THE EUROPEAN SOVEREIGN DEBT CRISIS

Executive Summary
The report studies the effect of the European sovereign debt crisis on global financial markets and polices being employed by policy makers and financial institutions to curb the crisis. Academic journals as well as business journals were used for this report and furthermore, relevant information was obtained from Bloomberg. To give a concise and rich report, comparisons are made between past defaulting sovereign nations to determine whether there are lessons the EU members could learn. In addition, a forecast was regarding the long-term global impact of the crisis.

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Introduction

The European debt crisis is an ongoing financial crisis that has made it difficult for some countries in the Eurozone to repay or re-finance government debt without the assistance of third parties. It is understood to be Europe's struggle to pay historic debt. Portugal, Greece, Ireland, Spain and Italy, all EU member states, have failed to boost their economic growth enough to be able to pay bondholders as agreed.

The debt crisis started in early July 2007 at a time when the so-called subprime crisis was just a point of discussion in the world at large. At this time, the spread on the risk premium on an Irish ten-year maturity sovereign bond was still negative. Also, the Irish sovereign government paid a lower interest rate than the German sovereign government. It was in March 2008, when Bear Steams had just been rescued from its financial crisis, that in the view of the public, the European banking crisis took a decisive turn. At this point, the Irish risk premium was only about 30 basis points; the spread rose at a more rapid rate with fluctuations due to the Lehman Brothers' financial crisis which led to the nationalization of Anglo Irish in January 2009.

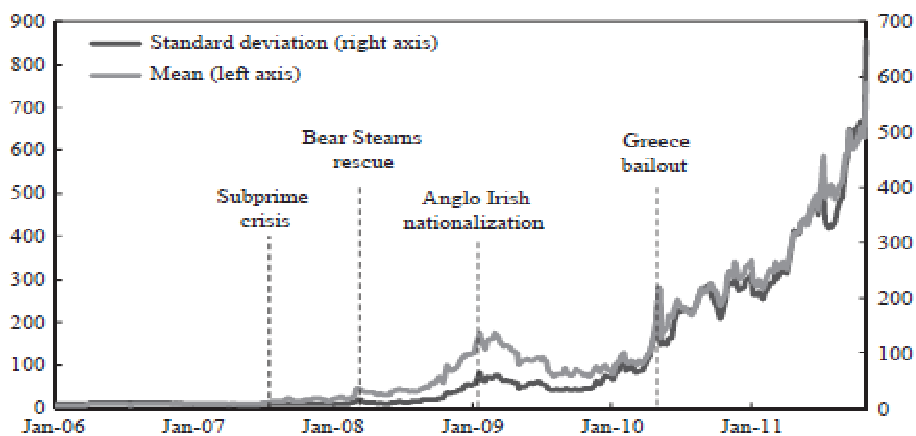


Figure1: Increase and dispersion of Eurozone sovereign spreads

Causes of the European Sovereign Crisis

The crisis resulted from many complex factors including easy credit conditions during the period from 2002 to 2008 that enhanced high-risk lending and borrowing practices. However, I will summarize the main causes in the following section.

- Rising household and government debt levels

In 1992, EU members signed the Maastricht Treaty, under which they promised to reduce their deficit spending as well as their debt. However, a number of the EU member states, such as Greece and Italy, were not able to abide by this rule, thereby failing to abide by their own internal rules and ignoring internationally agreed standards. This led to the countries masking their debt levels through a combination of methods such as inconsistent accounting, off-balance sheet transactions as well as through the use of complex currency and credit derivatives. Further, the adoption of a single currency led many EU members to receive similar or very low interest rates for their bonds during the pre-crisis years.

From a statistical point of view, in 2007 the average fiscal deficit in the Eurozone was only about point six per cent before it grew to about seven per cent during the financial crisis. In the same period, government debt rose from about 66 per cent to about 84 per cent of GDP. A US economist, Paul Krugman, mentioned Greece as being the only nation where fiscal irresponsibility was at the heart of the sovereign default. (Krugman, 2012)

