Current state of the sovereign debt crisis

University of Saint Andrews, February 2012

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Views expressed are my own and do not necessarily represent views of the Bank of Finland

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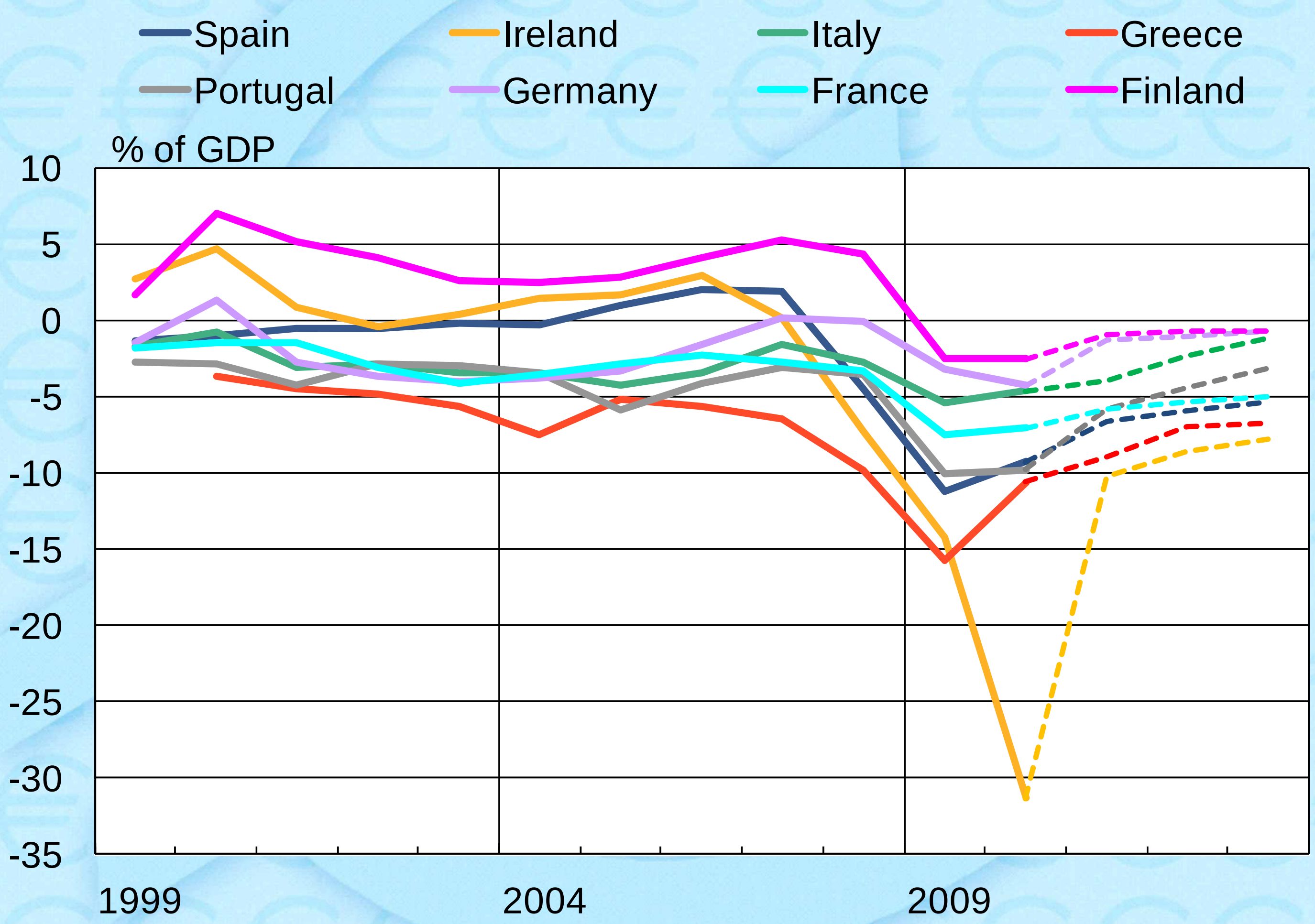
I. Introduction

General government deficit



Sources: Eurostat ja European Commission.

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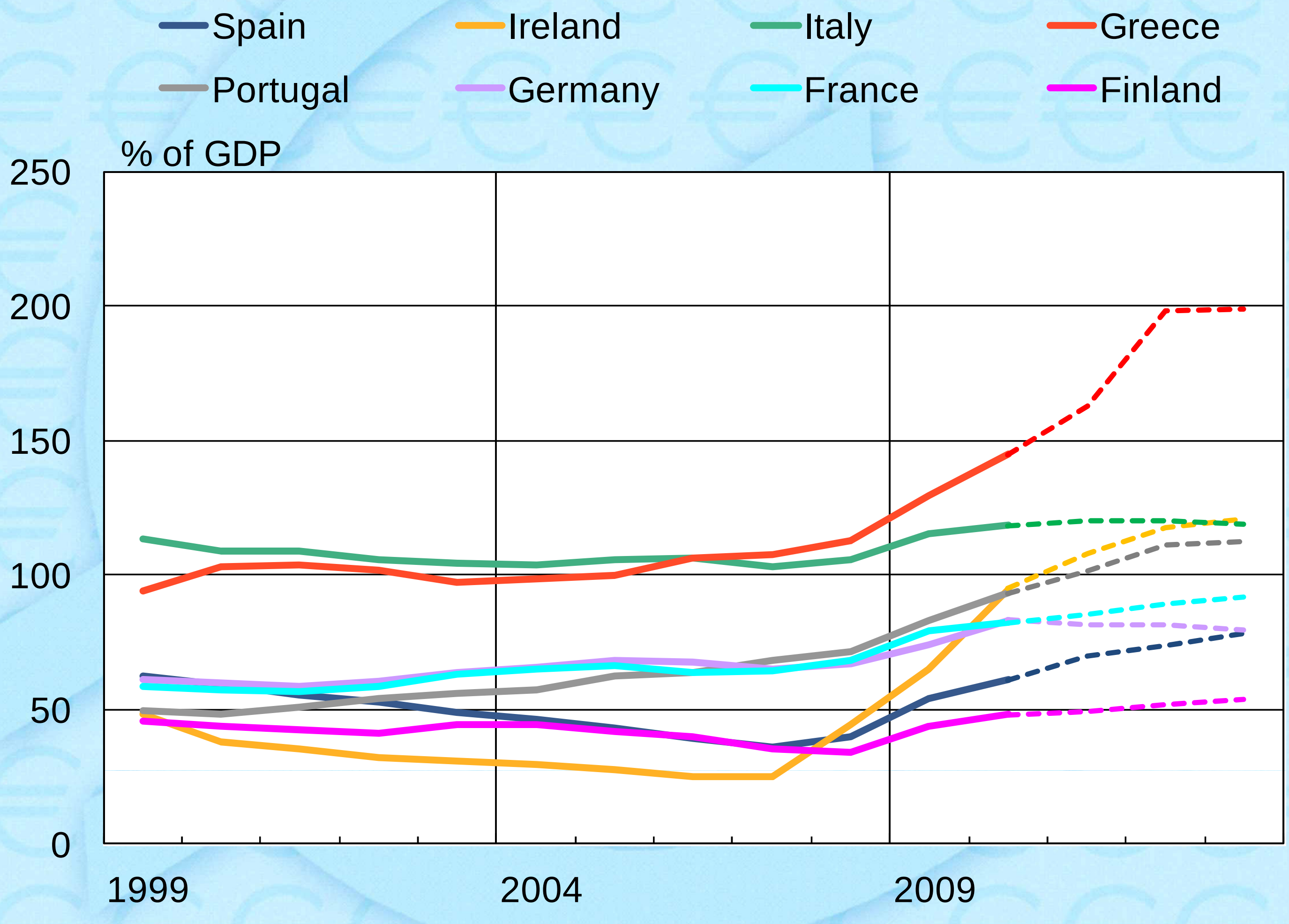
General government debt



Sources: Eurostat and European Commission.

