

DEBT CRISIS AND DISTRIBUTION OF WEALTH

Prepared for: European Union, ConnectMUN 2011
Directors Stuart Warren, Zach Hauser
Chair: Yoora Kang

INTRODUCTION

In 2009, the European Union's eurozone began to face its first major financial crisis since its inception in 1999. The economic causes leading up to this current crisis are controversial and complex to analyse. They include economic contagion from the earlier recession in the United States, a global fear from credit swaps, and increasing disparities between countries' interest rates. The impact of the European debt crisis is being felt globally, as traders and investors treat European markets with greater caution or steer clear of them altogether. The effects on the European populace have been significant, even including riots over austerity measures introduced to combat sovereign debt (the debt that a country's government itself owes. While bailouts have solved some short-term problems, the crisis is hardly over. The EU needs to marshal itself as a driving force for cooperation and communication in regulation among its member states to lay the European sovereign debt crisis to rest.

Essentially, the main cause of the financial crisis in Europe is diminishing confidence in its countries' economies. Investors see warning signs, such as an increase in credit default swapping, large deficits in some EU member states, and wide bond yield spreads, which erode their confidence in the EU markets. As a result, investing and the doing of business in the European Union falls, which further diminishes confidence in the markets. One major cause of this diminished confidence is the dramatic increase in credit default swapping that has been occurring over the past few years (Erman & Neary, 2010). Credit default swapping is basically a form of insurance, except instead of being on a house, a car, or a person, it is on the defaulting of a country on its debt. When a person purchases a credit default swap for Greece, for example, he or she pays an to an insurance agency, guaranteeing that the agency will repay larger damages in the event of Greece's default on its sovereign debts—turning a profit. Credit default swaps can also refer to specific companies or institutions within a country, or to non-default credit events such a credit rating reassessments. An increase in the amount of debt credit swaps taken out on a country is very bad news for that country, because it indicates that investors suspect

that country's economy is on the verge of collapse or crisis. In the recent sovereign debt crisis, increased amounts of debt swaps were taken out on Greece, Portugal, Ireland and other countries, indicating that confidence in these countries' finances was low and that their economies may be at risk. Because these countries are European Union and Eurozone members, there exists real fear that a major negative credit event in any of these countries could spread throughout Europe. More pessimistic analysts believe that a major collapse, such as a Eurozone sovereign government's default on its debt, could threaten the entire future of the euro. (Erman & Neary, 2010).

Related to the issue of credit default swapping is an increase in bond yield spreads within the EU. Bond yield spread refers to the disparity between returns on loans of varying quality ratings (risk levels). (Investopedia, 2011) This disparity is increasing in the EU, indicating that the riskier bonds are being perceived as more riskier than in the past. This stifles investment and further reduces economic confidence across the EU. The increase in bond yield spreads is both an indicator and a further cause of the lack of confidence in Europe's economies that is causing economic woe in the first place.

Another primary cause of the Eurozone economic crisis is, of course, poor fiscal policies on the part of member states. Countries such as Greece, Ireland, and Spain have immensed immense deficits over the few decades from a combination of excessive government spending, low retirement ages, low taxes, and other factors. These countries have found themselves in financial trouble simply because their expenses far exceed revenue. As they are members of the greater EU, and the EU cannot allow total collapse in one member state to affect the EU at large, these countries' failing treasuries have to be propped up by other EU members, meaning that faulty management of some EU states' economies has drained finances from all of them. (Hutchinson, 2011).

The debt crisis in Europe has had far-reaching effects on the rest of the world, but it has also affected everyday people who aren't involved in investment and business—the European people. Austerity measures imposed by governments trying to rescue their financial prospects have decreased Europeans' quality of life; for example, by increasing the retirement age, making the workweek longer, and placing caps on bonuses. The civil unrest caused by the debt crisis has caused damage to personal and state property alike. (Frazer & Marlier, 2011). Of course, the wider economic crisis's effects cannot be overstated: unemployment, bankruptcy, and poverty have all afflicted European citizens because of the economic strain.

Additionally, the debt crisis has taken its toll on some of the strongest economies of the EU: most prominently, Germany. Germany is touted as the strongest economy in the EU, but by financing the bailouts of failing countries, Germany has

been dragged into the economic crisis. In distributing wealth to less financial successful countries, Germany and other financially stable EU countries have sustained significant losses to their own economies. And of course, even the Eurozone states who have not significantly contributed to bailouts have suffered because they share a currency—the euro—with failing countries. As a result, the outlook of the entire European Union is negatively affected. (Hutchinson, 2011).

