

# The crisis and euro area public finances: what are the fiscal costs and the fiscal risks?

**Lunchtime seminar:**  
***“Measuring the impact of the crisis on public debt”***  
**Centre for European Policy Studies**  
**Brussels, 24 November 2009**

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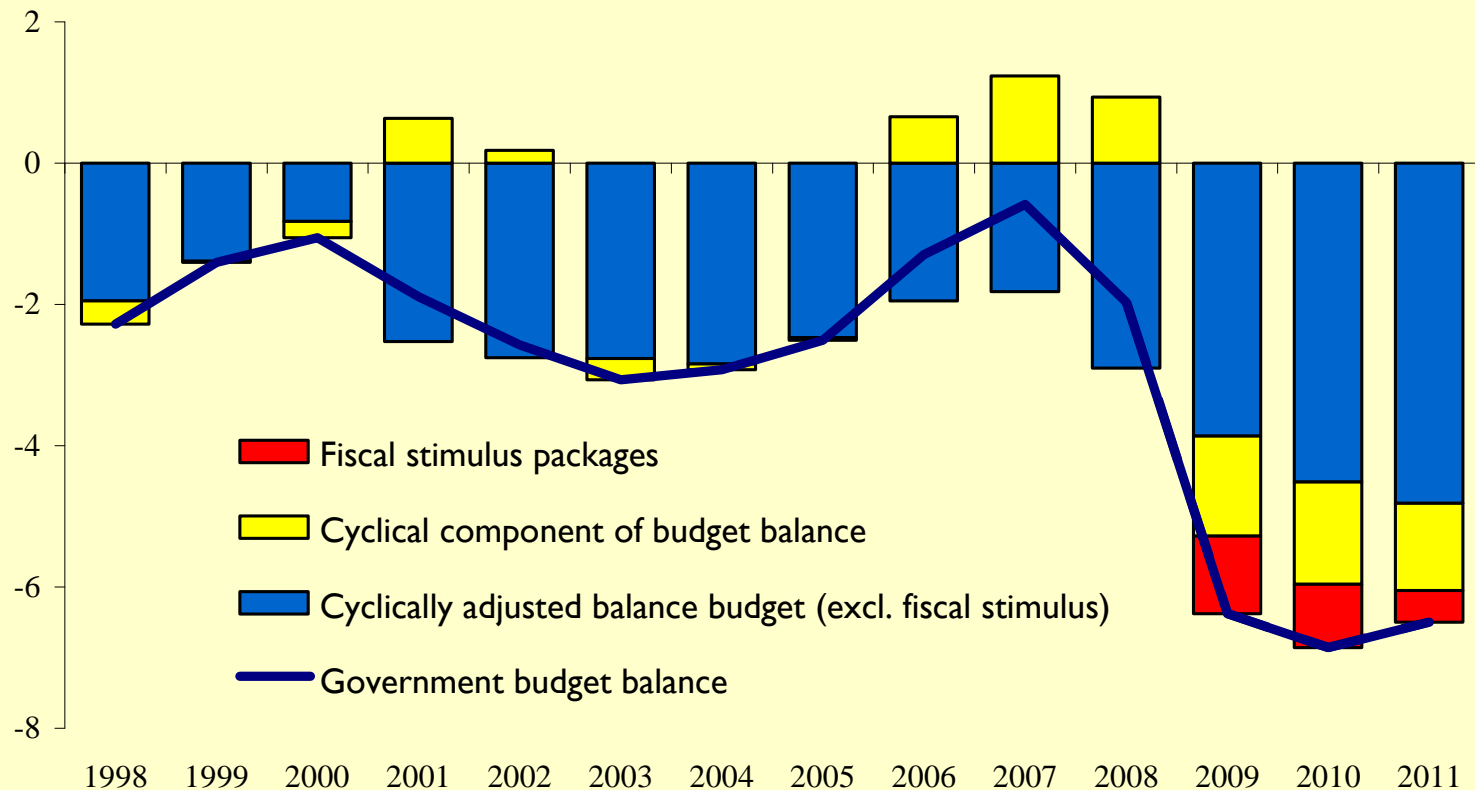
This presentation was prepared with the help of Maria Grazia Attinasi and Marien Ferdinandusse

