by a committee consisting mainly of central bankers which led to the Maastricht Treaty in 1991. The treaty established budgetary and monetary rules for countries wishing to join the EMU - called the "convergence criteria"[i]. The criterion were designed to be a basis for qualifying for the EMU and pertained to the size of budget deficits, national debt, inflation, interest rates, and exchange rates. Denmark, Sweden, and the United Kingdom chose not to join from the inception.

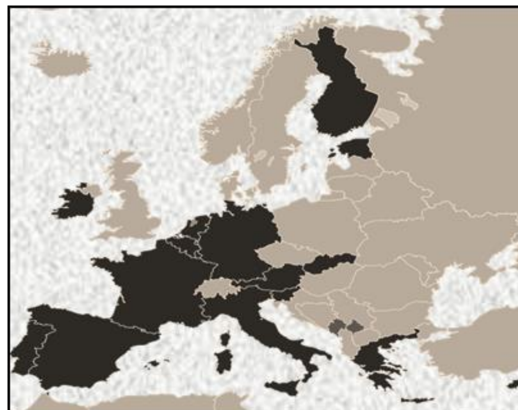

Figure 1. The Euro Zone,
Source ECB

The "Euro system" comprised the European Central Bank (ECB),with 11 central banks of participating States assuming the responsibility for monetary policy. A large part of Europe came to have the same currency much like the Roman Empire, but with a crucial difference. The members were sovereign countries with their own tax systems. Greece failed to qualify, but was later admitted on 1 January 2001. The 'Euro' took the form of notes and coins in 2002, and replaced the domestic currencies. From eleven euro zone members in 1999, the number increased to 17 in 2011[ii].

Justification for the Euro: The overarching justification for the Euro was not merely economic, but political[iii]. A single currency was perceived as a symbol of political and social integration in the post WW II Europe and a catalyst for further integration in other spheres. At the micro level, the use of a common currency was expected to increase cross-border competition, integration and efficiency in the markets for goods, services and capital. These developments were expected to reduce transactions costs (Hämäläinen: 1999). The underlying logic for economies to integrate and adopt a single currency was based largely on the 'Theory of Optimum Currency Areas (OCA)', pioneered in the seminal work of Robert Mundell (1961).

At the macroeconomic level, a single monetary policy in the euro area was expected to be geared to price stability. According to the ECB, the monetary policy in the Euro system has been guided by two "pillars". First, an inflation target broadly based on an assessment of future price developments and the risks to price stability in the euro area measured by the Harmonized Index of Consumer Prices (HICP) and second, a "reference value"— not a specific monetary target— for the growth of a broad monetary aggregate.

The Euro system's commitment to price stability was expected to contribute to the long-term stability and credibility of the euro and promote its attractiveness as a trading and investment currency. In the long run, the development and integration of the euro area financial markets was expected to enhance the attractiveness of the euro. The Euro was also expected to become an important currency in the foreign exchange markets.

Convergence, cohabitation and divergence**:** Since the euro came into existence in 1999, and later in the physical form in 2002, there remained some skepticism on its future as some members had failed to stay within the norms under the growth and stability pact. Nevertheless, the euro area money and financial markets saw rapid changes with the introduction of a new currency. Bond markets that were segmented got integrated in short period. From 1999 to 2002, and then on, there was convergence in the yields on government bonds (figure 2a). Interest rate dispersion between the rates offered by different banks in also declined (Figure 2b). The dispersion of country short term rates measured also reduced.

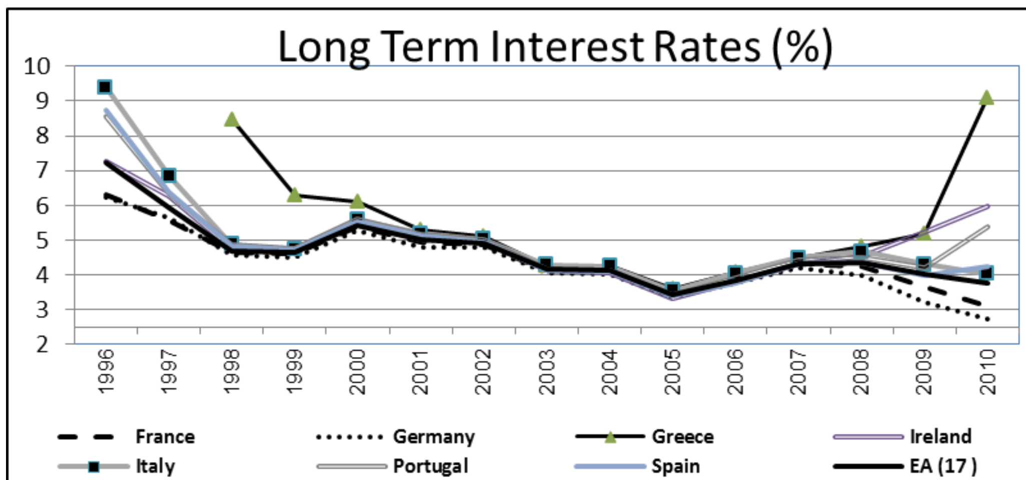

Figure 2a
Source: OECD data

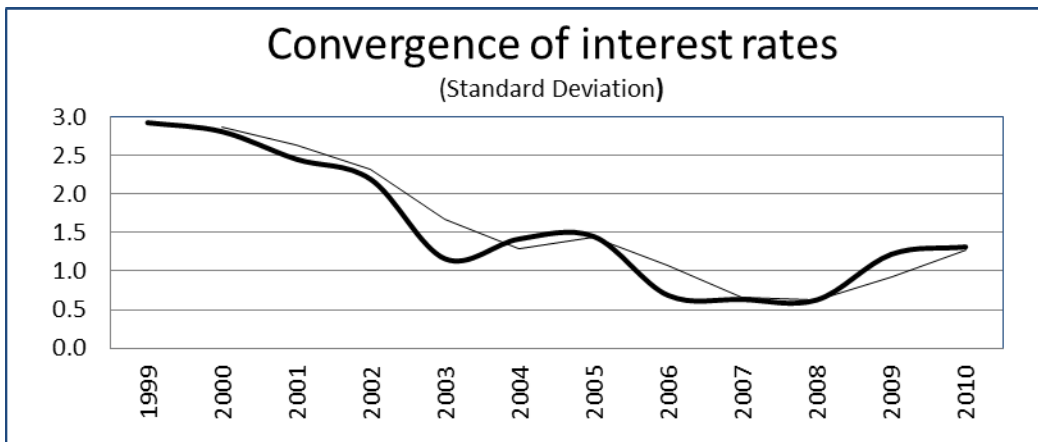

Figure 2b
Source: Eurostat data

Increased competition, the establishment of common benchmarks and lower transaction costs led to narrowing of yield and spreads and market liquidity across borders. These changes were facilitated by the TARGET[iv] system that linked large-value national payments in the EU. Thus similar instruments traded in the different national markets came to be perceived as close substitutes.

