The European Debt Crisis: Collapse or Renewal?

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September 21, 2011

What is this crisis all about?

A sovereign debt as well as banking crisis

- It is a **sovereign debt crisis** of several 'peripheral' European countries that are members of the euro zone: Greece, Ireland and Portugal who have received bailouts and Italy and Spain who are experiencing extreme distress

- It is also a **banking crisis** involving major European banks mostly based in Belgium, France and Germany that are heavily leveraged and have substantial exposure to the sovereign debt of these countries

- It is a crisis centered **in the euro zone**, the financial core of the EU which is the second most important pillar of the world economy and accounts for over a fifth of GWP

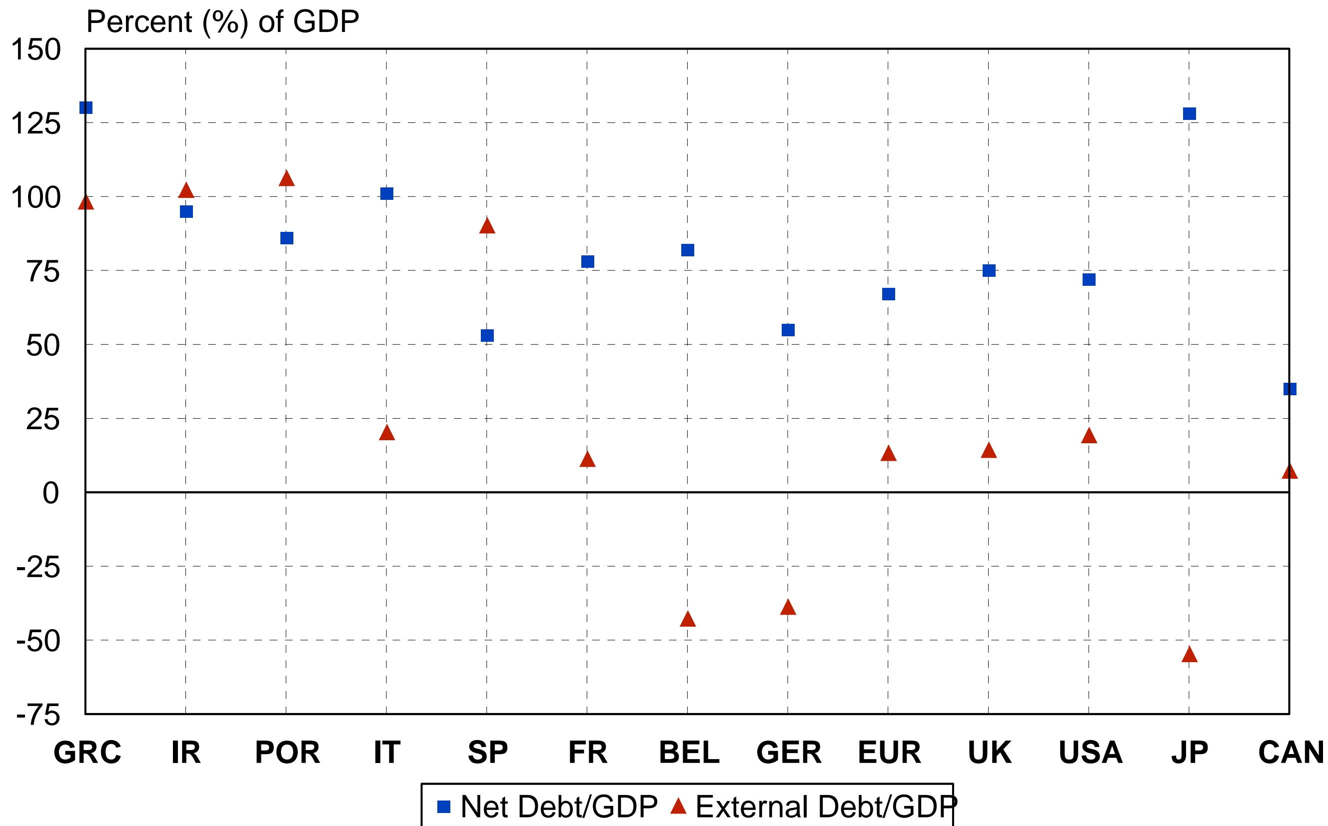
A European or a Euro Area Crisis?

A distinctly Euro Area Problem

- Public debt levels and budget deficits are high in nearly all of Europe, as well as the U.S.A. and Japan
- Two key factors differentiate whether a country will be in highest risk of default:
- - whether it can print its own currency
  - the degree of external indebtedness
- Euro Area members **cannot print money** to service their debt or depreciate currency to stimulate economy
- Countries with the highest degree of **external indebtedness** are the most dependent on market confidence and are the most vulnerable

