US AND EURO ZONE DEBT CRISIS: A PERSPECTIVE FROM DEVELOPING COUNTRIES

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Introduction and Background

The European Union (EU) is currently faced with a sovereign debt crisis which started in November 2009 and became acute during mid 2010 in turn putting many European countries on the brink of default. Due to this crisis, commodity-producing as well as the service sectors have come under pressure. The banking sector now faces a paralysis for the foreseeable future. The low economic growths combined with poor forecasts are growths combined with poor forecasts are contributing to rising unemployment levels. Countries such as Greece, Ireland, Italy, Spain and Portugal are the most affected countries due to this crisis. The worst aspect is that EU faces this milieu at a time when the world was barely getting out of the debris of the global financial crisis that started in 2007.

While many developing countries managed to insulate themselves from the global financial crisis it is suspected that it will be difficult to escape the direct and indirect effects of the EU debt crisis. Already India and Bangladesh have reported the cancellation of export orders from EU. Similarly many conflict-prone countries are foreseeing slashing of aid inflows originating from EU. There is also a contagion effect that is expected if this crisis prolongs. This has already started happening within EU to some extent. For example France is closely integrated with the Italian financial markets and a default to Italy will have a huge negative impact on France and its trading partners. EU as a whole will impact US which has its own on-going debt crisis which is not being helped by the rising expenditure on the war on terror.

It is public knowledge now that several EU countries misreported their debt levels in violation of the international financial rules. In order to become a Euro zone member one of the conditions was that government debt to GDP ratio should not exceed 60 percent. However in the interest of European foreign policy several member states were given entry into Euro zone who did not meet this criterion. In fact this lesson is extremely important for other regional blocks now contemplating a single currency (e.g. ASEAN). Monetary unions must be careful in the manner in which they select their members.

Sources and Channels of Crisis

Before moving onwards it is important here to clearly identify the sources and channels through which the Euro zone crisis has come about. First is the shortage of liquidity that was created in EU banks during and after the global financial crisis. This is despite the fact that several EU governments had put in place bailout packages in anticipation of such a shortage of liquidity and instability of the financial sector. In the smaller EU member states it was seen that harsh austerity packages were put in place without a pro-growth strategy or a transition plan explaining how painful reforms will pave the way for future economic growth and redeeming lost jobs. Further evaluation is needed to see how the entry of IMF in EU member countries such as Greece impacted the regional macroeconomic dynamics.

The second is the manner in which the banking sector's reactive policy measures impacted the factors market in particular the situation in the labour market. In several cases skilled and unskilled workers have been laid off with severance packages promised for the future. This implied a sudden reduction in aggregated demand and piling of inventories.

Crisis Economies

EU member countries had a varying magnitude of impact at least in the beginning of the crisis therefore in order to capture this heterogeneity of economic influence it is important to see the performance of these economies individually in a brief manner.

Greece is the most critical which is now on the brink of default. Violent protests due to painful fiscal measures are now a usual occurrence. The debt to GDP ratio is in the vicinity of 160 percent. What is more surprising is that Greece already had a debt to GDP ratio as high as 100 percent at the time of joining EU in 2001. [1]According to some sources [2]the Greek government misreported its country's official budgetary statements and paid hundreds of million dollars to banks for hiding actual debts and deficits. At one point Greece was running a fiscal deficit to GDP ratio of around 13.6 percent which is one of the highest in the world. Similarly Greece is paying 12.6 percent of yield on its 10 years bond which is expensive by any comparison regionally or globally.

After becoming a full EU member Greece witnessed a lower debt servicing burden as the bond markets did not fear inflation or devaluing currency value. However the economy could not build upon this windfall confidence. More recently EU had to rescue Greece twice by giving € 110 billion bailout package on the first occasion and € 109 billion the second time to put Greece out of the crisis. While this support to Greece imposed a pressure on already ailing economies of EU it did not substantially help Greece either. Its debt rating reduced to CCC which is the lowest for any government in the world. Moody's had declared Greece default virtually certain by mid 2011. The only hope at that time was that Greece would privatize key public sector assets and raise $40 billion. Some respite came for the Greeks when Euro zone leaders recently met to give Greece another € 100 billion loan and the banking sector which was holding Greek debt are agreed to share a 50 percent loss on bonds. These measures are projected to help reduce debt to GDP ratio to 120 percent by 2020[3].

