Scientific Papers Series Management, Economic Engineering in Agriculture and Rural Development
Vol. 15, Issue 4, 2015
PRINT ISSN 2284-7995, E-ISSN 2285-3952

IMPACT OF THE ECONOMIC CRISIS ON EUROPEAN UNION DURING 2008 – 2015 PERIOD

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Abstract

This study presents the origins and manifestations of the economic crisis that started in 2008 at both world level and in the European Union. In both cases the study analyzes also some of the measures undertaken in order to overpass the crisis and their results. During the same year, 2009, the European Union witnessed a decline of its GDP by 4.4 %, while the Euro zone had a decline of 4.5 %. Only from this synthetic data results a conclusion that the European Union and the Euro zone were more affected by the economic crisis than the rest of the world. This situation remained true in 2013 and 2014. In 2013 the world economy had a growth rate of its GDP of 2.3 % while European Union had a growth rate of 0.1 % and the Euro zone of – 0.5 % (World Bank Data). In 2014, according to the forecasts of the World Bank the world economy had a growth rate of 2.6 % while the Euro zone of only 0.9 % (World Bank Data) and the European Union as a whole of 1.3 % (Forecast for European Union for 2014 from Eurostat). A second part of the study is focused on the situation of European Union from the perspective of the current year, 2015, as well as from the point of view of the prospects for 2015 and the coming years.

Key words: *economic crisis, European Union, GDP, slower growth, recession*

INTRODUCTION

The impact of the economic crisis on the European Union has been particularly strong. This is why the speed of the recovery from this crisis has been unusually long and slow. This slow recovery may be understood as a symptom of a permanent decline in GDP of the European Union member countries following the economic crisis [10]. This may also mean that for some member countries the economy have not yet recovered completely as of 2015 from the initial recession. The estimated long term output losses from the economic crisis are ranging from almost none in Germany to almost 20% in Italy and Spain.
In this work we present some factors that explain the long and slow recovery and also the long term side effects of the crisis.

MATERIALS AND METHODS

In this work, in order to meet the need of information to be used a bibliographical research and a statistical research have been performed, through which data for the conclusions regarding the performed study were collected, processed and analysed. Statistical tables have been used by which data were presented in a tabular way. This is a method which allows the description of indicators on which the performed analysis is based, and the establishing of the existing connections between its component elements. Graphical representations have been used to emphasize the extent and/or variation of data subject to the statistical research in view of showing their evolution in time.

RESULTS AND DISCUSSIONS

The economic crisis on the European Union
The factors of the economic crisis on European Union are: The economic crisis made the economies more vulnerable to other negative external shocks (like global competition, economic effects of sanctions imposed on Russian Federation, etc.); The trend of economic growth in the European Union have been slowing down long before the onset of the crisis; The economic crisis has lead to big reductions in labor

productivity and this phenomenon takes a long time to reverse.

In Figure 1. below there is a graphic presentation of this slow and differentiated recovery in some of the European Union member countries. In this graph the level of GDP from 2007 was considered as being 1 and the next years reflect the increase of GDP per working age person.

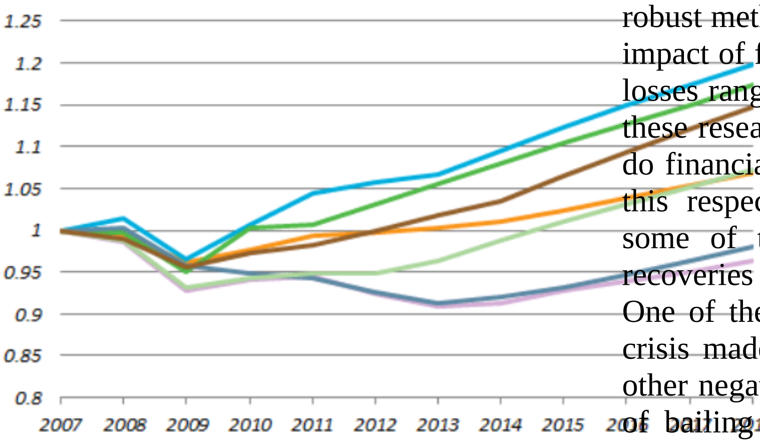

Fig. 1. GDP per Working Age Person in Advanced Economies since 2007

Source: Euromonitor Macro Model and International Statistics.

