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The European Sovereign Debt Crisis: Responses to the Financial Crisis

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Executive Summary

The ongoing European sovereign debt crisis continues to shake financial markets and the Eurozone. The International Monetary Fund and the European Union (EU) have acted swiftly to diminish panic and uncertainty by providing emergency assistance to Greece, Ireland and Portugal. However, uncertainty remains and queries have arisen over the vigor and effectiveness of multi-lateral institutions like the EU. This paper will establish the origins of the crisis, enumerate European and international responses, bring to light possible alternatives to implemented policies, and finally explore the broader implications for Europe, the United States and the rest of the world.

1 Introduction

The Eurozone's fiscally troubled economies, specifically Portugal, Ireland, Italy, Greece and Spain, triggered a severe crisis of confidence. The advent of the global financial crisis coupled with Greece's public debt admission in October 2009 sparked dismay throughout global markets as the full extent of Eurozone debt levels were unveiled. According to the Economist, Greece's budget deficit reached 15.4%, Ireland's was 14.3%, Spain's 11.2%, Portugal's 9.3%, and Italy's 5.3%, of GDP in 2009.[1] The European Union (EU) rescued Greece and Ireland; most recently, Portugal admitted its need for a similar rescue loan. Perhaps other wrecked countries will need to be helped at a later date. The three aforementioned countries are economically small; the largest is Greece, accounting for only 2.5% of euro-area GDP.[2] However, Portugal's recent capitulation to EU authority has awakened fears that the debt contagion could spread to Spain, making the debt crisis far more serious. These preceding events and the scope of Spain's own debt have raised panic in markets.[3]

This paper will attempt to ascertain the origins of the crisis; to enumerate European and international responses; to draw attention to possible alternatives to implemented policies; and finally to explore the broader implications for Europe, the United States, and the rest of the world.

2 Origins of Crisis

The global financial crisis led to the deterioration of government budgets and finances as nations utilized public expenditures to provide stability and stimulus.[4] Reacting in a similar manner, Eurozone nations faced their own strand of fiscal distress due to heavy borrowing practices, property bubbles, and living above their means. The accessibility of easy credit led to an overreliance on external credit sources to fund domestic debt. Additionally, the commercial and financial interdependence Europe developed with foreign nations made it more vulnerable to economic volatility, resulting in a domino effect when crisis occurs in other parts of the world.

Acknowledging the inherent risks of crises due to their common currency, the EU established the Stability and Growth Pact in 1997 to set a budget deficit ceiling of 3% of GDP and an external debt ceiling of 60% of GDP.[5] The pact sought to ensure that member states maintained budget discipline in order to diminish systemic risk and encourage monetary stability. In addition, the pact required greater coordination of monetary and economic policies from members of the monetary union, lowering the degree of national sovereignty and clout for certain member states.[6]

2.1 Greece

Before the spread of the global financial crisis, Greece borrowed heavily from abroad to fund large deficits in its budget and current account.[7] The roots of Greece's fiscal calamity lie in prolonged deficit spending, economic mismanagement, government misreporting, and tax evasion. When pressed on where Greece had gone wrong, Prime Minister George Papandreou answered, "Corruption, cronyism, clientalistic [sic] politics; a lot of money was wasted basically through these types of practices."[8]

Beginning with the adoption of the euro in 2001, Greece's budget deficit averaged 5% of GDP per year until 2008 compared to a Eurozone average of 2%. Moreover, its current account deficits averaged 9% per year, compared to a Eurozone average of 1%.[9] In 2009, Greece's budget deficit was estimated at 13.6% of GDP. However, a reevaluation of Greece's balance sheets in the latter part of 2009 revealed Greece's budget deficit was in reality closer to 15.4% of GDP.[10]

Soon afterwards, Greece committed itself to a drastic austerity program in order to avoid a default, but it later accepted €110 billion ($155 billion) in financial assistance from the EU and International Monetary Fund (IMF) in May of 2010.[11]

