Europe at a Crossroads:
Euro Area Crisis & the gradual Formation of a new Architecture

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Euro Area Crisis & the gradual Formation of a new Architecture

- Today's discussion will concentrate on the Euro Area crisis, specifically

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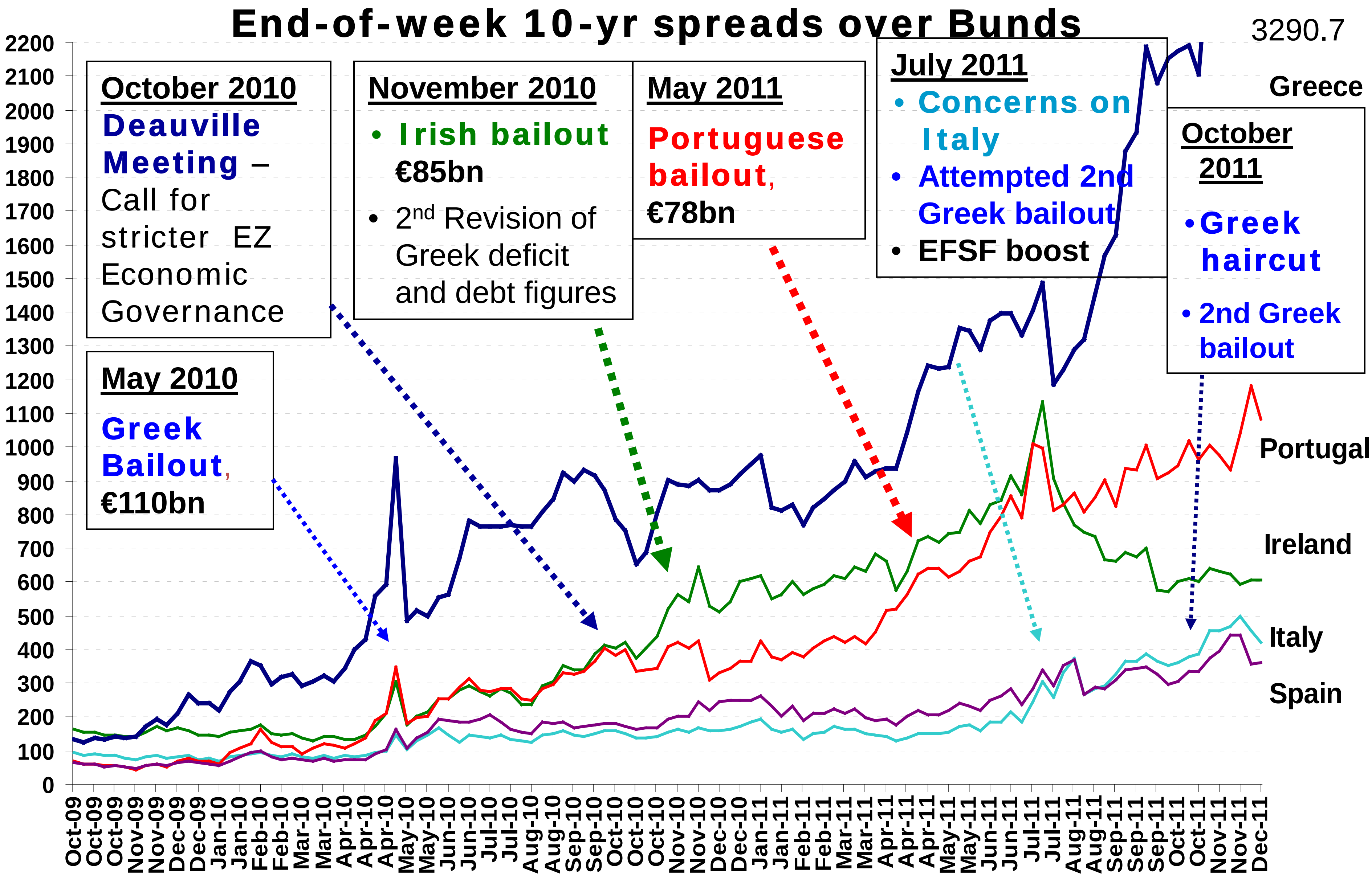

