

A Study on the Sovereign Debt Crisis in Europe

دراسة حول أزمة الديون السيادية في أوروبا

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Title The Sovereign Debt Crisis in Europe
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Topic: The Sovereign Debt Crisis in Europe

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The Sovereign Debt Crisis in Europe

Introduction

The effects of the financial crisis is still being felt all over the World more than 5 years after it struck, catching the United States, Europe and the rest of the World unexpectedly and when everyone least expected. The 2007 financial crisis which rocked governments and financial markets exposed a lot of loopholes in financial transactions in relation to risk analysis. The global economy was on the brink of crumbling and critical measures and bailout programs had to be put in place to prevent a global financial meltdown. These bailout options led to the acquisition of debts by several countries. Some countries were able to manage their GDP and debt ratios, while others were not able to and are still struggling to keep their heads above water. This dissertation takes a closer look at the financial crisis in Europe and it's link to the 2007 financial crisis, its causes, consequences and effects in countries belonging to the European Union, with a primary focus on its impact on the PIGS countries (Portugal, Italy, Greece and Spain) and to show that The primary objective of this research is to show that the sovereign debt crisis faced by some countries in the European Union can be closely linked to the 2007 financial crisis and economic mismanagement. In Europe in general, the financial crisis spelt dire consequences for the European Union, their financial markets, the government and the citizens. However, market indicators have shown that Portugal, Italy, Greece and Spain were the worst hit. These market indicators will be critically analyzed, also, the varying impact of the financial crisis on these countries will be observed, as well as measures taken by these countries as well as

the European Union to come up with a bailout and how successful these bailout plans have been so far. The objective of the research carried out in this project is to uncover the primary causes of the sovereign debt crisis in Europe. Was it caused by excessive spending by individual Eurozone countries or was it due to global the crash in global markets or a combination of both factors? The analysis of the findings in this project will be based on a combination of excerpts and research findings from previous studies related to the same issue. However, the limitations involved in using this method is that it will be based on individual research methods, rather than collective findings and opinions from a wider scope of people.

Research Methodology

The primary research methodology used in this dissertation involves the use of a combination of investigator triangulation (which involves the use of results obtained from several researchers on topics related to the financial and sovereign debt crisis in the European Union) and statistical analysis, which is based on the use of different sets of related statistical data. Many of the researchers used a combination of qualitative, qualitative and statistical analysis. Through the use of data triangulation based on different research methods, provides for a wider and more in-depth analysis of the topic. The sample data is from the PIGS (Portugal, Italy, Greece and Spain) countries which were most affected and the financial records used in this dissertation will be sample data from these countries, with data collected primarily from the IMF and other articles which establish links between the 2007 global financial crisis and the sovereign debt crisis in the European Union. However, the use of such a wide scope in research has the possibility of providing too much information which can lead to conflicting and confusing facts and figures in some cases. This is considered to be the primary limitation in this case. However, to overcome this limitation, a collective set of information that are closely linked will be used in this dissertation, which are got from the most trustworthy global resources. Also the collection and analysis from sources which are too divergent will be avoided.

Objectives

The objective of this project is to;

- Critically analyze the root problems that led to the high sovereign debt in several countries in the European Union, with a primary focus on the PIGS countries (Portugal, Italy, Greece and Spain). This dissertation will also discuss and analyze how each country fell victim to high sovereign national debt, bearing in mind that these countries have got their own distinct issues in their public and private financial sectors.
- Establish links between the 2007 financial crisis and the sovereign national debt in the aforementioned PIGS countries.
- Highlight attempts made by the European Union to curtail the effects of the high sovereign debt from spreading to other countries in the Eurozone, which could ultimately lead to the devaluation of the Euro.

Other possible ways of curbing sovereign national debt in general will be discussed which would be applicable not just to the European Union countries, but to other countries and economies in the World. It is hoped that the research and information found in this project will provide valuable data and be a viable resource for future studies related to this topic.

Origins of the financial crisis in Europe

While the actual cause of the financial crisis is still grey in some areas, many have linked it to the crash of some of the global banks in the United States. One of such banks was the Lehman brothers, a global bank with interests spread across the United States, Europe and the rest of the World. When the Lehman Brothers declared bankruptcy, this rocked the global financial market, as the Lehman Brothers was known to be one of the biggest banks globally. This initiated a wakeup call for many other banks globally and as such financial transactions became more stringent and lending and borrowing activities from which banks thrive was brought almost to a complete halt. The European financial crisis started in 2007 and events took a turn for the worse in 2010, when the sovereign debt crisis reared its ugly head, leading to governments within and outside the European Union taking drastic measures in order to prevent a total financial meltdown in the region. The financial crises was due to the combination of factors most of which originated from financial issues in the global banking system. The collapse of the Lehman brothers almost brought down the World's financial system and it took a lot of effort from the United States government, using tax-payer's money to finance bail-outs in a bid to support the ailing financial industry (The Economist, 2013).

Events leading to the crash of the American and subsequently, the European financial market included the greedy borrowing of the European market from the American financial

market and the purchase of shady securities. This reckless borrowing led to a surge in debt. Financial experts have linked this borrowing without adequate security in the United States as the primary reason that had a cascading effect in the Eurozone financial market; “According to Peter Praet, a member of the Executive Board of the European Central Bank (ECB), the Eurozone financial crisis first started when the US mortgage market collapsed as “a complex network of financial derivative products” (Glannoulis, 2013). The financial crisis in the United States caused a re-evaluation of debt and securities in banks in the European Union. This led to the revelation that domestic debt within the EU had led to a huge strain in the solvency of several banks, a drop in government bonds which were widely used as a major for of collateral. This necessitated bailouts by the governments in the European Union of several domestic banks at the expense of national debt. As a countries debts increases, the level of spending tends to reduce, leading to economic cuts.

