

Debt and Deficit

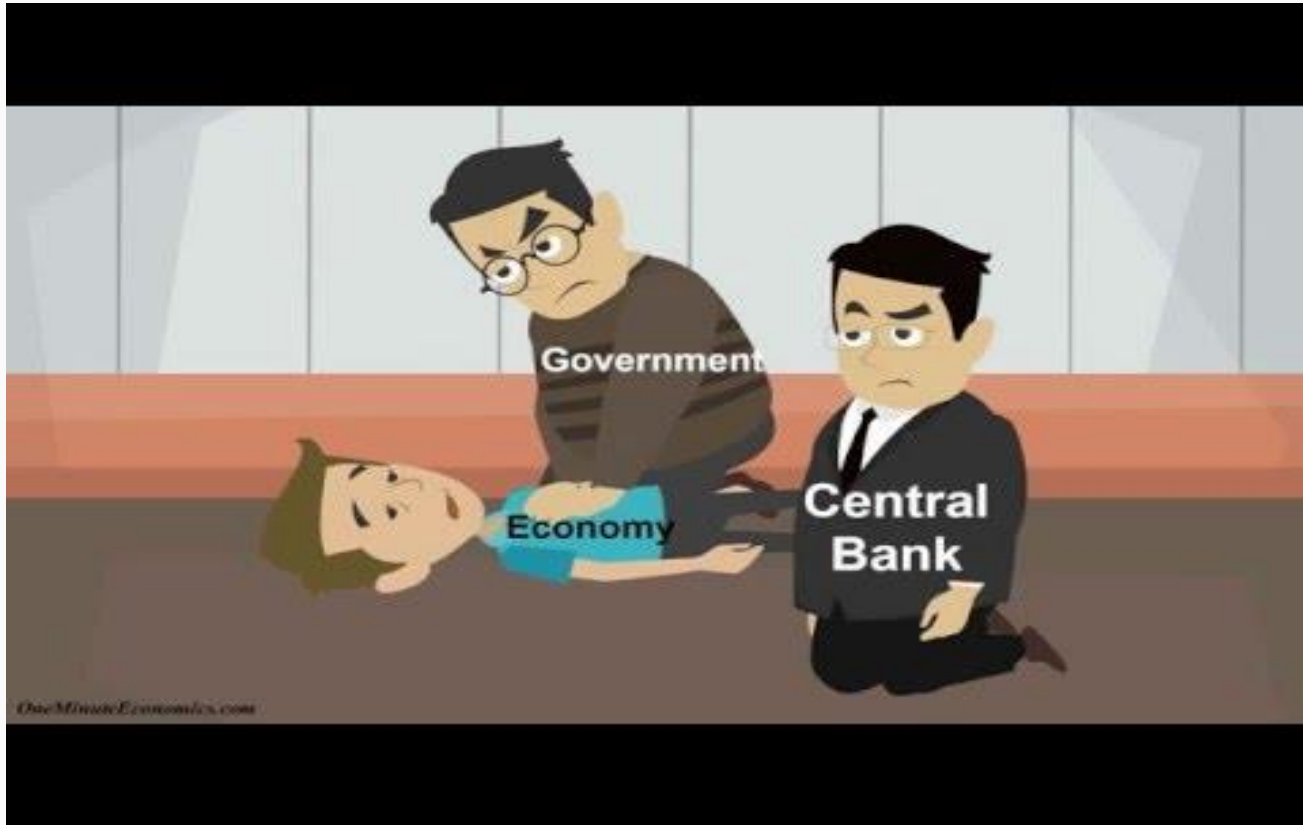
Burel, Dhonte, Kim, Montelibano, Salandanan