# Outline

1. Introduction
2. The fiscal costs of the crisis
3. The fiscal risks from the crisis
4. Reversing the rise in government debt-to-GDP

# Factors behind rising euro area deficit ratio

Accommodating the impact of automatic stabilisers (yellow) and organising fiscal stimulus (red) during the crisis has come at a very high cost for public finances. Also “structural” factors behind expansionary fiscal stance (blue).



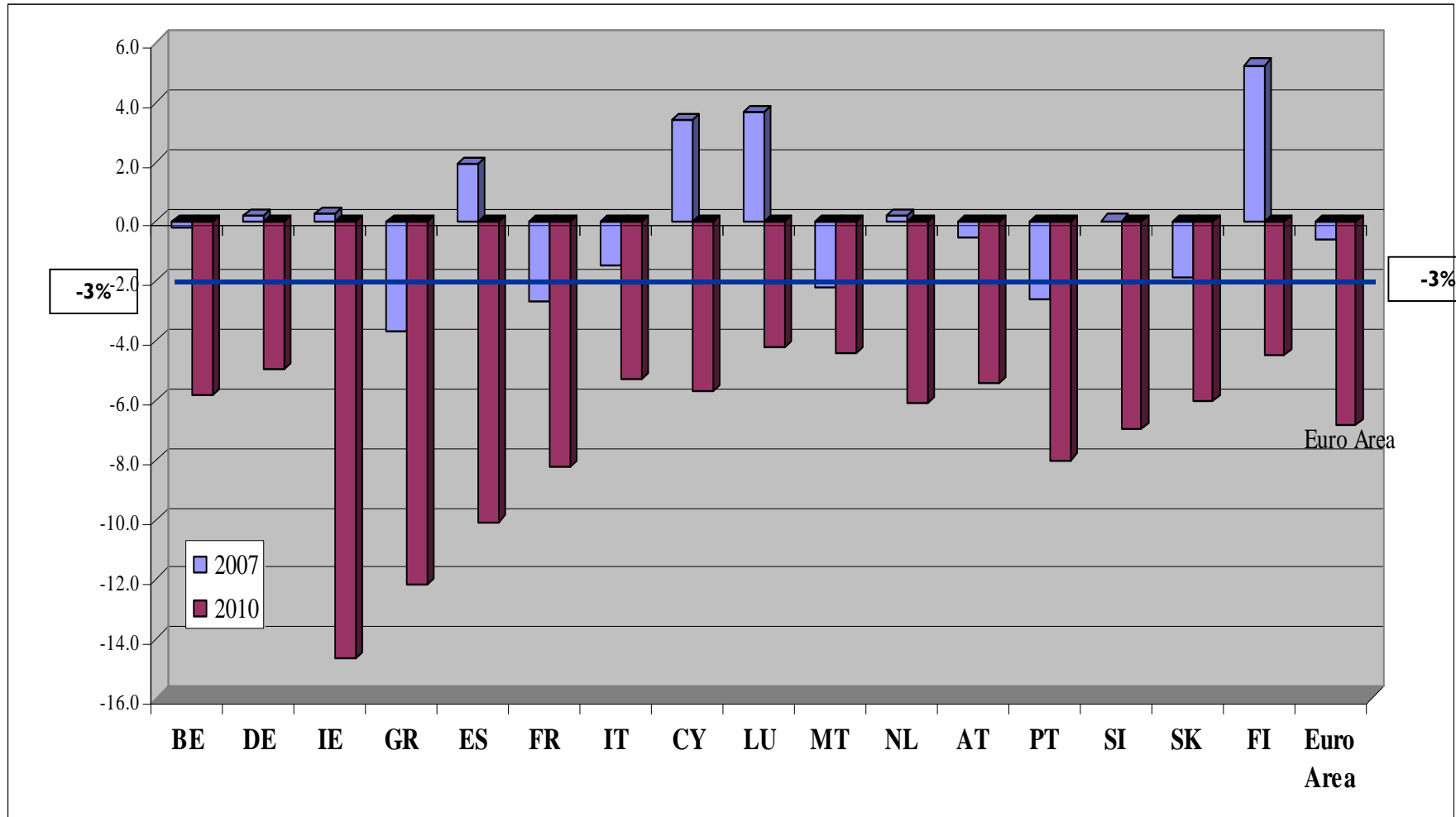
Source: EC Forecast Autumn 2009.

