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The Euro-zone Financial Crisis: Causes, Consequences and Policy Responses

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Abstracts

The Financial Crisis that knocked the world in 2008 has seriously affected the world economy and appears to be the worst that the Euro-Zone has experienced since its creation and it's threatening till now its existence with the development of anti-globalization, nationalism, protectionism in some country members and even worst the BREXIT[1]. The Crisis has had dramatic consequences not only for the Euro-Zone but for the Majority of its financial and commercial partners such as the European Union (EU) as well as for the EU immediate vicinity: Turkey, the Middle East and Africa. This paper tries to highlight in details the main causes of the euro-zone crisis, how the area has been affected (consequences) and the different policies that have been undertaken to overcome that situation as well as lessons for Turkey to learn from the crisis. It is therefore the EU institutions reports, general researches and books on finance, banking and law related to the financial crisis that have mainly been able to provide information needed to elaborate this work. And the result shows the weaknesses existing in the Euro-Zone financial regulations, the limits and needs for a common action not only at the Euro-Zone level but at European including international level; it also reopened the debate on the responsibility and the role of public authorities in the economy.

Keywords: Financial Crisis, Euro Zone, Stability & Instability, Policy Responses.

1 Introduction

From the beginning, the European politician leaders initiative of creating a European

monetary union the Euro, like the Dollar in USA, didn't please many economists like Robert Mundell and Jan Tinbergen both Nobel Prizes who were pessimistic about the idea because

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according to them, the existence of many barriers such as language diversities, differences in monetary and fiscal policies etc...will be a failure. But who could have thought, when the euro was introduced that, it would have gained in value against the dollar and many other currencies and become second reference currency alongside the dollar, created a common market with a single currency without exchange rate fluctuations, creating wealth and prosperity for all country members and strengthened the role of Europe as an economic power until the crisis of subprime "borrowers being approved for loans they could not afford", which upsets in international finance since 2008, starting as a debt crisis in Greece in 2010 and as the crisis of public debt in Ireland, have firstly led to a financial crisis and then to economic crisis in the Euro-zone and the whole European Union (EU), what confirms the fears of economists at the start point of the Euro project. The European Union financial regulation has been able to contain the crisis but not to solve it; furthermore the area has been facing a political crisis (disagreements among key policymaker over the appropriate crisis exist solution). Governments in several European countries have collapsed as a direct or indirect result of the crisis.

1.1 Creation of the Euro-Zone[2]:

After the Second World War, the Treaty of Rome signed in 1957[3], is the starting point which set the noble objective for Europe to create a common market to increase economic prosperity contributing to an ever closer union between European people for an everlasting peace. However, the economic and monetary union and the single currency did not appear in the text. In 1992 the Maastricht treaty transformed the European Community into a full Economic and Monetary Union. Participants are requires a series of Macroeconomic criteria that must be observed in order to become a member of the monetary union "the Euro-Zone".

The Maastricht Treaty criteria[4] (1- control of inflation, 2- control of public debt , 3- control of public deficit, 3- the stability of the exchange rate and 4- the convergence of interest rates)

In 1995 a formal commitment of 15 member states in favor of a single currency adopted a timetable at Madrid European Summit, on the basis of Green Paper[5]

Until 2001 the Euro exists only in scriptural form (checks, transfers, bank cards). Tax and authorities salaries payment can be done in national currency or Euro; there were no prohibition or requirement to use the single currency. In 2002, the appearance of Euro (coins and notes)followed by early withdrawal of the national currencies marked the end of the dual circulation of Euro and national currencies. Slovenia joined the Euro-zone in 2007, Cyprus on January 1, 2008, Slovakia in January 2009,and then Estonia in January 2011 as the seventeenth member state participating in the Euro-zone; in January 2014, Latvia became the eighteenth Member to adopt Euro as currency. And the last country to adopt the euro is Lithuania on 1 January 2015. Countries member of the Euro-Zone: **Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy,**

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[2]Creation of the Euro-Zone:http://www.europarl.europa.eu/atyourservice/en/displayFtu.html?ftuId=FTU_4.1.1.html

[3] Access to EU Law: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv%3Axy0023

[4]Access to EU Law: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv%3Axy0026

[6]Green Paper: is a EU report and consultation document of policy proposals for debate and discussion without any commitment to action.