Further investigation into the European Union’s financial crisis has linked it all the way back to the formation of the European Union, where countries such as Greece and Cyprus gave grey data about the actual state of their true economic and financial situation. Other member states of the European Union chose to disregard this data in their eagerness to increase the number of EU member states. Also, several countries recorded high budget deficits, but all of this information was disregarded at that point in time, a direct violation of the rules regarding the minimum requirements for countries to become member states of the European Union. Countries that gave this false data include Greece and Cyprus, who at the moment are among the EU countries in the worst shape economically, despite several attempts at bailouts by other members of the European Union states. This has put other European Union countries at a dilemma for if

the economy in member states such as Greece and Spain continue in their downward spiral, then the overall strength and stability of the Euro, the currency of the European Union would be at risk and at this time, other EU countries are still trying to stabilize their own economy. Another factor that led to the economic and financial crisis in the European Union was their involvement in the global financial bubble in the form of mortgages, which also originated from the United States. Slow actions and indecision were also some of the reasons why the financial crisis in the Eurozone got to critical levels. Had other member countries of the European Union acted more swiftly and decisively, quick and effective solutions would have been put in place to cushion the effect of the crisis and thus set up a viable plan of action that would have put things in better shape. However, this was not the case. Difference in views and opinions in the parliaments of other countries and the snail pace decision making process of these houses of parliaments delayed the initiation of viable action plans led to the decline in the financial situation, much like a tumor, which if it had been removed quickly, would not have spread to other parts of the body.

General Effects of the Global Recession on European Union Sovereign National Debt

The global recession that shook economies globally is also one of the underlying problems behind the sovereign national debt in some countries in the European Union. After the global recession, unlike some other countries in the European union, countries with high sovereign debt could not recover and became unable to make payments for the money they owed, thus these countries within the European union had to go hat in hand to the IMF and other

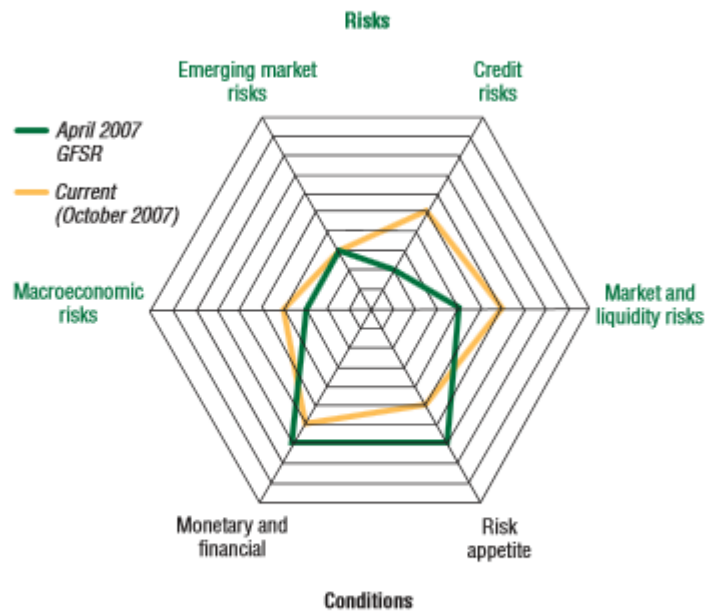
countries in the Eurozone in an attempt to seek help for debt payments. Previous findings from the International Monetary Fund IMF showed that there has been a rise in credit and market risks, leading to the increased volatility in major Global markets. In its report in September 2007, it was noted that the credit discipline in most financial markets-especially in the US leveraged loan markets as well as in their nonprime mortgage and other related credit markets-has greatly deteriorated which demonstrated an increasing fragility in the global financial market. The idea of these Global Financial reports from the IMF is to observe the systemic vulnerabilities in global markets, bringing it to the attention of stakeholders in these global markets and proffer possible remedies to these problems. These problems in the Global market are analyzed using tools such as the Global financial stability map. The Global financial stability map is a tool created by the International Monetary Fund to assess how changes in factors such as Credit risks, macroeconomic risks, emerging market risks and market and liquidation risks can impact global financial stability in coming years.

Initial IMF reports, warning of the Impending Debt Crisis

Prior to the Global debt crisis, the IMF did a global research on existing market trends and using the Global financial stability map with it associated variables, discovered that the existing market trends would ultimately lead to a global crash in global finances. This analysis was published in the September 2007 Global Financial Stability Report. The Global financial Stability report is a bi-annual analysis of the financial markets. The September 2007 report focused primarily on

gaining information based on discussions with banks, credit rating agencies and other financial institutions, academic researchers, regulatory authorities as well as other major financial centers in different countries. Based on this input, the IMF were able to draw their own conclusion on the future state of the global sovereign debt. This report is not based on just Europe alone, but all major financial markets globally. In the September 2007 report, the IMF discovered that there has been a great increase in markets lending without taking appropriate consideration on risks, leading to increasing volatility in the market. Some of the threats of financial stability as discovered in the IMF report include the funding by short-term market securities for medium-term, hard to value and illiquid assets, such as credit securities. The 2007 report also noticed the increased weakening of credit discipline. Credits were approved without properly analyzing the associated risks and due diligence on the part of borrowers and counterparties and minimized monitoring of those borrowing. The Global financial stability map can be seen below;

Figure 1.1. Global Financial Stability Map



Source: IMF staff estimates.
Note: Closer to center signifies less risk or tighter conditions.

The diagram above shows that credit risks have greatly risen in global markets April and October 2007 (the month of the release of the report). This goes on to validate the unprecedented increase in credit risks globally. At this point, the international market became aware of the impending crisis.

About the European Union

The European Union consists of 28 member states, which merged together to form a political and economic partnership between these countries all of which are located in Europe. The European Union was created after the second World War, as a means of uniting all the countries in Europe, most of which had been devastated by the war, to foster cooperation and

growth between member states and also as a means to avoid any further conflict between member states. This coalition was formed in 1958 and was initially known as the European Economic Community or EEC and started with six countries which were Belgium, France, Luxemburg, Germany, Italy, and the Netherlands. As cooperation between member states of the EEC grew, the EEC incorporated several more countries and was later renamed to the European Union in 1993 Member States of the European Union can be found in the attached literature of this dissertation.

