The debt crisis in Europe – developments during the spring

The debt crisis in Europe has recently been mainly characterised by the elections in Greece, the problems in the Spanish banking sector and the concern that problems would spread to Italy. This has contributed to increased financial unease in the euro area, which has a negative effect on the conditions for growth. The following article aims to provide a general outline of the recent sequence of events in the debt crisis.[9]

Ireland says yes to fiscal package and Portuguese bank support

At the beginning of June, Irish voters said yes to the EU's fiscal compact (see the Monetary Policy Report published in February 2012 for a more detailed description of the fiscal compact). This means that Ireland's budget deficit in relation to GDP must be reduced to the limit of 3 per cent stipulated in the EU Stability and Growth Pact, by 2015. At the end of 2011, the deficit amounted to just over 13 per cent of GDP.

It is also clear that Portugal will inject new capital into three of its largest banks. All in all, this involves an additional EUR 6.6 billion to meet the European Banking Authority's requirement that core Tier 1 capital in the banks should amount to 9 per cent, with effect from the end of June 2012.

Greek election leads to new government

Greece has earlier been granted two loans by the IMF and the EU which amount to a total of EUR 180 billion. The background to the loans is that the country's national debt is at an unsustainable level and they have not succeeded in refinancing it on the market. The loans are part of a support programme that is conditional on Greece strengthening its public finances, which has been difficult to achieve. The savings requirements led to a new election at the beginning of May 2012. The election entailed successes for parties opposed to the agreed savings programme. The difficulties in forming a majority government led to an extra election being called on 17 June. The new democracy party, which expressed support for the savings programme, has since been able to form a government together with two support parties.

When the IMF approved the second programme for Greece in March 2012, a first review was planned for the end of May. However, the review was postponed while waiting for a government with which to hold a dialogue. Prior to this first review, a number of criteria were to be met for Greece to receive the next payment. However, there is a large risk that Greece will not have succeeded in fulfilling the requirements.

Cyprus has also applied for assistance

At the end of June, Cyprus also applied for assistance from the EU. This was done with reference to the financial sector's large exposure to Greece. Preliminary data points to the need for assistance amounting to

[9] See also the article "The debt crisis in Europe" in the Monetary Policy Report of October 2011.

almost EUR 10 billion, which corresponds to more than half of the country's GDP.

Spanish banking crisis caused by problems in the property sector

The Spanish banks' total lending to the property sector amounts to around 30 per cent of Spain's GDP. This, together with housing prices having declined by 25 per cent over the past four years, has led to a large percentage of problem loans. In April this year the percentage of loans with late payment amounted to almost 9 per cent of the total outstanding loans, which is the highest figure since April 1994, according to the Spanish central bank. The credit rating agency Moody's cut the credit ratings for a large number of Spanish banks in May and June, with reference to their exposures to the Spanish state and the risk of further losses in the wake of the on-going property crisis. Spanish banks are also among those who have increased their borrowing from the ECB the most during the spring.

The problems in the banking sector have become clear in the case of Bankia, which is a merger of seven smaller savings banks. Bankia is the Spanish bank with the largest exposure to the property sector. At the end of May, the bank requested EUR 19 billion in government support, which has given the state a controlling share in the bank of around 90 per cent.

Support to Spanish banks

Parts of the banking sector now need to be recapitalised. The Spanish government therefore requested support for its banking system from the other euro area countries in June. Prior to this they had issued a promise of loans of up to EUR 100 billion. This amount is much larger than the 40 billion that would be needed according to an IMF report to recapitalise the banking system and the 62 billion that a preliminary, independent evaluation had calculated in June. A loan of EUR 100 billion corresponds to scarcely 10 per cent out of Spain's GDP. The cost of the loan caused Moody's to cut Spain's credit rating by three stages in the middle of June.

The condition for the support is that Spain reforms its financial sector. The support will be administered by the Spanish state bank fund, Fondo de Reestructuración Ordenada Bancaria (FROB). At present, there is no fiscal policy measures package to accompany the loan; more than that Spain shall follow the regulations regarding budget discipline in the so-called "Six Pack" agreement (see the Monetary Policy Report in February 2012 for a more detailed description of the "Six Pack" agreement).

Public finance deficit in the Spanish regions

The market unease regarding Spain has also been affected by the deficits in the Spanish regions' finances. The region of Catalonia, which accounts for 20 per cent of the Spanish economy, has loans maturing that amount to almost 7 per cent of the region's GDP in 2012. This has recently made the regional president request assistance from the Spanish state to finance the deficit. The regions' indebtedness led to Moody's downgrading the credit rating for Catalonia and three other Spanish regions in May.

Concern that problems may spread to Italy

The increased concern over the situation in Spain has put further focus on Italy. Concern among investors is largely based on uncertainty over whether the Italian government has the capacity to implement the necessary measures to manage the country's large national debt. This is reflected in, for instance, the fact that Italian government bonds, like Spanish interest rates have increased recently. In addition, there are also problems in the banking sector in Italy. The government decided at the end of June to lend EUR 2 billion to Banca Monte dei Paschi di Siena. The bonds issued by the bank should be convertible to share capital at a later date and the aim is that the bank can then meet the European Banking Authority's requirement for core Tier 1 capital to amount to 9 per cent with effect from the end of June.