2.2 Ireland

Once hailed as the "Celtic Tiger," Ireland's economy performed exceptionally well due to a successful financial services industry and robust property market. Yet, this reliance on the construction and financial sectors, coupled with the arrival of the global financial crisis, caused a deflation in its domestic property assets and hurt households, banks, and the government.[12] The Irish Republic became the first Eurozone country to fall into recession in 2008. Between 2008 and 2009, its output decreased by 10%. Unemployment increased from 4.5% in 2007 to nearly 13% in March 2010. When the crisis hit in 2009, the government's deficit was estimated at 14.5% percent of GDP. Unlike Greece, Ireland's fiscal shortfall was incurred due to the escalating cost of propping up its undercapitalized banks.[13] In response, the Irish government implemented a series of consolidation measures to help contain the deficit below 12% in 2010.[14]

In late November of 2010, Ireland formally sought support from the IMF and EU and agreed to an €80 billion bailout that required the drafting of a new budget.[15] Ireland's new budget is a four-year plan that slashes $20 billion via spending cuts and new taxes; these cuts include reducing unemployment benefits and welfare allotments.[16]

2.3 Portugal

Portugal's adoption of the euro originally resulted in an economic boom, yet it increased its susceptibility to the banking system's volatile performance. The global financial crisis worsened these pre-existing, homegrown problems.[17] After Ireland's bailout, speculation quickly arose that Portugal would require a bailout as it shared some of the symptoms of Greece and Ireland. The government's repeated fiscal adjustments became increasingly difficult as they were met with strong political opposition. Moreover, on March 23, Portugal's prime minister Jose Socrates resigned after failing to win support for the fourth austerity package in a year. Markets responded by slashing Portugal's credit rating to near-junk status on March 29, 2011 while ten-year bond yields rose above 8%.[18]

On April 6, Portugal's prime minister admitted that his country needed a rescue loan from the EU. The government has yet to define the amount or conditions of this aid. Portugal now joins Greece and Ireland in the Eurozone's sovereign-debt crisis. Portugal's public debt levels are significantly lower than Greece, and its banking industry is comparatively more stable than that of Ireland. Rescue funds are enough to cope with Portugal's situation; the fear, however, is that confidence in neighboring Spain will be shaken.[19]

2.4 Spain

After fifteen years of strong growth led by a housing boom, Spain was hit hard by the global financial crisis. Its output fell dramatically driven by sharp declines in investment, exports, and private consumption, while weaker imports and rising government demand provided some offset. Moreover, Spain's unemployment rate skyrocketed, reaching 20%. The government deficit declined from a surplus of 2% of GDP in 2007 to a deficit of 11.2% of GDP in 2009, "due to the large stimulus and evaporating cyclical and one-off revenues."[20]

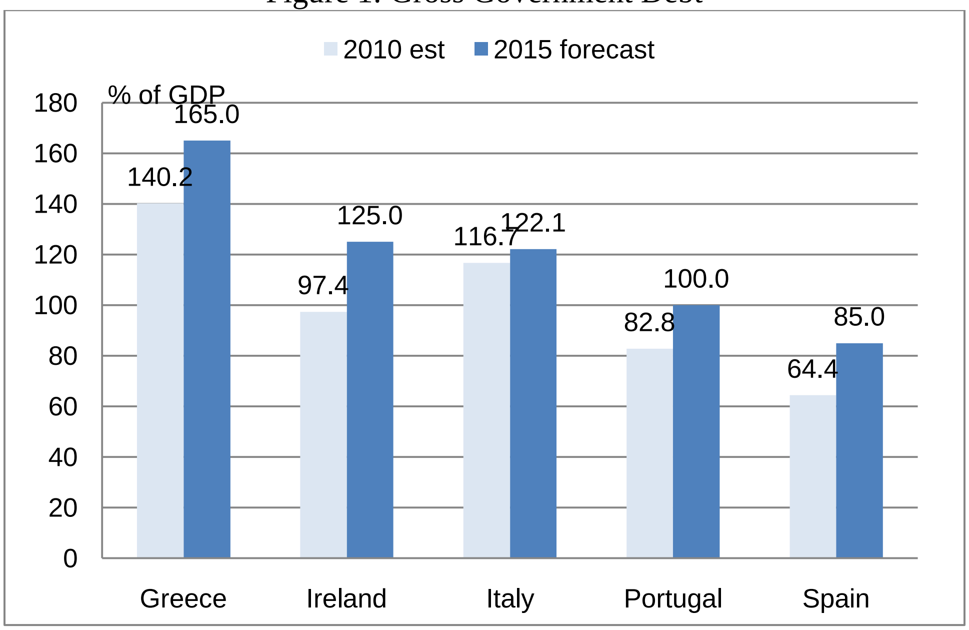
Spain shares several of the weaknesses of the three fallen economies. The country has lost its competitiveness, and it has a large current account deficit similar to Greece and Portugal. Spanish bond yields are narrowing and are continuing to fall as of April 6, 2011. Prime Minister

