Charlotte Walther
Poli Sci 001

In *Europe's Financial Crisis: A Short Guide to How the Euro Fell Into Crisis and the Consequences for the World*, authored by John Authors, many points were made regarding just how the Eurozone fell so deep into crisis. From the premature send off of individual currencies to create the euro, to banks foregoing moral hazard and participating in newer riskier ways to earn money, and the U.S. credit crisis, there were many indications Europe was headed for rocky shores. In this essay I will explore the possible causes as well as solutions to the turbulence the Eurozone has survived the past couple of decades.

I. The euro had been introduced in order to converge all of Europe's economies to facilitate easier investing across all borders, instead this drove them even further apart. Europe said out with the old in with the new in 1999 when it decided to disband the use of the French franc, German deutschmark, Irish punt, Portuguese escudo, Italian lira, and the Spanish peseta and instead fixed all these countries into the same form of currency, the euro. The United Kingdom decided to stay out while Greece did anything it could to become a part of the euro club which they joined. The euro was an overly ambitious attempt to control the foreign exchange market and forego the expense of cross border trade. The goal was to ultimately strengthen Europe's trading ties while making it more difficult for others to compete.[1] The Bretton-Woods deal was off, meaning the world's currency was no longer fixed against the U.S. dollar that was then fixed against actual gold in the federal reserve. The Bretton Woods Agreement had previously meant that purchasing currency would lower the supply of the currency and raise its price. If a currency's price became too high, the central bank would print more. This would increase the

---

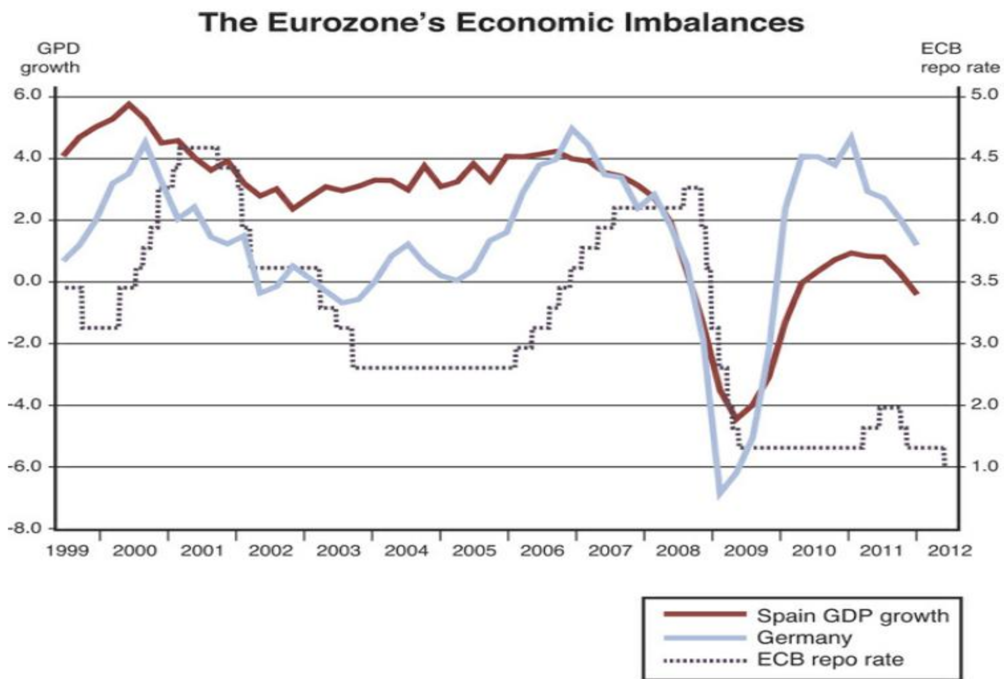
[1] John Authers, *Europe's Financial Crisis: a Short Guide to How the Euro Fell into Crisis and the Consequences for the World* (Upper Saddle River, NJ: FT Press, 2012), 15.

