

Vicious circles

The interplay between Europe's financial and sovereign debt crises

SUMMARY

From 2007 a series of crises in the economic and financial sphere hit the European Union. These were partly linked and tended to amplify each other. Two of the hardest hitting, the financial and sovereign debt crises, were closely intertwined and put immense pressure on the euro area, stressing the financial sector and pushing Member State governments' budgets to their very limits. Several Member States lost access to the capital markets, and required financial assistance from both the euro area and the IMF. Unlike the United States economy, the euro area economy has failed to bounce back from the economic crisis owing to its ongoing sovereign debt crisis.

Although the initial shock of the financial crisis came from the United States of America, the crisis took a different twist in the euro area, which was not prepared for such an event. There were no proper crisis resolution mechanisms in place, nor were there sufficient budgetary margins available to save the banks and reinvigorate the economy without putting the sustainability of public finances in jeopardy. The Stability and Growth Pact, a central element of Economic and Monetary Union, had failed to produce the necessary fiscal margin. Problems were compounded by macroeconomic imbalances that had built up inside several Member States.

The European Union fought on two parallel fronts: saving banks and supporting stressed sovereigns in order to extinguish the fire, while also correcting the framework with the aim of avoiding a recurrence of similar crises. Although the worst seems to be over, problems persist and a renewed flare-up is not impossible.



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One crisis too many

In summer 2007 the first signs of a [financial crisis](#) were perceived in the USA. A year later, the Lehman Brothers bank collapsed, triggering an acute crisis in the financial sector. This sent the USA as well as the world economy into a recession. The US authorities responded in a forceful manner, with most of the attention focused on improving financial supervision in order to stabilise the banking sector. The crisis in the USA was hard but the medicine was strong, and once the banking sector had stabilised growth came back surprisingly fast.

The transmission of the crisis to the European Union (EU) came first and foremost through the highly internationalised banking sector, triggering a severe banking crisis, although not all countries were hit in the same way, or with the same intensity. As in the rest of the world, [interbank lending](#) came to a virtual standstill, and melt-down of the financial sector could only be averted through very strong measures taken by the European Central Bank (ECB), then under the helm of President Jean-Claude Trichet.¹ As in the USA, prudential supervision of the banking system was improved substantially. What did not return, however, was growth. Instead the EU went into a fully fledged [sovereign debt crisis](#).

Anticyclical policy and automatic stabilisers

Saving the banking sector – and with it the economy – proved to be a [very expensive](#) operation. In addition to the ECB's action, several Member States had either to bail out or wind down banks with public money. Most countries also engaged in some sort of support to the economy by injecting money into it, thus deliberately acting in an anticyclical manner. These operations pushed public debt up in a significant way, all the more so as the economic slow-down reduced tax revenue.

In principle, the EU is equipped with a strong instrument, the [Stability and Growth Pact \(SGP\)](#), designed to allow for anticyclical policies – especially in the case of extreme economic shocks, as well as to let automatic stabilisers work. In all cases action takes place at the national level, but the underlying framework is European. In order to provide the necessary fiscal space, Member States and the EU institutions agreed the Stability and Growth Pact (SGP) in summer 1997. This created the basis to go beyond the Treaty's requirement to avoid excessive deficits (Article 126(1) of the Treaty on the Functioning of the European Union (TFEU)). The pact stated that 'Member States undertake to abide by the medium-term budgetary objective of positions [close to balance or in surplus](#)'. In addition to providing fiscal space, the

SGP was also destined to maintain the fiscal discipline enshrined in the Maastricht criteria after Member States had been admitted to the euro area, as well as to ensure

Anticyclical policy

This involves voluntary action by the state to soften the economic cycle, by injecting money to increase economic activity in bad times and to reduce expenses during an economic boom. Typically the state would increase public debt in the former case, and reimburse part of the debt in the latter. Anticyclical policy may be limited to those cases where strong shocks hit the economy.

