Czech University of Life Sciences Prague

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Diploma Thesis

Financial Assistance to EU Member States

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Thesis title

Financial Assistance to EU Member States

Objectives of thesis

The topic of this thesis is the current issue of financial assistance to EU member states as a reaction to persistent economic problems of certain EU member states after the financial crisis.

The aim of the thesis is to analyse the functioning of tools of financial assistance to member states of the EU.

Methodology

First part of the thesis is a review of literature on the topic of government budget, describes government behaviour in case of budget deficit and government debt. It also reviews available literature on tools of financial assistance.

The second part of the thesis then analyses the financial assistance effect on the example of chosen states; compares their macroeconomic development to deduct the possibilities for states in need of financial aid. To do so, it uses the comparison and analysis methodology. Macroeconomic data of chosen countries are compared and further analysed.

The proposed extent of the thesis

60-80 pages

Keywords

Government debt, financial assistance, European Union, ESM, EFSF, EFSM

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LIŠKA, V. *Makroekonomie*. Praha: Professional Publishing, 2004. ISBN 80-86419-54-1.
NORDHAUS, W D. – SAMUELSON, P A. *Economics*. New York: McGraw-Hill, 1992. ISBN 0-07-054879-.
RYVKIN, Boris. Saving the Euro: Tensions with European Treaty Law in the European Union's Efforts to Protect the Common Currency. Cornell International Law Journal. 2012.

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Declaration

I declare that I have worked on my diploma thesis titled “Financial Assistance to EU Member States” by myself and I have used only the sources mentioned at the end of the thesis.

In Prague on ________________

Lucie Říhová

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I would like to thank my supervisor, doc. Ing. Karel Tomšík, Ph.D., for his advice and support during my work on this thesis.

Finanční pomoc členským státům EU

Financial Assistance to EU Member States

Souhrn

Tato práce se zabývá aktuální problematikou finanční pomoci členským státům Evropské unie, aplikované a rozvinuté jako reakce na dluhovou krizi v eurozóně.

Práce čtenáře seznamuje s problematikou vládního deficit a veřejného dluhu, který byl hlavní příčinou žádostí o finanční asistenci v EU v posledních letech. Následně práce popisuje hlavní programy finanční pomoc, které mohou využít členské státy Evropské unie.

Praktická část se zabývá aplikovanými programy a jejich dopady na vývoj dluhu států, které přijaly pomoc z programů finanční pomoci členským státům EU. Analyzuje vývoj makroekonimických ukazatelů těchto států v průběhu finanční asistence a porovnává jej s cíli pomoci.

Klíčová slova

Finanční pomoc, Evropská unie, ESM, EFSF, EFSM, vládní dluh

Summary

The topic of this thesis is the current issue of financial assistance to EU member states as a reaction to persistent debt problems of certain EU member states after the financial crisis.

Firstly, it introduces reader into the concept of governmental deficit and sovereign debt, which was the main cause for requesting a financial aid in last years. Next, it describes the development of tools of financial assistance to EU member states and its current state.

The practical part of the thesis analyses the functioning of the assistance tools on an example of two EU member states, which have recently received help from the financial assistance programmes. It analyses the development of certain macroeconomic indicators tied to the sovereign debt and compares them with the assistance aims.

Keywords

Financial assistance, European Union, ESM, EFSF, EFSM, government debt

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1. Introduction

In recent past, countries around Europe have struggled with poor economic results. A period of low economic output has revealed issues in public finance system in certain countries. As a result of the overall economic situation, certain European countries came close to a threat of defaulting on their debts and had to make a call for financial assistance to intergovernmental institutions to help them bridge a period of low government revenues. This thesis focuses on the financial assistance topic, the reasons for calls made by the countries in financial difficulties, and on the course of the financial assistance itself.

As a result of the subprime mortgage crisis in USA in 2008 and following global financial instability, European countries fell into economic crisis in 2009 and following years. The course of crisis has been similar in most European countries – sharp decline in growth of the economy, and slow recovery.

However, some countries have been affected by the crisis worse than others (most notably Portugal, Ireland, Greece and Spain, but also others). In these countries, the prolonged period of low economic output led to uncovering of issues in debt structure, which, combined with unfavourable economic situation yielding low government revenues, resulted in high amounts of accumulated public debt, and in difficulties in raising funds to finance budget deficits.

The European Union (EU) member states, which find themselves in such a difficult situation, have the option to call for a financial assistance. As a part of stabilization process, these countries may receive various financial supports from both EU and non-EU sources.

This thesis aims to analyse this system of financial assistance in the EU to the member states in financial difficulties, and to analyse examples of its utilization.

As stated above, it was mainly unsustainable amounts of debt accumulated, which led various countries to call for financial assistance. Therefore, the first part of this thesis reviews the topic of fiscal deficit and sovereign debt.

The system of this assistance is then also reviewed, showing possibilities for the EU member states (MS) to call for the assistance.

Second part of the thesis is an analysis of the financial assistance granted to two chosen countries, and development of public debt, fiscal deficit and other connected indicators before and during the financial assistance.

2. Aim of the thesis

This thesis aims to analyse functioning of the system of financial assistance to the member states of the European Union. The main focus is on the debt accumulation and indicators connected to it (fiscal deficit, interest rates on government bonds). To evaluate the development of given indicators under the financial assistance, two examples of countries, which have undergone the assistance programme, are used. The analysis focuses on conditions prior to the financial assistance as well as on the development during the financial assistance, in order to find out whether the condition of given indicators have improved. The objectives of the financial assistance, stated by the lenders, are then compared with the real situation at the end of financial assistance (or last recorded data) to find out whether they were reached.

3. Methodology

First part of the thesis is a review of literature on the topic of government budget, its deficit and fiscal policy. It also reviews available sources of information on tools of financial assistance available to the member states of the European Union.

Second part of the thesis uses the comparison and analysis methodology. Macroeconomic data of chosen countries connected to fiscal deficit, its funding and sovereign debt are analysed and compared to each other and to average development in the area to find differences in the developments of given countries under similar financial difficulties. Data are obtained from databases of international organizations available and accessible online. A synthesis of obtained information is executed in the conclusion of this work to find out whether the goals of financial assistance were met and whether prior conditions may generally affect the development of selected indicators.

4. Literature review

The literature review serves as a basis for understanding of the system of financial assistance to countries in financial difficulties.

First part of the literature review describes the concept of public finance. Its main aim is to introduce the reader into the topic of government budget, its functions and its deficit. The long-term unsustainable amounts of deficit of government budget and consequential sovereign debt has been one of the main reasons why in recent past, certain countries in Europe have asked for a financial assistance from international organizations. It also reviews basis of fiscal policy.

Second part is focused on the current possibilities of financial assistance for the member states of the European Union. As in the last years, the requests for financial assistance in Europe have multiplied, the system of available tools had to be reviewed and extended – between years 2010 and 2012, the system has changed significantly and new tools have been introduced as a response to current unfavourable situation of certain countries experiencing issues with their debt situation. This work therefore reviews the tools of financial assistance available to member states of the European Union (and also assistance programmes of the EU to partner non-member countries).

4.1 Government and the economy

The following part of literature review is focused on the topic of fiscal deficit, government debt and fiscal policy. It serves as an introduction to the topic of financial assistance to countries.

Public finance

A modern state as a public institution has to oversee a whole range of functions. To do so, it has to have its own funds. These funds are referred to as public finance. (1)

The activity of managing public finance is referred to as public budgeting; depending on the organisation of given state, it includes not only a central government budget, but also budgets of smaller administrative units (provincial, regional, municipal,…), as well as budgets of state-owned companies. (1) Governments use public budgeting to control, plan and record expenditures and revenues. (2)

Function of public finance

The functions of public finance are as follows:

a) Allocation function – the results of allocation of resources by market forces may sometimes be perceived as not as effective as they should be. Therefore, the government, representing its people, steps into the open market and allocates resources to chosen sectors, which it perceives as essential. (1) The amount of governmental intervention into open market is given by the nature of given state.
b) Redistribution function – this function is based on the presumption, that results of open market economy can sometimes be perceived as “unfair”, i.e. socially unacceptable, and not benefiting the society. This function is ensured by reallocation of pensions towards “weaker” population, as well as utilizing public funds. (1) A condition that generally holds is that more socially oriented state records higher reallocation of pensions.
c) Stabilization function – this function is based on belief that the open market economy does not automatically ensure a stable growth of economy, sustainable inflation, low unemployment and a healthy balance of payments. The stabilization function includes supporting economic activity and supporting or restraining aggregate demand, to mitigate the negative effects of cyclical fluctuation of the economy. (1)

To ensure the stabilization function of the economy, government uses fiscal policy (i.e. policy that uses government expenditure/income to influence the development of economy in given state).

Government budget

The government budget generally contains a list of programmes on the expenditure side, such as health care, education, welfare etc. (2) The expenditures are consumption, as well as investment, and transfers (such as the welfare programme). (1)

Other part of a budget is the income side. Most commonly, the income are tax revenues - individual income tax, social insurance tax, corporate tax etc. (2) The revenues can also come from duty fees or rent from renting public properties. (1) However, government can also fund its budget in different ways, such as selling government property, or borrowing.

Fiscal Policy

A well-executed fiscal policy can be a tool to tackle periods of recession – if it is to be used with effectivity and caution. Following chapter explains the principles behind it.

The Keynesian multiplier

As stated above, fiscal policy is a government policy, which utilizes the government revenue and expenditure to influence a development in economy of the state. (1) The possibility of utilizing of government expenditure as a boost to economic growth, and therefore as a tool of fiscal policy, was thoroughly examined by J.M. Keynes in his work. Keynesian view on economy introduced the idea of multipliers, as explained below.

Basic multiplier model

The basic multiplier model says that any amount, of which the disposable income of consumers rises, generates more than the given amount in the rise of GDP. This means that a rise of 1 USD in disposable income of a consumer will generate more than 1USD rise in the GDP, due to “secondary consumption respending”. (2)

Fiscal policy in the multiplier model

Fiscal policy as such consist of two main factors: the government expenditure on goods and services (commonly referred to as “G”), and taxes and transfers (“T”). As long as there are unemployed resources in the economy, changes in G and T can be used as means of fiscal policy to result in desired change the level of GDP. (2) This fiscal policy then affects

the aggregate demand, resp. aggregate supply, and according to effects on these variables, the policy is either expansionary, or contractionary:

A) Expansionary policy – The aim of the expansionary policy is boosting aggregate demand (resp. supply). (1) Theory says that rise in government expenditure G, ceteris paribus, results in a multiplied rise in GDP – much alike the rise in disposable income in basic multiplier model. Lowering taxes has a similar effect on the economy, as it will also yield a higher disposable income for the consumers, which will in turn result in higher GDP. However, the multiplier in this case is not as high as in the case of government expenditure, as a part of the extra income is saved, and only rest goes into the respending cycle. (2)
B) Contractionary policy – The aim of the contractionary policy is to restrict the aggregate demand (resp. supply) and effectively restrict the economic activity of the country. (1) The idea is same as with the contractionary policy, just reversed: a rise in taxes, ceteris paribus, will generate a lower GDP; lower government spending will generate the same result. ". (2)

Fiscal deficit

A fiscal deficit, if used with discretion, may become a tool of fiscal policy, however, it may also be a basis of large issues with a sovereign debt.

Balanced budget, surplus and deficit

A neutral state of budget is a balanced budget – one in which the revenues equal the expenditures. In macroeconomics, this relationship is expressed as the net taxes T (this means taxes minus transfer payments) minus governmental spending G equals to zero. (1)

$$T - G = O$$

However, such a budget is rather unique, since most of governmental budgets tend to have a deficit; that means that expenditures exceed revenues.

$$T - G < 0$$

Opposite case (revenues higher than expenditures) is a budget surplus. (2)

$$T - G > 0$$

A budget deficit is a very controversial topic. The concept of perceiving the budget balance has notably developed over the years. In the past, an “old-fashioned” view on deficit said that public finance are a mere application of family finance – therefore, that the budget should be balanced without any deficits, and, preferably, as small as possible. (2)

Modern view on public finance, however, tends to stress the importance of budget deficit as a mean to fight the recession. According to the Keynesian theory of multiplicators, public spending tends to have a significant effect on the economic development of a country. While higher deficits (i.e. higher government expenditures) help to fight the recession, lower deficits or surpluses slow down inflation. (2) Therefore, a budget deficit is not only a result of the downward sloping phase of economic cycle, but also a result of active role of government in development of economy. (1)

Cyclical and structural deficit

To better describe and address a government deficit, it is necessary to distinguish whether given deficit is of structural or cyclical nature.

First on the topic of structural and cyclical parts of budget:

The structural part of government budget is an active one – the government can actively act on its contents and magnitude; it is determined by discretionary policy such as setting tax rates, social security benefits, or the size of defence spending. (2)

The cyclical part of budget is determined by the phase of economic cycle and the amount of national income and output – this part cannot be actively regulated. (2)

The structural and cyclical part of deficit derives from conditions stated above; a cyclical deficit originates from the phase of economic cycle and, theoretically, it is about to be mitigated when the economy recovers.

The structural deficit, however, is defined as the deficit of government budget in a situation when the real output of the economy equals its potential output. (1) This also means that structural deficit is what is left after deducting the cyclical part of deficit from the actual value of government deficit.

This is also the deficit part originating from government policies. The danger of this type of deficit, according to some economists, comes from political involvement – generous

social politics, the general aversion against introducing higher taxes or too ambitious investments, all these factors can contribute to accumulating a structural deficit, which, at one point, can prove unbearable. (1)

Financing of budget deficit and its issues

To fund the budget deficits, government have few options. A common way to raise funds to finance deficit spending is debt financing – borrowing necessary funds. A government can borrow from various sources: from private resources inside the country, from central bank, or from investors abroad.

Issuing government bonds

Most usual way of financing a budget deficit is issuing government bonds, which are then sold to investors. As with usual bonds, government is obliged to pay interests to investors, and at the end of maturity to repay the borrowed amount. Government bonds are usually perceived as low risk investment, as country forced to default is rather less common situation than a defaulting company. (1) However, in recent history, there are cases of countries defaulting (most recently for example Argentina in 2014).

The level of trust of investors in given country is reflected in the interest rate on government bonds, as will be further discussed in second part of this thesis.

Crowding-out effect

A rather controversial issue is funding government debt by local investors. What seems as an optimal solution (lenders are inhabitants of given state, therefore state "owes to its own people"), can actually be more complicated, as the crowding out effect may occur. According to this theory, by using up funds of private lenders, the government actually restricts consumption, as the funds used for funding deficit spending would otherwise be spent on consumption without any involvement of the government. Also, this step can raise interest rates for private sector. (1)

Other theory says that crowding out occurs also at the point of government spending – according to it, government spending crowds out private investment from projects where private funds could be more effective, for example on public work projects or health programs. (2)

Monetization of the budget deficit

Another possibility to fund a fiscal deficit is to borrow from a central bank. In this model, central bank is forced to buy bonds from government, and to buy these bonds, it prints new money. This leads to intervention into open market, and therefore in many countries with market economy, this option is prohibited by law. (1)

Selling of state assets

Last possibility to raise funds to cover deficit spending is privatization of assets owned by the state. However, this option leaves the privatized assets fully in the hands of private subjects and the government loses all decision power on given assets, therefore governments tend to be very careful about using this option of financing. (1)

Sovereign debt

A sovereign debt is a total amount of all cumulated liabilities of the government, and their interests.

