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The Eurozone Crisis

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“The Eurozone Crisis”

The European monetary union was developed and implemented initially with the future objective of a fiscal union, then ultimately a political union. However the current European sovereign debt crisis has highlighted the importance of initially having the framework and gradual implementation of a fiscal union far sooner than is currently being discussed. To put this into context, the 17 member Eurozone was established on 1st January 1999 and on 1st January 2002; all member currencies were replaced with the Euro. In 2007, a year prior to the financial crisis, Jean-Claude Trichet, then president of the European Central Bank (ECB) proposed a fiscal union of Eurozone countries. On January 30th 2012, after the financial crisis, credit crisis and European sovereign debt crisis, 25 of the 27 EU member states signed the fiscal compact treaty on stability, coordination and governance in Economic and Monetary Union. This is after 10 years of the formal implementation of the European Monetary Union.

Due to political interests and objectives, the Eurozone's biggest failure has been the admittance of periphery countries such as Greece, which met the criteria for admittance through oversight on key metrics. In 2004, the Greek Finance Minister admitted that since 1999, the budget deficit of Greece was never below 3% of its GDP, a key requirement of entry into the Eurozone. However, at the time, the Greek Finance Ministry had claimed it had less in order to join the Eurozone. Other countries also were criticised for doing the same in order to join the Euro as quickly as possible, with Greece being the main culprit. Of course the main benefit of joining the strong single currency was the ability of governments to issue debt at lower cost, mainly thanks to stronger economies like Germany's. Greece's deficit climbed on joining the Euro and relied on heavier borrowing on the capital markets, partly as a source of funding for the 2004 Olympics. Even with this key admission of failure, the EU said that Greece's membership of the single currency would not be questioned. Even with these mistakes, it is possible to believe that if there was a roadmap to fiscal union prior to the 2008 financial crisis and subsequent economic turmoil, a fiscally united Europe may have properly managed and avoided a sovereign debt crisis. In other words, due to the lack of a fiscal union, the credit crisis of 2008 eventually pushed the Eurozone into a crisis.

The development of the 2008 financial crisis took the form of the collapse of the US sub-prime market, which shook the financial stability of the banking system, caused Lehman brothers to collapse, and damaged the global economy. Central banks and governments were then forced into increasing their deficits to re-capitalise the banking system and to enhance growth through monetary and fiscal policies, which near-terminally indebted nations. In the US since the crisis started, an estimated \$245bn has been spent, invested or loaned to banks and other financial institutions to prevent their collapse. This is 41% of the total \$594 billion used by the US government to shore up capital across key industries. By comparison, the European Commission estimated in 2011 that the recapitalization of European banks has cost EUR 420 billion, and plans are needed for further funding. This has consequently led to the increase of government deficits, reduction in budgets and a severe impact on global economic growth. The IMF estimates that Euro area GDP growth will fall from 3% in 2007 to 1% by the end of 2012, with a gradual slow incline to 1.7% by 2016. So there will be slow growth until 2016, but at what cost? Euro area gross

government debt was 66% of GDP in 2007, and forecasted to be 90% in 2011 and 2012, slowly declining to 86% in 2016.

The Eurozone sovereign debt crisis highlighted the fiscal mismanagement of countries, even prior to the 2008 financial crisis, as evidently seen with Greece. Considering the Eurozone entry's deficit ceiling of 3% of GDP, last year Eurostat estimated that Ireland's deficit was 32%, Greece was 11% and Spain and Portugal's 9%. Even if we describe these as the worst culprits, the Eurozone 17 members' deficit went from 2.6% of GDP in 2002 to 6.1% in 2010.

