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EUROPEAN SOVEREIGN DEBT CRISIS: CAUSES AND IMPLICATIONS

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Abstract

After the financial meltdown in 2008, Europe is now struggling with sovereign debt crisis. The crisis, which is creating chaos in the economy and politics of the continent, has started impacting the global economy. The present article aims to find out the causes and implications of European sovereign debt crisis. It argues that the crisis is the result of some structural flaws in the Economic and Monetary Union (EMU) of the European Union (EU) and in global economy. The article underscores that the crisis is changing the political landscape of Europe and, with rising voice of disunity, threatening the existence of euro and the EU.

1. Introduction

The ongoing European sovereign debt crisis can be depicted as a later episode of the global financial crisis 2008. In the immediate aftermath of the financial meltdown in 2008, the global financial crisis made an important shift in Europe - risk of default shifted from the private banking sector to sovereign states. With fear of default by some sovereign states and fear of contagion for others, the European sovereign debt crisis has become a nightmare for the continent. Moreover, the crisis has made the global economic outlook gloomier. The global economy, which is yet to recover from the global financial crisis originated from the sub-prime mortgage crisis in the US, is in the threat of another series of crises - explosion of euro, financial chaos in Europe, prolonged recession in the European Union (EU) countries, negative impact on the export of the US and China and so on.

The present article aims to investigate the causes and implications of European sovereign debt crisis. In doing so, it will attempt to answer the following questions. What has led the European countries to a situation that they can no more manage their government debt? Are the concerning European

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governments too generous, or is there any structural flaw that has originated the crisis? What was the role of global financial crisis in shaping the debt crisis? Is the crisis related to present global economic structure? How did the crisis affect the people in the crisis ridden countries? What will be the implications of the crisis for the eurozone or the Economic Monetary Union (EMU), the EU, the whole Europe and the global economy?

The article is organised as follows. Following the introduction, section two provides an overview of the European sovereign debt crisis. Section three makes an elaborate attempt to identify the causes of the crisis. Section four deals with the probable implications of the crisis and section five concludes the article.

2. European Sovereign Debt Crisis: An Overview

The European sovereign debt crisis appeared on the scene in November 2009, when the newly elected socialist government of Greece announced that its predecessor had concealed the size of the country's ballooning deficit and the actual budget deficit of the country would be 12.7 per cent of GDP - more than twice the previously announced figure. Meanwhile, the country's government debt reached to 140 per cent of GDP. High debt burden along with high fiscal deficit made Greece vulnerable in the eye of credit rating agencies.[1] Hence, in December 2009, three credit rating agencies – Fitch, Standard and Poor's and Moody's, downgraded Greece's sovereign credit rating.

With the aim of reducing debt, Greece put in place two austerity packages - first one in February 2010 and second one in March 2010. But the austerity packages could not calm down the market. Amidst the fear of default or a debt restructuring by Greece, borrowing cost for Greece started creeping up and by April 2010 it reached to a record high level. High borrowing cost prompted the Greek government to appeal for a bailout from the eurozone and the International Monetary Fund (IMF). The credit rating agencies became worried that Greece would not be able to face the political, economic, and budgetary challenges necessary to put the public debt burden onto a sustained downward trajectory. It led them to downgrade Greece's sovereign credit rating to junk status.[2] In May 2010, the eurozone nations and the IMF declared a bailout package of €110 billion for Greece. Yet, Greece's growth outlook remained gloomy and so was its credit rating. By June 2011, Greece became the lowest rated country in the world.[3]

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[1] "Fitch downgrades Greece to BBB+", 08 December 2009, available at http://ftalphaville.ft.com/blog/2009/12/08/87676/fitch-downgrades-greece-to-bbb/, accessed on 30 March 2012.

[2] "S&P downgrades Greece ratings into junk status", Reuters, 27 April 2010.

[3] "Greece falls to S&P's lowest rated, default warned", Reuters, 13 June 2011.

Greece was not the only country in such problem. Within January 2012, Hungary's sovereign debt was degraded to junk status by the above mentioned three credit rating agencies. In January 2012, credit rating of 9 out of 13 eurozone countries including France and Austria was downgraded. Cyprus' sovereign debt was also declared junk by Fitch in June 2012.

Few days after the declaration of bailout package for Greece in May 2010, the EU leaders, along with the IMF, declared a larger rescue package of nearly € 750 billion (nearly US$ 957 billion) to deal with the continent wide sovereign debt crisis. The rescue package included the newly created European Financial Stability Facility (EFSF) with initial capital of € 440 billion (nearly US$ 560 billion). Also, as part of the rescue plan, European Central Bank (ECB) began buying eurozone government bonds directly to inject cash into the financial system.

The European leaders hoped that the declaration of the rescue package would calm down the market by assuring about the solvency of euro countries.[4] But in the following months, interest rate of borrowing for the debt ridden countries began creeping up again. This was because countries which had gone through drastic cut in government expenditure in order to meet deficit targets fell further behind as their economies slowed and revenues declined.[5] Eventually, bailout arrangements were made by eurozone members and the IMF for Ireland in November 2010 and for Portugal in May 2011. Ireland received a bailout of € 85 billion (nearly US$ 108 billion); for Portugal the amount was € 78 billion (nearly US$ 100 billion).

Initially Ireland declined to accept the bailout which the country considered to be an attack on its sovereignty[6]; but finally it had to accept the bailout under the pressure from the financial markets as well as the European leaders.[7] In fact, the bailout programmes could not improve the debt scenario, if not aggravated it. The austerity measures imposed on Greece, Ireland, and Portugal in return of the bailout packages, led the already weakened economies into recession and contrary to the hope of its designers, did little to ease their debt burden. Greece's debt burden even increased. Renewed debt crisis over the winter of 2010 and

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[4] "Europe Officials Move to Carry Out Aid Package", *The New York Times*, 10 May 2010.

[5] "European Debt Crisis", *The New York Times*, available at http://topics.nytimes.com/top/reference/timestopics/subjects/e/european_sovereign_debt_crisis/index.html?8qa, accessed on 15 June 2012.

[6] "Ireland denies pressure to seek bailout", Market Watch, 14 November 2010, available at http://articles.marketwatch.com/2010-11-14/markets/ 30809841_1_justice-minister-dermot-ahern-ireland-eu-european-union-officials, accessed on 15 April 2012.