The convergence in interest rates meant a fall in nominal rates in the peripheral economies towards the lower German levels (figure 2a). Credibility of the monetary policy on price stability and the accompanying economic growth were seen as positive outcomes of a single market and a seemingly stable common currency.

Credit growth surged as currency risk premium diminished and competition spurred financial innovations as financial institutions could borrow easily abroad (figure 3a). The growth in credit was concentrated in the housing sector. Construction and financial services grew rapidly thereby increasing macroeconomic vulnerability. While property prices boomed (figure 3b), the credit growth got translated into a buildup in debt.

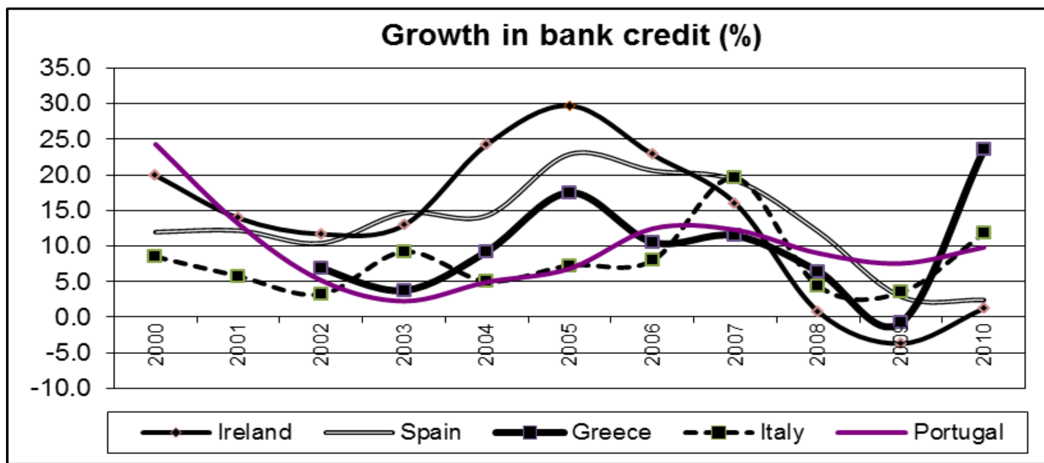

Figure 3a,
Source: IMF, IFS data

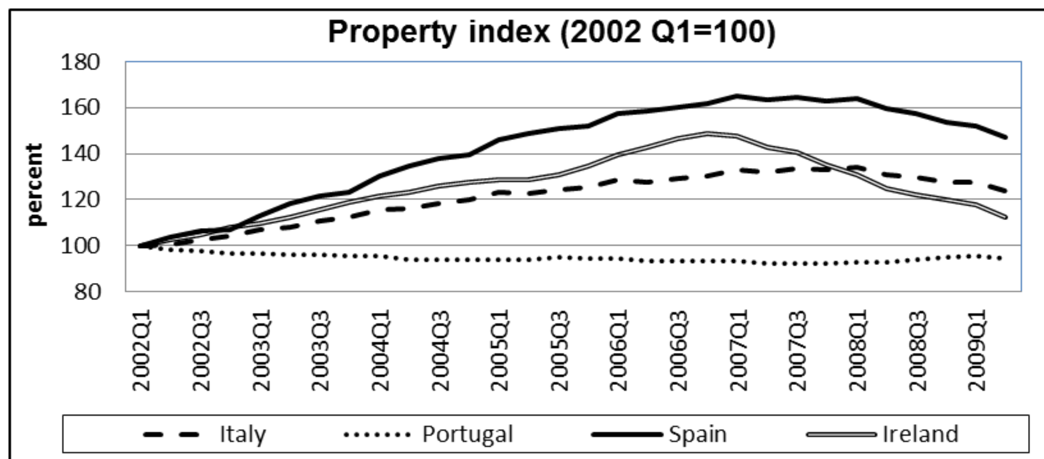

Figure 3b
Source: FT. com

Faster growth hid the weakness in the fiscal system that got revealed with the worsening in the fiscal deficit and public debt (Annex table). Growth was also accompanied by a rise in demand for imports and, in turn, a larger current account deficit from 2003. The rise in the twin deficits (figure 4a and 4b) were financed largely through debt, especially, in the case of Greece. So long as growth was strong, it was hard to make out whether there had been an improvement in the fundamentals, or it was a bubble. Till 2005, the general growth momentum was in place, perhaps waiting *for a trigger*.