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[1] Dylan Matthews, Everything you need to know in one post series, Washington Post, 28 Sep, 2011, can be found on below link: (http://www.washingtonpost.com/2011/02/25/ABjfuEJ_category.html?blogId=ezra-klein&tag=Everything%20you%20need%20to%20know%20in%20one%20post%20series).

[2] According to Washington Post: Greece hired Wall Street firms, most notably Goldman Sachs,which helped to hide its debt, so as not to run afoul of E.U. rules. In October 2009, the conservative government was voted out, and the new socialist government announced that deficits were more than double previous estimates.

[3] Gavin Hewitt, Leaders agree eurozone debt deal after late-night talks, BBC NEWS Europe, 27 Oct 2011. (http://www.bbc.co.uk/news/world-europe-15472547)

Spain is a five times bigger economy than Greece and contributes 11.5 percent to overall EU GDP. [4] It is the 4th largest economy of the EU and 14th largest of the world. The collapse of Spain will therefore imply greater adverse impacts for EU and the world. Currently, unemployment is high at around 23 percent, budget deficit in 2009 was 9.97 percent of GDP. Total public and private debt stands at 270 percent of GDP. There is no sign of growth in the economy after a sharp 3.6 percent negative GDP growth in 2009. [5]Spain has recently passed a constitutional amendment with a rule to keep the budget deficit within strict limits, however the government has faced protests and social unrest for cuts in public expenditures and tax raise. The challenge now will be to revive domestic resource mobilization which seems difficult as tax revenues cannot be expected to increase under a milieu of depressed growth.

Italy is another country which carried up debt up to 120 percent of GDP which is the double of the euro zone criteria of 60 percent, but debt sustainability indicators were ignored as Italy is the 3rd largest economy and Europe and there were little chances of its failure[6]. It is the 7th largest economy in the world and a member of G-20 - a group of the world's major economic powers. Already it is being said that Italy's failure will be impossible to bail out and can have severe contagion and knock on effects on other economies inside and outside EU. The German and French banks have invested $150 billion in Italy's debt while USA banks and financial institutions have $ 36.6 billion. This implies that any default by the Italian government can lead to severe strains in the banking sector in EU and US. Italy has € 500 billion bonds maturing in the next three years which is double of € 256 billion three year aid given to Ireland, Portugal and Greece put together. Italy's € 1.8 trillion debt is higher than the combined debt of Portugal, Ireland, [7]Greece and Spain.

Economists are of the view that despite these high debts, Italy has substantial private sector savings. Last year its budget deficit was 4.6 percent of GDP which is half of Greece, Ireland and Spain.[8] Due to these relatively better macroeconomic fundamentals European Central Bank had announced in August 2011 that it will buy Italian and Spanish governments' bonds to reduce their cost of borrowing and put the larger countries out of crisis.

Portugal which quickly recovered from the global financial crisis of 2007 found itself hit by Greek debt crisis in late 2009. Its lower productivity levels on the supply side and strict labor market regulation make it harder to generate and then sustain economic

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[4] Brian Sullivan, The Real Threat Is Spain, Not Greece, CNBC Business News, Tuesday, 10 Apr 2012, can find on (http://www.cnbc.com/id/47008853/The_Real_Threat_Is_Spain_Not_Greece_Sullivan)

[5] http://spaineconomy.blogspot.com/2008/08/spains-budget-deficit-rising-sharply.html

[6] Bruno mascitelli, As Italy debt crisis deepens is Berlusconi turning a blind eye, The Conversation, 5th Aug 2011 (http://theconversation.edu.au/as-italys-debt-crisis-deepens-is-berlusconi-turning-a-blind-eye-2674)

[7] The Telegraph (http://www.telegraph.co.uk/finance/financialcrisis/8880481/Debt-crisis-as-it-happened-November-9-2011.html)

[8] Roger Bootle, For all italy's attraction, there is good reason for concern, The Telegraph, 18th July 2011, see at (http://www.telegraph.co.uk/finance/comment/rogerbootle/8643297/For-all-Italys-attractions-theres-good-reason-for-concerns.html)

growth. In April 2011 Portugal asked for a bailout from EU and became the 3rd European Union country to get a bailout after admitting it could not deal with its deficit and debt problem. In May IMF and the Euro zone agreed to provide €78 billion to Portugal. Moody's reduced Portuguese [9]rating to junk and said it's on a high risk of second bail out requirement. Portugal had 9.1 percent deficit to GDP ratio in 2010 and planned to reduce it to 3 percent by 2013 by reducing government spending, increasing taxes and supporting the banking system,[10] but Moody's predicted it may not be able to achieve its targets.