Note: for 2011, it is assumed that half of the 2010 stimulus is still in place

# Euro area public finances under strain

## Sharp change in budget balance of euro area countries / euro area, 2007-2010

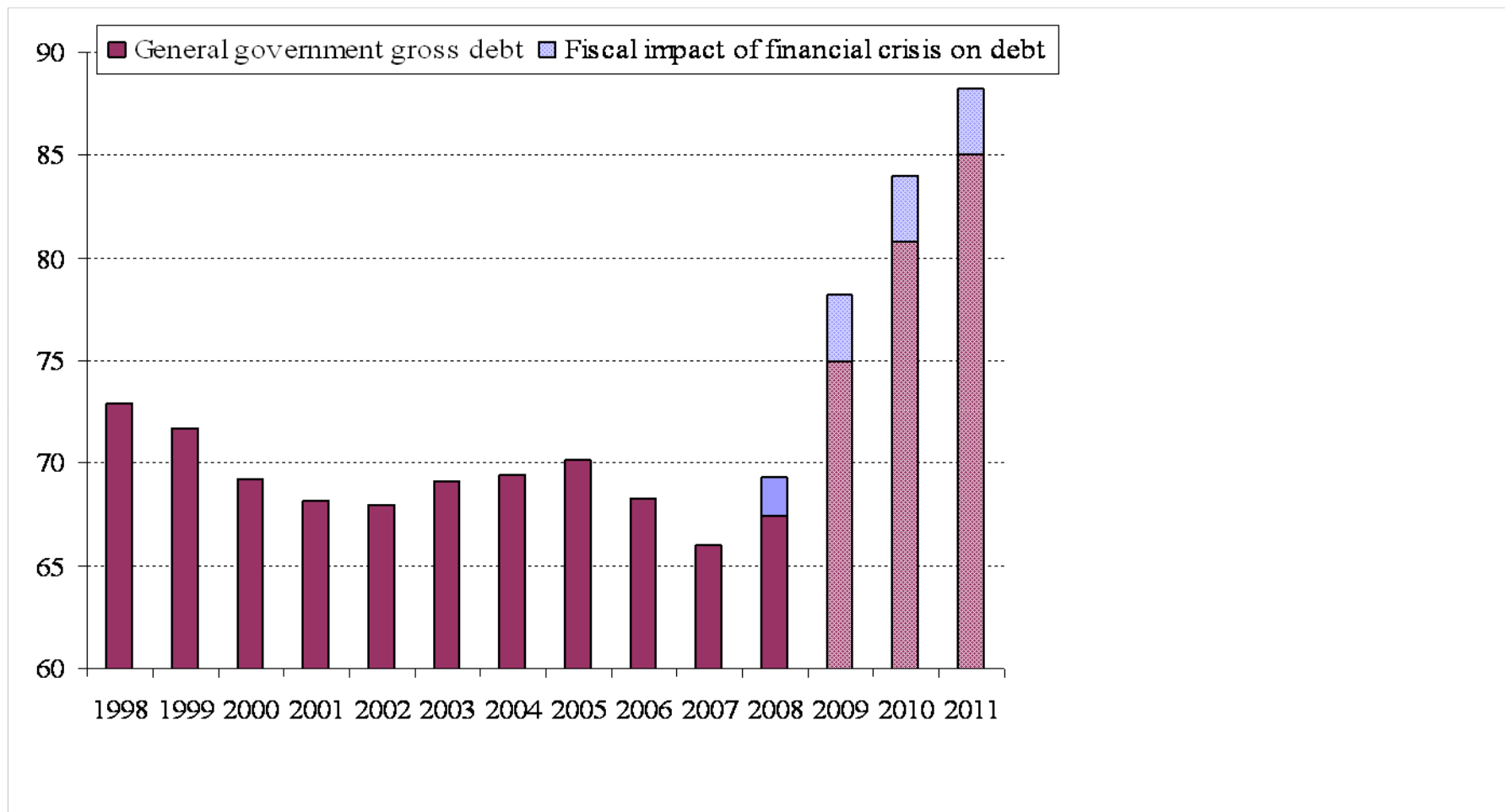
(% GDP; based on EC Autumn '09 forecast)



