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The euro on the brink

'Multiple' crises and complex solutions

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'Challenges for the global economy after the Tohoku earthquake'

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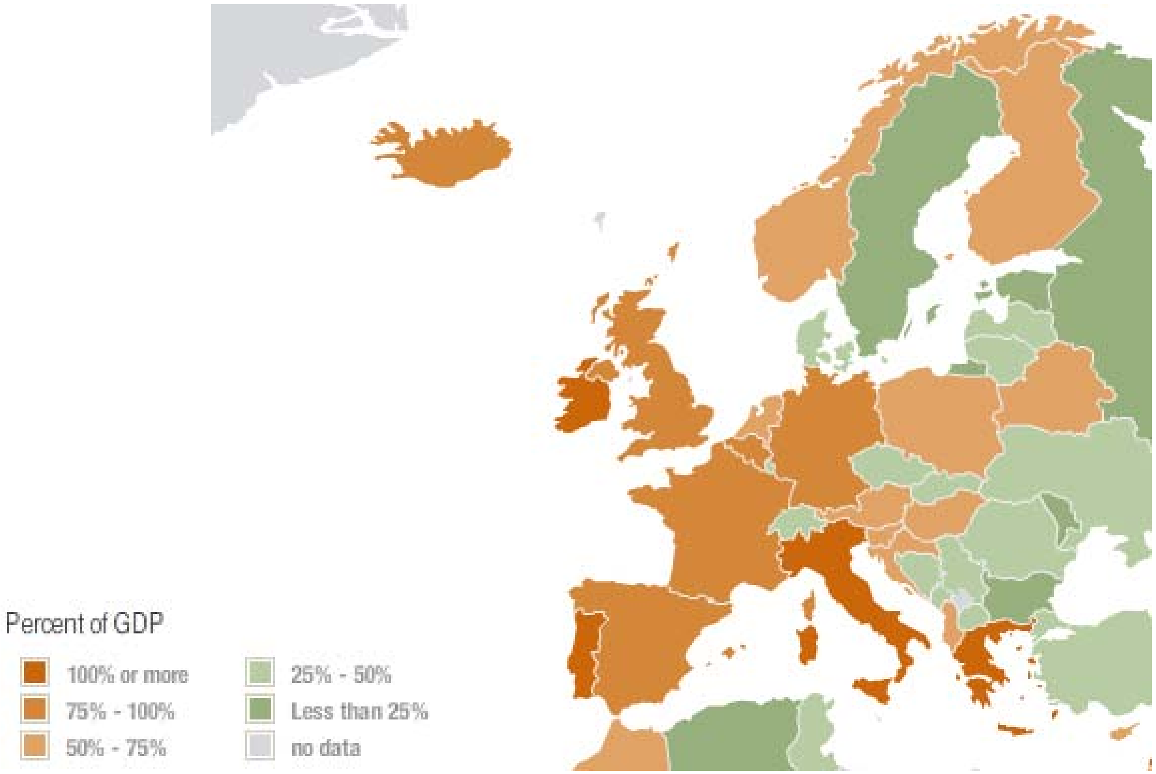
Outline

- Introduction
- The critical outlook of the euro periphery
- Stress points and spillovers
- The long genesis of the euro crisis
- EMU 'on the brink'
- Possible solutions and scenarios

European economies' sovereign debt (as a share of GDP)



Source: IMF WEO September 2011

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Introduction

- Europe's sovereign debt crisis has:
  - exposed the deficiencies in the governance of the EMU;
  - shown the limits of its framework of policy cooperation;
  - exposed the imbalances within Europe;
  - exacerbated the structural weaknesses of its model of growth;
  - emphasised the regional differences - or "two-speed" Europe.

