NIESR

Nothing ventured nothing gained: Identifying and managing risk in today’s world

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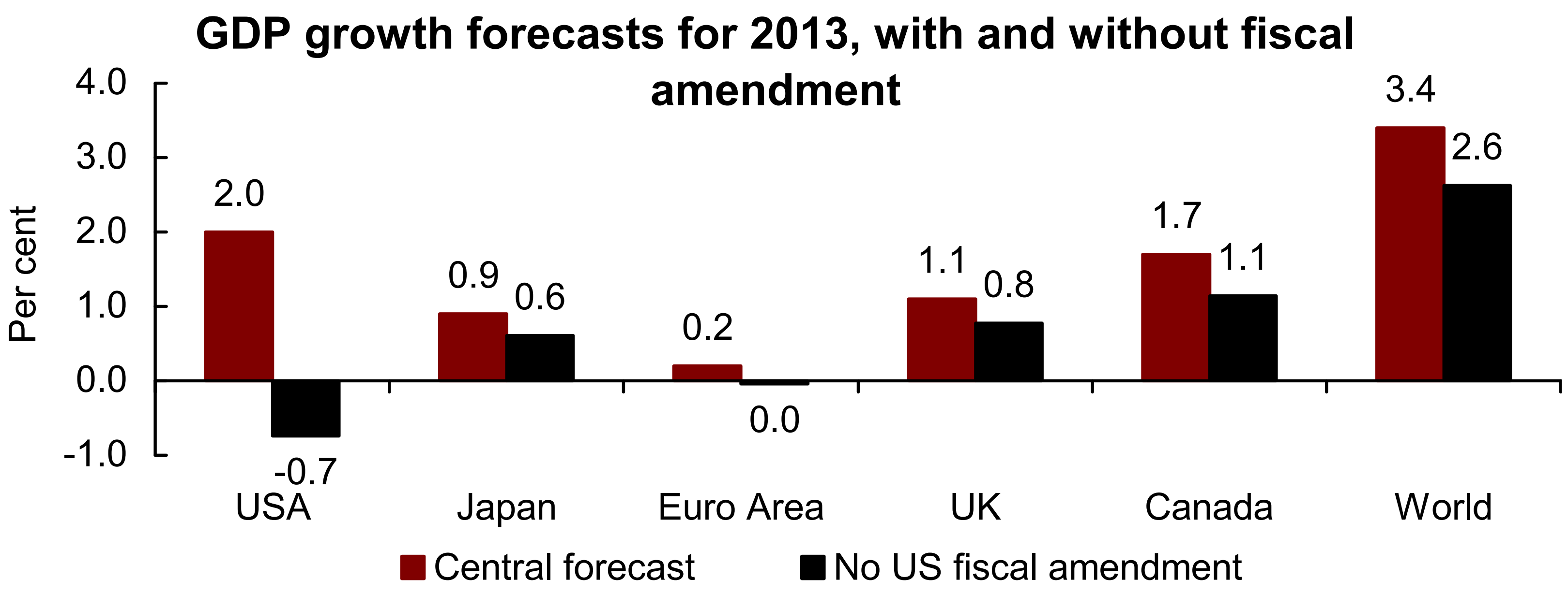
Where are the main risks in the global economy?

- Europe remains the epicentre of global uncertainty
  - Sovereign debt crisis
  - Banking crisis
  - Confidence crisis
- Outside of Europe
  - Fiscal uncertainty in US unlikely to be resolved by election
  - QE may lead to runaway inflation expectations
  - Sharp slowdown in BRIC economies?

US Fiscal Cliff will be avoided….

- … but agreement delayed until last minute
  - Current legislation would push US into recession in 2013
  - Repeat of August 2011 debacle with debt ceiling likely
  - Expect high market volatility at turn of year

