The Euro Debt Crisis:
Will the Euro Survive?

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What caused the debt crisis in the Euro Zone?

- The debt crisis in the euro zone has been caused by the global financial crisis of 2008 and the global economic downturn of 2009-10 that resulted from the meltdown coupled by the inadequate response of Euro Zone governments to extinguish the flames and treat the effects of the crisis on Euro Zone economies
- As a result, the global financial crisis has continued to fester and has metastasised into a sovereign debt and now the ‘Euro’ debt crisis.

What caused the debt crisis in the Euro Zone?

- By bailing out the banking system to prevent its collapse, governments have socialized the losses of the private banks, i.e. *allowed the banks to keep their gains and socialized the their losses*, in effect transferring the losses to the public sector.
- This action led to a massive rise in public sector debt levels –on top of the previously existing high debt exposure of these governments.
- In addition, the global recession cut into tax revenues and increased public expenditures and added even more to public sector debt levels

What caused the debt crisis in the Euro Zone?

- While these actions saved the banking system from outright collapse and prevented a ‘great depression’ and the solvency of the private banking sector is being gradually restored, the fiscal position of governments has been greatly impaired. Debt-to-GDP ratios have surged all across the advanced industrial world, undermining market confidence in government bonds and resulting in cuts in the credit ratings of many countries.
- This is how a private sector banking debt crisis has metastasised into a public sector sovereign debt crisis

What caused the debt crisis in the Euro Zone?

- The US and the UK, originally the epicentres of the global financial crisis have seen their budget deficits peak to over 10%, their gross public debt exposure has reached 100% of GDP. Yet neither the US nor the UK have faced an immediate crisis. Why has the focus of the crisis manifested itself in the Euro Zone instead?
- The basic answer is that the Euro Zone is a special construction that is new, is incomplete and places higher demands on its members while it leaves them with fewer tools to react to the crisis.

What caused the debt crisis in the Euro Zone?

- It is the European Monetary Union (EMU)
- 17 nations share the same currency
- Share a common central bank, the ECB
- Share a common monetary policy and by extension, common exchange rate policy
- Each member country can no longer adjust interest rates or exchange rates to deal with the crisis
- The only tool at their disposal is fiscal policy. Even then, there is a constraint to which they can use fiscal policy as budget deficits are limited to 3% of GDP and debt levels to 60% of GDP

What caused the debt crisis in the Euro Zone?

- The Euro Zone is a monetary union not a full-fledged economic union!
- Although they share the same currency, each country is responsible for its own debts, its own fiscal policy, and its own banking system.
- There is a fatal flaw in the design of the EMU that has been pointed out by economists from the beginning: You cannot have a stable monetary union without a fiscal union and a common Treasury and debt issuing agency.

What caused the debt crisis in the Euro Zone?

- A fiscal union means that all member countries pool their debts into a single common euro zone debt, issue a single euro-wide debt obligation such as euro bonds and coordinate and harmonize the fiscal policies of each member state.
- Within any economic union, as within any single country, some regions produce more than they consume while others consume more than they produce. Money generated from the surplus production regions needs to flow to the consuming regions to maintain balance in the system. Financial imbalances within the union should no longer matter as imbalances with regions outside the union.

What caused the debt crisis in the Euro Zone?

- In the absence of a fiscal union and a common treasury, each country is responsible for its own debts, and needs to finance them on the global financial market. If its debt level, payments imbalances or budget deficits rise too high then the markets loose confidence or refuse to finance them which results in a liquidity or insolvency crisis for the member state which then puts pressure on the rest of the members and results into the problem we see today in the euro zone.
- Then either the member has to take drastic action to resolve the problem on its own or other members are compelled to intervene to assist the weak member to overcome their problem.

What caused the debt crisis in the Euro Zone?

- When the euro was launched in 1999, interest rates in all peripheral member states from Ireland to Portugal, Spain, Italy and Greece fell dramatically to reach the level of core members such as Germany and France.
- At the same time euro area banks could buy bonds (i.e. lend to these countries) on the understanding that they were risk-free, like bonds issued by their home country. The EC and ECB interpreted the Basel II capital adequacy rules to mean that euro area banks did not have to post any capital against their purchases of bonds of euro area member countries. In effect bonds issued by peripheral countries like Greece were considered to be of the same quality as German bonds.

What caused the debt crisis in the Euro Zone?

