Chapter 1

The Impact of Sovereign Debt Crisis on the EU Economy: Is This the End of the Dream?

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ABSTRACT

The subprime mortgage crisis, which started in the United States in 2008, turned into a global crisis in a short time. Following the policies to reduce and mitigate the impacts of the global crisis, a sovereign debt crisis began that led to tremendous increases in government deficits and debt stock in the European Union region and made government financial systems unsustainable. This debt crisis, which started in the second half of 2009 in Greece, has resulted in a spillover effect for every EU member country. The ongoing crisis has rendered the future of Economic and Monetary Union uncertain. This chapter aims to determine the root causes of sovereign debt crisis in the EU and the economic and financial effects of and precautions for the crisis. This study also discusses the degradation of the EU’s economic and political integration as a result of the sovereign debt crisis.

INTRODUCTION

The European Coal and Steel Community (ECSC) was founded with the Schuman Declaration in 1951 following World War II, by six members: Belgium, Federal Germany, Luxembourg, France, Italy and the Netherlands. In 1957, all six members signed the Treaty of Rome to establish the European Economic Community (EEC), which was based on free movement of labor, goods, and services (European Central Bank, 2011). As a result of rapid globalization and the acceptance of the idea that political partnership would be more beneficial for regional development, growth, and peace, the EEC, which was an economic partnership, ultimately became the European Union (EU) in its final stage of regional integration. (Gökbunar et al., 2008).

The idea of the Economic and Monetary Union (EMU) stems from the very first Werner Report in 1970, though the EMU was not formed until a decade later. It has been suggested that this delay was due to a lack of sufficient support from EU members and the recession following the first oil crisis in 1973 (Akçay, 2013). In 1979, The
The Impact of Sovereign Debt Crisis on the EU Economy

European Monetary System (EMS), which aimed to overcome the instability among the member states’ currencies, was established to combat the economic instabilities of the 1970s (European Central Bank, 2011). The ratification of the Single European Act by the member states (and later revised by the European Council in 1986) meant that both the single market and the EMU were brought into being. The Delors Report, which laid the groundwork for the EMU, was signed in 1992 as the Maastrict Treaty (Dellas, 1997). The Maastrict Treaty aimed to create fiscal convergence among the member nations and put forth a three-stage implementation process designed for the EMU (Vallée, 2014). The first stage (1990-1993) was the creation of an EU with a single market; the second stage (1994-1998) was the establishment of the European Monetary Institute (EMI) to accelerate the fiscal harmonization process among member states; and third stage (1999-onward) was use of single currency (the euro), transfer of national authority on monetary and currency policies to the European Central Bank (ECB), and finally the establishment of the ‘Eurozone’ (European Central Bank, 2011). There are presently 17 EU member states in the third stage. The EU is in the process of political integration—the natural result of trade integration based on a single market and a single currency. It is a major project with the goal of solidifying Europe’s position by eliminating the costs of globalization.

Since the removal of obstacles to the movement of capital in the 1980s, capital and capital movements have become more global. As stated by Tobin (2000), the globalization of financial markets affects assets, debt, bank loans, and real capital. The globalization of capital in particular has caused an increase of liquidity in international markets, as well as a decrease in fund costs, the emergence of new financial instruments, and the internationalization of alternate financial institutions (Tobin, 2000). Nevertheless, financial globalization and the integration of markets also lead to denser capital movements and deeper financial crises (Ureche-Rangau & Burietz, 2013).

Together with the liberalization of capital movements and globalization, economic crises in developed economies have caused ripples throughout the entire world. The subprime mortgage crisis, starting in the US following the bankruptcy of Lehman Brothers in September 2008, is among the best examples of this phenomenon (Lane, 2012). With farther-reaching repercussions than the Great Depression of 1929, the US subprime mortgage crisis caused the Eurozone to enter sovereign debt crisis.

This paper discusses the underlying causes of the sovereign debt crisis; the economic and financial effects of the crisis and the measure taken to counteract it; as well as the continuity of the EU, with its ultimate goal of political union.

EUROZONE SOVEREIGN DEBT CRISIS

Literature Review

Tanzi & Schuknecht (2000) identifies that public budgets were either balanced or had surpluses in countries that supported institutional limitations in the period between the beginning of 1900s and the 1960s. Since the 1980s, the increases in fiscal deficits have also caused an increase in sovereign debts. Consequently, sovereign debts are now not only an important public finance resource, but also a public revenue type among fiscal policy instruments that are used for classifying countries based on metrics of sustainability of public finance (Teica, 2012).

There are many studies on sovereign debt crisis in the EU and elsewhere, one being the study by Tanzi & Schuknecht (2000) that states that chronic high sovereign deficits create an unsustainable debt burden, especially in countries where real interest rates of government borrowing...