Note: 2007 level normalized to 1 for all countries. [22], [23]

From Figure 1. results that some countries (especially Germany, France and Great Britain in Europe and United States and Japan outside of Europe) had a sustained recovery although at low growth rates with a maximum of 1.2. At the same time other European countries, such as Spain and Italy remained under the level of 2007 for the whole period 2008 – 2015.

Economic growth has been disappointing in comparison to past recoveries. One significant factor in the growth slowdown of recent years has been the faster than normal of the population aging phenomenon. The decline in the growth rate of the working age population (ages 15 - 64) on its own can account for a decline in the annual GDP growth rate of advanced economies of 0.7 percentage points [17].

The recovery was so slow because the financial crises in general usually cause large permanent damage to economic activity levels. Some researchers analyzed the effects of financial crises over a 10 year horizon using a panel of 190 countries from 1960 to 2001 [1]. The peak estimated output loss from a financial crisis in their sample is almost 8%, with output losses of around 7% at a 10 year horizon. Such results have been criticized for some of their statistical assumptions, in particular not taking into account differences in the length of crises across countries. More robust methods still find a significant long run impact of financial crises, with 10 year output losses ranging from 5 to 10% [13]. Following these researches the question arises as to why do financial crises lead to slow recoveries. In this respect in the following are presented some of the key factors behind the slow recoveries after the 2008 crisis.

One of the clear factors is that the financial crisis made the economy more vulnerable to other negative shocks. For example, the costs of bailing out banks and the decline in tax revenues due to lower economic activity or fiscal stimulus attempts affects in a negative way the government finances.

In the case of Southern European countries, such as Italy and Spain, the initial crisis led to growing concerns about the sustainability of public finances. The result was a sovereign debt crisis on top of the original recession. The increase in sovereign debt risk premia then fed back into further increases in private sector costs of financing and more economic uncertainty. Fiscal cutbacks attempting to stabilize sovereign debt risk premia caused even bigger contractions in economic activity in the short run. The compound effect of two financial crises with a few years delay has contributed to output losses in Southern Europe of a magnitude matching the great depression of the 1930's. Such a huge implication can explain in itself the long time needed for recovery.

Slower long term growth in the Euro zone

If we analyze the economies in a broader sense we can say that not all decline of GDP is related to the crisis. The trend towards slower growth was present in European Union long before the crisis. This aspect is particularly relevant for the Eurozone, where productivity growth slowed down significantly starting in 1995. According to European Commission estimates productivity growth in the Eurozone had already dropped below 1% in the early 2000‘s. But even if we assumed a trend growth of 1% instead of 1.7% in the Euro zone the estimate of the peak output loss since 2007 is still 14.2% in Spain (compared to an initial estimate of 18.7%) and 14.8% in Italy (compared to the initial estimate of 20%) [24]. Pre-crisis declines in potential growth rates matter, but they cannot explain most of the deviation of output from trend after 2007.

Impact of the economic crisis on the employment rates

The crisis has had also a persistent negative effect on employment rates. In the United States the employment to population ratio has gone down from 63.3% in the beginning of 2007 to 59% in July 2014.

The European Union experience varies significantly across countries. The employment rate of the 20 - 64 age population in 2013 was less than 0.5 percentage points below that in 2007 in France and Great Britain. The German employment rate actually increased in the same period by more than 4 percentage points. But in Italy, there was a similar decline in the employment rate as in the United States, and in Spain the employment rate declined by more than 10 percentage points over the 2007 – 2013 period [3]. Usually, employment can respond more quickly to economic conditions than capital so a faster recovery is more likely.

There are anyway several factors that could slow down this process or even lead to a long-term decline in employment:

Part of the reduction in employment rates is due to accelerating population aging. People of 55 - 64 years are less likely to participate in labor markets, though recent years have seen significant increases in labor force participation rates of this age group.

Lower labor productivity reduces the profitability of hiring. As a result, demand for labor declines. The decline in labor productivity below trend is likely to be quasi-permanent, due to the factors discussed above. As a result, this mechanism should depress employment for many years after the crisis.