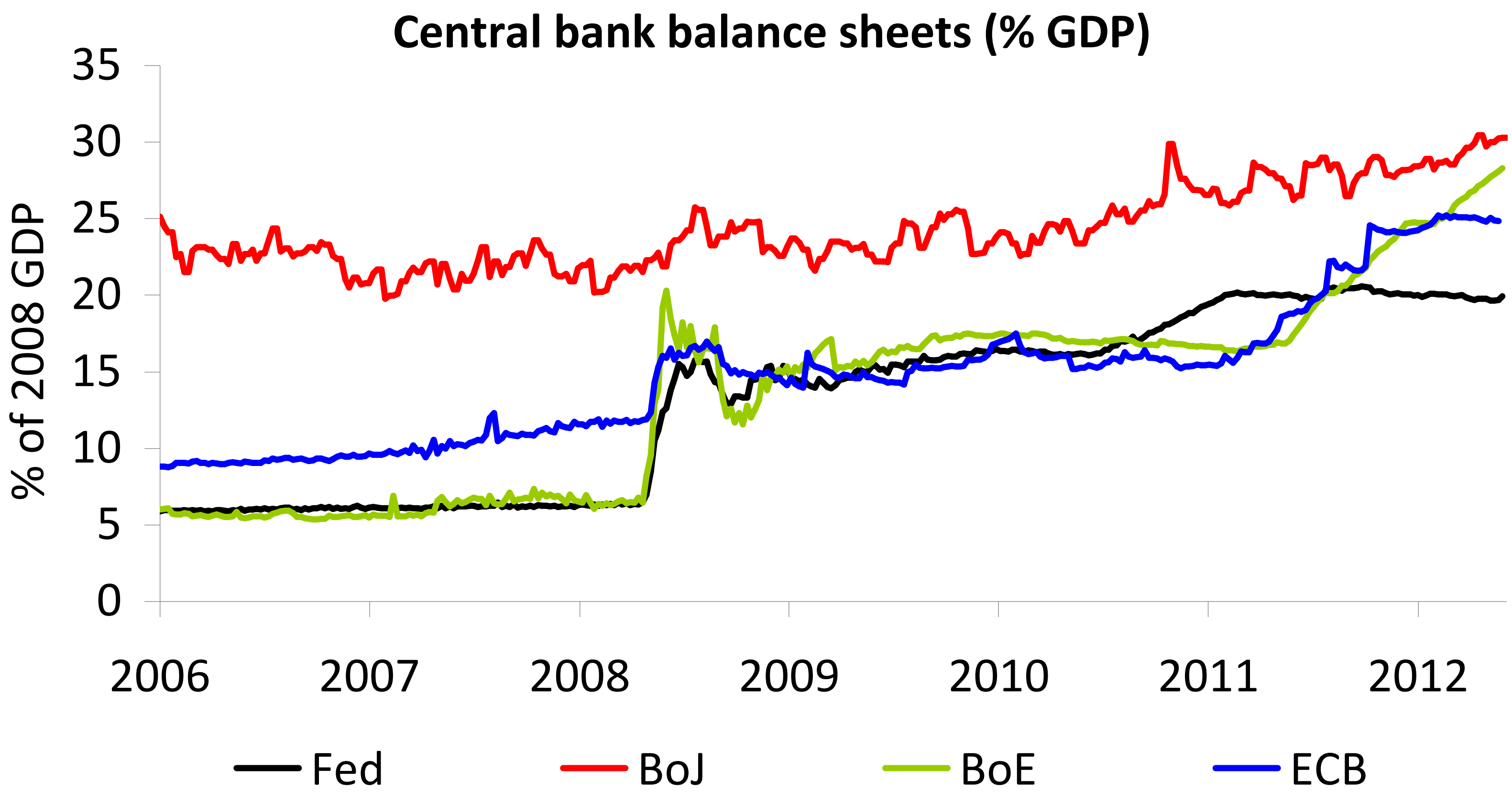


Aggressive monetary easing in US

- Open-ended commitment to extend/increase policy accommodation
- Sufficient to ease pressures on bond yields from fiscal cliff
- Federal Reserve's GDP forecasts are optimistic in the extreme
  - Would require $3.5 trillion more in QE 2013-14
  - Pushing inflation towards 5%
- Risks in medium-term related to withdrawal of QE

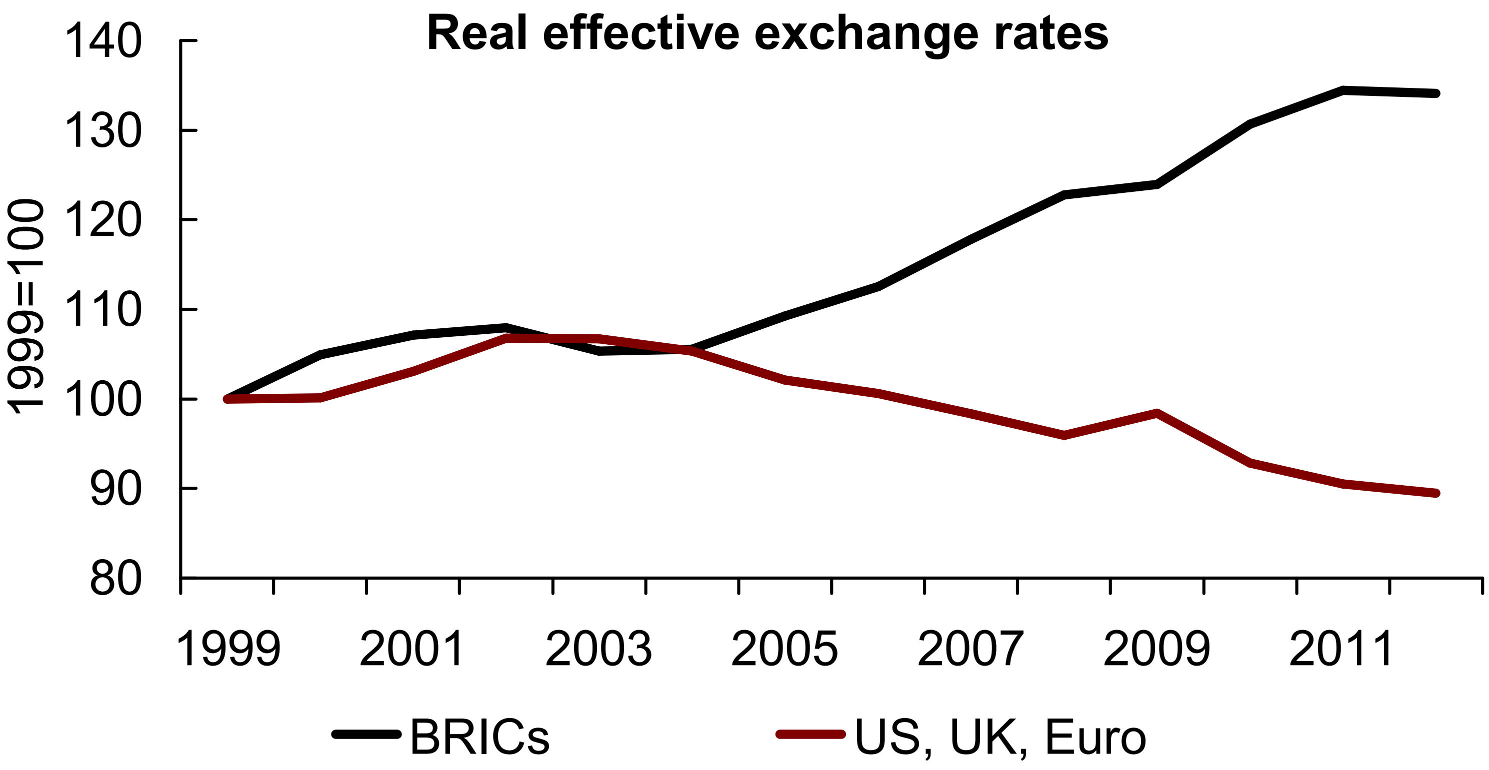
What happens to inflation expectations?