Latvia, Lithuania, Luxemburg, Mlata, Netherland, Portugal, Slovakia, Slovenia and Spain.

2 Causes of the Financial Crisis

Before starting the analysis, it is important to clarify the meaning of a Financial Crisis. Accordingly financial crises can be very diverse according to the types of markets or financial institutions they affect. So there are crises affecting banking sector, real estate, stock market, currency, sovereign debt and many other crises[6] The historian of economics, Charles P. Kindleberger, in his famous book “Manias, Panic and crashes: a history of financial crises, defines a financial crisis as a brief but sharp deterioration of all or several financial indicators[7].

The financial crisis of 2008 being a banking sector crisis which originated from subprime crisis: macroeconomic crisis (the default of poor households) and the microeconomic crisis (the bankruptcy of a financial institution), will spread to a significant part of the financial system; affect the real sector of economy which will totally change the stability of the global financial system.

A study by the Centre for Economic Policy Research (CEPR)[8] says that, most of the financial crises including Euro-zone were caused, by imbalances between countries of the Euro-zone due to excessive debt (both public and private) which leads to public deficit.

2.1 Subprime

The term Subprime refers to a type of mortgage which quality is considered to be the lowest among the three existing categories[9], with the two others being Alternate (the least risky: -A) and Prime (medium risk: A-paper).

The financial crisis began in the summer of 2007 by a slowdown in economic activity combined with an increase in interest rates contributed to the increase in the debt ratio of United States households. Indeed, the massive grant of loans to low-income households, which boosted purchases of real estate, led to an inflationary bubble phenomenon[10] it has given an increasing number of people access to the property. At that time, the political will was clearly in favour of even granting loan to the poorest people, including the NINJA (no income, no job, no assets), acquiring real estate. But when small families found themselves unable to repay their loans, banks were no longer able to recover the funds lent in the subprime tranches, causing severe damage to financial institutions. To mitigate these credit effects, banks have securitized their lending by transforming them in securities traded on financial markets. The massive use of that technique, which was supposed to better distribute risk, significantly increased the volume of credit available on the market and

[6] Robert BOYER , The financial crises: report, Paris, 2004, p.13.

[7] Charles Poor KINDLEBERGER, Manias, panics and crashes: a history of financial crises, , 1989, p.6.

[8] http://cepr.org/data

[9] Frederic S. MISHKIN: Money, banking and financial markets 2010, p. 276

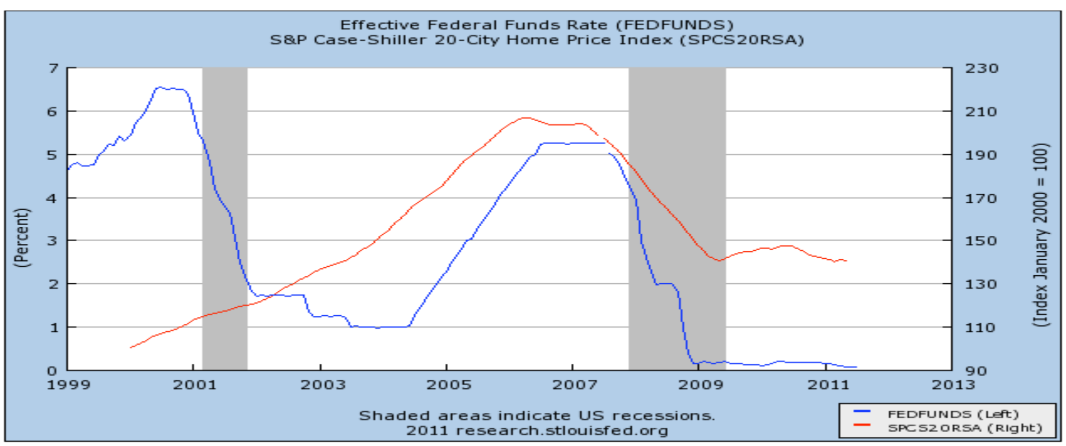
[10] Goetzmann, Peng, Yen, The subprime Crisis and House Price Appreciation, Mai 2009

ultimately put enormous risk on lenders who thought they were investing in safe products rated by the rating agencies as triple A (AAA). In a week, from August 9 to 16, 2007, the main European stock market indices experienced sharp downward corrections: " In the United Kingdom, FTSE 100: - 8.37%, In Germany, DAX: - 4.42; In France, CAC 40: - 8.42%[11]. Thus, the initial banking crisis turned into a stock market crisis. The revelations of the deteriorated values of securitized products have caused contagion of this crisis to Europe and the rest of the world.