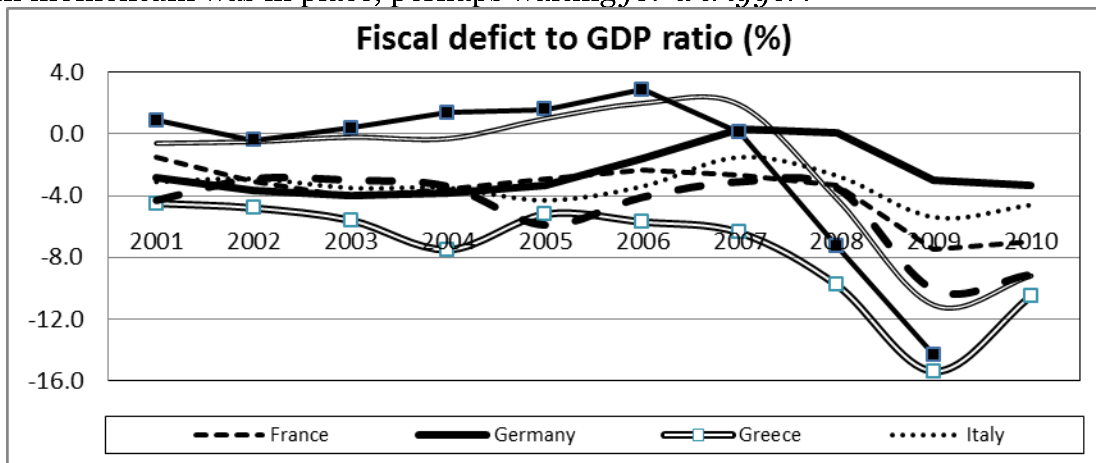

Figure 4a
Source: Eurostat

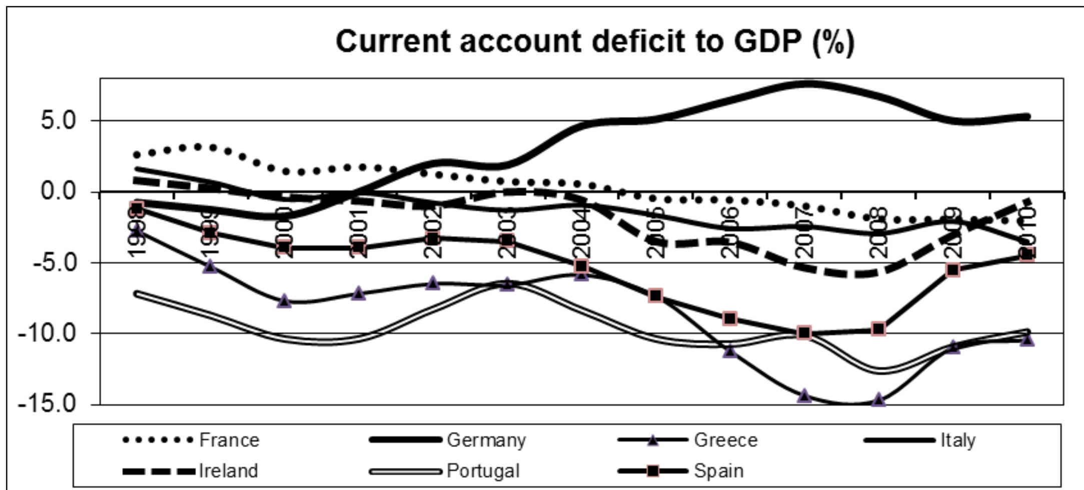

Figure 4b
Source; Eurostat

Section 3
From Global crisis to the Euro zone crisis

The global financial crisis in 2007–08 acted as the trigger that set the snow ball of debt rolling across Europe and in the euro zone as growth declined sharply (figure 5). The financial crisis led to disruption in financial intermediation. The credit boom from 2003 lasting till early 2007 was supported by falling interest rates. But from 2006, interest rates across euro zone started to diverge, marking out the weak from the strong economies (as shown in figure 2a). Excessive lending had left banks with bad debts and governments with large fiscal deficit and public debt in the peripheral economies (albeit of varying magnitudes).

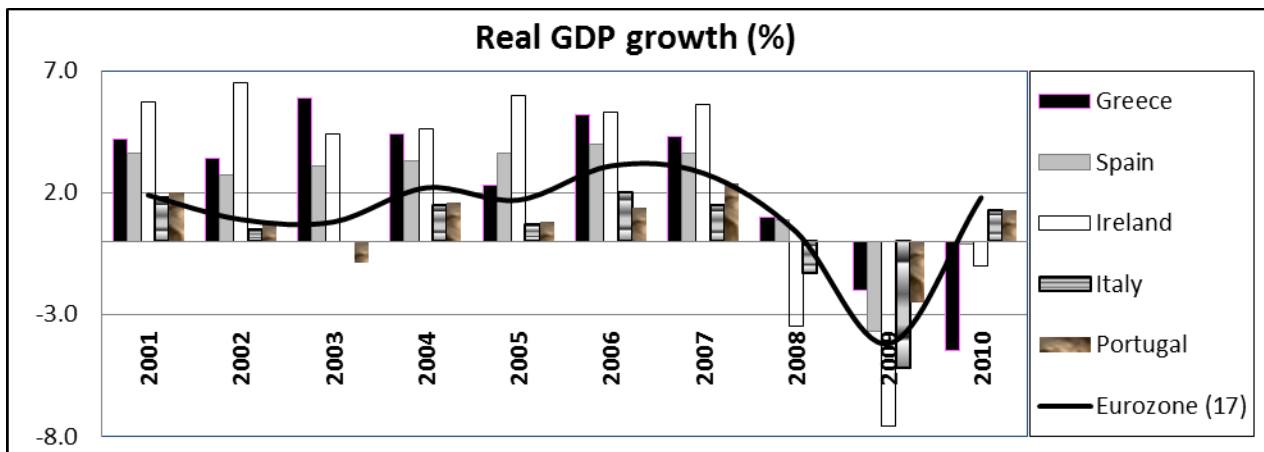

Figure 5
Source: Eurostat

In order to meet liquidity problem arising from financial crisis, on 11 October 2008, the EU held an extraordinary summit in Paris to define a joint action for the euro zone and agreed to a bank rescue plan to boost their finances and guarantee interbank lending. Coordination against the crisis was considered vital to prevent the actions of one country harming another and exacerbating bank solvency and credit shortage.

The various emergency measures announced to counter financial crisis during 2008-2009, appeared to have been successful in averting financial crisis and supporting short-term domestic demand. However, they aggravated fiscal deficit and debt. In late 2009, Greece admitted that its fiscal deficit was understated (12.7 % of GDP, as against 3.7 % stated earlier). Ratings agencies downgraded Greek bank and government debt. In late 2009, its public debt was over 113 % of GDP, far more that the euro zone limit of 60 %. A crisis of confidence due to high fiscal deficit and debt was marked by widening bond yields and risk insurance on credit default swaps. By early 2010, a sovereign debt crisis in the euro zone was clearly on hand with Greece in the eye of the storm. The problems of Ireland, Portugal and Spain were also out in the open. Even though, the configuration of fiscal deficit, public debt, private debt and bank lending across these economies was considerably different, the financial markets passed a similar judgment through a rise in the CDS premiums, albeit differentiated (figure 6). After all, the global financial crisis had brought home an important lesson - that on the extreme, all private debt could potentially be public debt.