- Risk that expectations jump as economy recovers



Loose monetary stance in advanced economies…

- … associated with appreciation in BRICs



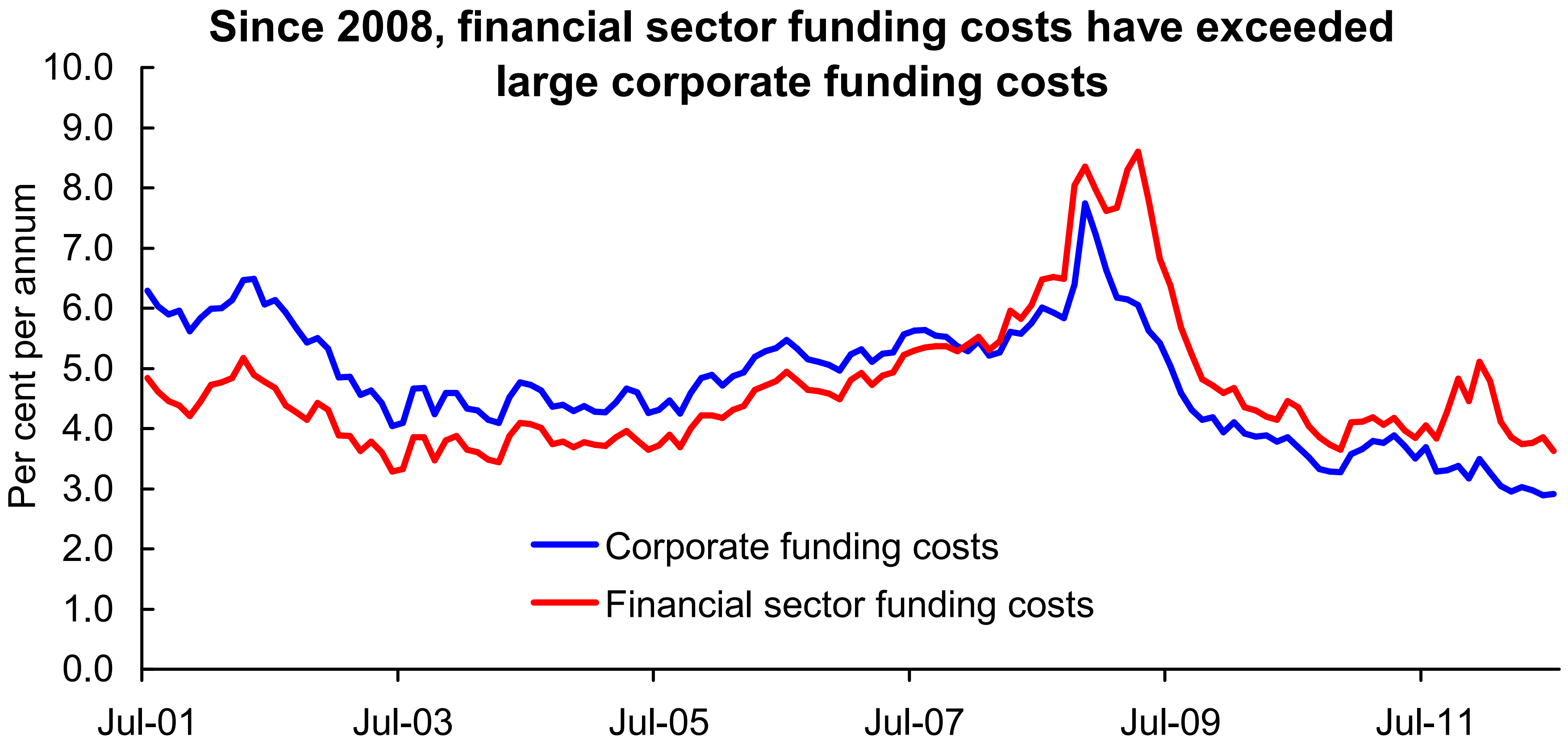
Key issues in Europe

- The EU has fallen back into recession
  - At least 10 of 27 EU economies to contract in 2012
  - Greece, Spain, Italy, Portugal contract further 2013
  - Most remain below trend 2014
- 3 main sources of weakness
  - Banking system remains impaired
  - Persistent uncertainty over evolution of Euro Area
  - Severe fiscal austerity introduced in a synchronised way

What's wrong with banks?

- Ailing banks are failing to fulfil the crucial role of intermediary between lenders and borrowers
  - Pressure on bank asset base through losses on market value of vulnerable government bonds (Greece, Spain, Italy, Portugal, Ireland)
  - Further losses due to drop in housing values, especially in Spain and Ireland
  - At same time, rise in capital ratios to provide a buffer against crises has tightened lending conditions
  - Bank lending is clearly weak, although it is difficult to distinguish demand and supply effects

Illustration of the disfunction in the banking sector….



- Suggests banks should be borrowing from firms currently!