Background and History



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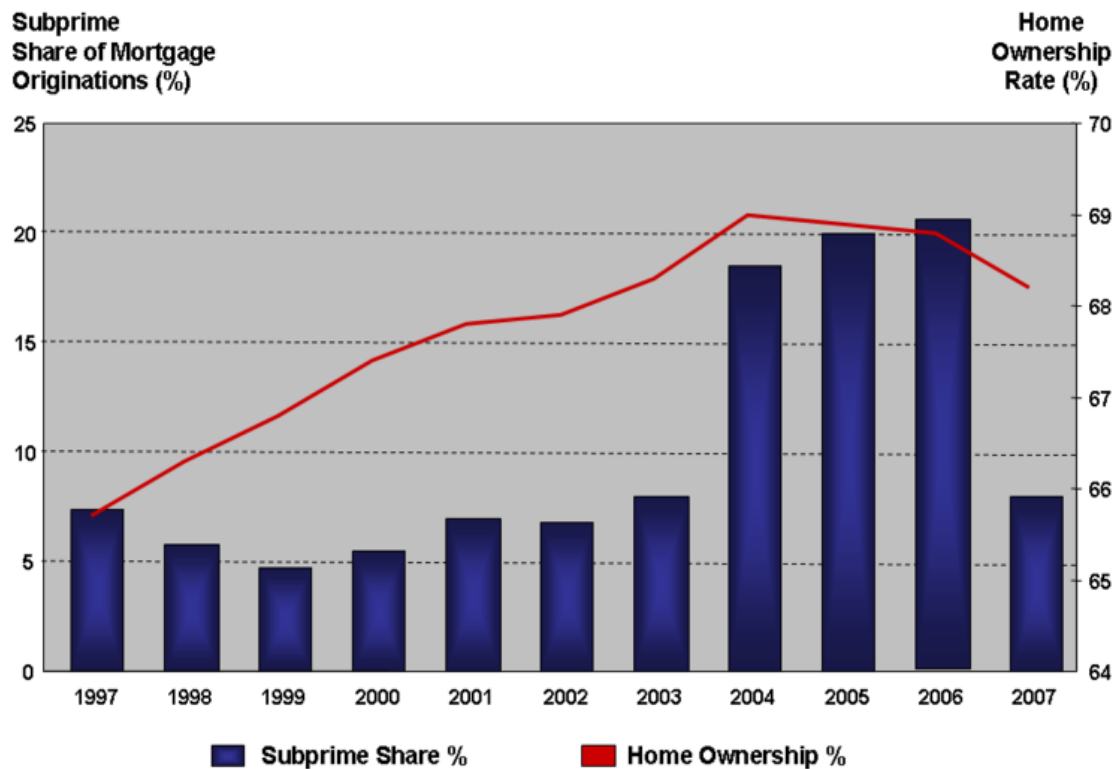


Before the Financial Crisis

Long period of:

- rapid credit growth,
- low risk premium,
- abundant liquidity,
- development of real estate bubbles

U.S. Subprime Lending Expanded Significantly 2004-2006



Sources: U.S. Census Bureau; Harvard University- State of the Nation's Housing Report 2008

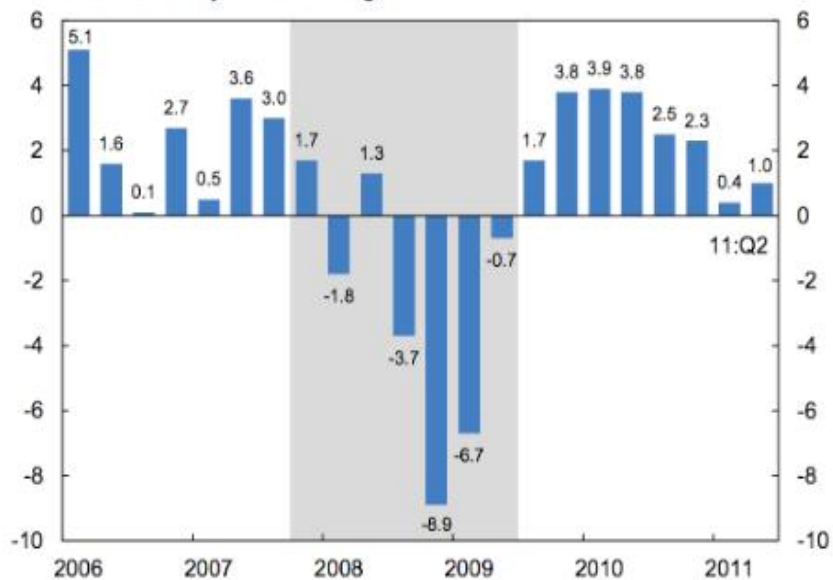
During the Financial Crisis

Great Recession in the U.S (December 2007-June 2009)