# Jump in euro area government gross debt ratio

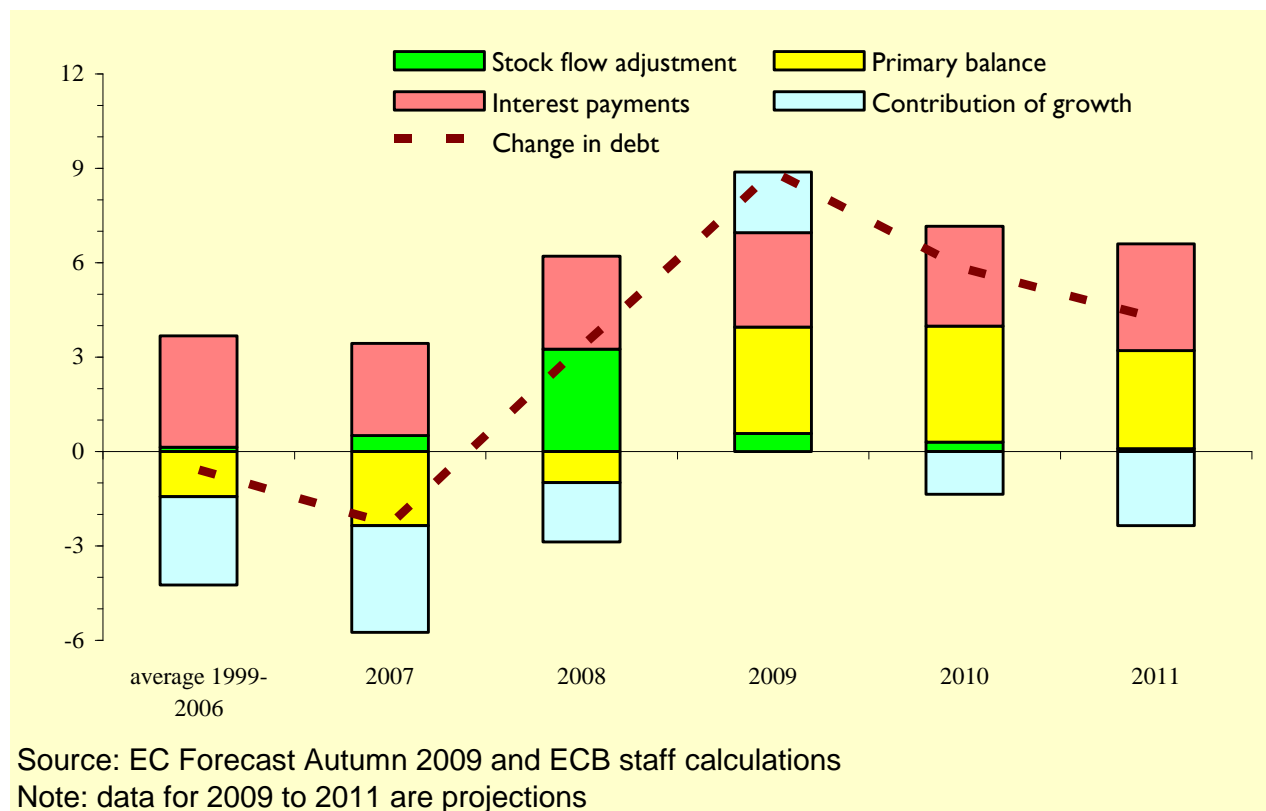
## Considerable fiscal costs of financial and economic crisis

