The European debt crisis: implications for Asia and the Pacific

Asia-Pacific economies are increasingly concerned about the impact of the public debt crisis in a number of European economies. In recent months, the scale of public debt in Greece in particular, but also in Ireland, Portugal and Spain, has led to credit downgrades and increases in the debt servicing costs of those countries. In response, their Governments have pledged to close their fiscal deficits and decrease their levels of debt in the coming years through stringent programmes of budget cuts, as affirmed recently by the G-20. Further compounding the fiscal gap are ageing societies and decades-old weak economic growth which will require additional resources as well as leading to declining tax proceeds. Consequently, the global financial markets have yet to be convinced that the affected countries will be able to reduce budget deficits sufficiently to lower public debt to the level required. The worst-case scenario of sovereign debt defaults in one or more European countries at some point remains a concern.

For Asia-Pacific economies, two questions arise:

(a) To what degree will these difficulties translate into reduced growth prospects as the region continues its V-shaped recovery from the global economic crisis? While some impact on Asia-Pacific is inevitable given the global linkages of economies in this region, it is important to establish whether the impact will be restricted to a limited moderating of their otherwise robust ongoing recovery, or whether the impact will threaten a downturn in Asia-Pacific akin to a double-dip recession;

(b) As the crisis has exposed policy tensions inherent to the European integration process, how will the Asia-Pacific region evolve its exchange rate and fiscal policy coordination?

I. Impact of the crisis

There are three key channels through which the impact of the European debt crisis is likely to spill over into the Asia-Pacific region. The first is the impact on the cost of sovereign debt financing for Asia-Pacific economies. The second is the trade channel, driven by the effect of reduced growth in some European countries on import demand for Asia-Pacific goods and services. The third is the impact of the debt crisis on the global financial sector, and the consequent effect on the provision of credit to the regional banking and private sectors.

Public debt financing in Asia and the Pacific less at risk

The most immediate pressure point for European Governments with public debt pressures will come from the financing of upcoming debt issues. Global financial markets are pricing in the risk of default, with yield spreads on sovereign debt rising up to and even beyond the levels last seen during the subprime crisis in some countries (see figure 1). The countries most affected have been those with persistently large public debt stocks as a proportion of their economies, high budget deficits, and consequently profligate public spending. In an effort to allay future questions of debt sustainability, these countries are also committing to sizeable deficit reduction programmes in the coming years.

Sources: ESCAP analysis based on data from EIU online, accessed on 10 June 2010; and OECDStat Extracts.

1 In the Toronto Summit Declaration of 27 June 2010, the G-20 state that “…recent events highlight the importance of sustainable public finances and the need for our countries to put in place credible, properly phased and growth-friendly plans to deliver fiscal sustainability, differentiated for and tailored to national circumstances”, available online at http://www.g20.org/Documents/g20_declaration_en.pdf.
The risk for Asia-Pacific Governments lies in the possibility that financial markets might harbour similar concerns about their management of public debt. This would manifest itself in similar increases in the funding cost of new sovereign debt issuance. Such a situation would not only increase the budgetary impact to governments of new debt issuance, it would also increase the private sector’s cost of issuing debt. This crowding out effect is due to the fact that interest rates on private sector debts are usually set on the basis of a risk premium over and above that of the economy’s sovereign bond rates.

However, as it appears, the European debt crisis remains contained. No evidence of “herding” has emerged, suggesting that financial markets are adopting an increasingly sophisticated and differentiated view of global emerging economies. The spread on credit default swaps for Asian sovereign bonds, the cost to insure against default on such bonds, has remained fairly steady and is far below the levels seen during the subprime crisis (figure 2). This means that the markets currently do not view significant risks for sovereign debt issued from the region.

The financial markets are not penalizing Asia and the Pacific debt because they recognize that the macroeconomic fundamentals of Asia-Pacific economies are better than those of Europe. Public finances and budget deficits in major developing economies across Asia and the Pacific are generally in a healthier state than in European countries (see figure 3). Perceptions of a number of the Asia-Pacific economies that display relatively high levels of public debt as a share of GDP—Japan, India and Singapore—are better as the debt is mainly issued to local investors (such as government pension or social security funds) and in local currency. In the case of Japan, the Government’s debt is backed by its vast assets, which has an additional mitigating effect.

Higher GDP growth for Asia-Pacific economies provides them with comparatively higher tax receipts while, at the same time, lower expenditure is required to support the economy; therefore there will be greater leeway to reduce the stock of public debt in coming years. Current GDP growth forecasts for European economies already include the impact of expected public debt reduction measures; however, these measures may have to be intensified in the coming months as the impact of the debt crisis increases, implying that GDP growth forecasts for these economies will be revised downwards.

