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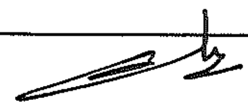

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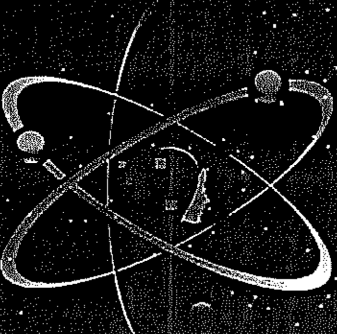

JOURNAL OF INFORMATION AND COMPUTATIONAL SCIENCE

Journal of Information and Computational Science

UGC - Care Group - II Certified Journal

ISSN NO: 1548-7741 / web : www.joics.org / E-mail : submitjoics@gmail.com

Certificate of Publication

This is to certify that the paper entitled

ASIA AND EUROPEAN SOVEREIGN-DEBT CRISIS

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Has been published in

JOURNAL OF INFORMATION AND COMPUTATIONAL SCIENCE,VOLUME 10, ISSUE 2, FEBRUARY-2020

S. Joseph

Joseph Sung

Editor-In-Chief

JOICS

International Organization for Standardization

7021-2008

Dr. AAA (2019-20)

ASIA AND EUROPEAN SOVEREIGN-DEBT CRISIS

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Abstract

The International Monetary Fund says the ***euro zone debt crisis and slowdown in the United States pose severe risks to Asia.*** *In its latest Asia-Pacific outlook the IMF warned near-term* ***risks to Asia's economies are "decidedly" rising.*** *It advised the region's policymakers to reduce their reliance on exports and be ready to respond quickly if foreign banks sell assets or cut off credit to cover large losses at home.*

The European debt crisis is the shorthand term for ***Europe's struggle to pay the debts it has built up in recent decades.*** *Five of the region's countries – Greece, Portugal, Ireland, Italy, and Spain – have, to varying degrees, failed to generate enough economic growth to make their ability to pay back bondholders the guarantee it was intended to be. Although these five were seen as being the countries in immediate danger of a possible default, the crisis has far-reaching consequences that extend beyond their borders to the world as a whole. In fact, the head of the Bank of England referred to it as* ***"the most serious financial crisis at least since the 1930s, if not ever," in October 2011*** *This is one of most important problems facing the world economy, but it is also one of the hardest to understand..*

This paper highlights effect of 'European Sovereign Debt Crises' on Asia and lesson for Asian countries

Key Terms

IMF-International Monetary Fund; ECB- European Central Bank; EFSF- European Financial Stability Facility

Introduction

The only thing that could prevent the Euro zone debt crisis from at some point imploding is **economic growth, and that's not happening**. According to Eurostat, the GDP for the 17-nation Euro zone plunged **0.6 per cent in the final quarter of 2012**, a steeper drop than the 0.4 per cent economists had expected and the worst decline since 2009, and the third consecutive decline.

The **average unemployment rate across the Euro zone is at a staggering 12 per cent, the highest since the creation of the economic bloc in 1995.** The problem is far more acute in some countries; Spain, for instance, has an unemployment rate of 26.3 per cent, and in Greece it's 26.4 per cent and recent economic data indicates things are **getting worse**. Industrial production in Spain plunged 8.5 per cent in February from a year earlier; in Italy it was down 3.8 per cent.

While a healthy EU could prop up one or two struggling members, instead a handful of healthy countries are trying to prop up many struggling neighbors.

There's almost no chance the European debt crisis will be resolved without a major meltdown - it's just a question of when.

Money Morning Global Investing Strategist Martin Hutchinson said he expects the Euro zone economy to "stagnate," and suggested investors keep a watchful eye on it.

"For us as investors, the whole region is best avoided," Hutchinson said.(Refer1)

Definition and Meaning

The **European sovereign debt crisis** (often referred to as the **Euro zone crisis**) is an ongoing financial crisis that has made it difficult or impossible for some countries in the euro area to repay or re-finance their government debt without the assistance of third parties.(Refer1) A period of time in which several European countries faced the collapse of financial institutions, high government debt and rapidly rising bond yield spreads in government securities. The European sovereign debt crisis started in 2008, with the collapse of **Iceland's banking system**, and spread to primarily to Greece, Ireland and Portugal during 2009. The debt crisis led to a crisis of confidence for European businesses and economies.