An organisation such as the EU has the potential to play a crucial role in solving a the current European financial crisis. As an international organisation, it fosters cooperation between member states, exemplified by the aid member states have given one another and the agreements they have reached (such France and Germany's recent adoption of a shared position on the debt crisis.) As well, the EU has demonstrated that it has been able to borrow significant sums of money from the IMF and other sources in order to bail out a few of its Member States. The EU can make policy that all of its members have to follow in the long term, even if their political leaders or internal political climates fluctuate in the meantime. Diplomatic pressure can also be crucial; Greece has implemented austerity measures largely due to the pressure of other member states.

PAST ACTION

On June 1, 1998, the EU established the European Central Bank (ECB), a bank that has since administered financial exchanges between EU member states. The ECB's current main function is to minimize inflation in the Eurozone. Its methods include setting interest rates in the Eurozone, authorizing banks to issue euro banknotes, and managing the Eurozone's foreign currency reserves.. (Communication department of the European Commission, 2011) (European Financial Stability Facility, 2011)

Recently, the EU has utilized two bailout mechanisms, the European Financial Stability Facility (EFSF) and the European Financial Stabilization Mechanism (EFSM), to keep its economies and governments on track. The EU Member States established the EFSF with the backing of the IMF on May 9, 2010. The EFSF's function is to support EU member states whose economies are struggling by lending them money guaranteed by other EU countries. The EFSF has the ability to lend up to €440 billion to struggling countries (European Financial Stability Facility, 2011).

In addition to the EFSF, the EU established the European Financial Stabilization Mechanism (EFSM) on May 9, 2010, which has the ability to lend up to €60 billion of financial assistance to any EU member state “experiencing or ... seriously

threatened with a severe economic or financial disturbance caused by exceptional occurrences beyond its control.” Unlike the EFSE, the EFSM can only provide assistance to EU member states that are in the Eurozone (Europa, 2010). The bailouts provided by the EFSF and EFSM are supplemented by a €250 loan from the IMF (Dawn.com, 2011).

To date, the EU has issued three major bailouts to its failing countries. It lent €110 billion to Greece on May 2, 2010. In November of 2010, the EU issued a second bail-out package of €85 billion to Ireland. Finally, in May 2011, the EU bailed-out Portugal for €78 billion.

In March 2011, certain countries, both EU members and non-EU members, joined the Euro Plus Pact, with the aim of agreeing on “concrete actions” to carry out in order to improve Europe’s economies. However, the pact drew criticism from some EU members and was not supported by all of them, partially because the pact was developed by the French and German governments without the input of other Member States.

Also in March 2011, the EU adopted the Stability and Growth Pact, another pact intended to produce concrete action, but in this case it was to define concrete penalties for transgressions of previous EU policies relating to debt and deficit reduction, with the hope of instilling more financial discipline in the countries of the EU who, according to the pact, “did not generate a satisfactory decline of public debt.” (Council of the European Union, 2011)

BLOC POSITIONS

As the strongest economy in the Eurozone, Germany’s role in the debt crisis has been as a prime mover in bailing out its fellow EU members and funding the European Financial Stability Facility and the European Stability Mechanism (Yahoo! News, 2011). Germany has experienced an increased burden on its own economy as a result; its debt ratio (the ratio of debt to gross GDP) has increased from 64% to 84% over the past two years. (Forex News, 2011) Germany has also been against the use of bond buybacks, which attempt to rescue countries with failing economies by allowing them to buy back their bonds at a discounted price. Germany has been a proponent of stricter controls on budget deficits, something which has been unenforced in many EU countries since 1999. (Fouquet & Neuger, 2011) At one time, Germany’s Minister Wolfgang Schaeuble stated that the country will not contribute any more money than it already has to bailout efforts. (Yahoo! News, 2011)

France and Germany stated that they came to a joint position on the debt crisis in July 2011; however, the details of that position were not released. Prior to their agreement, the two countries disagreed on the issue of bond buyback, with France being in favour of allowing ailing countries to buy back their bonds at a lower price. French President Nicolas Sarkozy has warned the public that “it is not possible to let Greece fall for economic reasons and for moral reasons.” Since July 2011, the French and German governments have been further working together to

IMF on the condition of decreasing its spending and actually following the inflation and deficit limits imposed by the European Central Bank that it has exceeded for years (BBC Newsbeat, 2010). In order to achieve these goals, the Greek government has engaged in austerity measures, including increasing the retirement age, cutting spending on pensions and other social welfare programs, and decreasing government wages (Reuters, 2010), which has caused great civil unrest as its citizens feel the adverse affects of these cuts. Currently Greece is struggling to decrease its deficit, keep the peace internally, and satisfy the requirements of aid packages from the EU and IMF (BBC Newsbeat, 2010). Greece could default on its sovereign soon, if it does not receive more funds from the EU. Some analysts have promoted the intentional and organized default of Greece on its debt, although the government's official policy is that it is not considering the possibility of defaulting. Nonetheless, the press have reported that the government is considering that route of dealing with its debt.

