

# Sovereign Debt

## The Implications for China of the Financial Crisis in Europe

Liu Mingli

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## Executive Summary

The current sovereign debt crisis is not a new phenomenon but has occurred with some regularity in the past, particularly after big economic downturns. Similar incidents in recent history include the Latin American crisis in the 1980s, the Russian crisis in 1998, the crisis in Argentina in 2002, and so on. The current debt crisis is located in Europe. But a further study shows that all major advanced economies have problems with their debt burden, including many European countries, the United States, and Japan. Their debt-to-GDP ratios increased rapidly after the subprime crisis in 2007. The global sovereign debt is expected to increase to about US\$50 trillion, with G-7 countries accounting for about 80 percent of the new increase.

Since the end of World War II, most debt crises were seen in developing countries, while no sovereign debt default occurred in developed economies. Currently however, advanced economies are in trouble. The discussion over the causes of the European debt crisis has been intensive, ranging from issues such as massive budget deficits to speculation by hedge funds, and unfair rating systems. These factors cannot however explain why the crisis occurred in the eurozone and not the United States, the UK or Japan whose debt ratios are much higher than the eurozone average. The key difference between the eurozone and other advanced countries is that the eurozone is a monetary union with both economic and political weaknesses. The gap in competitiveness between member states has been steadily growing, while political solidarity has seen just the opposite.

So far, European countries have adopted measures to save themselves from outright default but these actions have not been enough to evince a market turnaround. The European Financial Stability Facility is just a game of borrowing to pay down the ever increasing debt. Furthermore, attempts at austerity make future economic prospects even more pessimistic. Meanwhile, stress tests of European banks also failed to convince the markets that the financial system is moving towards health and long-term stability.

The fundamental way in which debt relief can be achieved is through rapid economic growth so that governments obtain more fiscal revenue to pay off the debt. However, since the beginning of the 21st century, the EU's economic growth has been moderate, with an average growth rate of two

percent. To achieve higher rates of growth, the EU needs more structural reform and innovation, which are not new topics but were dealt with in the Lisbon Agenda (2000). From the experience of the last ten years, in particular the failure of the Lisbon Agenda, we can see that rapid growth is not easy to bring about in the EU. There were increasing signs that countries on the periphery of the eurozone, such as Greece and Portugal, were showing an alarming decline of growth momentum, risking moving into a debt spiral.

Europe will continue to be troubled by debt. For other developed countries, such as the United States and Japan, the situation is similar, although they do not have a debt crisis. Newly published U.S. economic figures show that recovery is fragile. Japan's debt is the highest among developed economies, it cannot be expected to decrease quickly. The debt issue will exist for quite some time since almost all the major developed economies are involved, the impact on the world economy will be significant.

As the world's second biggest economy, the top creditor and the largest exporter, China also will inevitably be affected. Since almost all major rich economies accounting for a large share of the world economy are in trouble, China's external environment will deteriorate. Austerity measures and high unemployment will reduce domestic demand, which means less demand for imports from China. Protectionism will put China's exports under pressure. With its fast growing economy and accumulation of foreign reserves, China needs to adjust its economic structure through a reform of the exchange rate regime, which is also expected to reduce outside pressures. Turbulence in the exchange market makes it hard for China to take action, however, and pressure from the United States for currency reform continues to increase.

Against the background of the Euro's depreciation, if China increases its share of the Euro in the RMB currency basket, the situation may worsen as the RMB would depreciate with the Euro against the U.S. dollar, contrary to U.S. aims. In addition, turbulence in international financial markets will also make China's management of its foreign reserves risk-prone.

Excepting these challenges, the debt issue in advanced countries also provides China with a number of opportunities. Since all major international currencies are troubled by debt burdens, a problem which cannot be solved in the near future, their credit could be undermined in the long run. Diversification of international currencies may be a future trend, which could provide an opportunity for RMB internationalization. In the current

situation, the RMB is not yet a freely convertible currency, however, so the internationalization process would be long. The debt issue also brings opportunities for EU-China cooperation. It is in the interest of both to build international agencies together, to bring more Chinese ODI to Europe and to share their experiences of managing the banking crises.

# Introduction

The sovereign debt crisis in Europe reminds us that the financial crisis is far from over.<sup>1</sup> Many studies have tried to find the underlying reasons for the debt crisis, including huge budget deficits, the shock of the financial crisis, speculation by hedge funds, and unfair credit ratings. These factors are reasonable but do not suffice to explain the vast scale of the present crisis. As far as sovereign debt is concerned, too much research has concentrated on Europe and neglected other countries. One interesting thing is that the sovereign debt ratio in many advanced economies, including the UK, the United States and Japan, are much higher than the European average. Some questions seem pertinent: What is the situation of the sovereign debt level globally and how many countries are troubled with debt burden? Why did the debt crisis occur in Europe and not the other advanced economies? Will a similar crisis occur in other countries with heavy debt? Can the measures taken so far solve the debt problem? And finally, as the biggest emerging economy, how will China be influenced by the debt issue?

This paper is an attempt to answer these questions. It is divided into three parts. In the first part, the major sovereign debt crises in history will be reviewed as well as the key figures of the current global situation; the reasons for the European debt crisis; and lastly a comparison of Europe and other relevant countries will be given.

The second part deals with the trends of the debt crisis. This section attempts to make it easier to predict what could happen in the future. The current debt situation is different from previous cases since all major advanced economies are involved it is much more serious. The measures taken to combat the debt crisis in Europe will also be touched upon.

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<sup>1</sup> Sovereign debt, also known as public debt, is debt owed by governments. Since governments usually do not go bankrupt like individuals and firms, sovereign debt is usually less risky than private debt. But there has not been a lack of cases when governments have had problems paying their debt. If potential lenders or bond purchasers begin to suspect that a government may fail to pay back its debt, they may demand a high interest rate in compensation for the risk of default. A dramatic rise in the interest rate faced by a government due to fear that it will fail to honor its debt is sometimes called a sovereign debt crisis.

The third and last part of this report focuses on the implications of the crisis for China. Although China's debt level is relatively low, the country will be influenced by debt issues, as the world's second biggest economy, the top creditor and largest exporter.

# Sovereign Debt: Developed Economies in Trouble

## The Sovereign Debt Crisis in History

In history, sovereign defaults often occurred in the aftermath of armed conflicts, political upheaval, or global economic distress. When economic activity and public confidence were disrupted, the government usually ran a huge public deficit and could not raise money to pay off the debt. Both World War I and World War II, the Great Depression of the 1930s, the oil shocks of the 1970s, and the collapse of the Soviet Union gave rise to economic and political stress that led to sovereign defaults.<sup>2</sup> An IMF study shows that there were as many as 257 sovereign defaults between 1824 and 2004. Between 1981 and 1990 alone, there were 74 defaults.<sup>3</sup> Below, some classic cases of sovereign debt crises in modern times will be touched upon.

## The Latin American Debt Crisis in the 1980s

In the 1960s and 70s many Latin American countries, notably Brazil, Argentina, and Mexico, borrowed large sums of money from international creditors for their industrialization, and especially infrastructure programs. These countries had booming economies at the time, so creditors were happy to continue to provide loans. Between 1975 and 1982, the Latin American debt to commercial banks increased at a cumulative annual rate of 20.4 percent. This heightened borrowing quadrupled Latin American external debts from US\$75 billion in 1975 to more than US\$315 billion in 1983.<sup>4</sup> During the crisis, there was a large capital outflow, particularly to the United States, which led to the depreciation of the currencies of these countries. Their economies were badly hurt by the debt crisis. Real GDP increased by only 12.4 per-

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<sup>2</sup> Chris Jochnick and Fraser A. Preston, eds., *Sovereign Debt at the Crossroads: Challenges and Proposals for Resolving the Third World Debt Crisis* (Oxford and New York: Oxford University Press, 2006).

