Chapter 2
Impact of the 2008 Global Financial Crisis

As mentioned earlier, the 2008 financial crisis rapidly developed and spread into a global economic shock, which resulted in a number of European bank failures and stock market declines (Fackler 2008; Altman 2009). Economies worldwide slowed during this period due to tightening credit and drops in international trade. At the onset of the financial crisis, some European countries viewed it as a purely American phenomenon. Yet, that view quickly changed following the rapid decline of economic activity in Europe. What made matters worse was that global trade shrank sharply, thus eroding the prospects for European exports. In addition, public protests, sparked by rising rates of unemployment and concerns over the growing financial and economic turmoil, increased the political stakes for European governments and their leaders. As a result, the global economic crisis strained the ties that bound together the members of the European Union (EU) and presented a significant challenge to the ideals of solidarity and common interests (Nanto 2009).

Following the outbreak of the financial crisis, on November 26, 2008, the European Union proposed a European stimulus plan amounting to US$256 billion (€200 billion based on 11/26/08 exchange rate) or 1.5% of the EU GDP—around 1.2% of GDP from national budgets and the rest 0.3% of GDP from EU and European Investment Bank budgets (Europa 2008). The stimulus aimed at limiting the economic slowdown through national economic policies extending over a period of two years. The measures include supporting medium-term growth through increased public spending on infrastructures (road networks and railway), assisting the housing sector (notably construction and renovation), and increasing in benefits and allowances to low-income and unemployed households. For the entire world, the estimated US$2 trillion total in stimulus packages amounts to approximately 3% of world Gross Domestic Product, exceeding the call by the International Monetary Fund (IMF) for fiscal stimulus by 2% of global GDP to counter worsening economic conditions worldwide (Nanto 2009).

As of mid-2012, several European countries are still suffering from the sovereign debt problem and need international assistance. In hindsight, statistics revealed that some Euro zone countries are much more heavily indebted than others, as a result

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of borrowing recklessly at the cheap interest rates available inside the Euro (Cecchetti et al. 2011). The escalating debt threatened to reduce their economies to a fragile level. When the financial crisis hit, they were powerless to fend it off and a sovereign debt crisis swiftly emerged.

The debt problem in these four southern European countries traces its roots back to the previous decade. Loans to the real economy increased at an average rate of around 20% in Greece and Spain over the period 2002 to 2007. During this period, weak financial regulation and supervision encouraged a significant increase in risk taking. The very low real interest rates, which were sometimes even negative, created highly favorable conditions for housing bubbles, as is the case with Spain. This then, increased the current account deficits so that by 2008, Greece, Portugal, and Spain had accumulated net foreign liabilities of over 70% of the national GDP, according to OECD (Barnes 2010). These three countries had a credibility problem. They lacked the ability to adequately repay their debts due to low growth rate, high deficit, and decreasing foreign direct investment (First Post 2011). Spain's creditors were mainly domestic institutions, but Greece and Portugal had a higher percent of their debt in the hands of foreign creditors, which was seen by certain analysts as more difficult to sustain. In addition, Italian national debt had reached around US$2.0 trillion (€1.6 trillion)—three times greater than the national debt of Greece, Portugal, and Ireland combined (First Post 2011).

Furthermore, by joining the Euro zone, member nations gave up the ability to individually devalue their currency in bad times. In the past, countries often used devaluation when there was an economic downturn to balance their economies. To remedy potential problems, the Economic Monetary Union stipulated the Stability and Growth Pact that required member countries to maintain a government budget deficit of no more than 3% of GDP and public debt of no more than 60% of GDP. However, there were no fixed rules governing the exact details of how penalties are levied (Harrington 2011). As a result, most of the countries in deep trouble during this financial crisis had little incentive to follow the rules and were frequently in violation of them.