- This action opened the flood gates of lending to these countries at the same time as the US was engaging in the biggest bout of monetary expansion in modern history
- The result was that too much money flowed suddenly to countries that were ill prepared to deal with so much money at once, either because they were financially unsophisticated borrowers, institutionally weak or were uncompetitive to make the most efficient use of the funds
- This resulted in housing booms in some countries like Ireland and Spain or budget deficits in other countries like Portugal and Greece

What caused the debt crisis in the Euro Zone?

- As the global financial bubble burst in 2008 bringing down the financial system and the global economy, this pushed weak euro area members with high budget deficits, high external debt exposure and public debt levels over the edge.
- First over the edge where Iceland and the Baltic economies of Lithuania, Estonia and Latvia. Since they were not in the euro you did not hear much about them in the press. Then came Greece in early 2010, followed by Ireland and Portugal later in the same year. Since they were euro members, that is when it became labelled the ‘euro debt crisis’. Now, it is Spain and Italy that are threatened along with Hungary which is not a euro member.

What Actions Have Been Taken to Stem the Crisis?

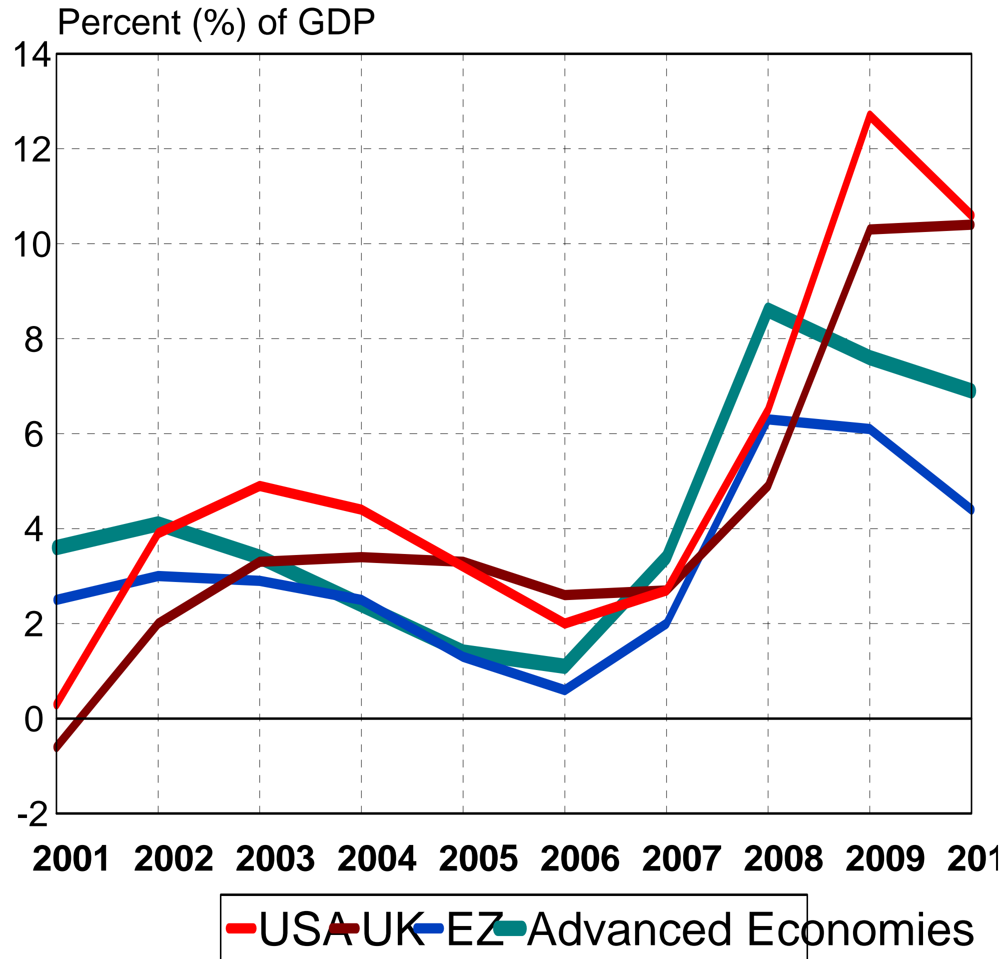
- Europe’s response to the crisis has been muted, incoherent and incomplete.
- It has been muted 1) because the extent of financial stimulus has been far less than the one provided in the US and the UK and 2) the extent of fiscal accommodation has been significantly less as well.
- Financial support to the banking industry in the form of monetary creation, government guarantees, insurance and capital injections amounted to $10.5 trillion in the US (74% of GDP), $1.8 trillion in the UK (74% of GDP), but $3 trillion in the Euro Zone (18% of GDP)

Government Support to Financial Industry

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 Englan 2009

Fiscal Impact of Global Downturn on Major Economies



What Actions Have Been Taken to Stem the Crisis?

