Kobe University Tokyo

The European Sovereign Debt Crisis

Causes, Policy Responses and Lessons Learnt

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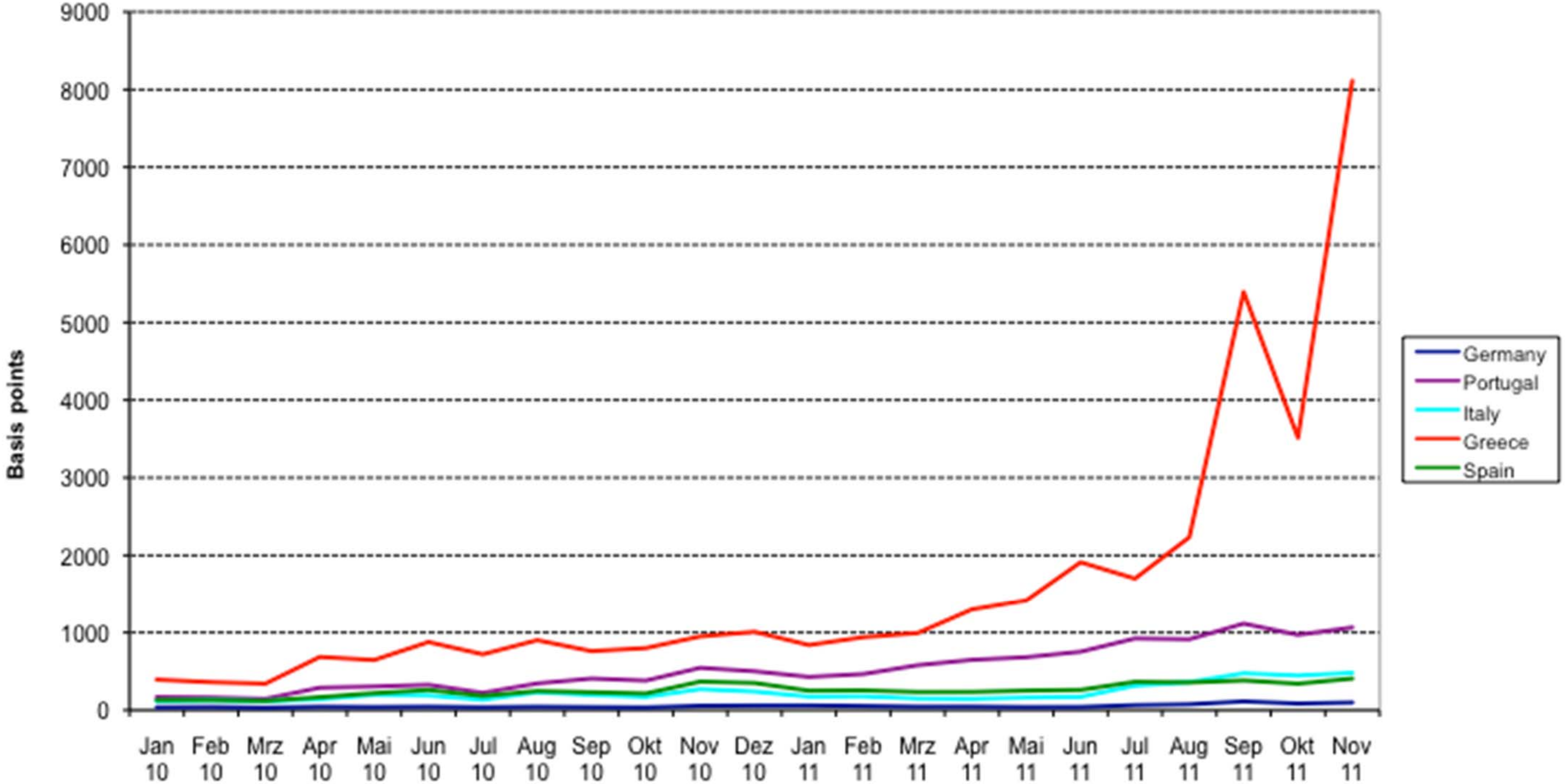
1. Motivation (1/4)

- The world financial crisis started in 2007 and proceeded in two phases:
  - “**Subprime crisis**” (2007-): Private debt crisis originated in the US on the markets for private subprime mortgage loans.
  - „**Sovereign debt crisis**“ (2010-): Public debt crisis originated in Europe on the markets for sovereign debt obligations.

1. Motivation (2/4)

- Early signals of the **second phase** emerged in March 2010, when
  - **Rumors spread** that the public deficit in Greece was much larger than officially reported;
  - **CDS spreads** for Greek government bonds started to rise indicating increasing mistrust among market participants;
  - **Interest rate spreads** between 10-years Greek and German government bonds began to rise.