- Large amounts of mortgage-backed securities and derivatives lost significant value → jeopardized the solvency of over-leveraged banks and financial institutions in the U.S. and Europe
- In September 2008, Lehman Brothers, the country's fourth-largest investment bank filed for bankruptcy.
- United States alone shed more than 7.5 million jobs.

Real GDP Growth

Annualized Quarterly Percent Change



Source: Bureau of Economic Analysis

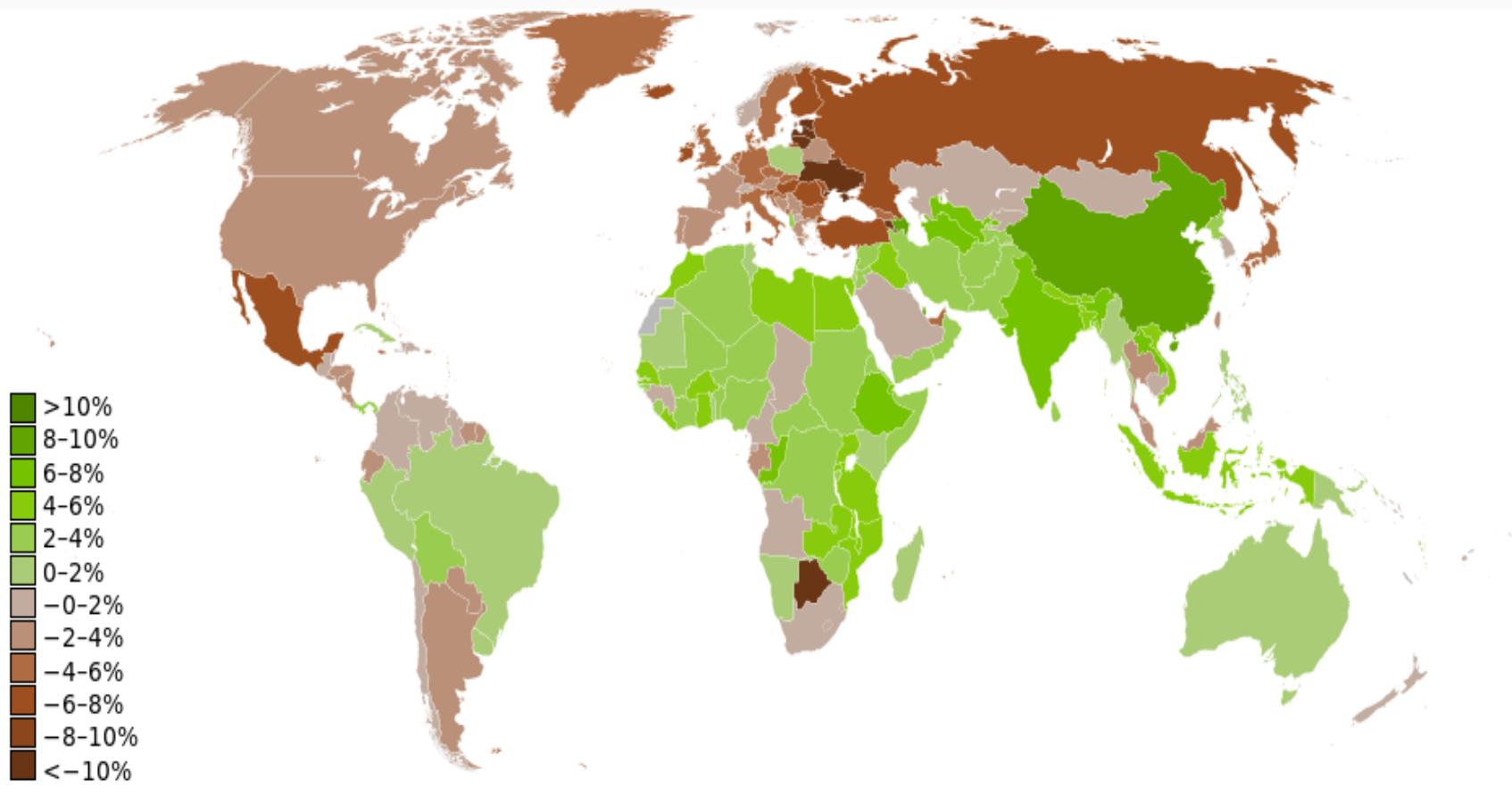
US Unemployment Rate



Source: BLS

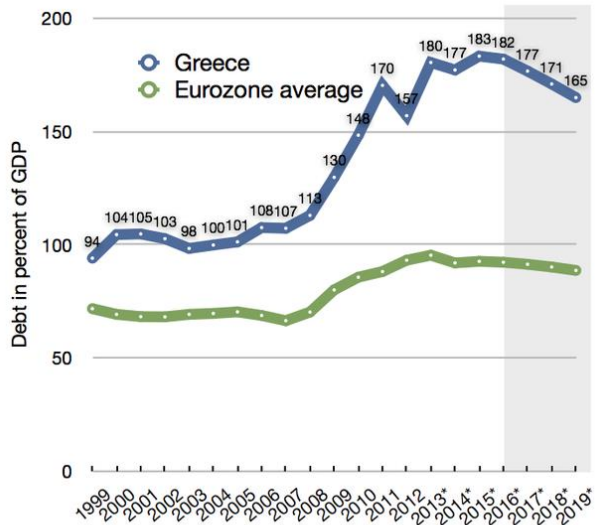


Real GDP Growth in 2009



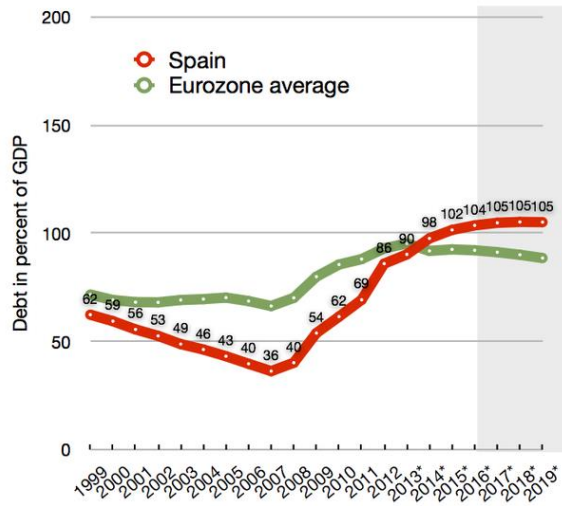
After the Financial Crisis

- Economic downturn → slow economic growth
- There are 5 European countries that have failed to make economic growth to be able to pay the debt they owe to bondholders. These are Greece – 177%, Spain – 99% , Portugal – 129%, Italy – 132%, and Ireland – 75% .



