Causes of the 2008 sovereign debt crisis in europe

ASSIGN
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“ Discuss the causes of the sovereign debt crisis in Europe since 2008 and critically analyse the proposed responses. It is important that you inform your arguments using academic literature.”

Introduction

The European sovereign debt crisis came to prominence in late 2009, when newly elected Greek Prime Minister George Papandreou announced that previous governments had been distorting the country’s deficit data (Nelson et al., 2012). A revision of the budget deficit forecast was revealed as 12. 7% of GDP – a valuation that was almost double the previous figure of 6. 0% (Gibson et al. 2012). The reaction to this was a fall in investor confidence, which caused sovereign bond yields to rise to an all-time high (see Appendix 1). This impacted not only Greece, but also other heavily indebted countries within the Eurozone – identified as peripheral nations (Greece, Ireland, Italy, Portugal and Spain).

There is growing concern within the Eurozone that these periphery nations could ultimately default on their sovereign debt. European banks currently hold a large portion of the regions government bonds (see Appendix 2); if one nation was to default on its sovereign debt payments it would cause financial pressure throughout the Eurozone (Constâncio 2012). This is a known as financial contagion, a term described by Dornbusch (2000) as the spread of market shocks from one country to another. The fear of contagion has forced the European Central Bank (ECB) to bailout a number of the periphery nations; however, this is not viewed as a sustainable practice. The

aim of this essay is to identify the causes of the sovereign debt crisis and analyse the proposed responses by the European Union (EU).

Causes

A complex phenomenon, such as the sovereign debt crisis, is built up of a variety of elements. Most analysts believe that the crisis was caused by structural weaknesses present both at the European and national levels, along with factors specific to (Dombret 2013). Thestructure of the Eurozoneis a key factor contributing to the current crisis. A structural deficit exists within the Eurozone with the fact that there is a single monetary policy and decentralised fiscal policy. This creates an imbalance as the monetary policy is controlled by the ECB, whereas individual member states are trusted to set their own revenues and expenditures (Lapavitsas et al. 2010). Given this imbalance, it has led to ‘ fiscal free-riding’ by the peripheral economies. These nations have had an increased incentive to borrow as the cost of debt is spread across the entire currency area.

The Stability and Growth Pact was created to regulate fiscal expenditure, with one of its tenants being that annual government expenditure should not exceed 3% of GDP (see Appendix 3); however, due to a lack of automatic sanctions, these rules have been universally broken, thus setting the pathway to the current crisis (Anand et al. 2012).

Themispricing of sovereign riskand subsequentmisuse of capitalis also a significant factor that has led to the sovereign debt crisis. As the periphery prepared to join the Euro, their sovereign bond yields began converging with those of the core nations (see Appendix 4). This allowed the periphery

access to substantial amounts of low-cost credit, which traditionally, they had not experienced before. Voltz (2012) suggests that the sovereign risk of the periphery was mispriced by the capital markets, which has led to an " unsustainable accumulation of private and public debt". In Greece, the inflow of capital financed excessive government spending, whilst in Ireland and Spain it led to creation of banking and real-estate bubbles. When capital markets tightened during thefinancial crisis of 2008, the unsustainability of these debts became apparent as the periphery struggled to finance its existing sovereign debt. Moreover, the governments were forced to assume private sector debt as national banks declined and speculative bubbles burst – necessitating large bailout packages (Nelson et al. 2012).

The Eurozone created an illusionary sense of prosperity. Lin (2012) explains that the sense of prosperity was illusionary as there was a progressiveloss of competivenessof the periphery in relation to the core. This loss of competitiveness was partly a result of sharp wage rises in the non-core countries, leading to large current account deficits (Lapavitsas 2012). These deficits were funded by sovereign debt, with most of the debt being held by the core's banks – a key factor in increasing contagion risk. Historically, nations running a current account deficit would devalue their currency in order to improve their position (Simkovic 2011); however, due to the monetary policy inflexibility within the Eurozone this is not possible.

