Contagion and the European Financial Crisis

The eurozone debt crisis began in earnest within days of the October 4, 2009 election victory for George Papandreou's Pan-Hellenic Socialist (Pasok) party in Greece. In the immediate aftermath of the election, Papandreou announced major revisions to the previous government's budget deficit projections. On October 21st, the newly formed government informed the eurozone's statistical agency, Eurostat, that the country's 2008 deficit was 7.7% of GDP rather than the previously reported 5%.[1] They also revised the 2009 deficit projection upward from 3.7% of GDP to 12.5% – a figure that eventually rose to 15.4%.[2]

The significant correction of Greek deficit statistics sent the first large ripples of concern through bond markets. Since then, investors have increasingly sought refuge from the sovereign debt of "risky" countries, driving a growing wedge between the borrowing costs of fiscally troubled eurozone economies and the cost of borrowing for countries seen as "safe," particularly Germany. This brief traces how this unfolded as the "Greek" crisis metastasized into a wider eurozone crisis. It describes how and why sovereign bondholders fled from Greek, then Irish, Portuguese, Italian, and now Spanish debt.

Greece, Part I

The full impact of Papandreou's announcement took months to be fully felt. In the weeks immediately following the Greek revisions, the yield on ten-year Greek debt (i.e., the country's effective interest rate) rose only modestly. This was because the unreliability of Greek fiscal statistics was hardly a surprise – Eurostat had repeatedly been forced to check or express reservations about reported data.[3] Instead of panicking, the markets assumed a wait-and-see posture in order to ascertain how Greece and its eurozone partners would react to the new information. It was ultimately a lack of faith in Greek austerity measures, combined with the halting and ambivalent reaction on the part of Greece's eurozone partners, which provoked the most acute reactions from the markets.

Papandreou, who had campaigned on a platform of Keynesian stimulus, changed course and presented a host of austerity-minded reforms on December 14, 2009.[4] His government followed up with a three-year reform plan a month later. Yet neither was greeted with much confidence. Unions made it clear that reform would not come easily, and responded to the December proposals with a call to strike. Moreover, the long-term plans were widely dismissed as being overly optimistic. Markets were consequently unimpressed: Greek interest rates actually jumped 64 basis points in the week following December 14th, and they hardly reacted at all to the three-year plan.[5] Ratings agencies' downgrades and negative warnings, having begun in late October, continued throughout January and February.

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With Greece struggling to address the problem on its own, wealthier eurozone countries – Germany above all – were guilty of sending mixed messages regarding their willingness to lend assistance. Early in 2009, German Finance Minister Per Steinbrück had described a eurozone default as unimaginable, and indicated Germany would step into prevent one.[6] When crisis struck, however, German Chancellor Angela Merkel portrayed the Greek situation as a domestic concern, announcing on December 11th that the Greeks would have to find a way to unwind their own debt problems.[7] Merkel hardened her line in March 2010, making it clear that Germany would not act unless Greece was utterly unable to finance itself, and then only if the International Monetary Fund (IMF) was also involved. These statements, especially the prospect of IMF involvement, alerted the bond markets to the very real possibility of default.[8] After Merkel's comments, the yield on Greek debt began a more rapid climb, reaching 8.64% by April 22, 2011. This was nearly double the 4.4% that prevailed on the day of Pasok's election victory just seven months earlier. Faced with such steep borrowing costs, Papandreou was forced to ask for help securing cheaper funds on April 23rd. In response, the ratings agencies promptly cut Greek sovereign debt to "junk" status.

On May 2nd, eurozone finance ministers announced €110 billion in financial assistance spread over three years, €30 billion of which would come from the IMF. Furthermore, the European Central Bank (ECB) would continue to accept Greek government debt as collateral despite its junk rating, thus ensuring that secondary markets for Greek debt would remain liquid. The assistance, however, was contingent on Greece meeting stringent conditions that, it was hoped, would return the country to longer-term fiscal stability. For a time, at least, this was enough: Greece had access to the funding it needed regardless of the market-determined yield on its debt.

However, despite the solution to the immediate problem, Greece was not the only eurozone economy with a debt problem. Indeed, in the early months of the "Greek" crisis, the cost of Portuguese and Irish borrowing had risen as well. It was apparent to those formulating the Greek bailout that any rescue might ultimately need to be larger than Greece. As a result, eurozone countries agreed in meetings on May 10th and 11th to set aside €500 billion in resources to finance troubled economies that could no longer fund themselves at market-determined rates. It was hoped that the creation of such a facility would eliminate much of the uncertainty that had contributed to the deterioration of Greece's situation. The funding was split between the €440 billion European Financial Stability Facility (EFSF), drawn from member state contributions, and the European Financial Stability Mechanism (EFSM), which was authorized to borrow up to €60 billion on open markets in order to lend to distressed states at discounted rates. These were buttressed by an additional €250 billion in available funds provided by the IMF.

