Lecture 16: European Sovereign Debt Crisis

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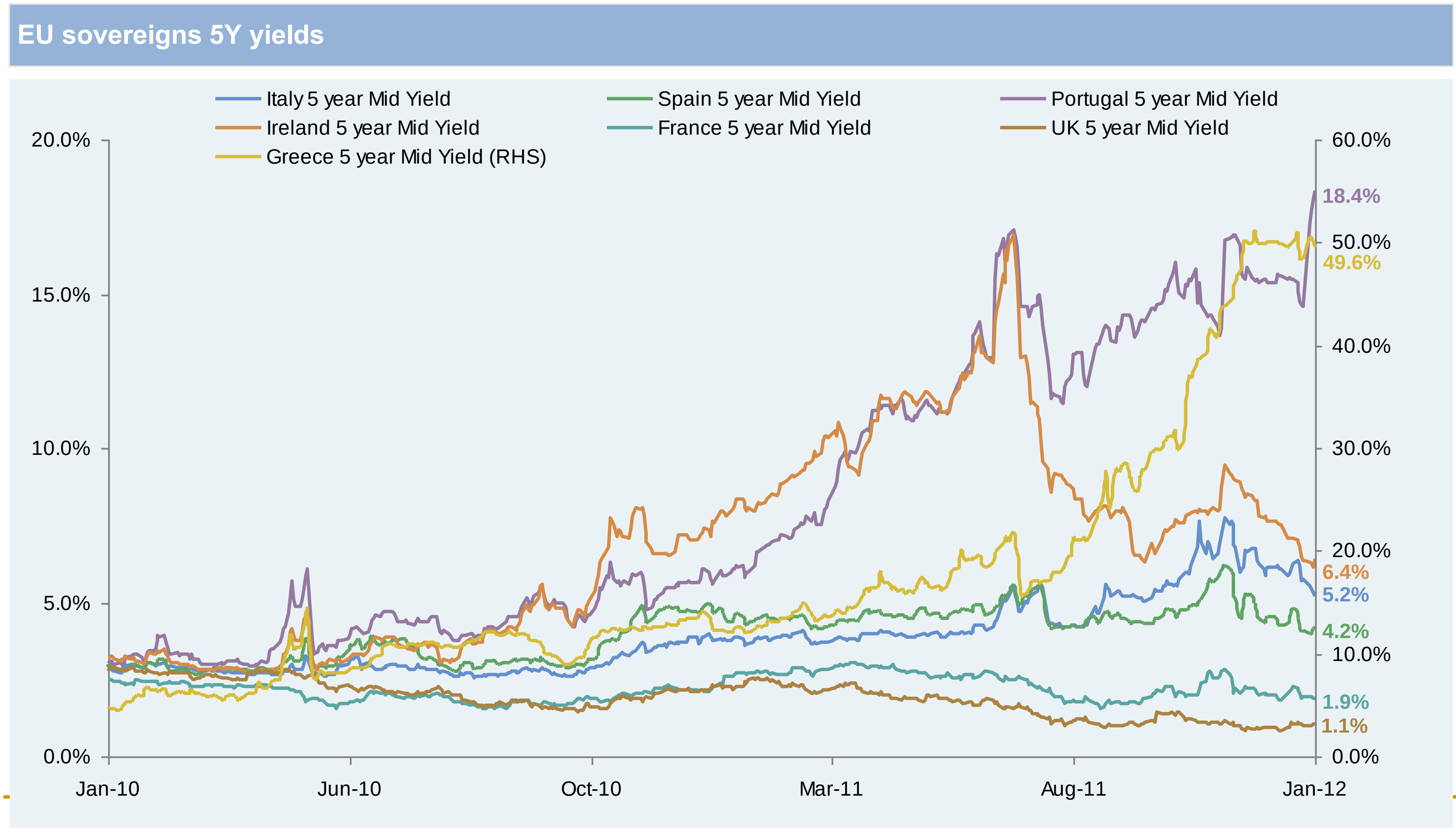
Outline

- **Causes**
- **Impact**
- **ActionTaken**

Background

- **The European sovereign debt crisis (referred to by some as the ESDC) is an ongoing financial crisis that has made it difficult or impossible for some countries in the euro area to refinance their government debt without the assistance of third parties***



Source: Dataquery as of 20th Jan 2012, Research reports

Source: Wikipedia and JP Morgan

Background

The euro area: core and peripheral countries

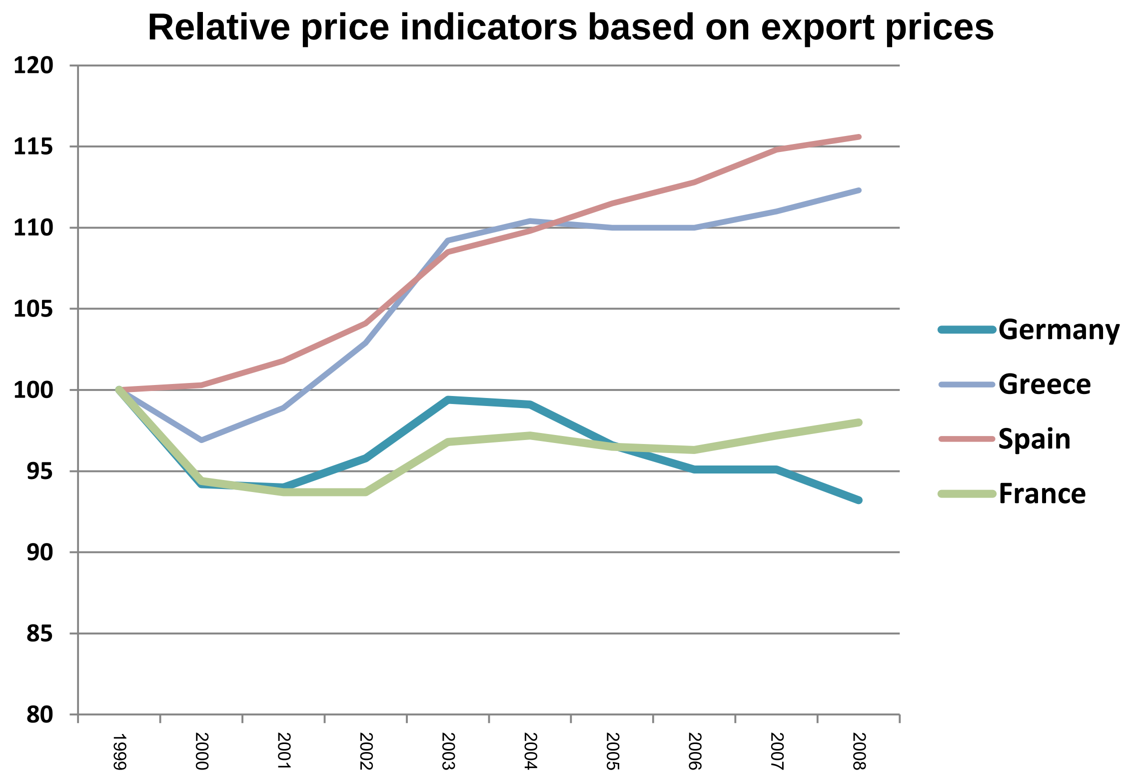
Core countries:
Germany, France, Netherlands, Austria, etc.