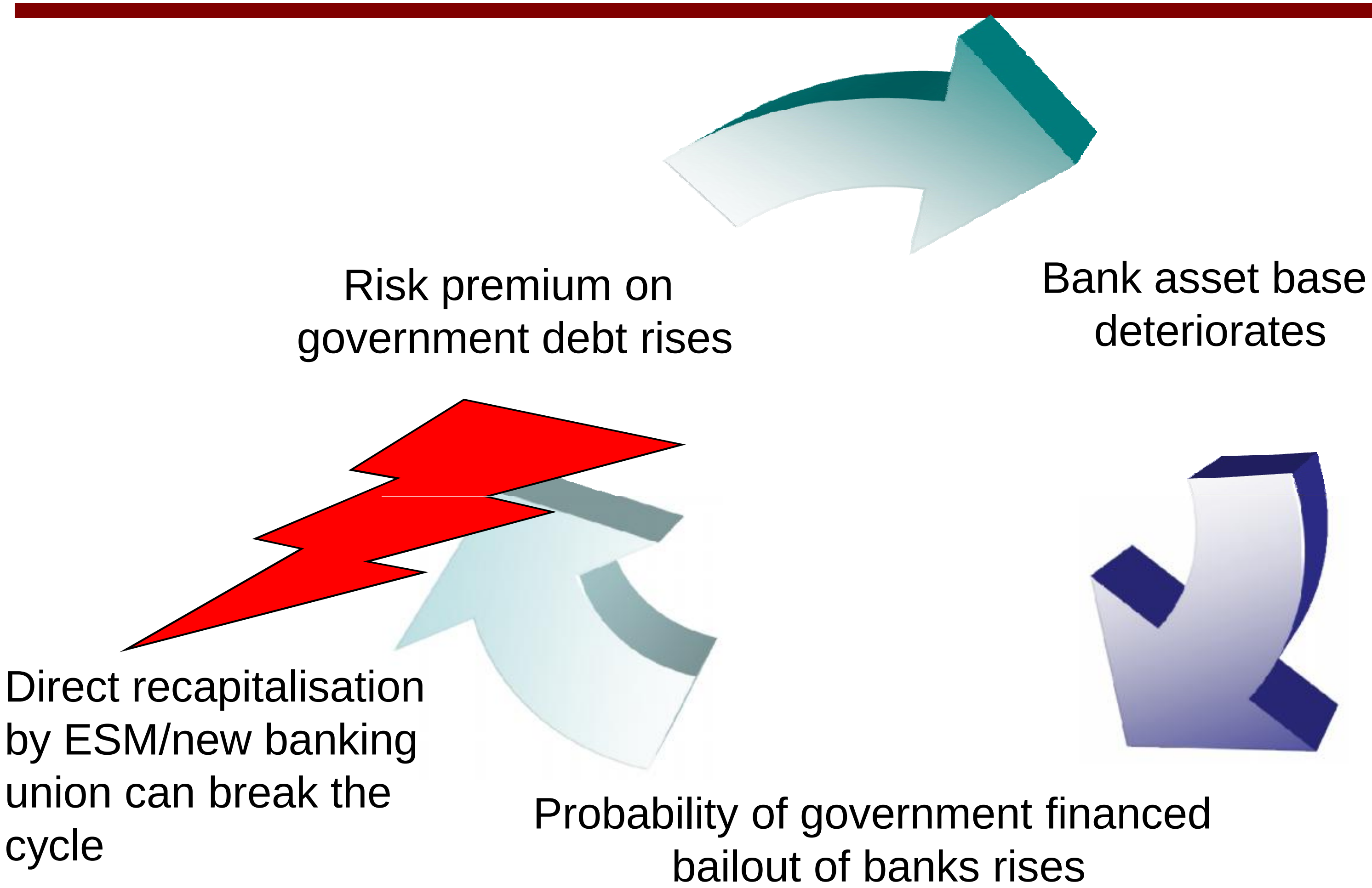
Evolution of the Euro Area

- Politicians forced to choose between deeper integration and partial disintegration of Euro Area
- Is the political will strong enough to maintain EMU intact?
  - Requires:
    - Creation of a banking union within EMU
    - Sharing of sovereign credit risk
    - Move towards fiscal union
    - Internal devaluations to correct imbalances in competitiveness
  - Entails:
    - High bond yields persisting into 2014 as adjustment takes time
    - Further rises in unemployment due to austerity and wage cuts
    - Probably further bailouts/debt restructuring
  - Burdens may eventually prove too great to bear for either lenders or borrowers

Banking union in the Euro Area

- Agreed in principle, although implementation is likely to take several years.
  - Euro Area-wide banking supervisor run by the ECB, common rules for bank resolution and a common deposit guarantee scheme.
- Banking union makes a step towards breaking negative spiral between sovereign and banks
  - Failed banks would be bailed out by the coordinated banking union, rather than ending up on government balance sheets

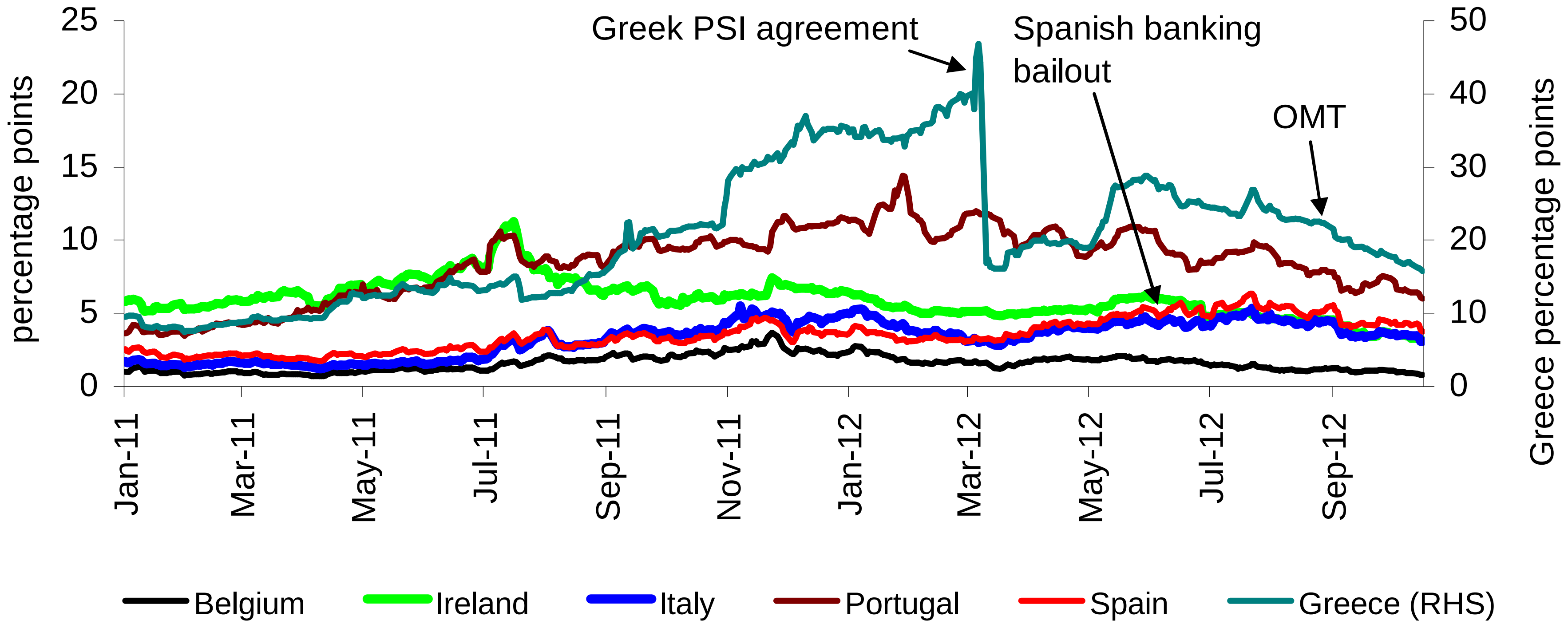
Vicious cycle between banks and sovereigns