- However, the euro crisis did not develop overnight, but incubated over the years
  - the process of European integration exacerbated existing weaknesses and accentuated divergencies

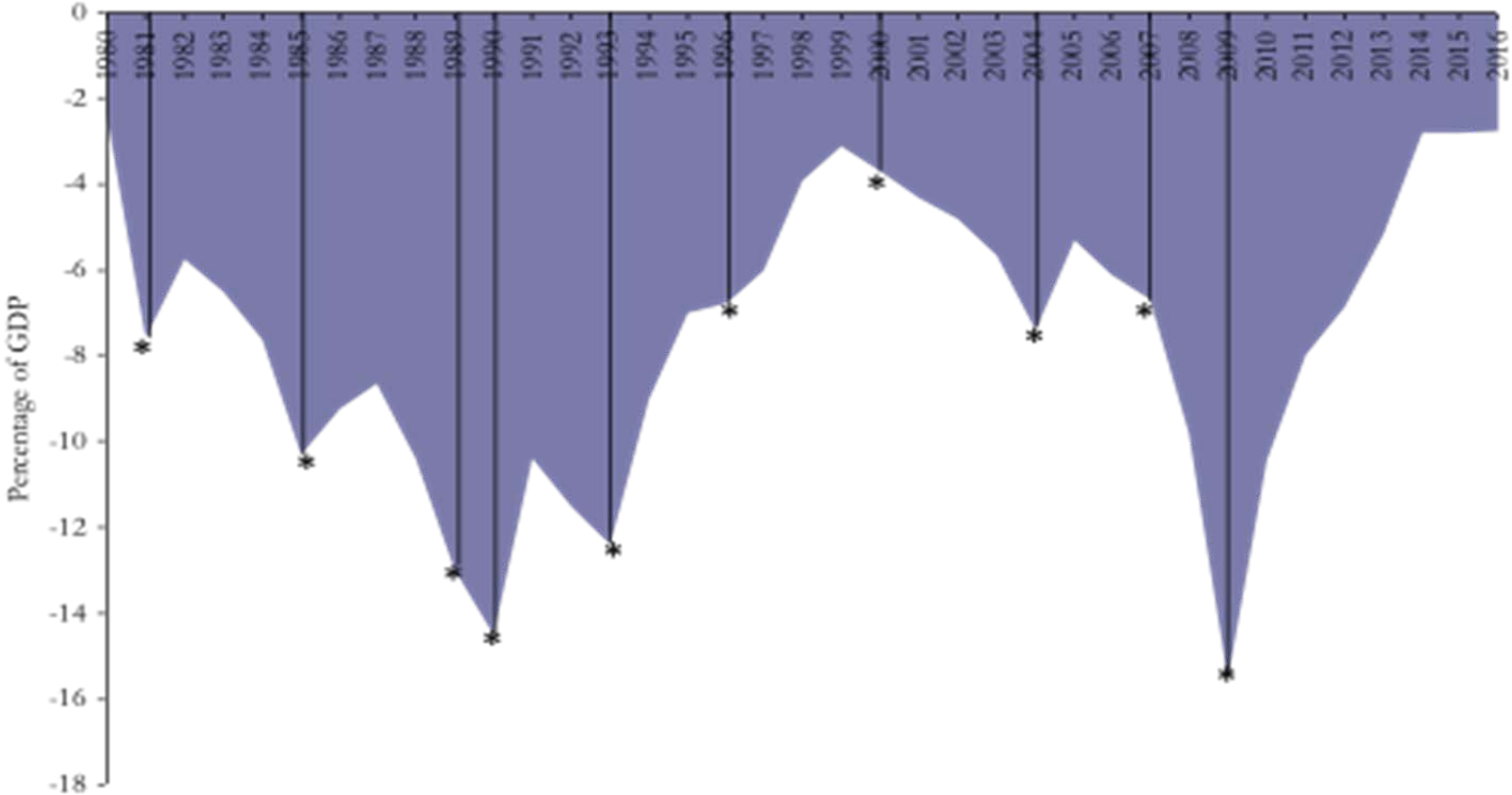
Greece and Italy

- Greece and Italy were admitted to the EMU with public debt exceeding 60% of GDP that was sanctioned in the Maastricht Treaty in 1992.

- However, Italy, one of the signatories of the Treaty of Rome in 1957 and one of Europe's largest economies, was deemed necessary to the success of the euro.

- Being about 2% of the total euro area economy, Greece was believed to be too small to have any significant impact on the stability of the currency union.

