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Sovereign Debt Challenges in the Euro Area: Implications for APEC

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I. The Euro area crisis and the global economic outlook

Euro area sovereign debt crisis: the current state of play

Since July 2011, the Euro area has been caught up in a new wave of sovereign debt problems. A crisis of confidence has escalated beyond the small economies of Greece, Ireland and Portugal and has now spread to larger Euro area economies Italy and Spain. France and Belgium are also under increasing pressure as the costs of supporting their banks and struggling Euro area members are stretching their budgets. In early December 2011, Standard and Poor's (S&P) placed the 15 members of the Euro area, including Germany, on negative credit watch, implying there is a 50 percent chance of sovereign credit downgrades.

Obstacles to a sustainable solution

At a special summit held on 9 December, European leaders agreed on a new "fiscal compact"[1] and strengthened stabilisation tools to address current market tensions. Key provisions of the agreement include:

- a cap of 0.5 percent of nominal Gross Domestic Product (GDP) will be imposed on government structural budget deficits;
- for any Euro member state whose deficit exceeds 3 percent of GDP, there will be "automatic consequences". Those consequences are as yet unspecified.
- European economies will also consider[2] providing an extra €200 billion to the International Monetary Fund (IMF) to bolster the fund's resource to fight the crisis;
- the European Stability Mechanism (ESM) will be brought forward in July 2012 to replace the temporary European Financial Stability Facility (EFSF).
- the adequacy of the ESM/EFSF funds of €500 billion will be reassessed in March 2012; and
- European leaders reassured the market that measures imposed on the private sector[3] in adversary Greek debt were unique and exceptional.

The European Central Bank (ECB) is also stepping up its support to banks. Newly announced measures by the ECB include lowering the policy rate to 1 percent, widening the range of collateral used by banks in exchange for ECB liquidity and offering unlimited three-year loans to banks on more favourable terms.

Initial market reaction to the measures outlined at the 9 December Summit was cautiously positive. Global equity markets showed some recovery from their earlier steep losses. The market however continues to cast doubt as to whether the measures outlined at the summit are sufficient to contain the crisis.

The agreement at the summit has arguably done little to address short-term liquidity pressure. The market was notably disappointed that the agreed deal was not strong enough to have the ECB committed to unlimited government bond purchases. It will be important to monitor the developments in larger economies such as Italy and Spain. If they were to lose market access, the resources currently available under the ESM/EFSF and the IMF may not be sufficient to meet their short-term funding needs, which are estimated to be around €1.3 trillion for 2012 and 2013 (Table 1).

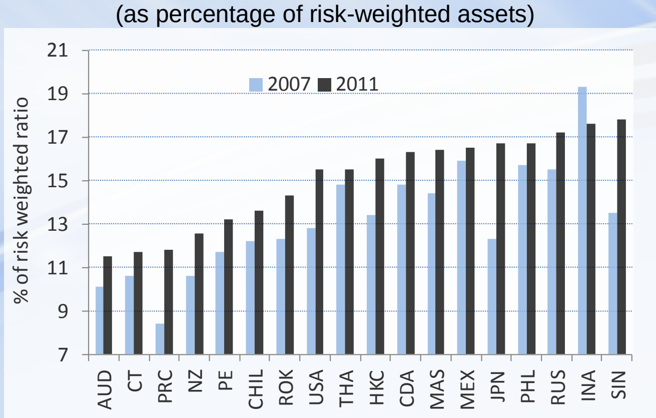
Table 1: A snapshot of projected fiscal positions for selected Euro area economies

	Gross financing needs		Fiscal balance	Gross debt	GDP growth	Credit ratings
	2012	2013	2011	2011	2011	9-Dec-11
	€ billions		% GDP	% GDP	%	S&P
Greece	36	32	-8.0	165.6	-5.0	CC
Ireland	22	24	-10.3	109.3	0.4	BBB+
Italy	373	306	-4.0	121.1	0.6	A
Portugal	38	36	-5.9	106.0	-2.2	BBB-
Spain	224	216	-6.1	67.4	0.8	AA-

