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Sovereign debt in the European Union

Octavian Ciobănaşu[1]

The current economic situation in the European Union is critical due to the financial crisis and to sovereign debt. There are a few countries at risk of default, but the most immediate risk is posed by Greece and Italy. The Euro currency is threatened and the EU must take correct measures to prevent it from disappearing. There are quite a few approaches that governments take and each of them has risks and benefits. This paper presents the various suggestions of combinations of measures possible. The matter analyzed being very complex, and trying to simplify it, the paper presents a series of approaches possible in solving the problems that are afflicting the banking system and the EU countries.

Keywords: *Sovereign, Debt, Crisis, Euro, Default.*
JEL Classification: *G01, G15*

1. Introduction

Today the hot topic in the EU is sovereign debt. Given the financial situation of Greece, Italy and other EU countries (Portugal, Ireland, Spain), the idea of sovereign default is a scary perspective for the Euro currency. Before the financial crisis in 2008, the banks had to worry about lending money to the private sector and less about sovereign debt, which was considered safe. Nowadays things have changed: financial markets are very erratic; the prospects of sovereign default are becoming a reality for some countries; the Euro currency is struggling to survive; bailouts have become a common point of the

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agenda; lending to the private sector has dropped being substituted by public debt (especially abroad).[1]

These are just a few of the problems the financial sector is facing. The US has a big problem with foreign debt but, as Alan Greenspan said, as long as it can print dollars, the US cannot go bankrupt. [2] Europe, on the other hand does not have such a tool. The European Central Bank cannot afford to print Euro in order to cover the debt of member countries because this would "dilute" the existing assets and the currency itself, or it has chosen to wait and see that European Countries are doing their part in adopting proper reforms, before it decisively intervenes to save European Countries and reassure investors. In this situation, the developed economies of the EU, led by Germany, are trying to solve the sovereign debt problems of EU countries such as Portugal, Ireland, Italy, Greece and Spain (defined as the PIIGS countries). The Greek sovereign debt was the main issue in the last part of 2011, and there were intense talks at the G20 summit in Cannes, regarding the plan to save this country from default. The solution that the great European powers came up with was to cut Greece's debt by 100 billion Euro and to grant it the second bailout amounting to 109 billion Euro, on top of the first one announced in May 2010, amounting to 107 billion Euro, from the EU and IMF[3]. After cancelling the referendum regarding the remaining in the euro zone and the acceptance of the austerity measures and of the plan for economic recovery of Greece, agreed upon together with the European Union and the International Monetary Fund, the Greek prime minister resigned leaving behind a new national unity government led by Lucas Papademos, former vice-president of the European Central Bank. The latter has the job to fulfill the agreement with the EU and IMF for the economic recovery of Greece.

[1] Deutsche Bank Research: „Public debt in 2020 – Monitoring fiscal risks in developed markets", July 6th, 2011

[2] Greenspan, Alan: "The age of turbulence", Penguin Books 2008, London

[3] The euro-zone crisis: „The long shadow of Greece", from The Economist print edition, Oct 26th 2011

After the temporary stabilization of the situation in Greece, the eyes of the world have moved towards Italy. This country has a public debt five times that of Greece, reaching a value of 1.9 billion Euro. As a result of the pressure from the financial markets, the pressure of the international community and the fabulous growth of the spread for Italian government bonds (at a level above 7%, considered unsustainable for meeting a country's financial needs), the prime minister Silvio Berlusconi resigned, but not before the approval by the Italian Parliament of the austerity plan of measures for the recovery of the economy. The New Italian prime minister, designated by the President Giorgio Napolitano, is Mario Monti. The latter presented the list of technocratic ministers of his government amongst which Corrado Passera, now former CEO of the Intesa Sanpaolo Bank S.p.A. to whom the Ministry of Infrastructure and Development was assigned. Mario Monti also holds himself the portfolio of the Ministry of Economy and Finance. The Italian newspaper "La Repubblica" states that the former prime minister, Silvio Berlusconi was taken down by the spread on the government bonds and by the stock exchange markets. Anyhow, even after the new government was announced, the stock markets haven't recovered, the investors remaining skeptical in regards to its capacity to fix the economy. Even more, some European Banks (such as BNP Paribas) have started to reduce their exposure to Italian government bonds, in order to avoid a possible future collapse. Besides the substantial losses that they have recorded, the banks have also announced layoffs in the near future.