Jose Luis Rodriguez Zapatero's recent decision not to seek re-election will likely add greater uncertainty to Spain's already dubious fiscal future. [21]

2.5 Italy

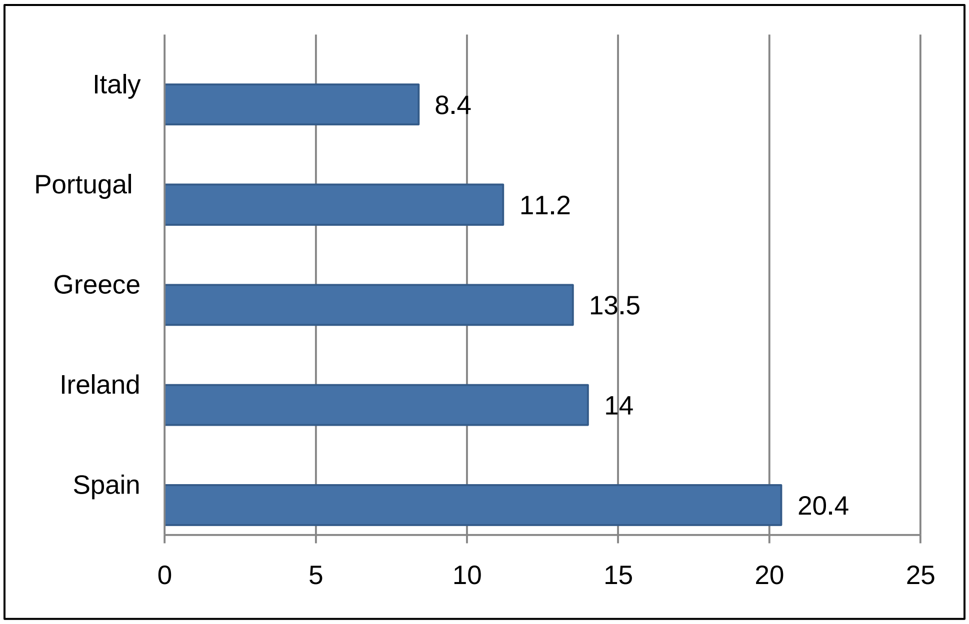
Confidence, trade and credit were quickly shaken due to the global financial crisis in Italy.[22] The global reduction in demand reduced Italy's exports, contracting Italy's private consumption and output. The country's unemployment rate continues to be the lowest amongst Europe's debt-ridden nations. However, fear of unfavorable market reactions has limited Italy's ability to use fiscal policy to stimulate its economy. The overall public debt increased to about 116.7% of GDP by 2010.

Figure 1: Gross Government Debt



Sources: The Economist, IMF, European Commission, Citigroup, Thomas Reuters

Figure 2: Unemployment Percent, February 2011 or Latest



Source: The Economist.

