INTERNATIONAL JOURNAL OF RESEARCH IN COMPUTER APPLICATION & MANAGEMENT

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   STATEMENT OF THE PROBLEM

   OBJECTIVES

   HYPOTHESES

   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

   RECOMMENDATIONS/SUGGESTIONS

   CONCLUSIONS

   SCOPE FOR FURTHER RESEARCH

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UNDERSTANDING EURO-CRISIS: HOW DID IT OCCUR?

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ABSTRACT
Using theoretical framework of optimum currency area, the paper the made an attempt to provide the reasons behind emergence of Euro crisis. Interestingly, it appears that the adverse impact of global recession due to US Sub-prime crisis triggered off the Euro zone crisis is a situation when Greece was already living beyond its means. Common factors between the US and European crisis include investment bankers and rating agencies and use of off balance activities to create macro level information asymmetry.

KEYWORDS
Economic Integration, Crisis, Investment Bankers.

JEL CODES
F15, H12, G24.

INTRODUCTION
Crises are not new to global economy. They occur in different countries at different points of time for different reasons but produce the same impact in terms of disruption of economic activity. This is true of Great Depression of 1930s, Sub-Prime Crisis in US and the Euro zone Crisis. Euro crisis occurred in 2010 and had contributed to rising government indebtedness and endangered the longer-term sustainability of public finances, a prerequisite for smooth functioning of Economic and Monetary Union. The objective of the paper is to understand the underlying reasons behind Euro Crisis.

PLAN OF THE PAPER
Section I develops the theoretical framework of the study. Section II provides the literature review relating to the theme of the paper. Rationale of the study is given in section III. Section IV will analyze the reasons behind occurrence of the crisis. Section V provides the summary and conclusion of the study.

SECTION I: THEORETICAL FRAMEWORK OF ECONOMIC INTEGRATION
Independent states can integrate their economies to varying degrees in order to achieve the benefits of size, such as greater internal efficiency and more robustness to external events. The degrees of economic integration can be divided into six steps of economic integration.
1) A preferential trading area (with reduced customs tariffs between certain countries);
2) A free trade area (with no internal tariffs on some or all goods between the participating countries);
3) A customs union (with the same external customs tariffs for third countries and a common trade policy);
4) A common market (with common product regulations and free movement of goods, capital, labour and services);
5) Economic and monetary union (a single market with a single currency and monetary policy);
6) Complete economic integration (all the above plus harmonised fiscal and other economic policies);

The main objective behind the internationalization of the euro is transaction costs in foreign exchange and securities market. By converting to a single currency, union leaders hope to achieve benefits that include
- Price stability,
- Greater confidence among investors,
- A simpler single market economy,
- A reduction in transaction costs due to the absence of currency exchanges, and
- An integrated banking system.

It is expected that international business and currency transactions will also become simpler and more efficient under the euro. The ultimate goal is a strong and stable Europe that features open markets. However at the same time, "savings glut" in one country with a trade surplus can drive capital into other countries with trade deficits, artificially lowering interest rates and creating asset bubbles. A country with a large trade surplus would generally see the value of its currency appreciate relative to other currencies, which would reduce the imbalance as the relative price of its exports increases. This currency appreciation occurs as the importing country sells its currency to buy the exporting country's currency used to purchase the goods. To reduce trade imbalances a country could encourage domestic saving by restricting or penalizing the flow of capital across borders, or by raising interest rates, although this benefit is likely offset by slowing down the economy and increasing government interest payments. Either way, many of the countries involved in the crisis are on the Euro, so individual interest rates and capital controls are not available. The only solution left to raise a country's level of saving is to reduce budget deficits and to change consumption and savings habits. For example, if a country's citizens saved more instead of consuming imports, this would reduce its trade deficit.