The recession has created a large number of long term unemployed (without a job for more than six months). Job finding rates for these long term unemployed are typically lower for reasons ranging from bad image (being a longer time in unemployment sends a bad signal that the job seeker may be a lower quality employee) to faster depreciation of job skills.

The good news in the United States is that since 2010 the number of long term unemployed has dropped by more than 50%, though much of this decline is due to lower labor force participation.

The economic crisis in the European Union led to long term declines in the capital stock and total factor productivity

Investment in European Union and other developed economies declined in 2009 and had only a very partial recovery in the following years. In 2013, the investment to GDP ratio was still almost 3 - 4 percentage points below its pre-crisis level in the United States, France, Germany and Great Britain. In Italy the investment to GDP ratio is still 5 percentage points below its 2007 level, while in Spain it has declined by almost 13 percentage points.

The Spanish case is extreme and mostly represents lower residential investment. But there is little doubt that business investment has also suffered tremendously. The effect of many years of low investment is a lower capital stock available for workers in the economy, making them less productive. Reversing the loss of capital would require several years of an investment boom, but such a boom is highly unlikely according to current forecasts.

Even if the capital stock recovers, labor productivity can stay depressed if the financial crisis reduces the overall efficiency with which the economy uses both capital and workers - that is if the crisis lowers the Total Factor Productivity (TFP) of the economy below the normal trend.

Using European Commission estimates some researchers [11] determined that lower labor productivity accounted for 57% of the decline in potential output growth over the 2008 - 2013 period relative to average growth in

Scientific Papers Series Management, Economic Engineering in Agriculture and Rural Development
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PRINT ISSN 2284-7995, E-ISSN 2285-3952

1998 – 2007 period, with a roughly equal decomposition between lower capital accumulation and lower Total Factor Productivity.

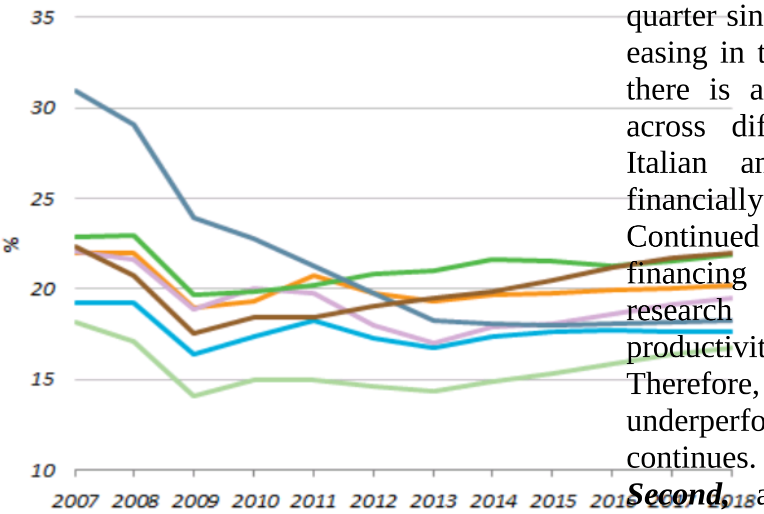

Fig. 2. Investment to GDP Ratios in a number of developed countries after the beginning of the crisis in 2008
Source: IMF World Economic Outlook, April 2014. Note: [7], [5]

