KEY FACTORS BEHIND THE EUROPEAN DEBT CRISIS

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Abstract

This paper analyzes the main macroeconomic indicators since 1995 in selected European Union countries as well as in the eurozone. Based on a comprehensive comparative analysis of net international investment position, current account and the debt level in some sectors of the economy, the paper found that there is a trend towards a divergence process instead of the intended real convergence process in the EU countries. In addition, in line with the present significant deterioration of public finance, the paper provides a comparative analysis across the individual countries in the eurozone.

The study came to the conclusion that countries that lost their competitiveness had external deficits, which caused fiscal deficits, including public debt. Since the creation of the European Union these countries have ignored the rules set out in the Stability and Growth Pact, which has led to fiscal unsustainability. In order to put the economy on a balanced, sustainable and strong economic growth path in the EU countries, a credible fiscal consolidation plan, structural reforms and a proactive policy in the decision-making process, including improvement of governance on all levels of the European Union, are needed.

Keywords: fiscal deficit, primary fiscal balance, public debt, sustainability of public debt
JEL Classification: H60, H61, H63, H63

Introduction

As result of a very ambition goal – the creation of European monetary union (EMU), the Maastricht Treaty was adopted. In this Treaty are clear specified all the necessary conditions for a well-functioning EMU. In addition, but, in particular, to bring the public finance in individual countries under control, the European leaders also decided to create the Stability and Growth Pact (SGP)[1]. The main goal of this paper is to analyze the main factors behind the present unsustainable fiscal development in some eurozone countries.

[1] The Stability and Growth Pact was created in 1977 in Amsterdam. The SGP clearly set up the rules for managing the public finance for each country of European Community.

1. Theoretical approach

The Theory of Optimal currency area clearly demonstrates the prerequisites for a well-functioning currency area[2]. Mundell in his theory emphasized that an independent monetary policy is essential. In addition, Mundell underlined that for creation an optimal currency area should be fulfilled the following conditions[3]:

- Individual countries have the same symmetric cycles,
- Mundell underscored in his theory that the potential members of monetary union should have the highest level of political integration,
- Mundel set out that in an Optimal currency area there should be high degree of flexibility of nominal wages and prices, and
- One of the critical factors for establishing an optimal currency area is trade interconnection and the existence of mobility of production factors.

Since the European Monetary Union has been in place for more than 13 years, it is necessary to make ex-post assessment of previous economic development, which contributed to the present debt crisis.

2. The past development of the EMU

In order to better understand the present stage of EMU development it is important to analyze past development. The question is: what happened? What are the main factors which significantly contributed to the deterioration of overall development in EMU, but, in particular, which factors are behind the fiscal unsustainability – debt crisis, wide spread economic imbalances and vulnerability of some EMU member countries? The process of external imbalances is closely related to the current account deficit.

2.1 Current account

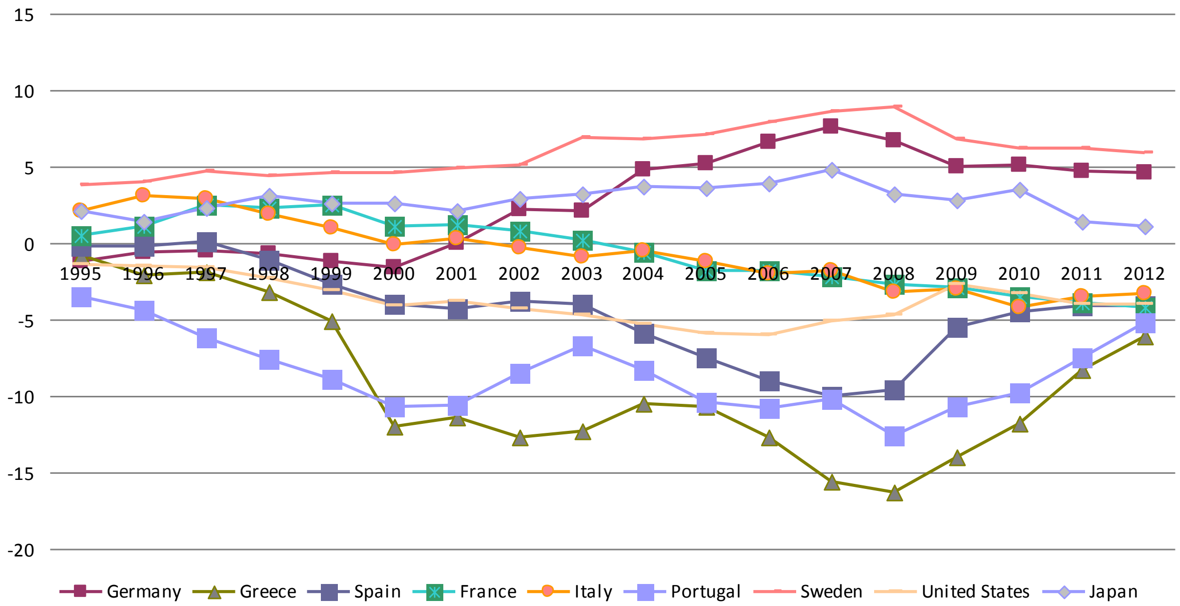
External balance is always very important for the assessment of competitiveness of a real convergence in eurozone countries. Figure 1 shows the development of the current account since 1995, including an outlook for 2011 and 2012. This graph shows that the higher the current account deficit, the higher the public debt. On one side, countries such as Greece,