<sup>3</sup> Sol Palha, "The ulterior motive behind the Greek bailout," May 5, 2010, <http://www.financialsensearchive.com/fsu/editorials/ti/2010/0505.html>

<sup>4</sup> Anne Dullum and Kishore G. Kulkarni, "Comparison of 1980s Latin American and 1990s East Asian Financial Crisis," [http://kulkarnibooks.com/assets/downloads/kishore\\_papers/paper\\_with\\_Annie\\_dullum\\_on\\_financial\\_crisis\\_comparison.pdf](http://kulkarnibooks.com/assets/downloads/kishore_papers/paper_with_Annie_dullum_on_financial_crisis_comparison.pdf)

cent in the 1980s. In per capita terms, there was 9.6 percent negative growth during this decade.<sup>5</sup>

### **The Russian Financial Crisis, 1998**

After the Asian financial crisis that commenced in May 1997, there was a decline in world commodity prices. Countries heavily dependent on the export of raw materials were severely hit. Russia was one of them with more than 80 percent of its exports being petroleum, natural gas, metals, and timber. As a result, its government debt grew. At the end of 1997, the situation was very tense with the tax receipts down, which had a negative effect on the financing of major budget items. On August 13, 1998, the Russian stock, bond, and currency markets collapsed, because investors feared that the government would devalue the ruble, or default on domestic debt. At that time, annual yields on ruble denominated bonds were more than 200 percent. The stock market had to be closed temporarily as prices plummeted. When the market closed, it had shrunk 65 percent with only a small number of shares actually traded. From January to August 1998, the stock market had lost more than 75 percent of its value.<sup>6</sup>

### **The Argentine Crisis, 2002**

In the 1990s and early 2000s, fixed exchange rates made imports cheap, which resulted in large outflows of money, resulting in increasing unemployment.<sup>7</sup> Public debt grew enormously during the 1990s, and Argentina showed no signs of being able to pay. During the last week of 2001, the interim government could not fulfill debt payments. When the default was declared in 2002, foreign investors left, and capital inflow ceased almost completely. As a result, the crisis in Argentina became the largest debt default in history.<sup>8</sup>

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<sup>5</sup> See MBALib, <http://wiki.mbalib.com/wiki/%E5%80%BA%E5%8A%A1%E5%8D%B1%E6%9C%BA>

<sup>6</sup> Ricky Schmidt, "The 1998 Russian Financial Crisis, Part: Course of Events," <http://stockbreakthroughs.com/2009/03/08/the-1998-russian-financial-crisis/>

<sup>7</sup> "Economic Crisis in Argentina (1999-2002)," World-Crisis.net, <http://www.world-crisis.net/financial-crisis/argentine-crisis.html>

<sup>8</sup> Millan L. B. Mulraine, "An Analysis of the 2002 Argentine Currency Crisis," unpubl. paper (January 2005), <http://homes.chass.utoronto.ca/~mulraine/arg.pdf>

### The Current Situation

The current situation is different from the above cases. In history, sovereign debt crises occurred mostly in developing countries. Since the end of World War II, no sovereign default has occurred in a developed economy until the current crisis. According to the credit rating company Moody's, the global sovereign debt was expected to hit US\$49.5 trillion by the end of 2009, an increase of 45 percent since 2007. The expected US\$15.3 trillion increase in worldwide government debt is more than one hundred times the inflation-adjusted cost of the Marshall Plan after World War II. The G-7 countries account for 78 percent of the increase.<sup>9</sup> The IMF report also shows that the financial crisis has increased sovereign risks and exposed underlying vulnerabilities. G-7 sovereign debt levels as a proportion of GDP are nearing a 60-year high.<sup>10</sup>

Figure 1. Sovereign Debt to GDP in the G-7



Source: IMF, Fiscal Affairs Department database

Note: Average using purchasing power parity GDP weights.

<sup>9</sup> "Global sovereign debt to hit \$49.5 trln-Moody's," Reuters, November 24, 2009, <http://news.alibaba.com/article/detail/markets/100205868-1-global-sovereign-debt-hit-%252449.5.html>

<sup>10</sup> International Monetary Fund, *Global Financial Stability Report, Meeting New Challenges to Stability and Building a Safer System*, April 2010, p. 3, <http://www.imf.org/external/pubs/ft/gfsr/2010/01/pdf/text.pdf>

Figure 1 shows that the sovereign debt-to-GDP ratio has been increasing slowly since the 1970s with a dramatic increase after the U.S. subprime crisis in 2007. The debt-to-GDP ratio is expected to increase to over 100 percent, equivalent to the situation in the aftermath of World War II. To explain the dramatic increase of debt in developed countries, the problem of sovereign debt has to be studied in a broader context, which means taking the private sector into account.

In developed countries, people are used to living with debt. In the 1980s and 1990s, a rise in debt levels accompanied what economists called the “great moderation,” when growth was stable and unemployment and inflation remained low. Those who cautioned against rising debt levels were laughed at, since asset prices were rising fast making balance-sheets look healthy. With the economy buoyant, debtors could afford to meet their interest payments without defaulting.<sup>11</sup> Debt increased at every level, from consumers to companies to banks to whole countries, although, the effect varied from country to country. A survey by the McKinsey Global Institute showed that average total debt (private and public sector combined) in ten mature economies rose from 200 percent of GDP in 1995 to 300 percent in 2008.<sup>12</sup>

In the aftermath of the financial crisis, the distinction between debt in the private and public sectors has become blurred. If the private sector suffers, the government may be forced to step in and assume or guarantee the debt, as happened in 2008. Otherwise the economy may end up in a deep recession which will cut the tax revenues governments need to service their own debt.<sup>13</sup>

After the collapse of Lehman Brothers Holdings, which was the beginning of financial turmoil, the U.S. government presented a US\$700 billion rescue plan in September 2008 in order to calm down the financial market, and this plan passed Congress at the end of the year. As the financial turmoil later spread to Europe, France, Germany, Spain, the Netherlands, and Austria committed 1.3 trillion Euros in October 2008 to prevent the collapse of

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<sup>11</sup> “A special report on debt,” *The Economist*, June 24, 2010, [http://www.economist.com/node/16397110?story\\_id=16397110](http://www.economist.com/node/16397110?story_id=16397110)

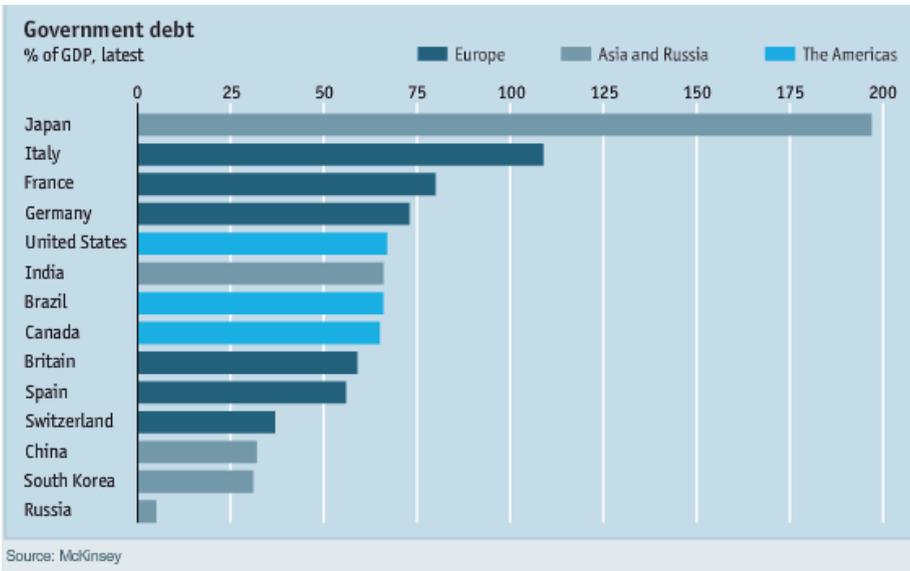
<sup>12</sup> McKinsey Global Institute, *Debt and Deleveraging: The global credit bubble and its economic consequences*, January 2010, [http://www.mckinsey.com/mgi/reports/freepass\\_pdfs/debt\\_and\\_deleveraging/debt\\_and\\_deleveraging\\_full\\_report.pdf](http://www.mckinsey.com/mgi/reports/freepass_pdfs/debt_and_deleveraging/debt_and_deleveraging_full_report.pdf)

<sup>13</sup> “A special report on debt,” *The Economist*, June 24, 2010.

the financial system. Similar measures were also taken in other developed countries. We know that public finance was not healthy already even before the crisis. After the huge rescue plan, public finance would definitely get worse. In the case of the EU, its average government deficit as a percentage of GDP was 0.8 percent the year before the financial crisis, but in 2009, one year after the financial crisis, the figure increased to 6.8 percent.<sup>14</sup>

With huge public deficits, the only way to get money is to borrow more, which would make the debt-to-GDP ratio increase as well. In Figure 2, we can see that the major developed countries have a high debt burden. In particular, Japan's debt ratio is as high as almost 200 percent, while the debt ratios of major developing economies, such as China, India, and Brazil, are much lower.

Figure 2. Debt Burden of Major Developed Countries



The high debt ratio in developed economies resulted in a crisis. In December 2009, the three most well known rating firms downgraded the credit rating of Greece, when the Greek deficit as a percentage of GDP had increased to 13.6 percent and debt ratio to 113 percent. At the beginning of 2010, other European countries like Portugal, Italy, Ireland, Spain; the

<sup>14</sup> Eurostat, <http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tsieb080&plugin=1>

so called “PIIGS,” fell into trouble because of similar government deficit and debt problems. The crisis was so severe that people were wondering whether there would be a sovereign default or even a total collapse of the eurozone.

### **What Has Caused the Crisis in Europe?**

From figures presented above we can see that the debt issue is common to major developed economies. The average debt ratio of Euro-zone countries is similar to that of the United States and much lower than Japan’s. Why did the crisis occur only in Europe?