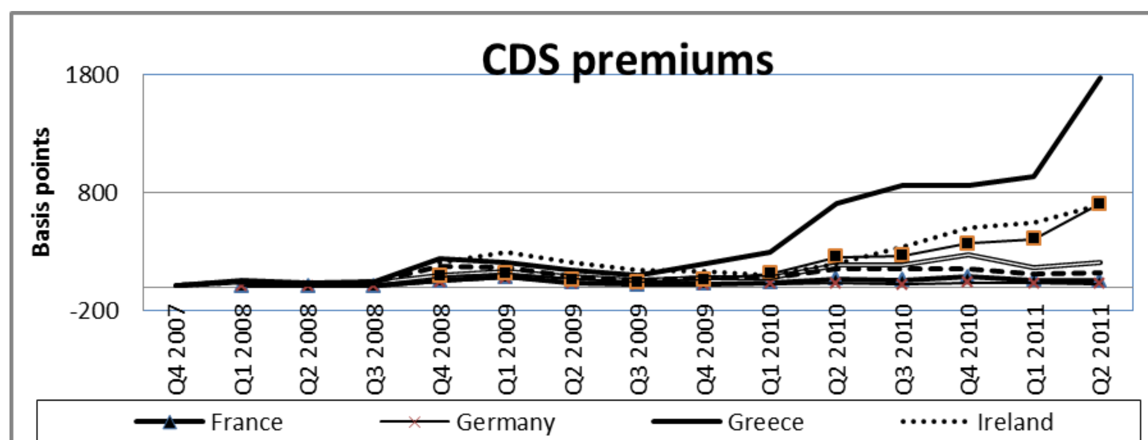

Figure 6
Source: Datastream

On 2 May 2010, to reassure investors confidence, the EU and IMF put together a €110bn bailout package for Greece conditional on implementation of austerity measures. This was followed on 9 May 2010 by a decision by 27 member states of the European Union to create the European Financial Stability Facility (EFSF), a special purpose vehicle, in order to help preserve financial stability in Europe by providing financial assistance to euro zone states in difficulty. The EFSF was empowered to sell bonds and use the money to make loans up to a maximum of € 440 billion to euro zone nations. The bonds were to be backed by guarantees given by the European Commission representing the whole EU, the euro zone member states, and the IMF. The EFSF combined the € 60 billion loan coming from the European financial stabilization mechanism (reliant on guarantees given by the European Commission using the EU budget as collateral) and a € 250 billion loan backed by the IMF in order to obtain a financial safety net up to € 750 billion. The agreement allowed the ECB to start buying government debt which was expected to reduce bond yields. As per the conditions, Greece was to mobilise $ 70 billion by way of privatisation of its state enterprises [v]. In November, 2010 EU and IMF agree to bail-out the Irish Republic with 85 bn Euros. The Irish Republic soon passes the toughest budget in the country's history.

The measures taken in May 2010 had a palliative effect. Serious doubts remained on the ability of Greece to service its debt and bond yields started to spike again. In April 2011, Portugal admitted that it could not deal with its finances and asked the EU for help. In May 2011, European finance ministers approved euro 78 billion rescue loans to Portugal. Meanwhile, Moody's lowered Greece's credit rating to junk status on June 1 2011 (to Caa1 from B1).

An extraordinary summit was again convened on 21 July 2011 in Brussels. The leaders decided to take measures to stop the risk of contagion. They agreed on a further bailout for Greece for 109 billion euros with the participation of the IMF and voluntary contribution from the private sector in order to cover the financing gap. The EFSF was indicated as the financing vehicle for the disbursement with regular assessment by the Commission in liaison with the ECB and the IMF.

The agreement included extending the loan repayment periods and a cut in interest rates. To prevent the possible contagion, the leaders agreed to increase the flexibility of the EFSF to be able to lend to states preventively on the basis of a precautionary programme. The EFSF was empowered to recapitalize financial institutions through loans to governments even in those countries that were not under any programme. Further the EFSF was allowed to intervene in the secondary markets to deal with exceptional financial market circumstances and in the event of a risk to financial stability.

To increase fiscal consolidation and growth in the euro area, the 17 leaders pledged continued support to the countries successfully implementing their programmes. They agreed to apply to Portugal and Ireland the same EFSF lending conditions that they confirmed for Greece, i.e., extended debt maturities to a minimum of 15 years and reduced interest rate to around 3.5 %. It was agreed that all the euro area member states would strictly adhere to the agreed fiscal targets. In addition to solving their eventual macro-economic imbalances, the member states (with the exception of those under a programme) are to reduce their deficits below 3 percent by 2013. As an additional measure, the leaders invited the European Investment Bank to help the countries receiving EU and IMF assistance in absorbing the funds.

All these measures have so far failed to assuage the financial markets. The indications are that the financial markets continue to be deeply sceptical about their effectiveness. While Greece remains an extreme case, the problem of public and private debt (in varying proportions) in other peripheral economies like Ireland, Portugal, Spain and Italy are also a source of concern albeit with their own peculiarities. We recount some of the specificities of the problem faced in these economies before reverting to the overarching dimensions and implications of the euro zone crisis.

Ireland: The case of Ireland has been marked by an almost whole sale nationalization of the banking sector that translated into severe fiscal stress. But not long back, the Ireland was hailed as the Celtic tiger for its economic dynamism. The economy expanded rapidly during 1997–2007 with investment stimulated, in part, due to a low corporate tax rates. With low interest rates, there was rapid expansion of credit and property valuations from 2002 to 2007. The rise in mortgages was accompanied by banks relying heavily on whole sale external borrowing. As property prices showed a downward movement from 2007 Irish banks stood exposed and came under severe pressure. The property price crash by the first half of 2009 broadly coincided with the tightening of credit control.

By mid April 09, there was a marked increase in Irish bond yields and the government had to nationalize banks and take on the liabilities[vi]. In September 2010, government support for six banks had risen markedly to 32 per cent of GDP. In November 2010, the government decided to seek a €85 billion "bailout" from the ECB and the IMF. Thus the problems of Ireland stemmed from an excessive build up of bank lending rather than public debt as in the case of Greece. But, the banking crisis turned into a fiscal problem. In terms of unemployment, Ireland with an unemployment rate of 13.7 percent is among the worst-affected, after Spain which also witnessed a collapse in the property sector.

Spain, like Ireland, was considered a dynamic economy and till 2005 and attracted significant foreign investment. The economy witnessed a real estate boom with construction representing close to 16 per cent of GDP. This changed with the global crisis. In cumulative terms, housing prices fell significantly from 2007. As the real estate boom collapsed there was a rise in the levels of personal debt. On the public finances front, tax revenues collapsed, deficits soared and the budget position moved to a deficit of over 11 per cent in 2009 (Annex tables). Interest rates on lending to companies and other categories showed an upward turn and financing continued to decline indicating weakness of the economy.

The one difference that marks out Spain is that its public debt at about 60 per cent of GDP (in 2010) is low by euro zone standards. But the problem is on account of foreign exposure to its private debt. The Spanish banks have relied heavily on whole sale finance from abroad. Spain also has a very high rate of unemployment in comparison to the rest of the euro zone. Unemployment among youth is particularly high in Spain and remains a potential source of unrest.

Portugal: While the Financial Crisis affected the Portuguese economy on account of which its fiscal deficit and public debt deteriorated from -3.1 per cent and 68 per cent of GDP (in 2007) to -10 per cent and 83 percent in 2009, the down turn in GDP growth for Portugal was one of the mildest (only -2.5 %) compared to a sharper decline in the rest of the euro zone. Public debt and deficit is also lower than Greece. In that respect, the situation of Portugal is unlike the other peripheral economies that witnessed a boom-bust situation. Portugal, however, has a significantly large external current account deficit and external debt fuelled largely by private sector borrowing.

