Research Report

ECOSOC

Establishing effective measures to prevent further economic crisis in the EU

MUNISH '11

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Forum:	Ecosoc
Issue:	Establishing effective measures to prevent further economic crisis in the EU
Student Officer:	Gabriel de Massiac
Position:	Deputy-Chair

Introduction

In a Europe were major economic turmoil is ongoing, governments are forced to last minute rescues and the fear that the European crisis could have a global impact." Europe is the largest trading partner of both the US and China. Dissolution of the European Union would make nations from Asia to Latin America that holds the euro as a reserve currency much weaker"[1]. Therefore, the crisis in Europe is a global problem. To counter the global fear and mistrust in European markets, establishing effective measures to prevent further economic crisis in the EU seems mandatory. Markets are dizzy; governments are forced to last-minute rescues. Today the European Union faces two major problems, the current debt crisis in numerous countries in the European Union and secondly the consequences of the subprime related crisis for the European financial institutions.

Key terms:

GDP: An estimate of the total money value of all the final goods and services produced in a given one-year period using the factors of production located within a particular country's borders.

Mortgage: A temporary, conditional pledge of property to a creditor as security for performance of an obligation or repayment of a debt

Bonds/Obligation: In finance, a bond is a debt security, in which the authorized issuer owes the holders a debt and, depending on the terms of the bond, is obliged to pay interest and/or to repay the principal at a later date, and termed maturity. A bond is a formal contract to repay borrowed money with interest at fixed intervals

Government deficit occurs when a government spends more money than it takes in

Interest rate: Rate of the money that is paid for a financial service(loan etc..)

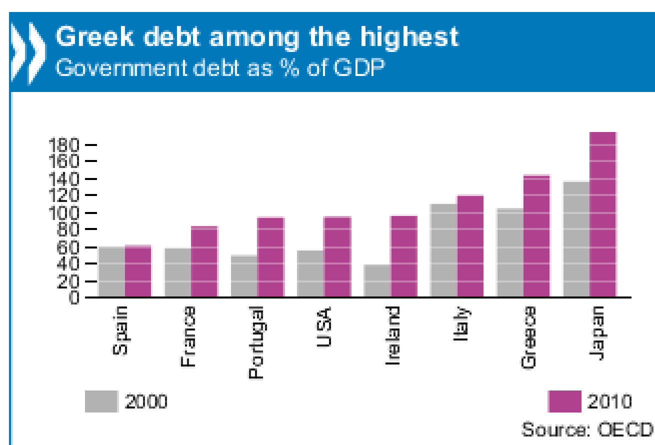
Credit rating agencies: are agencies that assign credit ratings for issuers of certain debt obligations as well as the debt instruments themselves. Investors often follow the ratings of these agencies and therefore these agencies somehow direct the market.

[1] Newsweek August 2011 release

General overview:

1 Debt Crisis:

A Greece (origin of the crisis)



The world crisis from November 2008 hit the growth rate of many economies. It had a particularly large effect on the Greek economy. The Greek economy was severely hit in 2009 with the country's largest industries, tourism and shipping's revenues, falling by a 15 %. [2] Due to the growth reductions, Greece wasn't getting as much from taxpayers as in the past so this made place for a higher public deficit. Like many other governments in the Eurozone, Greece has misreported the country's official economic statistics[3]. The Greek governments made several deals with banks to borrow an important amount of money so that they could stay amongst the European Union monetary guidelines. The main purpose of these deals was to ensure the government at the time could continue to have a high budget while hiding the huge deficit to the European Union. However the main problem with these loans is that for obvious reasons, the banks to borrowed money to Greece would ask higher interest on the loaning. According to Bloomberg magazine, Greece's May 2010 deficit was of 13, 6 %, which is one of the highest in the world relative to GDP. The Greek government bond market relies on foreign investors, and the problem with Greece is that these investors got afraid. Due to this fear, investors weren't buying Greek bonds anymore. The Greece government's answers were higher interest rates that aimed to appeal investors again. However, it resulted in the Greek government not able to pay for their creditors. Greece felt into a position called Payment Default.

B Investors scared European obligations

The international investors got scared for the situation in Greece. However, as the world is economically connected, the impacts of the Greek payment default well beyond the Greek borders. One of the biggest fears was that the Greek crisis could spread around the European Union. The investors trust in other numerous European economies had reduced. Rumors spread that the same could happen to economies such as Ireland, with a government deficit in 2010 of 32.4%[4] of GDP, Spain with 9.2%[5], and Portugal at 9.1%[6]. Investors thought to themselves, "If this happened to Greece, why couldn't it happen to all these countries facing the same difficulties?" Many of these obligations of the countries were worth less, so the concerned countries had to give higher interests to go round with their budget deficits.

