

Understanding the European Debt Crisis

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It's good to understand Europe's debt crisis and why it's affecting U.S. markets. Here's an overview of how the European Union operates, why the euro is in danger, and what the crisis could mean to American investors.

Unless you regularly read the Financial Times or otherwise keep up with world financial news, you may be wondering how the crisis in Europe came to be and what effect it might have on the U.S. economy. Here, in a nutshell, is the backstory, along with possible scenarios for how it might play out at home and abroad.

The European Union

In 1951, six European nations came together to form the European Coal and Steel Community (ECSC) for the purpose of preventing future war between France and Germany and to create a common market for coal and steel. Out of this evolved the European Economic Community (EEC), later called the European Community (EC), which expanded the markets and eventually led to the European Union (EU), an economic and political union that now comprises 27 member states located primarily in Europe.

The goal of the EU is to ensure the free movement of people, goods, services, and capital by abolishing passport controls and maintaining a single market

through a standardized system of laws that apply in all member states.

Today, the EU has a combined population of over 500 million inhabitants and comprises about 26% of the global economy. Individually, member states vary widely in size, population, and wealth. But as members of the union, all are considered equal.

The euro

To facilitate trade and strengthen the power of the EU, in 1995 the euro was officially adopted as the currency of the EU. To participate in the euro, each member state had to meet strict criteria, including low inflation, interest rates close to the EU average, a budget deficit of less than 3% of their GDP, and debt that is less than 60% of their GDP.

Not all member states met the criteria. Those that did officially exchanged their national currencies for the euro on Dec. 31, 1998.

Today, 17 of the 27 members of the EU have adopted the euro as their currency. Members of the

eurozone are Austria, Belgium, Cypress, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain. Of the 10 remaining EU members, seven are obliged to join the eurozone as soon as they meet the entrance requirements, while three others, Denmark, Sweden, and the United Kingdom, have opt-out provisions.

European Central Bank

Monetary policy for the eurozone is managed by the European Central Bank (ECB). Current president Jean-Claude Trichet, like his U.S. counterpart Ben Bernanke, is charged with keeping inflation low – under, but close to, 2%.

However, the ECB operates somewhat differently. When it is necessary to pump money into the system to stimulate the economy, the U.S. central bank does it primarily by buying Treasury bonds. In the eurozone, the ECB lends cash to member banks via short-term repurchase agreements backed by collateral such as public or private debt securities. The borrowing banks list the deposits as liabilities on their balance sheets. The ECB lists the contracts as assets.

Because members have to meet stringent requirements to gain entrance to the eurozone, it is presumed that all the securities listed as collateral are equally good and equally protected from the risk of inflation. However, most countries in the eurozone no longer meet those requirements. At the end of 2010, the average debt-to-GDP ratio for the eurozone as a whole was over 80%. For Greece and Italy, it was well over 100%.

European sovereign debt crisis

As debt levels have risen in certain countries – primarily Greece, Ireland, Italy, Portugal, and Spain – international traders have questioned their ability to pay and have priced the securities lower in the marketplace. So the collateral backing the ECB loans is now worth less than the face value

of the notes. This forces the ECB to mark down those assets and creates an imbalance between the liabilities listed on the banks' balance sheets and the assets listed on the ECB balance sheet. To preserve the reputation and value of the euro in the international marketplace, these imbalances must be reconciled.

One way to restore balance and help the struggling countries avoid default is for the EU and the International Monetary Fund (IMF) to bail them out under the terms of the newly created European Financial Stability Facility. Over the past year and a half, Greece, Italy, and Portugal have all accepted rescue packages. In return, they have agreed to extreme austerity measures.

Austerity measures for all

Today, the austerity movement is spreading throughout Europe as governments seek to raise taxes and cut government spending in an effort to strengthen their balance sheets.

In “Europe Enters Era of Belt-Tightening,” Financial Times noted, “Each eurozone country is taking the measures it must take or can take – from pursuing tax cheats in Spain and Greece, to reducing child benefits in Ireland and controlling public spending almost everywhere – to reach a budget deficit target of 3% of GDP in the next three or four years.”

Despite public protests, austerity measures seem to be appropriate, given the fact that the central bank can do only so much to fix struggling member nations, each of which has its own tax structure and separate economy. With interest rates near zero and limited options for monetary policy, all that's left is tight fiscal policy if weak EU members hope to gain access to capital. Each country must slash spending in its own way if it wants to get debt levels below 60% of GDP.

The problem is that GDPs are dropping as well, even in the healthier countries. Germany's quarterly

economic growth slowed in the second quarter of 2011 to 0.1% of GDP. France failed to grow at all. And Greece — well, the Economist calls the austerity plan “doomed to fail,” saying a “debt restructuring is the only really likely outcome here.”