The European sovereign debt crisis was brought to heel by the financial guarantees by European countries, who feared the collapse of the euro and financial contagion, and by the International Monetary Fund (IMF). Ratings agencies downgraded the debt of several eurozone countries, with Greek debt at one point being moved to junk status. As part of the loan agreements, countries receiving bailout funds were required to meet austerity measures designed to slow down the growth of public sector debt.(Refer2)

Theoretical Background

The global economy has experienced slow growth since the U.S. financial crisis of 2008-2009, which has exposed the unsustainable fiscal policies of countries in Europe and around the globe. Greece, which spent heartily for years and failed to undertake fiscal reforms, was one of the first to feel the pinch of weaker growth. When growth slows, so do tax revenues – making high budget deficits unsustainable. The result was that the new Prime Minister George Papandreou, in late 2009, was forced to announce that previous governments had failed to reveal the size of the nation's deficits. In truth, **Greece's debts were so large that they actually exceed the size of the nation's entire economy, and the country could no longer hide the problem.**

Investors responded by demanding higher yields on Greece's bonds, which raised the cost of the country's debt burden and necessitated a series of bailouts by the European Union and European Central Bank (ECB). The markets also began driving up bond yields in the other heavily indebted countries in the region, anticipating problems similar to what occurred in Greece.

Unfortunately, the solution isn't that simple for one critical reason: **European banks remain one of the largest holders of region's government debt, although they reduced their positions throughout the second half of 2011.** Banks are required to keep a certain amount of assets on their balance sheets relative to the amount of debt they hold.

If a country defaults on its debt, the value of its bonds will plunge. For banks, this could mean a sharp reduction in the amount of assets on their balance sheet – and possible insolvency. Due to the growing interconnectedness of the global financial system, a bank failure doesn't happen in a vacuum. Instead, there is the possibility that a **series of bank failures will spiral into a more destructive "contagion" or "domino effect."** The best example of this is the U.S. financial crisis, when a series of collapses by smaller financial institutions ultimately led to the failure of **Lehman Brothers** and the government bailouts or forced takeovers of many others. Since European governments are already struggling with their finances, there is less latitude for government backstopping of this crisis compared to the one that hit the United States (Refer3).

How has the European debt crisis affected the financial markets?

The possibility of a **contagion has made the European debt crisis a key focal point for the world financial markets in the 2010-2012 periods.** With the market turmoil of 2008 and 2009 in fairly recent memory, investors' reaction to any bad news out of Europe was swift: sell anything risky, and buy the government bonds of the largest, most financially sound countries. Typically, European bank stocks – and the European markets as a whole – performed much

worse than their global counterparts during the times when the crisis was on center stage. The bond markets of the affected nations also performed poorly, as rising yields means that prices are falling. At the same time, yields on U.S. Treasuries fell to historically low levels in a reflection of investors' **"flight to safety."**

The ECB's commitment to preserving the euro zone, markets rallied worldwide. In fact, the second half of 2012 brought none of the crisis-related disruptions that had characterized the prior two years.

Asian capitals have tended to view the EU as a serious economic and trade power. Since the euro crisis broke in Greece in 2009, with bailouts needed for Greece, Ireland, Portugal, and potentially Spain and Italy as well, however, the **European Union** has begun to look like a **sick and declining power from many vantage points in East Asia**. This image is especially pronounced in Asian financial cities, where the economics rather than the politics of the EU is widely reported. Many in Asia – a continent where states have among the highest savings rates in the world – do not understand how Europe got into this mess in the first place..

The Asian Development Bank (ADB) said **developing countries in Asia would continue to be affected by the unfavorable developments in the euro zone, particularly in foreign trade.** Developing Asia's export growth may remain dampened given that the euro zone remains one of its biggest export markets.

Findings

- The European Union has taken action, but it has moved slowly since it requires the **consent of all nations in the union**. The primary course of action thus far has been a series of **bailouts for Europe's troubled economies.**
- In spring, 2010, when the **European Union and International Monetary Fund disbursed** 110 billion euros (the equivalent of $163 billion) to Greece. Greece required a second bailout in mid-2011, this time worth about $157 billion. On March 9, 2012, Greece and its creditors agreed to a debt restructuring that set the stage for another round of bailout funds. Ireland and Portugal also received bailouts, in November 2010 and May 2011, respectively.
- The Euro zone member states also created the **European Financial Stability Facility (EFSF)** to provide **emergency lending to countries in financial difficulty.**
- In December 2011, the **European Central Bank made €489 ($639 billion) in credit available to the region's troubled banks at ultra-low rates**, then followed with a second round in February 2012. The name for this program was the **Long Term Refinancing Operation, or LTRO**. Numerous financial institutions had debt coming due in 2012, causing them to hold on to their reserves rather than extend loans. Slower loan growth, in turn, could weigh on economic growth and make the crisis worse. As a

result, the ECB sought to boost the banks' balance sheets to help forestall this potential issue.