[2] Eurostat 2010 EPP
[3] New York Times Global Business February 2010
[4] Economic Statistics Department of Finance Government of Ireland
[5] European Economic Statistics 2010
[6] Eurostat 2010 Portugal's deficit

C Affected countries

I Spain and Italy

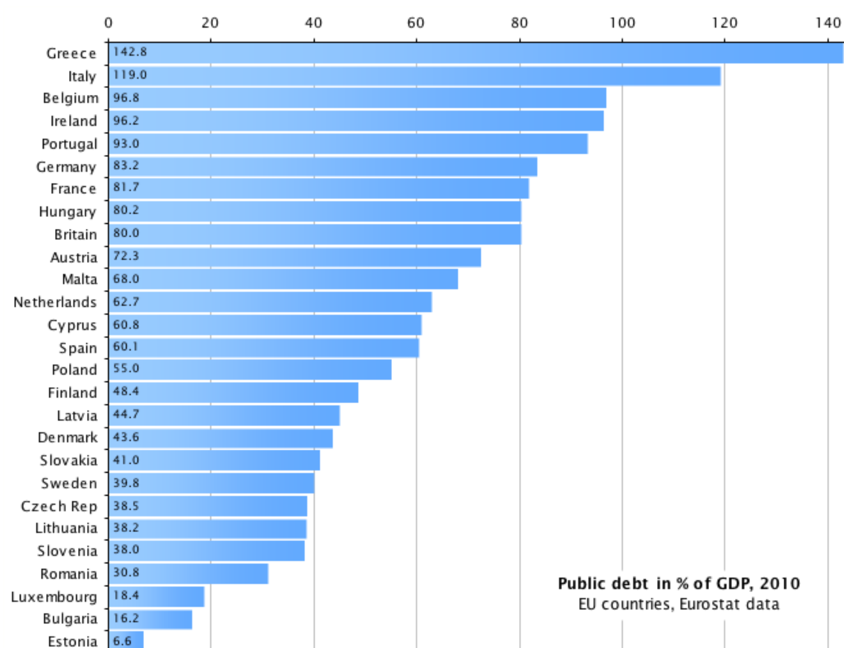
Between the 4th and the 11th of August, the ECB(European Central Bank) has bought up to 22 billion euros of Spanish and Italian debt. The ECB now has 96 billion euros of governmental obligations and to calm down the investors she claimed to continue her interventions on the obligation market. So far the ECB action had direct effect; the Italian interest rate went from 6,195% on the 4th, to 5, 04% the 11th. Same thing goes for the Spanish interest rate, going from 6,284% to 4,992%. According to Christoph Rieger, who is an expert strategist for Commerzbank saying "the optimistic will underline the will of the ECB to end the crisis". Spain has succeeded to lower its deficit from 11,2 % in 2009 to 9,2% in 2010. Also Spain is doing quite well in terms of public debt, comparing to other European countries, with their debt being 60,1 % of their GDP which is significantly lower than Greece's with 142,8%[7].

II Ireland and Portugal

It is important to note that the situation in Ireland is not due to governmental budget errors, but merely the guarantee of the Irish state to the six main banks that financed the property bubble in the United States of America. By September 2010, the Irish banks couldn't raise their incomes and for the third time, they needed a guarantee that in case of failure, the Irish state would back them up, so they could do business again. If there is no guarantee, who wants to do business with a bank who hasn't got enough money to ensure payments. The problem with this Irish state guarantee is that it made the help required for the Irish bank, rise to 32% of the Irish GDP. Therefore, the Irsih government asked for the help of the IMF and the ECB, and ended up in an 85 billion euros bailout agreement[8]. On the Portugal side, on the 16th of May 2011 the European Union leaders agreed to bailout Portugal with an estimated 78 billion euros

IV Other countries

While most of the other European Union countries remain doing relatively well, governments are recovering from the global subprime related meltdown that shattered their economic growth. Belgian political parties seem unable to reach to an agreement to form a government and the Iceland government still has to repay international investors for the crash of their *Landsbanki* and *Islandsbanki.*