Ireland maintained a balanced budget up until the crisis started. One of the major reasons of the crisis in this country was the real estate bubble. It had 25 percent of its economy involved in this sector while in the case of other EU economies this activity represented under a 10 percent share. [11]Some experts assume that Ireland along with Spain should be temporarily taken out of the euro zone. The common feature between both these economies is that they had a budget surplus at the time of joining but suffered due to the property bubble. In 2007 the Irish government had announced that it will cover all bank losses but this promise became impossible with continued banking sector exposure and was very difficult for the government to rescue banking sector debts on its own. Ireland nationalized one of its major banks and bailed out some others. Consequently Ireland's budget deficit to GDP ratio rose to 32 percent. Moody's downgraded Ireland's rating and Ireland became the 5th country with highest default probability. The IMF and Euro zone agreed to bail out Ireland with € 110 billion and observe how macro and microeconomy responds. The 10 years' bond yield reached 12.43 percent which is limiting the chances of Ireland to return to the targets planned until 2013[12].

The euro zone still has no comprehensive plan to face these problems in an integrated manner. It will be a long time before the investor's confidence is fully restored. The need for structural reforms still remains. Not everyone has blamed the single currency for the spread of this crisis. Although Poland's example is an example where its is a member of EU but it does not use Euro as a legal tender. The country is still experiencing better economic prospects in comparison to its neighbors. Still it is important to understand that going forward the major challenge will be the stability of the banking system in Europe. This is a bigger concern compared to the management of a single currency.

There are two remedial strategies for getting rid of this crisis. First is a radical reform where the member states have more financial freedom. This should be combined with an increase in the overall budget of EU, redistribution of wealth through taxation

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[9] The term "junk" is reserved for all bonds with Standard & Poor's ratings below BBB and/or Moody's ratings below Baa.

[10] Dylan Matthews, Everything you need to know about the European debt crisis in one post, The Washington Post, 28/09/2011

[11] ibid

[12] ibid

measures, guarantee of minimum wage and employment protection schemes and cross border investment for revival of labour intensive sectors particularly the industrial sector. Some have also welcomed the revival of the industrial policy which had disappeared after the liberalization of trade and investment across the globe. These reforms will be challenging in political terms as the value of the euro will slide down in turn increasing the costs of debt servicing and value of imports.

The second remedial measure and a more radical one is to break up the euro zone, nationalize crisis-ridden banks, and introduce country-specific industrial policies. This strategy will also involve a downward valuation for the euro however the euro may not slide in comparison to the first remedy mentioned above.

Recently EU has increased the European Financial Stability Facility (EFSF) from €440 billion to €1 trillion, and European banks have been urged to accept losses of up to 50 percent on Greek debts and to raise €106 billion capital by 2012, which will protect European countries in the danger zone from any future defaults[13].

Link with US Debt Crisis

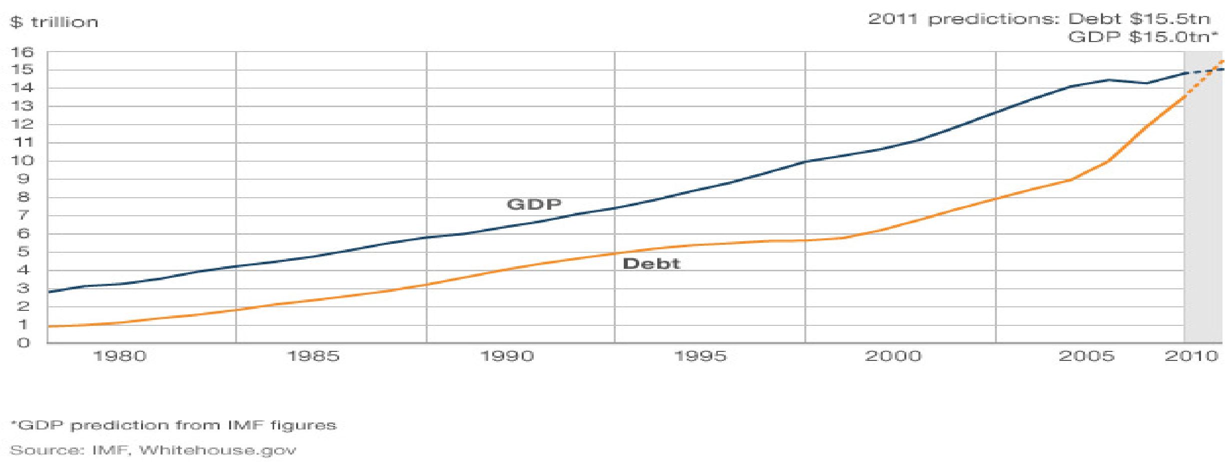
In August 2011 the US announced that it may have to default on is public debt obligations unless the current ceiling limit was raised. Debt ceiling is the legal limit on the total amount of the debt which the US government can borrow to pay its bills. This limit was $14.3 trillion which was then increased by $ 2.4 trillion due to the current US debt crisis. A US default would have created panic of a larger magnitude in comparison to the global financial crisis[14]. Many economists are considering this debt crisis; the worst since 1930s great depression.