Source: IMF September 2011 Fiscal Monitor, Standard and Poor's

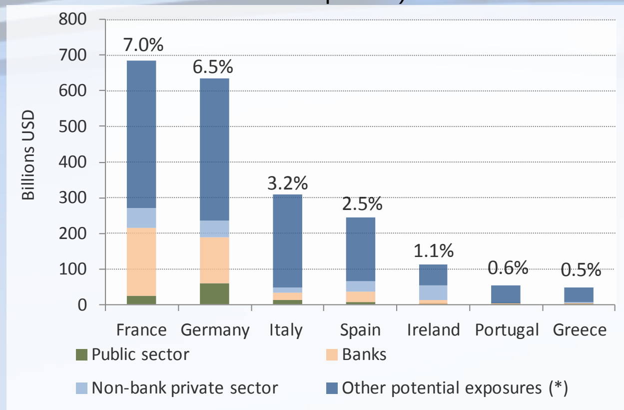
While the summit emphasised fiscal discipline, it failed to come up with a coherent solution to address the slowdown in the Euro economy and put a brake on the region's rising debt. Fears are that a great emphasis on short-term fiscal austerity would push the Euro area into deep recession and jeopardize economies from generating sufficient income to service debt. Ultimately, a sustainable solution to the Euro area crisis requires more resolute macroeconomic and structural reforms to address the long-term imbalances existing in some Euro area member states.

Figure 1: Risk-weighted Capital Adequacy Ratios for selected APEC[4] economies – 2007 and 2011
(as percentage of risk-weighted assets)



Source: IMF September 2011 Financial Soundness Indicators, National Sources
Note: Data for Japan as of 2010

Figure 2: Exposures of US banks to selected economies in the Euro area
(in billions USD and as percentage of total US banks' external exposure)



Source: BIS June 2011 report
(*) Other potential exposures include derivatives contracts, guarantees extended and credit commitments

Weakened global growth outlook

The uncertainty over the Euro area sovereign debt is having a negative impact on the global economic outlook. Data in the last few months has shown a slowdown in the Euro area, including Germany. Growth prospects have also weakened in emerging economies, which have prompted some central banks to cut policy rates. In the light of recent developments, the IMF[5] has warned that the probability of a global recession, which it defines as global growth of less than 2 percent, has increased from an estimated 5 percent in May, to 10 percent currently.

II. Transmission mechanisms to APEC economies

Financial linkages

The banking system in many APEC economies is better placed now compared to 2007, prior to the global financial crisis, with most banks maintaining risk-weighted capital adequacy ratios well above 10 percent (Figure 1).

Nevertheless, the high level of integration of banks in the APEC region with the world financial system suggests that the region could be vulnerable to volatility caused by the Euro crisis. There are multiple channels in which a severe Euro financial crisis could affect the financial system in APEC, including but not limited to the following:

a) Weakening of bank balance sheets

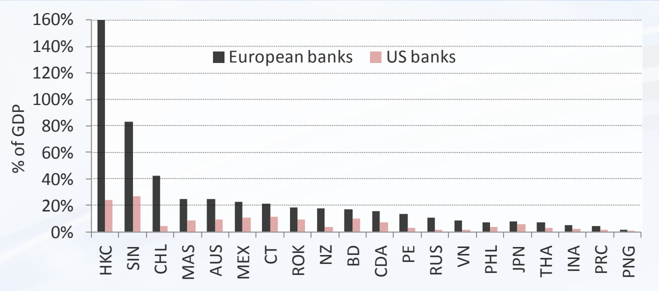
Overall, the exposure of banks in the APEC region to the high-spread Euro area sovereigns' debts (Portugal, Ireland, Italy, Greece and Spain) is limited, arguably with the exception of the United States (USA). According to the Bank for International Settlements (BIS), the direct exposure[6] of US banks to the five Euro economies is around USD 180 billion, equivalent to 5 percent of total US foreign credit claims. However, if contracts on derivatives, commitments and guarantees are included, total US exposure to these sovereign debts is at least four times larger.