The most serious Greek sovereign debt crisis was set off in late 2009 when the government admitted that its deficit would be 12.7% of its gross domestic product, not the 3.7% the previous government had forecasted earlier (The New York Times 2012). In early 2010, fears over a potential default grew into a full-fledged financial panic. As the fear spread to Portugal and Spain, leaders of Europe's more affluent countries like Germany and France, worrying about lasting damage to the euro, stepped in with a pledge to defend the common currency. When the problem spread, Greece secured a bailout package worth US$158 billion (€110 billion, based on exchange rate at that time) in May 2010 and then in November 2010 Ireland received a bailout amounting to US$113 billion (€85 billion) (Minder 2011; The New York Times 2012). In April 2011, Portugal was also in trouble and requested an international aid package worth US$110 billion (€78 billion) which was approved in May 2011 (Minder 2011).

As the sovereign debt problems continued to ail the Euro zone, in September 2011, OECD reported that major economies were tilting back into recession and fears were growing that Italy might be the next country facing a financial crisis—after

Greece, Ireland, and Portugal (Bryant 2011). About a year after the initial bailout, the Greek economy continued to sag under US$483 billion (€340 billion) of debt, as the austerity package sent the economy deeper into recession (The New York Times 2012). As a result, a second bailout became necessary. In February 2012, European finance ministers approved a new bailout of US$172 billion (€130 billion euros), subjecting to Greece taking immediate steps to implement the deep structural changes needed to rectify the defunct economy (The New York Times 2012). Spain became the fourth and largest country to ask Europe to rescue its failing banks, with a loan of up to US$125 billion (€100 billion) agreed on by the Euro zone financial ministers on June 10, 2012 (Wolls and Dilorenzo 2012). Since the deal imposed no conditions on the overall Spanish economy and no new austerity measures, the Spanish government emphasized that it was an aid not a rescue (RTE 2012).

The impact of the 2008 global financial crisis on each country can be easily observed from the following four graphs, namely the percentage of real GDP growth per capita, total general government debt percentage of GDP, unemployment rate of labor force, and consumer price inflation from 2005 to 2010.

Comparisons of the Four Countries

Figure 2.1 shows that all four countries had an obvious GDP growth decline starting in 2008 and reached its lowest level in 2009. The exception is Greece, which experiences a continuous drop throughout. In 2010, all but Greece had a clear financial recovery, although Spain still had a negative growth.

In terms of the total general government debt as a percentage of the GDP, Fig. 2.2 indicates that government debt increased from 2008 onwards for all four countries, reflecting increasing financial needs during and after the financial crisis. In particular, the government debt in Italy is relatively stable, as it was already at a relatively high level (over 100%), and Greece saw a sharper debt increase in 2010 compared to the other three countries.

Reinhart and Rogoff (2009) reported findings from their research on financial crises over the last 800 years that the aftermath of a financial crisis brings slow and halted growth, sustained high unemployment, and surging public debt—with the overhang of public and private debt being the most important impediment to a normal recovery from the recession.

As for the unemployment rate, Fig. 2.3 shows that all four countries had unemployment rate increase starting from 2008, with Spain experiencing a sharper increase. A clear sign of warning is that Spain more than doubled its unemployment rate over the six years.

Figure 2.4 indicates the upward trend of consumer price inflation from 2007 to 2008 in these four economies, with Portugal having the least change. However, all inflation dropped drastically in 2009, which very likely came about because of the effect of the financial stimulus plan adopted by each country. Yet, it rose again in 2010 with Greece having the largest increase.

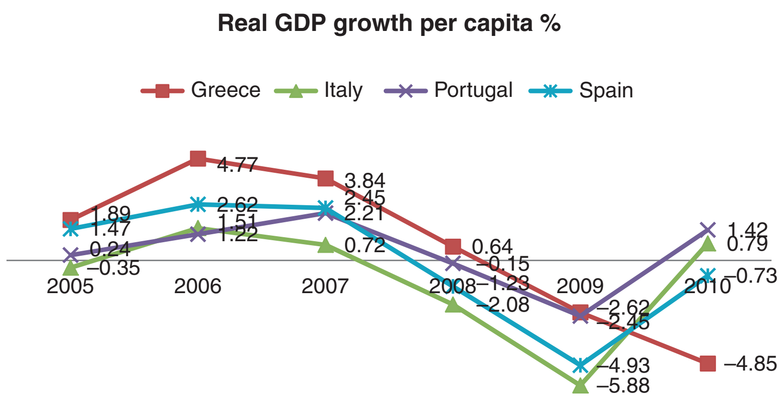

Fig. 2.1 Real GDP growth per capita for Greece, Italy, Portugal, and Spain from 2005–2010

