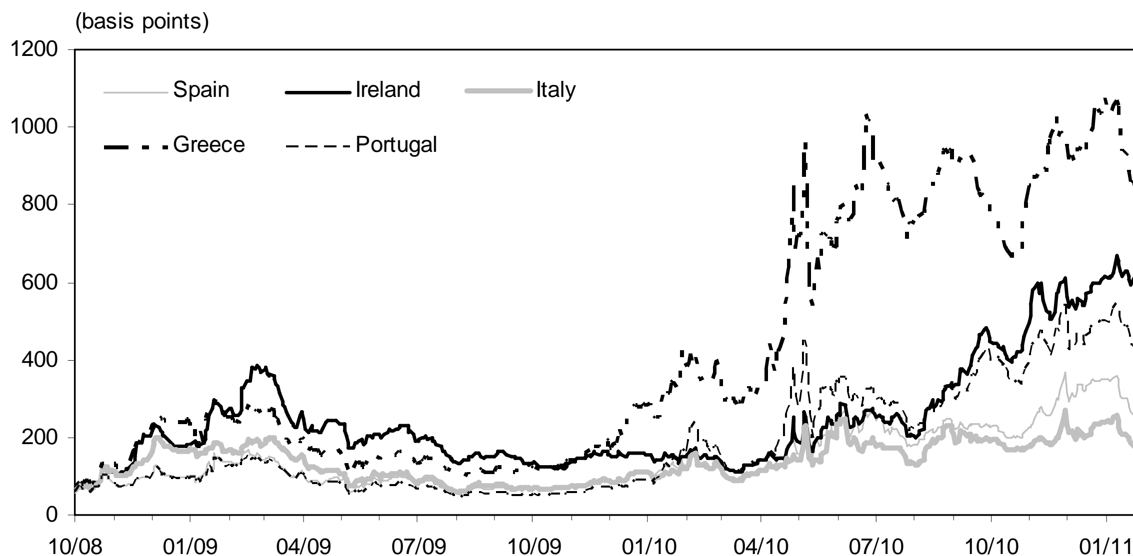
Box 2.2

An update on the European sovereign debt situation

The European sovereign debt problem subsided for a brief period following the €110 billion package of emergency loans jointly provided by the European Union (EU) and International Monetary Fund (IMF) to Greece and the set-up of a €750 billion European Financial Stability Facility (EFSF) backed by the IMF, the EU and the European Central Bank (ECB) in May 2010 (See ***Box 1.1*** of the ***Half-yearly Economic Report 2010*** for earlier developments). However, the problem came into the limelight again in late September 2010, when Ireland's government finance was saddled by its banking sector, and market concerns soon spread to other highly-indebted eurozone economies. In late November, Ireland officially requested international financial aid and subsequently secured a €85 billion rescue package. Yet bond yields widened across Ireland, Italy, Portugal and Spain (collectively known as "PIIGS" together with Greece) (***Chart 1***). This was followed by a fresh spate of credit rating actions in December, when the sovereign ratings of Ireland, Portugal and Hungary were downgraded and Belgium placed on negative watch (***Table 1***).

Chart 1: CDS spreads on PIIGS soared again in late 2010, exceeding the highs in April-June 2010



In response, the ECB decided to extend its remaining nonstandard liquidity measures until at least mid-April 2011, and continued its bond buying to relieve the pressure on indebted countries' funding costs. Between May 2010 and December 2010, the ECB had bought €73.5 billion of European debt. In mid-December, the ECB said it would nearly double its capital base to €10.76 billion, indicating that the ECB was prepared to cushion against potential losses from its bond purchase. In addition, EU leaders agreed to create a permanent European Stability Mechanism (ESM) after the expiry of the current emergency rescue fund in 2013.