Optimum currency area refers to the geographic area in which a single currency would create the greatest economic benefit. Robert Mundell in the 1960s theorizes that this may not be the most efficient economic arrangement. In particular, countries, which share strong economic ties, may benefit from a common currency. This allows for closer integration of capital markets and facilitates trade. However, a common currency results in a loss of each country's ability to direct fiscal and monetary policy interventions to stabilize their economies. The school of economists who are, broadly, adherents of the post-Keynesian school of the Modern Monetary Theory condemned the introduction of the Euro currency from the beginning, on the basis that the Euro zone does not fulfill the necessary criteria for an optimum currency area, though it is moving in that direction. Let us analyse the scenario Euro in the light of the above description.

SECTION II: LITERATURE REVIEW

Does it matter whether the euro achieves the status of international currency? Policy-makers and academic writers have long regarded currency hegemony as a source of political as well as economic benefits. For instance, Kunz (1995) writes: 'Geopolitical power depends on financial power, each of which supports the other. To ignore the real benefits of controlling the international currency system is [unfortunate] ... The death of the dollar order will drastically increase the price of the American dream while simultaneously shattering American global influence.' Even the recent East Asian currency crises, which led to the demise of dollar pegs, are sometimes interpreted as an alarming example of the impending decline of the 'dollar order' (e.g., Los Angeles Times, 22 July 1997). According to Cohen (1997), monetary supremacy 'confers substantial political benefits on the hegemon. At home, the country should be better insulated from outside influence or coercion in formulating and implementing policy

EURO VS DOLLAR without constraint as well as to exercise a degree of influence or coercion over others. The expansion of its currency's authoritative domain, in principle, translates directly into effective political power.' Frankel (1995) also notes the 'benefits to political power and prestige', which, though 'nebulous', reflect the association between the loss of key currency status and the historical decline of great powers. The economic advantages from currency hegemony include a comparative advantage for markets and institutions of the issuing country, the advantage for trade of having other countries peg their exchange rates to one's own (elimination of exchange rate uncertainty), and the ability to finance balance of payments deficits with liabilities denominated in the international money, which other countries will accept without effective limit. This does weaken a constraint on economic policy, although the possible resulting overhang of liquid liabilities may ultimately pose problems. De Gaulle went too far in claiming that the power of the dollar 'enabled the United States to be indebted to foreign countries free of charge' (quoted by Kunz, 1995) - if only because foreigners hold most of that debt in interest-bearing US Treasury securities - but there was some substance in his basic insight. Still, under Bretton Woods other countries had to accumulate dollars or threaten to break up the system. With a floating dollar (and flexible exchange rates, in general), the nature of the external constraint has changed (see the Introduction to Alogoskoufis et al., 1991). Yet, in the short and medium run, the USA has been able to build up international liabilities in dollars at a lower interest rate than it would otherwise have had to pay (see below and Artus, 1997a). Moreover, it has the option to eliminate some of this debt with surprise inflation. McKinnon (1993) states that 'The "privilege" of going into international debt so heavily in your own currency is one that is open only to the centre ... country.'

Lane, Philip R. (2012) in his article concluded that the origin and propagation of the European sovereign debt crisis can be attributed to the flawed original design of the euro. In particular, there was an incomplete understanding of the fragility of a monetary union under crisis conditions, especially in the absence of banking union and other European-level buffer mechanisms. Moreover, the inherent messiness involved in proposing and implementing incremental multi-country crisis management responses on the fly has been an important destabilizing factor throughout the crisis. The most benign perspective on the European sovereign debt crisis is that it provides an opportunity to implement reforms that are necessary for a stable monetary union but that would not have been politically feasible in its absence. A more modest hope is that the unfolding reform process will deliver a monetary union that can survive, even if it remains vulnerable to recurring crises. However, the alternative scenario in which the single European currency implodes is no longer unthinkable, even if it would unleash the "mother of all financial crises" (Eichengreen 2010). The stakes are high.

From the above extant literature it is quite clear that there are both outcomes (positive as well as negative) of euro as international currency is possible. Therefore, it is required to understand the reasons behind the euro crisis that occurred globally.