- Fiscal injections, in terms of budget deficits as % of GDP in the US and UK were more than double those in the EZ. Even worse, the US and the UK have given themselves more time to reign in their budget deficits while in the EZ there has been mounting pressure on member states to balance their budgets much sooner.
- Most peripheral countries have not recovered from the 2009 global recession but are being forced to adopt austerity measures prematurely in order to prevent contagion and stabilize their fiscal positions. In the absence of fiscal union, each country has been left to fend for itself and face the wrath of global bond markets.

What Actions Have Been Taken to Stem the Crisis?

- The ECB, the most powerful institution in the EZ purchased peripheral country bonds in the secondary market in order to put a floor on bond prices, to prevent their fall that would in turn precipitate multi-billion dollar losses to the euro area banks that hold them and thus preventing the sovereign debt crisis from evolving into a euro banking crisis.
- Remember that euro area banks have not set aside capital and have not boosted prudential reserves sufficiently to guard against potential bond losses.
- In December 2011 the ECB launched a LTRO whereby it lent euro area banks €1 trillion for terms of up to 3 years to finance their holdings of EZ bonds thus holding up their prices and buy time for euro members.

What Actions Have Been Taken to Stem the Crisis?

- Although the ECB has been at the forefront of battling this crisis it has operated with substantial constraints:
- It's only mandate is price stability not economic growth as is the mandate of most central banks in the world.
- It is not allowed to create money and serve as lender of last resort as most central banks.
- Purchasing bonds of area country members is prohibited by the Growth & Stability Pact (GSP)
- The actions it has taken so far have violated its mandate resulting in the resignation of two senior German board members
- It is skirting the rules to defend the euro. The line between **illiquidity** and **insolvency** is too thin and subject to interpretation and dispute.

What Actions Have Been Taken to Stem the Crisis?

- When Greece, Ireland and Portugal lost the confidence of the bond markets, and were unable to finance their debt at sustainable rates, Germany and France the principal core members came to the assistance of these countries with the help of the IMF.
- The EC, the ECB and the IMF –the Troika- offered emergency bailout packages to these countries on the condition that they undertake austerity measures to eliminate their budget deficits along with structural reform measures to open up their labour markets and make their economies more competitive.

What Actions Have Been Taken to Stem the Crisis?

- To funnel funds to these countries they created the European Financial Stability Facility (EFSF) which is to be transformed into the European Stability Mechanism (ESM) on July 1, 2012. This is a € 500 billion facility to be augmented to €750 with the help of the recent action of the IMF. Each country's contribution is limited to its percentage share of capital in the ECB which means that it is only responsible for its own share of the debt. No country is jointly and severally liable for the total debt of this fund.
- It borrows at AAA low market rates and lends money to the debt stricken countries and charges a low but non-trivial interest to the debtors.