1. Motivation (3/4)



Source: Bloomberg; own calculations

Figure 1: Credit default swaps (5 Y) of selected countries since 2010

1. Motivation (4/4)

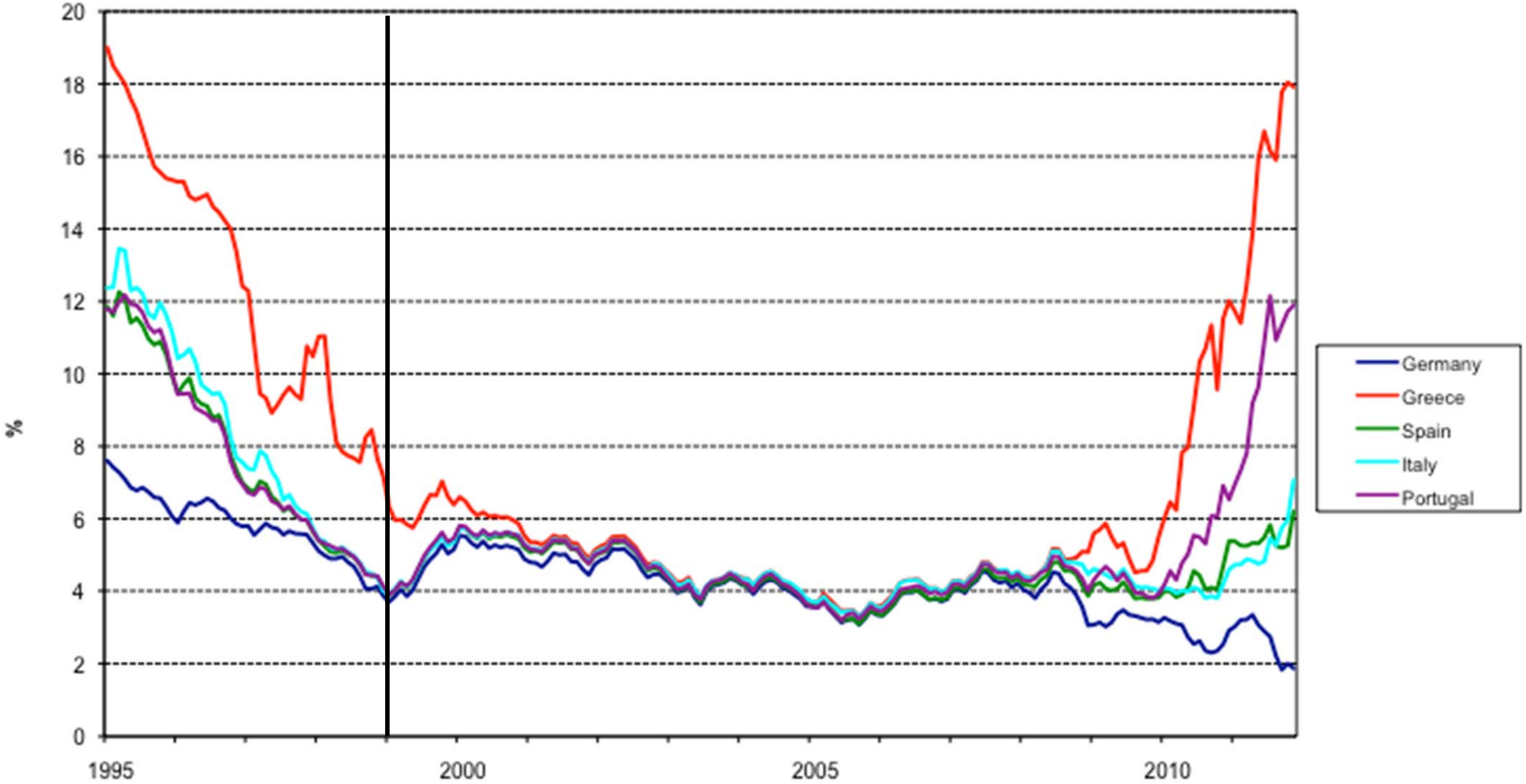
2. Origins and Course of Crisis (1/4)

Fundamental pillars of EMU:

- “**No-bail-out clause**“, according to which
  - neither the European Union
  - nor single member countries

  could be made liable for outstanding debt of any other member state.
- "**Stability and Growth Pact**" (SPG) which stipulated a fiscal monitoring of all EU member countries after accession to EMU.

2. Origins and Course of Crisis (2/4)



Source: Eurostat; own calculations

Figure 2: Long-term rate of return (10 Y) of selected countries since 1995

2. Origins and Course of Crisis (3/4)

- Despite SGP, fiscal authorities in EMU member countries did not show much fiscal discipline.