Each of the European Union states joined the European Union with their different currencies all merging to become one under the Euro, thus leaving their currencies inextricably linked, implying that any effect on the economy of many member state could devalue the Euro, thus affecting other member states. The formation of the European Union fostered cooperation and the removal of boundaries between European Union states, providing benefits such as the ease of trade, free movement of goods and services from one country to another as well as the movement of labor between member states. This increased cooperation between European Union countries was meant to foster peace and cooperation between the member States, in line with the post Second World War agreements and intentions. The merging of the European Union States also allowed for the creation of a larger economic and financial market for the Eurozone, however, there were still some boundaries based on the economic and financial policies, which is country dependent. However, this did not come with consequences. Several Eurozone States were less economically and financially stable and the conflict of economic and financial policies proved to be a general point of dissent between EU States. This escalated when several States fell under during the global financial crisis, which threatened the financial stability of other

States. Economically stronger States such as Germany and France imposed tough conditions in the enforcement of their bailout plans for countries such as Portugal, Italy, Greece and Spain, who were seriously feeling the impact of the financial crisis and still are. Though still linked by a common currency, each European Union member state maintained their own economic and financial market and it remained the responsibility of individual governments to ensure that they maintained economic and financial growth as well as establish a healthy GDP, keeping public and private debt to a minimum. For this reason, even though several European Union countries face the sovereign debt crisis others were still able to keep their heads well above water. Countries such as Germany have remained relatively stable even during the global crisis and other member states of the European Union are looking up to them to help financially and with a bailout plan.

The Impact of the Sovereign Debt Crisis on PIGS Countries (Portugal, Italy, Greece and Spain)

Empirical studies have shown that governments can choose to intervene in the money markets to provide liquidity (Kindleberger, 2005; Von Hagen and Ho, 2007). When governments take such actions without a corresponding increase in their GDP to cushion the effects of extra spending, this will ultimately lead to a considerable increase on the debt burden ultimately increasing the sovereign national debt, especially when there are cases of bad loans (Laeven and

Valentica, 2008). Empirical studies carried out by Reinhart and Rogoff provided arguments showing that after a banking and financial crisis, government expenses are increased due to rescue programs, which leads to modifications in government budgets due to reduced tax revenues. According to their study Reinhart and Rogoff showed that this can lead to an increase of up to 86% of sovereign national debt (Reinhart and Rogoff, 2008). Further studies by Acharya et al also established that after the 2007 financial crisis, from that period up until 2010, the financial crisis is directly proportional to government sovereign debts and that government sovereign national debt fuels banking and financial crises (Acharya et al, 2011). The variables used in the study by Reinhart and Rogoff are based on observations linking the banking crises and sovereign debt over a period of 3 year intervals. Excerpts from the study carried out by Reinhart and Rogoff can be seen below;

Table 1

Dependent variable Sample Independent variables	Emerging markets: share of countries in default or restructuring 1971–2009	
	OLS (robust errors)	Fractional logit (robust errors)
Emerging markets: external debt/GDP ($t - 1$)	0.574	0.013
<i>p</i> -value	0.000	0.000
Observations	39	39
R^2	0.615	0.595
Dependent variable Sample Independent variables	Emerging markets: share of countries in systemic banking crises 1971–2009	
	OLS (robust errors)	Fractional logit (robust errors)
Emerging markets: external debt/GDP ($t - 1$)	0.383	0.007
<i>p</i> -value	0.000	0.000
Observations	39	39
R^2	0.479	0.514

Sources: Reinhart and Rogoff (2009a), sources cited therein, and authors' calculations.

Table 2

Explanatory variables:	1974–2009	
	Dependent variable: first year of a banking crisis	default
Banking crisis ($t - 1$ to $t - 3$)	0.218	0.004
<i>p</i> -value	0.000	0.391
Default ($t - 1$ to $t - 3$)	−0.042	0.018
<i>p</i> -value	0.115	−0.051
Financial center crisis (t to $t - 2$)	0.781	−0.051
<i>p</i> -value	0.016	0.004
External debt/GDP ($t - 1$)	0.001	0.001
<i>p</i> -value	0.000	0.152
Intercept	0.060	0.043
<i>p</i> -value	0.000	0.000
Observations	1,496	1,496
Number of positive observations	85	55
R^2	0.295	0.012

From their data, it can be seen that the number of positive observations is high (85%). The main consideration in their research is the relevant debt to GDP ratio. Based on their data, it can be seen that the banking crisis continues to be a considerable predictor of the debt crisis. The PIGS countries observed in this dissertation all faced the financial crisis before becoming immersed in sovereign national debt.

The global financial crisis took its toll on most countries in the World, however, some countries were worse hit than others. Portugal, Greece, Italy and Spain were some of the European Union countries that seriously felt the impact of the crisis in many sectors of their economy. These countries of the Eurozone have been grouped together because they share a

history linked to high unemployment rates, instability in their political and economic systems as well as issues causing long term instability in these countries political systems. One of major impact of the sovereign national debt crisis on affected countries is their exclusion from the international capital markets. At the moment, not many investors would be keen on investing in countries with high sovereign national debt and facing the possibility of defaulting on existing debts. The sovereign national debt crisis also affects the banking sector and economy at large. Banks will have no access to funding and economic productivity will be greatly reduced as companies in the private sector will be unable to get funding from banks towards the execution of normally profitable projects. This has led to job layoffs and increased unemployment rates. The PIGS countries are heavily in debt which is one of the primary reasons why they have been grouped together. Even though some of them have got above average GDP performance, their high economic debt remains a burden to them as well as to the European Union as a whole. The better understand the economic and financial state of the PIGS countries, each of them will be analyzed individually, along with how the debt crisis impacted their different economies.

The Sovereign Debt Crisis in Portugal

Portugal has a population of over 10 million people and its primary export products are agricultural produce, which makes up about 75% of annual exports. May 2011 saw Portugal deep in economic debt, thus, necessitating the negotiation of a bailout from other countries in the Eurozone- those that could afford to help out. Portugal got a bailout fund of 78 billion Euros, got from the International Monetary Fund (IMF) and other creditors from Europe. This required the

introduction of spending cuts as well as tax increases (Minder, 2013). Unfortunately, Portugal was unable to maintain their budgets within the agreed limits, thus leading to a further meltdown of the country's economy, which led to one of the most severe recessions in the Eurozone. The recession in Portugal led to job cuts, which led to unemployment rates spiking up to about 18% (Minder, 2013).