Greece fiscal deficit (as a share of GDP)



Source: IMF WEO September 2011
*Drop down lines indicate election years

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Ireland, Spain and Portugal

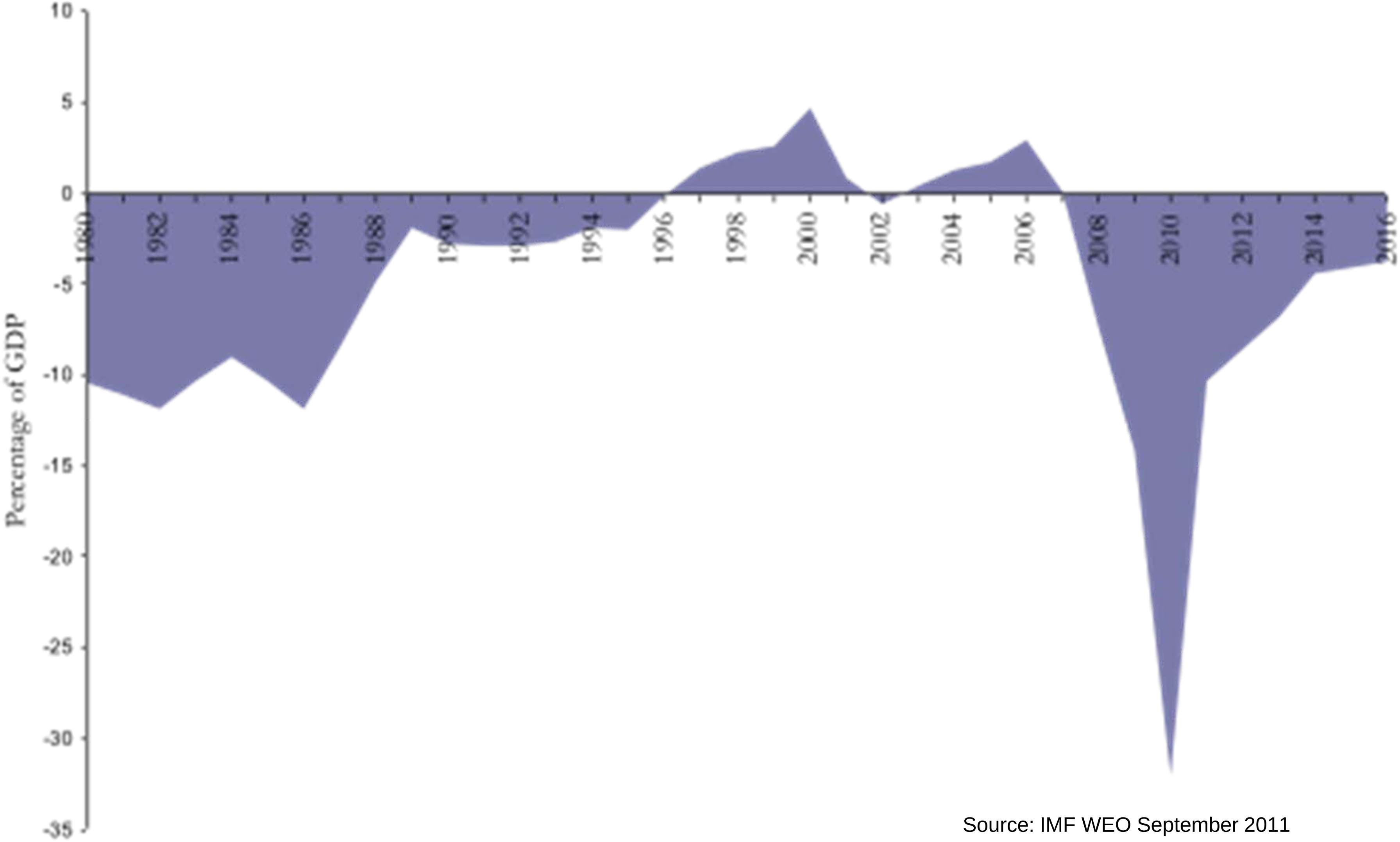
- Ireland and Spain suffered from interest rates inappropriate for the pace of their economic growth and/or of credit growth.

