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The European Union and the Eurozone: The Danger that Lay Ahead

María Lorca-Susino

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Miami - Florida European Union Center

University of Miami
1000 Memorial Drive
101 Ferré Building
Coral Gables, FL 33124-2231
Phone: 305-284-3266
Fax: (305) 284 4406
Web: www.miami.edu/eucenter

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The European Union and the Eurozone: The Danger that Lay Ahead

María Lorca-Susino[♣]

The past two years have been very dramatic for the EU, particularly for the Eurozone. Not only have the financial and economic crises impacted every single country but, most importantly, southern European countries have developed problems of their own, which are affecting the entire system worldwide.

In 2010 a sovereign debt problem unfolded in Greece. However, solving this problem and avoiding contagion to other countries and areas of the world has proven to be quite a challenge. March 2011 was a decisive month for both the EU and the Eurozone because two dramatic but necessary financial and economic agreements took place. The first one was the agreement to reinforce the Stability and Growth Pact by automatically implementing harsher financial sanctions for rule breakers. The second was to finally agree, after two years of debate, on establishing the European Stability Mechanism (ESM).

This deal was sealed among European Finance Ministers to approve a detailed agreement establishing a permanent crisis mechanism, which was designed on November 28, 2010, following a proposal by the European Commission and agreed to by the euro area Ministers of Finance. The purpose of this mechanism is to safeguard financial stability in the euro area by expanding the mandate of the European Financial Stability Facility (EFSF). The EMS is ready to lend around €500bn, or about $710bn to troubled Eurozone countries; however, this amount does not seem to be enough to support Eurozone member states in difficulties. The ESM will start operating in 2013 to replace the current EFSF. The ESM has been created with the intention to prevent and end any future sovereign-debt crisis, the reason being that after Greece received the rescue package in May 2010, it was thought that the area was saved and that it was business as usual; however, the situation in Greece has not improved, and other countries have shown the need for economic support.

This paper summarizes the Greek situation by analyzing the two rescue plans in order to help the country avoid default, and also seeks to open the debate on whether Eurozone member states such as Greece should be left to its own devices and default on its sovereign debt; thus, this work briefly reviews and compares default cases such as Asia and Argentina. Also, it aims at shedding light on the actions that have been taken to save the rest of the euro area countries in difficulties and pinpoints that the measures taken are not enough to settle the financial markets. After two years of crisis and panic, it is clear that the instability in the Eurozone will only disappear with the introduction of a Eurobond; however, this financial requisite requires fiscal unity, which is the one integration step that is clearly not accepted by Eurozone governments as of summer 2011. Finally, this paper highlights the role of the banking system in underpinning the stability of the European Union in order to bring stability and trust to the union.

This paper concludes that the EU faces a make or break moment in summer 2011. The efforts to save Greece and other countries in difficult situations are not working. The current course of action is demonstrating that the European Union and the euro may not be saved for a number of reasons. Firstly, a financial crisis is being worked out by politicians representing different sovereign countries. These politicians are therefore defending their national interests; that is, their tax payers' money. Secondly, the EFSF, worth €440bn, is simply not enough to cover both the existing and expected financial necessities. Unless it is agreed that this fund enjoys a safety net of a few trillion euros to rescue countries in difficulties, the markets are not going to calm down. Also, there should be a fiscal union and a European

♣ María Lorca-Susino, Ph.D. is full-time lecturer of economics at the University of Miami as well as Associate Editor at the European Union Center of the University of Miami. She holds a Master in Business Administration in Finance, and a Master of Science in Economics and a Bachelors of Arts and Science in Political Science (University of Miami). She has recently published "The Euro in the 21st Century" (Ashgate). Her research interests include comparative political economy, with a special interest in the European Union and Spain. Her most recent publications are all available on line at www.miami.edu/eucenter. The author would also like to thank Alfonso Camiñas-Muiña, Assistant Editor at the Miami-Florida European Union Center of Excellence, for his valuable help and comments in editing this paper.

bond, which is an option that is not accepted by some EU member states. Still, European politicians believe that the European Central Bank should follow the Federal Reserve Bank's footsteps. However, the Fed is the central bank of a fiscally unified country, the ECB is not. Thus, politicians should understand that the European Central Bank has a limited "obligation" to help those countries in difficulties.

Understanding the Greek Conundrum: Two Rescue Plans and One Mission

In May 2010 Greece publicly announced to the world that it was on the brick of bankruptcy with a country debt expected to reach about €350bn by 2014.[2] The world, and most importantly the EU, could not afford such a financial disaster because the world is still fighting to survive the crisis of 2007. Thus, it was agreed that Greece had to be saved and a bail-out plan was put in place to help Greece under the motto: "save now, ask later."

