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A Comprehensive Approach to the European Sovereign Debt Crisis

Its roots, process and enlightenment on china

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Abstract - In the winter of 2009, the three largest credit rating agencies downgraded Greece's sovereign rating in a row, which triggered the European sovereign debt crisis. Subsequently, Portugal, Italy, Ireland and Spain all sunk into the debt storm, which indicated that the entire European area was troubled by the debt crisis. The debt crisis created unprecedented challenges to the euro area. Moreover, it risked a conflagration on the international financial markets and received worldwide attention. The purpose of this article is to bring an economic perspective to understand the European sovereign debt crisis by exploring its roots and process and putting up with some suggestions for china.

Keywords – The European debt crisis; Root; Process; Enlightenment

1. The process of the European sovereign debt crisis

To join in the euro zone, Greece conducted cross-currency swap agreements with Goldman Sachs in 2000 and 2001, which meant that Greece took on much more future debts in exchange for less debts and lower deficit rate. After the new Greek government came to power in 2009, they found that the previous government covered up the true financial situation, so raised fiscal deficit to 12.7 per cent, which exceeded the limit of 3 per cent. Actually, the deficit of Greek had been worse than initially reported to the EU for most of the last decade. The news was announced very quickly, three largest credit rating agencies downgraded Greece's sovereign rating in a row. As the crisis intensified, S&P company downgraded Greece rating to "CC" in July 2011, and down to "selective default" in February of this year.

Dim economic assessments were suddenly made: Greece should exit or take a holiday from the system. Such pessimism stood in sharp contrast to pre-crisis evaluations of the euro's collapse as being very unlikely [1]. In any event, Greece's debt may be close to 150 per cent of GDP by 2013. At last, the Greece sovereign debt crisis came to a temporary relief thanks to €750 billion by EU finance ministers and €250 billion aid fund provided by IMF. Greece has taken many rounds of austerity fiscal policy, mainly including cutting government spending, raising certain types of tax rates. Even after its bail-out, the Greek position seemed face with a major risk of default on its debts. The Greek case simply pierced its political illusions.

The second and third victim countries were shot down. In September 2010, Ireland government announced that, the previous deficit of GDP was inaccurate, it would be upgraded to 32 per cent--the highest figure in European history--as to rescue five domestic largest banks. In November 2010, the Irish government officially turned to the European Union and the International Monetary Fund for assistance, became the second victim country of European debt crisis.

In January 2010, Moody enterprise warned Portugal that if it did not take effective measures to control its deficit, the company would downgrade Portugal sovereign debt rating. The delayed responses, in early May 2010, both the €110 billion bail-out loan for Greece and the €750 billion rescue mechanism for the Euro-system as a whole. The Portugal became the third victim country of European debt crisis. Measures to cut back government spending include freezing government retirement pension plans, cutting down public sector employees' income bonus and holiday allowance. Therefore, its rescue was squeezed by an unprecedented struggle with the international financial markets and serious strikes and discontent at home.

The Greek economy was far from being in a unique position in 2011. The debt crisis spread to the central countries from other countries in the edge of the Europe. In February 2010, the deficit figure of 9.8 per cent of GDP was reported by the Spanish Ministry of Finance. In the next day, the stock market plummeted 6 per cent. In July 2011, Italy also involved in the crisis. The standard & Poor's harbored negative prospects for Italy, and downgraded Italy long-term sovereign debt rating to "A" in September. Germany was predicted that its budget deficit would reach 5.5 per cent of the domestic income. The major member countries in euro-zone were beginning to feel the impact of the crisis. Eventually, the Greek is not the center of the debt crisis, the European Union became a byword for the nightmare of uncontrolled deficits.

Struck by the increasingly intensifying European debt crisis, global economy is likely to sink into the second recession and became more vulnerable to inflation. Debt crisis caused a contradiction about whether to cut expenditure between European countries. The US and European government enforced a list of economic sanctions and trade barriers to protect their domestic economies. At the same time, the European sovereign debt crisis began to affect china's economy through foreign trade, RMB exchange rate and financial policy. It brought a disaster to china's foreign trade, commodities and services export, which decreased significantly for shrinking consumption ability of European countries, as china's largest export market. The European debt crisis shrank china's foreign exchange reserves for continuous depreciating euro and added the pressure of RMB appreciation.

2. The roots of the EU debt crisis

The EU debt crisis is evolutionary product of American financial crisis and exposes the weaknesses of the euro area. For its european inherited features, it is necessary to analysis the causes of the European sovereign debt crisis. In times of global economic integration, it is the global financial crisis that ignited the debt crisis, however, the roots of EU debt crisis are governance problems in Euro-zone.

2.1. Most European countries have been maintaining long-term high-welfare low-growth pattern of expenditure, virtually pushed government debt to a dangerous level.

