15-8. The Eurozone crisis (2010-now)

The Eurozone: a botched attempt to transform a common market into a single currency

The Eurozone was born in 1999 and became fully effective with the release of banknotes and coins in 2002. It originated in the wake of earlier projects to create a federal Europe: the ECSC (European Coal and Steel Community) in 1952, the Common Market of six countries, instituted by the Treaty of Rome in 1957, the European Union, instituted by the Maastricht Treaty of 1993. These different projects were essentially of a commercial nature.

The Eurozone project amounted to providing the European Union with a common currency.

Earlier unified monetary systems, such as the American dollar, had made it obvious that a common currency requires as its operational background a *federal state* type of organisation displaying in particular:

1. a common tax and fiscal system
2. either elementary units made out of geographic blocks of more or less comparable economic strength, or the presence of a compensation mechanism re-establishing from time to time the overall balance of the system

In the case of the Eurozone, the fact that member countries are no comparable economic units is not remedied by the presence of a rebalancing compensation mechanism. Indeed, the Target2 system of money traffic within the Eurozone is reminiscent of the *Interdistrict Settlement Account* (ISA) system existing in the United States but lacks the periodical compensation mechanism between the 17 financial districts under which the 50 states are distributed in the United States.

Within the Eurozone, the ordinary adjustment mechanisms of debt default and devaluation are lacking for individual countries

Within a monetary system with floating currency parities, two adjustment mechanisms exist:

1. A country may decide to adjust the parity level of its currency through devaluation to take into account an economic reality that has become unfavourable
2. A country may default on its debt, which will then automatically lead to a devaluation of its currency compared to others, readjusting to what it is really worth - which the amount of the "haircut" (the loss incurred by investors) indicates.

Within the Eurozone, these two mechanisms are no longer available to individual countries. In addition, as no proper solidarity mechanism within the zone has been instated, the only available option is that of so-called "internal devaluation", meaning that costs in the production of commodities and in the supply of services should drop so as to make them competitive again within the zone.

However the liberal ideology shared by the "Troika" institutions (European Community, International Monetary Fund, Central European Bank) demands that among the three elements that play a role in the cost of commodities and services, i.e.

1) wages paid to wage-earners;

2) dividends paid to shareholders of companies and interest paid to creditors;

3) ultra-high salaries and bonuses paid to companies' executives;

only wages would be regarded as an *adjustment variable*, i.e. likely to be lowered.

<u>Imbalances exist due to countries member of the Eurozone being dissimilar economic units</u>

The Eurozone benefited in its early years in its dealings with countries with other currencies, from the fact of having a single interest rate attached to each particular maturity (the length of time the loan is lent). These interest rates would reflect the power balance between the Eurozone as a whole and the rest of the world around it.

Poorer countries within the zone benefited therefore of the interest rates applying to the Eurozone as a whole. But – in the absence of a proper federal organisation for the Eurozone – this advantage only lasted until outside partners started to realize that credit risk – the risk for interest payments not being made or of refunding of principal

(loan amount) not taking place – became prominent. At that point, credit risk premiums began to get included within the coupon level of sovereign debt of the individual countries within the Eurozone, creating imbalances within the zone. At some point, the risk attached to some weaker countries became perceived as being so high that a *convertibility* risk premium became included by potential investors (lenders) in sovereign debt, to account for the risk being associated with the country leaving the Eurozone altogether.

Why is the federal construction of the Eurozone missing?

The founders of the European Union assumed that federalism would "automatically follow" the creation of a common market. But were they in good faith or was it the case that only a common market was actually of interest to them?

The fraudulent entry of Italy and Greece in the Eurozone

Conditions were set for countries to become part of the Eurozone, known as the Stability and Growth Pact, that their yearly deficit would be less than 3% of their GDP (Gross Domestic Product) and their overall debt would be less than 60% of GDP.

