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# To what extent does the European Debt Crisis affect both the European and the Global Economies

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To what extent does the European Debt Crisis affect both the European and the  
Global economies?

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## Table of Contents

<b>Abstract</b> .....	<b>3</b>
<b>Introduction</b> .....	<b>4-5</b>
<b>Theoretical Explanation of Sovereign Debt Crisis</b> .....	<b>5-7</b>
<b>The Relationship Between the 2007-2009 US Housing Bubble and the European Sovereign Debt Crisis</b> .....	<b>8</b>
<b>The Debt Crisis' Impact On The European Economy</b> .....	<b>8-19</b>
<b>Differing Opinions</b> .....	<b>20-21</b>
<b>The Debt Crisis's Influence on the Economies Abroad</b> .....	<b>21-22</b>
<b>Possible Approaches to Remedy the Debt Crisis</b> .....	<b>23</b>
<b>Conclusion</b> .....	<b>24</b>
<b>Works Cited</b> .....	<b>25-27</b>

## **Abstract**

The goal of my research is to analyze the relationship between the 2007-2009 United States financial crisis and the ongoing European Sovereign Debt Crisis and the Debt Crisis' possible effects on the global economy and to examine the different approaches to reduce the devastating effects of the European Debt Crisis.

First, I am going to analyze the relationship between the bursting of the US Housing Bubble and the European Debt Crisis. According to Robert Kolb (2011), a Finance professor at the University of Chicago, the bursting of the US Housing Bubble in 2007 that resulted in the 2007-2009 economic recession left financial institutions, such as banks, with serious liquidity problems because borrowers kept defaulting on their mortgage loans. Second, I am going to explain the European Debt Crisis' possible effects on the global economy. For instance, if many European countries are unable to pay off their debts from the US, US banks would be damaged. In addition, European loans could hurt US taxpayers. For instance, Lachman (2011) writes that "the International Monetary Fund (IMF)'s lending commitments made to Greece, Ireland, and Portugal total around \$100 billion, and considering that the U.S. has a 17<sup>3</sup>/<sub>4</sub>% share in the IMF, these lending commitments put the U.S. taxpayer at risk for almost \$20 billion should those countries be unable to repay the IMF." Third, I am going to examine the different approaches to reduce the devastating effects of the different financial crises, such as implementing the appropriate combination of fiscal and monetary policies.

I will write this paper primarily by reading economic books and the Wall Street Journal.

## Introduction

The European Sovereign Debt Crisis has been ongoing since 2010. Its impact should not be overlooked because the whole European Union, even the whole world, will be affected by its consequence. The countries that are hit hardest by this crisis include Greece, Spain, and Portugal. Currently, international agencies such as the International Monetary Fund and the European Central Bank are trying to figure out ways to reduce the damage.

Before discussing the European Debt Crisis in detail, some background information about the European financial system must be mentioned. The following information about the European Central Bank and bond ratings is based on Stephen Cecchetti's (2008) *Money, Banking, and Financial Markets*. The European Central Bank (ECB) is the main bank of the European Union. It uses interest rates to control supplies of money and credit and is responsible for the smooth operation of the payment system and the issuance of currency. Its main responsibility is to maintain price stability.<sup>1</sup> The ECB was established and followed at the expense of the individual European countries giving up their own independent central banks. At the same time, it allowed for more centralization, which was critical during a time period of deep economic recession.

The severe debt crisis in Europe is mainly triggered by the governments' attempts to advance their economies by borrowing large amounts of money from individual investors and major banking institutions, reflecting large government deficits and expanding government debt. When a government issues increasing amounts of debt relative to GDP, it risks a lower bond

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<sup>1</sup> In addition, bond ratings are used by rating agencies to estimate the likelihood that a corporate or government borrower will make a bond's promised payments. Among the important rating agencies are Moody's and Standard and Poor's.

rating, so that investors demand higher risk premiums and hence higher interest rates to compensate for the added default risk.<sup>2</sup> Cutting spending and /or raising taxes may ease the problem in the short run; economic growth is the best long-run approach since it increases people's wealth and their ability to pay off debt. However, higher long-run growth may be best stimulated by cutting taxes today, which worsens the immediate problem.