A sovereign debt is cumulated by government funding its deficit by debt financing, which is a primary debt. A primary debt plus interests on it equals total sovereign debt.

A budget deficit for the given year is equal to the increase in the government debt. (2) When a government fiscal year ends with a deficit, the sovereign debt rises. However, not only this affects the total amount of accumulated debt, but also the willingness of investors to invest in government bonds of given country. Generally, investors are more willing to invest in a country with lower debt, which therefore bears lower risk of debt default. This leads to lower interest rate and lower expenses of government in deficit funding ("cheaper" loans and better accessibility of debt financing). (1)

On the opposite side, when a country's debt rises, investors perceive investing in its bonds as a more risky investment and therefore require a higher premium on their investment, which leads to higher interest on government bonds. High interest rates increase the possibility that a country will not be able to cover interest expenses, will lose its access to financial markets (due to unbearably high rates) and will default on its debt. (1)

However, the interest rate is not the only concern with highly indebted countries; empirical evidence shows that, in the long run, a larger government debt may slow down the growth

of potential output of given economy; this is mainly due to costs of the government debt (paying the interest takes out a significant amount from government revenues, which could otherwise be used for other spending). (2)

In a country with healthy economy, debt financing and a rising sovereign debt does not necessarily pose a threat, since the total amount of debt as such is not the most important indicator – that is a debt-to-GDP ratio, an amount of total debt in percentage of gross domestic product. If the country's debt rises, but so does the economic output, the debt-to-GDP ratio remains sustainable. (1)

4.2 European system of financial stabilization

In 2008-2009, Europe has been hit by crisis originating in the U.S. housing mortgage bubble. This crisis on financial market, originally considered to be purely local, has soon grown into unexpected magnitude. The severity of this crisis had affected financial markets outside the U.S. as well, most notably the European financial market, as those two are closely interconnected. As a consequence, this crisis has triggered a worldwide recession, which has put many economies to a test.

Most European economies have been hit hard and have undergone a period of economic recession. Still, great amount of them have soon begun their way to economic recovery and growth.

However, some of the European countries did not manage to recover from the crisis as smoothly as others – these extreme conditions have become a stability test for economies and have revealed severe structural problems in financing of public sector in many European countries. Countries such as Portugal, Ireland, Greece or Spain have fallen into deep debt crisis and seemed to be unable to stabilize their condition, using their own means.

In this state, multiple countries have called for a financial assistance.

To respond to these calls for macroeconomic assistance, the European Union already had certain systems in place. However, they have proven to be insufficient, and therefore new facilities have been developed, first temporary (ESFS, ESFM), which then developed into permanent solution (ESM).

The main aim of these programmes is to preserve financial stability across the EU and to improve borrowing capacities of debt-ridden member states. (3) Financial assistance offered in this system is considered a loan, rather than a fiscal transfer, and it is linked to macroeconomic conditionality – i.e. they are conditioned by certain macroeconomic measures and reforms imposed on beneficiary state to ensure creating sustainability and meaningful utilization of the financial assistance. Also, the loans are distributed in tranches (they are divided into multiple payments) so that if the beneficiary country does not comply with conditions agreed, the loans transfer can be suspended. (4)

The following chapter also mentions the International Monetary Fund (IMF), as it is a very important lender of a financial assistance for the euro area countries, and it tends to collaborate with other lenders very closely.

Chronology of development of new financial assistance facilities

Before the crisis

Before the year 2010, the European Union already had in place systems for financial assistance to both its members as well as partner countries.

Those systems were the Balance of Payments facility and the Macrofinancial Assistance to non-member countries.

However, the Balance of Payments, established in 2002, was never designed to deliver a financial assistance in the amount necessary after year 2010. Although its financial cap has been extended twice, the facility still was not able to cover the calls for assistance from indebted member states. (5) Therefore, a new solution had to be introduced swiftly.

May 2010 – the EFSM and EFSF

In May 2010, two stabilisation mechanisms were set up as an emergency response to lasting debt problems originating in the financial crisis. Their aim was to preserve the financial stability of member states of the European Union in relation to the sovereign debt crisis. These two mechanisms were the European Financial Stabilisation Mechanism (further referred to as the "EFSM") and the European Financial Stability Facility ("EFSF"). Both these mechanisms were from beginning perceived as temporary and were expected to be replaced by other permanent mechanisms. (4)

October 2012 – the ESM

The expected permanent replacement came into function in 2012. The European Stability Mechanism ("ESM") was built on base of the EFSF and have replaced both previous mechanisms. (4) The ESFM and the EFSF are still administering loans to previously agreed member states, however all new financial assistance requests from year 2012 are managed under the ESM.

Current system

The following chapter reviews the financial assistance programmes available.

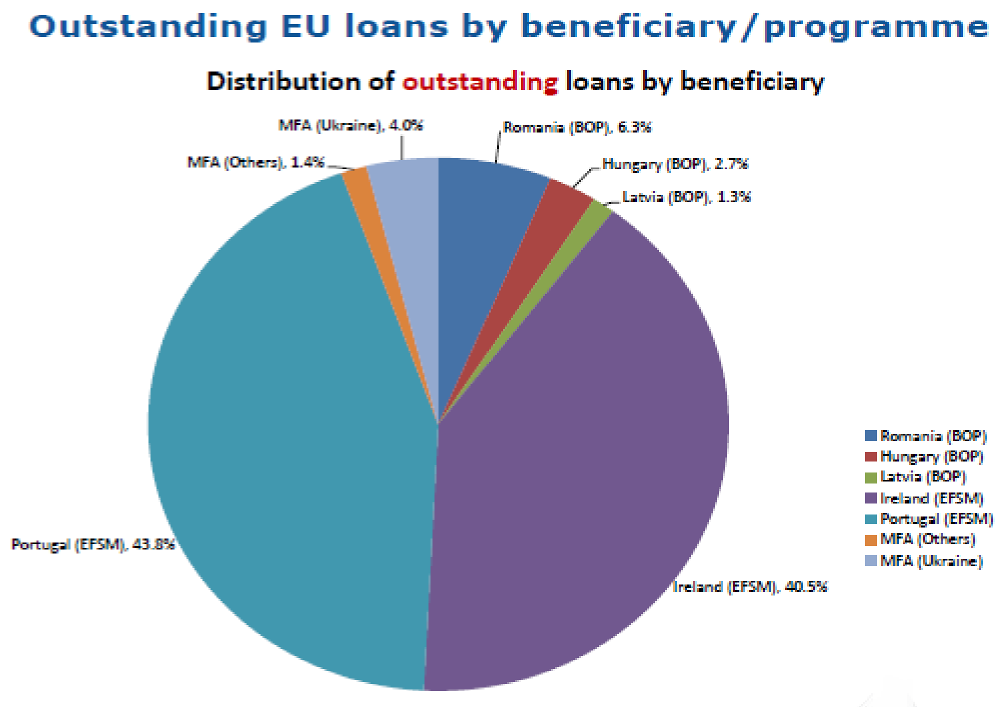
a) European Union

The European Union has established three different financial assistance programmes, operating both inside its member states and outside. These programmes are the EFSM, the "Balance of Payments program" and the "Macrofinancial assistance".

The entity entitled to operate these programmes is the European Commission. These programmes are funded in the international capital markets, where the European Commission acts as a borrower on behalf of the EU. The EU is using outstanding bonds to raise necessary funds. At the end of 2015, the EU has had approximately 54 billion in these bonds. (6)

The beneficiaries of these outstanding EU loans can be seen in graph below. The graph also shows the programmes, under which the loans were disbursed (see next chapters for explanations).

Graph 1 – Outstanding EU loans by beneficiary and programme



(Source: Investor presentation, European Commission)

The European Union can only use finance raised on the capital market to financial assistance to its beneficiary countries; the funds cannot be used to finance EU budgetary expenses. Also, although being serviced by the Commission, the loans are then lent to beneficiary countries under same conditions (same coupon, maturity and for the same amount) as they are raised. There is no additional margin added to the loan by the EU (or the Commission). (6)

Table 1 shows credit rating of the EU. Generally, the good credit rating is assigned to the fact that all loans are guaranteed by the 28 member states including highly important and stable economies. (7) This results in good lending conditions, as the EU bond is unrelated to the credit risk of the consequentia1l loan from EU to the beneficiary country. By this process, countries in need of financial assistance gain access to much better lending conditions than they would if they tried to raise the funds on their own. As the loan rates for EU are usually rated as "AAA", they are among the most favourable rates available globally. (6)

Table 1 – Credit rating of EU

Agency	Rating	Outlook	Comments of the agency
FitchRatings	AAA	Stable	- Rating based on the strong political support from its 28 Member States. - Limited debt service requirements and possibility to prioritise debt service over other budget expenditures. - Multiple sources of protection for bondholders, including coverage of EU borrowings by the EU budget.
Moody's	Aaa	Stable	- Conservative budget management, which demands a balanced budget. - Debt issued by EU backed by multiple layers of debt-service protection. - Very strong ability and high willingness of the 28 EU's member states to offer support.
STANDARD &POOR'S	AA+	Negative	- December 2013, S&P changed the EU's rating from AAA to AA+. S&P's outlook on the EU is negative. - Budget revenues total EUR 1,024 billion over the 2014-2020 MFF period. These revenues could be reallocated for debt service if any of the outstanding loans defaults.

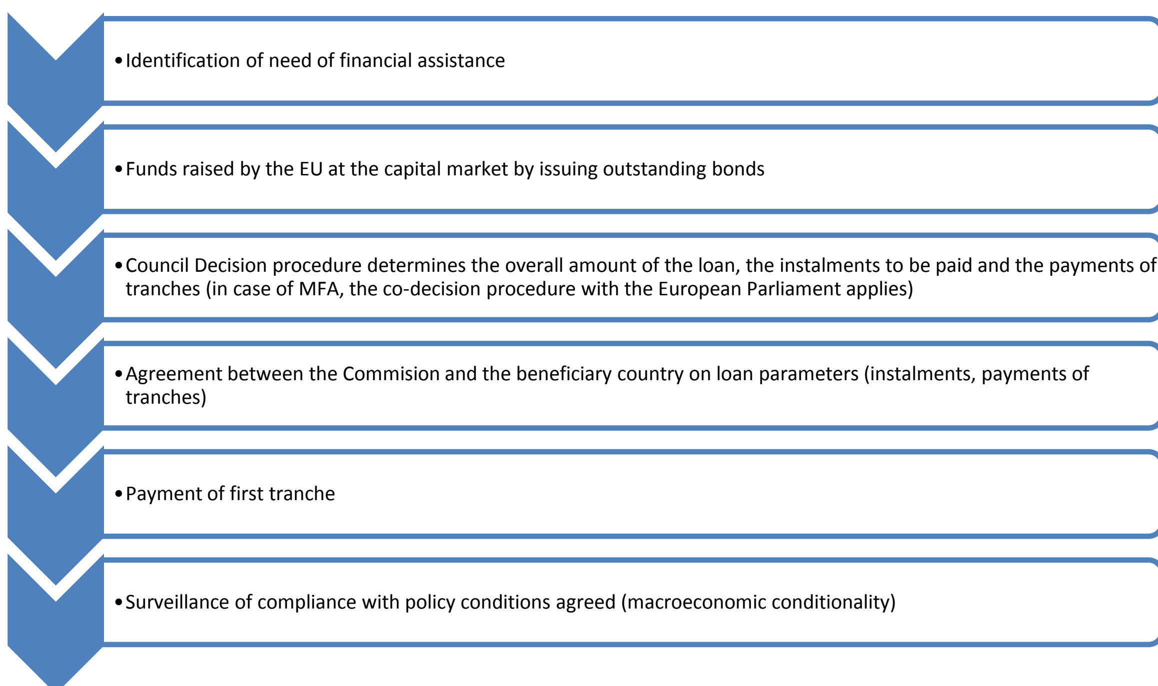
(Source: Investor presentation, European Commission)

Funds raised at the capital market are lent to beneficiary country. The exact amount lent, value of individual tranches and maturity of loan is then decided by the Council (or, in the case of Macrofinancial Assistance, in co-decision with the European Parliament). The maturity can span between 3 and 30 years, and the payments are denominated in euros.

After this decision, the loan is prepared to be paid to the beneficiary country in tranches, and compliance with conditions agreed is reviewed regularly. (7)

The following table shows the general process of loan disbursement, while next chapters will point out different specifics of given programmes.

Table 2 – Lending process under the EU programmes



(Source: The EU as a borrower, European Commission)

a. European Financial Stabilisation Mechanism

The EFSM serves as a loan provider for EU member states. Under this mechanism, the Commission can borrow up to 60 billion EUR on the financial markets. This loan is guaranteed by the EU budget. (4)

The financial assistance from the EFSM has two main underlying rules: first, the EFSM provides assistance to a member state of the EU which "is experiencing, or is seriously threatened with, a severe financial disturbance"; and secondly, "the financial disturbance or threat of financial disturbance is due to events beyond the control of the Member State concerned". (8)

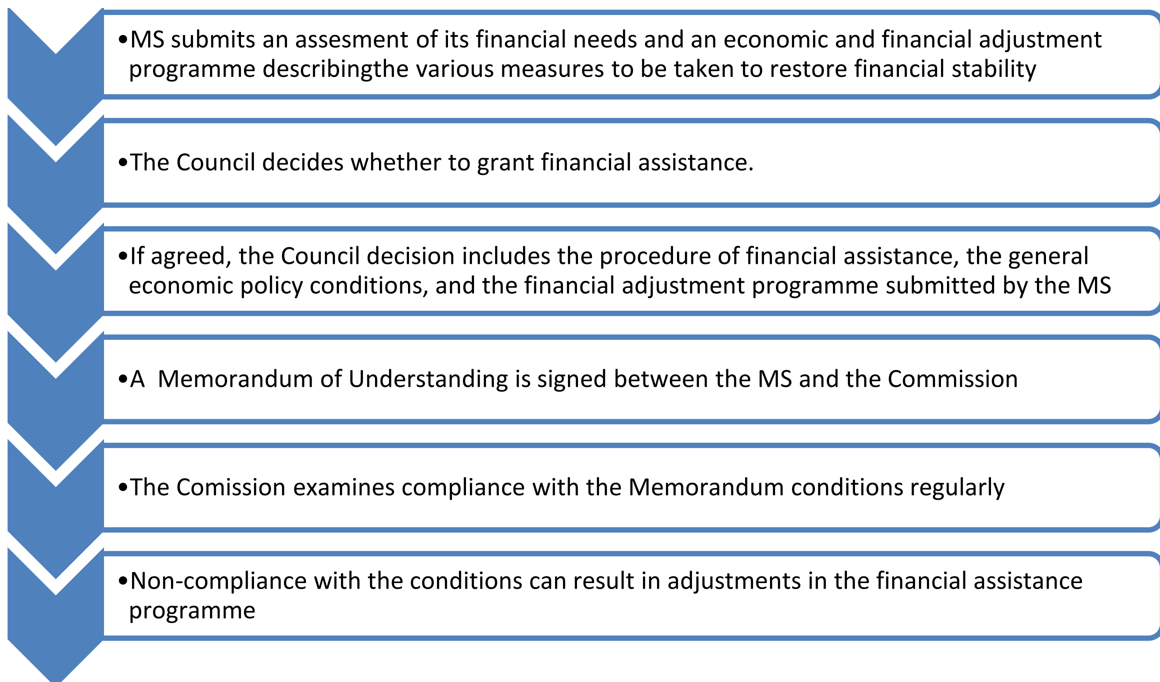
The exact form of assistance is either a loan, or a credit line. The credit line, in this case, is "an authorisation to a member state to draw funds up to a specified ceiling for a given period of time". (8)

The EFSM has first been activated to provide loans to Eurozone members in 2011. The loans were sent to help Ireland and Portugal, in a total amount of 46.8 billion euro, of which Ireland has received 22.5 billion euro and Portugal 24.3 billion. (6) This has left 13.2 billion for further use. Ireland's loan maturity was set on December 2015, however, this maturity was lengthened. The average maturity of Ireland's EFSM loans is now 15.4 years, and Portugal's 12.5 years (both with an option to be prolonged up to 19.5 years) (7).