Credible commitment to sharing of credit risk

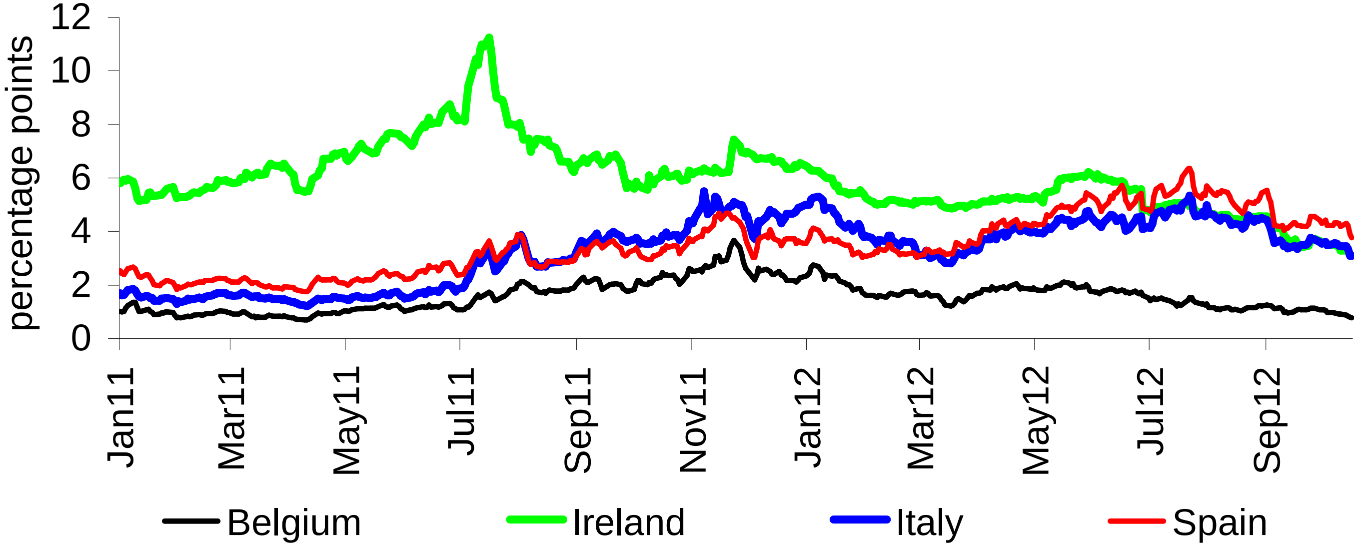
- Latest ECB action is a decisive step in this direction
  - Sept 2012 introduced Outright Money Transactions (OMT)
  - Allows for unlimited purchase of sovereign bonds
  - Only applicable to countries on sovereign bailout programmes
  - Comes with conditionality and loss of fiscal sovereignty……

10-year government bond spreads have responded favourably



- The OMT appears to have quelled markets for now

Bond spreads in Ireland have performed impressively



- Highlights importance of setting *achievable* rather than *stringent* targets
- Compare Ireland/Spain budget plans for 2012
  - Spain planned 3.2 pp improvement for 2011, but achieved just 0.4 pp
  - Ireland planned 1.0 pp improvement for 2011 and achieved 1.6 pp
- Markets don't like to be disappointed! But are less concerned with magnitude of correction

Move towards fiscal integration??

- Huge political resistance from all sides
- Ireland desperate to get off bailout programme to regain sovereignty
- Spain reluctant to accept bailout that entails conditionality
- Long-standing back-burner goal of EMU, but next to no progress in last decade

Internal devaluations

- Difficult, but not insurmountable obstacle
- Requires a decline in real wages, without reducing productivity
- Potential feedbacks to banking system through rise in arrears/default
- Recent improvements in current account deficits (Greece, Ireland, Portugal, Spain, plus Baltics) mostly reflect lack of domestic demand rather than competitiveness gains

What are the alternatives??

- Possibility of some country(ies) leaving EMU cannot be rules out
- What would this entail?.....

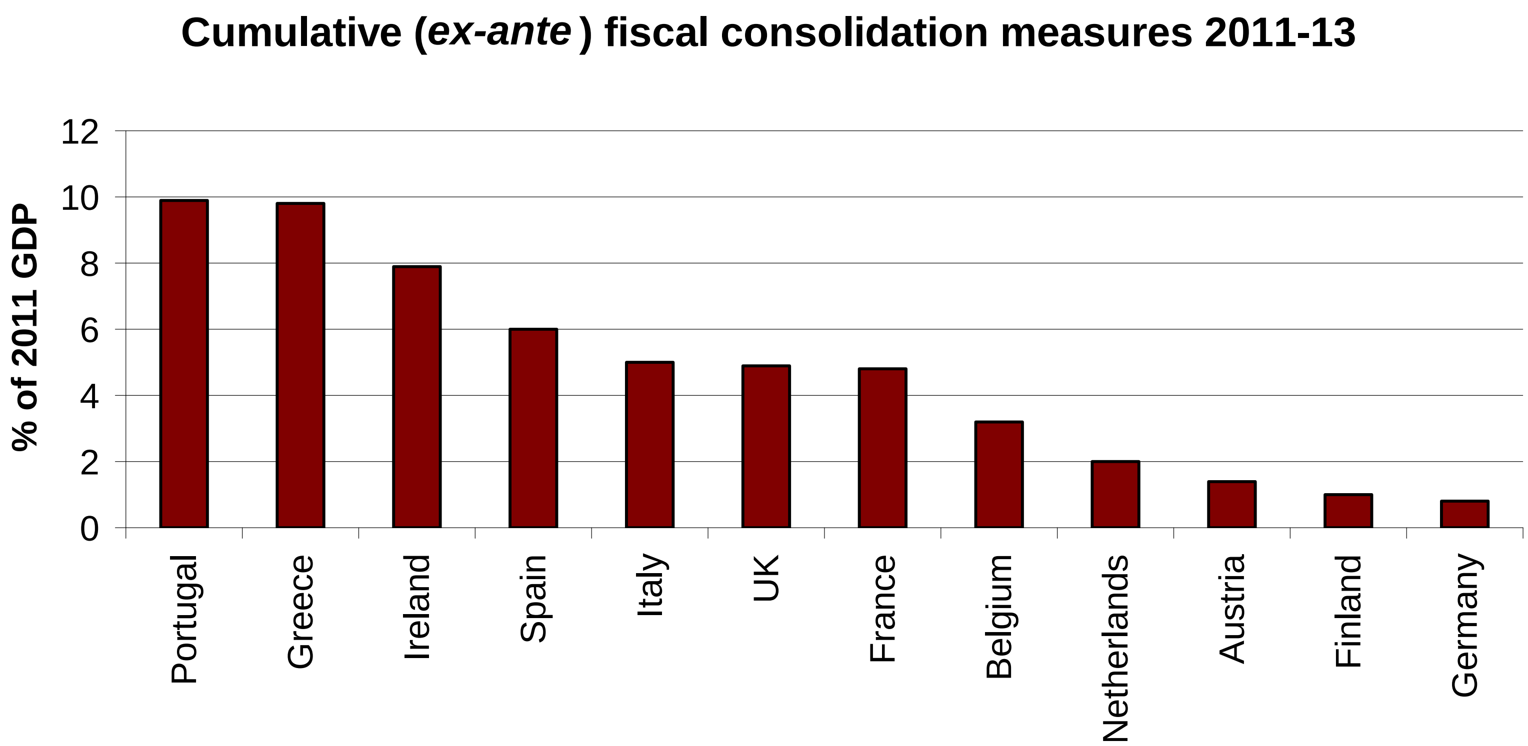
Greek exit from EMU?