Ireland

Ireland was the first country to turn to the new facilities. Unlike Greece, where the chief fiscal problem lay in a long tradition of profligacy and creative accounting, Ireland had been relatively fiscally sound. The country ran surpluses for most of the decade leading up to the crisis, and its debt-to-GDP ratio stood at only 25.1% at the end of 2007. The problem in Ireland was not with its government but with its corporations and consumers – economically dependent, credit-fueled consumption and a large banking sector that borrowed heavily from international markets fueled Irish financial woes. Irish households and financial corporations had become highly indebted: financial corporations increased their net indebtedness from 1.9% of GDP in 2001 to a peak of over 17% of GDP in 2006 despite accumulating 600% of GDP in new assets over the same period. Households' net assets fell from over 100% of GDP in 2001 to less than 65% by 2007.[9]

Consequently, the Irish economy was especially vulnerable to the banking crisis that struck in 2007-08. As international credit markets gradually froze, Irish banks were deprived of their main source of funding. This cut off the credit spigot that had previously fueled the Irish property bubble and Irish consumption, and that, ultimately, provided for much of the country's growth. As a result, Ireland was the first in Europe to slip into recession in 2008, and its banking sector quickly found itself in a dire situation: banks had lost their main source of funding, had loaned extensively into the Irish property market that had turned sharply downward, and were exposed to a significant amount of low-quality, sub-prime debt from the United States. By September 2008, the entire system was on the brink of collapse.

In order to avert the looming financial catastrophe, the Irish government embarked on an extensive and sustained campaign of costly supports for the ailing banks. It guaranteed all deposits and bank-issued debt, recapitalized or nationalized its biggest banks, and established a "bad bank" to dispose of low-quality assets within the system. Official estimates place the total cost of the packages around €40 billion, or roughly 25% of Irish GDP in 2010.[10] Combined with the loss of tax revenue, Irish deficits jumped from zero in 2007 to over 32% of GDP by 2010. Government debt quadrupled to 96.2% of GDP.[11]

The sovereign bond markets reacted to the Irish debt situation by adopting the same wait-and-see posture that characterized their initial response to the Greek situation. Despite the rapid increases in Ireland's debt burden, the yield on ten-year Irish debt was the same in May 2010 as it had been in May 2008 before the crisis began. Interest rates crept slowly upwards after the announcement of the Greek bailout, but the markets seemed at least somewhat satisfied with the EFSF and EFSM as a bulwark against default.

That changed on October 18, 2010. After meeting in Deauville, Merkel and French President Nicolas Sarkozy issued a joint statement that further crisis response must involve "adequate participation" of private creditors – a thinly veiled reference to debt restructuring.[12] Like the warning of IMF involvement in the run-up to the Greek bailout, this increased the threat of default, pushing up the cost of borrowing for all troubled eurozone economies. Ireland – whose sovereign debt now guaranteed much of the country's privately-owed debt – was hit particularly hard. On the day of the Deauville summit, Ireland could borrow at 6.02%. Within a month, that figure had peaked at 8.92%. Facing further need to bail out its banking sector, a rapidly eroding tax base, and

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unsustainable borrowing costs, Ireland turned to the EU and IMF for assistance at the end of November, receiving a total package of €85 billion.

Portugal

While Portugal came to the EU and IMF after Ireland and needed help far later than Greece, its fiscal problems developed alongside those in the other two countries. Portugal's woes loosely parallel events in Greece, with the chief difference being that it entered the crisis period with a smaller debt burden: its debt-to-GDP ratio in 2007 was 68.3%, Greece's was 105.4%. As a result, the evolution of the Portuguese crisis took longer to reach the point where assistance became necessary.

The Portuguese case is curious because, unlike Ireland or Greece, there was no single overriding economic problem fueling market worries. Its debt burden was not particularly high and its recession following the financial crisis was not especially deep. Nevertheless, a lackluster economic performance in the years leading up to the crisis and concerns over the flexibility and competitiveness of the country as a whole included it in the category of Mediterranean countries in potential need of reform.[13] This was underscored in late 2009 when Portugal, like Greece, was forced to revise its deficit figures upward from 5.9% of GDP to 8%.

The ensuing 18 months were characterized by a cycle of Jose Socrates' Socialist government attempting to reign in its budget deficits, the ratings agencies reacting with skepticism, and Portuguese borrowing costs continuing to climb. The ratings agencies initially placed negative credit watches on Portugal in the weeks following its deficit revision. The government responded in early 2010 by announcing its intention to calm markets through pay freezes, public sector reductions, privatizations, and tax increases on the wealthy. Nevertheless, the government was forced to make a second upward revision of the 2009 deficit to 9.4% of GDP. Citing deteriorating debt metrics, Fitch then downgraded Portuguese debt to a lower-quality investment grade in March and December, followed by Standard & Poor's in April, and Moody's in July. From October 2009 to March 2011, markets grew increasingly concerned as the yields on Portuguese long-term bond doubled from 3.85% to 7.80%.