In 2013, the EFSM was replaced by the ESM. However, some funds were still available unused, and a part of this amount (7.2 billion) was then used in July 2015 as a short-term bridge loan to Greece. (6) This has provided Greece with financial assistance until the start of the ESM assistance programme. The full amount has been repaid in August 2015. (7)

Also, a planned lengthening of a loan to Portugal is scheduled to take another 4.75 billion euro in 2016, which leaves the EFSM still active. (7)

Table 3 – Procedure of the EFSM financial assistance



(Source: European Financial Stabilisation Mechanism, European Commission)

The EFSM is also compatible with the Balance of Payments programme aiming at non-Eurozone member states. Also, the EFSM does not prohibit assistance from outside the EU, especially from the International Monetary Fund – actually, "packages" of financial aid combined from EFSM, EFSF and IMF were sent to both Ireland and Portugal. (8)

b. Balance of Payments program (BoP)

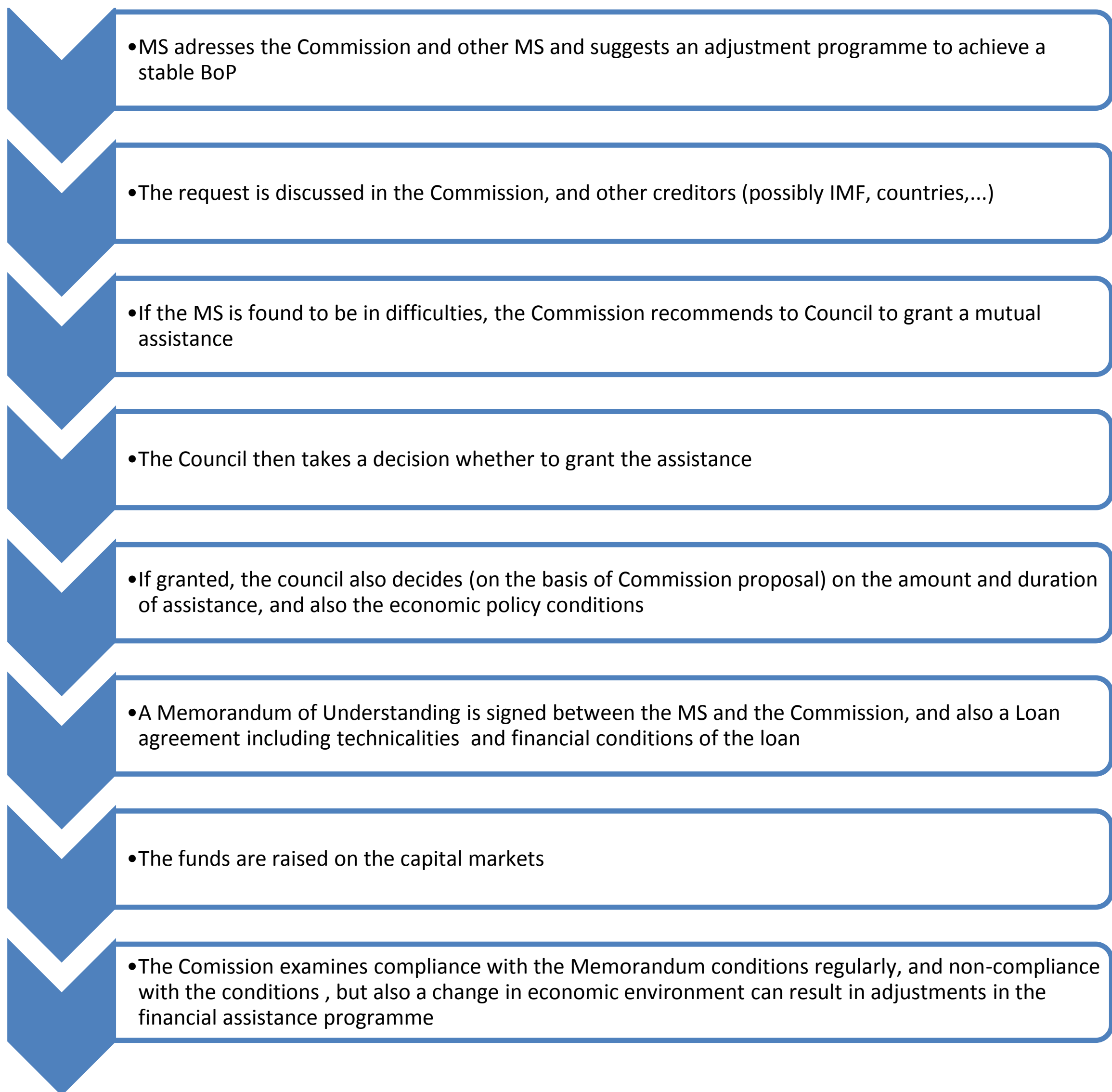
The BoP is a financial assistance program for non-Eurozone member states. This programme has been functioning long before the crisis – a Council Regulation establishing this medium-term financial assistance has been passed in 2002. However, as a response to the crisis, the amount of funds which can be raised (and then sent to beneficiary countries) has been changed from original 12 billion euro to 25 billion euro in 2008 (5) and then to current level of 50 billion euro in 2009. (7)

The beneficiary state can receive financial assistance if it is (or there is a probability it will be) in difficulties regarding the balance of payments. The BoP assistance is meant to be an aid for country's external financing constraints. In many cases, the EU support is extended to cooperation with the IMF and other international institutions or countries. (5)

Economic policy conditions in the case of BoP usually include fiscal consolidation, governance measures (taxation, government spending controls,…), but also financial sector stabilisation measures (banking regulations) and structural reforms to improve business environment.

Countries, which have been (or still are included) in the BoP programme are Hungary (6.5 billion euro), Latvia (3.1 billion euro) and Romania (5 billion euro). (7) All of the countries have received this assistance from EU as a part of a "package" of international financial assistance, including assistance from IMF, under which Hungary has received a total of 20 billion euro, Latvia 7.5 billion euro and Romania 20 billion euro. (5) Programmes for Hungary and Latvia have already been closed, however Romania stays in a "precautionary BoP assistance" programme. (9) Therefore, Romania has a possibility to request help in case "of an unforeseen marked deterioration in the economic and/or financial situation". (9) An assistance of 4 billion euro (of which 2 billion is from the BoP programme and 2 billion from IMF) is agreed to be disbursed for Romania in case of difficulties with balance of payments would occur again. (9)

Table 4 - Procedure of the BoP financial assistance



(Source: Balance of Payments, European Commission)

c. Macro-financial assistance (MFA)

Macro-Financial assistance is not exactly a financial assistance to EU member states, as its beneficiary countries are partner countries outside the EU. However, it is a programme of financial assistance from the EU with a secondary aim of improving member states balance of payments (as shows the formulation "partner countries" in the definition of beneficiary countries), therefore it is included in this work.

As stated, the MFA takes the form of a medium or long term loans or grants to countries outside the EU. The loan is funded by finance raised in capital markets (the usual procedure same for BoP and EFSM), while the grant form is financed directly from EU budget. (10) It is necessary to make clear that most assistance under BoP is in form of loans, grants are rather exceptional; as only "when the beneficiary country shows a particularly low level of economic development and faces an unsustainable external financial situation, MFA may also include a sizeable grant." (11)

It is only available to countries which are benefiting from an IMF assistance programme – it is intended strictly as a complement to IMF funding, therefore it does not open new projects but rather supplement the ongoing IMF funding. (11)

The exact definition of beneficiary countries says that "MFA is designed for countries geographically, economically and politically close to the EU. These include candidate and potential candidate countries, countries bordering the EU covered by the European Neighbourhood Policy and, in certain circumstances, other third countries." (11)

The funds from MFA are paid to central bank of a beneficiary country, and the further use is then left on the country's full discretion (for reserves, foreign exchange market interventions, or as a direct budget support). (11)

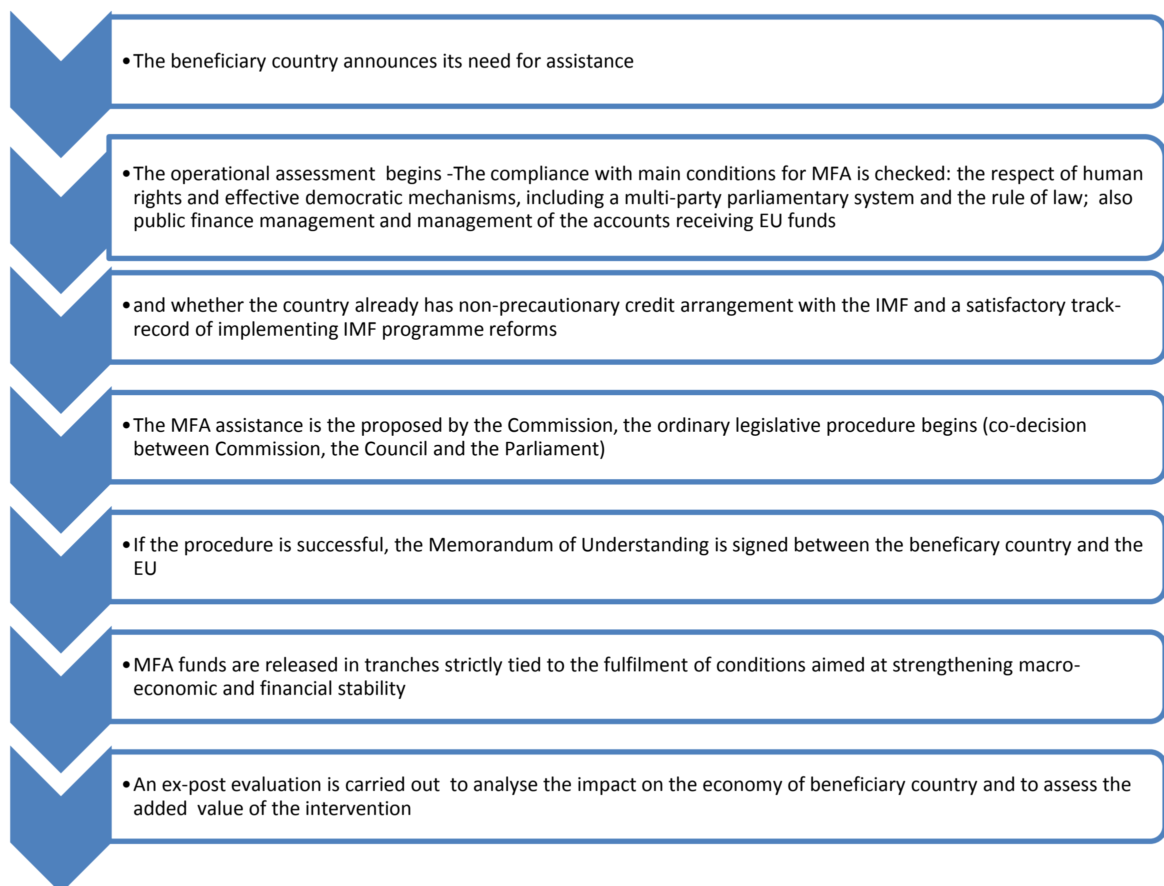
The MFA support is not limited by any ceilings and the amount is decided on a case-to-case basis. While deciding on an amount of MFA, the assistance from other sources is also taken into account. (11) Currently, it includes 3.01 billion EUR outstanding. (7)

Another difference of the MFA programme is its decision process. Unlike other programs of financial assistance under the EU, MFA programs are subjected to ordinary legislative procedure, therefore the proposal from the Commission needs to be accepted by both the European parliament and the Council of European Union. (11) This is often pointed out as

a large issue of the MFA assistance, since the ordinary legislative procedure can be lengthy and therefore the MFA is unable to respond with flexibility to changing economic and politic environment. In 2011, the Commission has tried to resolve this issue by proposing a reform on this issue, suggesting to make the MFA subject to implementing acts This in the EU legislative means that Commission would have the sole power to take the decision on MFA for beneficiary country and subsequently it would mean rapid shortening of decision time, but also a great power at the hands of the Commission. However, this proposal was after two years of discussion withdrawn by the Commission itself. (10)

Under new development of situation at Ukraine and the need to launch new MFA operations in 2014 and 2015, the Commission has promised to look for a new alternative on shortening the process of MFA launching. (10)

Table 5 - Procedure of the MFA financial assistance



(Source: Macro-Financial Assistance to non-EU countries, European Commission)

The latest countries either accepted under MFA include in the 2009 Armenia, Bosnia and Hercegovina, Georgia and Serbia, in 2010 Ukraine and Moldova, and in 2014 Jordan, the Kyrgyz Republic and Tunisia. (10) Overall, the main beneficiary country over the last years was Ukraine, due to its deteriorating political and economic situation, which has received 1.35 billion euro. (11)

Fot the year 2016, the plan is to disburse up to 1,2 billion EUR to Ukraine and 0,1 billion EUR in other financial assistance programmes. (7)

d. Pooled bilateral loans

The pooled bilateral loans administration is a special case of a financial assistance facility; for the financial assistance to Greece, it was utilised from May 2010 as a part of the first Economic Adjustment Programme for Greece under the name of Greek Loan Facility. (12) This rather provisional solution pooled loans from the Euro area member states to Greece.