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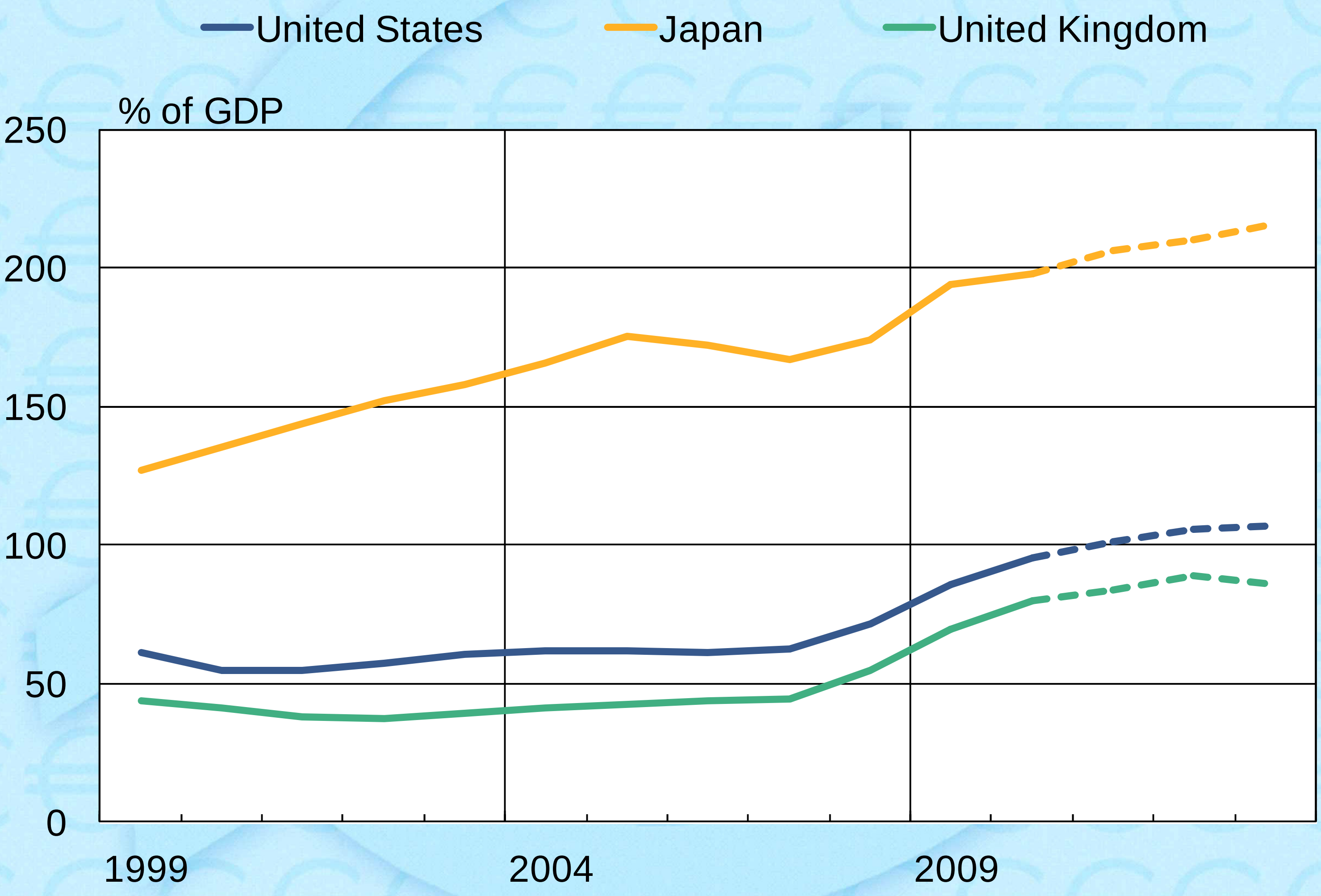
General government debt



Source: European Commission.

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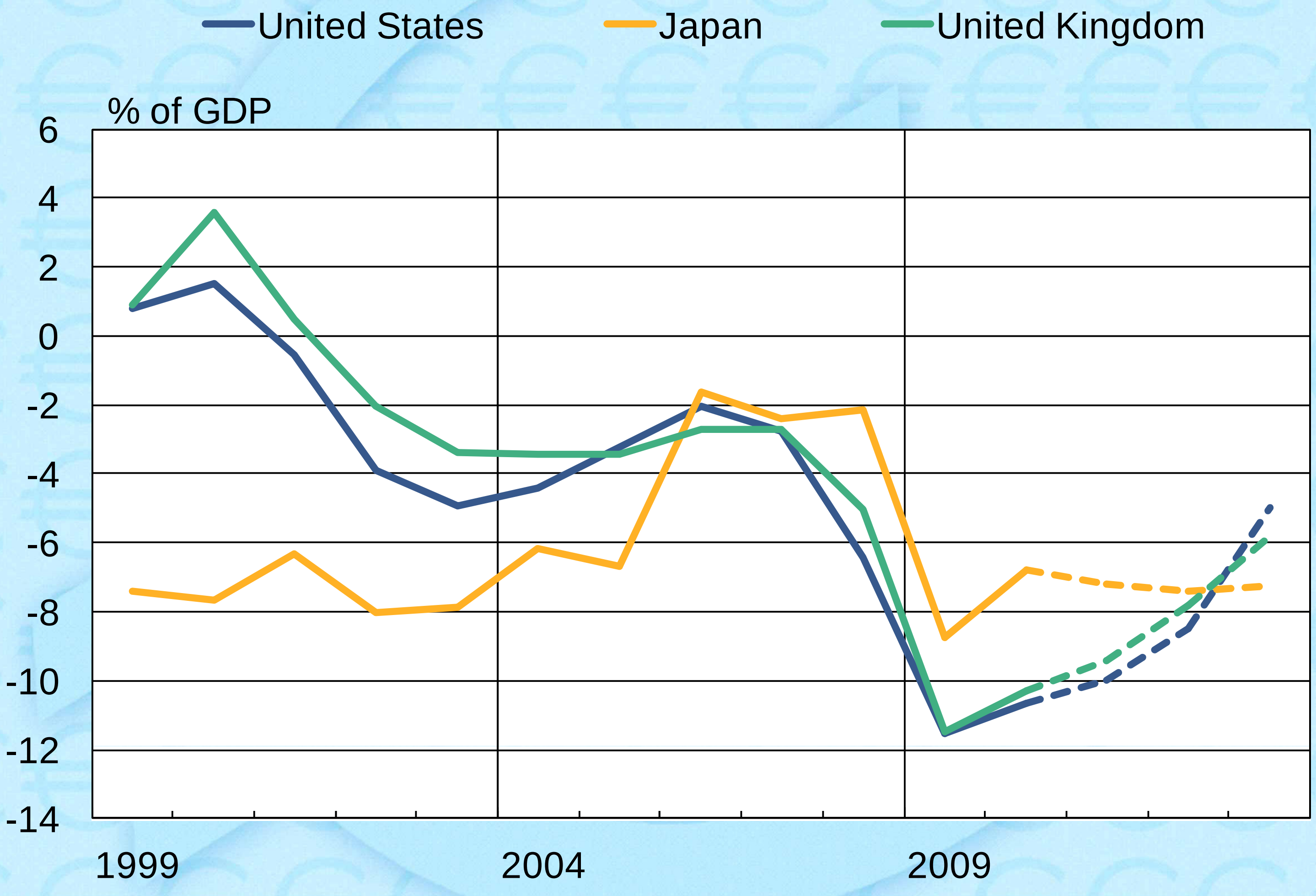
General government deficit



Source: European Commission.