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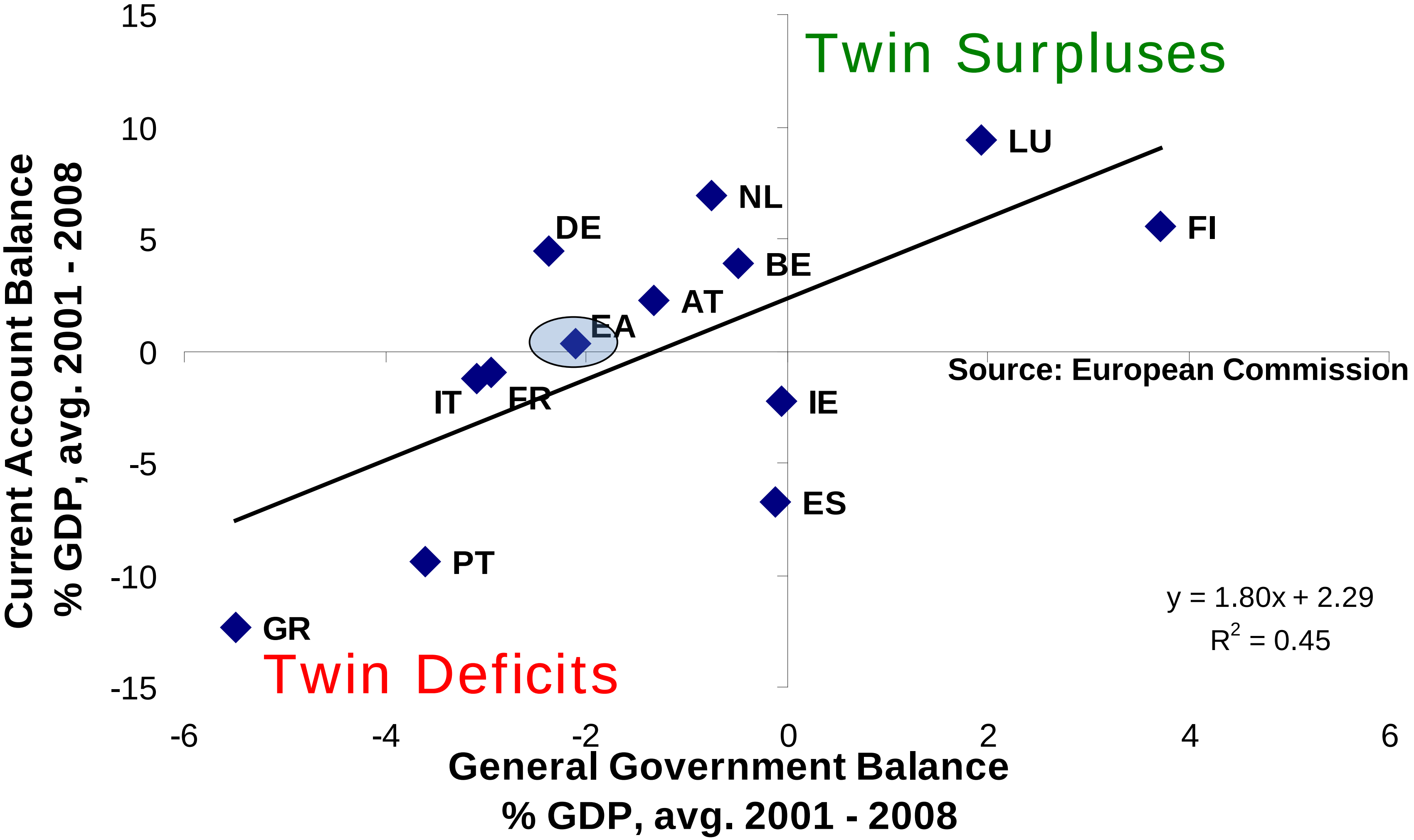
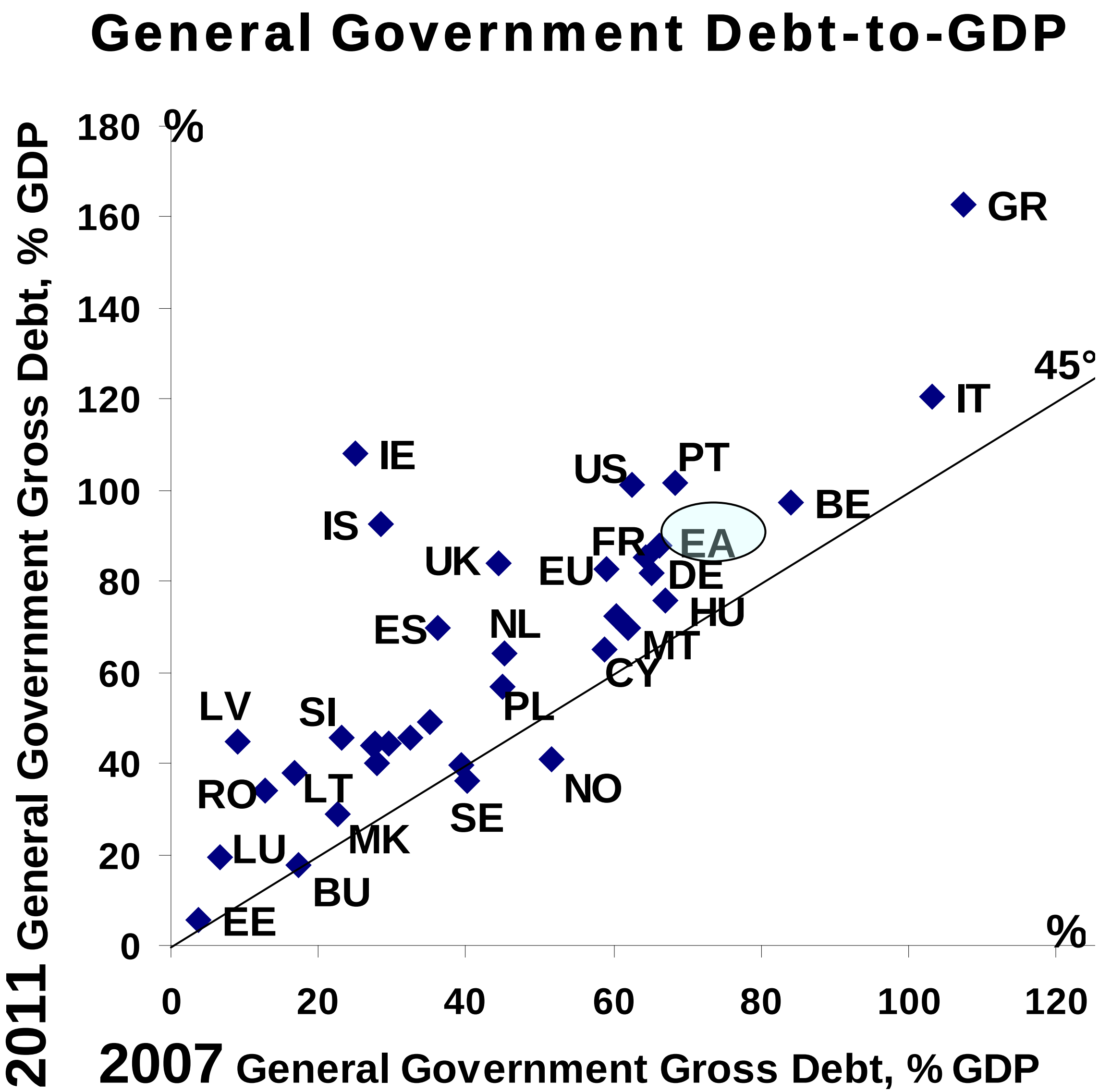
Source: Bloomberg

