EU debt crisis, out of control?

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Ireland and Greece have a couple of things in common .The word bailout is synonymous with them and their respective governments ignored market risks, falling into a debt trap by continuously financing their debt with even more debt. All this was possible largely due to their Eurozone membership.

In February 1992, the Maastricht Treaty was signed by representatives of twelve EU nations, it was clear that a single currency leading to the Euro was on the cards, signaling greater economic and political union among the euro states. Thus, the euro was born in 1999 and the agenda behind the formation of the euro was to compete with the US.

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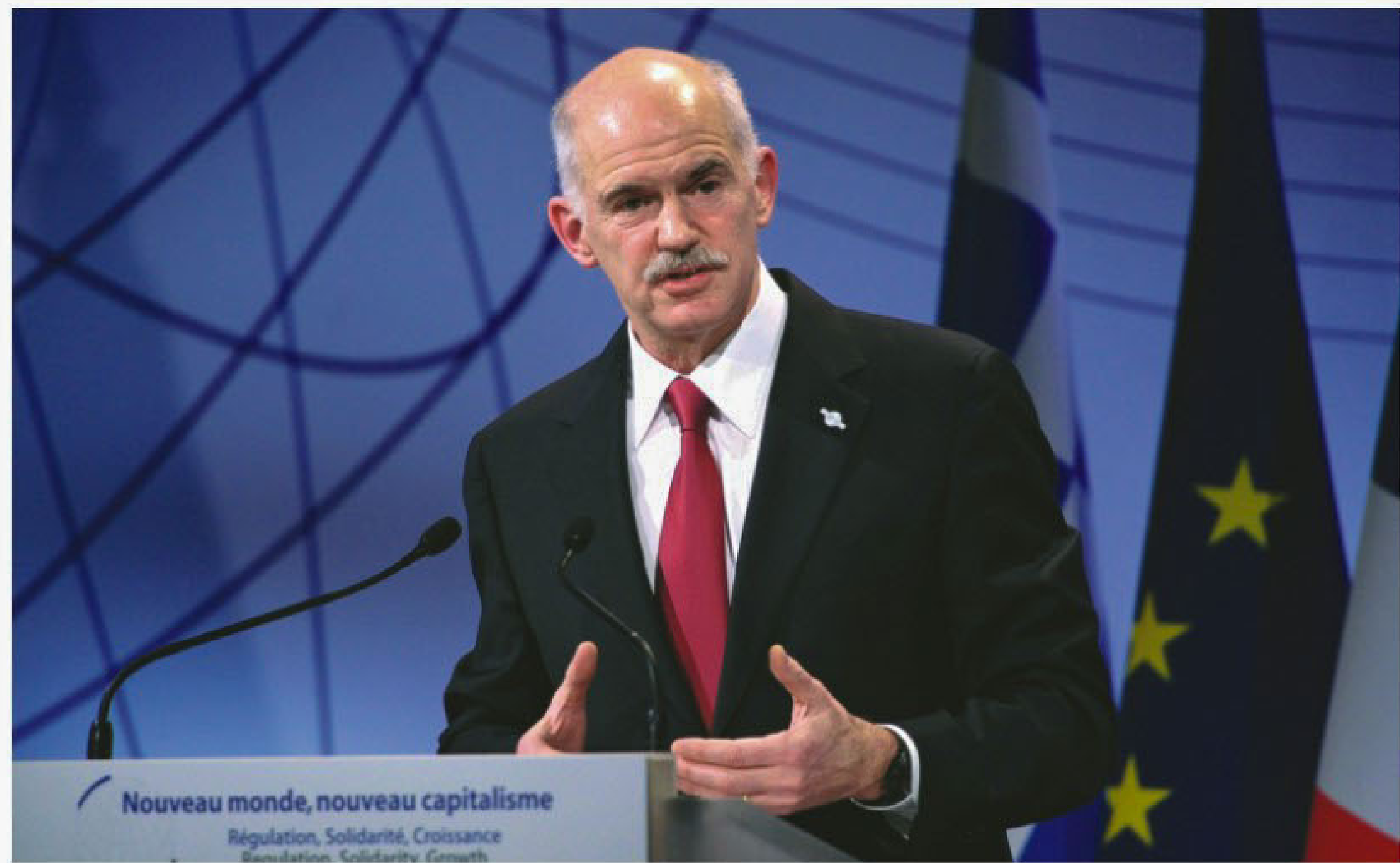
Ten years on, the euro established itself firmly as the second largest reserve currency in the world and was a major contributor to the economic success of the euro states. The eurozone has a combined GDP of $16 trillion, which is higher than that of the US. The idea to establish the EU as the supreme economic powerhouse of the world was not a bad one. The fact that there were many structural imbalances, which the leaders sought to attend to once a problem surfaced, was not a good one either. Exactly a decade later, a major problem has surfaced and the leaders are running for the elusive panacea.