(% of GDP; based on EC Autumn '09 forecast and ESCB estimates)



# Factors behind rising euro area gross debt ratio

- Government debt projected to increase from 66% of GDP in 2007 to 88.2% in 2011
- In all years, significant positive contribution from interest payments (red)
- 2008 increase largely due to bank capital injections (stock-flow adjustment; green)
- 2009-11 increase mainly due to expansionary fiscal stance (yellow), in 2009 also due to negative GDP growth (blue)



# Substantial fiscal risks from the crisis

## 1. Primary balance

- automatic stabilisers may not reverse fully
- fiscal stimulus measures may be prolonged or expanded
- government spending growth trend appears unsustainable
- countries may engage in window-dressing or creative accounting

## 2. Economic growth

- higher primary surplus needed to reverse the rise in debt ratio if output growth would be permanently lower

## 3. Interest payments

- higher interest rates likely when financial conditions normalise

## 4. Stock-flow adjustments

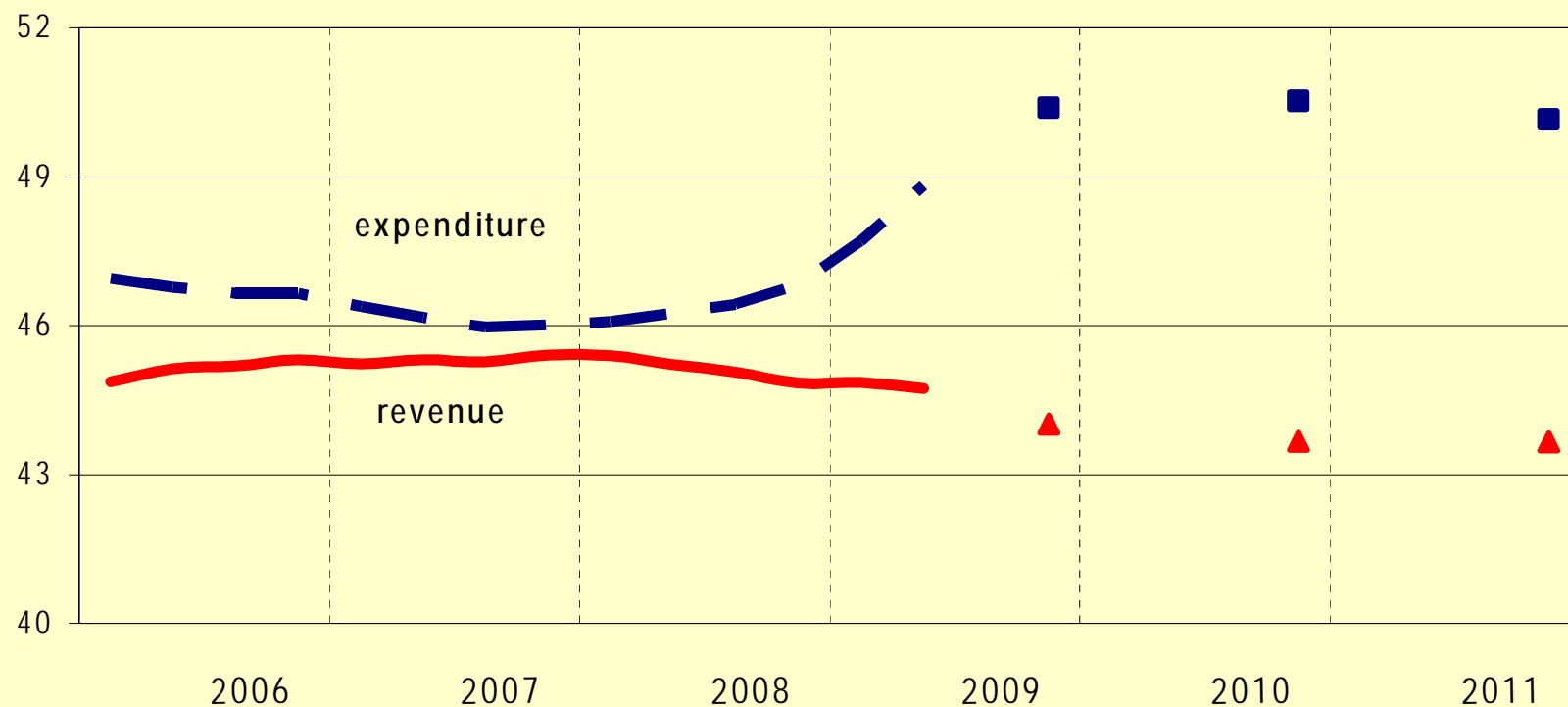
- risk of additional bank recapitalisations and asset purchases