[2] Historically, the first Theory of Optimal Currency are was formulated at the beginning of 60's by Nobel price winners Robert Mundell (1961), at the present professor at the Columbia University. Later, this theory was developed by McKinnon (1963), Kennen (1969) and deDrauwe (1994).
[3] See Sipko, J. Medzinárodný platobný styk, Elita , 2000, pp. 56-61.

Portugal and Spain have had a current account deficit since 1995. On the other side, Sweden, which has a higher current account surplus, also has a low fiscal deficit and public debt.

This graph also shows that a more convergent trend within eurozone countries was before the single currency. The higher the export, the higher the value added of export, the higher current account surplus, as in Germany and Sweden.

Fig. 1: Current account



Source: Graph set out from Eurostat data

The global financial crisis significantly contributed to the deterioration of fiscal sustainability in eurozone countries (see Table 1). The table clearly demonstrates two groups of countries.

On one side, such countries as Finland, Germany and Netherlands completed structural reforms in the past and have relatively high productivity growth and their products are very competitive in the international market. Those countries do not have problems with the sustainability of public finance and debt sustainability. This group of countries has reached a current account surplus even when the global economy was in a mild path of recovery (2010 – 2011). High productivity growth combined with the highly competitive products significantly contributes to the positive external positions in these countries.

Tab. 1: Real GDP growth, current account, fiscal deficit, public debt of selected eurozone countries

Country	GDP			Current account			Fiscal deficit			Public debt		
	2010	**2011**	**2112**	**2010**	**2011**	**2012**	**2011**	**2012**	**2013**	**2011**	**2012**	**2013**
Finland	6,6	3,5	2,2	3,1	2,5	2,5	-1,3	-1,2	-1,2	50,0	53,1	55,9
Germany	3,6	2,7	1,3	5,7	5,0	4,9	-1,0	-1,1	-0,9	80,9	79,9	77,5
Netherlands	1,6	1,6	1,3	7,1	7,5	7,7	-4,4	-3,5	-3,7	64,4	65,8	67,9
Greece[4]	-4,4	-5,0	-2,0	-10,5	-8,4	-6,7	-9,5	-7,2	-6,9	164,5	176,5	179,1
Italy	1,3	0,6	0,3	-3,3	-3,5	-3,0	-4,0	-2,7	-2,5	119,0	120,5	121,2
Ireland	-0,4	0,4	1,5	0,5	1,8	1,9	-10,3	-8,5	-7,7	104,2	113,3	118,5
Portugal	1,3	2,2	-1,8	-9,9	-8,6	-6,4	-7,2	-4,8	-4,4	102,8	112,7	115,9
Spain	-0,1	0,8	1,1	-4,6	-3,8	-3,1	-6,7	-6,0	-5,6	69,1	73,6	78,0
Slovakia	4,0	3,3	3,3	-3,5	-1,3	-1,1	-6,0	-5,7	-5,9	45,3	48,8	51,6
Euro area	**1,8**	**1,6**	**1,1**	**0,8**	**0,8**	**1,0**	**-4,1**	**-3,5**	**-3,3**	**86,9**	**88,6**	**89,5**

Source: Table set from Eurostat, ECB, IMF and OECD data.

On the other side, countries such as Greece, Ireland, Italy, Portugal, Spain and Slovakia, with low level of structural reforms, very low productivity growth and with a relatively very low level of competitiveness have reached current account deficits[5]. Based on the latest economic outlook provided by the EC, ECB, IMF and OECD, the deterioration of public finance, namely fiscal deficit will improve during the 2011 – 2013; however, the public debt sustainability will follow an although mild, but deteriorated path for the same period for all debtor countries, Greece, Ireland, Italy, Portugal, Spain and Slovakia.