Spain and Italy's financial markets have also been experiencing increased pressure and have used austerity measures and financial bailout packages from the EU and IMF to keep their economies afloat. Both countries have suffered from protests in response to austerity measures imposed on its citizens by the government. Both countries are currently pursuing a reduction of their deficits and improvement of their general financial situations (Hutchinson, 2011). Spain has agreed to reduce its deficit in order to satisfy its bailout agreement with the EU. (Voigt, 2011) The situation in Ireland has also been dire; corruption allegations plaguing the Irish sovereign debt crisis have led to great controversy and the main Irish banks are still struggling. Despite a massive bailout by the ECB and IMF, Irish banks' debt was downgraded by Moody's to "junk" status in April 2011.

When Iceland suddenly lost its status as one of the strongest economies in Europe in 2008 amidst the failure of its banking system, its government responded by taking nationalizing banks and borrowing money from the EU and IMF in order to do so. A diplomatic controversy erupted as a result of Iceland's decision not to guarantee foreign deposits in its banks. (BBC, 2009).
with third countries." (Europa, 2011)

Italy has a markedly extreme position on immigration. Its government employs harsh penalties on immigrants who are not legally permitted to be in the country, including fines and prison terms. In the summer of 2008, the Italian government deployed troops onto their streets, to combat illegal immigration. The government has even allowed private citizens to form street patrols with the expressed purpose of preventing rape, a problem that tends to be often blamed on immigrants. Italy has faced criticism from both member states and citizens of the EU for being

QUESTIONS TO CONSIDER:

- 1) Should countries with strong economies such as Germany leave the EU in order to keep their economies intact?
- 2) Should EU Member States with failing economies default on their debts to solve their problems?
- 3) How can the EU preserve cooperation among its Member States when some of them (with weaker economies) are so dependent on other ones (with stronger economies)?

- 4) How can the EU lessen the negative impacts of austerity measures on average people living in the countries that have put them in place?
- 5) Does the future of the euro necessitate reevaluation in the wake of the current crisis?

WORKS CITED

- BBC. (2009, February 2). BBC NEWS | Europe | Timeline: Iceland economic crisis. Retrieved October 1, 2011, from BBC News: <http://news.bbc.co.uk/2/hi/7851853.stm>
- BBC Newsbeat. (2010, May 6). BBC - Newsbeat - Greek financial crisis explained. Retrieved October 1, 2011, from BBC Newsbeat: <http://www.bbc.co.uk/news-beat/10100201>
- Communication department of the European Commission. (2011). EUROPA - European Central Bank. Retrieved October 4, 2011, from Europa: http://europa.eu/about-eu/institutions-bodies/ecb/index_en.htm
- Council of the European Union. (2011, March 15). Council reaches agreement on measures to strengthen economic governance. Retrieved September 26, 2011, from Consilium: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/119888.pdf
- Council of the European Union. (2011, March 15). http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/119888.pdf. Retrieved October 1, 2011, from European Council: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/119888.pdf
- Dawn.com. (2011, July 21). Germany, France reach deal on euro debt crisis | Business | DAWN.COM. Retrieved October 1, 2011, from <http://www.dawn.com/2011/07/21/germany-france-reach-deal-on-euro-debt-crisis.html>
- Erman, B., & Neary, C. (2010, March 19). What are credit default swaps? Retrieved October 1, 2011, from The Globe and Mail: <http://www.theglobeandmail.com/report-on-business/economy/what-are-credit-default-swaps/article1495104/>
- Europa. (2010, May 10). EUROPA - Press Releases - The European Stabilization Mechanism. Retrieved September 25, 2011, from Europa: <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/173>
- European Commission. (2009). http://ec.europa.eu/economy_finance/publications/publication15887_en.pdf. Retrieved October 4, 2011, from EUROPA - European Commission: http://ec.europa.eu/economy_finance/publications/publication15887_en.pdf