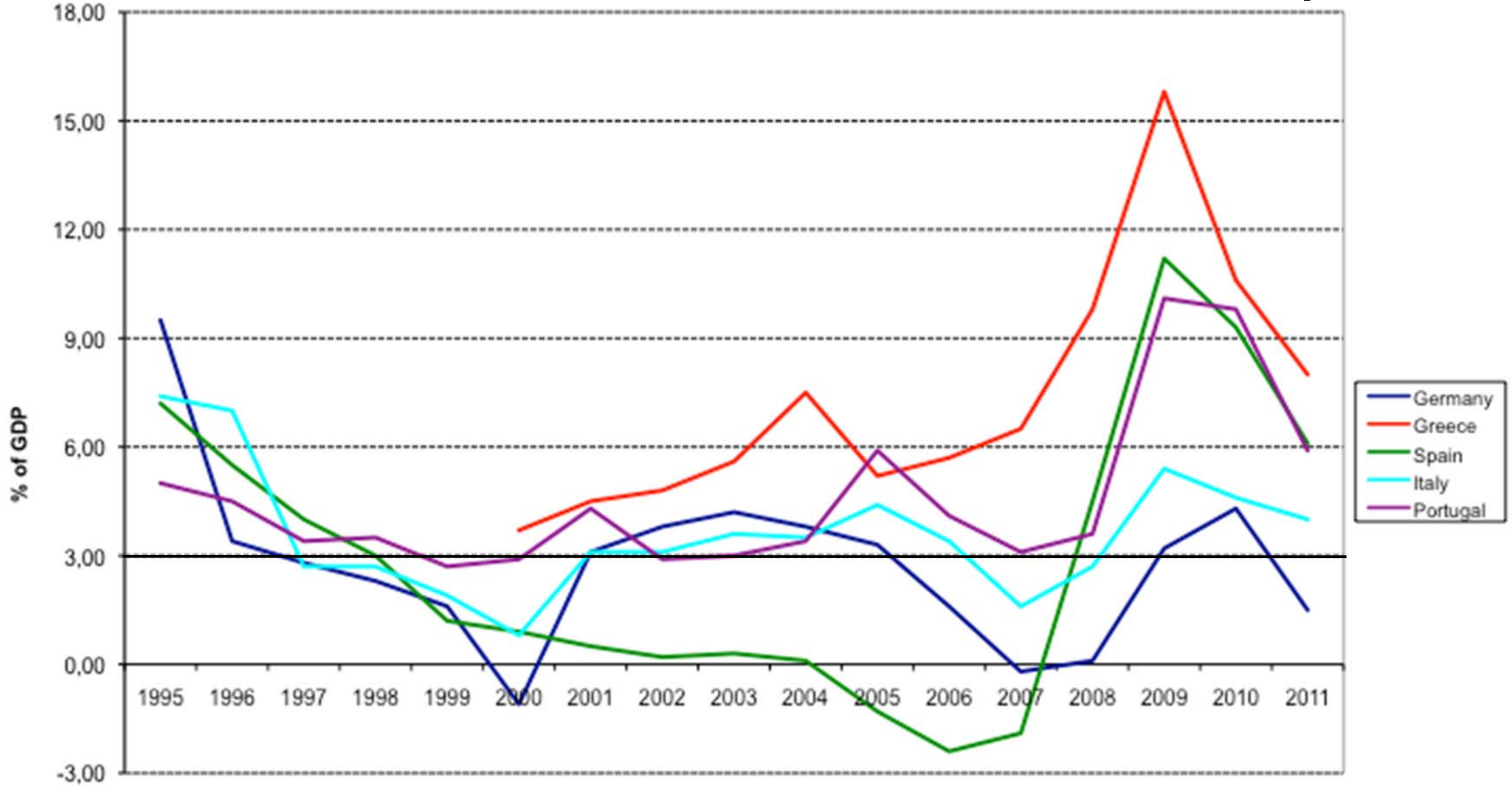


Figure 3: Public deficits of selected countries since 1995

Source: Eurostat

2. Origins and Course of Crisis (4/4)

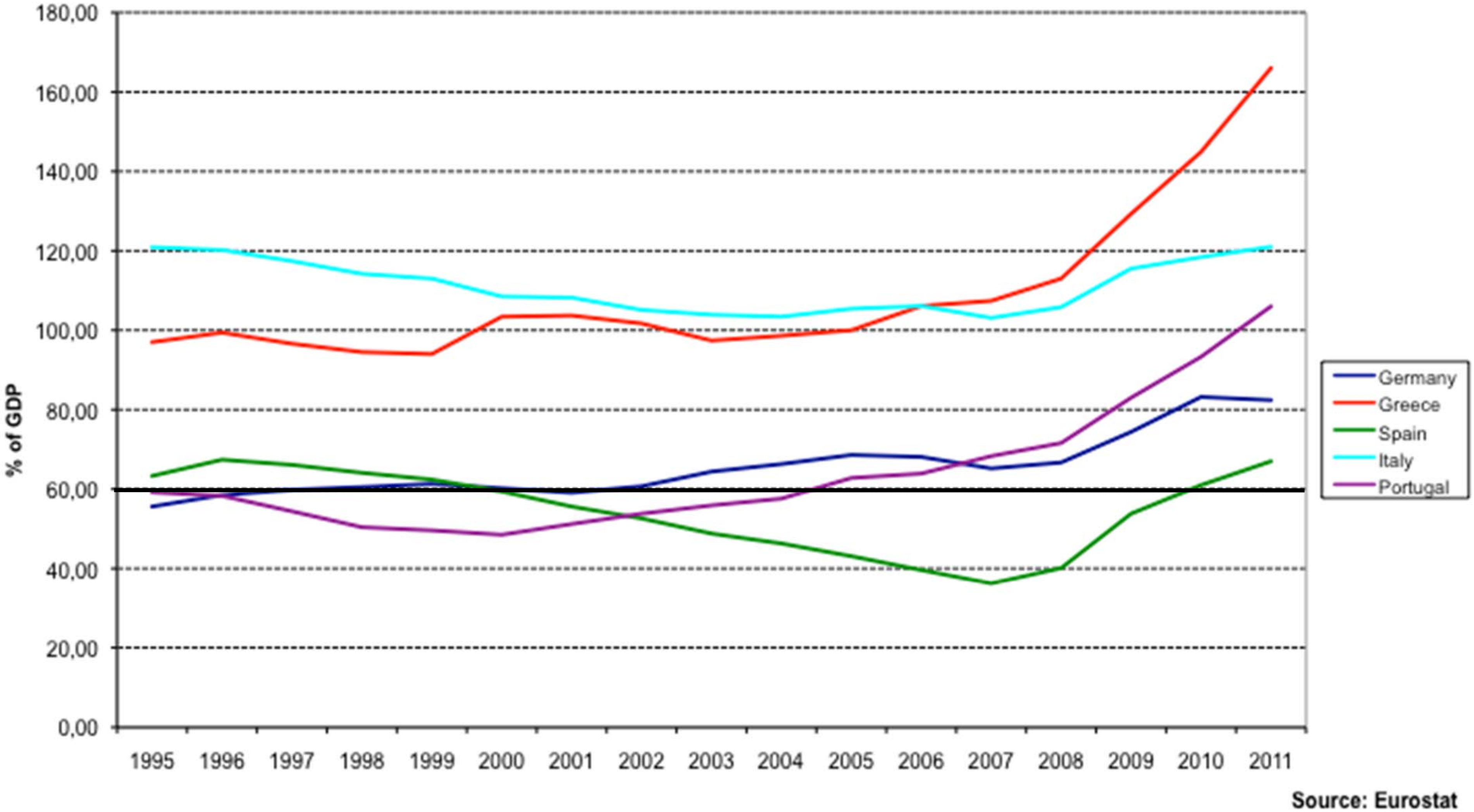
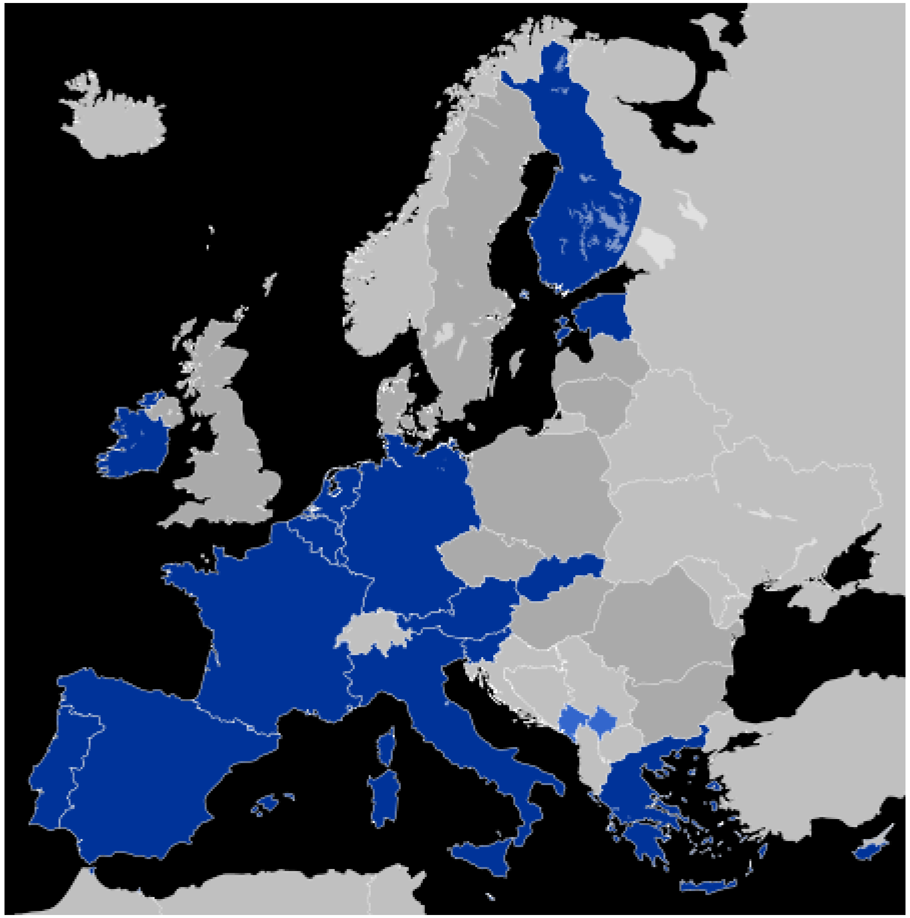