## 5. Contingent liabilities

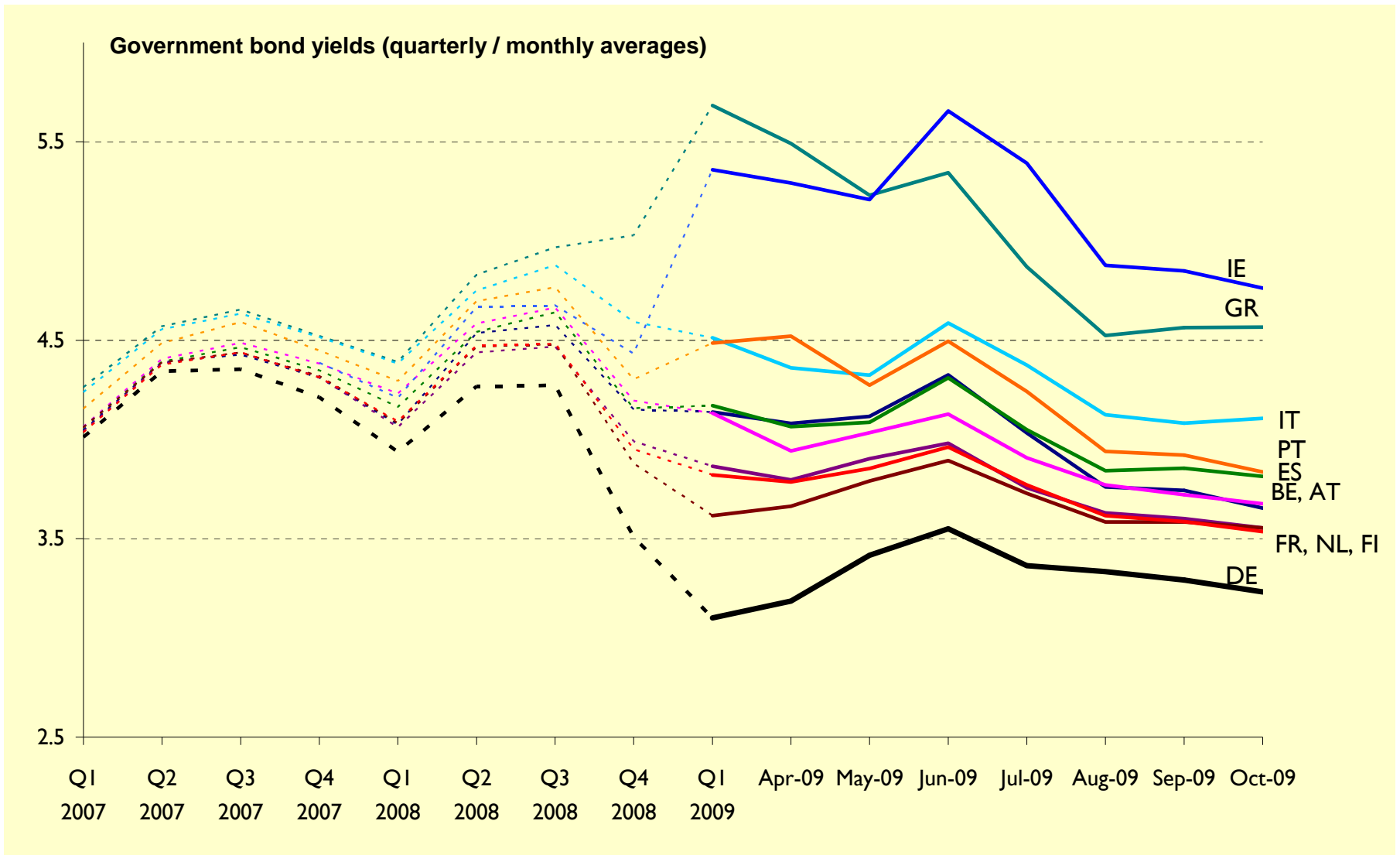
# Euro area government revenue and expenditure