Box 2.2 (Cont'd)

Table 1 : Summary of more recent credit rating actions

	Date	Actions by rating agency
Portugal	21 Dec 2010	Moody's changed outlook to negative; rating kept at A1
	30 Nov 2010	Downgraded by S&P to A- from A+, outlook negative
	23 Dec 2010	Downgraded by Fitch to A+ from AA-, outlook negative
Ireland	17 Dec 2010	Downgraded by Moody's to Baa1 from Aa2, outlook negative
	23 Nov 2010	Downgraded by S&P to A from AA-, outlook negative
	2 Feb 2011	Downgraded by S&P to A- from A, outlook negative
	9 Dec 2010	Downgraded by Fitch to BBB+ from A+
Greece	16 Dec 2010	Moody's changed outlook to negative; rating kept at Ba1
	2 Dec 2010	S&P changed outlook to negative; rating kept at BB+
	14 Jan 2011	Downgraded by Fitch to BB+ from BBB-, outlook negative
Spain	15 Dec 2010	Moody's changed outlook to negative; rating kept at Aa1
	1 Feb 2011	S&P reaffirmed AA rating and maintained outlook negative
Hungary	6 Dec 2010	Downgraded by Moody's to Baa3 from Baa1, outlook negative
	23 Dec 2010	Downgraded by Fitch to BBB from BBB+, outlook negative
Belgium	14 Dec 2010	S&P changed outlook to negative; rating kept at AA+

While the rescue measures provide liquidity in times of need, the markets are concerned if they can fundamentally address the issue of solvency. Ultimately, whether a country can remain solvent hinges on its ability to repay or roll over its debt, and this would in turn depend on its growth prospects, debt profile, and cost of funding. Many economies across Europe have put in austerity measures to slash their deficits and reduce debt. Yet their growth outlooks remain uncertain. Although the eurozone saw strong growth in the second quarter of 2010, at a seasonally adjusted quarter-to-quarter rate of 1.0%, growth moderated to 0.3% each in the third and fourth quarters, and much of it was driven by the core members, i.e. Germany and France, while some highly indebted peripherals, including PIIGS, saw meagre growth and even continued contraction. Thus it calls into question whether the peripheral economies can generate sufficient income to cover their debt over the longer term (***Table 2***). Their governments are trying to implement structural reforms to improve competitiveness, but this would take time to bear fruits and is also likely to meet with resistance from the affected social groups and stakeholders. Meanwhile, the costs of borrowing for these countries to service their debts remain high as evidenced by the elevated CDS spreads.

Box 2.2 (Cont'd)

Table 2 : Growth and fiscal liability indicators for the PIIGS economies

	Growth projection for 2011[#]	Government debt maturing by 2011[@]	Fiscal balance as % of GDP in 2009*	Government gross debt as % of GDP	
				2009*	2015(*F*)[^]
		(€bn)	(%)	(%)	(%)
Eurozone 16	1.5	n.a.	-6.3	79.2	n.a.
Portugal	0.0	33.1	-9.3	76.1	97.8
Italy	1.0	359.6	-5.3	116.0	118.8
Ireland	2.3	15.0	-14.4	65.5	113.9
Greece	-2.6	51.6	-15.4	126.8	133.9
Spain	0.6	159.5	-11.1	53.2	82.0
Hungary	2.0	29.6	-4.4	78.4	82.5
Belgium	1.7	83.1	-6.0	96.2	108.2

Notes: (#) Data for eurozone, Italy and Spain sourced from IMF's *World Economic Outlook Update*, January 2011; others from *World Economic Outlook*, October 2010.
(@) Sourced from Bloomberg.
(*) Sourced from Eurostat.
(^) Sourced from IMF's *Fiscal Monitor*, November 2010.
n.a. Not available.

The markets are also closely watching if the eurozone member economies will agree on the details of ESM, establishing viable mechanisms to impose fiscal discipline on member economies and also to deal with fiscal and financial crises within the eurozone in future. Reportedly, there is notable division among the eurozone members. Specifically, the financially stronger core members like Germany are seemingly unwilling to share too much of the financing burden and favour more stringent requirements for the ESM.

The European sovereign debt problem would remain a source of risk to the external environment until it is fully resolved. Apart from its potential destabilising effect on the financial markets, there is also considerable concern about the drag on the economic growth of the eurozone posed by the large-scale budget cuts in the European economies. After all, the advanced economies, including Europe, remain the principal driving forces behind the final demand in global trade. This could have notable implications for exports of Asia, including those of Hong Kong, in the event of a prolonged weakness of the eurozone economy. This is an area that requires close attention.