The Portuguese government aim to cut down their budget deficit to 5.5 percent of their GDP, however, their lenders have given them a steeper target of a 3 percent cut. The policies and strategies put in place by the Portuguese government hasn't given much hope to internal and international financial and economic analysts due to the severe state of recession and unemployment. The country and her creditors remain hopeful and are continuously examining new and improved strategies for their economic recovery from the Global Sovereign debt crisis. The Debt crisis in Portugal was caused primarily by impeded economic growth, stagnant productivity levels, caused by the neglect of their manufacturing sector, as well as underdeveloped credit markets.

Sovereign National debt Crisis situation in Italy

The Italian economy is driven primarily by agriculture and the manufacture of consumer products. Even though Italy has got the third largest economy in the European Union, it is plagued by large economic debts, which recorded a gross public debt which is 133 percent of its GDP for the year 2013 (CIA, 2013). Italy currently has a youth unemployment of about 40 percent and a general unemployment rate just above 8%. Italy has a population of about 61

million people and has a Gross Domestic Product growth rate of -1.8%. Unlike smaller nations which other member States of the European Union were able to bailout, this is not to be the case with Italy, as its gross debt is much higher than that of the other PIIGS countries and other member states of the Eurozone who are still afloat may not have the economic and financial resources to initiate a bailout due to the capacity of Italy's debt. The chart below shows a comparison of the sovereign debts of all the PIIGS countries (Source: Fisher investments market minder)

Table .3



From the Chart above, with a debt of 319 billion Euros, it can be seen that Italy's debt is almost double that of all other PIIGS countries combined. This makes Italy's debt crisis a lot more difficult to resolve internally by other Eurozone countries, thus they need very strategic

economic policies to put things right. Austerity measures were put in place quite late and the country is in dire need of viable and sustainable economic reforms to help reduce its public debt. This shows that Italy's sink into huge economic debt was primarily due to the country's inability to stimulate growth to match its minimal GDP growth in comparison to its rapidly expanding economy. Also unprecedented and uncontrolled spending by the Italian government increased the country's debt levels. As the interest on existing debt grew, the Italian government could not manage this increased debt based on their slow GDP growth rate over the years, ultimately leading to an increase in their sovereign debt, thus necessitating urgent economic reforms. The Italian government is also plagued by issues related to corruption and tax evasion by government officials which has impaired their economic and financial growth.

Sovereign National Debt in Greece

The economic and financial crisis in Greece made the most waves in the World, due to the magnitude of their problems or perhaps due to the interesting mythical history Greece has got. Due to the depth of the sovereign debt crisis in Greece, perhaps, this might be a good time for the Greek gods to intervene. Greece currently has a population of about 10 million people, with a GDP of -4.2%, which is quite slow. Greece currently has got a pretty high unemployment rate of about 27.9%. The financial crisis in Greece began after it incurred debts as a result of expenses related to the Athens 2004 Olympics held in Greece. Also linked as causes of the economic and financial woes of Greece is the widespread tax evasion, the 50% increase in public sector wages, widespread borrowing, budget deficit and many years of overspending (BBC,

2013). Greece benefited for a while with low interest rates, which prompted increased consumer spending and a period of rapid GDP growth. This was before the global recession era in 2007. The global financial crisis revealed that Greece was actually deep in debt and they were having problems paying. After they could not recover from the global financial crisis, Greece was then forced to ask other members of the European Union for bailout when they didn't have the capacity to repay their huge debts. Greece's debt crisis worsened when they was slow response from the authorities of the European Union and there was a great fear among investors of a possible debt default (OxfordEconomics, 2012).

Sovereign Debt Crisis in Spain

Prior to the economic recession, Spain had a period of steady growth. The Spanish economy thrives on services, agriculture (with products such as olives, grapes, pork, poultry and dairy products) and industry. Spain has a population of about 47 million people and has an unemployment rate of about 26%. The country's GDP growth rate is at -1.3% (CIA, 2013), Spain currently has a GDP to debt ratio of 125%, much higher than the standards set by the Eurozone (98%). Spain's period of economic growth came to an end after a 16 year period of a steady growth trend from the mid-nineties up until 2006. The EMU introduced lower interest rates which stimulated an increase in consumer spending and real estate purchases, which was pretty much the same as in Greece. Spain's financial issues started with the global economic and

financial crisis. Some countries were able to recover from the global recession, unfortunately, Spain was not one of those and the country faced a period of steady decline into global sovereign debt. Unlike other countries in the EU, Spain's issues lies not in the size of the debt in the public sector, rather it is due to the liabilities found in the private sector and households. The issue began, when interest rates for property and real estate became very low, leading to reckless lending and borrowing by citizens for the procurement of property, which lead to a huge property bubble. As is usual with all bubbles, the Spanish property bubble burst and the prices of properties dropped drastically. Another issue faced by Spain was overspending. With a steady increase in worker's wages, there was an increased spending, which led to inflation. Normally, the right thing to do I such a situation would be to devalue the country's currency, however, Spain cannot afford to do that because they commonly share the Euro with other members of the Eurozone and Spain devaluing their currency would ultimately affect other Eurozone member countries (Knight, 2012).

Impact of the sovereign debt crisis on Economies and Social life

Having a high sovereign national debt affects the economy of any country in multiple ways. The banking and financial industry is the most affected by the sovereign debt crisis. When a country declares that it is facing a debt crisis, automatically, that country becomes unable to participate actively in capital markets and government bonds from that country loses a lot of value. For this reason, borrowing and lending activities among banks locally and internationally becomes very stringent. Everyone wants to hold onto their funds due to uncertainties and lack of

confidence. Capital necessary for increased productivity and investments becomes minimal. The banking and financial sector plays a huge role in a nation's economy and when the banking system becomes at a standstill, other economic activities are adversely affected. This is because banks provide the financing for many public and private projects and when there is no finance these projects cannot be executed. Private investors will also be skeptical about investing in these projects. If projects cannot be initiated nor executed, then there will be no job opportunities for the employed and unemployed. With no projects available and no funds to pay for already completed projects, companies will not have enough funds to be productive and keep the ball rolling. This will lead to job cuts and no new job vacancies. Thus, one of the main effects of the crisis is an increase in unemployment. Sovereign debt leads to unavailability of funds in the country, which requires job cuts. As is seen from data related to the PIGS countries, the unemployment rate is one of the first things to sky-rocket when a country becomes overwhelmed with debt.