Peripheral countries:
Portugal, Ireland, Greece, Spain

PIIGS

Causes

- **Loss of competitiveness** for smaller countries from joining the euro in 1999 contributed to large fiscal spending to maintain standard of living
- **Low interest rates** allowed Ireland, Greece and Portugal to depend on deficit-spending

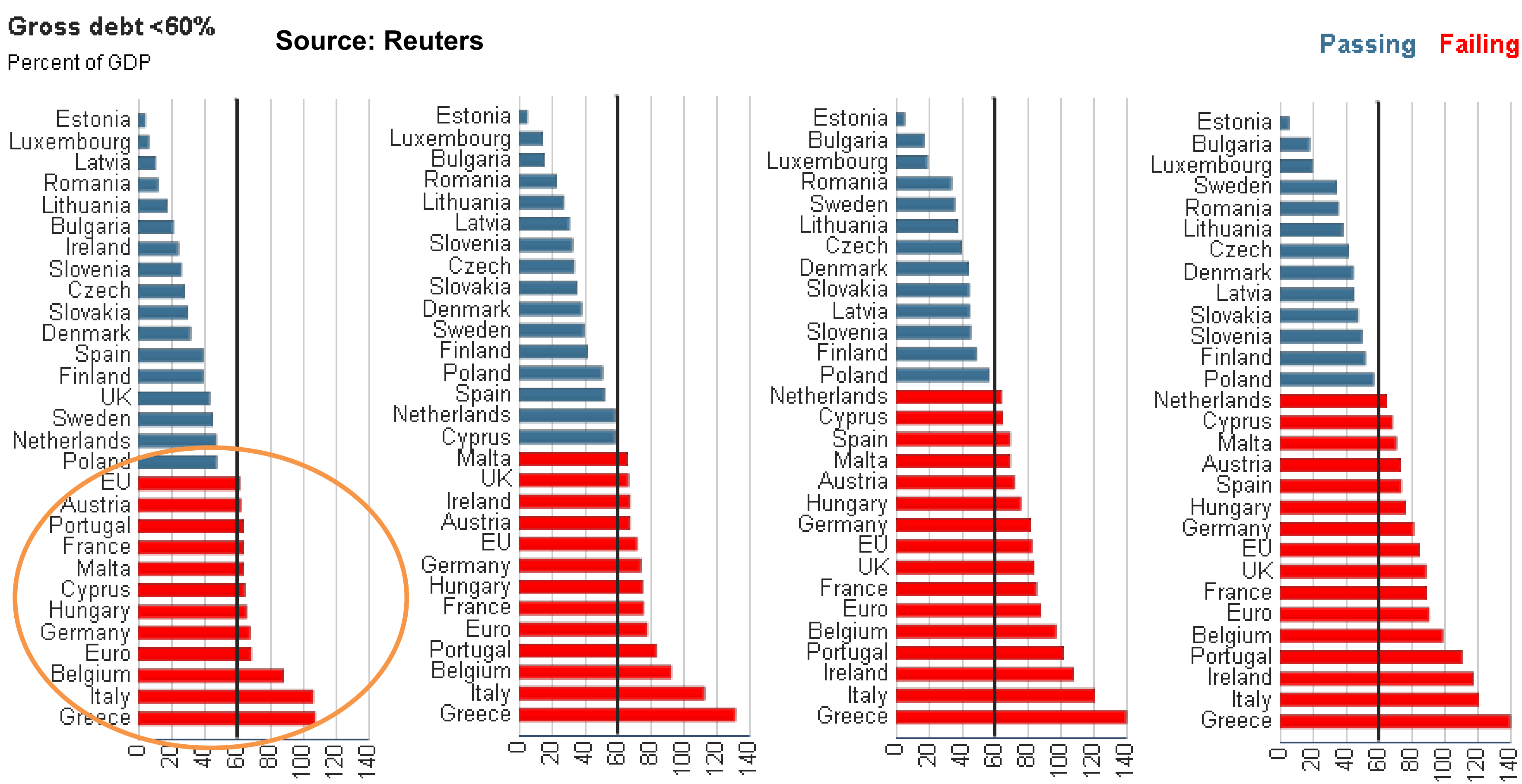


Source: Stanley W. Black (2010) and European Commission (2010)

Causes

- **Members of the EU circumvented fiscal discipline (as indicated in the Maastricht criteria)**

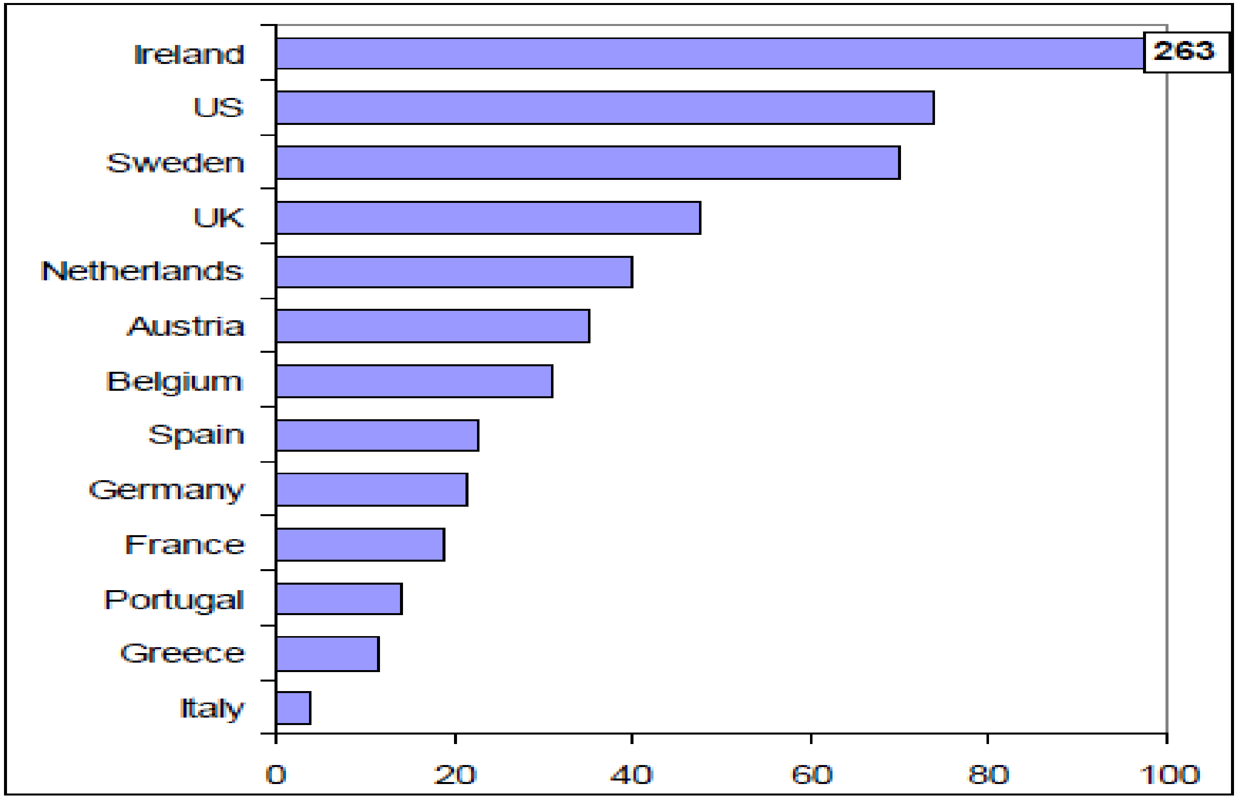
2002 - 06 Avg | **2007 - 11 Avg** | **2011** | **2012F**



Causes

- **Subprime crisis worsened fiscal position of countries in Europe due to reduction in tax revenue, fiscal stimulus and financial sector bailout**

Public Support to the Financial Sector
(as of 18 February 2009, % of GDP)

