

NIESR

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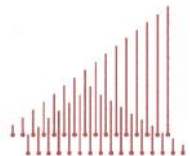
# Policy Challenges Facing Europe

Dawn Holland

National Institute of Economic and Social Research

23 November 2012, Beijing, China

International Conference on Euro Area Crisis and Its Impact on China's Economy

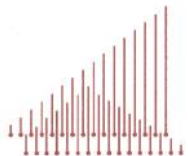


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## Key issues in Europe

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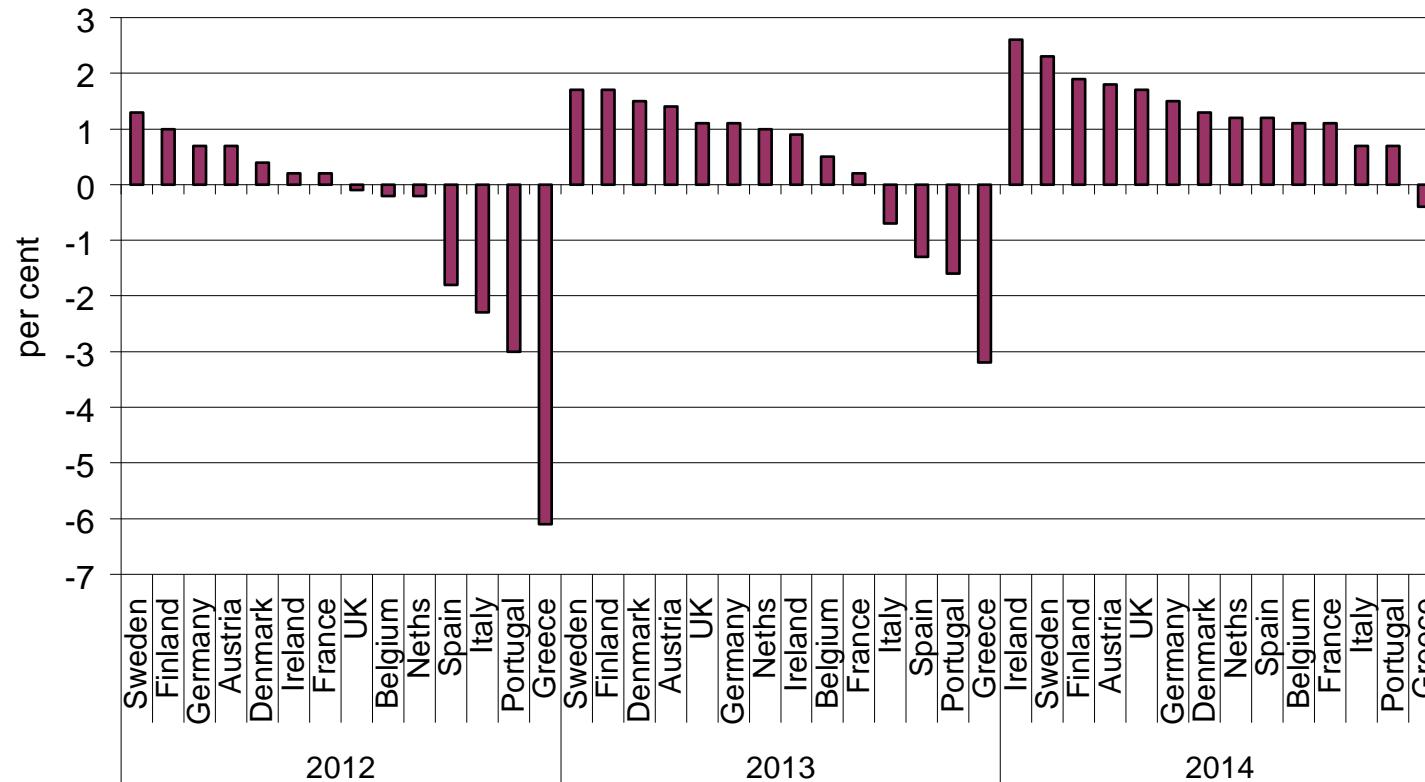
- **Europe remains focal point of global uncertainty**
  - Banking crisis
  - Sovereign debt crisis
  - Confidence crisis
- **3 main sources of weakness**
  - Banking system remains impaired
  - Persistent uncertainty over evolution of Euro Area
  - Severe fiscal austerity introduced in a synchronised way



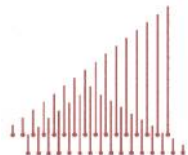
# Weak growth across Europe is widespread

- At least 10 of 27 EU economies to contract in 2012

GDP growth forecasts in Europe



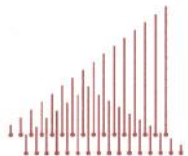
Source: National Institute Economic Review, October 2012, No. 222.