Original proposal amounted to 80 billion EUR. This proposal was then reduced of 2,7 billion EUR, due to denial to participate by Slovakia, and Ireland and Portugal not participating due to their own request of financial assistance. (12) In the end, only 52,9 billion EUR was disbursed. (9)

The loans are administered by the European commission. (12)

Bilateral loans are also used in other cases of financial assistance, even outside the Euro area (such as the case of bilateral loans to Ireland from United Kingdom and Sweden) (7), however these loans are purely a bilateral matter and are not managed by the European Commission.

b) EFSF

European Financial Stability Facility is legally a private company established under Luxembourg law. It is a body founded on an international agreement. (7)

It was created as a temporary crisis resolution mechanism in June 2010. Since July 2013 (4), the EFSF does not provide any new financial assistance, as its operation scope has been overtaken by the recently established ESM. However, the ESFS does still receive loan repayments from countries, which have received assistance from it. It also administers the payments to holders of EFSF bonds, and other administrative issues. (13)

EFSF has, during its operation time, provided assistance to Ireland, Portugal and Greece between its foundation (2010) and expiration of its last programme to Greece (2015). (13)

The maximal amount EFSF can raise is 440 billion EUR. At the end of 2015, 187 billion has been used on financial assistance. (7)

The agreement on financial assistance is signed with the Commission, similar as in the case of the EFSM. However, the actual authority to raise money on capital markets, which then will be lent to the beneficiary state, relies purely on the participant states (guarantors, and in effect lenders to beneficiary country). (3) Interestingly, guarantors have to guarantee an amount which is 20% more than the amount actually borrowed (3) – this precaution serves as a buffer zone for the case of unexpected expenses, and it was introduced in order to enhance investors' confidence, so that the interest rates would be as low as possible.

The guarantors are all members of the Euro area, unless specified otherwise (some countries have quit this programme due to their own financial difficulties).

c) ESM

European Stability Mechanism is an international financial institution, which has been established in October 2012 under international treaty. (7) It is a permanent replacement for two temporary solutions for financial assistance – the ESFS and the ESFM. As stated before, the two previous programmes are still active for administration of already started financial assistance, however all new requests are (and will be) covered by ESM.

As it is a logical follower of the ESFS, its main features build on the EFSF's, such as the fact that the borrowing is not backed up by the EU budget, but it is guaranteed by the member states themselves (guarantors). (3) The guarantor member states have paid in an amount of 80 billion EUR of capital as a backup for the ESM loans. (14)

It is currently the only and permanent instrument for answering the requests for financial assistance by the member states of the euro area. (4)

Its lending capacity is 500 bil EUR, currently has been utilized 50,3 billion EUR. (7) The ESM raises funds on financial markets by issuing three and six month bills, as well as medium and long-term debt (possible maturity is up to 45 years). (14)

So far, the ESM has provided funds for Spain, Cyprus and Greece (14)

As well as in the EFSF, the guarantors for loans are member states of the Euro area. (4) A special feature of the ESM is that it is designed to cooperate closely with the IMF, therefore, if an Euro area member state requests aid from the ESM, it is expected to request an assistance from the IMF as well. (14) Similar cooperation is exercised also in the case of the European Central Bank. (4)

d) IMF

IMF lending is available to all its member countries, and is primarily aimed towards countries "experiencing actual or potential balance of payments problems." (15) A country can borrow from the IMF if it has issues with its balance of payments, that is if it cannot find resources to finance its net international payments including not only imports, but also external debt payments etc. (15)

The IMF lending is often coupled with other financial assistance from EU/EFSF/ESM, and the European Commission and the IMF tend to respond to requests for financial assistance together, with aid of the European Central Bank (colloquially known as "the Troika").

Similar as the case with EU lending, IMF assistance is disbursed on a basis of Memorandum of Understanding, which specifies the conditions for lending (15) (usually containing specific policies which are supposed to re-establish macroeconomic balance).

The IMF lending is disbursed on a basis of two kinds:

a) Non-concessional lending

Under the non-concessional lending, IMF offers a range of programmes: Stand-By Arrangements, Flexible Credit Line, Precautionary and Liquidity Line, and the Extended Funding Facility. (15)

Under the financial assistance to Eurozone countries during the sovereign debt crisis, two of those programmes were used: the Stand-By Arrangement and the Extended Funding Facility. (16)

The Stand-By Arrangement (SBA) is used to help to overcome short-term issues of the states in financing assistance need. They include the conditionality and duration of an SBA is usually 12-24 months. (15) The repayments are them made within three to five years. (17)

Under the Extended Funding Facility (EFF), the countries can helped to overcome the medium and long term problems. (15) The conditionality includes fundamental economic reforms. Arrangements should not exceed four years, repayments are expected in 4,5 to 10 years. (17)

First financial assistance to Greece was funded under the SBA (30 bil. EUR), second and third under the EFF (28 bil. EUR, total amount for the third programme not decided yet), same as the programmes for Ireland (22,5 bil. EUR), Portugal (26 bil. EUR) and Cyprus (1 bil. EUR). (16)

b) Concessional lending

The concessional lending is usually aimed at low income countries and therefore does not have a large importance to Eurozone member countries.

5. Analysis of Financial assistance to Greece and Portugal

This work shows the development of two countries which have requested financial assistance in last 6 years. The countries chosen have similar population and workforce, as well as comparable economic output (as further described in chapter "Comparison of assistance programmes").

As an aftermath of dire economic conditions in 2008-2009, they both recorded rising level of sovereign debt. As a result, both countries have asked for financial assistance – Greece in year 2010 and Portugal in 2011. Both countries have been granted a combined assistance package from various sources. Portugal has undergone a single round of so called Economic Adjustment Programme; Greece is currently in its third round.

This part of the thesis explains the development of macroeconomic conditions before the requests for aid, during the financial assistance rounds and latest results. First, the work shows initial conditions in given countries and the macroeconomic imbalances which forced the countries to request the financial assistance. Next chapter describes conditions of the assistance itself, main lenders and chronological disbursements of assistance. Further, the main aims of the aid itself are discussed. Next chapter analyses the macroeconomic development of countries during the financial assistance and after; it points out possible effects of the assistance, as well as issues which the adjustment programmes did not manage to tackle. Last chapter summarizes the effectiveness of the financial aid in given states and emphasizes problematic parts of the programmes and possible causes.

The data sets observed in this thesis are tied to the sovereign debt and its funding – the fiscal deficit, the interest rates, the total sovereign debt of the country, the debt-to-GDP ratio. For observing the overall development in economy, a data set for GDP and GDP per capita is used.

The development leading to the financial assistance is shown on historical data from years before the request for financial assistance. The development in given countries under financial assistance is illustrated on years 2010 – 2015, and, unless stated otherwise, all data are in billion EUR in constant prices. For the gross domestic product (GDP), expenditure approach was used.

5.1 Initial conditions in Greece and Portugal

Greece

Greece was the first country in Euro area, which started to encounter macroeconomic imbalance as a result of the financial crisis originating in the U.S. In the end, these issues resulted in Greece asking for financial assistance in the year 2010.

However, Greek debt issues did not originate purely in the worldwide crisis; long before the year 2008, Greek macroeconomic situation has been far from stable. Even before the economic crisis reached Euro area, Greek government was using relatively cheap loans to fund its operations, and therefore cumulating government debt. Greek sovereign debt was not an immediate result of the financial crisis; it has accumulated over years with Greek deficit funding.

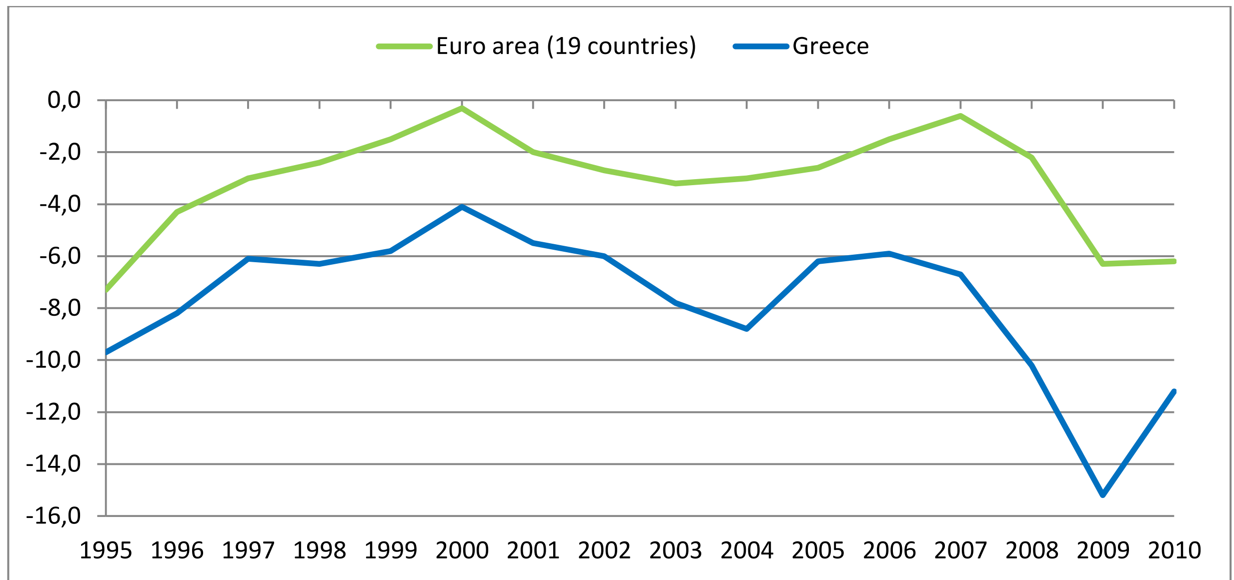
The following chapter explains imbalances connected to the debt accumulation, which contributed to dire situation in Greece and the need of financial assistance.

a) Persistent and high fiscal deficit

In recent past, Greece has a history of high government deficit. As can be seen from the graph, the development has approximately followed the trends in Euro area with its peaks and falls according to overall economic trends in Europe, however, in years 1995-2002, Greek deficit was on average 2,2 times higher compared to average in Euro area. In years 2003-2008, the gap widened and Greek deficit has reached on average 3,5 times the average of Euro area for the same period. This development led Greece to an incredible fiscal deficit of 15,2% of GDP in year 2009, when the high government expenditures trying to mitigate effects of the crisis led Eurozone to deficit of average 6,3%. (18)

As can be seen from the graph, the sudden burden of crisis had hit Greece unprepared and revealed issues in the structure of its fiscal planning, leading Greece to much steeper fall in deficit than the Eurozone was experiencing.

Graph 2 – Greece, Fiscal deficit, in % of GDP



(Source: Eurostat Database, European Commission)

b) Rise in interest rates

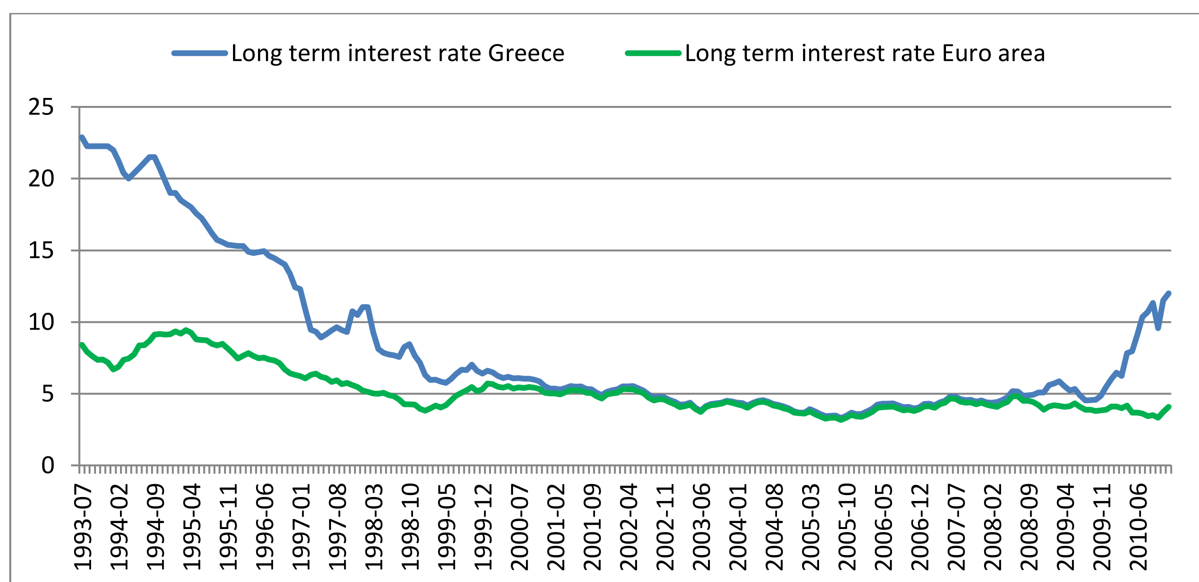
Rising fiscal deficit led inevitably to rise in external funding. For Greece, this was not a challenge in the pre-crisis years, since its interest rates were maintained low by membership in Euro area – investors had confidence in the strength of the group. Having the back up of a large international institution made Greek loans cheaper, and Greek government has used this easily achievable credit to finance its operations.

However, it became an issue during and after the crisis, as the confidence of investors quickly deteriorated, shaken by uncovered issues in Greek fiscal matters.

Graph 3 shows high level of convergence of Greek interest rates to interest rates of Euro area in years preceding the entrance to Euro area (2001). After the entry to Euro area, Greek interest rates equalled the average of Euro area, which was about ½ of Greek average value in preceding decade. This significant fall in interest rates made deficit funding rather cheap for Greece. (19)

Once the crisis struck the Euro area, capital became more expensive and the investors lost trust in Greece as a debtor. As a result, the interest rates rose from 4,4% in the beginning of year 2008 to 12% in the end of 2010 (as seen in graph 3). (20)For Greece it became expensive to finance its budget from loans and as a result of expensive borrowing and high government deficit, its sovereign debt skyrocketed in 2009-2010 (as explained in next chapter).

