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Europe's euro and competitiveness crises☆

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1. Introduction

In 2008–2009 the United States and other advanced countries faced the most serious financial crisis and recession since the Great Depression of 1929. Growth resumed in 2010, but the recovery was slow. In this paper, I will begin by briefly reviewing the causes and effects of the global financial crisis and the policies adopted to overcome the crisis. Then, I will examine the continuing crisis in the countries of the Eurozone periphery and discuss when and how that crisis would end. Finally, I will analyze "the other" crisis or challenge facing the European Union and Europe as a whole, namely its anemic growth and persistently very high unemployment rate.

2. Causes and effects of the "Great Recession"

The most recent global financial crisis started in the U.S. housing sector in 2007 as a result of banks giving huge amounts of (sub-prime) loans or mortgages to individuals and families that could not afford them. When many individuals and families defaulted on their loans, U.S. banks fell into a deep crisis, which then spread to the entire financial sector in 2008 and, from there, to the U.S. real sector and the rest of the world economy. The result was the "Great Recession".

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Contagion spread from the United States across the Atlantic because many European banks had committed even greater excesses than U.S. banks and some European nations faced an even greater housing bubble than the United States (Salvatore, 2010). Deep recession in all advanced countries then greatly reduced their imports and foreign direct investments to emerging markets, thereby spreading the crisis to the rest of the world. Most emerging market economies (such as Russia, Mexico and Turkey) fell into a deep recession, while China and India faced a sharp slow-down in their record-breaking growth.

At the depth of the recession in 2009, real GDP fell by 2.8 percent in the United States, 4.4 percent in the Euro Area, 5.2 percent in the United Kingdom, and 5.5 percent in Japan, and 2.7 percent in Canada, among the largest advanced nations. The recovery was so slow in most large advanced nations that it took until 2014 (2011 for the United States and not yet in Italy and Spain) to return to their pre-crisis level of real GDP. In the largest emerging markets, growth fell by 7.8 percent in Russia, 4.8 percent in Turkey, and 4.7 in Mexico, while China and India faced only a growth slowdown.

The United States and other advanced nations responded to the Great Recession by rescuing banks and other financial institutions from bankruptcy, slashing interest rates, introducing huge economic stimulus packages, making huge injections of liquidity, and undertaking quantitative easing or QE in March 2015. These efforts, however, only succeeded in preventing the recession from being deeper than otherwise and the subsequent recovery to be even slower than it would have been. Slow growth and high unemployment remain the most serious economic problems facing most advanced nations in 2015.

3. The crisis in the Eurozone

The immediate cause of the Eurozone crisis was the unsustainable budget deficits and government debts in the weaker periphery member states or GIPSIs (Greece, Ireland, Portugal, Spain and Italy) since the introduction of the Euro in 1999. At the depth of the crisis (recession) in 2009, the budget deficit as a percentage of GDP was 15.6 in Greece, 13.8 in Ireland, 10.8 in Spain, 9.9 in Portugal and 4.4 in Italy. The government debt as a percentage of GDP in 2009 (2013 in parentheses) reached 129.9 (173.8) in Greece, 116.4 (132.5) in Italy, 83.7 (128.8) in Portugal, 64.4 (122.8) in Ireland, and 54.0 (93.9) in Spain.

The creation of the euro encouraged and made possible increasing budget deficits and government debts by the GIPSIs because financial markets believed that, with the euro as the common currency, the holding of a GIPSI government bond was no more risky than holding a German government bond. This dramatically lowered borrowing rates on GIPSIs government bonds, thus encouraging these countries to borrow even more. When Lehaman Brothers failed in October 2008, however, financial markets realized that holding a GIPSI government bond was much more risky than holding a German government bonds. This led to a sharp increase in the borrowing rate on GIPSIs bonds, thus making their budget deficits and governments debts no longer sustainable.

Excessive government borrowing and debt, however, was not the fundamental cause of the crisis, which was instead the significant loss in international competitiveness of the GIPSI since the creation of the euro. Indeed, the large government deficit and debt of the GIPSI since the creation of the euro only postponed the serious loss in their international competitiveness from becoming evident. In other words, the loss of the GIPSI's international competitiveness (the ability to export and competing with imports) was overcome or made up by excessive budget deficits and government debt, which prevented aggregate domestic demand, employment and growth from falling and thus plunging these countries into recession. In short, without the excessive borrowing