The reason why Greece performed so poorly is widely known. Greece has not respected the Stability and Growth Pact and was never forced to put finances in order and, as a consequence, the SGP has been reformed once again with stricter rules and compliance requirements. Much has been written to explain that once upon a time France and Germany did not comply with the SGP and that they were not forced to obey; hence, why should Greece be forced to observe the SGP? Although France and Germany did not comply, Greece cannot be compared with economic and financial soundness of these countries. Greece has technically defaulted on its sovereign debt, while Germany is the strongest country in the union and the second biggest exporter in the world. However, this work could not faithfully explain the situation if it did not present another reason that sheds light on the current financial distress. Greece used "creative accounting"[3] to work out the numbers on its national accounts in 2009, which led to the budget crisis in 2010. It has been well-documented that in 2008 Greece presented budget deficit estimates for 2009, which stood at about 6.7% of gross domestic product; however, in October 2008 the newly elected Greek government revised the estimate of the government budget deficit for 2009 from 6.7% of the gross domestic product (GDP) to 12.7% of GDP".[4] It was then explained that Goldman Sachs helped Greece "obscure billions in debt from the budget overseers in Brussels."[5]

To save Greece, the International Monetary Fund (IMF) and the Euro area nations came up with what was labeled a "lending facility", or bailout, of €110bn ($146.2Bn) on May 2, 2010: €30bn in standby agreement with the IMF and €80bn from euro area member states in the form of bilateral loans, once approved in national parliaments.[6] The terms of the bail-out were set as a three year bailout plan that Greece would have to repay with an interest of 7.5%. The first loan, worth €30bn, was given before May 19, 2010, the date by which Greece had to make debt repayment and avoid defaulting on its massive debt. However, Greece was also asked to take some extreme austerity measures that would help cut €30bn over the next three years, which was expected to help reduce public debt from 13.6% in May 2010 to less than 3% by 2014. Some of these austerity measures - scraping bonus payments for public sector workers, capping annual holiday bonuses, increasing the Value Added Tax from 21% to 23%, raising taxes on fuel, alcohol, and tobacco by 10% and taxing illegal construction[7] - have shaken the social roots of the country and have caused social demonstrations and general strikes.

Despite intentions and actions taken to curve spending, neither investors nor the market believed in Greece and, as a result, on February 7, 2011, the country's Credit Default Swap (CDS) soared to 472.6

[2] Disclaimer: Amounts presented in this paper are rough estimates that can vary due to the financial markets performances and economic events.
[3] Greece has been characterized for year for what can be called "creative accounting." For more information refer to http://articles.moneycentral.msn.com/Investing/JubaksJournal/why-every-nation-cooks-its-books.aspx?pgnew=true
[4] Rebecca Nelson, Paul Belkin, et al. "Greece debt crisis: Overview, policy responses, and implications," Congressional Research Service, US Government. http://www.fas.org/sgp/crs/row/R41167.pdf
[5] Louise Story, Landin Thomas, Nelson D Schwartz, "Wall St. helped to mask debt fueling Europe's crisis," The New York Times, February 12, 2010. http://www.nytimes.com/2010/02/14/business/global/14debt.html?pagewanted=all
[6] European Commission Economic and Financial Affairs, "Euro area and IMF agreement on financial support programme for Greece," European Commission, May 5, 2010.
[7] "Eurozone approves massive Greece bail-out," BBC News, May 2, 2010.

points. At that point, the country witnessed a flight of capital as the market realized that "default" was a very real possibility, and investors showed a total lack of confidence in the country. With this scenario, Greece had no other option but to see its debt downgraded by the three major rating agencies: On May 7, 2011, Moody's downgraded Greece from Ba1 to B1; on May 9, 2011, S&P downgraded Greece from BB- to B; finally, Fitch downgraded on May 20, 2011, from BB+ to B+.

In July 2011, just about twelve months after Greece asked for the first rescue package, more money was needed; if Greece were to not get a second rescue package, the world would witness and suffer a sovereign default. The problem is that the first rescue plan has not been enough to solve the problem because Greece is immersed in a severe economic recession and the situation is such that on June 1st, 2011, Moody's downgraded Greece to Caa1, on par with Cuba, and raised the nation's risk of default to 50%.[8]

The second round of financial help was worth €109bn[9] in new loans and Greece agreed in return to implement about €78bn in additional austerity measures and asset sales through 2015.[10] This time, however, this rescue plan involved some sacrifice on the bondholders' side. In fact, this new rescue package includes a target of about €37bn in bondholders' commitment to either swap or rollover their debt for new bonds that mature in 30 years, which would represent a 21 per cent reduction in the bonds' value and "is expected to trigger a selective default."[11] What Papandreou promised in return to the IMF and the Eurozone member states to secure this second package was that the government was going to implement a €6.4 billion spending cut from June 2011 to December 2011, another €22 billion up to 2015, and €50 billion in sales of assets. What is mindboggling is that it was chosen to implement easier adjustments first and hard ones later, which makes it seem as if political actors are postponing the hardest cuts for later: €6.4bn in 2011 and €22bn in 2015.

