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The European debt crisis

There is much talk in the media about the 'debt crisis' and as professional accountants we ought to have an understanding of how it has come about, and what is being done and what may be done to try and resolve it. Furthermore although only an unfortunate few of us have noticed any significant ill-effect as a result of the crisis we ought to consider the potential impact that it could have on both businesses and individuals.

The principle cause

With the introduction of the Euro it became possible for some Eurozone countries to borrow at much cheaper rates than previously. This is because although the debt was still national debt, the assumption was made that being within the Euro meant that the risk of these countries had declined as a result of the economic rules they were now bound into. The principle rules required Eurozone members to ensure that government debt did not exceed 60% of GDP and that any budget deficit should not exceed 3% of GDP. Effectively the gloss of the good credit rating of countries such as Germany rubbed off on countries such as Portugal, Ireland, Italy, Greece and Spain – the 'PIIGS' as they are sometimes known.

So what went wrong?

Unfortunately while Germany continued its tradition of investing in research and development and other productive purposes, the PIIGS used too much of the available credit to consume more, build generous social systems and fund a construction boom.

As a result of the growth in consumption, many of the countries now in trouble built up large balance of payment deficits that are clearly not sustainable. However, this excess consumption was tacitly encouraged by others as it helped demand and growth in their own economy.

The financial crisis which started in 2007 caused problems with the liquidity of banks and, as a result, lending and economic growth faltered. However, many of the loans made to both governments and private organisations had assumed certain levels of growth and when these failed to materialise problems arose with repaying and servicing the debts.

The construction boom led to real estate bubbles especially in Ireland and Spain. A large quantity of bank loans, made against the security of property, the demand for which evaporated due to the economic slowdown, have gone bad. This has caused the need for large write offs. In Ireland the government had to step in and guarantee these loans in order to prevent the six main Irish banks from failing.

The failure of some countries to stay within the economic rules set for the Eurozone and the failure of the Eurozone as a whole to police these rules, which effectively let countries get away with circumventing and/or ignoring the rules, has meant that countries are now tied to a currency over which they have little control and which, due in part to their own failure to abide by the criteria set, is no longer suitable for their needs. As a member of the Euro they do not have the power to devalue their currency or the monetary policy flexibility to take other action to try and resolve the situation they find themselves in. For instance, in Greece tourism – which accounts for 18% of Greek GDP and employs about one in five Greek workers – has been significantly reduced as a result of the strength of the Euro.

As the crisis has developed, the loss of confidence in the countries affected has led to rises in the bond yields required on their government debt. Given the amount of debt their governments have, bond yields can quickly achieve a level at which the government can no longer afford to service their debt. This loss of confidence has been fuelled by downgrades from the credit rating agencies, media speculation and speculators betting against the Euro and/or certain countries. Indeed, the bail out that Portugal required was thought to be driven to a certain extent by the actions of speculators.

A lack of firm and decisive action by the Eurozone countries and institutions has also added to the crisis. The Euro was established with no mechanism for a country to leave and bail outs of individual countries were not allowed for or expected. This is because all Eurozone members were supposed to adhere to the rules that would have prevented the current situation arising in the first place. Hence, there has been much dithering before action has been taken.

So where are we now?
In most of the nations with problems, the key issue is thought to be one of liquidity as opposed to insolvency. That is, while they can fundamentally service the debt they hold given normal economic conditions, they may have problems finding the cash they need in the short term. As long as countries are given assistance and provided with loans to keep them liquid when required, default in the short term can be avoided. Greece is however potentially insolvent and more drastic action is likely to be needed. Indeed some Greek creditors have already had to agree to a significant write down of the value of their debt – this is known as taking a haircut.

What has been done so far?
No country has been allowed to default for fear that this could cause a domino effect and cause defaults of other banks and nations – known as contagion.

However, this has led to piecemeal action – ‘bail outs’ – as and where the crisis has required it and many commentators fear it is simply putting off the day when the problem must be faced properly – ‘kicking the can down the road’ is an expression that has been much used. The existence of credit default swaps (CDS) which provide guarantees on sovereign bonds has exacerbated the fears as it is has made it less clear as to where exactly the pain will fall if a country defaults. There is perhaps too much fear of default. For instance, Russia defaulted in 1998 but can once again borrow in the international money markets at reasonable rates.