- The World's number two global player-**China** has been highly depending on external demand. So it would be more **affected by trade than financial channels**.
- The IMF report highlights the **threat of capital outflows from the region**, (foreign investors from advanced economies could reverse the large positions they have built in Asian markets since 2009)
- Actions by European policy makers usually helped to stabilize the financial markets in the short term, they were widely criticized as merely **"kicking the can down the road,"** or postponing a true solution to a later date
- Consumer goods **giant Unilever** is now offering **smaller packages to keep pace with the thinner wallets of its European customers.** The company says the strategy comes from the developing economies in Asia and is vital now that **"poverty is returning to Europe,"** as one manager says.
- Several **euro zone economies continue to struggle with huge government debts** and worrisome conditions of their financial sectors. The economic problems have been blamed for the high unemployment rates that, in turn, led to street protests.

Suggestions

- Export-reliant economies should help **to rebalance the global economy**
- China and other countries of Asia that **rely on exports should give more importance to domestic growth**
- **Direct loans to banks and banking regulation** (On June 28, 2012 Euro zone leaders agreed to permit loans by the European Stability Mechanism to be made directly to stressed banks rather than through Euro zone states, to avoid adding to sovereign debt.
- The reform was linked to plans for banking regulation by the European Central Bank. The reform was immediately reflected by a reduction in yield of long-term bonds issued by member states such as Italy and Spain and a rise in value of the Euro)
- **Less austerity, more investment** (There has been substantial criticism over the austerity measures implemented by most European nations to counter this debt crisis. US economist and Nobel laureate Paul Krugman argues that an abrupt return to "'non-Keynesian' financial policies" is not a viable solution)
- Crisis countries must significantly **increase their international competitiveness** to generate economic growth and improve their terms of trade.
- European countries **must shift their economies to higher quality products and services,** though this is a long-term process and may not bring immediate relief.
- Another option would be to **implement fiscal devaluation, based on an idea originally developed by John Maynard Keynes in 1931**. According to this neo-Keynesian logic, policy makers can increase the competitiveness of an economy by lowering corporate tax

burden such as employer's social security contributions, while offsetting the loss of government revenues through higher taxes on consumption (VAT) and pollution, i.e. by pursuing an ecological tax reform.

- Many of the countries involved in the crisis are on the euro, so devaluation, individual interest rates and capital controls are not available. The only solution left to raise a country's level of **saving is to reduce budget deficits and to change consumption and savings habits**
- Crisis countries should address current account imbalances
- The Asian Development Bank said **central banks in Asia also have room to adjust policies to become more accommodative of economic growth.**

Lesson for Asian countries

- Governments across Asia are using the crisis as a cautionary tale against **welfare state systems.** They raise the bogeyman of the crisis in Europe to warn their populations against popular demands for more health care, unemployment and retirement benefits, subsidies in public education.
- Asian governments are **warning their populations to brace for a European 'Lehman Brothers' crisis trigger.**
- They **have learnt a lesson from the 1997 Asia Financial Crisis**, when economies were left high and dry after international hedge and slush funds pulled out their money from Asian banks and stock markets following the run on the Thai baht.
- They are **careful of international organizations, especially the International Monetary Fund,** which imposed draconian conditional ties on Thailand, South Korea and Indonesia in exchange for structural reform loans which often caused more pain that the disease they were supposed to cure.
- Today they have **greater voting rights in the international financial institutions**, and even occupy key positions in the global financial system. Sri Mulyani Indrawati, an Indonesian economist and former Finance Minister, is Managing Director of the World Bank group. The finance minister and Deputy Prime Minister of Singapore, Tharman Shanmugaratnam, chairs the IMF's International Monetary and Financial committee; while Zhu Min, a Chinese economist, is now Deputy Managing Director in the IMF.
- Many Asian states and companies have investments at risk as a result of the euro crisis. Asian sovereign wealth funds are major shareholders of some **European banks whose continued viability may be in question.**
- Asian countries are worried **and are eager to see Europe recover**. **China** holds much of its vaunted reserves (estimated at over US$3.2 trillion) in Euros. Since 2010, Greece, Spain, Portugal and other EU states have courted Asian, and especially Chinese leaders to hold or buy more Euro bonds and other assets.
- **India** would rather **spend its reserves on domestic development**;

