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A History of Europe's Debt Crisis and Current Issues

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Nick Nasad \ 12:41 AM EST \ February 20th, 2012

With Europe these past few years, the financial markets are seeing the crisis of too much government debt and poor government balance sheets as well as a weak banking sector unfolding. The crisis originated with Greece, moved to Ireland and Portugal, and struck Italy in the second half of 2011. This article will try and present the historical reasons why, as well as the key issues facing Europe in early 2012. At the root here, this story is about competitiveness, interest rates, and the imbalances that grew out of the introduction of the euro.

Failure of the Growth and Stability Pact

In the 1990's the European nations that wanted to pursue a currency union, laid out the "European Stability and Growth Pact" which attempted to limit countries' budget deficits to 3% of GDP with a secondary goal of keeping total debt load below 60% of GDP.

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Life in the Red Zone

Euro-zone governments have increasingly broken their self-imposed limit of annual budget deficits of no more than 3% of gross domestic product.

Not yet in the euro zone | THE HIGH GROUND Surplus | WITHIN THE TARGET Deficit of 3.0% or less | BREAKING THE RULE Deficit of 3.1%-6.0% | DOUBLING THE LOAD Deficit of 6.1% of GDP or more

Limit under the Maastricht Treaty: Deficit of 3.0% of GDP

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011 estimate
Euro area	-1.5	-0.1	-2.0	-2.7	-3.1	-2.9	-2.5	-1.4	-0.7	-2.1	-6.4	-6.2	-4.1
Austria	-2.3	-1.7	0	-0.7	-1.5	-4.4	-1.7	-1.5	-0.9	-0.9	-4.1	-4.4	-3.4
Belgium	-0.6	0	0.4	-0.1	-0.1	-0.3	-2.7	0.1	-0.3	-1.3	-5.8	-4.1	-3.6
Cyprus	-4.3	-2.3	-2.2	-4.4	-6.6	-4.1	-2.4	-1.2	3.5	0.9	-6.1	-5.3	-6.7
Estonia	-3.5	-0.2	-0.1	0.3	1.7	1.6	1.6	2.5	2.4	-2.9	-2.0	0.2	0.8
Finland	1.6	6.8	5.0	4.0	2.4	2.3	2.7	4.0	5.3	4.3	-2.5	-2.5	-1.0
France	-1.8	-1.5	-1.6	-3.3	-4.1	-3.6	-2.9	-2.3	-2.7	-3.3	-7.5	-7.1	-5.8
Germany	-1.6	1.1	-3.1	-3.8	-4.2	-3.8	-3.3	-1.6	0.2	-0.1	-3.2	-4.3	-1.3
Greece	-3.1	-3.7	-4.5	-4.8	-5.7	-7.6	-5.5	-5.7	-6.5	-9.8	-15.8	-10.6	-8.9
Ireland	2.7	4.7	0.9	-0.4	0.4	1.4	1.7	2.9	0.1	-7.3	-14.2	-31.3	-10.3
Italy	-2.0	-0.8	-3.1	-3.1	-3.6	-3.5	-4.4	-3.4	-1.6	-2.7	-5.4	-4.6	-4.0
Luxembourg	3.4	6.0	6.1	2.1	0.5	-1.1	0	1.4	3.7	3.0	-0.9	-1.1	-0.6
Malta	-7.7	-5.8	-6.4	-5.8	-9.2	-4.7	-2.9	-2.8	-2.4	-4.6	-3.7	-3.6	-3.0
Netherlands	0.4	2.0	-0.2	-2.1	-3.1	-1.7	-0.3	0.5	0.2	0.5	-5.6	-5.1	-4.3
Portugal	-2.7	-2.9	-4.3	-2.9	-3.0	-3.4	-5.9	-4.1	-3.1	-3.6	-10.1	-9.8	-5.8
Slovakia	-7.4	-12.3	-6.5	-8.2	-2.8	-2.4	-2.8	-3.2	-1.8	-2.1	-8.0	-7.7	-5.8
Slovenia	-3.0	-3.7	-4.0	-2.4	-2.7	-2.3	-1.5	-1.4	0	-1.9	-6.1	-5.8	-5.7
Spain	-1.2	-0.9	-0.5	-0.2	-0.3	-0.1	1.3	2.4	1.9	-4.5	-11.2	-9.3	-6.6

Note: Data include debt ratios for Greece, Slovenia, Cyprus, Malta, Slovakia and Estonia since 1999, even though they joined the euro zone later.

Source: European Commission

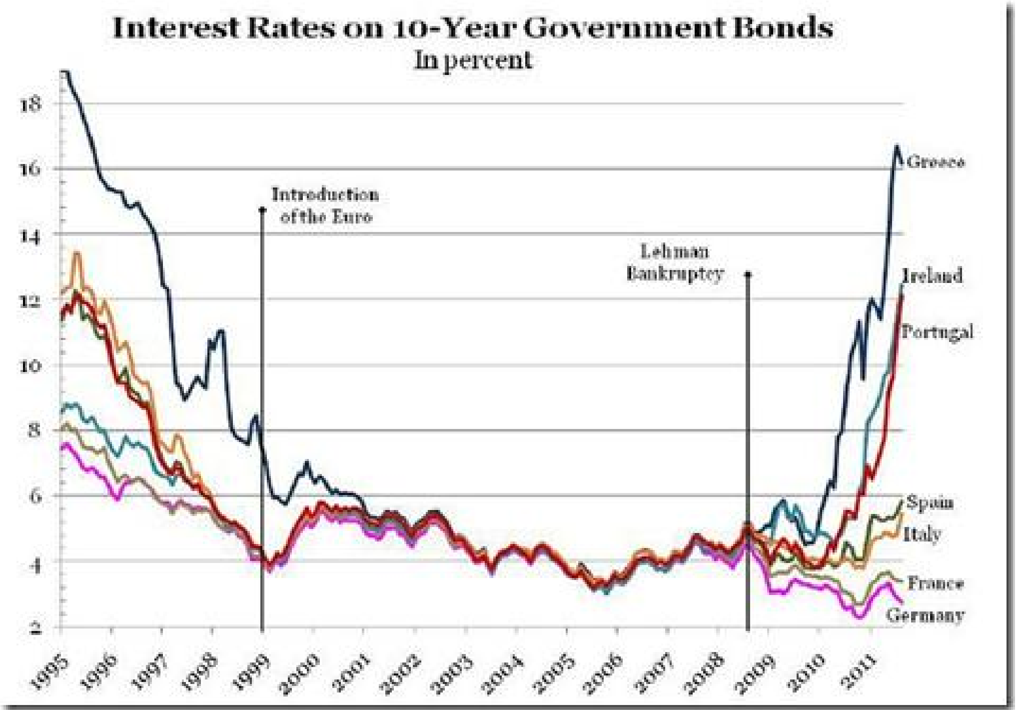
Who was able to keep to these rules during the 9 years prior to the 2008 financial crisis and who wasn't?

- Germany was the first country to break the rules, running a deficit above 3% in 2001, and the 4 years after that. That's 5 out of 9 years it did not meet the targets.
- France ran a deficit above 3% from 2002 to 2004, missing the target 3 out of the 9 years.
- Italy was the worst offender, breaking the rules 6 years out of 9.
- Spain, a country now being targeted during the sovereign debt crisis, was actually the best performer here, keeping to the target of the Growth & Stability pact all 9 years.

Therefore it wasn't who followed the rules here that eventually got into trouble, which means we had another key factor that was at the root of the current crisis.

Converging Interest Rates & Growth in Debt Levels

Well, there are 2 key factors. The first one to consider was the narrowing in borrowing costs charged the various governments within the Euro-zone.