Figure 4: National debt of selected countries since 1995

3. Policy Responses (1/10)

- **Authorities** in the euro zone began reacting in May and June 2010.
- **Policy reactions** implied some **coordination failures** which were due to the fact that
  - monetary and fiscal policy tools were separated into the hands of different institutions;
  - fiscal consequences of any kind of policy response were scattered between authorities in different countries.

3. Policy Responses (2/10)



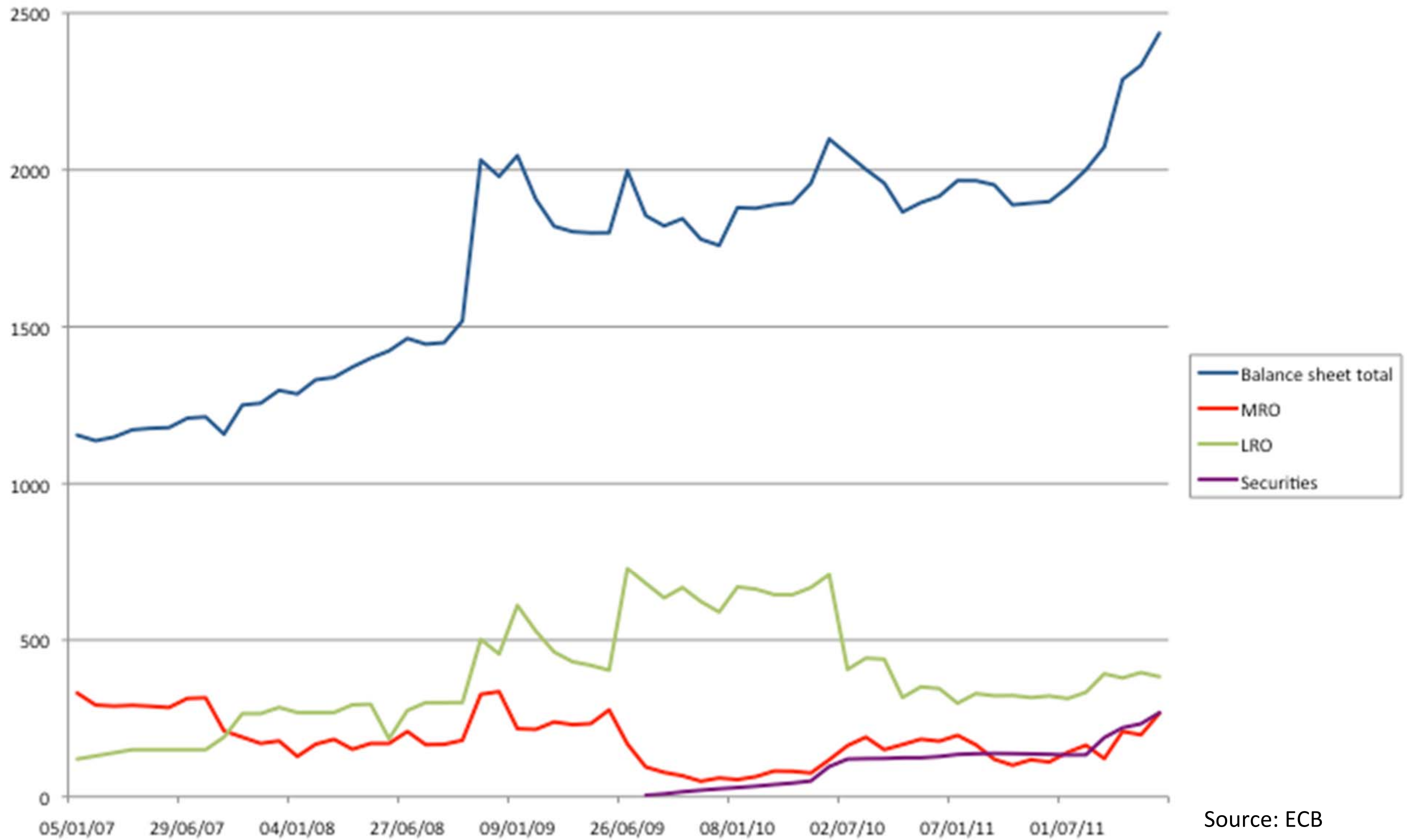
3. Policy Responses (3/10)

- European Central Bank’s (ECBs) most important policy instrument were short-term loans which are granted against collateral:
  - “**Main refinancing operations**", once a week with a duration of one week.
  - “**Longer-term refinancing operations**“, once a month with a duration of three months.
- Before the crisis, Eurosystem did never buy sovereign debt in open market operations on secondary markets.

3. Policy Responses (4/10)

- In May 2010, Eurosystem started a policy of "quantitative" and "qualitative easing“.
  - **Quantitative easing:** Expansion of the **size** of **balance sheet**.
  - **Qualitative easing:** Change in the **composition** of **assets** towards
    - more risky assets and/or
    - to assets with a longer duration.