First of all, fiscal discipline has not been observed by member states. According to the Stability and Growth Pact adopted in 1997, members of the European Monetary Union must respect certain criteria; an annual budget deficit no higher than 3 percent of GDP, and a national debt lower than 60 percent of GDP. However, Greece, who joined the Euro-zone in 2001, did not abide by the rules. The Greek economy was one of the fastest growing in the eurozone. From 2000 to 2007, foreign capital flooded the country and it grew at an annual rate of 4.2 percent. A strong economy and falling bond yields allowed the government of Greece to run large structural deficits. To keep within the monetary union guidelines, the government of Greece consistently and deliberately misreported the country’s official economic statistics. Goldman Sachs helped the Greek Government to mask the true extent of its deficit with the help of a derivatives deal that legally circumvented the EU Maastricht Treaty deficit rules.<sup>15</sup> In 2009, the new government under Giorgios Papandreou revised its estimate of the Greek deficit from 6 to 12.7 percent, which was far above the red line of three percent. In April 2010, the Greek deficit was revised up to 13.6 percent, which was much worse than expected.<sup>16</sup>

To make things worse, Greece is not the only member of the European Monetary Union, who does not respect the pact. The major mission of the Stability and Growth Pact is to keep the economic and monetary union

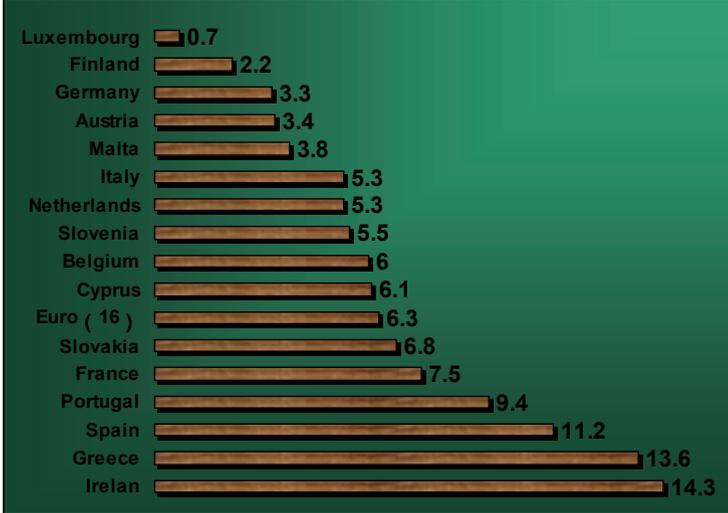
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<sup>15</sup> Beat Balzli, “How Goldman Sachs Helped Greece to Mask its True Debt,” Spiegel Online, August 2, 2010, <http://www.spiegel.de/international/europe/0,1518,676634,00.html>

<sup>16</sup> “Greece’s budget deficit worse than first thought,” BBC News, April 22, 2010, <http://news.bbc.co.uk/2/hi/8637270.stm>

stable. But the reality is that about 14 of the 16 eurozone member states cannot meet the requirements (see Figure 3).

Figure 3. Deficit/GDP Ratio of Eurozone Countries, 2009



Source: Eurostat

Second, rating agencies triggered the crisis. In the modern financial market, confidence is crucial. Even governments need market confidence in order to raise money. However, to a large extent, market confidence is in the hands of three big international rating companies, Moody's, Standard & Poor's and Fitch. Throughout the debt crisis we can find that every time rating companies downgraded the rating of countries like Greece, Spain, and Portugal the financial market would fall into turmoil. When the "Big Tree" downgraded Greece in December, it triggered the debt crisis. Since then, the reports of rating companies became the weather vane of the debt crisis. Every downgrading leads to a deeper crisis leading European government officials to criticize the rating companies. Finance Minister Wolfgang Schäuble of Germany even told traders not to take global rating agencies "too seriously."<sup>17</sup>

When we go back in history, there have been cases when rating companies have played an important role in a crisis. We can see that countries with

<sup>17</sup> See "The case against the euro," BBC News, June 11, 2010, [http://www.bbc.co.uk/blogs/thereporters/gavinhewitt/2010/06/the\\_case\\_against\\_the\\_euro.html](http://www.bbc.co.uk/blogs/thereporters/gavinhewitt/2010/06/the_case_against_the_euro.html)

good relations with the United States will be judged favorably, and vice versa. For example, at the beginning of 2003 when the relations between Germany and the United States were tense because of the Iraqi war, many German companies were downgraded. The price of their shares fell to an all-time low, including the large industrial conglomerate ThyssenKrupp.<sup>18</sup>

In December of 2009, rating companies started to downgrade Greece. In the meanwhile, the U.S. debt ratio was about 80 percent and the government deficit ratio 12 percent, both higher than the average European level, but U.S. credit was kept stable at AAA. Some European officials are calling for curbs on rating companies, arguing that conflicts of interest and bad information make their assessments unreliable, even dangerous.<sup>19</sup>

Third, there has been speculation that Germany “betrayed” Europe. Political solidarity is necessary for the stability of the European Monetary Union. Without it, the sharing of a currency will do more harm than good, which is the stark reality now confronting the eurozone.<sup>20</sup>

Behind the debt crisis, there is also a political crisis. The EU is rich as the world’s biggest economy. Greece is just a small country in southern Europe, accounting for about two percent of total EU GDP. Nevertheless, Greece led Europe into crisis. One of reasons is that there was lack of solidarity among European leaders at the beginning of the crisis. No effective decision was made to stop the crisis, which made the situation deteriorate. The key factor was Germany’s attitude. It used to play the role of the engine of European integration but this time, Germany seemed more concerned about itself than Europe. It took Berlin months to support a financial aid package for Greece. On May 2, eurozone finance ministers, the IMF and the Greek Government agreed on a loan package for Greece worth up to 110 billion Euros over three years. The decision came more than one month after EU leaders had agreed on the broad outlines of financial support and two and half months after they first discussed the option of helping Greece. Berlin was blamed for putting domestic politics ahead of the survival of the

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<sup>18</sup> Jiang Yong, “Why U.S. Rating Agencies Can Destroy Other Countries,” [http://www.caogen.com/blog/Infor\\_detail.aspx?id=175&articleId=20398](http://www.caogen.com/blog/Infor_detail.aspx?id=175&articleId=20398)

<sup>19</sup> Stevenson Jacobs and Daniel Wagner, “Credit Rating Agencies Playing Big Roll In European Debt Crisis,” *The Huffington Post*, April 29, 2010, [http://www.huffingtonpost.com/2010/04/29/credit-rating-agencies-pl\\_n\\_556645.html](http://www.huffingtonpost.com/2010/04/29/credit-rating-agencies-pl_n_556645.html)

<sup>20</sup> Simon Tilford, “How to save the euro,” essays, Centre of European Reform, [http://www.cer.org.uk/pdf/essay\\_euro\\_tilford\\_14sept10.pdf](http://www.cer.org.uk/pdf/essay_euro_tilford_14sept10.pdf)

Euro. Angela Merkel's hesitancy and prevarication increased the cost of the bailout, unsettled financial markets and poisoned the political atmosphere in Europe.<sup>21</sup>

Last but not least, the deficiency of the Euro might be the most important reason for the debt crisis in Europe. When the Euro entered into force in 1999, the monetary union did not meet the economic convergence criteria but politicians wanted to use the euro to promote the integration process. In this sense, the euro is more of a political result than an economic one. After the launch of the euro, the imbalance among member states worsened, which meant that the gap in competitiveness between member states grew. Because of the common currency, Greece could not adjust its balance payments by depreciating its currency. Its trade deficit within the eurozone continued to grow, and the country had to borrow money. This was the background of the debt crisis of Greece. In addition, the eurozone has a common monetary policy but different fiscal policies, which makes it hard in the eurozone to make quick and effective decisions when facing a crisis. Financial speculators and hedge funds selling euro have also been accused by both the Spanish and Greek prime ministers of having worsened the crisis. But why did they choose the euro rather than other currencies? Compared with the U.S. dollar, the British pound, and the Japanese yen, the euro is easier for speculators to attack. This can explain why the debt crisis occurred in Europe, despite the fact that the debt ratio as a percentage of GDP in other developed economies was even higher.

In summary, the sovereign debt crisis is not a new phenomenon but has occurred in the past, particularly after big economic downturns. Famous cases in modern history include the Latin America crisis in the 1980s, the Russian crisis in 1998, and the crisis in Argentina in 2002. The current debt crisis is located in Europe but all major advanced economies are actually troubled with debt burdens, including the United States, and Japan. The debt-to-GDP ratio of these countries increased rapidly after the subprime crisis in 2007.

The global sovereign debt is expected to increase to about US\$50 trillion, with G-7 countries accounting for about 80 percent of the additional

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<sup>21</sup> Katinka Barysch, "Germany, the euro and the politics of the bail-out," *Briefing Note*, Centre for European Reform, June 2010, [http://www.cer.org.uk/pdf/bn\\_barysch\\_germanyandeurope\\_28jun10.pdf](http://www.cer.org.uk/pdf/bn_barysch_germanyandeurope_28jun10.pdf)

increase. This is the biggest difference between the current debt crisis and previous cases. After the end of World War II, debt crises occurred in developing countries, and no sovereign debt default occurred in developed economies. The situation is different this time, since advanced economies are in trouble. So far, much of the discussion has focused on the causes, including factors like huge budget deficits, speculation by hedge funds, and unfair rating systems, but they cannot explain why the crisis occurred in the eurozone and not in the United States, the UK or Japan whose debt ratio are much higher than the eurozone average. The key difference between the eurozone and other advanced countries is that the eurozone is a monetary union with both economic and political weaknesses. The gap in competitiveness between member states is growing larger, while political solidarity is weakening.