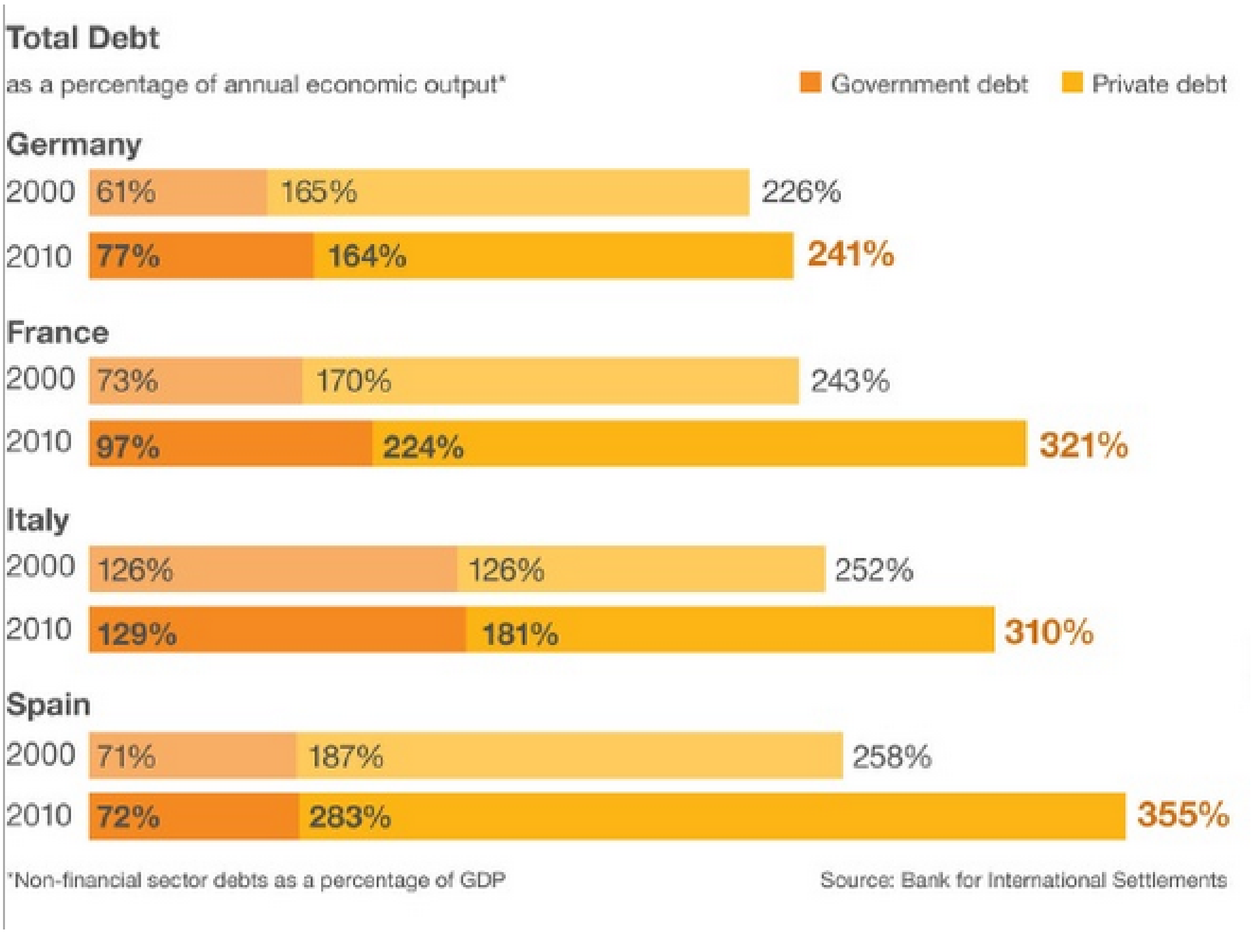
Economist

The chart to the right shows the 10-year yields for the various Euro-zone countries as they approached the introduction of monetary and currency union in 1999 and shows that these rates converged during that period. Prior to this convergence, in 1995 for instance, interest rates varied widely, with those countries on the periphery – Greece (19%), Portugal (11%), Spain (11%) and Italy (12%) – paying much higher borrowing costs.

As Europe got closer to the introduction of the Euro, all of these spreads tightened to such a degree that a country like Italy or Spain, which historically had more generous social benefits and were less competitive than those in northern European were able to borrow at the exact same prices. A country like Greece, just a few years later, held the same privilege.

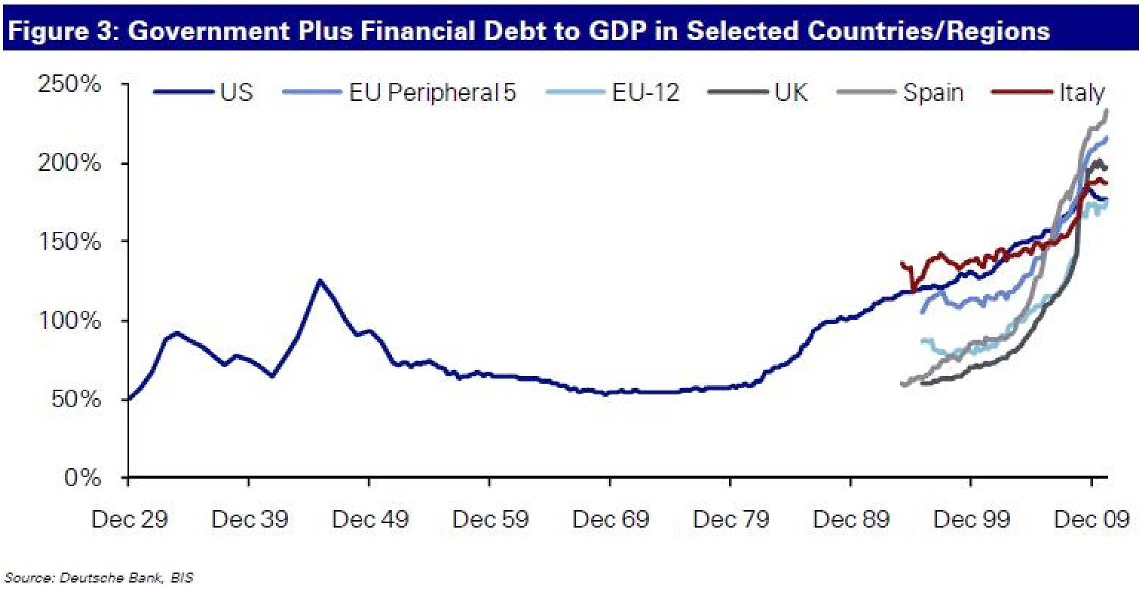
This convergence laid the seeds for the current crisis as it created big imbalances in sovereign bond markets, as countries like Greece, Ireland, Portugal, Spain, and Italy (and their banking systems) were all able to borrow much more than they would have been able to if they were not a part of the euro.

After the collapse of Lehman Brothers these spreads started to widen out as investors become concerned about defaults, counterparty risk, and the solvency of these "periphery" European nations.



Now, it wasn't even necessarily government debt that exploded as a result of these lower borrowing costs, but private debt loads. In the chart above we see the difference in government and private debt from 2000 to 2010.

- In Germany, government debt grew from 61% of GDP to 77%, while private debts remained the same around 165% of GDP.
- In France, government debt grew from 73% to 97% of GDP, while private debt rose from 170% to 224%, bringing the total debt load from 243% of GDP to 321%.
- In Italy, gov't debt remained relatively constant, while private debts grew by 55%.
- In Spain, gov't debt growth was also tame, but fueled by a housing boom, its private debt load jumped by 100% of GDP, bringing its total debt to 355% of GDP.

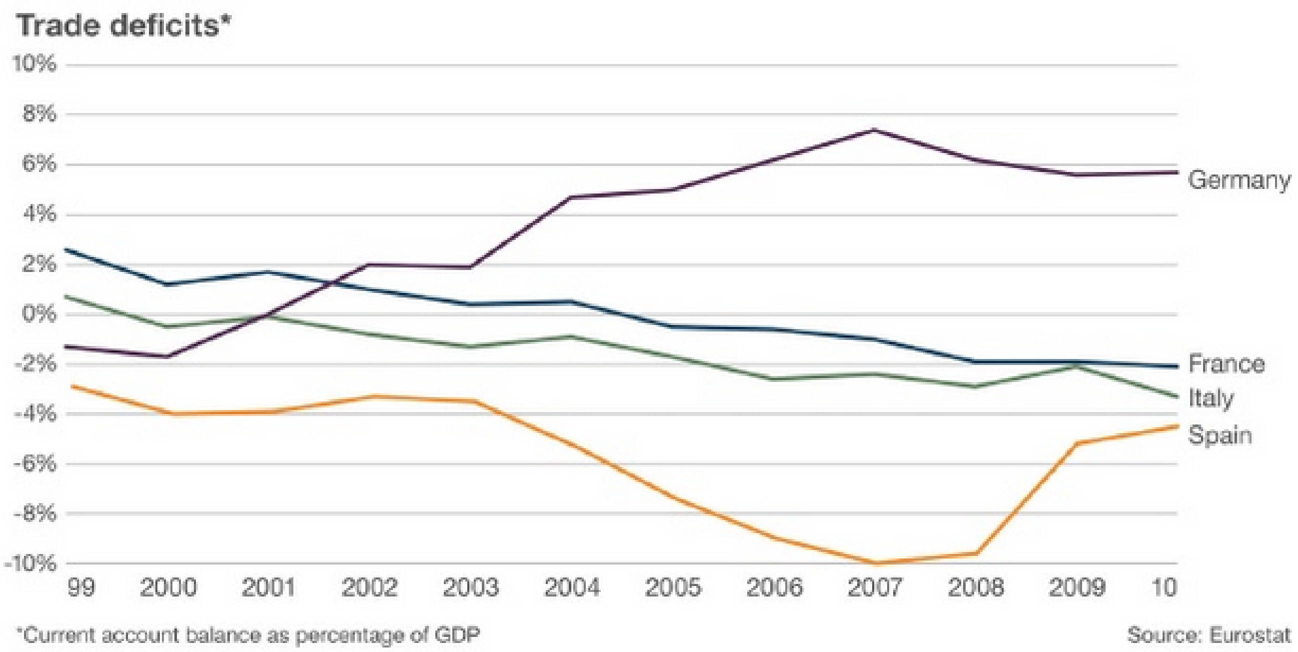


The point to take away here then is that these lower rates allowed a leveraging up of household and bank debt which is now causing a deleveraging cycle.