2.2 Interest Rate[12]

After holding the interest rate at a very low rate and for an exceptionally long period (from the beginning of 2002 to the summer of 2004, see Figure 1), in June 2004 the FED[13] began raising its key rate, from 1% to 5.25% within two years. This rate increase had a direct impact on the amount of monthly payments owed by debtors to banks after the reset period, leading the most fragile debtors of them to default. In spring 2006, as interest rates are still rising, real estate prices stabilize and then decline. Despite this context, subprime loans continue to be massively granted and derivatives derived from their securitization continue to be rated by rating agencies as very safe until spring 2007

(------FEDFUNDS--------- REAL ESTATE PRICE)



Source: Federal Reserve Bank of St. Louis.

FIGURE 1: US FEDFUNDS AND REAL ESTATE PRICE INDEX[14]

After the significant decline in real estate prices (see Figure 1), banks were no longer able to sell the mortgaged homes to an amount that allows them to recover their loans. And due to the interdependency of the Euro-Zone and US financial markets it almost had the same effect on the on the Euro-Zone's financial market.

In fact in the Euro-zone states, it is the private sector, companies and individuals who went into debt. Interest rates fell to historic levels since their adoption of the Euro, especially in

[11]Journal of the Net, Economic and Financial Crisis: Causes and Situation, 2010

[12]Federal Reserve Bank of New York

[13]US central-banking system comprising of 12 regional central banks called the FED (Federal Reserve Banks)

[14]Source : Federal Reserve Bank of St. Louis

the Mediterranean countries (Greece, Italy, Portugal,and Spain). And this encouraged an economic boom based on debt. During that economic boom, salaries rose sharply in the area which has caused losses in banks, where the lowest annual results.

2.3 Leverage

An additional factor that has also contributed to the subprime crisis is the use of leverage. This mechanism greatly boosts the return on equity invested by borrowing to finance the acquisition of securities. The greater the proportion of the loan, the better is the return. On the other hand, in the event of a decrease in the security, the losses will also be very large. The leverage effect is due to the fact that only a small amount of deposits is required. In the case where the market is falling and the valuation of the securities held results in a potential loss greater than the initial deposit, the lending bank will make a margin call in order to reconstitute its cushion of security. In practice, this means that when the amount of deposits made by the borrower is no longer sufficient to cover the loss recorded by the collateral, the lender will require the borrower to increase the deposit at least equivalent to the recorded loss.

2.4 Rating Agencies

Accounting standards and credit rating agencies have also helped to reinforce the belief that financial markets are self-regulating[15]. In principle, rating agencies aim to rate banks and their financial products impartially and fairly. However, some critics pointed out the possible conflicts of interest, leading rating agencies to issue biased opinions[16].

2.5 Sovereign Debt Crisis

To save banks from bankruptcy, Euro-zone States had to help their banks, where the largest deficits and more debts. These negative effects have spread in several European countries.

Which country respected the Maastricht Treaty criteria?

The Italian government has consistently exceeded the 3% limit. In fact, Germany with Italy was the first large countries to violate the 3% rule. After that, it was the turn of France. Among the major economies of the Euro-zone, since the creation of the Euro-zone only Spain has respected the 3% rule until the financial crisis of 2008. But Greece is a particular case; it has never respected the 3% limit, instead of that, it has made up its accounts with the help of Goldman Sachs, to hide much of its debt, in order to be a member of the Euro-zone.

(------- EU(27 COUNTRIES),-------- USA)

[15]Paul DE GRAUWE, « The Banking Crisis: Causes, Consequences and Remedies », November 2008, p. 5.