[7] "After weeks of denying need for bailout, Ireland capitulates", *Los Angeles Times*, 22 November 2010.

spring of 2011 led to the fall of governments in Ireland and Portugal, and unrest in Spain.[8]

By summer 2011, the debt crisis began affecting Italy and Spain, the third and fourth largest economy of eurozone. Interest rate of borrowing soared for Italy and Spain. The European Central Bank responded by buying large amount of Italian and Spanish bonds but it could not calm down the market. This time, worries were even greater as Italy and Spain were too big economies to be bailed out. Market also began worrying about the banks in France and elsewhere which were exposed to risk due to their large holding of debt from Greece and other shaky governments.

Official figures released in August 2011 showed that the continent was tipping toward a second recession with quarterly growth rate falling to its lowest in two years. Germany – the Continent's powerhouse that stood behind almost all bailout mechanisms for eurozone countries – slowed almost to a standstill. As it was revealed that the debt crisis had started infecting the rest of the 17-country eurozone, most of Europe's main stock indexes lost ground.

In September 2011, European officials warned Greece that they would withhold the next installment of its bailout funding in October 2011, if it did not push through further radical cuts in government spending. It was really a serious threat for Greece as such a withholding would certainly lead the country to bankruptcy. In fact, the country was going to have run out of cash in August 2011, unless there was a new installment of money from the first bailout.[9] Although the government of George Papandreou hesitated, the cut in government spending was pushed through ignoring days of giant street protests. However, George Papandreou had to pay the political cost of the austerity package by stepping down in November 2011. Lucas Papademos swore as the new Prime Minister in a new coalition government.

In October 2011, the EU leaders engineered a new plan to resolve the European sovereign debt crisis. The plan, among others, included requesting the holders of Greek debt to cut the value of their holdings by 50 per cent and leveraging the capacity of the EFSF up to € 1 trillion. Meanwhile in a meeting in August 2011, German Chancellor Angela Merkel and French President Nicolas Sarkozy called eurozone members for enshrining a "golden rule" of balancing budget into their national constitutions. Both leaders ruled out issuing euro bonds, a collective bond to share responsibility for government debt across member states, which was being prescribed by many analysts. Instead, they proposed to form "a true economic government for the eurozone."[10] Eventually at

[8] "European Debt Crisis", The New York Times, *op. cit*.
[9] *Ibid*.
[10] "Sarkozy and Merkel Vow Fiscal Unity for Euro Nations", *The New York Times*, 16 August 2011.

the end of January 2012, the EU members, except the UK and the Czech Republic, agreed the intergovernmental "Treaty on Stability, Coordination and Governance in the Economic and Monetary Union." The treaty required each signatory state to incorporate a "balanced budget rule" into national legal system or at constitutional level. It would provide the European Court of Justice with power to check whether nations implement budget rule properly and to fine them up to 0.1 per cent of national output (GDP) if they fail to do so. It also includes provision for more automatic mechanism to force states to correct budget deficits.

In early 2012, Lucas Papademos faced the same fate as George Papandreou. France and Germany again threatened Greece to withhold the second bailout package without further drastic cuts in spending. At that moment, the bailout package was badly required by the country to avoid a default as its next debt payment would come due in March 2012. The austerity package proposed by Germany and France included a 22 per cent cut in the benchmark minimum wage, cuts of 150,000 jobs in public sector and loosening of public sector job protections. With elections looming as soon as April, for Lucas Papademos's coalition, the austerity package sounded nothing but a call for committing political suicide. The Greek Prime Minister, however, managed to approve the new austerity measures by the parliament. Greek workers responded by walking off the job for the second general strike in a week. Street demonstrations in Athens turned violent, and 80,000 people marched in protest the day before parliament approved the package. Although Greece may have dodged a default with its last-minute bailout deal, doubt still remains over its ability to repay its staggering debts.

By January 2012, 9 out of 17 eurozone members, including France and Austria, found themselves caught in debt crisis. Standard and Poor's downgraded Portugal's credit to junk status while Italy and Spain's debt was downgraded by two notches. The ratings revisions came at the end of a week in which French President Nicholas Sarkozy and Italian Prime Minister Mario Monti warned German Chancellor Angela Merkel that the crisis could deepen if steps were not taken to fuel growth. Growing voice against the austerity measures, even among her allies, prompted the German leader to admit for the first time that the harsh programme of austerity she had been pushing on the eurozone was not a cure-all for the crisis.[11]

Throughout the spring of 2012 sense of resistance to the German prescription of austerity grew stronger. In May 2012, voters in France and Greece punished politicians favouring austerity. In Greece, votes of the two traditionally dominant parties were cut in half while anti-austerity parties - both far right and far left, gained. On the other hand, French voters ousted conservative President Nicolas

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[11] "European Debt Crisis", The New York Times, *op. cit*.

Sarkozy, one of Chancellor Merkel's closest allies in pushing harsh austerity measures, in favour of socialist Francois Hollande.

Before election, Francois Hollande declared that he would renegotiate the EU fiscal treaty if he was elected.[12] Therefore, after election, he challenged the "inevitability" of the austerity measures. Germany warned that the EU fiscal treaty was not negotiable. Angela Merkel's only concession to the new French President was to say that Germany would discuss new policies to boost economic growth but only after the ratification of the fiscal treaty.[13]

In a week after Francois Hollande was elected as President, Angela Merkel's Christian Democratic Party suffered a stinging defeat in parliamentary elections in Germany's most populous state, North Rhine-Westphalia. In the election, "Ms. Merkel and her party had hoped to sway the electorate with their hard line on Europe, painting Ms. Kraft almost as a domestic version of the spendthrifts the Germans complain about in Greece, Portugal and other economically struggling nations in Europe. Instead, the voters handed Ms. Kraft, who pushed the state deeper into debt but hired more police officers and teachers and abolished fees for higher education, a significant victory."[14] This election result, along with weakening or ousting of a number of allies in other countries, led Germany to talk with a somewhat compromising voice which was unimaginable even a few months ago.

Thus, on one hand, with deepening crisis in Spain and Italy and a double-dip recession in a wide range of European countries, the European sovereign debt crisis is entering in a critical stage and on the other hand, debate on the solution of the crisis is taking a new course with rising voice against Germany-led austerity measures.