Trade impact on Asia and the Pacific is contained

The measures being taken by affected European economies to decrease their public debt levels are likely to constrain GDP growth rates in the coming years. Governments are attempting to reduce their spending across a broad range of public sector services, including the salaries of civil service workers, which will shrink aggregate demand, with an overall effect on import demand levels. The impact on import demand may be greater than the perceived impact of the slowdown in countries’ GDP growth. This is because a corollary to the debt difficulties of Europe has been a depreciation of the euro, which will make imports more expensive. Furthermore, the major European economies, the EU-15, are an important source of import demand for Asia-Pacific developing economies, accounting for 14.4 per cent of total exports in 2009 (see figure 5). Indeed, the EU-15 ranks as the second most important extraregional export market for these Asia-Pacific economies, only marginally behind the United States, which accounted for 14.6 per cent of total export demand in 2009. Until 2008, the relative importance of the EU-15 had been growing, as the share of exports to the United States had been on a downward trend, whereas the share of exports to the EU-15 had held relatively steady.

Furthermore, even though a weaker European currency should increase exports and help the recovery of affected members of the euro zone, the effects are not likely to substantially support their import demand from Asia and the Pacific in the immediate future, as exchange rate cost advantages typically have one-off effects, and exports from the European Union do not depend significantly on Asia-Pacific inputs of goods and services.

Notwithstanding the above, it is important to recognize that, to date, the crisis has been contained within the small European countries, and that it is only these countries that are having to rein in budget deficits the hardest. Greece, Portugal and Ireland together account for just over 5 per cent of euro zone GDP, and even with Spain, which accounts for 11.7 per cent included, their total contribution to euro zone GDP is less than 20 per cent. Second, higher receipts from tourism and foreign direct investment will have a stabilizing effect on euro zone GDP. The European Commission forecasts GDP growth at 0.9 per cent for the euro zone in 2010, which, although markedly lower than forecasts of 3.1 per cent for the United States, does not differ widely in absolute terms from the growth levels of previous years, averaging 1.7 per cent over the pre-crisis period 2002-2006. Indeed, the relatively low level of recent and upcoming growth in the euro zone means that, while the euro zone provides a large and steady source of demand, the euro zone is not an important growth driver for Asia-Pacific exports.

In contrast, the exports of Asia-Pacific developing countries have continued to be bolstered by robust demand from within the region. Intraregional exports account for 39.5 per cent of their exports, by far the largest share of total exports (see figure 5). Some of these exports remain linked to demand in developed countries, as they reflect intraregional exports as part of intercountry production networks supplying final demand in the European Union and the United States. However, even accounting for such exports, intraregional exports supplying final demand in Asia and the Pacific are still a very large proportion of total exports. Discounting exports to China, the major recipient of inputs from the region for processing and onward export to supply final demand in developed Asia-Pacific economies, provides an important growth driver for Asia-Pacific exports.

Figure 5. Share of developing ESCAP exports to main trading partners, as a percentage of developing ESCAP total exports

Source: ESCAP analysis, based on IMF Direction of Trade Statistics (DOTS).
Notes: The scale on the left side shows the percentages for exports of developing ESCAP countries to China (the dark-coloured bars) and other developing ESCAP countries (shown by the light-coloured bars). The scale on right side shows percentages for developing ESCAP exports to the United States and the EU-15.

3 The EU-15 comprises Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and the United Kingdom of Great Britain and Northern Ireland.
4 The euro zone comprises 16 countries, namely the EU-15 (minus Denmark, Sweden and the United Kingdom), Cyprus, Malta, Slovakia and Slovenia.
countries, intraregional exports still account for 28.1 per cent of total exports (see figure 5). Furthermore this figure may be taken as a lower bound as an estimate of true regional final demand, as a substantial proportion of exports to China are also to supply the sizeable and growing final demand of the domestic economy.

Overall, the debt crisis in European countries remains worrisome and will have an impact on Asia-Pacific exports, but this will be somewhat offset by demand from the United States and from within Asia and the Pacific. The more pressing concern for growth in this region is the possibility that the debt crisis will spill over to the rest of the European Union and the global economy through the financial channel.

The risk of return of financial contagion

Contagion would spark off another seizure in global inter-bank lending arising from the uncertainty regarding the extent to which banks in developed countries hold affected sovereign bonds and the possibility of losses through default on some of these bonds. It is not clear whether affected banks in developed countries will be able to maintain their commitments in the face of losses on sovereign bond holdings, which may lead other banks to refrain from lending to them. Similarly, affected banks would themselves be less able to lend to other banks due to provisioning for losses on sovereign bond holdings.