Beyond these high-spread economies' sovereign debt, US banks have a very close relationship with European financial institutions. Lending by US banks to French and German banks (the largest holders of the high-spread economies' debt) is worth more than USD 1.2 trillion. The US financial system would therefore be in significant danger if the propagation in the Euro crisis were to spread to banks in the larger European economies (Figure 2).

b) Increased volatility in the capital markets

Ongoing sovereign stress has seen financial institutions moving away from European banks in order to reduce their exposure. On top of that, European banks are under pressure to recapitalise their capital by July 2012. Facing rising costs of capital and impaired market access, there is a risk that European banks could opt to reduce their foreign lending in order to strengthen their domestic balance sheets. If this were to occur, some small and open economies in Asia and Latin America are particularly vulnerable given their relatively high dependence on funding from Europe.

Figure 3: Consolidated claims of European and US banks on selected APEC economies (June 2011)
(as percentage of GDP)



Source: BIS June 2011 report, IMF September 2011 World Economic Outlook and PSU staff calculations

According to a BIS report, APEC markets (excluding Japan and the USA) sourced 54 percent of their external credit from European banks, compared to 18 percent from the USA and 11 percent from Japan. Looking at individual APEC economies, Hong Kong, China and Singapore are among the most highly exposed to a sudden disruption in capital markets given their large reliance on the financial sector for growth. To a lesser extent, other small and open APEC economies - including Australia, Chile, Malaysia, Mexico, and Chinese Taipei - are also vulnerable to a European credit crunch given that their liability with European banks is worth more than 20 percent of GDP (Figure 3).

Another global financial crisis would not only affect APEC economies by reducing the availability of credit but also by increasing funding costs. Asian businesses and households, which have benefited from relatively low interest rates, would potentially suffer a larger impact from rising funding costs.

c) Exchange rate fluctuations

Episodes of global financial instability are typically associated with reduced risk appetite and increased market volatility which in turn can result in sharp fluctuations in the currency markets. In particular, financial instability makes the carry-trade less appealing, thus putting downward pressure on perceived 'risky' currencies. This has been evident in some APEC economies which have seen their currencies drop in value vis-à-vis the US dollar and Japanese yen in recent months.

The consequences of large exchange rate fluctuations can be damaging, especially for some small and open APEC economies. Since a large part of their external debt is usually denominated in foreign currency, currency depreciation would ultimately increase the value of their external indebtedness.

d) Increased volatility in equity markets

Apart from credit disruption, the uncertainty over the sovereign debt crisis is also weighing heavily on equity markets. Some investors have been selling their positions outside Europe to cover their losses in the Euro market. Since July 2011, the MSCI global index has fallen by 12 percent[7]. The decline in emerging markets across APEC economies is even more striking. Over the same period, the MSCI for emerging Asia and emerging Latin American have fallen by 19 percent and 18 percent, respectively, compared to 8 percent losses in the US index.

In the current climate, many heavily indebted companies may struggle to replace funding via bond issues with loans from banks. Any further deterioration in the financial markets would therefore negatively impact the real economy through lower consumption and business investments.

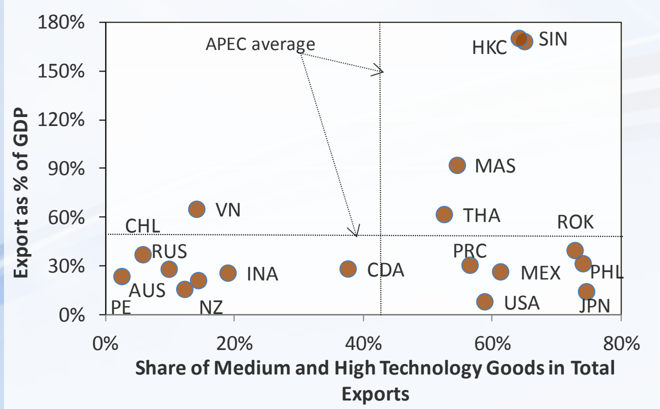
Trade

According to the November 2011 edition of the PSU Trade Monitoring Report, "the world economy is now entering another challenging phase in which the rebound in trade volumes will no longer play such an important role in growth as before". The report stated that the WTO had revised their 2011 growth forecast for world merchandise exports to 5.8 percent in volume terms - down from their earlier conservative estimate of 6.5 percent in April. This potential slowdown in the world export growth is pronounced, particularly when in comparison to 2010 when it grew by 14.1 percent.