A culmination of the factors mentioned above has resulted in a hugefall in investor confidence, marked by a decrease in available credit (see Appendix 5). Due to the high levels of high risk sovereign debt, Standard & Poor has downgraded the credit ratings of a number of Eurozone nations. To regain

global confidence, the EU must provide a strategy that will tackle the underlying issues present within the Eurozone.

Responses

The immediate response from the EU has been to createfinancial firewalls. These have been in the form of rescue mechanisms, such as the EFSF (2010-2013) & ESM (2012+), which have the ability to buy sovereign debt, recapitalise banks and provide bailout packages to the Eurozone nations (Thesing 2011). However, this is a short term solution to a long term problem. Regling (2012), CEO of EFSF, has stated that the mechanisms should only be used to “ buy time” while the root causes are eliminated. This calls for responses aimed at reducing government debts and deficits, as well as structural reforms at European and national levels.

A favoured approach by national governments to contain their finances has been an implementation offiscal consolidation. AÄŸca (2013) defines fiscal consolidation as policies that “ cut budget deficits and reduce public debt levels”. The ECB and IMF have been aiding nations with the design, implementation and supervision of these policy reforms. Fiscal consolidation has, so far, proven to be a success, with Ireland’s sovereign bond yields falling from 11. 8% to 3. 5%. Undoubtedly, this route of austerity carries negative implications. As well as the social costs involved, fiscal consolidation is known to stagnate economic growth (Anand 2012). To regain investor confidence, the fiscal policies need to be coupled with nationalstructural reformsaimed at increasing competitiveness (Dombret 2013). Ireland and Spain have both reduced their current account deficits

through the use of these reforms (see Appendix 6), highlighting that the periphery must embrace this strategy.

As we have discussed, the lack of fiscal control and regulation was a major factor in the birth of the sovereign debt crisis. To rectify this problem there has been major responses a European level. A new reform of the Stability & Growth Pact, known as thefiscal compact, was created in 2011 with the aim of providing “ enhanced coordination in fiscal and economic policy” within the Eurozone (Regling 2012). This reform ensures member states adhere to the 3% deficit and 60% debt-to-gdp rules of the Maastricht Treaty, through the creation of an automatic sanction procedure. A yearly review of Member States’ budgetary and structural policies, known as the European Semester, has also been put into effect (Bowler 2013). These structural reforms will help put government finances on track. However, it does not address the underlying issue that member states are trusted to set their own fiscal budgets. To address this issue, analysts have called for the creation of a Europeanfiscal union. Weidmann (2012) believes that a fiscal union provides the “ cornerstone of framework for the monetary union”. To achieve this, it would require deeper political integration within the Eurozone; this would necessitate legislative changes at both the European and national level.

Accomplishing the required level of political integration, with the 18 member-states, would be a near-impossible task due to the conflicting agendas and ideals (Feust 2012). Hence, if they structural deficits within the Eurozone are to be fixed, these nations will need to work collectively.

A current topic of debate has been to do with the potential introduction of so called “ Eurobonds”, where bonds are issued on a European front and finances distributed accordingly. While the introduction of these bonds would send a statement of commitment to the Euro (Nelson et al. 2012), the incentive to increase debt would rise as the liability would be spread across the member-nations. This would result in a case of the core, again, paying for the actions of the periphery.

Conclusion

Nevertheless, the European sovereign debt crisis remains a growing problem for the global economy. I feel the elemental decision that needs to be made is whether the euro should be brought closer together, or whether it would be best for the future of the Eurozone to sever ties with the periphery. Although fracturing the euro is a radical response, it may be the only way to curb the threat financial contagion poses. Regardless of the decision made, the European sovereign debt crisis has exposed dangers of fiscal recklessness, and should serve as a lesson to future economists, governments and monetary unions (Sandoval et al. 2011).

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