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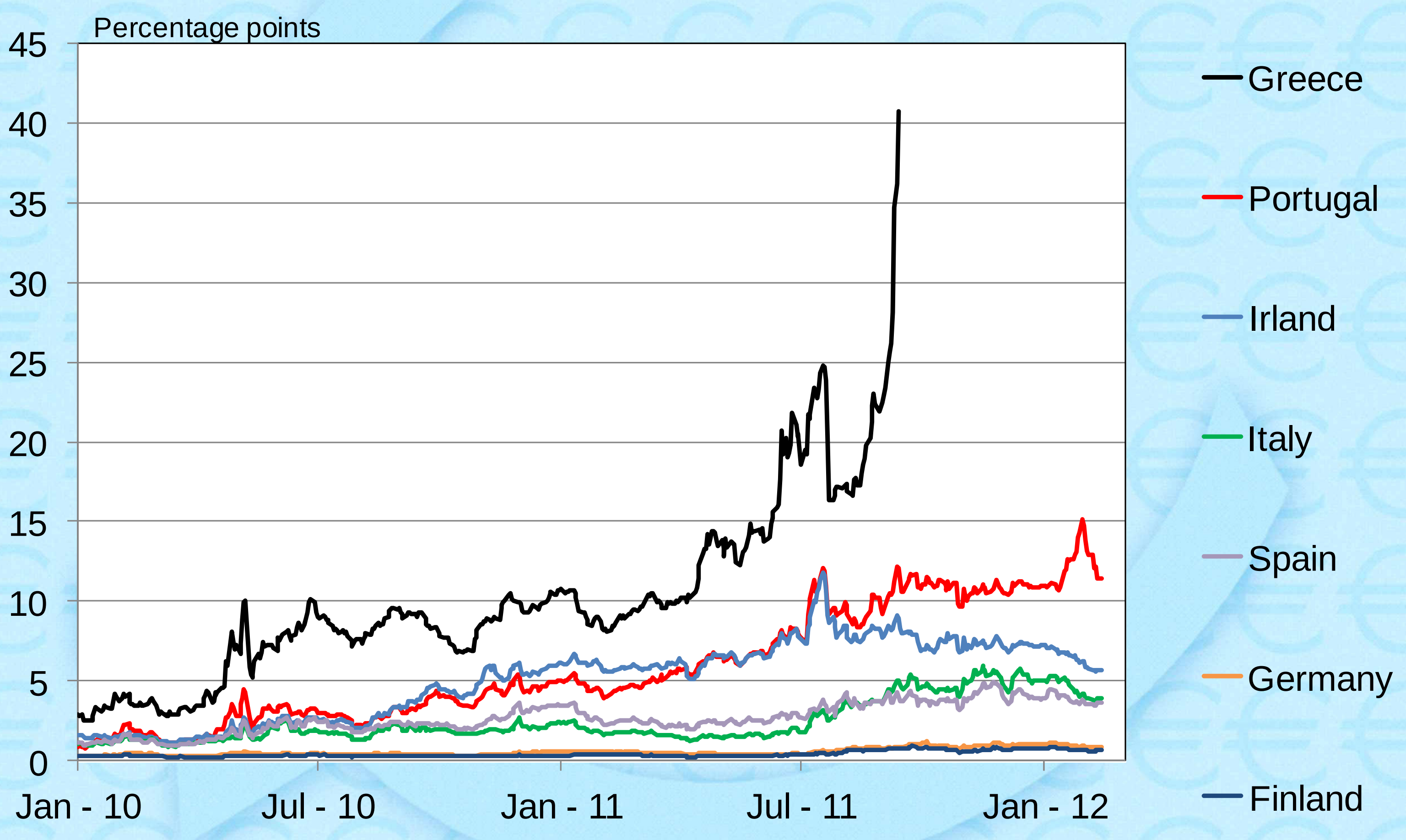
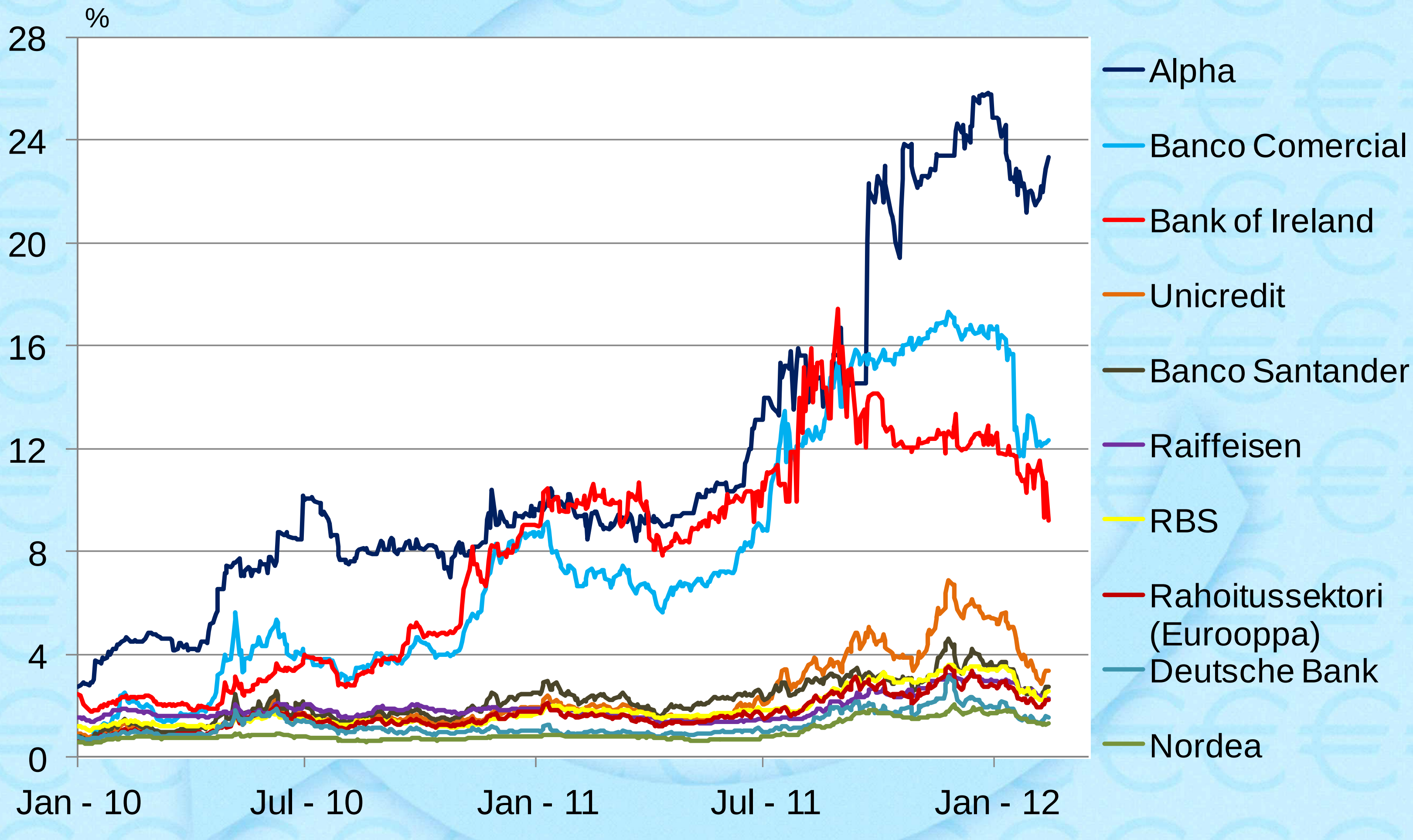
Euro area sovereign CDS prices