At the same time a Stanford University study [6] provided a detailed decomposition of the slow recovery in the United States. The study finds that below trend labor productivity growth is responsible for 62% of the output losses in the United States in 2007 – 2013 period. Of this proportion, the decline in capital is responsible for 33% of the output loss while below trend TFP growth accounts for 29% of the output loss.
According to the studies there are several factors underlying the decline in capital and ***Total Factor Productivity***:
First, the crisis seems to have led to a long-term reduction in the supply of credit in developed economies, due to a combination of stricter financial regulation and an increase in the risk aversion of financial institutions. While interest rates have declined, this compensates only partially for the tightening in collateral requirements and other lending standards.
Looking at the Federal Reserve‘s bank lending conditions survey, credit standards have tightened during the initial phase of the crisis, and have yet to recover to pre crisis levels.
In the Eurozone, the ECB‘s bank lending conditions survey indicates that credit standards on business loans tightened each quarter since mid-2007, and have only started easing in the second quarter of 2014. Again, there is a large dispersion in performance across different Eurozone members, with Italian and Spanish firms much more financially constrained than German firms. Continued restrictions on access to external financing discourage capital investment, research and development and other productivity enhancing expenditures. Therefore, labor productivity is likely to underperform as long as the credit crunch continues.
Second, as the result of some research suggests that even if lending standards recovered completely, negative effects on capital investment and Total Factor Productivity would continue for many years through several channels.
For example, reductions in research and development spending and new business entry during the financial crisis reduce the growth rate of innovation over several years, cumulating into permanent declines in the efficiency of the economy. In the United States for example, the number of business startups (firms less than one year old) declined by more than 25% in 2007 – 2010 period, leading to a “missing generation“ of new firms [15].
A recent Federal reserve study [14] tried to quantify the effect of lower innovation due to a financial crisis in a macroeconomic model with bank capital constraints and new business entry. The study finds that for plausible model parameter values, even if the initial financial shock dissipates after a few years the reduction in business entry and innovation can generate permanent declines in labor productivity exceeding 6%, leading to permanent declines in GDP of more than 10%.
And third, the financial shocks cause long lasting distortions in the allocation of capital, a key source of loan collateral, across firms. The misallocation of capital across firms hurts

in particular small and medium enterprises with high return investment opportunities and high dependence on external financing, constraining their ability to get loans and to expand. This again leads to persistent declines in investment and productivity. In a model calibrated [8] to the United States great recession, Khan and Thomas (2013) find that this effect can significantly slow down the recovery.

Some aspects related to the establishment of the Euro zone

In the 1992 Treaty on the European Union also known as the Maastricht Treaty in addition to outlining the current form of the European Union as a single market for goods, services, labor it was also provided the legal foundation and design of the euro currency by setting the so called “convergence criteria” that European Union member states would have to meet to become members of the European Monetary System (EMU).

The criteria specified in Article 104c of the Maastricht Treaty mentioned that that a nation’s actual government deficits would not exceed 3% of GDP, and that its government debt would be below 60% of GDP. The criteria also set limits on inflation, long-term interest, and national currency exchange rates.

While the criteria for joining the common currency were well defined, in reality the implementation levels were more flexible. As a result, the process involved making political compromises and sidestepped critically important economic membership criteria. For example, political necessity held that the six European Union founding members would also be original Euro zone members, despite their inability to meet agreed-upon economic criteria.

Furthermore, Europeans’ unwillingness to pay direct taxes to fund an European Union budget sufficiently large to counteract regional imbalances and economic shocks led to an absence of a central fiscal authority, essential for well functioning currency unions. When the euro was implemented in 1999, the Euro zone nations were less integrated than prescribed and moreover the European Union leaders further weakened the financial and macroeconomic rules of the Stability and Growth Pact. The latter provides a framework for coordinating national fiscal policies in the European Union and serves to safeguard sound public finances, based on shared European Union interest. In this way while the political goal of implementing a common currency was achieved, there was no central fiscal agent, no effective budget discipline enforcement, and no clearly defined path toward further economic convergence.

The manifestation of the economic crisis in the Euro zone

From its beginnings, the flaws in the design of the Euro as a common currency were pointed out by a number of economists, but its inherent problems were not fully exposed until soon after the beginning of the global economic crisis that started in 2008.

Some researchers [12] presented structural design issues of the common currency. Since then, it has become increasingly clear that the problems affecting the Euro zone are not only structural and multilateral, but also country specific as a result of the existing differences and gaps between the member countries. The specific problems related to member states are at the same time highly interconnected due to the policies built around the common currency [19]. In the manifestation of the crisis in the Euro zone there are in fact several distinct but inter-connected and mutually reinforcing crises [9]. One of these crises relates to the design of Euro area institutions. The second crisis refers to the excessive debt levels among some Euro zone member states made it impossible to service their sovereign debt without further increasing their financial obligations to their bond holders.

The combined problems of euro-denominated sovereign debt and the inability of the European Central Bank to guarantee the sovereign debt led to concerns that regional financial instability would be transferred to other nations, closely linked asset markets, and financial institutions within and outside of the Euro zone. To limit such “contagion” effects, financial rescue packages collectively supported by other Euro zone members and the International Monetary Fund, combined with sovereign bond purchases by the European Central Bank and domestic policy reforms (as well as debt restructuring in the case of Greece), temporarily enabled the most deeply affected nations of Greece, Portugal, Ireland, Italy, and Spain to fulfill their international financial obligations.

