Causes of the eurozone crisis: a summary

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The reasons for the eurozone crisis are many and varied, with some general causes and some country-specific factors. A summary of the key issues are provided in this short note. The list is not exhaustive.

What's happened

Over the past few years a number of countries in the eurozone – Greece in May 2010 and February 2012, Ireland in November 2010, Portugal in May 2011, Spain in July 2012 for its banks and Cyprus in May 2013 – have been forced into taking emergency loans from other eurozone and EU governments and the IMF. These countries' governments asked for these loans when they became unable to fund their budget deficits at sustainable interest rates on the financial markets and faced the prospect of defaulting on their debt.

In return for the loans, these countries signed up to implement economic reforms and public sector austerity intended to reduce their budget deficits and make their economies more competitive. So, inability to borrow money on the markets to fund deficits was the short-term factor behind the crisis, but what were the underlying reasons behind it?

Causes of the crisis

One-size-fits-all monetary policy

The single currency began in 1999 with 11 member countries (there are now 18). As a result, euro members gave control of monetary policy to the European Central Bank (ECB) which sets interest rates for the whole of the eurozone. Some large countries, notably Germany, had weak growth and this led to the ECB setting a relatively low interest rate. However, this rate was too low for some booming economies like Ireland and Spain and helped create large housing market bubbles there.

Also, by giving up an independent monetary policy and currency, countries with high debt burdens were not able to use certain measures to respond to the crisis that countries outside the euro (like the UK) could use. These include allowing higher inflation (to reduce the debt burden), directly/indirectly depreciating your currency (to promote exports) and buying up your own debt to avoid default (like in quantitative easing programmes).

Misplaced confidence and assessment of risks

Borrowing costs for all eurozone governments converged upon the euro's creation, meaning countries, like Greece, that previously had to offer a higher interest rate than, say, Germany to attract investment were now able to borrow more cheaply. Likewise, private sector borrowing costs in these countries also fell toward German levels. This fuelled a build up of government debt in Greece and Portugal, as well as private sector debt in Portugal, Ireland and Spain. The implication was that financial markets perceived every country in the eurozone to have virtually the same risk of defaulting on their loans (perhaps assuming all eurozone countries ‘were in it together’). Once the global financial crisis began in 2008, investors thought again. Countries with high debt burdens and weak economies, such as Greece, soon saw their borrowing costs rise.

Economic divergence and trade imbalances

As mentioned above, different economies in the eurozone were growing at different speeds in the 2000s. Many of the countries that ultimately needed bailouts also saw their economy’s productivity levels and competitiveness decline (due to higher labour costs) relative to the eurozone average (and especially Germany) during this period. So, countries like Greece, Ireland and Spain, who were growing strongly and buying lots of imports, were also becoming less competitive internationally. The result was that a large trade deficit had to be funded by high levels of public and private borrowing (which had become cheaper).

Once the financial crisis hit and borrowing costs starting rising for these countries, confidence in their ability to repay this debt was called into question, making financing it more difficult and expensive. The single currency also meant that the easy way to regain competitiveness (at least in the short-term) of devaluing your currency was not an option for these countries. Meanwhile, Germany had accumulated large trade surpluses during this time, partly as a result of lowering its labour costs (through restraint in wage growth).

Response to the crisis

When the euro was created, no mechanism was set up to deal with debt crises such as those seen since 2010. As a result, emergency rescue plans had to be drawn up and agreed on the hoof. The long drawn-out affairs that became synonymous with these bailouts were viewed unfavourably by many. It also created the impression that the larger eurozone countries that were providing the bulk of the loans were split as to how best to resolve the crisis. This lack of decisive action weakened confidence in international markets, prolonging the crisis.

Country-specific factors

The reasons leading up to the crisis were different for each country. Some of these factors are summarised very briefly below:

- **Greece** (loans totalling €240bn) – high public sector debt, generous public sector benefits, chronic tax evasion and weak competitiveness.

- **Ireland** (loans totalling €85 billion, including €17.5 billion from Irish Treasury and National Pension Reserve Fund) – declining competitiveness and property bubble funded by banks which went bust and were taken over and underwritten by the state, causing government debt crisis.

- **Portugal** (loans totalling €78bn) – moderately high private and public sector debt, weak competitiveness, and anaemic growth.

- **Spain** (loans totalling €41bn) – an ailing banking sector had lent heavily to construction sector before the housing bubble burst.

- **Cyprus** (loans totalling €10bn) – collapse of the banking sector (massive relative to size of economy), partly due to links to Greece.

The majority of the loans provided to the countries were funded by other eurozone countries, with the IMF also contributing.