My paper is divided into six sections: theoretical explanation of debt crisis, the relationship between the 2007-2009 US Housing Bubble and the European sovereign debt crisis, the debt crisis' impact on the European economy, differing opinions, the debt crisis' impact on the global economy, and the possible approaches to remedy the debt crisis.

### **Theoretical Explanation of Sovereign Debt Crisis**

A sovereign debt crisis can arise when a government runs persistently high budget deficits relative to gross domestic product (GDP). Persistently large deficit-to-GDP ratios accumulate as ever-higher and more dangerous values of outstanding debt to GDP. At some point, market participants begin to doubt whether the government can repay the debt, in which case a default is threatened.

When a country borrows money from another, it has the responsibility to repay the loan. Failure to repay will lower the credit rating for the country, limiting access to the capital market and potentially straining international relations. There are two types of bond or loan markets, private and governmental, and they are treated separately in regard to credit risk and lenders' willingness to lend. For example, if the government of Greece has high credit risk, then I may not want to lend to them, except at a very high interest rate to compensate for the risk. However,

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<sup>2</sup> There are three major differing opinions on solving this crisis in government budgets: cut spending, stimulate economic growth, and raise taxes.

if a creditworthy Greek firm asks me for a loan, I would more likely lend to this firm. Just because a country's government bonds are risky, that need not mean that private bond issues are not forthcoming in the bond markets. In general, if any borrower fails to pay back the money on time, the interest rate at which it can subsequently borrow would increase as investors demand higher premiums; the borrower would build bad credit, making it more expensive for it to borrow money in the future in the case of a government. In the long run, the country will more likely face default, a point at which it can no longer pay back the money because of the high interest rate along with relatively low economic activity. For a given amount of debt, higher economic growth can lower the ratio of debt to GDP as suggested in the previous section.

A government default can further trigger a collapse of the nation's banking system. For example, if government default is threatened, the value of government bonds will fall. To the extent that a bank holds these bonds, the value of bank assets declines and the bank's solvency is endangered. The threat of insolvency then may lead to a bank run, which occurs when depositors simultaneously withdraw money from a bank when the bank does not have enough money or other easily-liquidated assets at the time to give out. This can occur even if the bank is solvent. If the run is on a single bank, that bank may be able to borrow from some other banks. However, if the run affects a broad range of banks, the problem gets severe (Reinhart and Rogoff 2009). For instance, during the US subprime financial crisis in 2007, banks experienced runs simultaneously because problematic mortgage assets, including many issued by government housing agencies, were held widely in the banking sector.

A collapse of a nation's banking system may lead to economic recessions or worse. There are at least two types of recessions: recession resulting from a financial crisis and recession due to productivity shock. Recessions associated with a banking crisis are especially costly, in part

because creditworthy borrowers who would make productive use of resources cannot gain access to those resources. In addition, bank crises are often accompanied by other crises, such as inflation, exchange rate crisis, and foreign and domestic debt crisis. Furthermore, during a recession associated with financial crisis, debtors generally are unable to repay their debts. For instance, during the US subprime mortgage crisis, since the house buyers could not repay their loans to the banks, they just left the mess to the banks. Recessions associated with a decrease in productivity, a war, or a political rebellion impose different costs. In contrast to a recession due to financial crisis, during a recession due to productivity shock, there is damage to the machinery associated with financial intermediaries. In the case of the European Sovereign Debt Crisis, there is a recession associated with financial crisis in which the banking sector experienced defaults on their loans.

There certainly are measures to prevent sovereign default and the potential liquidity crises from happening. For instance, “a liquidity crisis occurs when a country that is both willing and able to service its debts over the long run finds itself temporarily unable to roll over its debts. In this situation, a third party (i.e. IMF) can make a short-term bridge loan, with no risk, that will keep the borrower on its feet and prevent it from defaulting” (Reinhart and Rogoff 59-60). This could happen only if the creditors were fully convinced that a country had every intention of repaying the debts over the longer term. Of course, lenders are aware of moral hazard, which means that for some countries, if they got bailed out once, will pursue riskier policies and expect another bailout later.

