BACKGROUND GUIDE

EUROPEAN UNION

SNAMUN'24

AGENDA: "SUGGESTING MEASURES TO COUNTER EURO-ZONE DEBT CRISIS"

LETTER FROM EXECUTIVE BOARD

We are pleased to welcome you to the academic stimulation of the academic simulation of The European Union (EU) The Lawrence School Sanawar Model United Nations 2024. In this committee, we shall analyze a very challenging and common subject today: Suggesting measures to counter euro-zone debt crisis. Please note that this background guide is in no way meant to be an exhaustive guide on the subject, but merely a stepping stone for the rest of your research, which you are expected to undertake independently. Also, not under any circumstances can the background guide be quoted or used as substantial proof in committee sessions. The more information and understanding you acquire on the agenda, the more you will be able to influence the documentation process through debate in the committee.

We understand that MUN conferences can be an overwhelming experience for first-timers but it must be noted that our aspirations from the delegates is not how experienced or articulate they are. Rather, we want to see how he/she can respect disparities and differences of opinion, work around these, while extending their own foreign policy so that it includes more comprehensive solutions without compromising their stand and initiate consensus building. New ideas are by their very nature disruptive, but far less disruptive than a world set against the backdrop of stereotypes and regional instability due to which reform is essential in policy making and conflict resolution. Thus, we welcome fresh perspectives for intelligent management of human capital which shall shape the direction of this world. You can send you position papers to the e-mail ID mentioned below We are

looking forward to meeting you all at the campus. Don't be afraid to speak up and be heard.

Regards,

Executive Board

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EUROPEAN UNION

Agenda:

"Suggesting measures to counter euro-zone debt crisis"

EUROPEAN UNION

WHAT IS EUROZONE?

The Eurozone refers to the 19 European Union countries that have adopted the Euro as their official currency.

WHAT IS THE EUROZONE CRISIS?

The Euro Crisis is a financial crisis that occurred in the Eurozone starting in 2009. It was a period marked by high sovereign debt, banking system failures, and an acute economic recession in the region.

GLOSSARY

- **Sovereign Debt is the debt of a country's central government. Sovereign debts are usually in the country's own currency.**
- **Banking System Failure refers to a situation where most banks within a country's banking system become insolvent, leading to an economic crisis.**
- **Public debt: For instance, public debt can be likened to a credit card debt. When the government spends more than it has (mainly through taxes), it accumulates public debt. If the debt becomes too high, investors (the creditors) might lose confidence in the government's ability to repay.**
- **Financial contagion: The concept of financial contagion can be compared to a disease spreading. If one bank or country goes bankrupt, it can spread to other banks or countries due to interconnected financial systems.**
- **Economic competitiveness: Competitiveness can be viewed as participating in a race where countries are competitors. The faster economies grow by producing quality goods that others want to buy, the further ahead they get in the race.**
- **Bailout fund: Bailout is a general term for extending financial support to a company or a country facing a potential bankruptcy threat. It can take the form of loans, cash, bonds, or stock purchases.**

Timeline:

Period of economic uncertainty in the euro zone beginning in 2009 that was triggered by high levels of public debt particularly in the countries that were grouped under the acronym "PIIGS"(Portugal, Ireland, Italy, Greece, Spain).

2009

- ***October***
    - **In a snap election called by Prime Minister of the New Democrscy(ND) party, Greek voters express their dissatisfaction with a sluggish economy by emphatically supporting the opposition. PASOK leader George Papandreou is sworn in as prime minister.**
    - ***November***
        - **Papandreou's administration uncovers evidence that misleading accounting practices had concealed excessive borrowing by the preceding ND government. Based on corrected figures, the Greek budget deficit for the year more than doubled to 12.7 percent of GDP.**
        - **Ratings agencies Fitch and Standard & Poor's downgrade Greece's credit rating to below investment-grade status. The Greek stock market tumbles, and the Papandreou administration reveals that Greece's sovereign debt burden now tops €300 billion (about $440 billion). This puts Greek debt at 113 percent of GDP, almost double the amount allowed under Maastricht.**

2010

- ***February***
    - **Papandreou unveils an austerity plan aimed at reducing Greece's budget deficit by almost 10 percent by 2012. It includes a freeze on public-sector wages and a variety of tax increases. The EU endorses the plan, but protests and wildcat strikes sweep the country.**

