Special Report 2011/03

Euro crisis: 'We're not like that!'

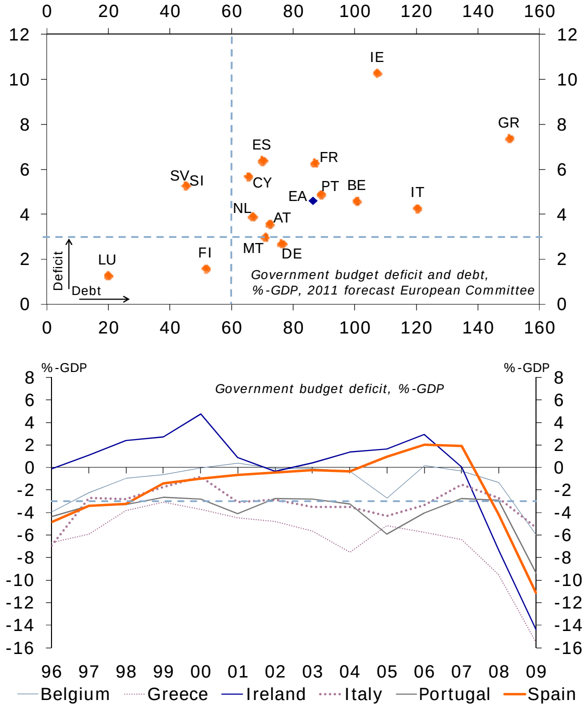
Investors have been keeping a close watch on the financial situation of a number of eurozone countries since the Autumn of 2009. Financial markets are chiefly concerned about – in order of severity – Greece, Ireland, Portugal and Spain, and to a lesser extent Italy and Belgium, given the premium on those countries' government bonds. Over the past year their governments have regularly reiterated that their economic situation is not at all like that of the others: 'We're not like that!' Although the key differences separating these countries are undeniable, so too is the seriousness of their shared and individual problems.

Government finances out of kilter

A major ***similarity*** between the countries referred to above is the state of their government finances. They all have a government debt and a budget deficit in excess of that permitted under European agreements. Figure 1 shows the combination of government debt and budget deficit expected for 2011 relative to GDP for each country. The top right-hand area of the chart features Greece and Ireland, which are expected to have the highest budget deficits in the eurozone this year and occupy first and third place respectively among the countries with the highest debt to GDP ratio. Spain will continue to have one of the highest budget deficits in the eurozone, but its government debt will be comfortably below the eurozone average. Portugal will be around the average for the eurozone in 2011 for both its debt and deficit. Italy and Belgium each have a government debt of more than 100% of GDP, but average budget deficits. Therefore only Ireland and Greece present a *combination* of above-average debt and deficit levels.

A major ***difference*** between Ireland and Spain on the one hand and Portugal, Greece and

Figure 1: Government finances



Source: EC, Reuters EcoWin, ISO country codes

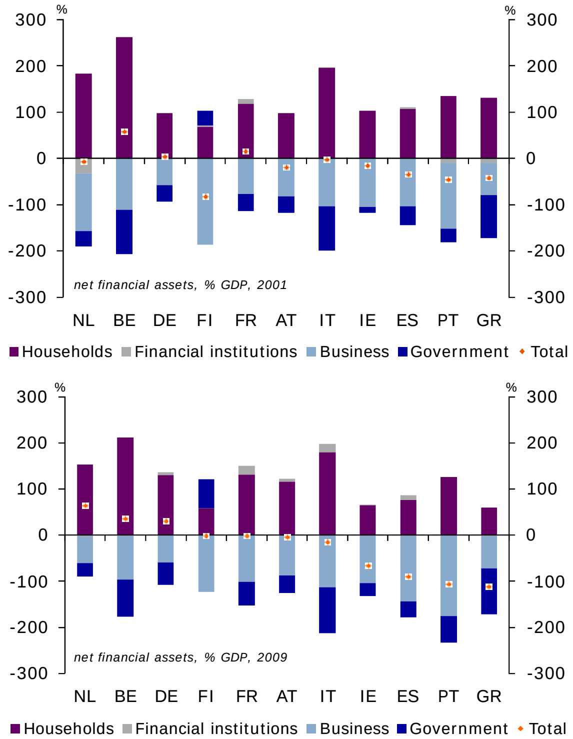
Italy on the other is to be found in the causes of their high budget deficits. The first two countries experienced an overheated property market in which both property prices and building activity reached unsustainable levels. This pushed up economic growth as well as tax revenues. Accordingly, Spain and Ireland from 2002 to 2007 boasted a budgetary equilibrium or surplus (figure 1). Both countries' government debt was consequently very low in 2007 (36% and 25% respectively of GDP). But the sharp correction of the untenable situation in the property market caused a substantial fall in tax revenues. Moreover, the governments in both countries had to come to the aid of banks facing major losses on property loans. In Ireland the size of the damage compared to the size of the economy far outstripped that in Spain, and consequently the impact on Ireland's government finances was likewise far greater.