## **The Relationship Between the 2007-2009 US Housing Bubble and the European Sovereign Debt Crisis**

Both the 2007-2009 US economic recessions and the ongoing European Sovereign Debt Crisis were caused by the bursting of the housing bubble, leading to consumers' default on their loans and mortgages. A decrease in the world interest rate decreased the mortgage rate and, combined with relaxed lending standards, increased housing demand. Cheap housing prices gave people the incentive to buy many houses by borrowing from banks with the hope of selling them later at higher prices. In other words, people viewed their houses as speculative investments rather than living properties. However, after the burst of the housing bubble, housing prices dropped drastically. Consequently, many people who borrowed from banks could not repay the mortgage. Banks foreclosed on houses whose values were falling, lowering bank capital and thus making banks riskier. As banks became riskier, other intermediaries became increasingly unwilling to lend to them. The banking crises, in turn, resulted in the crash of the stock markets, destroying wealth. In response to this vicious cycle, some euro countries, while rescuing financial institutions in distress, faced difficulties in balancing their budgets and financing their debt, signaling the European Sovereign Debt Crisis (Kolb 2011). Overall, consumers defaulted on their mortgages due to the bursting of the housing bubble, banks collapsed, stock markets crashed, and all of those events led to the 2007-2009 US economic recessions and the European Sovereign Debt Crisis.

### **The Debt Crisis' Impact On The European Economy**

Among the European countries affected by the European Debt Crisis are Greece, Spain, Italy, Portugal, Cyprus, Slovenia, and the Netherlands. Of these countries, Greece is the one that

needs help the most. Germany and France, along with the ECB and IMF, have played major roles in attempting to rescue those struggling countries.

### Greece

Since Greece has such a high relative debt-to-GDP ratio, in order to revive its economy, creditors may have to make compromises and financial institutions (i.e. IMF and ECB) may have to provide bailout funds; however, those institutions must be aware of moral hazard, meaning that Greece could take the bailout funds for granted and take subsequent risky actions. Therefore, as a condition for receiving the bailout funds, Greece must take austerity measures to keep its economy under control.

Greece's heavy debt has been putting itself on the edge of leaving the European Union (EU), and its major supporters (i.e. IMF and ECB) may need to help reduce Greek debt by forcing current losses on the creditors. According to Forelle and Paris (2012), "The largest hurdle is now the insistence of Greece's rescuers, the other euro-zone countries and the International Monetary Fund on low compensation for creditors that participate in the restructuring." However, the hardest problem is to convince the reluctant creditors to accept the deal. The most basic condition for accepting this deal should be that Greece promises to pay back the loan in a certain time in the future. Paris et.al (2012) says in his article that "EU finance ministers urged Greece to provide written assurances to its partners that it would meet its promises before a second bailout can be implemented." If Greece does not set a good example of making the promised payment on time while receiving bailout funds, other countries hit hard by the crisis such as Portugal will have little incentive to do so (Taylor 2012). This is a game theory concept,

which means that each country anticipates the actions of others and adjusts its own actions accordingly.

However, several EU ministers have lost faith in Greece's ability to pay back the loans on time. As a result, Greece is expected to take more austerity measures as a condition in order to get more bailout funds. As predicted, Standard and Poor's declared Greece in default in February of 2012. The International Swaps and Derivatives Association was asked to consider whether Greek legislation to retrofit its debt with collective-action clauses, rewriting contracts that potentially force losses on private investors, should trigger credit-default-swap payouts, a form of insurance for bondholders (Bernard and Burne 2012). Nevertheless, in the worst case scenario, if all the countries default simultaneously, insurance markets would break down, forcing losses on the bondholders and causing banks to collapse. According to Burne (2012), "the daisy chain of contracts between buyers and sellers amounts to a gross \$69.9 billion of CDS, a form of insurance, outstanding. If CDS are triggered, buyers receive the face value of their debt, less the recovery value assigned to the affected bonds." This may be a method of finding a legal way for the insurance company to avoid paying off, forcing losses on individual investors. There was a possibility that Greece will eventually get out of the European Union because of its heavy debt that places great burden on other European countries and causes the euro to depreciate. In addition, Greece leaving the European Union will possibly cause several other European countries to leave and break down the Union. Moreover, if Greece leaves the Union, the European economy would be even worse, because Greek debt would never be paid off, and as a result, the Euro would inflate. In this view, it is crucial that Greece stays in the Union.