## Tendency: Is the Crisis Over?

The European debt crisis began in December 2009 and peaked in May 2010 when Greece had bonds amounting to 8.5 billion euro maturing. There was widespread concern over a possible default, which could have caused the crisis to spread to other countries. Fortunately, there was no default, and the financial markets gradually calmed down over the summer. But the question is whether the crisis is over as a result of the combative measures that have been taken so far? One lesson that can be drawn from the financial crisis is that although financial markets seem to be at peace, the situation may still be risky. To find out the future prospects of the debt crisis, we have to analyze what kinds of measures were and are being taken and whether these measures are enough to save developed economies from their debt burdens.

### The European Financial Stability Facility

The European Financial Stability Facility (EFSF) is a special purpose mechanism agreed upon by the sixteen member states of the eurozone on May 10, 2010. Its aim is to preserve financial stability in Europe by providing financial assistance to member states in difficulty. The package is worth a total of 750 billion euro, with 440 billion in guarantees coming from members of the eurozone and a further 60 billion coming from the European Union. The International Monetary Fund is also expected to contribute 250 billion.<sup>22</sup> This project is the result of months of discussion among European leaders. Although it was seen to be late, the huge amount of 750 billion euro amazed the world. It was described as Nuclear Option to halt the crisis of the euro.<sup>23</sup> It is judged to be enough for the debt of southern European countries in crisis. However, much criticism of this facility remains.

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<sup>22</sup> Council of the European Union, Economic and Financial Affairs, Press Release, 9596/10 (Presse 108), May 9–10, 2010, [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ecofin/114324.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/114324.pdf)

<sup>23</sup> "750 Billion Euro Package: EU Turns to 'Nuclear Option' to Halt Euro Speculation," Spiegel Online, May 10, 2010, <http://www.spiegel.de/international/europe/0,1518,693997,00.html>

On one hand, there might be problems during the implementation phase. After the declaration on May 10, many of the details of the plan were not widely known. The market was in doubt: "It buys time. They are trying to give the impression that they're still united," as Song Seng Wun, an economist with CIMB-GK Research in Singapore, told the Associated Press.<sup>24</sup> Meanwhile, the European Financial Stability Facility, which will issue bonds on behalf of eurozone countries that cannot tap the capital markets, will rely on technical support from Germany's government debt agency staff.<sup>25</sup> As pointed out above, the German policy towards Europe is different compared to ten years ago. As far as IMF is concerned, which is responsible for assistance amounting to 250 billion euro, historical experiences show that the role of IMF in debt crises is controversial, since it usually imposes requirements on countries in trouble. Also this time, IMF set conditions for European countries who needed funding, including an austerity budget and thus if European countries cannot meet IMF requirements, they are not assured of a loan.

On the other hand, EFSF is just a lending programme. 750 billion euro is a huge amount, but it is not a transfer to European countries in trouble. When European countries need financial assistance, they can borrow from EFSF but they have to pay back the loan with interest. In this sense, EFSF is just an emergency measure as at the time speculators, including hedge funds, were attacking the euro. The major purpose of this measure is to fight against this type of speculation. EFSF is not capable of handling the fundamental issue which is the high debt ratio as it does not provide any money to reduce debt burdens. If the fundamentals do not improve, speculators may launch another attack at any time.

### **Austerity**

The Greek debt crisis occurred after the new government revised the estimate of its public deficit as a percentage of GDP to 13.6 percent. The high deficit was believed to be the major reason for the debt crisis. Since Greece's near default in April, European governments have rushed to adopt rigorous

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<sup>24</sup> Ibid.

<sup>25</sup> James Wilson, "Shadows over a symbol of stability," *Financial Times*, June 29, 2010, [http://www.ft.com/cms/s/0/079aa2fa-8244-11df-9467-00144feabdc0,dwp\\_uuid=77a7411a-824f-11df-9467-00144feabdc0.html](http://www.ft.com/cms/s/0/079aa2fa-8244-11df-9467-00144feabdc0,dwp_uuid=77a7411a-824f-11df-9467-00144feabdc0.html)

austerity programs, including tax increases and spending cuts, in an effort to convince investors that governments are serious about controlling their public deficits. As media described, Europe has entered an age of austerity.<sup>26</sup> Countries having introduced austerity programs in 2010 include:

- UK—£6.2bn of cuts already announced, £50bn expected by early 2015
- Ireland—public-sector pay cuts of up to 20 percent, plus reductions in child benefit, tax rises, and nurses, teachers, and police officers being laid off.
- Portugal—income, corporate and VAT tax rises coupled with spending cuts aimed at halving the budget deficit by next year.
- Spain—15bn euro slashed from spending this year and next to reduce deficit by more than 4 percent of GDP. Cuts to civil service pay, pensions, investment and child benefits
- Germany—80bn euro of spending cuts over four years
- Italy—Slashing spending by 24bn euro over three years to halve deficit by freezing public-sector pay and hiring, 10 percent cuts in all ministries and pay cuts for top civil servants
- Greece—huge austerity drive, budget cuts of 30bn euro over three years with the goal of cutting Greece’s public deficit to less than 3 percent of GDP by 2014.<sup>27</sup>

With huge public deficits, it is a matter-of-course that European governments need to take austerity measures. This should have been done already in the past decade. The problem is timing. With poor economic performance, particularly in southern Europe, austerity measures prompt strikes and slowdowns, which in their turn shrink the domestic market, investment and tax receipts. Some business owners are even taking a novel approach to escape their debts: emigration.<sup>28</sup>

<sup>26</sup> See “Europeans on the age of austerity,” BBC News, June 22, 2010, <http://www.bbc.co.uk/news/10370305>

<sup>27</sup> “Austerity Europe: who faces the cuts,” *The Guardian*, June 11, 2010, <http://www.guardian.co.uk/business/2010/jun/11/europe-deficit-crisis-austerity-budgets>

<sup>28</sup> Michael Hudson, “Austerity is not the only option,” *Financial Times*, July 7, 2010

European trade unions announced an EU-wide day of protest on September 29 against government austerity measures. The announcement of the day of action coincided with the publishing of economic data suggesting that national austerity measures are slowing down the EU's recovery. The financial-information company Markit reported on August 23 that its monthly eurozone purchasing managers' index had fallen to 56.1 in August compared to 56.7 in July, which were two month lows. Growth in the eurozone outside of France and Germany had slowed to near stagnation and services contracted as austerity measures took effect.<sup>29</sup>

It does not make sense economically for European countries to take tough austerity measures at a moment when recovery is fragile after a deep recession. The reasons for the decision may be that European governments want to show the financial market their capability of controlling the budget, so they can continue to raise money; members with better economic performance want to take this opportunity to consolidate the fiscal discipline and the IMF has asked them to do so. Regardless of what factors are behind measures taken, European countries need growth to pay the debt. Too much austerity is risky for their economic future. Poor economic growth prospects, not budget deficits, lie at the heart of the eurozone crisis.<sup>30</sup>

For such ambitious austerity plans that encounter strong domestic resistance, questions remain as to whether or not European countries can achieve growth in this atmosphere. Even though European countries may succeed, debt burdens would not be reduced. Sovereign debt will grow with high from the risk of European bonds. So, even if European countries can balance their budgets, which is not very likely, debt-to-GDP ratio will continue to grow. For southern European countries, mostly having bond interest higher than five percent, growth is negative. It is also the case in the UK and according to new forecasts, spending cuts increase the chances of a double-dip recession. The recovery in the UK economy is fragile and the chance is rather high for a renewed slowdown.<sup>31</sup>

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[http://www.ft.com/cms/s/0/337fef82-89f7-11df-bd30-00144feab49a,dwp\\_uuid=32461f5e-94f3-11df-af3b-00144feab49a.html](http://www.ft.com/cms/s/0/337fef82-89f7-11df-bd30-00144feab49a,dwp_uuid=32461f5e-94f3-11df-af3b-00144feab49a.html)

<sup>29</sup> Jim Brunsten, "Unions to protest against austerity measures," *EuropeanVoice.com*, <http://www.europeanvoice.com/article/2010/08/unions-announce-day-of-protests/68719.aspx>

<sup>30</sup> Tilford, "How to save the euro."

<sup>31</sup> Daniel Pimlott, "Businesses fear cuts boost slowdown risk," *Financial Times*, August 30, 2010, [http://www.ft.com/cms/s/0/c547a436-b39c-11df-81aa-00144feabdc0,dwp\\_uuid=](http://www.ft.com/cms/s/0/c547a436-b39c-11df-81aa-00144feabdc0,dwp_uuid=)

## Bank Stress Tests

European banks are exposed to the financial crisis as well as the debt crisis. The European Central Bank's Financial Stability Review showed that the latest estimate of the potential cumulative write-downs on securities and loans for the eurozone banking sector is 515 billion euro from 2007 to 2010. At the same time, the total estimate of potential loan write-downs from 2007 to 2010 has increased slightly and further write-downs are likely during 2011.<sup>32</sup> Some economies like Italy are faced with a severe refinancing challenge over the coming years.<sup>33</sup> In addition, as the European banks have not recovered from the financial crisis, sovereign debt will hit them again, because most of European sovereign debts are owed by European banks. If there is a default, European banks will suffer.