Automatic stabilisers

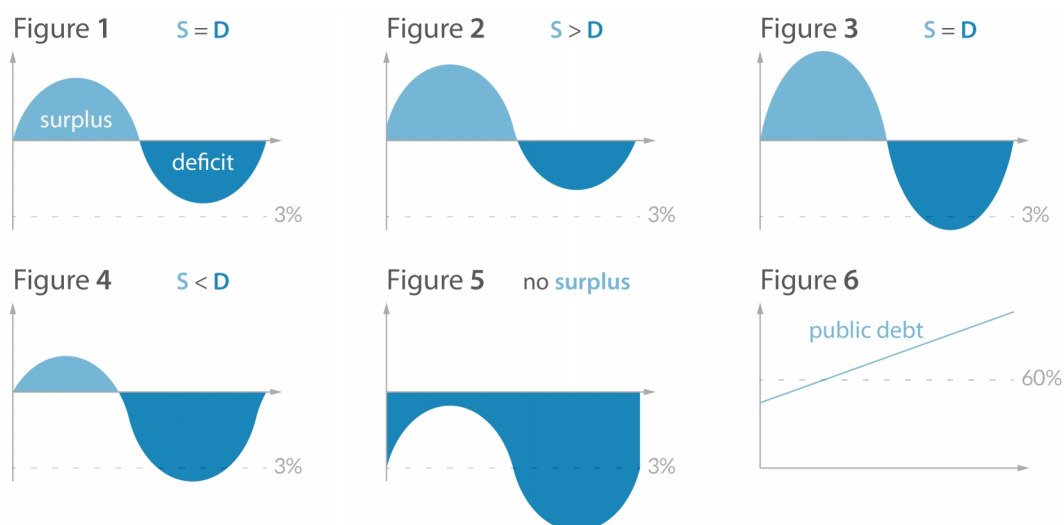
During economic downturns, most public expenditure remains at the same level (unlike the rest of the economy which is contracting) and some expenditure, such as unemployment benefits, may even increase, thus creating an automatic anticyclical effect. Typically, the deficit-to-GDP ratio increases when such automatic stabilisers are at work.

that contingent liabilities, especially those stemming from strained pension systems, could be kept in check.

The 3% deficit limit foreseen in the Treaty gives leeway for Member States to conduct anticyclical policies and to let the automatic stabilisers work. The 60% debt limit is meant to ensure that a Member State does not experience a sovereign debt crisis.

Reaching positions close to balance or in surplus in the SGP

The SGP aims broadly to achieve the oscillation around zero of surpluses and deficits over the medium term. Figure 1 shows a situation where the two cancel each other out, thus achieving a balanced position. Figure 2 shows a similar situation, except that the surplus is higher than the deficit, which allows for reserves to be accumulated for really bad times. Both cases respect the central SGP requirement and stay within the 3% deficit limit set by the Treaty.



The next cases illustrate infringements of the SGP. In Figure 3 the position is still balanced, but the 3% limit is breached. Here the pact's [preventive and corrective instruments](#) come into play, or flexibility might be applied temporarily. If corrected in a timely manner there should be neither sanctions nor adverse consequences for the budget.

Figure 4 shows a double problem: the 3% limit is breached for a longer period and positions in deficit are reached over the medium term. Figure 5 goes a step further and shows a case of an apparent inability (or unwillingness) to achieve a budget surplus. In both cases an accumulation of deficits is likely to increase the overall public debt, pushing it beyond the Treaty's limit of 60%, as illustrated in Figure 6. If that happens over a long period of time, a point can be reached where the state's debt may become [unsustainable](#).

There is a stark difference between Figures 1 and 2 on the one side, and Figures 4 and 5 on the other. Conceptually, those calling for the SGP to be upheld and those asking for additional flexibility in an already stressed system are worlds apart. One way to reconcile the two sides would be to accept flexibility only in exceptional cases and for a short period, as outlined in the Commission's Communication on [flexibility](#) (illustrated in Figure 3).

The evolution of public debt prior to and during the crises

In the run-up to monetary union, public debt built up dramatically inside the future euro area. From 1980 to 1996, Member States' deficits averaged around 5% a year, doubling debt to over 70% of GDP.² As fulfilling the Maastricht criteria was mandatory for joining the euro area, efforts were made to get national deficits below 3%, where they broadly stayed until the financial crisis hit in 2007–2008. However, during the first years of the euro's existence, which were economically prosperous times, the Member States did

not generally compensate for deficits with surpluses. The SGP's requirement that positions remain in balance or in surplus (Figures 1 and 2) were not met. As a result overall debt could not be brought under the 60% limit.

In 2011, an ECB analytical [paper](#) found that 'the first nine years of the euro – from 1999 to 2007 – can, in retrospect, probably be best characterised as "wasted good times" during which the foundations were laid for the present crisis in EMU'. The Member States' lack of fiscal space did not put them in a position to fight the financial crisis.