I. External and internal (fiscal) imbalances in the Euro Area

- ✓ **Uncompetitive South vs. competitive North**
- ✓ **Fiscal profligacy almost everywhere**



I. Public Debt: The Damoclean sword



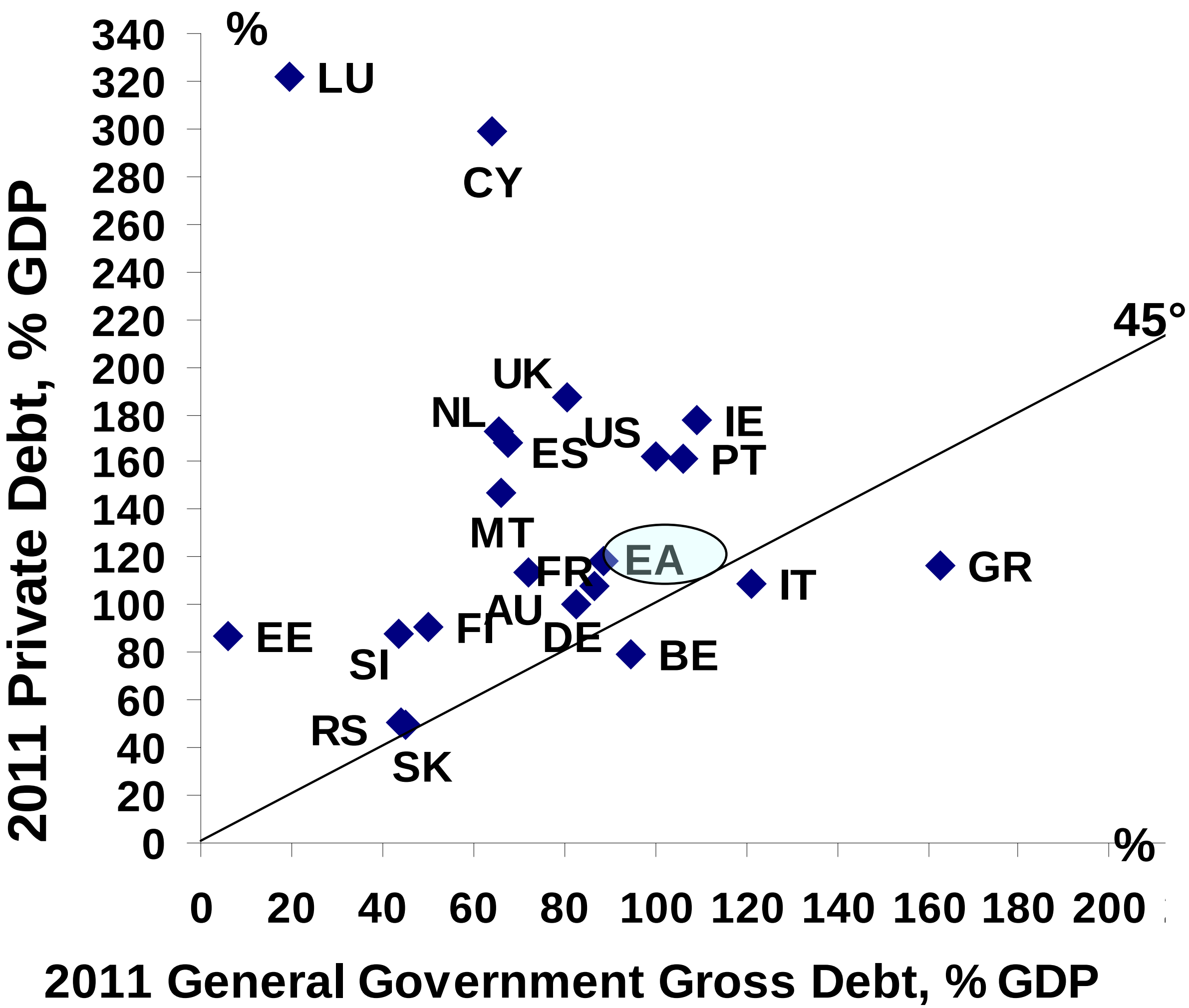
Source: EU

2011 GG Debt (€ bn)	
Portugal	174.5
Ireland	168.8
Italy	1,910.9
Spain	748.0
Greece	354.7
Belgium	360
Germany	2,098.6
France	1,697.1
UK	1,450.9

- ✓ **Debt Deterioration everywhere from 2007 to 2011**
- ✓ **Largest deterioration in Ireland**
- ✓ **EA showed smaller deterioration than US or UK**