supply and lower the price, this is a monetary policy often used by central banks to control inflation[2], which the European system had disallowed the ability of any longer. This allowed for the groundwork of the deep economic problems the Eurozone would soon face.[3] The price of currency was now at the will of the market, which is impossible to control or predict. By joining the European Union, a country was sacrificing some individuality while also foregoing the opportunity to print money to get out of debt, because they were now at the will of a central European bank which would henceforth make the monetary policy decisions. There was not even a European treasury department at the time the euro took off. The U.K. knew to stay out of the euro because of what had occurred with the E.M.S. a few years prior. The European Monetary System was in place from 1979 to 1993, under which European countries' currencies were only allowed to vary against each other within a certain bandwidth.[4] Therein lies the problem with such a system, that inflation rates tend to weaken an exchange rate if one of the countries participating in the trade has a higher inflation rate. This can be seen in how fast an economy is growing as well. In 1999 Germany's economy was growing at 1% per year while Spain was over exerting itself at 4% per year. The correct thing for the European Union to do would be to wait a few years to allow for the convergence of Spain and Germanys numbers to align. The ECB set interest rates across all the countries for one that was more appropriate for its largest member, Germany. This further slowed their economy to outright recession from 2002 to 2004, and

---

[2] Micahel Bordo, "The Operation and Demise of the Bretton Woods System," The operation and demise of the Bretton Woods system | VOX, CEPR Policy Portal, April 23, 2017, https://voxeu.org/article/operation-and-demise-bretton-woods-system, 1.
[3] John Authers, *Europe's Financial Crisis: a Short Guide to How the Euro Fell into Crisis and the Consequences for the World* (Upper Saddle River, NJ: FT Press, 2012), 15.
[4] Giancarlo Corsetti, "The Euro Crisis in the Mirror of the European Monetary System," The euro crisis in the mirror of the European Monetary System | VOX, CEPR Policy Portal, February 15, 2019, https://voxeu.org/article/euro-crisis-mirror-european-monetary-system, 1.

Spain's inflation ended up being double that of Germanys. Germany's money inflated Spain's real estate bubbles, causing a huge rise in housing prices like in America's housing bubble crisis of the early 2000’s. Spanish consumers were getting rich, which in turn was used in an attempt to assist Germany out of its slump by buying up German exports, at the cost of a major trade deficit for Spain. It was a vicious cycle of credit and debt moving around the European Union. There was a 45 cent difference in the exchange



[5]rate from Spanish to German goods, which further undervalued Spanish currency allowing them to grow inflation unchecked.[6]

[5] John Authors, “The Data from the Book” (NJ, 2012).
[6] John Authers, *Europe's Financial Crisis: a Short Guide to How the Euro Fell into Crisis and the Consequences for the World* (Upper Saddle River, NJ: FT Press, 2012), 21.

II. The rise of new markets caused by financial breakthroughs unforeseeable in the past facilitated the need for banks to find new, riskier things to do. Since many of their jobs were usurped by these new markets, they chose to go into speculative excesses- this is especially true of the engorged and poorly run banking systems in the Eurozone, this combined with a large central bank handing out cheap interest rates in an attempt to build up alongside the housing bubble in America caused detriment to the global economy. A bubble can occur in any market where things are traded. In the 17th century there was a tulip mania bubble, where Dutch merchants were seen spending their whole life savings on just one tulip bulb. Similar to the way gold soared then crashed in the 1980's. There is no agreed measure to determine when a bubble occurs, just that there is no solid justification for the price to be that high.[7] Every century or so, it seems fear outways logic and then greed outweighs fear, and this is represented in the markets. The United States was witness to a large housing bubble that formed in the early 2000's. In order to keep this from happening again there are more prudent lending terms, rising interest rates, and corrected housing prices in order to keep demand at bay. Home buyers had felt rushed and agreed to pay what they could not afford on a mortgage. There was then an increase in demand for lenders who were willing to give non-traditional mortgages that had a low chance of ever being repaid, for instance to low-income, low-credit borrowers, and the banks got in on it as well. The risk was very high as credit expanded into all corners of the market.[8] The signs of a housing bubble are the prices being insanely high (some say more than 3x annual income for a house is unacceptable), and housing prices increasing more rapidly than rent ones. In many