The large consumer market of the European Union depends highly on the stability of the Euro. Currently, over 300 million Europeans use the Euro daily. If the debt crisis spreads to other economies in the European Union, the Euro will get devalued and European imports for personal and industrial activities will witness a drastic drop. When countries are unable to pay back debts, it will have a domino impact on other economies in the World. Banks will refuse to lend, businesses will be unwilling to hire new employees and existing employees will risk being fired, and investments will be minimal, leading to recession. This was a similar issue globally between 2007 and 2011, when the World witnessed a global recession. The global financial crisis in 2007 caused by the global banking crisis transcended into the sovereign national debt crisis, which

started in 2010 and still being faced by several countries in the European Union and indeed the rest of the World today.

The sovereign national debt crisis does not only affect economies, but also the social lives of consumers. Austerity measures is the first option considered by most governments. Unemployment leads to indignation and social unrest, leading to riots and an increase in crime rates. Widespread protests by affected citizens is not uncommon and is a way for the people to display their discomfort to the government and urge them to find effective means to end the crisis.

The Banking Sector in Europe

One of the lessons learnt by the European banking sector due to the recession and global economic crisis was the need to be more stringent in their spending and loans processes. Stricter policies and measures were put in place and a recent report by Ernst and Young show that banks are optimistic that the upcoming months would see improved performances due to the results that will be achieved by their restructuring policies (Ernst & Young, 2013). Banks remain the government's primary creditor and when the country is victim to the sovereign debt crisis, the banks will not have access to funds, leading to their inability to lend to the private sector and the economy in general. Banks in affected countries have got unstable balance sheets, thus limiting their access to funds from international wholesale markets, which would have an impeding effect

on the enforcement of country's monetary policy, should the government be expected to default on their debts (Neri & Ropele, 2013). When the financial crisis hit financial institutions globally, Europe was not left out and like other governments in the World, governments in the European Union had to proceed with bailout plans. This led to some countries with weaker economies falling into high sovereign national debt, which empirical studies mentioned earlier shows its link to the financial crisis.

European Union Bailout Plans

The sovereign debt crisis in Portugal, Italy, Greece and Spain if not properly contained could spread to other parts of Europe. Investors will critically consider investing in other European Union countries with slow GDP growth as well as those who have not maintained a substantial and active financial and credit markets. The general fear would be that if one country in the European Union could fall into sovereign debt crisis, there is a huge risk that another member country in the Union will. Also, if the crisis continues, there is a possibility of a break-up of the Eurozone. This could occur if countries with strong currencies like Germany determine that the continued sovereign crisis in other peripheral European Union countries will affect their economy negatively and can no longer guarantee monetary stability. While this might seem a bit far-fetched, this possibility exists and looms closer with each passing day as Portugal, Italy, Greece and Spain struggle under the impact of the sovereign national debt. For these reasons, it is imperative that concerned authorities in the European Union act quickly to bailout other member states facing crisis.

European Union policymakers are in support of stabilizing credit markets as the steep reduction in lending has been identified as the key reason for the slow recovery (IMF, 2013). Macroeconomic stability and growth relies strongly on healthy credit markets. Putting together a bailout strategy for European Union nations worst hit by the recession and high sovereign national debt is not an easy task. This primarily because each country that has fallen under has got distinct economic issues, different private and public debt structures and different political and social systems. Some policies might go well with one country, while the others may not be willing to conform to proposed bailout plans. The primary concern among European Union countries was that their banking systems and sovereign national debt of affected countries would eventually spread to banks in other Eurozone countries with stronger economies, thus, leading to a spread in economic and financial stability in more European union countries, which could ultimately lead to a devaluation of the Euro, the European Union's common currency. The European Union bailout plans include seeking means to help banks in affected countries to attain sustainable stability through an effective re-capitalization process. However, the challenge lies in the source of the funds to be supplied to failed and failing banks. This is still misty, however, it is speculated that this recapitalization will come from the International Monetary Fund (IMF) and the central banks of individual Eurozone countries. Rescuing Eurozone countries with high sovereign national debt has got to be a collective effort for other member states or they would risk devaluation of the Euro or the break out of some countries from the European Union, which will undermine the original idea for the creation of the Union. This has put a huge responsibility on Germany, which has got one of the most stable economies in the European Union and for this reason, other member states and indeed, the rest of the World look to them to actively participate

in bailout activities for countries which do not have the immediate resources to pay up their sovereign debt.

Understanding the importance of policies that support improvements in the credit market, the challenge as afore mentioned lies in policymakers in the European Union to create policies that will be of benefit to member states, bearing in mind that each country has got their own peculiar set of problems, thus requiring different policies.

Germany's bailout attempts

The European Union could not and cannot afford to have any of its member States to sink in under Global sovereign debt as this would have an impact on the economies of other member States. This is primarily because huge economic debts in one Member State would have an overall impact on the Euro, which is the shared currency of all Eurozone States. In this regard, it became necessary for Eurozone countries to ensure that a viable bailout plan can be negotiated for any member State, should that State fall into economic crisis. Many feel that Germany holds the key in bailing out the rest of Europe from the financial crisis, however, Germany has to deal with their problems. Statistics show that “Only 44% of Germans own their own home, as against 58% of French people, 69% of Italians and 83% of Spaniards. According to a recent Bundesbank study, the average household wealth in Germany is 195,000 euros, as against 229,000 euros in France and 285,000 in Spain” (Bruton, 2013). Evidently, this shows that Germany alone cannot

resolve the problems of the European Union has fallen into as a result of the financial crisis. One of the primary measures Germany has suggested as conditions for bailing out countries like Greece is the imposition of austerity measures.