In the event of a deep recession in the Euro area as a result of an intensification of the sovereign debt crisis, global trade would slow even further. This would have adverse consequences for APEC economies. The impact of weak external demand on the United States could be significant, since the Euro area accounts for 15 percent of its exports. Weak export revenues, when combined with stagnating public and private consumption, could undermine the fragile economic recovery. The implications of a US recession could be severe for other APEC economies, especially those that are closely integrated with the US economy, such as Mexico and Canada.

The adverse trade impact is also likely to be acute for small and open economies in APEC - especially those in East Asia - due to their high reliance on external trade as a source of growth. Moreover, their concentration on cyclical and credit-sensitive technology goods, such as

Figure 4: Contribution of external demand to GDP for selected APEC economies (Average over 2005 – 10)
(as percentage of GDP and percentage of total exports)



Source: UN Comtrade, IMF September 2011 World Economic Outlook and PSU staff calculations
Note: The technological classification of products into medium and high-tech categories follows the definition reported in Annex II of UNIDO, Industrial Development Report (2009).

electronics, could contribute to a steeper decline in trade since consumers tend to forgo purchase of such goods during an economic downturn (Figure 4).

The sharp disruption in global demand for export goods could potentially translate into a sharp correction in commodity prices. While this is good news for consumers, commodity exporters, such as Australia, Chile, Peru and Russia, would likely be significantly affected.

III. Implications for policy responses

Policy challenges

Since the 2008 global financial crisis, many APEC economies have implemented policies designed to strengthen their economic resilience to external shocks. However, the current crisis is posing a different set of challenges to policy makers.

First and foremost, the capacity of fiscal policy to respond to shocks is considerably more constrained than it was at the onset of the 2008 global financial crisis. In most APEC economies, government fiscal balances are weaker than they were in 2007 (Figure 5). The costs of past stimulus packages have also resulted in rising public debt. In some APEC economies, higher commodity prices and/or strong capital inflows have helped to strengthen the government's fiscal position. However, a rapid reversal of these tailwinds could jeopardize this progress.

Secondly, the scope for monetary policy to accommodate the economy is more restricted than it was in 2008. In advanced APEC economies, weaker growth prospects have led to a prolonged period of low interest rates, even approaching zero in the Japan and United States.

Figure 5a: Fiscal balance for APEC economies in 2007 and 2010
(as percentage of GDP)

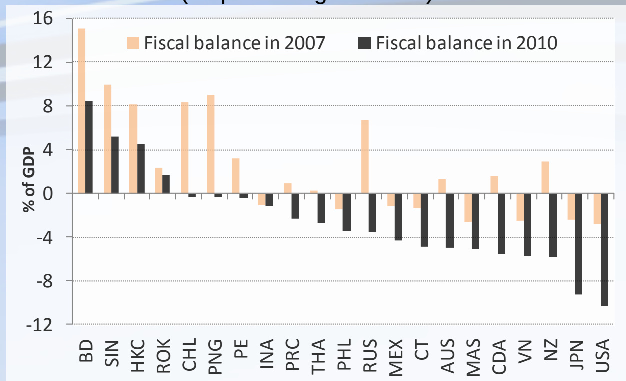
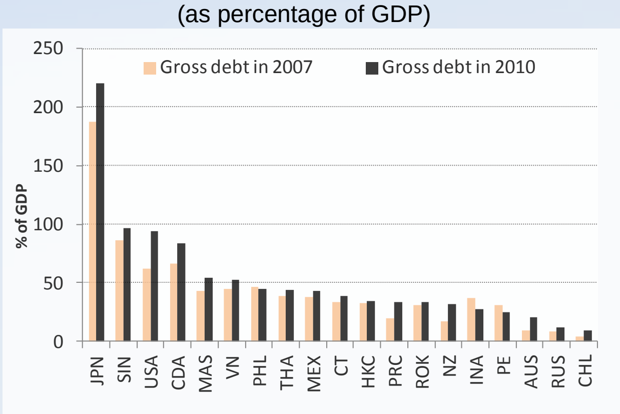


Figure 5b: Gross government debt for APEC economies in 2007 and 2010
(as percentage of GDP)



Source: IMF September 2011 World Economic Outlook

On the other hand, central banks in emerging APEC economies are continuing a long and drawn out battle with inflation. Many APEC economies continue to experience inflation rates higher than their historical average.