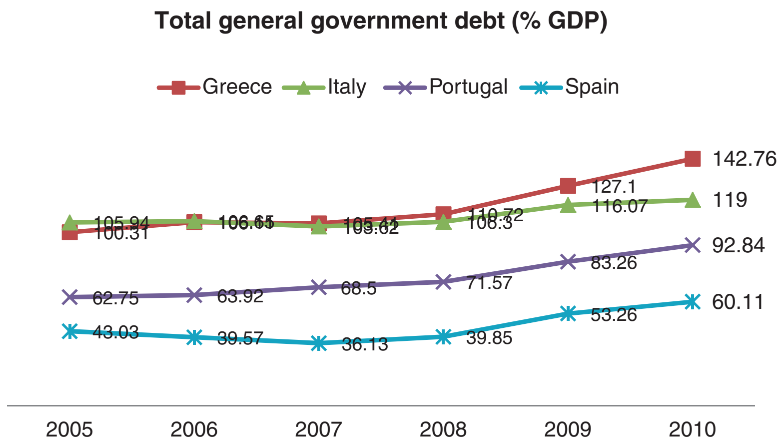

Fig. 2.2 Total general government debt (% of GDP) of Greece, Italy, Portugal, and Spain from 2005–2010

In general, the above four figures for these Southern European countries show that the four indicators were impacted by the 2008 global financial crisis, with the real GDP growth and consumer price inflation having clear fluctuations. The development patterns of these four countries are similar, with Greece having the most negative result and Spain having high unemployment rate yet a low total general government debt.

In what follows, we briefly described the impact of 2008 global financial crisis on Greece, Italy, Portugal, and Spain in sequence. Please note that the reported stimulus package is based on publicly available data and is not an exhaustive list. The reported amount was based on the exchange rate at the time of each stimulus, and thus varies. In addition, the depth of the report depends on the English literature

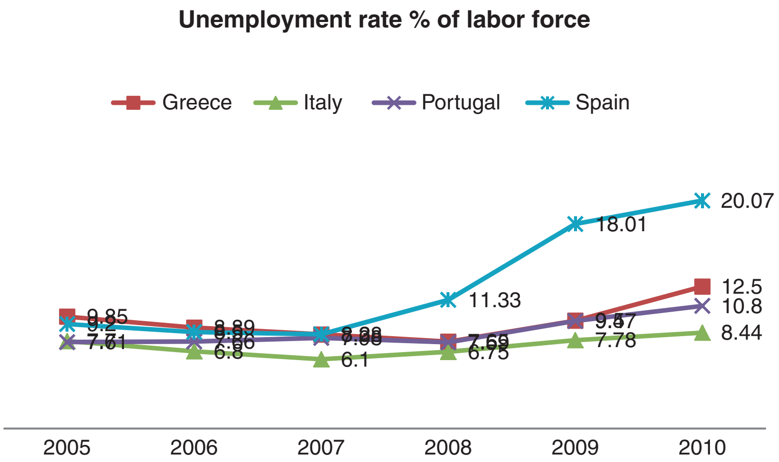

Fig. 2.3 Unemployment rate percentage of labor force in Greece, Italy, Portugal, and Spain from 2005–2010

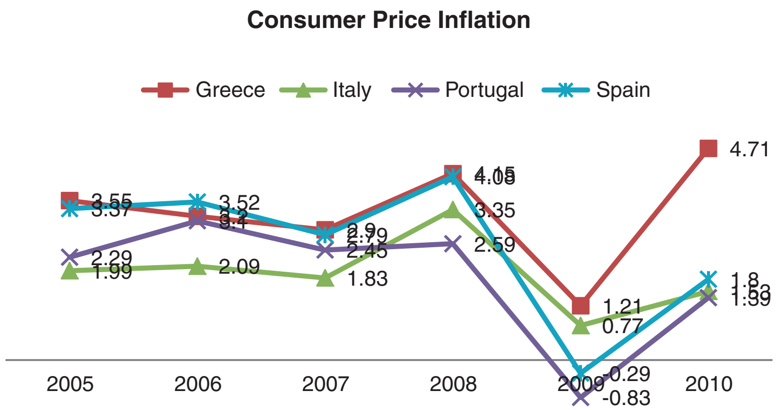

Fig. 2.4 Consumer price inflation of Greece, Italy, Portugal, and Spain from 2005–2010

available for each country. Readers can refer to Appendix 1 for details on the stimulus package each country adopted and Appendix 2 for the important meetings conducted by key global leaders during this financial crisis.