- Would entail…
  - Massive disruption to the banking sector; Capital controls
  - At least a 50 per cent depreciation initially
  - High inflation
  - Households and firms would suffer
  - Emigration?
- Not a choice Greece would make voluntarily
  - But repeatedly breaching targets imposed by Troika could make it inevitable. Set achievable targets!!!
- Contagion risks high…
  - ECB to commit to buy sovereign bonds in unlimited quantities
  - Private and official sectors would need to absorb upfront losses *and* make new funds available

German exit from EMU?

- Unthinkable? Probably…
  - But rise in contingent liabilities of EFSF and ECB viewed with unease
- Economic consequences
  - Germany benefits from exceptionally low interest rates and undervalued exchange rate within EMU
  - Outside EMU:
    - Interest rates rise 2 percentage points
    - Exchange rate appreciates 10-15 per cent
- Could ECB withstand loss of its backbone?
  - At minimum expect significant rise in risk premium on euro assets.
- Contagion risks higher…
  - Widespread break-up of EMU likely
  - May be difficult to main integrity of European Union

Fiscal austerity strangling growth in Europe



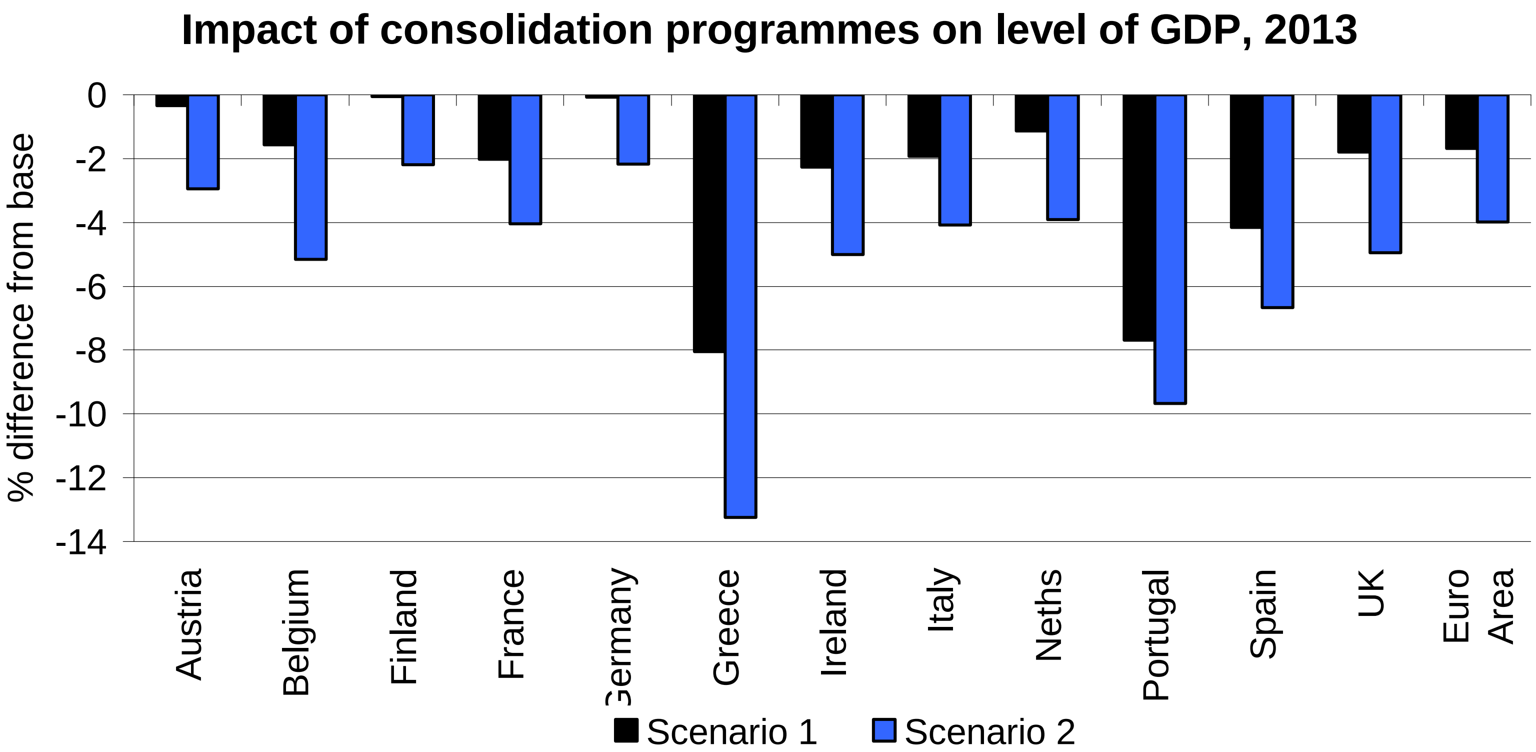
- Policies as of January 2012 – excludes recent measures announce for Spain, Italy

Coordinated fiscal austerity across Europe

- What is the economic impact of EU consolidation plans for 2011-13?
  - – Given the state of the economy
    - Impaired banks
    - Interest rates trapped at lower bound
  - – Given ongoing consolidation elsewhere
- How effective are consolidation measures at present?
  - – What happens to expected budget balance?
- Are they self-defeating?
  - – What happens to expected Debt-to-GDP ratios?