Greece was still entitled to the last payment of the first bail-out plan when asking for a second rescue package. To get this money, Greece had to convince the IMF to agree to grant the final payment of the first rescue package.[12] This last tranche consisted of a €12bn payment due on June 29, 2011, out of which €3.3bn were coming from the IMF. In order to receive this money, Greece had to agree to further cuts: €14.32bn of public spending cuts and €14.09bn of tax increases for 5 years. These extra austerity measures are causing much trouble for Greece. Greece must deal with the international market's lack of trust in any of the promised deficit cuts and debt reductions; furthermore, it has to deal with instability forces at home from two sources, the first being a tremendous opposition from members of labor unions that took over the Finance Ministry offices in central Athens. Unions prevented employees from entering buildings and hung a banner from the roof calling for a general strike to oppose the measures.[13] The second source of distress comes from the Conservative party, whose leaders rejected the new austerity measures, claiming that these measures would flatten the Greek economy and destroy Greek society.[14]

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[8] Jonathan Stearns and Maria Petrakis, "EU preparing new rescue plan for Greece," June 4, 2011. http://www.bloomberg.com/news/2011-06-03/eu-preparing-new-rescue-package-for-greece.html

[9] Peter Spiegel, Quentin Peel, Patrick Jenkins, and Richard Milne, "Deal on Greece bail-out," Financial Times, Friday 22, 2011

[10] Natalie Weeks and Marcus Bensasson, "Papandreou Clinches Votes for Second Greek Budget Bill," Bloomberg, June 30, 2011. http://www.bloomberg.com/news/2011-06-30/papandreou-wins-enough-votes-to-pass-greek-budget-bill-ensuring-bailout.html

[11] Peter Spiegel and Quentin Peel, "EU leaders agree €109bn Greek bail-out," Financial Times, July 21, 2011.

[12] Andrew Hickley, "Juncker raises doubts on IMF Greek payment," GFS News, May 27, 2011. http://www.gfsnews.com/article/1968/1/

[13] Jonathan Stearns and Maria Petrakis, "Greece to Get Next Aid Payment From New Bailout, " Bloomberg, June 3, 2011. http://www.bloomberg.com/news/2011-06-03/greece-to-get-next-aid-installment-as-euro-zone-officials-plan-new-bailout.html

[14] Nick LLiev, "Greece suffers second round of severe austerity measures," The Sofia Echo, May 30, 2011. http://sofiaecho.com/2011/05/30/1097351_greece-faces-second-round-of-severe-austerity-measures

Greece Is Not Alone: A Fool's Consolation

Both the market and investors have been waiting for politicians to make a decision over what should be done to solve the problem other than throwing money at what can be called the "Greek black hole" to avoid default. There have been many options, but the most interesting one has been to implement an adjusted version of the "Brady Plan" in Greece. This plan was used by the IMF to bring most Latin American countries out of their financial crises. The Brady Plan for Greece was briefly discussed by few economists as an option to solve the crisis but never became a valid scenario, despite its proven effectiveness in the Latin American case. However, some form of an "informal" Brady plan seems to be operating in the market.

The assistance that Greece received was aimed at preventing default, but something must be done about Greece's debt, which is expected to surpass 140% of the GDP in 2011. Thus, the debate on "defaulting vs. no-defaulting" has sparked a debate. One side defends that countries should be left to default and self-organize, such as the case of Argentina. Argentina is again making headlines as a miracle, since it did not accept any financial help and defaulted in its sovereign debts, making it the biggest default in history to date. Ten years later, Argentina has paid almost everything. But it has a tremendous advantage over Greece: Argentina has abundant natural resources which are being demanded by developing countries, mainly China. The demand for raw material during the past 2 years has helped the country enjoy an impressive expansionary economic momentum and has improved national accounts, which would help pay back remaining debts. The other side believes that countries should be helped with economic rescue packages conditional to structural reforms and debt restructuring. This was the approach used during the Asian crisis in the late 1990s. However, this has been pejoratively called "financial imperialism." Nonetheless, this new form of imperialism has quite an interesting track record among Southeast Asian countries, since most of these countries that were given financial aid and forced to restructure are today strong in the international markets.

The table below summarizes the problem faced during the past sovereign debt crisis, the amount of the rescue fund provided and the outcome. In summary, Mexico can be considered the first country which had difficulties. Due to its geographical situation, the US immediately decided to provide the necessary funding to stop the crisis and control the situation. Thus, when Mexico was at the dawn of default the US helped with about $50bn in loans. The East Asian crisis was different. Those countries immersed in the Asian crisis were helped either by the IMF, the World Bank, G7 countries, or a combination. When Thailand—the first country in the area—ran into financial difficulties, the US did not rush to save it, as the problem in this country was regarded as insignificant. However, the 1997 East Asian crisis demonstrated that no problem is small enough and that contagion will become a fact. This lack of response on the part of the US has been blamed and used to explain the spillover effect to the rest of the area. Years later, Russia ran into sovereign debt difficulties and defaulted selectively after receiving some help.