The 2008 financial crisis was a tipping point for the periphery countries, which suffered from the shutdown of credit markets they had depended on to sell debt to. Greece used the privilege of issuing Euro debt immensely. In 2002, Greece's gross debt stood at 102% of GDP or EUR 159bn. In 2010, this became 145% of GDP and EUR 329bn. And at what point did the markets start realising there was something wrong? Greece's 10-year bond yields were relatively flat, even till the end of 2009. On 1st October 2009, it was 4.6%, a year later 10.2%, then a year later 23%. Now it is approximately 34%. The word 'contagion' has been used widely to describe what has happened since 2008, with the collapse of Lehman Brothers in September 2008 and the start of the sovereign debt crisis in 2010. But fiscal mismanagement was always clearly present. Perhaps 'realisation' is more of an accurate term.

For the rest of the world, increasing government deficits further to combat the slowdown in economic growth and recession, as well as the Eurozone sovereign debt crisis, no longer became a solution. Fiscal austerity has been taken up as the bitter medicine across Europe and much of the rest of the world, but it has been a bitter pill to swallow and given rise to a populist movement. Riots have erupted in Greece, Spain and Italy over austerity plans. Students in the United Kingdom have demonstrated, sometimes violently, at the rising cost of University tuition. High unemployment across the region is a veritable indicator of the economic gloom caused by austerity; unemployment in the Euro area rose from a low of 7.6% to an estimated 10% in 2011.

Now, we are in a situation where Eurozone governments have realised that fiscal union is the only 'clean' solution to the sovereign debt crisis and have been trying to rush reforms through, which are still far from achieving anything. Plans to solve the crisis have missed the key issue. If private bondholders of Greek debt agreed to 50% haircuts on their holdings, would this really prevent Greece from repeating its fiscal mismanagement? And in what state would this leave private bondholders, some of whom are European banks? Similarly with the European Financial Stability Facility and European Financial Stability Mechanism, both EU backed vehicles designed to support distressed Eurozone states. This time the burden is spread across the EU and financial markets. And even if there was an 'orderly' default of Sovereign debt and even expulsion of some members from the Eurozone, fiscal unity and management would still not be in place. Now it seems the Eurozone is ready to discuss a fiscal compact, but has it had enough time to plan? The fiscal union should be implemented, but the planning shouldn't be hasty. At the very least, countries will find it difficult agreeing to give up their fiscal authority.

Short-term political objectives and lack of planning is a combination that can be seen to cause disastrous and long felt consequences, such as post-2003 Iraq. Although there were many reasons why Saddam Hussein's brutal regime should have been removed, an adequate and well-prepared plan was lacking for re-building the country once the regime collapsed in 2003. This has caused continuing problems in the following years such as political instability, insurgency attacks and sectarian warfare. The US and the UK

have been giving until recently military support to Iraq, as well as supporting the reconstruction of the Iraqi economy, which it needs. But as seen before, with the growing government deficits of these countries and the relative expense of this support, can any foreign government now afford to give Iraq or any other country the support it still needs? The US and Europe are firmly focused on resolving their economic difficulties, and asking tax-paying nationals to pay for foreign development of other nations has become a politically sensitive issue. Put into context, Iraq's financial system is severely in need of development in order to support its economy, and as such the Central Bank of Iraq wants all the banks to raise their capitalisation to at least \$215m. But how can Iraq's financial system recapitalise when Europe is having difficulty recapitalising its own banks and ensuring the financial stability of the region?

And beyond Iraq, the Arab Spring has been telling. A surprise populist movement across the Middle East and North Africa since 2010 has shown limited direct foreign intervention compared to Iraq in 2003. When looking at the Gaddafi regime and the Libyan revolution of last year, foreign nations were nervous about intervening when Gaddafi started attacking his own people to put down a revolt. A no-fly zone was put in place, and arms given to the rebels, but it seems that politicians were not ready to persuade taxpayers to pay for direct intervention, even in the name of human rights. And with the European sovereign debt crisis still unresolved, the view has transpired that the cost of intervention is unjustified. In Syria, a similar populist revolution is still taking place and being brutally put down by the regime there, but this time with no foreign intervention aside from economic sanctions. And finally Iran, a country which continues to be an uncertain threat to its neighbours through its resistance to transparency on its nuclear programme, as well as threatening global oil supply through the Strait of Hormuz. This time a country's aggression could be external, and intervention largely has been economic sanctions such as the recent European oil embargo. If the situation escalates and Iran moves aggressively beyond its national borders, will foreign nations intervene if necessary given their domestic economic situations?