Trade and Competitiveness

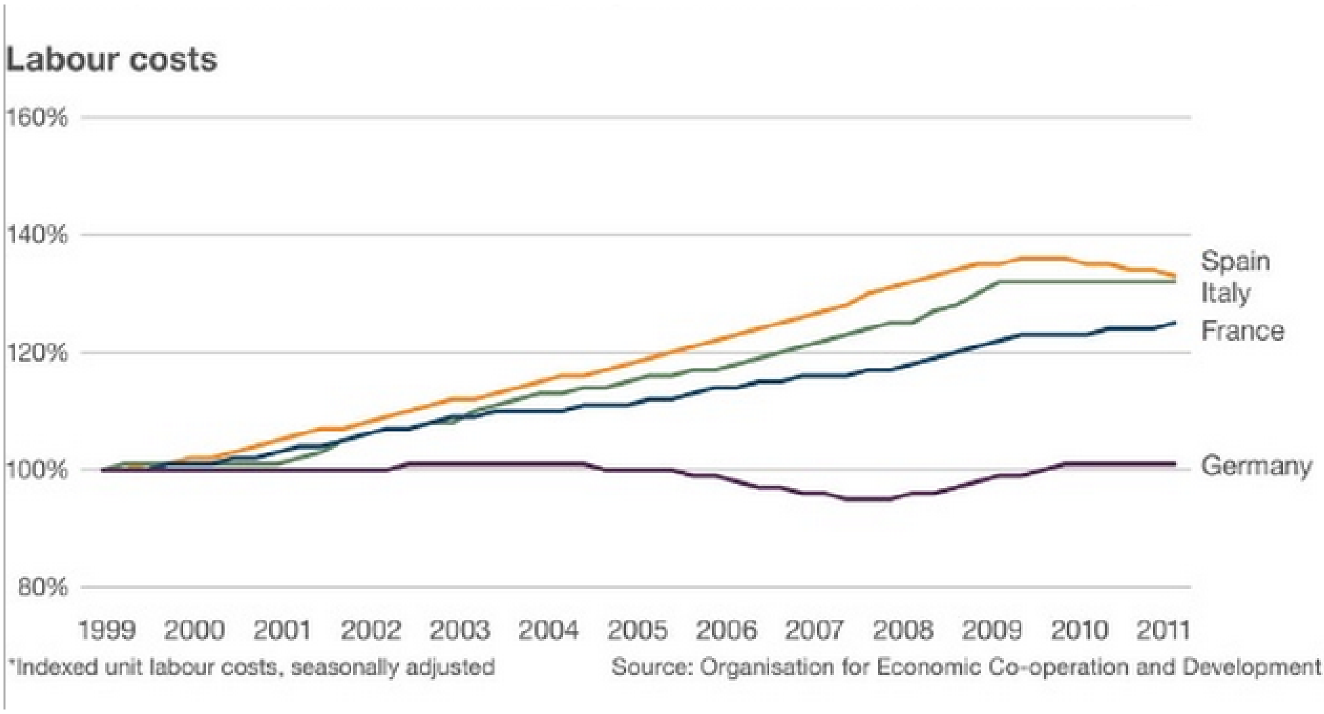
If the introduction of the Euro creates these imbalances via lower borrowing costs, why would a country like Germany – which was the guarantee of stability in the monetary pact – agree to it?

Well, for Germany we have to think about the benefit to its economy from trade by having a single currency. Because countries could no longer use devaluations to compete with German exports, Germany was able to capture more of the European market. Also, the "periphery" countries were able to go ahead and borrow cheaply and use that money to buy goods from Germany's meaning even more export growth for Germany.



The 2000's therefore were very good for Germany on that front as it enjoyed robust trade surpluses, at the expense of countries like France, Italy and Spain which saw its economies running big trade deficits.

The bad news was that all this borrowing masked another big imbalance which was the deterioration of competitiveness of the periphery economies versus Germany, best measured by using labor costs.



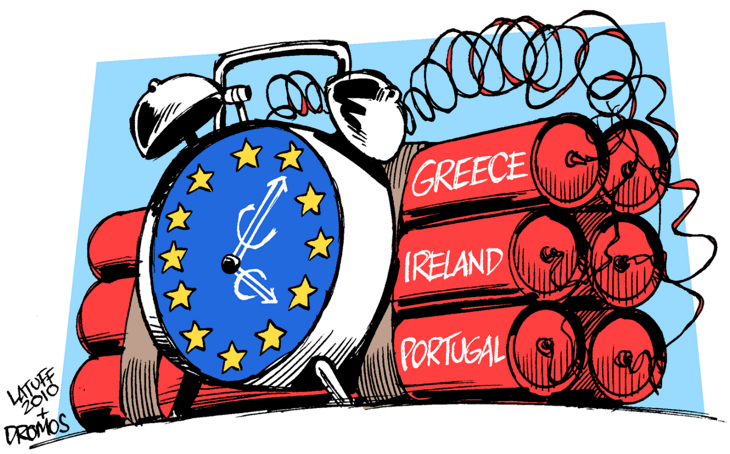
If we take the labor costs in Germany, France, Italy and Spain at the start of 1999 and relative to each other start them at 100%, the image above shows that Germany has kept its labor costs relatively steady during the subsequent 10 years. That is a result of the re-unification of East and West Germany as well as an agreement by workers and unions to keep pay increases small – in essence an internal devaluation.

In Spain, Italy, and France meanwhile labor costs have risen by 25-30%. This puts these countries' exporters at a big disadvantage, and the only way to address the issue would be for these countries to bring their labor costs back in line with Germany, or for Germany to allow its wages to rise.

That is a process that a country like Greece is going through now with its austerity measures which includes lowering salaries and the minimum wage for instance, but it's an issue that these bigger countries will have to face as well.

Current Crisis – Debt Overhand and Weak Banking Sector

Having gone through some of the historical reasons and underlying problems for the imbalances that plagued the Euro-zone, let's delve deeper into the key issues during the current crisis.



Currently the concern is that the governments and banks that borrowed or lent out too much during the 2000's now face the process of refinancing those debt loads at a time when borrowing costs have gone up. Whether they will be able to fully pay back those loans will mean that these issues will continue to haunt the Euro-zone for the next few years, if not decade.

The sovereign debt crisis is now also finely interwoven with the banking system and the prospect of a financial system crisis because many of the institutions that own sovereign bonds are European banks. What the ECB has done most recently is provide cheap refinancing to the European banking system via its long-term refinance operations – "LTRO". The most recent version of this policy came in December 2011, as the central bank offered 3-year loans at 1% interest which saw a big uptake – around 500 billion euro.