For the time being, European banks are being forced to pay more for short-term dollar borrowings than U.S. and Asian banks, suggesting that lenders world-wide are increasingly nervous about the risks posed by European banks. Rising LIBOR is diminishing the hope for sustained global financial health.<sup>34</sup> The increase in banks' borrowing costs can translate into higher rates for consumers on mortgages, credit cards and corporate loans.<sup>35</sup>

To maintain confidence in the European banking industry, an EU-wide banking stress test exercise was conducted by the Committee of European Banking Supervisors. The decision came at an EU summit in Brussels on June 17.<sup>36</sup> The results were released on July 23. Of the 91 banks tested, only seven failed: five in Spain (Unnim, Diada, Espiga, Banca Cívica, and Cajasur), one in Germany (Hypo Real Estate), and one in Greece (ATEBank). The

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<sup>32</sup> "Financial Stability Review," European Central Bank, June 2010, <http://www.ecb.int/pub/fsr/html/summary201006.en.html>

<sup>33</sup> Vincent Fernando, "ECB Warns Of A Debt Refinancing Collision Between Governments And Banks," Business Insider, June 1, 2010, <http://www.businessinsider.com/europe-debt-rollover-crisis-2010-6>

<sup>34</sup> The London Interbank Offered Rate (LIBOR) is a daily reference rate based on the interest rates at which banks borrow unsecured funds from other banks in the London wholesale money market.

<sup>35</sup> "Europe's Banks Hit by Rising Loan Costs," *The Wall Street Journal*, May 25, 2010, <http://online.wsj.com/article/SB10001424052748704792104575264883867618368.html>

<sup>36</sup> "Debt woes, bank taxes and growth plan dominate EU summit," European Commission, [http://ec.europa.eu/news/economy/100618\\_en.htm](http://ec.europa.eu/news/economy/100618_en.htm)

result was much better than expected, but did not bring back confidence, because the stress test had been greeted with widespread skepticism.<sup>37</sup>

There are doubts that merely 3.5bn euro of additional equity would be sufficient to make Europe's banking system sound again. A US\$75bn capital shortfall has been identified in the United States after the stress tests pursued in May 2009. The poor communication ahead of the disclosures has also been negative. EU leaders rushed to decide in June to publish test results without realizing that their end-July deadline was far too short given the complexity and diplomatic haggling involved. This stands in stark contrast with the masterful channeling of market expectations by U.S. authorities throughout late April and early May 2009.<sup>38</sup>

In September, investors became nervous when news spread from the German Banking Association, that the country's 10 biggest lenders might need additional capital amounting to 105bn euro.<sup>39</sup>

## The Trend

The problem with debt is the need to repay. If creditors lose faith in borrowers, they will demand repayment of the existing debt or refuse to renew old loans. Many forced sales will cause asset prices to fall and make creditors even less willing to extend loans. From early 2007 there were signs that economies were reaching the limit of their ability to absorb more borrowing.<sup>40</sup>

So far, European countries have adopted measures to rescue themselves from debt crisis. However, as discussed above, the current measures being taken are not enough to convince the market. The European Financial Stability Facility is just a game of borrowing to pay debt and austerity measures make future economic prospects more pessimistic. The stress test of European banks did not convince the market that the financial system is healthy.

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<sup>37</sup> Robert M. Cutler, "Scepticism Over Stress Testing of European Banks," Oilprice.com, August 9, 2010, <http://oilprice.com/Geo-Politics/Europe/Scepticism-Over-Stress-Testing-of-European-Banks.html>

<sup>38</sup> Nicolas Véron, "Europe's stress tests: only one step towards banking repair," bruegel, July 29, 2010, <http://www.bruegel.org/publications/show/publication/europes-stress-tests-only-one-step-toward-banking-repair.html>

<sup>39</sup> Peter Garnham, "Worries about German banks stalk euro," *Financial Times*, September 7, 2010, <http://www.ft.com/cms/s/0/9a698e7a-ba61-11df-8e5c-00144feab49a.html?ftcamp=rss>

<sup>40</sup> "A special report on debt," *The Economist*, June 24, 2010.

The fundamental way to relieve countries from debt is to achieve rapid economic growth. That way, governments can get more fiscal revenue to pay the debt. But since the beginning of the 21st century, EU economic growth has been moderate, with an average growth rate of two percent.<sup>41</sup> To achieve more growth, the EU needs more structural reform and innovation, which are not new topics as was illustrated in the Lisbon Agenda, which was implemented in 2000. From the experiences during the past ten years, in particular the failure of Lisbon Agenda, we can see that rapid growth is not easy to achieve in the EU. There were indications that countries such as Greece and Portugal experienced a decline of growth momentum, with the risk that they were moving into a debt spiral.<sup>42</sup> Europe will continue to be troubled by debt. For other developed countries, such as the United States and Japan, the situation is similar although they do not have a debt crisis. Newly published U.S. economic data show that the recovery is fragile. Japan's debt is the highest in developed economies, and therefore it cannot be expected it to decrease quickly.

From the above analysis, it can be concluded that the debt issue will exist for quite a long time. Since almost all the major developed economies are involved, the impact on the world economy will be considerable.

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<sup>41</sup> Eurostat, <http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tsieb020>

<sup>42</sup> Garnham, "Worries about German banks stalk euro."

## Implications for China

As is seen from facts discussed above, the sovereign debt is a problem for developed countries. China's financial situation and public debt level are comparatively healthy. However, China is an emerging economy and has been growing fast in recent years, which makes it more and more involved in globalization. China is the world's second biggest economy, top creditor and largest exporter. Sovereign debt in major rich economies accounting for a large share of the world economy is bound to influence China.

### External Economic Environment

First of all, pressure on exports may increase. As an export oriented economy, trade volume as a percentage of GDP in China is as high as 70–80 percent.<sup>43</sup> It is estimated that the foreign trade sector employs more than 80 million people.<sup>44</sup> In 2009, China overtook Germany as the world's largest exporter. Hence, developments in the external economic environment are crucial to China's economic growth. Developed economies were badly hurt by the financial crisis in 2008. The U.S. GDP shrunk by 2.6 percent in 2009 and by 4.2 percent in the EU.<sup>45</sup> The global downturn reduced China's exports, dropping by 16 percent in 2009.

Both Europe and the United States are struggling to improve their economic recovery which is still fragile. Debt burden would put another shadow on their future economic growth. With a high debt ratio, developed countries, particular in Europe, have to cut deficits, which could endanger future economic prospects. Although the United States decided to continue to stimulate its economy, unemployment is still high. The weakness

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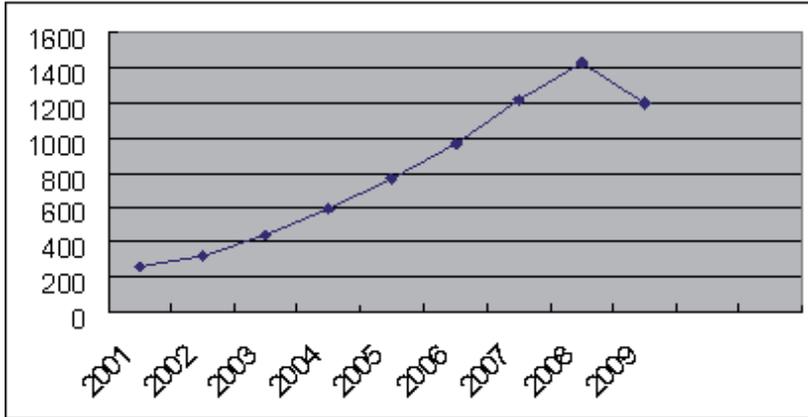
<sup>43</sup> Ren Zeping and Chen Changsheng, "The Contribution of Export to Chinese Economic Growth," ifeng.com, June 2, 2010 <http://finance.ifeng.com/news/20100602/2267006.shtml>

<sup>44</sup> Wayne M. Morrison, "China and the Global Financial Crisis: Implications for the United States," *CRS Report for Congress*, June 3, 2009, <http://www.fas.org/sgp/crs/row/RS22984.pdf>

<sup>45</sup> Eurostat, <http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tsieb020>

of the housing market continues to slow down the recovery.<sup>46</sup> With a high sovereign debt rate, governments and private firms compete for financial resources leaving the private sector with less capital for operations.

**Figure 3. Chinese Exports, 2001–09 (US\$ bn)**



Source: China Customs

During the deep downturn in 2009, many firms had to lay off workers. Although there are signs of recovery, firms are not confident enough to recruit new employees, partly because of the debt crisis. In the United States, the average unemployment rate in 2010 is estimated at 9.5 percent. The number of people filing for jobless claims in August rose to a nine-month high of 500,000.<sup>47</sup> The unemployment rate in the 16-country eurozone remained at a record 10 percent in July 2010. As many as 23 million men and women in the EU were unemployed in July, according to data released by Eurostat on Aug 31, 2010. In particular Spain has been hard hit with an unemployment rate of over 20 percent.<sup>48</sup> In such a situation, austerity measures and high employment reduce domestic demand, which means less demand for imports from China. The EU, the United States and Japan are China's top

<sup>46</sup> Robin Harding, "Beige Book shows slow pace of recovery," *Financial Times*, September 8, 2010, <http://www.ft.com/cms/s/0/37c5168e-bb6c-11df-a136-00144feab49a.html>

<sup>47</sup> "US budget office warns over extending tax cuts," *Financial Times*, August 19, 2010, <http://www.ft.com/cms/s/0/f3ea8ac0-ab9e-11df-abee-00144feabdc0.html>

<sup>48</sup> Eurostat, [http://epp.eurostat.ec.europa.eu/cache/ITY\\_PUBLIC/3-31082010-BP/EN/3-31082010-BP-EN.PDF](http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/3-31082010-BP/EN/3-31082010-BP-EN.PDF)

three trading partners, accounting for about 40 percent of China's exports. High debt in these countries will definitely cut China's export revenues.