The slow pace of the Portuguese crisis rapidly accelerated on March 23, 2011 when Socrates failed to secure the votes for additional fiscal cutbacks. The ratings agencies immediately responded by downgrading Portuguese debt to "junk" status. Interest rates soared more than 100 basis points in ten days, and the government was quickly forced to ask the EU for financial assistance on April 6th. The aid package, announced a month later, provided €78 billion over three years.

Greece, Part II

With Ireland and Portugal out of private credit markets, attention returned to Greece in June 2011. Papandreou's precarious government was entirely dependent on EU funding –

private debt markets priced Greek debt at an entirely unaffordable 16% – and it needed the release of a €12 billion tranche of its bailout in order to avoid outright default in July. Moreover, it had become clear that the Greek state would require significantly more assistance than was provided in the first assistance package.

European leaders, for their part, faced heightened resistance to additional Greek bailouts. Public opposition to sending taxpayer money to support what they saw as profligate Greeks was growing increasingly intense, particularly in Slovakia and northern Europe. In the Netherlands, further supports required the parliamentary backing of the Labor party, which demanded private haircuts and more stringent austerity requirements before contributing any further funds.[14] Merkel hoped to soothe rising public worries in Germany by compelling private sector haircuts in any further bailouts and by splitting the cost among all 27 EU member states, not merely the 17 that used the euro.[15] Both initiatives were opposed: British Prime Minister David Cameron successfully fought off attempts to get non-eurozone members to contribute, and Merkel accepted that any private sector involvement must be voluntary. Nevertheless, there was widespread acceptance of the fact that any further financing for Greece must be tied to strict austerity measures.

For Papandreou, this demand was complicated by the eruption of widespread protests over austerity measures. By June 5th, the number of protesters in Athens' Syntagma square had swelled to several hundred thousand. Moreover, the opposition New Democracy (ND) party had announced that it would oppose any efforts by the Papandreou government to push through further austerity measures.[16] The tension reached a head in the final week of June. European leaders, meeting on June 23rd and 24th, officially agreed to release the €12 billion and to negotiate a further €120 billion in financial assistance on the condition that the Greek government pass a draconian set of austerity and privatization measures within the week. Papandreou set the parliamentary vote for June 29th and managed to push the measure through amidst a general strike and violent protests.

The internal dissent among European leaders over further Greek assistance worsened as 2011 wore on and the particulars of the second bailout – as well as the creation of a more permanent successor to the EFSF and EFSM – were negotiated. Though a €130 billion package was finally approved in February 2012, it faced public hostility and organized opposition by major parties in the Netherlands, Finland, and Slovakia. Within Greece itself, Papandreou struggled to maintain backing for continued austerity measures. After a catastrophic one-day flirtation with the idea of putting further cuts to a referendum, Papandreou was forced to resign to make way for a technocratic government with a mandate for continued reform.

The second part of the Greek crisis signaled a new phase of the wider crisis. Since May 2010, there had been some certainty that the EFSF and ESM would prevent countries like Portugal and Ireland from defaulting in an uncontrolled way, even if the question of private sector involvement remained open. The troubled resolution to the second Greek

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crisis made it apparent that any further bailouts would be seriously challenged on two fronts: the willingness of debtor countries to continue with austerity and the willingness of creditors to continue financing debtors through their restructuring. Uncontrolled default was again a very real possibility.

Italy

That uncertainty directly contributed to the spread of the crisis to Italy in 2011. Europe's financial fragilities, put on display with the second Greek bailout, were further emphasized by the July 15th release of a European Banking Authority stress test, which found that 16 of the 91 banks tested needed to raise additional capital.[17]

The twin fears of Greek default and contagion to other eurozone economies were particularly dangerous for Italy. While its debt burden has long been among the highest in the world, Italian bonds are held primarily by domestic savers and Italian governments have managed their heavy borrowing for decades. Moreover, Italy managed to keep its own deficits relatively controlled throughout the financial crisis and ensuing recessions. As a result, Italy had initially been considered a safe haven in comparison to Greece, Ireland, Portugal, or Spain. The new threat to Italy – and holders of Italian debt – was that a Greek default would trigger problems within the European banking system that would make it hard for Italy to roll over its own mountain of public debt.

