

INFLUENCE OF THE FINANCIAL REGULATORY SYSTEM ON EUROPEAN SOVEREIGN DEBT CRISIS

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ABSTRACT

European sovereign debt crisis is a big challenge not only for Europe but also for the whole world. In this paper, first I will give an introduction about European sovereign debt crisis, then analyze the cause of this debt crisis. In the discussion part, I will analyze some problems of the financial regulatory system such as bureaucracy, inadequate regulation, the uncertainty of regulatory integration and synergy, which is smaller than the countries have planned, which are parts of the cause of the crisis. After that I will analyze the problems of the financial regulatory system, there are some ideas and suggestions for the financial regulatory system in this part. The last part of the article is the conclusion. Countries in Europe are very closely associated with each other. After the breakout of the debt crisis, European countries should build a more stable finance system which can support euro to compete with dollar in the international monetary system. It is good for countries all over the world if euro could break the dominance of the dollar monopoly.

Keywords: Europe, sovereign debt crisis, financial regulatory system, ideas

INTRODUCTION

European sovereign debt crisis is a multi-year debt crisis that has been taking place in the European Union since the end of 2009. The global economy has experienced slow growth since the U.S. financial crisis of 2008-2009, which has exposed the unsustainable fiscal policies of the countries in Europe and around the globe. Several euro zone members such as Greece, Portugal, Ireland, Spain and Italy were unable to repay or refinance their government debt or to bail out over-indebted banks under their national supervision without the assistance of third parties like other Eurozone countries, the European Central Bank, or the International Monetary Fund. The detailed causes of the debt crisis varied. In several countries, private debts arising from a property bubble were transferred to sovereign debt as a result of banking system bailouts and government responses to slowing economies' post-bubble (Koba, 2012). Greece, which spent heartily for years and failed to undertake fiscal reforms, was one of the first to feel the pinch of weaker growth (Nelson et al., 2012). When growth slows, so do tax revenues – it makes high budget deficits unsustainable. The result was that the new Prime Minister George Papandreou, in late 2009, was forced to announce that previous governments had failed to reveal the size of the nation's deficits. In fact, Greece's debts were so large that they actually exceed the size of the nation's entire economy, and the country could no longer hide the problem. In this article I will try to analyze the cause of

the sovereign debt crisis and find where the problems existed, then give some ideas or suggestion on these problems.

CAUSES OF EUROPEAN SOVEREIGN DEBT CRISIS

The direct cause of the crisis is government departments and private departments' over-indebtedness for a long term (*Table 1*).

Table 1: Current Account Balances (Billions of U.S. dollars)

Country	2000	2006	2010	2013
France	19.3	-13.0	-33.8	-36.9
Germany	-34.2	173.4	194.6	254.9
All Peripheral Europe (GIIPS)	-47.8	-197.8	-186.0	44.2
Italy	-2.2	-27.5	-70.3	20.5
Spain	-23.1	-110.9	-62.3	10.6

Source: IMF's World Economic database. (2016) <https://www.imf.org/external/pubs/ft/weo/2016/02/weodata/weoseladv.aspx?a=1&c=163%2c998&s=BCA>

Long-term debt investments led to huge government deficits (*Gewaltig*, 2010). According to the European Union's Stability and Growth Pact, the deficit government should not exceed 3% of Gross Domestic Product, but there was a sharp increase of government deficit at the beginning of the European sovereign debt crisis from 2007 to 2009. For instance, after Greece entered the Eurozone, Greek average annual debt deficit reached 5% from 2001 to 2008. But the statistics of annual debt deficit of Eurozone accounted only 2% in the same period. The annual current account deficit of Greece is 9%, the Eurozone is only 1% in the same period. Greek foreign debt to GDP ratio reached 115% in 2009. These problems are ubiquity in Portugal, Italy, Ireland, Greece and Spain (PIIGS).

With increasing depth of regional integration in Europe, some countries such as Greece and Portugal which develop more slowly than other countries in Europe increased their wages, social welfare, unemployment benefits and other aspects gradually to the same level of Germany, France and other developed countries in Europe, therefore, their levels of expenditure exceed domestic output more and more after several years. As wages and social welfare of these countries are difficult to adjust downwards after they have been raised, it led to the increase of the government and private sector debt increased year by year.