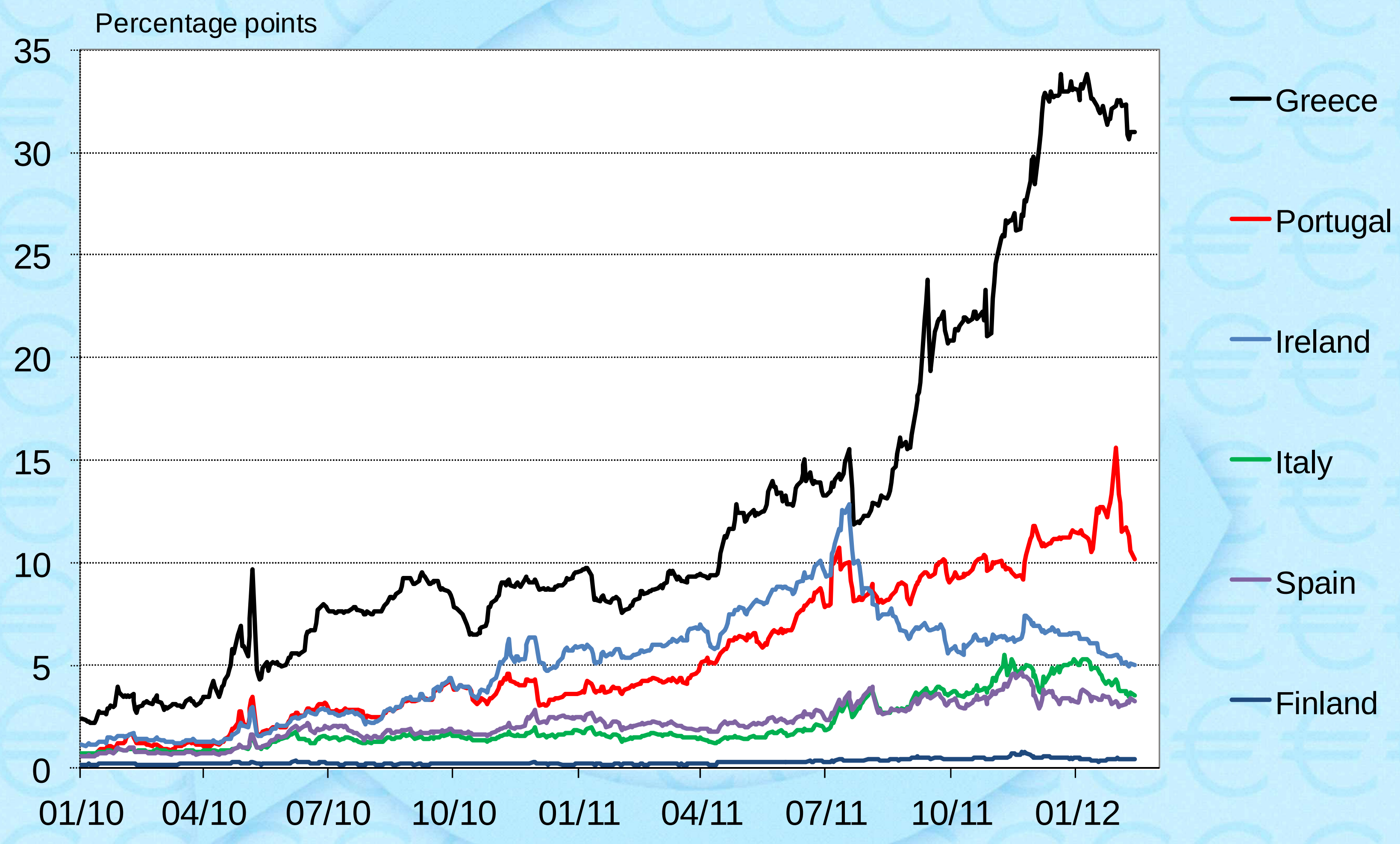
Source: Bloomberg. 5-year CDS prices.
Quotations for Greece are no longer regularly available.

Euro area bank CDS prices



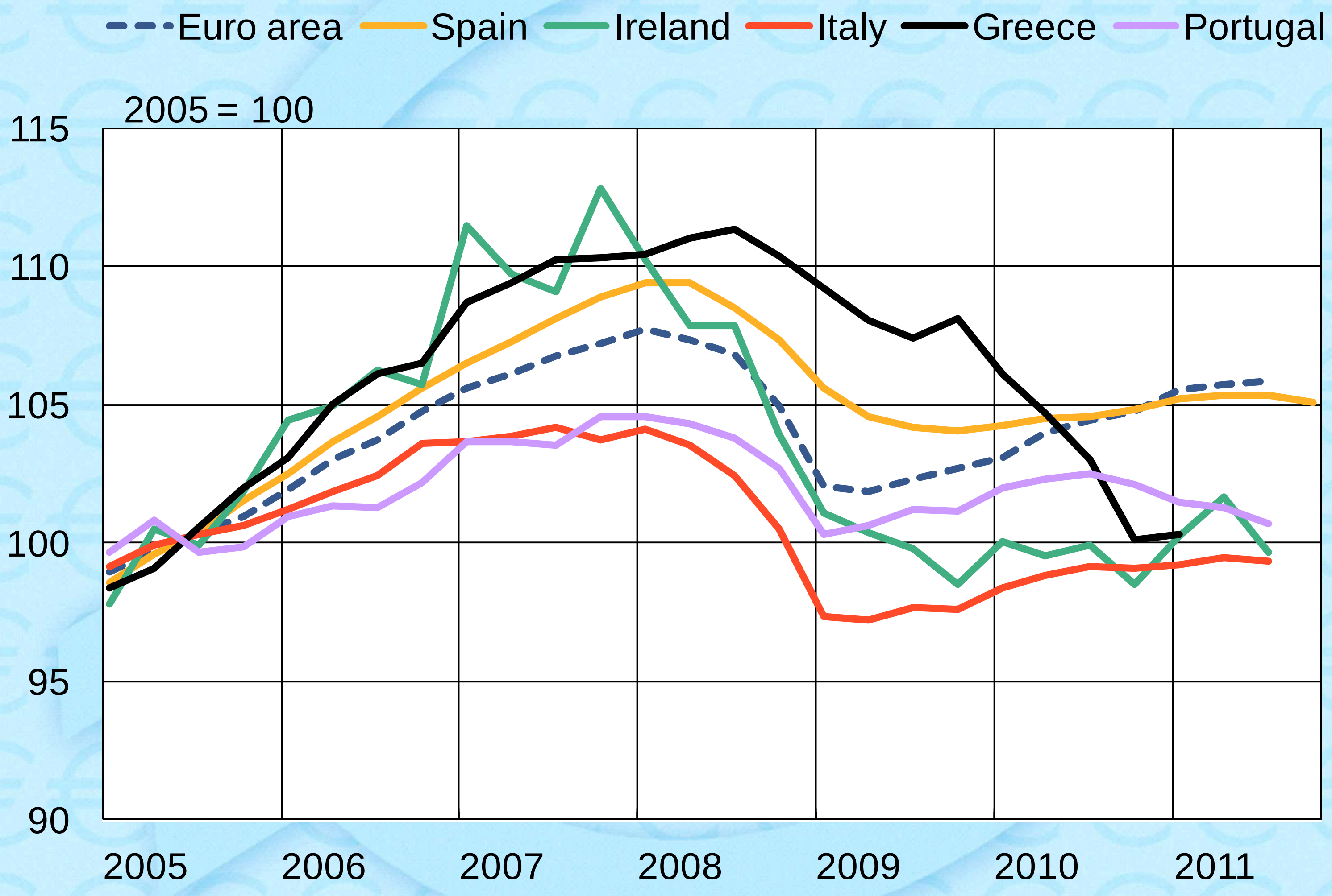
Source: Bloomberg.
5-year CDS prices.

Sovereign yield spreads vis-à-vis Germany (10 y)



Source: Bloomberg.

GDP, GIIPS



Source: Eurostat.