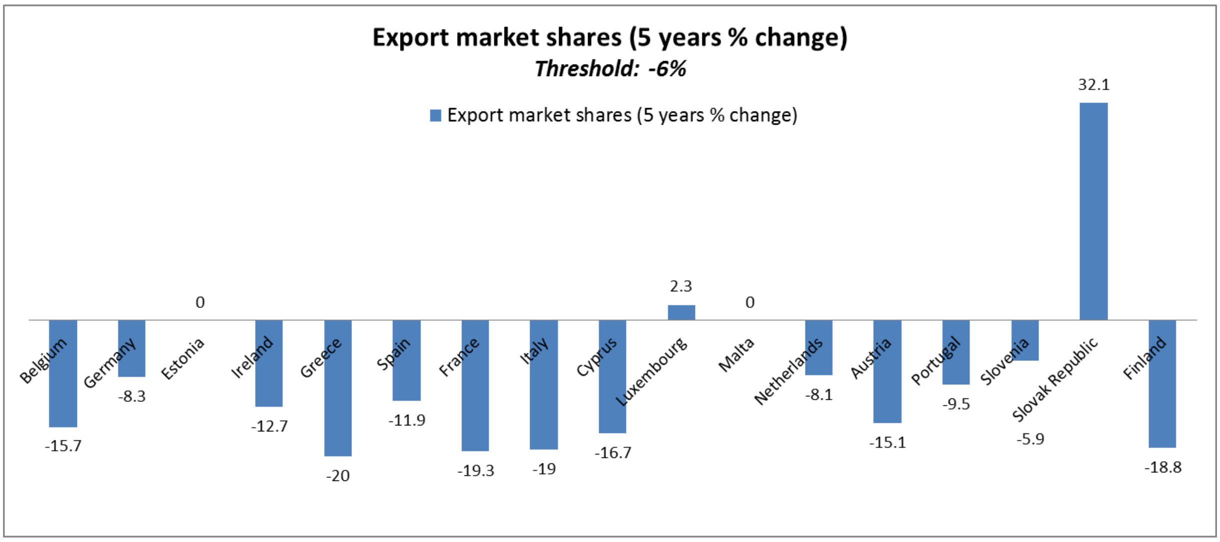
[4] Global finacial crisis unprecendently hit almost all EMU countries, but in particular, Greece, Ireland and Portugal, with Italy and Spain shortly thereafter. In Greece, the origin of crisis lies in the governemt sector. The Greek authorities were not able to manage public finances appropriately. On one side, revenue significantly decreased and expenditure rose due to high social transfers and high pensions. Therefore, the Greek authorities applied for a program with the European Comission, European Central Bank, including the International Monetary Fund. The program was oriented on both fiscal policy and structural policy. In terms of an adjustment program and its impementation in Greece, the political committment was not materialized. Therefore, Greece applied fo the second program with the EC, ECB and IMF. This program was focused on debt sustainability. In addition, in order to realize productivity gains, the new program was oriented on liberalization of labor and service markets. So, this approach concentrates on improvement of competitiveness. The main idea was to eliminate wage rigidities and to create conditions that wage level should be consistent with the growth of productivity. In this regard, labor costs should be improved of about 15% by 2015. Furthermore, a new program has addressed Greek unsustainable debt dynamics. Except nominal reduction in the value of bonds by 53,5 percent, there is also a reduction of intererst rate on official debt. Despite these very positive conditions, which were very generous, still there is a problem with the financing needs. Based on the conditions set out in the program, Greece will be able to reduce public debt to the range of 116-117 percent by 2020. In order to fullfill this very ambitions goal, the Greek authorities should implement all necessary measures in a timely manner.

[5] Researchers, academia and policy-makers generally agreed that the higher the current account deficit, the higher the public debt.

2.2 Export performance

The external balance is determined by the level of competitiveness and is based on the market share of each country (see Figure 2).