Once the financial crisis unfolded, governments had to take a number of measures, most of them increasing state expenditure. Independently from ECB actions designed to revive interbank lending, governments pursued their own support initiatives for banks, either to save them or to wind them down.³ The economy, which had already shown signs of weakness shortly before the start of the financial crisis, got weaker as a result of the banks' troubles. A [European Economic Recovery Plan \(EERP\)](#) was launched. The aim was to strengthen demand in the Member States by €200 billion, which corresponded to 1.5% of GDP. At the same time tax revenue dropped due to a slump in economic activities, and the automatic stabilisers came into play.

The impact of all these measures on Member State budgets was dramatic. In the euro area the average deficit went up to 6% in 2010, whilst public debt soared to 85%, which corresponds to an increase of about 20%.⁴ The agreed measures to increase demand would have been in stark contrast with SGP requirements, but there was a general consensus that the pact would have to be suspended for a short period of time.

To sum up, the absence of fiscal space got in the way of the unhindered working of anticyclical policies and the proper functioning of automatic stabilisers. Instead, the urgency of the matter forced a suspension of the fiscal rules.

The sovereign debt crisis

Experts generally consider that a sovereign's debt is at [risk](#) once debt exceeds 85-90% of GDP. There is nothing automatic about that number. The threshold might be higher or lower, depending on many factors, such as possible macroeconomic imbalances, political uncertainty, economic expectations, and events occurring in other countries. Indeed, in several Member States macroeconomic imbalances had been building up. These included discrepancies between low productivity increases and high wage increases, real-estate bubbles, as well as the parallel occurrences of sustained trade deficits and a loss of competitiveness. Several Member States had been living beyond their means.⁵ There is ample [evidence](#) that imbalances increased inside some Member States after the launch of the euro.

High macroeconomic imbalances and soaring public debt led to a substantial level of instability. In 2009-2010 a string of revelations concerning statistical fraud in Greece took the world by surprise. It became apparent that the country's deficit and debt levels were substantially higher than previously reported. With each new revelation the financial markets reassessed the risks linked to Greek government bonds, gradually pushing their interest rates up. It took half a year for the government to lose access to the financial markets, after which the country plunged into a sovereign debt crisis. In order to stop the country openly defaulting on its debt, several ad hoc mechanisms were created at the European level, which would later culminate in the [European Stability Mechanism \(ESM\)](#). In essence, funding from capital markets was replaced with conditional International Monetary Fund (IMF) and EU loans, the latter being either

guaranteed by the other euro-area states, or granted directly by them. The aim was to avoid an extremely 'hard landing' for [Greece](#), as well as to shield the rest of Europe from the fallout of a default.⁶ Thanks to the loans provided by the EU and the IMF, the Greek administration would continue operating, use the time bought to put its budget on a sound footing, and carry out structural reforms destined to overcome its macroeconomic imbalances. It was expected that the country would reinvigorate its economy and end-up in a position where it could pay back its debt.

Until the events in Greece, almost nobody had expected a sovereign default to happen inside the euro area.⁷ Markets and rating agencies barely differentiated between the best and worst performing countries. Suddenly financial markets grew nervous and confidence plummeted. The creditworthiness of several Member States was reassessed. [Some](#) argue that the loss of trust constituted a key element in the crises (see box).

A domino effect was triggered. [Ireland](#) came under scrutiny for the weight of its sovereign debt, which had soared following the bursting of a real-estate bubble and bank bailouts. Ireland had to apply for conditional help from the EU and the IMF. Portugal was next, especially in view of the existence of large and increasing macroeconomic imbalances. Investor confidence diminished fast, interest rates went up dramatically, and eventually the

country also requested conditional help. Cyprus followed, plagued by a deep banking crisis, the consequence of an unsustainable banking model and exposure to overleveraged real-estate companies and to Greek debt. The credit agencies ended up downgrading the country's debt to junk status. After a long and tortuous operation, Cyprus also asked for conditional help.⁸

Crisis of confidence

The height of the crisis was characterised by a very high level of uncertainty across many fields. Could one's own bank be hit? Would the global banking sector survive? Were central banks still able to carry out their tasks? Would the global economic slowdown accelerate? Were there other EU Member States threatened by a default on their debt? Did stricken countries have the capacity to help themselves, or could sufficient international help be mustered? Might the euro area's very existence be threatened and would some states have to give up using the common currency? Would the authorities have both the will and the capacity to act in time? Were rules, such as the SGP, still valid? Could the instruments which were set up to save banks or sovereigns be legally challenged, i.e. be forced to be scrapped when they were most needed?

