The Impact of The Sovereign Debt Crisis on The Eurozone Countries

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Abstract
The turmoil affecting capital markets since summer 2007 and its intensification since mid-September 2008 inflicted noticeable blows to world economy. These last years the euro-zone's financial institutions seem to be seriously hit by aggravating tensions. In 2010, this crisis intensified with the Greek debt crisis. It dated back to autumn 2010 with the Irish public debt. In this paper, we analyse the recent developments in the eurozone, mainly the PIIGS (Portugal, Ireland, Italy, Greece and Spain) countries financial crises and the threats the eurozone risks. Finally, we propose some solutions for the crises.

Key Words: Eurozone, Debt crisis, Growth, Sovereign risk
JEL Classification: F34, G01, G15, H63

1. The World Financial Crisis

The international financial crisis which hit world economy now two years has been marketed as the most serious crisis that ever occurred after the 1929 Great Depression (Trabelsi, 2011). Although the crisis initiated with the American subprime market bubble (Bénard, 2008), it has progressively spread to the majority of international financial markets through derived products.

The global nature of the crisis is its most distinctive feature in that most countries were affected. Subprime credits are purely an American practice (they exist under more or less moderated forms in other countries like the UK) and it is the American institutions which are known for loans. This crisis has nevertheless quickly expanded due to an interdependence characterizing financial institutions, of the securitization which allowed investors access to foreign real estate markets and to re-evaluation of risk price. Decrease in risky assets prices in the US affected European banks which possessed such assets, reducing thus their demand and speeding European stock markets collapse.

The crisis hit everywhere mainly Asia and Russia where unemployment figures and social difficulties are so dramatic. The current financial and economic crisis is a systematic, spectacular and particularly destructive crisis (Borrell, 2009).

2. The Eurozone Financial Crisis

To face this crisis, the European Union (EU) undertook large scale measures setting up a financial stability plan totalling 750 billion euros in the form of loans and equities. The eurozone is able to support any member state in serious financing difficulties. The International Monetary Fund (IMF) in its turn vowed to support the Europeans with half of that amount. Finally the European Central Bank (ECB) lent its support by purchasing public and private debts accumulated by the eurozone. In return, the countries in crisis must continuously prove their solvency by credibly reorganizing their finances and by initiating reforms conducive to economic growth. Differently put, the current eurozone crisis is a public debt crisis. Table 1 shows that all PIIGS countries, France and Germany have exceeded the budgetary limit of 3% deficit in 2009-2010. The eurozone average exceeded 6%.

The Greek public finances recovery plan is still awaited and a mounting fear of a contagion phenomenon within the eurozone is felt day after day. Analysts still doubt the ability of Greece to reorganize its accounts and timely meet its financial obligations (debt and interests pay-off) and subsequently revive its economy. Then, Greece called for help from its European partners and the IMF which agreed to lend it 110 billion euros over three years. In return, Greece should install, under the tight supervision of its creditors, a drastic budgetary scheme.

Table 1: General Government Deficit/Surplus (% of GDP)

	2008	2009	2010
Greece	-9.8%	-15.8%	-10.6%
Ireland	-7.3%	-14.2%	-31.3%
Portugal	-3.6%	-10.1%	-9.8%
Spain	-4.5%	-11.2%	-9.3%
Italy	-2.7%	-5.4%	-4.6%
France	-3.3%	-7.5%	-7.1%
Germany	-0.1%	-3.2%	-4.3%
Eurozone	-2.1%	-6.4%	-6.3%

Source: Eurostat, 2011-12-20

2.1. The Case of Greece

The Greek debt crisis is born out of their creditors' fear of its ability to pay back its public debt and its accrued interests. It jointly resulted from the world economic crisis and some country-specific factors; high indebtedness (142.8% of GDP in 2010, see Table 2) and a large budget deficit.

The Greek crisis revealed another weakness of the monetary union's budgetary scheme; lack of control of member states' budget policies. This system facilitated entry of Greece into the eurozone by providing false declaration on its public debt and budget deficit. The system could not stop the Greek government to fool Brussels again in 2009 by declaring a budget deficit between 6% and 7% not the real 15.4% deficit (see Table 2).

