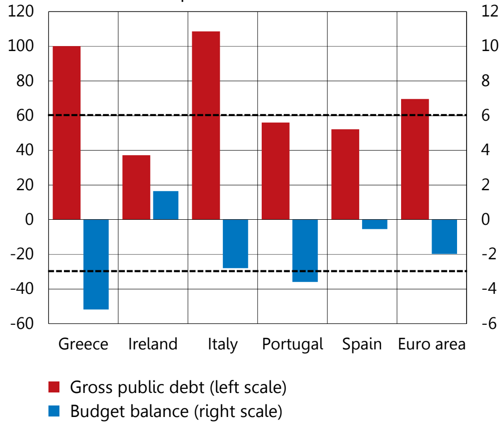
The debt crisis in Europe

The debt crisis in the euro area is creating considerable unease on the financial markets. The central issue is the risk that Greece and other countries with weak public finances will experience difficulties in paying off their loans. Potential debt write-offs would rebound on the lenders, who are mainly the banks in the crisis countries but also banks in, for instance, Germany and France. The link between heavily-indebted states and the international financial system has meant that concern has also spread to other countries than those that are most under pressure. Greece, Ireland and Portugal have received extensive aid, but these measures are mainly useful in managing the acute situation. Resolving the more long-term problems requires that the crisis countries implement fiscal policy tightening to reduce public sector deficits, as well as structural and institutional reforms to regain lost competitiveness and improve the functioning of the economy. This article aims to provide a more detailed description of the conditions for managing the debt crisis in the euro area.

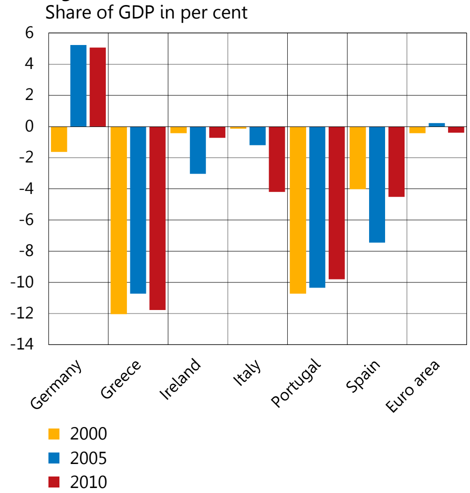
Figure A11. Gross public debt and budget balance, average 1997–2007
Share of GDP in per cent



Note. The broken line indicates the criteria of the Stability and Growth Pact, according to which public debt may amount to a maximum of 60 per cent of GDP and the budget deficit to a maximum of 3 per cent of GDP.

Source: European Commission

Figure A12. Current account balance
Share of GDP in per cent



Source: European Commission

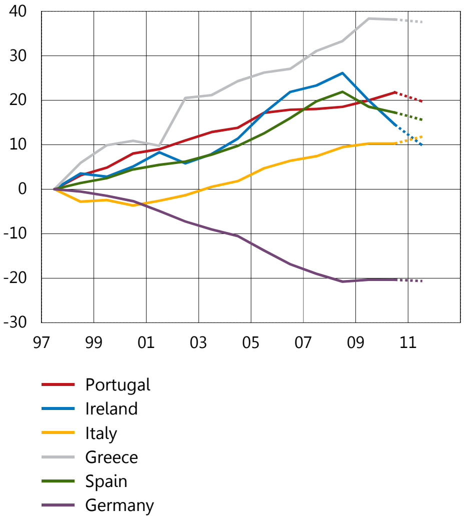
Various reasons for weak public finances

Since spring 2010 Greece, and later on Ireland and Portugal, have experienced difficulty in obtaining funding on the international bond market. Both Greece and Portugal have long had problems in their public finances, which has also led to a confidence crisis for their domestic banking sectors. Ireland, which on the other hand had a relatively low sovereign debt to start with, (see Figure A11), instead had high credit growth in the private sector in the wake of soaring property prices. The financial problems in the Irish public sector arose more as the result of the state taking on the costs of guarantees for banks affected by falling asset prices during the financial crisis. What the countries now suffering problems have in common is that they had relatively low total domestic savings. This was reflected in the current account deficit, which was funded through an inflow of capital from abroad, something that became more difficult to obtain during the financial crisis 2008-2009 (see Figure A12). Another common factor is that these countries have for a long time been losing competitiveness in relation to the average for the euro area (see Figure A13).

Greece, Ireland and Portugal are now receiving assistance from the International Monetary Fund (IMF), the EU and the euro area collaboration through three year aid packages corresponding to around 45 per cent of GDP in each respective country.[9] In return, they must implement measures to reduce their public deficits and debt levels in order to regain market funding. Regardless of the cause of the current weak public finances, the crisis countries are thus facing the same challenges: tightening to reduce budget deficits and public debt, as well as reforms to regain their international competitiveness and to improve their growth prospects.

