Financial unrest in Europe – possible consequences for financial stability in Sweden

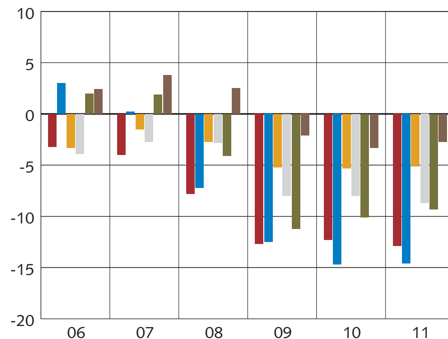
Increased problems with refinancing central government debt in European sovereigns with the weakest government finances may lead to higher interest rates, thus increasing costs for banks and businesses. Given that the banking system in Europe is closely integrated, increased concern for banks in southern Europe could spread further up through Europe. Contagion could spread both from banks in fiscally weak countries to their counterparties in other countries and via subsidiaries and branches. Such a development could entail disturbances in the functioning of the financial market and could also affect financial stability in Sweden.

The financial crisis has exposed and exacerbated fiscal weaknesses in several European sovereigns and led to concern in the market over how in particular countries such as Portugal, Italy, Ireland, Greece and Spain will be able to fund their budget deficits. Part of the increased budget problems can be attributed to costs directly related to the financial crisis. For example, the tax intake has decreased while government expenditure, such as unemployment support, has increased. Fiscal policy stimulation programmes have also been launched to prevent further falls in demand. All in all this has led to large budget deficits that are funded through government market borrowing. The deficit, in turn has increased countries' central government debt.

For the countries entering the crisis with weak government finances this has led to record deficits. For example, Greece had a deficit of 13.6 per cent of GDP in 2009, closely followed by Ireland and Spain, which also had two-digit deficits (see Chart B1). The large borrowing requirements have led to central government debt relative to GDP in industrial countries growing faster than at any time since the Second World War. Sweden, on the other hand, entered the crisis with a large fiscal surplus and, even if the deficit has risen since 2009, it is low in an international comparison. The CDS spread has risen since October 2009, particularly for Greece, but also for the other four EMU countries with the weakest government finances (see Chart B2).

Country risk, measured in terms of the CDS premium, is affected by several factors related to a country's financial position. Country risk is affected by the amount of the claims held by international banks on the country's public sector and by how great the need is to consolidate central government finances. Furthermore, a country's current account affects its country risk, as this captures the degree of saving in both the public and private sectors. Major current account deficits are an indicator of rapidly growing foreign debt and increasing risks for the sustainability of a country's financial position.

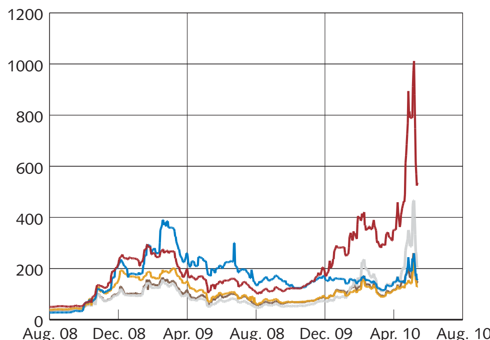
Chart B1. Budget balance in selected EU countries
Percentage of GDP



Note: Forecasts for 2010 and 2011 are taken from the European Commission.

Source: Reuters EcoWin

Chart B2. CDS spreads (5 years) for selected EU countries
Basis points



Source: Reuters EcoWin

Even if all these five countries' economies have several common features, there are also differences between them. Greece's main problem is government finances and a large central government debt in relation to GDP. Spain has extremely high unemployment of almost 20 per cent and its property market has collapsed, which has also happened in Ireland. Italy has a lower budget deficit but instead a central government debt of 116 per cent of GDP. All in all most countries must tighten their budgets considerably in coming years to achieve balance and prevent an explosive increase in sovereign debt.

Increased sovereign debt risks leading to higher interest rates. An increase in the budget deficit of one percentage point in relation to GDP tends from a historical perspective to lead to a rise in ten-year rates of just over 30 basis points. Some countries, however, risk being hit by considerably greater interest rate increases. Drastic increases in interest rates have already affected primarily the southern European countries. Higher interest rates may mean, in principle, that it will be impossible to pay off the debt. Ultimately, the country may be forced to seek external funding, for example from the International Monetary Fund (IMF), or suspend payments and renegotiate central government debt.