Options for policy responses

Looking ahead, the threat of an intensification of the Euro area sovereign debt problem has highlighted the need for governments to take proactive measures to prevent the current crisis from evolving into a full blown financial and economic crisis. Possible policy options could include:

a) Strengthening the commitment toward fiscal sustainability

The Euro area sovereign debt crisis reveals the importance of fiscal sustainability to the stability of the economy and broader society. For some APEC economies with high deficits and debt, strengthening the commitment toward fiscal sustainability would be the most effective tool to prevent possible financial contagion. Meanwhile, other APEC economies with relatively stronger fiscal positions would also benefit from strengthening fiscal fundamentals as it would help to mitigate the impact of a possible reversal of favourable cyclical factors.

Policies toward fiscal sustainability could include the strengthening of the medium-term fiscal savings plan. In the short-term, however, each economy may need to adjust the pace and the composition of the fiscal savings process according to the intensity of the market pressure and the magnitude of downside risks to its economic growth. Notably, the IMF has recommended that economies with low debt and deficits should slow the pace of fiscal consolidation[8] if downside risks materialize.

The likelihood of moderate pace fiscal adjustments in the short-term highlights the need for governments to transparently communicate the medium-term deficit and debt targets, which should also be backed up by a credible plan to raise revenues and address expenditure pressures. During this volatile period, fiscal transparency is critical as it helps to anchor creditor's expectations in the government's ability to manage public finances. It also helps to avoid a possible deterioration in market perception of the government's creditworthiness, which could result in rising interest rates and liquidity pressures.

Over the longer term, the course of pursuing fiscal sustainability should include strengthening the institutional framework by:

- legislating fiscal rules to reduce future budget uncertainty;
- introducing multi-year budgeting frameworks; applying sanctions for non-compliance; and
- adopting or strengthening an objective and independent fiscal assessment body to monitor the adherence to fiscal rules and promote the transparency of fiscal policy.

b) Advancing monetary policy responses

In times of financial crisis, monetary policy is an important tool to mitigate the spill-over effects into the domestic economies via a tightening of credit. Recent moves by central banks in the APEC region to lower policy rates are encouraging. In late November 2011, some of the world's largest central banks[9], including the US Federal Reserve and the Bank of Japan, launched a joint action to lower the cost of loans in USD to European banks. This coordinated action was greeted with optimism by the market. It has also shown that although the policy rates are near zero in the Japan and United States, central banks can still effectively mitigate the effects of financial strains through collaborative responses and other quantitative measures.

Going forward, the IMF[10] has recommended that monetary authorities should stay biased toward monetary expansion for a considerable period. In most APEC economies, lower commodity prices and a deceleration in economic activity has helped to lower inflationary pressures and create scope for monetary authorities to further reduce policy rate to support the economy if necessary. In other large APEC economies, (e.g. Japan and the United States), where the policy rates are near zero, central banks could rely on other unconventional measures to help lower private borrowing rates. In particular, it is suggested that:

- In Japan, deflationary pressures remain the main headwinds for growth. The central bank should therefore accelerate and expand its asset-purchasing of corporate bonds, commercial paper and exchange traded funds in order to stimulate the economy and put an end to more than a decade of deflation.

- In the United States, the large fall in housing prices has deteriorated the ability for many households to refinance their mortgage at lower interest rates. The creation of a special mortgage lending facility that helps those households to have improved access to credit and reduce their payment burdens would reinforce a critical channel for low interest rates to stimulate the economy.