[16]Frank PARTNOY, « How and Why Credit Rating Agencies Are Not Like Other Gatekeepers », University of San Diego Legal Studies Research Paper Series, Research Paper No. 07-46, May 2006, p. 69.

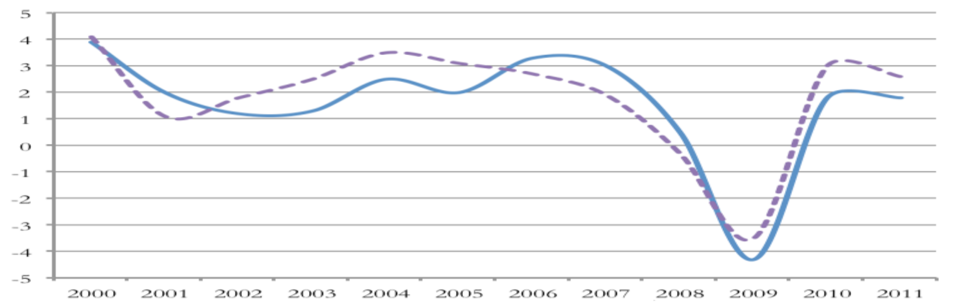
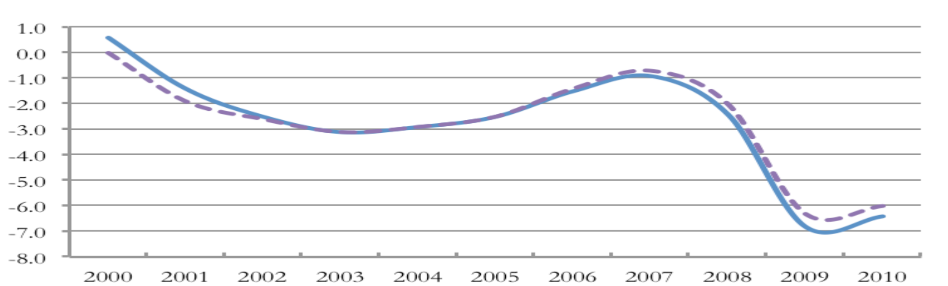


FIGURE 2: REAL GDP GROWTH RATE %[17]

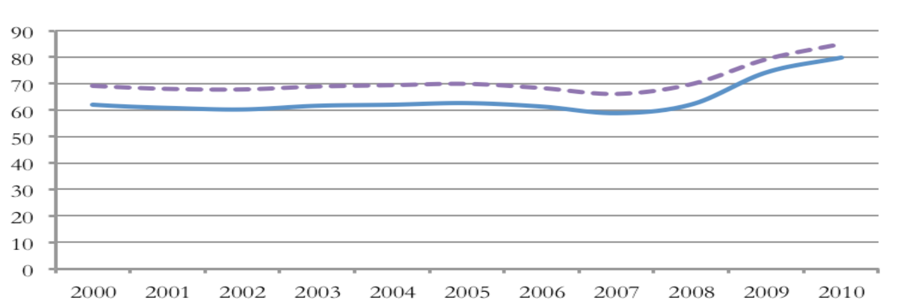
(------EU (27 countries) ------ Euro-Zone (17 countries))



Source: Eurostat.

FIGURE 3: PUBLIC DEFICIT OF GDP %[18]

(------EU (27 countries) ------ Euro-Zone (17 countries))



Source: Eurostat.

FIGURE 4: PUBLIC DEBT OF GDP %[19]

2.6 European Monetary Union Defects[20]

[17]Source : Eurostat

[18]Ibid.

[19]Ibid

According to some observers, this crisis has revealed many of the European Monetary Union defects. We can meet some like:

A common monetary policy designed with European Central Bank (ECB) confined to monetary stability (dogma of inflation and prohibition to lend directly to States).

The ECB monetary policy were applied to a set of economies that were very different one from the other.

A lack of common fiscal, economic and tax policy what have created tax competition between States.

No specificity of the Euro-zone in the general functioning of the European Union. Although there is a Euro-zone, there is no coordination between countries and there is no solidarity between states. And loans of any country can be guaranteed only by the finance of the country concerned

And finally as one of the reasons we can mention the fact that the area does not have a unified body to control the public budget of its country members.

