

Focus on Economics

No. 9, 8th November 2012

Ways out of the euro crisis: Growth needs financing

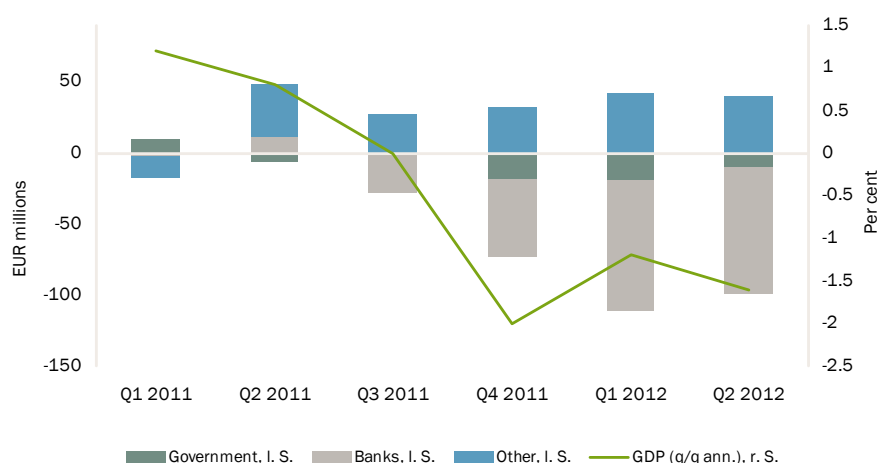
Author: Dr Jörg Zeuner, Tel. +49 (0) 69 7431-2931, research@KfW.de

Recessions in the reforming countries are hampering fiscal consolidation. Capital outflows from these countries are a major cause for the contraction of the economies. Debt capital urgently needed for enterprises and gross fixed capital formation is lacking. Reversing capital flows and improving the supply of credit to the private sector would promote growth.

The Euro crisis has many causes. Besides consolidation, however, there is a second major trigger for the recessions: many investors and banks have turned away from the business sectors of today's reforming countries (Figure 1a). Lack of funding is forcing enterprises to suspend capital formation projects and lay off workers. Both employed and unemployed people are reducing their consumption and the economies are shrinking (Figure 1b).

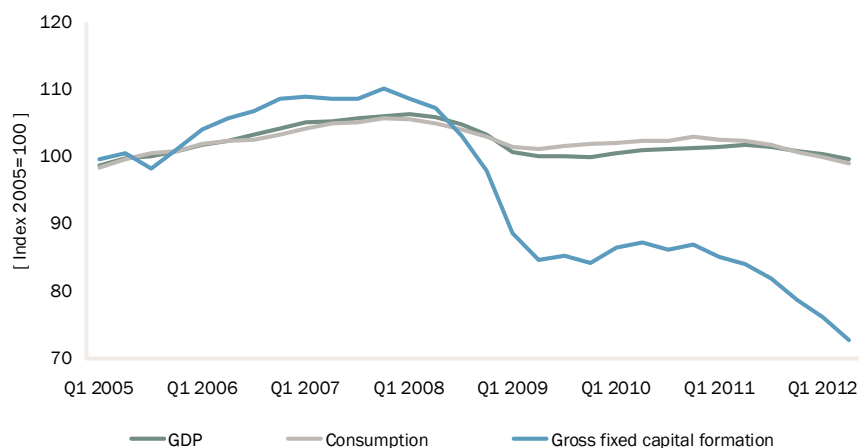
There are two reasons why providers of capital have lost confidence: (i) The reforming states are weak. In Ireland and Spain, the bursting of the real estate bubbles has created instability. Before the crisis, both economies met the Maastricht criteria. Italy's growth of around 1 % annually between 2002 and 2006 was too weak and the debt ratio of some 120 % of GDP in 2009 too high for the country to finance the sudden rise in interest rates from tax revenues over the long term. The state's debt bearing capacity was thrown into doubt. Greece and Portugal were lacking budget discipline and competitiveness. In almost all countries, unit labour costs were in retrospect too high. (ii) There was no European mechanism that would have ensured the stability of the banking system in

Figure 1a: Spain – Net capital imports in EUR millions and GDP growth in per cent



Source: Banco de España, Eurostat, own calculation

Figure 1b: GDP / Consumption / Gross fixed capital formation by Reforming Countries (w/o GR)



Source: Eurostat, Datastream, own calculation

the peripheral countries. The Eurozone was lacking a fast and smoothly functioning crisis management system (Figure 2).