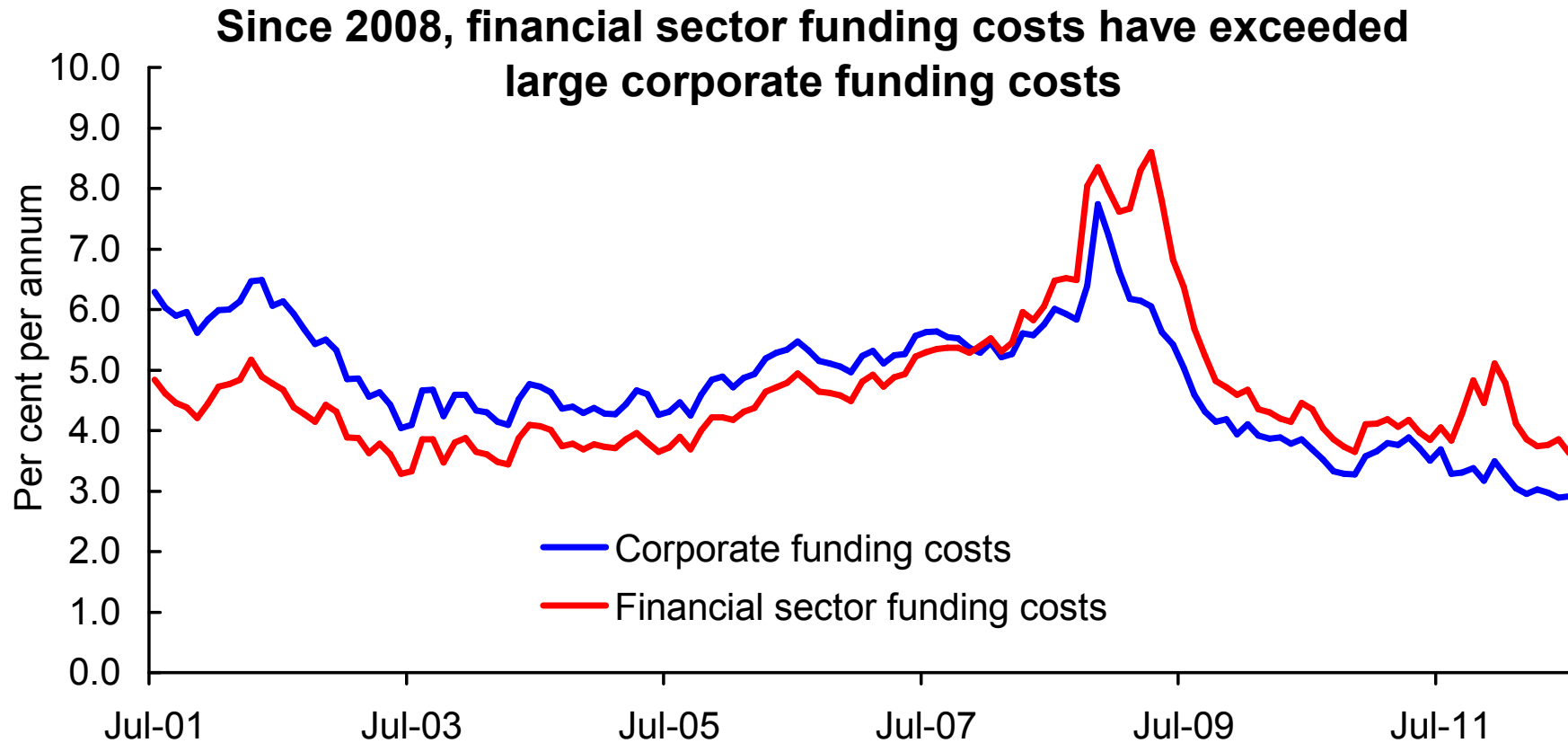
## What's wrong with banks?

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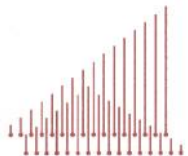
- Ailing banks are failing to fulfil the crucial role of intermediary between lenders and borrowers
  - Pressure on bank asset base through losses on market value of vulnerable government bonds (Greece, Spain, Italy, Portugal, Ireland)
  - Further losses due to drop in housing values, especially in Spain and Ireland
  - At same time, rise in capital ratios to provide a buffer against crises has tightened lending conditions
  - Lack of trust and transparency in the banking sector



## Illustration of the disfunction in the banking sector....



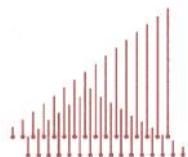
- Suggests banks should be borrowing from firms currently!



## Evolution of the composition of the Euro Area

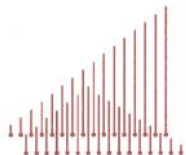
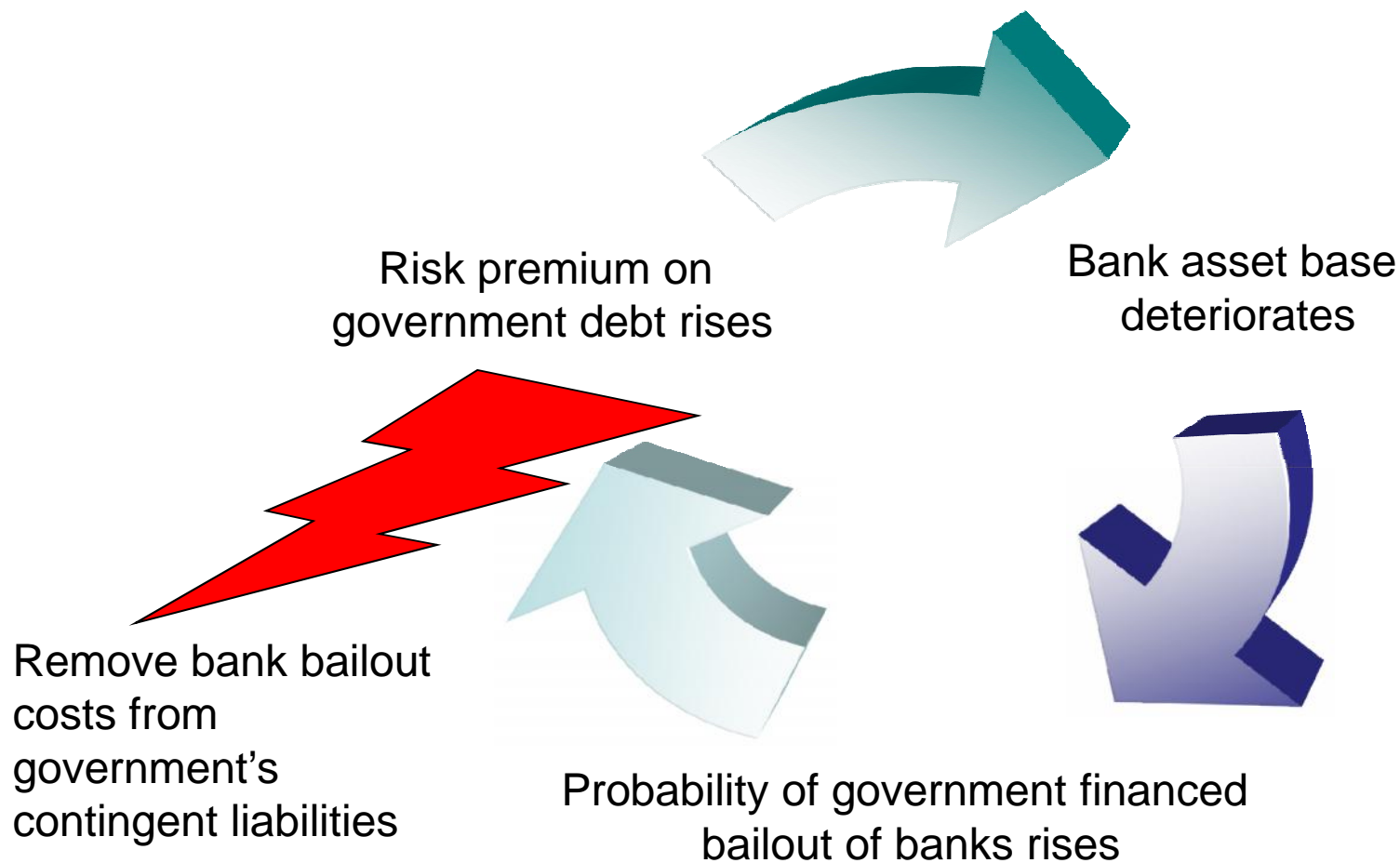
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- Politicians forced to choose between deeper integration and partial disintegration of Euro Area
- Is the political will strong enough to maintain EMU intact?
  - 4 key requirements