The focus countries of the debt crisis –PIIGS, are the "developing" countries in the euro zone. These countries, whose industrial base is relatively weak, mainly rely on labor-intensive manufacturing industry and tourism service industry to develop their economy. Inherited economic weaknesses placed the economy in a vulnerable international position when the international credit crisis spread in 2008–09. Economic growth speed becomes more slowly under the influence of the financial crisis.

What's more, the aging population increased gradually, which deteriorated the imbalanced population structure continuously. Not surprisingly, IPIIGS had sustained a high level of structural unemployment, especially among young workers, for more than a decade. The rigidity of the employment laws – often poorly enforced – is compensated by the flexibility offered by the very large informal economy, estimated at being up to 29.5 per cent of GDP [2]. All these phenomena resulted in a huge pension, unemployment compensation and other social relief expenditure. There is a long history of sensitive issues such as the pension, health or labor market systems.

Domestic tax evasion phenomenon appears repeatedly, which reduced the governmental tax revenue sharply. The EU Commission estimated that uncollected tax revenue amounted to 30 per cent. Indeed, it has fluctuated around the equivalent of 100 per cent of GDP since 1993. Huge government agencies and their staff have aggravated the government burden. Successive governments have sustained high levels of public debt, much of this is related to the inelastic expenditures of the public sector wage bill. Government has been in budget deficit year after year, this eventually led to the outbreak of the European debt crisis.

2.2. Although the euro zone has been unprecedented successful template of the world's regional monetary, but it is not perfect.

The European sovereign debt crisis exposed the underlying weakness of governance of the euro area--an incomplete, imbalanced set of rules, which is the arch-criminal for this crisis. Maastricht had stressed on rules of self-discipline, but had signally failed to supply much central competence to check and intervene in cases of 'moral hazard' concern.

First, the implementation of fiscal policy and monetary policy does not coordinate with, forming a two-element structure of european characteristics. The euro-zone monetary policy is formulated by the European Central Bank uniformly, which usually spend a long time to balance the interests of all countries in Europe. Once the economic crisis erupted, the European Union's council of ministers and the European central bank failed to provide a timely and effective rescue project. In response to this crisis, many countries have no choice but to use expansionary fiscal policy excessively. This way strengthened the dependence on the fiscal policy and resulted in a huge financial burden and fiscal deficit. This debt burden grow bigger and bigger, eventually beyond the government's ability to deal with. The result of the European sovereign debt crisis was that its institutions behaved in ways that were either not foreseen or were dysfunctional, at least in some important respects. The absence of a set of comprehensive and effective regulatory regime also contributes to the imbalance of local debts.

Second, the tax system in euro-zone countries is not unified, which caused capital convergence flow. The tax of enterprises varies from one country to another country. In Germany and French, the company tax rate are around 30 per cent, however, the tax rate of countries located in the European edge and Eastern European countries is below 20 per cent, which caused a large number of capital flow into those countries provided higher interest rates. Subsequently, capital was invested in real estate and tourism, causing huge economic bubble. When the credit squeeze and economic recession spread, economic growth rate of euro zone countries declined sharply.

Third, when problems arise, countries participate in the game to consider their own interests, which costs lots of time and causes the salvage operations without efficiency. The European Union is composed of 27 countries with different national conditions. These countries also have big disparity in political and economy. To its critics, the euro area was seen as sustaining severe demand imbalances, exacerbating divergences between the growing deficits of Greece, Portugal, Spain and Malta, and the growing surpluses of Germany and the Netherlands [3]. The European Union has not set up the exit mechanism. When a member nation is in crisis, the only way to solve problem is to go on a long-time internal consultations, which loses the best rescue opportunity and reduces overall euro-zone interests. Whether rescue Greece, German and French have delayed the solution of the problem for their different opinions. The problems of economic governance further exposed the vulnerabilities of no political union behind EMU.

2.3. It is the global financial crisis that triggered the European debt crisis.

The America financial crisis led to a global economic recession, countries have launched their own rescue plans--easy fiscal and monetary policy. Companies and government agencies' massive borrowing behavior increased leverage ratio and their default risk in private and government field.

The financial markets highlighted Greece as being in danger of default on its foreign borrowing. All three major credit rating agencies further downgraded sovereign debt ratings, caused the public and investors' psychological panic and malignant expectation. Countless investors sold their euro-investment, while speculators took the opportunity to invest risk assets. This behavior accelerated the deterioration and development of the crisis.

3. Lessons we can learn from the European sovereign debt crisis:

The implications of the crisis for Europe were profound. The government had failed to overcome the crisis of low competitiveness, trade and investment imbalance, and fiscal mismanagement. The future of European debt crisis is full of many uncertainties. There is no possibility for our country to occur debt crisis in short term. However, in huge local government debt era, a thorough analysis of the European debt crisis can still give us some enlightenment.