That concern led to calls for the Italian government of Prime Minister Silvio Berlusconi to reduce its public spending and attempt to reign in the debt. ECB President Jean-Claude Trichet and Bank of Italy Governor Mario Draghi wrote to Berlusconi in August, urging him to pursue liberalizing and privatizing reforms previously advocated by the IMF.[18] Among the most controversial recommendations was the call for pension reform, which triggered staunch objections from Berlusconi's key coalition partner, Umberto Bossi's Lega Nord. A proposal to raise Italy's VAT also sparked opposition from Italian economics minister Giulio Tremonti, with whom Berlusconi had an extremely strained relationship.[19]

The infighting within the Italian government worsened market concerns over Italian debt. While it was Spain that faced higher borrowing costs at the start of August, the Spanish government had been relatively efficient in implementing an austerity-minded budget, negotiating cutbacks with the country's powerful regional governments, and raising taxes. As a result, Spanish interest rates remained high but stable and sustainable – barely. In contrast, Italy appeared incapable of generating the sort of domestic reforms that would allay bondholders' fears. Yields on Italian debt rose above Spanish debt by the end of the month.

Berlusconi's response was a series of ineffective half-measures which pleased no one, even as his cabinet continued to fracture. In late September, Standard & Poor's cited the "fragile" government as a reason behind a downgrade of Italian sovereign debt.[20] Berlusconi himself fed into the critique by publicly complaining about Tremonti – a figure with strong credibility with Italy's economic partners – and his inability to force Tremonti out of government.[21] With Bossi continuing to object to an increase in the pension age and Berlusconi unable to marshal a majority in support of the more extreme austerity demanded by bond holders, the markets punished Italian debt harshly. A debt auction on October 28th met with little demand; banks began to sell Italian paper, the price of using Italian debt as collateral jumped, and the yield on Italian debt spiked to 7.42% – a 575 basis point premium over German bonds.

Berlusconi, unable to respond, resigned on November 12th. The new technocratic government under Mario Monti has restored a degree of faith in the Italian government's ability to close its fiscal holes. Though dangers still lurk for the Monti government – not least its reliance on the support of Berlusconi's former party – the cost of Italian borrowing declined markedly until problems emerged in Spain.

Spain

As of this writing, the eurozone crisis has shifted to Spain. Like Ireland, the country was fiscally responsible in the years before the crisis but was heavily reliant on a credit-fueled bubble in residential property and construction. When credit markets froze and the bubble popped, the Spanish economy lost its major engine for economic growth. The cost of the country's unemployment insurance spiked at a time when tax revenues dropped.

Although Spanish deficits have been high since the crisis began, the country had benefitted from an initially low debt burden and relatively little loss in market confidence. Moreover, while the country continues to run above-projected deficits, it brought those deficits downward for two consecutive years. A lengthy period of negative or stagnant growth combined with heavy unemployment, however, means the country's overall debt burden has continued to expand, triggering multiple rounds of ratings agency downgrades and pushing the cost of borrowing to the boundaries of what is sustainable.

In recent months, the center-right Popular Party government of Mariano Rajoy, elected in December 2011, has created new concerns. Although he has proposed a cost-cutting budget including €27 billion in austerity measures, he has publicly chafed at calls for additional cuts from Brussels, announcing he was "not going to tell the other presidents or heads of state about the deficit figure that will be included in [the Spanish] budget."[22] The markets immediately reacted by selling Spanish sovereigns. Furthermore, the cuts he has announced face major opposition from the population, public sector workers, and some of Spain's powerful regional governments.

Looking ahead, the biggest concern in Spain centers around its banking sector. The fear is that Spanish default rates will rise as a consequence of the country's extended recession – though the CEO of Spain's largest lender somewhat self-interestedly describes the worry as "stupid."[23] Combined with falling home prices, this would potentially force debt writedowns for Spain's already-fragile banking sector. Added to this domestic exposure is the fact that Spanish banks are poorly positioned to deal with a default elsewhere in the

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eurozone: in the July 2010 stress tests, the majority of failing banks were Spanish. With the government unable to afford a major bank bailout, a Spanish banking collapse could not only bring down the Spanish economy and force the country into default, but it also threatens the European financial system as a whole.

Conclusion

Ultimately, the story of the eurozone debt crisis is one of failing market confidence in states' capacity to repay their sovereign debt. It started with Greece being forced to ask its wealthier eurozone partners for shelter from private borrowing costs. Ireland and Portugal, unable to convince markets of their own sustainable plans for emerging from debt, were compelled to follow suit. The uncertain European response to crises in these three smaller countries triggered bond market concerns that larger European economies, particularly Italy, would be unable to roll their own debt over in the event of default. With the Italian crisis receding for the moment, Spain – an economy larger than Ireland, Portugal, and Greece put together – is in authentic fiscal difficulty. It must convince markets that it can repay its debts as long as borrowing costs remain at sustainable levels. If it fails to do so, it is entirely unclear that such a large economy can be successfully rescued.

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