

# Causes of the european sovereign debt crisis economics essay



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Europe currently experiences a severe sovereign debt crisis. The debt crisis in some member states of the euro area has raised public uncertainty about the viability of European Economic and Monetary Union (EMU) and the euro's future. While the execution of the euro in the year 1999 created many interest in regional monetary integration and even monetary unification in several corners of the world, the present crisis had the opposed effect, even raising expectations of the euro area breaking up. The crisis has illustrated the problems and tensions that will ineluctably arise within a monetary union when imbalances build up and become unbearable. The causes of the European crisis will be further review below. Also, we would describes why the Greece crisis could cause so much havoc to the global economy.

## **CAUSES OF THE EUROPEAN SOVEREIGN DEBT CRISIS**

European countries had just weathered the 2008-2009 crisis and were set up hopes for recovery. However, on November 2009 George Papandreou's newly elected Socialist government in Greece revealed that the predecessor government had lied to the public about the true picture of Greece's public finances, that the budget deficit for 2009 would be 12.7% instead of 4.6% of Gross Domestic Product (GDP), as previously reported. That revelation created a panic atmosphere among lenders or bondholders, as credit agencies lowered their ratings of Greece's sovereign debt, which is the first time in 10 years that Greece's rating falls below the investment grade. The country has then realized itself hardly to borrow or even roll over existing debt except at prohibitively high interest rates.

The disclosure of the actual Greek fiscal condition raised serious doubts about the country's ability to meet its obligation. The following downgrades rating and ever rising interest rates led to an exacerbation of Greece's capital markets access that made it even more difficult and nearly impossible for the government to refinance itself, leading a downward spiral for the Greek's economy. Therefore at that point, the government forced to appeal to its European Union members and IMF for bailout. However, the bailout failed to recover market trust in the Greek economy. In addition, it failed to cease contagion of the crisis to other nations in the euro area.

Precisely, the crisis of Greece and the hesitant political response from the other European nations raised issues over the debt condition and the structural and competitiveness problems of the economically weaker periphery member countries of the euro area, named PIIGS (Portugal, Ireland, Italy, Greece, and Spain). As a result, the costs of borrowing for the PIIGS lifted significantly and the cost of insuring sovereign debt against default soared as their creditability to repay the debt have vanished. The crisis also creates awareness of the existing imbalances in the euro area, which form a serious problem. The below are the major causes of the crisis:

Banking crisis fuelling sovereign debt crisis and vice versa

It is wrong to assume that the European debt crisis is actually caused by thriftless government spending, especially because of the luxurious social security systems. Rather, the origins of the European debt crisis can be traced back to the global financial crisis occurred in 2008-2009, which spilled over into a sovereign debt crisis in various euro area countries in early 2010.

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In order to offset the rapid falls in output, euro area governments responded with counter-cyclical fiscal policies that lifted fiscal deficits. Then, fiscal positions become worse as the tax revenues fell and transfer payments grew larger due to the increased unemployment rate during the crisis. In many countries, government bailouts of banking systems also contributed to an increase in public debt. Private debt turned to public debt, be it through banking crises or the burst of housing bubbles, leading to the sovereign debt crisis. Between 2007 and 2010, the debt to GDP ratio of the euro area increased from 66.3% to 85.4%.

Greece is a unique case in the sense that the Greek debt level had already been relatively high before the crisis, which is 107.7% of GDP in 2007. Greek debt, which has been on a continuous rise since 2003, has arrived at a level of 144.9% of GDP in 2010. Similar to Greece, Italy had a debt level more than 100% of GDP prior to the crisis, but the debt to GDP ratio fell between Italy's adoption of the euro in 1999 and 2007.

Among the countries in euro area, the most dramatic increase in public debt occurred in Ireland, where the country's debt problems can be clearly arise to the country's banking crisis. Ireland did not face a fiscal or debt problem until the year 2008. Accordingly, the Irish debt to GDP ratio fell gradually over this period from 64.3% to 24.9%, with Ireland being one of the EU countries with the least public debt burden. The condition changed in the course of the Irish banking crisis in September 2008 when the European governments and institutions and also the US government guaranteed most liabilities of Irish-owned banks. As a result, the Irish deficit ballooned and the debt to GDP ratio shot up from 24.9% in 2007 to 94.9% in 2010. The <https://assignbuster.com/causes-of-the-european-sovereign-debt-crisis-economics-essay/>

ensuing exacerbation of Ireland's access to capital markets in the autumn 2010 led it to seek for international financial rescue package by the IMF and the EU of over €90 billion in November 2011 to finance its borrowing and bank recapitalization needs.