## Requirement 1: Break vicious cycle between banks and sovereigns

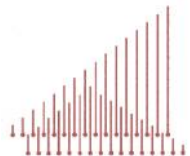
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## Banking union in the Euro Area

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- **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
- **Not a short-term solution**
  - Agreed in principle, although implementation is likely to take several years.
- **Direct bailouts through the European Stability Mechanism (ESM) may help in short-term**

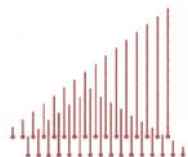




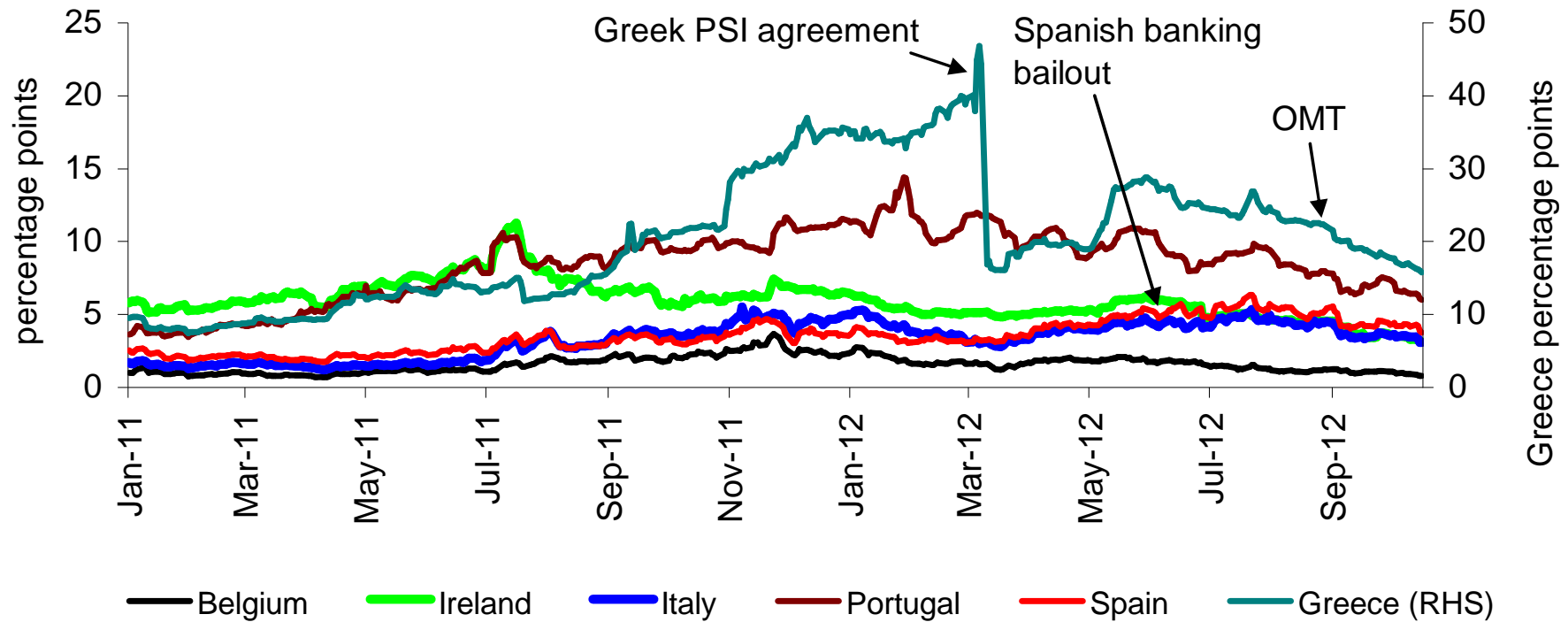
## Requirement 2: Credible commitment to sharing of credit risk

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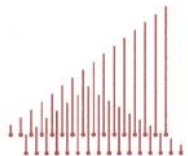
- Latest ECB action is a decisive step in this direction
  - Sept 2012 introduced Outright Money Transactions (OMT)
  - Allows for unlimited purchase of sovereign bonds
  - Only applicable to countries on sovereign bailout programmes
  - Comes with conditionality and loss of fiscal sovereignty.....



# 10-year government bond spreads have responded favourably



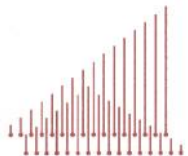
- The OMT appears to have quelled markets for now



## Requirement 3: Move towards fiscal integration

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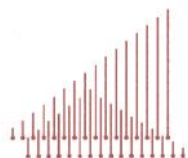
- Huge political resistance from all sides
- Ireland desperate to get off bailout programme to regain sovereignty
- Spain reluctant to accept bailout that entails conditionality
- Long-standing back-burner goal of EMU, but next to no progress in last decade



## Requirement 4: Internal devaluations within EMU

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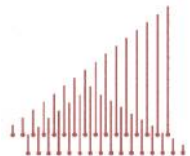
- Difficult, but not insurmountable obstacle
- Requires a decline in real wages, without reducing productivity
- Potential feedbacks to banking system through rise in arrears/default
- Recent improvements in current account deficits (Greece, Ireland, Portugal, Spain, plus Baltics) mostly reflect lack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



## What are the alternatives??

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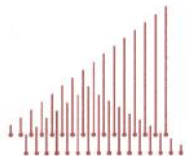
- Possibility of some country(ies) leaving EMU cannot be ruled out
- What would this entail?.....



# Greek exit from EMU?

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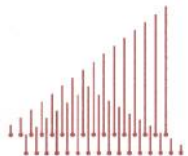
- **Would entail...**
  - Massive disruption to the banking sector; Capital controls
  - At least a 50 per cent depreciation initially
  - High inflation
  - Households and firms would suffer
  - Emigration?
- **Not a choice Greece would make voluntarily**
  - But repeatedly breaching targets imposed 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?