Greece has opted for the first of these alternatives. Greece's estimated borrowing requirement is, however, so great that the other euro countries have also decided to grant loans. The situation can be compared with that prevailing in the autumn of 2008, when Iceland and Latvia received extensive financing packages from the IMF, towards which the Nordic countries, among others, contributed financing. Just as in that case, the loans to Greece are linked to conditions. These are intended to stabilise public finances and increase the competitiveness of the Greek economy.

Even if the loans allow Greece to implement necessary reforms, it remains to be seen if this will be sufficient to extricate the country from its debt crisis. There is a risk that part of the debt will have to be written down when it proves to be too large to be paid. One problem is that the international community currently lacks any framework for dealing with such a situation. Earlier cases of countries suspending payments on central government debt, such as Argentina in 2002, have proved to be difficult to manage from the point of view of coordination, since it is often a matter of different types of creditor that are affected. This in turn has contributed to unnecessary unease in the financial markets. In 2003, the IMF discussed setting up a mechanism, the Sovereign Debt Restructuring Mechanism (SDRM), which could make it easier for countries that had to suspend payments by increasing incentives for borrowers and lenders to reach rapid and orderly agreement. The member countries of the IMF did not, however, succeed in agreeing on this proposal.

Several of the countries also have a highly indebted private sector. This applies in particular to Ireland, Portugal and Spain. As a rule, increased refinancing costs for the government also mean that the private sector has to pay more to refinance its debt. This may in turn lead to fiscal problems spreading to the private sector. This makes these countries particularly vulnerable in a situation when the market is questioning their fiscal consolidation ability.

Most states have thereby found themselves facing a difficult dilemma – budget deficits need to be reduced to keep risk premiums on government bonds down. Otherwise there is a risk that interest rates will rise, possibly impeding economic recovery. Budget cuts may mean falling demand, which may hinder growth, with an even worse budget situation and even higher interest rates in consequence. Accordingly, a balance must be struck between fiscal stimulation and budget discipline. For this reason a recovery in private demand is also important. Up to now, countries that have initiated major cuts seem to have succeeded in keeping risk premiums down. To some extent, Ireland and the Baltic countries are examples of this.

How could stability in the financial system in Sweden be affected by these developments? There are principally three channels through which fiscal uncertainty could affect other countries.

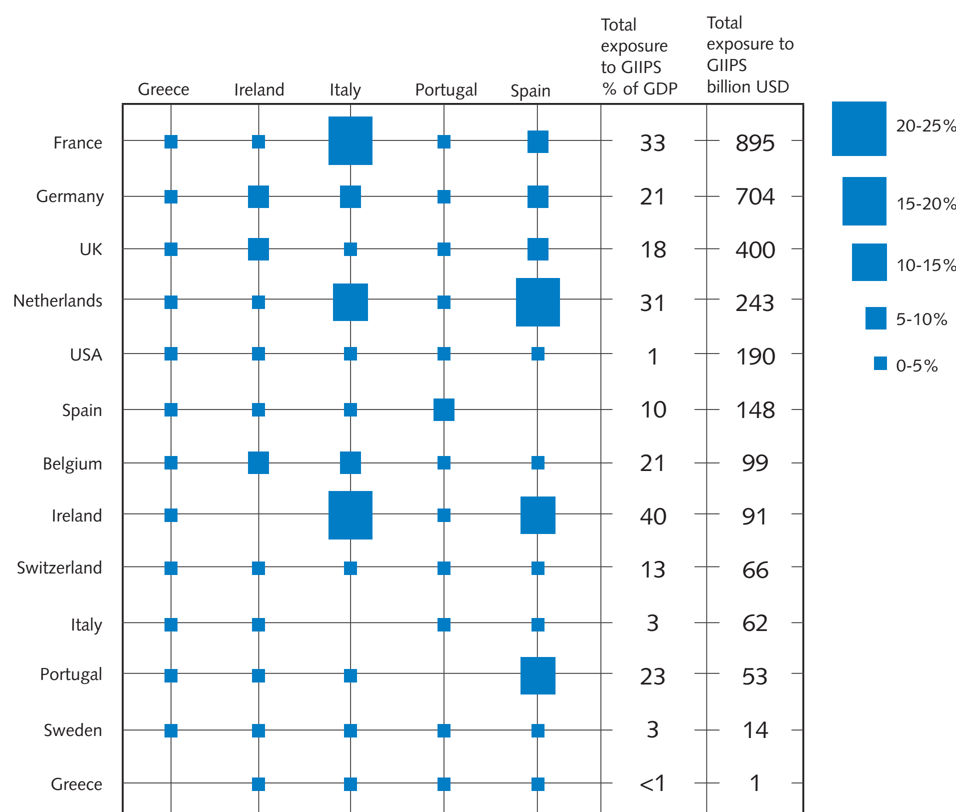
A first channel could be directly through the banking system. Swedish banks have relatively little exposure to Portugal, Italy, Ireland, Greece or Spain. This means that there is no risk that problems in any of these countries would affect the Swedish banking system to any great degree via their exposures.