- Jump by 4.5 p.p. in expenditure-to-GDP ratio and in EC Autumn '09 forecast little retreat
- Steady decline in revenue-to-GDP ratio (1.5 p.p.) bottoms out in EC Autumn '09 forecast
- Structural spending ratio unsustainable if one-off loss of potential output and trend growth would be permanently lower

Four-quarter moving sums as a percentage of GDP



# Euro area long-term government bond yields



# The fiscal costs of selected systemic banking crises

- Recovery rates in past banking crises in advanced countries seldom reached 100%
- Many euro area governments have included market-based incentives for banks to repay financial support when market conditions improve
- Uncertainty about need for further bailout operations, the timing of assets disposal and recovery rate are additional sources of fiscal risk

Country	Starting date of crisis (t)	Gross fiscal costs after five years (% of GDP)	Recovery of fiscal costs during period t to t+5 (% of GDP)	Recovery of fiscal costs during period t to t+5 (% of gross fiscal costs)
Finland	Sep. 1991	12.8	1.7	13.3
Japan	Nov. 1997	14	0.1	0.7
Norway	Oct. 1991	2.7	2.1	77.8
Sweden	Sep. 1991	3.6	3.4	94.4

Source: Laeven, L. and Valencia, F. (2008), "Systemic Banking Crises: A New Database", IMF Working Paper 08/224.

Note: The starting date of banking crises is based on the definition of systemic banking crises used by the authors.

# Fiscal risks from contingent liabilities

Euro area governments have made extensive use of implicit and explicit guarantees to stabilise financial sector and non-financial firms, which are 'off balance' until called:

1. Higher levels of retail deposit insurance (not in table)
2. Commitments for recapitalisation and the provision of guarantees on bank loans
3. Guarantees to special purpose vehicles, which take over toxic assets from banks
4. Guarantees to non-financial firms (not in table)

<b>Government contingent liabilities (cumulative amount for 2008 and 2009)</b>		
<b>as % GDP</b>	<b>Provided</b>	<b>Ceiling</b>
Belgium	21.0	34.6
Germany	6.3	18.7
Ireland	214.8	242.0
Greece	0.6	6.1
Spain	3.1	18.9
France	5.1	16.8
Italy	-	-
Cyprus	-	-
Luxembourg	12.8	-
Malta	-	-
Netherlands	5.0	35.0
Austria	6.6	27.8
Portugal	3.8	12.4
Slovenia	-	33.2
Slovakia	-	-
Finland	0.1	28.1
<b>Euro area</b>	<b>8.3</b>	<b>19.9</b>

