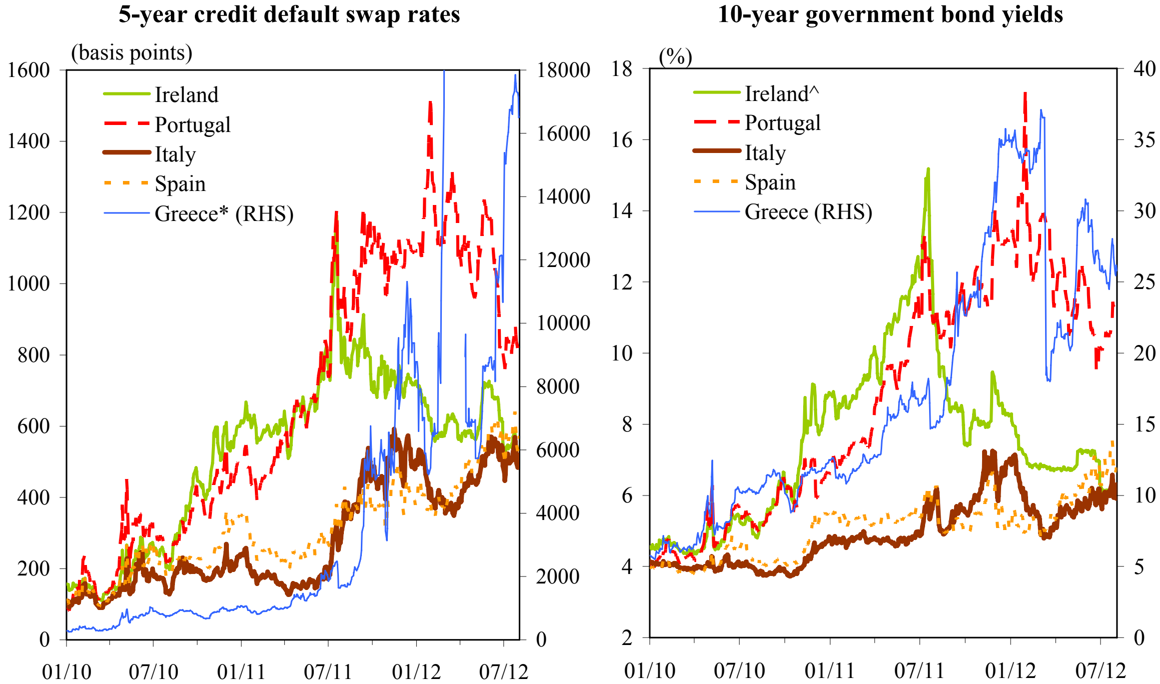
Box 2.1

Recent developments of the eurozone sovereign debt crisis

The eurozone sovereign debt situation worsened again during the second quarter of 2012, triggered by the heightened risk of a "Grexit" and also growing fears over contagion to the larger economies such as Spain and Italy, especially so for the former which was being saddled by a feeble banking sector (for earlier developments, please see ***Box 2.1*** of the ***Half-yearly Economic Report 2011***). Although the likelihood of an imminent "Grexit" subsided upon the victory of the pro-bailout parties in the parliament election in mid-June, Greece still looks set to face a difficult road ahead while striving to meet the bailout requirements. Moreover, while EU leaders made some progress towards tackling the debt crisis at the EU Summit on 28-29 June, the Summit failed to reassure markets given its conditionality and lack of details, as evidenced by the sustained high borrowing costs for Spain and Italy, with the former ten-year government bond yield at times surging over 7% to successive highs in recent months (***Chart 1***).

Chart 1 : Risk premiums on Spain and Italy stayed elevated



Notes : (*) Greece completed a bond swap with private creditors in early March and the corresponding CDS was settled and terminated. The subsequent CDS protects the renewed Greek bonds and is hence not directly comparable with that in preceding period.

(^) 9-year government bond.

Specifically, the late-June summit (see ***Table 1*** for details) addressed three important dimensions, i.e. (i) the balance between national sovereignty and burden sharing, through greater consensus on specific and time-bound roadmaps to further fiscal integration as well as a banking union; (ii) provision of liquidity to banks and sovereigns, through direct recapitalisation of banks and bond purchases by the rescue funds, viz the European Financial Stability Facility/European Stability Mechanism (EFSF/ESM), without gaining preferential seniority status; and (iii) prospects for improved growth, through agreeing to mobilise around €120 billion to boost growth.

Nevertheless, the proposed direct recapitalisation of banks by EFSF/ESM is subject to the setting up of a single eurozone banking supervisory authority, involving the European Central Bank (ECB), by end-2012. Also, the envisioned banking union would entail a common deposit insurance and bank resolution in addition to bank supervision, which will likely take time to materialise and command more bickering amid divided national interests.

Box 2.1 (Cont'd)