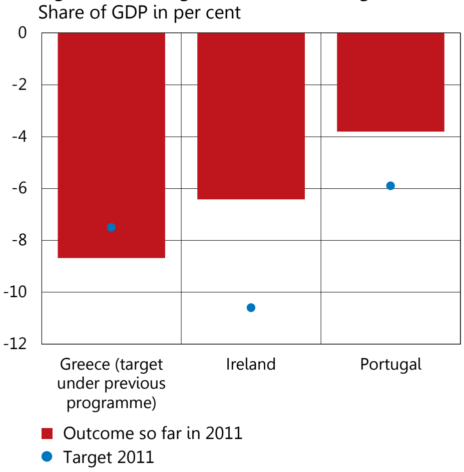
[9] Greece's package corresponds to around 48 per cent of GDP, Ireland's to 43 per cent (excluding its own funds) and Portugal's to 45 per cent.

Figure A13. Unit labour cost compared with the average for the euro area
Difference between index where 1997 = 100



Note. The broken line represents the OECD's forecast.
Source: OECD

Figure A14. Budget outcome and target
Share of GDP in per cent



Note. Budget outcome until the end of September. For Ireland, target and outcome are specified excluding capital injections to the banks. In Greece's case, it has already been established that the targets for 2011 will not be achieved.
Sources: National sources, Eurostat and IMF

Over the past year the reforms in Ireland have continued and the country looks set to meet the fiscal policy goals in the support programme (see Figure A14). All in all, developments have resulted in much lower, albeit still relatively high, bond rates. Portugal has recently needed to announce new measures to attain its fiscal policy goals. Greece has implemented substantial tightening. However, the situation has deteriorated lately, with a heavy fall in growth and problems in implementing further measures. As a result, Greek bond yields remain at a high level (see Figure A15). As Greece, Ireland and Portugal are being funded through the support programmes and not at these rates, the levels are not a direct measure of the difficulties in obtaining market funding, but they nevertheless comprise an indicator of confidence in the countries' fiscal policy prospects.

What help is available?

Prolonged negotiations regarding a second support package for Greece, combined with questions regarding the euro area's management of debt crises within the monetary union have contributed to the unease spreading to more countries than those hardest hit. For example, the interest rate differential for government bonds with regard to Germany rose in Spain, Italy, Belgium and Cyprus and even France during summer 2011. Part of the unease appears to revolve around if and when the current support facilities can be extended to offer further guarantees to individual countries and to possible capital injections to European banks.

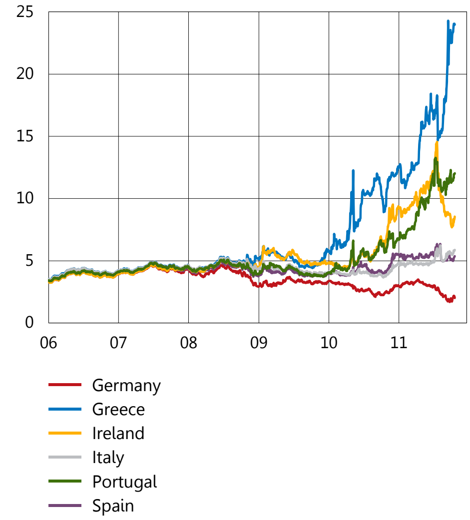
The facilities currently available consist of three parts. The largest, the EFSF (European Financial Stability Facility), was established in spring 2010 and has been built using guarantees from the euro area countries themselves. With the support of these guarantees the EFSF will take loans on the international capital markets and in turn grant loans to euro countries in financial distress. The second part is the EFSM (European Financial Stability Mechanism) which is based on a guarantee from the EU. With effect from 2013 these two will be replaced by the European Stability Mechanism, ESM. The third part, which was also announced in spring 2010, was that the IMF could provide loans of up to EUR 250 billion. Ireland's and Portugal's support packages are funded with the aid of these mechanisms, while the first support package for Greece was funded through bilateral loans from the IMF and several EU countries.

In addition to the assistance provided through the above facilities, the ECB has made support purchases of government securities as part of its extraordinary measures.

As the debt crisis in the euro area has intensified, decisions have been taken on gradual extensions to the EFSF and its mandate. For one thing the guarantee framework has been raised to retain a lending capacity of EUR 440 billion. Moreover, the EFSF should be able to provide support through direct purchases of government bonds. It has also been decided that the EFSF should be able to offer credit facilities to countries that do not have acute funding needs, and provide loans to fund the recapitalisation of banks even in euro countries not covered by the existing support programmes.