Fig. 2: Export Market Shares (2006-2011)



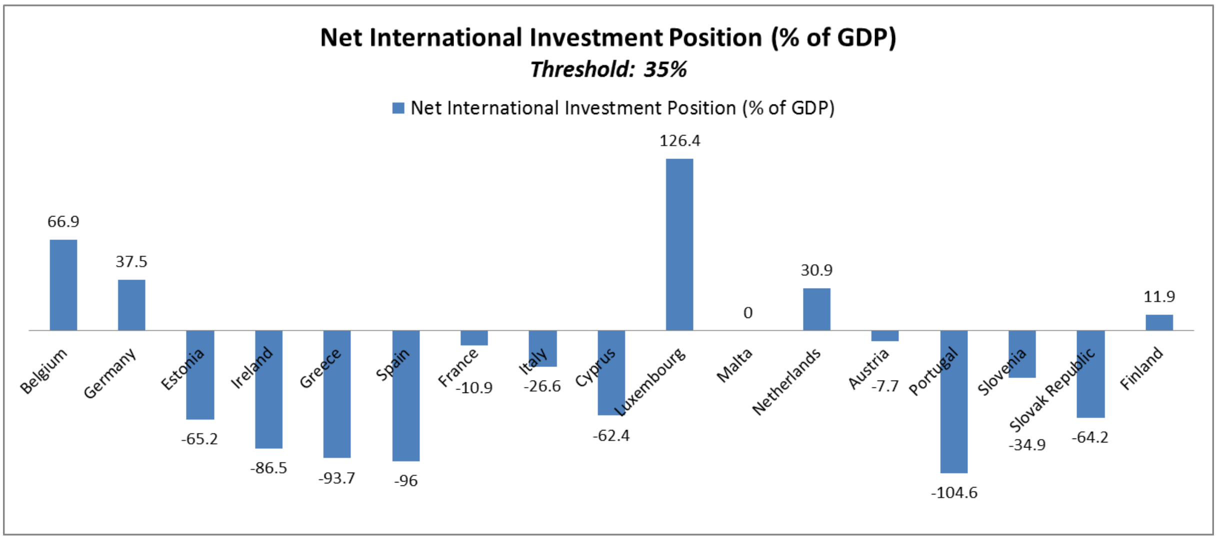
Source: Table set from Eurostat, ECB, OECD data.

Those countries that rely on structural reforms obtain significant shares of the market. Considering a threshold of -6%, based on 5 years' average changes, it can be seen that a majority of eurozone countries significantly lost market share. There are only five countries that surpassed this threshold (Estonia, Luxembourg, Malta, Slovenia, Slovak Republic). All countries except Luxembourg are new entrants to the eurozone. In these countries, FDI significantly contributed to higher GDP growth as well as to higher market share. On the other side, the majority of countries, including the most technologically developed countries as France, Germany, Netherlands and Finland, gradually declined their share in the international market of goods and services. The main reason is slowly realized structural reforms, but also a significant factor is steadily growing economies of emerging markets; mainly, Southeast Asia. The most indebted countries have reached the most remarkable changes (e.g. Ireland, Greece, Spain).

2.3 Net investment position

To assess external balance, Net International Investment Position (NIIP) is essential. Figure 3 clearly depicts the NIIP as a percentage to GDP. By taking into consideration a threshold of 35% of GDP NIIP, there are two clear conclusions.

Fig. 3: Net Investment Position (2011)



Source: Table set from Eurostat, ECB, OECD data.

First, those countries whose economies are export-driven, such as Germany, Netherlands, Finland and Luxembourg, have a very high proportion of these indicators. Second, those countries that remarkably lost market share, including deterioration of competitiveness, have very low (negative) NIIP. A majority of countries with very negative trend of NIIP such as Greece, Portugal and Spain also belong to the most indebted countries. Lack of structural reforms and loss of competitiveness are the main factors that contributed to these negative trends in NIIP.