The measures taken which have prevented default to date include:

European Union (EU)
Emergency measures taken by the EU include:

- Increasing the minimum level of bank capitalisation to aid their stability and ability to withstand further shocks.
- European Financial Stability Facility (EFSF). This was created in May 2010 to raise the funds needed to provide loans to Eurozone countries in financial trouble, to buy sovereign debt and to recapitalise banks. The EFSF is jointly and severally guaranteed by the Eurozone countries.
- European Financial Stabilisation Mechanism (EFSM). This was created in January 2011 and involves the European Commission raising funds using the EU budget as collateral. The EFSM has lent funds in conjunction with both the EFSF and the International Monetary Fund (IMF).

European Central Bank (ECB)
As already mentioned the key problem is one of liquidity and hence the ECB has taken action in conjunction with the other leading central banks of the world in order to try and ensure that both governments and major banks have sufficient liquidity.

Specifically the ECB has bought both government and private debt securities in the open market, as by so doing it provides liquidity or cash to the government or organisation selling the debt securities.

As the crisis has progressed the ECB has accepted Greek Government bonds of any status as collateral for lending. These purchases are obviously politically motivated and not normal commercial transactions. As such they have effectively reduced the independence of the ECB and unhappiness with this has prompted some high level resignations.

International Monetary Fund (IMF)
In conjunction with the EU, the IMF has made loans available. The IMF first became involved as a result of the inability of Europe to agree a solution to the emerging Greek crisis. Some countries are thought to have been keen for the

IMF to become involved due to the reputation the IMF has for imposing stringent fiscal austerity measures. It is thought that nations may take more heed of measures imposed by the IMF than measures imposed by their European counterparts.

In early 2012, the IMF was seeking an extra $500bn for additional lending that it anticipates may be needed to assist countries with liquidity problems. This is a clear indication that in the IMF's view there is still much to be done.

As expected the extra lending which has been made has required the recipient countries to adopt stringent fiscal austerity measures. However, Christine Lagarde, the new head of the IMF has been critical of the emphasis there has been on austerity measures and has called for more measures to promote growth.

In the US, growth is being promoted through the devaluation of the dollar and other measures and there has been less emphasis on austerity measures. This is driven by the US fear of a 1930s style depression. In Germany, on the other hand, there is more enthusiasm for imposing austerity measures as there is a fear of inflation due to the hyperinflation Germany suffered between the two world wars. All nations are victims of their history. Ironically the economic woes of Germany between the two world wars were largely a result of the stringent measures imposed on Germany after the end of World War 1.

What else is likely to be done?
With regard to the Euro the most likely outcome at the current time is that the Euro continues in its present form with its existing members. However, this view could easily be overtaken by events even between the time I write this and the date of publication. For this to happen emergency funds will need to be provided when and where required and, if necessary, a managed default may occur in one or more countries. The popularity of this option is that by holding the Euro together the risk of contagion is minimised. However, the contagion feared if Greece is allowed to exit the Euro seems to be in danger of occurring anyway as witnessed by the sudden rise that occurred in Italian bond yields in late 2011. Furthermore countries at risk will be encouraged to promise much with regard to potential fiscal measures that may be imposed on them safe in the knowledge that no effective sanction will be taken against them when they fail to comply. This option seems to be a 'let's muddle through and see what happens approach' but does not necessarily seem sustainable in the long run. Furthermore, it is not necessarily the best approach for the countries involved as they will remain locked into a currency which fails to suit their needs.

In order to reduce the risk of further and ongoing crises, a closer fiscal union between Eurozone members is envisaged. This will involve more stringent fiscal rules and greater penalties for countries not abiding by the rules.

As Eurozone members have individually lost control of their interest rates, exchange rates and capital controls they need to adjust exports and/or consumption as otherwise the trade imbalances which threaten to undermine the Euro will continue. For example, Germany needs to promote domestic consumption while Greece needs to reduce consumption and promote exports. It will be a difficult task for Greece to achieve this whilst they remain in the Euro. Historically, a country in this position would carry out a currency devaluation to promote exports and growth.

The European Stability Mechanisation (ESM) is a permanent scheme which is due to take over from both the EFSF and EFSM from July 2012. It will act as a financial firewall and through guarantees, limit the potential for default by any one country and hence the risk of contagion.