I. Private Debt: The hidden Damoclean sword

Household & Corporate Debt-to-GDP in 2011



- ✓ EA Private debt higher than Public debt in 2011
- ✓ Most countries above the 45-degree line: Higher private than public debt
- ✓ Exceptions are Belgium, Italy & Greece, where Private debt is smaller than Public Debt

Source: EU, IMF, ECB, Federal Reserve, NBS

I. In sum, different Euro Area countries confronted with different challenges

✓ **IRELAND**

- ↓ Housing market
- ↓ Banks → rise of public debt
- ↓ High private debt

✓ **PORTUGAL**

- ↓ Low competitiveness
- ↓ Large fiscal deficits, but not debt
- ↓ High private debt

✓ **SPAIN**

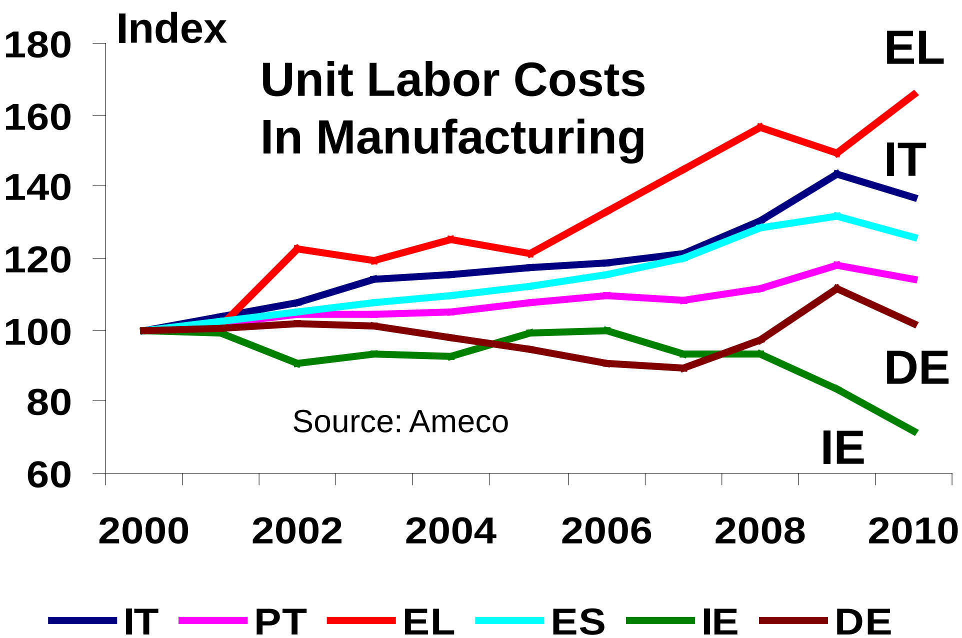
- ↓ Low competitiveness
- ↓ Housing market
- ↓ Small savings banks
- ↓ High private debt

GREECE

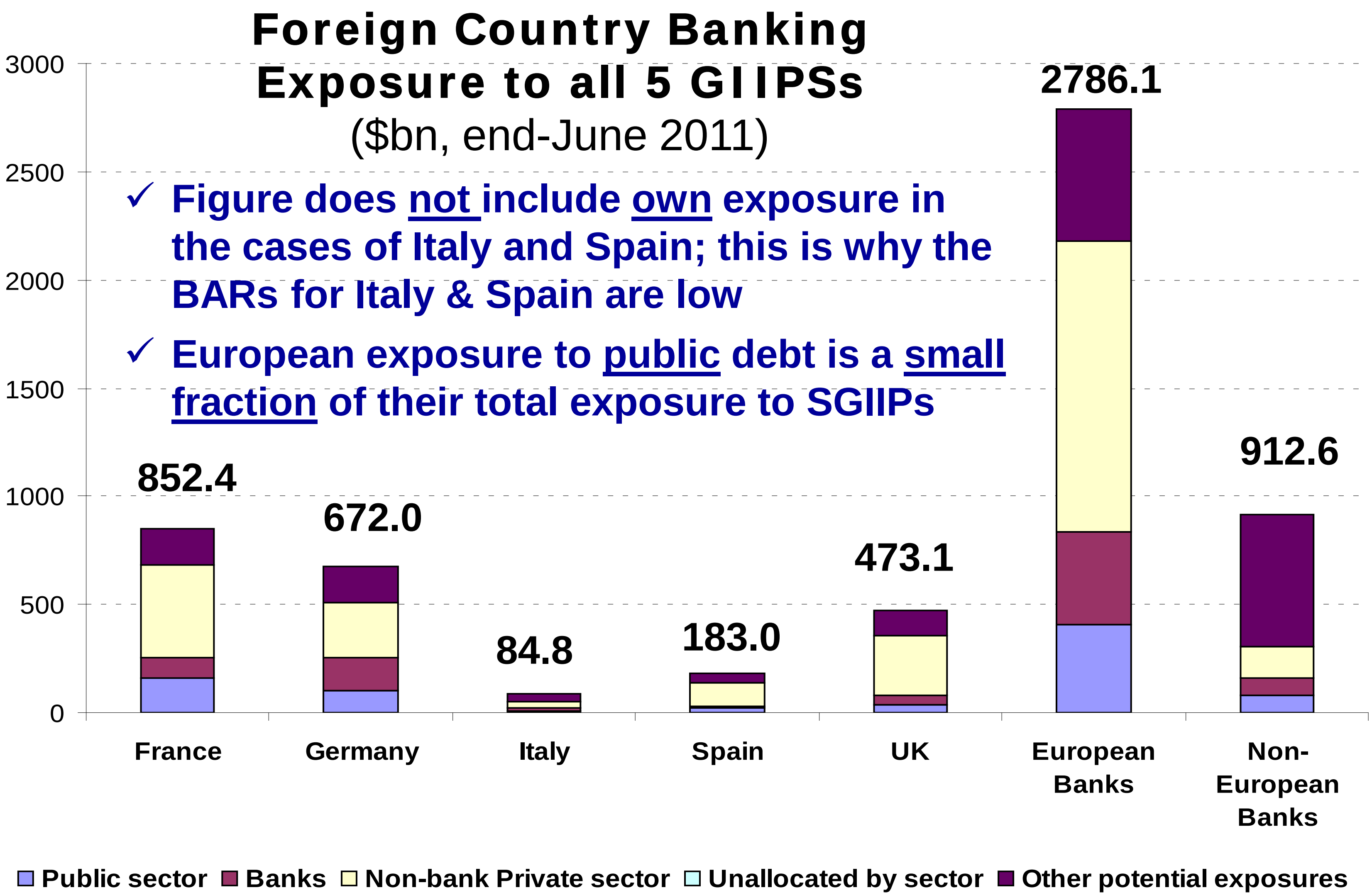
- ↓ Low competitiveness
- ↓ High fiscal deficits & debt