SECTION III: RATIONALE OF THE STUDY

As we have seen there are number of papers relating to the issues of euro either as international currency or as case of crisis. There is need to understand first the euro-crisis and later on to know the possible reasons for the occurring of such phenomenon. Therefore, the basic objective of the present study is;

- ✓ To understand the euro crisis
- ✓ To know the reasons behind the occurrences of euro crisis

SECTION IV: ORIGIN OF EURO CRISIS

There are numbers of factor which are responsible for the origin of euro crises

(1) RELAXATION IN THE NORMS FOR ELIGIBILITY

Greece has been living beyond its means since even before it joined the euro, and its rising level of debt has placed a huge strain on the country's economy. This constituted the most controversial point relating to formation of European economic and monetary union, which ultimately led to its disintegration. In the early-mid 2000s, Greece's economy was strong and the government took advantage of running a large deficit. As the world economy cooled in the late 2000s, Greece was hit especially hard because its main industries—shipping and tourism—were especially sensitive to changes in the business cycle. As a result, the country's debt began to pile up rapidly. In early 2010, as concerns about Greece's national debt grew, policy makers suggested that emergency bailouts might be necessary.

(2) BORROWING SURGE BY GREECE AFTER ADOPTING THE EURO

European Union members signed the Maastricht Treaty, under which they pledged to limit their deficit spending and debt levels. The Greek government borrowed heavily and went on something of a spending spree after it adopted the euro. Public spending soared and public sector wages practically doubled in the past decade. It has more than 340bn Euros of debt and for a country of 11 million people, debt per capita works out to be about 31,000 Euros. Surge in government debt led to rise in public expenditure, and ceteris paribus, it should lead to income generation a la Keynesian multiplier. However, presence of widespread tax evasion nullified the rise in income resulting from government expenditure financed out of international debt and left the country in an unprecedented mess. Historic enmity to Turkey led to high defense spending, and fuelled public deficits – financed primarily by German and French banks.

(3) USE OF DERIVATIVES TO CREATE MORAL HAZARD AT A MACRO-ECONOMIC LEVEL AND CREATION OF INFORMATION ASYMMETRY AT MACRO LEVEL

However, a number of European Union member states, including Greece and Italy, were able to circumvent rules and mask their deficit and debt levels through the use of complex currency and credit derivatives structures. The structures were designed by prominent U.S. investment banks, who received substantial fees in return for their services and who took on little credit risk themselves. Financial reforms within the U.S. since the financial crisis have only served to reinforce special protections for derivatives—including greater access to government guarantees—while minimizing disclosure to broader financial markets. The revision of Greece's 2009 budget deficit from a forecast of "6–8% of GDP" to 12.7% by the new Pasok Government in late 2009 (a number which, after reclassification of expenses under IMF/EU supervision was further raised to 15.4% in 2010) has been cited as one of the issues that ignited the Greek debt crisis. This added a new dimension in the world financial turmoil, as the issues of "creative accounting" and manipulation of statistics by several nations came into focus, potentially undermining investor confidence. The role of investment banks in US sub-prime crisis is well known and needs no elaboration. It also needs to be added that a number of reports mentioned manipulation of data by EU and other nations aiming, as was the case in Greece, to mask the sizes of public debts and deficits. These have included analyses of examples in several countries or have focused on Italy, the United Kingdom, Spain, the United States, and even Germany.

(4) POLITICAL FACTORS

Investors worked on wrong assumptions while buying Greek bonds, banks made money by underwriting Greek bonds, while EU politicians in Brussels turned a blind eye. In their opinion, economy of was in pink of health. Investors assumed they were implicitly lending to a strong Berlin when they bought Eurobonds from weaker Athens.

(5) CREDIT RATING AGENCIES

The international U.S. based credit rating agencies – Moody's, Standard & Poor's and Fitch- have played a central and controversial role in the current European bond market crisis. As with the housing bubble and the Icelandic crisis, the ratings agencies have been under fire. The agencies have been accused of giving overly generous ratings due to conflicts of interest. Government officials have criticized the ratings agencies. Following downgrades of Greece, Spain and Portugal, Germany's foreign minister Guido Westerwelle said that traders should not take global rating agencies "too seriously" and called for an "independent" European rating agency, which could avoid the conflicts of interest that he claimed US-based agencies faced. European leaders are reportedly studying the possibility of setting up a European ratings agency in order that the private U.S.-based ratings agencies have less influence on developments in European financial markets in the future. According to German consultant company Roland Berger, setting up a new ratings agency would cost €300 million and could be operating by 2014.