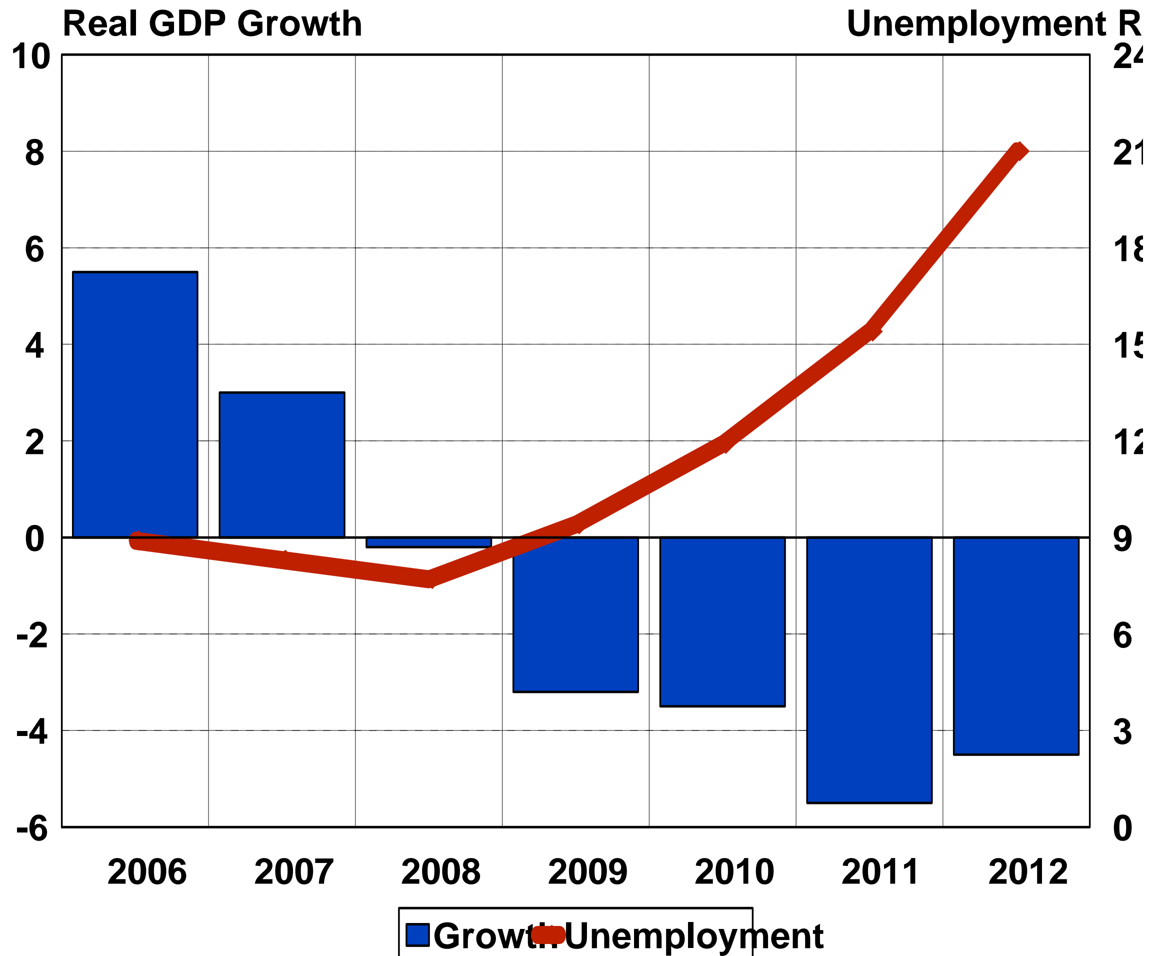
What Actions Have Been Taken to Stem the Crisis?

- The EFSF and its successor the EMS are adequate to service the needs of Ireland, Portugal and Greece. If the crisis spreads to Spain or Italy, the firewall attempted by this fund will not be adequate to take care the needs of Spain, let alone those of Italy should the crisis spread there. In the event the crisis engulfs both Spain and Italy, either they will have to raise it to 3 trillion, accept the collapse of the EMU or find an other solution.
- The tax payers of the countries on the lending side of these funds are becoming increasingly disdainful on the prospect that they are assuming the risks and debts of other less prudent and more profligate nations.

Has the Strategy Worked?

- The first test case of the Euro response to the crisis, i.e. Greece has shown that the strategy has failed utterly. Greece never experienced a recovery from the global downturn of 2009, its economy is now in its 5th year of economic contraction, GDP has fallen by nearly 20% since 2008 and unemployment is approaching 25%.
- Greece’s problem was mall diagnosed as a liquidity problem and it has since evolved into an insolvency problem. When the Troika finally admitted the full scale of the problem they managed an orderly restructuring of Greek debt the Private Sector Initiative (PSI) whereby creditors accepted a 74% cut in the amounts owed based on Present Value basis.

