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## “If you are in debt, you are not free”

This is the title of the book our former Prime Minister, Göran Persson, published in 1997 to explain how Sweden overcame its economic crisis. Now looking at sovereign debt levels in Greece, Portugal, and other industrial countries, as well as leveraged households in, for example, the US, the UK, and the Baltics, it is painfully clear to me that this message is still valid.

Budget consolidation and deleveraging are the words of the day. When help with debt restructuring and financial support to avoid default is coming, concessions have to be made. Welfare services are usually scaled down, taxes increased, and pensions cut. The political dimension is in focus. Populations prefer more welfare and lower taxes, not the opposite. The critique is often vociferous against governments that are committed to consolidating the budget. Usually, the IMF is not welcome, as concessions then seem to be enhanced. As there are no alternatives when financial markets have lost faith and expect default, there is little or no freedom to implement economic policies other than what creditors demand.

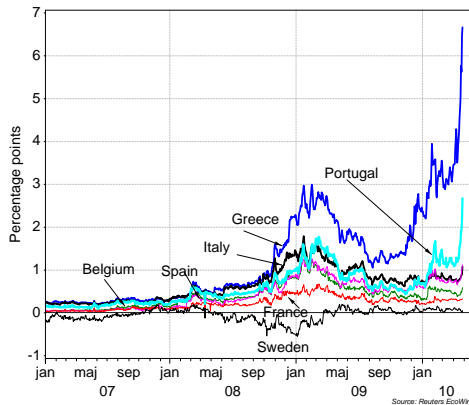
The length of time needed for a population and politicians to create crisis awareness differs among countries. In the Baltic countries, people understood the dimension of the crisis, and the program with creditors was on track soon. In Greece, it seems that it will take longer. A majority of the Greek population rejects help from IMF, and a third general strike is planned covering at least half of the labor force. As support for Greece has not been finalized in European parliaments – for example in Germany, which is the largest bilateral creditor – it is even more important for Greece to create consensus and stand behind the government in order to avoid a complete breakdown of the Greek economy, and also increased turbulence in Europe. There are some lessons learnt after a sovereign debt crisis:

- 1) There are seldom any quick fixes: the hard work of deleveraging must be carried out, even if it takes time.
- 2) Deleveraging presents a clear dilemma. It reduces growth and could even create a recession when public services are cut, taxes are increased, and costs come down (by even lowering nominal wages which seems difficult in many of the older EU-countries), thus lowering domestic demand. At the same time, the most important method to ease the burden of deleveraging is to enhance growth so that debt is reduced quicker. Managing the deleveraging process is demanding for politicians and central bankers, as there is a need to put on the brakes and hit the accelerators simultaneously. Without structural reforms that improve the functioning of markets (labour, products, financial, housing, etc.), the deleveraging process will take longer. And there is probably a phase in the beginning when the reforms will increase the pain before improving the growth outlook in the medium term. To explain this dilemma is a pedagogic challenge!

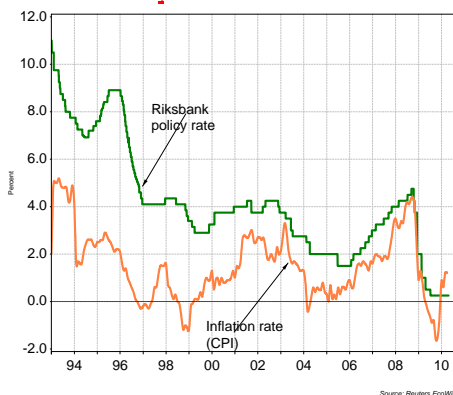
# To the Point (continued)

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**Chart 1: Interest rate spreads with Germany, 10 yr bonds 2007-2010**