March

- **Papandreou proposes a new financial package for Greece that**

- includes additional public-sector pay cuts and a 2 percent sales tax increase.By the end of the month, leaders of the euro zone and the IMF have agreed upon a deal whereby both parties would provide financial support for Greece.
- *April*
  - The 2009 Greek budget deficit is revised up to 13.6 percent, and Greek government bond yields skyrocket as Standard & Poor's downgrades their credit worthiness to junk status.
- *May*
  - On May 2 Papandreou, the IMF, and euro-zone leaders agree to a €110 billion ($143 billion) bailout package that would take effect over the next three years. In response, some 50,000 people take to the streets of Athens to protest the additional budget cuts mandated under the terms of the deal. Three people are killed when the demonstrations turn violent.
  - Responding to rising Portuguese bond yields and continued volatility in the value of the euro, the EU and the IMF create a €750 billion ($1 trillion) emergency fund to shore up flagging euro-zone economies.
- *July*
  - The EU releases the results of "stress tests" conducted on 91 European financial institutions. Of the banks that were tested, seven did not maintain the minimum amount of ready capital required by examiners.
- *September*
  - Ireland's central bank announces that the cost of bailing out Anglo Irish Bank, nationalized by the Irish government in January 2009, could reach as much as €34.3 billion ($46.6 billion). This pushes Ireland's budget deficit to 32 percent of GDP.
- *November*
  - After months of delay, Ireland's government officially applies for bailout funds from the EU and the IMF. Embattled Irish Prime Minister submits a harsh austerity budget and promises

to call a general election in 2011. Within a week an €85 billion ($113 billion) rescue package is approved by European leaders.

2011

- *February*
    - European finance ministers announce the creation of the European Stability Mechanism (ESM), a permanent €500 billion ($673 billion) fund intended to serve as a lender of last resort for ailing euro-zone economies.
- *April*
    - Sócrates, serving in a caretaker role pending elections in Portugal, requests bailout relief from the EU and the IMF.
- *May*
    - European leaders approve a €78 billion ($110 billion) bailout package for Portugal on the condition that Portuguese officials implement a series of austerity measures.
    - Unimpressed with Portugal's recovery in the wake of the May 2011 bailout package, Moody's rating agency lowers the country's debt rating to junk status. To stabilize the eurozone as a whole, existing Greek loans are restructured with more generous terms. The cost of these changes is passed along to private bondholders, and Fitch characterizes the action as a "selective default." This marks the first government default within the euro zone since the adoption of the single currency.

September

- Switzerland, a non-EU country surrounded by euro-zone economies, has watched its currency, the franc, appreciate dramatically against the struggling euro. With export and tourism revenues falling, the Swiss National Bank stuns the international currency market by devaluing the franc and pegging its value to that of the euro.

October

- **Slovakia's coalition government collapses when Prime Minister Iveta Radičová ties her country's approval of the expansion of the European Financial Stability Facility (EFSF), the EU's primary bailout mechanism, to a confidence motion in parliament.**

November

- **A summit of G20 leaders convenes at Cannes, France, on November 3 to discuss the IMF and the ongoing euro-zone crisis. For the first time, European leaders publicly declare that Greece's departure from the single currency is a possibility, with Sarkozy stating that "now it is up to [Greece] to decide" on the matter.**

December

European leaders convene in Brussels on December 9 (exactly 20 years after the European Council meeting that concluded with the **Maastricht Treaty***) for a summit that promises to reshape the EU. Sweeping changes are proposed to integrate euro-zone economies more deeply, creating a "fiscal stability union," and additional penalties are suggested for countries exceeding specific deficit benchmarks. The euro continues its seven-month slide against the dollar, as analysts cite a lack of decisive action on the part of EU leaders and the European Central Bank for the loss of faith in the single currency.*

2012

- *January*
  - **Standard & Poor's downgrades nine euro-zone countries, stripping France and Austria of their AAA ratings and classifying the debts of Portugal and Cyprus as junk. This makes Portugal the second European country (after Greece) to have its debt downgraded to non-investment status by all three ratings agencies.**
  - **out.**
- *February*
  - **As Greek lawmakers debate another round of austerity measures, violent street protests erupt in Athens. The Greek**

parliament ultimately approves the spending cuts, which opens the door to an additional €130 billion (about $173 billion) in bailout funds from the ECB, the EU, and the IMF. Global markets respond positively to the news, but initial gains are erased by the continued possibility of an uncontrolled Greek default. This round of loans injects an additional €530 billion (about $700 billion) into the banking system. In just over two months the ECB has loaned more than €1 trillion (about $1.3 trillion) to private banks in an effort to increase liquidity in the credit market and to encourage lending to what ECB chairman Mario Draghi calls the "real economy."