Most believe that avoiding default is the right path, but then the problem becomes what to do with the massive amount of sovereign debt spread worldwide. From the beginning of the Greek crisis, one case scenario was "no restructuring" of the Greek debt. However, this could not be an option because, in order for Greece to be able to pull through the current economic situation, there was going to be a need to impose some debt restructuring upon private investors. "Voluntary restructuring" was a second option. Should Greece take this option, the question would remain whether the restructuring is drastic enough to convince the market that the post-Restructuring debt stock would be honorable and serviceable this time around. Finally, a "forced restructuring" was not negotiable, as it was treated by the market and investors as a default and a restructuring. However, it seems that the third option is the way to go, since the second rescue plan includes involvement on the side of bondholders and investors on Greek sovereign bonds. In fact, "the Institute of International Finance estimated the total reduction in the net present value of Greek

debt to be 21 per cent."[15] Thus, Greece has defaulted selectively in its debt despite receiving economic rescue during the past two years.

Greece is not alone, the difference being that very few countries have received both financial aid and have defaulted. The table below shows the list of countries that were once about to default on their sovereign debt and a summary of the rescue package provided by international institutions. In the case of Southeast Asia, it is important to mention that a total of $116bn left the area weeks before a full-fledged crisis spread mercilessly throughout the area. In the European case, it has already been reported that, despite the help provided in June to countries in difficulty, "US money market funds have sharply cut their exposure to banks in the Eurozone over the past few weeks and reduced the available credit, even in stronger countries such as France."[16]

[15] Wolfang Munchau, "The Eurozone crisis is on pause, not over," Financial Times, July 24, 2011.
[16] Dan McCrum and Patrick Jenkins, "US funds cut Eurozone exposure," July 25, 2011, Financial Times. http://www.ft.com/cms/s/0/1cda4056-b495-11e0-a21d-00144feabdc0.html?ftcamp=rss#axzz1TE85Jt5H

Country	When	Amount	Result
Mexico[17]	December 1994	$50bn loan by US government	**No Default**
Thailand[18]	August 1997	$21bn loan by the IMF and other countries (1st on August 11, for $17bn: Japan, Australian, Hong Kong, Malaysia, Singapore, Indonesia, Korea, World Bank, and Asian Development Bank 2nd on August 20, for $3.9bn by the IMF)	**No Default** Repaid loan in 2003, 4 years ahead of schedule
Indonesia[19]	August 1997	$23bn loan by the IMF and (IMF: $11.4bn The rest: Bank of Indonesia among others)	**No Default** Repaid IMF in 2006
South Korea[20]	July 1997	$58.5 bn loan by the G7 governments, the IMF, the World Bank and the Asian Development Bank (IMF: $21bn Dec 1997)	**No Default** By first quarter of 1999, the crisis was considered to be over (August 2001 repayment to IMF)
Malaysia[21]	September 1998	IMF help was refused	**No Default** By 1999 economic growth was back mainly due to the international capital flow that came back to East Asia in the forth quarter of 1998[22]
Russia	July 1998	$25bn loan by IMF and WB (IMF: $23bn on July 13, 1998[23])	**Selective Default** August 19, 1998 Russia fails to pay its debt on GKO and defaults. IMF and G7 declare will not provide more funds to Russia
Brazil	1999	$41.5bn loan by IMF, World Bank, and G7 Nations $18bn loan by the IMF[24] and other international aid agencies will chip in $9 billion. The remaining $14.5 billion will come from industrial countries in North America, Europe and Asia. The United States will contribute $5 billion[25]	**No Default** Paid off its loans earlier on December 2005

[17] Charles Calomiris, "Lessons from the Tequila Crisis for Successful Financial Liberalization," American Enterprise Institute for Public Policy Research, October 1, 1999. http://www.aei.org/article/15090

[18] International Monetary Fund, "IMF Approves Stand-by Credit for Thailand," Press Release Number 97/37, August 20, 1997. http://www.imf.org/external/np/sec/pr/1997/pr9737.htm

[19] International Monetary Fund, "Camdessus Commends Indonesian Actions," Press Release Number 97/22, October 31, 1997. http://www.imf.org/external/np/sec/nb/1997/nb9722.htm

[20] Jahyeong Koo and Sherry L. Kiser, "Recovery from a financial crisis: the case of South Korea," Federal Reserve of Dallas. http://www.dallasfed.org/research/efr/2001/efr0104c.pdf

[21] The Economist, "A prickly pair," A survey of South-East Asia, February 10, 2010. http://www.economist.com/node/280660

[22] Mahani Zainal Abidin, "The Financial Crisis in Malaysia: The Economic and Political Consequences," Institute of Southeast Asian Studies, October 1999. http://www.iseas.edu.sg/trends996.pdf

[23] International Monetary Fund, "Camdessus says IMF Board to Consider Strengthened Reform Program Supported by Substantial Increase in Financing for Russia," Press Release Number 98/24. http://www.imf.org/external/np/sec/nb/1998/nb9824.htm

Argentina	2002	Refused IMF help and defaulted on part of external debt: $93bn (biggest default in history)	**Voluntary Default** March 2005: President Kirchner declares the restructuring of the country's debt to be a success. Argentina offered to exchange more than $100bn in defaulted bonds[26] Trying to pay back bondholders particularly Paris Club[27]

[24] International Monetary Fund, "IMF Approves SDR 13 Billion Stand-By Credit for Brazil; Activates NAB," Press Release Number 98/59, December 2, 1998. http://www.imf.org/external/np/sec/pr/1998/pr9859.htm