3 Responses

As the financial crisis in Europe intensified, countries within Europe disengaged themselves from each nation's problems and focused on their own economic hardships. However, as time went by and the crisis worsened, it was clear that the effects of the economic meltdown would create a contagion and spill over into the rest of Europe. The European financial crisis is unique due to the diversity of countries, policies, culture, and financial systems involved. Therefore, a harmonized approach cannot be prescribed like in the United States. "In the United States, we were talking about the potential default of banks, that there were certain banks that were 'too big to fail.' In Europe, they're now talking about the potential default of countries: 'countries that are too big to fail.'"[23]

Burgeoning public and investor woe eventually forced EU ministers to enact a €110 billion ($147 billion) rescue package for Greece on May 2, 2010. The package set out to prevent Greece from defaulting and to halt the spread of the crisis to other peripheral countries. Set as a precondition for the loan, Greece agreed to implement austerity measures worth 13% of GDP.[24] This controversial condition was met with swift and violent criticism from many Greek citizens.[25]

Shorty thereafter, the EU created the European Financial Stability Facility (EFSF) to safeguard against a wider crisis.[26] The EFSF was created to preserve financial stability and assist member nations if necessary. This mechanism provides over €750 billion for member states in extraordinary and difficult circumstances beyond member states' control.[27] Consequently, the EU has committed itself to accelerating structural reforms, strengthening fiscal discipline, and establishing a more effective and permanent crisis resolution framework.[28] According to the Organization for Economic Cooperation and Development, "The short-term challenges to European policymakers are magnified by the need to press ahead with the implementation of structural reforms that will help to prevent future financial crises, enhance resilience to adverse economic shocks and improve both long-term growth prospects and the long-term sustainability of the public finances, in the context of ageing populations."[29] The proposed European Economic Recovery Plan "combines short-term measures with an acceleration of structural reforms as set out in the Lisbon strategy country specific recommendations."[30] This plan is a response to the crisis. It aims to stimulate demand and boost consumer confidence, to lessen the human cost of the economic downturn, and minimize its impact on the most vulnerable.

As diversified as nations in Europe are, so are the reactions of their people. For example, "social unrest had been more limited in Spain than in Greece or Ireland."[31] However, the cuts to public spending have resulted in Spain suffering more social unrest. In Greece, protesting workers continue to pour into the streets demanding the cessation of international intervention. Moreover, while Portugal, Ireland, Italy, Greece and Spain were the most affected during the crisis, protests can be seen all over Europe starting from France covering all countries extending to Bulgaria.

Nonetheless, according to populations in those countries that maintained their financial stability (such as Poland) or survived the crisis fairly well, the demands and economic hardships of others should not be their country's burden. Most ordinary citizens (particularly in Germany) believe they should not have to help other countries who got themselves into trouble by living beyond their means. Still, politicians realize that it is probably wiser and cheaper to help the financially distressed countries now rather than later.

4 Possible Alternatives and Solutions

Apart from the official responses taken by the EU, IMF, and European Central Bank, a number of different and unique alternatives exist for Greece, Ireland, Portugal and other debt ridden nations to ameliorate their debt issues.

4.1 Debt Restructuring

Upon the IMF's approval of a bailout loan to Greece, Prime Minister Papandreou expressed his view that debt restructuring was not an option.[32] Papandreou stated that austerity measures would be enough to cut down the deficit and that debt restructuring would be disastrous to Greece's banking system, adversely affecting Greek families in the process. European officials have long insisted Eurozone nations can recover without restructuring and such a measure would damage banks across Europe and create panic in the markets.[33] Yet, aside from Papandreou and the EU's assurances, the final result of Greece's austerity measures and those of Portugal and Ireland remain uncertain. In the event that implemented austerity measures embraced by the IMF and EU do not result in the desired consequences, the debt crisis could continue to spill over and spread its contagion across other debt-ridden nations. While debt restructuring presents its own caveats, it remains a viable option to many European nations who continue to express fears of a possible default.[34]

Furthermore, a recent article published by the German business daily Financial Times Deutschland has stated the EU has "lost faith in Greece" and its ability to service its debt.[35] Moreover, Deutschland claims representatives of several euro zone governments have stated restructuring could no longer be ruled out.[36]

