The G20 and Global Capital Markets

Critical Issues and Analysis

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Introduction

Countries stood in solidarity with Norway after it experienced the largest attack on national soil since World War II, on July 22. A bomb was detonated outside the prime minister's office in downtown Oslo and a shooting rampage at a summer camp on Utøya Island by confessed killer Anders Behring Breivik left the country and the world in shock.

At long last there is some good news for Japan. Moody's Analytics has reported that half the loss of output has rebounded and the growth outlook for 2012 is 3.2%. However, it says the Bank of Japan is not being aggressive about deflation and the strength of the yen.

Consumer confidence is waning across the globe — even in countries with strong fiscal positions such as Canada. Consumers cite job worries and therefore the ability to pay back credit obligations as the reason for the decline. Consequently they are also holding off on buying big ticket items.

In July, the U.S. Justice Department launched a criminal investigation into the role of Credit Suisse in a case of tax evasion involving four bankers indicted on charges of conspiring to help clients through secret bank accounts, similar to a case against UBS in 2008–09. The Swiss and U.S. governments are in talks with respect to untaxed assets held in Swiss bank accounts.

The European debt crisis intensified as Moody's downgraded Ireland and Portugal to junk status. Saying default seemed certain, Moody's also downgraded Greece one notch above a default rating even after European leaders produced a rescue plan on July 21. Fitch had already downgraded Greece's credit rating. The heads of state and government in the euro area and the EU institutions agreed on a further bailout for Greece, calling on the International Monetary Fund (IMF) to finance a total of €109 billion with voluntary contributions from the private sector to cover the financing gap. The leaders agreed to extend loan repayment periods and to cut interest rates. Furthermore, Greece must relaunch its economy by promoting competitiveness, growth, job creation and training. The rescue plan is designed specifically for Greece's exceptional and unique situation.

To prevent possible contagion, European leaders agreed to increase the flexibility of the European Financial Stability Facility (EFSF) to be able to lend to states on a precautionary basis and recapitalize financial institutions through loans to governments in countries not under any program. The EFSF will be allowed to intervene in secondary markets in certain financial market circumstances as determined by the European Central Bank (ECB) if there is risk to financial stability. The intervention would require an agreement of the member states of the EFSF or the European Stability Mechanism (ESM), which will replace the EFSF in 2013. The leaders pledged continued support to the countries successfully implementing their programs to increase fiscal consolidation and growth in the euro area. They also agreed to apply the EFSF lending conditions of extended debt maturities to a minimum of 15 years and reduced interest rate to 3.5% to Greece as well as Portugal and Ireland. Furthermore, they agreed that all the euro area member states will strictly adhere to the fiscal targets they set. In addition to solving their eventual macroeconomic imbalances, the member states (with the exception of those under a program) will have to reduce their deficits below 3% by 2013. As an additional assistance measure, the leaders invited the European Commission and the European Investment Bank to help the countries currently receiving EU and IMF assistance to absorb EU funds, which should increase growth and employment.

With regard to economic governance, the euro area members called for the rapid finalization of instruments to strengthen jobs and growth and macroeconomic surveillance. They agreed that the importance of external credit ratings should be reduced and they called on the European Commission to present proposals on credit rating agencies. Herman Van Rompuy, president of the European Council, was invited to propose improvements to crisis management in the euro area by October.[1]

As the debt crisis spread to Italy, which has the largest outstanding debt load in Europe, but which passed an austerity budget package cutting €47 billion, French banks are being scrutinized for

1 European Council (2011), "A Common Response to the Crisis Situation," July 21. <www.european-council.europa.eu/home-page/highlights/a-common-response-to-the-crisis-situation.aspx?lang=en>.

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exposure. The Bank of International Settlements (BIS) reports that 45% of Italian debt held by foreign banks is held by French institutions, which is more than France's exposure to Greece, Ireland, Portugal and Spain combined.

In the United States, after a tense month of negotiations and the threat of a downgrade, markets were rattled as the deadline for the country's debt default grew closer. Late on July 31, lawmakers agreed to raise the debt ceiling by at least $2.1 trillion and to cut $1 trillion in spending over the next 10 years, accompanied by a deficit reduction of $1.5 trillion to come from bipartisan committee recommendations.

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