Besides quantitative easing, it is important for monetary authorities to stay vigilant on liquidity pressures in the financial markets and the possible spill-over effects into the real economy. Furthermore, stronger regulation and supervision to mitigate financial stress caused by volatile capital flows is necessary. According to the IMF[11], the use of monetary policy to manage capital flows across borders requires greater collaboration between central banks in a multilateral framework, in conjunction with stronger macro-prudential rules as well as more comprehensive data monitoring.

c) Embarking on structural reform to enable more sustainable and resilient growth

The current crisis provides a unique opportunity for governments to embark on bold structural reforms in order to reorient their economies toward more sustainable and resilient growth. Given the heterogeneity of the APEC economies, the agenda for structural reform in the APEC region can be highly differentiated: the challenge faced by emerging economies differs both in nature and extent from those faced by advanced economies.

In the current environment where growth is slowing down in developed economies, it is in the interest of emerging APEC economies to reduce their dependence on external demand and promote domestic demand as a source of growth. Some economies in the APEC region have already taken positive steps toward achieving this. China, for example, has implemented policies to reduce precautionary savings and spur consumption through pension reforms. Looking ahead, governments in emerging APEC economies could restructure fiscal spending priorities to promote private consumption. Policies along this line could include the development of a fiscally sustainable social safety net, which could be in the form of health or unemployment insurance as well as by increasing public support for education.

Other possible options include reforms in the tax system to remove distortions to the private sector's decision to save and invest, i.e. shifting toward a more growth-friendly consumption tax. Reforms in the pension and social welfare system are also considered as other crucial agenda items for many advanced economies as they have important implications for the long-term sustainability of public finance and economic growth.

IV. Concluding note: mitigating the impact through proactive approach

The Euro crisis has brought great uncertainty into the global economy. The high level of integration and interdependence of the APEC region with the world economy, through trade, investment and financial linkages, implies that the region would be clearly affected if the crisis were to intensify. However, the extent and magnitude of the impact could be managed if governments implement proactive measures to mitigate financial contagion risks. For advanced APEC economies, the sovereign debt crisis offers an opportunity to embark on bold structural reforms to address the underlying imbalances of public and private savings and promote sustainable economic growth. On the other hand, it is important that emerging economies to restructure fiscal spending priorities to reduce the economy's reliance on export revenues and rebalance the economy toward more robust domestic demand.

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* **The Author** is an Analyst at the APEC Policy Support Unit. The views expressed in this Policy Brief are those of the author and do not represent the views of the APEC Secretariat or APEC member economies.

Notes:

1. The "fiscal compact" was tentatively agreed upon by 26 EU members, with Sweden, the Czech Republic and Hungary requiring an endorsement from their parliaments. The United Kingdom was the only EU member that did not agree to changes to the treaty.

2. This will be decided within 10 days since the conclusion of the 9 December summit.

3. At the October 2011 Summit, European leaders reached an agreement with the private sector on a "voluntary" discount of 50 percent in the nominal value of Greek sovereign debt. This raised fears among private investors that the same treatment could apply in the future if other Euro members were to default on their debt.

4. IMF September 2011 World Economic Outlook.

5. Abbreviations used for graphs are as follows: Australia (AUS), Brunei Darussalam (BD), Canada (CDA), Chile (CHL), China (PRC), Hong Kong China (HKC), Indonesia (INA), Japan (JPN), Korea (ROK), Malaysia (MAS), Mexico (MEX), New Zealand (NZ), Papua New Guinea (PNG), Peru (PE), the Philippines (PHL), Russia (RUS), Singapore (SIN), Chinese Taipei (CT), Thailand (THA), Vietnam (VN).

6. Direct exposure is defined as lending to the public sectors, banks and non-bank private sectors.

7. As of 9 December 2011.

8. According to the OECD, fiscal consolidation refers to a policy aimed at reducing government deficits and debt accumulation.

9. The action was participated by the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, the Federal Reserve and Swiss National bank.

10. IMF September 2011 World Economic Outlook.

11. IMF Research Policy Paper, "The Multilateral Aspects of Policies Affecting Capital Flows", October 2011.

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