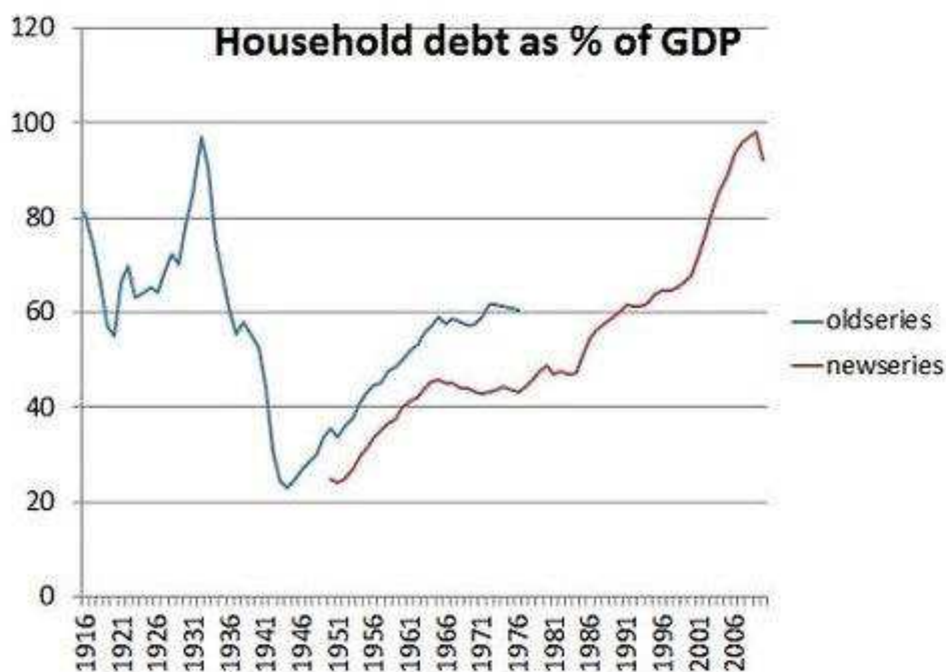


Figure 2: Household debt as a percentage of GDP. Source: Krugman, Paul (2012).

Household debt was another problem. In April 2007, the International Monetary Fund (IMF) reported 'that in advanced economies during the five years preceding 2007, the ratio of

household debt to income rose by an average of 39 percentage points, to 138 percent'. (International Monetary Fund 2012)

- Trade imbalances

Martin Wolf, a journalist with the Financial Times, believed that the root of the European crisis was the result of the growing trade imbalances. He noted that in the run-up to the crisis in 1999–2007, Germany's public debt and fiscal deficit relative to GDP was considerably better than that of most EU members. In the same period, countries such as Portugal, Spain Ireland, and Italy were in a worse position in terms of their balance of payments (Wolf, 2011).

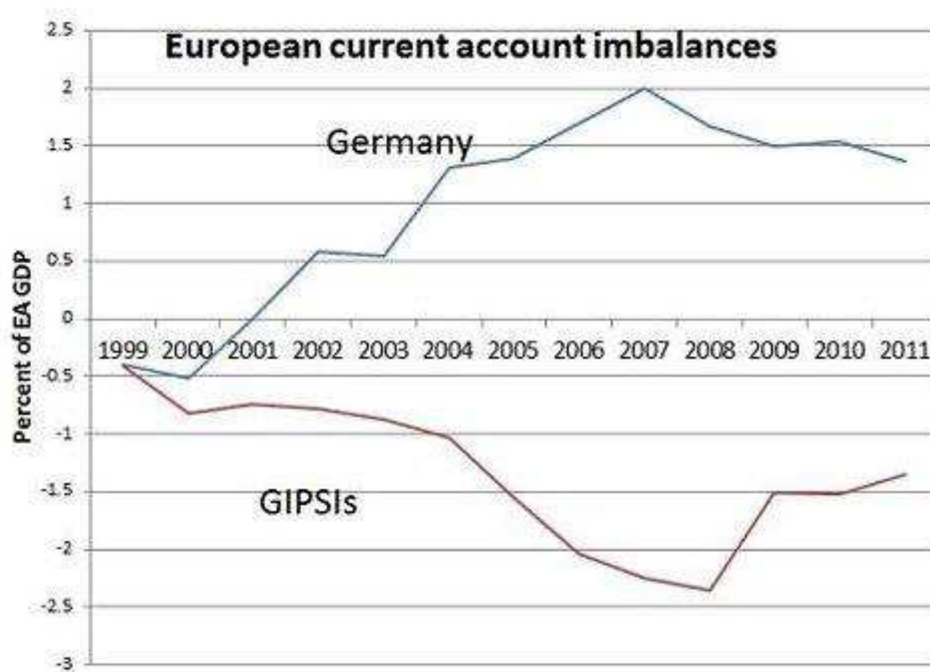


Figure 3 European current account imbalances. Source: Krugman (2012).