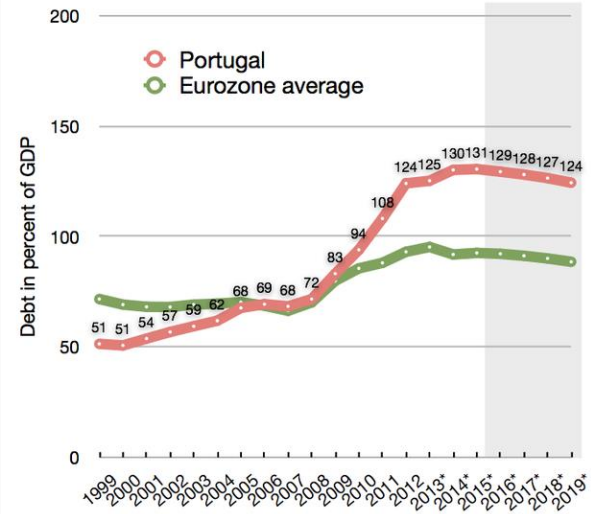
Source: Eurostat

* Ernst & Young using data from Oxford Economics



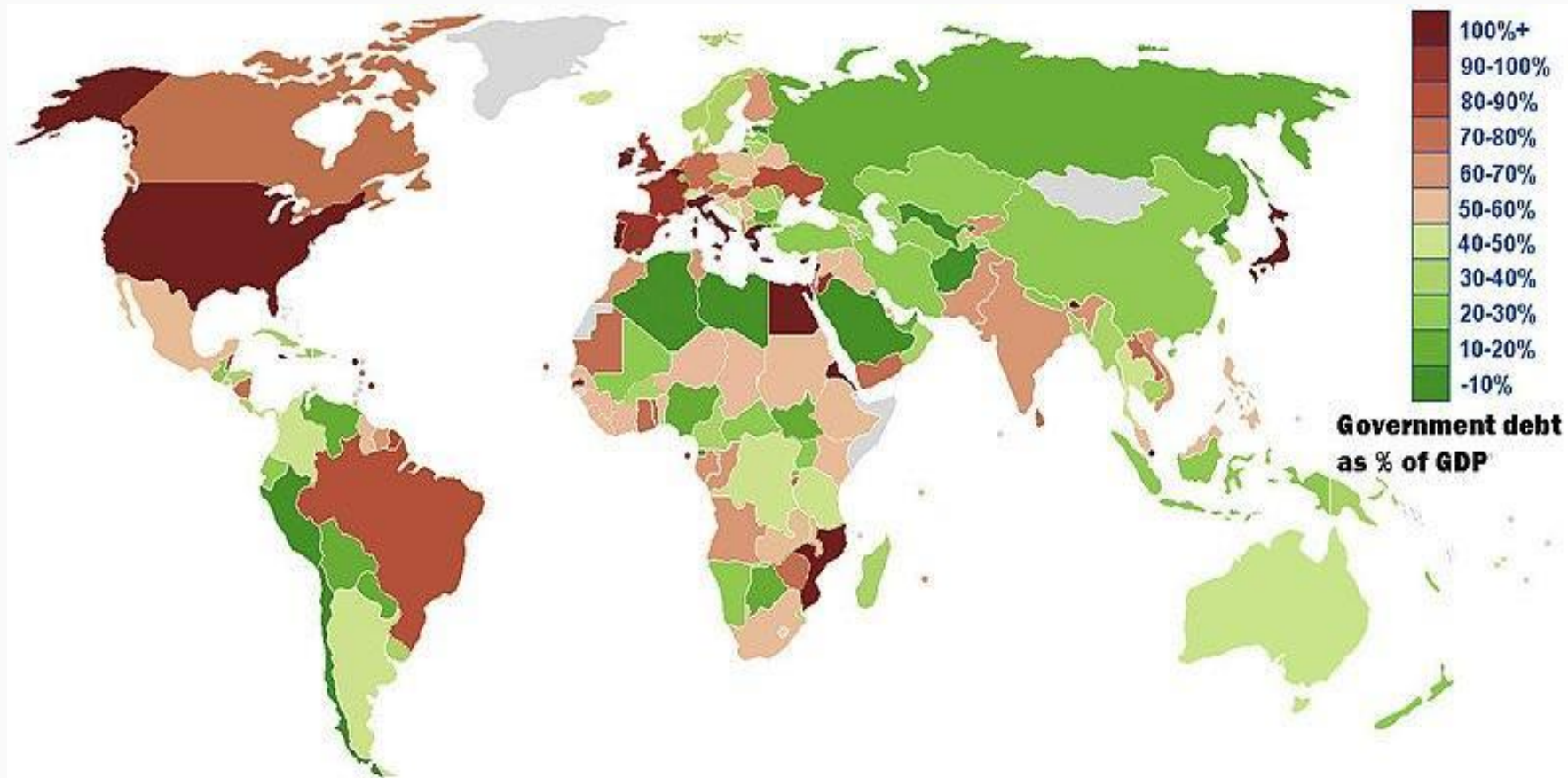
Source: Eurostat

* Source: Ernst & Young using data from Oxford Economics



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After the Financial Crisis

Various solutions done by the government and federal reserve:

- Bailouts
- European Financial Stability Facility