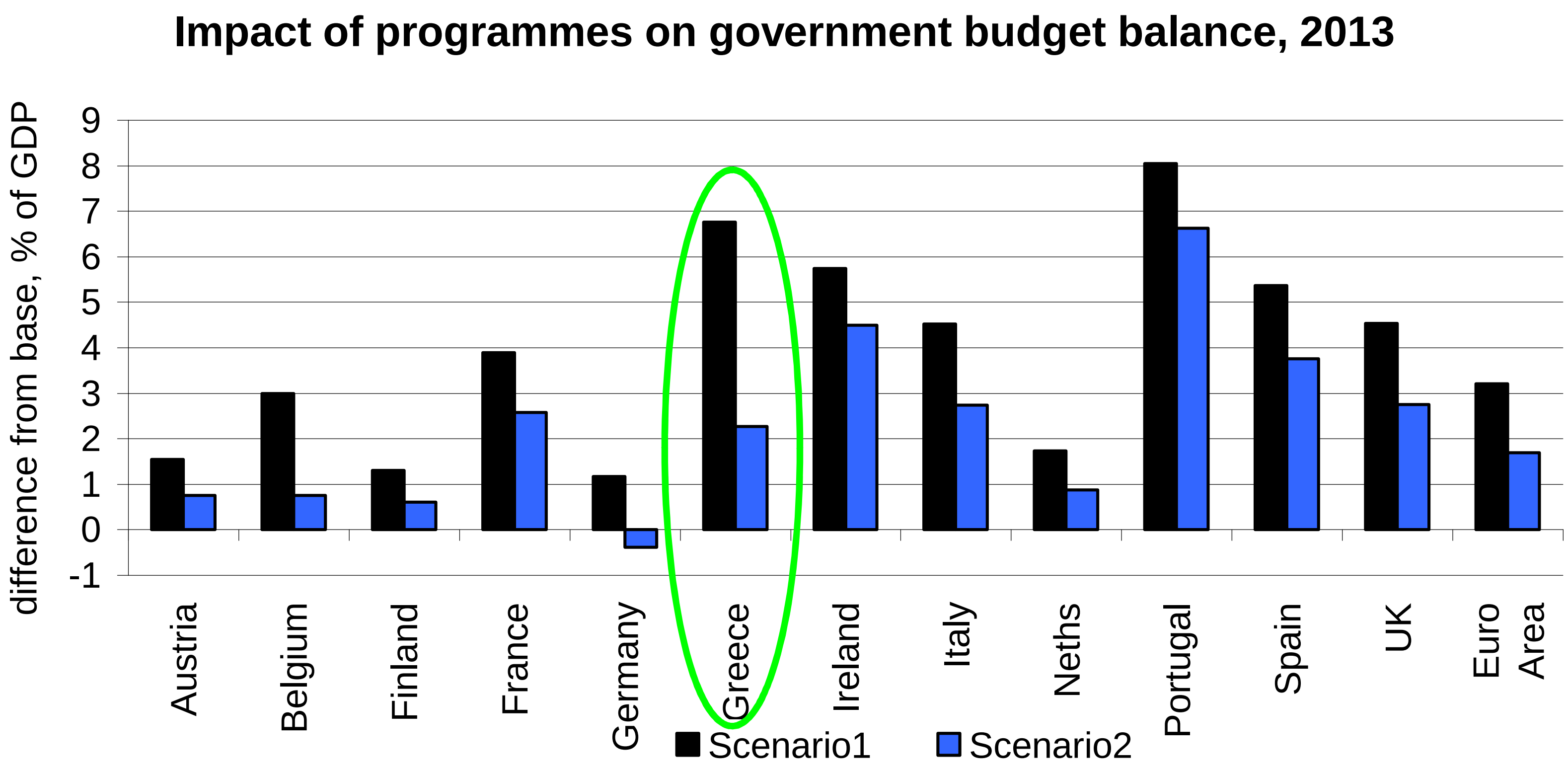
Output declines nearly double in most countries…..