[25] Associate Press, "$41.5 billion deal for Brazil to halt financial maelstrom, " Deseret News, November 14, 1998. http://www.deseretnews.com/article/662853/415-billion-deal-for-Brazil-to-halt-financial-maelstrom.html

[26] BBC News, "Time line: Argentina," http://news.bbc.co.uk/2/hi/americas/country_profiles/1196005.stm

[27] Jude Webber, "Argentina and Paris Club: still at odds," Financial Times, March 1, 2011. http://blogs.ft.com/beyond-brics/2011/03/01/argentina-and-paris-club-still-wrangling/#axzz1TEppIAA8

The lesson learned from this long list of countries in disarray has been that in a globalized world, no matter how small a country is, it may have a devastating effect on the rest of the world. However, the EU and the Eurozone are facing another challenge. It is agreed that Greece must be saved, but voices are claiming that saving Greece should not cause the bankruptcy of other countries.

Greece must be saved in order to stop contagion. There are other countries in the area under stress, such as Portugal and Ireland, but these countries are suffering their own set of problems that are not attributable to Greece. However, when the risks of all these countries in difficulties are put together, the world faces Armageddon.

As for the Greek problem, according to the information available, 60% of the debt is held by European countries, 29% by Greece, 3% in the hands of Asian countries, 3% in the USA and 5% in other various countries.[28] Therefore, the problem is mainly European, since almost 90% is held in the EU; thus, the Greek problem alone has little effect at the international level. Also, the Bank of International Settlement (BIS) has presented that 43% of the debt is in the hands of banks; in particular, the BIS also provides information on the breakdown of bank exposure to Greece's debt. In fact, the information shows that Germany has about €80bn, France has an exposure of about €100bn, and the US has a bit less than €50bn involved.[29] Finally, it is important to explain that there are two groups of creditors in Greece: the official lenders, which consist of the IMF and the EU, and the private sector.

As mentioned, Portugal and Ireland are facing their own sets of problems and are also under the watch and supervision of the IMF and the EU. Also, it is important to mention that this second bailout plan for Greece has helped relax the general terms and conditions for Greece, Ireland and Portugal. For instance, under the new contract, the interest on the repay loans for these countries has now been set at 3.5%, rather than the 7% required before, and the repayment schedule has been extended from 7.5 years to a range that varies between 15 to 30 years.[30]

WHO IS RECEIVING MONEY

Country	How much	When
1st Lending Facility for Greece	**€110bn**	May 2010
1st emergency tranche	€30bn	May 19, 2011
3rd tranche	€12bn ($17.4)	July 16, 2011
2nd Rescue plan for Greece	**€102bn**	July 21, 2011
1st Rescue plan for Ireland	**€85bn**	November 2010
1st Rescue plan for Portugal	**€78bn**	April 2011
AMOUNT LOANED	**€375bn**	From May 2010 to July 2011

Saving Greece and Saving Europe: The EFSF and the European Central Bank

The Greek problem has demonstrated that the EU and the Eurozone were not ready for member state default. The idea was that since member states had to respect the Stability and Growth Pact, there was little chance that countries would pile up deficits and incur massive debt. However, this unlikely scenario became a crude reality in May 2010. European Union policy makers approved three lending facilities in early May for Eurozone member states out of fear that the Greek sovereign debt crisis might spread to other countries. To stop contagion and to help Greece and other countries, it was necessary to deal with the "no bail-out rule." Thus, the problem was not the risk of default, but how to treat this threat of default

[28] Boris Groendahl, "German Banks Top French on $23 Billion Greek Debt, BIS Says," Bloomberg, June 6, 2011. http://www.businessweek.com/news/2011-06-06/german-banks-top-french-on-23-billion-greek-debt-bis-says.html
[29] Boris Groendahl, "German Banks Top French on $23 Billion Greek Debt, BIS Says," Bloomberg, June 6, 2011. http://www.businessweek.com/news/2011-06-06/german-banks-top-french-on-23-billion-greek-debt-bis-says.html
[30] Peter Spiegel and Quentin Peel, "Deal on Greece bail-out," Financial Times, July 22, 2011.

and deal with Article 125. Article 125[31] (ex Article 103 TEC) states that neither the EU nor a member state should be liable or assume the commitment of any public body or entity of any member state. This article directly bans any direct fiscal transfers from one member state to another and also seems to ban purchases of sovereign debt in the primary market. On May 11, 2010 the Council of the European Union approved the Council Regulation (EU) No 407/2010, which established the European financial stabilization mechanism; the No-Bail out rule of Article 125 was bypassed using Article 122(2) of the Treaty. This article foresees the possibility of granting Union financial assistance to a Member State in difficulties or seriously threatened with severe difficulties caused by exceptional occurrences beyond its control."[32]