In 2009, Paul Krugman wrote that a trade deficit requires a corresponding inflow of capital to fund it. This can reduce interest rates and stimulate the creation of bubbles (Krugman, 2009). In addition, the EU locks countries into an exchange rate that can result in a high risk for their economies converging in productivity. Simon Johnson explains the hope for convergence in the European zone (Johnson, 2012).

- Structural Problems of the EU System and Monetary Policy Inflexibility

In the EU system, the countries are required to follow a similar fiscal path, but this is not enforced. Countries with the same monetary system have freedom to develop their own fiscal policies in taxes and expenses. Therefore, even though there is some agreement on monetary policy through the ECB, countries do not adhere to it. This feature brought about the fiscal free riding of the peripheral economies, especially Greece, as it is very difficult to regulate and control national financial institutions.

The single monetary policy adopted by the EU prevents member states from acting independently. In particular, the members of the EU can't pay creditors and eliminate their risk of defaulting. They cannot devalue their currency to make exports cheaper which, in principle, would improve their balance of trade and increase GDP.

- Loss of confidence

Before the crisis started, regulators and banks assumed that the sovereign debt of EU members was safe. For this reason, banks bought bonds from weaker members of the EU such as Greece that offered lower premiums but were as sound as the stronger members. But as the crisis developed, it was apparent that the weaker members of the EU couldn't pay their debts and their bonds were riskier. The loss of confidence was marked by rising credit default swaps (CDS), indicating market expectation about a nation's creditworthiness. The graph below gives further information.

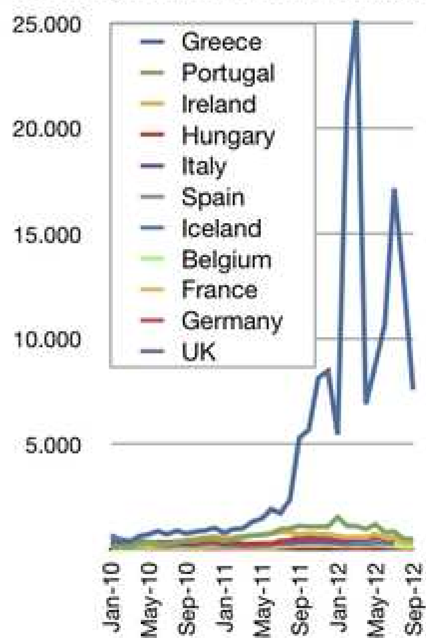


Figure 4: Sovereign CDS prices of selected European countries (2010–2012)

The interest on long-term sovereign debt also contributed to the crisis. A good example of this was the Spanish bailout in June 2012. Further, in December 2011 S&P placed its long-term sovereign ratings on fifteen members of the Eurozone on CreditWatch with negative implications (S&P, 2011).

Impact of the Euro Crisis on the Bond Market and Its Implication for Other Markets.

In November 2009, the UK's Guardian reported that Greece's debt was the highest in the EU, running at about 12.5 per cent of GDP, and was projected to rise to about 135 per cent by 2011. Despite these projections, the rating agencies saw no reason to downgrade their bonds because Greece was the fastest growing economy from 2000 to 2007. In April 2012, Greek bonds were downgraded to junk status. Due to the downgrade of Greek bonds, investors stopped buying them. The impact this had on Greece became a global phenomenon. The London FTSE 100 fell by over 150 points and there was a corresponding fall in New York and Frankfurt. Due to the downgrade of Greek bonds and the effect of this,

other weak EU members – Spain, Italy Portugal and Ireland – were afraid that they might also default.

Below is a graph showing the performance of the Greek bond and their performance.