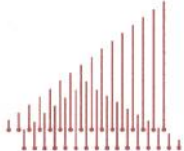
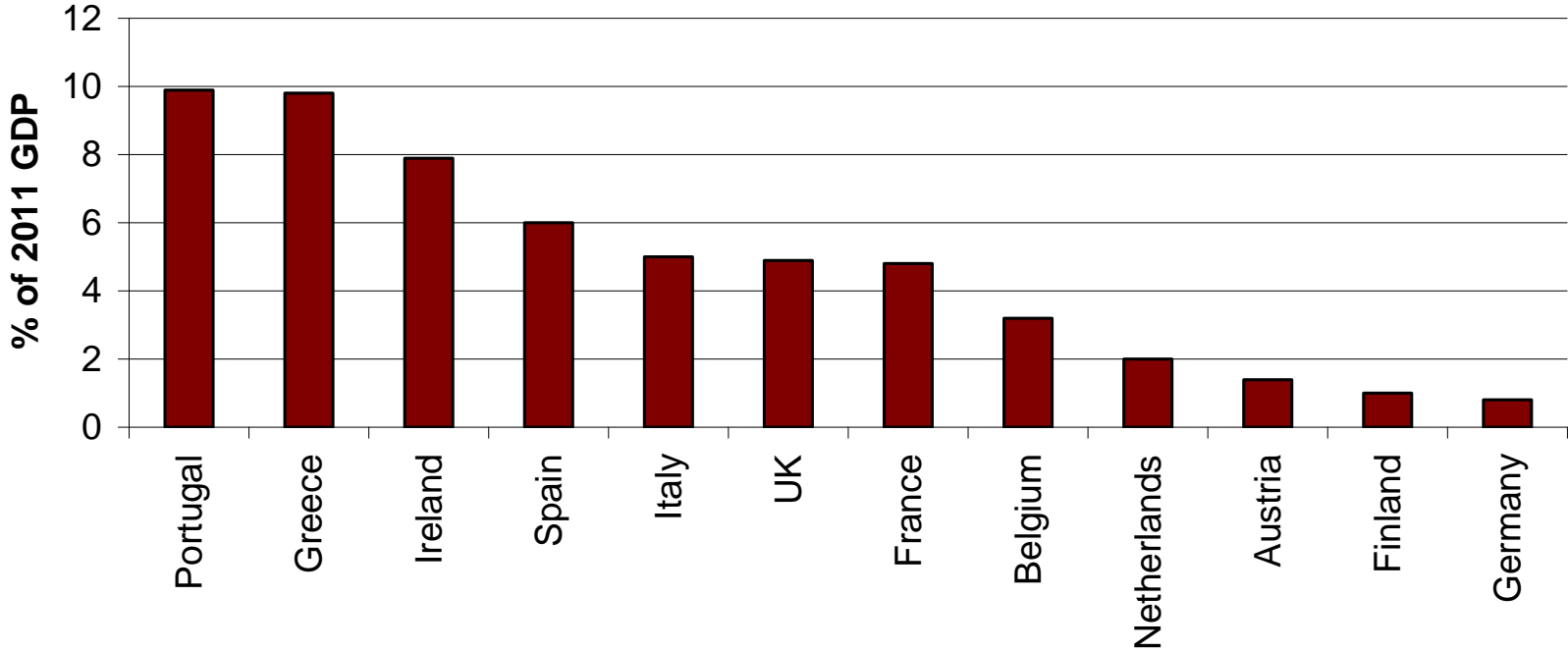
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- **Unthinkable? Probably...**
  - But rise in contingent liabilities of EFSF and ECB viewed with unease
- **Economic consequences**
  - Germany benefits from exceptionally low interest rates and undervalued exchange rate within EMU
  - Outside EMU:
    - 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

Cumulative (ex-ante) fiscal consolidation measures 2011-13

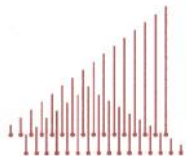




## Coordinated fiscal austerity across Europe

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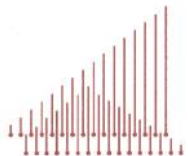
- What is the economic impact of EU consolidation plans for 2011-13?
  - Given the state of the economy
    - Impaired banks
    - Interest rates trapped at lower bound
  - Given ongoing consolidation elsewhere
- Based on simulations using the National Institute's Global Econometric Model (NiGEM)