These and many more such questions were asked. The problems were highly interconnected. Fear was widespread, and an increase in precautionary saving ensued. Demand decreased, as did public investment. At a worldwide level, confidence was shattered for both businesses and consumers.

Feedback loops between the financial crisis and the sovereign debt crisis

When the financial crisis swept over from the USA to the EU, the effects on the Member States were asymmetric. On the one hand, countries hit by the financial crisis but with no major macroeconomic imbalances and with strong budgetary buffers, such as Germany, fared relatively well and avoided sliding into a sovereign debt crisis. On the other hand, countries that had not been strongly exposed to the financial crisis but that showed substantial macroeconomic imbalances and lacked credible budgetary buffers, such as Portugal, were thrown totally off balance by the general lack of confidence, and slid into a sovereign debt crisis.

The ECB [noted](#) that until the last month of 2009, despite the financial crisis, the euro area's banking sector resisted well when compared with what happened in the USA. It was only when Greece triggered a crisis in confidence that the spreads (the difference

between interest rates) on bonds, as well as spreads on credit default swaps ([CDS](#)) for bonds, started to increase, pushing several Member States into default. At the same time as the USA started enjoying a strong economic recovery, the EU got embroiled in various feed-back loops. The initial strong fiscal stimulus, including that from the EERP, could not possibly be maintained because of soaring debt levels, thus weakening the economy. Similarly, the fiscal space necessary for renewed rescues of the financial sector shrank. Mechanisms such as the ESM helped to restore stability, but the financial engagement of all euro-area states and the guarantees they subscribed had the effect of linking all of them to the crisis, or at least bore the potential for them to be drawn into the crisis.⁹ Also, as the ECB's balance sheet contained substantial exposure to bonds from weaker states, possible central bank [losses](#) on these following a state default may have ultimately had to be borne by all the euro-area Member States.

The rescue of banks was achieved largely using public (i.e. taxpayers') money, depleting whatever reserves had been built up prior to the crisis and increasing public debt, often to a level where the state's creditworthiness could be called into question. In turn, weakened sovereigns¹⁰ were less able to help the banking sector if it was hit by new negative events. Banks had at the same time substantially increased their exposure to bonds with a low credit rating, and were therefore vulnerable to [sovereign shocks](#). A fragile equilibrium was reached; any new shock hitting banks would immediately have been transmitted to the sovereigns, and any new shock to the sovereigns would have been transmitted to the banks. This process may have been self-accelerating. Contagion could also have spread to other countries via the banking sector, and possibly also through the rescue mechanisms. A [nexus](#) had been established between the banks and the sovereigns.

Severing the link between banks and sovereigns

To break up the nexus between the banks and the sovereigns, as well as to return to growth and employment, a three-pronged approach was chosen.

First, the banking sector had to be made more resilient. Soon after the start of the financial crisis, banking supervision was addressed, with the creation of agencies such as the European Banking Authority ([EBA](#)). Once the sovereign debt crisis unfolded, supervision was extended to what is now called the [Banking Union](#), with (i) a Single Supervisory Mechanism ([SSM](#)), where the ECB was given wide-ranging financial supervision powers, (ii) a Single Resolution Mechanism ([SRM](#)) designed to carry out the resolution (winding down) of failing banks, and (iii) improved national Deposit Guarantee Schemes (DGS). Wherever possible, systems were designed to minimise shocks to sovereigns.

Secondly, the sovereigns were made more resilient with the reform of the [SGP](#). The Stability and Growth Pact was strengthened in a number of ways, with the adoption of the six-pack. The aim was to identify, at the earliest stage possible, the emergence of problems that might impact negatively on state finances and apply corrective actions accordingly. In this respect, much attention was given to the macroeconomic imbalances which were latent within several Member States. A Macroeconomic Imbalance Procedure ([MIP](#)), similar to the Excessive Deficit Procedure ([EDP](#)) (the so-called 'corrective arm' of the SGP), was included in the package. More attention was given to monitoring debt, rather than concentrating on deficits. Economic and budgetary coordination was improved through the creation of the European Semester. The two-pack brought additional elements to the six-pack, including EU oversight rights

on early drafts of national budgets, in order to prevent excessive deficits. The intergovernmental Treaty on Stability, Coordination and Governance (TSCG, also known as the [Fiscal Compact](#)) further reinforced this framework.