The causes of the debt problems of Spain and Ireland are different from Greece. Because of the U.S. subprime mortgage crisis, the real estate markets of Spain and Ireland are rapidly depressed, the domestic banking system of these countries has a large number of bad debts which led to a banking crisis eventually in these countries (*O'Donovan*, 2012). When the government tried to save the banking system, the ability of debt and repayment services became a serious problem.

At that time, the governments of Portugal, Italy, Ireland, Greece and Spain were saddled with a huge debt and the ability of further borrowing decreased. The credit

of these governments was unable to make investors feel at ease. Investors generally treat the number of 6% as a warning line of sovereign debt crisis, once a country is above the level of 6%, the country will face a sovereign debt crisis. The outlook of Italian debt problems is relatively optimistic in the PIIGS countries, but its yield level of ten-year bonds is close to 6%. In 2009, the PIIGS countries' government deficits were already several times to the warning line of 3% except for Italy. When the huge budget deficit of government cannot be compensated with a new way of debt issued, the debt crisis will inevitably erupt.

Portugal, Italy, Ireland, Greece and Spain experienced such a serious crisis, that their governments' slow movement, omission or indiscriminate treatment should take responsibility for that. Although the performance of the five countries is different before and after the crisis, the malpractice of these governments is an important factor in boosting the crisis.

First, in order to pursue short-term benefits, the government used an obscurantist policy to please the people in the polls and in the process of general elections. For instance, the Greek government concealed a large amount of financial deficit until 2009 (*Stewart, 2015*).

Second, some governments attempted to evade the regulatory penalties of the European Commission and the European Central Bank through various ways. Leaders of economically developed countries such as Germany, France were not a good model in this respect, and other countries in Europe also followed actions that Germany and France had done before.

Third, some governments such as the Irish government and the Spanish government let their domestic economic bubble increase, and once the bubble burst, they spent a lot of wealth which came from taxpayers to aid the virtual economy that led to the distortion of the economic structure artificially.

Fourth, the heads of governments are too timid. They are afraid to take decisive measures to stifle the crisis at the very beginning. For instance, the Italian government did not take a decisive action in 2009 when their deficit reached 5.3% and they just procrastinated to do some help which led to the escalation of the crisis.

Fifth, the factor driving the European sovereign debt crisis is the health of the balance sheets of Europe's banks, which hold hundreds of billions of euros of Eurozone sovereign debt. According to a stress test of 2010, conducted by the Organization for Economic Co-operation and Development (OECD), Europe's largest financial institutions have €286.2 billion in trading book exposures and €1,400.5 billion of banking book exposures (*Wolf, 2011*). Adding it up, the amounts increased to €1,686.7. In another way, the total Eurozone sovereign debt in 2010 was reported to be €7,862 billion, meaning that the Eurozone banks held 21.5% of the debt of Eurozone member states.

The defects of the Eurozone system have also been revealed in the sovereign debt crisis. According to the design of the Eurozone system, no member of the Eurozone has right to issue currency and it also does not have an independent monetary policy, the European Central Bank is responsible for currency and monetary policy implementation in the whole region. During the process of European economic integration, the common currency brought a lot of benefits to the countries in the

Eurozone. In the good situation of economic development, the common currency promotes trade development outside the region while reduces the costs of macro trading. However, when bad situation of development is coming, countries in crisis cannot be adapted to the local conditions to implement monetary policy and then it cannot devalue its own currency to reduce debt and increase the international competitiveness of their export products. What they can do is to aggregate demand through the methods of austerity budget and tax increases to increase the source of funding to pay their debt, which makes the depressed economic situation even worse. For instance, Iceland was able to rebound quickly from the abyss of bankruptcy because the government and the central bank of Iceland could devalue its own currency to promote the export of its domestic products. This is a welfare policy that countries in the Eurozone cannot gain (*Forelle, 2012*).

THE SYSTEM OF FINANCIAL REGULATION

European debt crisis is essentially a great earthquake of Economy and Finance, and it became a crack because Eurozone monetary policy and fiscal policy disjointed. From this point of view, the European sovereign debt crisis reminded us that we needed to strengthen the regulation of finance.