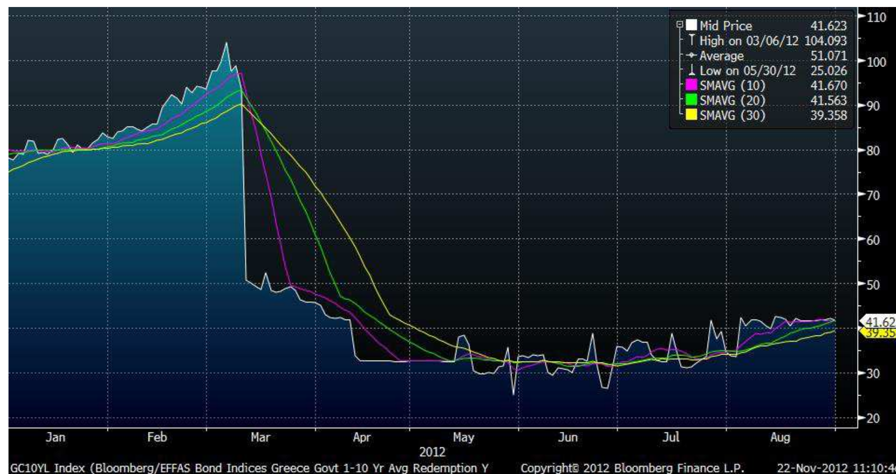


Figure 5: YTD bonds for Greece

Economically, a debt crisis or an individual Euro member defaulting on its public debt should not jeopardize the stability of the Euro. The internal price stability ought not to be endangered, as long as the ECB does not monetize public debt and deficits directly to each government. In this case, a government's access to private credit should pose no interference on money supply and inflation in the Eurozone (Reuters 2011). However, the high bond spreads coupled with significant CDS spreads has lead to the Euro fluctuating against other major currencies. Figure 6 shows this volatility against the US dollar. Even within the derivatives markets, downturns have been observed as investors have moved away from investing in European derivatives to investing in emerging markets.

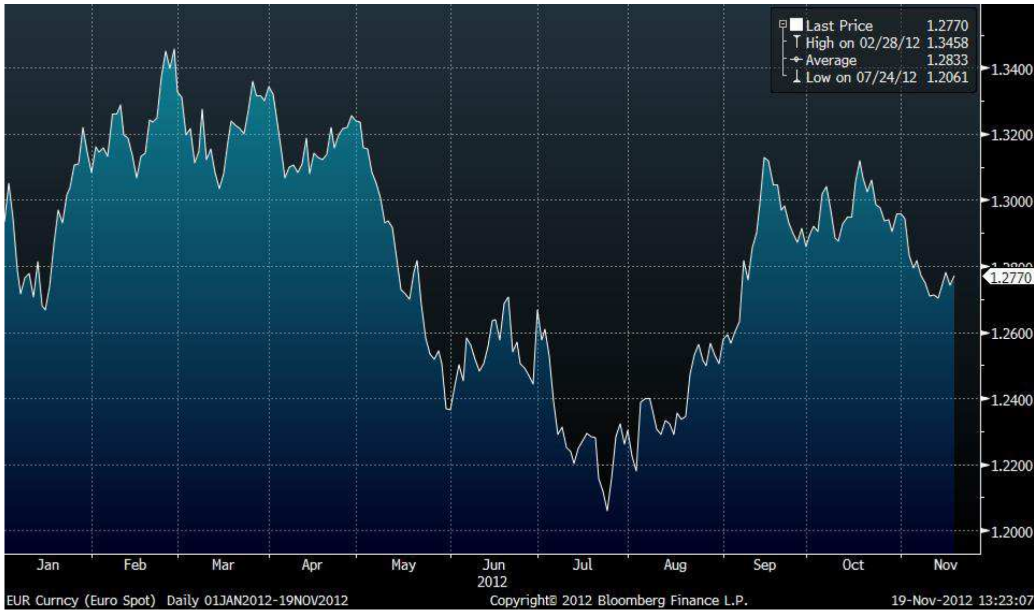


Figure 6: Euro – USD exchange rate currency

Gold has shown recent highs as investors attempt to escape the volatility of currency exchange in the face of the debt crisis (Gold futures, 2011). However the Eurozone's crisis has not rallied gold prices. Sharp falls in stock market values would previously have secured gold in a crisis, but with stocks making up for their losses, gains in gold are falling. Figure 7 provides evidence of the prices falling in the last few months.