- ECB → purchasing government bonds to help lessen the yields
- Quantitative Easing
- Fiscal authority (Germany and Greece) → lower spending and increase taxes (but reduced government spending means lower economic growth)

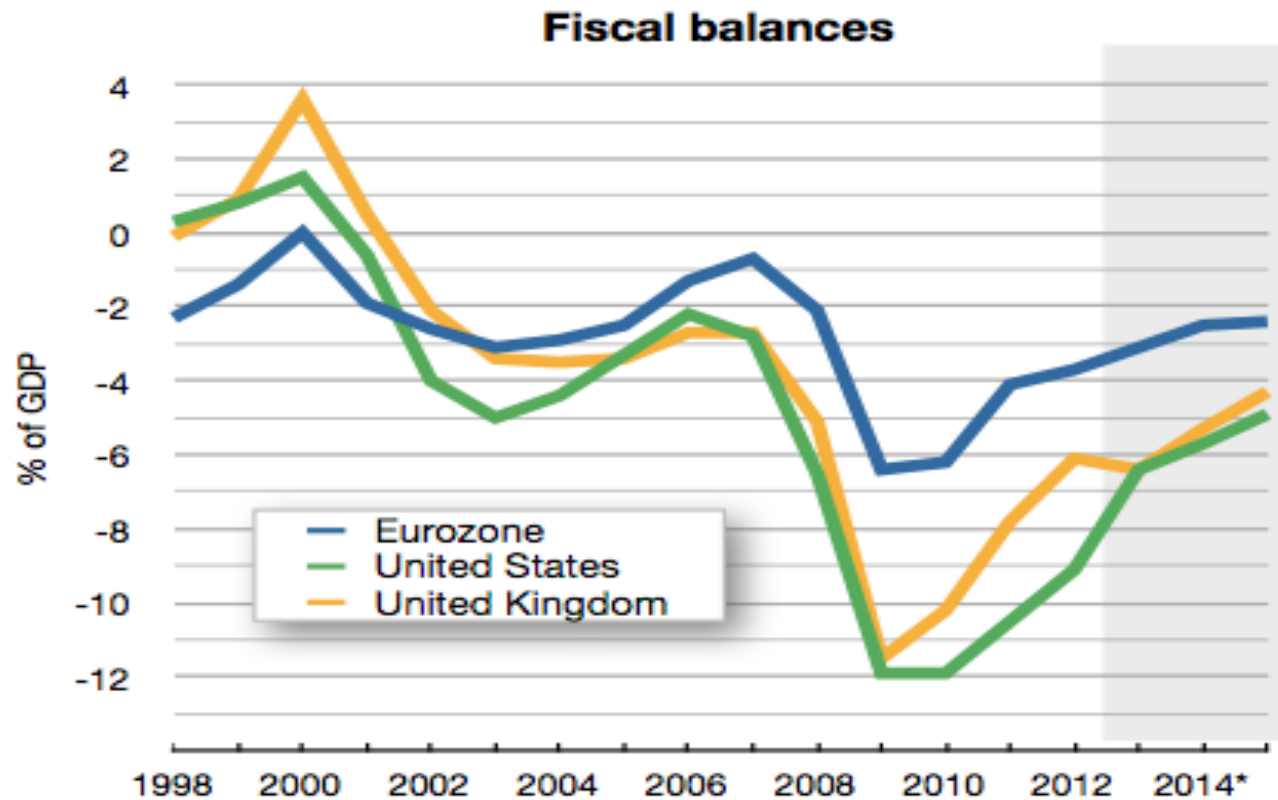
Problem



Problems

- Rising household and government debt levels
- Trade imbalances
- Structural problem of Eurozone system
- Monetary policy inflexibility