---

[7] Susan Wachter, "The Housing Bubble: The Real Causes -- and Casualties," Knowledge@Wharton, accessed April 17, 2020, https://knowledge.wharton.upenn.edu/article/housing-bubble-real-causes/, 1.
[8] Anne Sraders, "The Lehman Brothers Collapse and How It's Changed the Economy Today," TheStreet, September 12, 2018, https://www.thestreet.com/markets/lehman-brothers-collapse-14703153, 1.

American Cities housing can be 10x a person's annual income. Increased debt in one area is another sign, an example being how household mortgage debt had increased 8.8% from 2015 to 2016. There are other factors that could also be affecting the prices, without worry of a bubble occuring, like high migration or low unemployment.

III. Banks need to rely on moral hazard to succeed. After the Lehman Brothers collapse following the housing crisis of 2008, the American government decided it could no longer allow such over leveraging and subprime lending that had allowed for one institution to be the catalyst for the economic disasters of 2008 that had followed. Although lenders had already begun to default on risky loans and risky subprime mortgages a year prior to their collapse, the Lehman brothers continued to buy up real estate; they doubled their assets a year before the big crash came down on them. They went from 111 billion in 2007 (following them doubling their assets), to 1 billion after just one week of investors and lenders alike jumping ship. As the Lehman Brothers attempted to sell off some of their real estate and decrease mortgages, the point was moot, and they claimed bankruptcy, causing their stock to plummet 93% from where it had been three days earlier. One of the largest factors contributing to their collapse was their over lending during the housing bubble previously mentioned in the early 2000’s prior to the 2008 market crash. The moral hazard that caused the Lehman Brothers to fail was that investors and hedge fund managers were so disconnected from the money, meaning that it was easier for them to be risky with money that was not their own, when they felt as though they could not technically fail themselves. There was also the matter of complicated insurance contracts known as credit default

swaps which had been used to insure many European bonds the European banks had been led to believe were of top quality. Due to the complicated nature of credit default swaps, that had repackaged and dispersed subprime assets so many times, no one knew who it was that would lose out when the loan was not paid, this made things convoluted and easy to ignore for a time. Who wants to focus on what you could stand to lose when it feels like you're making billions. AIG, or American International Institute, a prominent insurance institution was once believed to be too big to fail. AIG had guaranteed too many of the mortgage bonds held by european banks, but it became clear there was no money for them. AIG had gambled on the collateralized debt obligations of borrowers and lost. Following the breakdown of Lehman Brothers, the government bailed out AIG after they declared bankruptcy the same year, to the tune of $182 billion, which was in turn used on their credit default swaps and given to European banks. This is the reason the American government had chosen to intervene in AIG's collapse and not the Lehman Brothers, if they had not done so, then Europe's banks would have collapsed.[9] But after a decade the U.S financial stability service was finally able to remove AIG from their list of systematic risks, which they created using surveys of banks to keep them in check. AIG has also returned its debt to taxpayers. It was due to American investment banks aggressively selling to the easily duped European banks that nearly caused their collapse, by buying into high risk U.S. subprime debt prior to the market crash. Banks in America have recovered from this a lot faster than any in Europe.