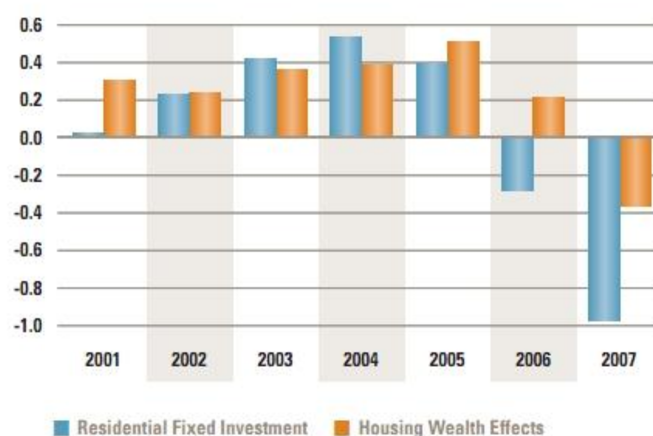
[7] Financial Times 2010
[8] Irish Times 2010

France is scared to lose its triple-A rating as France stands out amongst the six triple-A rated euro-zone countries for having one of the highest ratios of debt and deficit to GDP. Nordic countries such as Sweden, Denmark, Norway and Finland remain doing well. The UK's growth hopes are in doubt as important sectors of their economy retreats. Manufacturing production fell 0,4% in June 2011[9]. For the former Soviet Union countries are the least exposed to euro region risks[10] According to the European Bank for Reconstruction and Development (EBRD), southern-eastern European countries remain at risk, as the credit to the private sector has been severely reduced in the region.

2 Subprime related bank crisis

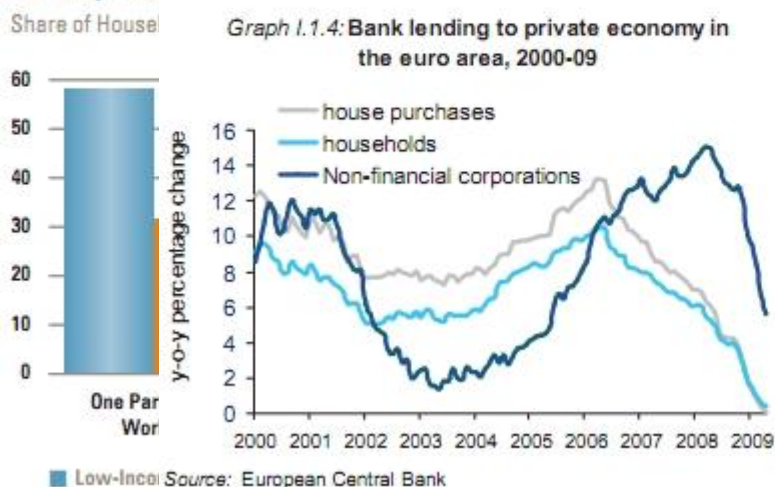
Subprime crisis USA

In the years before the crisis, important amounts of money flooded in the USA from amongst others Asia and major oil importers of the Middle-East. This money, combined with low US interest rates, permitted the easy borrowing conditions. The loans were of various types such as credit cards loaning and housing. The subprime crisis in the USA was majorly due to the housing crisis. For years, important funds had borrowed money to enable people to buy a house. Millions who couldn't have afforded it to promise house payments before, suddenly could. In 2006, when the creditors realized their credit was given away to easily with the likelihood of these people not being able to pay their mortgage back, so the investment funds that done this tried to get rid of these mortgages. Their solution was a financial products such as the MBS's "mortgage backed securities". They would enable the creditors to sell



[9] Office for National Statistics UK
[10] EBRD 2011 on Euro-zone crisis

these MBS's to investment funds all over the world. Rating agencies, such as Standards and Poor's (the same S&P has recently retired the AAA status of American bond) gave triple-A ratings to these MBS's while their real value was considered as junk. As the people who loaned the money couldn't pay back their mortgage, the holders of these MBS's decided to sell the houses. House prices dropped. There was a housing crisis. The crisis expanded to other areas of the US economy.



According to *the US Financial Crisis inquiry commission, "* **the crisis was avoidable and was caused by widespread failures in financial regulation including the ancient federal reserve to stem the tide of toxic mortgages ; Dramatic breakdowns in corporate governance including too many financial firms acting recklessly and taking on too much risk; An explosive mix of excessive borrowing and risk by households and Wall Street that put the financial system on a collision course with crisis; Key policy makers ill prepared for the crisis, lacking a full understanding of the financial system they oversaw; and systemic breaches in accountability and ethics at all levels***"*[11]

European banks

As many of the financial institutions that invested in MBS's and other subprime-related financial products, were from all over the world, a certain amount of these institutions were European Banks, such as the Anglo Irish Bank etc. These banks had lost lot money and they were out of liquidity. Therefore, these banks found themselves in serious problems, trying to do business with institutions that refused to do business with banks that couldn't guarantee the payment. This forced the ECB (European Central Bank) to pump in 150 billion dollars of emergency funds to free up liquidity. In a press release, BNP Paribas bank said; "the complete evaporation of liquidity in certain market segments of the US housing market made it impossible to value certain assets fairly regardless of their credit rating" Investors started to get scared not knowing what their assets were really worth.