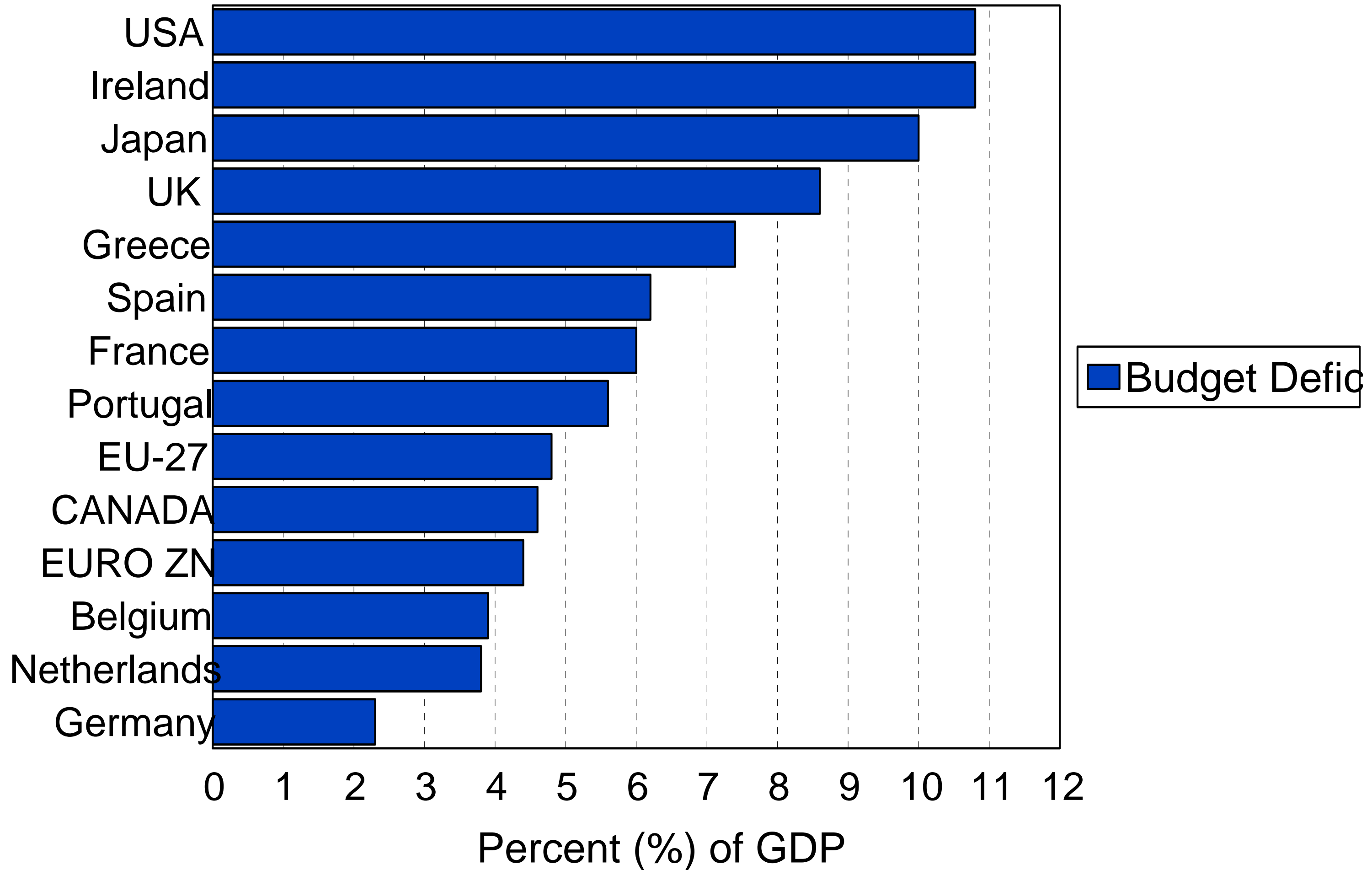
Total Net Debt & External Indebtedness, 2010

High levels of external indebtedness spells trouble



Source: IMF, Global Financial Stability Report, April 2011

Budget Deficits, IMF Spring Projections for 2011



What are the causes of this crisis?

Global financial deleveraging and the global economic downturn of 2009

- The **global financial crisis** of 2008 which was precipitated by financial deregulation, sub-prime lending, US housing meltdown and subsequent banking and financial crisis that ensued
- The **global economic downturn** of 2009 that resulted from the financial crisis -the deepest contraction since the 1930s depression
- These events have ushered an era of **deleveraging** in the global financial system where private and public sectors are in the process of reducing debt levels, financial leverage and risk exposure

How did governments respond to the crisis?

With massive monetary and fiscal support measures

- To prevent the financial system from outright collapse governments intervened forcefully to **bailout big banks** and injected massive amounts of liquidity to stabilize the situation and restore confidence
- To offset the damage to the real economy governments undertook a globally coordinated (G20) effort of **fiscal stimulus packages** to prevent a global depression
- The unprecedented effort was successful in stopping the financial meltdown and averting an economic catastrophe i.e. - a world depression, **at least for now**.

Government Support to Financial Industry

The support to financial industry has been of biblical proportions

Government Support Packages to Financial Sector United States, United Kingdom and Eurozone				
Trillions of US $	**UK**	**USA**	**EURO**	**Total**
Central Bank				
- "Money creatio	0.32	3.76	0.98	5.06
- Collateral swa	0.30	0.20	0.00	0.50
Government				
- Guarantees	0.64	2.08	1.68	4.40
- Insurance	0.33	3.74	0.00	4.07
- Capital	0.12	0.70	0.31	1.13
Total (% of GDP)	74%	73%	18%	15.16

Source: Alessandri & Haldane, Table 1, Banking on the State, Bank of England, November, 2009

How did governments respond to the crisis?

An unprecedented response of BIBLICAL proportions

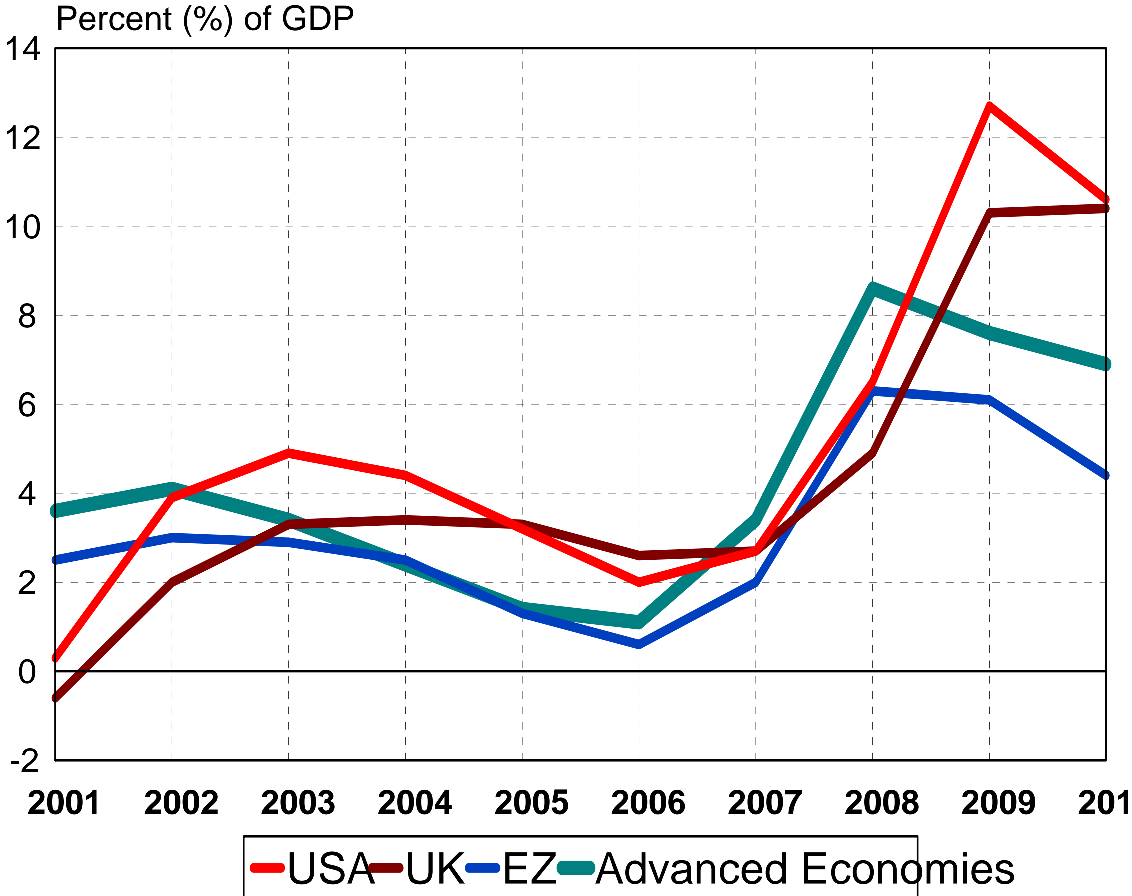
- The governments of the USA, UK and the Eurozone alone injected over **$15 trillion** or 25% of GWP in the form of money creation, collateral swaps, loan guarantees, capital insurance and capital injections amounting to 74% of UK, 73% of US and 18% of Euro Zone GDP