IV. The catalyst for the Eurozone's troubles occurred with the U.S. credit crisis Due to Wall Street's booming success made by repackaging debt from subprime mortgages and selling them

[9] Anne Sraders, "The Lehman Brothers Collapse and How It's Changed the Economy Today," TheStreet, September 12, 2018, https://www.thestreet.com/markets/lehman-brothers-collapse-14703153, 2.

to European banks, when the crash came it was obvious Europe's banking system was sitting on many of the losses. It was wondered if their country could even afford to keep their banks from failing let alone settle sovereign debts. Typically a government would allow for a little inflation, and just print out more money to pay off their debt, but for all countries now utilizing the new Euro it was impossible. Greece was the first to admit it could not finance its deficit, at first the plan was to bail them out, but soon other countries such as Ireland, Portugal, and Spain reached out for help- causing worry there was even money to give in times of need. Stern economic backtracking in spending in Greece was counterproductive and worsened their economy by slowing it down further. Although they reduced government spending they had also accidentally reduced economic activity. Due to the premature decision to enact one currency for all those members of the European Union, the only choice was for all of those countries to stand behind each other's debt as a whole, making the Eurozone a solvent for the debt. Because they had not accounted for this occurring, a new European department of treasury needed to be formed, this meant taxpayers in the stronger European countries would be paying for their lesser fortunate brothers and sisters to get out of debt. If any one of these countries were to default on their debt the whole system would come crashing down as a whole.

V. The European Countries must back their debt as a whole and the risk of collapse should dissipate. If you judge the Eurozone by the whole, and not through their individual debt, then their deficit is even lower than that of the United Kingdom or the United States. As long as the weaker nations may accept the fact that larger ones need more control of interest rates currency, as well as decisions regarding public spending. It has become a lot more of a political and trust issue than merely running the numbers on what would be efficient. If the issues are too large for

the European Union to solve, the only other option is to downsize.[10] Many people would be happy to allow Greece to separate themselves along with their extensive issues. Portugal and Ireland are other likely candidates if there were to be a departure from the union. Another option the Eurozone remains to have would be to devalue the euro at about one dollar, where it had remained at about $1.22 throughout their crisis. This would boost their imports and exports but may have some negative effect on the countries economies they heavily import from.

There were many reasons the European Union faced such hardships, the largest one stemming from their decision to enact the euro. American hedge fund managers who were aware of European banks' willingness to invest in risky subprime debt packages also had a lasting effect once the American credit crisis occurred. It was only once this happened the extent of damage done to their banks by bad debt had shown its cracks in their entire system. Housing bubbles burst and investments went bad, bankrupting thousands of businesses including the once too big to fail Lehman Brothers and AIG. America's economy has since recovered whereas Europes still stands on what seems to feel like a teeter totter, with one bad decision having the power to bankrupt the entire Eurozone. If stronger countries like Germany remain to back the weaker nations debt then all should be well, as long as there are no missteps.

[10] John Authers, *Europe's Financial Crisis: a Short Guide to How the Euro Fell into Crisis and the Consequences for the World* (Upper Saddle River, NJ: FT Press, 2012), 150.

Bibliography

Authers, John. *Europe's Financial Crisis: a Short Guide to How the Euro Fell into Crisis and the Consequences for the World*. Upper Saddle River, NJ: FT Press, 2012.

Authors, John. “The Data from the Book.” NJ: Upper Saddle River, 2012.

Bordo, Micahel. “The Operation and Demise of the Bretton Woods System.” The operation and demise of the Bretton Woods system | VOX, CEPR Policy Portal, April 23, 2017. https://voxeu.org/article/operation-and-demise-bretton-woods-system.

Corsetti, Giancarlo. "The Euro Crisis in the Mirror of the European Monetary System." The euro crisis in the mirror of the European Monetary System | VOX, CEPR Policy Portal, February 15, 2019. https://voxeu.org/article/euro-crisis-mirror-european-monetary-system.

Sraders, Anne. "The Lehman Brothers Collapse and How It's Changed the Economy Today." TheStreet, September 12, 2018. https://www.thestreet.com/markets/lehman-brothers-collapse-14703153.

Wachter, Susan. "The Housing Bubble: The Real Causes -- and Casualties." Knowledge@Wharton. Accessed April 17, 2020. https://knowledge.wharton.upenn.edu/article/housing-bubble-real-causes/.