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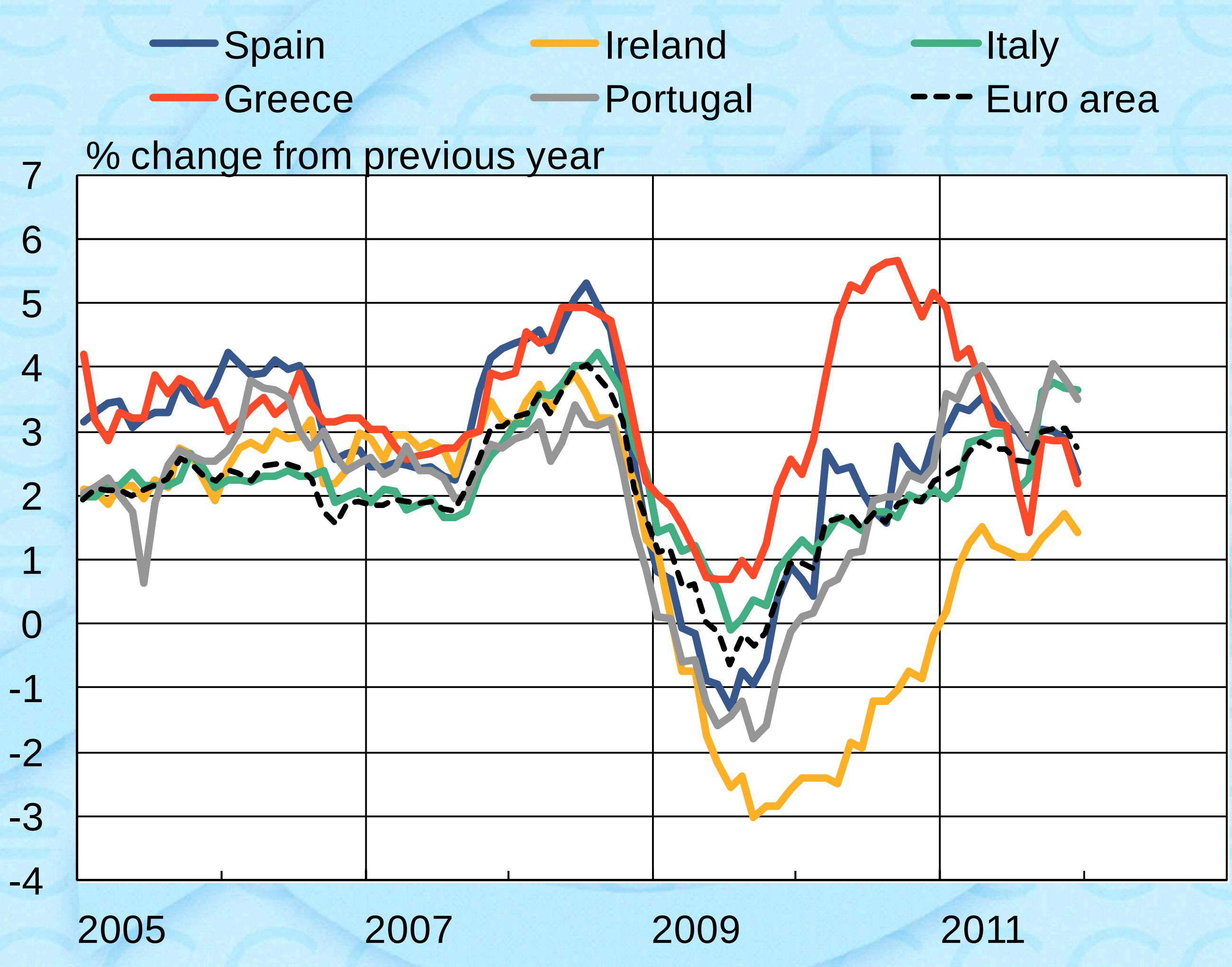
Inflation, GIIPS



Source: Eurostat.

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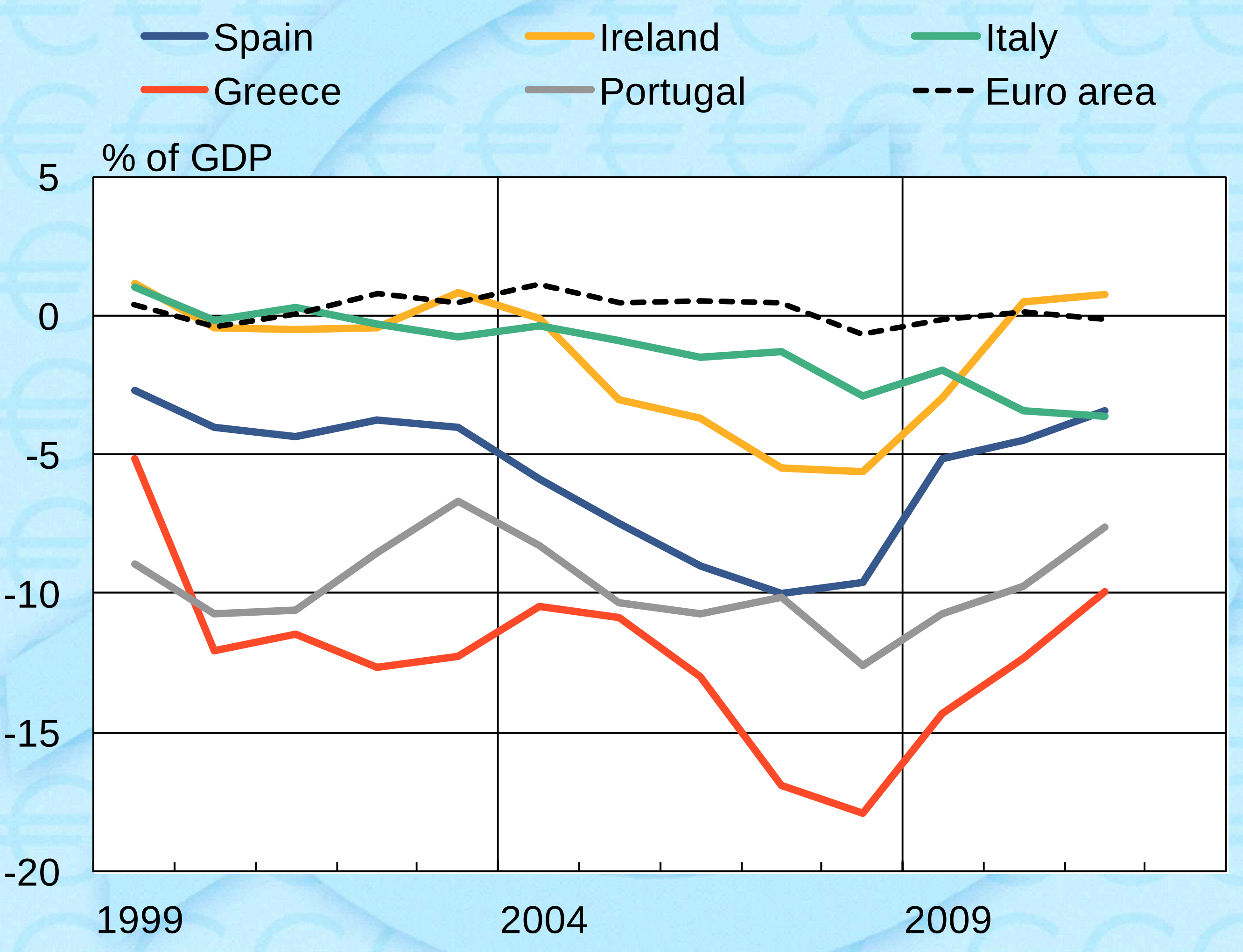
Current account, GIIPS



Source: European Commission forecast, Autumn 2011.