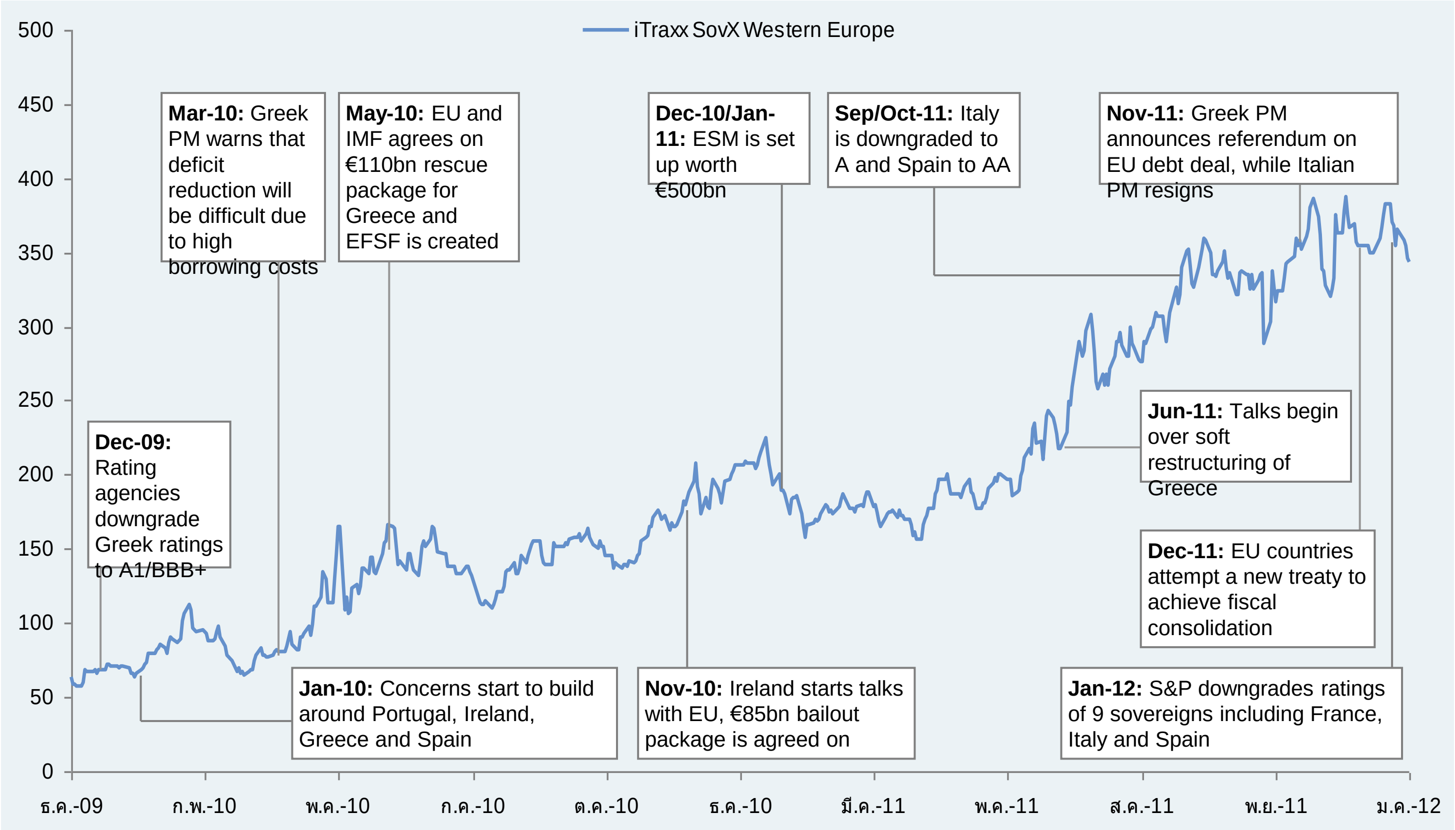


Source: Stanley W. Black (2010), International Monetary Fund (2009).

Causes

- **Rapid debt accumulation prompted concerns over fiscal sustainability**

iTraxx Europe 5Y SovX Western Europe (bps)



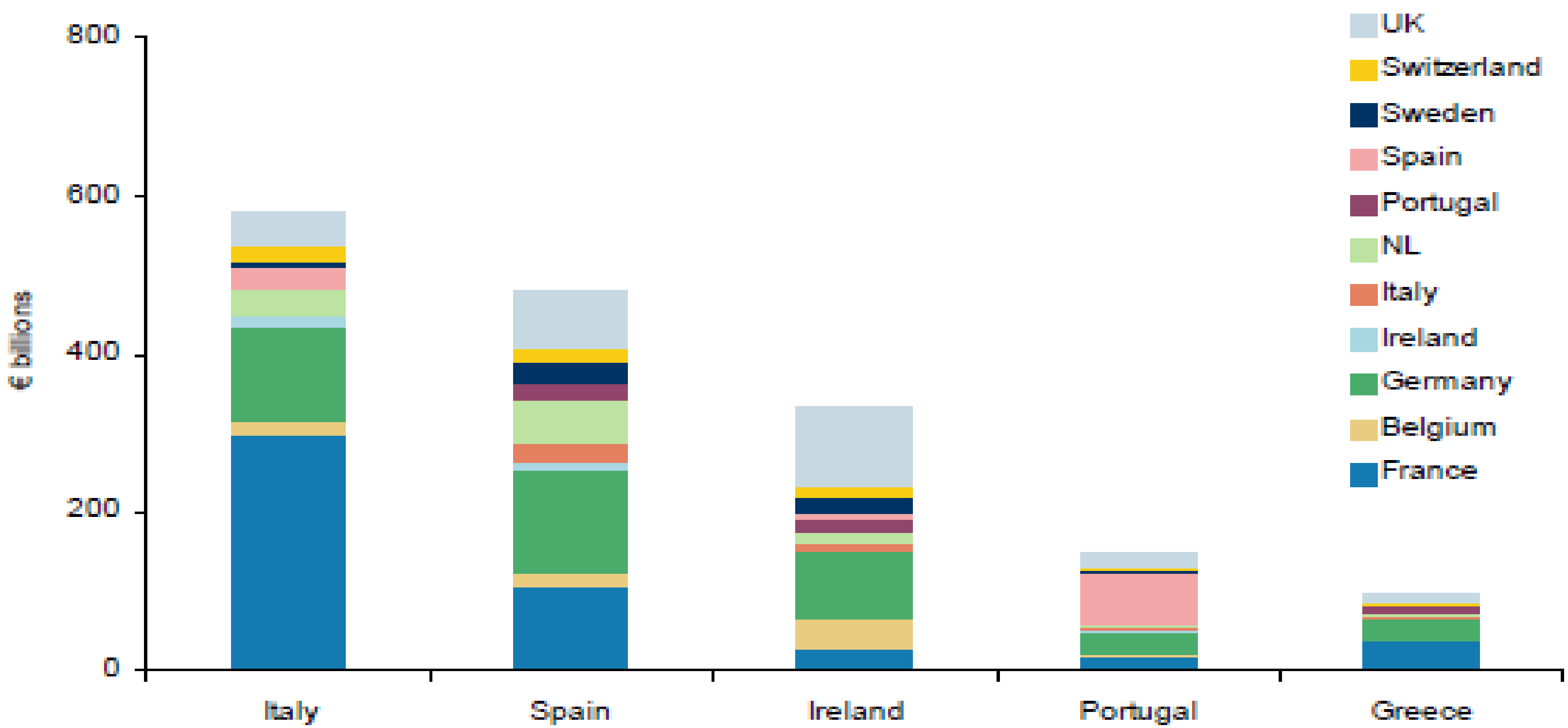
Source: Dataquery as of 20th Jan 2012
The iTraxx SovX index comprises equal weightings of 15 European Sovereign CDS contracts and gives us an implicit 5-year funding level for the constituents comprising the index. Constituents of the SovX index are Germany, France, Greece, Belgium, Denmark, Norway, Spain , Sweden, Netherlands, Portugal, Austria, Finland, UK and Italy.