Figure 6. Daily three-month United States dollar LIBOR interest rates, 2 June 2008 to 2 June 2010

Source: Based on data from CEIC Data Company Limited (accessed 3 June 2010).

The reluctance of banks to engage in interbank lending has been seen in recent months in the rising value of the London Interbank Offered Rate (LIBOR), a measure of the perceived risk in lending money between banks (see figure 6). The three-month dollar LIBOR has risen to its highest levels since August 2009, while euro LIBOR is at its highest levels since January 2010.

Nevertheless, international concerns at present do not approach those at the height of the subprime crisis, when LIBOR rates were close to ten times their current levels.

The probability that banks’ survival will be jeopardized to the degree that they were during the subprime crisis are currently regarded by the financial markets as being lower. This is because the sovereign bond market does not represent as large a share of the European economy as did subprime investments in the United States economy, and because the observable holdings of affected sovereign bonds by key banks do not appear to be as large in relation to their total investments as were subprime-related products. However, during the subprime crisis, investments held off balance sheets were eventually revealed and had to be accounted for. The risk, therefore, is that the scale of investments in sovereign-bond-related products will be underestimated and that the full range of transmission mechanisms through which these products could spread contagion between financial institutions will not be recognized until it is too late.

Figure 7. Loan to deposit ratio of selected developing ESCAP economies, latest available data

Source: ESCAP staff estimation based on data from CEIC Company Limited; IMF 2009 Article IV Consultation (for Kazakhstan); and Bank of Thailand (for Thailand, accessed 22 June 2010).

Notes: Data for Kazakhstan and the Philippines refer to April 2009. Data for Indonesia refer to May 2009. Data for India and the Philippines refer to Q4 2009. Data for India refer to credit to the deposit ratio of scheduled commercial banks. Data for Thailand refer to all commercial banks as at March 2010.

The impact of a credit crunch arising from the debt crisis has the potential to affect the financial sector in parts of Asia and the Pacific. As Asia-Pacific banks are not believed to have significant holdings of European sovereign debt products, they are not considered to be at significant direct risk from the debt crisis. The financial sector is more at risk indirectly through exposure to any global credit crunch. While the banking sector in most of the region is healthy at the domestic level, in some economies it is exposed to global shocks due to dependence on loans from abroad. In a number of economies, banks are carrying loans that exceed domestic deposits (see figure 7), necessitating wholesale funding from foreign banks. As with the subprime crisis, banking operations in such cases have the potential to be disrupted by an international credit crunch during which affected banks in other regions are unwilling or unable to engage in inter-bank lending. The external public debt of countries

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7 See, for example, Financial Times, “Goldman asks, is sovereign strain Europe’s subprime?” 12 February 2010 (available online at http://ftalphaville.ft.com/blog/2010/02/12/148051/is-sovereign-strain-europes-subprime/).

could be similarly impacted, although such debt does not represent a large share of total public debt for most economies in the region.

There may also be an impact on asset markets in the region, as affected financial institutions in developed countries withdraw from portfolio investments in Asia and the Pacific in an attempt to cash in on profitable investments to offset losses sustained during the debt crisis, and a return to traditional safe haven investments—a “flight to safety”. Similarly, there could be an impact on foreign direct investment to the region if European companies cope with losses in their home markets by shelving investment plans in Asia and the Pacific. Nevertheless, both portfolio and direct investment in the region have proved fairly resilient to such home market pressures and may indeed become more attractive options for investors, given the favourable comparative growth prospects of Asia and the Pacific.

Asia and the Pacific needs to maintain support measures

While the Asia-Pacific region at present has not been affected to a substantial degree by the spillover from the European debt crisis, there remains cause for considerable concern, as the crisis has the potential to worsen in the coming months, thus leading to possibly greater contagion.

In this climate of uncertainty, policymakers in the region should adopt measures to protect themselves against contagion from the debt crisis. These measures will be most applicable not only to those economies that are exposed through foreign trade or external financing needs, but also those that may experience excessive interest by the international investment community in the form of large inflows of speculative capital. Those economies could experience overheating asset markets and currency appreciation pressures on their exports.

• Governments that are at risk of sharp withdrawals of external financing and a credit crunch should maintain channels for rapid liquidity support to their financial sectors in the case of a financial shock from abroad. These channels, which were established in the wake of the subprime crisis, are currently being wound up in response to the region’s rapid growth recovery in recent months.