Table 2: Public Debt and Deficit (% of GDP)

	Public debt in 2009	Public debt in 2010	Public Deficit in 2009	Public Deficit in 2010
Greece	127.1%	142.8%	15.4%	10.5%
Ireland	65.6%	96.2%	14.3%	32.4%
Portugal	83%	93%	10.1%	9.1%
Spain	53.3%	60.1%	11.1%	9.2%
Italy	116.1%	119%	5.4%	4.6%
France	78.3%	81.7%	7.5%	7%
Germany	73.5%	83.2%	3%	3.3%
Eurozone	79.3%	85.1%	6.3%	6%

Source: Eurostat 2011-11-26

2.2. The Case of Ireland

Ireland's deficit is the result of the bad debts of the banks taken in charge by the state. Several reasons explain Ireland's current difficulties. First, Irish banks' rescue plan is as high as 70 billion euros, representing the highest debt/GDP ratio in the world. Moreover, growth prospects record a decrease of (– 1.1%) instead of the predicted increase (2.5%) for 2011. Yet, economic growth is a requirement for debt pay-off.

It is to be noted as well that Irish liabilities have consequences on Europe. Spain, Portugal and Italy witnessed an increase in rates as a reaction to pressure on Ireland. In order to recover from this increase, some countries like Germany requested Ireland to accept the help of the

European Union so that to avoid a worsening of the situation. Borrowing costs in Ireland reached a record during these last months following worries about a deficit which reached 32.4% of the GDP in 2010 (see Table 2). This situation brought fear of a Greek scenario where budgetary problems of a country throw the whole eurozone into a crisis. The gross debt/GDP ratio increased over the period 2007-2010 by 62.3% in Ireland. The same ratio is 38.2% in Greece and 36.3% in Spain.

The Irish government could not face this crisis by itself. In response, a European-based rescue plan has been put in place in cooperation with the European Financial Stability Facility (EFSF) which insured loans worth 80 to 90 billion euros.

2.3. The Case of Portugal

Portugal, like Greece, has seen an increase in its borrowing rates following lowering the rating of its sovereign debt from A+ to A-. If this country seems similar to Greece, its indebtedness and deficit are minimum. Portugal has a public deficit of 10.1% of the GDP in 2009, then 9.1% in 2010 against 15.4% for Greece in 2009 and 10.5% in 2010 (see Table 2). Its public indebtedness is 83% of the GDP against 127.1% for Greece in 2009.

At the end of 2010, Portugal had a public debt of 93% (see Table 2) less than Greece (142.8%), Italy (119%) and Ireland (96.2%). Some authors point out that average GDP growth during the period 1969-73 was 8.2% while during the period 2006-2010, it was 0.3%. Andrade and Duarte (2011) point out that unemployment rate was multiplied by 3 in Portugal between 2000 and 2010 (from 4% to 11%). For these authors, the Portuguese problem will be solved only with output growth.

Andrade and Duarte (2011) indicate that Portugal crisis resulted from three issues: the sluggish Portuguese output growth, a monetary integration associated with poor policies and lack of accountability and transparency of political governance.

2.4. The Case of Spain

Spain precipitated into the crisis following lowering its credit rating from AA+ to AA. Moreover, this country was hit before by the real estate crisis, indicating slim chances of economic growth. Public deficit increased to 11.1% of the GDP in 2009 (see Table 2). Indeed, if Spain records such a deficit, it is likely the case that the real estate-based economic model on which this country has grounded its growth till the crisis was badly hit by the crisis which burdened the country's budget. This public deficit is reduced to 9.2% of the GDP in 2010 (see Tale 2). For some analysts, lowering Spain's credit rating is more worrying given its weight in the Eurozone which is neatly superior to that of Greece and Portugal.

2.5. The Case of Italy

The worsening of Portugal and Greece's debts and the domestic tensions characterizing the Italian government have largely weighted on Italy's debt which is 119% of the Italian GDP and 25% the eurozone debt in 2010 (see Table 2). The Italian government's declaration of an austerity plan allowed for temporarily appeasing those tensions. However, things got ugly after Standard & Poor's lowering of Italy's credit rating in 20th September 2011.

2.6. The Case of France and Germany

To face this crisis, France has recently undertaken some measures which allowed for economising 11 billion euros on 2011 and 2012 and has reduced retirement age by one year (2017 instead of 2018), leveraging taxes on companies and setting a VAT intermediary rate at 7%. Worth noting is that according to the Bank for International Settlements (BIS), French banks hold 106 billion euros of the Italian debt, which represent twice the amount held by German banks. The European Commission predicts a deficit of 5.3% of the GDP in 2012 for France against 1% for Germany. It is worth underlining that France had the most important public deficit of the eurozone of approximately 137 billion euros in 2010.