- These figures do **<u>not</u>** take into account the injections from other countries and do **<u>not</u>** include the fiscal policy packages that were put into effect by all countries

- The government response was not only unprecedented, it was nothing short of **BIBLICAL** proportions!

Fiscal Impact of Global Downturn on Major Economies

Large fiscal gaps opened up as a result of the downturn



Source: IMF WEO Database, April 2011

What was the legacy of this unprecedented government response?

Prevented the worst but economic and financial conditions remain fragile

- It led to a massive **transfer of liabilities** from the private banking sector to the public sector
- Raised government **debt ratios** to the highest level in the post WWII era
- It forced central banks to slash interest rates to **zero** levels and create large amounts of money
- As a result both fiscal and monetary policy arsenals have been **depleted** of most of their ammunition
- Although governments succeeded in preventing the worse, the banking system remains extremely fragile, governments have become over indebted, the economic recovery has been weak, financial markets are edgy and economic prospects remain precarious

What is the problem with Europe?

A common currency without a common Treasury
A fragmented and highly leveraged banking system

- The EMU, the common currency union that the European's built was not designed to withstand the kind of financial tsunami that hit it
- Why not?
- Because they united their currencies, adopted a common monetary policy and promoted financial and economic interdependence without a common **Treasury**, fiscal policy and a mechanism to support each other through fiscal transfers in times of trouble
- Because in the European banking model there is no separation between retail and investment banking, and there is no European-wide regulation of banks
- Because they want to share **common benefits** but are reluctant to share the **common responsibilities** that come along with them
- Common responsibilities imply a **common cheque book!**

How did they get here?

- Since the introduction of the common currency -the euro- interest rates across Euro area countries converged, an expected outcome that was part of the plan

- Interest rates fell far more drastically in the periphery than the core, e.g. short-term rates fell from 17% to 3% in Portugal, even more in Greece

- This created an economic boom in the periphery especially in the interest sensitive sectors of the economy such as financial services, construction and the housing sector

- Banking on the newfound prosperity, periphery countries allowed wages to rise and boosted social spending

- Making things worse was the uneven application of monetary policy -that in the early period of 2001-2005 the ECB lowered interest rates even more to support the sluggish industrial economies of the core, esp. Germany while the periphery was in need of a tighter monetary stance

How did they get here?

- As one would expect in a common currency area, the structure of **comparative advantage shifted**. Industrial production migrated to the north especially to Germany as well as the non-euro periphery
- of Eastern Europe, Turkey and of course China

- This resulted in **growing trade and payments imbalances** in the periphery, esp. Portugal, Spain, Greece and Italy

- While the global economy was undergoing strong expansion from the mid-1990s to 2007 fuelled by monetary expansion and low interest rates in the USA these countries benefited from the global financial leveraging cycle that **George Soros** has called the **'super bubble'.**

- When the super bubble burst in 2008, the world shifted gears to a **deleveraging cycle**. Following the global recession of 2009 and the large run up in debts, this is when these countries run into financial trouble