One of the conditions to joining the eurozone, also known as the Maastricht criteria, was to limit the government deficit to 3 percent of GDP.

However, to gain entry into eurozone, Greece tinkered with their finances and forced their way into the EU. This rule was framed so as to ensure that no member had to pay for the debts of another member as laid out in article 125 of the European Treaty. But fast-forward a decade and two countries have had to be bailed out through Germany's deep pockets.

On January 2001, Greeks hailed Greece's entry into the EU as a major milestone in the history of Greece, which would bring in more economic success. And until the major part of the decade, it was a rosy story. Due to the infusion of the euro into the Greek financial system, low interest rates and low bond yields encouraged the Greek government to borrow more and refinance its debt, which was already more than 100 percent to GDP. This populist move kept the pensioners and government workers happy as the deficits continued to widen. Until 2007, Greece recorded high levels of growth and attracted increasing amounts of foreign direct investment.

Then started the downhill climb for Greece when in 2009, it was reported that the economy shrank by close to 2 percent and actual budget deficit was 12.6 percent, twice the forecasted number. As 2009 was nearing its end, Fitch and S&P downgraded their ratings on Greek bonds leading to a spike in borrowing costs. To make matters worse, in early 2010, it was revealed that Greece had paid large sums of money to Goldman Sachs and other financial institutions to shield themselves from EU observers



AFP

Greece's Prime Minister Georges Papandreou speaks during the opening session of the third symposium "New World, New Capitalism" on January 6 in Paris. Papandreou pleads for the creation of euro bonds.

about their real level of debts. Yields on Greek bonds rose astronomically as S&P downgraded the bonds to "junk" status and investors started to lose confidence in the entire eurozone countries.

Thus, to restore confidence among investors, Germany made inroads into its wallet and Greece was not allowed to default after EU pumped in 45 billion euros in loans into the Greek economy.

After the Greek bailout, the EU feared the worst as the sovereign debt crisis spread to other countries in the eurozone. Ireland, with a high level of borrowing and double digit deficit of 14 percent to GDP respectively, was next in line to default. Due to the low corporate tax rate, companies started flocking in huge numbers as the Irish economy was labeled as the 'Celtic Tiger during its heydays. Ireland's woes started when the Irish government financed their debt by borrowing from their EU member states as the Irish economy slipped into recession in the middle of 2008. The recession led to a drastic cut in Irish government's revenues as lenders, mainly British banks, started to compel the Irish government to increase taxes to avoid default of their loans.

While the British banks lent money to the Irish government, the Irish banks in turn borrowed and disbursed those loans to its EU member states, thus plaguing its neighbours with toxic loans. This, apart from the property bubble, weakened the Irish banking system and the economy as a whole. As a result of waning investor confidence, interest rates inched up further, increasing fears of a crippling Irish economy. In November last year, the EU decided to drive in a 85 billion euro package to renew confidence in the euro currency.

In the year 2010, as the euro fell to new lows and bond yields went the opposite direction, the EU and investors alike are pondering over who will be next in line to receive the bailout in 2011.

Although Greece and Ireland make up roughly about 5 percent of Eurozone's GDP, contagion fears that the debt crisis would spread to countries like Spain is making the EU nervous. Spain is the fifth largest country in the EU and roughly makes up 13 percent of eurozone's GDP. While unemployment levels of EU stands at roughly 10 percent, Spain's unemployment rate is at a staggering 20 percent. Although the euro has fallen to record lows, Spain's stands little to gain as more than 80 percent of its exports go to the eurozone members. With the European Financial Stability Facility worth 440 billion euro allocated by the EU, Spain's requirements might not be met, given its debt size.

As the process of unveiling the euro was taking place, policymakers knew that while the currency would be under the control of the European Central Bank (ECB), doubts remained about how the wider monetary policy could be exercised for the eurozone.

Had there been a single authority dictating taxes and spending issues with stricter control over minimum regulations as laid down in the European Treaty, a debt crisis endangering the survival of the euro itself could have been averted. For even the government deficit of 3 ECB to GDP was surpassed 97 times by EU member countries.