Several countries did not meet these conditions, Italy and Greece in particular. Both hid the paltry circumstances of their debt through a so-called "off-market" currency swap, a financial instrument that has no legitimacy as it is nothing more than a loan disguised as a derivative in order to conceal its true nature. The other countries turned a blind eye to this trick as the presence of these countries within the monetary union was regarded essential.

The Credit-Default Swap speculation against Greece

In insurance, the price to be paid for the contract's premium is calculated *actuarially*, meaning that it reflects an objective assessment of risk, i.e. the probability of a casualty and the likely amount of the loss.

However a second mechanism may intervene in the determination of the premium amount: the supply and demand environment for such a contract. Indeed if large

numbers of customers apply for an insurance type, the insurer will raise the premium level as the opportunity for a higher profit will not remain ignored by him. Should the higher price be then interpreted as reflecting only a rising credit risk premium, it is risk itself that will be supposed to have risen.

The Credit-Default Swap (CDS) is a type of derivative allowing the subscriber to be insured against a possible loss incurred with a debt instrument (loan), i.e. the non-payment of due interest or lack of refunding of the principal (loan amount). The CDS can however also be used speculatively in what is called holding a “naked” position, meaning that the subscriber is actually not exposed to loss.

When Greece got in dire straits in the first months of 2010, speculators acquired in large quantities “naked” CDS positions on Greece debt, being fully aware that the rising price of the premium would be interpreted by the markets as reflecting a rising risk, pushing therefore Greece to default on its sovereign debt, and making thus the CDS contract more valuable (as being likely to be compensated for a higher loss).

The European Parliament banned “naked” CDS positions in November 2011.

The Cyprus crisis of 2012-13

A “bail-out” occurs when a government moves in with an injection of cash to prevent the default of a financial institution, using to that effect taxpayers’ money. A “bail-in” occurs when the money of depositors on their accounts in a bank is used to prevent the insolvency of that bank to result in its bankruptcy.

In an initial official announcement it was stated that a 6,75% levy would be raised on current accounts up to 100,000 € and 9,9% on accounts with higher deposits. The explanation for these figures was that the Cypriot president had refused that any tax levied would be higher than 10%. The 6,75% rate was thus reverse-engineered from the 9,9% set as a ceiling for deposits higher than 100,000 €. In the end, accounts with deposits lower than 100,000 € suffered no loss; on those with a higher amount a 37.5 % levy was raised.

OMT (Outright Monetary Transactions): the European Central Bank acts as the Eurozone’s governing body

In July 2012, Mario Draghi, the head of the European Central Bank, announced simultaneously the creation of the OMT programme and that “All will be done to preserve the euro!” The situation immediately stabilised within the Eurozone.

Current commentators imagined that it was due to the reference to the OMT programme while it was truly the statement about no member country being allowed to leave the Eurozone that had done the job.

As a consequence of this statement the interest rates that the financial markets were demanding on the sovereign debt of countries in crisis, and especially from Greece, dropped dramatically. The reason was clear: the credit risk premium was not required any longer as those countries’ sovereign debt got guaranteed by the Eurozone as a whole, and the *convertibility* premium, assignable to a return of the country to its former currency, vanished as the very possibility of it had disappeared.

Besides, the OMT programme is flawed in its concept. It aims at lowering the interest rates on the long-term debt of countries in crisis through the purchase of such bonds on the secondary capital market. But if these rates are high it is because the credit and convertibility risk premiums encompassed are high, and as they reflect risk, these can only be marginally lowered through a supply and demand mechanism.

Greece vs. Troika

On January 25 the left-wing party Syriza won the elections in Greece. It immediately questioned the austerity programme imposed on Greece by the Troika.

The Troika programme, presented by itself as a TINA (There Is No Alternative), has had over a five-year period, dramatic consequences for Greece: the country’s GDP got lower by 25%, unemployment rose to 26% (51% among young people), sovereign debt rose under the programme from 120% to 175%.

At the time the lecture is given in April 2015, the outcome of the confrontation between the Syriza-led government and the Troika remains unclear.