Today the US is today borrowing and spending more than ever in anticipation of lifting the economy out of the current slowdown. Some tax cuts to the rich have been allowed assuming that if the tax burden is lowered for the top 10 percent wealth holders they may end up saving and investing more.

The fact that the US debt crisis followed the global financial crisis has further exacerbated the problem at hand. The large inflow of global funds in the boom period of 2000s and lower interest rates made the credit conditions very easy which encouraged debt consumption, especially in the housing market where various types of loans were easily available. But as the house prices declined some major financial institution faced heavy losses which damaged the confidence of investors in turn also reducing credit availability. IMF had already predicted in 2009 (Figure 1) that US debt will soon take over the value of GDP.

[13] Gavin Hewitt, Leaders agree Euro zone debt deal after last night talks, BBC News, 27th Oct 2011, see at (http://www.bbc.co.uk/news/world-europe-15472547)
[14] http://www.bbc.co.uk/news/business-14204527, Bill passed by the House of Representatives after an agreement between the Republican and Democratic leaders on 2nd of Aug,2011.

Figure 1 The Narrowing Margin Between US Debt and GDP



Continued Reasons for Crisis in US

Though official reports state that the recession is over in the US, prospects for growth in the near term still remain low. The demand for commodities still remains low and in turn (at the time of writing of this brief) the unemployment rate was as high as 9.2 percent with 14.1 million Americans jobless[15].

The growing concern is the ballooning social safety expenditures which have to be covered. Spending in health insurance programmes medicare and Medicaid continue to grow. The rate of growth in these expenditures is higher than the percentage rate of inflation. On the revenue side the US governments kitty stands weak after two substantial tax cuts in the Bush era in 2001 and 2003.This tax cut increases the national debt and deficit and its duration has been extended for two more years and is now due to expire in 2013. This extension itself will cost $3.3 trillion. This has now implied that the US will not be able to make necessary investments in maintaining existing infrastructure and creating new one which is necessary for maintaining global competitiveness. Finally the US is still fighting hard in Afghanistan. It has only recently exited from Iraq however continues to finance the home grown government. Given that there are no deadlines attached to these foreign war operations it becomes difficult to forecast the potential savings from reform of government budget. Although Congressional Research Service has indicated that war expenditures will decline after 2008 however it has increased again (Figure 2) since relatively reduced level in 2010.