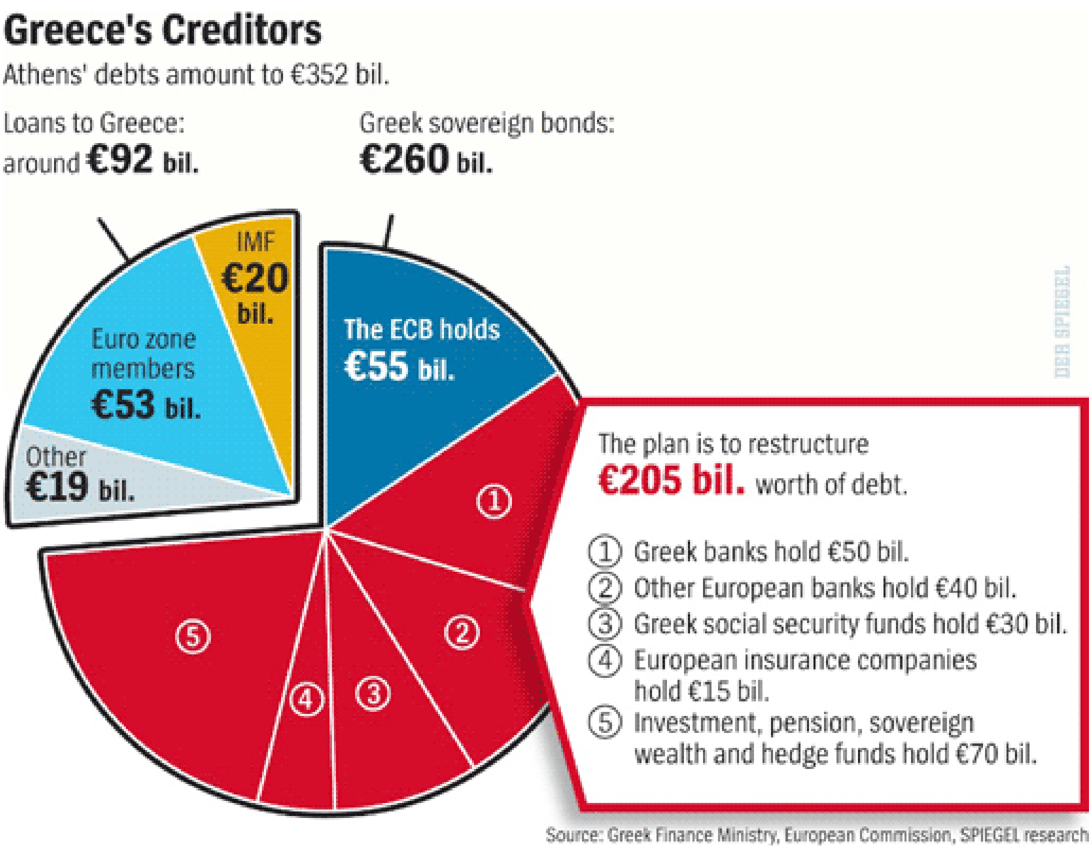
Banks were eager to take on those loans as they needed to rollover debts that were coming due in the early part of 2012 and in the later part of 2011, many European banks were facing a financial freeze in terms of finding funding.

Greek Debt Restructuring

Before we talk further about the banking system, let's look more closely at the sovereigns (governments) that are facing deep pressure starting with the country in the worst position – Greece.

Because of its heavy debt load, and inability to meet its redemptions and interest payments, Greece will have to restructure its debt – to enter into a "selective default".

Here's the Greek debt:



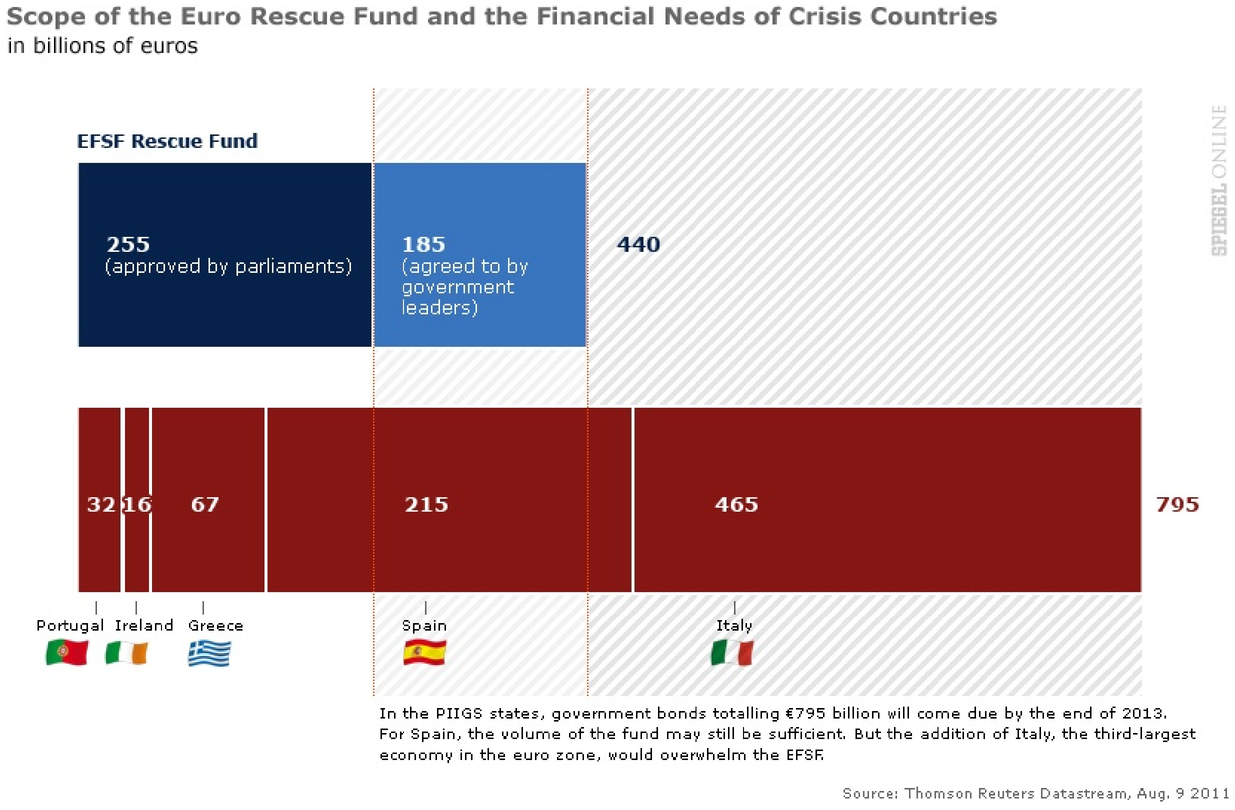
The total amount of debt held by private creditors amounts to about €205 billion, with the ECB (known as an "official" creditor) holding another €55 billion. Another €92 billion is money lend to Greece as part of its 1st rescue package. - that is debt held by private creditors of Greece. The situation now is that Greece will have to "restructure" its debt, a term that implies a default because Greece is unable to pay back the full amount owed.

In the debt restructuring deal currently under discussion, private creditors would swap out their current bond holdings for those with longer maturities and smaller coupons, with the end result being that about €100 billion of the €205 billion will come off the books. The private creditors are doing this on a voluntary basis because it could be worse and Greece could default on the full amount of debt, and the various EU countries will offer "sweeteners" to participants to accept the deal.

By making it a voluntary restructuring, it would also avoid being labeled a "credit event" by credit rating agencies meaning that credit default swaps – insurance against a country not meetings its obligations – would not be paid out. As of right now, the Greece case is unique, but it could be a sign of what's to come for other countries if they too are unable to meet their commitments going forward.