ITALY

- ↓ competitiveness
- ↓ High debt

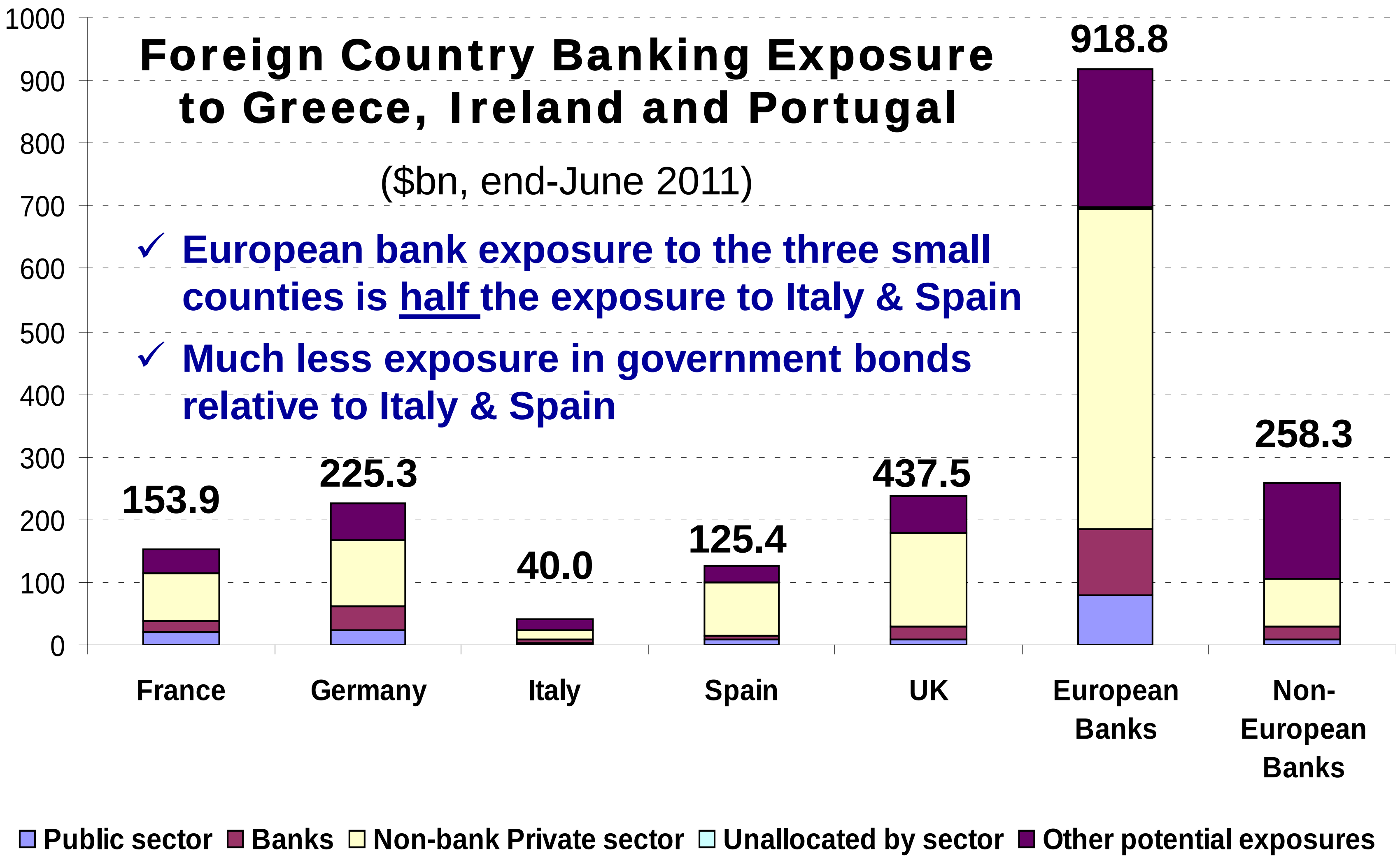


I. Debt crisis can easily turn into a banking crisis



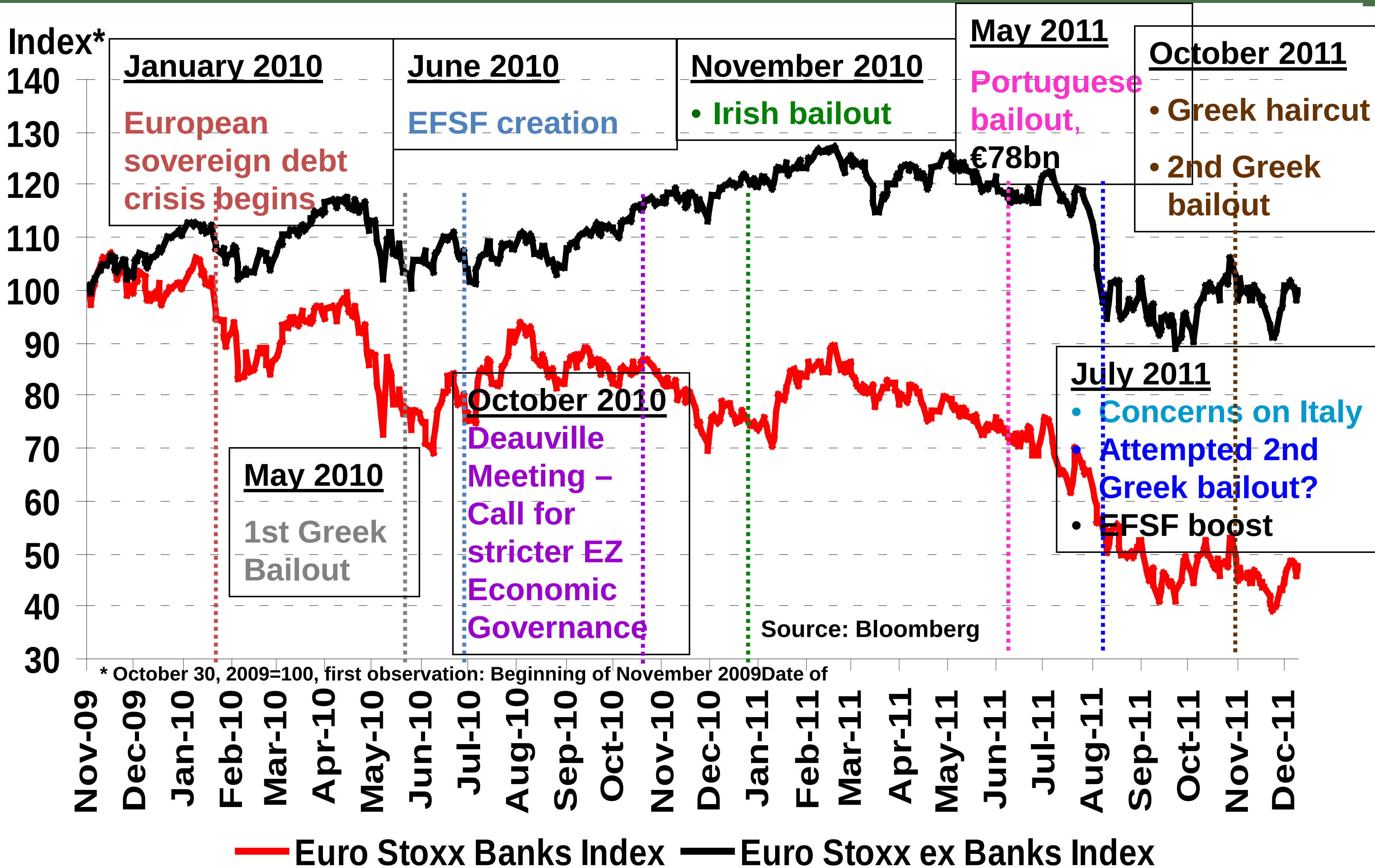
Source: BIS

I. Debt crisis can easily turn into a banking crisis



Source: BIS

I. Euro Area bank stocks distressed



Capital deficiency € 114.7 bn from (a) stress tests that mark-to-market sovereign bonds, and (b) increase in Core Tier I ratio to 9% from 7%

I. Gloomy forecasts for next year

✓ A recession in the Euro Area is likely, making the EU political landscape volatile and the Greek adjustment even more difficult

	Real GDP (% yoy)			Inflation (avg % yoy)			Current Account (% of GDP)			Gen.Budget Balance (% of GDP)		
	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012
GREECE	-3.5	-5.8	-3.2	4.7	2.9	1.5	-12.2	-9.9	-7.8	-10.8	-9.1	-5.4
USA	3.0	1.7	2.0	1.6	3.2	2.3	-3.2	-3.1	-2.9	-10.5	-10.0	-7.5
EURO AREA	1.9	1.5	0.0	1.6	2.7	1.9	-0.5	-0.6	-0.4	-6.2	-4.3	-3.5
UK	1.8	0.9	0.7	3.3	4.5	2.8	-2.5	-1.0	-0.8	-9.3	-8.2	-7.0
JAPAN	4.1	-0.5	1.9	-1.0	-0.2	-0.2	3.6	2.0	2.0	-9.2	-10.5	-10.0

II

I. Economics: Imbalances and Markets

II. Politics: What is the solution for the Euro Area?

II. Euro Area Crisis: Two problems to address

- ✓ Euro Area countries understand EMU dissolution is not an option: Implies huge costs in financing, in trade, in politics and the average European living standards

- ✓ The crisis revealed **two needs, not necessarily complementary**:

  1) **Need for actions to contain the crisis**

  2) **Need for a better long-run framework, which would ensure long-term stability of the euro**

- ✓ Euro Area has chosen to focus on redesigning its framework and ignored the need to contain the crisis, which has slowly grown larger and larger.