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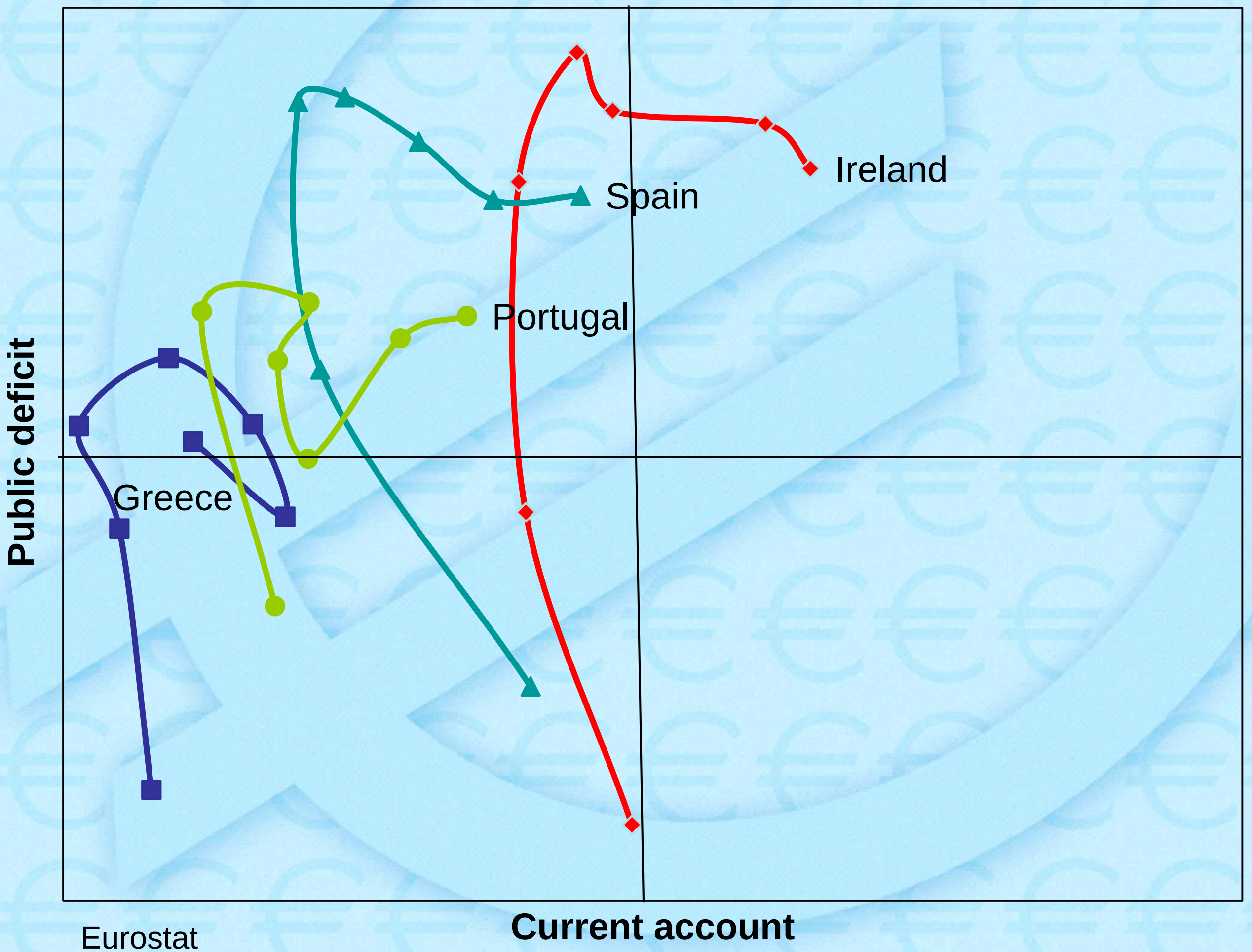
II. Design faults?

Current account and public deficits in Greece, Ireland, Portugal and Spain in 2003-2009



Assessments on Greece 2006-2007

- IMF (Article IV report, Dec 2006):
  - *" Significant fiscal consolidation was put in place in 2005–06, but further deficit cuts are needed."*
  - "*Vulnerabilities have developed in the form of very high credit growth, persistent inflationary pressures, eroding competitiveness, and an unsustainably large current account deficit."*
- OECD (Country report, May 2007):
  - *"There has been substantial [fiscal] consolidation since 2004."*
  - *"Losses in competitiveness may ultimately undermine growth performance."*
  - *"The clearest sign of macroeconomic tension is an increase in the current account deficit."*
- Broad picture in 2006-2007:
  - Fiscal situation seen to be on the mend.
  - External deficit seen as a vulnerability.
  - But no alarm bells, no perceived need for drastic action.

Assessments on Ireland 2006-2007

- IMF (Article IV report, June 2006):
  - *”Economic policies have been in line with Fund policy advice.”*
  - *”Financial system continues to perform well, but rapid credit growth is a vulnerability.”*
  - *“concentration of lending in property-related sectors… banks’ reliance on wholesale funding…”*
  - *“Regulatory and supervisory framework has been strengthened in line with the recommendations of the 2000 FSAP.”*
- OECD (Economic survey, March 2006)
  - *“The fiscal position is healthy.”*
  - “*House prices may have overshot fundamentals to some extent, although this does not imply that they will fall significantly.”*
- Broad picture in 2006:
  - Growth performance based on genuine productivity miracle, strong public finances.
  - Well-supervised financial sector, but property sector risks recognized.
  - Again, no alarms sounding!

Current account – the missing link

- Before the crisis,
  - Current accounts within a monetary union were seen as largely unimportant.
  - Balance-of-payments crises were seen as largely impossible:
    - BOP crises traditionally involve run on a currency, forcing interest rates up.
    - But monetary union shares a common currency and interest rate, so there is no risk of speculative attack.
- Now we know that:
  - Sovereigns within a currency union are leveraged entities and can be subject to a run,
    - … and once a sovereign is targeted, the financial sector goes down with it.
  - As long as solvency is defined along national borders, the monetary union alone does not shield from a BOP crisis.

A regulatory failure?

- Stability and growth pact focuses only on public finances.
  - More generally, national imbalances and competitiveness were not included.
  - The 2003 revision of the Stability and Growth Pact clearly unfortunate.
    - The new Pact was not necessarily much worse than the old, but revision had wrong motivations.
      - Signalled lack of political will for macroeconomic coordination.

- The ”No bail out” –clause had no real bite**.**
  - No enforcement mechanism.
- Integration of euro countries had not not progressed sufficiently far.
  - In particular, regulation and supervision of financial markets had remained entirely national.
  - Financial markets did not impose sufficient discipline on member countries.

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III. EU and euro area reforms

TREATY ON STABILITY, COORDINATION AND GOVERNANCE IN THE ECONOMIC AND MONETARY UNION

- To foster budgetary discipline through a fiscal compact
- To strengthen the coordination of economic policies
- To improve the governance of the euro area (“Six Pact”)
  - Fiscal surveillance and enforcement
  - Macroeconomic imbalances and enforcement
  - More automatic sanctions
- The treaty shall enter into force on 1 January 2013 if ratified by 12 euro area countries.
- The aim is to incorporate this treaty into the legal framework of the European Union within five years.

Fiscal compact

- ♦ The budgetary position of the general government should be balanced or in surplus.
- ♦ Medium-term objective: structural budget deficit not to exceed 0.5 % of GDP.
- ♦ Structural deficit of at most 1 % of GDP allowed if the ratio of government debt is significantly below 60 % and risks in terms of long-term sustainability are low.
- ♦ Contracting parties may temporarily deviate from their medium-term objective or the adjustment path towards it only in exceptional circumstances as defined in Stability and Growth Pact.

Fiscal compact (II)

- The rules should be incorporated in the national law of the contracting parties at the latest one year after the entry into force of the treaty.
- The provisions in the national law should be binding, permanent and preferably constitutional or otherwise guaranteed to be respected throughout the national budgetary processes.
  - Compliance ultimately judged by European Court of Justice.
- A correction mechanism to be triggered automatically in the event of significant deviations as specified in the revised Stability and Growth Pact.

Excessive Deficit Procedure (EDP) and European Stability Mechanism (ESM)

- European Commission may initiate an excessive deficit procedure which includes deficit targets over several years.
- Automatic sanctions on euro area countries with excessively high budget deficits; can be avoided only with a reversed qualified majority.
- The permanent European Stability Mechanism (ESM) to replace the temporary EFSF should be operational in mid-2012. The lending capacity of ESM will be 500 billion euros.

- The objective of the reforms is to move toward a ”Maastrict plus” type system, not a complete fiscal union.
  - Each country has responsibility of its economy.
  - The aim is to strictly apply the commonly accepted rules.
- Eurobonds?
  - Several proposals, perhaps best known is the idea of blue bonds and red bonds.
  - Would move Europe (excluding UK?) strongly toward federalist direction
    - It seems that there is not very much support, except in the problem countries.
  - Would probably require changing a change in the EU Treaty.
    - Not a tool to resolve the current crisis?

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IV. Policies in the crisis countries

- ♦ Necessary to achieve a turnaround in the public debt to GDP ratio and then proceed with reduction of indebtedness.
  - – This will take 10-20 years.
- ♦ Consolidation of public finances
  - – To convince the markets and the creditors
  - – Negative impact on economic growth in the short run.
- ♦ Structural policies
  - – To improve economic growth in the medium to long run
  - – Improving the legitimacy of government and administration
    - Achieving the positive effects will take time.