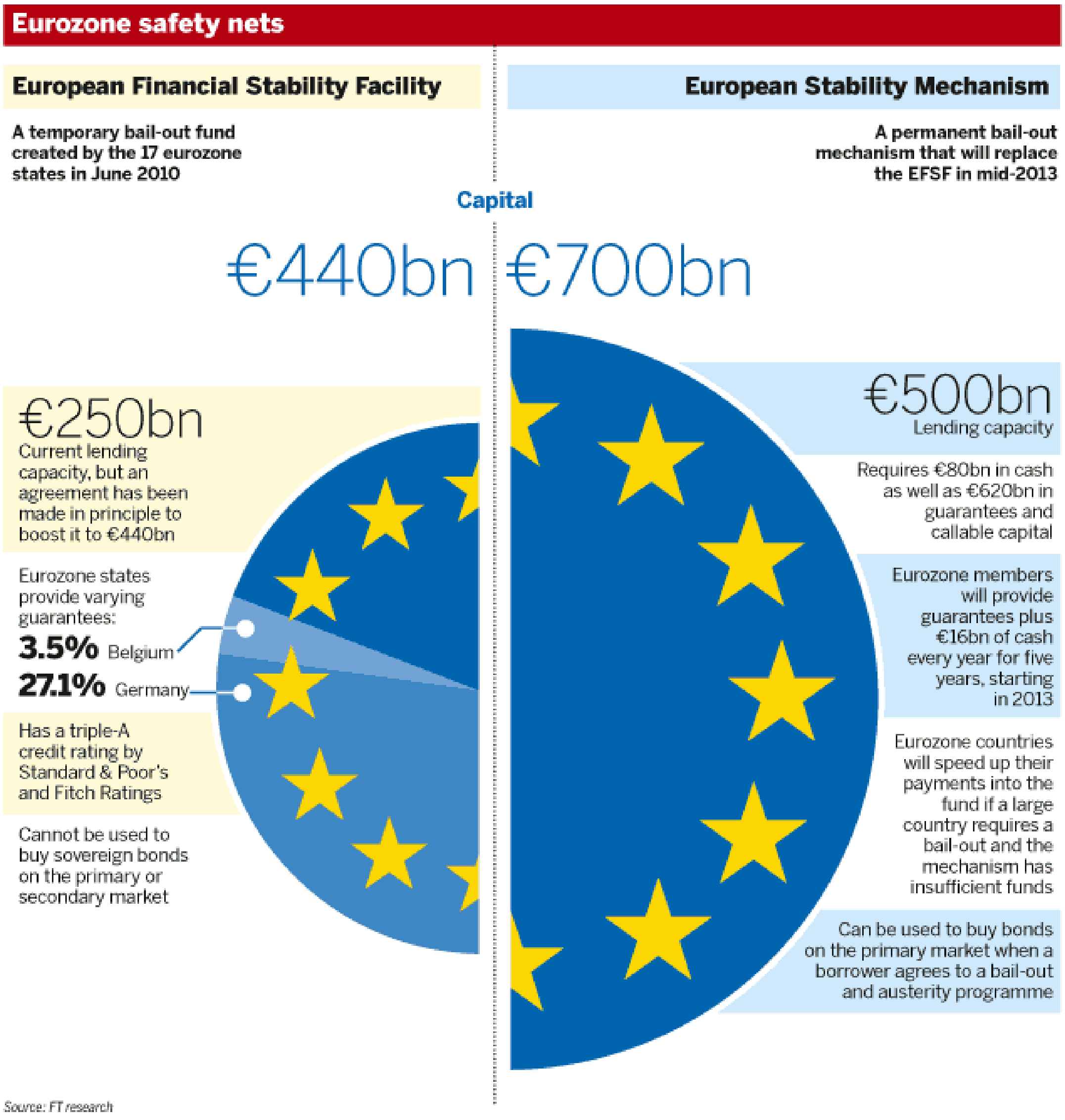
Contagion and Firewalls

When we think about Greece and amount of debt that is coming due in 2012 it's a relatively small amount when we consider the debt of Spain and Italy.



In 2012 and 2013 Spain has €215 billion of bonds maturing that need to be rolled over while Italy has €465 billion. Combining that with Portugal, Ireland and Greece, it comes to a grand total of €795 billion. The European Financial Stability Fund (EFSF) was set up with €440 billion of lending capacity, enough to cover the three smaller nations that have already been bailed out, but not enough to cover Spain and Italy.

In the middle of 2012 the European Stability Mechanism (ESM) will be introduced with a lending capacity of €500 billion, which will supersede the EFSF, but again does not pack the firepower needed to cover the debts of the bigger nations if they were to get frozen out of bond markets.



The Case of Italy – A 1% Move in Yields Causes Crisis

The concerns are not farfetched considering a country like Italy, which prior to the middle of 2011 wasn't in the crosshairs of bond vigilantes. As long as the yield on Italy's 10-year debt stayed below 5%, Italy was considered to have a sustainable debt load. It wasn't until the middle of 2011, when yields rose from 5% to 6% that Italy went from "everything is okay" to a crisis moment.

Because of the huge debt that Italy has to roll over – as debt is never really retired but simply refinanced – a jump of 100 basis points, or 1%, made the sovereign bond markets go from normalcy to a full blown crisis.

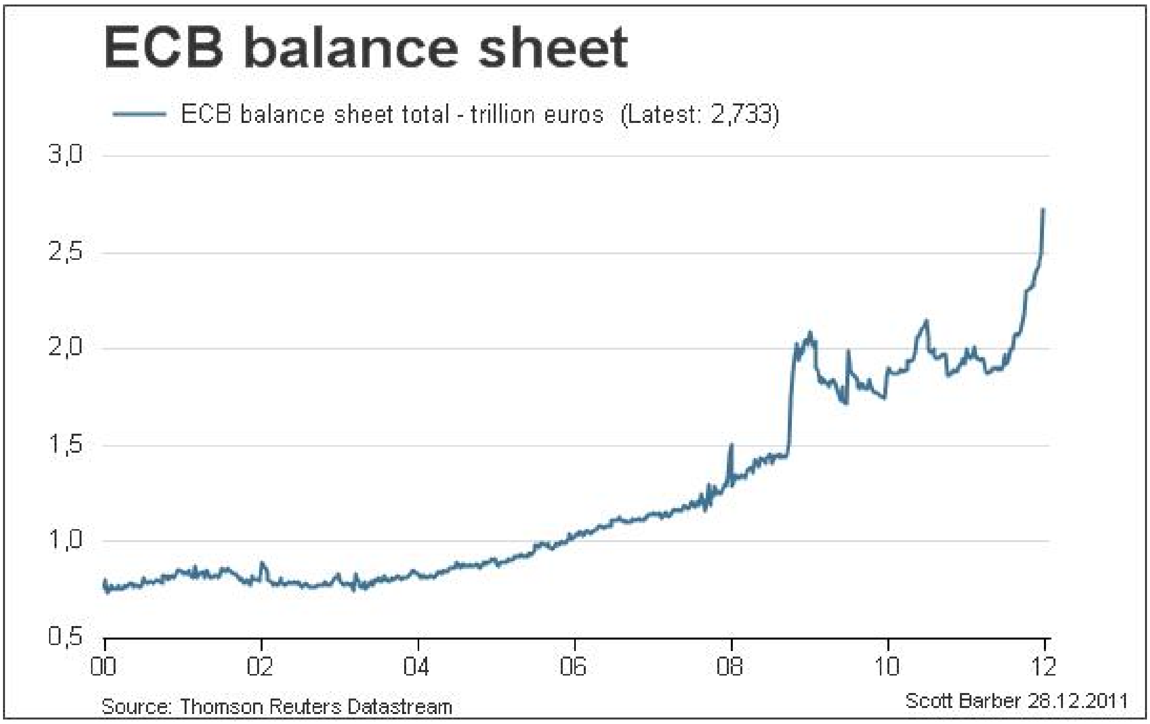
This is a phenomenon that all the major Western nations have to be concerned with – for instance the US and Japan – as small increases in the cost to borrow and roll over debt can create full blow sovereign debt crises in a short span of time.

In Italy's case, the ECB stepped in to buy the country's bonds which brought yields back down to 5% in August/September of 2011, before they rallied again to 7%, creating another acute crisis moment, which was only solved with the exit of the country's Prime Minister Silvio Burlesconi, who could not pass the required austerity measures meant to reassure bond markets that the country would get its budget deficits under control.

Yields have come down in 2012, back to near 5.5% as the LTRO loans helped bring some stability to sovereign bond markets, and gave European (and Italian) banks the ability to conduct a "carry trade. Use the 1% interest loans to buy bonds which yield above 5%, pocketing that difference.

ECB Fights Back by Expanding its Balance Sheet

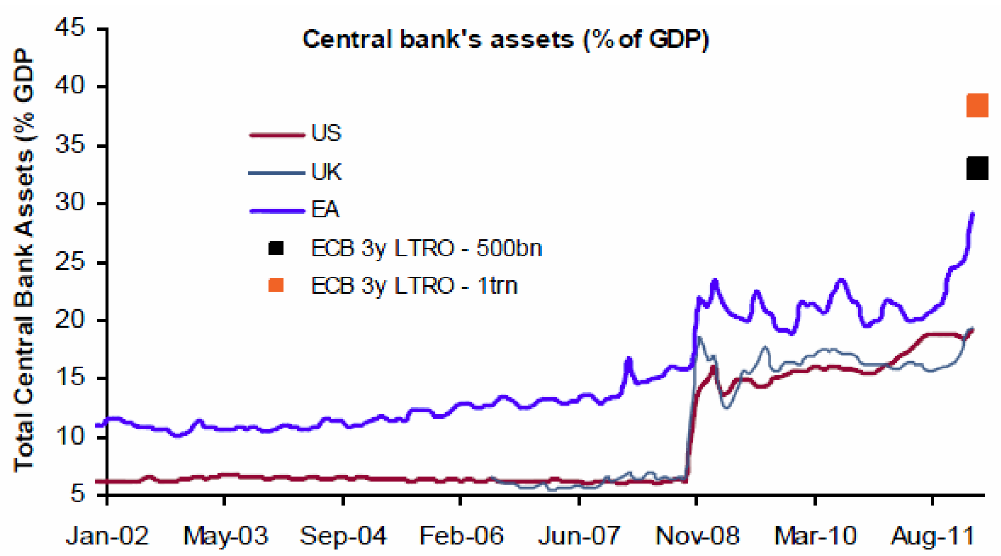
While the action the ECB has undertaken – lending out near €500 billion to the banking system and setting up a 2nd LTRO tender in late February – have stabilized conditions, they have also meant that the ECB balance sheet has exploded over the last 6 months.