In terms of other social indicators that are critical for productivity, Portugal ranks low. For instance, as per the OECD surveys, Portugal has one of the lowest percentage of population with at least upper secondary education in the age group of 25 to 64 as compared to the EU average. Alongside, Portugal has also shown an increase in the structural rate of unemployment right from 2000. In other words, Portugal faces a somewhat different problem from some of the other peripheral economies, that is - of chronic low rate of growth.

Italy: Italy is the eighth-largest economy in the world and the fourth-largest in Europe in terms of nominal GDP (in 2010). It has been a slow growth economy with GDP growth averaging just about 1 per cent per annum over 2000-07 as compared to close to 2 per cent for the euro zone. While its fiscal deficit at -4.6 per cent of GDP in 2010 is lower than the - 6 per cent for the euro zone, Italy's public debt and external debt ratios at 119 and 108 are rather large. Even though much of the public debt is held by its residents, it has large private tradable debt which makes it very difficult to rescue. While its unemployment rate at 8.4 per cent is lower than the average for the euro zone, Italy has always been characterized by north- south divide with the southern parts witnessing chronically high unemployment rates.

An point to note is that there are significant differences in terms of the configuration of macroeconomic variables and structural differences (an aspect we discuss in the next section) across the euro zone economies that are currently in trouble. In Greece, the banks – which were reasonably strong on a "stand-alone" basis were undone by revelations about the weakness of public finances. In Ireland, causation ran in an opposite direction with failing domestic banks imposing a burden on the fiscal position. Regardless of the causation, the consequences have been the same: as confidence eroded, the inflow of foreign capital dried up and public debt mounted. Nevertheless, the markets have been penalizing one economy after another, albeit to different degrees. And the contagion effect seems to be spreading. Are there some dimensions that make the euro zone crisis special? We turn to this question in the next section.

Section 4
Some critical dimensions of the EZ crisis

By 2011, the euro zone crisis turned predominantly into a sovereign debt crisis intricately woven with bank debt and claims across borders within and outside the monetary union. In that respect, the euro zone problem is somewhat unique and sui generis[vii].

A monetary union without a fiscal union: The creation of the Euro zone had an inherent contradiction of being a monetary union but not a fiscal union. The introduction of the euro in 1999 explicitly prevented the ECB or any national central bank from financing government deficits. As a consequence the central bank has no power to monetize deficits.

The above arrangement put a premium on each country to follow a similar fiscal path, but, without a common treasury to enforce it. The spending authorities remained national and subject to their own political compulsions. So long as growth across the region was strong, the fiscal capacity was not a source of worry. In such an arrangement the possibility of fiscal free riding is present as seen from the current episode for Greece. Given the differences in the structure and competitiveness of the peripheral economies, it is not surprising that their compliance to the growth and stability pact was often in breach. And this weakness got further exposed in the after math of the global crisis due to the operation of fiscal stabilizers, a rise in the unemployment compensation and a fall in tax revenues. The option of improving the competiveness of the economy through exchange rate depreciation was not available from the very inception of the monetary union. The EU budget is only 1 % of the EU GDP and not an effective instrument for fiscal stabilization. Had there been a fiscal union, with a system horizontal transfer and controls, the deficit and debt ratio of the peripheral economies may have been contained. But in the present case, a fiscal crisis in the periphery automatically translated into zonal monetary and financial crisis with the central monetary authority not empowered to act as the lender of last resort.

This brings home an important lesson that setting up pacts and codes of conduct by themselves are not enough, unless, the underlying incentives to adhere to them are also reasonably well aligned. It has also been argued that the fiscal criteria proved difficult to enforce but generated a false assurance that as long as there was a criteria, all was well. They failed to see that other structural problems were far more dangerous to economic stability of the euro zone that included the lack of control and regulation over national financial institutions[viii] (Pavoncello: 2011).

Varying productivity and Structural differences: Within the euro zone, there is substantial variation in terms of productivity. The peripheral economies have lower labor productivity compared to Germany (taken as a bench mark of 100) which clearly stands out in terms of unit labour costs. Only France and Ireland are comparable to Germany on this count (figure 7a).

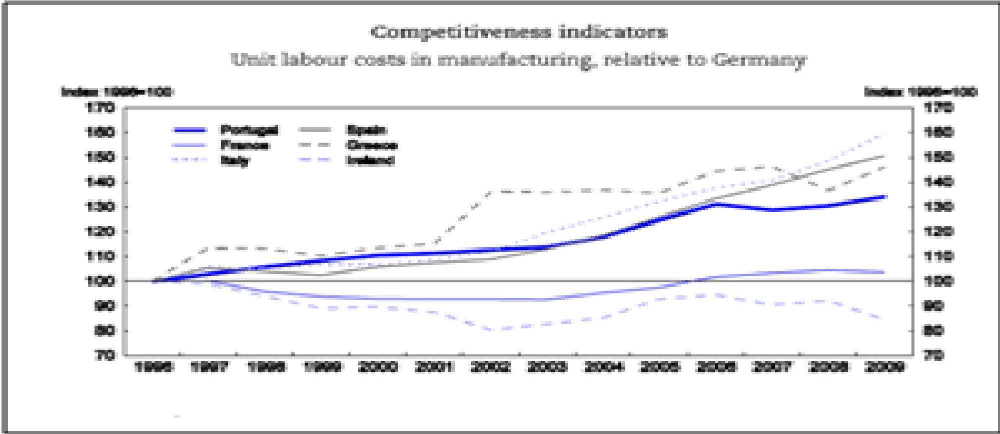

Figure 7a
Source: OECD

The Global competitiveness index for the Euro zone countries also shows vast differences in terms of the ranking and score (annex table). On account of differences in the labor market conditions the unemployment rates are also vast divergent. As compared to the peripheral economies, Germany has the lowest rate of unemployment rate due to its short-time working scheme and flexible time arrangements in the manufacturing sector (Annex table and figure 6b). The fact that there has been a persistence different in the unemployment levels show that labour mobility remained far more limited as compared capital mobility despite there being a monetary union.