Another channel could be contagion through the financial system in Europe. Banks in countries such as France and the Netherlands have large exposures in Spain. A large part of the Spanish central government debt matures this year and over the next four years. In a situation where growth is not picking up and fiscal consolidation is not being implemented as planned there is a risk that the market will increase its focus on the Spanish government finances. This, in combination with continued general concern over the fiscal situation, above all in Greece, Portugal and Ireland, could lead to an increased cost to Spain to refinance its debt. Higher general interest rates could in turn expose weaknesses in the financial system in Spain. Spanish savings banks in particular (cajas) are struggling with bad loans due to deterioration in the property market and increased funding costs could increase the problems of these banks. The fact that banks in Europe are closely integrated may in turn contribute to passing on concern over one country's government finances to other countries' financial systems. This may in turn create major concern over potentially risky exposures other banks may have, which could have negative consequences for the Swedish banking system in an indirect way.

Figure B1 shows the largest European countries' banks' exposure to Greece, Italy, Spain, Portugal and Ireland. In absolute figures the total exposure is greatest in France, but, given the size of the French economy, this exposure is not as great when expressed as a percentage of GDP. Ireland, Belgium, the Netherlands and France have considerable exposures, above all to Italy and Spain, and this means that they would be extra vulnerable if the fiscal problems were to get worse or if problems in banks were to arise in these countries. Concern over the banking system in southern Europe could thus spread on up through Europe and ultimately affect financial stability in Sweden through increased borrowing costs for businesses and banks. Given the size of the Spanish economy, any problems in the banking sector there could have greater consequences for financial stability in Europe and consequently Sweden than, for example, contagion from Portugal or Greece. It is also possible that problems from Spain, for example, could spread to Sweden via a country to which Swedish banks have large exposures, such as Germany or the United Kingdom. But as these countries in turn do not have any large exposures to Spain or the other four countries, the risk of problems there spreading to Sweden should be small. On the other hand, a spread of turmoil through the European banking system could lead to disturbances in the efficiency of financial markets; for example Swedish banks' international borrowing may be made more difficult. The latest financial crisis has shown that even relatively small events can have unexpectedly large effects on the financial system. If the same situation arises as before during the crisis, when market efficiency was severely impaired, there is a risk that Swedish banks and businesses will also be affected by it.

A third channel for influencing Swedish financial stability could derive from Greece. Greek banks have subsidiaries operating in many eastern and central European countries, such as Bulgaria and Romania. In a situation where these banks run into problems due to the crisis in Greece, this could spread to banks in these countries. Bulgaria, like Estonia and Lithuania, has a fixed exchange rate within the framework

Figure B1. Shows exposures (Q4 2009) to Greece, Ireland, Italy, Portugal and Spain of banks in the respective countries as a percentage of GDP.



Source: BIS

of a currency board. If the banking system in Bulgaria runs into major problems this may lead to increased pressure on the currency. During the financial crisis there was concern that the Baltic countries would be forced to devalue and that this could also affect other countries in eastern and central Europe with fixed exchange rates, such as Bulgaria. In a situation where Greek banks also have problems in Bulgaria, increased pressure on the Baltic countries' currencies cannot be ruled out. This in turn could impact Swedish banks, which run major operations there.

An argument against this happening is that to date the Baltic countries have succeeded well in tightening their economic policy. The fact that it appears that Estonia could join the European single currency contributes to stability and could also counteract any contagion effects from central and eastern Europe. Portugal, Italy, Ireland, Greece and Spain all have euro as their currency. This means that all adjustment must be made through fiscal policy and structural reform. Accordingly, the countries cannot use devaluation as a way out of the crisis, which was common in connection with previous fiscal crises. What these countries must do now to rectify their fiscal problems is to implement "internal devaluation" in the same manner as is taking place in Estonia, Latvia and Lithuania. This means both a very tight fiscal policy and structural reforms to make the economies more competitive. The Baltic countries have up to now succeeded with this policy. It remains to be seen whether the five countries with the weakest government finances in the euro area will succeed in implementing the same policy.