Greece

Greece has a capitalist economy with the public sector accounting for about 40% of GDP (CIA 2012). According to the World Bank, Greece is an advanced country with the service sector making up about 78.8% of its national economic output. It is a major beneficiary of EU aid, equal to about 3.3% of the annual GDP. The Greek economy grew by nearly 4% per year between 2003 and 2007, due partly to infrastructural spending related to the 2004 Athens Olympic Games and in part to an increased availability of credit, supporting record levels of consumer spending (CIA 2012).

During the 1990s, the Greek economy had shown significant progress in terms of fiscal and monetary adjustments, which culminated in its accession to the Economic and Monetary Union (EMU) of the European Union. Post-accession however, the reform zeal subsided and complacency prevailed. Aided by cheap money, the country had not undertaken far-reaching structural reforms since then (Blavoukos and Pagoulatos 2008). Instead, the Greek government borrowed heavily and went on a spending spree after it adopted the Euro. Public spending soared and public sector wages practically doubled in the past decade (Nelson et al. 2011). However, as the money flowed out of the government's coffers, tax income was hit because of widespread tax evasion.

As a result, the fiscal outlook deteriorated significantly in the 2000s. In particular, the 2004 Olympic Games generated deficits, and the government failed to exercise fiscal discipline or implement the necessary reforms in the pension system, public administration, and elsewhere (Pagoulatos 2010). Although from 2000 to 2007, Greece still experienced enviable economic gains with an average real GDP growth of 4.27%, it depended upon being able to successfully finance all of its borrowings to sustain such growth. From 2002 to 2007, Greece violated the EU's Growth and Stability Pact budget deficit criterion of no more than 3% of the GDP with deficits averaging 5.4% of its GDP (Barnes 2010). With the Euro currency, Greece can no longer devalue its own currency in order to finance its debt.

Initially, Greece held up better during the 2008 global economic crisis than many other OECD countries, as the banking sector had only marginal exposure to the toxic assets and growth remained positive until the end of 2008 (Sorsa et al. 2009). Yet, it was unlikely to avoid a recession as global confidence, tourism, and shipping receipts had all fallen substantially. The impact of the crisis shook the confidence of households and businesses, which were reigning in spending. When the financial crisis perpetrated through the entire world, Greece's situation started to become more and more perilous. The economy went into recession in 2009 and contracted by 2% as a result of the world financial crisis and tightening credit conditions (Dimireva 2009). The authorities responded with fiscal measures to assist the financial sector and announced in mid-June 2009 a consolidation plan, aimed at reducing the structural budget deficit by cutting civil service employment, freezing government wages, cutting 10% of "elastic" budget outlays, and levying taxes on high incomes (Sorsa et al. 2009). However, their room for policy maneuver was tightly restricted by the high public debt, repeated fiscal slippages, and large external and internal imbalances, which had been reflected in high sovereign interest-rate spreads as risk aversion rose (Sorsa et al. 2009). For Greece, it was the combination of the high debt to GDP ratio, deficit to GDP ratio, stagnant economy, shrinking tax base, and a dysfunctional tax collection system which increased Greece's vulnerability and exacerbated its shortage of liquidity (Abboushi 2011).

Later on, Greece's eroding public finances, inaccurate and misreported statistics, and consistent underperformance on reforms prompted major credit rating agencies in late 2009 to downgrade its international debt rating. Under intense pressure from the EU and international market participants, the government adopted a medium-term austerity program that includes cutting government spending further, decreasing tax evasion, reworking the health-care and pension systems, and reforming the labor and product markets (CIA 2012). Athens, however, faces long-term challenges to push through unpopular reforms in the face of widespread unrest from the country's powerful labor unions and the general public (CIA 2012). By the end of 2009, as a result of a combination of international and local factors (the world financial crisis and uncontrolled government spending, respectively), the Greek economy faced its most-severe crisis since the restoration of democracy in 1974 (Lynn 2011).