The third crisis is that the Eurozone faced a banking crisis initiated by real estate booms in Ireland and Spain. The global financial crisis created a “sudden stop” of the private capital inflows once private investors recognized that risks had been underestimated and interest rates increased, which led to a collapse of real estate markets. The large size of the Euro zone banks relative to their home nations’ economic output made it impossible for the heavily indebted home nations to guarantee the debt. Moreover, the banks were already highly leveraged, and much of the bank debt was issued by their home governments.

While the banking crisis had appeared to be somewhat under control, it also manifested itself in the case of Cyprus, whose main banks had assets far exceeding that nation’s annual economic output, but a significant part of the assets consisted of previously restructured Greek sovereign bonds. As in previous cases of over leveraged financial institutions, policy makers were faced with a difficult choice of either rescuing the banks and thereby jeopardizing sovereign solvency, or refusing rescue and risking severe economic downturns. While Cyprus’ economy is very small relative to that of the Euro zone as a whole, this manifestation of the crisis may have far reaching consequences, in that bank creditors may be expected to bear part of the costs of bank recapitalization in addition to or instead of the European Stability Mechanism.

A fourth crisis was in the balance of payments due to competitiveness disparities and “asymmetric shocks” internal to the Euro zone. That is, Eurozone countries faced country-specific shocks, including fiscal and current account imbalances in Greece, a surge in credit and banking crises in Ireland and Spain, and productivity growth in Portugal and Italy.

Over a decade before 2008, current account balances of both the European Union, as a whole, and the Euro zone in particular obscured rising deficits of Greece, Ireland, Italy, Portugal, and Spain, which were offset by increased German surpluses. While core nations - such as Austria, Finland and Germany - improved their asset positions, countries in the periphery - Greece, Ireland, Italy, Portugal, and Spain - accumulated large net foreign liabilities.

According to a study the current account imbalances within the Euro zone were made worse by the common currency because it eliminated exchange risks, provided incentives for investors to ignore country-specific investment risks, and created unrealistic expectations about economic convergence between core and periphery nations [16]. The artificially low interest rates in the periphery attracted capital movements from the core, and resulted in current account deficits accompanied by rapidly rising prices and so undermined these nations’ competitiveness.

In their efforts to improve their competitive position without exiting the Euro, periphery nations were unable to devalue their currency for the purposes of improving their current account imbalances and enhancing their competitiveness. Instead, they were forced to bring about devaluation by decreasing prices and costs (including wages) using deflationary macroeconomic policies.

Such policies not only lead to long and painful periods of recession and budget deficits, but are also prone to extended periods with high unemployment, protracted deflationary spirals, possible additional sovereign debt and banking crises, and social unrest [4]. On the other side, cost and price competitive core nations (such as Germany) that had experienced high productivity growth over the decade prior to the crisis were unable to appreciate their currency to help restore internal trade competitiveness and balance within the Euro zone.

Perhaps more important than economic aspects are the political ones of the Euro zone crisis. European member states and people neither agree on the causes of the crisis nor on the path forward. The prevailing view in core nations (predominantly in northern parts of the Euro zone) links the crisis to a lack of enforcement of rules, whereas the predominant view in the periphery is that the crisis is the result of systematic flaws.

Further, the core nations' dominant view is that austerity measures are the preferred policy response to the complex economic crisis, whereas the view of the periphery nations is that such policies are counterproductive and cannot be supported by the limited availability of political capital. In other words one can say that the crisis of the common European currency appears to reflect a search for a common European purpose.

Main responses related to the Euro zone crisis

The decision makers have mainly focused their responses to the Euro zone crisis on efforts to develop solutions for sovereign debt and banking crises and to strengthen the institutional framework of the European Union and Euro zone.

Increased funding for and the consolidation of temporary institutions into the permanent European Stability Mechanism in 2012 have improved the financial stability of the most indebted Euro zone nations. Another important decision was to establish a banking union and in this way the European Central Bank has a new supervisory role over Euro zone banks.