3. Causes of the European Sovereign Debt Crisis

3.1 *Are those European Governments too Generous?*

Popular belief is that it is the profligacy of some European governments which is to be blamed to create the European sovereign debt crisis. But figure 1 and 2 suggest that the governments of the troubled countries, namely Greece, Cyprus, Hungary, Ireland, Portugal, Italy, and Spain cannot be blamed for being too generous. Figure 1 shows that all these countries' government spending is lower than countries like France, Denmark, and Sweden which are far from the

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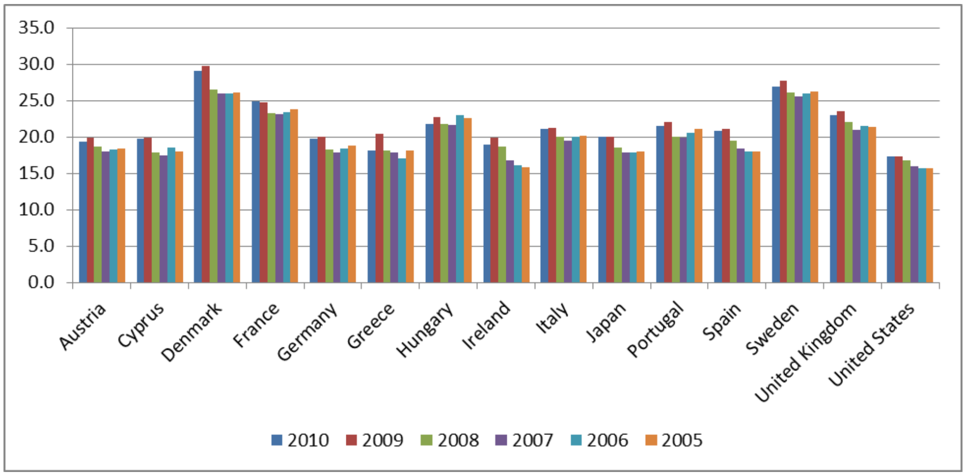
[12] "25 EU countries sign up to German-led fiscal treaty", 31 January 2012, available at http://www.euractiv.com/euro-finance/25-eu-countries-sign-german-led-news-510489, accessed on 15 May 2012.

[13] "Germany warns Francois Hollande eurozone austerity treaty not up for negotiation ", *The Telegraph*, 07 May 2012.

[14] "In Rebuke to Merkel's Party, Social Democrats Win German Vote", *The New York Times*, 13 May 2012.

crisis of managing debt. (France is not immune from the sovereign debt crisis but the risk of France origins from the fear of contagion, not from debt). Among the troubled countries, government spending of Hungary, Italy, and Portugal are a bit higher than their peers, but they too spend less than the UK. On the other hand, government spending of other troubled countries – Greece, Ireland, Cyprus, and Spain are quite comparable with countries like Germany, Japan, and Austria which are considered to be quite strong economies.

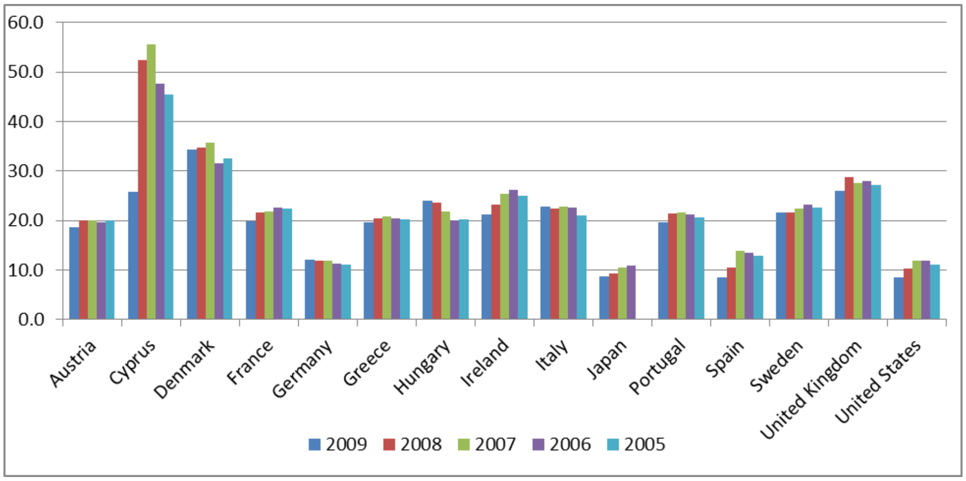
Figure 1: General Government Final Consumption Expenditure (% of GDP)



Source: World Bank, available at http://databank.worldbank.org/Data/Views/VariableSelection/SelectVariables.aspx?source=World%20Development%20Indicators%20and%20Global%20Development%20Finance#, accessed on 15 March 2012.

Then, is it the case that the governments of the troubled countries earn less tax revenue, which has compelled them to borrow more than others? Figure 2 suggests that this is not the case. Except Spain, all the troubled countries' tax revenues are comparable with countries like Austria, France and Sweden and much higher than countries like Germany, Japan and the US. Tax revenue of Cyprus, one the most hardly hit countries, is exceptionally higher than others. Hence, statistics does not support the popular belief that the generosity of the troubled countries is at the root of the crisis.

Figure 2: Tax Revenue (% of GDP)

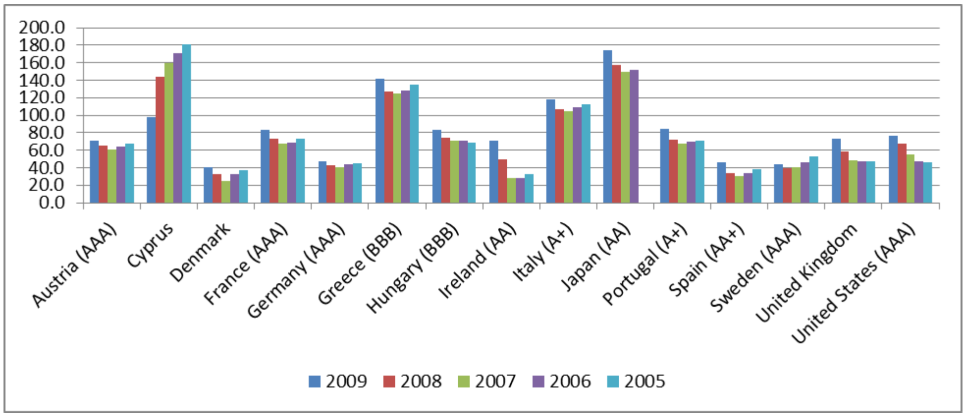


Source: World Bank, available at http://databank.worldbank.org/Data/Views/VariableSelection/SelectVariables.aspx?source=World%20Development%20Indicators%20and%20Global%20Development%20Finance# , accessed on 15 March 2012.