Source: JP Morgan

Causes

- **Financial interconnectedness caused financial contagion across Europe**

German and French financial institutions were largely exposed to sovereign debts issued by PIIGs



Source: Deustche Bank

Causes

- **Spillovers from the subprime crisis**

- **BNP-Paribas forced to close funds in August 2007**
- **UK bank Northern Rock taken over by government**
- **German state banks IKB, WestLB, BayernLB and SachsenLB bailed out by government**
- **Irish banks given government deposit guarantees**
- **Switzerland injects funds into UBS**
- **Iceland's banks unable to roll over short term borrowing, default on deposits of foreigners**

Source: Stanley W. Black (2010)

The origins of the Greek crisis

Source: www.euro-challenge.org

Greece’s euro membership marked by consumption, investment booms

Wages rise faster than productivity, competitiveness deteriorates

Low interest rates fuel credit growth

Poor fiscal discipline and weak institutions

Large revisions to budgetary statistics

Unsustainable pension, health systems

Greece and the EU rise to the challenge

May 2010: Greece adopts €110bn program supported by the EU and IMF

Program aims to restore sustainable public finances and recover lost competitiveness

Far-reaching structural reforms being adopted (e.g. landmark pension reform)

Drastic cuts in public expenditure across all levels of government

Program will stabilize debt ratio (but at a high level)

Source: www.euro-challenge.org

The origins of the Irish crisis

Source: www.euro-challenge.org

Ireland experienced strong growth in recent decades

Transformation from agricultural economy to “Celtic Tiger”

Strong presence of multinational companies, skilled workforce

But reckless lending by banks to commercial property developers

Bad debt of banks causes problems for whole economy

Deep recession – 14% unemployment

Ireland and the EU rise to the challenge

Government already taking drastic measures over last several years

November 2010: Ireland adopts €85bn program supported by the EU and IMF

Program aims to cut budget deficit and repair the damage caused by the banking crisis

Shrinking and restructuring of banking sectors

Drastic cuts in public expenditure across all levels of government

Source: www.euro-challenge.org

Cypriot crisis of 2013

- The United States' subprime mortgage crisis in 2007-2008 led to a domino effect of negative consequences in the global economy including the European Union. **The Cypriot economy went into a deep recession** in 2009, as the economy shrank by 1.67% with large falls specifically in tourism and shipping activity which caused rising unemployment.

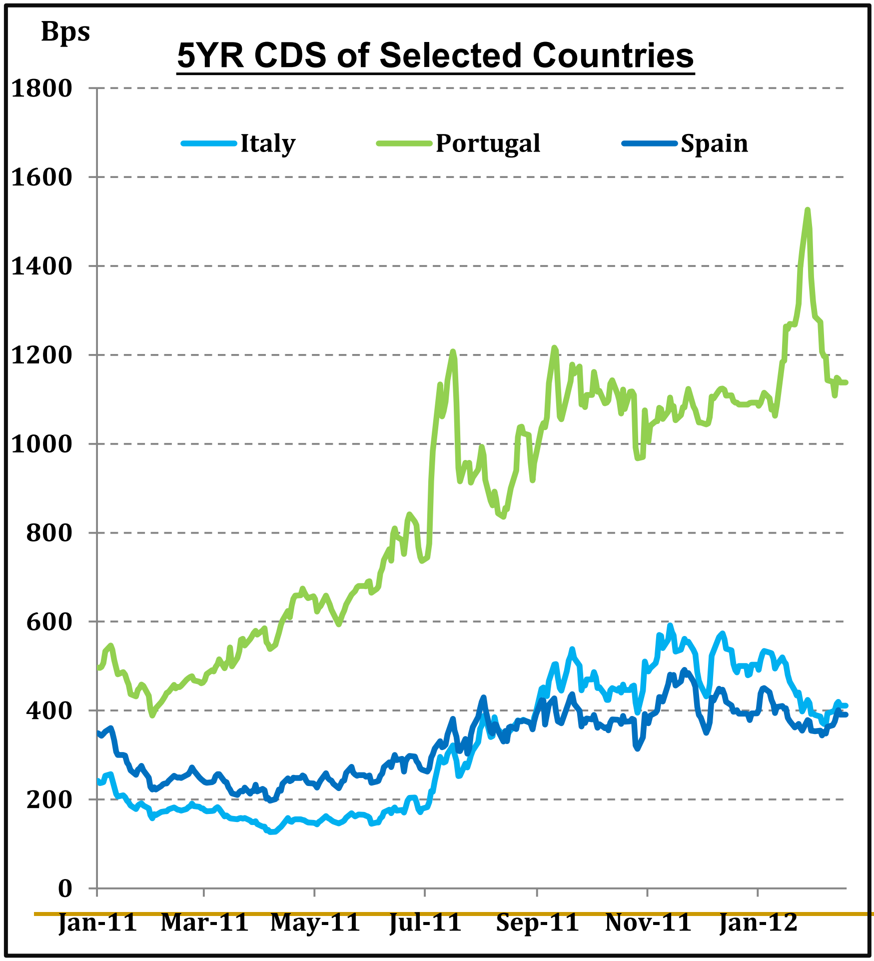
- With rising unemployment and associated benefits the size of state debt increased. The banks were then **exposed to a haircut of upwards of 50% in 2011 during the Greek government-debt crisis**, leading to fears of a collapse of the Cypriot banks. The Cypriot state, unable to raise liquidity from the markets to support its financial sector, requested a bailout from the European Union.

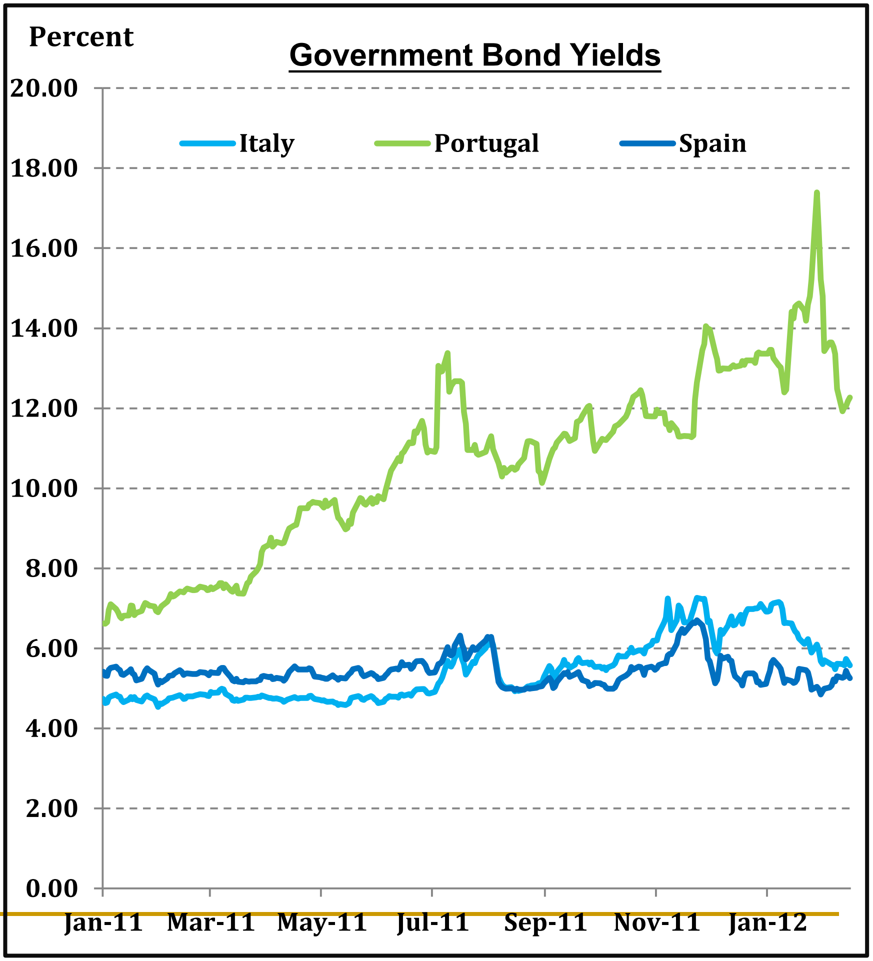
- Progress on **fiscal and structural reforms was slow and following a serious explosion at a naval base in July 2011 the major credit rating agencies downgraded** the country's rating in September. Yields on its long-term bonds rose above 12% and there was concern that the country would be unable to stabilize its banks.