One of the most important decisions for dramatically reducing the fear of a Euro zone collapse was the European Central Bank's long - anticipated decision to commit itself to supporting sovereign bond markets [20]. By announcing itself as a lender of last resort, bond yield spreads (the interest rates on a government bond compared to that of very solid status benchmark bonds, such as German bonds) among Euro zone member states that had emerged since the start of the Euro zone crisis dramatically reduced.

One of the most intractable problems - the large, internal imbalances within the Euro zone - has thus far not been dealt with in an adequate manner. Efforts to regain competitiveness have focused on devaluing through lowering prices, wages, and production costs in periphery nations and less on conducting the reverse in core nations. These policies have had only minimal effects on bridging the competitiveness gap between periphery and core nations.

Based on several years of experience and analysis after the start of the crisis in 2008 there appears to be an increasingly widespread realization that the controversial austerity policies consisting of spending cuts and tax increases may have worsened and prolonged the Euro zone crisis by dampening economic growth and causing historically high unemployment levels in many Euro zone member states, and thereby further increased debt burdens among households, firms, and governments.

Some economists have proposed alternative solutions to the austerity policies and have suggested ways to enable nations in the periphery to regain competitiveness. Among these alternative solutions it was proposed a combination of prioritizing economic growth, restoring the banks' ability to lend, and replacing the current austerity policies [21].

Effects of the economic crisis in the Euro zone on other regions

International institutions such as the International Monetary Fund [7] and researchers indicated that if it is contained the Eurozone crisis may have limited effects on areas outside of the Euro zone as well as outside Europe.

Anyway, without consistent economic growth, the crisis will not only affect the Eurozone but it will also affect the economic growth in other areas of Europe and areas outside Europe that are linked to Europe by trade and investment flows [10].

Due to the intensity of such linkages, spillover effects of a possible Euro collapse would have the most severe impacts on Europe's emerging markets, followed by the advanced economies in Europe, and nations of the Commonwealth of Independent States, while impacts on the United States and Canada would be relatively minor.

The implications of the Euro zone crisis for the United States and for the United States – European Union cooperation are difficult to assess. Anyway, the United States exposure to economic events in Europe, while less than for the European Union's regional trading partners, is considerable due to the level of economic integration of the two areas.

A possible Euro depreciation relative to the US dollar might increase the United States trade deficit with the European Union. At the same time the uncertainty in the Eurozone may create a flight to safety of investors and businessmen which might further appreciate the US dollar relative to the Euro, and as such decrease the U.S. Treasury yields and increase the U.S. stock market volatility.

European Union in 2015: still affected by the economic crisis

The European Union crisis is much more comprehensive than the economic and financial sides. The crisis affects the economy, politics and social conditions in European Union member countries and puts under a question mark even the foundations of this organization of economic integration.

In 2015, after 7 years since the start of the crisis there is a much broader perspective of the crisis in Europe, particularly in European Union. Things are no longer related only to economic aspects and a larger, history based approach is more and more used. This perspective can be found with Stratford Global Intelligence. Another perspective has been determined at the beginning of June 2015 by Pew Research Center that analyzed six major European economies.

From the perspective of Stratford Global Intelligence Europe as a continent is facing with two interconnected crises [3]. The first is the crisis of the European Union as organization. The organization began as a project of economic integration, but it was also intended to be more than that. It was an organization that aimed to create Europeans, that is European citizens. The national distinctions between European nations is real and has proved destabilizing, since Europe has been filled with nations with diverging interests and historical inheritances.

The European Union did not intend to replace these nations; the characteristics of the nation states were too deep and based on millennia of history. The European Union project was intended to add to the national identities a European identity. There would be nations and they would keep their sovereignty, but the citizens of these nations would increasingly come to see themselves as Europeans. That European identity would both create a common culture and diminish the particularity of states. The inducement to all of Europe was prosperity and peace. The European Union would create ongoing prosperity, which would eliminate the danger of conflict.

The challenge to Europe in this sense was that prosperity is at best cyclical, and it is also regional. Europe is struggling with integration because without general prosperity, the seduction of Europeans away from the socio-cultural identities of nations will fail. Therefore, the crisis of the European Union, focused on the European Peninsula, is one of the destabilizing forces.