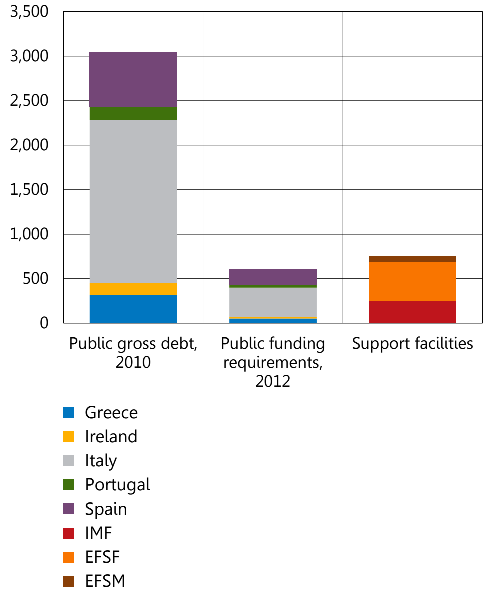
The current facilities do include some scope to help further countries in addition to those already receiving assistance. Figure A16 shows the support facilities (including the 140 billion or so promised in the existing programmes) in relation to the funding needs of Greece, Ireland, Italy, Portugal and Spain over the coming year. But if several large countries, such as Spain and Italy, were to experience problems obtaining funding on the capital markets at the same time, the money would not be enough. One can add a need for capital injections to several European banks. One difficulty in this context is that many euro area countries cannot significantly increase their guarantees to the EFSF without the risk of losing credibility for their own public finances. Discussions about this were still underway at the EU-level at the time of the monetary policy meeting.

Figure A15. Government bonds with 10 years left to maturity
Per cent



Source: Reuters EcoWin

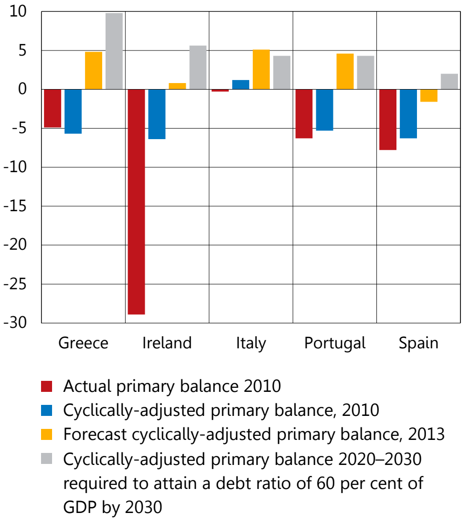
Figure A16. Support facilities and possible needs
Billions, EUR



Note. Public funding requirements are forecast budget deficit plus maturity.

Sources: Bloomberg, European Commission, Eurostat, IMF and the Riksbank

Figure A17. Austerity requirements
Per cent of GDP



Note. Primary balance refers to budget balance minus net interest income. Cyclically-adjusted primary balance when adjusted for level of economic activity.

Source: IMF Fiscal Monitor September 2011

Sustained challenge

However, the above programmes aim to manage the more acute problems of liquidity shortages – not to provide long-term support for the crisis countries. As the countries must show that they can gradually manage their own funding, the willingness of the guarantee countries to inject more money will depend on the willingness of the countries receiving assistance to make reforms.

Regardless of how the problems are managed in the short term, the countries must thus implement fiscal policy reforms over a long period of time. The Riksbank has shown in an earlier article that today's crisis countries must make the transition from deficit to a surplus that must be maintained for many years to attain a sustainable debt development.[10] Despite a considerable improvement in the budget balance in Greece and Ireland, there is a long way to go before they reach a level that can stabilise their debt, and even further to go before they can reach a debt level of 60 per cent of GDP in accordance with the requirements of the Stability and Growth Pact (see Figure A17). In comparison, it can be mentioned that it took Sweden around four years to stabilise a relatively lower public debt ratio during the 1990s.

But it is not only tax increases and savings that are necessary. Many of the countries now experiencing problems as a result of weak public finances also have weak economic policy institutions and have a relatively low rating according to indicators that can be used as measures of institutional weakness.[11] This may make it difficult to recover taxes, but also to make savings in the public sector. Structural reforms are thus important, to raise the long-term growth rate and tax revenue in the economy, and also to improve the institutions so that it is possible to actually recover these taxes.

It is a difficult challenge to attain a credible reduction in debt without at the same time slowing down demand too much. The Riksbank's growth forecast for the euro area is therefore moderate, despite a large amount of spare capacity in the economy. The challenge is particularly great for the countries that are forced at the same time to restore their competitiveness by holding back prices and wages. But although tighter fiscal policy can be expected to hold back growth in several euro countries over the coming years, it is necessary to maintain increased fiscal policy discipline in heavily-indebted countries. This is required to create stability and reduce vulnerability in the future.

[10] See the article "The sustainable development of public debt?" in the Monetary Policy Report, July 2011.
[11] See, for instance, Transparency International's Corruption Perception Index, the European Commission's measure of the illegal sector as a percentage of GDP (European Economy, nr 5, 2011) or the World Bank's Worldwide Governance Indicators.