The Greek election in June 2012 played an extremely important role in deciding the fate of Europe. The pro-bailout candidate, Antonis Samaras, won and saved Greece from leaving the

European Union. The pro-bailout leader agreed to the terms of the agreement by reducing government spending, while the anti-bailout candidate did not agree but instead wanted to stimulate economic growth. According to Granitsas (2012) from the Wall Street Journal, “more than one in five Greek workers are unemployed, including half of those under the age of 25. Homelessness, personal bankruptcies, crime, suicide and mortality from ill health are rising. Young, educated people are leaving the country for opportunities abroad.” Certainly, most Greek people do not want a further cut in government spending. While the anti-bailout candidate had his reasons for not agreeing to the terms of the bailout fund, the cost of Greece leaving the Union far outweighs its benefit. If Greece leaves the Union and revert back to its old currency, its avoidance to pay back the debt would impose great economic burden on the European Union. According to a Wall Street Journal article, “A Syriza (anti-bailout radical party) victory could lead to a breakdown of Greece's cooperation with its European creditors and eventually a Greek exit from the euro” (Granitsas 2012). Growing fear of a Greek exit could exacerbate the capital flight from Spain and other financially fragile euro members, because if Greece does not repay its loans, the financing institutions will not have the necessary amount of euro to fund the other struggling countries. “Moody's listed Spain, Italy, Portugal, Ireland and Cyprus as most at risk” (Walker and Steinhauser 2012). Even if Greece had avoided paying back the debt, it would print its original currency heavily, making the currency worthless. The election played a decisive role in determining Europe’s fate: the pro-bailout leader won and prevented Greece from leaving the European Union.

The election is just a first step. Since Greece has a huge amount of debt, the bondholders and creditors need to make compromises. “The officials argued that the findings indicate a need for official creditors to write down their claims by at least 30 billion euros if they want to keep

Greece in the euro zone” (Paris et.al 2012). If the bondholders do not want a Greek exit from the European Union, they need to take some losses on the money they are owed; however, Greece’s big lenders such as Germany and Finland still refuse to help Greece even though they know the consequence. Therefore, the ECB, the IMF, and the European Financial Stability Facility (EFSF) need to be able to withstand some losses and convince the creditors to come to an agreement to help Greece, because otherwise, countries such as Spain would get the wrong message that the euro zone has no way of containing the debt crisis. However, moral hazard comes into play because Greece may rely excessively on those organizations and fail to do its own part in restructuring its economy.

In order to keep its austerity programs running, Greece planned to offer a large debt auction in order to raise fund to repay debt to the ECB and secure further aid from its international creditors. According to a Wall Street Journal article, “the auction could raise up to 5 billion euros. Greece was left with no options other than to increase its auction sizes after its euro-zone partners declined to provide it with a bridge loan until a disbursement of crucial aid in coming months” (Bartha 2012). However, Greece’s economy is always fluctuating up and down, so it is difficult to predict what is going to happen next.

As Greece was trying to recover quickly, it asked for more time for budget cuts. “The extra time would allow Greece to spread out budget cuts over a longer period as it tries to spur economic growth in order to be able to pay its debts” (Granitsas and Paris 2012). The extra time is crucial, both for Greece and its creditors.

## Spain

Spain and Italy are in the same situation as Greece with regard to their devastating economic conditions. Based on a Wall Street Journal article, “Spain struck an agreement in June 2012 with the 16 other euro-area members to ask for as much as €100 billion (\$125.7 billion) from European Union bailout facilities, specifically to recapitalize a number of regional banks that have been devastated by the explosion of a real-estate bubble” (House and Granitsas 2012). What is happening in Spain is just like what happened in the US. After housing prices increased, people began to borrow heavily in order to invest in housing. However, after the bursting of the housing bubble, borrowers defaulted on their loans. This series of defaults led to several bankruptcies in Spain. As a result, Spain is in a desperate need for help.