In December 2009, Greece admitted that its debts had reached US$429 billion (€300 billion)—the highest in modern history; in addition, it was burdened with debt amounting to 113% of the GDP—nearly double the Euro zone limit of 60% (BBC 2012a).

Italy

Italy has a diversified industrial economy, divided into a developed and private-company-clustered industrial north and a less-developed and welfare-dependent agricultural south that has high unemployment. Italy has a sizable underground economy, which by estimation accounts for as much as 17% of GDP (CIA 2012). In the mid-1990s, Italy enjoyed vigorous growth and became one of the first 11 Euro zone countries. However, from the late 1990s, it plunged into a downturn, where in most years, economic growth was behind that of Europe's average. In 2005, it had the worst economic statistics of all Euro zone countries: zero growth in GDP and the deficit jumped to 4.1% of the GDP; in 2006, because of the Torino Olympic Winter Games, there was a rise of 1.9% in GDP; in 2007, Italy's GDP rose 1.5%, while the European Union enjoyed a 2.9% increase (Wang 2009).

In addition, Italy has had a debt ratio of over 100% of its GDP ever since 1991. The country averaged an abysmal 0.75% annual economic growth rate over the past 15 years, which was much lower than the rate of interest it pays on its debts (Knight 2011). The main cause of Italy's "current account deficit" was the weak Italian economic performance resulting from structural problems (Barnes 2010). Like other southern European economies, Italian wage levels rose too quickly during the good years, and left Italy uncompetitive within the Euro zone.

Italy, unlike Greece, actually had been quite financially prudent because the government spent less on providing public services and benefits to its people than it earned in taxes (Knight 2011). The only reason Italy continued to borrow was to meet the principal and interest payments on its existing debts. Furthermore, it was plagued by poor regulation, vested business interests, an aging population, and weak investments. All of which conspired to limit the country's ability to increase production (Knight 2011). As a result, the high public debt burdens and structural impediments to growth rendered Italy vulnerable to scrutiny by financial markets (CIA 2012).

When the financial crisis exploded in autumn 2008, the Italian Government was prudent. The first stimulus package amounting to US$3.8 billion (€3 billion) was introduced in November 2008. It included transfers to low-income households and relief measures for enterprises, fully financed by revenue increases and expenditure cuts (Dilje 2008; Economy Watch 2010a). Following the European Economic Recovery Plan, a second fiscal package was approved in February 2009. The total value of this economic stimulus package was worth around US$101 billion (€80 billion) (Economy Watch 2010a; OECD n.d.) The package included a temporary freeze on regulated energy prices and road tolls, around US$3 billion (€2.4 billion) in tax breaks for poorer families, reduction in advance tax payments and speedy reimbursements of excess tax payments, some marginal easing of the direct and indirect tax burden for companies, delayed payment of VAT, a car-scrapping incentive, and mortgage rates capped at 4% (Dilje 2008; OECD n.d.). This package also emphasized the state's responsibility of underwriting special convertible bonds issued by banks, including state help for Italian banks worth up to US$25.2 billion (€20 billion) to ensure their continuous support by lending (Economy Watch 2010a).

In general, 2009 was characterized by widespread negative economic performance. GDP in Italy decreased in real terms by five percentage points from its average value recorded in 2008 (Knight 2011). In 2009, the number of people in employment declined by 380,000 (−1.6% on an annual basis), while the unemployment rate rose to 7.8% (Eurofound 2010). The economic recession affected the Italian production system in its entirety, with mechanical engineering and small companies taking the worst hit in terms of turnover, investments, and employment. In many cases, these crises also affected large-sized companies, causing damaging effects to subcontractors and suppliers (Eurofound 2010). During the financial crisis, the largest job losses have taken place among workers on temporary employment contracts.

