THE FINANCIAL CRISIS AND ITS IMPLICATIONS ON THE PUBLIC DEFICIT OF THE EU COUNTRIES

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Abstract: *In this paper, the authors make an analysis of the second wave of the actual World Financial Crisis. They present the consequences of the first wave of the World Financial Crisis, namely the Banking Crisis, on the EU countries public debts.*

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1. European Bailout Plan

The first wave of the global financial crisis consisted of a deep crisis within the international banking system caused by mortgage contracts. The devastating effects of this first wave were only delayed - not eliminated - by states interventions through state bailouts given to banks in difficulty. To mitigate the effects of this crisis, the European Bailout Plan was passed in 2008 within the EU Zone, which in summary provided the following:

- Any financial support had to be given on time and it was temporary;
- Taxpayers interests had to be protected;
- Remaining shareholders had to deal with governmental interventions;
- Governments were free to change companies management when necessary;
- Governments were entitled to changing banking wage policies;
- Stipulations relating to EU Bailout Plan had to be followed as stated;
- No secondary effects on other UE members were allowed.

Besides the bailout amount of 1465 billion Euros, the EU Bailout Plan also stipulated that bailed banks could not give dividends to investors until the total amount received by them was returned to the governments. Moreover, governments had the right to be represented on the board of directors of bailed banks by special observers. As a consequence of the above stipulations, European stock markets fell the very next day this plan was approved.

There were also some exceptions. Many French banks like Credit Agricole or BNP Parisbas refused governmental help because of its interfering role in bank management. Other banks accepted the bailout plan, as following: Barclay's (UK): 1.62 billion £; Royal Bank of Scotland (UK): 5 billion £; Fortis (The Netherlands/Belgium): 11.2 billion €; Dexia (France/Belgium): 6.4 billion €; Hypo Real Estate (Germany): 35 billion €.

This bailout given to banks by EU states was misunderstood by them, for several reasons, among which the following:

- When banks know that the state will support them during crises, they can afford to take bigger risks.
- Without more regulation, banks are driven to increase their returns by taking bigger risks.
- When banks gain huge amounts of money, they keep the profits; when banks loose, it is the state that pays.

Looking back, one can see that the European public has discovered an interesting fact: the 2008-2009 fiscal stimulus programs, which were aimed at forestalling an even greater crisis, generated more debts than jobs. By analyzing this situation, one conclusion arises: cheap money (through cost and high liquidity levels) has deepened the crisis.

2. It's all in the history

Recent past history showed, on one hand, the financial crisis deepened the problems of several European countries because of the monetary and financial structures of the Euro zone. On the other hand, the crisis resulted in extreme shortage of liquidity for European banks. During 2007-2008, banks of core Euro zone countries (**Germany**, **France**, **The Netherlands**, **Belgium**) continued to lend to peripheral countries (Italy, Spain, Ireland, Greece, Portugal). Gross cross-border claims from core to periphery reached 1.5 trillion Euros in 2008, representing almost three times the capital of core banks.

The European Central Bank (ECB) intervened, lending freely and making it possible for banks to start dealing with their weak position. Also, the ECB reaction was very different in 2009 when states were facing growing borrowing needs due to the crisis. The ECB watched as interest rates rose, financial institutions speculated against state debt, and state bankruptcy raised its head. In such a difficult financial environment, the Euro zone left each state to defend itself in the financial markets.

When looking closer at the above mentioned time line, the following can be stated: The financial crisis has been followed by a wave of governmental defaults on public debt obligations; The financial crisis has led to, or exacerbated, sharp economic downturns, low government revenues, widening government deficits, and high levels of debt, pushing many governments into default; As recovery from the global financial crisis begins, the global recession endures, at some point to the threat of a second wave of the crisis: **sovereign debt crisis**.

3. Sovereign debt crises

In a financial crisis, government spending increases dramatically in the attempt to stabilize the financial system and stimulate economic activity. Hence, tax revenues fall, fiscal surpluses turn into deficits and existing deficits increase. Because of the difficult financial situation, all sixteen members of the European Monetary Union (EMU) have violated treaty limits on allowable budget deficits (some more than four times). Moreover, the leading economies of the world have all seen their deficits shoot higher, some to record levels.