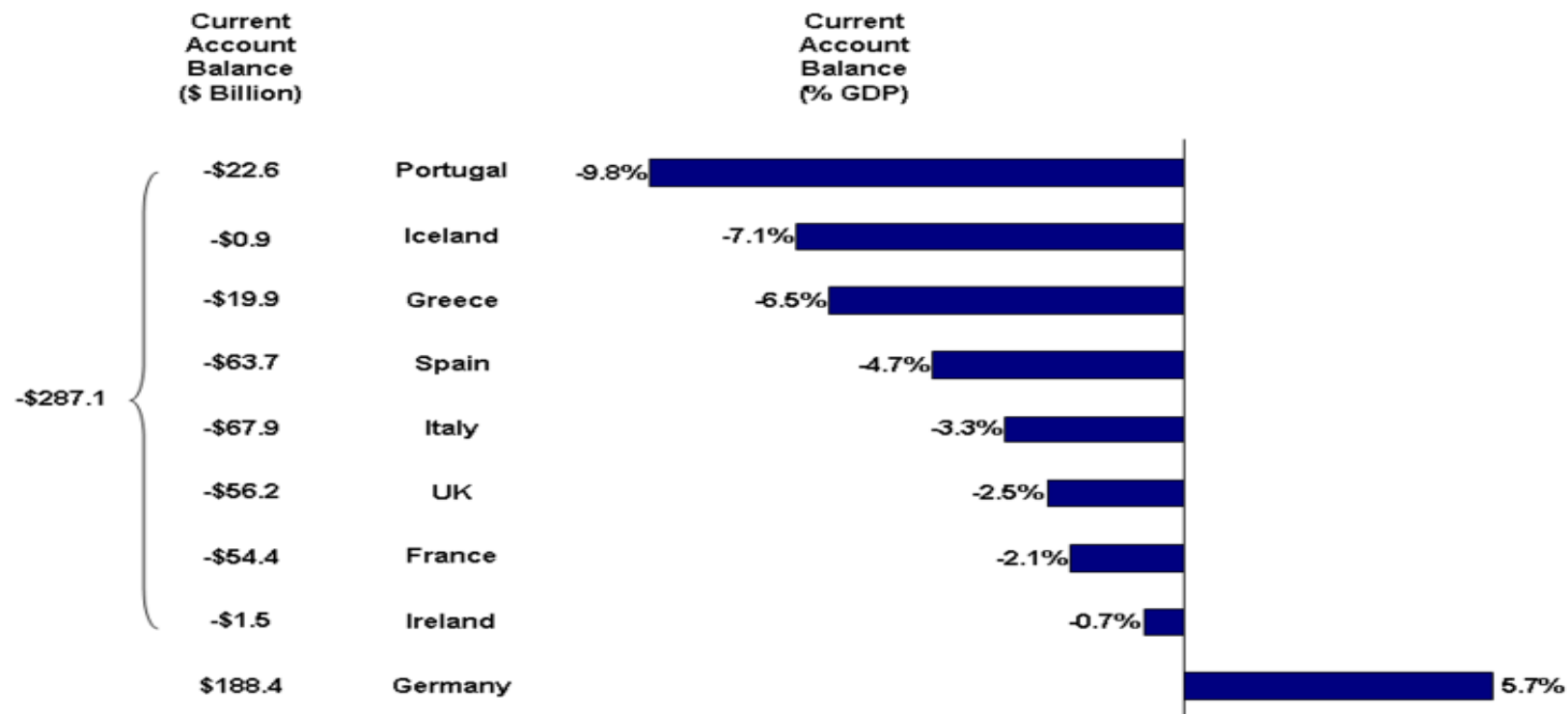
Rising Household and Government Debt Level