3. Is the European Currency a weakness or strength?

Installing the Euro helped member states strengthen their currency across financial markets and avoid devaluating it. At the same time, the stability pact which forces governments to remain within deficit limits and to respect indebtedness thresholds came in handy. In order to respond primarily to budget deficit explosions, the Maastricht Treaty set up a procedure targeting excessive deficits. Accordingly, public debt should not exceed a 60% limit and the annual public deficit is set at 3% of GDP. Within these limits, each country was able to conserve its economic and budget policies. Some analysts even assume that the protection of the euro has favoured lax economic and budget policies for some governments at the expense of the whole eurozone.

The financial and economic crisis does in fact deepen differences among the eurozone economies. Each country has its own difficulties. Ireland is paying large amounts on its financial activities. Spain's real estate business is derailing. Greece witnesses social problems. In front of these difficulties, the stability pact rules are no longer respected. In Table 2, no country respected Maastricht's criteria in 2010.

These domestic difficulties are proportional to those outside the eurozone. The eurozone is protected from currencies attacks and more and more states are joining it: Finland, Sweden, Denmark, members of the European Union, wish to rejoin the union rapidly (Buiter and Sibert, 2008). Even the UK is thinking of it despite their attachment to the pound. Island, which is seriously hit by the crisis, thinks of submitting an admission application to the EU and the euro. Thus, the eurozone attracts the outsiders, yet paradoxically its members are unwilling to introduce solidarity mechanisms which favour them.

4. Threats to the Eurozone

Daniel Gros, director of the Centre for European Policy Studies (CEPS), highlights the worrying signs of the tensions on the interbank market. These tensions translate lack of trust in the idea that the system is restored. For him, more and more banks prefer to trust the ECB with their deposits rather than lend other banks. He forwards the following explanation: the problems surrounding the crisis, like the precarious Greek public finances and the Spanish real estate business, have not been solved although they should be with no difficulty. Greece is but 2% of the eurozone economy and its debt is just 1.5% of Eurozone's GDP. Spain is similar. In the worst case, the combined losses of the Spanish banks and of other banks intervening in the Spanish real estate business do not exceed 3% of the Eurozone's GDP. Daniel Gros is questioning the paralysis of the eurozone banking system against problems which could be easily solved.

The Greek experience has shown that neglecting difficulties may generate a circle of risk premium increases and a decrease in investors' trust. However, there is a more worrying second raison which is at the origin of financial market instability; a large number of European banking systems are undercapitalized. According to the ECB, the amount of banks liabilities (interbank debts included) is 20 times higher than their capitals and reserves. In other words, bad debts are 20 times higher than capital debts which some banks may soon face.

Daniel Gros underlines that in the worst case Greece's and Spain's losses will not exceed 450 billion euros. However, the funds mobilized by the eurozone are 750 billion euros and proportionally they are enough to face the crisis. Nevertheless, this is not the adequate approach to follow. European rescue funds could be used to save banks but given that the ratio is 1 to 20 between the capital and the liabilities this measure needs astronomical financial packages. Consequently, to cover Spain's and Greece's losses the 450 billion euros should be 9000 billion Euros, recovering thus the Eurozone's financial sector debt and maintaining its stability. Accordingly, Europe cannot avoid its financial markets crisis if it does not remedy its banking sector.

5. The Weaknesses of the European Union's Economic Organization

With the massively spreading international crisis across Europe, the weaknesses of the European economic organization emerged again. Facing the financial and economic crises together, European countries reacted in an individual fashion and without cooperation and sometimes taking opposite directions. The ECB and European governments failed to find the appropriate combination between monetary and budget policies as the EU does not have centralized decisions on economic policy able to fix and coordinate budget policies across European states.

This is only possible through balancing the Monetary and Economic Union (MEU) by installing a European economic government and reforming competition between states. This would further push member states to implement the "2020 EU Strategy", following the failure of the "Lisbon Strategy". Certainly, the EU succeeded in devising a European Monetary Fund (EMF) which would purchase the liabilities of a country in crisis. Nevertheless, there are no synchronized projects and Europe's task is a difficult one. In fact, Jamet (2008) notes that unemployment rates are increasing within the eurozone since the crisis began. It reached 10.7 % in 2010 against 7.5 % in 2007. The Eurozone's public finances considerably decreased due to the stimulus plans, an increase in social expenses and a decrease in revenues. According to the European Commission, public debt of member states will represent 88.2 % of the Eurozone's GDP in 2011 against 66 % in 2007. In Ireland, public debt is of 24.8 % in 2007 to reach 96.2 % of the GDP in 2010. It reached 142.8 % of the GDP in Greece by 2010. This state of affairs raises serious questions about the future of the stability and growth pact. It highlights also the opportunity to maintain the same traditional criteria on the entry of new states within the eurozone. Adding to this, the social and budget difficulties in a context of an expected economic growth will be relatively weak during the coming years and which did not exceed 1.5% in 2010 except for Germany (3.7%) against an average of 1.9 % in the eurozone (see Table 3). Another key element is the slackening of active population growth which is explained by the weakness of innovation and investment in Europe.