  - ❖ The new design, which comes ex-post with a 15-year lag, tends to inhibit actions that can counter the crisis but add to **moral hazard**

  - ❖ Example is the insistence on having the private sector participate in the losses; following the Deauville declaration in October 18 2010 and the declaration in April 2011, spreads widened and the crisis worsened

- ✓ Solving the crisis also proved hard as agreeing on how the share the loses is difficult among 17 nations with multiple political parties, powerful private groups, EU agencies fighting for turf (EU Commission, ECB), free riders, etc.

II. Correct sequence of policies was not followed

❖ **Most economists agree: *Crisis comes first, design issues later***

1) **Separate insolvent from illiquid countries**; Restructure the debt of insolvent and provide unlimited backing to illiquid ones; Urgent need to create a firewall around solvent governments.

2) **Shore up the capital base of European banks** to be able to withstand country defaults

   - ✓ IMF's discussion on the need to recapitalize European banks pinpoints the issue
   - ✓ Increasing core Tier I capital requirements to 9% from current 7% is **not prudent**

3) **Switch to an agenda of growth** from the current obsession with fiscal discipline

   - ✓ Possible need to follow the US example of handling the crisis; Meets strong German opposition as it increases moral hazard; Greece has no discretionary power

4) **Redesign the long-term EA framework** in a way that does not allow crises, implying change of treaties

   - ✓ The design effort on the new Euro Area architecture is along those lines

II. The decisions up to December 2011

The **Six-Pack**: Six legislative proposals on economic governance

1. Stronger preventive and corrective action to ensure fiscal sustainability
   - ❖ **Stronger preventive arm** (*Expenditure growth linked to the mid-term GDP growth rate, so that any extra expenditure is financed by either expenditure cuts or an increase in revenue*).
   - ❖ ***Better enforcement*** (*Recommendation for corrective action to the Member State. Recommendation adopted by the Council by qualified majority voting. Sanctions in the case of no compliance applied automatically except if the Council decides otherwise by using the reverse qualified majority rule).*
   - ❖ ***Excessive Deficit Procedure*** *(Stricter rules: open Excessive Deficit Procedure on the basis of the debt criterion, etc)*
   - ❖ ***National budgetary frameworks*** *(Enhanced fiscal reliability of the member states, multi-annual fiscal planning, adoption of fiscal rules, greater transparency with the provision of the necessary statistical data on central and general government as well as extra-budgetary bodies, government guarantees etc.)*
2. Reducing macro-economic imbalances and promoting competitiveness through preventive and corrective action
   - ❖ ***Early warning system*** *(alert system is established based on an economic reading of a scoreboard consisting of a set of indicators covering the major sources of macro-economic imbalances).*
   - ❖ ***Preventive and corrective action*** *(preventive recommendations from the Commission at an early stage before the imbalances become large, etc.)*
   - ❖ **Rigorous enforcement**

II. The decisions up to December 2011 (continued)

3. **<u>EU Council October 26, 2011</u>**

- For Greece
  - ✓ Voluntary nominal discount of 50% on notional Greek debt held by private investors, with EA contribution to the PSI package up to € 30 bn and a target DEBT/GDP 120% in 2020
  - ✓ a new EU-IMF programme of €100 bn
- leverage EFSF resources to yield up to € 1 tr
- increase Core Tier 1 capital ratio of banks to 9% by the end of June 2012 (*wrong policy, procyclical)*

4. **<u>EU Council December 8, 2011</u>**

- Longer Term
  - ✓ a new fiscal rule: annual structural deficit will not exceed 0.5% of GDP
  - ✓ fiscal rule in national legal systems at constitutional or equivalent level
  - ✓ automatic correction mechanism defined by each Member State on the basis of common principles
  - ✓ Court of Justice to verify the transposition of this rule at national level
  - ✓ ex ante reporting of national debt issuance plans
  - ✓ breach of the 3% deficit ceiling => automatic consequences unless a qualified majority is opposed
  - ✓ measures & sanctions proposed by the Commission will be adopted unless a qualified majority is opposed
  - ✓ benchmark for debt reduction (1/20 rule) for Member States with a government debt in excess of 60%
- Short-term measures to fight the crisis
  - ✓ acceleration of the entry into force of the ESM by July 2012
  - ✓ additional resources for the IMF of up to € 200 bn, in the form of bilateral loans
  - ✓ emergency ESM voting rules: a qualified majority of 85 % in case the EC and the ECB conclude that an urgent decision is needed

II. European politics summarized in four battle grounds

1) Solidarity & growth vs. discipline

- ❖ Hardliners insist on discipline; on ECB independence; have the upper hand today

2) Euro-ins vs. Euro-outs

- ❖ Treaty is for the EU-27, not the EA-17. UK objected to Treaty change
- ❖ Rules for the 17 may affect Internal Market rules
- ❖ The Euro-plus group has formed with Denmark, Latvia, Lithuania, Poland, Romania & Bulgaria; Hungary, Sweden, Czech Republic to consult their parliaments; UK out

3) Federalists vs. Inter-governmentalists

- ❖ Nationalists want the EU Council to take the decisions, as opposed to the EU Commission and the European Parliament; Inter-governmentalists have gained power since enlargement in 2004

4) National vs. Pooled sovereignty

- ❖ Will EA move towards a fiscal union? Markets are pushing them in that direction

II. Will the ECB mellow down?

ECB is the only large player that can confront the markets today

- ECB intervened to stabilize banking system, hence constrained Sudden Stop in Periphery
- Yet, ECB resists implicit fiscal role -> not a lender of last resort; not as aggressive as the Fed
- Draghi recently Insisted on a "EU fiscal compact"