Thirdly, macroeconomic imbalances were not seen only from their perspective as a threat to budgets, but also as impediments to growth and employment. The correction of macroeconomic imbalances through structural reforms gained in importance with the [European Semester](#). In order to further increase competitiveness, the [Euro Plus Pact](#) was signed.

Appraisal and outlook

In principle the governance framework has been improved to a point where the nexus between the banks and the sovereigns should have been severed. However, [some](#) would like to go further, especially in the field of [Banking Union](#) in the short term, for instance by adding further backstops and by creating a European Deposit Guarantee Scheme (EDIS), as well as by propping up the Economic and Monetary Union, for instance by adding a European Monetary Fund or creating a 'fiscal capacity' for the euro area. Several of these suggested proposals would require a Treaty change. However, a heated debate over the rightfulness of the new governance rules, as well as about the way countries subject to programmes were treated, has accompanied the whole process and has never settled down. The European Parliament's [Troika report](#) of March 2014 is testimony to these conflicting views.

A debate is raging between those who would allow more flexibility in the rules and those who would enforce the rules as they are. All agree that the priority should now be 'growth-friendly fiscal consolidation', but there seems to be no consensus as to what exactly that might mean, especially in relation to the SGP's requirement of a budget that is balanced over the medium term. The Bank for International Settlements (BIS) has long [advised](#) sovereigns to stay well under 85% general government debt in preparedness for extraordinary shocks. The Dutch Presidency, meanwhile, is keeping the topic of interacting crises firmly on the Ecofin [agenda](#).

Main references

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[The mutating euro area crisis: is the balance between "sceptics" and "advocates" shifting?](#), Francesco Paolo Mongelli, ECB Occasional Paper Series No 144, February 2013.

[Resolution of the Amsterdam European Council on the Stability and Growth Pact](#), Amsterdam, 17 June 1997, Official Journal C 236 of 2 August 1997.

Endnotes

¹ The ECB, in its role of lender of last resort, was the first central bank worldwide to act by massively injecting money into banks in order to compensate for completely dried-up interbank lending. Its actions were immediately followed by all other major central banks, including the US Federal Reserve. The ECB's role of lender of last resort is restricted to banks, as it is barred by Article 123 TFEU from acting as a lender to sovereigns.

- ² See [ECB](#) paper No 129, p. 8.
- ³ In Ireland the rescue of the Anglo Irish Bank resulted in a deficit of 32.4% in 2010. See ECB paper No. 129, p. 12.
- ⁴ See [ECB](#) paper No 129, p. 12.
- ⁵ See [ECB](#) paper No 144, p. 15.
- ⁶ The assumption was that EU and IMF help would spare Greece from an even deeper crisis. Once a government has lost access to capital it can only cover its expenditures with its current tax income. If the difference between expenditures and tax income – i.e. the deficit – was very high prior to the default, then the necessary adjustment through a reduction in expenditures or an increase in taxes becomes extremely difficult, resulting in a long and deep recession. In addition, strong exposure of foreign banks to that country's (public or private) debt can destabilise banks in other countries, possibly followed by further knock-on effects.
- ⁷ There had been three cases outside the euro area where EU and IMF help was requested by Member States: Hungary in October 2008, Latvia in February 2009 and Romania in March 2009. EU help was granted under Article 143 TFEU, which is not applicable to the euro area. Not only was there a general belief that the euro would shield Member States from a state default, Article 125 TFEU also forbids bail-outs, which is meant as an incentive to the Member States to reduce moral hazard.
- ⁸ First, the Cypriot government tried to solve its banking crisis with an injection of Russian capital. In January 2012, €2.5 billion were lent to Cyprus, with no conditionality attached. With no incentive to reform the banking sector or other relevant parts of the economy, the causes of the crisis were not removed and the situation became untenable. In November 2012, EU and IMF help was requested, but a fierce and long battle over conditionality delayed the start of the programme until May 2013, thus letting the crisis fester, and greatly increasing the adjustment burden for the country.
- ⁹ Supporting mechanisms, such as the ESM, were created outside the Community framework, in order to circumvent Article 125 TFEU, which prohibits states from being bailed out. If a Member State under the programme defaulted on its debt towards the ESM or similar arrangements, not only would that create possible economic domino effects in the rest of the euro area, but the fact of honouring the guarantees would also legally amount to a bail-out, thus infringing the Treaty as well as national law and court judgments in some Member States.
- ¹⁰ The term 'sovereign' is used in the sense of 'government', or 'public administration'.

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