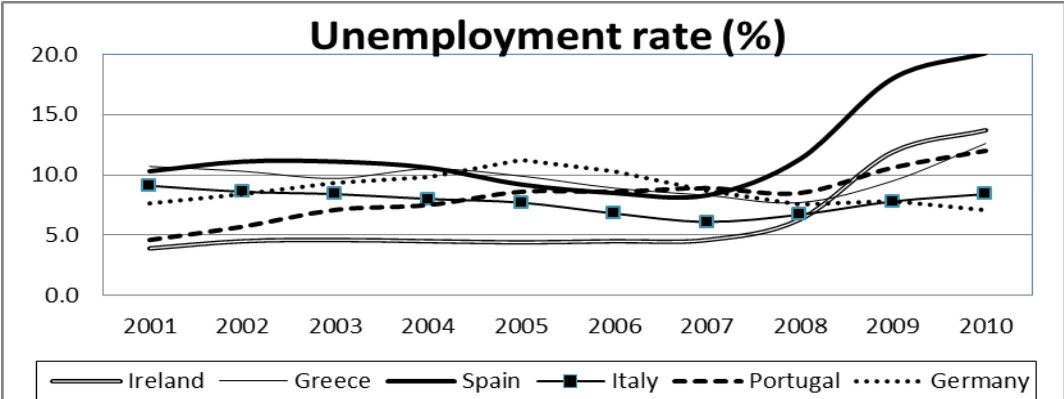

Figure 7b
Source Eurostat

The above differences in a currency union could get sharply exaggerated, as they did, when countries are subject to asymmetric shocks, or to put it the other way around, when their capacity to weather a similar shock is vastly different. Member countries cannot use the exchange rate adjustment to improve their competitiveness. Large fiscal deficit and public debt with interconnected and weak banking systems can then make matters worse if debt is held across borders which is an issue we deal with shortly. In the peripheral economies of the euro zone all these problems seem to have occurred in quick succession.

Role of cross border lending: The modest success of the euro had all along been crucially dependent on the ability of the constituent economies to maintain, or appear to maintain, fiscal discipline and the ability of the private sector and the financial services industry to retain the trust of the markets. Ironically, it is the integration in the financial and money markets, that in part, was due to a common currency, which makes the euro zone crisis harder to untangle.

Table 1 Percentage of debt held abroad		
Country	**Govt. debt / GDP ratio**	**% of bonds held abroad**
Greece	140.2	58.0
Ireland	97.4	54.2
Portugal	82.8	66.0
Spain	64.4	38.7
Source: Economist Jan 15, 2011, pp72		

This foregoing integration is seen in terms of the large share of public debt held across borders (table 1) with European banks (German, French, British and others) having cross border exposure. Data from the Bank of International settlements gives an indication of the magnitude of exposure for major economies in the euro zone. Germany and France non euro economies like UK and US have substantial exposure to bank debt of the peripheral economies (Table 2). In respect of the US, the indirect exposure is several times larger than the direct exposure. The interlocking and conflicting interests of the holders of the liabilities of the peripheral euro zone economies thorough cross border holding of debt makes the resolution of the euro zone crisis furthermore difficult.

Aggregate data, needs to be interpreted *with caution*, as the magnitude is not a direct indicator of the potential default but only of the total exposure at a point in time, that too with incomplete coverage. Nevertheless, given their large exposure, the European banks may find it difficult to wish away their engagement with the peripheral economies.

Table 2: Bank exposure to Euro zone periphery USD Billion Position as of March 2011					
	Greece	**Portugal**	**Ireland**	**Italy**	**Spain**
Direct exposure to public and private debt					
France	56.9	28.3	30.1	410.2	146.1
Germany	23.8	38.9	116.5	164.9	177.9
UK	14.7	26.6	136.6	68.9	100.8
US	8.7	5.6	58.9	44.1	57.9
Indirect exposure through derivatives / guarantees					
France	8.3	5.7	25.3	85.6	37.7
Germany	5.2	12.5	38.8	61.6	45.8
UK	4.6	4.7	47.6	30.0	30.2
US	38.4	49.4	59.7	248.0	154.6
Total exposure					
France	65.8	34.0	55.4	495.9	183.7
Germany	29.0	51.4	155.3	226.5	223.6
UK	19.2	31.3	184.2	98.9	131.0
US	47.0	55.0	118.6	292.1	212.5
Source: BIS, , July,2011, Preliminary International Banking Statistics, Q1, 2011					

Decision making system in the Euro zone: Even at the national level where there are sub national entities, decision making is always problematic. In the case of the Euro zone decisions on financial assistance requires unanimity among representatives of member states. In a monetary union, political decisions taken in one country affect the economies of other countries. Except for the ECB there are few organisations that have a euro zone wide view. But the ECB is a central bank with a limited focus on the macro-economy. But economic policies remain controlled by national governments with fiscal consequences.

Section 5
Implications of the EZC and possible directions

The euro zone crisis has been moving from one peripheral economy to the next, and more recently, is affecting the core economies in the euro zone. The EU accounts for close to 26 per cent of the world GDP (at market exchange rates) and the euro zone 19.4 per cent. The Euro area accounts for about 10 per cent of the global equity markets turnover and the euro accounts for 26 percent of the allocated global holding of reserves. Thus the significance of this crisis is not merely that it comes in the aftermath of the global crisis, but more importantly, it threatens the pace of recovery of the global economy especially because the EU and within that, the Euro zone is a significant market for rest of the world.

In its "spillover" report on the effects of euro zone policies on other major economies, the IMF observed that an intensification of the euro area debt crisis, especially if stress were to spread to the core economies could have major global consequences. In particular, if the Euro area core economies were to be affected. Banks throughout the euro zone immediately require more and higher quality capital. While capital raising and recapitalizing banks is needed, the report observes that in the short run, this may have a contractionary effect. But the critical question that arises in this context is where the resources for recapitalizing the banks will come from?

Implications for the advanced countries: More than any part of the world, the manner in which the current crisis is dealt is important for the Euro zone and to Europe. The creation of the European Union and the euro zone has been part of the European dream of integration. A breakup of the euro would be painful in economic terms and in terms of its political fallout [ix].

A serious challenge is being faced by the two European giants Germany and France because the banks of both these countries face large exposures as already indicated. The markets have been relentless in pricing them down. Even the United Kingdom, that technically remains outside the euro zone does not have the choice of remaining a passive spectator for the same reason as British banks also have a substantial exposure to debt in the troubled countries of the Euro zone.

As at present, the United States has a large financial stake in Europe. American banks have over $600 billion of exposure in the troubled economies of the euro zone as per BIS data. There are close trading links as Europe is US's largest trading partner and the largest destination for investment by U.S. corporations.

Following the collapse of the Lehman brothers in 2008, the US opened short term loans to European banks. In 2009, the US Fed went in for the second round of quantitative easing by buying treasury bonds and pushing down long-term interest rates. By August 2011, its own debt position has become a matter of concern. The capacity of US to accommodate liquidity in order to support the euro zone economies, this time around may be more limited.