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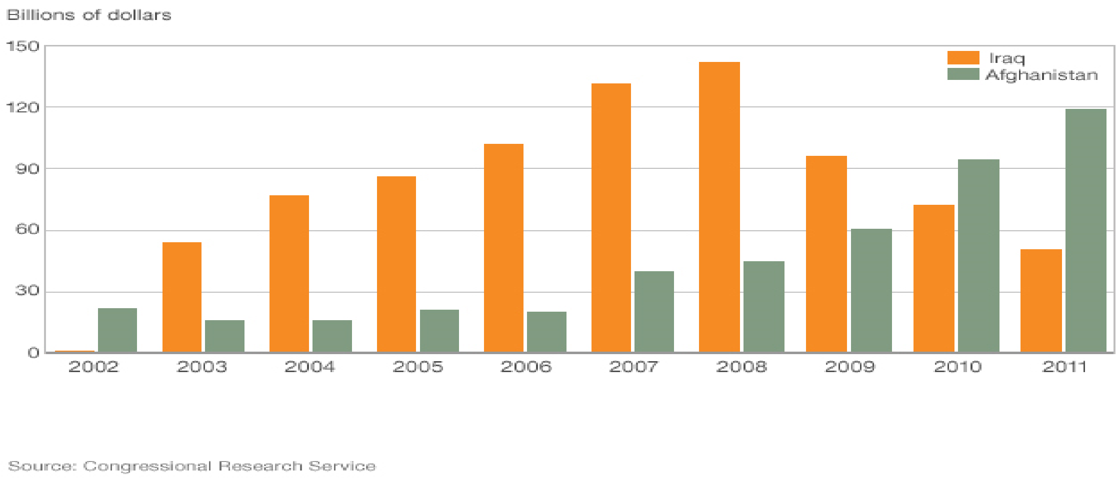
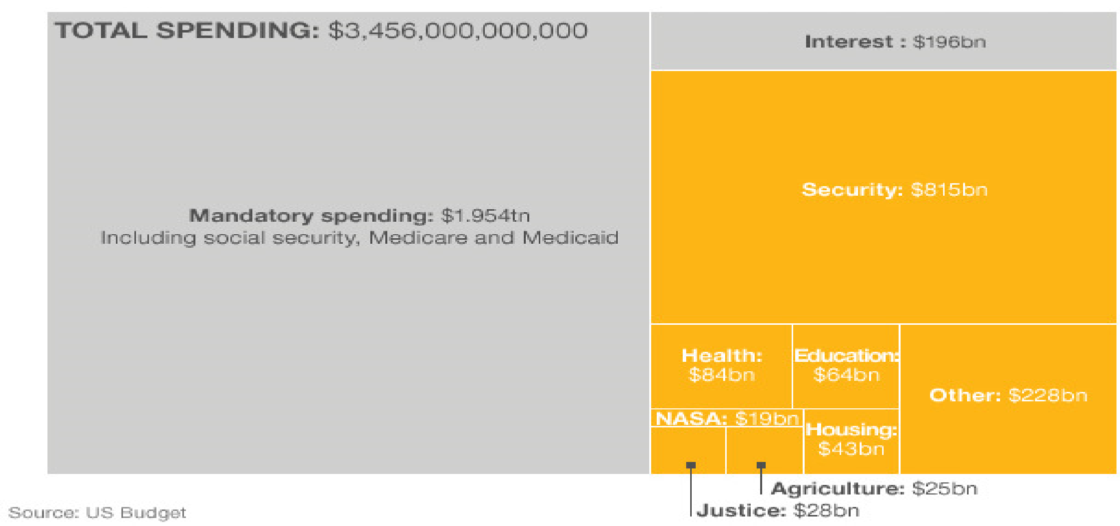
15 http://townhall.com/tipsheet/katiepavlich/2011/07/08/more_jobless_americans_unemployment_jumps_to_9.2_percent, US rate of unemployment has a lot of ups and downs, current rate is 8.2% but this figure is taken when the US debt crisis were on peak as well as the unemployment rate was on high.

Figure 2 Estimated War Funding



The US government plans to cut the deficit by at least $3 trillion over the next 10 years. There is a lot of speculation on how these cuts will come with some suggesting students will get less support for their education while others are talking about cuts in defense and social securities. However international aid from US government can be easily defended on political grounds. Figure 3 indicates the limited space available with the policy managers to maneuver curtailing the deficit.

Figure 3 US Budgetary Expenditures



More than half of the US annual budget is mandatory with social security and health programs which are difficult to cut. On the discretionary side more than half goes to security which is also not an easy task to reduce. So without a tax rise or some sudden spurt of economic growth it would not be easy to reduce the deficit.

President Obama offered his plan for curtailment of deficit which relied on $1.5 trillion tax increase from 2013. The incidence of tax will be greater on high income earners. $800 billion will come by letting Bush era tax cuts expires while remaining $700 billion will come from changing tax rates and limiting deductions. Republicans have already opposed this proposal of increasing tax on wealthy suggesting that this may hamper the much needed restoration of economic growth and creation of jobs. US may be able to save $1.1 trillion by ending the wars in Afghanistan and Iraq.

In order to meet the increasing health budget needs, President Obama has also proposed a $580 billion adjustment program by 2013, which includes $248 billion from Medicare and $72 billion from Medicaid. Opponents view this proposal as a further burden on economy[16].

Fears of a Double Dip and Potential Impact on Developing Countries

In the aftermath of the global financial crisis the economic growth rate in developed economies has slowed down from 3.1 percent in 2010 to 1.5 percent at the time of writing of this brief. The unemployment rate in advance countries continues to increase while credit rating of businesses declines. Even China which played a key role in economic recovery from the financial crisis in 2008-09, had seen a decline in growth for the third consecutive quarter and this has a significant impact on developing countries as China for many is a leading provider of aid and trade flows[17].