Similar to Ireland, Spain did not face a fiscal or debt problem before 2008. Spain's destiny changed when the global financial crisis put a sudden end to the long cycle of high growth that had been accompanied by a construction and real estate boom. When output contracted in 2008, the Spanish housing bubble burst and hence destabilized the entire banking system.

Even in Portugal, which had seen a steady rise of its debt to GDP ratio after joining the euro area in 1999, which its debt stood at 49.6% of GDP, which is so far the largest increase of public debt happened during and after the 2008-2009 crises, with debt soaring from 26.6% in 2007 to 94.9% in 2010.

Therefore, the sovereign debt crisis has been directly connected to the global financial crisis and the ensuing problems of European countries' banking sectors after the bankruptcy of Lehman Brothers. With exacerbating public finances, sovereign risk has increased and deteriorated bank's balance sheets. The interdependence between sovereign credit and banking systems has been at the key of the crisis as sovereign debt of euro area countries are held in large quantities by euro area banks.

Mispricing of risk and misallocation of capital

A key element that led to the crisis was a mispricing of risk by capital markets and an ensuing misallocation of capital in the previous years before

the outbreak of the crisis. European monetary unification brought about a convergence of interest rates among euro area members. Spreads of sovereign bonds of the PIIGS over Germany narrowed rapidly in the run up to EMU membership and almost gone once they had become the euro area members. Sovereign risk of all euro area countries, including the PIIGS, was priced more or less the same as German sovereign debt. This is due to the risk of euro area central government bonds was weighted at zero in regulatory capital calculations and because the Euro treated such debt as risk-free collateral when these were offered as collateral for repos and other collateral financing trades.

It is now apparent that the availability of cheap credit brought to an unbearable accumulation of private (as in Ireland, Portugal, and Spain) and public (as in Greece and Portugal) debt in today's crisis countries. The decrease in real interest rates in the periphery countries after they join the euro area and the inflowing capital supplied unbearable developments, including excessive credit dynamics and real estate bubbles in Spain and excessive fiscal spending in Greece. It also decreased the tension for economic reform to enhance competitiveness within the monetary union as countries could simply finance their current account deficits through a plenty of capital inflow.

#### Imbalances in the euro area

A high level of public debt is not a problem, as long as the government can refinance itself and roll over its debt. This requires public debt and the interest burden to grow slower than the economy and the tax base. This is

no longer the case in the PIIGS anymore. Current debt crisis in the PIIGS is hence not merely a debt crisis; it is first and foremost a competitiveness and growth crisis that has contributed to structural imbalances within the euro area.

The structural imbalances, caused by high current-account deficits of the periphery countries and matching surpluses in core countries, are at the origin of the current problems since a lack of competitiveness impedes the periphery countries' chances of growing out of the crisis. Essentially, deficit countries need to become surplus countries to service their debt. However, the fact that the PIIGS are members of a monetary union and hence competitiveness cannot be recovered by means of currency devaluation makes the adjustment much difficult.

#### Lack of trust in European governments' crisis responses

The crisis is not just an economic disaster, but also a political disaster, arises from erratic responses and pressures among euro area governments, representing surplus and deficit countries with contradictory interests. European leaders were believed that a balance of payments crisis was impossible within a monetary union. Since such a problem was not considered a priori, no crisis resolution mechanism had been taken into account. European policymakers hence faced the challenge of crafting a crisis response in the midst of crisis.

The worries of the surplus countries, led by Germany, that an easy bailout of Greece would set a negative precedent and create moral hazard problems with other deficit countries, especially the larger euro area members Italy

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and Spain. Fears of moral hazard and a “ transfer union”, where deficit countries would have to be financed permanently, made surplus countries also refused to advocate proposals such as those for Eurobonds. The slow negotiation processes between governments, which have needed to safeguard support from their domestic constituencies, have evoked the impression of a “ European political system was ill-equipped to overcome any financial crisis”.