Source: Eurosystem.  
Note: Provisional data

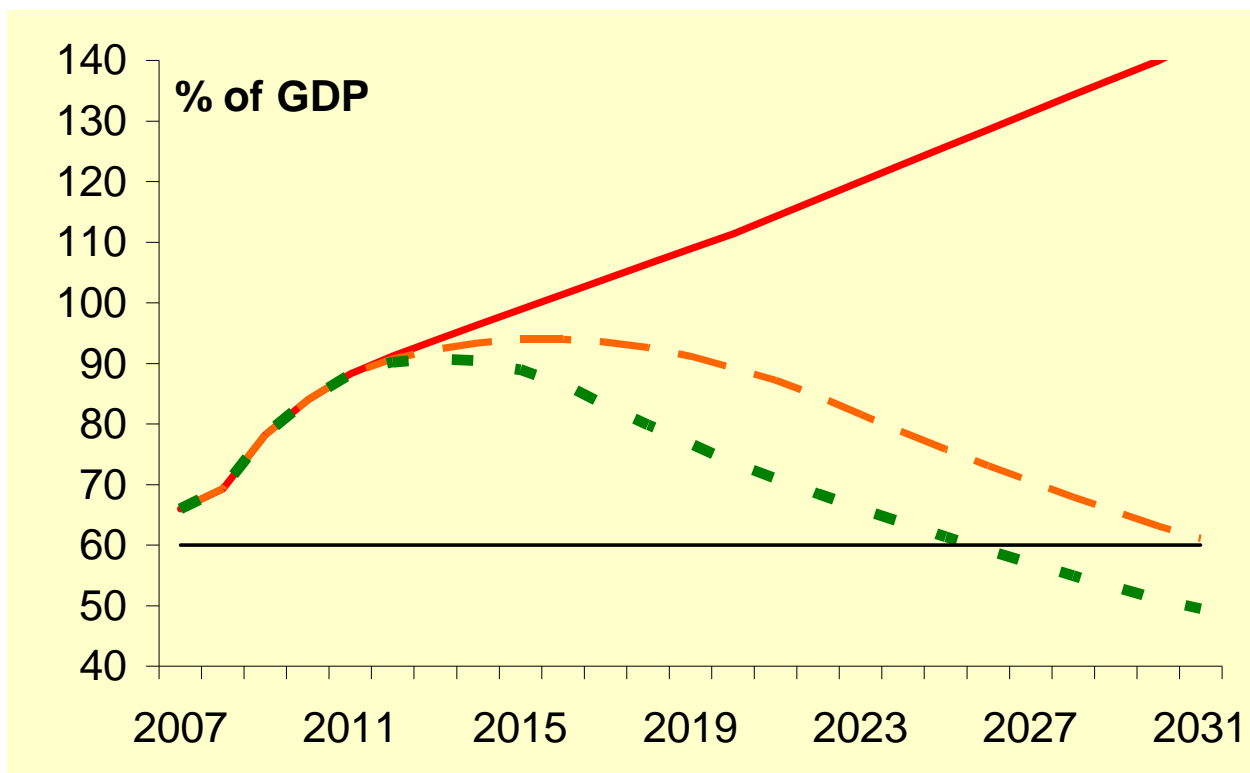
# Scenarios for euro area gross debt-to-GDP ratio

Path of euro area government debt ratio under different consolidation scenario's as of 2011:

- Green: annual consolidation of 1.0% of GDP until balanced budget is achieved
- Orange: annual consolidation of 0.5% of GDP until balanced budget is achieved
- Red: no consolidation; fiscal sustainability in danger

Consolidation to exceed SGP benchmark of 0.5% per year to ensure timely debt reduction !

*All scenarios exclude sale of bank assets acquired during the crisis and ignore extra ageing costs*



**Thank you very much for your attention!**