- In addition, strong economic growth and potential overheating in Ireland and Spain required countercyclical policy measures to avoid excessive credit growth and build up in property bubble.

- Government interventions in response to the global financial crisis led to the widening of public deficits and debt, even for 'fiscally virtuous' countries such as Germany.

- Ireland and Spain, and to some extent Portugal, ended up joining the group of countries with long-term public finance problems such as Greece and Italy.

Ireland fiscal deficit (as a share of GDP)

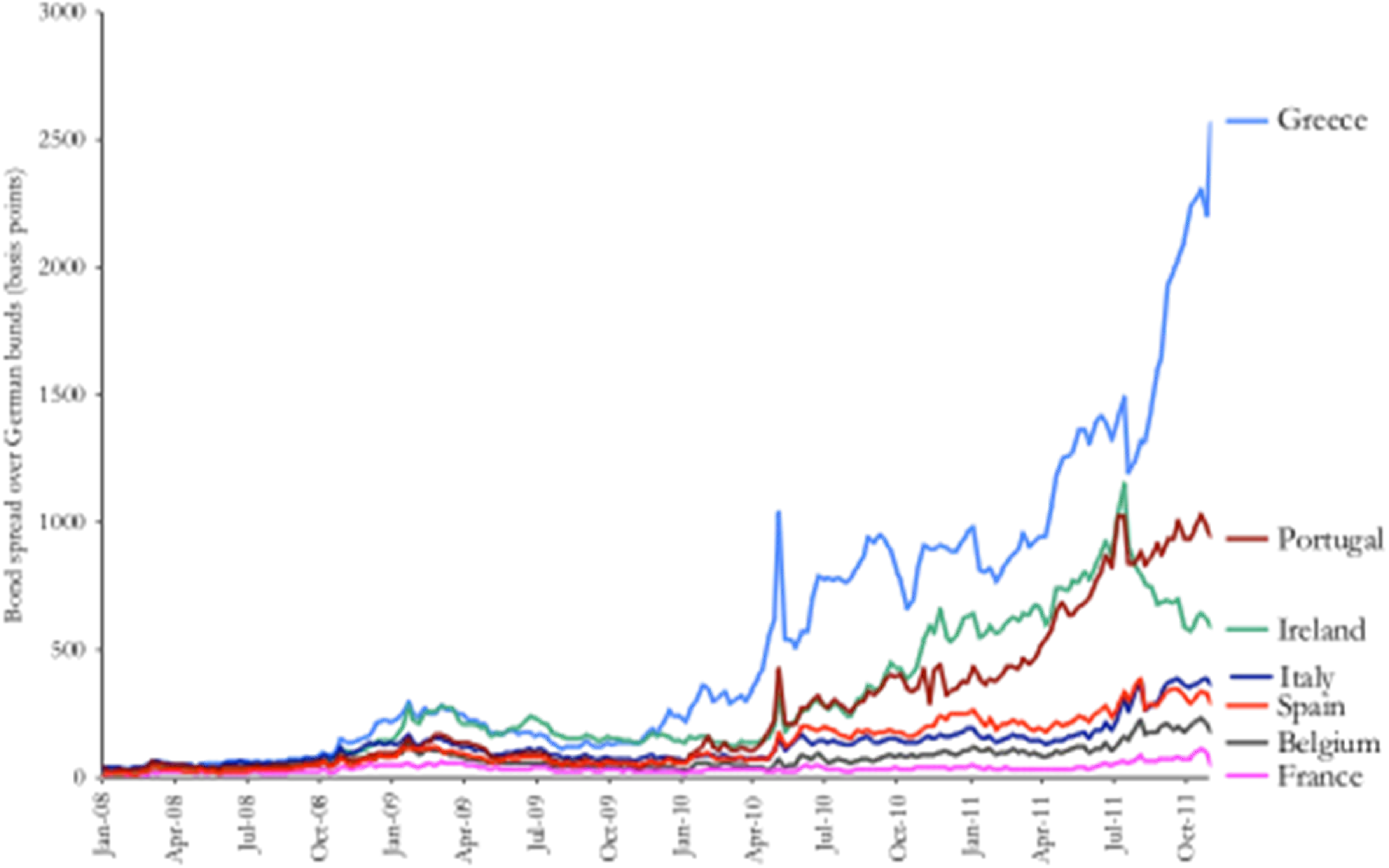


Source: IMF WEO September 2011

The critical outlook of the euro periphery

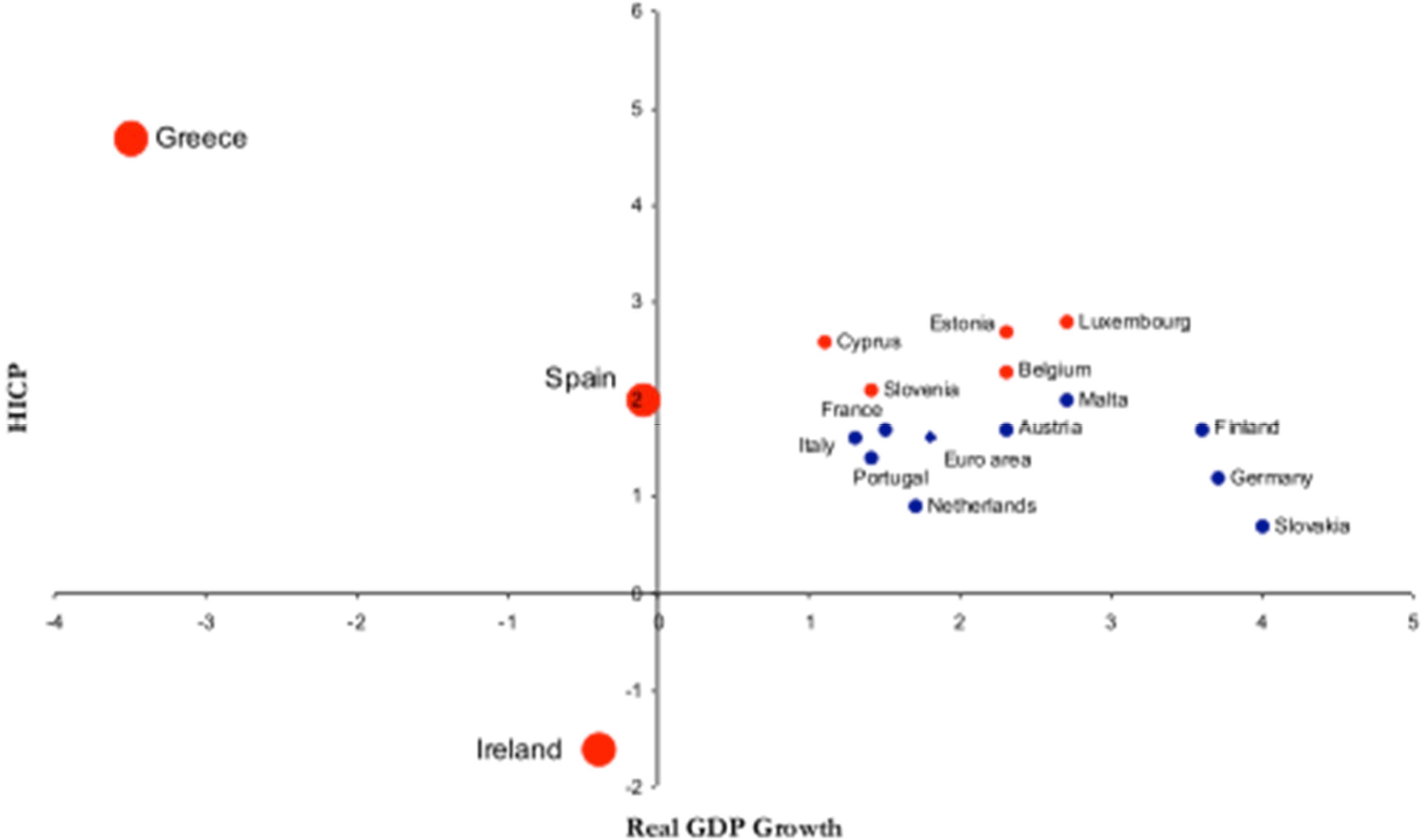
- Unsustainable cost of government borrowing
- ‘Two-speed’ Europe: growth and inflation
- Record levels of youth unemployment