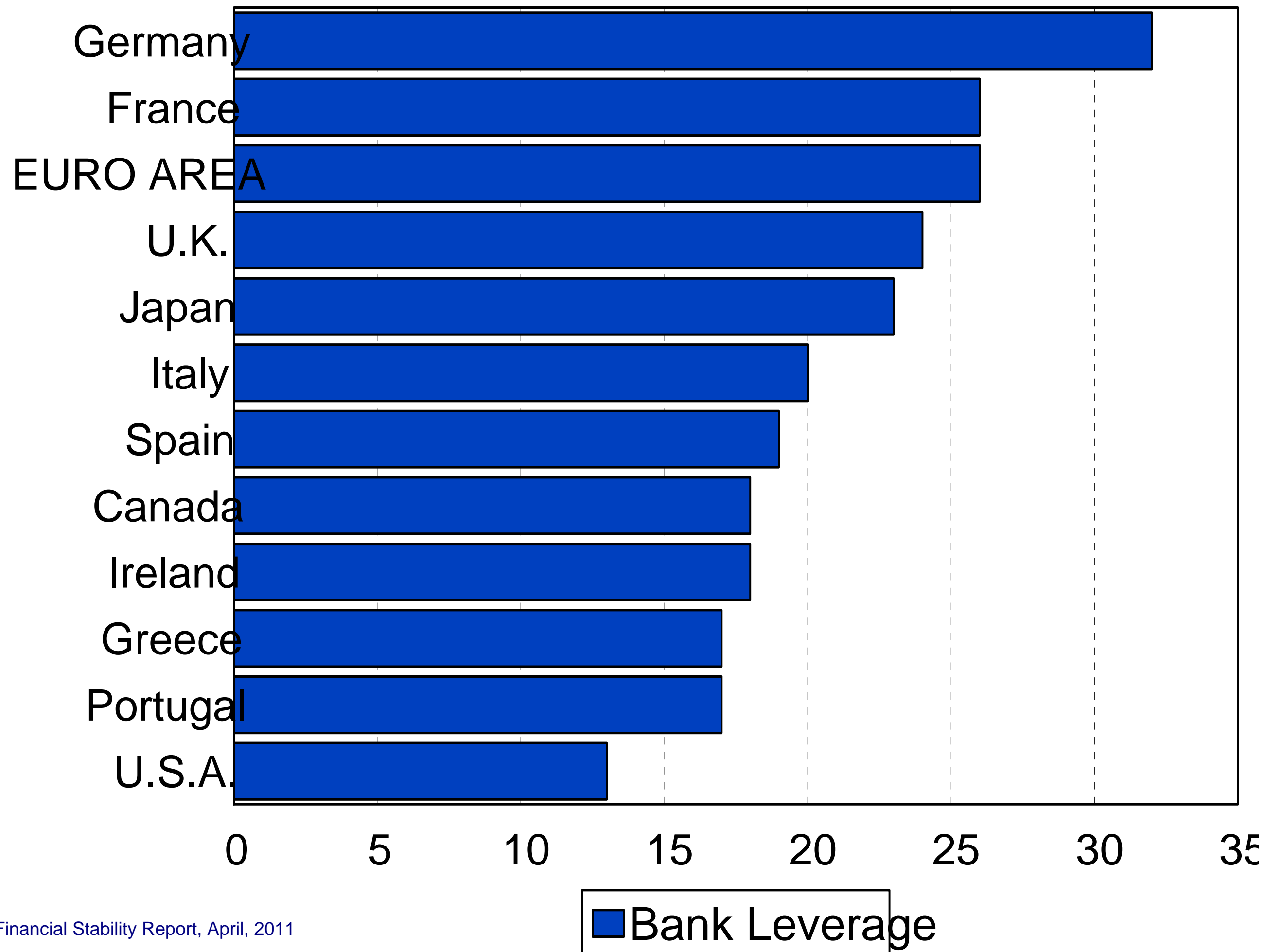
The Role of the Banks, Again?

- Where did the money to finance the growing trade and payments imbalances of the euro-periphery come from?
- It came from the big banks in the euro-core and the UK. What these banks did is raise funds in the wholesale interbank market at rock bottom rates and they used it to buy sovereign bonds of the periphery that initially traded with large spreads against the German bunds, - a European form of **carry trade-** that enabled these banks to rack up huge profits in a market that was considered risk free!

- According to the Basel II capital adequacy rules for banks, they didn't have to post capital against the purchase of euro-denominated, euro-area member sovereign bonds, because they were classified as **zero-weight** or **risk free assets.** Since bank regulation rules in Europe are different from those in Canada or the USA, European banks were not and still are not subject to any restrictions on their capital ratios and leverage

- For large European banks there was no limit to how much of these bonds they could buy so they fell all over themselves to lend money at falling spreads to the euro periphery countries

Bank Leverage Multiples of European Banks



IMF, Global Financial Stability Report, April, 2011

How did they get here?

- Euro periphery borrowed to finance trade and payments imbalances that benefited the euro core

- Euro core banks financed the loans on the assumption that they were risk free that benefited the euro core

- In fact this is a European version of America's **sub-prime** crisis: credit in the form of sovereign loans was given to sub-prime borrowers on the assumption it was risk free by large 'too big to fail' euro area banks and sold as AAA debt to investors

- If the Euro area was an Economic Union i.e. shared both a common currency and common treasury, there would be no problem with Europe. The trade and payments deficits of some countries would be financed by the surpluses of other countries and both costs and benefits would be shared. Payment imbalance problems would be internalized and would not threaten the currency union

Some additional aggravating factors:

- The only mandate of the ECB is to issue money and protect price stability. Has **no** mandate to deal with **financial crises** and **no ‘lender of last resort**’ functions

- The line between **liquidity and solvency** is very thin and so is the line between **financial and price stability**

- If the ECB intervened in 2008 and again in 2010 to buy bonds of sovereign members, it has acted beyond its mandate. In the absence of a common Euro Treasury it was **‘forced to act’** to avert a crisis from spinning out of control

- **History tells** us that central banks were not created to deal with normal times, they were created out of a need to respond to financial panics and sovereign debt crises

- Since the Federal Reserve shifted to an expansionary monetary policy mode in 2001, the ECB has not followed, allowing the euro to appreciate by over 50% against the USD

Some additional aggravating factors:

- The ECB is a clone of the **Bundensbank.** The mind set is different from the Federal Reserve: the USA suffered from a **deflationary depression** in the 1930s, Germany suffered from an **inflationary depression** in the 1920s.

- Understandably, **Germans fear inflation** more, **Americans fear deflation** more. This explains the differing attitudes of the two central banks. This is **no time to fight old wars!**