# NiGEM Overview

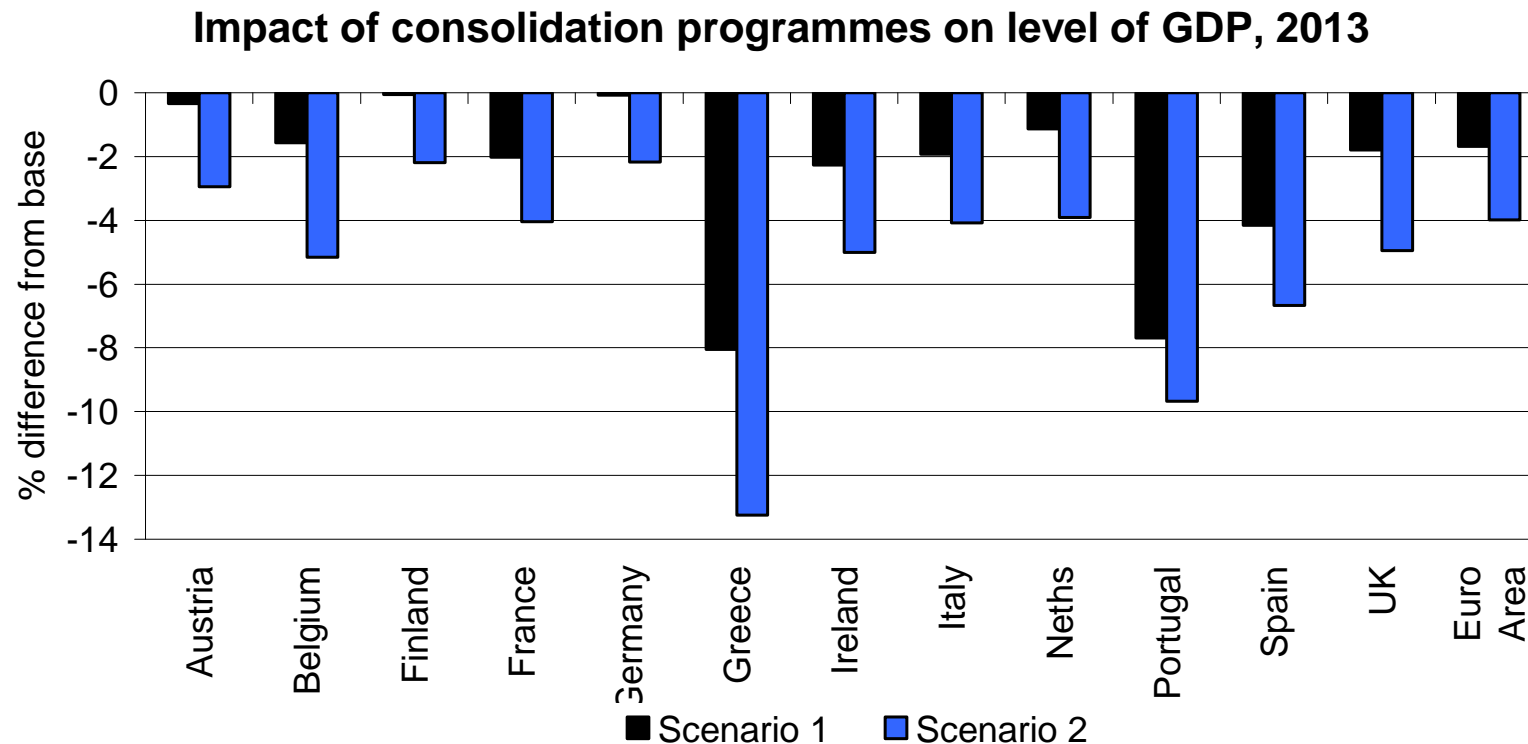
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- NiGEM is a large-scale structural econometric model of the world economy
  - Discrete models for 40 countries and 6 regional blocks for the remaining countries
- Country Linkages
  - trade and competitiveness
  - interacting financial markets
  - international stocks of assets
- Endogenous policy rules for interest rates and fiscal solvency
- Rational expectations options
  - Financial markets
    - Exchange rates
    - Long rates
    - Equity prices
  - Labour markets
- Exogenous labour force