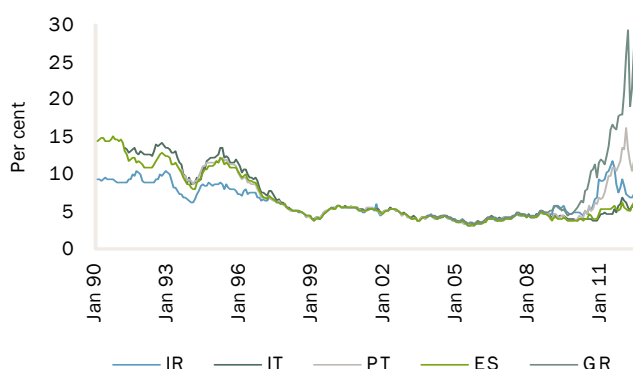
Unlike the governments, the private sector in the reforming countries still lacks funding.

The governments in the programme countries Greece, Ireland and Portugal are receiving financial assistance from the European Union and the International Monetary Fund. Italy and Spain still have access to the capital market and Ireland and Portugal will return to the capital market in the near future. The European Central Bank's OMT (Outright Monetary Transactions) bond-buying programme can be expected to draw mainly institutional investors back into the government bond markets of the reforming countries. Many of them are not yet rolling over their expiring government bond positions in these countries. However, the investment committees in charge could soon revise this decision because of the OMT. Interest rates are attractive and risk is limited because of the expected ECB buybacks in the event of a crisis. In contrast, the banks in the reforming countries are currently only able to borrow from the ECB. And even where money is available, many banks are forced to shorten their balance sheets because of risk considerations instead of extending them. Accordingly, lending interest rates and lending standards are prohibitive for enterprises and new loans needed for growth are hard to come by. The downturn is further reducing demand for loans (Figures 3a-c).

The recessions have also overshadowed the consolidation progress, particularly in Greece. Measured by estimated GDP for 2012 under the first rescue programme, in particular Greece has now reached the debt level that was the target of the reforms in nominal terms at the time. Budget consolidation in Ireland and Portugal is even more successful (Figure 4). However, in these countries the cost in the form of plummeting growth rates is also higher than expected.

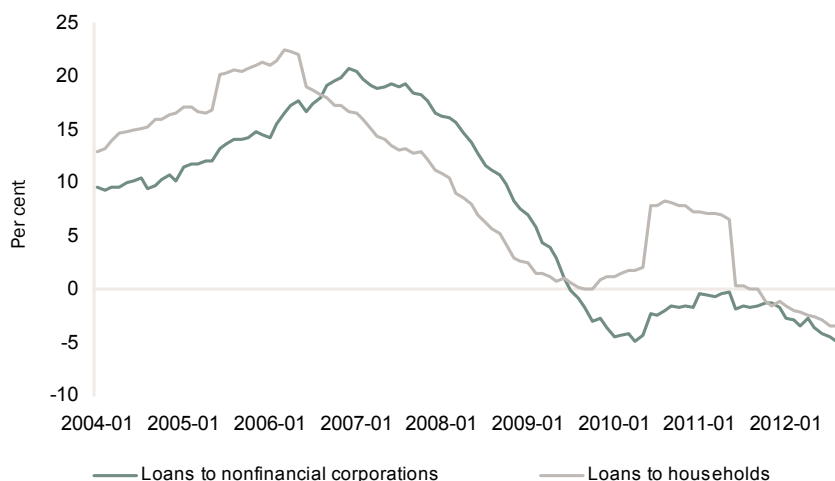
On a positive note, current account deficits are also on the decline (Figure 5). In this context, membership in the monetary union is less harmful than expected. In Ireland, Spain and Italy, exports are expected to grow this year. At the same time, membership in the Eurozone provides the reforming countries with stability. First and