March

- On March 2, 25 EU countries sign the new pact on fiscal discipline. While it will be binding only for those countries that use the euro, the other signatories can choose to abide by its guidelines. Unlike previous EU treaties, unanimous support from member countries is not required, and the agreement will enter into force upon ratification by 12 of the 17 euro-zone countries.Euro-zone finance ministers announce an expansion of the EFSF and ESM. The two primary elements of the euro zone's financial firewall will now have access to a combined €800 billion (about $1 trillion) in funding. This increase was made at the urging of the G20 and the IMF, who had expressed concern that the existing rescue funds were not sufficient to manage the bailout of a country such as Spain or Italy.

2015

- January
  - Switzerland abandons its three-year-old peg to the euro, causing the Swiss stock market to plunge and the franc to skyrocket nearly 30 percent against the euro

July

On July 5 Greeks overwhelmingly voice their support for Tsipras and vote "no" on accepting the troika's most-recent bailout terms. Over the following week, negotiators hammer out a deal that leaves intact many of the demands requested by Greece's creditors, and on July 12 the

framework for an €86 billion ($96 billion) bailout package is agreed upon.In a surprising move, the IMF criticizes the terms imposed by its troika partners, stating that Greece's debt can only be made sustainable by enacting significant debt-relief measures.

TOWARDS ANOTHER EURO-CRISIS?

Ten years ago, the eurozone experienced an existential crisis. During 2012, it became a popular sport to forecast the date when the system would crash and the euro would disappear. In those days when the sovereign debt crisis hit the eurozone, we learned that the system is fragile and that relatively small shocks could lead to its disintegration.

PRE CRISIS PERIOD

During this period, the spreads were virtually zero. This implies that government bonds in the eurozone countries were seen as (almost) perfect substitutes. Thus, investors considered the risk involved in holding, say, a Greek government bond to be the same as the risk in holding a German bond. One can say that this was the honeymoon period of the eurozone. Everything looked beautiful, no clouds in the sky. A remarkable situation during which investors and policymakers lived in a fantasy world.

CRISIS PERIOD

The financial crisis of 2008 completely changed the risk perceptions in the government bond markets. The governments of those countries hit most by the financial crisis saw their budgetary and debt situation deteriorate quickly. As the national government bond markets lacked a backstop, i.e. a central bank willing to provide liquidity in the government bond markets in times of crisis, the self-fulfilling liquidity crises described earlier were set in motion. These self-fulfilling crises had further dramatic effects. They led some countries to be pushed into "bad equilibria" and others into "good equilibria".It also led to an unsustainable political situation where the creditor countries that had received massive inflows of capital dictated the austerity programmes to the high-risk countries, which suffered twice. Once because the harsh austerity programmes led to unnecessary suffering for millions of people.

POST CRISIS PERIOD

It took the ECB until September 2012 to accept its responsibility: The ECB then announced that it was ready to provide unlimited liquidity support in the government bond markets. This so-called Outright Monetary Transactions (OMT) programme started a process of normalisation during which yields gradually converged again. This convergence was sometimes bumpy, as during the second Greek crisis in 2015. It ultimately led to an almost complete convergence of the yields at the end of 2019.By promising unlimited purchases of government bonds during a liquidity crisis, the ECB took the fear factor out of the market. Suddenly, Greek, Spanish and Italian bonds, whose prices had collapsed as a result of fear of liquidity shortages, appeared to be cheap for private investors. They massively returned to these bond markets, bought the bonds and raised their prices. The spreads collapsed quickly. This recovery showed the importance of having a lender of last resort in the government bond markets, i.e. a central bank willing to provide unlimited amounts of liquidity in the government bond markets. In doing so, the ECB actually mimicked what central banks in stand-alone countries do. It also saved the eurozone.Then came the coronavirus pandemic in 2020. There was a risk that the huge shock that hit the eurozone countries would trigger a new sovereign debt crisis, especially since the high-risk countries in the periphery also appeared to have suffered significantly larger negative effects on their GDP than low-risk countries.

TODAY'S CHALLENGE:WILL THE SURGE IN INFLATION LEAD TO A NEW SURGE IN FRAGILITY?