5.1. The similarities between the eurozone and the US crises

Jean-Claude Trichet (2008), president of the ECB insists on the differences between the Eurozone's financial structures and those of the US. The US financial system rests essentially on the market contrary to that of the eurozone which is to a large extent centred on banks. On this, he pointed out that at the end of 2007, bank credits to the private sector reached 145 % of the GDP in the eurozone against only 63 % n the US. Reversely, the direct issuing of equities represents 81 % of the GDP in the eurozone and 168 % in the US. Private credit allocation between the two blocks is then totally different. Bank credits, equities issuing not included, in the eurozone covers two thirds of external financing against only 30 % in the US. This clearly explains the approaches adopted by the two blocks. In the eurozone, in order to insure businesses' and households' normal access to credits, there must be an adequate liquidity level. Credit allocation must essentially be conducted with the contribution of banks.

5.2. How can the Eurozone bypass the crisis?

In order to define common policies to bypass the crisis, analysts propose two strategies:

- Reforming the Eurozone's governance according to the following foundations; controlling private indebtedness, internalizing budget regulations within member states laws and the adoption of common positions on international economic disequilibrium.
- Defining a common structural reform program in view of replacing the Lisbon Strategy.

Finally, we should note the agreement signed between France and Germany in 27th October 2011, which predicts:

- Private banks will give up 50% of the public debt held on Greece (ECB and the IMF are not involved).
- Banks should recapitalise an amount of 106 billion euros (30 billions for Greece, 26.1b for Spain, 14.7 b for Italy, 8.8 b for France and 5.1 b for Germany). This recapitalisation will be done through calling for savings plan practiced by the States, and ultimately by the EFSF.
- The EFSF is not authorized to become a bank, yet a leverage effect will be sought through two mechanisms: « raising credits for new issuances by member states » and/or accessorily calling for private or sovereign investors to cooperate with the IMF.

Table 3: Real GDP Growth Rates

	2008	2009	2010
Greece	2.9%	-2%	-4.5%
Ireland	-3%	-7%	-0.4%
Portugal	0%	-2.9%	1.4%
Spain	0.9%	-3.7%	-0.1%
Italy	-1.2%	-5.1%	1.5%
France	-0.1%	-2.7%	1.5%
Germany	1.1%	-5.1%	3.7%
Eurozone	0.4%	-4.2%	1.9%

Source: Eurostat, 2011-12-20

6. Conclusion

The causes of the financial crisis are attributed to markets and essentially to the regulations targeting customer protection and financial transparency and to products derived from the securitization of credits following the Basle II system. This crisis is revealing of the failure of the governance model and the regulating institutions like the IMF and the World Bank which called for reforming regulating organizations, abolishing fiscal paradises, re-evaluation of credit rating agency (CRA) and creating a new economic order. This crisis led public authorities to intervene in the form of liquidity injections as debts or capital and a partial or total nationalisation.

Therefore, it was made clear that the recent financial turmoil had important repercussions on fiscal policy of the eurozone economies since governments of the EMU countries provided large amounts of money to the domestic banking system in order to stabilize it.

We should insist as well on the fact that public authorities, governments and central banks must act to win, preserve and reinforce households' and businesses' trust in order to open the path for durable wealth. The trust of economic agents depends today on the judgement of central banks' determination to maintain prices stable.

It is time now to think of a social transformation project passing by financial markets regulation and economic growth to fight unemployment and to improve services. To this effect, two solutions will be possible: a unique authority of financial control for the EU or a system of European authorities of financial supervision including a central organism which coordinates between local organisms. Each of these solutions will improve supervision and help eliminate systematic risks in a European capital market which is growing and more and more integrated. This systematic crisis needs a systematic response.

The European Union must take advantage of the Greek crisis in order to repair the structural defects of the economic and monetary union issued from the Maastricht Treaty by installing an economic European government. Not only does the creation of such institution allow avoiding the debt crisis, but also it gives the EU a budget policy instrument which allows it to conduct coherent up-to-date politics. Thinking about eliminating some financial instruments like the credit default swaps (CDS) so as to limit financial markets speculation should be on the agenda. Finally, creating a European IMF may help fight indebtedness crises.

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