- … when we allow for impaired interest rate and credit channels

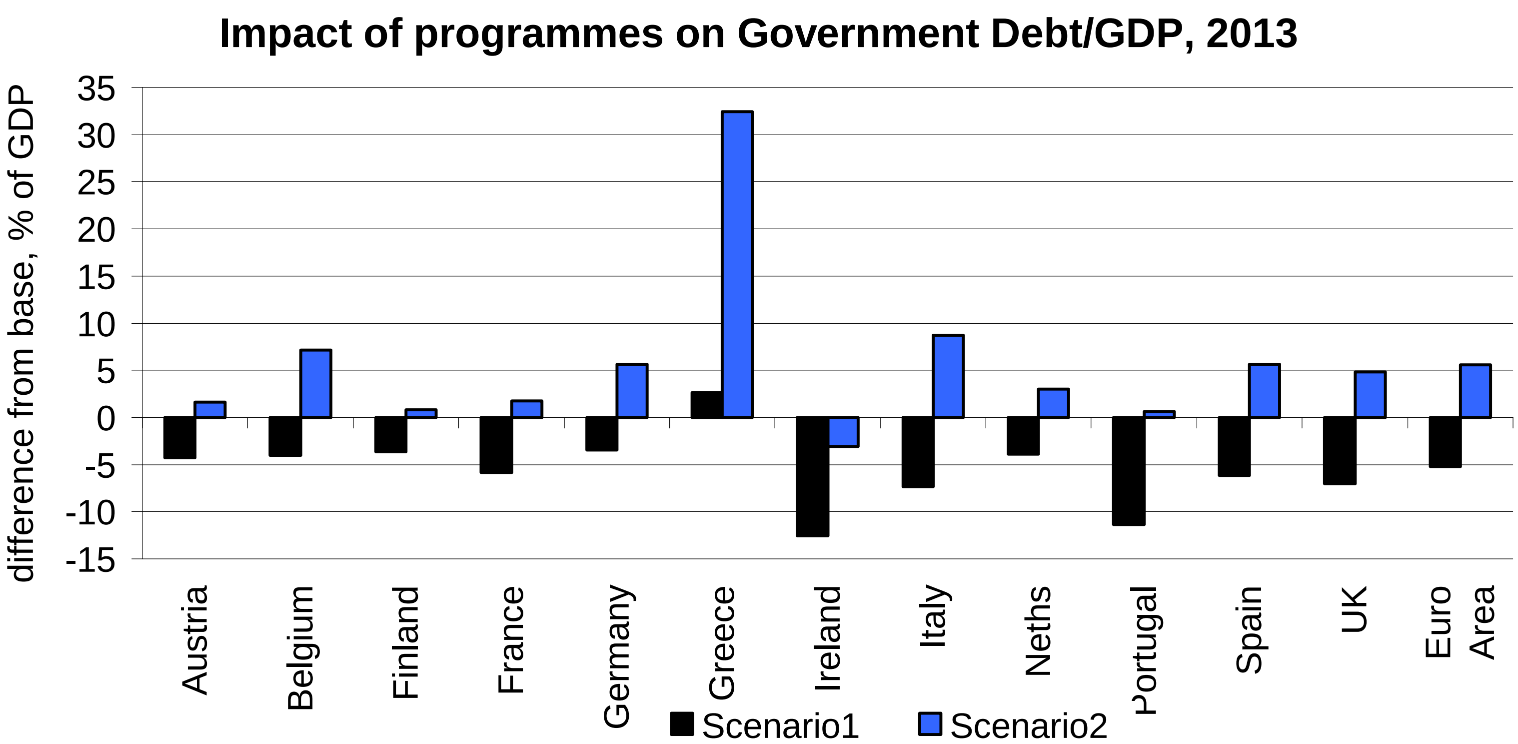


Fiscal balances improve….

- … but not by as much when output declines deepen



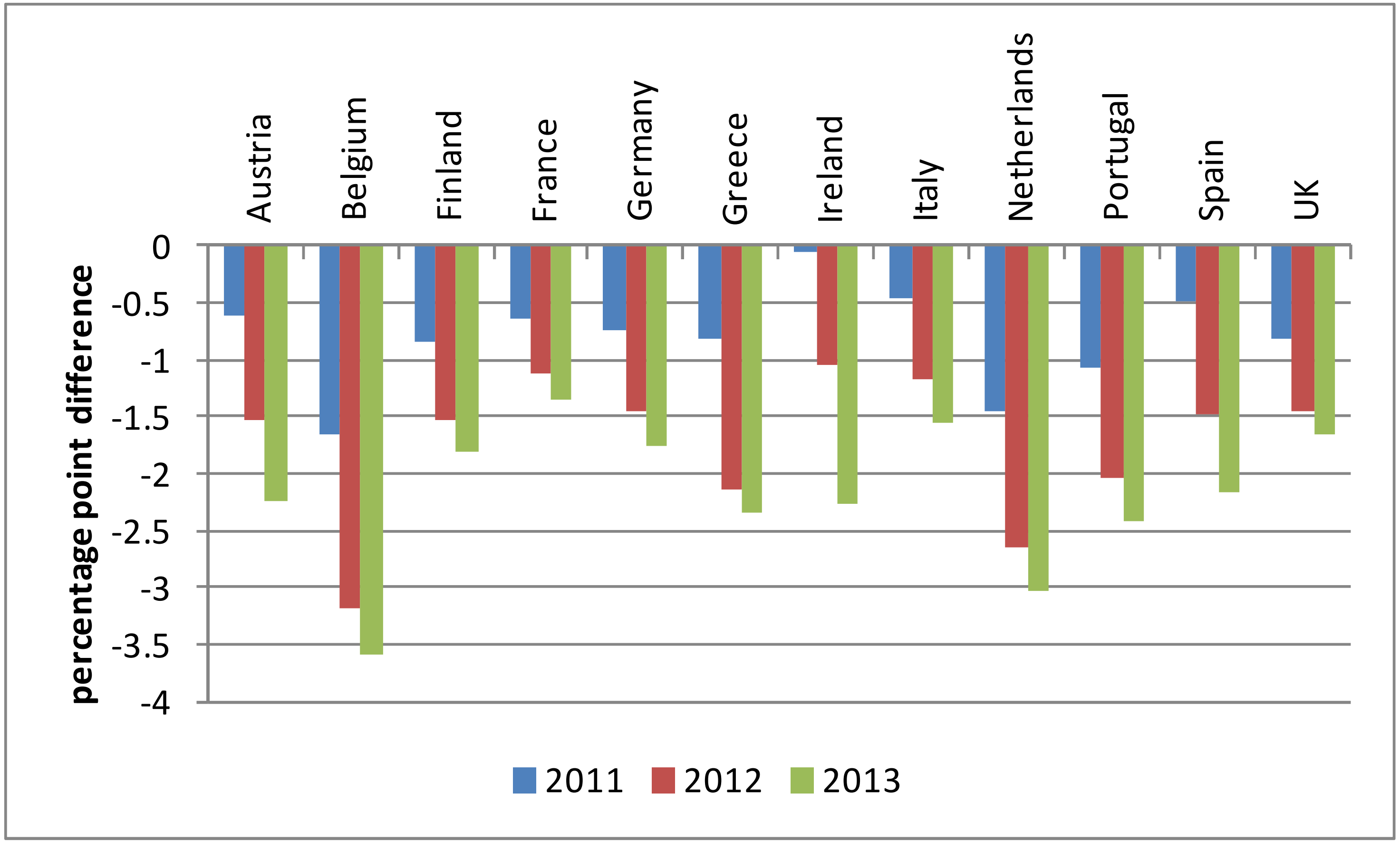
Self-defeating fiscal consolidation is worsening debt positions



- Feedbacks on government borrowing premia??

On average output declines by 2% by 2013 due to spillovers

Impact of joint policy action on the level of GDP relative to unilateral action



Thank you