Greece in Depression



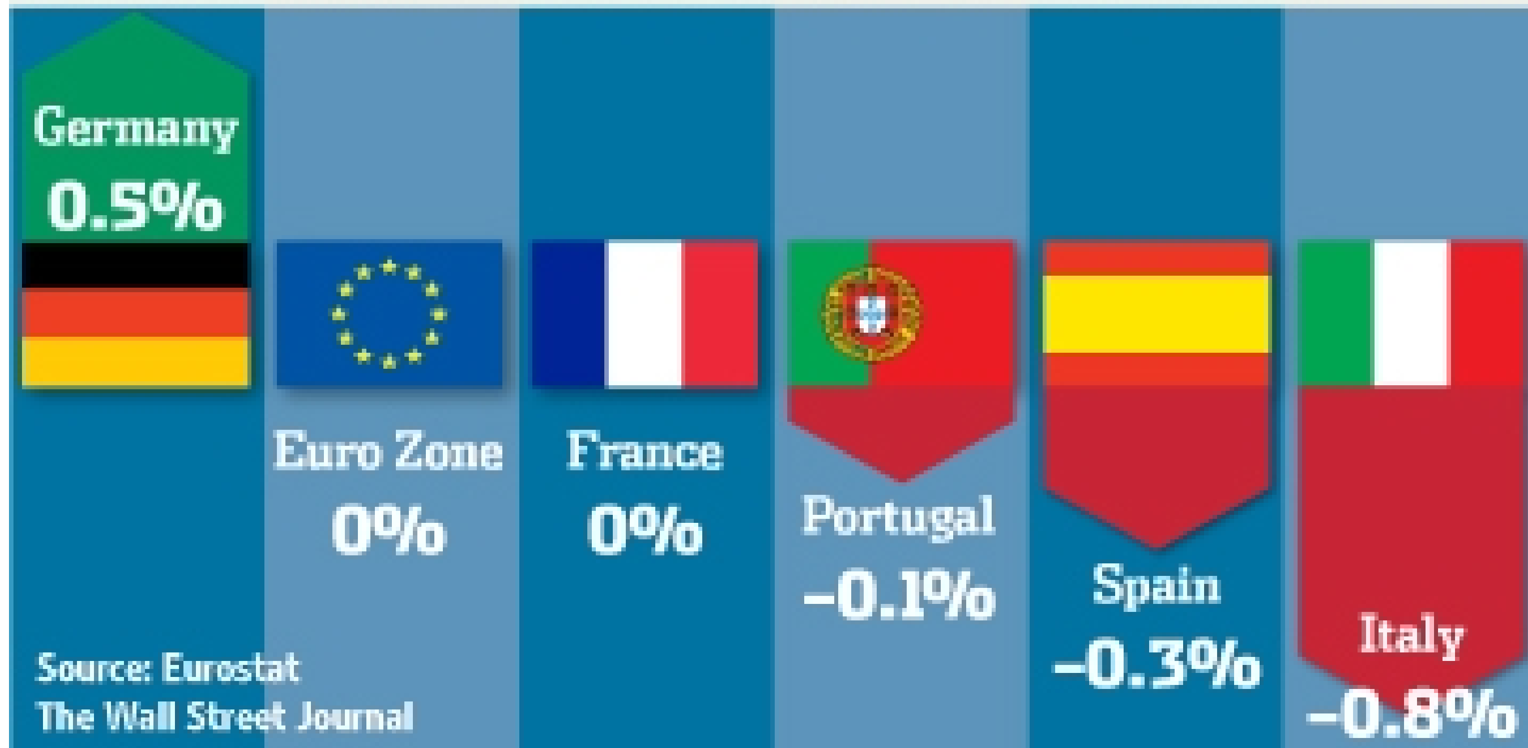
Has the Strategy Worked?

- Although the debt restructuring or ‘soft default’ erased one third of Greece’s debt, the debt-GDP ratio will still hover around 120% of GDP in 2020, hardly a success story.
- Faced with the prospect of years of austerity and hardship, the limits of social and political tolerance were reached in the May 6th national elections in Greece which polarized the political scene and gave anti-austerity and anti-bailout parties near 50% of the vote. Enough to obstruct the bailout package and cancel the structural reforms.
- The EZ has plunged again in an renewed and potentially deeper round of crisis

Are the Actions Sufficient to Resolve the Crisis?

- The tragedy of the situation is that despite the best efforts of the Troika, the crisis has mutated and spread to more countries in the EZ. On May 15, 2012, Eurostat announced that half of the EZ is in recession again with little prospect of any resolution in the near term. The probability of a disorderly exit from the EZ by Greece has risen above 50% with **catastrophic** consequences for Greece while the collateral damage this event could have on the EZ and the world economy is incalculable at this time.
- Should Greece exit the EZ, consider Greece ‘dead’ and the rest of the EZ severely wounded.

Half of EZ in Recession



What More or What Else Needs to be Done?