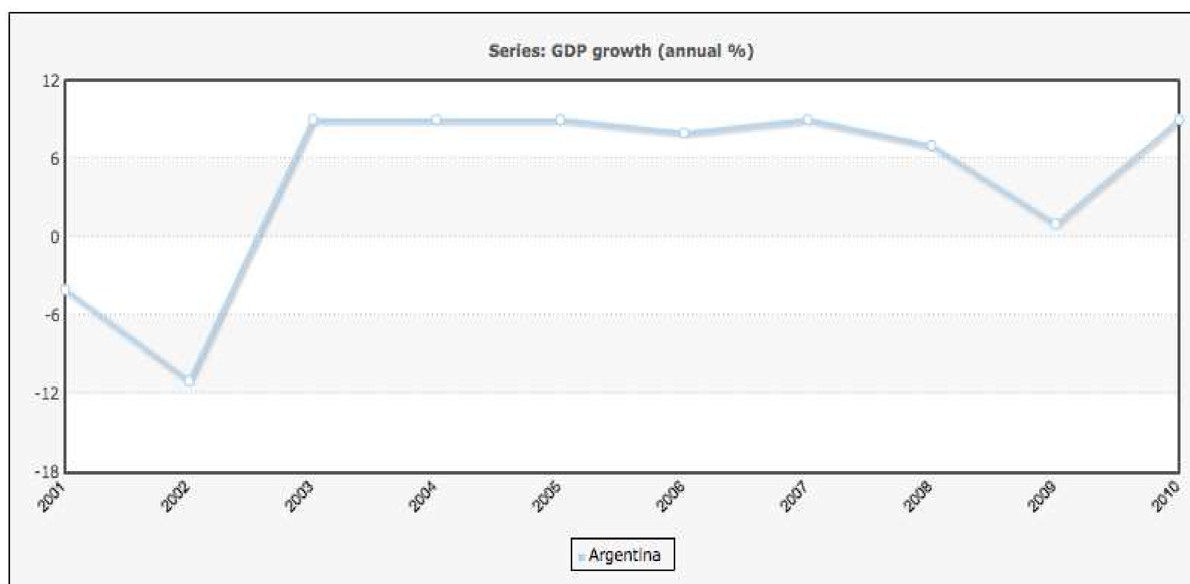
Figure 7: Gold spot prices in USD

Presently, although the strength of the dollar is keeping gold prices down, gold is gaining position in terms of the Euro because of the increase in the sale of European bonds. Once the dollar retracts, gold's strength in terms of the Euro is likely to increase gold's dollar denominated price.

Concept of Sovereign Default

A governments is obliged to comply with its interest payments on debt obligated in respect of its bonds or bank loans. Countries often hesitate to default on their debts since it is difficult and very expensive to borrow funds after defaulting. However, normal bankruptcy rules do not apply to defaulting nations and thus they are likely to escape the legal consequence of debt. Either way, sovereign defaults are very rare or are precipitated by economic and financial crises affecting the defaulting countries. Investors in sovereign debt carefully and closely study the financial status as well as the political temperament of sovereign borrowers in order to determine the risk of the default.

The recession in Argentina started in mid-1998. In December 2001, Argentina announced that the state had defaulted. It was the largest sovereign default in history. A debt burden of over $100 billon due to domestic and foreign bondholders had to be restructured (Hornbeck, 2004). In the aftermath of the default, the government decided to settle the currency on the US dollar, making devaluation inevitable. According to the CEPR's (2011) report, after the GDP had downsized by five per cent in 2002, a mere nine years later, the IMF planned economic growth was expected to be eight per cent. Again, the same report (CEPR, 2011) demonstrates that not only the pre-recession GDP level was achieved but poverty, income inequality and unemployment fell dramatically. The IMF's restructuring plan lead the defaulting economy to grow from minus eleven per cent in 2002 to nine per cent in 2010 (World Bank).



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Measuring a country's financial vulnerability to external effects requires two main dimensions to be taken into account as described by Gros and Mayer – the state of public finances and the availability of national resources. One of the major concerns and differences between the Greek and Argentinean defaults was the government debt-to- GDP ratio which was less than 50 per cent of GDP for Argentina and 100 per cent of GDP for Greece (Gros and Mayer).

The Effectiveness of Policies and Measures Taken By Policy Makers and Financial Institutions

There have been a number of policies and measures taken to solve the Euro debt crisis:

1) **Euro Breakup** - Weak individual countries leaving the Eurozone. From the start, economists denounced the introduction of the Euro currency on the basis that the Eurozone did not fulfill the necessary criteria for an optimum currency area. Thus, as the debt crisis expanded beyond Greece, economists believed that the disbandment of the Eurozone was very important to stabilize the economies. Although this is not feasible in the near future, experts believe that the breakup of the Eurozone could benefit all the economies and aid recovery from this depression.

2) **Official Refinancing Only (ORO)** - The continuum of debt policy options thus begins with the mildest form of liquidity problem – an official sector lender of last resort provides financing to tide over the sovereign country until panic subsides and there is a return to market access. This 'official refinancing only' (ORO) option characterizes the adjustment programmes presently in place for Ireland and Portugal.

3) **Market Buy Backs (MB)** - Sovereign repurchase of debt at a discount in the secondary market is an important market-oriented form of reducing debt. The ECB has already conducted extensive purchase of the bonds of the weak EU members – Greece, Ireland, Portugal, Italy, and Spain in its Securities Markets Programme (SMP). However, so far there is no mechanism for the conveyance to Greece of savings from the difference between the ECB's purchase price and the face value of these bonds.