Source: Wikipedia

Impact

- Loss of confidence in financial markets increased costs of funds



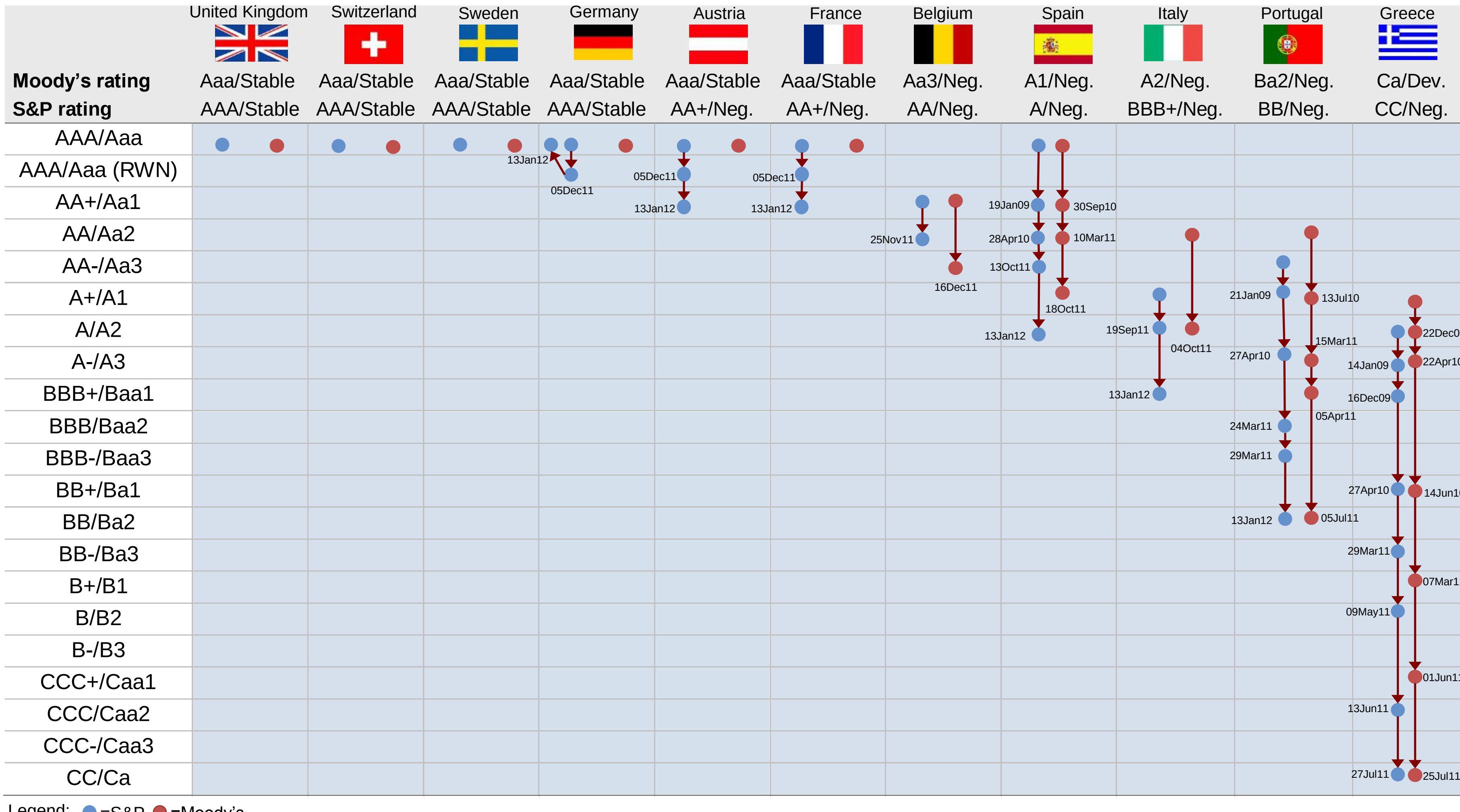


Source: Bloomberg

Impact

- Credit rating agencies persistently downgraded euro-zone sovereign

Sovereign ratings changes since January 1, 2009

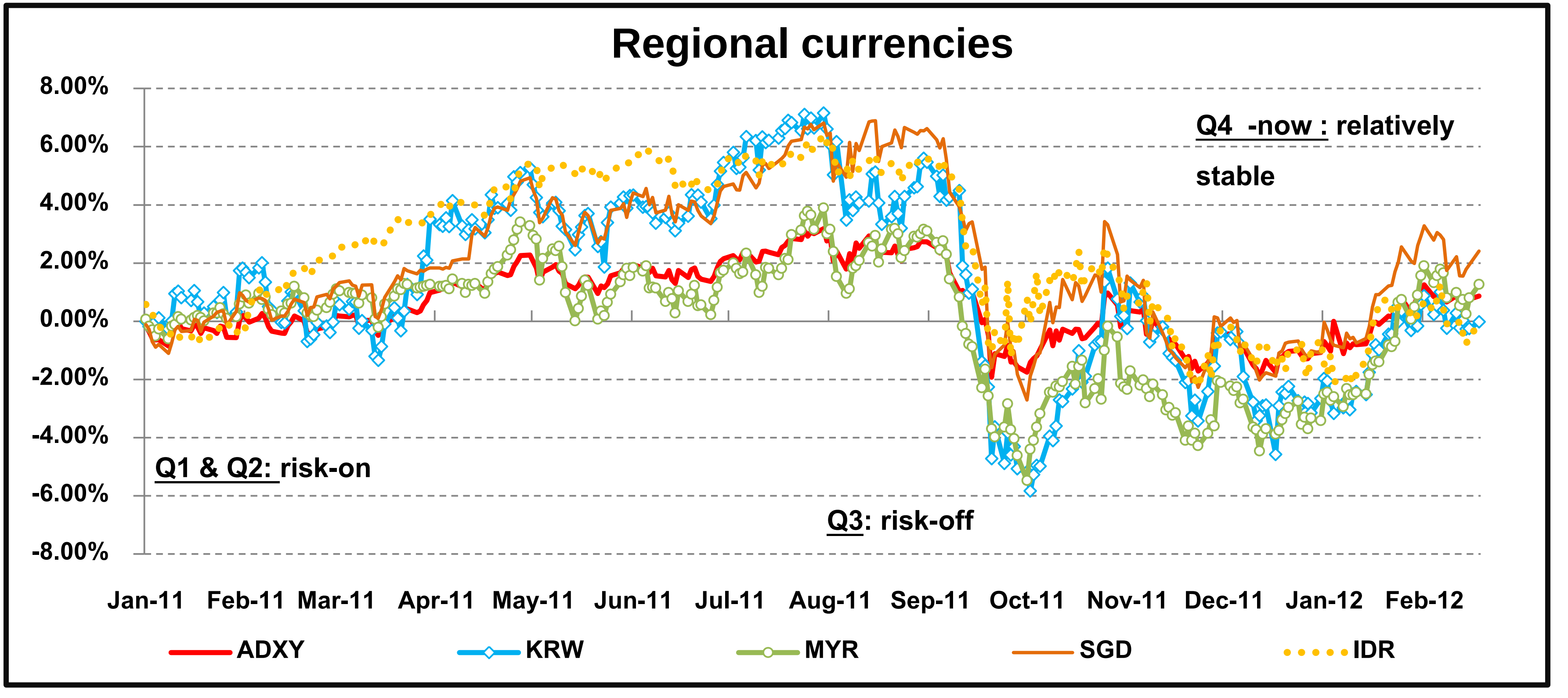


Note: Current ratings as of 16 January 2012; RWN= Ratings watch negative

Source: JP Morgan

Impact

- Financial markets and capital flows have been more volatile with risk-on and risk-off phenomena alternating