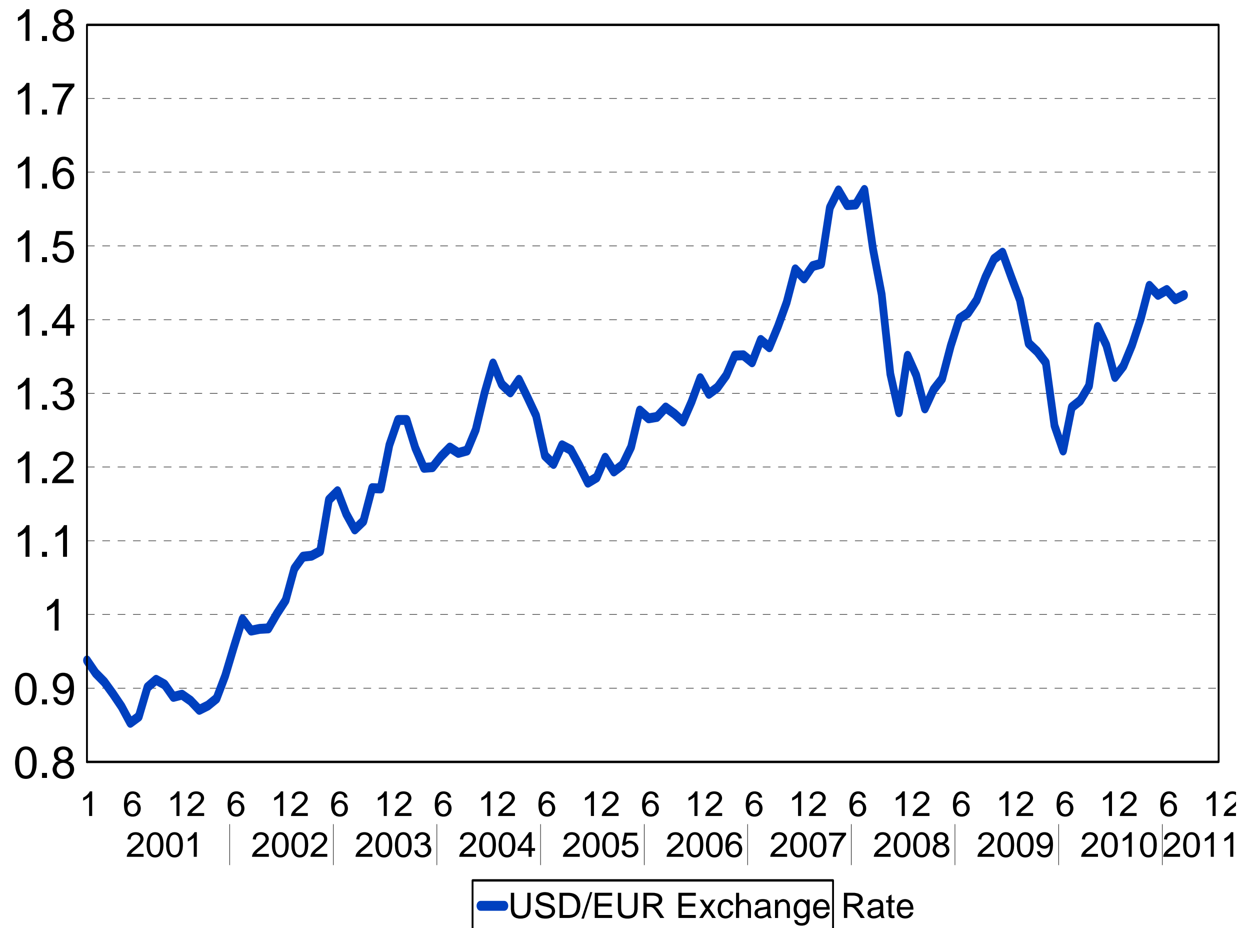
- The appreciation of the euro combined with the opening of markets in Eastern Europe and the integration of China and NIC low cost countries into the world trading system have seriously aggravated the **competitiveness** of the euro periphery

- The Euro area monetary policy intervention to the global financial crisis fell far **short** of the responses in the US and UK - 18% of GDP vs. 73% & 74% in the US and UK

- While Euro area fiscal response was far more muted - a deficit of 6% of GDP in 2009 compared to those of the US (12.7%), the UK (10.3%) and other AICs (7.6%)

- **Could Europe’s insufficient response be a reason why the crisis has reignited again in Europe?**

EUR/USD Exchange Rate, 2001-2011



Insufficient Policy Response?

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Has the problem been ill diagnosed?

Greece is not the cause but is the victim

- True enough, Greece the country were the euro debt crisis first broke out and is the centre of financial news made economic policy errors and was slow to reform and restructure its economy
- But Greece is not the only country to have made mistakes or been slow to adjust
- Yet Greece and the world media have been made to believe that Greece is the cause of the crisis which now is infecting the rest of the EZ when in fact they are more of the **victim** than the cause
- If the EZ is so strong as the European leaders have us believe, why is a tiny country accounting for 2.5% of EZ GDP capable of bringing down the whole financial house of cards?

Mal diagnosis is slowly killing the patient!

- The euro periphery needs to rein in its budget deficits
- The euro periphery needs to undertake deep structural reforms to increase competitiveness and attain real institutional convergence with the euro core
- Euro area countries need to move towards closer harmonization of tax, social and economic policies
- All of Europe suffers from an **'entitlement complex'** and they have to demand less from the state and more from the private sector
- But all these reforms require i) a renewed **vision** for the future, ii) political **will** by Euro leaders and most of all iii) **time** to implement them!

Yes, at least in the case of Greece

- Structural adjustment programs are never easy, they raise fear, cause pain to some, bring hope and benefits to many - they require time and patience

- The public has to be prepared so they understand the necessity, the goal and the road map

- They are implemented gradually and carefully so as not to hurt confidence, harm demand and cause an economic contraction

- Unfortunately, Euro leaders **panicked** in January 2010 and they tried to correct the Greek fiscal crisis overnight -they misdiagnosed the problem, made wrong assumptions, made rosy estimates and demanded severe austerity measures that Greece could not deliver within the short time table

- The Greek government has been equally complacent and slow to address the root of the problem. Structural reforms should have been front loaded with more emphasis on surgical spending cuts in the public sector instead of tax increases