The Chief Economist of the World Bank Justin Yifu Lin while commenting on the current financial and debt crisis has said that "Developing countries should hope for the best and prepare for the worst".

We try to list below the main challenges which developing countries may face as the debt crisis in the West deepens:

- Advance economies and specially EU provides trade opportunities to developing countries under preferential market access arrangements. During the 2000s economies such as India, Pakistan and Bangladesh have greatly benefited due to expansion in EU import demand. These benefits helped in augmenting foreign exchange reserves via exports receipts, creation of new jobs in industry and helping millions to come out of the poverty trap.
- A reduction in the value of the Euro against the dollar is putting more pressure on developing countries dollar-based exports. Even otherwise a fall in value of Euro vis-à-vis currencies in developing countries will imply rising in prices of exports from developing countries and thereby implying a reduction in demand

[16] The guardian Monday 19 September 2011, See at(http://www.guardian.co.uk/world/2011/sep/19/obama-deficit-cuts-main-points),

[17] Isabella Massa, How the Euro zone debt crisis could affect the developing countries, The Guardian(bolg) Friday 21 October 2011, see at (http://www.guardian.co.uk/global-development/poverty-matters/2011/oct/21/eurozone-crisis-developing-countries)

for exported goods. The austerity measures put in place by many EU economies have already led to a reduction in export orders from developing countries.

- The falling value of the Euro will significantly impact the value of remittances sent by the Diaspora working in EU.
- EU is a key provider of foreign aid under both bilateral and multilateral arrangements. The aid inflows to developing countries will be affected. UK has imposed the biggest cut in government spending since WWII amounting to £83 billion by 2014-15. France and Germany are cutting €45 and 80 billion respectively. These slashed categories include aid assistance to developing economies. UN in 2008-09 had indicated that the achievement of MDGs in developing countries is being affected due to a reduction in commitments by the developed countries.
- Another potential negative impact comes in the form of reduced foreign investment by EU businesses in developing countries. During the earlier part of 2000s there was a renewed spree by EU investors who entered East Asian, Latin American and South Asian markets. The shrinking corporate savings in EU will imply lesser investible funds and this impact will be felt in the above mentioned regions as foreign direct and portfolio investment may see a decline.
- The debt crisis has increased the unemployment rate in Euro zone to 10 percent and in the US to 9.2 percent. It affects the labor markets of the developing countries as a substantial number of people from the developing world work in developed countries or in outsourced concerns from developing countries. Both the US and EU have now further tightened their immigration policies in order to reduce the number of workers entering their boundaries. This will not only result in the falling rate of migrants going abroad from developing countries but also lead to some reverse migration into developing countries as laid of expatriates come back to their native countries. This is bad news for poor countries in particularly as on average remittance of lower income countries are 8 percent of GDP. Some countries such as Tajikistan, Nepal and Gambia are dependent on remittances to the extent of 39, 22 and 14 percent of GDP respectively.
- Although the effectiveness of putting more finances towards war on terrorism is ambiguous, the reduced budget availability with US and EU governments will imply lesser funds towards this goal. The countries affected by the US initiated war on terror require substantial investment for relief, rehabilitation and the reconstruction process. Such sudden shortage of funds may result in a premature end to fight against terror in several parts of the world which then may be affected by civil war. This phase can then also provide a safe time and space for terrorist to reorganize themselves.

  A debt crisis in the West which is the main contributor towards development funds maintained at IMF, World Bank and other multilateral agencies could affect the operational strength of these institutions. It will decrease their development administration capacity globally. It with tighten the conditions of loans from these institutions and will imply an additional resource mobilization burden on poor countries. Several developing countries are already reeling under IMF conditionalities which were imposed amid food, fuel and financial crisis of 2007-08.

- It has been observed that uncertainties associated with US and EU debt crises has led to volatility in oil and food prices which can push millions of more people further below the poverty line.

Conclusion

To end this note it is also important to look at some of the positive changes which are starting to take place as this crisis deepens. The BRICs countries are now starting to have a leading role in the international monetary finance. These countries due to their large foreign exchange reserves and factors of production are balancing the governance of global institutions. A change has been seen in the composition of traditional trading partners. The domestic demand in Brazil, China and India is now paving the way for strong inward flow of goods. The same can be observed in the case of East Asia. Previously many regional blocks were looking at EU as a role model for regional integration. This crisis has now given us a chance to look beyond EU and not trip over the same hurdles.

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