What else might happen?
With regard to the Euro two other options have been suggested:

- The first option involves a Greek default and expulsion or departure from the Euro. Supporters of this feel that the contagion caused by a Greek default could be managed and this would help rebuild confidence in the remaining Eurozone. (Sacrificing the weakest member of the herd may just make the rest of the herd safer.) Equally, the remaining Eurozone countries would abide more rigorously to any fiscal rules imposed on them for fear of following the fate of Greece. While Greece would initially bear significant pain as a result of falling out of the Euro, there is a worry that after a few years other troubled countries, still struggling within the Euro, may see the Greek economy recovering and decide that they too will choose to leave thus causing the Euro project to effectively fail.
- The second option which currently seems the least likely is that Germany leaves the Euro and introduces a new Deutschmark or enters into a new currency union with other Northern European nations with more closely aligned economies. This would leave the Euro to slump and find a new level which would meet the needs of the PIIGS and others.

At the present time the collapse of the Euro in its present form seems politically unacceptable and hence neither of the above options seems likely to occur. However, a Greek withdrawal or expulsion has at times seemed close and events could rapidly develop such that the currently favoured option becomes unsustainable.

Other suggestions that have arisen during the crisis but which have so far not been acted upon include:

- The issue of Eurobonds or stability bonds has been much talked about. These bonds would be jointly issued and underwritten by all Eurozone countries as opposed to the current situation where each nation state issues and is responsible for their own debt. This approach is not

favoured by Germany as it would effectively involve Germany taking on others liabilities.
- A European Monetary Fund has been suggested. This fund would lend to governments at a cheap rate dependant on that nation abiding by certain fiscal rules. This would encourage fiscal responsibility as otherwise a nation would need to access the traditional and more costly commercial bond markets.

What are the implications for business and individuals?
For countries where austerity measures are imposed there is likely to be a reduction in economic activity and a reduction in both government and private sector jobs and hence an increase in unemployment. Equally the need to abide by such austerity measures is likely to lead to higher or additional taxes and reduced government spending. In this environment it will be hard to restart economic growth.

Furthermore, countries for which the Euro is at too high a value will continue to suffer a lack of competitiveness. It will be a difficult task for these countries to rebuild competitiveness without the option to devalue their currency.

As the economies of all the European nations are intertwined the reduction in demand in one or a few countries will impact on the whole of Europe and beyond.

As such, there is a risk of a deflationary slump within Europe and this would only be made worse if there were significant defaults which resulted in the much feared contagion.

In economic circumstances such as these the ability of companies to borrow may be curtailed. Even individuals remaining in employment may find that their overdraft and credit card limits are reduced.

Without wanting to sound over-dramatic the situation above is a recipe for further political and social unrest. The crisis has already caused the fall of a number of governments and more worryingly, from the point of view of the average suffering citizen, some of their replacements lack democratic credibility. Political extremism and nationalism could easily flourish and more government failures could arise. Military coups or other non-democratic forms of government could result. As I write tear gas is being used against rioters in Greece.

All of the above creates uncertainty, nervousness and swings in confidence and hence volatility in stock markets. For most of us this will simply exacerbate existing problems although no doubt some lucky or clever individuals and organisations will benefit from such volatility.

What about the UK?

Just because the UK is outside the Eurozone we cannot pretend that we are isolated from the problems in the Eurozone. Any defaults that occur are bound to impact on the UK banking sector and as Europe is our largest trading partner any reduction in economic activity caused by the crisis is bound to impact on economic activity in the UK. Furthermore, we have our own fiscal problems to deal with. However, at least within the UK we have the monetary policy flexibility to do what needs to be done given our own economic circumstances. Complacency though is not an option and we would do well to remember our own riots, in the summer of 2011, which many have blamed on the economic problems we face.

Conclusion

As a whole, Europe is not vastly indebted. If Europe works together then it should be possible to overcome the current debt crisis. But at times of economic hardship it is not easy for the nation states within Europe to put aside their own self-interest for the common good.

Action to reduce the harmful levels of uncertainty has been taken and a full-blown crisis has so far been avoided. However, there is a need to ensure that the demands for austerity do not extinguish the potential for much needed growth. Too much austerity could condemn nations to persistent stagnation, the social cost of which should not be underestimated. Youth unemployment in Spain is currently at about 40% I believe. While within Europe there seems to be a political acceptance of these costs in support of the Euro project, a sovereign nation and its population are unlikely to want to bear such pain for long.

Students should aim to read a good newspaper on a regular basis in order to keep up with developments as they arise.

William Parrott is a lecturer at Kaplan Financial

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