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brainstorm

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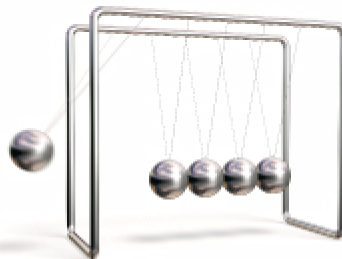
The European Debt Crisis

by Kim Pierce

One of the most significant challenges to the global economic recovery is the debt crisis that has taken hold of the European continent this year. In spite of aggressive fiscal and monetary policy responses to the crisis, pessimism abounds over the strength of the single-currency union and it is feared that the European economy may be pushed back into recession. While it is easy to be glum about the unfolding debt crisis, it is just as reasonable to be optimistic about Europe's current predicament. The crisis may in fact be a golden opportunity for the euro zone to rectify its structural imbalances and implement necessary fiscal reforms. If successful, Europe will emerge stronger and better for having survived the debt crisis.



That being said, the fiscal challenges facing Europe are daunting. For example, the IMF forecasts deficits across the euro zone this year to total 7% of GDP,

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while gross debt is likely to approach 85% of GDP. These figures far exceed the EU's membership criteria which require member-states to demonstrate fiscal integrity by maintaining a deficit-to-GDP ratio of 3% or less, and a debt-to-GDP ratio of 60% or less.

While Greece faces the most acute, and most-publicized, problems - with its deficitto-GDP ratio of some 13% and debt-to-GDP ratio of over 125% - Portugal, Spain, Ireland and Italy are not in very much better standing. Even the economic powerhouses, Germany and France, who are the strongest euro zone nations, appear fiscally vulnerable in today's post-recession world. Not to mention the situation prevailing elsewhere in Europe. The U.K. is the most poignant non-EU example with a deficitto- GDP of 13% and debt-to-GDP ratio of 80%.

However, it is important to note that even before the debt crisis made headlines the euro zone economy was barely growing. Its real GDP has barely risen 1% since the recovery began last summer and shrank a stunning 5% during the recession. Comparatively, the U.S. economy, which began recovering about the same time, has grown at about a 3% rate after contracting 4% during the downturn. Moreover, chances that Europe will slide back into recession continue to loom. European interest rates are up and stock prices are down as banks scramble to absorb the mass of troubled sovereign debt on their balance sheets, and credit will only get tighter. The confidence of European consumers has been severely tested, and this will further dampen already-retarded spending. A double-dip recession in Europe will make it all but impossible to put a handle on mounting deficit and debt levels.

Given this seemingly bleak outlook; widespread pessimism about the future of the euro zone is not surprising. The structure of the single-currency union, created at the turn of the century, through the coming together of 16 distinct economies without any effective fiscal policy-making mechanisms, the euro zone was shaky from the start. Membership ensured that capital flowed relatively freely across euro zone borders, and provided weaker, less fiscally-robust, states with easy access to finance grand government spending. However, the free flow of capital was not matched by a similar pattern of labour mobility, and which was significantly weaker between the euro zone's small and large economies. This had the effect of prolonging and complicating the process of unifying member-states' economic performance and makes formulating a single, workable monetary policy for all euro zone economies difficult, thus adding to the pressure on fiscal policy.

However understandable skepticism about the future of the euro zone might seem within the context of Europe's current predicament, it is however misplaced. The most striking vote of confidence in the union is the landmark commitment made recently by the European Union and International Monetary Fund to establish a massive bailout fund to help troubled euro zone countries. The huge $1 trillion fund will provide low-interest rate loans, guarantees and possibly even grants to members to help ensure they meet debt obligations and maintain access to capital markets. The fund's value is estimated at the amount needed to

finance deficits and roll over maturing debt in Greece, Portugal, Ireland and Spain over the next five years. Additionally, the European Central Bank's commitment to sterilize its purchase of sovereign debt, and so limiting the impact on credit growth and money supply, has already brought down long-term sovereign rates. Prevailing low inflation rates across the continent will also see the ECB keeping short-term rates lower for a longer period of time.

Steadfast support by European and international financial institutions to maintain the integrity of the union makes its dissolution very unlikely. Moreover, the huge costs such a turn of events would have on the whole European economy are simply too large to bear. In this context, the future of the euro zone is clear... it is here to stay. So, if the European monetary union is to survive and indeed thrive, it must be strengthened. The proposed fiscal reforms and bailout package attest to this fact, but they will only be effective if the EU, IMF and ECB are willing to step up their commitment to reform, if necessary. More importantly, governments must implement their proposed spending cuts, increase taxes and increase tax compliance aimed at reducing deficits and stabilizing their debts. This will not be easy, as the Greek riots painfully show, but it is certainly possible.

To facilitate the reform process, one key ingredient is for the ECB to follow a more expansionary monetary policy, resulting in a weaker euro. The ECB must also help buy up troubled sovereign debt from European financial institutions, which is stifling bank balance sheets, and may have to help banks roll over their own debt. Much of the estimated $2.3 trillion in bank debt which matures by the end of 2012 was issued during the recession with guarantees provided by today's shaky European governments.

By that time, and given the success of Europe's consistent economic expansion, its fiscal problems will be less daunting. European banks' balance sheets will be strengthened and the ECB will be the largest holder of sovereign debt. But, Europe faces a difficult path to get there. Although the worst of the financial panic is over, markets remain ill at ease and the economic recession will likely lag on until European nations successfully formulate and implement credible austerity plans. The ECB's recent proposal of bank stress tests is an impressive step in the right direction; especially in light of the success achieved by similar action taken in the U.S. which brought an end to financial panic and ushered in an economic recovery in that country.

If successfully implemented, aggressive actions will produce a much stronger

Europe and will also cement authority in the EU, IMF and ECB. Moreover, by assuming European governments' debts these institutions will thereby gain greater influence over national fiscal policies. The resulting improved fiscal policy coordination will create a more workable and stable euro zone. The lessons to be learn't from the debt crisis are numerous.

The real test however, will be whether the euro zone will follow through with its proposed commitment to tackling its fiscal and structural problems, thereby emerging stronger and bolder for doing so.

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Look forward to hearing from you!

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