3.2 *Is Debt the Sole Reason of the Crisis?*

Figure 3 shows the debt performance of the troubled countries compared to others. Debt of Cyprus, Greece and Italy is really higher, comparable to Japan only. But the other countries are not in so bad situation. Debt of Hungary, Ireland, and Portugal are comparable to France and debt of Spain is comparable to the UK and Germany. The debt scenario implies that mounted debt cannot be identified as the sole reason of the crisis. The argument is further strengthened if one looks at the debt performance of the countries *vis-à-vis* their sovereign credit rating. Hungary's debt performance is much better than Japan and comparable to France. But in contrast, Japan and France enjoys AA and AAA rating respectively while the rating of Hungary is BBB, just at the brink of junk status.

Figure 3: Central Government Debt (% of GDP)



Note: Countries' credit ratings given in parentheses refer to Standard and Poor's rating in January 2010.
Source: World Bank and Exclusive Economy, available at http://exclusiveeconomy.com/2010/02/sp-credit-ratings-for-countries-and-states/, accessed on 05 May 2012.

In fact, the credit rating agencies did not downgrade the countries' credit rating solely on the ground of debt. They downgraded the credit rating of the above mentioned countries on three main grounds: first, the countries showed poor growth outlook which was supposed to reduce their capability to repay; second, to manage the fiscal pressure, countries were required to run such tight austerity measures which was politically difficult to do and hence uncertainty prevailed about governments' success to implement needed fiscal management; third, there existed fear of contagion. All these, according to the credit rating agencies, had made those sovereign debts riskier than before.

Thus, the European sovereign debt crisis is neither stemmed from mounted debt only nor it is a result of inability of concerning governments; rather it is resulted from some structural flaws that the countries are facing for years. The flaws lie firstly in the structure of the EMU and more importantly in the structure of the global economy. The three above mentioned reasons of downgrading sovereign rating also indicate to these structural flaws.

3.3 *Structural Flaws in the EMU*

Since the inception of EMU, it has been debated that the EU is not suitable to form an optimum currency area (OCA). Conventional approach sets forth some criteria for OCA. These are - factor mobility, economic openness, price and wage flexibility, mechanism for fiscal transfer to balance out surpluses and deficits, integration of financial markets, product diversity, difference in inflation rates, similarity of shocks and variability of exchange rate.[15] It is argued that the EU lacks in some of these criteria.

First, factor mobility, particularly, labour mobility is relatively low in Europe. In 2000, labour migration within the EU members was only 0.1 per cent of the total EU-15[16] population while labour migration between the US counties was 5.9 per cent of its total population in 1999.[17]

Second, the EU lacks in the mechanism of fiscal transfer which helps to overcome harmful effects of asymmetric shocks. Only 1.24 per cent of the EU's total GDP is used for fiscal transfers while in the dollar zone, the central government compensate about 40 per cent of falls in any state's GDP with fiscal transfers.

Third, in OCA wages and prices have to be flexible and responsive to competitive market forces. But in the EU, it is alleged that German wages have been repressed artificially and most of Germany's 'export miracle' was not due to intensive increases in productivity rates, but the result of extensive wage (and demand) repression.[18] The artificially high competitiveness of German unit labour costs compared with Spain, Italy or Greece has created another imbalance in the EU.

Fourth, OCA requires similarities between rates of inflation among the members. The EU went through the same process but while meeting the condition, another problem was created within the EU. Under the Growth and Stability Pact, member states of the EU adopted strategies to adapt to the proposed inflation rate but they had to do it at the expense of high unemployment rates.[19]

Finally, OCA requires high degree of diversification in the member economies which make them less vulnerable to sector-specific shocks. Though

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[15] Erdoğan Kotil, Fatih Konur and Kemal Çakıcı, "Assessment of the Euro Zone According to the Criteria of the Theory of Optimum Currency Areas", *International Research Journal of Finance and Economics*, Issue 27, 2009, p. 30.

[16] The EU-15 refers to Belgium, Denmark, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal, Finland, Sweden, and the United Kingdom.

[17] F. F. Heinz and M. Ward-Warmedinge, *Cross-border Labour Mobility within an enlarged EU*, European Central Bank, Occasional Paper Series, No. 52, October 2006, p. 7.

[18] Annemarie Detlef, "Causes of the Sovereign Debt Crisis", 16 April 2012, available at http://www.e-ir.info/2012/04/16/causes-of-the-sovereign-debt-crisis/, accessed on 02 May 2012.

[19] M. Baimbridge, B. Burkit, and P. Whyman, "Is Europe Ready for EMU? Theory, Evidence and Consequences", 1998, available at http://www.brugesgroup.com/mediacentre/index.live?article=102, accessed on 20 March 2012.

all industrialised member states of the EU fulfill this criterion, weaker economies like Greece were relatively undiversified.

According to the theory of OCA, if a monetary union is not an OCA, then some of its participants will face severe macroeconomic costs, like persistent higher unemployment and lower output that will outweigh the micro-economic benefits of a single currency.[20] And this is what the EMU is experiencing now.

As mentioned before, due to artificial repression of wages, Germany is highly competitive compared to countries in the European periphery like Greece, in terms of unit labour cost. When the EMU locked these countries of different levels of competitiveness and technological development into a common currency, countries in the European periphery found their markets flooded by more competitive German products which eventually demolished their productive structure and industrial capacity.[21] These peripheral countries had already been suffering from unemployment due to adaptation of the proposed inflation rates required for the entry into the EMU. Now trapped with unemployment and damaged industrial capacity, economic growth in the periphery began to rely on easy and cheap credit thanks to the deregulation of financial sector. By relying on cheap credit, those countries became vulnerable to financial crises like the present one.

At the first hit of the financial crisis, the EMU member countries responded in the similar way as the US did. They injected quantities of fresh public money, borrowed by the member states, into their banks, involved in the speculation process, to replace the 'departed' private money, i.e., the troubled derivatives. But the EMU has some shortcomings compared to the US to deal with The Great Recession resulted by the global financial crisis.[22] First, the EMU cannot write blank checks like the US. As dollar is the world's reserve currency, the US can do it, since it will make very little difference for the value of the dollar, at least while the crisis is unfolding. Second, the EMU does not have an internal surplus recycling mechanism like the US (e.g. a federal budget or a military-industrial complex) that would allow it to transfer profits from surplus region (e.g. Germany) to deficit regions (e.g. Greece). Third, the EMU member countries cannot devalue their currencies to increase competitiveness. All these made it difficult for the EMU countries, particularly the weaker ones, to deal with the recession.

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[20] Dr. Hussein Mualla, "Why European Union Is Not An Optimal Currency Area: The Limits of Integration", *Ege Academic Review*, Vol. 6, No. 2, 2006, p. 60.