- At this moment Greece is heading for an other election on June 17, 2012. Unless the Greeks come to their senses and start thinking rationally instead of emotionally, unless the 35% of the Greek electorate that abstained from the May election decides to step in and grant the pro EZ and pro austerity and reform parties enough votes to give them a modest parliamentary majority, it is a foregone conclusion that Greece will be forced to leave the EZ. Not because it is being pushed out, but because circumstances will cause a run on the banks, meltdown in the banking system, the government will run out of money to pay for the basics and they will be forced to print Drachmas to prevent catastrophe.

What More or What Else Needs to be Done?

- Should this occur, the markets will start asking which other EZ country will be next in line. The uncertainty and chaos that will be unleashed may prove enough to force other countries out of the EZ. When one looks at the economic fault lines in Europe, other countries that potentially could eventually leave include all of Southern Europe, which means Portugal, Spain and Italy and possibly Ireland.
- At this late point in the crisis, expanding the ESM and reinforcing the ‘firewall’ will not be enough to prevent the inevitable.

What More or What Else Needs to be Done?

- The second tragedy is that there has been a solution all along, which Germany has refused outright to consider.
- If the EU wants to be called a 'Union', wants to have a common currency and a common central bank it also needs to pool its separate national debts into a common and collective debt, have a common debt instrument such as euro bonds, have a common Treasury and debt issuing agency, and coordinate its fiscal policy.
- If all EZ member countries were to resolve to pool their individual debts and issue common bonds that will be **jointly and severally** backed by all member states in exchange for establishing a EZ Treasury with common fiscal rules and structural reforms over the medium term to ensure that the periphery becomes more competitive, the crisis would end in one single day!

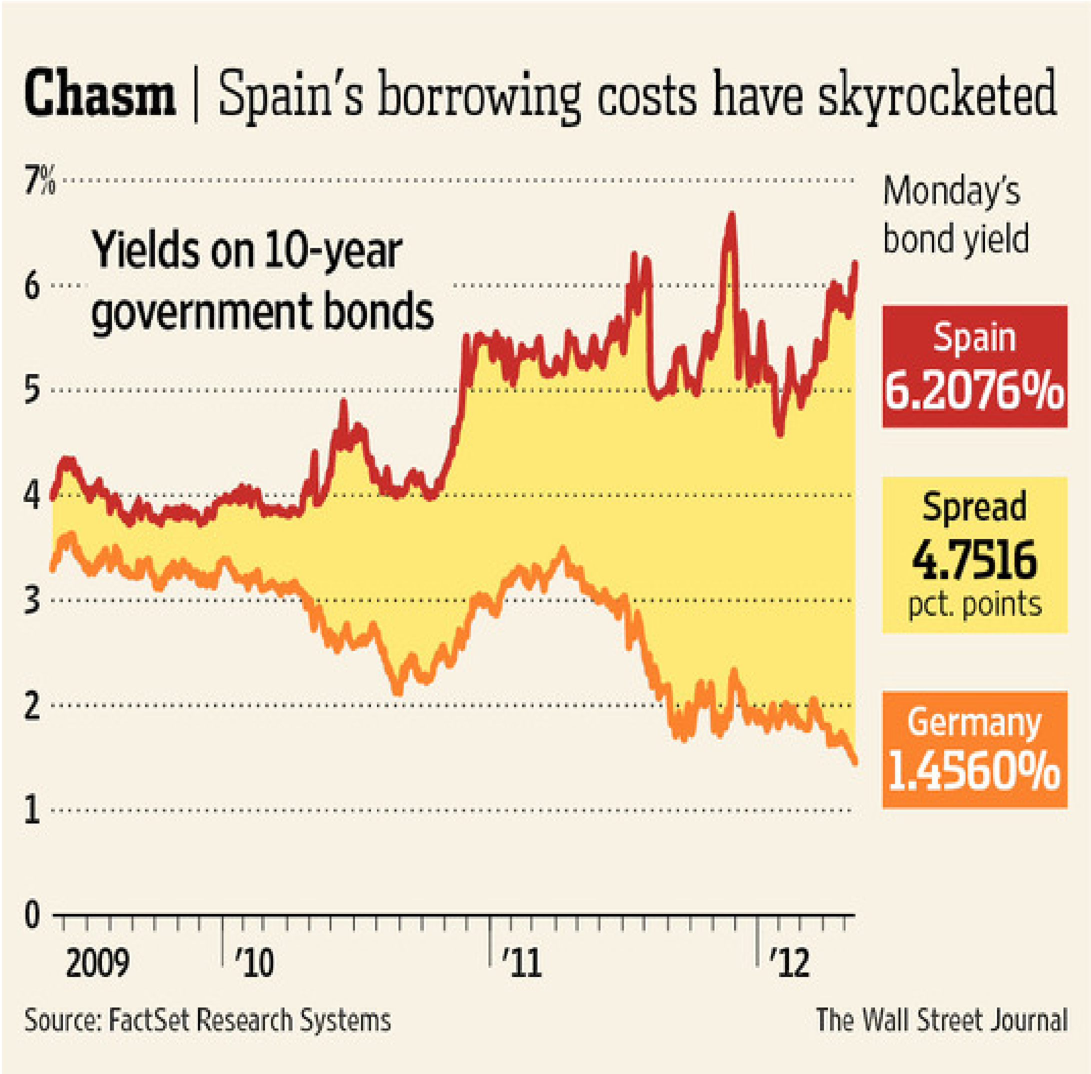
What More or What Else Needs to be Done?