- **Japan** is too distracted with the fallout from its March 2011 earthquake, tsunami and nuclear crisis.
- **China** may respond to calls to buy more Euro bonds, but it is unlikely to go beyond token purchases as it is already holding a huge amount of American debt. Asian capitals are nervous that the EU may become inward looking or that trade with Asia may go down; this would hurt Asian exports as the EU is among the top three trading partners of every major Asian economy.
- Despite these negative sentiments and pessimism about the EU, there are some silver linings. **The EU is still seen as a powerful and credible regional organization**. One of the most enduring images of the EU in the **popular media in China is that of a political and diplomatic power.**
- The **European institution most respected in Asian public opinion is not the Commission, but the European Central Bank (ECB)**. Its president, Jean-Claude Trichet, is well known and respected in Asian circles. Within the EU, **Germany's** star is probably shining brighter than ever, with Berlin seen as the most critical player and decision-maker in the 17-member euro zone; and Germany (and to a lesser extent, **France**) recognized as among the key countries with the necessary resources and will to push through difficult reforms for the euro zone.(Refer5)
- The Asian Development Bank said the Philippines and other developing countries in Asia have the **capacity to remain stable in the event that the prolonged crisis in the eurozone should evolve into another global economic meltdown.**
- In one of its latest papers, the ADB said **deterioration in the eurozone condition would drag the growth of Asian economies lower but only to a manageable extent.**
- The **euro crisis is still far from fundamentally resolved** and its evolution will clearly impinge heavily on its future impact.
- The ADB said that with the **current scenario in the eurozone, the possibility of the crisis** transforming into a bigger problem for the global economy could not be discounted.
- It said, however, that ongoing efforts to address the eurozone crisis, including the European Central Bank's pumping of liquidity, still gave a good chance that the current crisis would head toward a slow recovery rather than a deterioration.
- The ADB said **developing countries in Asia would continue to be affected by the unfavorable developments in the eurozone, particularly in foreign trade**. Developing Asia's export growth may remain dampened given that the eurozone remains one of its biggest export markets.
- But the ADB said the **impact was not expected to cause a recession in Asia because countries in the eastern part of the globe have flexibility to implement measures to boost growth.**
- Developing Asia still has **relatively ample policy space to cushion a major external shock**. Therefore, not only is the magnitude of the shock smaller relative to the global

crisis, but the region has monetary, fiscal and financial policy tools to mitigate the impact of another external shock,- the ADB said.

- Compared with their Western counterparts, debt levels of Asian countries are much smaller. The ADB said this would give **governments in Asia the flexibility to spend on stimulus programs.**
- The ADB said **central banks in Asia also have room to adjust policies to become more accommodative of economic growth.**

Conclusion

Economist Paul Krugman, the Nobel Prize winner analyzed the relationship between GDP and reduction in budget deficits for several European countries in April 2012 and concluded that **austerity was slowing growth,** similar to Martin Wolf. He also wrote: "... this also implies that 1 euro of austerity yields only about 0.4 euros of reduced deficit, even in the short run. No wonder, then, that the **whole austerity enterprise is spiraling into disaster.**

A European Crisis Resolution Mechanism (ECRM) is urgently needed to turn off future debt
Note:-

- The **2008–2011 Icelandic financial crises** was a major economic and political crisis in Iceland that involved the collapse of all three of the country's major privately owned commercial banks, following their difficulties in refinancing their short-term debt and a run on deposits in the Netherlands and the United Kingdom. Relative to the size of its economy, Iceland's systemic banking collapse is
the largest suffered by any country in economic history
- **Lehman Brothers Holdings Inc.** was a global financial services firm. Before declaring bankruptcy in 2008, Lehman was the fourth-largest investment bank in the US (behind Goldman Sachs, Morgan Stanley, and Merrill Lynch), doing business in investment banking, equity and fixed-income sales and trading (especially U.S. Treasury securities), research, investment management, private equity, and private banking.
- In economics, **austerity** describes **policies used by governments to reduce budget deficits during adverse economic conditions.** These policies can include spending cuts, tax increases, or a mixture of the two Austerity policies demonstrate governments' liquidity to their creditors and credit rating agencies by bringing fiscal income closer to expenditure. The economic effects of austerity are unclear, due to its wide and non-specific definition, the limited historic sample of natural experiments and the potential conflation with the effects of other events which tend to precede austerity, such as recessions and financial crises. In macroeconomics, reducing government spending generally increases unemployment. This increases safety net spending and reduces tax

revenues, to some extent. Government spending contributes to gross domestic product **(GDP)**, so the **debt-to-GDP ratio** which signifies liquidity may not immediately improve. Short-term deficit spending particularly contributes to GDP growth when consumers and businesses are unwilling or unable to spend. Under the theory of expansionary fiscal contraction **(EFC)**, a major reduction in government spending can change future expectations about taxes and government spending, encouraging private consumption and resulting in overall economic expansion (Refer6).

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