The governments of countries with debt are taking similar measures for improving the economic situation. Until now, the measures adopted by the governments of EU countries with large deficits were: cutting government spending, increasing taxes and VAT, cutting welfare expenses, taxing pensions, reducing the number of government employees, increasing investments, the reduction of tax evasion, improving the collection of taxes, increasing the retirement age, adopting reforms and the reduction of corruption. These are just

a few of the options that governments have at hand, but there are many more, depending on the local debt structure. However, any measure that contributes to reaffirm the faith in financial markets is welcome.

Measures for reducing sovereign debt

Let's look for a moment at the benefits and side effects of some of the most important debt reduction measures.

Government spending represents a large part of a country's GDP. Most of the time, government spending is excessive and must be reduced. However, the way this is achieved is very important. In our view, besides reducing redundant costs, government spending must be administered efficiently. Austerity by itself is not the solution. In order to lose weight people often go on a starvation diet (the equivalent of austerity), with no physical exercise involved (the equivalent of investments). This slows down the metabolism up to the point where you cannot lose any more weight since the body goes in starvation mode (the reduction of the consumption of energy and functions of the body to the minimum). As soon as they start eating normally again, they pack on more weight than before the diet. By including physical exercise, you can keep the metabolism rate up (the equivalent of maintaining the economy running properly) and burn fat (reduce the debt). In the same way, if austerity is the only means to reduce deficit, it will just slow down the economy as a whole, determining a chain reaction in the private sector as well. In this perspective, money would stop circulating, and everyone would hold back spending until better times. Therefore, governments should become more efficient at spending taxpayers' money on measures that keep the economy running.

Those investments that generate jobs and are also profitable are the way to go. The time for big government is over. Efficient government is the way to go.

Also, we must keep in mind that consumer spending should be maintained at an adequate level, to keep the economy going. In the economy, money changes hands, therefore one person's spending is

another's income.[1] If everybody were to cut spending at the same time, the result would be falling production due to falling demand. In such cases, governments must step in to compensate through policies, the start of a downward spiral.
Increasing taxes is a much debated method. In times of financial crisis, it is difficult to increase the burden on the population through more taxes. This is a usually a last resort measure because it determines a fall in spending and an increase in tax evasion. In the U.S., there was a debate on whether to tax the rich more. According to the Federal Reserve, the top 20% of Americans now hold roughly 84% of U.S. wealth, the 2nd 20% holds 11%, the 3rd 20% holds 4 %, the 4th 20% (0.2%) and the 5th 20% (0.1%). Some of the wealthiest people are in favor of taxing the rich more, however, this hasn't happened. In the end it's the middle and lower class that feel more the burden of additional tax. Higher taxes, including VAT, are not beneficial for the growth of the economy because they bring lower spending. There are however views that state that taxes should not be increased for SMEs and corporations because they generate jobs and help the economy. However, many corporations have organized their activity in such manner as to pay the least taxes. Often it's very hard to establish where multinational companies conduct most of their activities in order to compute how much tax they should pay. They avoid paying higher taxes through legal schemes, however there are many sectors in the economy where tax evasion takes place.
Tax evasion is a big problem for governments and their budgets. In Italy tax evasion accounted in 2010 for losses in tax collection for the country of €100 billion a year, equivalent to some 6% of GDP. Cash transactions in Italy facilitate tax evasion and the fact that only 66 transactions per person were made in 2010 compared to 170 in the euro zone, confirms this hypothesis. According to recent information

[1] Legrain, Philippe: "Aftershock – Reshaping the World Economy after the Crisis", Abacus, 2011, London

from the newspaper "La Repubblica", one of the probable measures that the Monti Government will implement is to limit cash transactions to 2.500 Eur. In this way it will try to limit this phenomenon which is very harmful to the economy.
In Greece the picture is even gloomier from this standpoint.[1] Its budget deficit in 2010 was 10.5% of gross domestic product. It remains to be seen what measures the Greek government will adopt to improve the situation. The politicians should work together in order to adopt the best economic policies for their country.
Politics play a big role in pushing reforms and reducing debt. However, the kind of measures stated earlier, such as reducing welfare costs, raising taxes, cutting government spending and increasing the retirement age are very painful to bear by the population. Only strong ruling political parties can afford to push through such unpopular measures. The population is not likely to swallow the pill easily. In any case, come election time, they will probably lose power. In some countries such risk is unacceptable by the ruling political party or coalition. Therefore, the government may not go all the way with the implementation of the necessary measures. This might be the case of Greece, which is still very likely to default. As mentioned earlier, the EU and IMF agreed in 2010 to a 110 billion Euro three year bail-out package to rescue Greece's economy, on condition that they push through austerity cuts. This approach has not up to now solved the problem, but rather it has postponed it. It's difficult to believe that Greece can reduce deficit and debt so fast.
Rumors of deterioration of the financial situation of a country have a very real impact on financial markets. Nowadays investors are very wary of potential problems and markets punish strongly those affected by negative rumors. European Banks have seen their value drop quite a lot in 2011 alone, mainly due to their exposures to sovereign debt. In fact, given its value, sovereign debt poses a real and immediate threat