3. Policy Responses (5/10)



Source: ECB

Figure 5: Size and asset composition of the Eurosystem's consolidated balance sheet (2007-2011) (in Bill. Euro)

3. Policy Responses (6/10)

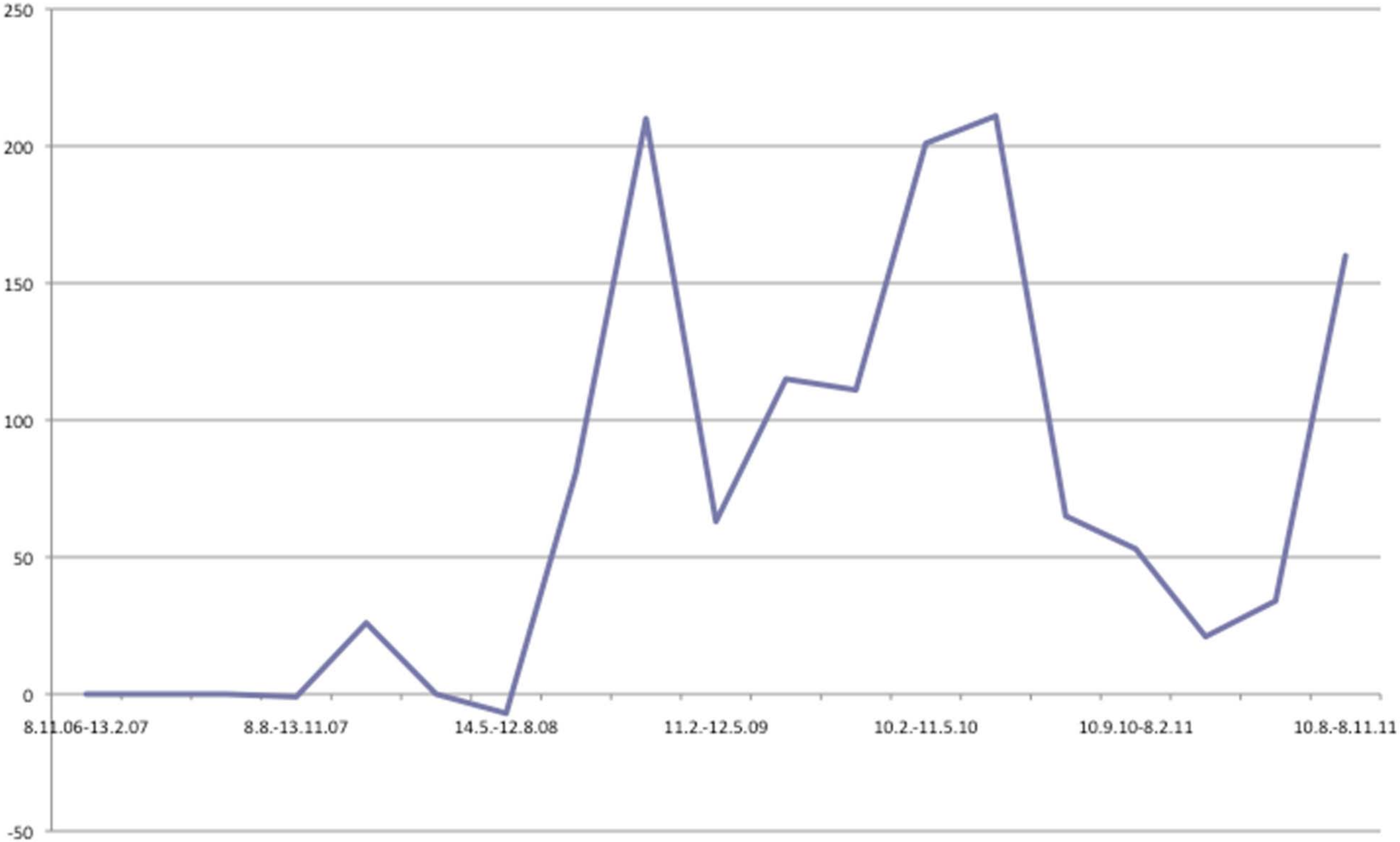


Figure 6: Excess Liquidity in Euro Area (2007-2011)

(in Bill. Euro)

Source: ECB

3. Policy Responses (7/10)

- Fiscal policy options discussed and partly implemented :
  - **Default and debt restructuring:** Replacement of existing government debt obligations with new obligations under different terms;
  - **"Eurobonds“:** Issue of debt obligations nominated in Euro and jointly guaranteed by the 17 Euro zone member states;
  - **Bilateral financial assistance** between euro zone member countries and single crisis countries;
  - **European debt agency** grants loans to national governments against the promise to start an adjustment program.

3. Policy Responses (8/10)

- European governments decided to choose the last two alternatives:
  - Greece received **bilateral financial assistance** from the EU Commission, euro zone member states and IMF.
  - In June 2010, a temporary "**European Financial Stability Mechanism (EFSM)**" was founded with a total volume of € 750 bn.
    - EFSF can only act after a **support request** is made by an euro area member state.
    - In addition, a **country program** must have been negotiated with the European Commission and the IMF, and such a program must have been accepted by all euro area finance ministers, and a memorandum of understanding has to be signed.

3. Policy Responses (9/10)

Table 1: EFSM funding and loan disbursements (October 10, 2011)

Amount	Maturity	Raised on	Loan beneficiary	Disbursed on
€ 5,0 bn.	5yr	5 Jan 11	Ireland	12 Jan 11
€ 3.4 bn.	7 yr	17 Mar 11	Ireland	24 Mar 11
€ 4.75 bn.	10 yr	24 May 11	IRL, P	31 May 11
€ 4.75 bn.	5 yr	25 May 11	Portugal	1 June 11
€ 5.0 bn.	10 yr	14 Sept 11	Portugal	21 Sep 11
€ 4.0 bn.	15 yr	22 Sept 11	IRL, P	29 Sep 11
€ 1.1 bn.	7 yr	29 Sept. 11	IRL, P	6 Oct 11

Source: http://ec.europa.eu

3. Policy Responses (10/10)

Table 2 : Greek Austerity Packages

Measures	1. Package Feb 2010	2. Package Mar 2010	3. Package May 2010	4. Package Sept. 2011
Wage cuts for civil servants	+			
Sales tax increases	+	+		
Abolition of tax exemptions		+		
Increases in retirement ages		+		
Public spending cuts			+	
Privat. of publ. corp.			+	
Public layoffs				+