The Euro zone crisis and the EMEs: The current crisis is important in terms of the current transition that is taking place globally in the geo political context. For both China and India, Europe and the euro zone accounts for a significant market. Therefore stagnation or worse, a downturn in the euro zone will dent their export growth.

But in regard to China, the threats and the opportunities are somewhat interestingly balanced. China has been looking for opportunities to diversify its foreign exchange assets. The current situation provides China an opportunity to make bargains during a fire sale that may follow to gain political mileage and acquire useful and perhaps strategic assets by simply offering to hold troubled assets of the troubled euro zone States. These assets could be in the form of sovereign debt as well as real assets like interest in public sector units that may be privatized. The manner in which the euro zone and the EU would respond to this possibility remains to be seen.

As far as India is concerned, the European Union is a major trade partner accounting for as much as 20.2 per cent of India's exports (in 2009-10) and 13.3 per cent of India's imports. European Union countries imported roughly € 33.1 billion worth of Agriculture products, Fuel and mining products, machinery and transport equipment, chemicals, semi manufactured products textile and clothing products in 2010 from India. The EU exports to India amounted to €34.8bl, majority of which was machinery, chemical products and semi manufactured items which was almost 2.6 percent of EU exports. Bilateral trade between the two has been growing on an average of 9.6 per cent during 2006-10. EU services exports to India during 2010 was €9.8 billion and EU imports from India was €8.1 billion. That apart, the total FDI from EU during 2010 amounted to €3.0 billion while India also invested about €0.6 billion in the EU. In other words, a slowdown in the euro zone and the EU is likely to have a major adverse impact on India's exports.

Apart from trade, the euro zone experience has some lessons for India. Whole sale debt funding has been the unmaking for banks in the Euro zone. While it is difficult to argue that banks should only raise debt resources through retail deposits, at the same time, the current episode shows that large scale *reliance* on whole sale debt, especially, from across borders may not be in the interest of financial stability. In this context, the Indian banking system has traditionally relied on retail deposits which despite higher cost; serve as a stable source of funding. Without necessarily shunning the option, any substantial shift towards whole sale debt funding may not be a desirable.

India, despite its high fiscal deficit and debt has the advantage of public debt being *passively* held in bank portfolios. This practice has continued hitherto as a vestige of the era of financial repression. While there is every reason to maintain prudence in public finance, at a given point, this EZ experience raises the question of whether sovereign debt of a country can be held largely outside a country in portfolios that keep getting churned and subject to day to day re-pricing. This issue is important since sovereign debt, unlike corporate debt, is meant to finance long term development.

The global financial crisis demonstrated that the globalised banking system played a crucial role in transmitting the crisis from the advanced economies to various parts of the world, including the emerging markets. The current crisis also bears lessons for making a choice on the manner in which foreign banks operating in emerging economies should be allowed by the regulators to expand, that is, through the route of subsidiaries or through branches.

Possible directions: For dealing with the EZ crisis, the possible alternatives being debated are on three broad lines. The first is the route of austerity, in particular, fiscal consolidation, including privatization. This is the default policy choice. A forgone conclusion is that this will impose social costs. While fiscal consolidation is desirable, the question is whether, at all, this choice will lead to sustained growth in *the near future*, since the compression at this juncture would be extreme. Real growth is stagnating and prospects of exports leading growth appear dim. The peripheral economies are subject to a large mismatch between revenues and expenditure at the level of the government and at the household level leading to unsustainable governments and private debt. The possibility that these economies will grow themselves out of the problem seems remote. In any case, this choice does not address the structural problems faced in the peripheral economies. Therefore, the current strategy of announcing short term palliatives such as further bail outs along with sharp fiscal consolidation may only prolong the agony but not deal with the uncertainty prevailing in the euro zone.

The second option, (rather an imperative), would be to go in for a closer fiscal union and a substantially enlarged European budget with a limited system of fiscal transfers from rich countries to the poor countries, a common form of protection for employment *on the German lines with more flexibility*, greater cross border investment even if this implies takeover of sick and ailing public sector units by companies from the richer Euro zone states. A further step would then be to move the ECB into the role of a proper central banker and then floating euro bonds.

A fiscal union, if that be the future road, between what are clearly a few strong and other weaker economies is going to be a major political and economic challenge. In light of the experience thus far, it may be necessary to build an institutional framework that permits a multi speed Europe rather than hoping for complete convergence that breaks down in times of stress. Ironically, in the event of a fiscal union materializing, Germany will face a daunting challenge of supporting a large part of the transfers. Germany has been through a similar, (if not the same) experience, the most recent being the experience of German unification where the country had to set up the Treuhandanstalt[†], step up fiscal transfers and absorb a large and a substantially poorer labour force. It was successful. The process culminated in the adoption of the 2010 plan and Germany bouncing back as the economic power house of Europe. But as of now, this option is hardly finding favour in the big two (Germany and France) due to the fiscal burden that may befall them. Notwithstanding the political challenges *en route, a* creditable road map towards fiscal union will undoubtedly be a challenge and require considerable groundwork.

The third option is the radical one, of peripheral economies leaving the euro zone. A breakdown of the currency may be a very expensive proposition. But if that were to happen, it could lead to insolvency of several Euro zone countries, a breakdown in intra zone payments. Given that public debt in these countries is present in the balance sheets of banks and insurance companies across the world, contagion effects and instability could spread through the financial system. In comparison, the sub-prime crisis may almost pale into insignificance (Pagano, 2010, Eichengreen 2007).This outcome also means an end of the European dream.

[†] *An agency set up to privatise East German enterprises*

Concluding observations: The outcome of the current crisis may be a matter of conjecture. As we have argued, the options, if at all, before the Euro zone and indeed the EU are very stark. None of the three choices are simple. Status quo is also not an option. The choices will have to be political, but the consequences will undoubtedly be economic. The issue is not any more on how to deal with the current crisis. Rather, to make the choice on 'The Euro' – as Eichengreen put it, to 'love it or to leave it' and depending on that, to do what needs to done. In the end, we conclude by observing that neither of these two roads would be easy, the one that carries with it the vision of unification still holds a dream but the other route may only take the euro economies further apart.