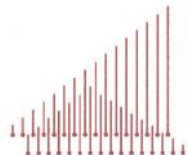


# Output declines nearly double in most countries.....

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

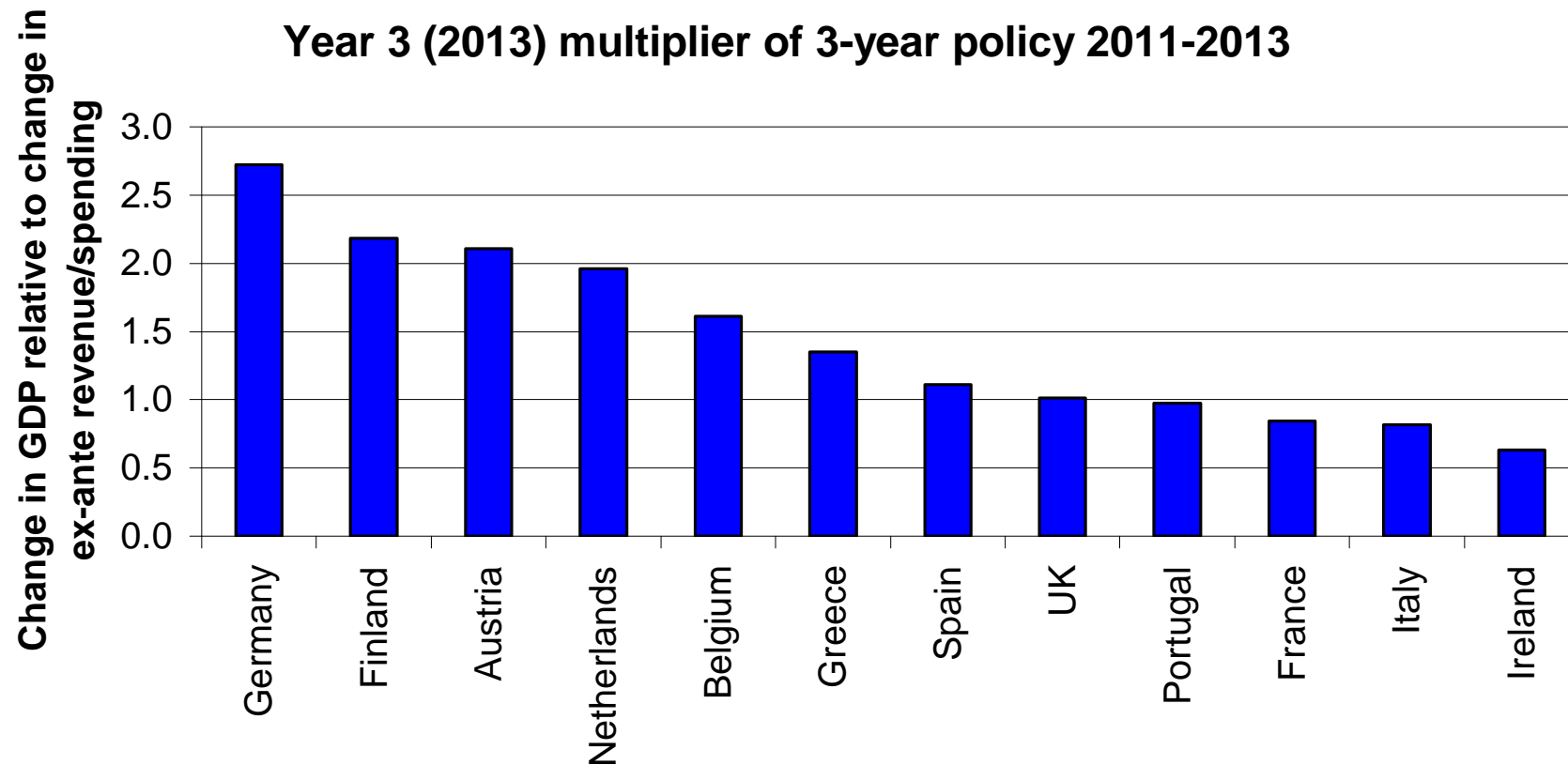


Source: NiGEM simulations

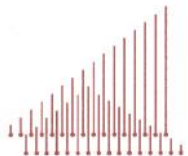


## Implied year 3 multipliers of 3 year policy, 2011-2013

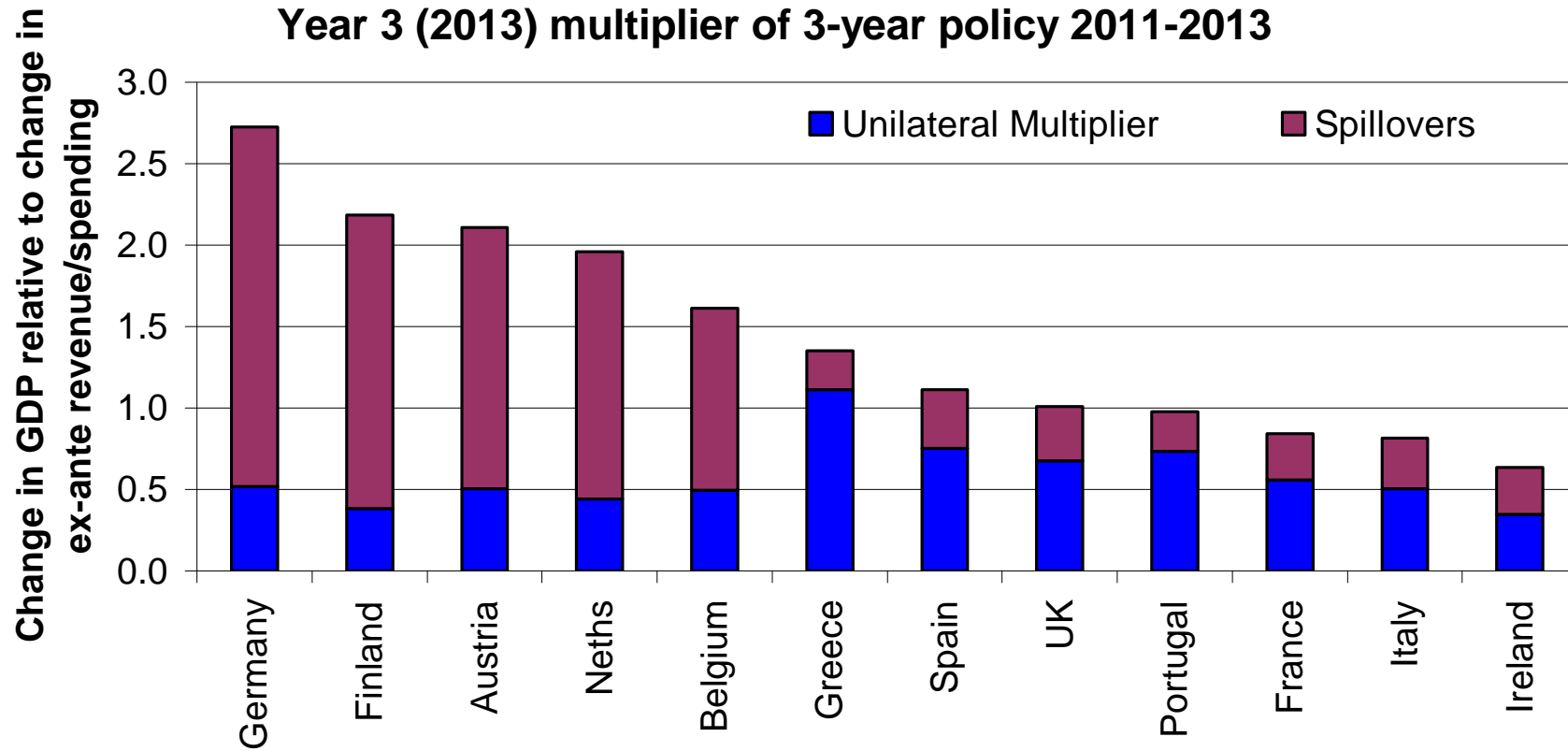
- Implied multipliers mostly greater than 1