The cost of government borrowing



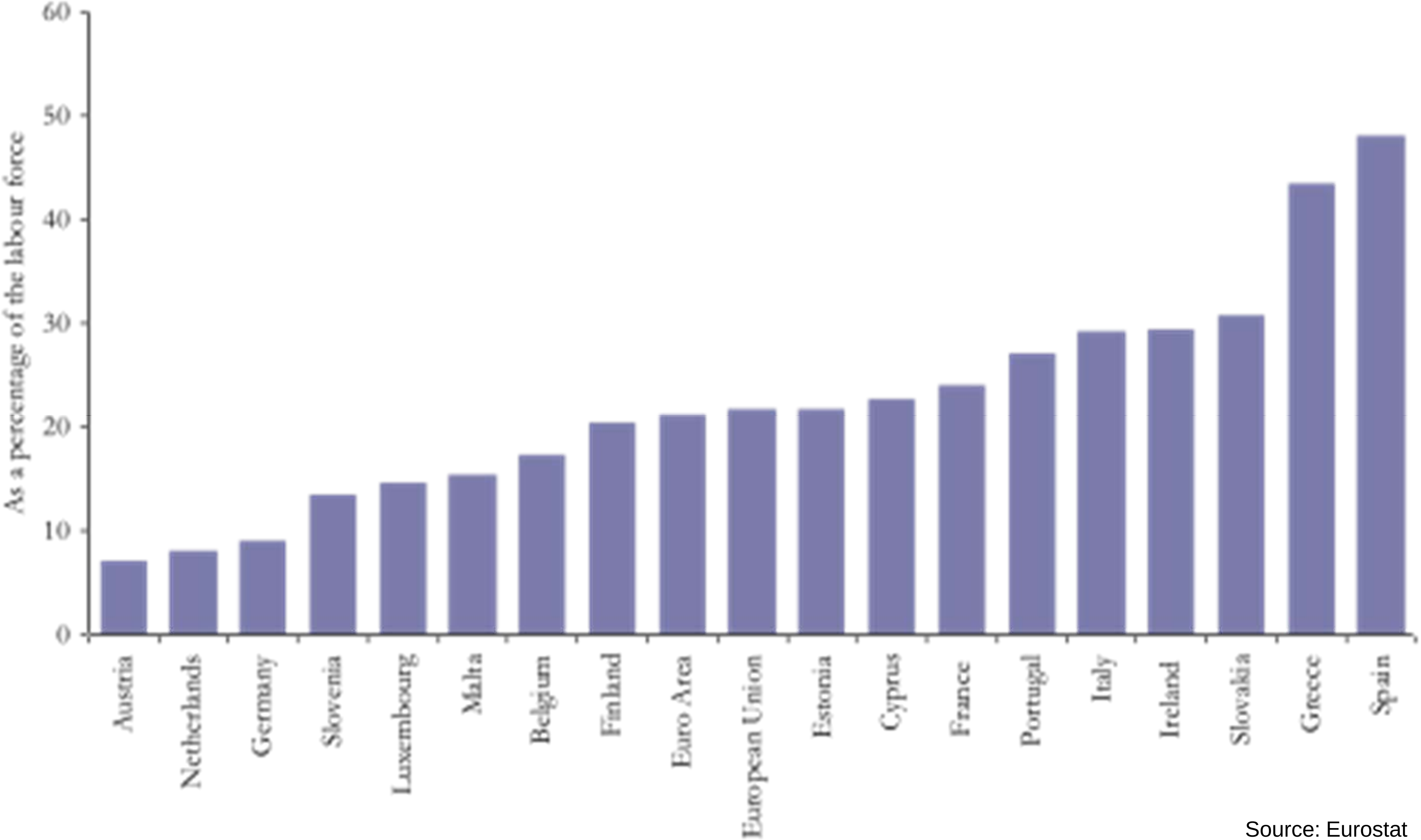
Source: Financial Times

GDP growth and Inflation, Euro Area 2010



Source: Eurostat

Youth unemployment, Euro area, September 2011*