The second crisis rests in the strategic structure of Europe and is less clear than the first. Leaving aside the outlying islands and other peninsulas that make up Europe, the Continent's primordial issue is the relationship between the largely unified but poorer mainland, dominated by Russia, and the wealthier but much more fragmented peninsula. Between Russia and the peninsula lies a borderland that at times as has been under the control of Russia or a peninsular power or, more often, divided.

As for the study carried put by Pew Research Center and published at the beginning of June 2015, the findings are rather positive [18].The report examined the public opinion in six European Union countries: France, Germany, Italy, Poland, Spain and the United Kingdom.

The findings are based on 6,028 face-to-face and telephone interviews in these European Union member states with adults 18 and older and conducted from April 7 to May 13, 2015.

The main findings are presented in Figure 3. According to the survey this revival in pro-European Union sentiment is closely related to the public's economic mood, meaning that better economic conditions in certain countries led to more favorable attitude towards the European Union.

As of early June 2015 most European publics surveyed still think economic conditions in their countries are not encouraging. But the economic downturn appears to have bottomed out in most places, and there are signs of recovery, particularly in Spain and the United Kingdom.

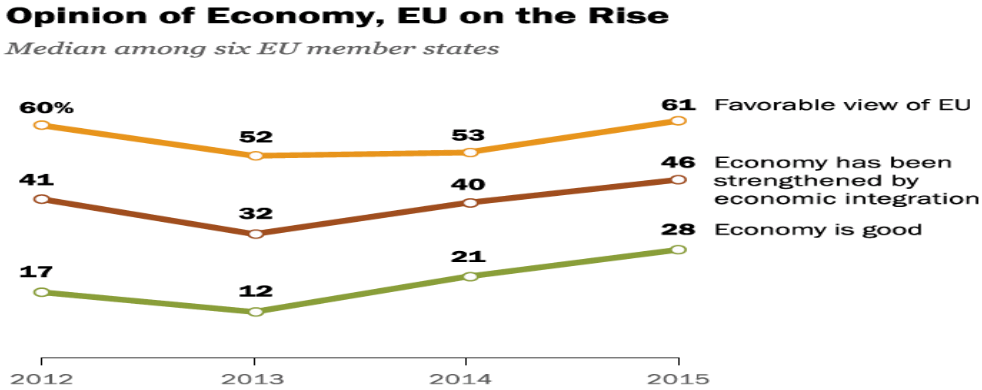

Fig. 3. A more positive opinion on economy and European Union in six major member states
Source: [18, pag. 3]

Public assessment of the current economic situation has correspondingly improved across Europe in the past two years, even while publics remain fairly pessimistic about the future. And those who now think economic conditions are good are much more likely to favor the European Union and European economic integration than those who see their economy as doing poorly. At the same time, in some nations there are quite significant differences between the higher level of trust in the European Union as an institution and the lower public confidence in the European project.

CONCLUSIONS

The impact of the economic crisis in the European Union revealed and made more clear than before the existence of significant differences among the member countries. They have different levels of development, different levels of competitiveness and labor market flexibility and, as result, different problems that may require different solutions. Maybe one consequence of the economic crisis for the European Union will be to decide an improvement of the functioning mechanisms so that each member country can find its specific and useful solutions.
At the same time the severe impact of the economic crisis on the Euro zone raised numerous questions on the possibility of the Euro mechanism to adapt to the crisis and provide solutions for overpassing the crisis. Several times the very existence of Euro was put under a question mark. And despite some relaunch of the economy in the Euro zone in 2014 - 2015, the Greek economy problem, as well as the problems of other Euro Mediterranean countries, maintain some incertitude at least on the effectiveness of the Euro mechanism.
At a global level the crisis was a proof of the interconnectedness among participants confirming that the global system is both dynamic and inter-active: a phenomenon taking place in one large market will disseminate very fast in the majority if not all the other markets.
The conclusion of this proof of interconnectedness is that the world economy really needs a global governance mechanism. If the problems are global and interconnected, then the decision making system should also be global in scope and reaction. Discussions on a global governance system have been present for a long time, maybe even starting with the founding of the United Nations. But one consequence of this crisis is that it creates the real need for designing and implementing an effective system of global governance, at least in the banking and financial sector.

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