Apart from diminishing demand, the European debt crisis also put pressure on the euro. A weak euro comes as some comfort for European countries but adds pressure to Chinese exports. A weaker euro means a comparatively strong RMB, which will dent the competitive advantages of China's goods in the European market, China's biggest export market. In 2009, China's exports to European markets declined by 19.4 percent. In 2010, depreciation of the euro exchange rate against the RMB further depressed China's exports to Europe.

To make things worse, pessimism regarding the future and high unemployment may lead to protectionism in developed economies. In September 2010, the United Steelworkers Union, the biggest industrial labor union in the United States representing about 700,000 workers, increased pressure on the Obama administration to step up actions against China for "unfair competition," calling for an investigation into Beijing's support for its renewable energy industry.<sup>49</sup> According to figures released in September 2010, the trade surplus was US\$20.03bn in August, down from US\$28.7bn a month earlier. While the trade surplus was below expectations, it was still relatively large and unlikely to pacify U.S. critics, who are pushing for legislation and accuse China of manipulating its currency.<sup>50</sup>

Second, reform of the RMB exchange rate regime would be endangered by the crisis. Exchange rate reform has long been a hot issue in both China's economic and external relations. As its economy is growing fast, the structure of the economy has to be reformed, and the exchange rate regime reform is in line with this strategic goal. In the meanwhile, there are also pressures from the outside, like a group of lawmakers in the U.S. Congress, who have been pressing for tougher actions to force China to revalue the RMB.

The reform of the mechanism for setting the RMB exchange rate can be divided into three stages. The first stage started on July 21, 2005, when China implemented a floating exchange rate system, which is market-based and refers to a basket of currencies. The basket is dominated by the U.S.

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<sup>49</sup> Alan Beattie, "US union calls for action against China," *Financial Times*, September 10, 2010, <http://www.ft.com/cms/s/0/393772b4-bc75-11df-a42b-00144feab49a.html>

<sup>50</sup> Geoff Dyer, "China trade surplus in surprise drop," *Financial Times*, September 10, 2010 <http://www.ft.com/cms/s/0/43a98376-bc8f-11df-a42b-00144feab49a.html>

dollar, the euro, the Japanese yen and the South Korean won, with a smaller proportion made up of the British pound, the Thai baht, the Russian ruble, the Australian dollar, the Canadian dollar and the Singapore dollar. Until July 2008, the RMB appreciated nearly 21 percent against the U.S. dollar. The second stage was from July 2008 until June 2010, during which the RMB exchange rate fluctuated against the U.S. dollar at between 6.82 and 6.84 RMB. The third stage commenced in June 2010, when the central bank of China announced further promotion of a reform of the RMB exchange rate regime and great flexibility of the exchange rate.

The move was expected to mute criticism from U.S. President Barack Obama and other world leaders ahead of the G-20 summit in Toronto. In light of the euro's nosedive, such a move could be difficult. Letting the RMB appreciate against the U.S. dollar would mean a further increase in the RMB's value against the euro. The RMB rose about 20 percent against the euro during the first half of 2010, which increased pressure on Chinese exporters and will also have a negative impact on China's exports to European countries.<sup>51</sup>

Since Beijing's announcement in June, the RMB has risen less than one percent against the U.S. dollar during three months.<sup>52</sup> This fuels pressures in Washington for Congress to draft trade legislation which is threatening restrictions on Chinese exports. Some economists warn that China may face more problems.<sup>53</sup> In October, the difference between the United States and China about exchange rate issues became more obvious. The United States insisted the International Monetary Fund should intensify its focus on exchange rates and the reserve accumulation of China, while China accused the U.S. of destabilizing emerging economies by allowing ultra-loose monetary policy to flood the emerging world with money. As a result, international meetings of finance ministers and central bankers have often ended with no resolution.<sup>54</sup>

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<sup>51</sup> Keith Bradsher, "Europe's Debt Crisis Casts a Shadow Over China," *The New York Times*, May 17, 2010, [http://www.nytimes.com/2010/05/18/business/global/18yuan.html?pagewanted=1&\\_r=1](http://www.nytimes.com/2010/05/18/business/global/18yuan.html?pagewanted=1&_r=1)

<sup>52</sup> Alan Beattie, "US union calls for action against China," *Financial Times*, September 10, 2010, <http://www.ft.com/cms/s/0/393772b4-bc75-11df-a42b-00144feab49a.html>

<sup>53</sup> Harvey Morris, Daniel Dombey, and Alan Beattie, "Obama urges Wen to act over renminbi," *Financial Times*, September 23, 2010, <http://www.ft.com/cms/s/0/57356cca-c739-11df-aeb1-00144feab49a.html?ftcamp=rss>

<sup>54</sup> Chris Giles and Alan Beattie, "Battle lines drawn over currency war," *Financial*

China is facing a tough situation. If it does not take action, pressure will continue from the United States, but if China takes action, things may worsen. In the current monetary system, the U.S. dollar and the euro are two major international currencies and China does not have much choice over which currencies to include in its currency basket. To decrease the peg to dollars, the only choice is to increase the share of euro in the basket but for the time being, the weakness of the euro is exposed to the market. If China increases the share of the euro and it depreciates against the U.S. dollar, this means that the RMB will depreciate against the U.S. dollar. This is quite contrary to the expectations of the United States. If China does not make changes to its current currency basket, but radically reform the RMB exchange regime, allowing for a drastic appreciation of the RMB, real risks would ensue. Historical experience shows that Japan has been in a long recession since the 1985 Plaza Accord pushed the exchange value of the Japanese yen up against the U.S. dollar.<sup>55</sup>

Third, management of foreign reserves faces more difficulties. As of March 2010, China's foreign exchange reserves totaled US\$2.45 trillion, of which about 60 percent was invested in U.S. securities.<sup>56</sup> After the sub-prime crisis in 2007 and the financial crisis in 2008, the U.S. dollar showed a tendency to depreciate. In recent years, China has been trying to limit the dependence of its foreign exchange reserve on U.S. Treasury securities by expanding its holdings of European government bonds.<sup>57</sup> However, the debt crisis in 2010 showed that European bonds are not reliable. Of course, gold, as a natural currency, is another choice, but China's foreign reserve is too big for the gold market. Gold is not a substitute for U.S. bonds. China has to make a hard choice among foreign government bonds which all entail a high degree of risk.

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*Times*, October 10, 2010, <http://www.ft.com/cms/s/0/55e103f2-d495-11df-b230-00144feabdc0.html>

<sup>55</sup> Henry C. K. Liu, "Global sovereign debt crisis, Asia Times Online," May 13, 2010, [http://www.atimes.com/atimes/Global\\_Economy/LE13Dj03.html](http://www.atimes.com/atimes/Global_Economy/LE13Dj03.html)

<sup>56</sup> *Ibid.*

<sup>57</sup> Bradsher, "Europe's Debt Crisis Casts a Shadow Over China."

## **The Internationalization of the RMB**

The financial crisis in 2008 put China in the spotlight as the world's biggest creditor. The United States has to continue to raise money from China through selling treasury bonds. It is interesting that China as a developing country, whose GDP per capita ranks below 100 in the world, has been lending money to the United States, the world's richest country. Why does a developing country provide low interest loans to a super power? That is mainly because of the international monetary system.

After World War II, the Bretton Woods System formed the foundation for a renewed international monetary system. According to this system, the U.S. dollar, pegged to gold, was the only hard international currency. After the collapse of this system in 1973, the status of the U.S. dollar as an international currency has only been further reinforced. Over the past decades, the dollar's share in overall reserves has not declined very much. It was believed that the introduction of the euro could provide a direct challenge to the hegemony of the U.S. dollar. The current debt crisis makes the market believe that the U.S. dollar is safer than the euro. In international foreign exchange markets, dollar transactions have accounted for a dominant share over the past decades reflecting the fact that the U.S. dollar has continued to dominate financial transactions and has been the most important currency.<sup>58</sup>

The dominance of the U.S. dollar in the international monetary system is risky for international financial stability. It makes it possible for the United States to be the world's largest debtor and continuously register a massive current account deficit with the rest of the world. To correct this imbalance, the U.S. dollar has to depreciate, which is a burden on dollar-assets holders worldwide. Furthermore, dollar depreciation and worldwide pegging would increase global excessive liquidity. The financial crisis in 2008 is partly due to the monetary stimulus policy pursued by the Federal Reserve for years. The fragility of the dollar standard also arises from over-reliance on the trust in the ability of the United States to manage the dollar. The current international monetary system is basically dependent on the worldwide faith in this ability.<sup>59</sup> The global financial crisis brought along an urge

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<sup>58</sup> Gao Haihong and Yu Yongding, "Internationalization of the Renminbi," BoK-BIS Seminar, Seoul, March 19–20, 2009, <http://www.bis.org/repofficepubl/arpresearch/200903.05.pdf>

<sup>59</sup> Gao Haihong, "Current Global Dollar Standard: Problems and Regional Solutions

for reform of the current global financial architecture. One element of the reform proposal package is to consider alternatives to the U.S. dollar as an international currency. The euro has been one option since its introduction in 1999 but the debt crisis in 2010 has made it clear that the euro would not be a good substitute. This means that other currencies can have the opportunity to enhance their position in the international monetary system.