Following the LTRO action the ECB's balance sheet grew to €2.7 trillion. While not exactly similar to the "quantitative easing" undertaken by the Fed – expanding its balance sheet to buy long-term bonds and other securities – the ECB is lending out this money in the hope of stabilizing its banking system and in part expecting that banks will buy government bonds as a result.

Exhibit 6: ECB balance sheet could reach 35%-40% of GDP depending on the February 3y LTRO

Gross LTRO uptake shown



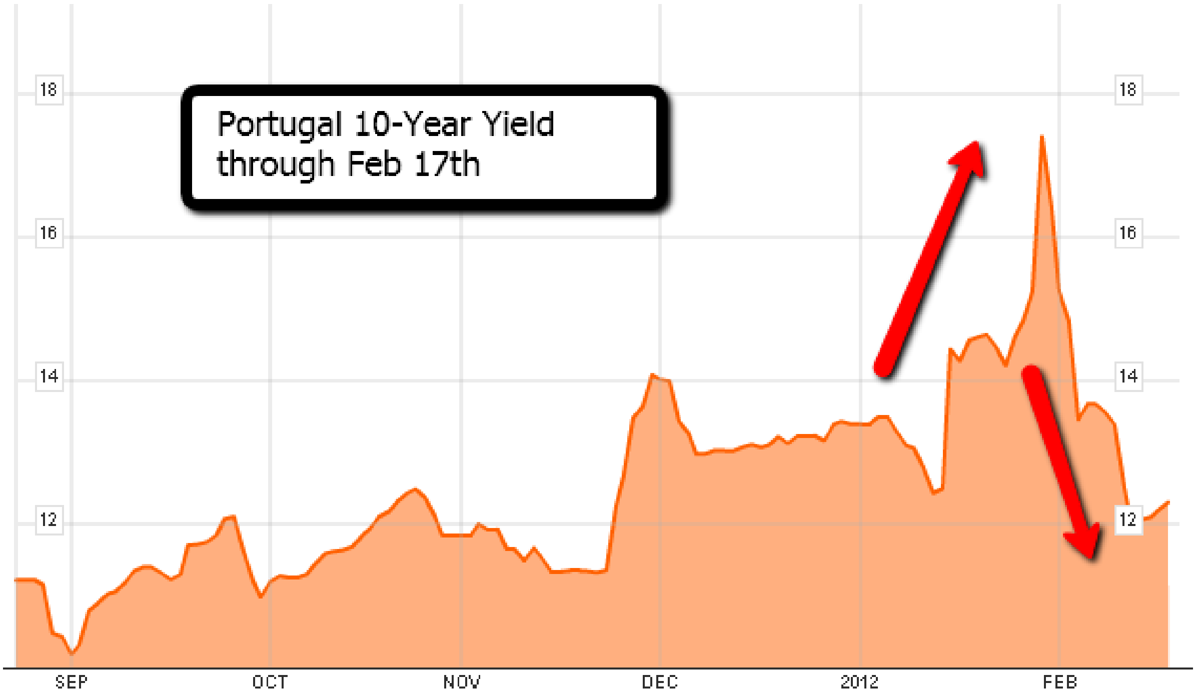
Source: European Central Bank, Federal Reserve, Bank of England, Thomson Reuters DataStream, Credit Suisse

In late February, the 2nd LTR0 operation is expected to have a similar take-up as the 1st, and that could send the ECB's balance sheet to €3.2 trillion. All this extra money floating around creates a big concern that it will bring about inflationary pressure – which is of course the opposite of the main mandate of the ECB. It also creates pressure on the Euro as more "money printing" debases the value of the currency.

Will Greece Act as A Template for Other Countries in the Future – Portugal

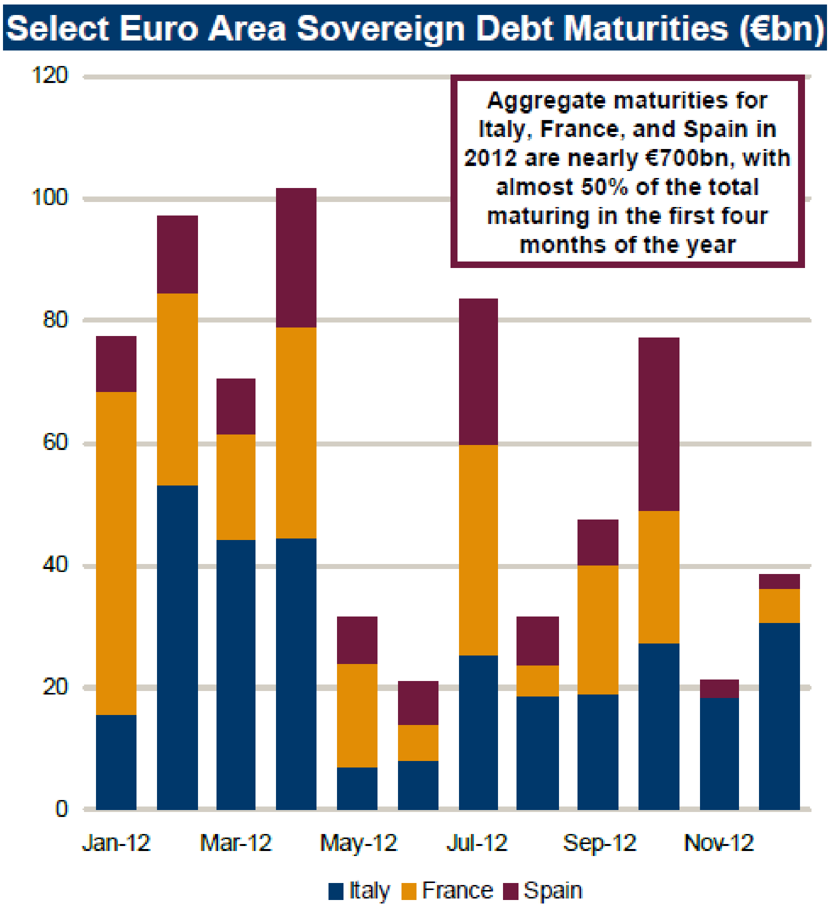
Let's backtrack to the Greek restructuring once again. While the negotiations are still continuing and final resolution could be expected soon, the issue is that what is happening with Greece may be used as a template for other countries that are unable to service their debt loads and find that they need to restructure. The most obvious case after Greece is Portugal, and the worst case scenario would be Spain and then Italy.

As the Greek debt restructuring talks progressed, the spotlight turned to Portugal for exactly this reason – and the country's 10-year yields spiked as investors sold off Portuguese bonds from their portfolios – fearing that they would not get full value back for their bonds.



With concern that Portugal would have to follow in Greece's footsteps the country's 10-year yields spiked to 17%-18%, before the ECB stepped in and helped ease pressure by provided some demand. With Portugal adamantly denying that it would need to restructure its debt and wants to be able to return to tap credit markets at the end of 2013. With ECB buying the markets calmed, returning yields back down to 14%. Still this is an issue that can come back at any point if the government is either unable to meet its fiscal deficit targets or if it finds a debt restructuring is beneficial to it after doing a cost-benefit analysis.