3 Consequences of the Crisis

The Euro-zone faces four major, and related, economic challenges, first: high debt levels and public deficits in some Euro-zone countries; second: weaknesses in the European banking system; third: economic recession[21] and high unemployment in some Euro-zone countries; fourth and last persistent trade imbalances within the Euro-zone[22].

As the main consequences of the Euro-zone financial crisis we can mention:

High public deficits with a very difficult environment in the country forced to correct their public deficits (Greece, Portugal, Spain ...) which led to government's changes.

Very large current account deficit due to loss of competitiveness.

Loss of growth and therefore job losses, low salaries, especially in Italy, Greece and Spain. Despite near-zero inflation, the purchasing power decreases, due to rising of unemployment, and the tendency to precautionary savings. Governments finances have also been affected due to the deterioration in the received taxes; because when there is less or negative growth, the state receives less taxes and vice versa, and less people working is equal to less income tax and as a result less people spending which means less Value Added Taxes; and also less company profits leads to less corporation tax and so on..., and uncompetitive exports in countries most affected, countries like Greece, Italy and Spain

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[20]Menzie D. Chinn, (2012),The Euro-zone in Crisis: Origins and Prospects:

https://dash.harvard.edu/bitstream/handle/1/10212562/34578/euro_crisis_for_lafollette_report.pdf?sequence=1

[21]Economic recession: a significant decline in economic activity, lasting more than a few months, normally visible in real GDP, real income, industrial production, and wholesale-retail sales

[22]Rebecca M. Nelson, ,Paul Belkin, Derek E. Mix & Martin A. Weiss (2012) The Euro-zone Crisis: Overview and Issues for Congress: https://fas.org/sgp/crs/row/R42377.pdf

Rising of defaults on mortgages is also both a consequence and a cause of the crisis. This phenomenon is observable in Spain.

The valuation of banks losses due to defaults on subprime loans and the sharp decline in asset market prices such as corporate bonds, made financing and investment operations almost impossible.

Recession: The consequences of this crisis were quickly felt on the real economy. Indeed, the decline in the value of movable and immovable assets has led households to reduce consumption and to save more.

These negative consequences are quite systematic, and appear in all crises. But the particular characteristics of this crisis also show favorable consequences such as resetting financial systems for example funding or financing can be made with less debt leverage and more capital, which will reduce liquidity risks. Certainly the crisis is accompanied by an exaggerated rise in risk premiums on companies and banks, but one can reasonably think that after the crisis a reasonable level of risk premiums can be found, higher than too low and braking down securitization which will allowed more simplicity, transparency and liquidity in financial market

4 Crisis Exit Policy

« We have [...] used an exceptional set of non-standard policy tools. These tools, combined with the bold action taken by euro area governments over recent months, have played an essential role in preventing a collapse of the financial system and in bolstering confidence »[23]

4.1 Euro-Zone States Policy

As a first plan, government in Euro-zone countries authorized the establishment of a special purpose vehicle or company whose statutes and officers are licensed by the government. The purpose of this company is to launch loans guaranteed by the government and lending to banks. Ultimately banks are refinanced by ECB and the reason why European banks prefer the special purpose company rather than directly refinancing their activity through the ECB is that first it is difficult in the current European institutional framework that banks take directly loan from the ECB, second is that it will lead to lowering the rate level of securities, The last reason is that the contribution of government guarantees the transfer of risk from the ECB to the states.