European Banks affecting Europe Economy

The financial crisis hit countries in Europe but some have been more vulnerable than others. With the European Central Bank being forced to save these financial institutions, large

[11] FCIC 12-04-2011 European parliament

amounts of money have been spent to bail out. Of course, these European financial institutions had several sectors where they were doing business, and their losses affected the other businesses where they were present. This caused a European crisis of credit. Banks wouldn't borrow money easily anymore. When banks do so, fewer funds are available for companies to invest which leads to less productivity. Let's say company A is building airplanes, if there is less money for them to invest in. They have less productivity. In good times, with a good productivity, company A buys components for their airplanes from company B. However, due to their less productivity, company A is going to ask company B less products. Company B has a problem, now they don't have as much demand as in the past. So eventually, company B has to lower their productivity. This leads to an economic meltdown.

Major parties involved:

ECB: the European Central Bank is an institution of the EU that administers the monetary policy of the 17 Eurozone member states. It has recently announced it bought 22 billion euros in Italian and Spanish debt. The ECB is the central actor in the European Union crisis.

Germany and France:

While Germany is Europe's n1 economy and remains relatively stable, France stands out among the six triple-A rated euro-zone countries for having the highest ratios of debt and deficit to GDP. The country's budget shrunk to 7, 1% of gross domestic product in 2010 from 7, 5% the year before.[12] Germany on its side said it wanted all indebted countries to reduce their deficit, at all costs. Germany and France have agreed to set a "golden rule" for the Eurozone countries. Both leaders, Angela Merkel and Nicolas Sarkozy have expressed their disappointment in Germany and France having to pay for the other countries errors. Therefore, on the 16th of August 2011, they have proposed that by mid-2012, all Eurozone countries adopt a "golden budget rule". Concretely, they want every country to engage on a clear budgetary trajectory, a deficit reduction and that every country would grave it in their constitution.

Indebted countries (Italy Greece Spain Ireland Portugal): These countries are the most indebted countries in the Eurozone. They need an intervention from the ECB to attract international investors in their countries again. These

[12] Wall Street Journal August 10th

countries still have a high budget deficits and demand rescue packages from the European Union.

Timeline key events:

Subprime related bank crisis

July 2007: begin of the credit crunch with the subprime mortgage crisis in the US

August 2007: The Credit crunch goes global due to large amount international investment funds having subprime mortgage securities.

October 2008: In Europe, hundreds of thousands of jobs are lost, house prices fall and many bankruptcies

December 2008: Globally, stock markets have reported the biggest annual falls for 24 years

Debt crisis timeline:

December 2009: The rating agency Fitch, sets Greek bond from A to BBB+ This is the first time in ten years that Greece is rated below A. Investors scared for other euro-zone countries

May 2 2010: IMF and EU agree for three years help package of 110 billion euros for Greece

August 2011: Angela Merkel and Nicolas Sarkozy agree on a "golden rule" which should set free the European markets.

Previous attempts to resolve the issue:

So far, the ESFS has been created. The ESFS aims to issue bonds guaranteed by European Area Member States (EAMS) for up to 440 billion euros[13] for on-lending to EAMS in difficulty, subject to conditions negotiated with the European Commission in liaison with the European Central Bank and IMF and to be approved by the EAMS. The IFSF has lent 5, 9 billion euros[14] to Portugal to ensure structural reforms to boost potential growth, improve competitiveness and to create jobs. European governments also have intervened publicly in the banking sector, some more than others as shows the table underneath. .