In the first chapter of this report, it was pointed out that the major international currencies, including the U.S. dollar, the euro and the Japanese yen, are linked to high levels of debt. The debt ratios are too high to be resolved in the near future. After the Wall Street financial crisis in 2008, capital flowed from the United States to Europe and other markets. However, when Europe was in crisis in 2010, capital flowed the opposite way, from Europe to the United States, to avoid risk. This kind of capital flow is short term. In the long run, capital may find other markets as both the U.S. dollar and the euro are risky due to debt levels. Emerging market corporate and sovereign bonds have been issued at a record pace in 2010, which is a sign of growing investor interest in opportunities outside the developed world following the financial crisis. Borrowers, including governments and companies, have raised almost US\$300bn to date, a ten per cent increase on the same period in 2009, which itself was a record year.<sup>60</sup>

Emerging markets have been subject to inflows of hot money in the past. When the money left as quickly as it arrived, it hit these economies hard. However, investors believe the financial crisis and shift in risk perceptions mean that the situation is different this time. Debt-to-GDP ratios in the developed world are about double those in emerging markets, and they are growing. Emerging markets debt assets grew from US\$3.3bn in March last year to US\$13.2bn in March 2010. Corporate borrowing, led by Chinese companies, now makes up about three-quarters of emerging market bond issuance, up from just over half before the financial crisis.<sup>61</sup>

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for East Asia," presented for the International Conference "Global Security in the 21st Century: Perspectives from China and Europe," organized by the Chinese Academy of Science and the Konrad-Adenauer Foundation, Beijing, CASS, Beijing, September 18–19, 2007, [http://en.iwep.org.cn/download/upload\\_files/bdp0w0ezo2bgnbqbqppi143y20071027162253.pdf](http://en.iwep.org.cn/download/upload_files/bdp0w0ezo2bgnbqbqppi143y20071027162253.pdf)

<sup>60</sup> Josh Noble, "Supply and demand: Appetite for EM shows no sign of waning," *Financial Times*, June 28, 2010, <http://blogs.ft.com/beyond-brics/2010/06/28/supply-and-demand-appetite-for-em-shows-now-sign-of-waning/>

<sup>61</sup> "Emerging markets set pace for debt issuance," *Financial Times*, June 28, 2010, <http://>

In addition, with economic recovery fragile, one of the choices for governments is to print more money to pay down the debt. There is no lack of precedents in U.S. history for this action. After the financial crisis in 2008, quantitative monetary easing has been adopted in the United States. For Europe, the European Central Bank has already loosened the criteria for lending capital to banks after the crisis. In Japan, the Bank of Japan set a course on October 5 towards quantitative easing by cutting its key interest rate and proposing a new fund to buy government bonds and other assets.<sup>62</sup>

More liquidity means more risk of depreciation. Major international currencies, including the U.S. dollar, the euro and the Japanese yen, may enter a period of collateral depreciation.<sup>63</sup> Since credit of major international currencies might be weakened by the debt, there is an opportunity for RMB internationalization. In recent years, the RMB has become a de facto currency of settlement and payment in the neighboring countries of Russia, Vietnam, Thailand, Myanmar and the Democratic People's Republic of Korea. RMB cross-border trade has enjoyed a tax rebate or exemption since 2010. China also issued six billion RMB treasury bonds in Hong Kong in 2009.

The internationalization of a country's currency can increase its say in global economic affairs and promote its economic and trade development. The internationalization of a currency has, however, to be in line with the country's economic power.<sup>64</sup> Although China's economic volume is as huge as that of the United States, the UK and Japan, its per capita GDP is still at the mid and low-income levels. The financial market in China is not as mature as in the United States or Europe. In addition, the RMB is not yet a freely convertible currency, which is necessary for its internationalization. Considering all these limitations, the RMB internationalization will be a long process but the opportunity is there.

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[www.ftchinese.com/story/001033280/ce](http://www.ftchinese.com/story/001033280/ce)

<sup>62</sup> Mure Dickie, "BoJ praised for 'decisive' economic plan," *Financial Times*, October 5, 2010, <http://www.ft.com/cms/s/0/3aab9de0-d03f-11df-9e63-00144feab49a.html>

<sup>63</sup> Warren Buffett, *ifeng.com*, May 20, 2010, <http://finance.ifeng.com/forex/whyw/20100520/2212983.shtml>

<sup>64</sup> Gao and Yu, "Internationalization of the Renminbi."

## **EU-China Cooperation**

The European debt crisis in 2010 occurred in the aftermath of the Wall Street financial turbulence in 2008. In this sense, both Europe and China are victims of the U.S. financial crisis. To manage the debt issue and avoid similar crises, cooperation between the EU and China would make sense and would provide an opportunity to enrich the content of their comprehensive strategic partnership.

## **Building International Ratings Agencies**

The role of rating agencies in debt crises was discussed above. Since the United States dominates the ratings market, other countries, including Europe and China, have little say in this area. One of the lessons we can learn from the European debt crisis is that the U.S. dominance of the ratings market expose other countries to risk. After the the European debt crisis, both Europe and China were seeking to establish or strengthen their own rating agencies. So far, they are doing this separately and are encountering problems.

Debt ratio as a percentage of GDP is much higher for the United States than the average level for Europe. Still, there is no debt crisis in the United States. In addition, the treasury bond yield is much lower than Europe, which facilitates the raising of money more easily and cheaply for the U.S. This is partly because U.S. credit is under the protection of rating agencies. Without its ratings hegemony, U.S. credit might be downgraded because of its high debt level. If U.S. sovereign credit was downgraded, the yield rate of treasury bonds would also increase, which would mean that the U.S. government has to pay more for raising money. Since the U.S. debt amounts to US\$13 trillion and rising, the extra interest would be incredible. Thus, the U.S. government will not give up the ratings hegemony easily. In addition, U.S. rating agencies have a long history and occupy almost 95 percent of the international market making it hard for other rating agencies to enter this market.

In Europe, the big three credit rating companies were threatened with fines and the creation of a new state-backed competitor in June 2010, weeks after European leaders attacked them for exacerbating Greece's problems with downgrades. The rating companies will be subject to a new European

supervisory body with the power to hand out fines and suspensions. Work on a proposal for a centralized European credit agency is also being carried out by the European Commission. However, bond investors have privately cast doubt on the credibility of any new body rating sovereign debt if it is bankrolled by those same countries.<sup>65</sup>

In China, rating companies are also developing fast. On July 11, 2010, Dagong Global Credit Rating Company, a professional rating company in China, released its sovereign credit risk report for fifty countries. It is the first time that a non-western rating company released information on sovereign credit risks. Its ratings are quite different from those of the big three. Among the fifty countries, 27 received different ratings from Dagong. Countries receiving higher ratings are mainly new emerging countries which have political stability and good economic performance. Countries with lower ratings are many developed countries which have shown little economic growth and are heavily burdened with increasing debt.<sup>66</sup> Although China's rating companies are making progress, they still face challenges. On September 22, 2010, the U.S. Securities and Exchange Commission denied the application of Dagong Global Credit Rating Company to become a Nationally Recognized Statistical Rating Organization in the United States.

So far, European and Chinese experiences show that both could shake the U.S. ratings hegemony. As major economies, and debtor and creditor of the world respectively, it may make sense if the EU and China work together to change the current ratings system.

### **China's Outward Direct Investments in Europe**

The EU and China are important economic partners. Their relations focus mainly on economic issues. The EU is China's biggest trading partner and export market, as well as China's second biggest source of foreign direct investment (FDI), while China is EU's second biggest trading partner after the United States. But there are also weaknesses in EU-China economic

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<sup>65</sup> David Charter and Patrick Hosking, "Europe launches credit ratings offensive," *The Times*, June 3, 2010, [http://business.timesonline.co.uk/tol/business/industry\\_sectors/banking\\_and\\_finance/article7142915.ece](http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article7142915.ece)

<sup>66</sup> "Dagong Global Releases Its First Sovereign Credit Rating Reports of 50 Countries," July 12, 2010, [http://jjckb.xinhuanet.com/wzpd/2010-07/12/content\\_236280.htm](http://jjckb.xinhuanet.com/wzpd/2010-07/12/content_236280.htm)

relations, primarily related to China's outward direct investments (ODI) in Europe.