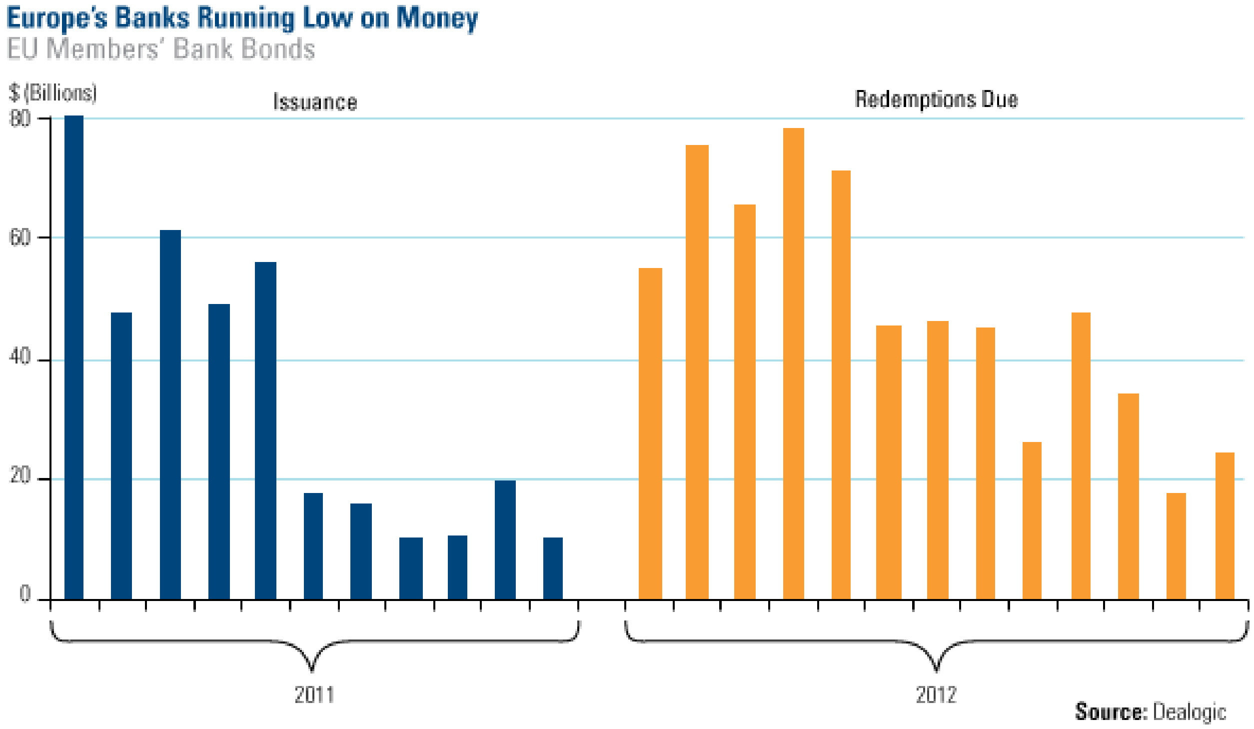
Will LTRO 1 & 2 Get Europe Through A Heavy Bond Issuance Schedule in Early Part of 2012



Beyond Portugal, a key concern is the heavy bond issuance by Italy and Spain in the 1Q of 2012. Prior to the ECB's LTRO the fear that these countries would not be able to roll over their debts froze European credit markets and came close to bringing about a funding/banking crisis. The ECB as we already discussed, is expanding its balance sheet in order to give loans to the banking sector, which has insulated the banking system.

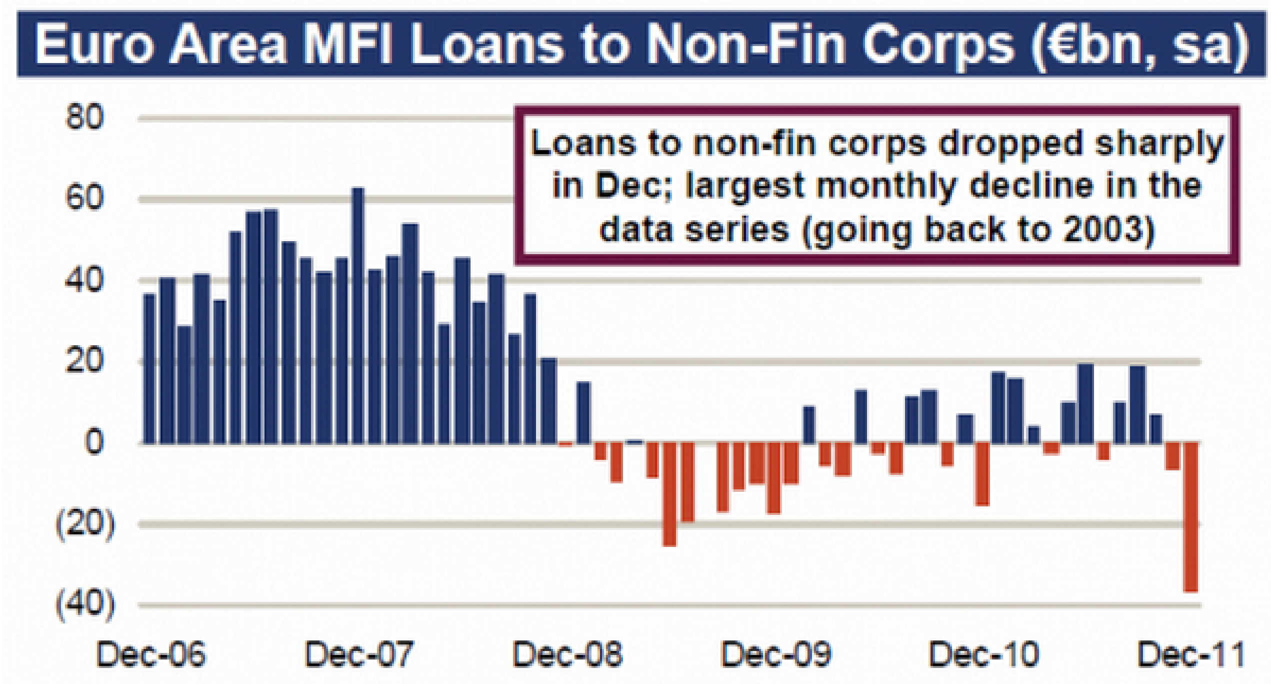
The image to the right shows the debt that is maturing in Spain, Italy and France during 2012 and therefore needs to be rolled over with January-April the heaviest months. That means that we will be seeing lots of debt auctions from these countries and so far in 2012 the results have been positive as Spain and Italy pay lower borrowing costs than they did in the latter parts of 2011. The months of July and October will also features heavy redemption and mean plenty of bond auctions.

It's not just sovereign debt that is maturing at a heavy rate in the early part of 2012, but bank debt as well.



The next four months see a ton of debt maturing in the European banking system and shows why European banks were eager to take advantage of the ECB's LTRO offer of cheap loans. Because they feared that the normal avenues of funding would not be available they were able to use the cheap loans from the ECB to guarantee refinancing of their maturing debt loads at 1%.

While this solves one problem another problem is that because banks are in a process of deleveraging and need to meet new capital requirements they are scaling back their lending. Less credit will hinder economic growth and can be a critical issue facing Europe in the next six months to a year as governments will be scaling back their spending as a result of austerity measures.



The chart above shows euro area loans to nonfinancial corporations. December saw the largest monthly decline in lending in this data series that goes back to 2003.

2 Negative Feedback Loops Facing Europe

The issue of having a sovereign debt overhang and bringing fiscal budgets into line via austerity creates the 1st of 2 negative feedback cycles for Europe.

With more austerity it makes aggregate demand decline, which makes unemployment rise which weakens economic growth.

Weaker economic growth means that central government revenues decline because less tax revenue is collected and countries have to pay out more in automatic stabilizers like unemployment insurance.

As a result governments miss fiscal deficit target which makes investors question the sustainability of those government debt loads which brings us back to the beginning of the cycle where governments have to implement even more austerity.

That perpetuates a cycle that foreshadows a tough road ahead for Europe and its currency.

Some countries like Greece have had several goes through this cycle already, while others like Italy and Spain are beginning to implement deeper austerity measures putting them at the beginning stages of this cycle.

The second cycle has to do with banks. As economic growth weakens and investors question government debt sustainability, government borrowing costs rise which means that confidence in banks declines due to their holdings of government debt.

As we have talked about the banking system and the sovereign bond market situation are very closely tied together and once those government borrowing costs rise the pressure increases on the European banking system.