Among all the obstacles, there is a certainty: when economies are contracting or even grow slowly, bringing these deficits back down to earth, the situation turns into an unenviable challenge. Governments have to survive by turning to the markets. Then those increased deficits turn into growing debt loads. When debt reaches 80 percent of the GDP threshold, the borrowing costs for governments start ticking higher and so does the market scrutiny. Related to this topic and in the attempt to warn financial markets, the IMF stated in 2010 that five of the top seven developed countries in the world would have debt levels exceeding 100 percent of GDP during the next four years.

If deficits and debts rise and economic activity appears unlikely to solve fiscal problems, the creditworthiness of the government falls under intense scrutiny. That's when downgrades appear. This is the situation many countries around the world had to face in 2009 and 2010, when the

sovereign debt crises burst. Greece's sovereign debt rating has been downgraded to *junk* status. Spain has lost its AAA rating. UK could have lost its AAA status if its deficit would not have been addressed. Across the ocean, Japan's outlook has been cut to negative and rating agencies have even warned the U.S.

In such an environment, when investors see more risk, they require more return. Therefore, the borrowing costs for troubled countries rises. Then, it becomes harder to finance spending needs and harder to finance existing debt. That's when defaults show up. Unless governments can **demonstrate** they're willing to take tough steps to reign in debt, crisis can spread quickly.

4. Public deficit, nowadays problem in the EU

Regarding the issue of the EU public deficit, it must be stated that this economic phenomenon is accepted within the union until it exceeds values stated in documents like: Maastricht Treaty (1992); Stability and Growth Pact (1997).

According to the Maastricht Treaty, countries have to meet several convergence criteria, among which the following:

- An inflation rate no more than 1.5% higher than the average of the three lowest inflation rates of EU member states over the previous year;
- Long-term interest rates must not exceed by more than 2% the lowest inflation rates of EU countries over the previous year;
- The Member State is required to join the exchange-rate mechanism (ERM II) for two consecutive years before entering the Euro zone and it should not have devalued its currency during the period;
- A government budget deficit must not exceed 3% of each country's GDP at the end of the preceding fiscal year;
- A gross debt to GDP ratio must not exceed 60% at the end of the preceding fiscal year.

On the other hand, the Stability and Growth Pact (1997) provided:

- mechanisms for multilateral surveillance and enforcement;
- stated that budgetary positions should normally be "close to balance or in surplus";
- if requirements are broken, EU can apply a fine of 0.5 % of the GDP to its members.

To comply with the provisions of the two treaties, EU members had to impose a strict budget discipline, because the budget positions of some countries pose a risk for the sustainability of the public finances of these countries and of the European Monetary Union (EMU) as a whole. Moreover, the national fiscal policies of EU members were strictly subordinated to the inflation target of the European Central Bank. Also, the national governments were obliged to meet rigid parameters and could not use fiscal policies freely to increase growth and employment.

Nevertheless, since the financial meltdown has begun, 20 EU countries (among which all 16 of the EMU's members) have been guilty of excessive spending. During all this period, European governments were and still are struggling to rein in deficits after the worst downturn since World War II. The table below presents some data concerning the amount of deficits:

Table no. 1 Budgetary Deficit/GDP

COUNTRY	2007	2008	2009
Ireland	0.1	-7.3	-14.3
Greece	-5.1	-7.7	-13.6
United Kingdom	-2.8	-4.9	-11.5
Spain	1.9	-4.1	-11.2
Portugal	-2.6	-2.8	-9.4
Iceland	5.4	-13.5	-9.1
Latvia	-0.3	-4.1	-9
Lithuania	-1	-3.3	-8.9
Romania	-2.5	-5.4	-8.3
France	-2.7	-3.3	-7.5
Netherlands	0.2	0.7	-5.3
Hungary	-5	-3.8	-4
Bulgaria	0.1	1.8	-3.9
Malta	-2.2	-4.5	-3.8

Source: Eurostat data

As it can be seen, twenty member countries are facing EU deadlines to get their budgets back in shape. They are all deemed crucial to economic stability and growth as the EU claws back from recession. A review of the situation in Hungary, Latvia, Lithuania and Malta shows all four countries have taken adequate steps to narrow their deficits. There are requests that Malta and Lithuania are granted another 1 and 2 years to get back in shape.