The surge in inflation creates two dilemmas for the ECB. The first dilemma is the traditional one that every central bank, including the ECB, faces after a supply shock. This dilemma can be described as follows: During the past year, major supply shocks occurred – energy and commodity prices increased dramatically, the cost of production increased and inflation surged in most countries as a result. It also led to losses of purchasing power so that production was negatively affected. This is often called stagflation. Stagflation is at the core of the dilemma faced by the central bank. If the latter wants to fight inflation, it will have to raise the interest rate. But this will have a negative effect on production. It may even lead to a recession. If, on the other hand, the central bank wants to avoid a recession, it cannot increase the interest rate too much but then inflation may not easily go down and may become a permanent feature. This leads to a very uncomfortable dilemma for the central bank. Whatever it chooses, the outcome will be painful: Fighting inflation may produce a recession, but fighting a recession may make inflation permanent. Most central bankers have elevated reducing inflation as their primary objective so that it looks likely that they are willing to risk a recession to fight inflation.

The second dilemma is the one that the ECB faces as a central banker of a monetary union (in addition to the one previously mentioned). This second dilemma can be described as follows: When the ECB raises the interest rate, it has very different effects on the long-term bond rates of the different member countries. Every one percentage point increase of the long-term rate of Germany leads to an amplified effect on the long-term rate in high-risk countries.

As can be seen from Figure 3, the spreads of Italy and Greece that were close to 1% at the start of 2022 have now moved in the 2.5%-3% range.Further increases in the interest rate triggered by the ECB's desire to fight inflation could lead to an explosion of the spreads and risk creating a new sovereign debt crisis.Thus, the second dilemma the ECB faces is the choice between fighting inflation at the risk of creating financial instability in the eurozone, or fighting financial instability at the risk of losing the battle against inflation – an equally uncomfortable dilemma as the first one.

There are two ways out of this dilemma. Both, however, create new discomforts. The first way out consists of a commitment by the ECB to provide an unlimited amount of liquidity to countries experiencing liquidity crises. In fact, in July 2022 the ECB announced a new programme, the Transmission Protection Instrument (TPI), which does exactly that: It provides liquidity to governments experiencing liquidity crises.[1] However, this will create additional liquidity in the system, which will interfere with the central bank's desire to fight inflation. The ECB will therefore have to withdraw liquidity from the system by selling government bonds from low-risk countries (Germany, the Netherlands, Finland). As a result, the ECB will increasingly accumulate high-risk government bonds at the expense of low-risk government bonds. This may create political problems when countries like Germany and the Netherlands resist.

There is a second potential way out of this dilemma. It consists of allowing inflation to increase above the self-imposed target of 2%. Several academic economists have argued that 2% is too low a target and that a target range of 3% to 4% would be more appropriate (see Blanchard, 2010; Ball, 2014; De Grauwe and Ji, 2019), mainly because it would make it less likely that central banks get trapped in the zero-lower-bound syndrome that has made monetary policies so ineffective for so long. Raising the inflation target would not eliminate the dilemma but it would make it less constraining, thereby reducing the probability of future crises. This way out from the dilemma, however, would trigger uncomfortable political problems similar to the previous one.

PROSPECT FOR THE FUTURE

Since the sovereign debt crisis of 2010-12, a new governance of the eurozone has emerged. This has made it possible for the eurozone to withstand the major economic disruptions brought about by the pandemic. But a new risk has emerged: inflation.
Will the need to fight inflation with higher interest rates again reveal the fragility of the eurozone? This leads to the question of whether the eurozone has now matured and permanently eliminated its fragile nature.
There is a fundamental contrast between the eurozone and stand-alone countries, i.e. countries with their own central bank. In a stand-alone country, the central bank faces one sovereign, which always prevails in times of crisis. There can be no doubt that in a stand-alone country the central bank will have to provide liquidity when the government faces a liquidity crisis.
One can have reasonable doubts about the question of whether the ECB will always be ready in the future to provide liquidity support to the sovereigns. Who will be at the helm of the bank in the future? Will the Governing Council that consists mainly of national central bankers always be receptive to the demand of one member country's government for support?
One cannot be sure about this; it stands in stark contrast with the certainty we have that if, for example, the British government were to experience a liquidity shortage, the Bank of England will always step in.
There is thus a fundamental credibility issue about the willingness of the ECB to be a lender of last resort in the government bond markets. This will continue to make the eurozone a fragile construction. As a result, the possibility of a future euro crisis cannot be excluded.

SITES TO REFER

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