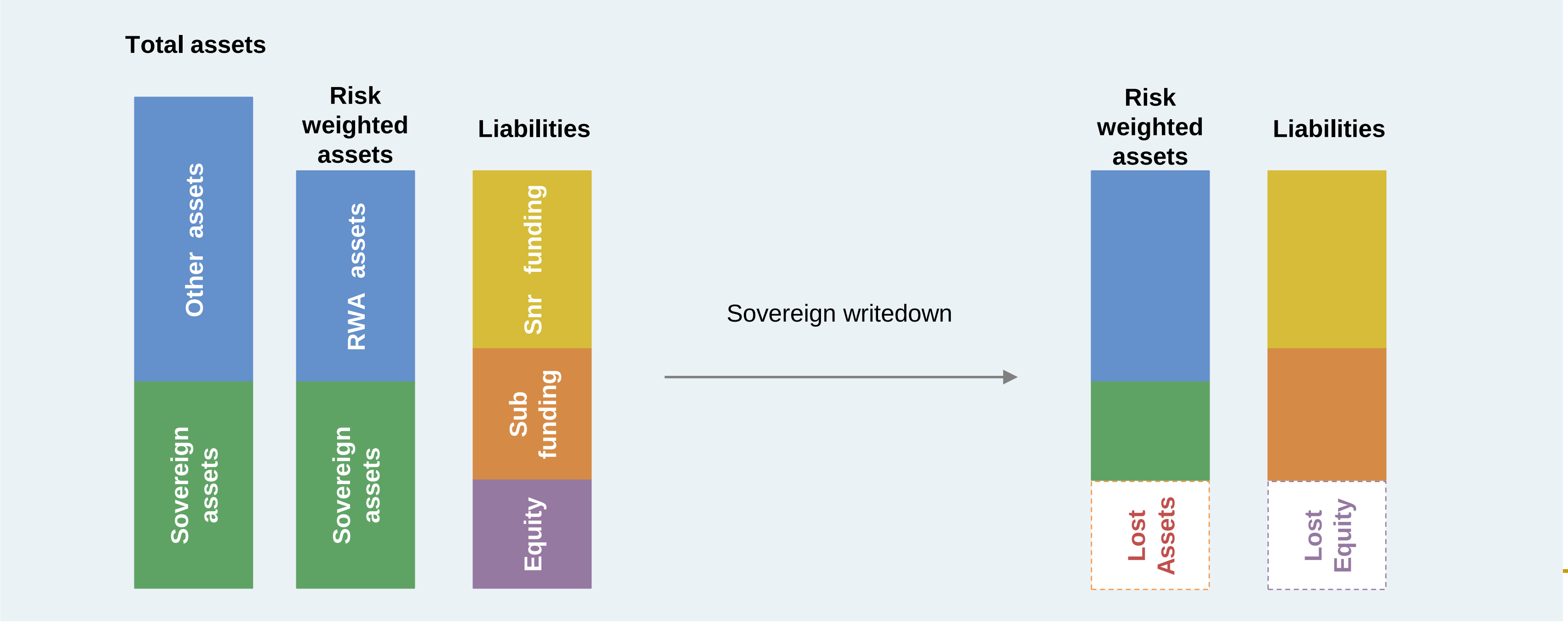
* Depreciation (-) /appreciation (+) from end-2010

Source: Bloomberg

Impact

❑ ESDC impaired banking sector's health

- Sovereign bonds have been an attractive asset source for banks historically
- Under Basel rules, banks can treat Sovereign assets as having zero capital requirements
- However, in a real downside scenario, there is a 1:1 direct impact of writedowns on a bank's equity–they lose money
- Sovereign concerns create fears of solvency across a bank's entire capital structure leading to paralysis in their ability to fund



Source: JP Morgan

Actions Taken

Liquidity Measures

Stabilisation phase

- Creation of "liquidity hospital" through a lender of last resort

Solvency

Rehabilitation phase

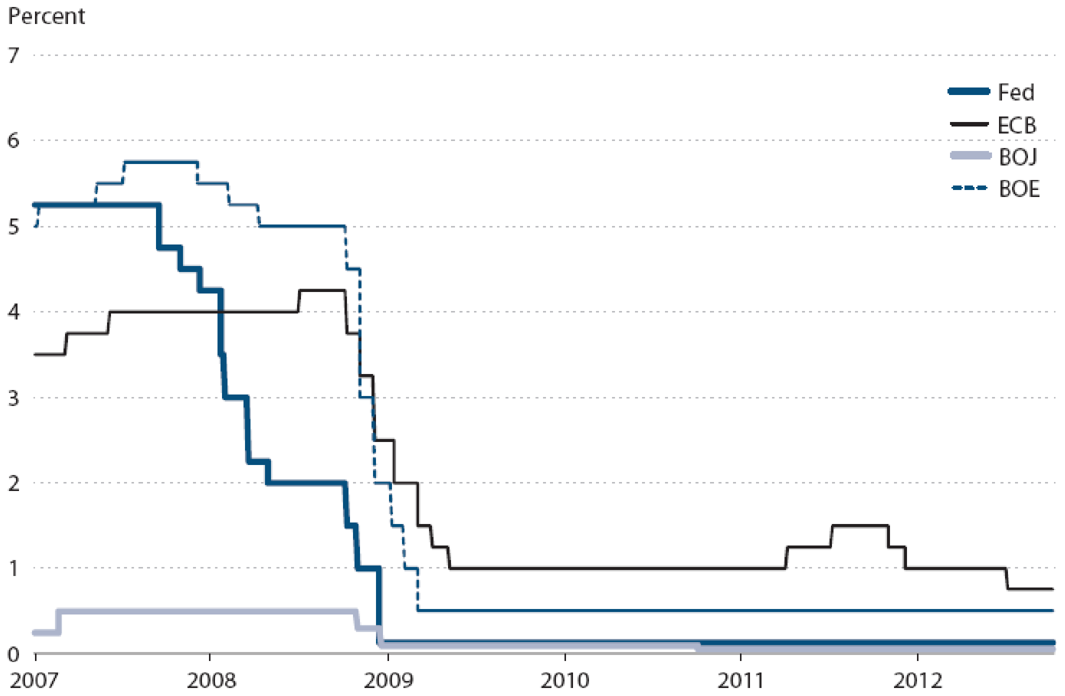
- Dealing with the chronic debt addiction of Europe
- Which solution is best?
- Will it work?

Source: JP Morgan

Actions Taken

- The ECB lowered the policy rate

Fed, ECB, BOJ, and BOE Main Policy Rates



NOTE: The main policy rates for the Fed, ECB, BOJ, and BOE are, respectively, the federal funds target rate, the main refinancing operations fixed/minimum bid rate, the uncollateralized overnight call rate, and the official Bank rate.