4.2 Implementation of an Innovative Fiscal Strategy mirroring the Osborne Plan of Britain

Following the example of other European nations, Britain is also implementing its own set of austerity measures led by George Osborne, the Chancellor of the Exchequer, to cut government debt. Despite popular disapproval, officials have decided to enact these measures due to fear that growing debt could cause foreign countries and investors to lose confidence in the British economy.[37] The Osborne plan includes extensive spending cuts and significant reform of welfare programs. Tenets of the plan include new limits on benefits for the poor, an increase of the retirement age for millions, a rise in college tuition rates and transportation fees, and a reduction of public payrolls. Although many acknowledge that women and the poor will be the most negatively impacted by welfare cuts,[38] in October 2010, public polls reported that over fifty-eight percent of British voters supported the proposed cuts.[39] Chancellor Osborne recently reaffirmed the necessity of fiscal austerity citing Portugal's predicament as a vindication of Britain's fiscal readjustment.[40]

4.3 Use of Foreign Investment and Stimulus to Improve their Economic Standing

An additional alternative to overcome the present debt crisis is to look to other economically dominant nations for economic support. During a visit to Europe last fall, the Chinese premier Wen Jiabao announced his support towards Greece, the EU and its currency. Wen reinforced this support by announcing the creation of a $5 billion fund to assist Greece's shipping industry.[41] China also promised to invest in Greek bonds as soon as they became available to the market. Wen added, "China will undertake a great effort to support Eurozone countries and Greece to overcome the crisis."[42] However, such an arrangement does not come without a price or a degree of quid pro quo. China has expressed its commitment to the Eurozone recovery while simultaneously advocating for a relaxation of EU restrictions on high-tech exports. China may also be using this crisis as a means to deflect international criticism of its trade policies and its reluctance to appreciate the yuan.[43]

4.4 Exit from the European Monetary Union

Exit from the European Monetary Union (EMU) remains a possible but extremely unlikely option. Germany at one point threatened to kick out fiscally irresponsible countries that were failing to follow EMU guidelines.[44] Although the forced or voluntary exit of a nation within the EMU is illegal, such an exit has been touted by some politicians and economists as a better alternative to the prevalent austerity strategy. Because fiscally troubled member states could potentially drag down the entire Eurozone, exit from the EMU may be welcomed by other states as a means to halt further damage to the union. Dismissal from the EMU would require that departing nations issue their own national currency at great expense and economic uncertainty. On the other hand, such an action would allow highly indebted nations to exercise their own monetary policy. Through currency devaluation, these nations could assuage fiscal austerity measures and stimulate the economy through more price-competitive exports.[45]

5 Broader Implications

The sovereign debt crisis has consequently raised fears and quandaries about the possible negative implications it poses to Europe, the United States, and the world economy. The crisis could have potentially dire economic consequences for a world already in the midst of a severe economic downturn. Doubts have risen over the integrity of the EU and its currency. In the case of the United States, the crisis could potentially slow down the United States' economic recovery in the short term. In the long term, the crisis provides a stern warning to the Unites States in regards to its fiscal policies and has led to increased discussion about a similar debt crisis erupting in the future.[46]

Remedies implemented by the EU and IMF were able to lessen investor and public woes to some degree.[47] Yet even after the rescue and the creation of the EFSF, doubts persisted over the conclusiveness of the crisis and if the responses were enough to avoid further calamity. Public financing from the EU and IMF might assuage the debt crisis, but it will not resolve the crisis comprehensively.[48] Doubts lingered, but between May and October 2010, it seemed the worst of the crisis had passed and Europe was on its way to a fragile comeback. Then, in November, came the problems of Ireland. The resulting turmoil in Ireland sparked discussions over the finality of the debt crisis and animated reservations over the EU's long-term future. Undergoing a political crisis and increasing difficulties to finance its debt, Portugal applied to the EU for assistance on April 6.[49] Portugal's call for help has fueled escalating speculation that Spain will need a rescue similar to that of Ireland, Greece and Portugal to complement their implemented austerity measures.[50]

