

# European debt crisis assignment

Business



**INTRODUCTION** On May 1998, Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland established the eurozone by fulfilling the necessary conditions for the adoption of the euro as their single currency. During the same period, the members of the Executive Board of the ECB were appointed. Our story begins two years later, when Greece becomes accepted as the 12th member of the eurozone countries.

In the recent past, a number of EU members, including Greece, Ireland, Portugal, Spain and Belgium, shook the global financial markets with their sovereign debt crisis. In this paper, we will primarily focus on financial crisis in Greece, discussing the current situation and exploring the root causes of the crisis. Moving along, we will discuss how a solitary monetary policy could potentially worsen Greece's current situation by imposing constraints on solution options.

Furthermore, we will discuss two sets of implications of the crisis evaluation regarding debt. The first set of implications deals with what will happen if Greece defaults on their debt, while the second set of implications deals with the actions that must be taken in order to prevent the occurrence of default. In the end, we will summarize our research and analysis about the topic.

**CRISIS EXPLAINED** The “ Greek financial crisis” revolves around the fact that the nation has a high level of debt and accompanied by a high probability of default.

The story of the Greek financial crisis obviously coincides with the current global economic crisis; however, the events in Greece are unlike the financial

events that have plagued the rest of the world. The story is twofold in that the Greek government is to blame for fraud and their poor financial practices, as well as the ECB for enabling such practices by making the cost of borrowing so low due to Germany and other more stable Eurozone nations. While the rest of the world can point the finger of blame at financial institutions and banks, the people of Greece can point their fingers at their government.

The global crisis can be largely blamed on the willingness of financial institutions to invest in U. S. mortgage backed bonds, but in Greece, the only mistake the banks made was lending the government ??? 30 billion. Currently attempting to work their way out of a \$1. 2 trillion debt, which equates to approximately a quarter of a million dollars per working adult, the country mainly has its government to blame. (Lewis). The overwhelming corruption of the Greek government can be traced back to the late 1990's, when the country had a strong desire to enter the Euro Zone.

With the goal of becoming a European financial power, Greece agreed to meet the Euro Zone standards in order to join the euro. Some of these standards include a budget deficit below 3% of gross domestic product and maintaining extremely low inflation, neither of which Greece was even close to obtaining let alone maintaining. To meet the standards, Greece used fraudulent methods and quite a bit of “ creativity” (including “ cooking the books”, decreasing certain tax rates, and changing the consumer price index).

Their fraudulent accounting methods seemed to carry on without much consequence until the fall of 2009. Eventually, it became known that the Greek government had exchanged over 70 valuable government properties for a worthless lake belonging to the Vatopaidi monastery. As the current government at the time began to crumble, new leadership took over (Lewis). Led by Prime Minister Papandreou and Finance Minister Papaconstantinou, the new government settled in, while the looming debt of the country grew daily.

Without a congressional budget office, the new leadership had no way of knowing the severity of the situation until they dug through the numbers. Something new was found daily, from a \$1 billion per year pension expense to phony job creation programs that were both left off the books. With all signs point to the fault of the government, the actions of the entire country had actually put Greece in their current situation. Not only had the government taken part in fraudulent practices, but the entire country had followed suit.

The overwhelming majority of the country avoided paying taxes, because doing so had no consequence. Some citizens flat out misstated their income to non taxable level and were not penalized. Even taxes that were considered unavoidable, such as real-estate tax, were not paid because of the enormous price discrepancies between the objective and actual land values, as well as the fact that no national land registry existed. Bribery also ran rampant throughout the country, getting everyone in on the corrupt action (Lewis).

Moving forward, some believe that Greece has no choice but to restructure their debt, while others are unsure of the effect such an action would have on the financial health of the Euro Zone as a whole. The government has attempted to outline plans for moving forward, which involve ??? 26 billion in austerity measures. This encompasses ??? 15.6 billion in spending cuts coming from wages, expenses in the public sector as well as defense and health care spending. The overall goal is to decrease the nation's budget gap to 1% of GDP by 2015 (Granitsas).

The receipt of a ??? 110 billion bailout from the International Monetary Fund and the European Central Bank serves as a temporary band aid to stop the bleeding to a degree and is a decent start for the country to begin to drag itself back from the brink. However many believe that these actions are feeble at best when compared to the severity of the situation at hand. If Greece were a company, there would be no question of debt restructuring, because it would be the only viable solution (Pasetti). Continuing with such a comparison, Greece's main issue would be the "operating losses" they have incurred.

The average multinational corporation could solve this problem by boosting revenues and cutting expenses, both very feasible actions and goals for a company. However, the size of Greece's deficit, and the fact that it is actually a country, make this usually realistic goal nearly impossible. Consider the idea that "in the business of running a nation, as you cut spending, you take a short-term hit to GDP growth, and therefore revenues (tax receipts)," and this is something Greece cannot afford to do (Pasetti).

Greece also has the increasingly difficult task of producing enough money to begin to pay down their debt principle.