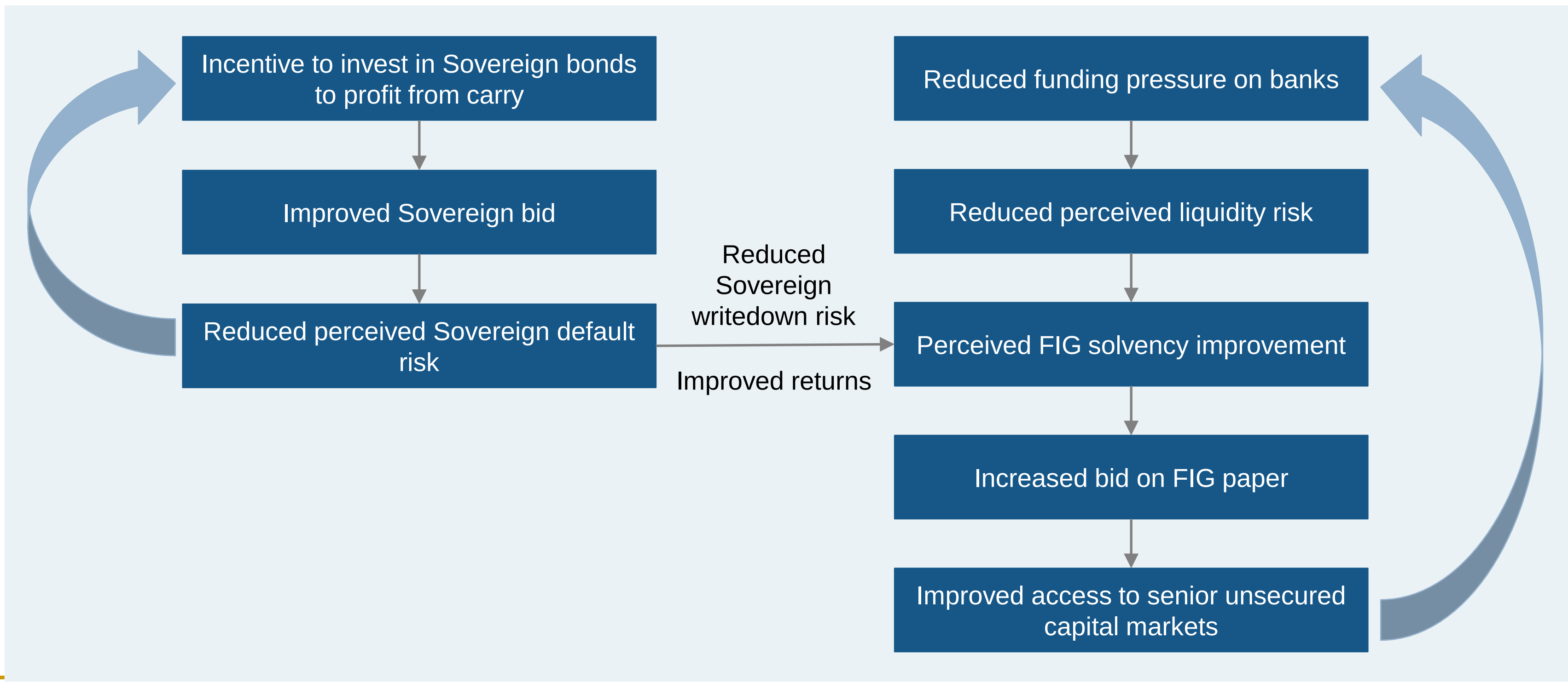
SOURCE: Fed, ECB, BOJ, and BOE.

Source: Fawley and Neely (2013)

Actions Taken

- **The ECB also implemented 3-year LTRO (Long-term Refinancing Operation)**
  - Unlimited liquidity to banks at 1% cost in return for positing wide range of eligible collateral
  - EUR 489.2bn drawn during first window in December 2011 from 523 bidders
  - Second operation on 29th February

Twin benefits

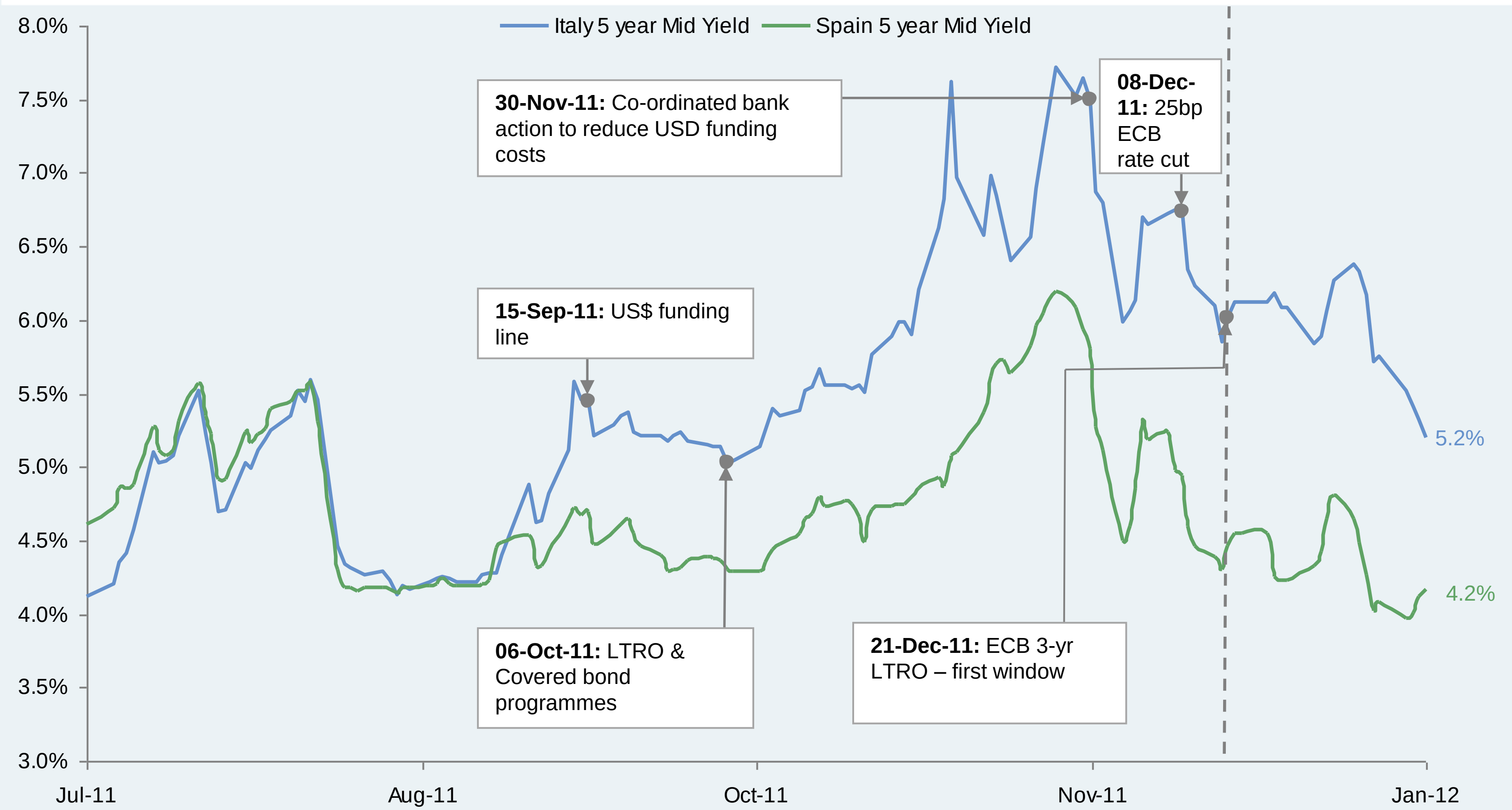


Source: JP Morgan

Actions Taken

- 3-year LTRO improved market confidence as reflected in declining peripheral yields