Graph 3 – Greece, Long term interest rate, % per year, market yields on government bonds with 10 years maturity and denomination in EUR

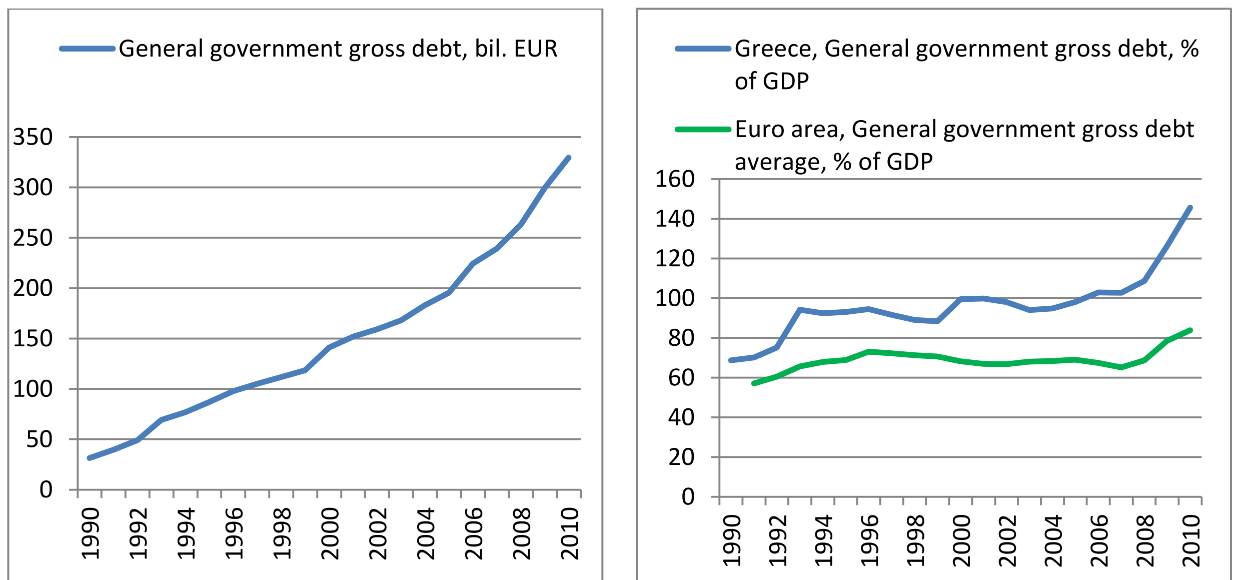


(Source: Data Warehouse, European Central Bank; OECD.Stat, OECD)

c) Accumulated sovereign debt

Graph 4 shows the accumulation of Greek sovereign debt in years before 2010. Even in years of economic growth, Greek sovereign debt kept fluctuating between 90% and 100% of Greek GDP, which is considerably above the level of euro area average, as shown in the graph 4. (21)

Graph 4 – Greece, Government gross debt development, 1990-2010



(Source: World Economic Outlook Database, IMF)

As explained before, the loans, which Greece used for public spending, were made possible by low interest rates, which Greece achieved by entering the EU, and by introducing Euro as local currency in 2001 (as seen in graph 3 above).

However, as an effect of financial crisis, high deficits and expensive borrowing, the debt accumulation accelerated. By 2010, the debt-to-GDP ratio climbed up to 145% (as compared to Euro area average of 68%). (21)

Call for assistance

As a result of accumulated debt and rising interest rates,in 2010, with the gross government debt reaching 145% of Greek GDP, Greece has officially asked for a financial assistance from the EU and IMF. (22) After an audit of its financial position by the European Commission, this assistance was granted the same year by the IMF and member states of the Eurozone. (9)

Portugal

Roots of the need for financial assistance in Portugal were very similar as in Greece, mainly macroeconomic imbalances – high accumulated debt and high interest rates on government bonds, making deficit funding nearly impossible. According to the European Commission, Portugal has suffered many structural issues, which led to its call for macroeconomic assistance in 2011. (23)

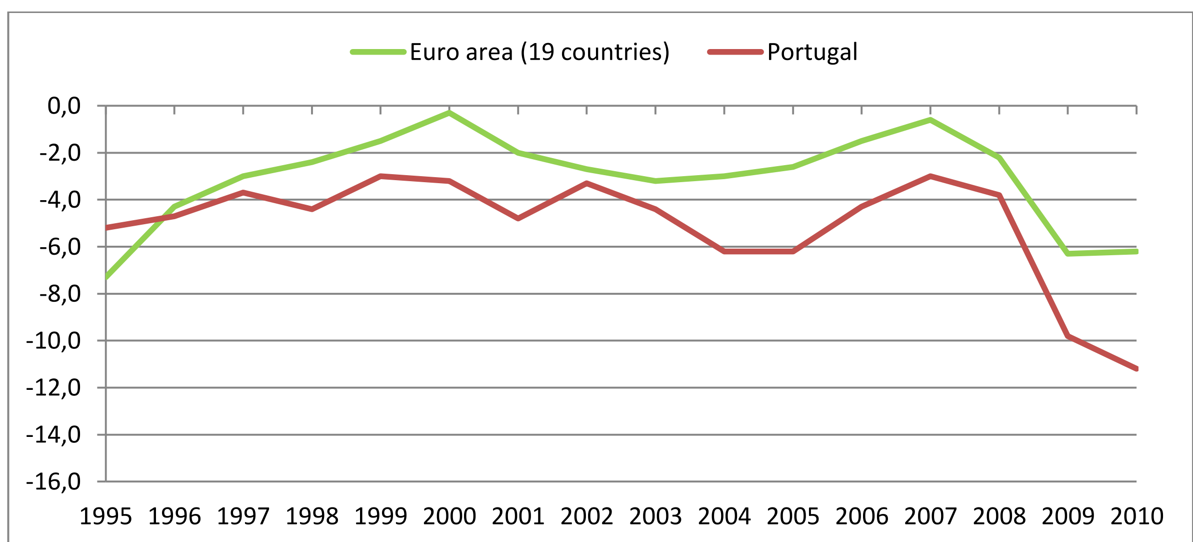
However, the case of Portugal differed in some details – mainly in the fact that a rapid accumulation of debt in the years before the crisis (and during it) occurred, rather than a stable accumulation over long time.

a) Fiscal deficit

The trends in Portuguese deficit development do not rely as strongly on a development in other Euro zone countries as Greece's, as shows the graph below. However, Portuguese deficit in average values has been much closer to the development of average deficit in Euro area in years 1995-2009, than Greek deficit development (with maximum difference of only about 3,6% in year 2005).

However, the deficit has quickly risen in years 2008-2010 (rise of 7,4%, from 3,8% to 11,2%), which was then reflected in the slope of debt accumulation of Portuguese government (see next chapter).

Graph 5 – Portugal, Fiscal deficit, % of GDP



(Source: Eurostat Database, European Commission)

b) Rise in interest rates

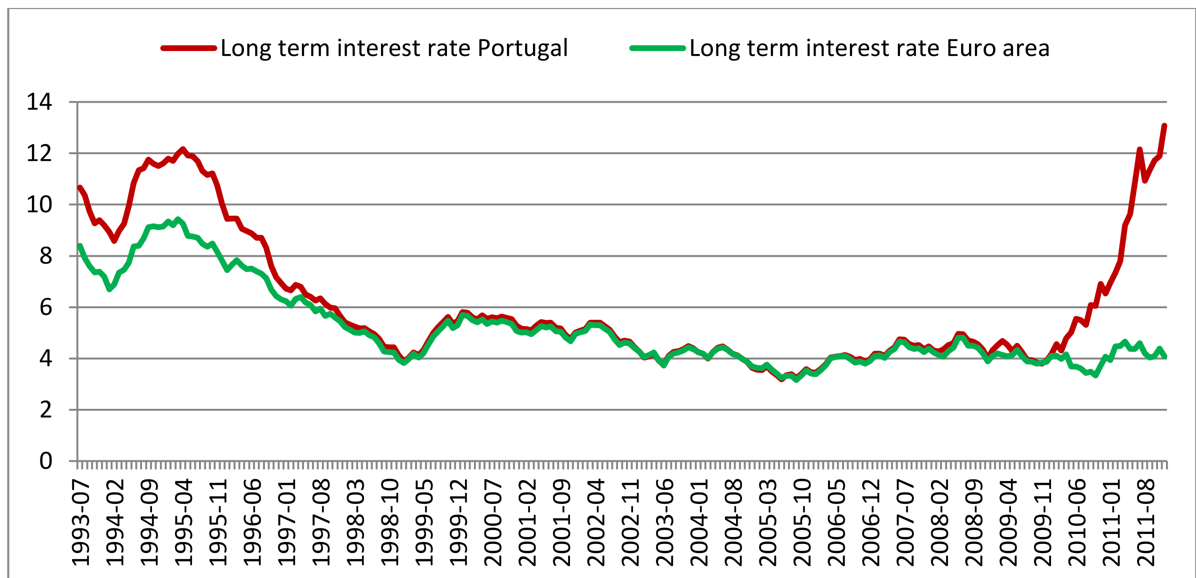
Another reason for requesting assistance was deterioration in investors' confidence. The overall situation in Euro area and accumulation of Portuguese debt has caused a loss of confidence in Portugal on capital markets, which led to fall in investor trust, same as in Greece.

An adding factor to loss of confidence and growing interest rates was a political crisis in government – before requesting any external aid, Portuguese government had prepared a "Stability Programme" to address the macroeconomic issues and to restore investors' confidence. However, although being approved by ECB and the European Commission, this programme did not receive parliamentary approval. This started a political crisis ending in resignation of Portuguese prime minister and new elections. (24)

All these conditions together have triggered a surge in interest rates, where at the end of 2011, the interest rates reached 13% as compared to Euro area's average of 4%. (19)

Consequentially, Portugal lost its access to debt funding, as it became unbearably expensive.

Graph 6 – Portugal, Long term interest rate, % per year, market yields on government bonds with 10 years maturity and denomination in EUR



(Source: Data Warehouse, European Central Bank; OECD.Stat, OECD)

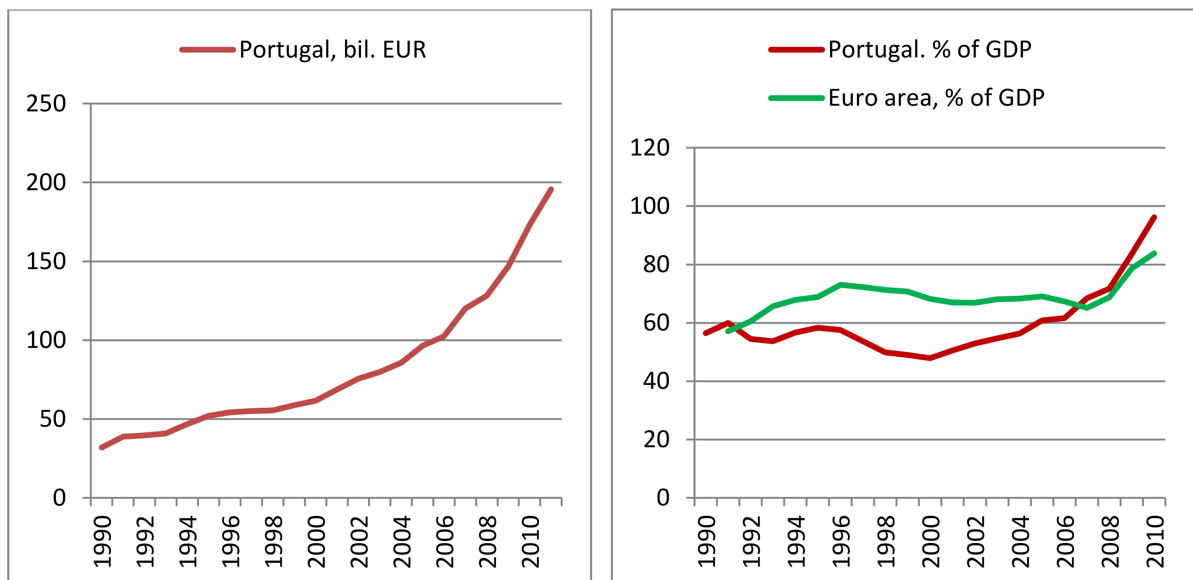
c) Rapid growth of sovereign debt

Same as Greece, Portugal was suffering from high sovereign debt. In 2011, the year when Portugal asked for financial assistance, the debt has reached 195,7 bil EUR, which equals 111% of Portuguese GDP that year. (21)

However, the high values of debt were not a result of long term accumulation of unsustainable amounts, such as the case in Greece; as can be seen on the graph 7, Portuguese debt-to-GDP ratio in years before the crisis was actually lower than average in the Euro area. But still, a slow, steady growth is observable since year 2000, which can be connected to better availability of debt financing after the accession to Euro area (Portugal entered the Euro area in year 1999, see the conversion of interest rates in graph 6 – long term rates). (25)

However, it was only in the year 2008 when the government gross debt of Portugal surpassed the average of Euro area (with the Euro area debt level at 69% of GDP and Portugal at 72%). Since then, Portugal's debt grew much quicker, reaching the level of 111% of GDP in 2011 (compared to 86% in Euro area). (21)

Graph 7 – Portugal, government gross debt development, 1990-2010



(Source: World Economic Outlook Database, IMF)

In comparison to Greek debt accumulation, graph 7 shows steeper accumulation of total debt in years of crisis and after it.

d) Household and corporate indebtedness

For Portugal, private debt was an additional issue connected to the high interest rates. The private sector debt grew over 200% of GDP in the year 2009. Not only was this an issue for the private entities, but also for Portuguese banks – the domestic banking sector acted as an intermediate for these loans, the leverage ratios were unbearable and caused large credit exposure for banks, which later resulted in need of recapitalizing certain Portuguese banks. (24)

Call for assistance

Portugal has requested financial aid in April 2011. The request was sent equally to EU, Euro area member states and the IMF. (26)

In May 2011, an Economic Adjustment Programme was negotiated between Portugal on one side and European Commission, the European Central Bank and the IMF on other. The amount offered to Portugal was altogether 78 billion EUR. (26)

5.2 Financial assistance to Greece and Portugal

Assistance to Greece

Greece has so far undergone two rounds of financial assistance, the first and second "Economic Adjustment Programmes", and currently is a part of a third one. (9) The first Economic Adjustment Programme was active in years 2010 to 2012, the second followed closely in years 2012 to 2015, and afterwards a third Economic Adjustment Programme was negotiated, which started in August 2015 and is expected to last until 2018, given that Greece will comply with the macroeconomic conditionality of the programme. This means that Greece is in a programme of financial assistance steadily from the year 2010.

The main lenders of the three Economic Adjustment programmes are as follows:

a) Greek Loan Facility – the so-called Greek Loan Facility is a group of loans provided by member states of the Euro area. These bilateral loans originally amounted up to 80 bil. EUR, however Slovakia decided to pull out of the agreement and Portugal and Ireland needed help themselves, so the amount disbursed was smaller. The GLF (organized by the European Commission) pooled these bilateral loans and "transformed" them into single loan to Greece. (22)
b) ESFS
c) ESM
d) IMF - Greece is also under an IMF Funding programme; its current round is planned from March 2010 to March 2016, and the tranches are tied to the rounds of the Economic Adjustment Programme.

Following table with information from the European Commission shows the exact agreed sums of financial help, split by lenders.