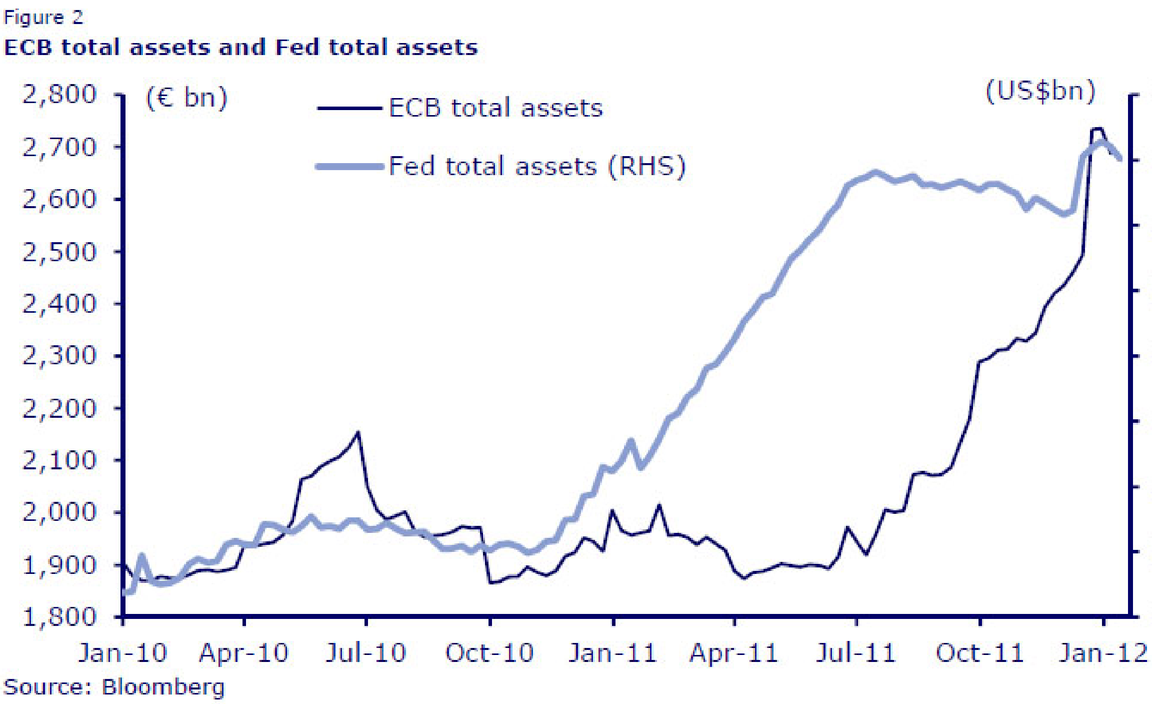
They then are unable to borrow and so they reduce credit availability which impacts economic growth. We saw that in our slide on bank lending before.

Therefore as we move forward with 2012, in addition to the Greek restructuring, the key issues to focus on will be how austerity measures will impact growth and how bank lending will develop over the next half year.

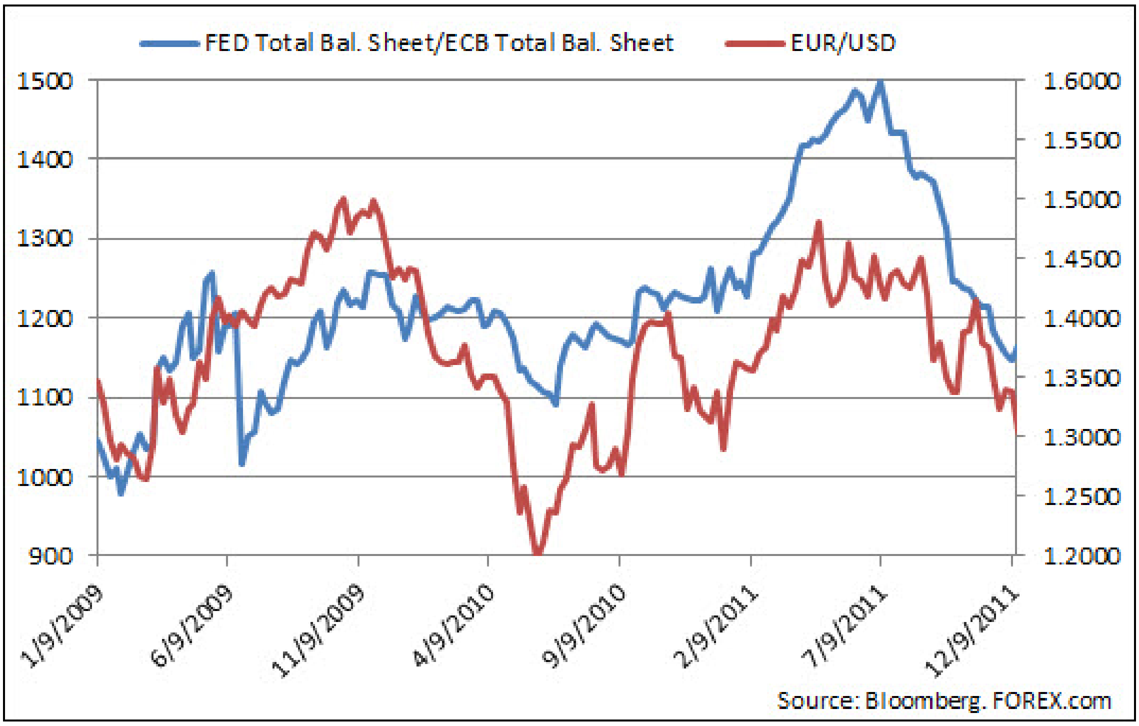
ECB Balance Sheet and the Euro

The 3rd key issue will be how much the ECB will do in terms of increasing its balance sheet to help prop up this deleveraging cycle. We have already covered the issue of the growth of the ECB's balance sheet.

What we want to do now is bring up the debt ratio between the ECB and the Fed.

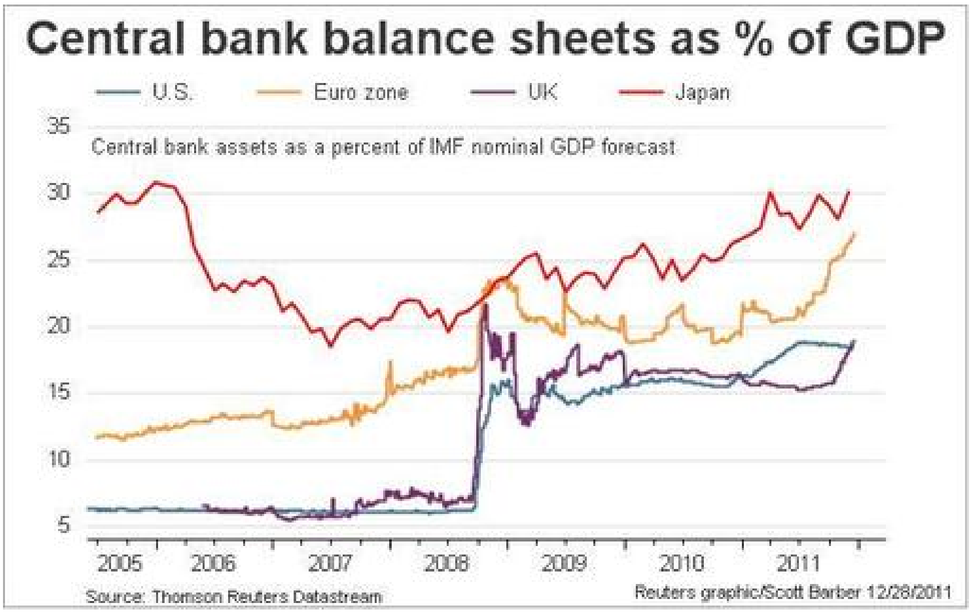


Above we see the recent changes in the ECB's and the Fed's balance sheets. Over the last half a year the ECB has outpaced the Fed in terms of adding to its balance sheet. The Fed was adding to its balance sheet via QE2 up until July 2011, but stopped afterwards, while the ECB with its LTRO lending has seen its balance sheet rise rapidly.



Next we want to see the ratio of the Fed balance sheet compared to the ECB's total balance sheet (blue line) and compare that the movement in the EUR/USD (red line). Throughout the first half of 2011 when the Fed's balance sheet was rising relative to the ECB's balance sheet the EUR/USD rallied. However, the trend reversed in the second half of 2011, as the ECB balance sheet rose at a faster rate than the Fed's which caused the EUR/USD to move in favor of the dollar.

Therefore as we move through 2012, it will be important to follow the growth in the ECB's balance sheet as a result of its support of its banking sector, while the Fed is still debating whether to undertake a 3rd round of QE.



This is a theme that is not only important to the ECB and the Fed, but also to the Bank of England and the Bank of Japan, as both of those central banks expanded their own quantitative easing programs at the beginning of 2012 and we will be addressing the history and issues facing those countries and central banks in future articles.

Nick Nasad *is an analyst, educator, and trader; and one of the main contributors to FXTimes – provider of Forex News, Analysis, Education, Videos, Charts, and other trading resources.*

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