Given Spain’s need for assistance, an important issue is how to deliver the aid. House and Granitsas (2012) said that “both the government and the International Monetary Fund have argued vehemently for the aid to go directly to the banks, rather than being channeled through a Spanish government that can ill afford to add to its debts.” Their main concern is to give the fund directly to those who need it rather than undergoing the risk that the government would improperly use the funds. Nevertheless, “Germany and others have objected that giving the aid directly to banks would give them less control over how the funds are used, and argue that it isn’t allowed by the bailout funds’ current charters” (House and Granitsas 2012). Both approaches have costs and benefits, and the decision depends on whether the benefits outweigh the costs, as well as whether the approach is legal.

Moreover, even though Spain has a large economy, “one in four of its workforce is officially unemployed” (House and Granitsas 2012). Therefore, it is very difficult to fix the

situation. If Spain were to spend more to stimulate economic growth, it would end up with even more debt. If Spain were to cut spending, the whole country would face the risk of collapse. However, reducing spending is beneficial in the long run because the government deficit will eventually decrease to a sustainable amount, but the question is how long it is going to take for the economy to completely recover?

In order to speed up the recovery, drastic measures need to take place. According to Roman and Winning (2012), “Spanish Prime Minister Mariano Rajoy announced new austerity measures that should help Madrid cut its budget deficit by €65 billion (\$80 billion) through to 2015.” Prime Minister Rajoy’s main austerity measures include tax increases, pay cuts, reduced unemployment benefits, reduced annual government subsidies, reduced public services, and a “break” for tax breaks for home buyers (Roman and Winning 2012). However, these measures will probably trigger the deterioration of the Spanish economy during these years or in the short run. These series of actions will result in people leaving the country to find opportunities abroad, which is not a good sign for the economy. “Analysts said the moves would hurt Spain’s recovery from recession” (Roman and Winning 2012). Since Spain is already in a recession and its unemployment rate is already very high, the austerity measures make the situation even worse, putting the country into a chaos. In Spain, “unemployment accounts for almost 25% of the workforce, and on top of that, the austerity measures will cut jobless benefits and cut 7% of the salary for central government employees” (Roman and Winning 2012). In addition, “hundreds of coal miners and their supporters rallied in Spain's capital against government plans to end subsidies for their sector. Some protesters threw rocks and firecrackers at police, the latest sign of growing social unrest in a country mired in an unprecedented, five-year-long crisis” (Roman and Winning 2012). A country’s deep economic recession, could lead to social unrest.

Even though these measures are devastating for the Spanish economy in the short run, the Spanish economy or even the euro-zone will benefit from them in the long run; since the economy is in such a deep recession, drastic measures need to take place in order to clean up the mess. The long run benefits outweigh the short run costs.

There were concerns that Spain won't be able to meet its funding needs, so the euro-zone finance ministers signed off on a bailout loan of up to 100 billion euros for troubled banks, with about 30 billion euros available immediately in case of urgent financing needs (Brat et.al 2012). Spain needs to implement tough austerity measures in order to maintain the health of its economy. Even though the austerity measures may be harmful to the already weakened Spanish economy in the short run, these measures will be helpful in the long run.

Since the Spanish banks have huge losses, as the government runs austerity measures, the European Central Bank and the other facilities may help those banks by buying the national bond while avoiding moral hazard. "The European Financial Stability Facility or its successor rescue fund would buy Spanish or Italian bonds on the primary market to help lower the interest rates at which the two countries are borrowing. Then the ECB would rekindle its program to buy bonds on the secondary market" (Forelle and Fairless 2012). On the surface, these large facilities are effectively helping the Spanish economy to rebound, but they only focused on the fiscal aspect of the economy but not on the monetary aspect. Only focusing on reducing the interest rate is not enough as the ECB also has to focus on keeping the money supply at a steady pace, which is a part of monetary policy. As the ECB buys bonds, interest rates fall and the money supply rises. However, if the money supply grows too fast, inflation will occur. Therefore, the ECB needs to focus less on fiscal policy and more on monetary policy.