Overall, Italy's precrisis stagnation and crisis vulnerability resulted from an inefficient state of bureaucracy, high levels of corruption, heavy taxation, and high public spending that accounts for about half of the national GDP. Like Spain, the country's productivity level was low, and like Greece, it had a problem in collecting tax and suffered from massive debt (First Post, n.d.).

Portugal

Portugal has become a diversified and increasingly service-based economy since joining the European Community—the EU's predecessor—in 1986; after that, the economy grew by more than the EU average for much of the 1990s, but fell back in 2001–2008 (CIA 2012). Since then, Portugal has become one of the weakest economies in the Euro zone, with traditionally high unemployment, inflexible labor laws, and governments that paid scant attention to improving overall competitiveness (Reguly 2011). From 2002 to 2007, deficits averaged well over 3% of GDP and the unemployment rate increased 65% (270,500 unemployed citizens in 2002, 448,600 unemployed citizens in 2007) (Barnes 2010). As a result, the country was ill prepared to get through the financial crisis of 2008.

Initially, the financial sector actually remained sound in Portugal, with the absence of a real estate bubble in the years preceding the crisis and low exposure to toxic assets (Barnes 2010). However, the country has been increasingly overshadowed by lower-cost producers in Central Europe and Asia as a target for foreign direct investment (CIA 2011). In 2008, Portuguese economic growth remained positive at 0.3%. Yet, the cumulating government debt, lasting high unemployment, high public spending, and low productivity began to crack up with the unfolding of the global financial recession. The GDP of Portugal contracted by 2.7% in 2008–2009 largely due to shrinking domestic demand. The impact on the labor market and on public finances has been especially severe, as unemployment rose to 9.47% in 2009; the budget deficit increased from 2.8% of GDP in 2008 to 9.4% in 2009 (Euro Challenge 2012).

This weak position is partly the result of overreliance on consumption and housing activity in the early 2000s. Weak subsequent labor productivity coupled with insufficient wage moderation has caused the large current account deficits (Barnes 2010). Portugal's growth prospect was weak and the financial crisis affected its economy severely, causing a wide range of domestic problems. Public deficit hiked with excessive debt levels, soaring to about 223% of Portugal's GDP (Tirone 2011). While the sovereign debt crisis took place mainly in Greece, it also triggered a wider lowering of confidence in national government throughout the entire European Union. As Portugal is akin to Greece in high government deficits and runs a deficit of 9.4% of GDP, it was impacted severely.

The Portuguese response to the crisis, approved by the Council of Ministers in December 2008, was the Investment and Employment Initiative. This strategy included an enhanced set of measures focused on the reinforcement of public investment, modernization of schools, technological infrastructures, direct support to the economy through fiscal measures, incentives for SMEs and exports, and support for employment and for the adoption of renewable energies (Economy Watch 2010b; Nelson et al. 2011). The Investment and Employment Initiative represents an additional stimulus to the economy of around US$2.92 billion (€2.18 billion, about 1.25% of GDP), of which US$1.74 billion (€1.3 billion, 0.8% of GDP) is directly financed through the government budget. Fifty percent of Portugal's economic stimulus package would be provided by members of European Union and remaining amount would come from Portugal itself (European Commission 2010; Economy Watch 2010b).

In January 2009, the Portuguese Parliament approved a new scheme of fiscal incentives focused particularly on research and development (R&D), extending the maximum rate of tax credit to 82.5% of total expenses on R&D, the highest rate in Europe. The system comprises two distinct components, cumulative in nature, with a fixed tax credit of 32.5% of total yearly expenses on R&D (also the highest in Europe), together with a second component of 50% over the annual increase of those expenses (OECD 2009). Unfortunately, the crisis coping measures did not turn the economy around.

In December 2009, Standard and Poor's rating agency lowered its long-term credit assessment of Portugal to "negative" from "stable," voicing concerns about the country's structural weaknesses in its economy and decreasing competitiveness (First Post 2011). Investors bet against Portugal, raising their premiums, and making it increasingly likely the country would not be able to finance itself in debt markets. Overall, the country's dependence on foreign debt made it more susceptible to the financial crisis.