Source: Wikipedia

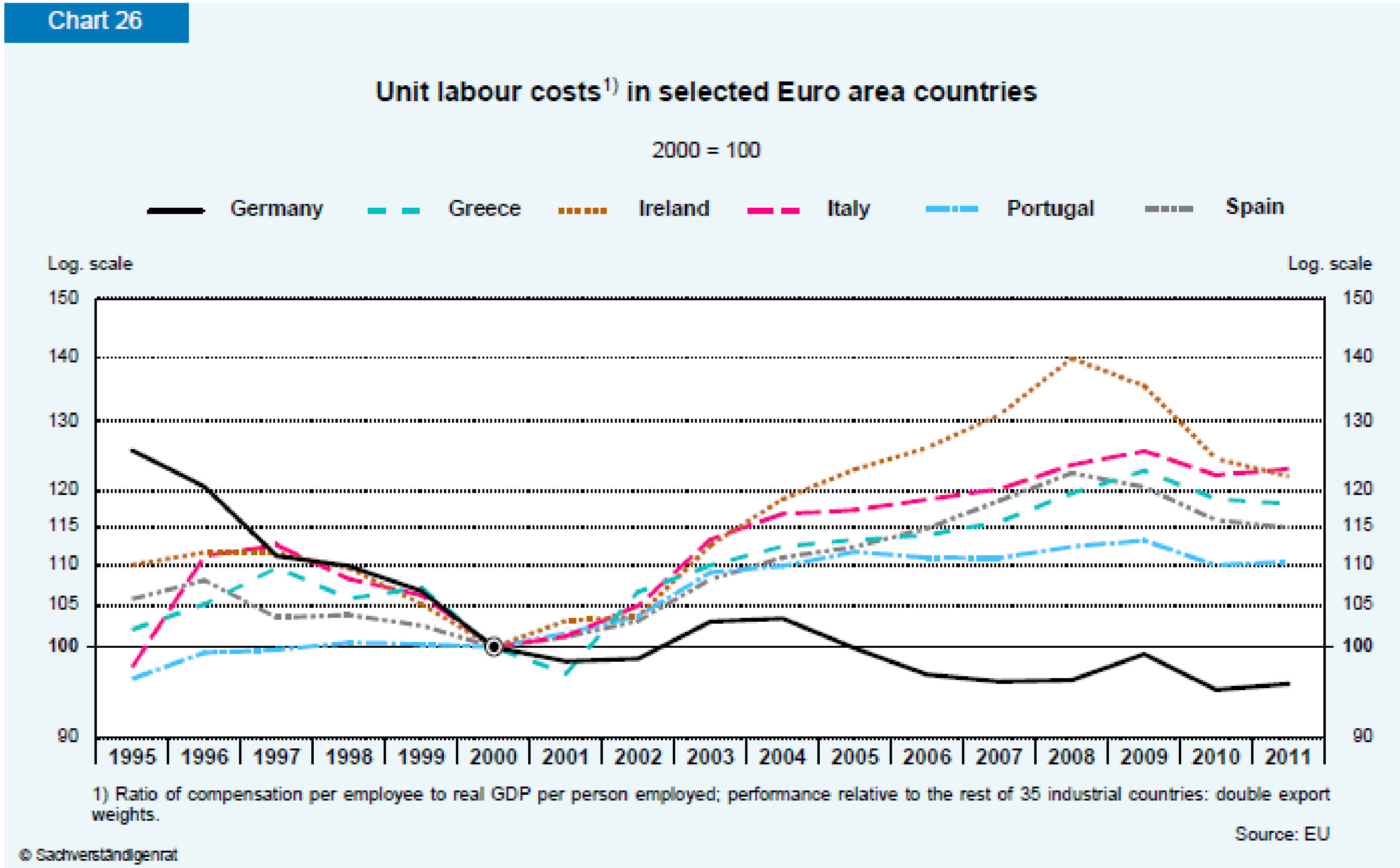
4. Lessons for the Future (1/3)

- How to prevent future sovereign debt crises?
  - **Increasing fiscal discipline**: Austria, Germany and Slovakia introduced a "balanced-budget amendment" or "debt brake" into their constitutions.

Country	Year of Enactment	Max. yearly Public Deficit (in % of GDP)	Year of Inauguration
Austria	2011	0.35 (1.25 in excep-tional cases)	n.a.
Germany	2009	• 0.35 for Federal Government • 0,00 for “Länder”	2016 2010
Slovakia	2011	Maximum total Govt. debt 60% gradually lowered to 50 %	

4. Lessons for the Future (2/3)

- **Improving competitiveness**



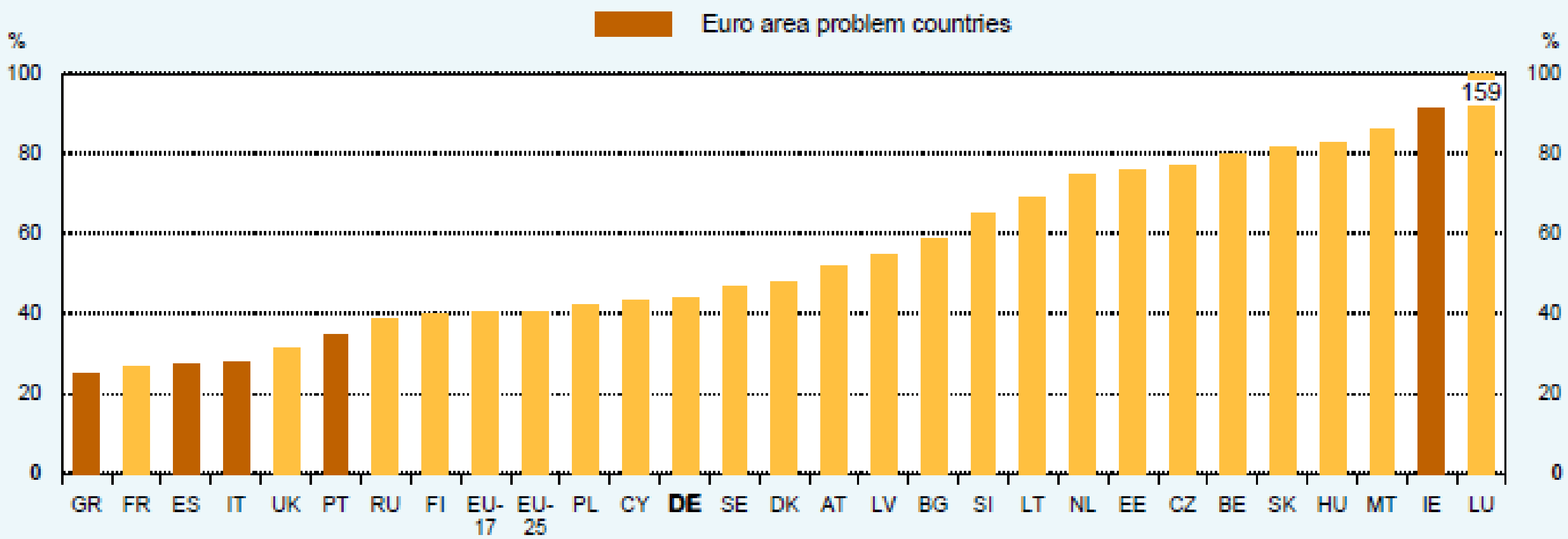
Source: Council of Economic Advisers

4. Lessons for the Future (3/3)

- **Increasing openness**:

Chart 28

Degree of openness[1)] of EU member states in 2010[2)]

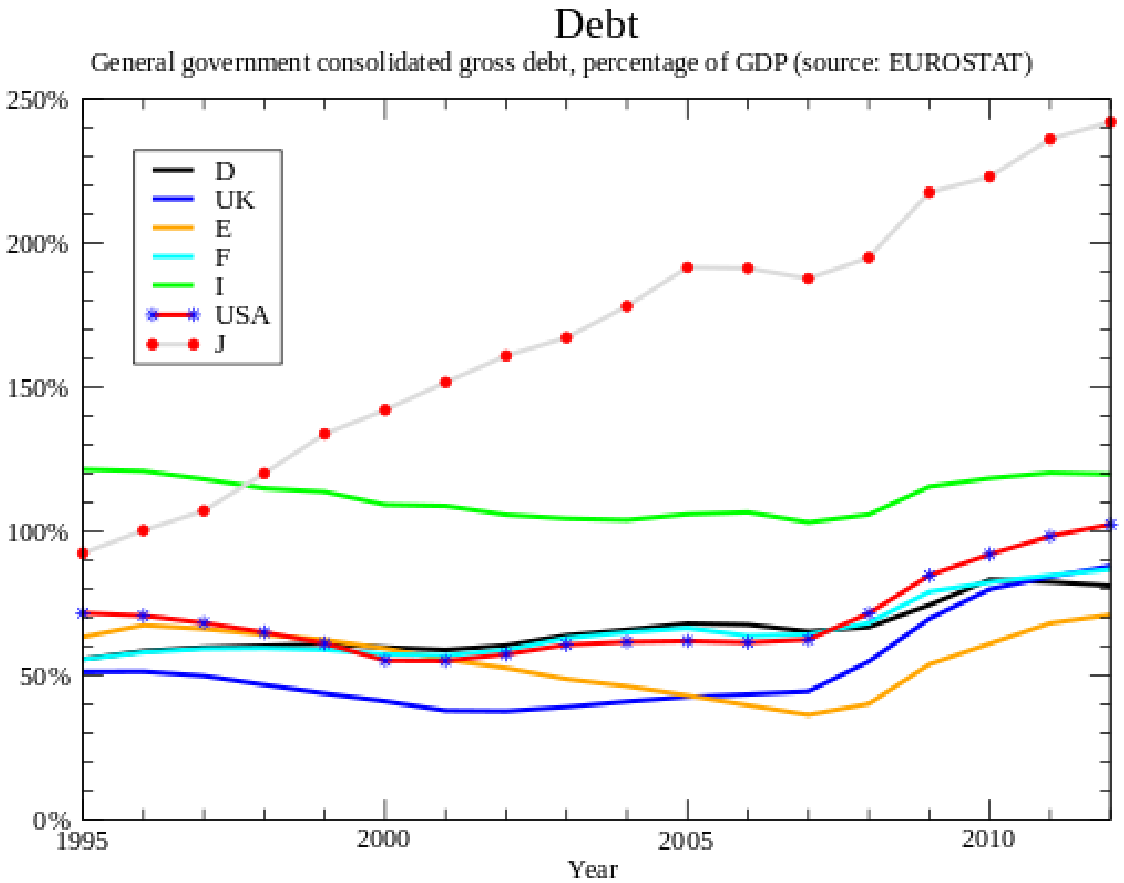


1) Average of exports and imports as a ratio of nominal GDP.– 2) GR: Greece; FR: France; ES: Spain; IT: Italy; UK: United Kingdom; PT: Portugal; RU: Romania; FI: Finland; PL: Poland; CY: Cyprus; DE: Germany; SE: Sweden; DK: Denmark; AT: Austria; LV: Latvia; BG: Bulgaria; SL: Slovenia; LT: Lithuania; NL: Netherlands; EE: Estonia; CZ: Czech Republic; BE: Belgium; SK: Slovakia; HU: Hungary; MT: Malta; IE: Ireland; LU: Luxembourg.

Source: EU

Source: Council of Economic Advisers

5. Why is Japan Different? (1/2)



Source: Wikipedia

5. Why is Japan Different? (2/2)

- Why did a sovereign debt crisis not yet occur in Japan?
  - JGB are mostly held **domestically**, e.g. by Japan Post Bank.
  - Greek investors may take refuge at a „**safe haven**“: Interest rates on German government bonds decreased during the crisis and even became negative.
  - Japan has access to an **autonomous** monetary policy, while monetary policy is **heteronomous** for Greece.

Final words...

Thank you for your attention!