As can be seen, the sovereign debt crisis has left powerless directly affected countries and greatly weakened indirectly affected countries, even ones which were previously economically strong. The new 'contagion' or 'realisation' might be that nations may not be able to act in foreign development or in intervening against foreign injustices. And one of the root causes has been not only fiscal mismanagement by nations, but also the availability of credit. Credit since ancient times has been an essential catalyst of growth. Through time and experience, the credit market has become more sophisticated and developed into a truly global financial market. The complexity of the global financial market and its many stakeholders has meant that the financial crisis and subsequent sovereign debt crisis has affected everyone. Greece's EUR 329bn of gross debt was ultimately held globally by institutions and individuals, who will be negatively impacted by any kind of default or collapse. Credit risk has evolved into a global phenomenon which has not been managed effectively.

And what of the ethics of the system? Greece was able to sell its debt to many 'financially sophisticated' buyers at low cost until 2010, who believed that the returns were justified or could even increase. When the 'contagion' came, selling Greek debt and even trying to profit from Greece's collapse through derivative products became endemic among the financial community. The question for many was not whether Greece could be saved, but ultimately could they save themselves and profit from its demise. A lack of risk management and questionable ethics in the financial markets has raised the question as to whether there is a better system without these flaws. Governments think the answer is more financial regulation and oversight, at the cost of growth and competition, but modern Islamic Finance, has been addressing these issues for the last 40 years.

Islamic Finance is young, has been developed on Shariah principles and has spread globally. Although the centres of Islamic Finance are Bahrain, Saudi Arabia and Malaysia, Islamic Banks and institutions have spread their presence and operations globally, and can be found in the USA and UK. According to Standard & Poor's Ratings Services, Shariah-compliant assets reached \$400bn globally in 2009, and although small compared to conventional financial assets, is growing and the expected market size could be as big as \$4 trillion.

Islamic Finance does not charge interest, bans speculation such as using derivative products and disallows charging penalties to customers, charging them a fair value fee instead. A Shariah-compliant asset is a business that does not directly or indirectly engage in the provision of prohibited items under Islam such as gambling and alcohol. Islamic Finance was developed on the basis of enterprise development, profit-sharing partnerships and tangible investing. In Islamic Finance, any transaction must be based on a tangible asset. Money cannot be borrowed without a tangible form of security of equal value, which makes the transaction stable. It also promotes charitable giving, where a 'Zakat' or mandatory donation must be made based on a fraction of the assets of any venture every year. Throughout the crisis the market for Islamic investing and financing has grown, and has been shown to be successful. From a financial context, when comparing the MSCI indices of Euro member companies which are Shariah-compliant versus those that are not, since January of 2008 the Shariah-compliant companies have always outperformed those which were not.

Islamic Finance is still a fledgling industry with a long road in its development, but it has been developed from the start under the pretext of a financial system that controls risk adequately and has ethical foundations. Perhaps the rest of the world can learn from this when it looks at how the system in place ultimately caused the sovereign debt crisis and how it can be prevented from happening in the future.

Emma Harriet Nicholson, Baroness Nicholson of Winterbourne (born 16 October 1941) is a British politician. She is a member of the House of Lords and of the UK Delegation to the Parliamentary Assembly of the Council of Europe and the European Security and Defence Assembly. Formerly a member of the Conservative Party, then Liberal Democrat, she served as a Member of Parliament from 1987 until her elevation to the House of Lords in 1997, and also served as a former Liberal Democrat member of the European Parliament for South England. <http://emmanicholson.info>