Table 1 : Summary of recent major events pertinent to the euro debt crisis*

2 Feb	The treaty on European Stability Mechanism (ESM) was signed
9 Feb	The European Central Bank (ECB) left its benchmark interest rate unchanged at 1.0% and approved the increase in the available pool of eligible collateral for credit operations temporarily
13 Feb	Moody's cut Italy's rating from A2 to A3, Spain from A1 to A3, Portugal from Ba2 to Ba3 (junk), Slovakia from A1 to A2, Slovenia from A1 to A2, Malta from A2 to A3. The ratings of these sovereigns along with France, Austria and the UK were given negative outlooks
21 Feb	Eurogroup agreed to a €130 billion bailout for Greece, aimed at lowering its debt-to-GDP ratio to 120.5% by 2020. Private investors were called on to waive 53.5% of principal under a debt swap. The official sector will retroactively cut rates for the Greek Loan Facility, national central banks which hold Greek debt in their investment portfolios will pass all accrued income to Greece until 2020, and the ECB will disperse any profits made under its Securities Markets Programme to Member States to support Greece
27 Feb	S&P cut Greece's credit rating from CC to selective default and the outlook of European Financial Stability Facility (EFSF) from developing to negative; Spanish government announced its budget deficit stood at 8.5% of GDP in 2011
29 Feb	The ECB allotted €529.5 billion in its three-year long-term refinancing operation to 800 financial institutions
2 Mar	25 European countries signed the Treaty on Stability, Coordination and Governance aimed at strengthening fiscal discipline and introducing stricter surveillance within the eurozone; Moody's cut Greece's credit rating to C
9 Mar	Greece averted the immediate threat of an disorderly default after winning acceptance from its private creditors for a bond swap deal
13 Mar	Fitch lifted Greece's credit rating to B- after the debt swap, outlook stable, while Moody's cut Cyprus' credit rating from Baa3 to Ba1, outlook negative
14 Mar	Eurozone Member States approved the second adjustment programme for Greece. Member States also authorised the EFSF to release the first €39.4 billion instalment, to be disbursed in several tranches
15 Mar	The International Monetary Fund (IMF) approved a €28 billion loan for Greece
30 Mar	The Eurogroup agreed to raise the overall ceiling for EFSF/ESM from €500 billion to €700 billion; Spain unveiled a harsh budget to raise taxes and slash spending to achieve €27 billion in deficit cuts in order to trim its budget deficit from 8.5% of GDP in 2011 to 5.3% in 2012
20 Apr	IMF members agreed to increase its crisis-fighting resources by US$430 billion
26 Apr	S&P downgraded Spain's credit rating from A to BBB+, outlook negative
2 May	S&P raised Greece's credit rating to CCC with a stable outlook from selective default after completion of the debt exchange
6 May	French Socialist Party Mr. Hollande won the presidential election and Greek election failed to form a coalition government. These signalled increasing pressure on European leaders to switch from austerity to a pro-growth strategy
9 May	Spanish government took over 45% indirect stake in Bankia, trying to dispel concerns over the government's ability to clean up the financial sector
1 June	Moody's lowered the highest assignable rating to domestic debt issuers in Greece to Caa2 based on the increasing risk of an exit from the eurozone
9 June	Eurozone finance ministers announced that they were willing to approve a loan of up to €100 billion to help recapitalise Spain's banking sector
13 June	Moody's downgraded Spain's and Cyprus' credit rating by three and two notches to Baa3 and Ba3 respectively, and put both on review for further downgrades

Box 2.1 (Cont'd)

17-20 June	Pro-bailout New Democracy party won the Greek parliamentary election and successfully formed a new administration with PASOK and the Democratic Left
18 June	More IMF members agreed to boost its crisis-fighting resources, bringing the newly raised fund to US$456 billion
22 June	The ECB decided to increase collateral availability to improve access of the banking sector to Eurosystem operations
25 June	The Spanish government formally requested aid to recapitalise its banking sector. Cyprus also requested aid for its banks and budget. Fitch downgraded Cyprus from BBB- to BB+ (junk), outlook negative
28-29 June	The European Council decided to establish a single eurozone banking supervisory authority, involving the ECB, by the end of 2012, and to enable the ESM to recapitalise banks directly. Existing EFSF/ESM instruments can be used more flexibly to stabilise markets without forcing austerity on recipient countries. They also agreed to develop a roadmap for fiscal integration, and mobilise €120 billion to boost growth
6 July	The ECB cut its rates by 0.25%, bringing the refinancing rate to a record low of 0.75%, and the overnight deposit rate to 0%. No changes were announced regarding the non-standard measures. Italy approved additional spending cuts worth €26 billion over three years to remove an expected VAT hike in October
9 July	Eurogroup gave Spain an extra year until 2014 to meet the agreed public deficit target
12 July	Spain announced a package of fiscal consolidation measures worth €65 billion, comprising a VAT increase, suspension of Christmas bonus for public sector workers and cut in unemployment benefits etc., as part of a deal with eurozone leaders to help rescue Spain's banks
13 July	Moody's cut Italy's rating by two notches to Baa2 from A3, outlook negative
20 July	Eurogroup unanimously agreed to grant financial assistance up to €100 billion for the Spanish banking sector
23 July	Spanish market regulators announced a 3-month ban on short-selling of all financial stocks; Moody's cut the credit rating outlook of three triple-A European countries, viz Germany, the Netherlands and Luxembourg to negative
26 July	ECB President Draghi indicated that the ECB would, within its mandate, do whatever it takes to preserve the euro

Note : (*) Please see ***Box 2.1*** of the ***2011 Economic Background and 2012 Prospects*** for earlier developments.

Also, EU leaders did not touch upon expanding the firepower of EFSF/ESM at the Summit meeting in late June. Although the overall ceiling of these funds was raised from €500 billion to €700 billion in March 2012, it is hardly sufficient when viewed against the sheer sizes of Italy's and Spain's outstanding debts alone (at €1.9 trillion and €735 billion respectively at end-2011). The capacity of the EFSF/ESM is also limited by the absence of the ECB's back-up as the lender of last resort and the grim prospect of having joint eurobonds anytime soon. Indeed, with the eurozone's unemployment rate staying elevated at 11.2% in June and its economy poised for an annual recession this year, the debt-ridden eurozone Member States will face an uphill battle in resuming growth, leaving their fiscal sustainability seriously in doubt. All in all, the eurozone sovereign debt crisis will remain the key threat to the global economy for an extended period of time.