While Spain and Ireland were among the best in class from the end of the nineties to the end of 2007 in terms of government finances, Portugal, Greece and Italy have been struggling with large deficits in their government budgets for years. In contrast to Spain and Ireland, the present budget deficits of these countries did not come on the heels of earlier surpluses. In addition, the economic downturn in Greece and Portugal in 2008-2009 was much less steep than in Spain and Ireland, partly because it was not preceded by an overheating of the property market. Both countries therefore have only a limited economic excuse for their large budget deficits and have for years been spending more than they receive in taxes. This applies equally to Italy, but not to Belgium. Greece differs from Portugal and Italy in that its budget deficits have been excessive for many years and, worse still, their true extent was masked by gravely deficient reporting. The sudden doubling of the budget deficit that was disclosed in the autumn of 2009 is seen as the start of the unrest in the market for European government bonds.

Debtor countries

The focus on Portugal and Spain as the next countries in need of help is not self-evident on the basis of their government finances. France is expected to have a higher deficit in 2011 than Portugal and its debt versus GDP ratio is of the same magnitude. Italy and Belgium both have very high government debt. But government finances are not the only thing investors are concerned about. In addition to the government, businesses and households have also built up major debt positions in a number of eurozone countries. Figure 2 shows the net financial assets (financial assets less financial liabilities) for households, businesses, financial institutions and the government. The total net financial assets of a country are a net financial *liability to* other countries or a net

Figure 2: Net financial assets and liabilities



Source: Eurostat, ISO country codes

financial *claim on* other countries[1]. As a rule, governments have more debts than financial assets. Businesses usually have *non-financial* assets (buildings, machines) and *financial* liabilities and therefore a net *financial* liability. Households as a group have more financial assets (in the form of loans to businesses and government and the ownership of businesses) than debts. The loans of households to businesses and the government are largely provided through financial institutions, which as intermediaries have virtually as much financial liabilities as assets. If the assets of the households of a given country are not sufficient to meet the financing requirements of businesses and the government, it will have a net financial liability with respect to other countries. Greece and Portugal both had a net international financial liability of more than 100% of GDP in 2009. Spain and Ireland also

[1] This net international ***financial*** position differs from the net international investment position as this also includes the non-financial net assets of foreign direct investments. But the outcomes presented by the two series are to a large extent in agreement with each other.

carried considerable net liabilities. It should be noted that for Ireland this largely comprised of equity investments by foreign investors in businesses established in Ireland. In the other three countries the major portion of the net liabilities consists of debts. Italy has only a limited international net debtor position and in Belgium the assets of the households are comfortably sufficient to offset the liabilities of businesses and the government.

A high net international debt position can be problematic as the country concerned will then be dependent on foreign investors both for new loans and for refinancing existing debt. Those investors financed increases in debt positions at low interest rates for many years up to 2008. To a significant extent this was done via banks in the debtor countries, which in their turn finance the households and businesses. These banks are faced with losses as the correction of the economic disequilibrium and the recession lead to increasing repayment problems for households and businesses. Investors are therefore suddenly less prepared to finance those *banks*, which as a result increasingly depend on the ECB for their financing. In addition, investors expect governments to bail out the banks if they run into trouble. This would give rise to an Irish scenario, in which government support saves the banking industry but entails a sharp deterioration of government finances. Consequently investors also become reluctant to finance the *governments* of the debtor countries. In short, it is not enough to consider only government finances when assessing the financial health of a country. In terms of their net international financial position, there are ***similarities*** between Greece, Portugal, Spain and also Ireland. Italy and Belgium do not fit into that group, however.