Due to the failures of the ratings agencies, European regulators will be given new powers to supervise ratings agencies. With the creation of the European Supervisory Authority in January 2011 the European Union set up a whole range of new financial regulatory institutions, including the European Securities and Markets Authority (ESMA), which became the EU's single credit-ratings firm regulator. Credit-ratings companies have to comply with the new standards or be denied operation on EU territory, says ESMA Chief Steven Maijoor.

But attempts to regulate more strictly credit rating agencies in the wake of the European sovereign debt crisis have been rather unsuccessful. Some European financial law and regulation experts have argued that the hastily drafted, unevenly transposed into national law, and poorly enforced EU rule on rating agencies has had little effect on the way financial analysts and economists interpret data or on the potential for conflicts of interests created by the complex contractual arrangements between credit rating agencies

(6) ROLE OF ENGLISH LANGUAGE PRESS

There has been considerable controversy about the role of the English-language press in the regard to the bond market crisis. The Spanish Prime Minister Jose Luis Rodriguez Zapatero has suggested that the recent financial market crisis in Europe is an attempt to undermine the euro in order that countries, such as the U.K. and the U.S., can continue to fund their large external deficits which are matched by large government deficits The U.S. and U.K. do not have large domestic savings pools to draw on and therefore are dependent on external savings e.g. from China. This is not the case in the Euro zone, which is self-funding. Zapatero ordered the Centro Nacional de Inteligencia intelligence service (National Intelligence Center, CNI in Spanish) to investigate the role of the "Anglo-Saxon Media" in fomenting the crisis. No results have so far been reported from this investigation.

(7) ROLE OF SPECULATORS

Financial speculators and hedge funds engaged in selling Euros have been accused by both the Spanish and Greek Prime Ministers of worsening the crisis. German chancellor Merkel has stated that "institutions bailed out with public funds are exploiting the budget crisis in Greece and elsewhere. The role of Goldman Sachs in Greek bond yield increases is also under scrutiny. It is not yet clear to what extent this bank has been involved in the unfolding of the crisis or if they have made a profit as a result of the sell-off on the Greek government debt market.

According to The Wall Street Journal hedge-funds managers already launched a concerted attack on the euro in early 2010. On February 8 the boutique research and brokerage firm Monness, Crespi, Hardt & Co. hosted an exclusive "idea dinner" at a private townhouse in Manhattan, where a small group of hedge-fund managers from SAC Capital Advisors LP, Soros Fund Management LLC, Green Light Capital Inc., Brigade Capital Management LLC and others eventually agreed that Greek government bonds represented the weakest link of the euro and that Greek contagion could soon spread to infect all sovereign debt in the world. Three days later the euro was hit with a wave of selling, triggering a decline that brought the currency below $1.36. On 8 June, exactly four months after the dinner, the Euro hit a four year low at $1.19 before it started to rise again. Traders estimate that bet for and against the euro account for a huge part of the daily three trillion dollar global currency market. In response to accusations that speculators were worsening the problem, some markets banned naked short selling for a few months.

SECTION V: CONCLUSION

England was the centre of global economy and after the Second World War, the centre of gravity of the global economy shifted to US. Over time, dollar emerged as the global currency. Formation of European Union and emergence of Euro may be seen to be an attempt by European Countries to challenge the dominance of dollar by offering a united front. It is interesting to note that while US emerged as the epic centre of global economic turmoil after establishing hegemony over the world, Europe in its attempt to challenge the hegemony of dollar in the shape of Euro zone generated a crisis, which soon emerged as a global problem. The global financial capitalism seems to be moving from one crisis to another, an inevitable price for global financial integration.

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