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Annex tables

Growth in GDP – Selected euro zone economies										
	2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Euro area	1.9	0.9	0.8	2.2	1.7	3.1	2.8	0.4	-4.2	1.8
Germany	1.2	0.0	-0.2	1.2	0.8	3.4	2.7	1.0	-4.7	3.6
France	1.8	0.9	0.9	2.5	1.8	2.5	2.3	-0.1	-2.7	1.5
Ireland	5.7	6.5	4.4	4.6	6.0	5.3	5.6	-3.5	-7.6	-1.0
Greece	4.2	3.4	5.9	4.4	2.3	5.2	4.3	1.0	-2.0	-4.5
Spain	3.6	2.7	3.1	3.3	3.6	4.0	3.6	0.9	-3.7	-0.1
Italy	1.8	0.5	0.0	1.5	0.7	2.0	1.5	-1.3	-5.2	1.3
Portugal	2.0	0.7	-0.9	1.6	0.8	1.4	2.4	0.0	-2.5	1.3
Source: Eurostat										

Fiscal Deficit and public debt to GDP ratio (%)									
	2001	**2002**		**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Fiscal Deficit / GDP (%)									
Euro area -17	-1.9	-2.6		-2.5	-1.4	-0.7	-2.0	-6.3	-6.0
Germany	-2.8	-3.7		-3.3	-1.6	0.3	0.1	-3.0	-3.3
France	-1.5	-3.1		-2.9	-2.3	-2.7	-3.3	-7.5	-7.0
Ireland	0.9	-0.4		1.6	2.9	0.1	-7.3	-14.3	-32.4
Greece	-4.5	-4.8		-5.2	-5.7	-6.4	-9.8	-15.4	-10.5
Spain	-0.6	-0.5		1.0	2.0	1.9	-4.2	-11.1	-9.2
Italy	-3.1	-2.9		-4.3	-3.4	-1.5	-2.7	-5.4	-4.6
Portugal	-4.3	-2.9		-5.9	-4.1	-3.1	-3.5	-10.1	-9.1
Public debt / GDP (%)									
Euro area- 17	68.1	67.9		70	68.4	66.2	69.9	79.3	85.1
Germany	58.8	60.4		68	67.6	64.9	66.3	73.5	83.2
France	56.9	58.8		66.4	63.7	63.9	67.7	78.3	81.7
Ireland	35.5	32.1		27.4	24.8	25.0	44.4	65.6	96.2
Greece	103.7	101.7		100	106.1	105.4	110.7	127.1	142.8
Spain	55.5	52.5		43	39.6	36.1	39.8	53.3	60.1
Italy	108.8	105.7		105.9	106.6	103.6	106.3	116.1	119
Portugal	51.2	53.8		62.8	63.9	68.3	71.6	83.0	93.0
Source: Eurostat									

External debt as ratio of GDP					
	Greece	Ireland	Spain	Portugal	Italy
2007	97	535	110	118	92
2008	139	697	68	182	43

2009	154	1041	158	207	110
2010	181	1121	171	221	108

Unemployment rate, annual average (%)										
Euro area 16	8.1	8.5	8.9	9.0	9.2	8.5	7.6	7.6	9.6	10.1
Germany	7.6	8.4	9.3	9.8	11.2	10.3	8.7	7.5	7.8	7.1
Ireland	3.9	4.5	4.6	4.5	4.4	4.5	4.6	6.3	11.9	13.7
Greece	10.7	10.3	9.7	10.5	9.9	8.9	8.3	7.7	9.5	12.6
Spain	10.3	11.1	11.1	10.6	9.2	8.5	8.3	11.3	18.0	20.1
Italy	9.1	8.6	8.4	8.0	7.7	6.8	6.1	6.7	7.8	8.4
Portugal	4.6	5.7	7.1	7.5	8.6	8.6	8.9	8.5	10.6	12.0
Source: Eurostat										

Ranking of Euro Area in the Global Competitiveness Index 2010–2011								
			Sub Indexes					
Country/ Economy	OVERALL INDEX		Basic requirements		Efficiency enhancers		Innovation and sophistication factors	
	Rank	Score	Rank	Score	Rank	Score	Rank	Score
Germany	5	5.39	6	5.89	13	5.11	5	5.51
Finland	7	5.37	5	5.97	14	5.09	6	5.43
Netherlands	8	5.33	9	5.82	8	5.24	8	5.16
France	15	5.13	16	5.67	15	5.09	16	4.83
Austria	18	5.09	15	5.67	19	4.83	13	4.97
Belgium	19	5.07	22	5.45	17	5.01	15	4.91
Luxembourg	20	5.05	10	5.81	20	4.92	19	4.76
Ireland	29	4.74	35	5.18	25	4.68	21	4.55
Estonia	33	4.61	25	5.38	34	4.52	45	3.90
Cyprus	40	4.50	29	5.28	36	4.46	36	4.07
Spain	42	4.49	38	5.13	32	4.56	41	3.96
Slovenia	45	4.42	34	5.18	46	4.33	35	4.08
Portugal	46	4.38	42	5.01	43	4.36	39	3.98
Italy	48	4.37	46	4.84	45	4.33	32	4.11
Malta	50	4.34	40	5.08	47	4.31	46	3.88
Slovak Republic	60	4.25	53	4.77	37	4.43	63	3.54
Greece	83	3.99	67	4.49	59	4.12	73	3.41
Source: Global Competitiveness Report 2010–2011, World Economic forum								

Endnotes

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[i] As per the convergence criteria, countries had to keep budget deficit below 3% of GDP, public debt below 60%, maintain price stability and ensure interest rates remained within limits for at least 2 yrs to gain admittance to EMU.

[ii] The euro zone currently consists of Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain

[iii] The success of the Marshall Plan led visionaries like Monnet, Schuman and others to push new cooperative initiatives like the creation of the European coal and steel community followed by the Treaty of Rome in 1957 which led to the setting up of the Common Market and spurred growth in Europe.

[iv] Trans-European Automated Real-time Gross Settlement Express Transfer (TARGET) system) is an interbank and cross-border payment system in the EU.

[v] The targeted privatizations include prime tourist real estate, national gambling monopoly, Post bank, Athens and Thessaloniki ports, Water and Sewer Company and the telephone company.

[vi] Between Jan 2009 to March 2009 the Irish government had to nationalise the Anglo Irish Bank, the Allied Irish Bank and the Bank of Ireland. These developments were linked to serious lapses in legal compliance also termed as circular lending (also termed as the Golden circle lending).

[vii] In political science, the unparalleled development of the EU as compared to other international organizations has led to its designation as a sui generis geopolitical entity. The same could be said about the euro zone.

[viii] Other factors not under control include the expansion of social benefits and the level of productivity.

[ix] There has already been political fallout of the current crisis in the peripheral euro zone economies in terms of public unrest in Greece, Italy and to some extent in Spain. At least two finance ministers have been sacked one in Greece and the other in Italy with the latest fallout being the resignation of the board member of the ECB.

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