European Council. (2011, April 20). http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/120296.pdf. Retrieved October 1, 2011, from Council of the European Union: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/120296.pdf

European Financial Stability Facility. (2011). About EFSE. Retrieved October 4, 2011, from EFSF: <http://www.efsf.europa.eu/about/index.htm>

Evans-Pritchard, A. (2011, August 2). Europe's money markets freeze as crisis escalates in Italy and Spain - Telegraph. Retrieved October 1, 2011, from The Telegraph: <http://www.telegraph.co.uk/finance/financialcrisis/8677989/Europes-money-markets-freeze-as-crisis-escalates-in-Italy-and-Spain.html>

Fitz-Gerald, K. (2011, August 24). The European Banking System is Finally on the Verge of Collapse - Money Morning. Retrieved October 1, 2011, from Money Morning: <http://moneymorning.com/2011/08/24/european-banking-system-is-finally-on-verge-of-collapse/>

Forex News. (2011, September 18). Germany's former central bank governor: EU to resolve the debt crisis requires a unified fiscal policy | Forex News. Retrieved September 25, 2011, from Forex News: <http://www.forex-news.co/germanys-former-central-bank-governor-eu-to-resolve-the-debt-crisis-requires-a-unified-fiscal-policy.html>

Fouquet, H., & Neuger, J. G. (2011, February 3). France Pushes for Buybacks to Stem Financial Crisis in Split With Germany -Bloomberg. Retrieved September 30, 2011, from Bloomberg: <http://www.bloomberg.com/news/2011-02-03/france-pushes-for-buybacks-to-stem-financial-crisis-in-split-with-germany.html>

Frazer, H., & Marlier, E. (2011, June 24). SYNTHESIS REPORT 2010-3_final.pdf. Retrieved October 4, 2011, from Peer Review in Social Protection and Social Inclusion and Assessment in Social Inclusion: http://www.peer-review-social-inclusion.eu/network-of-independent-experts/reports/2010-third-semester-report/synthesis-report-3_10

Hutchinson, M. (2011, September 2). European Sovereign Debt Crisis Summary - Money Morning - Only the News You Can Profit From. Retrieved October 1, 2011, from Money Morning: <http://moneymorning.com/tag/european-sovereign-debt-crisis-summary/>

Investopedia. (2011). High-Yield Bond Spread Definition. Retrieved October 8, 2011, from Investopedia: <http://www.investopedia.com/terms/h/high-yield-bond-spread.asp#axzz1aB04mOPN>

Mu, X. (2011, October 1). Sarkozy says Greece's failure to pull down Europe. Retrieved October 1, 2011, from Xinhuanet: http://news.xinhuanet.com/english2010/world/2011-10/01/c_131170374.htm

Reuters. (2010, February 3). Timeline: Greece's economic crisis | Reuters. Retrieved October 1, 2011, from Reuters: <http://www.reuters.com/article/2010/02/03/us-greece-economy-events-idUSTRE6124EL20100203>

Reuters. (2011, September 23). Analysis: Time running out on Athen's troika two-step. Retrieved October 5, 2011, from Reuters: <http://www.reuters.com/article/2011/09/23/us-eurozone-greece-backsliding-idUSTRE78M3JP20110923>

Stanage, N. (2010, November 18). Ireland's Financial Crisis: the Bankers Who Caused it - The Daily Beast. Retrieved October 1, 2011, from The Daily Beast: <http://www.thedailybeast.com/articles/2010/11/19/irelands-financial-crisis-the-bankers-who-caused-it.html>

Thompson, N. (2011, June 23). Timeline: Greece's financial crisis - CNN. Retrieved October 1, 2011, from CNN: http://articles.cnn.com/2011-06-23/world/greece.crisis.timeline_1_financial-crisis-eurozone-greek-economy?_s=PM:WORLD

Voigt, K. (2011, April 7). EU bailout: Portugal, Ireland, Greece... who's next? Retrieved October 4, 2011, from CNN: <http://business.blogs.cnn.com/2011/04/07/eu-bailout-portugal-ireland-greece-whos-next/>

Waterfield, B. (2010, December 10). EU bailout: how has Britain become involved? Retrieved October 4, 2011, from The Telegraph: <http://www.telegraph.co.uk/news/worldnews/europe/eu/8174460/EU-bailout-how-has-Britain-become-involved.html>

Yahoo! News. (2011, October 1). Germany 'won't give more to EU bail-out fund'. Retrieved October 4, 2011, from Yahoo! News: <http://news.yahoo.com/germany-wont-more-eu-bail-fund-090029990.html>