With its economy growing and foreign reserves accumulating, China has become a capital-surplus economy with fast growing overseas investments. According to an estimate for 2007, Chinese ODI exceed US\$20 billion, making China one of the top fifteen outward investors on an annual basis, ahead of Brazil and India. By the end of 2007, the cumulative ODI stock amounted to US\$128 billion, with more than 10,000 Chinese companies engaging in ODI in 173 countries and regions. This was twice as many companies as a decade before. However Chinese investments in Europe are still relatively insignificant. Although Greenfield Investments<sup>67</sup> in European projects funded by China have increased by 500 percent since 2000, they started from a very low base and thus remain modest. China accounted for 1.2 percent of such investments in Europe in the period 2004–06, similar to Korea but behind India.<sup>68</sup>

The major reason for the low level of Chinese Greenfield Investments is that there was wide-spread doubt in Europe over Chinese investments. It was believed that Chinese investments were owned by state-owned enterprises (SOEs) with close relations to the Chinese government. European governments and public opinion worried that Sovereign Wealth Funds (SWFs) and SOEs were vehicles that could allow “undemocratic states” to gain control of valuable financial and industrial assets. Based on such concerns, European governments prescribed strict conditions for investments by China's SWFs. For example, Germany and Austria tightened their control over foreign investments, and France set up its own SWFs with an explicit mandate to protect domestic enterprises against unwanted takeovers from abroad.<sup>69</sup> This made China's outward direct investments in Europe stagnant.

Actually, European concerns over Chinese investments have been exaggerated. Research has shown that large SOEs play a limited role in China's outward investments in Europe. The driving force behind these investments

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<sup>67</sup> A form of foreign direct investment where a parent company starts a new venture in a foreign country by constructing new operational facilities from the ground up.

<sup>68</sup> Françoise Nicolas, *Chinese Direct Investment in Europe: Facts and Fallacies*, Chatham House, Briefing Paper, June 2009, [http://www.chathamhouse.org.uk/files/14121\\_0609ch\\_odi.pdf](http://www.chathamhouse.org.uk/files/14121_0609ch_odi.pdf)

<sup>69</sup> Clara Marina O'Donnell, “How should Europe respond to sovereign investors in its defence sector?” *policy brief*, Centre for European Reform, September 2010, [http://www.cer.org.uk/pdf/pb\\_swf\\_defence\\_sept10.pdf](http://www.cer.org.uk/pdf/pb_swf_defence_sept10.pdf)

is to gain access to foreign markets, technologies and factors of production. The decision to invest rather than to export is sometimes precipitated by actual or threatened protectionism in major markets. In addition, the latest rounds in EU enlargement in 2004 and 2007 have attracted Chinese firms to lower-cost regions and allowed them to gain easy access to the rest of the EU.<sup>70</sup>

Fortunately, the financial crisis in 2008, and in particular the debt crisis in 2010, has changed the attitude of Europeans towards SWFs. At the height of the crisis, some Chinese SWFs bought billion-dollar stakes in companies like UBS, Barclays and Credit Suisse. In 2010, the Greek Government was encouraging Chinese SWFs to buy Greek Government bonds to alleviate its economic troubles. In June 2010, China has signaled its confidence in crisis-ridden Greece by signing investment deals worth billions of euro across a wide spectrum of economic activities. At a time when Greece was enduring the humiliation of having to accept financing from the European Union and International Monetary Fund to avoid a debt default, the Chinese have signed multibillion-euro agreements on shipping, tourism, and telecommunications. All this comes at a time when international market fears of a Greek collapse were undermining confidence in the whole European Union single currency eurozone and sent the euro reeling.<sup>71</sup>

Chinese investment in Greece in a moment of crisis has been seen in both Europe and China as successful. For Europe, with high government debt, investments from China will be helpful for attaining economic growth. On the Chinese side, it is also a wise choice to invest more in Europe, since China's foreign reserve management is facing challenges because all major international currencies might depreciate. The transformation of the foreign reserve from treasury bonds into physical assets might be a good choice. Further direct investment from China to Europe will be in the interest of both.

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<sup>70</sup> Nicolas, *Chinese Direct Investment in Europe*.

<sup>71</sup> Breffni O'Rourke, "China Seeking Major Investments in Greece, But Why Now?" Radio Free Europe/Radio Liberty, June 16, 2010, [http://www.rferl.org/content/China\\_Seeking\\_Major\\_Investments\\_In\\_Greece\\_But\\_Why\\_Now/2073276.html](http://www.rferl.org/content/China_Seeking_Major_Investments_In_Greece_But_Why_Now/2073276.html)

## Experience Sharing: The Swedish Model

As already discussed, the current debt issue was one of the results of the bank crisis in 2008. Even now, the U.S. and European banking systems are far from recovered. Moreover, this is not the first banking crisis in modern times in advanced economies.

In Sweden, real aggregate asset prices increased by a total of over 125 percent during the second half of the 1980s because of a credit boom. The expansion of credit was also associated with increased demand. The economy became overheated and inflation accelerated. At the end of the 1980s, asset prices began to fall and economic activity turned downwards. The Swedish banking system was in a crisis, as serious as in the United States in 2008. In the course of the Swedish financial crisis, the seven largest banks, with 90 percent of the market, suffered heavy losses.<sup>72</sup> However, at that time, Sweden did not just bail out its financial institutions by having the government take over debts. Sweden told its banks to write down their losses promptly before coming to the state for recapitalization. The state extracted pounds of flesh from bank shareholders before writing out checks. In September 1992, the government and the Social Democratic opposition jointly announced a general guarantee for the banking system. This broad political consensus was of vital importance and made the prompt handling of the financial crisis possible.<sup>73</sup>

Soon after the plan was announced, the government found that international confidence returned quicker than expected, easing pressure on the Swedish currency and bringing money back into the country. In addition, by the end of the crisis, the government had seized a substantial portion of the banking sector, and the agency had mostly fulfilled its hard-nosed mandate to drain share capital of the worst hit banks, before injecting cash. When markets stabilized, the Swedish state then reaped the benefits by taking these banks public again.<sup>74</sup>

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<sup>72</sup> Urban Bäckström, "How Sweden solved its banking crisis," *The Sunday Business Post Online*, January 25, 2009, <http://archives.tcm.ie/businesspost/2009/01/25/story38975.asp>

<sup>73</sup> Edward Harrison, "The Swedish banking crisis response: a model for the future?" *Credit Writedowns*, August 13, 2008, <http://www.creditwritedowns.com/2008/08/swedish-banking-crisis-response-model.html>

<sup>74</sup> Cater Dougherty, "Stopping a Financial Crisis, the Swedish Way," *The New York Times*, September 22, 2008, <http://www.nytimes.com/2008/09/23/business/worldbusiness/>

By comparison, Sweden and the United States have had similar difficulties in the banking system. While Sweden solved its problems successfully, the latter fell into a heavy debt burden. One of the major differences is that Sweden limited moral hazard problems by tough negotiations with the banks that needed support.<sup>75</sup> In addition, solidarity was showed in Sweden at the political level at the crucial moment. Although the Swedish model proved successful, it was not widely discussed at the time. Since European banks are still in difficulties, and China's financial institutions are more and more exposed to external risks concurrently with the progressing opening, a joint discussion of Swedish experiences could be of help for China's financial stability in the future.

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23krona.html

<sup>75</sup> Kevin Drum, "The Swedes did nationalize," <http://www.interfluidity.com/posts/1232308246.shtml>

## Concluding Remarks

Compared with historical cases of sovereign debt crises, the current situation is different. The present crisis is the first time that major developed economies are involved. Comparing Europe with other developed countries, we find that the deficiencies of the eurozone are the major reasons for the debt crisis in 2010. Although the debt crisis seems to have calmed down in recent months, it is too early to say the crisis is over. First of all, the total debt volume is so colossal that the situation is comparable to the one found after World War II. Second, countries involved are major advanced economies accounting for a large share of the world economy. Third, the measures taken so far have failed to reduce the debt burden. The debt issue will exist for a long time during which financial markets may fall into turmoil from time to time, undermining the global recovery.

As the world's second biggest economy, top creditor and largest exporter, China will inevitably be affected. It will face both challenges and opportunities. The challenges include, a possible increase of the pressure on exports; the RMB exchange rate regime might be in trouble; the management of foreign reserves might become more difficult. A major opportunity for China is the RMB internationalization, since the credit of major reserve currencies may be undermined by the huge amounts of debt found internationally. There are also opportunities for EU-China relations, which are often criticized for a lack of essential cooperation; such as cooperating on building up rating agencies, the low level of Chinese direct investments in Europe as well as too little sharing in the handling of the banking crisis.

Sovereign debt issues reflect the transfer of global economic power from the West to the East, but it is a common challenge for all countries because of globalization. If one country suffers a crisis, others will also suffer, as was the case after 2008. Cooperation not confrontation is the way to deal with the economic challenges in a globalized world. However, current financial mechanisms cannot ensure effective cooperation and need to be reformed and adapted to meet the requirements of the prevailing situation.

## **About the Author**

Dr. Liu Mingli is an associate research fellow at the European Institute of CICIR (The China Institute of Contemporary International Relations). His main research areas are European integration, European economy as well as Sino-European relations. With an economic background, he has been working on the sovereign debt issue as a guest researcher with ISDP from August until November 2010.