A vicious circle of titanic proportions

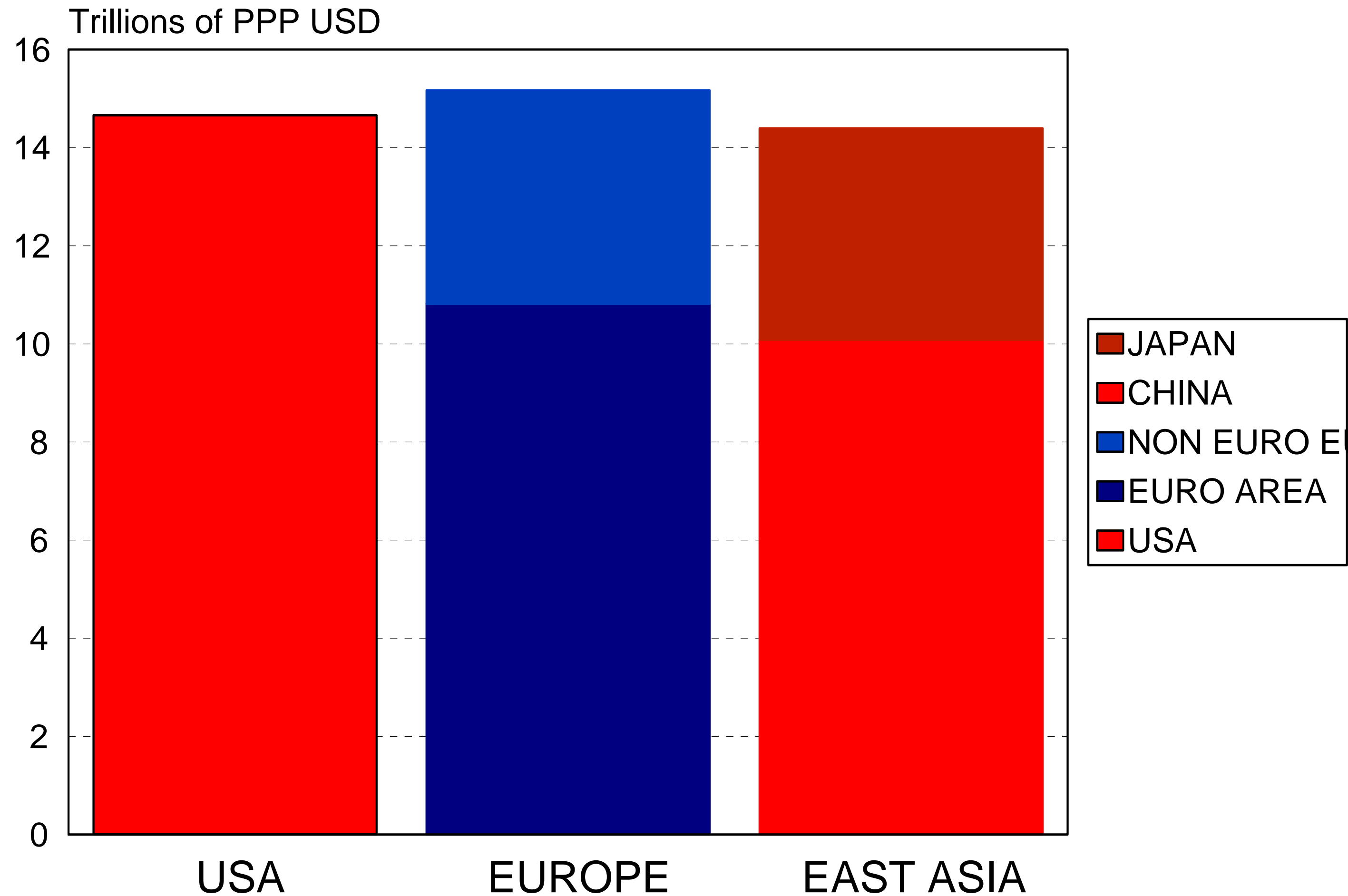
- After falling 2% in 2009, 4.5% in 2010, GDP in Greece is expected to contract another 5.5% in 2011
- With falling income, the debt-to-GDP ratio has risen dramatically from 110% before the crisis to near 150% now and transformed a fiscal and liquidity crisis into an insolvency
- As income falls, the budget deficit increases, and as it rises more austerity measures are demanded, in short a deadly vicious circle has been created
- Seeing this, markets are wondering if this is what to expect in Portugal, Italy and Spain. They are asking, “is the EZ capable of solving its own problems?“
- Greece is now becoming a case study of **‘how not to’** carry out austerity programs

What is at stake here?

- It is not only Greece and the rest of the euro periphery
- It is the rest of the EZ and the future of Europe in the world
- It is the global economy and the stability of the international monetary system, the bedrock on which the global financial system rests
- One third (33%) of central bank reserves in the world are presently held in euro-denominated assets
- The problems in Europe don't only threaten to engulf the rest of Europe but the entire world economy as well -- with **catastrophic** consequences for all!

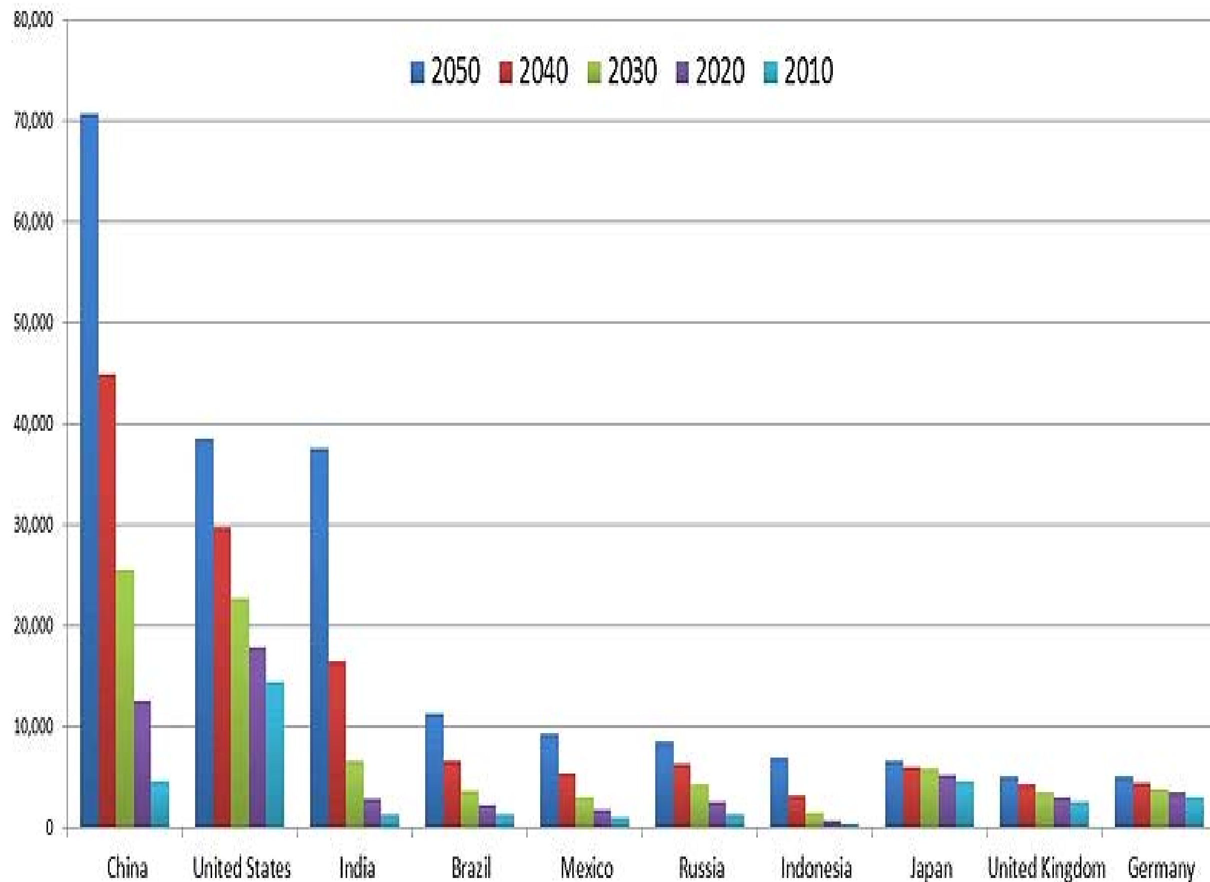
The Three Pillars of the Global Economy

Together they account for 60% of world economy



Europe's Positioning in the World

Germany, the 4th biggest economy today will fall to 10th position in less than four decades from now



What Must Europe Do?