[21] Costas Panayotakis, "Debunking the Greek (and European) Crisis Narrative", 17 November 2011, available at http://mrzine.monthlyreview.org/2011/panayotakis171111.html, accessed on 20 March 2012.

[22] Yanis Varoufakis, "First as History, Then as Farce: The Euro Crisis Revisited", 17 October 2010, available at http://thepressnet.com/2010/10/28/the-euro-crisis-revisited/, accessed on 20 March 2012.

At this point, another round of speculation took place. Some European banks and financial institutions started to bet on the possibility of default of the weaker eurozone members.[23] This speculative activity resulted in skyrocketing borrowing cost for those countries. The credit rating agencies started to doubt about their capacity to repay their debt and hence downgraded their credit rating, even to junk status.

The above discussion suggests that flawed attempt to create a monetary union, namely the EMU, had made the member countries, particularly the weaker ones, susceptible to debt crises like the present one. The global financial crisis has turned the long-standing problem of the EMU countries into a full scale crisis while the speculative activities of some financial institutions has quickened and accentuated the crisis itself.

3.4 *Structural Flaws in Global Economy*

In the last thirty years, the global economy has undergone profound transformations which can be characterised by the rise of neoliberalism, globalisation and financialisation. To be more precise, it can be said that "in the current world economy, finance reigns supreme and neo-liberalism and globalization are themselves expressions of finance."[24] In the words of Paul Sweezy, "the old structure of the economy, consisting of a production system sound by a modest financial adjunct, had given way to a new structure in which a greatly expanded financial sector had achieved a high degree of independence and sat on top of the underlying production system."[25]

Before discussing how the present trend of global economy is related to the European debt crisis, it will be pertinent to have a glimpse of the results of this trend. Three major impacts can be mentioned. First, increased financial investment and increased financial profit opportunities are crowding out real investment.[26] Even non-financial corporations are also giving more preference to financial investment and focusing more on short term returns rather than long

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[23] Michel Clerin, "What About Greece and Goldman Sachs", available at http://smooz.4your.net/diplomatic-world/files/DW_26_Greece.pdf, accessed on 02 April 2012.

[24] Gerald A. Epstein (ed.), Introduction, *Financialization and the World Economy*, Northampton, MA, Edward Elgar, 2005, p. 5.

[25] John Bellamy Foster and Fred Magdoff, *The Great Financial Crisis: Causes and Consequences*, Cornerstone Publications, India, 2009, p. 105.

[26] There are number of studies in support of this. For a detailed account of such studies, see, Ozgu Orhangazi, "Financialisation and Capital Accumulation in the Non-financial Corporate Sector: A theoretical and empirical investigation on the US economy: 1973-2003", *Cambridge Journal of Economics*, Vol. 32, No. 6, 2008, pp. 863-886.

term growth.[27] Second, as was noted by Keynes, the structure of finance periodically decouples the asset market from production and gives birth to speculative bubbles. Hence, it is of no surprise that in the age of financialisation, the world is seeing speculative bubbles one after another, which sooner or later bust and destabilise the global economic system thanks to financial deregulation. Third, financialisation increases income inequality and contributes to wage stagnation.[28] Thus the present trend of global economy has made the developed capitalist countries inherently weak, in terms of real production, employment and vulnerability to financial crises. This is true about the US as well as the EU countries. This weakness partly explains the inability of the eurozone countries to deal with the financial crises and the resultant recession or economic slowdown.

Therefore, the creation of housing bubble in the US, the eventual bust, contagion throughout the developed world and the resultant Great Recession - all these were not surprising, although shocking. At the onset of Global Financial Crisis 2008, European leaders claimed that it was an Anglo-Celtic crisis; that European banks were not engaged in the speculation and hence were not at the risk of collapse. But the truth soon came out and the ECB, the EC (European Commission) and the EU member states rushed to do what the US administration had done for Wall Street. They injected huge amount of public money into their troubled banks and provided guarantee for them.

The bailout packages that the eurozone governments offered to rescue their banks created additional burden on them and put them in risk. The ECB observes, "In early October 2008, euro area governments announced rescue packages for their national banking systems. In response, risk spreads of financial firms declined while sovereign spreads increased as investors perceived a 'credit risk transfer' from the banking sector to the government... [T]he financial rescue packages apparently slowed down the increase of risk premia for banks, but at the considerable cost of increasing the sensitivity of sovereign risk premia to any further crisis aggravation."[29]

Banks and other financial institutions have contributed in shaping the crisis in other ways too. Some banks, including the renowned Goldman Sachs, are blamed for constructing elaborate financial deals that helped the previous governments of Greece to hide the extent of the country's deficit. Moreover, as

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[27] See, Engelbert Stockhammer, "Financialisation and the Slowdown of Accumulation", *Cambridge Journal of Economics*, Vol. 28, 2004, p. 727.

[28] Thomas I. Palley, Financialization*: What It Is and Why It Matters,* Working Paper No. 525, The Levy Economics Institute and Economics for Democratic and Open Societies, Washington, D.C., December 2007, p. 2.

[29] Jacob W. Ejsing and Wolfgang Lemke, *The Janus-headed Salvation: Sovereign and Bank Credit Risk Premia during 2008-09*, Working Paper No. 1127, European Central Bank, December 2009, p.5.

mentioned before, some of those same banks were engaged in betting over the default of Greece and other weak eurozone countries which made it harder for them to borrow.

Thus, the flawed global economic structure, led by finance capital, had contributed much in creating and shaping the European sovereign debt crisis: by establishing the global economy on shaky foundations, by creating speculative bubbles one after another, by transferring the credit default risk from the banking sector to the government, and finally by giving birth to speculation over default of weaker eurozone members.

4. Implications of the Crisis

4.1 *Implications of a Default and Europe's Shortcomings to Prevent it*

Downgrading by credit rating agencies means higher interest rate of borrowing for the downgraded countries. Junk status makes borrowing even more difficult and brings the weak, heavily indebted economies at the brink of default. Greece has already gone through such bitter experience. In August 2011, the country stood to run out of cash to repay its debt; it was the new installment of money from the first bailout that saved the country from defaulting. What would happen if such a default really takes place? Default will shut down the window of borrowing for them. With the end of borrowing opportunity, countries like Greece, who are already suffering from recession or poor growth, high unemployment and mounted debt, will find it almost impossible to keep their economies functioning, at least in their present socio-economic structure.