On May 9, 2010, the EU's finance ministers adopted a regulation establishing a European Financial Stabilization Mechanism (EFSM) with the purpose of saving Greece and the union project, and which will help member states in difficulties caused by exceptional circumstances beyond their control to obtain financial assistance from the mechanism. The EFSM has a maximum total lending capacity of €60bn from the EU budget and administered by the European Commission. Furthermore, Eurozone member states agreed to create the European Financial Stability Facility (EFSF). The European Financial Stability Facility (EFSF) was a special purpose vehicle set up to make loans to Eurozone member states other than Greece. The EFSF has been the third lending facility established to help countries in difficulty. The EFSF has been endowed with up to €440bn, which can be supplemented with €250bn from the International Monetary Fund (IMF). The EFSF has the capacity to issue "bonds guaranteed by EAMS for up to €440 billion for on-lending to euro area member states (EAMS) in difficulty, subject to conditions negotiated with the European Commission, and in liaison with the European Central Bank and International Monetary Fund, and to be approved by the Eurogroup."[33] The facility has been granted the highest possible rating by the three rating agencies. The EFSF "is a Luxembourg-registered company owned by Euro Area Member States. It is headed by Klaus Regling, former Director-General for economic and financial affairs at the European Commission."[34] Troubled member states will receive funds after submitting a request comprising "an assessment of its financial needs and an economic and financial adjustment program describing the various measures to be taken to restore financial stability."[35] In fact, "in order to reach its objective the EFSF can, with the support of the German Debt Management Office (DMO), issue bonds or other debt instruments on the market to raise the funds needed to provide loans to countries in financial difficulties. Issues would be backed by guarantees given by the 16 euro area Member States of up to € 440 billion."[36]

Structure to Save the Project	Amount
EFSM or Second Lending Facility	€60bn
EFSF or Third Lending Facility	€440bn
International Monetary Fund	€250bn

This leads to the next question: Where is this money coming from? The top two contributors who will be required to put the money on the table to save countries are Germany, who contributes with €119,390.07

[31] Consolidated version of the Treaty on the Functioning of the European Union," Official Journal of the European Union, March 30, 2010
[32] Official Journal of the European Union, "Regulations," May 11, 2011. http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:118:0001:0001:EN:PDF
[33] European Financial Stability Facility, "What about the EFSF." http://www.efsf.europa.eu/about/index.htm
[34] European Financial Stability Facility, "What about the EFSF." http://www.efsf.europa.eu/about/index.htm
[35] European Commission Economic and Financial Affairs, "European financial stabilisation mechanism." http://ec.europa.eu/economy_finance/eu_borrower/efsm/index_en.htm
[36] European Financial Stability Facility, http://www.efsf.europa.eu/attachments/faq_en.pdf

million, followed by France, with €89,657.45 million. The table[37] below shows the contribution of a number of countries. While Germany and France contribute almost half of the money "chipped in," PIIGS countries are also putting in an important share. This might be a way to discourage them from running into financial trouble, since the money they will receive will be their own. This brings up an interesting philosophical paradigm: how would a country in financial difficulty be able to receive money when this money would have to be technically provided by the country itself?

Countries	Amount in million of €	Percent of total
Germany	**119,390.07**	**27%**
France	**89,657.45**	**20%**
PIIGS	**161,562.71**	**36%**
Portugal	11,035.38	
Ireland	7,002.40	
Italy	78,784.72	
Greece	12,387.70	
Spain	52,352.51	
2004 countries	**7,705.99**	**1.7%**
Rest of Eurozone	**53,778.58**	**12%**

So far the EFSF has been quite active in its short lifespan, issuing bonds for Ireland and Portugal, as presented in the table below.

European Commission placement on behalf of the EU under the EFSM

Country	Issued	Terms
Ireland	January 5, 2011	€5bn for 5 years with 2.500% annual coupon – 1st tranche
Ireland	March 17, 2011	€3.4bn for 8 years with 3.2500% annual coupon
Ireland	May 24, 2011	€3bn for 10 years with a 3.500% annual coupon
Portugal	May 24, 2011	€1.75bn for 10 years with a 3.5% annual coupon
Portugal	May 25, 2011	€4.75bn for 5 year with 2.75% annual coupon
Two further benchmark bonds are planned for the later second half of 2011		

Finally, after a lengthy and difficult negotiation between Germany and the rest of the Eurozone member states, the European Stability Mechanism (ESM) will become a permanent crisis mechanism in mid-2013. The ESM will substitute the EFSF, which will be active until mid-2013. The main feature is that the ESM will expand the capabilities of the EFSF as it will reinforce economic surveillance in the EU. The ESM will be asked to pay attention to debt sustainability, to have a more effective approach when enforcing measures and to focus on prevention to reduce the probability of another crisis in the future. The legal basis for the ESM is based on a Council Decision adopted under Article 122, which requires the Parliament to be informed, a "qualified majority" at the Council and an intergovernmental agreement. [38]

The EFSF has not been working alone in order to calm the markets and stabilize the system. The European Central Bank (ECB) has also been quite active buying bonds from the affected countries. Still, the combined efforts of the EFSF and the ECB are not enough. Even worse, neither investors nor the markets believe that the EFSF or the ESM starting in Mid-2013 will have enough funds to shore up the expected needs of countries in difficulties. It is important to mention that Greece, Portugal and Ireland are currently being helped, but Spain and Italy are expected to run into financial difficulties soon. Thus, the provisions of €440bn and the possible actions of the ECB would not be enough. Countries in difficulties are also helped by the European Central Bank (ECB) which is buying Greek, Italian, Portuguese, Irish and Spanish bonds. In order to stop contagion and in light of financial difficulties, the ECB has already bought €77bn of Greek, Portuguese and Irish debt, and it is expected to step into the market to purchase