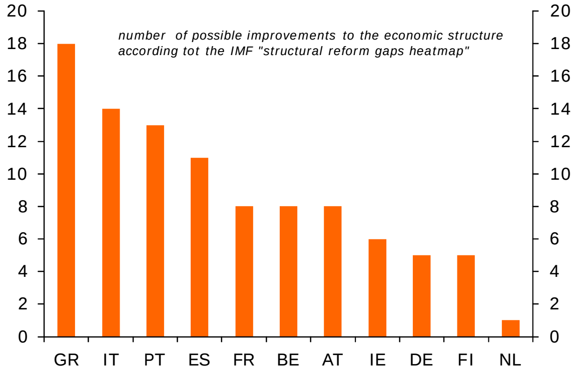
Growth capacity

Debt positions are usually related to Gross Domestic Product because the size of a country's economy will tend to reflect its earning capacity. The greater a country's GDP, the greater its capacity to repay a given amount of debt. A country's expected economic growth is therefore a key factor in its capacity to sustain its aggregated debt positions.

In the **short term**, demand for the goods and services produced in a country will determine its economic growth. In Spain and Ireland, the collapse of demand for economic activities relating to property needs to be compensated for by other activities. In addition, both households and governments in debtor countries are required to put their finances in order. This will limit the scope for growth of domestic demand for goods and services. The only way left to generate sufficient demand for their goods and services is via exports. But there are two reasons why this will not succeed in the short term. Firstly, their participation in the euro prevents the countries concerned from devaluating their currency as a quick fix for the price competitiveness they lost in past years. Secondly, governments in the other eurozone countries will also start to reduce their government deficits in 2011, meaning demand from those countries for goods and services can only rise to a limited extent.

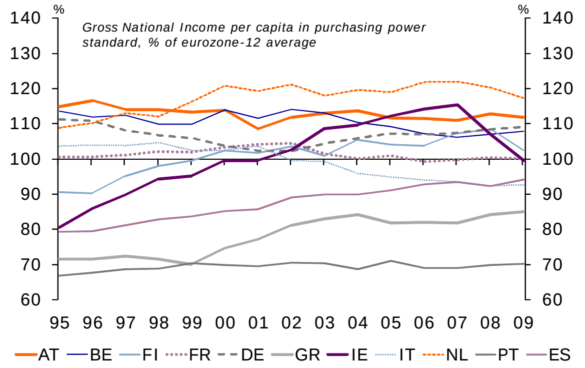
In the **long term**, the underlying strength of the economy will determine economic growth. This includes the flexibility of the labour market, the statutory and regulatory environment for businesses, the education level of the working population and the quality of the infrastructure and innovation. The IMF prepared a summary of necessary improvements in November 2010. Figure 3 shows the number of improvement points, with the categories coded red by the IMF receiving a double weighting and orange assessments receiving a single weighting.

Figure 3: Structural weakness



Source: IMF, Rabobank, ISO country codes

Figure 4: Sprinters and crawlers



Source: Reuters EcoWin, ISO country codes

The Southern European countries have the weakest economies of the eurozone countries shown. The ***difference*** compared to Ireland is substantial. Belgium likewise scores considerably better. Since the second half of the '90s this has also translated into a widely ***divergent*** development of per capita incomes (figure 4). From the mid-nineties onwards, Ireland swiftly made up its distance to the European average income. Portugal has been trailing behind for many years, however. Spain and Greece have been slightly more successful in narrowing the income gap, but continue to perform below the average. Lastly, Italy rapidly lost its position above the average income of the eurozone since its participation in the euro and now scores considerably lower than the European average. Belgium has fallen back slightly since 2002, but still ranks above average in per capita income.

It should also be noted that Southern Europe's structural underperformance works to its advantage in theory, as its scope for improving the economic structure and thus achieving higher economic growth is greater than in Ireland and Belgium. Having said that, the benefits of structural reform will only become manifest in the long term. So there is a clear need for starting such reform now. Greece is being forced to carry out speedy reforms in exchange for financial support from the IMF and the European Commission.

But there is no sign yet of thorough measures in the other Southern European countries.

Conclusion

Seeking to placate investors by highlighting differences compared to other countries is not all that useful. That both Greece and Ireland needed help makes this clear. In 2007 Ireland was, after Luxembourg and the Netherlands, the wealthiest country of the eurozone-12, while Greece had the lowest per capita income after Portugal. According to the IMF Greece has to carry out three times as many structural reforms as Ireland. And Ireland had very low government debt and a budget surplus before the crisis, without any window dressing of its financial situation. Unlike Ireland, Greece did not experience a property bubble. All told, these are not exactly countries that resemble each other. But the problems remain as large as ever. Placing countries in- or outside certain categories can certainly be useful. But in the end it is advisable, in addition to identifying significant similarities and differences, to base conclusions on the severity of a country's economic and financial problems on a thorough analysis of that country itself.

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