Implementing such strict austerity measures on Greece has proven to be difficult for the Greek people to cope with and there has been widespread protests among the people, they are looking for a plan B and possibly plan C. Many do not agree with the austerity measures as suggested by Germany and it is seen as the wrong primary choice, thus, other measures are being considered “In simple terms, Schäuble is concerned that the unpopularity of the austerity measures being imposed on Greece as part of the second bailout package would lead to a “wrong” democratic choice.” (Summer, 2012).

Effects and possible consequences of the Sovereign National Debt Crisis in PIGS Countries

The sovereign national debt crisis has acted as a destabilizer for the economic, financial and social infrastructure in these countries. It has also had a number of negative effects on the political stability of these country. Increased unemployment levels and increased austerity measures has brought about widespread unrest, riots and protests among the citizens. If the sovereign debt crisis in Europe is not quickly addressed, there is a danger of it spreading to other countries in the European Union. This is one of the direst possible consequences of the current debt crisis present in some countries in the Eurozone. This is because investors will get more and more skeptical about investing in other parts of the European Union, with the fear that those

countries even though they are currently stable might soon go under. Worse still for other Eurozone countries who might currently have slow economic growth for reasons not related to the present sovereign debt crisis. If government bonds are not purchased by investors, then there will be less funds available for the payment of debts, leading to a vicious cycle of debtors and creditors, so, if banks find it difficult to borrow. Also, if the situation worsens and banks in the weaker Eurozone countries are unable to get investors for their financial and credit markets, their economy will gradually slow down and they too will fall into sovereign national debt. For this reason, a 700 billion Eurozone firewall has been collectively put in place by other members of the Eurozone, to combat the possible spread of the crisis from countries with high sovereign debt to other countries in the European Union (BBC, 2012).

Qualitative Tools and Analysis

The data used in this dissertation merely scratches the surface of the related studies establishing the link between the financial crisis and sovereign national debt. However, the data used in this dissertation observes the relations over an extended period of time and it can be ascertained that little has changed in the financial crisis and its relations to sovereign debt appreciably over time. The sovereign national debt crisis in the European Union is the result of a sequence of events that led to the global recession between 2008 and 2011.

The recession was caused by reckless borrowing and lending in economic and financial markets without adequate risk analysis and consideration, which started primarily in the United

States as well as shady financial deals which involved over-spending in some countries which led to accumulated debts left unpaid. Assets which were used as collateral were devalued due to the recession and could not be used as a means of recouping borrowed funds. These activities sparked off the recession in the United States and being one of the largest economies in the World, which spilled over to other countries, of which countries in the European Union were among those worst hit. This also initiated a tightening of credit policies among banks and other financial institutions, leading to the grind to almost a halt of activities in the credit market, since no one was willing to lend and those who had already borrowed started focusing on paying back what they owe. The countries currently facing the sovereign debt crisis in the European Union include Portugal, Italy, Greece and Spain. Each of these countries are worst hit for several distinct reasons, which include over-spending, tax evasion, unpaid debts, real estate bubbles, corruption and most of all slow GDP growth.

The high sovereign debt crisis in Greece has caused a lot of concern for other member countries in the European Union. Greece incurred high debts due to their over-inflated expectations from the Athens Olympics held in Greece, which led to large borrowing and excessive spending. Unfortunately, the returns were below their initial expectations and they were left with a heavy debt. This is understandable, however, this was not the only issue that plagued the Greek economy, poor management and an unprecedented increase in wages that did not match the slow increase in their GDP growth. These countries with their different economic woes all have two things in common; large debt and slow GDP growth. Resolving these two primary issues is key to mitigate and possibly resolve issues related to sovereign debt crisis.

These issues can be resolved by initiating policies that will stimulate the monetary and credit markets in these countries as a means of increasing their overall GDP. Instilling initiatives that will increase overall policy in the economy of these countries is also important as it will allow both public and private investors to invest in these countries and thus initiate the smoother flow of funds in these countries. The global recession in 2007 had a primary resounding effect that locked down cash flow globally.

Recommendations

Solving high sovereign national debt is never easy and requires a lot of time and planning. Some recommendations towards solving the high sovereign national debt in the PIGS countries. This requires a step by step process and varies from country to country, depending on the core reasons each country fell into financial deficits. These steps primarily consists of;

- Evaluating the economic status of the country. This requires collective efforts from economic and financial experts within these countries as well as internationally, primarily because, there are certain things that only economists and financial experts who are from the country will be able to relate to. However, international experts will be able to see things from a broader perspective.
- Working together, both parties can analyze the country's economic situation and come up with a solution that will aid economic growth. One of the primary problems synonymous with the PIGs countries is a need to increase their GDP.

- Creation of economic reforms that would stimulate growth, initiate cuts to public services and social welfare system, however, this needs to be done smartly, so as not to spark off public indignation.
- For Portugal there is a need to limit their budget deficit. This can be done either by limiting their spending or being more productive so as to increase their income. This can be done by increasing exports over imports, as well as increase overall productivity, which is the primary issue for a country like Spain.
- For Spain, a balance has to be reached in the real estate sector to stabilize price hikes caused by the real estate bubble. Increasing public and private spending will also lead to a more vibrant economy. To do this, the government needs to find a way to restore hope to the public and private sectors. This can be done by investing in creating a viable environment for public and private investing.
- Italy poses the biggest problem due to their large economy, thus, they will need larger amounts from creditors. Italy needs to tackle issues related to tax evasion and corruption. Italy already has an active economy, however, internal issues related to the management of finances and corruption has plagued Italy for a long time and is not helping matters in these critical times of crisis.
- For Greece, overspending has been their primary problem. They spent too much on the Olympics event in Athens and did not get the expected returns and are now paying the price. In this case, there will be a need to cut down unnecessary spending for a couple of years and put the bailout money into developing infrastructure that will promote revenue generation.
- Tourism which has been a good source of revenue for Greece has suffered greatly due to the sovereign debt crisis. Some money should be invested to revive the tourism industry as this will attract more visitors and thus more revenue will be generated.