This eventually had led to a new set of reforms, imposing severe austerity measures to cut down spending and increasing tax rates, much to the displeasure of the common man. It now remains to be seen whether Milton Friedman who had predicted that the euro would collapse after a major recession would come true or not.

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ANALYSIS

Rising food prices bring host of political risks around the world

REUTERS, *London*

Record food prices will hit the world's poorest hardest, raising the risk of riots, export bans, foreign-owned farmland expropriation and further price spikes fuelled by short-term investors. The UN Food and Agriculture Organisation said food prices hit a record high in December and could rise further on erratic global weather patterns. For the first time they outstripped levels reached in early 2008, when spiralling prices prompted riots in countries including Haiti, Egypt and Cameroon and brought demands for tighter commodity market regulation.

The potential humanitarian, political and business impact -- particularly in impoverished states where food makes up the largest component of the inflation basket -- is already alarming policymakers and senior officials.

"Food price increases impact the poor hardest as food is a higher proportion of their incomes," said James Bond, chief operating officer of the World Bank's political risk insurance arm the Multilateral Investment Guarantee Agency (MIGA).

"It creates significant tension in poorer countries, exacerbates standard of living disparities and is a major source of unrest."

The 2008 price spike came to an abrupt end in September that year with the global crash that followed the demise of Lehman Brothers, sucking borrowed money out of markets as lenders called in their debts.

But right now, no one expects that to happen again.

So far, experts say weather-related supply shocks -- floods in Australia, drought in Argentina, dry weather and fires in Russia and potentially crop damaging frosts in Europe and North America -- were largely to blame. But they worry politics and markets could soon take over to produce a vicious circle.

"The danger is that what happens now is that you get a second shock as countries can respond by imposing export bans and financial markets investors pile in for short-term investment, pushing prices much higher, as they did in 2008," said Maximo Torero, divisional director for markets, trade and institutions at Washington DC's International Food Policy Research Institute (IFPRI).

Russia imposed export restrictions last year after fires and drought. In 2008, IFPRI says at least 13 countries including Argentina, Cambodia, Kazakhstan, China, Ethiopian, Malaysia and Zambia imposed either export bans or taxes, further squeezing supply.

POLITICAL RISK INSURERS WATCH

Torero said reports of unrest could further fuel price rises, driving speculative investment and promoting panic buying -- even if the causes might often in reality be more complex.

He pointed to reported food riots last year in Mozambique as an example, saying in reality they were as much about subsidy cuts as supply issues.

"Clearly what is needed is to increase production through appropriate investment in agriculture, to increase the information on stocks around the world, strengthen the regulation of the futures markets and to have safety net mechanisms to protect the poorest consumers," he said.

Political risk insurers, who provide protection against dangers such as confiscation or political violence, are watching closely -- although they say there has not yet been any direct impact on premiums.

"The potential is there for food riots and also for governments to take action such as embargos on food exports or nationalisation of assets involved in food production or storage in order to protect their people -- not always necessarily for the sake of altruism but often to preserve their position as governments in office," said a senior underwriter in the London political risk insurance market.

The highest risks of farmland expropriation remain in Latin America, insurers say -- particularly Venezuela, Bolivia and Ecuador -- but this is more down to local political factors than rising prices. The greatest impact of the recent rally could be on land deals in Africa, some suggest.

UN food price index

Calculated from price changes in meat, dairies cereals, oil and sugar

2002-2004 = 100

Source: UNFAO

AFP

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AFP

A farmer tends his cauliflower patch near Kolkata on January 7. India's food price inflation has touched a five-month high, fuelled by surging vegetable prices.

The 2008 spike produced a flurry of interest in farmland purchases both from Western funds and richer emerging countries such as China and Gulf states keen to preserve their supplies.

While some deals fell through after the crash, others are now entering production. But they have proved controversial. Local anger over the purchase of Madagascan farmland by South Korean firm Daewoo was seen by some as a contributing factor in the island's 2009 coup.

"The main risks will come where they are in an area where the population is short of food themselves and the deal is seen as being in some way inappropriately negotiated," said Jonathan Wood, global issues analyst at Control Risks. "So many of these projects are in East Africa: Ethiopia, Kenya, Tanzania. But a lot will depend on the individual deal."

Some investors such as London-based funds Emergent Asset Management and Chayton Capital say a key part of their strategy has been to ensure such projects clearly benefit the local community, for example through local milling.

"Smart investors don't own the land," said Bond at the World Bank's MIGA. "They work with contract farmers and see the domestic market as their first and most important market. It makes sense from a risk mitigation strategy."