Figure 2: Interest rates of 10-year government bonds in per cent



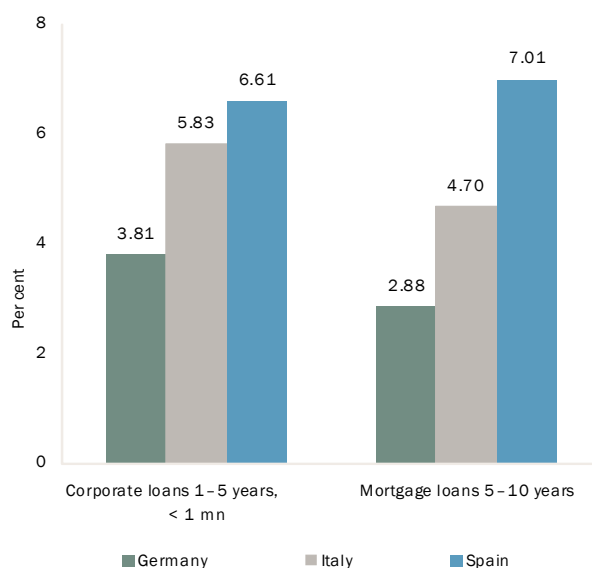
Source: Datastream

Figure 3a: Lending by GIIPS banks in per cent



Source: Datastream

Figure 3b: Interest rates on corporate loans / mortgage loans in per cent



Source: ECB, Feri

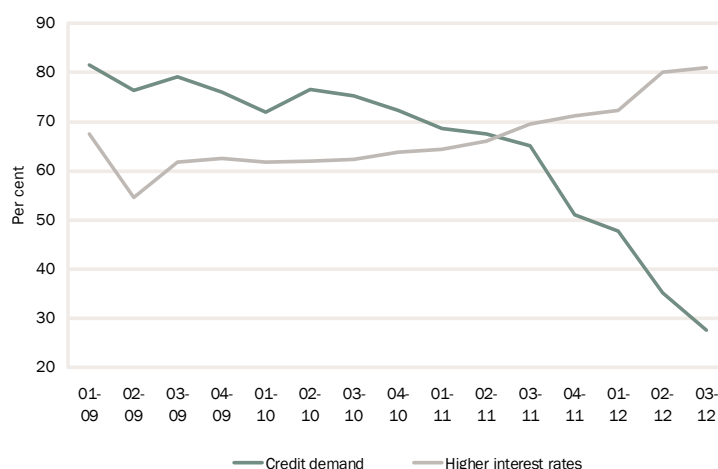
foremost, it is likely to have so far prevented panic among domestic savers.

An important prerequisite for sustainable growth is the provision of financing for enterprises, exports and capital formation. Capital inflows help to overcome recessions faster. The example of Korea shows this correlation impressively (Figure 6). For the reforming countries, there are several ways of following this example: the bold policy of the ECB in September created the first precondition for net capital inflows in the future. The gradual transformation of the Eurozone should further strengthen confidence. Public partnerships with private foreign investors to finance infrastructure (so-called public private partnerships) could lead to additional capital inflows. In this way, public capital formation could also increase again in the reforming countries despite the budget consolidation; the funds would be used efficiently.

In September, the policy of the ECB and the European Union had not yet left any positive traces in the capital markets. The volume of loans outstanding to private European non-banks dropped significantly yet again. Reversing the trend here would mean successful growth promotion. One possible approach: new channels for export, corporate and capital formation loans from abroad at European interest rates. The funds would have to be provided primarily from outside the reforming states. They could be backed by appropriate collateral instruments, for example from EU funds, and thereby bolster investor interest. Only in this way could refinancing be provided at low interest rates which could then be passed on to enterprises.

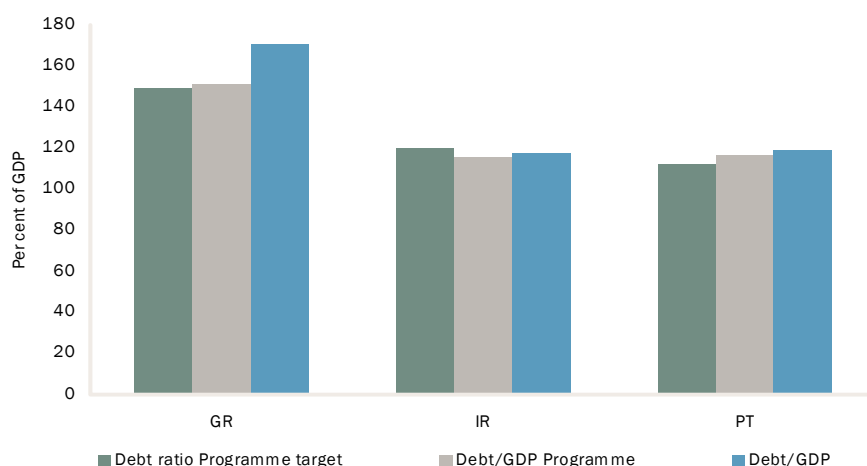
The experience from SME and start-up financing in Germany would be helpful in selecting the enterprises. In order to avoid entrenching inefficient structures, financing should be provided primarily to competitive enterprises, as they provide the greatest economic benefit by generating growth and innovation and securing employment. These are often enterprises with the following characteristics: (i) an above-average degree of internationalisation (export ratio and/or foreign turnover), (ii) above-average degree of innovation (R & D activities of the last three years, new products or processes), (iii) high productivity, (iv) sound financing structure (equity base and debt ratio) and (v) a sustainable stra-