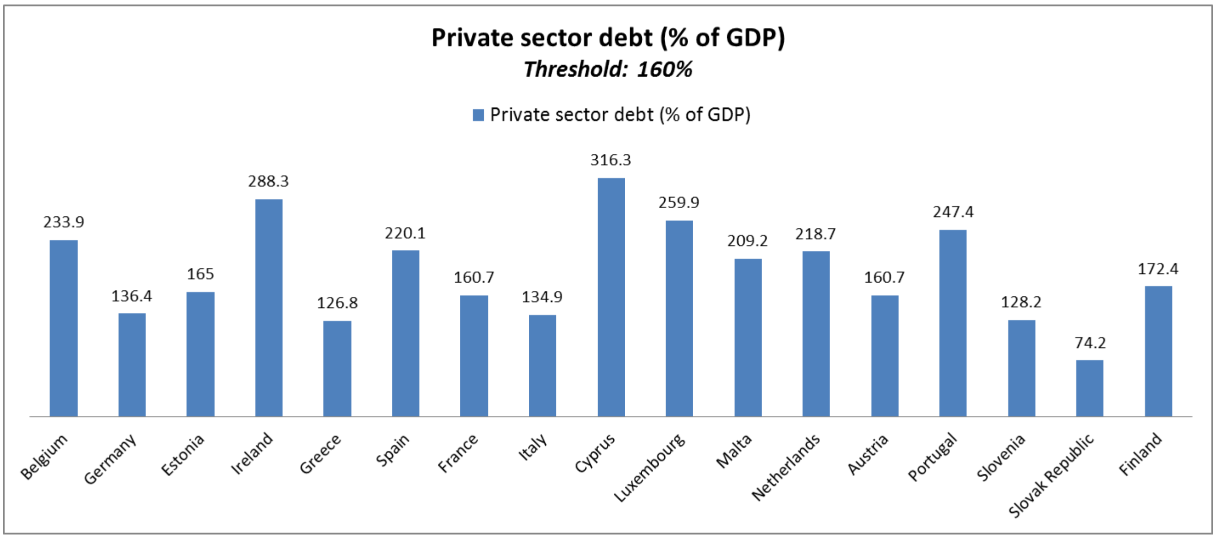
2.4 Private and public sector debt

The present stage of development in eurozone countries is closely related with the process of deterioration of debt in both private and public sectors.

2.4.1 Private sector debt

One of the critical factors for assessing the present unsustainable fiscal unsustainability is private sector debt. In Figure 5, we took as the main indicator private sector debt to GDP with a benchmark of 160% of GDP. This graph clearly explains that private sector debt to GDP is higher than public sector debt to GDP. However, if we take into consideration an indicator of 160%, there are such countries as Slovak Republic, Greece, Germany, Italy and Slovenia with the lowest ratio of private sector debt to GDP. However, a majority of eurozone countries have a very high level of private sector growth. To conclude, there is not only a very high level of private sector debt growth, but also private sector growth debt growth.[6]

Fig. 4: Private Sector Debt (2011)



Source: Table set from Eurostat, ECB, OECD data.

2.4.2 Public sector debt

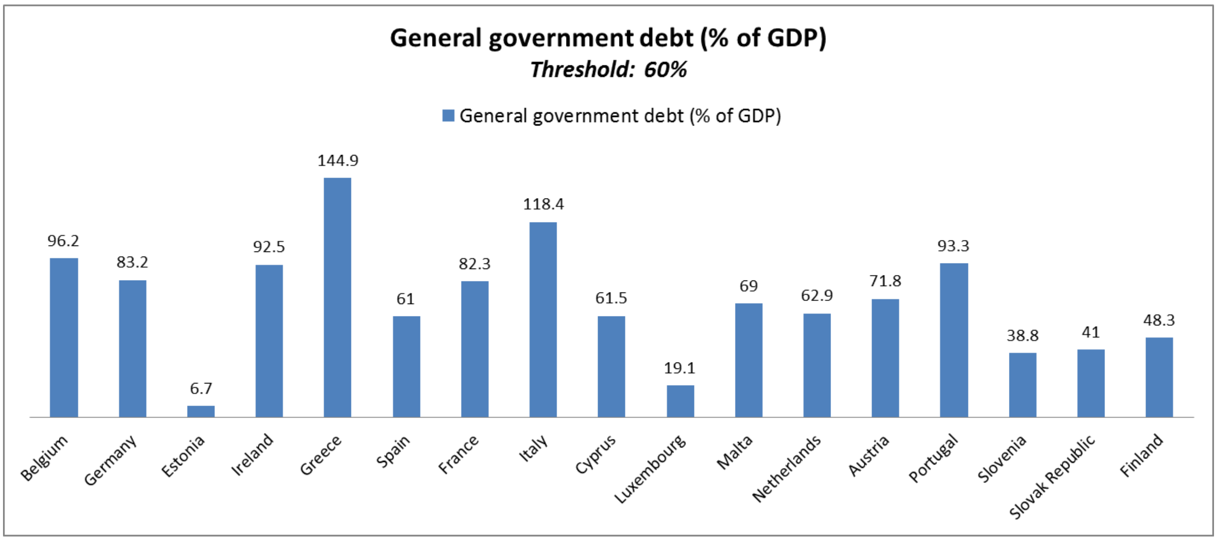
The level of public debt is imperative for future economic growth[7]. As Figure 5 demonstrates, a majority of eurozone countries have reached higher public debt ratio than was the requirement in the Maastricht Treaty (benchmark of 60%). Last year, only five countries were able to fulfill this performance criterion – Estonia, Finland, Luxembourg, Slovak Republic and Slovenia. A majority of eurozone countries permanently have broken the rules for reaching this criterion. Such countries are known as PIIGS countries[8]. Based on the theory of Debt Dynamics, the critical factor for assessing public level debt is its trend. Countries able to compete in the international market have also been able to reduce their public debt, mainly Germany. However, the most debtor countries having problems with the fiscal and debt sustainability, in particular, those that lost competitiveness, significantly deteriorated their public debt. The lack of competitiveness altogether with a poor fiscal discipline caused the present unprecedented deterioration of public debt sustainability.