Table 6 – Financial assistance to Greece

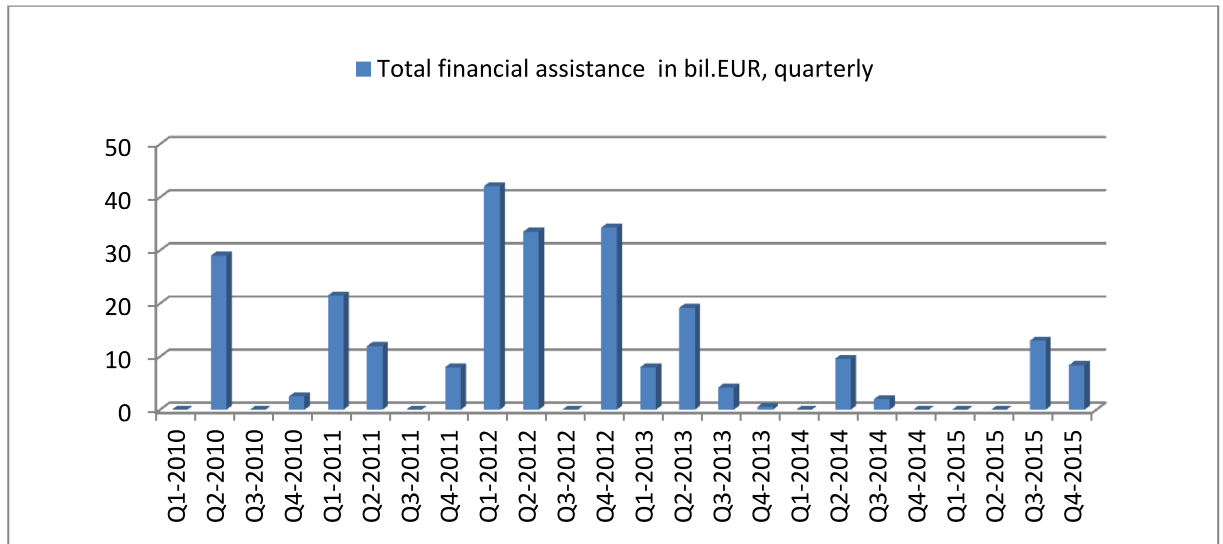
Programme	**1st Economic Adjustment Programme**	**2nd Economic Adjustment Programme**	**3rd Economic Adjustment Programme**
Lender	GLF, IMF	EFSF, IMF	ESM
Memorandum of understanding signed on	3rd May 2010	14th March 2012	19th August 2015
Running until	February 2012	June 2015	August 2018
Original commitment by lender	GLF – 80 bil. EUR IMF – 30 bil. EUR	ESFS – 144.7 bil. EUR IMF - 28 bil. EUR	ESM – up to 86 bil. EUR IMF participation in negotiations
Disbursed	GLF – 52.9 bil EUR – SK, IRL and PT did not participate IMF – 20.7 bil. EUR	ESFS – 141.8 bil. EUR IMF – 11.6 bil. EUR	ESM – 23 bil. EUR (September 2015)

(Source: own processing; data from ESM, EFSM, IMF)

Disbursements to Greece

The disbursement of financial assistance has not occurred in equal tranches, but has been adjusted according to financial needs of Greece and the compliance with macroeconomic conditionality. Following graph shows financial assistance of all three programs, both from the GLF (followed by ESFS and ESM) and the IMF, in the years 2010 to 2015.

Graph 8 – Disbursement of financial assistance to Greece



(Source: own processing; data from ESM, EFSM, IMF)

Assistance to Portugal

In the case of Portugal, the loan "package" of the financial assistance was composed from three lenders:

a) ESFM
b) ESFS
c) IMF

Originally, the package totalled 78 bil. EUR. By the end of 2014, from the total of 78 billion EUR offered, Portugal has used 76,3 billion EUR (24,3 bil. EUR from the EFSM, 26 bil. EUR from the EFSF and 26,5 bil.EUR from the IMF). This was the total package Portugal has received in multiple tranches. (26)

Table 7 – Financial assistance to Portugal

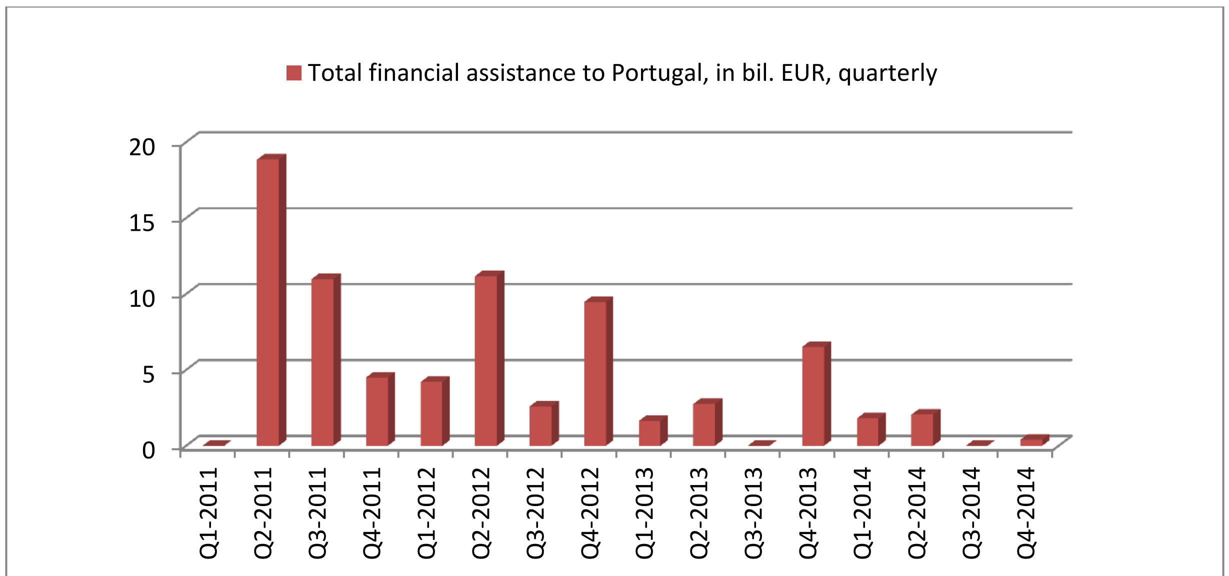
Programme	**Economic Adjustment Programme**
Lender	ESFM, ESFS, IMF
Memorandum of understanding signed on	3 May 2011
Running until	12 November 2014
Original commitment by lender	ESFM – 26 bil. EUR ESFS – 26 bil. EUR IMF – 26 bil. EUR
Disbursed	ESFM – 24,3 bil. EUR ESFS – 26 bil. EUR IMF – 26,63 bil EUR Total – 76, 93 bil. EUR

(Source: own processing; data from ESFS, EFSM, IMF)

Disbursements to Portugal

As in the case of Greece, the tranches of financial assistance were disbursed according to financial assistance needs and after concluding a thorough review on the current state of the macroeconomic conditionality. The tranches were split as shown in the graph 9.

Graph 9 – Disbursement of financial assistance to Portugal



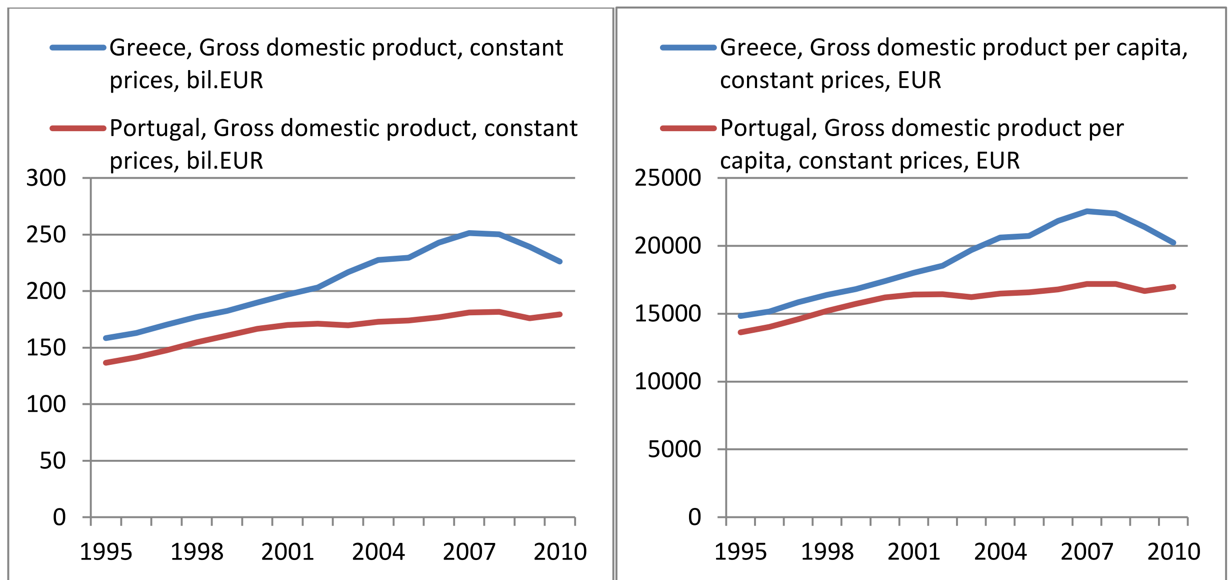
(Source: own processing; data from ESFS, EFSM, IMF)

As visible from the graph, Portugal, unlike Greece, has received the largest portion of the assistance right in the beginning of the Economic Adjustment Programme (a total of 18,9 bil. EUR and 11 bil. EUR in second and third quarter of 2011, respectively).

Comparison of the two assistance programmes

The two countries compared have similar population; Greece of about 11 million inhabitants and Portugal of 10,5. The number of employed persons, before the crisis, was 4,5 million for Greece, and 5 million for Portugal (all data from 2007). (21) The GDP levels are comparable at the beginning of observed period, however Greek GDP has accelerated its growth before the crisis of 2008.

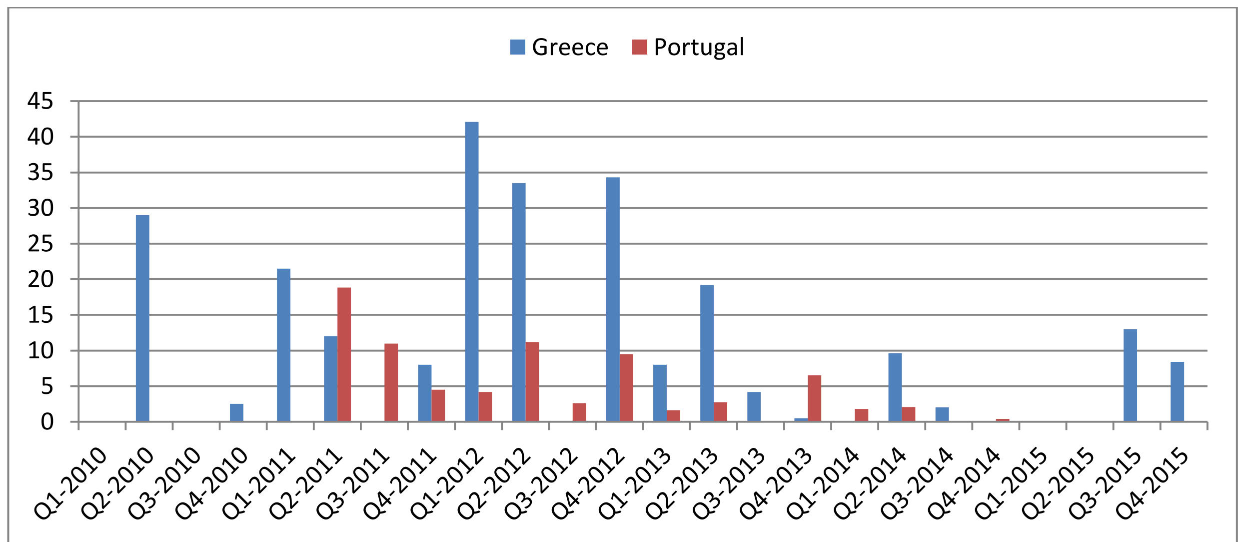
Graph 10 – Greece and Portugal, Comparison of GDP



(Source: World Economic Outlook Database, IMF)

As can be seen from graph 11, the amounts disbursed to each country differ significantly. With the total financial assistance disbursed so far to Greece being about 250 bil. EUR and Portugal with 76, 93 bil. EUR., the assistance to Greece equals about three times the Portuguese.

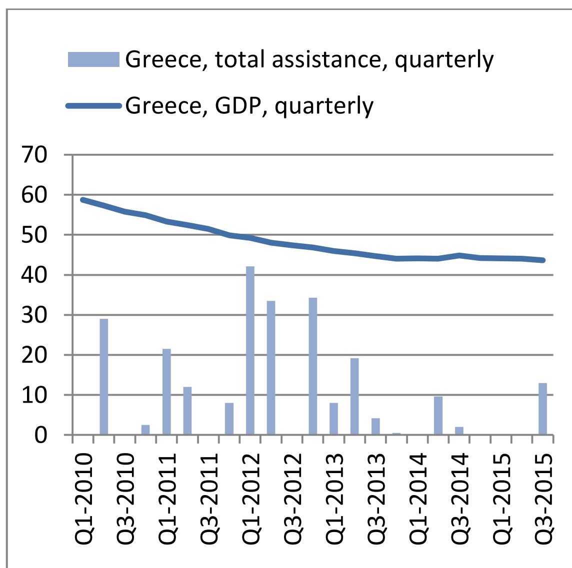
Graph 11 – Greece and Portugal, Total financial assistance disbursed, bil. EUR

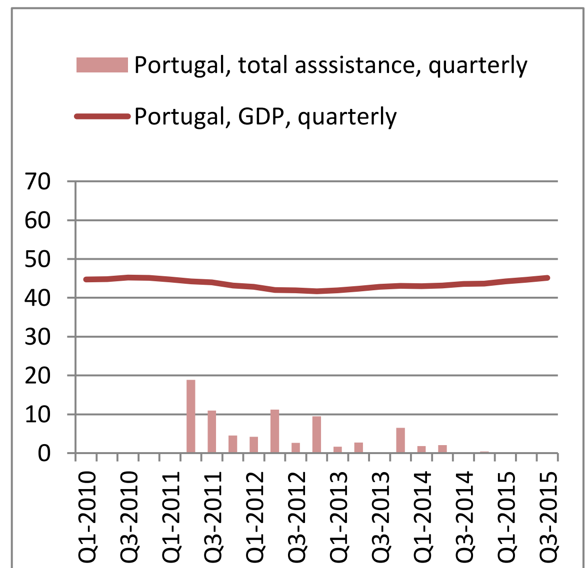


(Source: own processing)

The graph 12 compares Greek and Portuguese financial aid in comparison to country's GDP. It shows the significance of loaned amount in country's economy. Though the GDP values are comparable (at the end of observed period, Greek quarterly GDP equalled 45 bil. EUR, amount similar to GDP of Portugal in the same period), the value of financial assistance is significantly higher in the case of Greece.

Graph 12 – Greece and Portugal, Comparison of GDP to financial assistance amount, in bil. EUR





(Source: own processing; data from OECD.Stat. OECD)

5.3 Aims of Economic Adjustment Programmes

Following chapter lists the aims of the Economic Adjustment Programmes, as stated by the lenders.