From a historical perspective, financial markets have been constantly affected by financial crises, but it is also a way to continue to deal with financial crises and amendment regulations. There are mainly four types of regulatory systems taken by countries all over the world (*Chen, 2008*). The first one is the regulatory system of Germany and Japan, the management system of their economy and policy is dispersed. Therefore there is regulatory centralization to their central government. The second one is the regulatory system of the U. S. and Canada. Both the central government and the local government have a right of custody for banks, and in the meantime, each level of government has a number of agencies to regulate the financial market together. The third one is the regulatory system of Great Britain and Thailand. It is mainly regulated by one institution (central bank or specialized agency). The fourth is the regulatory system of the European Union and Union Monetaire Ouest Africaine (UMOA). A specialized institution regulates all of them.

U.S. tiered regulatory mode: The U.S. implemented the individual legislation and sub-sector regulatory system before 1999. The U.S. financial regulation system is very complex, which the regulatory authorities established based on federal law and state law that they have federal regulatory authorities and state regulatory authorities (*Calomiris, 2009*). Banking, securities and insurance also have their own industry regulatory authorities. Hence, the U.S. regulatory system comprises of three levels, which are the federal government, state governments and specialized institutions.

European single regulatory mode: Germany is the first country to build an independent integrated financial regulatory institution in Europe, because Germany implemented a universal banking system whose banks have been able to run the securities and insurance business simultaneously for a very long time (*Luan, 2009*). It is worth mentioning that although Germany and the United States belong to mixed business, there is a big difference between them. Germany is based on the

integrated operation inside the bank and the United States implements mixed operation through the financial holding company. This is the direct reason of regulatory mode differences between Germany and the United States.

PROBLEMS OF THE INTERNATIONAL FINANCIAL REGULATORY SYSTEM

Problem of human resource, people from different countries, regions suddenly enter a new working environment which needs to re-create objectives. There is no definite institution to undertake problems of preliminary trial and error stage.

Bureaucracy: Because the regulatory authority is often the highest authority, and it coupled with a super-sovereign operating mechanism which led to the mobility of staff very frequently, which caused that the staff could not focus on their job one hundred percent (*Wang*, 2015).

Synergy is smaller than has been planned. Despite the fact that there are improved interests of information sharing, the cultural differences, cognitive differences in the work environment may offset the synergy of Integrated Regulation.

Inadequate regulation: It is easier to display the situation of over regulation or lack of regulation if the high-risk and low-risk businesses are regulated together. In particular, lack of regulation of high-risk business is prone to adverse selection and moral hazard behavior that may reduce the regulatory capacity on the control of systemic risk.

The uncertainty of regulatory integration: Some businesses have a very significant positive effect on some industries in some countries but in the meantime it also will accumulate huge systemic risk. If there are some regulatory authorities in the regulatory system in their own country to let the regulation adjusted to their own country, the regulatory integration would not be as good as a regulatory approach by industry or region. At least, people doing the same business will produce a more objective judgment.

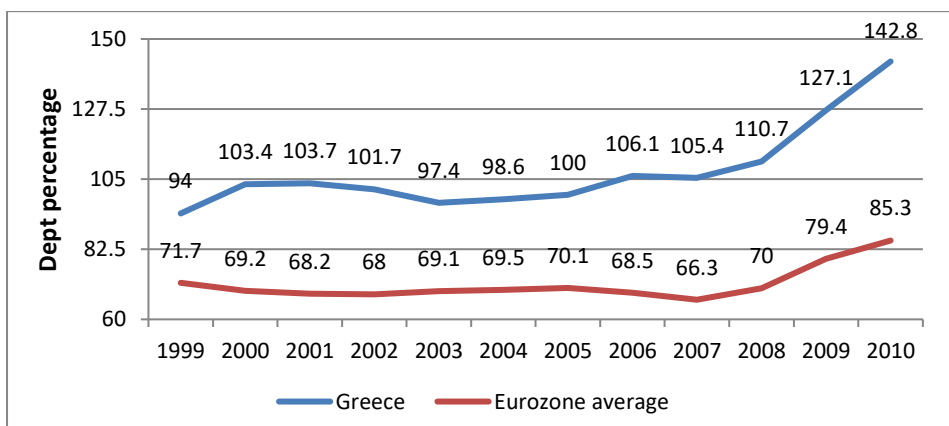
INFLUENCE OF THE FINANCIAL REGULATION SYSTEM ON THE EUROPEAN SOVEREIGN DEBT CRISIS