[6] To assess the overall debt indebtedness of the main sectors such as public, private, financial and nonfinancial, the present stage of development is unsustainable.

[7] Reinhart and Rogoff (2010) find that the difference in median growth rates of GDP between low debt (below 30 percent of GDP) and high debt (above 90 percent of GDP) groups is 2.6 percentage points in advanced economies over the period.

[8] Kumar, Manmohan S. And Jaejoon Woo (2 010) find that on average, a 10 percentage point increase in the initial debt-to-GDP ratio is associated with a slowdown in annual real per capita GDP growth of around 0.2 percentage points per year, with the impact being smaller (around 0.15) in advanced economies.

Fig. 5: General Government Debt (2011)



Source: Table set from Eurostat, ECB, OECD data.

3. Latest economic development

After the break out of the global financial crisis and during the last four years the situation in EMU countries significantly deteriorated. The trends in eurozone countries are more less of divergence than real convergence in terms of EMU countries. Official data clearly shows that in the EMU countries, economic imbalances continued and eurozone is dealing with the vulnerability of the main macroecomic indicators.

One lesson resercher, academia and policy-makers should learn is that loss of competitiveness always caused current account deficits and brought about a reduction in economic growth, which deteriorated public finance. On one side, those countries that are in line with world competition such as Finland, Germany, Luxembourg and Netherlands have current account surpluses, relatively very high net international investment positions, stable labor costs, managable public debt and relatively positive trends in reducing unemployment. On the other side, countries as present well-known as PIIGS that lost their competitiveness have curent account deficits, negative net international investment positions, loss of market share, very high public debt and growing unemployment.

The global financial crisis and recession caused the debt crisis in European Union, but especially in some eurozone countries. Growing public debt in the euroarea called for additional financing. Most debtor countries in the EMU lost access to the international capital markets. High spreads for sovereign bonds and inability to get money on domestic and international capital markets raised a question of how to finance the public debt. The

European sovereign debt crisis has not yet been fully resolved. Therefore, in this regard, in the euroarea several crucial steps have been taken.

Conclusion

The creation of European Montary Union was an unprecendented step in the right direction in modern economic history. Pre-monetary union led to real convergence in some important indicators such as GDP, intetrest rates, net international investment position and current account.

When EMU was created, the positive trends still appeared in some major macro and microeconomic indicators. However, one of the critical issues was loss of competitiveness in some countries as well as low fiscal discilpline. Low level of competiveness brought about the lower economic growth and declining revenue of the general governemnt budget. In this regards, official data analysis offered a clear conclusion that a majority of countries joining the EMU permanetly broke down the basic rules in Stability and Growth Pact. In addition, a majority of countries lost competitiveness and have reached deficits on current accounts. The former factor significantly contributed to the present unfavoravable situation in EMU countries as a whole.

Member States of EMU agreed on far-reaching fiscal consolidation plans and structural reforms. The most important is to implement all necessary measures in this regard. However, these measures should go with the existing international committments, to foster competitiveness and to increase employment, while maintaining consolidations targets.

To follow euroarea fiscal consolidation, the strenghtenining of fiscal governance is needed. In line with this, the lately adopted „fiscal compact“ is promising. Improving fiscal governance will enshrine the fiscal „golden rule“ in EU member countries.

The real life of recent development clearly shows and there is no doubt that behind this very unfavorable economic development in EMU member countries is the poor leadeship and lack of governace of European Union. Many representatives for EMU member countries failed to fulfill their own commitments, but mostly political ones. The question is whether the European Union will be able to function without political committment and whether it can manage itself.

The EMU will survive only if politicians take responsibility and decision-makers are highly competent. So, the political responsibility and high profile of decision-makers, including improvement of leadeship and governance are the main prerequisites for the recovery of EMU and establishment of a credible framework for fulfilling all necessary conditions set out in Optimal currency union.

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