• Those economies that are under pressure from excessive capital inflows should implement selective capital controls. Such controls would serve to manage the problem at its source, a better option than the current second-best solution of managing currency appreciation through a costly accumulation of reserves. The measures implemented by Indonesia and the Republic of Korea, for example, are worthy of further study.

• Due to the range of threats to growth arising from the debt crisis, policymakers in vulnerable Asia-Pacific economies should maintain their bias towards stimulus policies, despite the accompanying risks associated with debt accumulation, inflation and rising asset prices. The global economy is once again in the midst of an unpredictable cross-country crisis with the risk of significant instabilities.

II. Systemic implications for macroeconomic coordination in Asia and the Pacific

The global crisis, and subsequently the European debt crisis, continue to strengthen the region’s resolve to search for new sources of economic growth from within. To achieve this, the political will to boost regional economic integration through, inter alia, enhanced macroeconomic policy coordination, has gained momentum. In this regard, coordination on fiscal spending and exchange rate management are two key areas in which policymakers agree that policy action will be needed in future. Indeed, the pros and cons of a coordinated currency management system9 have been heavily debated for quite some time, a key concern being the need to avoid competitive devaluations of currencies in the region as a means of boosting trade during downturns.

In parallel, the integration of the European economic community and the birth in 1999 of its common currency, the euro, as the most visible manifestation of a European Union, and now its debt crisis have all provided Asia-Pacific policymakers with a fascinating study of what is an extraordinary experiment in regional governance and common policymaking.

What might be some of the immediate policy implications for Asia and the Pacific arising from the European debt crisis and its common currency? Or, put differently, can currency unification function without organized fiscal coordination among countries sharing the same currency? Going further, can fiscal coordination exist without political union? To what extent do monetary goals need to be balanced with fiscal policy to ensure the desired direction of a region’s macroeconomy? As the debt crisis evolves and continues to challenge the very future of the euro, these questions remain as vexing to European policymakers as they were a decade ago. While it is beyond the scope of this particular policy brief to address these issues in depth, there are a few key points that are of importance to the Asia-Pacific region:

(a) The debt crisis and subsequent decline in the value of the euro, nearly 15 per cent this year, revealed the tensions inherent in a monetary policy that is centralized by the European Central Bank—statutorily the most politically independent central bank in the world—and a fiscal policy that remains decentralized at the national level and is therefore much more politicized;

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9 It is interesting to note that, as early as the 1970s, the secretariat of ESCAP was requested to conduct the first feasibility study on setting up an Asian Central Bank.
(b) The crisis also revealed that the European Stability and Growth Act,\(^\text{10}\) which was designed precisely to overcome the disconnect identified above, is, despite its convergence criteria rules, too blunt an instrument, particularly in times of severe recession, to ensure stability in the Union. As of today, the fiscal deficit in the euro area stands at -7 per cent;

(c) Instead, a deeper, shared fiscal governance system carries with it the distinct advantage of enabling automatic stabilizers to transfer fiscal resources from one area to another, without acrimonious debates over how to distribute resources from one country to another. However, the extent to which countries must relinquish sovereignty in matters of taxation and spending has made this perhaps the most politically contested aspect of economic governance in the European Union and would suggest that any form of fiscal federalism in future may be politically untenable;

(d) Historically, most currency unifications or monetary unions that were not accompanied by fiscal and political unions folded\(^\text{11}\) when exogenous shocks hit. Currency union member countries should therefore share an understanding of how to deal with shocks and, when national interests give rise to conflicts, these costs should be accepted in the name of solidarity;

(e) Politically, a shared monetary policy is more palatable during a downturn if there is a shared federal fiscal system in place.

In charting its way forward, the Asia-Pacific region will necessarily evolve its own forms of policy coordination while drawing on the lessons and experiences emerging from the European Union. At this point, the European crisis underlines the need for policy coordination over exchange rates to move in parallel with some form of fiscal policy cooperation and deep political will to maintain solidarity in the face of what could otherwise be untenable disconnects.

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\(^{10}\) The Act defines the conditions and levels at which deficits and public debts (-3% and 60% of GDP, respectively) may be subject to corrections and the sanctions and penalties that would prevail on non-compliant members of the European Union.

\(^{11}\) Examples include experiments in monetary cooperation of the 1800s, for example, the Latin Monetary Union, the Scandinavian Monetary Union, and the more successful Zollverein (the Customs Union encompassing the German Federation, Prussia and Austria for a short while), which could be viewed as the precursor to modern monetary coordination, and the East African Currency Area.