Greece vs. Italy

% of GDP, 2010	**Greece**	**Italy**
Private consumption expenditure	74,5	60,5
Government consumption expenditure	18,2	21,1
Investments	16,6	19,7
Export	21,5	26,7
Import	30,4	28,6
Current Account (92 – 10)	-8,3	-0,1

Source: European Commission.

Challenges for Greece

- 2012 will be the 5th year with falling GDP.
- Debt-GDP ratio will be nearly 200 % at the end of the year unless something is done.
- Major changes in the economy:
  - Private consumption must go down a long time..
  - Massive need to move productive resources from public and closed private sector to export production.
  - Where are the new industries for exports?
- Major program for public sector consolidation and reform.

- A second aid package under negotiation.
- Voluntary restructuring of public debts held by the private sector under negotation.

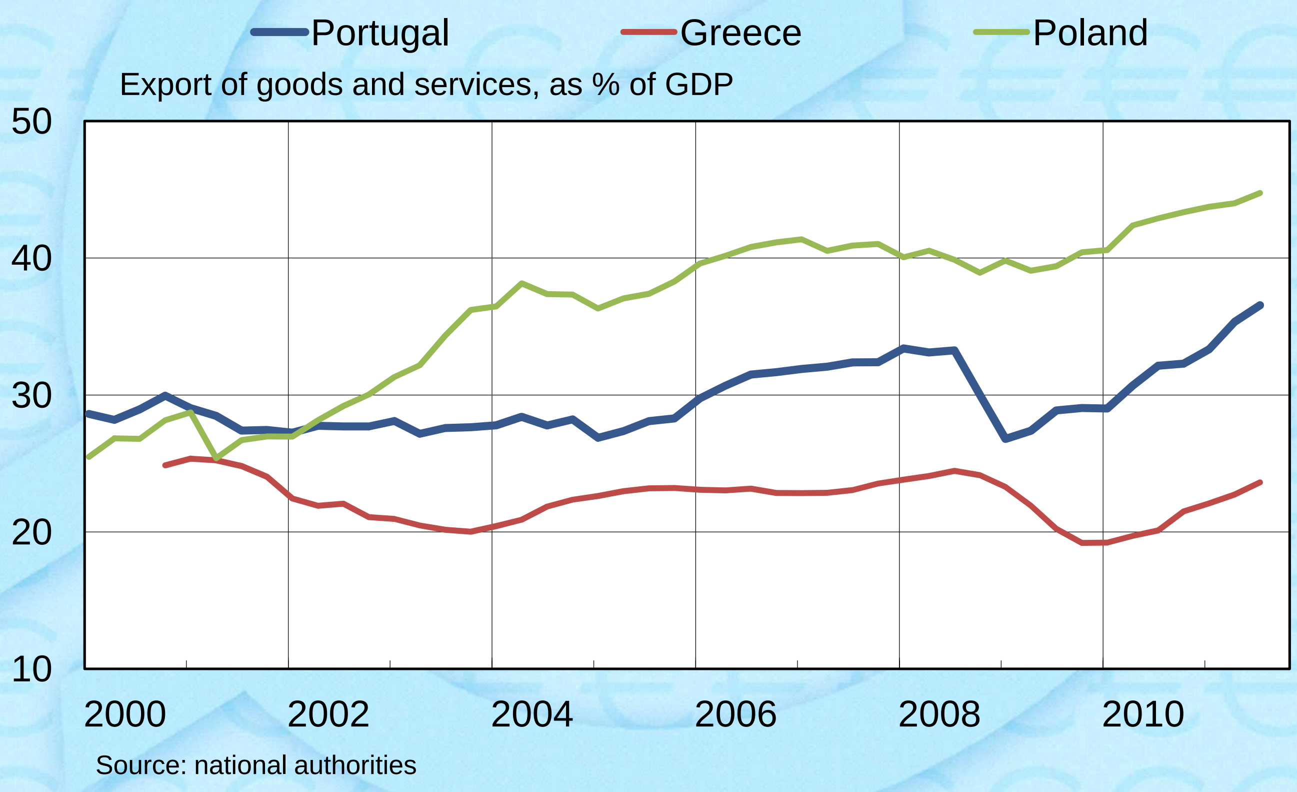
Challenges for Italy

- There are some strong private sectors and private sector financing is working so far. But:
- Liquidity crisis because of high public debt.
- Too big to fail?
  - Country's own actions decisive.
  - The new government has had a good start?
- Balancing of public finances is necessary (and should be achievable),
- But weak growth performance necessitates structural reforms to improve long-term sustainability.

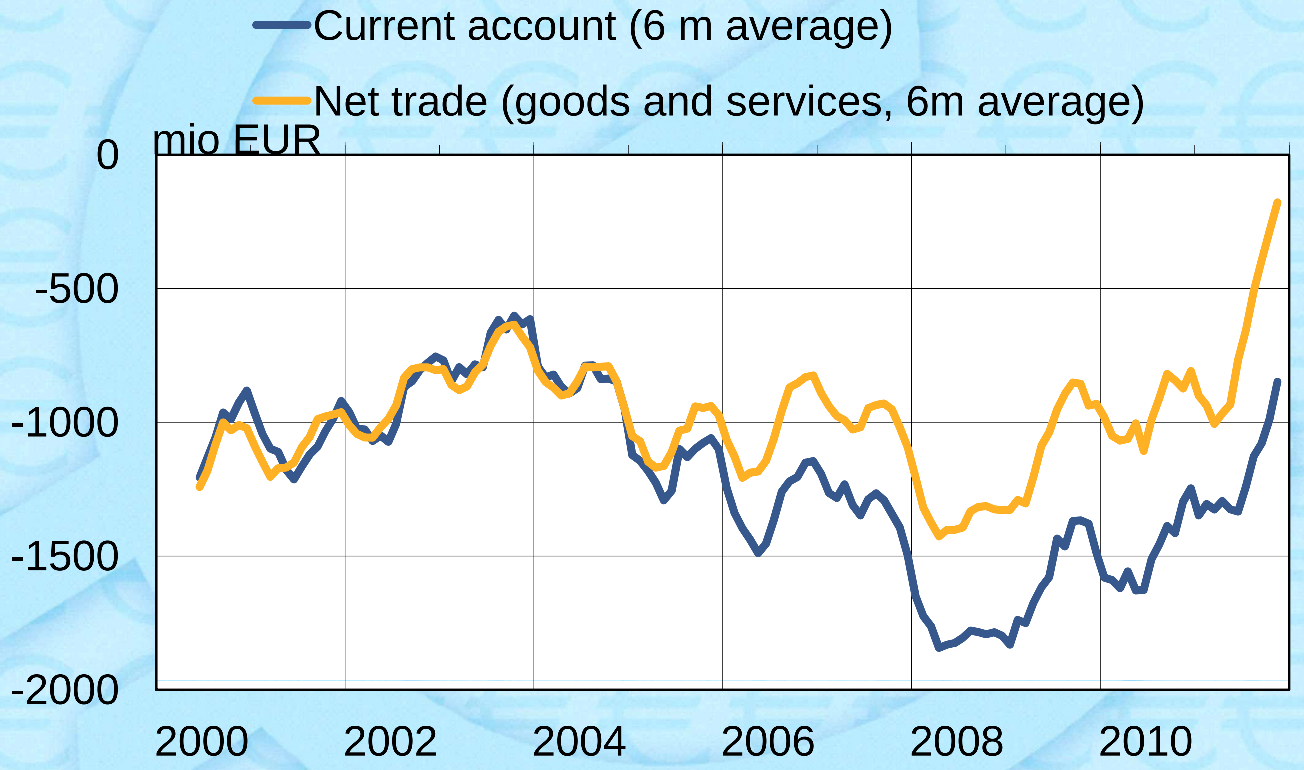
Challenges for Portugal

- External adjustment gathered pace lately and structural adjustment program started off fairly well.
- But:
  - Weak growth and structural problems deep rooted.
  - Debt flows have helped to avoid adjustment in domestic demand, debt servicing burden has become problematic.
  - Needs for relative price changes to improve competitiveness, but probably smaller than eg Greece.
  - Refinancing of public and private debt remains extremely challenging.