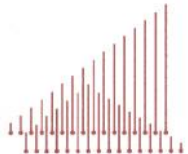
Source: NiGEM simulations



# But much of this is due to spillovers of policies abroad



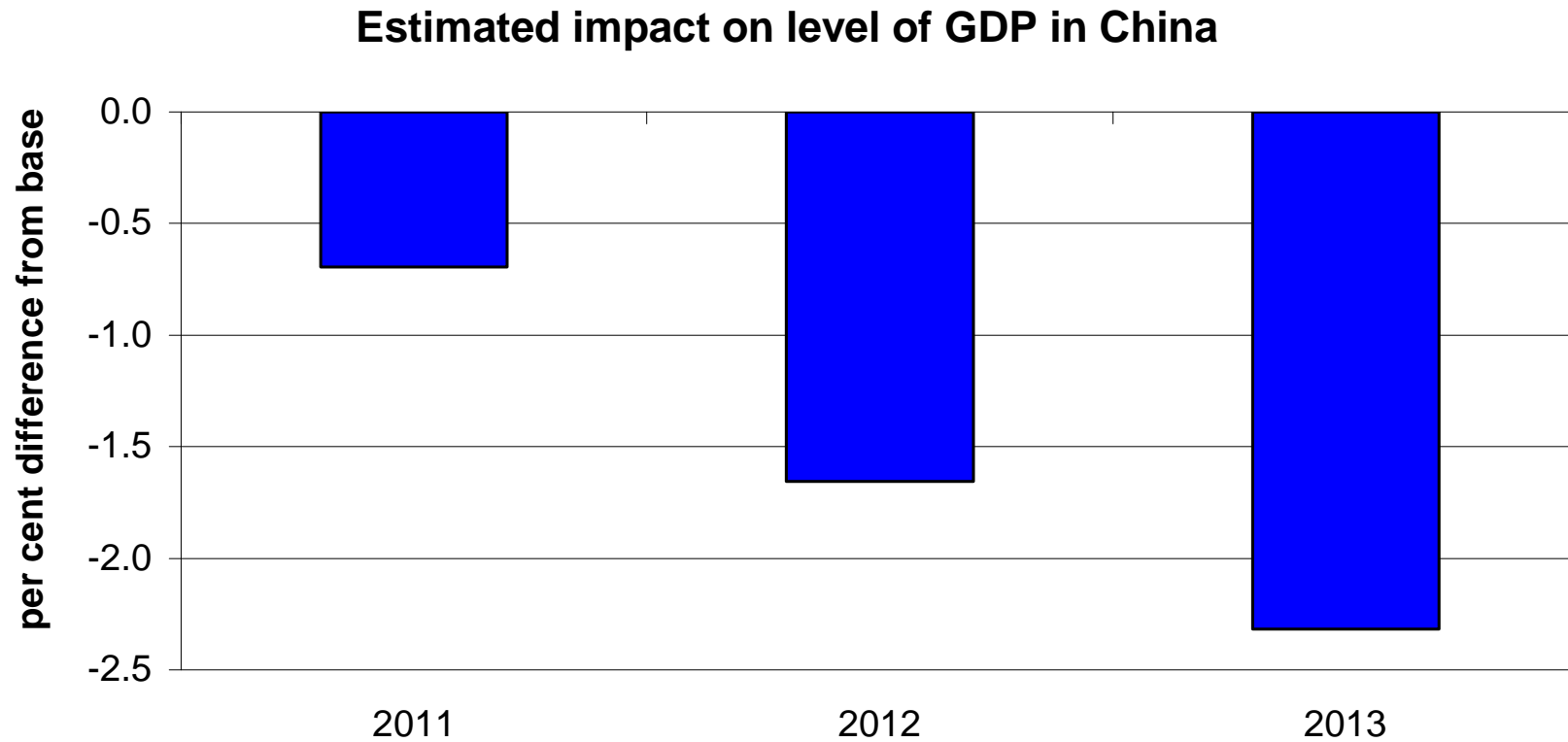
Source: NiGEM simulations



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# Impact of EU fiscal consolidation on China

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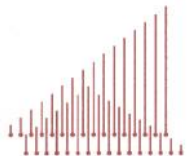


Source: NiGEM simulations



### ■ Priorities for Europe

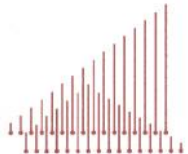
- Clean up banking system
- Break vicious links between banks and sovereigns (ESM for short-term and Banking union longer-term)
- Commitment to risk sharing (OMT)
- Move towards fiscal integration (difficult)
- Reconsider the speed of fiscal tightening
- Set achievable fiscal targets



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Thank you

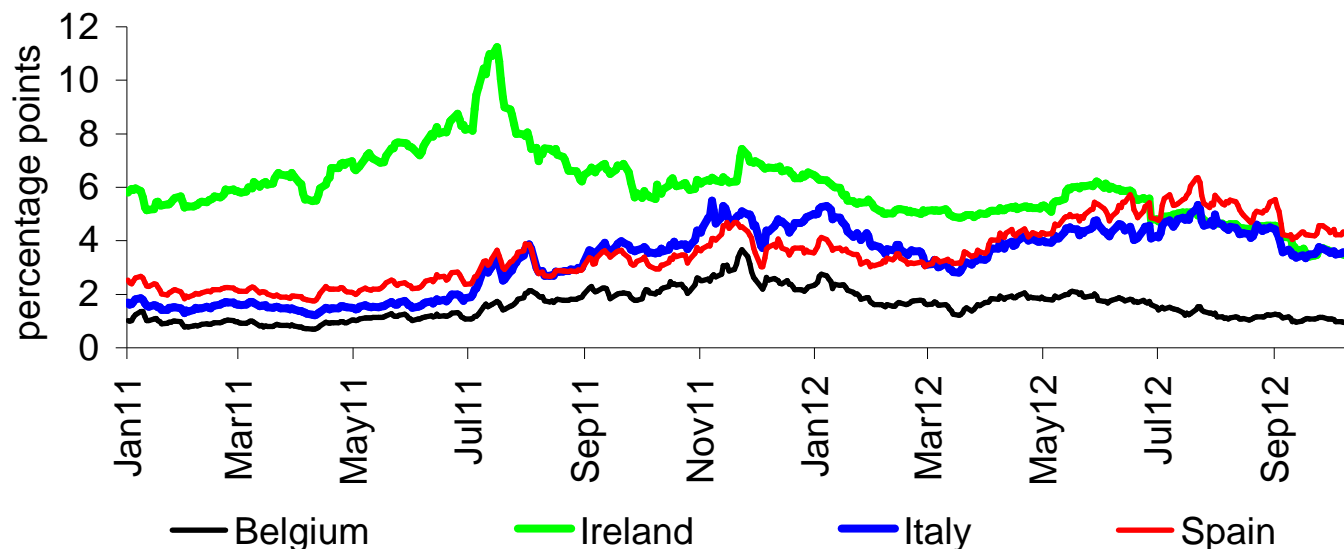
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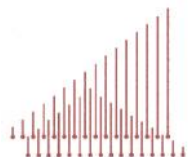
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## Bond spreads in Ireland have performed impressively



