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The European debt crisis: a brief discussion of its causes and possible solutions

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Abstract

The aim of the discussion paper is to define primary sources of European debt crisis and to identify the facts to be taken into account when providing solutions. The paper notes that heterogeneity of Eurozone countries, the lax fiscal policy and the application of different monetary policies have contributed to the emergence and spread of the crisis. The joint implementation of macro-prudential policy with the emphasis on prudential fiscal policy, the introduction of an effective system of fiscal transfers, or a compromise between interventionism and laissez-faire approach are some of the necessary solutions to the Eurozone crisis.

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Keywords: Eurozone; debt crisis; heterogeneity; monetary policy; Euro Illusion

1. Introduction

More effective allocation of resources in the worldwide economy and the growth of economic performance should be the results of globalization and financial integration. However, the accumulation of risks in the global financial system and the global economy along with their destabilization are the actual effects. (Popov, 2011) Moreover, consistent, politically promoted and economically incomplete European integration is also the cause of the systematic support of moral hazard in the financial sector and the source of economic agents' motivations to live on credit in Europe. The European sovereign debt crisis is, therefore, the result of systematic failures in the global economic and political order and serious structural defects in the Euro project. (Detlef, 2012) Consequently, the aim of the paper is

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to define the main sources of the crisis, theoretically and empirically, and identify the facts that must be taken into account when providing solutions.

The paper is organized as follows. The first section deals with a single monetary policy and the single currency in EMU. The second section discusses the consequences of the Euro Illusion. The third section provides an overview of selected empirical studies on the European debt crisis causes. The final section concludes and gives some facts to be taken into account when providing solutions to the current European sovereign debt crisis.

2. The single monetary policy and the single currency

The primary goal of European integration is to maintain peace and ensure freedom and prosperity in Europe. (European Commission, 2015) Also, the Treaty on the Functioning of the European Union is the confirmation as it emphasizes economic aspects of its formation to significantly limited extent. Moreover, the discrepancy in the opinions of political scientists and economists on the benefits of the single currency, i.e., euro for such a heterogeneous group of countries which constitute the EMU, argues for the goal. Outstanding confirmations are, of course, continually changing increasingly risky conditions and rules in EMU along with controversial politically promoted integration and harmonization of its members. Additionally, the ratification of the Maastricht treaty in 1992 cannot be considered as economically sufficient and reasonable decision due to lack of labour mobility and fiscal transfers, artificial suppression of German unit labour costs and the inflation policy benefiting mainly the surplus countries and a low level of diversification of the economies in EMU. (Detlef, 2012) The previous is documented in the empirical study of Ferreira, Dionisio & Zebende (2014). The authors stress that there are significant differences in the achieved levels of financial integration among selected Eurozone countries by applying the detrended cross-correlation analysis based on the CIP. Their results, based on data before the introduction of the Euro, show the problems of peripheral countries with asymmetric shocks that have prevented them from achieving the full degree of financial integration and gaining benefits from it. The example of such an asymmetric shock is the current debt crisis in the Eurozone. Furthermore, the significant source of problems in EMU is the disregard of fundamental principles for creation of an optimal and trouble-free functional currency area. For instance, according to the authors of Optimum Currency Area Theory, money is the essential tool for absorbing imbalances in an independent state with its own currency. Therefore, a country that decides to abandon its currency with adopting a single monetary policy to create a monetary union loses an important instrument to smooth internal and external imbalances emerging in a monetary union. (De Grauwe & Ji, 2013) Also, there exists a certain trade-off between the homogeneity of countries belonging to a monetary union and the existence of real adjustment mechanisms that would be present in it. Persistence of external imbalances in a monetary union is the main reason for its problems and the significant cause of the debt difficulties of its members. The current example is the European debt crisis in the Eurozone.

Fig. 1 shows major imbalances of the current account balance in EMU. The selected countries with higher and faster growing public debt show a deficit on a current account balance. (Sklias, Roukanas, & Maris, 2014; Guerreiro, 2014) Also, Ramos-Francia, García-Verdú, Aguilar-Argaez, & Cuadra-García (2014) showed that a large number of Eurozone countries developed large macroeconomic imbalances because of the expenditures higher than revenues. That led to their unstable imbalances of the current account. While the authors attributed problems in Greece to public sector, on the contrary, in Spain and Ireland they referred to the private sector that increased the asset prices. The authors stressed that the macroeconomic mismanagement together with the productivity differences were the primary causes of the imbalances in GIIPS countries because of higher production costs in these countries.