The ongoing crisis has also led to a reevaluation of the EU's and IMF's bailout strategy for insolvent nations and has prompted calls for an alternative approach through debt restructuring.[51] Serious questions remain over the future of the EU and the efficacy of its responses to the crisis. Certain analysts have suggested that these rescues provide only a short-term fix to the overall crisis. Moreover, the rescues fail to address the fundamental problems of Greece, Ireland, and Portugal and the inherent flaws of the Euro currency. EU officials, analysts, and investors are beginning to gain recognition of the long-term nature of the crisis and the host of new questions and ramifications it presents for the EU and world markets.[52] Currently, individual member nations lack control over the euro currency, a vital tool necessary for economic recovery after a financial crisis. That inability has prompted questions over the framework of the EU, its durability, and the willingness of European citizens to undergo harsh austerity and institutional changes as a price for defending the common currency.[53]

5.1 The Integrity of the European Union

The crisis has elucidated the vulnerability and shortcomings of the EU as a congruous confederation. Before and after the establishment of the Euro, critics argued the region lacked the labor-market mobility and wage flexibility necessary for long-term economic success due to deep linguistic and cultural differences.[54] Few believe the EMU will disintegrate completely and that the Euro will be dropped as a currency. Yet, all policy makers must recognize that to ensure the EMU remains viable, significant reform in its structure and policies are essential.[55] Moreover, questions remain over the fundamental convergence necessary for a more integrated Europe and if member nations are willing to forgo sovereignty to ensure fiscal discipline and stability on a regional level.[56]

5.2 The U.S. Economy

If market and investor confidence continues to diminish for the EU, the Euro will likely diminish in value. Euro depreciation would potentially hinder the United States' economic recovery by lowering US exports to, and increasing imports from, the EU. As a result, the US trade deficit will increase, undermining President Obama's initiative to double US exports.[57]

On the other hand, Europe's economic flux, risk, and higher prices combined with lower US interest rates could signal greater investment and a reallocation of capital towards the US economy and its real estate sector.[58]

5.3 A US Debt Crisis?

The United States' current fiscal trajectory is becoming increasingly worrisome and unsustainable in the long term.[59] The IMF recently noted US debt could surpass 100% of GDP as early as 2015. The IMF also noted the US will need to reduce its structural deficit by 2% of its GDP, a figure higher than Greece's deficit reduction target of 9% of GDP.[60] In May of 2010, Mervyn King, governor of the Bank of England stated publicly that the U.S. shares many of the same fiscal problems and risks inflicting Europe.[61]

However, the severity of the Greek, Irish, and Portuguese debt crises is unlikely to be matched in the United States. The US holds the advantage of the dollar acting as the primary reserve currency, a tool that can be used to ameliorate the severity of a possible debt crisis.[62]

In an effort to address the US fiscal situation and achieve fiscal sustainability, President Obama created the National Commission on Fiscal Responsibility and Reform in February of 2010.[63] The commission's newly published recommendations include an overall tax ceiling of 21% of GDP, federal spending limited to 22% of the economy, reform of the tax code, and gradual reductions in total federal health spending. Comprehensively, the plan aims to reduce the deficit by $4 trillion dollars over the next decade through spending cuts and tax reform.[64] Commission co-chair Erskine Bowles compared US budgetary trends to a cancer "that will destroy our country from within" if not addressed. [65]

6 Concluding Remarks

In the wake of the crisis, financial analyst Simon Johnson asserted that a lingering flaw of the European Commission is its inability to address problems until they become crises. This crisis has warned governments throughout the globe of the dangers of fiscal wanton. Britain along with other European nations introduced a salvo of austerity measures to prevent a debt crisis. The US is currently contemplating numerous options to cut the deficit, which if implemented, could have profound consequences for our social and political future. Johnson goes on to claim that only when crisis erupts can the EU can come together to develop solutions. If so, the question now is how the EU can succeed in the long-term if it does not have the capacity to address problems early? Perhaps, the most important lesson of this episode was the realization that public policy challenges can no longer be postponed as they used to be. The wages of evasion are clearly too caustic for any country or region to pay. A new public policy ethos is essential if progress is to be made. However, if this lesson is ignored, the EU or other nations may face a future crisis or problem. It is hard to then imagine the ramifications on the region and the rest of the world.[66]

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