All for one and one for all

- **Europe has lost the euro bet**. The eurosceptics have been vindicated! Without a dramatic shift in policy the euro zone is headed for a crash. Either many countries will exit the euro zone and default on their payments leaving a rubble of global proportions to clean up or they proceed towards further fiscal and economic integration

- Does **Europe really have a choice? Not at all!**

- The sooner European leaders realize this, the better.

- Fortunately, **Europe has solutions**. Europe's future can be secured! ***How?***

- Since the creation of the ECSC in 1951 and the Treaty of Rome in 1957, Europe has come a long way, has done what needed to be done and has guaranteed peace and prosperity in the region and Europe's broader periphery

What Must Europe Do?

*My name is Bond, **Euro** Bond !*

- Issue Euro Zone bonds or **euro bonds**. These bonds are to be backed by euro area member governments on a **'joint and several basis'** to gradually replace all national sovereign bonds as they mature

- This implies **pooling the fiscal risks** together and uniting their public debts, thus creating a single **$10.5** Trillion European government bond market

- A Euro Government bond (EGB) market large enough with a strength, depth, breadth and liquidity to rival the US Treasury market

Introduce the euro bond

- The combined strength of the euro bond will command at least a AA+ rating as the USA has today, if not **AAA**

- **Borrowing rates** for EGBs will **fall overnight** and extinguish the flames that are raging in the periphery and put a sudden **stop to the financial panic** and crisis of confidence in the EZ

- It will also put a **stop to the brewing banking** and **financial crisis** that is threatening the EZ's banking sector and indeed the global financial system

- It will **consolidate the euro's place** in the world as a global reserve currency

- It will **consolidate Europe's place** as one of the three major economies in the world well into the 21st century

EZ Debt Stocks & Debt Ratios

A Common EZ EGB would carry at least AA+ Rating

DEBT STOCKS AND DEBT-GDP RATIOS, EUROZONE, 2010							
	Debt/GDP Individual %	**GDP in USD**	**Gross Debt in USD**	**Debt/GDP Collective %**	**Debt Shares by country**		**S&P Rating**
Austria	69.9	376.8	263.4		2.54%		AAA
Belgium	97.1	465.7	452.2		4.37%		AA+
Cyprus	61.6	23.2	14.3		0.14%		BBB
Estonia	6.6	19.8	1.3		0.01%		A
Finland	48.4	239.2	115.8		1.12%		AAA
France	84.2	2582.5	2174.5		21.00%		AAA
Germany	80	3315.6	2652.5		25.61%		AAA
Greece	142	305.4	433.7		4.19%		CC
Ireland	96.1	204.3	196.3		1.90%		BBB+
Italy	119	2055.1	2445.6		23.61%		A+
Luxembourg	16.6	55	9.1		0.09%		AAA
Malta	67	8.3	5.6		0.05%		A
Netherlands	63.7	783.3	499.0		4.82%		AAA
Portugal	83.3	229.3	191.0		1.84%		BBB-
Slovakia	42	87.5	36.8		0.35%		A+
Slovenia	37.2	47.9	17.8		0.17%		AA
Spain	60.1	1410	847.4		8.18%		AA
EUROZONE	**69.1**	**12208.9**	**10356.1**	**84.8**	1.0000		AA+
PIG (Portugal, Ireland & Greece)					7.9%		
Source: IMF, 2010 Figures, WEO Data Base							

How will Germany benefit?

Create a Win-Win Situation

- It is clear how the eurobond can benefit the euro periphery, How does it benefit the euro core and Germany in particular?
- The introduction of the euro bond can reduce interest rates for Germany, contrary to conventional wisdom and common belief
- It is called **seigniorage**, or **‘the exorbitant benefit’**
- By creating an EGB market as large and liquid as the US Treasury market, it will convert the Euro from a ‘store of value’ instrument to a ‘means of payment’ instrument in the world market
- Countries will start writing contracts in Euro and making international payments in Euros. They will start using euro debt instruments as demand accounts, as precautionary balances and float
- The demand for EGBs will increase pushing down yields below German levels

Does Europe Want to be an Economic Superpower? Yes, it can!

The real question, is it willing?

- This is how the USA funded its super power status in the post WWII era.
- Europe can now share in the exorbitant benefit that the USA enjoys
- Is it bad for the USA? No, not really.
- The US share of world outlook has declined since 1945 from 55% of GWP to 21% today. A strong Euro cements the Atlantic Alliance and complements and reinforces the US Dollars position in the world
- It does a lot more, it secures peace and prosperity in the Western World and reduces the risk of global conflict as well

In case Germany is not convinced

The interest rate can be set in proportion to debt/GDP ratio

- Germans are obviously concerned that the euro bond will increase the interest they pay to service their debt - this is a justified concern

- This concern -in case the exorbitant benefit takes time to materialize- can be addressed