- Consider the idea. Instead of having 17 separate and fragmented national markets for bonds why not have one integrated pan EZ bond market. Already all EZ bonds are issued in the same currency, multinational companies issue euro-denominated bonds in a single EZ corporate bond market, do the same for sovereign bonds!
- By issuing euro bonds and creating a common market for European government bonds (EGBs) a $13 trillion EGB market can be created to match the $15 trillion US market for treasuries. Confidence would be restored overnight in Euro-denominated bonds and borrowing costs would plummet to the benefit of all EZ states.

What More or What Else Needs to be Done?

- Such a market would command at least the same credit rating as the US government bond market, i.e. AA+.
- For the security, liquidity, depth and breadth and efficiency of this market bond holders would be prepared to pay a higher price and EZ bond yields would plummet for all member states.
- This could save over €150 billion annually in interest costs for member states which could be used to reduce budget deficits, reduce the necessity of austerity measures and give time to the struggling economies of Southern Europe to restructure their economies and boost their competitiveness.

Cannibalization in Euro Bond Markets: The strong are eating up the weak



‘One for All and All for One’

- Many political leaders think that they will lose some of their economic sovereignty if they combine their debts and form a common Treasury.
- What they don’t realize is that in a global economic setting, where they are part of a common currency and integrated union and where the collateral damage from a breakdown of the EMU is so large, they no longer have sovereignty over economic affairs.
- Rather than suffer the painful consequences of a break-up they might as well embrace the common benefits of a fiscal union.
- If they are not prepared to stand together, they are poised to fall together.