4.2 ECB Policy

From the start of the crisis, on 9 August 2007, a few hours after tensions were observed in the European financial markets following the collapse of US subprime mortgages, the ECB made a record injection of 94.8 billion Euros[24], in the banking system. To prevent the crisis from worsening, it reduced its key rate by 0.5%[25]. Between that time and May 2009, it made

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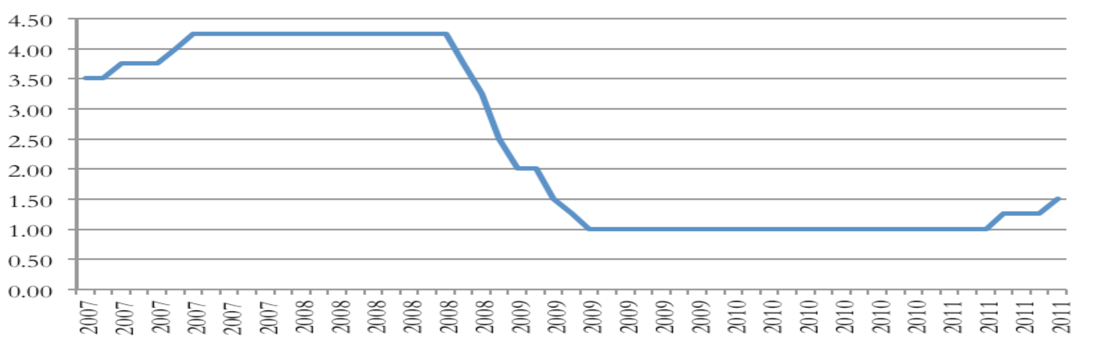
[23]Jean-Claude Trichet, President of the European Central Bank (ECB) Ceremony conferring the honorary title of Doctor Honoris Causa at the University of National and World Economy, Sofia, 12 June 2009.

[24]Richard HIAULT, "Central banks to the rescue of the markets", August 10, 2007

[25]Claire GATINOIS, "The exceptional gesture of central banks does not calm markets", October 10, 2008

seven successive declines and finally stopped at the rate of 1% in May 2009, its lowest level. These rescue actions were coordinated with the other major European Central banks.



Source: Eurostat.

FIGURE 4: ECB INTEREST RATE EVOLUTION[26]

4.3 The European Council

The Council ultimately managed to act in solidarity with the majority of the problems posed by the financial crisis. The Declaration on a Concerted Plan of Action of the Euro-zone countries was published at the Euro-zone Heads of State meeting in October 2008. This announcement expresses their willingness to adopt a coordinated approach, Agreement on the principles to be followed to counter the crisis: "ensuring sufficient liquidity for financial institutions; Facilitate the financing of banks which is currently constrained; Provide financial institutions with capital resources to continue to properly finance the economy; Provide sufficient recapitalization to banks in difficulty; Ensure sufficient flexibility in the implementation of accounting rules in the current exceptional circumstances; Strengthen cooperation procedures between European countries ".

This coordinated approach has not only been confined to countries in the euro area; it was approved by the European Council, for all the Member States. The European Council has also shown solidarity with the new member countries whose economies have been severely hit by the recession. The amount of aid funds made available to Central for Eastern European countries (CEECs) in November 2008 amounted to EUR 12 billion and were subsequently raised to 50 billion in March 2009[27].

4.4 The European Commission

The European Commission's action remained limited until the end of the summer 2008. It was the substantial aggravation of the crisis in September 2008 which ultimately prompted the institution to intervene. The commission was late on the diagnosis of the financial crisis: it has long believed that it was only an American crisis, while it was an American originated crisis. The inactivity of the Commission has also been justified by the lack of financial

[26]Source: Eurostat

[27]EurActiv, 24 March 2009.

resources and skills to intervene in the banking, monetary and economic management fields. Its narrow financial capacity substantially limits its scope because the EU budget which amounts to around 1% of the GDP of its Member States almost entirely finances specific policies such as agricultural expenditure. The Commission is not qualified to borrow or to provide credit guarantees[28].

4.5 International and National Policies

As a response to the situation, international authorities such as the IMF, and national authorities have formulated reform recommendations that could be summarized by the formula "more transparency, more regulation, more competition." More transparency in financial information, to avoid the uncertainties, undermine confidence; more regulation, that financial actors are not acting against the stability of the financial system; more competition for that financial information is more reliable and better used. The new focus is to analyze monetary policy and bank regulation together. The reason for this change is first the realization that traditional formal requirements for individual bank solvency are no longer seen as sufficient for systemic stability, and second there is also the realization that monetary policy should play a role to control systemic risks in the financial sector. The crisis has demonstrated that monetary policy influences the risks in the financial sector, and such risks have disruptive implications for output and price stability[29]. And to remedy to the budget deficits and the public debt government made a reform in tax policy by enforcing fiscal sustainability and increased tax levy in all its forms.