But this is one side of the coin. Default of a debtor necessarily means loss to the creditor. With 37 per cent of Greece's debt owed to French and German banks, weak Greece is now pulling down strong Germany and France. Similarly, Irish Republic is threatening the British banks. This is why Cristóbal Montoro, budget minister of Spain, commented pointing indirectly at German banks: "Those who are most interested in things going well for Spain are the creditors. Or do you think they don't want to get their loans back?"[30]

Hence, it is not only the defaulter countries themselves who will suffer from the default; the stronger euro and non-euro economies, whose banks had invested heavily in those weak economies, will also have to bear mounted loss in that case. This is why it is argued that through the bailout packages for Greece or Ireland or Spain, France and Germany are actually trying to prevent collapse of their own banking sectors. Some have termed the bailout packages as back-door bank bailouts.[31]

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[30] "Spaniards resigned to bleak future as austerity bites", *The Guardian*, 09 June 2012.

[31] David Dayen, "Greek "Bailout" is a Bank Bailout", 30 May 2012, available at http://news.firedoglake.com/2012/05/30/greek-bailout-is-a-bank-bailout/, accessed on 15 June 2012.

There is another more important reason of the eagerness of stronger eurozone members to prevent default of the weaker ones and that is – Euro. Euro will be hit hard in case of such default and such damage of Euro would bring catastrophe to all the eurozone members irrespective of weak or strong. This is why the French President Nicolas Sarkozy warns in the G20 summit at Cannes in November 2011: "We cannot accept the explosion of the Euro, which would mean the explosion of Europe… The crisis of the Euro is one of the most important crises that Europe has known since its creation. "[32]

Preventing default is, therefore, in the interest of all EU members, irrespective of weak or strong. In fact the EFSF was created with this purpose. But when Italy and Spain joined the march of probable defaulters, it became clear that Europe alone cannot solve the sovereign debt crisis. In late October 2011, EFSF's CEO, Klaus Regling, traveled to China to try to get Chinese support for the expansion of EFSF but failed.[33] Another attempt was made in the G20 summit at Canne in November 2011 to beef up the resources of the IMF and thus to provide a convincing international backstop for troubled eurozone economies.[34] But that attempt also failed. As the German Chancellor, Angela Merkel remarked in a news conference, "There are hardly any countries here which said they were ready to go along with the EFSF."[35] Thus, the sovereign debt crisis puts the eurozone in a dilemma - they cannot let the indebted member states to default but at the same time they cannot manage the money required to prevent that outcome.

4.2 *Cost and Benefit of an Exit*

It was perceived by many that Greece might exit the eurozone. The assumption became stronger particularly after the first round election of Greece in which the anti-austerity left coalition, Syriza, came in the front. It was assumed that if Syriza forms government, it would radically renegotiate the reforms and austerity measures its predecessor had committed at the time of the second bail-out. In reaction, the creditors of Greece would stop the flow of bail-out money to the Greek government which would make the country unable to pay its debts. The situation will further aggravate if ECB takes a hard position on such default. Greek banking system heavily depends on ECB money. If ECB

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[32] "The G20 and The Euro's Crisis: The Burning Fuse", *The Economist*, 04 November 2011.

[33] Jason voss, "European Sovereign Debt Crisis: Overview, Analysis, and Timeline of Major Events", CFA Institute, 18 June 2012.

[34] "G20 leaders fail to agree on IMF help for Europe", *The Independent*, 04 November 2011.

[35] "No new euro zone money for debt crisis at G20", Reuters, 04 November 2011.

halts the flow of money, leaving the banks with no euro to pay out, a new currency would be the only alternative.[36]

But what would be the cost of a Greek exit? As the first consequence, the reintroduced domestic currency Drachma would immediately fall against the euro, possibly losing 50 per cent or more of its value. The country's economic agony would intensify. In case of a precipitous exit without preparation, the cost would be even more. For, in that case, the country would be left without notes and coins and the surrounding chaos would paralyse the whole economy. Economists at UBS, a Swiss bank, have estimated that the cost of a catastrophic exit might amount to 40-50 per cent of GDP in the first year.[37] On the other hand, the only benefit from an exit would be the boosted competitiveness resulted from devaluation. But how much of this benefit can be reaped by Greece in the present economic structure, remains to be doubtful. Besides, for Greece, devaluation would mean increased burden of debt as it would increase the value of its debt to others.

But Greek exit would not be costless for others. European governments, that had made loans to Greece in the bail-out packages, would bear losses on their loans. In total, the Greek government owes other eurozone governments and institutions, including the ECB, over €290 billion, about 3 per cent of euro-wide GDP, and after an exit most of this would probably never be repaid. It is estimated that following an orderly and well-managed Greek exit – possibility of which is very low – the euro area would suffer an extra first-year GDP loss of 1.6 per cent, making the already prevailing mild recession harsher. As an indirect outcome, the other troubled peripheral economies would also be hit hard as the losses of the eurozone countries and institutions would reduce their possibility of getting assistance.

After the victory of New Democracy in second round Greek election, the party vowed its commitment not to leave the eurozone. Hence, Europe might have escaped immediate fear of 'Grexit'. But amidst the present economic and political uncertainty, it is difficult to guarantee that no such exit would take place in the future.

4.3 *The Austerity Measures and People's Response*

As discussed before, the EMU institutions, led by Germany and France, along with the IMF, have been stressing on austerity measures as the core mechanism to solve the sovereign debt crisis. The austerity measures they have been suggesting include cuts in social security, pensions, public sector wage,

[36] "Cutting up rough: How much do Greece and the rest of Europe stand to lose?" *The Economist*, 26 May 2012.
[37] *Ibid*.

public investment, subsidies for local government and education spending, cap on wages and bonuses and freezing salaries, increased health care fees, raised retirement age, and frozen/slowed down recruitment. They have also suggested selling out ports, airports, land and mining rights, telephone, water and electricity services, refineries, and many other public assets.[38]

In countries, which are suffering from recession for two to five years and facing double digit unemployment rate even up to 20 per cent (see Table 1 and 2 in Annex I), these austerity measures are bound to exacerbate the crisis instead of solving it. A year after Greece received its first bail-out, the country's industrial production declined by 11 per cent and unemployment rose up to 16 per cent. The number of Greeks out of work was up 40 per cent from a year earlier. And, ironically, the debt mountain had also blown up - heading towards 153 per cent of GDP.[39]

Newspapers, magazines, and televisions are flooded with reports describing how people's lives have been deteriorated by the crisis and the austerity measures. A Guardian Report on Greece says, "A new underclass has appeared: in the homeless and hungry who roam the streets; in the spiralling number of drug addicts; in the psychiatric patients ejected from institutions that can no longer offer them a place; in the thousands of shop owners forced to close and board up businesses; in those who forage through municipal rubbish bins at night; and in the pensioners who make do with rejects at fruit and vegetable markets."[40] Another Guardian report informs that one in 11 people in greater Athens is using soup kitchens (charity centre for distributing foods).[41]