In October of 2009, the Greek Prime Minister George Papandreou announced that his predecessor concealed a large number of fiscal deficits, which triggered market panic. As of December the same year, the three major rating agencies lowered the Greek sovereign debt rating, investors started to sell Greek bonds. At the same time, Ireland, Portugal, Spain and other countries' sovereign bond yields increased significantly, the European debt crisis broke out. The crisis broke out in Greece first. The financial crisis in Greece seriously affected the consumption of residents, leading to economic downturn, and no flexible monetary policy, the government had to rely on investment and consumption to stimulate the economy, the deficit continued to accumulate (*Figure 1*). The vicious circle of the deficit and the decline in exports eventually led to the gradual accumulation of Greek sovereign credit risk and was completely exposed in this economic crisis. The public generally argues that institutional problems are an important cause of the sovereign debt crisis and

the spread of the debt crisis in Europe. But one reason that cannot be ignored is the fact that the financial regulatory system in the Eurozone has great responsibility for the crisis. In fact, the biggest difference between the European Commission and its member states is how much the actual power is that the European financial regulator can have. A number of EU members argue that their own national financial regulators need more power and oppose the European financial regulators to have final arbitration in conflict with their own national regulatory authorities. It is difficult for the EU members to reach an agreement that laws and regulations between countries could not be coordinated and the responsibility is unclear. Under this situation, a regulatory gap appeared and regulatory efficiency was quite low. Moreover, the EU lacks of supervision on the rating agencies, and the competitiveness of the market is also inadequate but it also amplifies the risk when it happens. Financial derivatives became an incentive factor of the Greek crisis. After the crisis broke out, the EU decided to promote the financial regulatory reform program, namely the EU established two institutions which were the European Systemic Risk Board (ESRB) and the European Financial Stability Facility (EFSF). The ESRB is responsible for macro-prudential supervision, monitoring and evaluation of the macroeconomic development. The EFSF aims to improve the regulatory capacity of countries through the establishment of more consistent rules that form an effective supervision of transnational financial institutions and to strengthen the EU's micro-financial regulation and coordination.

Figure 1

Greek debt in comparison to Eurozone average



Source: Eurostat (2014) <https://ec.europa.eu/eurostat/en/web/products-manuals-and-guidelines/-/KS-GQ-14-010>

Some ideas for the development of the financial regulation system concerning the European sovereign debt crisis

First, complete the construction of financial regulation authorities and focus on team building. Staffs who are engaged in financial regulation play an important role

in carrying out the implementation of the financial regulatory system. Hence, to complete the construction of financial regulation authorities and focus on the team building are very important.

Second, give full play to financial regulation. In fact, there are a lot of specific ways to implement financial regulations. Financial institutions credit rating is a very effective way of financial regulation. Full use of computer-site supervision can greatly improve work efficiency and improve the entire regulatory process as well.

Third, improve international cooperation. In the case of transnational business, financial institutions become a trend. If there is no effective international cooperation in financial regulation, it will not achieve the ultimate purpose of financial regulation. In the background of economic and financial globalization and integration, countries have begun to attach importance to the necessity of international cooperation of financial regulation and established series of principles of international financial regulation. These principles not only improved the standardization of international financial regulation, reduced inequalities of competition in the international financial services industry, but also improved the safety of the international financial system. As time goes on, we should improve international cooperation to a new level.

CONCLUSION

There are differences in the development of European countries and countries in Europe are very closely associated with each other. Resources and capital accumulation in the area concerning the situation of economic development is good and safe. Thus, European countries formed a dual structure in Europe. The good development in Europe made countries in Europe over-confident and led to excessive consumption over the past 20 years. High consumption pattern must be maintained by a high level of social welfare and social security system, and more than half of the national income must be used for fiscal transfer payments to maintain the social welfare system. After the breakout of the European sovereign debt crisis, the requirement of other countries involved in relief on the premise is that Europe must help itself first. In the long run, Europe needs to promote the financial regulatory system comprehensively and accelerate the process of reform of financial acceleration environment in Europe. If Europe has a stable finance, it can support euro to compete with dollar in the international monetary system. And it is conducive to the trend of multi-polarization of the world to break the dominance of the United States and the dollar monopoly.

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