3.1. Accelerating Chinese economic restructure

Although the European sovereign debt crisis has exerted negative impact on china, it will urge Chinese government to restructure their economic system to some extent, shifting away more firmly from depending on exports and investment to expanding domestic demand for economic development. Chinese government should pay a close attention to the powerful role of domestic consumption, and constantly strengthen economic endogenous growth power. The European government had failed to overcome the crisis of low competitiveness, trade and investment imbalance, and fiscal mismanagement. In other words, the economy had lacked competitiveness and sustained economic growth.

In the future, China should gradually compress capital investment, increase resident income continuously, and enhance MPC as working key. At the same time, private enterprises should be encouraged to increase investment in science and technology industry, improve product technology content and additional value and create their own brand. Only comprehensive economic transformation of china's industrial sectors can improve the overall competitiveness of china's economy and cope with the financial crisis and the debt crisis.

3.2. Enhancing the government capability of debt management

From the surface, The European debt crisis is a crisis that the government debt burden exceedes their repayable ability. The problems of co-ordination and control that arise from debt crisis are evident in the processes of budget management. Chinese government has been effectively controlling fiscal deficit. By the end of 2010, china's liability ratio is 29.25 per cent, far below international debt warning line of 60 per cent. There is no possibility to emerge a debt crisis for china in short run. However, we should clearly aware that china also has many debt problems in many provinces and cities. After the financial crisis, many provincial debt ratios continue to rise for a huge new borrowing. The debt ratio of some local governments is above 100 per cent. If this situation goes on to deteriorate, bad debt risk and default risk hide in banking, which should attract enough attention.

The government should take actions to reduce the local debt and prevent the default risk, mainly from two aspects: one is to strengthen the government accounting books supervision, another is to improve government debt management by rising capital use efficiency. All this work, stressed that the government expenditure matches its revenue, aims at preventing expenses beyond governmental bearing capacity and keeping foreign debt and local debt always in the controllable safe range.

On the one hand, an effective measure to monitor local government debts is regular, comprehensive examination and assessment of local government debt conditions. Chinese government should overhaul and regulate comprehensively local government debts. On the other hand, a law should be launched to strengthen local governmental budget management and enforce debt limit strictly. Regulatory regime contributes to the equilibrium of local debts, and regulates the size, quality and usage of debt financing, reducing default risks to the minimum.

It is important to heighten the governmental awareness of controlling investment direction strictly and improving efficiency in the use of funds and government debt paying ability. The local government financing channels are relatively simple, mainly through expensive bank loans. On the one hand, financing sources of local governments should be expanded to meet the requirements of local development and cut the large financing expenses. In a high housing price society, local governments have no choice but depend on land sales as income to develop local economy. However, the high housing price is beyond what the most people can purchase, this investment will produce enormous economic bubbles. Therefore, it's necessary to carry out a legislation system to supervise governmental loan fund comprehensively and strictly.

3.3. Upgrading welfare system

Upgrading welfare system safeguards the coordinate development of welfare policy and economy, does not repeat the European debt crisis road. The European debt crisis arose with the aging population and the huge welfare spending. At present, China is also facing the problem of aging population, social pension expenditure also increased year by year. Although the amount of social welfare expenditure of our country is much lower than European countries', this is determined by the national economic development condition. Along with our country economic situation improves, our welfare system will be more comprehensive. The social welfare system is related to people's life, though it also should make both ends meet. Only in this way welfare system can be sustainable development. Based on Chinese national conditions, China should gradually improve the level and treatment of the social welfare system, continue to expand insurance coverage. Further, various measures should be taken to diminish the urban and rural difference and ensure the fairness of welfare.

3.4. Carefully dealing with the issue of RMB internationalization

The action to deal with RMB internationalization, should be careful. The European debt crisis tells us profoundly, the international leading currencies competition is not just an economic contest, it is also involved in other key variables -- politics, culture and ideology of integrated. The establishment of an international currency, not only needs a strong economic strength to support, seizes historical opportunity, but also needs the capacity to respond to challenges more importantly. At present, the RMB regionalization and internationalization has become an international trend, but our national comprehensive strength has not reached that level. In the exploration of RMB regionalization, china should also continue to adjust the structure of our country economy, strengthen financial risk management, and make every effort to the progressive realization of RMB internationalization.

4. Conclusions

Distinct from sub-prime mortgage crisis originated in U.S, the European sovereign debt crisis is caused by increasing unpaid debts in Greece and other European countries. The European debt crisis slowed the pace of global economic recovery, also caused some negative effects on our country economy. The Chinese government should examine this crisis carefully and regard the European sovereign debt crisis as an alarm. Firstly, Chinese government should restructure their economic system shifting away more firmly from depending on exports and investment to expanding domestic demand for economic development. Secondly, it is important to heighten the governmental awareness of controlling debt. Thirdly, various measures should be taken to improve the level and treatment of the social welfare system gradually. Further, the action to deal with RMB internationalization, should be careful.

The next research is to apply data mining method [8-17] in our work.

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Vitae

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