We can summarize the evolution of the crisis in to the following sketch:

5 The financial Crisis Effects on Turkey

The financial crisis that has developed in the United States and the European Union has had limited effects on the Turkish financial sector dominated by banks. It is rather the economic crisis that hit the Turkish real sector that had repercussions on the country's banking system. However, the separation between deposit banks and investment banks and the regulation of their activities have made it possible to limit the negative effects of these spin-offs.

As a result, the Turkish government has put in place a fiscal stimulus plan for the real sector. As for the central bank, it has taken measures to promote loans; in particular those to support foreign trade, and have attempted to influence the exchange rate in order to improve the international competitiveness of enterprises. This expansionary policy has deteriorated the budgetary balance, but Turkey has not faced an insolvency problem, unlike some Euro-Zone countries such as Greece, Spain or Portugal, due to its low budget deficit in the run-up of the crisis. Thanks to this policy and the organization of the financial

[28]Marek DABROWSKI, « The Global Financial Crisis: Lessons for European Integration », CASE Network Studies and Analyses, 20 July2009

[29]Financial crisis: causes, policy responses, future challenges: Brigitte Young 2014

Subprime crisis

Banks loses and reduction of loans

Rescue banks + stimulus plans = public debt (deficit)

Lack of sufficient recovery

Contagion of the crisis and the public debt crisis in Euro-zone

Unconvincing successive plans leading to the worsening the situation,

A new banking crisis because of the interdependence (bank / state)

sector, Turkey was able to quickly overcome its crisis as early as 2010 and achieve a growth rate of more than 11% in the first two quarters of 2011[30].

And Turkey on its road to access to the EU membership should learn from the financial drama that has knocked down the EU countries members and settle financial regulation and policies like those undertaken by the area to overcome the crisis; and by doing that, it will create economics proximities between the two parts and much better facilitate the assessment of Turkey to the block.

6 Conclusion

[30]Hasan Cömert and Selman Çolak, The Impacts of the Global Crisis on the Turkish Economy and Policy Responses, ERC Working Papers in Economics 14/17 December/ 2014.

These financial crises have revealed many of the Euro defect and has opened a wide field of issues about the financial system and the operating system of banks and other financial institutions. Despite the various rescue policies implemented, especially those based on government support to financial institutions was aimed to contain, solve and recovery from the crisis, unfortunately these solutions have been ineffective because they have put

countries in a bad situations such as debt, budget deficit and severe fiscal policy which moreover have created a doubt by worsening the situation which led to political crisis, development of nationalism and as a solution, some politicians are willing to withdraw their countries from the common currency and have the full control of their monetary policies (the National Front party in France directed my Marine LEPEN[31]) .

By mobilizing public means to overcome the drama, the crisis has demonstrated that the EU is the only economic actor which, thanks to its much more powerful institutions and its own rationality which differently from private sector, is aimed at the general interest can go backwards to take strict decisions when the economy is on the decline. In addition, the crisis has challenged the ability of markets to self-regulate itself and stressed the need for an adequate legal framework, not only at the Euro-Zone level but at European including international level to limit the duration and the scale of the recession, and also to prevent another unexpected and deeper crisis from occurring. The crisis has then highlighted the limits and needs for a common European action; it also reopened the debate on the responsibility and the role of public authorities in the economy.

But we think the real solution will be, to tight credit access conditions in the banks of the zone, reduce competition, act and collaborate for the common interest, it will also be important to strengthen the assessment models risks in financial institutions by introducing a notation system that fairly inform about the quality of risk assessment and finally reform the Euro-zone budget, fiscal, monetary policies and terms. Having a strong and unified financial regulation board to control the public budget of country members of the area will definitely reduce deflection moreover regain stability and stimulate an economic growth and create wealthy for all members.

Since its creation till now, the Euro is always under many critics from economists, political leaders, syndicates and civil society. we really wonder about the future of the Euro-Zone and also of European Union.

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[31]President of the Far right party who lost the second turn French presidential election of 7th may 2017

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