Reprioritisation of resources towards tradable sector has seemingly started



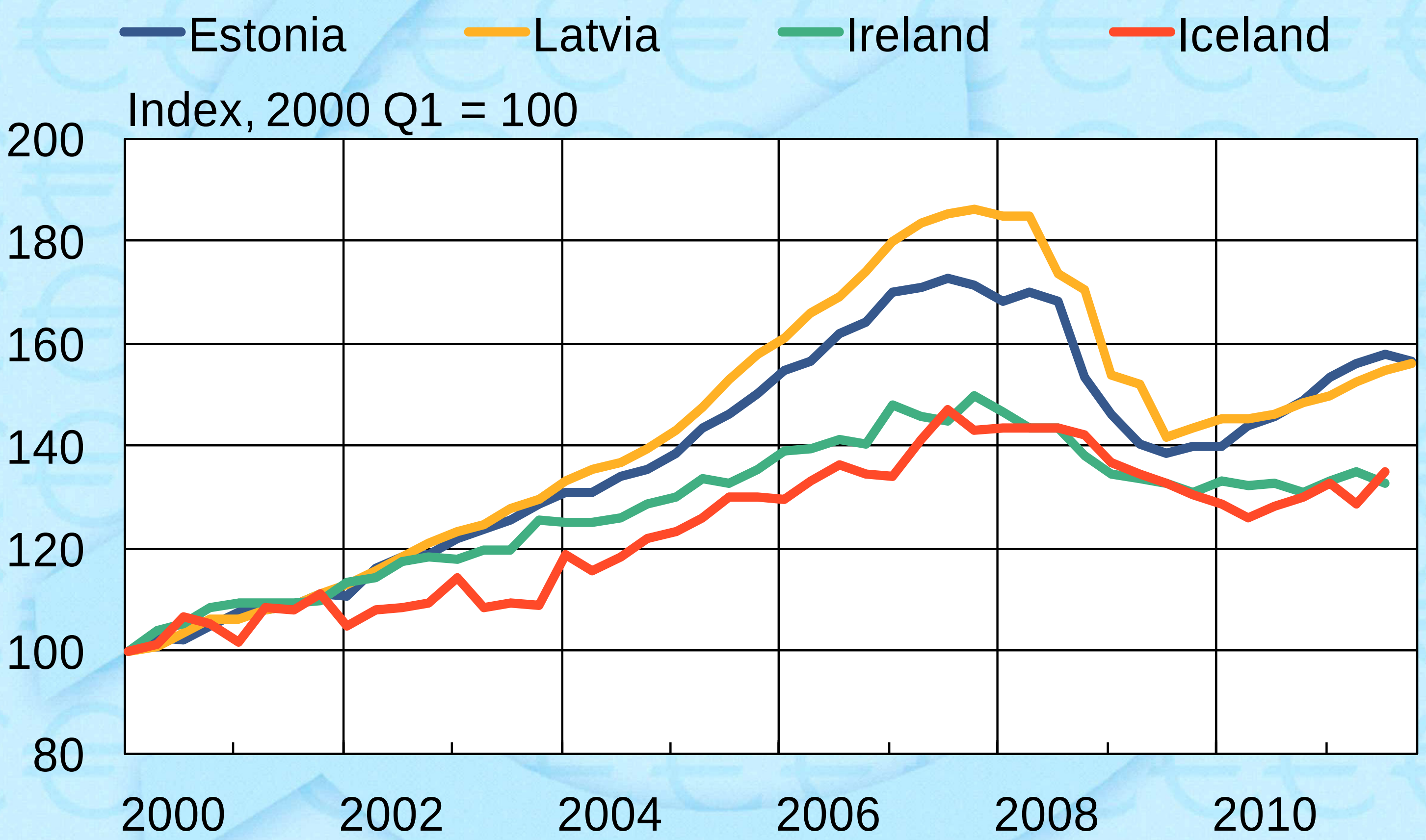
External adjustment speeding up, but large debt burden keeps debt servicing still high



Lähde: national statistics

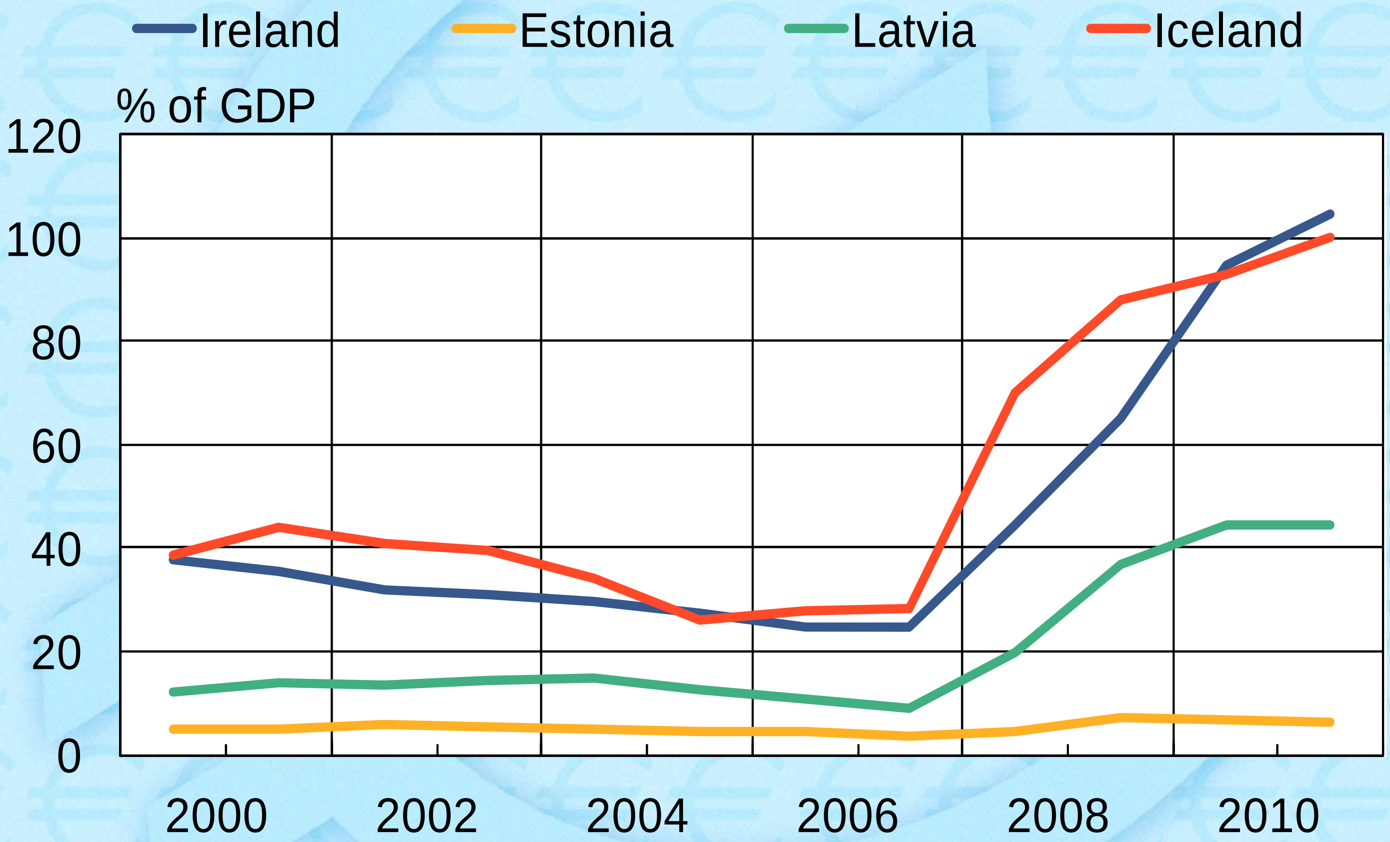
V. Examples of succesful (?) adjustment

GDP: Estonia, Latvia, Ireland and Iceland



Sorces: Eurostat, National authorities.

Government debt: Estonia, Latvia, Ireland and Iceland



Sorces: Eurostat (Q3 for 2011), Iceland (for 2000-2004) national authorities and for 2011 IMF forecast.

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Thank you!