Source: Eurostat and OECD

* Eurostat estimates from November 2013

Current Account Balances - 2010



Solutions



1. Give Targets to Gradually Reduce Debts

Stability and Growth Pact (SGP)

"Six-Pack" which were voted in October 2011

Five regulations and one directive approved by all 27 Member States started to be applied on December 13th 2011

1. Give Targets to Gradually Reduce Debts

- Public dept

Debt has to be below (or sufficiently declining towards) 60% of GDP

- Deficit

Deficits has to be below 3% of GDP

1. Give Targets to Gradually Reduce Debts

- What if countries doesn't respect the SGP ?

“excessive deficit procedure” (EDP) → recommendations and deadlines decided by the EU Council to correct their excessive deficit.

Only four respected it in 2011 : Estonia, Finland, Luxembourg and Sweden.

2. Debt Relief (Haircut)

What is “Haircut”?

→the difference between the market value of an asset used as loan collateral and the amount of the loan

→the percentage by which an asset's market value is reduced for the purpose of calculating capital requirement, margin and collateral levels.

→Debt relief

2. Debt Relief (Haircut)

In the event the collateral is sold to repay the loan, the lender will have a higher chance of being made loss.

Why?

→If debtors go bankrupt, then creditors will never get their money back.

→To collect debt safely

2. Debt Relief (Haircut)

Haircut applied to Greece

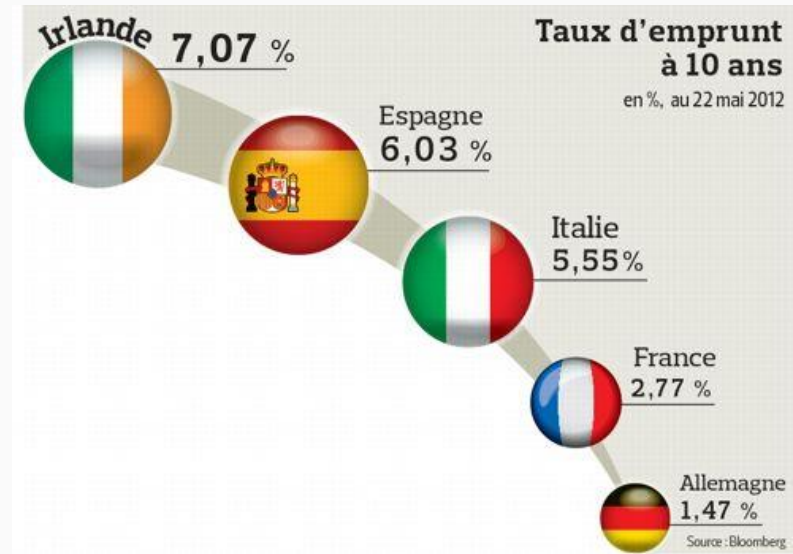
- ① In July 2011, private creditors agreed to a voluntary haircut of 21 percent on their Greek debt.
- ② Angela Merkel, the German chancellor, pushed private creditors to accept a 50 percent loss on their Greek bonds.
- ③ Troika launched the second bailout worth €130 billion.
- ④ In 2014 the outlook for the Greek economy improved.



3. Eurobonds (Neutralization of Debt) Change of Rules

Countries such as Greece or Italy can't get money from Banks because interest are too high for them

If other european countries help them to borrow with less interest, it's easier for them to respect european rules



3. Eurobonds (Neutralization of Debt)

Change of Rules

Problem : Some countries (France, Germany) doesn't agree with this situation because for themselves they borrow with even less interest so it's not a good deal for them

References

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[Reesonomics.eu](#) (eurobonds, the maastricht criteria, and stability pact)