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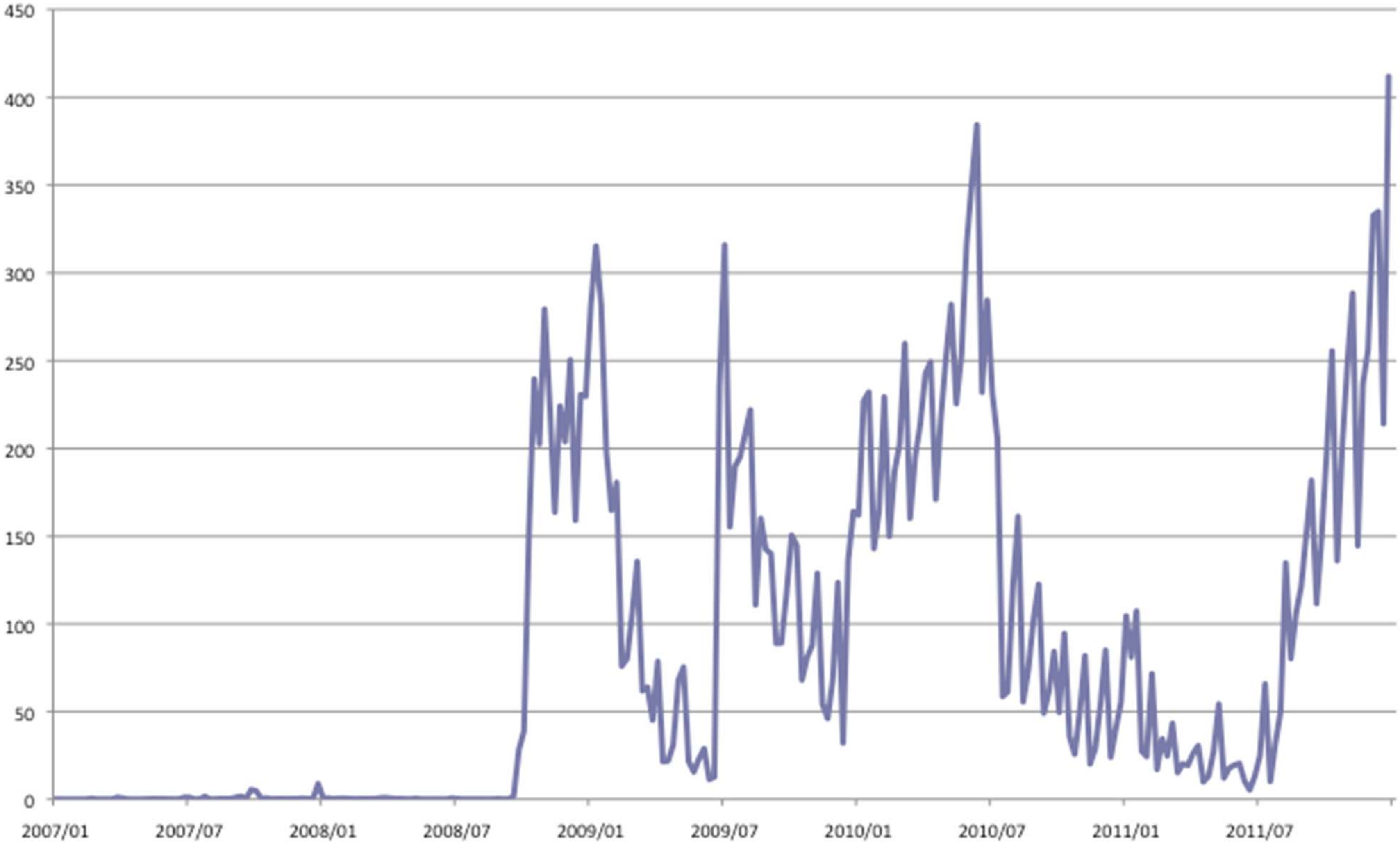
Appendix

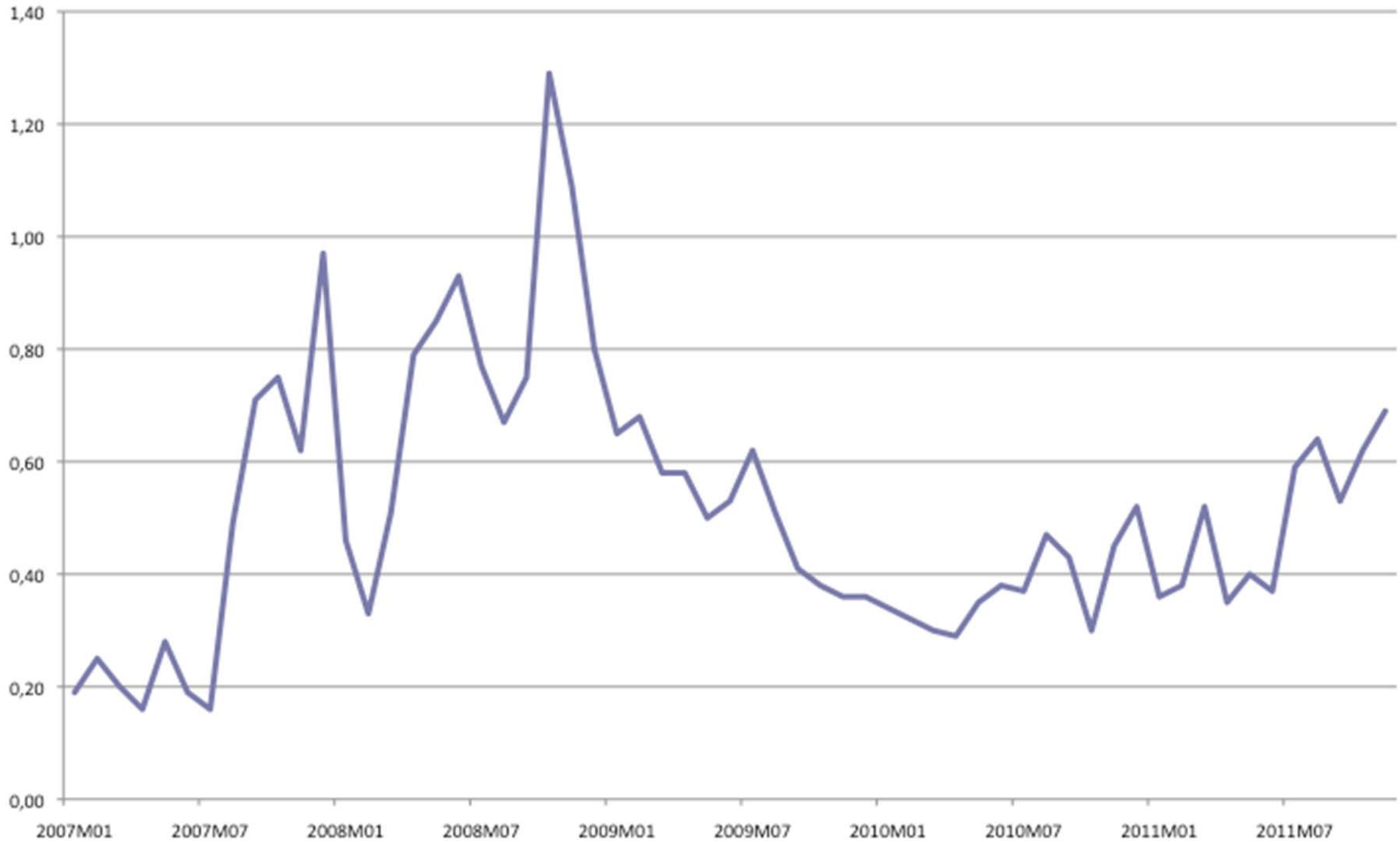


Source: ECB

Figure 8: Balances Outstanding in ECB's Deposit Facility (2007-2011)

(in Bill. Euro)

Appendix



Source: Eurostat

Figure 7: Interest Rate Spreads on European Interbank Markets (2007-2011)

(in %)