Most analysts stated that in 2010 unemployment rate in the EU would reach the level of 10.25% and the public deficit would be 7.5% of EU GDP. In 2009 budget shortfalls of two or three times the EU limit would have been unthinkable in most countries. Because many countries have exceeding deficits, the EU Commission proposed deadlines to reduce gaps. Here are some examples:

- Hungary met its 2009 deficit target of 3.9% of GDP. It has until 2011 to bring its deficit below 3%.
- Latvia ended 2009 with a deficit projected at just below 10% of GDP, as recommended by the EU. The target for 2010 was 8.5%.
- 13 countries were given 2-5 years to reinstate fiscal discipline: Italy, Belgium (until 2012); Germany, France, Spain, Austria, the Netherlands, the Czech Republic, Slovakia, Slovenia, Portugal (until 2013); Ireland (until 2014); UK (until 2014-2015).

The significant indicator for any country is Gross Debt to GDP Ratio, which has deteriorated strongly due to recession, stimulus, capital injection in banks, and reached dangerous levels in 2010 for the balance of European economies, as it follows: Greece 115%; Italy 116%; Belgium 97.2%; UK 78.7%; Portugal 77.4%, France 76.1%; Germany 72.1%; Austria 69.1%; Ireland 64%, Finland 41.3%. Many analysts think that the problem in today's Europe is due to a natural evolution of things and that the evolution of the financial crisis follows this pattern: over indebtedness was shifted from home buyers on to banks, then transferred to governments (e.g. the recent sovereign debt

crisis in Greece is only a natural development of things).

To prevent amplification of budgetary problems and their propagation in the EU, the 27 EU states have to reduce public deficit and have received guidelines from the EU to achieve this goal within 2011-2014.

5. The situation of Greece, "Achilles Heel of the EU"

Greece has accumulated high levels of debt during the decade before the crisis, when capital markets were highly liquid. As the crisis has unfolded, and capital markets have become more illiquid, Greece may no longer be able to roll over its maturing debt obligations. Some analysts have discussed the possibility of a Greek default. Greece has relied heavily on external financing for funding the budget. Between 2001, when it adopted the euro as its currency, and 2008, Greece's reported budget deficits averaged 5% per year, compared to a Euro-zone average of 2%. Its current account deficits averaged 9% per year, compared to a Euro-zone average of 1%.

The causes of financial crisis in Greece can be grouped into two categories, namely:

- *Domestic causes*: high government spending of successive Greek governments; weak revenue collection; structural rigidities in Greece's economy.
- *International causes*: access to capital at low interest rates after adopting the Euro; weak enforcement of EU rules concerning debt and deficit ceilings facilitated Greece's ability to accumulate high levels of external debt.

To prevent the entry of Greece into collapse, Euro-zone countries and the International Monetary Fund, seeking to halt a widening European debt crisis that has threatened the stability of the Euro, agreed to extend Greece an unprecedented €110 billion ($147 billion) rescue in return for Draconian budget cuts. Germany, whose population has been deeply sceptical of a bailout, beared the largest share of the Euro-zone contribution, namely €22.3 billion of the total amount. The Euro-zone loans carry an interest rate of about 5%, compared to about 3% for the IMF contribution. Some €10 billion will be set aside as "bank stabilization" fund for use if the condition of Greek financial institutions worsens.

The Greek government has promised to slash and then freeze public sector wages, raise sin taxes, increase value-added taxes, impose a new levy on businesses, cut pension payments and increase retirement ages for some public-sector workers. The steps are expected to save the state €30 billion through 2013. Thus, the Greek government has adopted the following measures:

- Public sector limit of €1,000 introduced to bi-annual bonus, abolished entirely for those earning over €3,000 a month;
- An 8% cut on public sector allowances and a 3% pay cut for DEKO (public sector utilities) employees;
- Limit of €800 per month to 13th and 14th monthly pension instalments; abolished for pensioners receiving over €2,500 a month;
- Return of a special tax on high pensions;
- Changes concerning laws governing lay-offs and overtime payment;
- Extraordinary taxes imposed on company profits;
- Increases in VAT to 23%, 11% and 5.5%.
- 10% rise in luxury taxes and taxes on alcohol, cigarettes, and fuel;
- Equalization of men and women pension age limits;
- General pension age has not been changed, but a mechanism has been introduced to scale them to life expectancy changes;
- Average retirement age for public sector workers has increased from 61 to 65;
- Public-owned companies to be reduced from 6,000 to 2,000.

Only the nearest future will show whether these harsh methods have generated the appropriate results.

6. Broader implications of Greece crisis: Spillover Effect