[37] European Financial Stability Facility, "Section A – EFSF general questions." http://www.efsf.europa.eu/attachments/faq_en.pdf

[38] Europa, "The European Stabilization Mechanism," Press release, May 10, 2010. http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/173

Italian and Spanish bonds for an estimated one trillion euros in the near future. The EFSF has already committed about €256 billion out of the €440bn available to help Greece, Portugal and Ireland. Finally, both the ECB and the EFSF might have to step in to support Italy with €1.8 trillion in debt, which is more that the PIIGS countries combined.[39]

The ECB buying activity is similar to the actions of the Federal Reserve. However, the US enjoys a fiscal unity and, as a result, the Fed mandate is strengthened, while the EU does not have this unity; thus, the ECB mandate is more limited. In fact, fiscal union is an integration step forward that Germany has opposed since the founding of the single currency. But it is not fair to blame Germany alone for this lack of interest on fiscal unity. Germany opposes it for two simple reasons. The introduction of a euro bond will, on the one hand, raise German funding costs significantly; on the other hand, if the fiscal union does not work out, Germans will have to pay for it. However, most countries would oppose a fiscal federation because it will force euro politicians to give up control over their national budgets. However, no currency union has ever survived without a fiscal union or some form of debt mutualization; in fact, the question of a euro bond or fiscal union is gaining recognition as the only way to stabilize the euro area and save the European Union.

The ECB has done a superb job so far controlling the crisis and contagion, but the situation has become too serious and costly for the ECB alone without a fiscal union to stamp out the crisis. The ECB cannot step in the market forever to buy bonds and the EFSF funds are not enough, as it is expected that the amount needed to save countries in difficulties would be about a two trillion euros. As a consequence, the market is unstable and the future of the union and the euro is seriously under review.

The European Banking System: The Stress Tests of Europe

Despite efforts to control the financial crisis, the EU has entered the second summer of "Greek Tragedy" and the situation is not improving. Each day brings news of financial calamity; however, the EU and the Eurozone have a distracting factor: a strong euro/dollar rate. Since the euro is strong, some believe that the union project is safe, but the EU and the Eurozone are facing more problems than just the difficulties of five countries on the brink of bankruptcy; the solvency of the entire union is at risk.

To add insult to injury, on July 16, 2011, Europe presented to the world the result of the "stress test" on the strength of the banking system. The purpose of these tests is to measure the resistance of European banks during economic instability. The idea for this test was inspired by the US banking crisis and, particularly, due to the difficult situation of Greece. The purpose of this type of test is to study and report publicly on the "health" situation of the European banking system to calm the markets and reassure investors that the European banking system is solid. The institution in charge of this task is the Committee of European Bank Supervisors (CEBS), whose mission is to create scenarios, analyze the exposure and make projections.

To date there have been three stress tests. The first one took place in September 2009 when the CEBS ran a very limited stress test on 22 banks that went almost unnoticed because the results were not made public. The second stress test took place on July 23, 2010, pressured by the events that unfolded in Greece and the exposure of European banks to a possible Greek default. This time 90 banks were tested. The third stress test was carried out this summer and published on July 16, 2011. In total, the list of banks stressed represents an approximate 65% of the European banking sector and 50% of the sector in each country analyzed.[40]

Currently, the EU and the Eurozone are suffering not only a difficult economic situation, but also the scrutiny of one of the most important pillars: the banking system. Due to the financial crisis that engulfed the world in 2007, and which is still being felt, banks are now forced more than ever to

[39] Andrew Davis and James Hertling, "ECB buying may reach $1.2 trillion in creeping fiscal union", Bloomberg August 9, 2011.
[40] Megan Murphy, "Analysts poring over southern Europe," Financial Times, July 16/July 17, 2011. http://www.ft.com/intl/cms/s/0/2be6b7e0-af05-11e0-bb89-00144feabdc0.html

implement the rules of Basel III. The purpose is to make sure that banks are ready to face a financial crisis and to measure the exposure of the banking system to the Greek problem. Basel III has helped estimate that the exposure of the banks tested to Greece's financial difficulties is €98.2bn ($138bn) which is €10bn less than the exposure during the second stress test in July 2010.[41] That is, if Greece goes under, European banks will lose $138bn with the subsequent impact at the economic and social level.