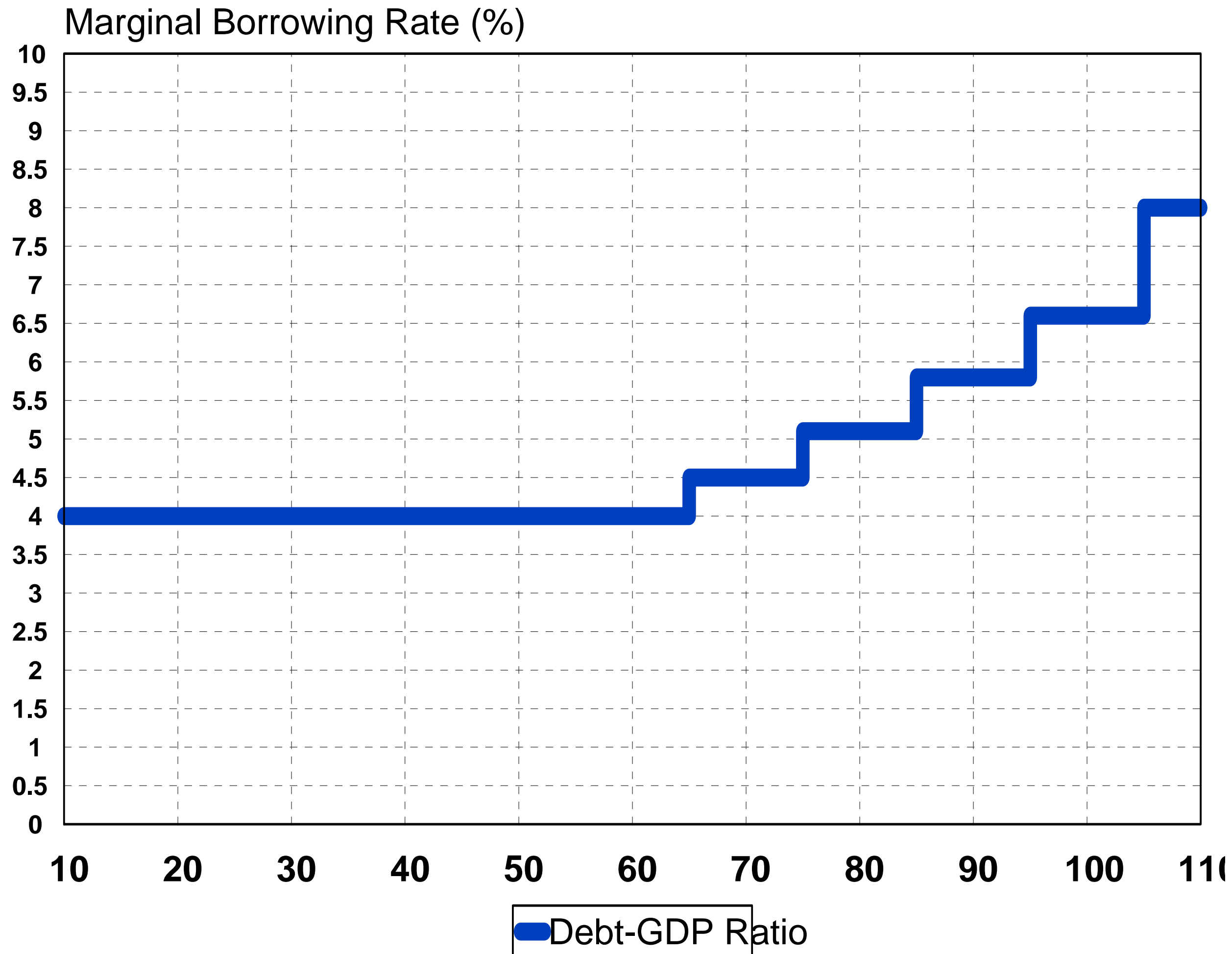
- The interest rate applied to each country's share of the total debt can be set at a **graduated rate** and in **proportion to each country's debt/GDP ratio.** For example, Greece will pay the same rate as Germany on the first 60% of its debt, then a gradually escalating rate on the balance

- This method **internalizes** the role of **market discipline**, mitigates **moral hazard** and penalizes countries with high debt ratios and creates the proper **incentives** to reduce debt exposure

- Even if Greece has to pay more than Germany, it will still pay less than it does now

Escalating marginal contribution rate in euro bond interest servicing: An illustration

When a country's debt-GDP ratio rises above 60%, it starts contributing a larger share of common euro bond interest expense



A defining moment in history

Opportunities like this are only presented once in a century!

- Germany holds all the cards now in its hands
- Will it exercise its option -as the United States did in 1944- and create a true **Economic Union** under its leadership?
- Or will it fail?
- When the USA failed to exercise its card in 1919, Europe collapsed and it precipitated the Great Depression and the Second World War
- When Japan was presented with a similar opportunity in the 1980s to become the leader in Southeast Asia, it failed as well and permanently relinquished this role to China
- It would be **tragic** if Germany doesn't step up to fill the role, it could precipitate the mother of all financial crises and result in the break up of the Euro, economic depression and down the road war as well

A con-federal fiscal structure?

New institutional structures to accompany euro bonds

- At a minimum, the following institutional mechanisms would need to be created:
- 1) a new EZ unified and transparent **public accounts system** (EUPAS) to record and report on a timely basis the revenues, expenditures and cash position of member governments;
- 2) an **increased coordination** of forecasting, planning and budgeting of member governments;
- 3) the creation of a supranational **Euro Area Treasury** that would assume control of the zone's finances and debt policy with veto power over member state borrowings;
- 4) the drafting of new, **more stringent rules** accompanied with sanctions to be incorporated in a new stability and growth pact (SGP-II);

A con-federal fiscal structure?

New institutional structures to accompany euro bonds

- 5) a euro-zone **debt management agency** to manage the issuance and duration of bond and treasury bill issues;
- 6) the creation of a **European banking supervisory authority** with uniform standards to monitor and regulate cross country lending and risk management;
- 7) the **revision of the mandate of the ECB** to expand its role beyond that of price stability to include the role of **lender of last resort** within the euro zone and
- 8) through agreed medium and long term **structural reform measures** to standardize and **harmonize** tax, labour market, pension and social policies across the euro zone by 2020.

The Road Path to the Solution

- A European Summit of leaders must be convened immediately to agree on the **creation of euro bonds** and a **common EU Treasury**

- If the EU Leadership signals to markets their **willingness to stand together** and proceed in the final step of EU integration it will **boost confidence** in the markets and give them the time needed to finalize, vote and implement the new institutional mechanisms

- The **size** of the **EFSF** must be expanded immediately to at least **1 Trillion Euro** as a stop gap measure

- Need to provide **emergency assistance to Greece** in the form of a zero-interest long-term loan to finance capital investment expenditures to restore growth in its economy

Final Thoughts

- We are seeing history in the making
- The costs of Eurozone disintegration are not just high – they are catastrophic!
- The benefits of a common Treasury, fiscal policy coordination and a unified European government bond (EGB) market are huge
- I am confident that Europe will make the right choice!
- ***THANK YOU !***

For further inquiries, contact the author:

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