Source: Eurostat
*Germany: August 2011; Greece, Estonia: July 2011

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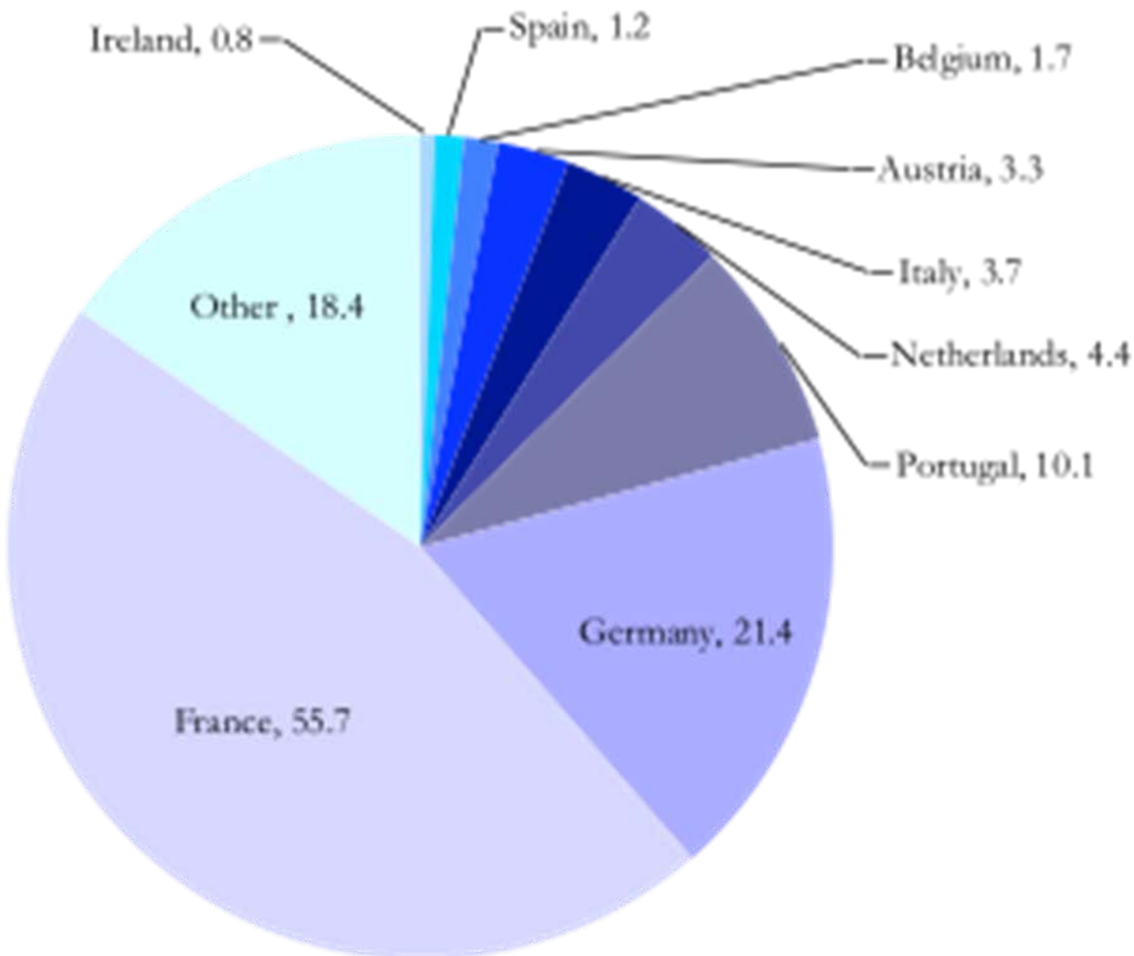
Stress points and spillovers