Figure 3c: Share of SMEs in Spain applying for credit and affected by higher external capital costs (interest)



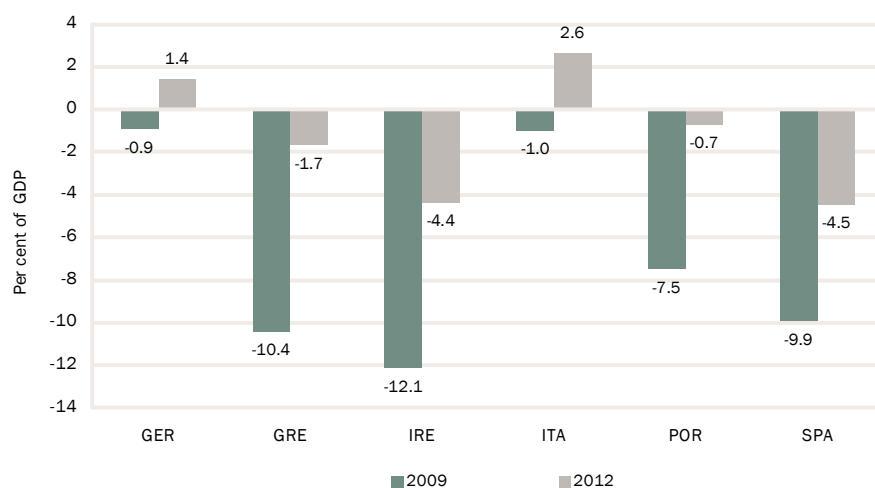
Source: Cámaras (Spanish Chambers of Commerce), Irish Small and Medium Enterprises Association (ISME)

Figure 4: Consolidation results in 2012 in the per cent of GDP



Source: IMF, own calculations

Figure 5: Current account balances for 2012 in per cent of GDP



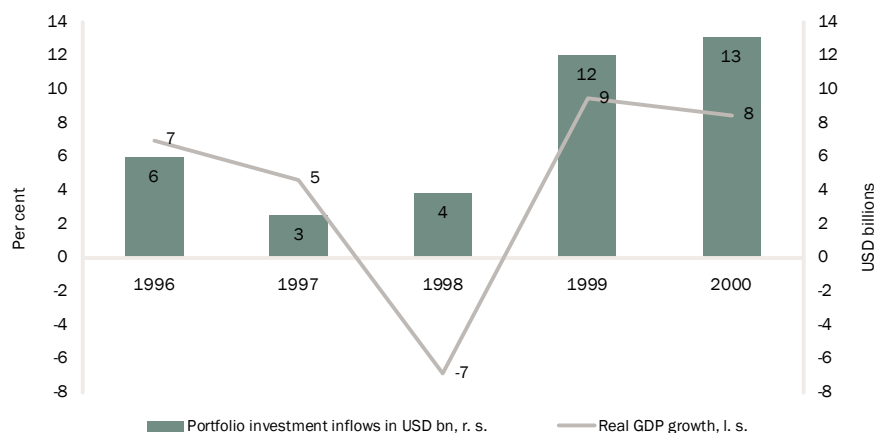
Source: World Economic Outlook

tegic and organisational setup (e. g. sales structure, succession planning, strategic alliances). Financial support for enterprises that are weak in development but labour-intensive may also be useful to secure employment but should be based primarily on labour market policy instruments.

Conclusion

The economic policy efforts undertaken by the reforming countries have had to absorb the freezing of the credit and capital markets in the past years and focus on a radical adjustment of the real economy to difficult financing conditions. The slump in private net capital inflows from abroad has hampered efforts by the state and industry in the reforming countries since the beginning of the crisis. The consequence: a clear reduction in the budget deficit and the current account deficit, fewer new loans and a significant decrease in employment. **The painful adjustment process is now in a very advanced stage.** If the adjustment process continues at the current pace and without

Figure 6: Korea – GDP growth in per cent and portfolio inflows in USD billions



Source: World Bank, World Development Indicators, www-database October 2012

negative external impacts, the macroeconomic imbalances – measured by the current account balance, budget deficit and unit labour costs – should soon be eliminated.

An important prerequisite for positive growth rates is the provision of financing.

The experience of the Asian crisis shows that a reversal of capital flows at reasonable terms helps to end recessions. Helping to make this happen is economic policy that promises success. Structural reforms must be put in place to ensure the sustainability of the efforts undertaken. ■