Greece and Spain are the two main countries that are heavily affected by the European Debt Crisis. In addition, I am also going to discuss the debt crisis' effect on the other European countries partly to make the discussion complete and partly because their part in this crisis indirectly influences the situations in Greece and Spain- there will be funds distributed to those countries but could otherwise be distributed to Greece and Spain- and vice versa. The countries that I will discuss are Cyprus, Slovenia, Germany, and the Netherlands.

### Cyprus

While Cyprus's debt is small compared to that of Spain and Greece, its problems are essentially the same: its government tries to blindly invest in economic enhancement. Cyprus's request for assistance comes after weeks of unsuccessful negotiations with Russia (House and Granitsas 2012). Since Cyprus's bond rating is low, Russia, or any other country, is naturally reluctant to lend it money. Therefore, according to the Wall Street Journal article, "Eurogroup President and Luxembourg Prime Minister Jean-Claude Juncker said the Eurogroup would mandate the European Central Bank (ECB) and the European Commission to negotiate conditionality for the aid" (House and Granitsas 2012). This means that the ECB will only be responsible to address the challenges of the financial sector.

Cyprus's government deficit is partly caused by Greece's continuous recession. House and Granitsas said that "Cyprus Popular Bank PCL—Cyprus's second-biggest bank—has asked the government to recapitalize it after the bank was hit by a €3.65 billion loss stemming from Greece's recent €200 billion debt restructuring" (House and Granitsas 2012). This is one of the examples that shows how the Greek deep recession is affecting the other European countries. In addition, "the government's support will cost it at least €1.8 billion, or 10% of expected gross

domestic product this year, blowing the government's deficit-reduction plans hopelessly off course” (House and Granitsas 2012). Therefore, the government needs to run austerity measures by reducing government spending. The severe government deficit causes Cyprus’s credit rating to go down sharply. “Cyprus's government debt is now rated as junk by all three of the world's major ratings firms, and Fitch said the capital shortfall in the banking system alone could reach €6 billion, or 33% of GDP (House and Granitsas 2012). Since the credit rating is too low, Cyprus may have a hard time finding a willing lender.

Furthermore, due to its large financial sector because of its huge amount of foreign money, Cyprus’s foreign liabilities of the banking sector were more than three times the size of annual output at the end of 2011 (House and Granitsas 2012). The best the government can do is to reduce spending and ask the IMF and the ECB for help in order to slowly recover; even though it is going to take long, it is important that Cyprus gains more credit.

### Slovenia

Along with Cyprus, Slovenia is also in an economic downturn. It objected to an economic downgrade by the rating agencies, Moody’s and Standard and Poor’s. “The government of Slovenia said a downgrade was unjustified in the light of actions already taken by Slovenian authorities to meet the country’s fiscal-austerity goals and shore up its banking sector” (Rousek 2012). In response, the two rating agencies said that “a lack of consensus among government coalition parties is undermining its response to rising fiscal and economic pressures” (Rousek 2012). Government consensus is important for dealing with economic hardship. If there is no consensus, no matter how much the government tries to reduce its debt and boost its economy, the situation will just get worse because everybody has different ideas. “The downgrades raise

concerns that Slovenia may be forced to ask for an international bailout” (Rousek 2012). Most of the European countries are already in trouble and asking for bailout, and one more country joining the party will only make the situation worse because the fund is limited; therefore, some European countries may have to ask for bailout funds from abroad.

In response to the downgrade, the Slovenian ministry said that the country’s banking sectors are manageable and cannot be compared to that of Spain. However, the rating agencies said that “the government was too involved in the banking sector, which is facing challenges with respect to recapitalization and high nonperforming loans” (Rousek 2012). Since the banking sector was too involved in either the debt restructuring of other countries or loaning out high risk loans, the downgrade was necessary in order to correctly inform the investors.

The heavy economic recessions of countries, such as Greece and Spain, negatively influence the banking sectors of other European countries, such as Cyprus and Slovenia, maximizing the debt crisis’ influence. The heavy debt of the struggling countries has also put the economies of the stronger countries, such as Germany and the Netherlands, at risk. Now, I am going to discuss Germany and the Netherlands and their roles in the European Sovereign Debt Crisis.