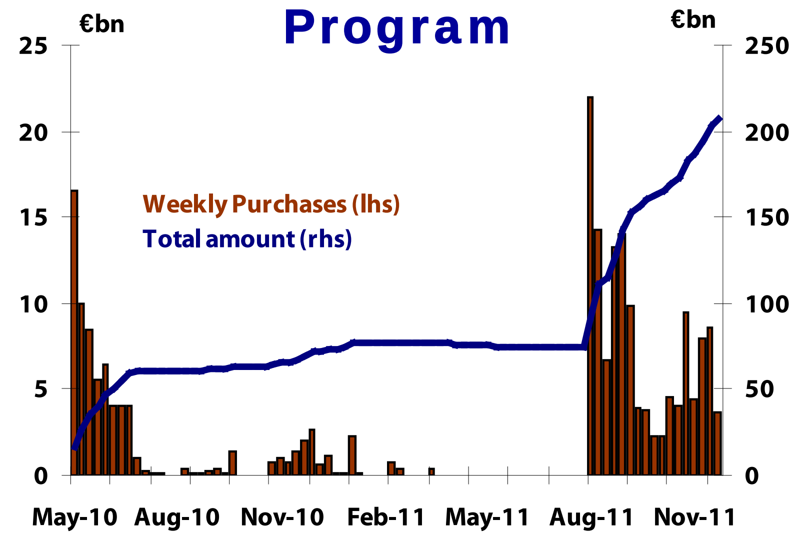
	EA			Greece		
	a	b	c	a*	b	c
Jun-07	464.6	28,026	1.7	4.3	353.0	1.2
Dec-07	637.1	29,494	2.2	8.8	391.3	2.2
Jun-08	483.0	30,839	1.6	11.6	424.5	2.7
Dec-08	843.2	31,831	2.6	40.6	464.5	8.7
Jun-09	896.8	31,804	2.8	54.0	490.6	11.0
Dec-09	728.6	31,144	2.3	49.7	491.9	10.1
Jun-10	870.4	32,578	2.7	94.3	543.2	17.4
Dec-10	546.7	32,200	1.7	97.8	514.1	19.0
Jun-11	497.5	31,743	1.6	103.1	503.2	20.5
Oct-11	596.4	33,538	1.8	111.1	483.4	23.0

* plus lending from the BoG through ELA

(a) Total Lending from the ECB (€bn)
(b) Total Banks Assets (€bn)
(c) % ratio a/b

Bank Borrowing from the ECB

The nuclear option: Securities Market Program



II. Greece: Tough road ahead as crisis was not contained early on

- ✓ Greece grew fast from 1994 to 2007 but the growth was imbalanced
  - ❖ Loss of Competitiveness led to an external disequilibrium
  - ❖ Fiscal laxity led to the current debt problem
- ✓ The Greek economy is in a deep recession with no clear sign of recovery, causing popular anger
  - ❖ Political risk clouds the picture ahead
  - ❖ the new recovery date of 2013 in the Troika Program is conditional on political stability and reforms being implemented soon
- ✓ Momentum for reforms fizzled away after the first 5 months of the Stabilization Program. Now, they have to be fully implemented.
- ✓ A Brady-bond solution to Greek sovereign debt would have been first best

II. Elements of a Greek strategy forward

- Political consensus and MoU ownership required on a Long-Term Growth Strategy that builds credibility
- Follow an export-led paradigm of growth (to replace the failed consumption-led one) based on price- and quality-competitiveness, support a switch from non-tradeables to tradeables sectors
- This strategy implies:
  - ✓ Emphasis on capturing tax evasion and increasing revenues without raising marginal tax rates
  - ✓ Reduce public consumption expenditure by shrinking redundant agencies
  - ✓ Privatizations should not be viewed exclusively as cash machines, but as a way to improve public sector efficiency and bring FDI
  - ✓ Improve absorption of Cohesion Funds, PPPs, stabilize business sentiment, stabilize tax regime, simplify legislation
  - ✓ Be more aggressive with special interest groups that extract economic rents, reduce bureaucratic cost to business, open-up markets and closed professions, emphasize education and R&D
  - ✓ Switch the allocation of public spending away from consumption and military towards Public Investment and Education

Concluding remarks

- The Euro Area is busy for two years fixing its architecture, avoiding a fiscal union, but strengthening
  - ✓ the harmonization of fiscal and competitiveness policies
  - ✓ the regulation and supervision of its financial sector
- Yet markets have anything but calmed, with the crisis mushrooming. Actions required to resolve the crisis tend to increase moral hazard and contradict the long-term optimal EMU design.
- Deauville decisions since October 2010 worsened crisis; withdrawn today
- After the crisis hit Italy in August 2011, the hardliners in Europe realized they had to switch priorities. This is evident in the October EU Council decisions, which provide for a 50% Greek haircut, a stronger – more levered - EFSF and a recapitalization of European banks
- Ireland and Portugal seem to manage the crisis thus far, while Italy began to take the required austerity actions under a new technocratic government
- Greece is in a graver spot, with the largest debt: After an initial strong reform momentum that lasted five months, the implementation of reforms stalled; "Ownership" of the Reform Program – a necessary condition for success, according to IMF's experience – was never attempted
- The October 27, 2011 EU Council decisions improve Greek debt sustainability
- Greece's survival is essential for Euro Area survival even if European banks are ring fenced from a Greek default; contagion is always present