Portugal - Aims of the assistance

According to European Commission, the main aims of the financial assistance were as follows:

1. **Fiscal consolidation**

Fiscal consolidation strategy aimed to restore investor confidence via consolidating public finances. (23) An initial Commission paper on Economic Adjustment Programme for Portugal from 2011 says that an aim of the programme is to to "put fiscal policy on a sustainable footing". (24) Therefore, it sets one of its aims at "setting the debt-to-GDP ratio on a downward path from 2013 onwards." (24)

This aim was to be reached by introducing measures of two aims: measures for raising revenues and measures for reducing expenditures; however, the reducing of expenses was a priority. (24)

2. **Stabilisation of the financial sector**

This goal aims to further restoring of market confidence. Its aim is to reduce the reliance on external financing. Higher liquidity and solvency was supposed to be reached by higher capital adequacy ratios and a solvency support fund. Additional aims include the unwinding of BPN bank and a reinforcement of the supervisory and regulatory framework. (24)

3. **Reducing external and internal imbalances to raise potential growth** (24)

This aim comprises all structural reforms to proper functioning of factor and product markets. The measures were to include:

- reform of the labour market,
- reinforcement of competition,
- a review of the judicial system,
- housing and rental market reform,
- liberalisation in services sector and network industries,
- reducing the administrative burden on companies,
- scaling down the direct involvement of government in the economy,
- strengthening human capital via further reform of the education system. (24)

Greece - Aims of the assistance

Aims for Greek Economic Adjustment programme were split as follows:

1. **Short-term:**

Fiscal consolidation

The aim of fiscal consolidation was to contain government's financing needs and to regain confidence on markets; same as in the case of Portugal, consolidation was primarily supposed to be based on savings in public expenditures, and secondarily on raising revenues. This also includes measures to maintain durability of the adjustments – they were supposed to be "locked" until 2012. Major part of reforms was therefore supposed to be aimed at the public administration, corruption and tax evasion. (22)

Financial sector consolidation

Also, financial sector policies were about to be introduced – to improve liquidity condition in Greek banking system. "In order to avoid deposit outflows, credible measures and good communication are needed to provide reassurance on the stability of the system. In parallel, it will be important to strengthen monitoring of liquidity and asset quality (including nonperforming loans), with a view to preventing problems in individual banks." (22)

2. **Medium-term: improvement of external competitiveness**

The economy was expected to be transformed into a growth model driven by exports and investments, areas, in which Greece was falling behind significantly. Main aim is to restore the economic growth. (22)

Also, reforms were suggested to modernize the public sector, increase efficiency of markets (especially labour and product) and ensure ease of doing business.

3. **Long-term: restoring Greece's credibility for private investors**

According to European Commission report from 2010, Greece has a history of unreliable fiscal and macroeconomic statistics reporting, and poor delivery on commitments. Investor trust is therefore one of main issues in current Greek state of economy. Therefore, goal is to improve the credibility by corrected data reporting and good policy implementation. The report sets this condition as crucial to long-term success of the Adjustment Programme, since "Greece will need to raise some EUR 60 billion in financial markets both in 2014 and in 2015 – after the end of the programme – to finance its public sector deficits, roll over its debt and also repay maturing liabilities to euro-area partners and the IMF" (22)

General aims connected to debt accumulation

For the purpose of analysis of effects of the financial assistance on the beneficiary countries' debt situation, a relevant goal is the fiscal consolidation, common for both countries. This goal is further specified by the Commission as reaching the following aims:

A) Output recovery gaining momentum
B) Government bonds at pre-crisis yields
C) Substantial fiscal adjustment
D) Sustainable public debt (23)

5.4 Macroeconomic development of Greece and Portugal during financial assistance

This part focuses on development of macroeconomic indicators connected to the debt accumulation. These indicators are connected to fulfilling the first aim of both Economic Adjustment Programmes.

GDP development

As can be seen from the following graph, at the beginning of observed period, Greece was already experiencing a fall in GDP, which has persisted through the whole first phase of the Economic Adjustment Programme.

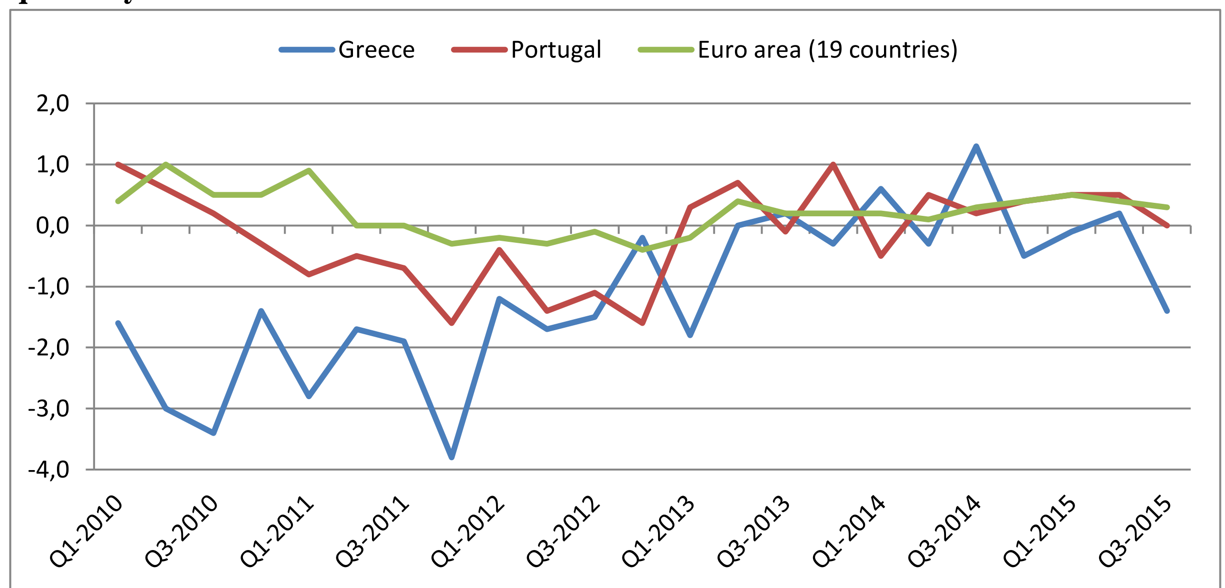
In late 2011, however, a negative rate of GDP growth occurred in the whole Euro area. This contraction of the economic output had severe effect on both Greece (negative economic quarterly growth reaching the value of -3,8%) and Portugal (where the change equalled -1,6%, mainly due to more stable economy, compared to Greece). This strong fall has occurred in time when the average change in GDP in Euro area was only -0,2%. (20)

This negative growth was also one of the reasons why Greece asked for a second Economic Adjustment Programme, which has started in 2012.

In 2013, the data show that a general growth tendency combined with the financial assistance has pulled GDP growth of Portugal to positive values, however yet very fragile (fluctuation between -0,1% and 0,7%). In 2014, this growth has stabilised around 0,3%, and Portugal has exited the financial assistance programme without the disbursement of last tranche prepared. (20) GDP growth equalling the GDP growth of Euro area states is quoted by European Commission as one of main achievements of the financial assistance programme. (23)

However, Greece was not so successful in returning to economic growth. Although a certain improvement in terms of lowering the negative GDP can be seen in years 2013 and 2014, the GDP change still fluctuates around zero and, recently, it shows a downward shift of -1,4%, lowest value since first quarter of 2013. According to the European Commission, this has occurred mainly due to weaker implementation of agreed reforms in year 2014. (27)

Graph 13 – Greece, Portugal and Euro area, Comparison of GDP change in %, quarterly



(Source: own processing; data from OECD.Stat. OECD)

Interest rates development

As can be seen from the graph below, Portugal's interest rates show a strong degree of conversion towards Euro area average values; however, spiking interest rates have remained to be a large problem of Greece.

Throughout the period of financial assistance, Portugal has managed to converge its interest rates towards the average of Euro area; from an all-time high (since the entry to Eurozone) of 13,9% in beginning of 2012 to less than 5% at the end of the financial assistance period. This has created a possibility for Portugal to further fund its deficits from borrowing at market for a reasonable cost, and therefore cut its dependency on financial assistance lending.

On the other hand, the development of interest rates in Greece was much less predictable and with many more spikes and falls, and rather less satisfying outcome. The steady rise in interest rates accelerated into steep growth after Euro summit in late October 2011, which approved of the rumoured debt restructuring in beginning of 2012. This restructuring suggestion involved a "50% nominal discount on notional Greek debt held by private investors", and prolonging the maturity of bonds. (28) This move, realized in February 2012, has relieved Greece of the most pressing obligations and helped to cut its debt by significant amount (see graph – 15 government consolidated gross debt), however the uncertainty preceding this step as well as political breakdown in Greek government (prime minister stepping down in November 2011 and preliminary elections announced for May 2012) has sent interest rates up to 29,24% in February 2012.

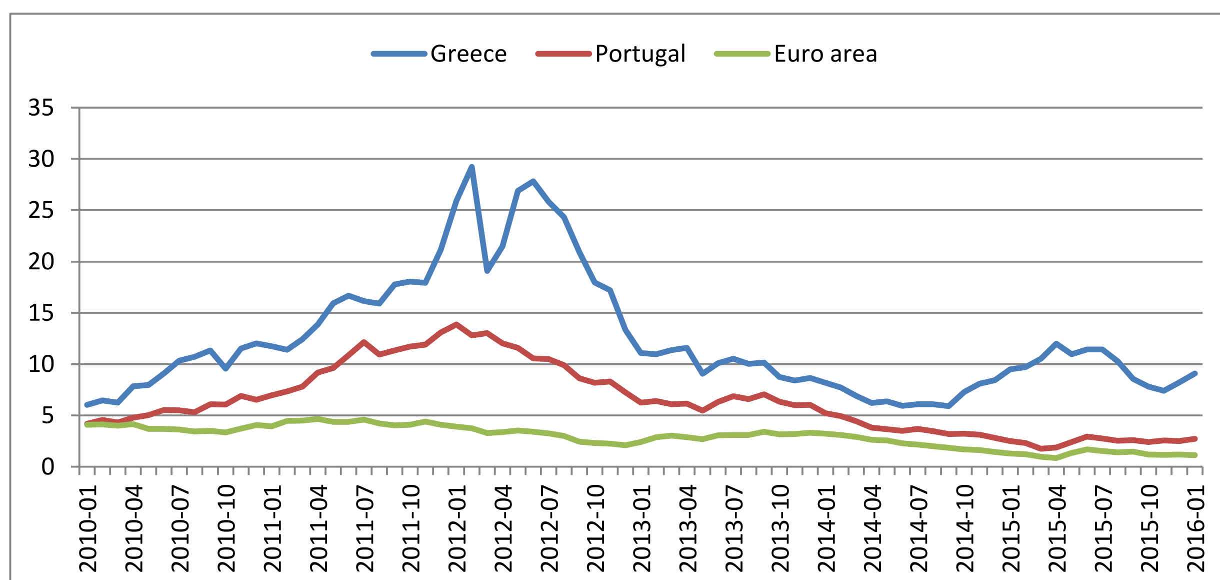
The following months were marked with great instability, both political and economic. The restructuring carried out in February 2012 (29) together with start of new Economic Adjustment Programme in early March seemed to calm the investors, with sudden drop of rates to 19%.

Unfortunately, political situation in Greece remained difficult and the elections in May 2012 resulted in unsuccessful trial to form a government, therefore another round of elections had to be carried out in June 2012. As can be seen from the graph, the interest rates have been spiking during this period of political instability.

Later, after second snap elections in June 2012, the government was assembled with a pro – austerity coalition in power. This political stabilization and the continuing Economic Adjustment Programme have together had a positive impact on rates, during second half of 2012, when they fell from 28% to 11%, and further continued to align themselves towards the interest rates of the EA.

However, this positive trend was broken in third quarter of 2014, when the government stepped down and new premature elections were called for January 2015. At the same time, the payments from the Economic Adjustment Programme were stopped for three quarters (Q4 2014, Q1 2015, Q2 2015) until the new government was established and the conditions for assistance could be renegotiated (same period when the GDP growth fell from 1,3% to -0,5% and never really recovered so far). In 2015, the interest rates spiked up to 12%, probably as a reaction of investors towards rather reluctant introduction of reforms conditioning further financial assistance. (27) The fact that a third Economic Adjustment Programme was negotiated in July 2015 (starting August 2015) probably helped to bring the rates down in the end of 2015, however the bond yield on government bonds is still far from stable and is expected to evolve in next months.

Graph 14 – Greece, Portugal and Euro area, Comparison of long term interest rate on government bonds, 10 years maturity, denomination in EUR



(Source: Data Warehouse, ECB; OECD.Stat, OECD)

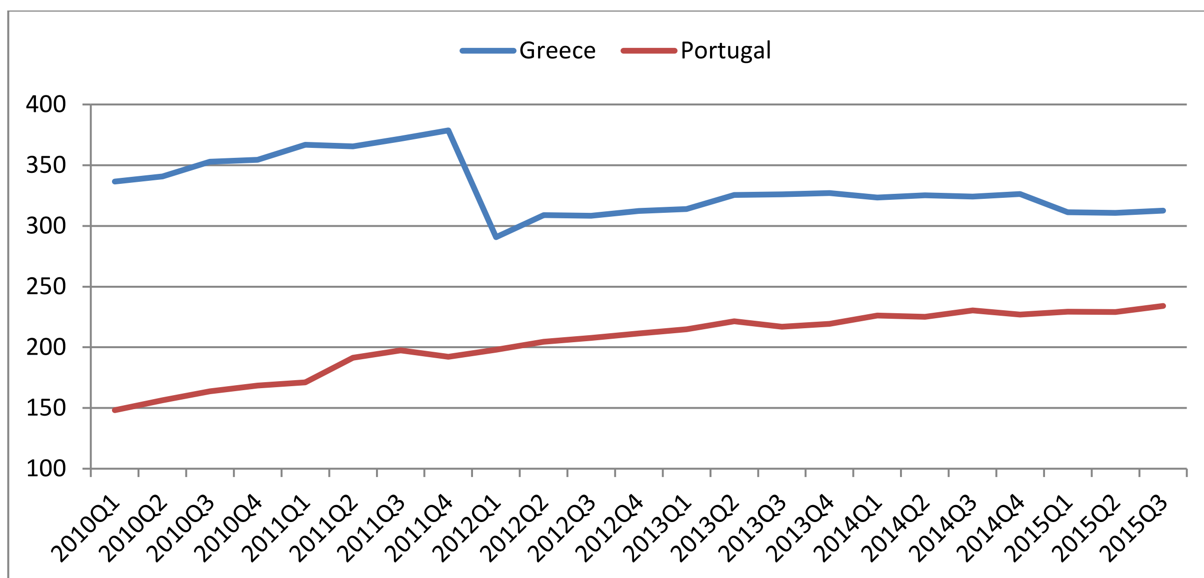
Government debt development

The comparison of debt accumulation in both Greece and Portugal shows another persisting issue. Graph 15 shows the total accumulated debt of both countries.

Portugal struggles with accumulating debt throughout the whole period of financial assistance, as well as after exiting the assistance programme.