### Germany

Germany is one of the stronger countries that support/provide funds to the struggling countries, and the heavy burden of providing funds to those countries causes the German economy to decline. Europe’s debt crisis has led Germany’s investment banking profit to decrease, causing a deep decline in bank earnings. Consequently, Germany seeks to decrease its banking costs by reducing risk-weighted assets and cutting jobs (Stevens and Henning 2012).

However, reducing too many risk-weighted assets will also reduce revenue, and cutting 1,900 jobs will not necessarily decrease enough costs. In addition, if the debt crisis continues to become worse, Germany's economic condition will only have a small chance of getting better because it will have to continue to help those countries that are in desperate need for help.

### The Netherlands

Another country that is in the same situation as Germany is the Netherlands. Since the Netherlands is one of the richest members of the euro zone, it is an important contributor for bailing out struggling Southern European countries. In order to fulfill both the domestic and international needs, the Dutch government agreed on a package to reduce budget deficit. However, austerity at home, coupled with continued support for Southern European countries, made Dutch voters very frustrated, and the Socialist party, which is anti-austerity, may gain the most support. According to an article, "Emile Roemer, leader of the Socialist Party in the Netherlands, has called for more time to implement European Union budget rules" (Van Tartwijk 2012). Instead of reducing budget deficit during the crisis, Roemer wanted enough time to stimulate economic growth by stabilizing price and creating jobs. If the voters were to choose the Socialist party, the country would face the problem of getting enough funds to support others while at the same time increase spending domestically. In addition, based on Mr. Roemer's plan, long-run growth may be best stimulated by cutting taxes today, which worsens the immediate problem, as discussed in the introduction. Therefore, taking the austerity measures is more beneficial. Since the European Debt Crisis damages the economies of a wide range of countries, the road to recovery is a long way to go.

## **Differing Opinions**

There are different opinions as to how to save the European economy from collapsing. Deutsche Bundesbank President Jens Weidmann is against the ECB buying more government bonds on the secondary market, something that Mr. Draghi, ECB president, strongly supports, and something that analysts say is an essential measure to save Spain, the euro zone's fourth-largest economy, from losing access to the capital markets (Buell 1 Aug 2012). Weidmann thinks that the ECB has intervened too much in the crisis and that the struggling countries rely too much on the ECB to get them off the hook, an issue of moral hazard. In addition, he says that ECB's power is limited and that the countries need to learn to manage themselves. Surely Weidmann has his own reasons. If the struggling countries rely too much on the ECB, they would not try in their utmost ability to repay their debts and make unwise decisions such as continuing to expand their debt. Consequently, countries such as Germany and Finland would be forced to provide cash for those troubled euro zone members and watch their people lose jobs; it would not be a fair game for those countries. However, at the same time, it is also crucial for the ECB to help those struggling countries to lower interest rate, because otherwise, it would be impossible for those countries to repay their debts due to their economic problems. Spain and Italy are currently in uncomfortable positions because of high interest rates. Nevertheless, low interest rate just encourages more borrowing, putting the struggling countries in a vicious cycle of deficit spending. While the ECB has a responsibility of helping those struggling countries, maybe the Euro will be easier to preserve if the struggling countries are forced out.

There is a way that the opinions of Mr. Draghi and Mr. Weidmann could be reconciled. According to the ECB president, Mr. Draghi, the bond purchases will be concentrated on shorter-maturity sovereign debt and may come after countries have decided to request help from the

bailout funds and have agreed to the conditions attached to financial support. The bond purchases would differ greatly from the previous bond purchases of the ECB. This condition somewhat reconciles the dispute between Draghi and Weidmann because Draghi has tightened his measures on bond purchase. Tightening the measures on bond purchase lowers inflationary potential, lowers risks, and helps the economies of the struggling countries build credits.

Nevertheless, “Spanish Prime Minister Mr. Rajoy asked for up to 100 billion euros in European Union aid in June 2012 to help clean up the country’s ailing banks” (House and Granitsas 2012). This puts the investors in big concerns. Since ECB president, Mr. Draghi, suggested that the ECB would target shorter-dated government bonds, the yields of the two-year Spanish and Italian bonds eased some percentage points. Because of it, Greece, Portugal and Ireland subsequently asked for help. However, on the other hand, the long-term bonds of those countries are still in trouble, so the countries are still in bad positions. As a result, Mr. Rajoy considered asking for a bailout in order to raise investor confidence. In order to get this bailout fund approved, Spanish government needs to agree to the contract by reducing spending and increasing tax.