Social ramification of the austerity measures is no less evident. Telegraph reports about Greece: "suicides have soared by 40 per cent in a year. Thefts and break-ins almost doubled between 2007 and 2009. Hostility to migrants ... has become widespread and unconcealed."[42] The same report identifies that the bigger danger to the future of Greece is: "People are switching off: from politics, from the mass media, from social life."[43] The report continues: ""We can't watch the television news anymore," says Dmitris, shaking his head. "If you watch it, with the constant uncertainty, it can make your psychology very low. It's like a nightmare we can't wake up from. Perhaps it's fortunate that we've had to cancel

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[38] Farooque Chowdhury, "Europe and Economy: Looming Dark Clouds", 24 September 2011, available at http://www.countercurrents.org/chowdhury240911.htm, accessed on 10 April 2012.
[39] "Debt-laden Greece mired in anger and humiliation", BBC News, 15 June 2011
[40] "Greek despair over further cuts sees suicide and crime rates on the rise", *The Guardian*, 24 September 2011.
[41] "Greece's cut-price potato movement shows Greeks chipping in", *The Guardian*, 27 March 2012.
[42] "The Greek Tragedy: No money No hope", *The Telegraph*, 24 September 2011.
[43] *Ibid*.

our cable TV subscription"... "It feels like we're in a post-war situation," says Mary. "There's no optimism; we don't know what happens next. We just try to survive.""

In Portugal, one in 10 graduates is now leaving the country. "This is the biggest emigration wave since the 1960s," says Filipa Pinho of the government's newly established Emigration Observatory.[44] Another report cites an Italian: "I know plenty of people in their 30s, even some in their 40s, still living with their parents... That's not normal."[45] Another Italian comments: "How can we say that a system that produces people with PhDs, who then have to work in call centres or cafes, is a system that works?"[46]

Hence, there is no wonder that Europe is watching demonstrations and strikes against those austerity measures from Greece to Spain, from Ireland to Italy, from Romania to France. In Romania, even police officers went on strike over their pay cut.

People's opposition to austerity has not been limited to demonstrations and strikes. In Ireland, Portugal and Netherlands, it has resulted in the fall of governments. French voters replaced Nicolas Sarkozy, Angela Merkel's closest ally, with a socialist president, François Hollande, who called for an emphasis on growth. In Greece the two traditional parties, New Democracy and Pasok, that supported the austerity measures, were ruined in the general election in May 2012 and an anti-austerity left coalition, Syriza came in the front. After the failure of all three leading parties to form a government, a second round election was held in the next month and this time conservative New Democracy managed to have a narrow victory. The message from the European voters is clear – reject the austerity measures.

4.4 *Humiliation of Sovereign States*

Along with austerity measures, the debt crisis has brought about humiliation for sovereign states. A BBC report says: "The Greeks are being humiliated… Their fate is being decided elsewhere, by unelected officials from the EU or the IMF… The IMF and the EU send in accountants and economists who occupy space in the finance ministry… There were suggestions, too, that foreigners should run Greek tax collection. Those ideas may have been sidelined but the resentment has not gone away. Some say that Greece has become a protectorate of the EU. Certainly the intervention from outside in Greece's internal affairs is

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[44] "Portugal's jobless graduates flee to Africa and Brazil", BBC News, 01 September 2011.

[45] "Europe on the breadline: hopelessness and Berlusconi", *The Guardian,* 18 October 2011.

[46] "Europe on the breadline: Naples Dinner Party leaves a bitter taste", *The Guardian*, 18 October 2011.

unprecedented… Perhaps in jest, but stinging nonetheless, German and European officials have spoken of Greece selling off its islands."[47]

It is not only the 'poor' Greece, the 'rich' Italy is also feeling the sting of humiliation. A Guardian report says, "The Italian Prime Minister, Silvio Berlusconi, was summoned to a late-night hotel meeting with Merkel, Sarkozy, the IMF Director General, Christine Lagarde and Obama, where he was instructed to bring Italy under quarterly IMF surveillance to ensure he implements tough austerity measures, including changes to the labour market, pension reform and the sell-off of state assets."[48] To save his face, however, Berlusconi insisted that he had invited the IMF to offer advice.

Dictation and humiliation by the IMF is not a new experience for the developing countries. Thanks to the sovereign debt crisis that the developed countries are now having a taste of it. One observer says, "Now, after Greek Tragedy and Italy Incident, the ruling elites… of IMF-dictated-poor countries should get "rid" of sense of shame. The founding fathers of the Bretton Woods institutions had not imagined that one day in future their institutions designed to subdue the poor world would discipline advanced capitalist countries."[49]

4.5 *Rising Voice of Disunity in the EU*

Many experts believe that the true motivation behind the introduction of Euro is political rather than economic. To them, following the Second World War, when Europe found that it was no more in the centre of the world, the European leaders attempted to unite the developed countries of the continent to strengthen their position *vis-à-vis* the US. Formation of the EU and introduction of Euro are the results of this attempt.[50] The sovereign debt crisis is now eroding the unity of the EU.

There was stark difference between the eurozone members; the sovereign debt crisis has widened the gap. Spain and Greece are suffering from mass unemployment while joblessness in Germany is at a record low. The bond yields of peripheral European states have blown out at a time when Germany enjoys remarkably low borrowing costs. This widening gap, along with the harsh austerity measures and the associated humiliation, has contributed in growing sense of disunity among the people of eurozone. This sense of disunity has been expressed in the elections across Europe. "[A] big chunk of the electorate is

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[47] "Debt-laden Greece mired in anger and humiliation", BBC News, *op. cit.*
[48] "G 20 summit fails to allay world recession fears", *The Guardian,* 04 November 2011.
[49] Farooque Chowdhury, "A Drama In Disarray: G20 Summit In Cannes", 06 November 2011, available at http://www.countercurrents.org/chowdhury061111.htm, accessed on 05 May 2012.
[50] Casimir Dadak, *op. cit.*

supporting anti-immigrant, anti-EU parties… For them, the EU is not the solution but the problem. It has brought either austerity, or migrants, or unwanted economic competition, or all three."[51]

Voice of disunity is heard not only at the mass level, but also at the government level. Germany and France threatened to eject Greece from the eurozone after it proposed a referendum on its second bail-out terms.[52] An idea of reforming the eurozone, consisting of strong economies only, is still floating. In contrast, voices are also increasingly heard in Europe, particularly in weaker economies, to abandon Euro. Most striking is Britain's plan to arrange a referendum on whether the country should stay in or leave the EU.[53] Thus, the sovereign debt crisis is challenging the very existence of the EU.