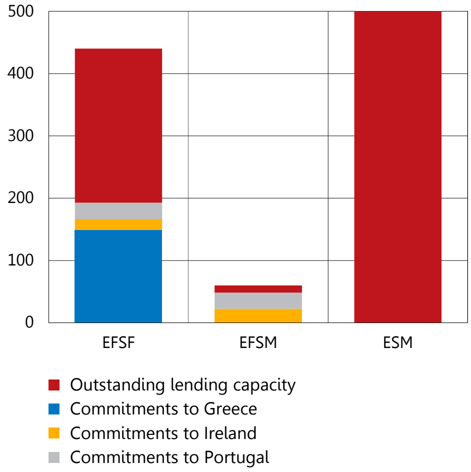
Support programme aimed at helping countries in crisis

At the same time as Greece was granted the first support package in May 2010, two temporary support facilities were established: the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF). The EFSM is guaranteed by the EU budget, while the EFSF is guaranteed by the euro area countries. These temporary facilities will be replaced by the permanent European Stability Mechanism (ESM), which will come into force at the beginning of July 2012 (given that all of the euro area countries have ratified the ESM treaty). On 30 March the Eurogroup decided that the EFSF and the ESM will run parallel to one another from July 2012 until the end of June 2013.

The EFSF's commitments to Greece, Ireland and Portugal amount to EUR 193 billion, and the EFSM has commitments to a value of EUR 48 billion to Ireland and Portugal (see Figure A1). To fund its lending, the ESM will take loans on the open market. To ensure that the ESM receives the highest credit rating, it has been given a capital structure similar to that of the IMF, with capital paid in. The euro area countries will gradually pay in capital so that in 2014 the total capital will amount to EUR 80 billion. This is assessed to be compatible with the intended lending capacity of EUR 500 billion. If the ESM needs to borrow money prior to this, the euro area countries have undertaken to ensure that the capital paid in always amounts to at least 15 per cent of the ESM's borrowing.

Despite the support programmes, the financial unease in the euro area has not abated. It has mainly affected Spain, through higher yields on the country's government bonds (see Figure A2). The ten-year rate has at times been above 7 per cent during the spring, which is the same level as prior to aid loans being granted to Greece, Ireland and Portugal (see Figure A3).

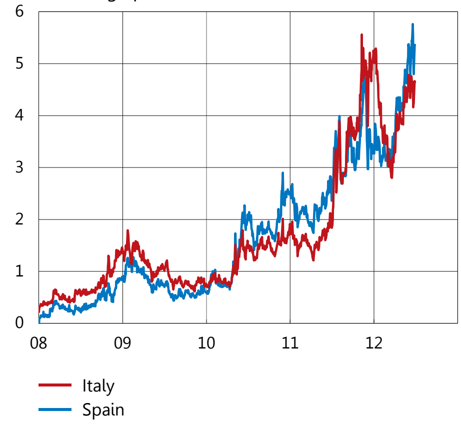
Figure A1. Support programme measures
Billion EUR



Note. Lending capacity in the ESM is attained through payments of capital made up to the end of 2014. The remaining lending capacity in the EFSF and the EFSM is only intended for use while waiting for the ESM to attain full capacity. This means that the total outstanding lending capacity will not exceed EUR 500 billion.

Sources: European Financial Stability Facility (EFSF) and European Financial Stability Mechanism (EFSM)

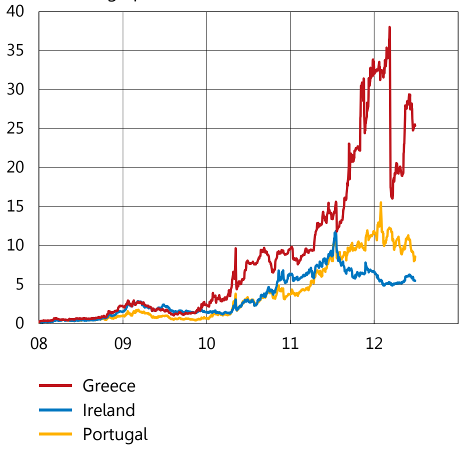
Figure A2. Government bond rates in various countries (difference compared to Germany)
Percentage points



Note. Government bonds with approximately 10 years left to maturity.

Source: Reuters EcoWin

Figure A3. Government bond rates in various countries (difference compared to Germany)
Percentage points



Note. Government bonds with approximately 10 years left to maturity.

Source: Reuters EcoWin

New agreements on how the relief mechanisms will be used

At the meeting of the European Council on 28-29 June an agreement was reached regarding the use of the rescue funds, which aims to break the links between banks' and countries' credit ratings.

The ESM relief fund is given the opportunity to recapitalise banks directly so that, for instance, the relief loans to Spanish banks will no longer be added to the Spanish national debt. Bank recapitalisation within the scope of the on-going relief programmes, for instance, in Ireland, may also be affected. One condition for direct recapitalisation of banks is that a joint banking supervision facility is first established under the ECB.

Further, the agreement means that the relief loans to Spanish banks will not have priority over other claims in the way that normally applies to loans from the ESM, which reduces the risk for private lenders and is expected to contribute to lower interest rates.

It was also proposed at the meeting of the European Council that the relief funds shall be used in a flexible way to stabilise the markets, which could entail relief purchases of government bonds to hold down interest costs for countries that observe the agreed budgetary regulations.