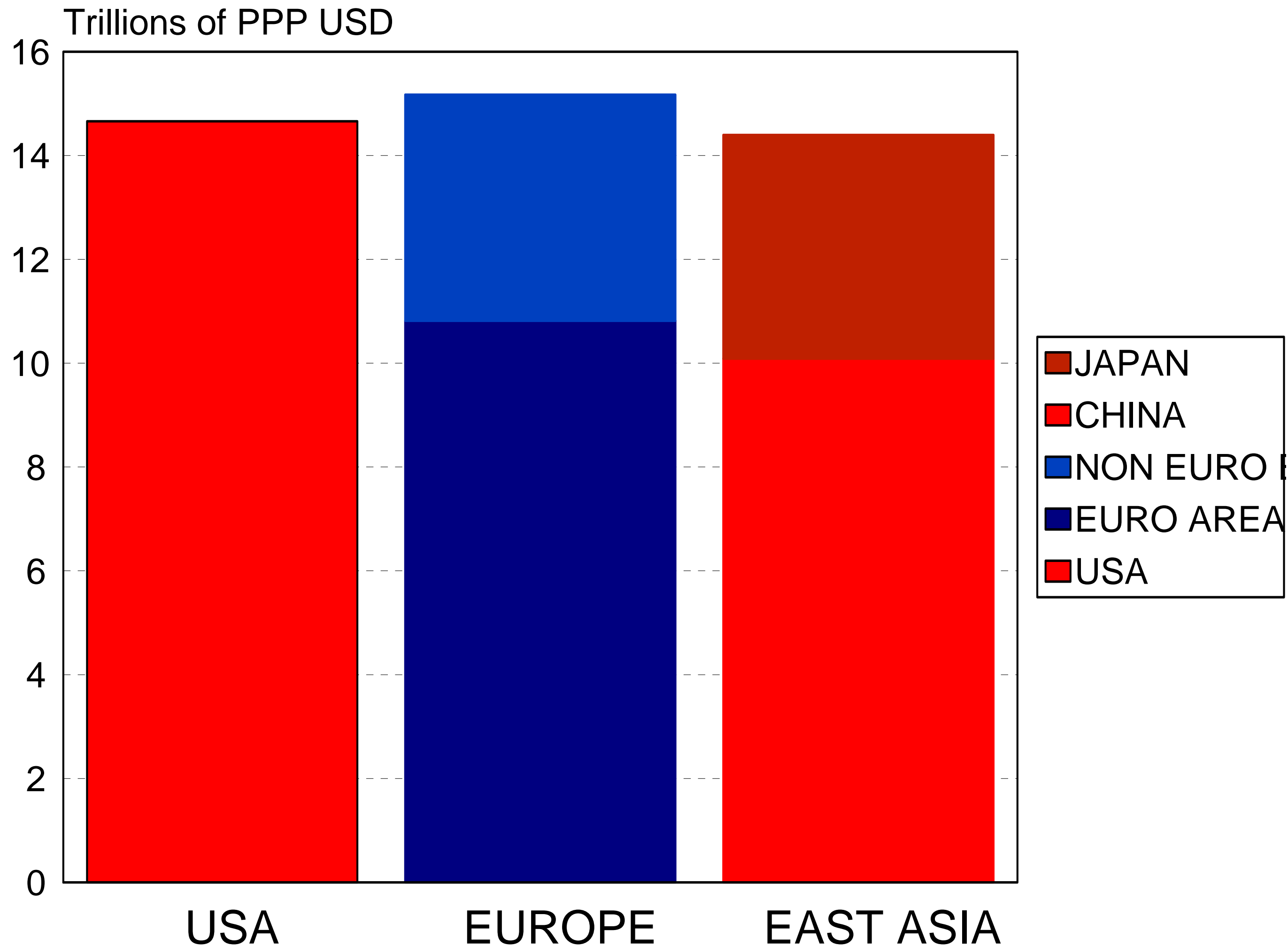
What is at Stake for Europe

- At stake is the financial prosperity of the whole of Europe. Germany and a few other members may be doing well right now but with a euro break up, Germany's economy and prosperity stand to suffer as well.
- If the EMU experiment ends in failure, it will unleash enormous amount of resentment, mistrust and animosity within the European family that will set back the project of European integration by at least one generation
- The economic weakness and bickering that will ensue will have major **unintended consequences**. China, Russia and other newly emerging powers will start vying for influence inside the European continent. Geopolitical events emanating from the Middle East might destabilize the balance of power in Southeast Europe that might force Europe into much costlier adventures such as war.

What is at Stake for the World?

- The EU is the word's largest economy. The EZ is second only to the US economy.
- The world economy is resting on three pillars: US, EU and East Asia (China & Japan)
- A break-up in the EZ will severely compromise one of the three pillars
- It will undermine the Euro-Atlantic Alliance
- The financial position of the US economy is already highly precarious and vulnerable to disruption. The collateral damage that will follow a break-up in the EZ might prove the proverbial straw that broke the camel's back.
- Let's be realistic, the financial stability, security and prosperity of the entire world depends on what happens in Europe.

The Three Pillars of the Global Economy



What is at Stake for Canada?

- Economically and geopolitically, Canada is fairly removed from Europe. Although the collateral damage may not be as severe, the consequences, both direct and indirect may prove quite painful in any case.
- Canada has a very open economy and depends heavily on commodities and international stability and growth. We also depend disproportionately on the US, which means that the more badly the US is affected, the more it will be felt here at home.

Will the Euro Survive?

- Unless European leaders find the courage and the resolve to pool their debts, issue euro bonds, create a common Treasury and create a fiscal union, the Euro Zone may not survive in the form we know it.
- At best it will survive in the form of a retrenched union of fewer members, diminished in stature and power.
- At worst, it could breakup completely and take a whole generation to digest the lessons of the experiment and rebuild in the next generation on a sounder and wiser basis.
- Alternatively, if Greece exits the EZ and experiences a catastrophe, this might prompt EZ partners to lend greater support and more patience to the other members and allow for a more stable EZ.

Questions & Answers

- Thank you for taking part in this presentation!