4.6 *Impact on Global Economy*

In a globalised world, the effect of European sovereign debt crisis cannot be expected to be limited within the boundary of the continent. Europe, including the eurozone countries, is an important export destination for the developed countries like the US as well as the emerging economies like China. With falling demand in the EU countries, mired with the sovereign debt crisis, US and Chinese export to the EU has diminished. In January 2012, US exports to the eurozone reduced by 11 per cent from the previous month. China's exports have also continued to fall in 2012, with February 2012 exports 15.2 per cent down from the previous year.[54] The US is further affected by the crisis through the falling value of Euro. During the crisis, the exchange rate of US dollar and US bond yields have risen which reveals that investors have started to view the country as a relatively safe haven. Investors' retained confidence is certainly good news for the US but rising dollar has reduced its competitiveness which has taken its toll by reducing export. Furthermore, the crisis has reduced European investment in the US. Investment of EU companies in the US has reduced from US$131.9 billion in 2010 to US$105.07 billion in 2011.[55] Thus, the European sovereign debt crisis has prevented the recovery of the US from recession from being more robust. Another concern for the US is that if banks fail in Europe due to overexposure to European sovereign debt, those banks will not be able to repay what they owe to US banks. This may in turn tighten credit to US businesses and consumers and slow economic growth. Due to tight government

[51] "Don't count on a Hamiltonian moment", *The Economist*, 28 May 2012.
[52] "Currency Disunion", *The Economist*, 7-13 April 2012, p. 54.
[53] "David Cameron says Britain will get vote on leaving EU, but not yet", *The Guardian*, 02 July 2012.
[54] Tim Christensen, "The Global Effects of the European Sovereign Debt Crisis", April 2012, available at http://ebook.law.uiowa.edu/ebook/uicifd-ebook/part-6-iv-global-effects-european-sovereign-debt-crisis , accessed on 07 June 2012.
[55] *Ibid*.

control, China's financial sector or currency is not exposed to the European sovereign debt crisis. But the country faces risk from another source. In 2011, China began implementing tight monetary policy to halt high inflation that often accompanies high growth. Faced with the reduced export, partly due to the European sovereign debt crisis, the country had to ease its monetary policy which has left it again in the risk of high inflation.[56] The experience of the US and China shows how the European sovereign debt crisis is affecting the global economy.

5. Conclusion

The European sovereign debt crisis is a structural crisis. In contrary to the popular belief, it has not resulted from the profligacy of some European states. Rather, it is stemmed from structural flaws in the EMU and in global economic structure. The present global economic structure, characterised by financialisation, neoliberalism and globalisation, has made the eurozone countries inherently weak, in terms of real production, employment and vulnerability to financial crises. The structural flaws in the EMU have added to these weaknesses, particularly for its weaker members and have limited the scope of all its member states to deal with financial crises and recessions. The global financial crisis has turned these long-standing problems of the EMU countries into a full scale crisis. It created financial turmoil in the eurozone countries and further weakened their real economy. Moreover, the bailout packages that the eurozone governments offered to rescue their banks, involved in speculative activities, created additional burden on them and transferred credit risk from the banking sector to the government. At this point, some European banks and financial institutions started betting on default of the weaker eurozone members. All these led the weaker eurozone members to a situation where the credit rating agencies started doubting their capacity to repay debt and hence downgraded their credit rating, even to junk status.

The European sovereign debt crisis has put Europe in a dilemma. On one hand, it cannot let its weaker members default as it would hit hard the Euro and cause irrecoverable loss to other stronger Euro and non-euro economies, whose banks invested heavily in those weak economies. On the other hand, particularly after Italy and Spain fell into the crisis, the continent can no more afford the money necessary to prevent such outcome. The EMU institutions, led by Germany and France, along with the IMF, have been stressing on austerity measures as the core mechanism to solve the sovereign debt crisis. But for the eurozone members, who have been suffering from recession and high unemployment for several years, these austerity measures have done nothing but exacerbating the crisis. Furthermore, the crisis has brought about humiliation for sovereign states, from 'poor' Greece to 'rich' Italy. All these have resulted in

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[56] *Ibid*.

political turmoil in Europe. Continent wide demonstrations, fall of governments in a number of countries, rise of anti-EU and anti-immigration sentiment, rise of socialist power from Greece to France, voice of disunity among the EU countries – all these indicate that the crisis is changing the political landscape of Europe.

As is expected in a globalised world, the effect of European sovereign debt crisis has not been limited within the boundary of the continent. The crisis has already started affecting US and China, the main driver of global consumption and growth respectively, through its impact on global trade, investment, and foreign exchange rate.

Thus, on one hand, the European sovereign debt crisis has created further chaos in the global economy, which is yet to recover from the global financial crisis. On the other hand, it is affecting global political landscape through creating political turmoil in Europe.

Annex I

Table 1: GDP Growth Rate (annual %)

Country Name	2011	2010	2009	2008	2007	2006	2005
Cyprus	0.5	1.1	-1.7	3.6	5.1	4.1	3.9
Greece	-6.9	-3.5	-3.3	-0.2	3.0	5.5	2.3
Ireland	-0.7	-0.4	-7.0	-3.0	5.2	5.3	5.3
Italy	0.4	1.8	-5.5	-1.2	1.7	2.2	0.9
Portugal	-1.6	1.4	-2.9	0.0	2.4	1.4	0.8
Spain	0.7	-0.1	-3.7	0.9	3.5	4.1	3.6

Source: World Bank, available at http://databank.worldbank.org/data/home.aspx, accessed on 15 March 2012.

Table 2: Unemployment Rate (% of total labour force)

Country Name	2010	2009	2008	2007	2006	2005
Cyprus	6.2	5.3	3.6	3.9	4.5	5.3
Greece	12.5	9.5	7.7	8.3	8.9	9.9
Ireland	13.5	11.7	6.0	4.6	4.4	4.3
Italy	8.4	7.8	6.7	6.1	6.8	7.7
Portugal	10.8	9.5	7.6	8.0	7.7	7.6
Spain	20.1	18.0	11.3	8.3	8.5	9.2

Source: World Bank, available at http://databank.worldbank.org/data/home.aspx, accessed on 15 March 2012.