**Chart 2: Policy interest rate and inflation rate in Sweden, 1993-2010**



- 3) The Baltic countries are moving from a phase of acute crisis to one of growth, even though we expect growth to be fragile for some time as domestic demand is depressed. We project that Estonia will show positive growth already this year, and that Latvia and Lithuania will follow suit next year. One of the carrots for the Baltics is membership in the EMU. Estonia is first in line, with a possible adoption of the euro in 2011. Even if membership holds many advantages for Estonia, and foreign investors, risks and challenges remain after joining EMU. Greece, which is already a member, does not have a carrot, but rather a stick to threaten it with being thrown out of the "Club." Greece has not taken advantage of being a member, and the lesson is that, with or without membership, it is the policies that are chosen and the work committed towards being competitive that counts.
- 4) It takes time to create confidence. Financial markets learn quickly if a country loses creditworthiness, but it takes longer to restore it. In Sweden, to regain confidence, policy rates were kept at a higher level than many thought reasonable, and, despite the introduction of an inflation target, it took time to convince financial markets that Sweden had reformed into a low-inflation economy. Hence, financial markets will for years be suspicious of Greek budget discipline.
- 5) Politicians' terms in office are often shorter than the time needed to implement and see the results from structural reforms. This reduces the incentive to undertake a reform agenda. During a crisis, there is the risk of being thrown out of office, resulting in new elections and more political instability. It is therefore good to create a platform for longer-term development discussions. In Denmark, establishment of a forum for globalisation issues seems to have been successful in creating a common understanding of policy needs. In Sweden, similar efforts have not been equally successful. One of the problems, perhaps, was insufficient government ownership. Also, perhaps, the government focused too much on how to finance reforms in the short run instead of looking at the long-term path towards change.
- 6) Taking advantage of the windows of opportunity open for reforms during and after a crisis is critical. Reforms are needed because globalisation is ongoing, and all countries, populations, companies, labour forces, etc., must be adaptable to external changes. Countries that have been in crises may – if they take it seriously – be better at implementing reforms. An open and small economy is wearing a golden straitjacket, and it has little or no freedom, except to adjust to the changes that occur. If implemented proactively, the reforms can harmonize with the ambitions of the majority of the people. However, if reforms are not undertaken while the window of opportunity is open, there is a risk of considerably less freedom.

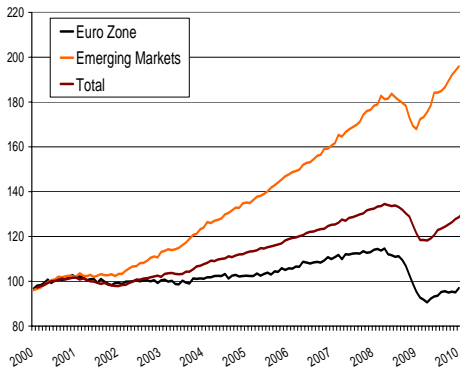
## In the decades to come: emerging markets rule

We expect growth in the global economy to reach almost 4% this year. This is not something the industrial countries should take credit for. Rather, the absolutely largest growth engines this year and in the years to come are the emerging markets. This is for several reasons:

# To the Point (continued)

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**Chart 3: Industrial production, total, Euro area and emerging markets, (index, 100=2000)**



Source: CPB, the Netherlands.

- 1) Potential growth rates are higher in Eastern Europe, Asia, Latin America, and Africa than in the industrial countries as these regions are starting from lower levels, have positive growth from the labour supply, and are enjoying greater productivity increases than industrial countries, which have already reached high development levels.
- 2) Private balance sheets in most of the emerging markets are sound, and the need for deleveraging among households and companies is not as large as in many of the industrial countries, which have fresh experiences of financial and property crises.
- 3) Public balance sheets in most emerging markets are also sounder than what they will be in a few years' time in industrial countries, when large budget deficits will have increased sovereign debt to levels that must be dealt with. Thus, going forward, domestic demand will not be as depressed in emerging markets as in industrial countries. In addition, governments of emerging markets have ample leeway to run expansionary fiscal and monetary policies (even if they have to watch out for overheating).
- 4) The financial sector is still in stress in many of the industrial countries, even if the IMF has revised downwards the scale of write-downs on loans and securities that banks would have to make 2007-2010 to \$2.3 trillion (from the earlier \$2.8 trillion). What is noticeable is that more than 90% of the total is forecast to belong to banks in the US and Europe, and only a small part to Asia. This means that the financial sector in Asia has advantages in supporting companies investing for expansion, compared with the financial sector in industrial countries, which is still in distress and in which companies have a lower demand for credits due to low capacity utilisation.

Globalisation continues, and the impact of emerging markets on global developments will only increase, especially from Asia but also from Latin America and Eastern Europe. Competition for companies operating in industrial countries will also be stronger, as well as for those that operate globally. This means that competition will increase for the labour force of industrial countries as well. The issue is no longer employment security, but rather the need to be employable. Education, different ways of increasing competence, the importance of being able to change jobs, sector and geographical location are aspects that will become more and more important for the labour force.

I don't think we are grasping the outcome of this crisis when it comes to the effects on structural adjustment and how it speeds the process up. Let us dig out the reports on globalisation and start over again, and let us move on with the deleveraging as fast as possible, because the alternative – to drag on, create turbulence, and slow the adjustment – is worse, and could cause stagnation for our next generations. Sounds fateful? Perhaps, but there is no time to lose, and, as the Chinese say: "When the wind rises, some people build walls; others build windmills."

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