[1] Tax dodging in Italy: "Evasive measures – A decree brings new measures to reduce tax cheating", From The Economist Print Edition, June 24th, 2010

to banking establishments especially in Europe. Potential increase in the risk of default of a country triggers its downgrading by the rating agencies such as Standard & Poor's, Moody's and Fitch Ratings. Even if worries are not totally objective, such a downgrade brings with it higher financing costs in the downgraded countries, due to risk premium. Therefore, the additional burden on a country's finances can actually worsen the situation. If investor confidence is restored because of measures adopted to keep debt under control and stimulate growth, then markets will calm down. If not, the outlook is not so good.

According to The Economist, one drawback for euro-zone members is that they can't devalue their currency (the Euro) to help facilitate fiscal consolidation. This would have allowed a competitive gain in exports from the EU because of the lower prices achieved due to depreciation of the currency. And because all economies would try to benefit from foreign demand and at the same time cut their debts, at some point they will get stuck.[1]

Germany however is the exception to the rule. It has not depreciated the currency (because it belongs to the Euro zone), yet its exports have fueled its economy throughout the financial crisis. Even though the German economy has slowed down, it is a clear example that results can be achieved by means of exports. Nonetheless, this is not a solution to all problems. Given the high level of indebtedness of countries such as Greece, and the poor outlook for growth, it's difficult to believe that the public will tolerate harsh austerity measures for as long as it takes to clear out the debt.

[1] Sovereign Debt: „A few things to remember about debt", from The Economist, July 15th, 2011

Conclusions

After taking into consideration various outcomes for solving the sovereign debt crisis, I have come up with a few suggestions. The first is that austerity measures adopted by governments should not be just to cut costs, but rather to cut those costs that are highest and produce the least results. The risk is that cutting costs from the wrong areas, might hinder growth altogether. Instead, the government machine should be improved and slimmed down. It's clear that that this is hard to achieve because politics is involved in the process. Politics quite often has other interests at heart than that of the whole country. These interests are usually short to middle term and as I said earlier, some sacrifices might be needed to achieve the task at hand. Until now, governments have gotten bigger and bigger. It now seems that the end of Big Government has come.

A second suggestion is that while struggling to reduce debt, governments must also adopt measures that stimulate investments throughout the economy. In this way, private companies would have work to do and would hire employees, putting in motion the engines of the economy. As a result productivity and consumer spending could grow. The banking system would be able to finance these investment projects in part but under certain conditions.

Banks should be better regulated and monitored. This would make sure that in their quest for higher returns they don't cross the line and take too many risks. The increase in complexity of the financial system in the US has led to the creation of many kinds of securities. These have allowed other speculative transactions of acid assets to lead to the crisis started in 2008.

Given the current difficult situation banks should be adequately capitalized. This is an issue on which everybody agrees. The level of capitalization is yet another matter upon which there is yet no common position. Christine Lagarde, the new IMF managing director believes that European Banks should increase their capital to cut the

chains of contagion in the Euro crisis.[1] However, after the stress tests, many banks and governments believe that the levels of capitalization are adequate. It remains to be seen if in the wake of a crisis in the EU, they will pass the test. On the other hand, too much regulation of the banking sector could hinder growth. This would just increase bureaucracy at the banking level and should be avoided at all costs. At a moment when banks are trying to promote transparency and simplicity, this could bring more harm than good. The solution in our view is to improve existing regulation and simplify it if possible.

One last recommendation in regards the future of the Euro currency: if the Euro is to survive this sovereign debt crisis in the EU, there should be a common fiscal policy at the level of the EU. Even if local governments have their say, once agreed upon, fiscal policies should be implemented throughout the EU in a unitary manner. This mechanism should be straightforward and quick, in order to be able to deal with the challenges that come up, efficiently. Our opinion is that the European Central Bank and the European Fund for Financial Stability (EFSF) will have a more important role in the next period in regards to the stabilization of the European banking system.

[1] The World Economy: „A call to arms", From The Economist, August 28th, 2011

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