Graph of Greek debt shows a significant fall in total debt amount after the February 2012 debt restructuring – from 378,7 bil EUR the debt fell by 23% to 290,7 bil. EUR. (18)

Graph 15 – Greece and Portugal, Comparison of government consolidated gross debt, central government, in bil. EUR

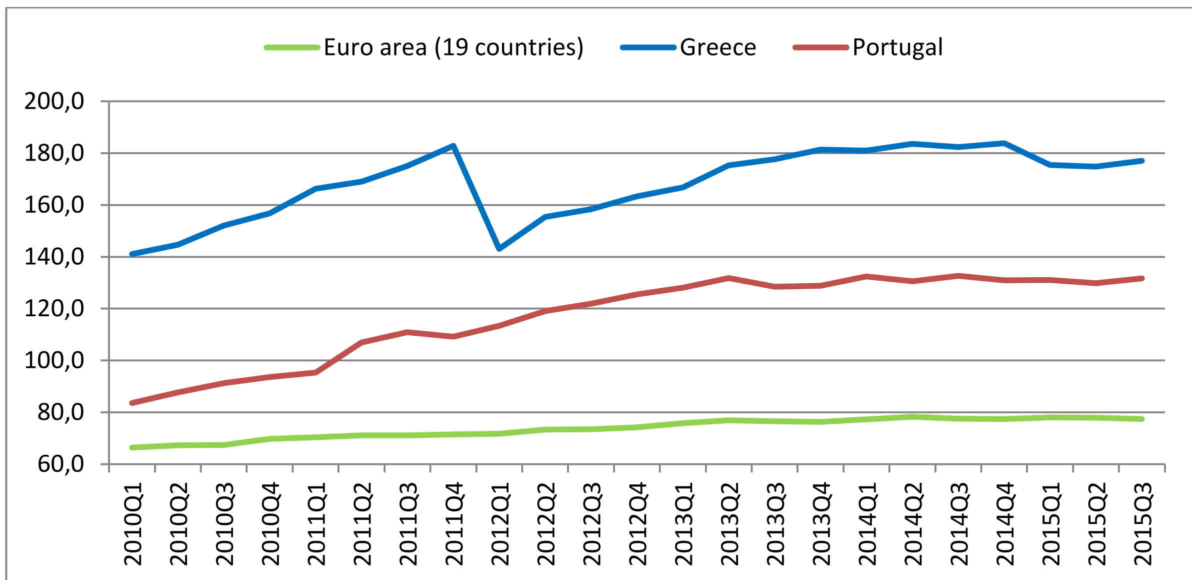


(Source: Eurostat Database, European Commission)

However, the true gravity of Greek debt is shown in comparison of debt-to-GDP ratios. While Portugal holds about the same slope as in the data above, Greek data show much steeper slope of debt-to-GDP ratio development, mainly due to contraction of Greek GDP in last year, which have, together with accumulation of new debt, effectively erased the effect of the debt restructuring in the debt-to-GDP ratio. The persistent negative rates of GDP growth combined with slowly, yet steadily rising debt might prove a large problem for Greece in the future.

It is notable that compared to Euro area, both of the countries still accumulate the debt-to-GDP in a faster pace.

Graph 16 – Greece and Portugal, Government consolidated gross debt, central government, % of gross domestic product



(Source: Eurostat Database, European Commission)

Fiscal development

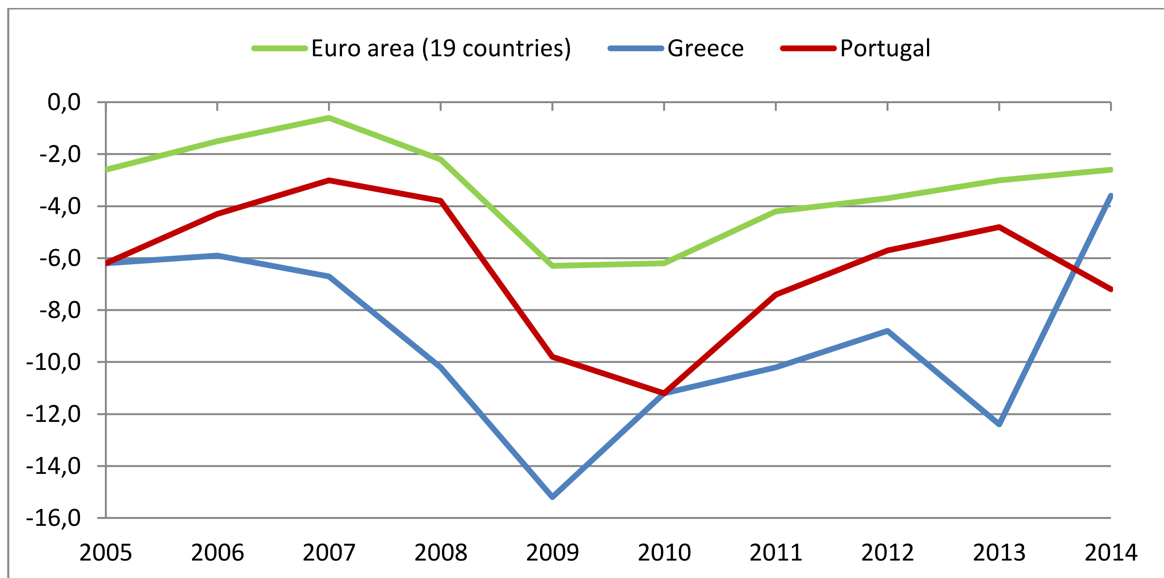
Following graph shows the fiscal development through last ten years. Both countries have entered the year 2010 with a substantial fiscal deficit as a result of higher government expenditure due to negative effects of the financial crisis on their economies (as was the case of other Euro area countries, as the graph shows a significant rise in deficit in years 2009-2010).

However, graph also shows that for Greece, as stated before, the large fiscal deficit is a long-term issue; the fiscal deficit has been rising steadily since 2006, even in a time of economic recovery and low deficits in Euro area. Therefore, the fall in 2008 – 2009 was much harder for Greece, and even after that, the rate of fiscal deficits is extremely unstable – Greece has been introducing austerity measures in waves since 2010, however, their result is rather dubious. 2013 has proven that Greek budget is still far from being balanced (growth of deficit from already high 8,8% of the GDP to 12,4%). (18)

For Portugal, the fiscal adjustment during the Economic Adjustment Programme has been substantial – its fiscal deficit has shrunk significantly. Though a similar trend is observable through the whole euro area (mainly due to the return towards growth in the after – crisis

years), Portuguese fiscal deficit has shrunk slightly faster. However, his positive trend has been broken in the year 2014, where the deficit grew significantly (from 4,8% to 7,2%). (18) At the time of data collection, the real results for 2015 were not yet known, however keeping this trend could mean a significant issue for recovering Portuguese economy.

Graph 17 – Portugal, Greece and the Euro area, Comparison of fiscal deficit, in % of GDP



(Source: Eurostat Database, European Commission)

5.5 Results of the assistance and its effects on debt accumulation

Portugal

End of aid

Portugal has exited its Economic Adjustment Programme three years after its start – in November 2014. (26) A total of 76,93 bil. EUR was disbursed to Portugal under the programme.

Economic result of the aid – reaching the aims?

The economic adjustment programme for Portugal is perceived by its participants as success. While it is true that the economic situation has developed during the course of financial aid and certain indicators improved, Portugal still struggles with issues.

Following is a comparison of points, which European Commission points out as goals – mostly successfully reached - in its assessment of the financial assistance programme for Portugal, and trends that the data sets used for previous chapter actually show.

The European Commission states the main achievements connected to debt accumulation as following:

A) Output recovery gaining momentum – according to EC, the real GDP growth has converged towards the Euro area average (23)

This might have been true for year 2014, when the EC assessment was publish, but, as seen in chapter 5, Portuguese GDP has slowed down its growth in 2015, and shows signs that the positive growth acceleration might not have been as stable as perceived at first.

B) Government bonds at pre-crisis yields – financing costs have been reduced in recent issuances (23)

So far, it seems that the consolidation was a success – investors seem to show confidence in Portugal, and the yields have actually fallen below the pre-crisis levels (2,45% for a government bond with 10 years maturity in Q3 of 2015). Of course, the overall low interest rates in Europe have had its influence, yet comparison with Greece shows that Portugal was actually successful in gaining investors trust.

C) Fiscal adjustment has been substantial (23)

To prove this point, EC in the assessment shows the development of fiscal deficit as % of GDP. However, as can be seen from graph 17, the positive trend has been broken by real results of the year 2014 (rather surprisingly, as predictions for year 2014 spoke of continuation in this trend). No real results are known so far of the year 2015, so it is not yet possible to say whether this rise in deficit is a fluctuation which will be evened out next year, or whether the deficit has set on the path of growth again.

D) Public debt high but sustainable (23)

Sustainability of the debt is a rather complex issue, which this a work of this extent cannot comprehend; however, during the period of Economic Adjustment Programme, the debt-to-GDP ratio has risen of 24% (from 106,9 to 130,95). This shows a very fast rate of debt accumulation, which may pose a threat to Portuguese public finance in the future – therefore a sustainability of the debt is a disputable matter.

The quoted assessment of Portuguese situation by the European commission says that "much (has been) achieved but challenges remain," (23) and that is a very apt summary of fiscal situation of Portugal. Main achievement is restoring investor's confidence, yet the fiscal results have much to achieve.

Current situation

Portugal is now under a post – programme surveillance by the European Commission and the European Central Bank. This surveillance will last until at least 75% of Portuguese debt is repaid – predicted at least until 2026. (26)

Under the post-programme surveillance, the European Commission and the European Central Bank "launch regular review missions to the Member State to analyse economic, fiscal and financial developments; and report semi-annual assessments which may recommend further measures when necessary". (26)

Outlook

According to an assessment of situation in Portugal by the OECD, the country is expected to return to economic growth; the economic recovery is expected to continue in 2016 as well as in 2017. (30) However, the OEDC assessment underlines the need of further

additional efforts; the necessity to public debt on a declining path and boost competitiveness.

Greece

State of aid

Greece is still under third Economic Adjustment Programme, planned until August 2018. So far, 247,8 bil. EUR have been loaned to Greece in forms of "packages", and at least 63 bil. EUR more is promised, given that Greece complies with the macroeconomic conditionality of the programme . Also, an offer for further assistance from IMF is still in negotiations at the time of writing this work.

Economic result of the aid - reaching the aims?

As the financial assistance is still in progress and a new, third round has been negotiated recently, it is safe to say that all the aims have not been reached so far.

Following is a comparison with goals stated by EC as key:

A) Output recovery gaining momentum

Greek GDP has, during the period of financial assistance, lowered the rate of its contraction. However, to speak of any "momentum" would be very optimistic; the growth rate of GDP oscillated around zero in years 2013 and 2014, and in recent data, it seems to have returned to negative values. The GDP growth development seems to be rather unstable and unpredictable.

B) Government bonds at pre-crisis yields – financing costs reduction

As can be seen from the data, the bond yields have in last year risen to amount more than twice compared to the average interest rate in Euro area.

C) Substantial fiscal adjustment

The fiscal deficit seems to be one area in which the Greek results from 2014 are surprisingly good – by application of austerity measures, Greece has managed to contract their fiscal deficit to value which is lowest since beginning of the financial crisis in 2008. Since the official data for 2015 are inaccessible so far, it is difficult to say if this trend will be sustainable, or not.

D) Sustainable public debt

Greek public debt has, during the period of financial assistance, fallen in total numbers (from the maximum of 378 bil. EUR in 2011 to 312 bil. EUR by the end of 2015). However, the debt-to-GDP ratio shows that the actual debt burden in the economy has risen – as the GDP of Greece fell down, the debt ratio has risen considerably. Therefore, the Greek debt cannot be described as sustainable.

Current situation

Currently, Greece is undergoing a third round of economic Adjustment Programme, while the final decision about the total amount offered for financial aid from the IMF is still unknown. To end of 2015, Greece has received a total of 247,8 bil. EUR of financial assistance , as a part of the Economic Adjustment Programmes.

Outlook

According to OECD, the confidence in Greece strengthens (though according to data this development is very slow). Greece has fallen back to negative GDP growth in the end of 2015, but it is expected to achieve some growth in late 2016. OECD stresses the importance of further efforts in poverty reduction, tax evasion reduction, and, most importantly, lowering the fiscal deficit. (31)

6. Conclusion

As can be seen from the results of this work, Portugal has reached certain improvements during the period of financial assistance. The results show a slow improvement in terms of economic output, as well as the interest rates on government bonds. Overall, Portugal is perceived to be slowly overcoming its debt issues, and mainly due to good implementation of reforms, it has gained investors' confidence. This has enabled Portugal to return to financial markets, free itself from the external financial assistance and to rely on its own financing capacity. Though it is still facing many challenges in terms of growth, debt-to-GDP ratio and total debt values, Portugal has quit the Economic Adjustment Programme on 12 November 2014 and currently is not expected to start another round of financial assistance.

Greece, on the other side, has not been able to permanently reverse the negative trends in any of the compared indicators during the observed period. Greek political instability and connected weak implementation of reforms (mainly in years 2014 and 2015) led to loss of investors' confidence; Greece has not been able to consolidate its public finance properly (high fluctuation od fiscal deficit) and mainly, Greek economic output has deteriorated significantly which in effect makes Greek debt-to-GDP ratio even more severe. Greece has so far entered a third round of the Economic Adjustment Programme, and is not expected to exit it in near future (the third round is planned until year 2018).

The results of this work confirm the ambiguity of the financial assistance concept, as the financial assistance to countries in need is a rather controversial measure. As can be seen from the development of countries described in this work, the financial assistance by itself does not seem to suffice to help the beneficiary country to overcome sovereign debt issues; the case of Portugal however shows that it may help to expand country's economic output, which may lead to lowering of fiscal deficit by increasing government revenues, and in medium and long term observation actually lead to lowering the debt burden. However, a set of well-designed reforms and its strict implementation is necessary. Also, restoring investors' confidence plays a major part in stabilization of the economic situation in the country.

The analysis also shows that financial assistance may be helpful for countries, which begin to experience debt issues as a result of strong recession or economic shocks. In that case, a

comparably lower value of assistance may bridge the period of inaccessibility to financial markets and may offer the beneficiary country a mean to finance its fiscal deficits in case of loss of access to financial markets (due to loss of investors' trust and high interest rates on its government bonds). This may, in turn, offer the beneficiary country time to consolidate its finance, while without the financial assistance it would be forced to default on its debt due to lack of funds.

However, it is not as effective in countries where debt issues are originating in long-term accumulation of debt and strong fiscal indiscipline in the form of steady high fiscal deficits. As in case of Greece, that despite a comparably higher value of financial assistance disbursed does not show signs of possible liberation of dependency on external assistance.

Further research possibilities

The author of this work acknowledges that due to the scope of this work, it was not possible to cover all aspects of given topic; many possibilities for further research remain open.

One of the possible further research topics is analysis of long-term data. The term observed in the analytical part of this thesis (from the beginning of financial aid 2010 until last data available in end of 2015) is rather short to draw any conclusion in the medium and long term horizon.

Another research possibility is to review effects of financial aid on other macroeconomic indicators not included in this work; the analysis of development of inflation, unemployment, and other indicators might show interesting relationships with the financial assistance.

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