[13] EFSF, www.efsf.europa.eu

[14] EFSF 22/06/2011 3,7 billion euros 29/06/2011 2,2 billion euros

Public interventions in the banking sector

% of GDP	Capital injections		Guarantees on bank liabilities		Relief of impaired assets		Liquidity and bank funding support		Total	
	Approved	Effective	Approved	Granted	Approved	Effective	Approved	Effective	Approved	Effective
Ireland	5.1	2.1	225.2	225.2	-	-	-	-	230.3	227.3
Belgium	4.2	5.7	70.8	16.3	5.7	5.0	NA	NR	74.6	35.3
United Kingdom	3.5	2.6	21.7	9.5	-	-	25.1	18.7	50.3	30.8
Netherlands	7.9	7.9	34.3	5.7	-	4.9	-	5.8	42.2	24.3
Luxembourg	6.9	7.9	12.4	NR	-	-	-	-	19.3	18.5
Sweden	1.6	0.2	48.5	8.8	-	-	0.1	-	50.2	9.0
Latvia	1.4	-	10.9	2.8	-	-	10.9	6.1	23.2	8.9
Austria	5.0	1.7	27.3	5.1	0.4	0.4	27.3	1.5	60.0	8.7
Germany	4.2	1.6	18.6	7.3	3.6	0.4	-	NR	26.4	6.3
Spain	-	-	9.3	2.8	-	-	2.8	1.8	12.1	4.6
France	1.2	0.8	16.6	3.1	2.3	0.3	-	-	20.1	4.2
Portugal	2.4	-	12.5	3.0	-	-	-	-	14.9	3.0
Greece	2.0	-	6.1	0.4	-	-	3.3	1.7	11.4	2.1
Denmark	6.1	0.3	253.0	NR	-	-	NA	NR	243.8	0.5
Hungary	1.1	0.1	5.9	-	-	-	-	-	7.0	0.1
Slovenia	-	-	32.8	-	-	-	-	-	32.8	-
Slovakia	-	-	-	-	-	-	-	-	-	-
Romania	-	-	-	-	-	-	-	-	-	-
Poland	-	-	-	-	-	-	-	-	-	-
Malta	-	-	-	-	-	-	-	-	-	-
Lithuania	-	-	-	-	-	-	-	-	-	-
Italy	1.3	-	NA	-	-	-	-	-	1.3	-
Finland	-	-	27.7	-	-	-	-	-	27.7	-
Estonia	-	-	-	-	-	-	-	-	-	-
Czech Republic	-	-	-	-	-	-	-	-	-	-
Cyprus	-	-	-	-	-	-	-	-	-	-
Bulgaria	-	-	-	-	-	-	-	-	-	-
European Union	2.6	0.5	24.7	7.8	12.0	0.5	4.3	3.0	43.6	11.8
Euro area	2.6	1.4	20.6	8.3	12.0	0.7	1.3	0.7	36.5	11.1

Note: Countries ranked by total effective support, NR = not reported by the Member State, NA = not available. *Source:* European Commission.

Paris and Berlin have both undertaken action by expressing the wish for a "golden rule" that would make Eurozone countries act more responsible concerning their deficit. "The payments that come from structural funds should be suspended in the Eurozone countries that do not meet recommendations on public budget deficits" said Nicolas Sarkozy, after the meeting with German Chancellor Angela Merkel. All the Eurozone states benefit from these funds that have been created in 1990. The three principal funds (European fund for regional development, social European fund, cohesion fund) are given to the countries that ask for it. Each region having a GDP (Gross Domestic Product) inferior to 75% of the European average gets these subventions which has the objective to help them develop and make their economy grow. Thus 49 billion euros are sent every year for the period of 2007-2013. In total, it would be 347 billion euros, or 35, 7%[15] of the total budget of the European Union. Eurosceptic find the plan very weak. They say the plans established so far are not easy to realize and they will take time, therefore they say it doesn't do anything on the short term.

Possible solutions:

1 More transparency on government budget deficits would be suitable as Greece and several other Euro-zone countries have been misreporting their government deficit. It would be easier to forecast the European markets for the ECB if all Euro-zone countries would properly report their deficits. That way, the ECB can establish a clear euro-zone rescue package trajectory

2 Invite all UN member states to control their debt in order to stabilize financial markets.

[15] ECB statistics

3 Make indebted euro-zone countries offer a long term replacement for their bonds for the already existing bonds guaranteed by either EFSF or newly created ESM (European stability mechanism) Thus, banks could put a limit on their losses that they must realize, and cover them over the time until maturity of the new bonds.

4 Create a UN agency which would rate government bonds in the world and would be independent from all the financial institutions as to judge and rate the sovereign debt status without being influenced.

Subprime:

1 The creation of a UN body that would supervise and be in charge of the surveillance of the international financial markets in cooperation with the respective financial regulatory organizations such as the Unites States FINRA(Financial Industry Regulatory Authority)

2 Launch a UN conference which would harmonize the financial markets which would also encourage UN member states to regulate their financial markets as they are globally linked. Harmony would be better for international transparence.

Appendix/Appendices:

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