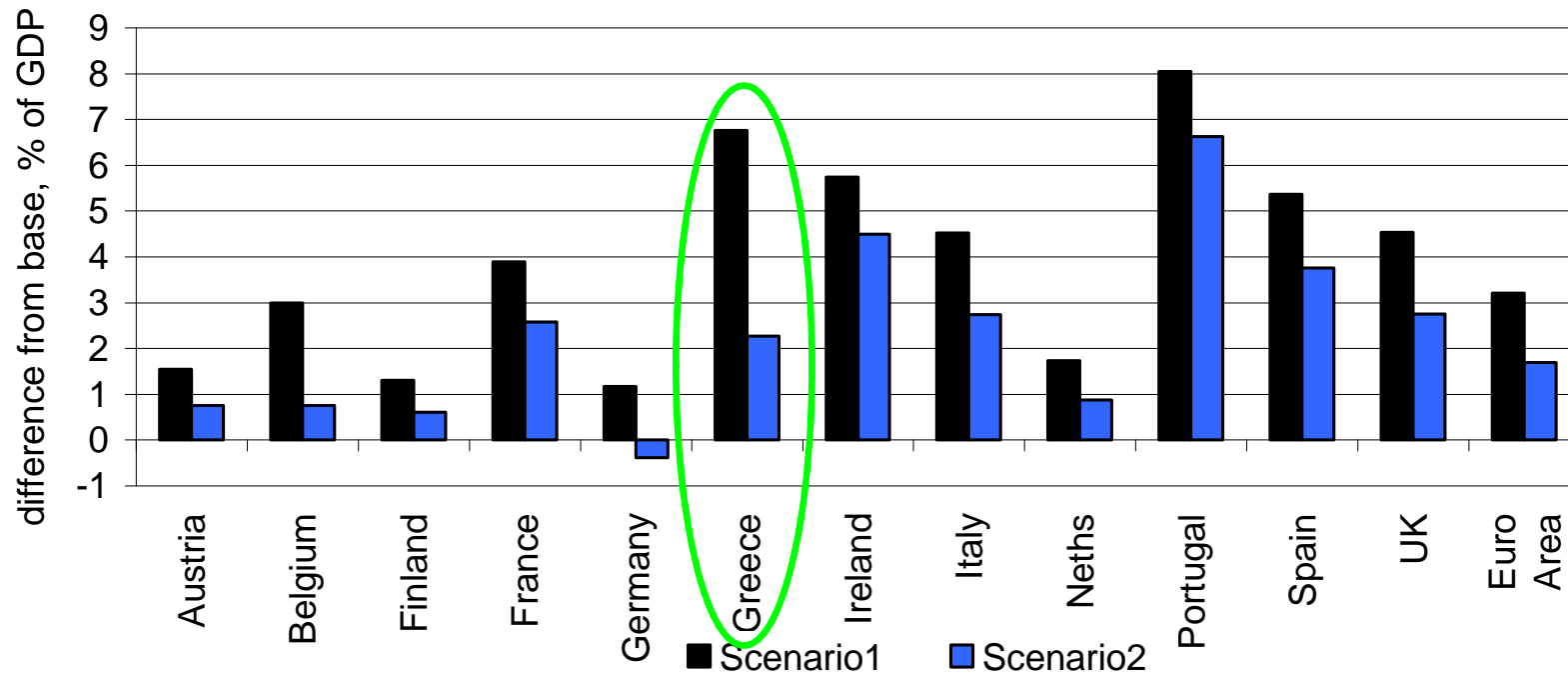
- Highlights importance of setting *achievable* rather than *stringent* targets
- Compare Ireland/Spain budget plans for 2012
  - Spain planned 3.2 pp improvement for 2011, but achieved just 0.4 pp
  - Ireland planned 1.0 pp improvement for 2011 and achieved 1.6 pp
- Markets don't like to be disappointed!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



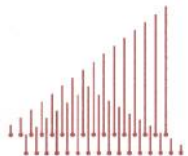
# Fiscal balances improve....

- ... but not by as much when output declines deepen

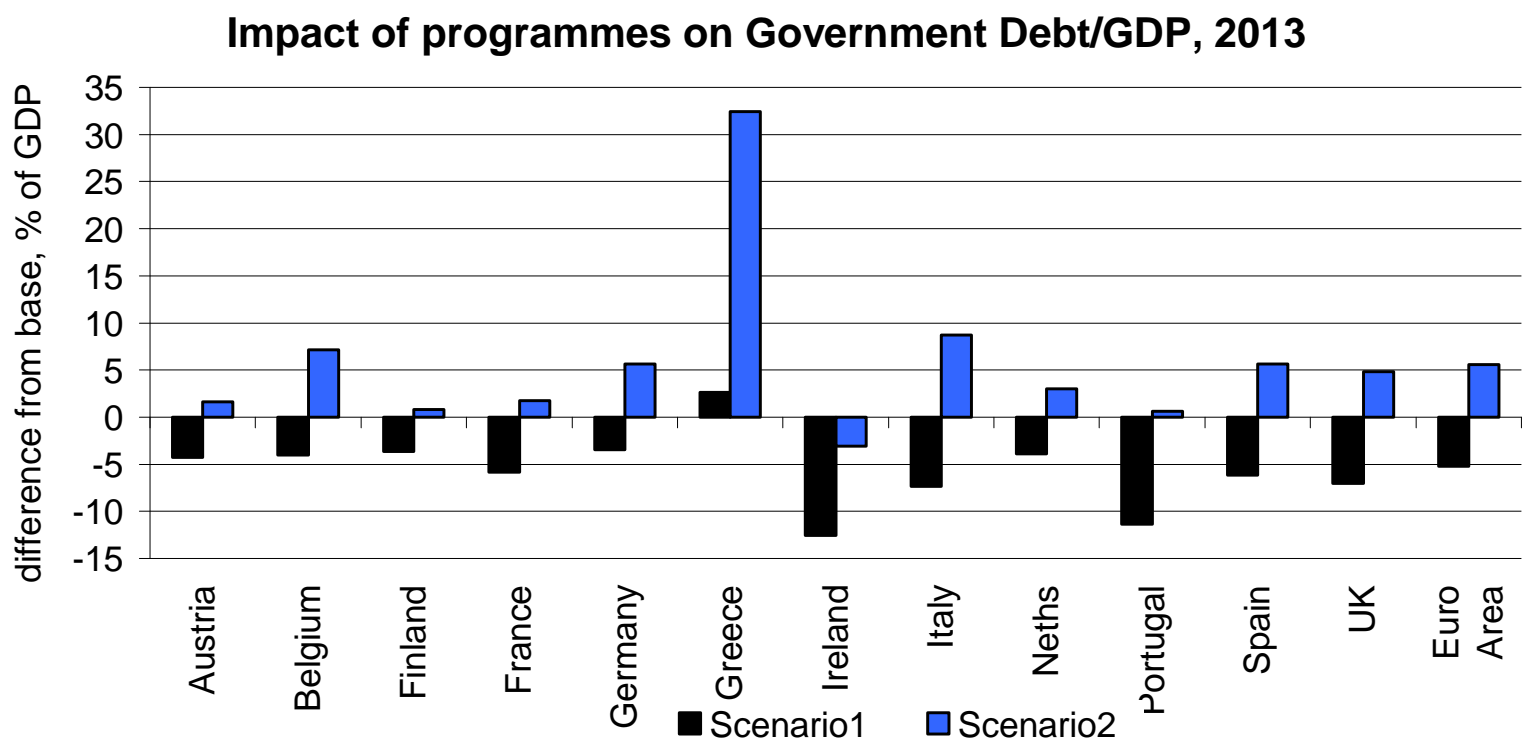
Impact of programmes on government budget balance, 2013



Source: NiGEM simulations



# Self-defeating fiscal consolidation is worsening debt positions



Source: NiGEM simulations

- **Feedbacks on government borrowing premia??**