Double dip?

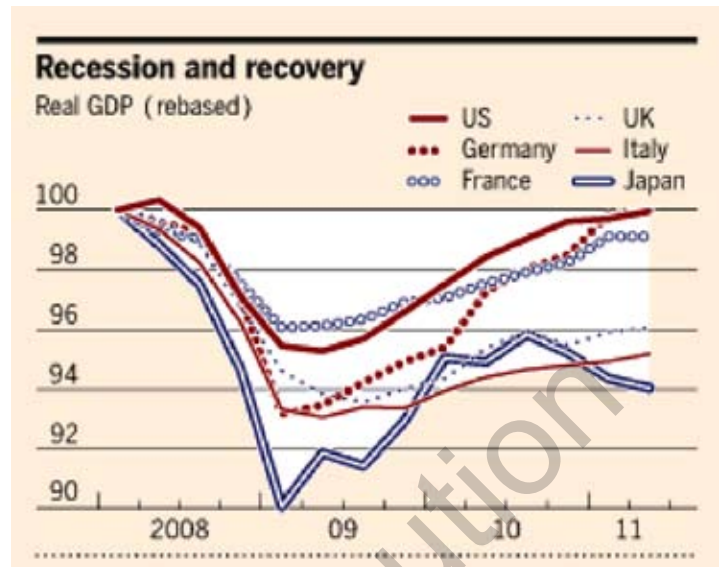
The biggest fear is that austerity programs will threaten an already precarious economic recovery. The recession that hit the United States following the 2008 financial crisis spread to Europe as businesses around the world, and particularly in the U.S., cut back on orders to reduce inventories. But the recession in Europe has been deeper and longer-lasting than in the U.S. Now, just as Europe is starting to emerge from recession, austerity measures are killing chances for growth.

Even the IMF, which was responsible for imposing austerity measures on the nations it bailed out, is warning developed countries not to pursue belt-tightening so fast that it imperils recovery. “For the advanced economies, there is an unmistakable need to restore fiscal sustainability through credible consolidation plans. At the same time, we know that slamming on the brakes too quickly will hurt the recovery and worsen job prospects. So fiscal adjustment must resolve the conundrum of being neither too fast nor too slow,” said Christine Lagarde, the new IMF chief, in a Financial Times op-ed piece.

Martin Wolf wrote in a recent Financial Times column, “Many ask whether high-income countries are at risk of a ‘double dip’ recession. My answer is: no, because the first one did not end.” By the second quarter of 2011, none of the six largest high-income economies had surpassed output levels reached before the crisis hit (see chart).

He says that in Germany and the U.S. there is fiscal room for maneuvering — i.e., they are able to spend more to jump-start the recovery. “But, alas, governments that can spend more will not and those who want to spend more now cannot.” It seems that austerity is here to stay, at least for a while.

The United States hasn’t yet instituted austerity



SOURCE: Financial Times

measures as extreme as those in Europe — except for forced austerity at state and local levels — but in a world of free exchange rates, budget cutting by one country is soon transmitted to other countries, leading to contraction elsewhere.

Here’s how it works: Europe slashes spending. It then needs to borrow fewer euros, which results in less demand for the European currency. Interest rates fall, investors then switch to investments denominated in other currencies. That makes the euro cheaper against the U.S. dollar, which drives up the prices of our goods and reduces demand for U.S. exports.

This time is different

Europe and the United States have been through economic cycles before. But the downturn that began in 2008 may turn out to be more protracted than any since the Great Depression. Carmen Reinhart and Kenneth Rogoff write in “A Decade of Debt”: “The combination of high and climbing public debts (a rising share of which is held by major central banks) and the protracted process of private deleveraging makes it likely that the ten years from 2008 to 2017 will be aptly described as a decade of debt.”

They say that high public indebtedness doesn’t always end in high interest rates and hyperinflation — a fear many people have right

now. Rather, the high debt levels may cast a shadow on economic growth, even when the sovereign's solvency is not called into question.

In addition to outright austerity programs – whose effectiveness they say will be limited by subpar economic conditions and rising debt servicing costs – sovereign nations will deal with this debt through “financial repression,” a subtle form of debt restructuring that includes “more directed lending to government by captive domestic audiences (such as pension funds – this is already happening in Europe), explicit or implicit caps on interest rates, and tighter regulation on cross-border capital movements.”

In other words, there's a good chance that interest rates will remain low and inflation will remain in check over the long deleveraging process that has only just begun.

Elaine Floyd, CFP®, is the Director of Retirement and Life Planning at Horsemouth, where she focuses on helping people understand the practical and technical aspects of retirement income planning. Horsemouth is an independent organization providing unique, unbiased insight into the most critical issues facing financial advisors and their clients. Horsemouth was founded in 1996 and is located in New York City.

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