4) **Debt Restructuring** -This is one of the policies being considered and is an important attempt by the International Monetary Fund to restructure the debt of all the economies. However, when the IMF approved a bailout loan to Greece, the Greek Prime Minister said that debt restructuring was not an option. European officials have long insisted that Eurozone nations can recover without restructuring and that such a measure would damage banks across Europe, creating panic in the markets. However, aside from Papandreou and the EU's assurances, the final result of Greece's austerity measures and those of Portugal and Ireland remain uncertain.

5) **Fiscal Integration and Eurozone Bonds** - A potential alternative to restructuring debt in the Eurozone would be to change institutional arrangements to permit country issuance of public debt jointly and severally guaranteed by the Eurozone (or EU) members – so-called Euro-bonds or the *EB* option. Access to such an arrangement would immediately reduce borrowing costs, especially for Greece, Ireland, and Portugal, but also Italy and Spain, and might marginally raise borrowing costs for France, Germany, the Netherlands and other Eurozone members.

6) **Exit from the European Monetary Union** - Another proposed alternative, which may solve the Euro debt, would be an exit from the European Monetary Union (EMU). This remains a possible but extremely doubtful option. At one point Germany tried to exclude fiscally irresponsible countries that were failing to follow EMU regulations. Even though the forced or voluntary exit of a nation within the EMU is unlawful, some politicians and economists have said such an exit was a better alternative to the prevaling austerity

strategy. Because fiscally troubled EU states could negatively affect the entire Eurozone, exit from the EMU may be welcomed by other states as a means to halt further damage to the zone. Dismissal from the EMU would require departing nations to issue their own currency at great expense and would engender economic uncertainty.

How The Crisis Will Affect The Financial Landscape, Lessons To Be Learned And New Trends That May Emerge From This Turmoil

The sovereign debt crisis has raised fears and uncertainties about the possible negative implications for Europe, the United States, and the world economy; the crisis could have dire economic consequences for a world already in the throes of a severe economic downturn. There are doubts about the integrity of the EU and its currency.

The ongoing crisis has also led to a re-evaluation of the EU's and IMF's bailout strategy for insolvent nations and there have been calls for debt restructuring as an alternative approach. Serious questions remain over the future of the EU and the efficacy of its responses to the crisis.

There is the possibility that the European sovereign crisis may affect the whole world including the US and the UK. The following can be the potential results of this instability on the US economy:

The US Economy

If market and investor confidence in the EU continue to diminish, the value of the Euro will probably weaken. A weakened Euro has the potential to hinder the US's economic recovery by reducing US exports to, and increasing imports from the EU. Further, Europe's economic fluctuations, risk, and higher prices combined with lower US interest rates could signal greater investment and a reallocation of capital to the US economy and its real estate sector.

A US debt crisis could follow the Euro crisis

The US's current fiscal trajectory is becoming increasingly worrisome and unsustainable. The IMF recently noted that US debt could increase to more than 100 per cent of GDP as early as 2015. The IMF also reported that the US would need to reduce its structural deficit by two

per cent of its GDP, a figure higher than Greece's deficit reduction target of nine per cent of GDP. In May 2010, Mervyn King, governor of the Bank of England stated openly that US shares may face the same fiscal problems and risks that were being experienced in Europe. However, the severity of the Greek, Irish, and Portuguese debt crises was unlikely to be matched in the US. The US has the benefit of the dollar acting as the primary fallback currency; a tool that can be used to counteract the severity of a possible debt crisis.

Conclusion

The European sovereign debt crisis has not only put the integrity of the EU at stake but has also clarified the weaknesses and shortcomings of the EU as a congruous coalition. Before and after the institution of the Euro, people argued that the Eurozone lacked the labour-market mobility and wage flexibility necessary for long-term economic success. This was due to profound language and cultural differences. Few believe the EMU will disintegrate completely or that the Euro will be discarded as a legal tender. However, all policy makers must recognize that to ensure ongoing feasibility of the EMU, significant changes to its structure and policies are essential. In addition, questions remain over the basic convergence necessary for a more integrated Europe and whether member nations are willing to remain as part of the Eurozone or would rather revert to their original currency. However, the Euro crisis seems to have worsened as after Greece, Portugal and Ireland there is a sovereign risk for Italy and Spain whose economies are too big to be bailed out by the IMF or ECB.

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