There are many suggestions as to what Greece can, but unfortunately many of these solutions only present new issues. Continuing with the corporation analogy, the current situation in Greece can be considered a dramatic result of the agency problem. If this is the case, we would consider the government to be the managers and the citizens of the country to be the shareholders. Although all parties, citizens included, took part in the corruption that has resulted in the country's crisis, the Greek government clearly acted without the long-term well being of the country in mind. In more of an international sense, the adoption of the Euro has tied Greece's hands in terms of what actions they can take to solve their issues. The monetary policy of the countries using the Euro is consolidated and controlled by the European Central Bank. This consolidation does not allow Greece to change their country's money supply to help their situation. Instead, the Greek government is forced to solely rely on fiscal policy, so they can only make changes to the taxation scheme and government expenditures.

Realistically, fiscal actions are insignificant compared to the scale of the financial crisis in Greece. The countries within the Euro Zone are also supposed to have similar interest rates, something that has not held true, especially after the downgrading of the Greek government. Furthermore, the downgrade and the current state of the country leave investors wary. The state of the government and the corruption that plagues the country further decreases any chance that investors have a desire to borrow from the country, even with low rates.

<https://assignbuster.com/european-debt-crisis-assignment/>

Even if the higher rates on lending may generate some interest, the extremely low credit rating and the high probability of default cancel out this positive. IMPLICATIONS There are two different sets of implications to consider when evaluating Greece's current situation regarding their debt. The first set of implications deals with what will happen if Greece defaults on their debt, while the second set of implications deals with the actions they must take in order to prevent the occurrence of default.

Before we go in depth analyzing the implications that will occur from Greece defaulting on its debt we must first address the question, would a default by Greece signify the end of the euro? We feel the answer to this question is both " Yes" and " No". If the Greek economy were to collapse the impact on the rest of the euro currency zone would appear to be minor, given that the country represents only about 2% of the euro area's gross domestic product. In addition, Greece is not home to any of the vital financial institutions of the euro zone.

On the other hand, the bankruptcy of Lehman Brothers, in 2008, draws similar comparisons to the current situation in Greece. Greece may actually be much more intertwined with certain aspects of the global economy that we do not realize, similar to how Lehman was in the US. The case of a possible Greece collapse may have similar outcomes to the default of Lehman. Although it is possible that the effects may not have a disastrous effect on the rest of the currency members, there is always that chance of uncertainty about the results of the event occurring just like there was about Lehman.

Beyond this, there are numerous implications if Greece defaults on their debt. The primary consequence Greece will face is being stripped of its eurozone status and no longer being part of the euro. Its status would be similar to that of Montenegro, who implemented the euro as legal tender without officially being a member of the single currency zone. Greek banks may also immediately become insolvent and thus be shut out of payment systems. Furthermore, Greek banks will no longer have access to the regular monetary policy operations and functions of the European Central Bank.

Overall, Greece defaulting on their debt will end up with them being shut out of financial markets for many years to come. The rest of the euro zone will also feel these implications as a result; the euro will be marred by a stigma caused by Greece and a new glaring weakness will become evident as the currency becomes less stable. In order for Greece to get anywhere near where they need to be to have a chance at balancing out their debts in the future, drastic measures must be taken.

As mentioned earlier, currently, Greece has only begun to use predictable measures to fix their debt crisis such as increasing indirect taxation by way of value-added and excise levies, hiking marginal income-tax rates and cracking down on tax evasion and fraud (Garello). It will likely take more extreme measures to solve this problem, and this will affect all other euro countries, the EU and the IMF. By 2013, for example, Greece's government debt could be at an unsustainable 170% of its gross domestic product (Hannon).



To return to sustainability, the Greek government needs to figure out a way in which it can pay back its debts, without having to go bankrupt. A possible solution that could be used to help fix this problem, but is also unlikely to happen, is to restructure some of its debt. While other countries may not be very eager to assist Greece in this way, at this point Greece will have to convince other nations that their economic crisis is not only self-inflicted by many years of extravagance, but also stems from defects in the currency area's overall structure.

Although most of the blame should fall upon Greeks themselves, writing off some of their debt is the price everyone has to pay in order to fix these problems without letting Greece fall victim to bankruptcy and creating a larger mess for everyone else. It is very unlikely that in the near future debt restructuring will occur as many leaders of a potential creditor nation won't agree to it. Greece Finance Minister Papaconstantinou denies that these measures will have any beneficial effect or benefits and claims that “restructuring is not the position of the Greek government” (Paris/Talley).

The IMF has already experienced the implications of these events, as they will most likely extend the repayment period of the ??? 30 billion it gave to Greece from three years to seven. Overall, Greece has put itself into a difficult situation and no matter what happens in the future, everyone that is attached to them in any way will end up feeling implications of some sort.

**CONCLUSION** In conclusion, the financial crisis in Greece arose from the corruption involving the Greek government and citizens.

Without bearing the long-term well being of the country in mind, the Greek government adopted the Euro and “ maintained” the euro zone standards by conducting fraudulent accounting methods. This not only resulted in huge deficits, which may lead to “ bankruptcy”, but it also limits the actions they can take to solve the issue at hand as they are constrained by the ECB.

While fiscal policy actions are feasible, they are feeble compared to the scale of the financial crisis in Greece.

The extreme measure, which is unlikely to happen, is to restructure some of it debt to other European Union members. If this takes place, all other euro zone countries will be affected, but even being able to do this may be difficult. Although Greece represents a small percentage of the European economy, the uncertainty of the event keeps the chance of the catastrophe to take place. Overall, Greece is in a very difficult situation and other euro countries will feel the implications to some degree at sometime.