- A key point which actually helped the US economy at a larger scale is to increase the employment rate which would stimulate the economy as that encourages people to build up lives by spending back in the country, Being able to take faculties from banks benefiting from those low interest rates that ECB has applied.

Countries that have fallen under due to sovereign national debt is in dire need of support from other Eurozone countries and from the West. Local and international financial institutions have also got a major role to play in helping out with economic and financial reforms to help reduce debt. At the moment, nothing further needs to be done towards providing relief for countries deep in debt. According to Antonis Samaras, Greece needs a two year breathing space to allow them meet up to the tough bailout conditions (BBC, 2012). A little time should be given to these countries to strategize on meeting up to the tough demands and targets set by lenders from the IMF and the European Union. This is to allow these countries to evaluate and re-evaluate the best means for them to meet up to the set demands and goals set by their lenders.

As mentioned earlier, increasing the GDP growth is a good way of mitigating and possibly putting an end to the sovereign debt crisis in countries within the European Union and in general. Unfortunately, it is not so simple. The first step towards increasing GDP growth is to create policies that will stimulate economy and create increase productivity in general. This can be done by encouraging investments and educating consumers on the need to keep consumption spending to minimum. Empowering consumers is also important to increase overall GDP growth. Policies supporting the growth of credit markets are perceived by most countries as a good place to start, as a well-functioning credit market can help improve macroeconomic development, growth and stability. According to the IMF analysis, many countries face weak bank credit growth and this has impacted their overall economic growth (IMF, 2013). According to the October 2013 IMF report, some of the primary factors affecting credit include restructuring corporate

and household policies. To do this, more governments should consider the enforcement of a variety of policies to be put in place to ease up the flow of the supply of credit. According to the IMF report for 2013, some these policies include;

1. Corporate debt restructuring: Governments in the European Union should have restructured corporate debts by taking leading roles through the use of state owned banks and asset management companies and also by introducing modified rules faster out of court resolution programs for corporations that have gone bankrupt.
2. Household debt restructuring: Similar to the corporate debt restructuring, household debt restructuring entails the modification of bankruptcy rules by the government to enable speedy out of court settlements This is especially useful in cases where the amount loaned has become higher than the value of the asset (in this case a home), due to the reduced value of the asset. This can done through the use of household debt restructuring programs which involves the intervention of state owned banks in such issues
3. Bank restructuring: To avoid the direct recapitalization of failing banks by the government through the implementation of programs to purchase distressed bank assets, the government can implement a requirement where banks require a higher insurance deposit from the banks to ensure that they have enough funds to prevent their loan deposits from being quickly drained
4. Implementing better Monetary policies: More central banks in the European Union should ease the required collaterals for other banks and ease credit through the use of corporate and mortgage bonds and other assets in the private sector, as well as the setup of restructured lending facilities to promote the availability of loans to banks.

5. Fiscal Programs: This involves the institution of subsidies through the use of guarantee programs for loans by state sponsored institutions
6. Financial Regulations: This involves the implementation of regulations that will ease the initial capital requirements from small and medium enterprises before the issuance of loans, especially for viable business opportunities.
7. Capital Market measures: More governments should consider the diversification of the available options for the financing of businesses and reduce the barriers for the issuance of corporate bonds to small and medium sized businesses.

To mitigate and ultimately solve the sovereign debt crisis in the PIGS countries, there is a need to align their strategy with those countries who their economic strategies have already started showing signs of positive economic growth. For example, studies have shown that Dubai's economy is following an upward trend. Dubai was one of the worst hit when the financial crisis took the financial and banking markets unawares. However, they implemented some new economic policies aimed at making it more attractive for investors, which brought an influx of investors to the country and this seems to be seeing some progress and driving the Dubai economy forward. Countries such as Portugal, Italy, Greece and Spain who are in distress due to the sovereign debt crisis should consider using a variety of the aforementioned monetary and credit policies to stimulate their monetary markets to promote growth and productivity, which are key elements to enable the increase in their overall GDP, which in turn will help in the payment of existing sovereign debt. Their policies and strategies should be aimed at making their economic environment more viable for investors. This has been lacking in these countries, apart from the property bubble in Spain, which burst with dire consequences. Policies to attract investments should be solid and attractive. For example, one very attractive policy to encourage investments is reduced taxes.

The table below excerpted from the IMF October 2013 report shows some countries which have already implemented some of these policies or something similar to the aforementioned monetary policies:

Table .4

Credit Policies Implemented since 2007

	Enhancing Credit Supply					Supporting Credit Demand	
	Monetary Policy ¹	Fiscal Programs on Credit	Supportive Financial Regulation ²	Capital Market Measures	Bank Restructuring ³	Corporate Debt Restructuring	Household Debt Restructuring
Euro Area							
Austria	Y				Y		
Belgium	Y	Y		Y	Y		
Estonia	Y					Y	Y
Finland	Y						
France	Y			Y	Y		
Germany	Y	Y			Y		
Greece	Y	Y			Y	Y	Y
Ireland	Y	Y			Y	Y	Y
Italy	Y	Y	Y	Y	Y	Y	Y
Netherlands	Y	Y		Y	Y		
Portugal	Y	Y			Y	Y	Y
Slovak Republic	Y						
Slovenia	Y	Y	Y		Y	Y	Y
Spain	Y	Y		Y	Y	Y	Y
Other Advanced Europe							
Denmark	Y	Y			Y		
Iceland		Y			Y	Y	Y
Norway	Y	Y					
Sweden	Y						
United Kingdom	Y	Y		Y	Y		Y
Non-European Countries							
Australia	Y						
India	Y	Y	Y	Y	Y	Y	
Japan	Y	Y	Y	Y	Y	Y	
Korea	Y	Y	Y	Y	Y	Y	Y
South Africa							
United States	Y	Y		Y	Y	Y	Y
Non-Euro-Area Central, Eastern, and Southeastern Europe							
Albania			Y			Y	Y
Bosnia and Herzegovina					Y		
Bulgaria			Y				
Croatia	Y	Y	Y			Y	
Czech Republic							
Hungary	Y	Y					Y
Latvia					Y	Y	Y
Lithuania		Y					Y
FYR Macedonia	Y	Y	Y				
Moldova	Y					Y	Y
Montenegro		Y					
Poland		Y					
Romania		Y	Y			Y	
Russia	Y	Y	Y		Y		
Serbia	Y	Y	Y		Y	Y	
Turkey							
Ukraine	Y	Y			Y	Y	

Source: IMF staff.