Italy and Spanish government 5Y yields

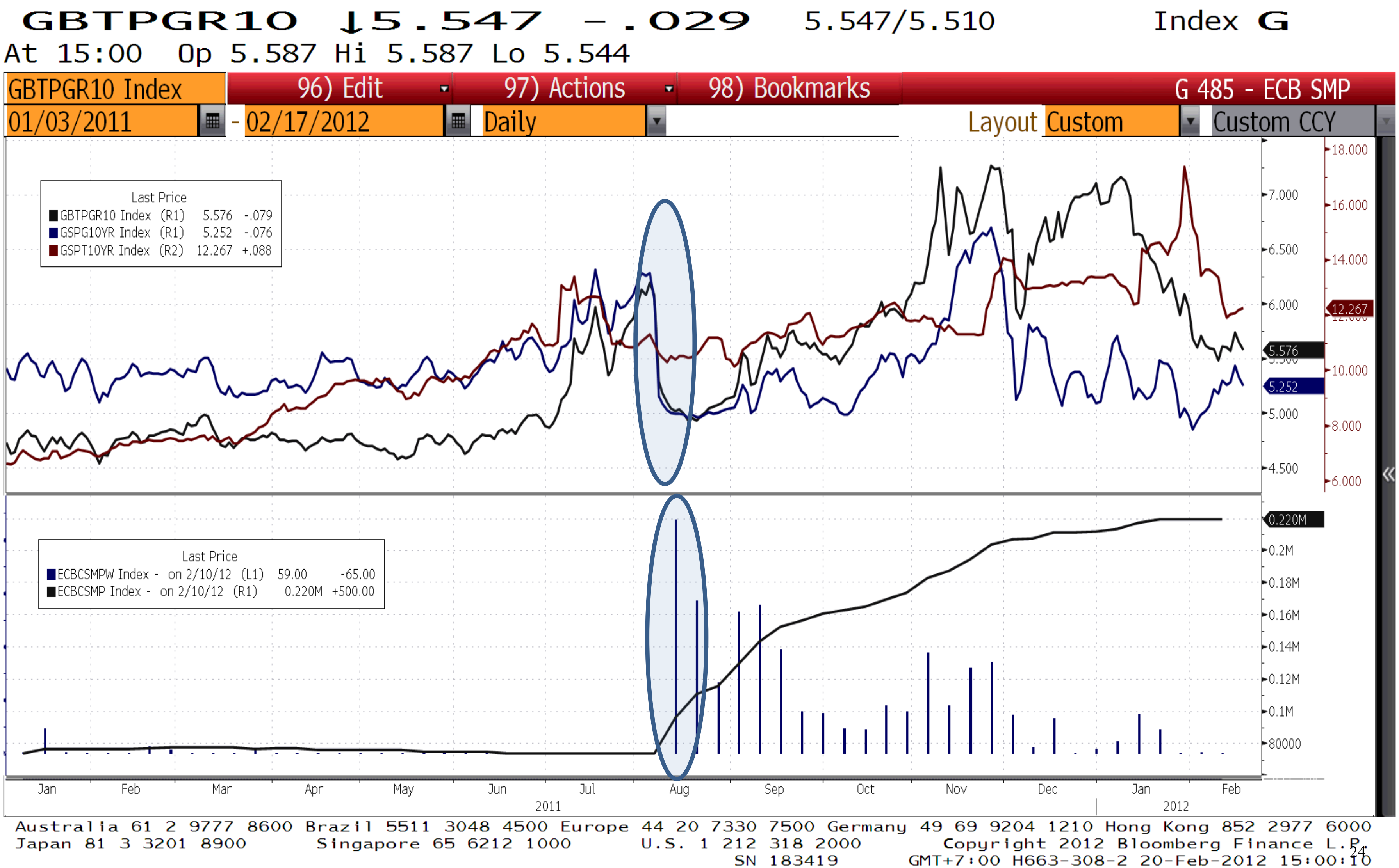


Source: Dataquery as of 20th Jan 2012, Research reports

Source: JP Morgan

Actions Taken

- The ECB also purchased peripheral countries' sovereign debt through securities market programme (SMP) to lower bond yields.



Actions Taken

European Financial Stability Facility (EFSF)

- The EFSF can issue bonds or other debt instruments on the market with the support of the German Debt Management Office to raise the funds needed to provide loans to eurozone countries in financial troubles, recapitalize banks or buy sovereign debt.

- The €440 billion lending capacity of the Facility may be combined with loans up to €60 billion from the European Financial Stabilisation Mechanism (reliant on funds raised by the European Commission using the EU budget as collateral) and up to €250 billion from the International Monetary Fund (IMF) to obtain a financial safety net up to €750 billion.

- Had there been no financial operations undertaken, the EFSF would have closed down after three years, on 30 June 2013. However, since the EFSF was activated in 2011 to lend money to Ireland and Portugal, the Facility will exist until its last obligation has been fully repaid.

European Financial Stability Facility

Countries	Initial EFSF maximum guarantee Commitments (€ mn)	Amended EFSF maximum guarantee Commitments (€ mn)
Austria	12,241.43	21,639
Belgium	15,292.18	27,032
Cyprus	863.09	1,525
Estonia		1,994
Finland	7,905.20	13,974
France	89,657.45	158,488
Germany	119,390.07	211,046
Greece	12,387.70	21,898
Ireland	7,002.40	12,378
Italy	78,784.72	139,268
Luxembourg	1,101.39	1,946
Malta	398.44	704.33
Netherlands	25,143.58	44,446
Portugal	11,035.38	19,507
Slovakia	4,371.54	7,727
Slovenia	2,072.92	3,664
Spain	52,352.51	92,544
Total	440,000.00	779,779.01
Total minus step-out	409,574.52	725,996.12
Total AAA	255,439.12	451,538.43

Source: Nomura, EFSF, Eurogroup working group

Source: Wikipedia

Actions Taken

- **Bailout from the EU and the IMF**

  - On 23 April 2010, the Greek government requested an initial loan of €45 billion from the EU and IMF, to cover its financial needs for the remaining part of 2010.

  - On 1 May 2010, the Greek government announced a series of austerity measures to secure a three year €110 billion loan.

  - To prevent default and euro-zone exit from happening, the troika (EU, IMF and ECB) eventually agreed in February 2012 to provide a second bailout package worth €130 billion,conditional on the implementation of another harsh austerity package (reducing the Greek spendings with €3.3bn in 2012 and another €10bn in 2013 and 2014).

  - For the first time, the bailout deal also included a debt restructure agreement with the private holders of Greek government bonds (banks, insurers and investment funds), to "voluntarily" accept a bond swap with a 53.5% nominal write-off along with lower interest rates and the maturity prolonged to 11-30 years (depending on the previous maturity).

Source: Wikipedia

Actions Taken

- Austerity measures

What Greece agree to implement through 2015 ….

- Public Sector wage bill reductions (0.5% of GDP)
- The number of civil servants reduction to 150,000 through 2015
- Rationalisation of social spending (cutting pension and health spending)
- Restructuring of government operations
- Reforming the tax system

To reduce debt to GDP to

120% in 2020

References and data sources

- **Wikipedia (2012-2013)**, ‘***European Sovereign Debt Crisis***’
- **Financial Markets Operations Group, Bank of Thailand (2012)**, ‘***Knowledge Exchange Programme on Euro Debt Crisis’ (21 Feb 2012)***
- **Euro Challenge Orientation (2011),** ‘***The Euro Area: Emerging from the Crisis’ (www.euro-challenge.com)***
- **Stanley W. Black (2010),** ‘***The Eurozone Financial Crisis’***