Spain

Spain's mixed capitalistic economy is the 13th largest in the world, and its per capita income roughly matches that of Germany and France; however, after almost 15 years of above average GDP growth, the Spanish economy began to slow in late 2007 and entered into a recession in the second quarter of 2008 (CIA 2012). Of all the European countries, Spain was one of the most gravely affected by the global economic crisis. Even without the global recession, Spain would most likely be undergoing a correction due to its extremely overheated housing market. At one point, investments in the Spanish housing sector made up almost 10% of its GDP (Stratfor 2009). Spanish mortgage lenders were offering loans very liberally—particularly to young migrants with no prior credit history, as part of government policies to speed up integration and assimilation—and were often giving loans of more than 100% of a property's total value (Stratfor 2009). In addition to heavily subsidized home ownership, wage growth outpaced that of other European countries, thus heightening financial vulnerability. During the third quarter of 2008 in Spain, the national GDP contracted for the first time in 15 years and in February 2009, it was confirmed that Spain had officially entered into a recession.

Actually, the Spanish banking system has been credited as one of the most solid and best equipped among all Western economies to cope with the worldwide liquidity crisis, as banks are required to have high capital provisions. In addition, banks demand various proofs and securities from intending borrowers (The Economist 2008). However, according to the Spanish Ministry of Housing, the residential real estate prices rose 201% from 1985 to 2007 and there was a growing family indebtedness (115%) chiefly related to the real estate boom and rocketing oil prices. Government housing statistics also showed that in the second quarter of 2005, Spanish families already carried US$841,700 million (€651,168 million) in mortgage debt. Based on Eurostat, from June 2007 to June 2008 Spain was the European country with the sharpest plunge in construction rates. After the outbreak of the 2008 global financial crisis, Spain experienced financial worries as well due to the collapse of its housing market, the deep involvement of unregulated savings banks in the real estate market, and increased public benefits that caused higher government spending and government debt.

Another key factor that complicated the situation was that around half of Spanish banks were unregulated. Spanish regional savings and loan banks, called *cajas*, account for half of Spain's banking system. They are not publically traded and are usually controlled by regional politicians instead of shareholders; in addition, they were not required to disclose certain information such as collateral on loans, repayment history, and loan-to-value ratios (Harrington 2011). Cajas often loan to those that larger banks turn away due to worries of repayment ability. However, when Spain's two largest banks slowed lending in 2007, the cajas continued to lend heavily into the cooling housing market. By 2009, cajas owned 56% of the country's mortgages, and loan payments from property developers accounted for one-fifth of the cajas' assets (Harrington 2011). When the housing market crashed in 2009, the cajas were paralyzed by a lack of income from these delinquent loans (Harrington 2011).

According to Hugh (2010), Spain's basic problem is not a fiscal one but a rapid escalation of the fiscal deficit in the context of a heavily indebted private sector. Even before the financial crisis, Spain's unemployment rate climbed around 37% between October 2007 and October 2008. By July 2009, it had shed 1.2 million jobs in one year. Compared to February 2008, Spain's industrial production declined 22% in February 2009 (Stratfor 2009). According to National Statistics Institute released on April 24, 2009, Spain for the first time in her history had over 4,000,000 people unemployed (BBC 2009). As unemployment skyrocketed, so did unemployment benefits. In a welfare state like Spain, unemployment benefits are generous. However, the reductions in the Spanish government's tax revenue, which is heavily dependent on real estate, exacerbated the problem.

In late 2008, the Spanish government announced a stimulus package of US$66 billion (€50 billion). Of that amount, US$10.6 billion (€8 billion) was distributed directly to local authorities for public projects meant to create 200,000 jobs (European Commission 2010; Stratfor 2009). With global demand for auto exports and industrial goods declining, production in the Spanish automotive sector declined by a whopping 47.6% in February 2009. To save the industry, the government gave around US$2,577 (€2000) in subsidies to new car buyers during the financial crisis to support car sales, as Spain's automotive sector accounts for about 10% of the country's total economic output and 15% of its total exports (Stratfor 2009).

In the past decade, Spain has enjoyed the low EU interest rate which prompted its continued growth. Yet by adopting the Euro, Spain could not devalue its currency. With Spain's rising debt, investors became more reluctant to invest and Spain's economy further declined (Harrington 2011).

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