Note: This table lists the various types of policies countries have implemented since 2007, based on Appendix Table 2.1, without consideration of the scope, duration, or effectiveness of those policies. "Stress test" and "coverage enhancement of deposit insurance" are excluded from the policies supporting credit demand. EU-wide fiscal programs (e.g., through the European Investment Bank and the European Bank for Reconstruction and Development) are not included although they are available for firms in the EU member countries (and in some non-EU European countries).

Source: (IMF, 2013).

Setting up recapitalization programs should be the first step. The government will not simply rescue failed and failing banks, rather, there should be a full take over after the banks acknowledge their losses. A similar approach was taken by Sweden in 1992 when they faced a similar financial crisis and had to find a way to resolve it before it got out of hand. In the 1990's when Sweden faced What the Swedish government did was not to simply take over the bad debts due to real estate lending gone bad due to depreciation of assets, however, what they did do was to ask the banks to state their losses before approaching the government for recapitalization and writing warrants to the government, which effectively turned the government to owners of the assets (Dougherty, 2008). The distressed assets were then sold and the funds flowed into the economy. The government then made the failed banks public again by selling its shares, thus enabling them to recoup even more money. The Swedish government at the time spent about \$18.3 billion, which amounted to about 4 percent of its GDP at the time (Dougherty, 2008). After the bailout and resale of the failed bank shares, the Swedish government did a recalculation and found out they had recouped all the money invested in the bailout, which basically means that it was a win-win situation for everyone. The ailed banks were rescued by the government and at the same time, the Swedish government was able to recoup their bailout investment. Portugal, Italy, Greece and Spain should consider implementing a bailout recapitalization plan similar to what was done by Sweden and see how it goes. Since it has been proven to have worked for Sweden, there is a high probability it will work for all or some of the aforementioned countries who face a similar situation. The method used by Sweden is most applicable to Spain, who face the same issues related to uncontrolled real estate lending and the subsequent devaluation of real estate assets.

Preventing Recession and Sovereign Debt Crisis

The economic and financial markets globally has learnt a lot from 2007 till date. Evidently, the recession was the primary stimulant for the unmanageable sovereign national debt being faced by Portugal, Italy, Greece and Spain. Though each country has got their own peculiar problems which led to the sovereign debt crisis, the underlying issue which could have prevented this or at least mitigated it would have been an increase in their GDP growth. Portugal, Italy, Greece and Spain all face slow GDP growth, thus leading to their inability to pay off their sovereign debts. One of the first measures they need to take is to increase their GDP growth. GDP growth requires that the economy gets stimulated in a way that would increase consumer productivity. Consumer productivity requires that consumers get empowered to have the necessary skillset as well as the resources to increase their productive capacity. Also, it is important to promote and encourage investments. This requires that the Government enforce policies that will encourage investors, by giving them an offer they cannot refuse. The government needs to put policies in place that will enable this to happen.

For example, in the United Arab Emirates, the government of Dubai created trade free zones and a tax free labor force. This has encouraged investors and businesses to invest in setting up their businesses in the country and has attracted a competent workforce to the region. Today, Dubai's economy is looking bright and there has been an increased influx of investors in the region. This has led to a growth of about 4.9 percent in the country's GDP for the past year (Reuters, 2013). Like other countries in Europe and the rest of the World, Dubai was hit hard by the global recession, however, they already had in place policies that encouraged productivity and investments. The government of Dubai also did all they could to encourage investments in the country. This is a good example of how government policies can help encourage and increase investments and also increase productivity. An influx of investments with a corresponding increase in consumer empowerment and productivity is a proven way of increasing overall

GDP growth, which is key to mitigating sovereign national debt as countries will have the resources to pay their debts as can be seen in the case of the United Arab Emirates.

Creating and enforcing policies that will stimulate growth in European Union countries is not an easy task and requires some austerity measures to be put in place. European Union countries are still working on policies that will increase austerity, rather than stimulate growth. These governments need to find a way to encourage investments into their economy instead of focusing primarily on austerity measures. Austerity tends to kill the morale of the citizens, causing their productive workforce to seek opportunities in other parts of the World, which in effect will reduce the overall productive workforce. This will then have adverse effects on the overall GDP growth of the country. Analysis by the IMF has shown that constraints in the credit market differs from country to country (IMF, 2013) thus, policies supporting credit markets should be made based on specific analysis specific to each country, bearing in mind the constraints faced by each government. Some of the primary constraints towards credit growth include Collateral constraints and debt overhang. Collateral constraints refers to issues related to using the issuance of collateral before a credit is given. In some cases, the price of the collateral will drop due to demand and supply. Lower collateral prices will restrict bank funding and will tighten credit supply (IMF, 2013).

Debt overhang prevents firms who already have high debt overhead from pursuing profitable business prospects, which in turn lowers their credit demand. This is also applicable to households who already have several mortgages. Both firms and households would want to focus on paying off these loans before taking new ones, which leaves a period of stagnancy in the credit markets. To overcome these constraints towards the growth of credit markets, policies such as

Increasing the confidence of investors to invest in the country and increasing the confidence of citizens are key elements necessary to fight the sovereign debt crisis in the European Union.

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- * Austria
- * Belgium
- * Bulgaria
- * Croatia
- * Cyprus
- * Czech Republic
- * Denmark
- * Estonia
- * Finland
- * France
- * Germany
- * Greece
- * Hungary
- * Iceland
- * Ireland
- * Italy
- * Latvia
- * Liechtenstein
- * Lithuania
- * Luxembourg

- * Malta
- * Netherlands
- * Norway
- * Poland
- * Portugal
- * Romania
- * Slovakia
- * Slovenia
- * Spain
- * Sweden
- * United Kingdom