Life And Debt Situation

The European welfare state's finances can no longer keep up with its promises

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Europe was on the brink even as it went on its great summer vacation this July. If the European Union had failed to reach an agreement on the second Greek bailout, it could have gradually come apart, starting with the exit of Greece. However, you would see no hint of this gathering political storm among vacationers. Perhaps they knew the politicians would eventually work things out, the EU would survive, and life would go on as before. They were right, but only up to a point.

The Greek parliament voted for a drastic austerity programme on June 29, followed by a vote on June 30 to fast-track it. The EU and IMF responded by releasing the fifth tranche of their €110 billion bailout programme. However, this first bailout was only a holding operation, not designed to curb the growth of Greek government debt, projected to rise to 172% of GDP by 2012.

In addition to restructuring government finances, Greek debt sustainability would also require a debt restructuring programme, and a second bailout package. With its austerity programme, the Greek government had delivered its part of the bargain. However, the other EU governments and private banks were dithering on their part of the deal. Some governments were adamant they wouldn't support any further bailout unless private banks agreed to restructure their loans. The banks were of course reluctant to do that: an estimated writing down of their loans by about 50%.

Set against the background of a potentially cataclysmic, though unlikely, default on US government debt if the US Congress fails to authorise enhanced borrowing limits by August, the dithering in Europe sent shivers through the financial markets. There was a sharp decline in the price of bonds issued not only by Greece, Ireland and Portugal, all peripheral EU economies, but even those issued by Italy and Spain, the third and fourth largest EU economies.

A scene in Athens: Austerity is such a lonely word

> EU leaders have rescued Greece. But they have not addressed the fiscal imbalance faced by many European governments that gave rise to the debt problem in the first place

This looming threat of a meltdown in the core EU economies helped to focus minds. The private banks agreed to swap existing Greek bonds maturing up to 2019 for new 30-year bonds at 3.5% interest, with a discounting or debt write-off of about 21%. Valued at €50 billion, this was a much smaller haircut than the earlier feared 50%. The European Central Bank withdrew its objection to this 'partial debt default', France withdrew its demand for a bank tax to finance the bailout, and the Germans, Dutch and Fins withdrew their objection to financing a further bailout.

On July 21, the EU governments and IMF announced their second Greek bailout package: a 30-year loan of €109 billion at 3.5% interest, to be disbursed over three years. This is in addition to the €50 billion of relief provided by private banks. The new package will help Greece buy back a part of its own debt, which is selling at a discount, and to service the balance of restructured debt at reduced rates of interest.

This fresh EU assistance is to be provided through the European Financial Stability Fund, now amounting to €440 billion. The terms and purposes for using this fund have been considerably liberalised. It can be accessed preemptively by EU countries under stress (read Spain and Italy) before they reach the point of default; it can be used to open lines of credit for EU countries under threat of speculative attack, to recapitalise banks that take haircuts in bailout packages, etc. The reduced interest rates will also benefit Ireland and Portugal, now servicing bailout debts incurred from their own rescue packages. The EU-IMF-private banks financed package is therefore a bold attempt to not only turn around Greece, Ireland and Portugal, but to also prevent a potential debt crises in core EU countries at risk such as Spain and Italy.

Thus, EU leaders have successfully rescued Greece and the EU itself, but only up to a point. They have not yet addressed the underlying fiscal imbalance faced by many European governments that gave rise to the excessive debt problem in the first place.

Public expenditure growth – increasingly led by the growth of entitlement payments of the European welfare state, pensions, healthcare etc – continues to outpace growth of revenues. As the dependency ratio, the ratio of earners to pensioners etc, deteriorates with the ageing of the European population, this structural imbalance is only getting worse. Technical solutions to fix the problem are available. For instance, raising the retirement age by just two years could substantially reduce the growth of public debt in many countries. However, such measures are politically unpalatable.

When France tried to increase the retirement age last year, students rioted on the streets. There were anti-austerity riots in Greece earlier this year, and similar protests by students and trade unions against an austerity package proposed in the UK last month. The finances of the European welfare state can no longer keep up with its promises, but finding a balance between the two has been elusive. Politicians can propose policies and negotiate solutions, but at the end of the day the future of the European welfare state lies in the hands of the European people.

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