In short, Basel I was the result of a number of deliberations and agreements that took place among central bankers from around the world who met in Basel (Switzerland) in 1988 to set the minimal capital requirements needed for the proper functioning of banks to reduce credit risk. This agreement, the 1988 Basel Accord, had to be enforced by 1992. Basel II expanded the requirements and guidelines of Basel I and had what was called three "pillars": minimum capital requirement, supervisory review and market discipline. Guidelines in Basel II were the norm in 2004, and the purpose was to create an international standard that banking regulators could set as benchmarks when creating rules about how much capital banks must keep in reserve to face any possible financial and operational risk inherent to the bank. Basel III was triggered by the need to put together a better banking system after the financial crisis of 2007 and would apply to more than 8,000 banks in the EU. It has been defined by the Bank of International Settlements as "a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision to strengthen the regulation, supervision and risk management of the banking sector" and it is based on the need to improve the banking sector's ability to absorb shocks arising from economic and financial stress, improve risk management and governance, and strengthen the transparency and disclosure of banks.

The EU has become the first area where these "rules" have become law and the so-called Capital Requirement Directive 4, which forced large banks to have bigger and better levels of capital ready in order to face a crisis, is causing many problems in the banking industry. First, the common equity tier one (CET1) is increasing from 2% to 4% of risk-weighted assets, but the problem is that there are 14 strict criteria to determine what can be counted as CET1. Second, Basel III forces banks to implement a "Capital Conservation Buffer", which should account for 2.5% of risk weighted assets. Thus, there is a total capital requirement of 7% that must be taken into account. This extra reserve requirement poses two intertwined threats to the system. First, banks have to put more money "away" to comply with this requirement which, in turn, will mean that there might be less money available for the banks to lend; this will reduce the liquidity available. Second, if the EU is the only area or country to implement these requirements, the EU would be at a disadvantage with less capital available. Thus, the idea is that banks must hold more top-quality capital and easy to sell assets in order to face potential losses. These rules and requirements aimed at ensuring liquidity may go against banks' global competitiveness and is the heated debate of Basel III. Basel II analyzed 90 European banks and concluded that those banks which failed the test will need €2.5bn in order to improve their capital to successfully face a difficult economic downturn. Altogether, banks in the EU must come up with €84bn of CET1capital by 2015 and €460bn by 2019, and reduce their risk and balance sheets substantially.[42]

Out of the 90 banks tested this summer for Basel III in the EU, sixteen barely passed and eight flunked the exam: five are Spanish, two are Greek, one is Austrian, and one is German. All banks tested in the UK, France, Portugal and Ireland passed. Out of these failing banks, the Spanish banks, particularly the cajas (saving banks), are widely viewed as undercapitalized and chock full of questionable loans made for political, rather than economic, reasons.[43] However, Governor of the Bank of Spain Miguel Angel Fernandez-Ordonez has defended that this failing grade is unjust, since he complains that these cajas do not need to raise new capital because the European Banking Authority (EBA) refused

[41] Nikki Tait, "EU leads pack on bank capital," Financial Times, July 21, 2011. http://www.ft.com/intl/cms/s/0/3fb41c06-b2e1-11e0-86b8-00144feabdc0.html

[42] Nikki Tait, "EU leads pack on bank capital," Financial Times, July 21, 2011. http://www.ft.com/intl/cms/s/0/3fb41c06-b2e1-11e0-86b8-00144feabdc0.html

[43] Collin Barr," Eight banks fail Europe's stress test," CNN Money, July 15, 2011. http://finance.fortune.cnn.com/tag/banks/

to count general provisions; that is, money that Spain requires to set aside for just such a crisis as the one envisioned in the stress tests.[44]

Final Words

Summer 2011 has become the make or break moment for the EU. The efforts to save Greece and other economically troubled countries are not working. The EU and the euro are will not see stability in the near future for a few reasons. First, a solution to the current financial crisis is being worked out by politicians representing different sovereign countries. These politicians are therefore defending their national interests and/or their taxpayers' money. Second, the third lending facility, or EFSF, worth €440bn, is simply not enough. Unless it is agreed that this fund enjoys a safety net of about a couple of trillion euros to rescue countries in difficulties, the markets are not going to calm down. Also, there should be a fiscal union and a European bond, which is an option that is not accepted by some EU member states for political reasons. Finally, politicians should understand that the entire burden of helping should not be dumped on the European Central Bank, since there is no fiscal unity in the area. The EUC is not the Federal Reserve. Until these points do not become a reality, the EU, the euro, and the rest of the world are going to be suffering from constant instability, and even possible disintegration of the Eurozone.

Current economic events demonstrate that the world financial system is under review. Years of uncontrolled excess are a thing of the past, and the rules of the game have changed for good or bad. Developed countries are now challenged by developing countries; thus, governments must restructure and individuals must review their lifestyles.

The EU and the Eurozone both have a big task ahead: the continuation of the European Union as a viable project. Mistakes have been made, and they are either solved or the union is left on its own to self-destruct, although it seems that overcoming mistakes might cause self-destruction as well.

I strongly believe that the project has been given a second chance. However, it will depend on how politicians in the EU approach the situation. The EU and the Eurozone may either become stronger or disappear after billions of euros have been "wasted" in the cause, and the social fiber of the countries suffer an unfair "punishment."

[44] "El Banco de Espana critica la metodología europeas de las pruebas de resistencia", El Boletin, July 15, 2011. http://www.elboletin.com/index.php?noticia=37901&name=Econom%C3%ADa