### **The Debt Crisis’s Influence on the Economies Abroad**

The European Debt Crisis not only influences the European countries, but also has a great influence on the economies abroad. Since the European economy is contracting sharply, many concerned local banks look for opportunities in the US and Latin American markets. However, “the increased search for alternative sources of funding is yet another indication that Europe’s debt crisis is far from over,” because increased borrowing will result in higher interest rates due

to higher risks (Ball 2012). In addition, as a result of investing and borrowing from abroad, the stock indexes for the US and Latin America have risen significantly.

The European funding institutions are looking for ways to raise funds from foreign companies. The main European funding institutions such as the ECB and the IMF will have to assess Greece's ability to cut its debt in order to decide whether to grant it bailout funds, and the outlook for Spain is not optimistic. Consequently, many European companies have established ties with companies abroad. For instance, a Spanish cement company, Cementos Portland, sold Blackstone Group LP a six-year bond with a 10% yield secured by Cementos Portland's US business for \$430 million (Ball 2012). In addition, Spain also looks to China for cash (Dominguez and Ho 2012).

However, even though borrowing from abroad allows the European companies to raise enough money to pay down its debt in the short run, it sounds like they are just swapping one debt for another rather than paying down the debt. Asking for foreign help is not a long term solution, so it is important for the European countries to impose proper austerity measures such as spending cuts.

Mr. Draghi argued that while government spending cuts hurt economic productivity in the short run, the negative effects can be offset by structural overhauls. Governments have made progress on deficit reduction, making economies more competitive. Banks have stabilized and bond markets are opening. Mr. Draghi also lowered interest rates back to record lows with back-to-back cuts (Blackstone 2012). Spending cuts and stabilized money supply, coupled with cheap borrowing rates, can together help the European economy to climb to the road of recovery, although at the risk of moral hazard associated with low rates, encouraging even more borrowing.

## **Possible Approaches to Remedy the Debt Crisis**

There are potentially two conflicting approaches to remedy the damage of the Debt Crisis. One is to stimulate economic growth, and the other is to cut spending. What we want is a combination of the two approaches. It is important to stimulate economic growth in order to raise revenues associated with greater levels of economic activity, but at the same time, it is also crucial to cut spending in order to reduce deficit. Since the affected countries have different levels of debts, different combinations of growth and spending cuts should be applied accordingly to each country based on cost-benefit analysis. For instance, since Greece is so heavily in debt, it may be constrained in the short run to cut spending and increase tax. On the other hand, for some of the stronger countries, it is important to stimulate economic growth in order to develop more funds to support the struggling countries.

In addition, the supporting organizations, such as the IMF, should focus more on monetary policy and less on fiscal policy. In other words, they should focus more on stabilizing the money supply rather than on decreasing interest rates. However, German Finance Minister thinks that “monetary policy cannot be used to solve fiscal problems” (Buell 9 Sept 2012). There are other factors beside money supply that affect interest rates and the bond market, such as the inflationary risks and bond ratings. Therefore, since everything is so uncertain, the affected European countries need to adjust their actions according to the severity of their debt crises.

## **Conclusion**

The European Debt Crisis arose because countries persistently tried to use more resources than were available, often to support social programs, and as a result, countries such as Greece and Spain are in deep recession. While cutting spending and/or raising taxes may ease the problem in the short run, economic growth is the best long run approach. Nevertheless, while cutting taxes today can stimulate long run growth, it worsens the immediate problem. In addition, the European countries need to focus more on monetary policy and less on fiscal policy. However, “monetary policy cannot be used to solve fiscal problems” because there are other factors besides money supply that affect interest rates and the bond market. Moreover, some European countries look to other countries, such as the US and China, for help, but even though borrowing from abroad helps to solve the immediate problem, it is not sustainable because the European countries are just swapping one debt for another. Many solutions for reducing the damage of the debt crisis have their costs as well as their benefits, and since the future of the crisis is so uncertain, the affected countries just need to adjust their actions according to the severity of their debts.

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