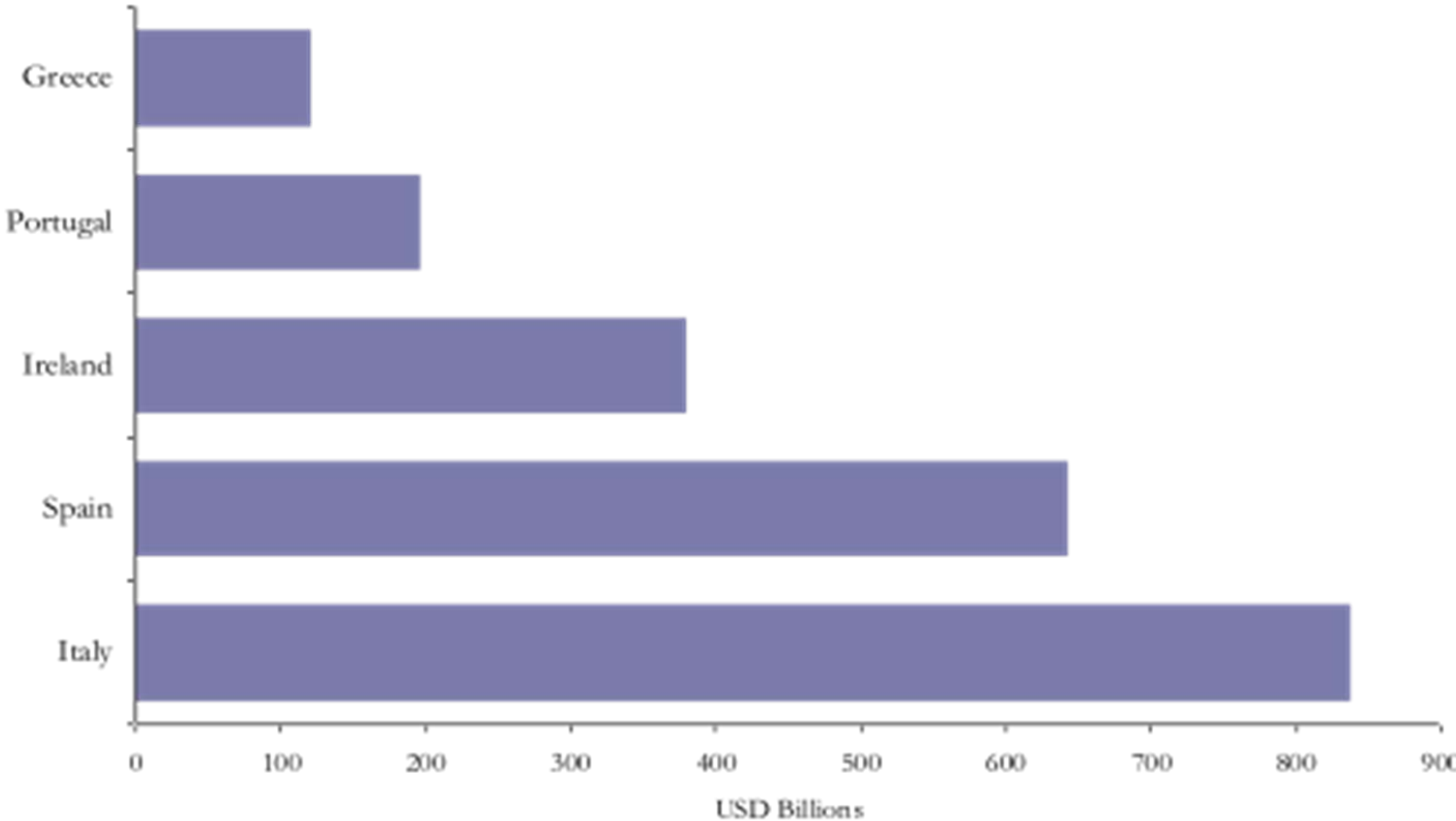
- Banks' direct holdings of sovereign debt
- European banks have sizeable exposures to banks in affected countries
- Credit Default Swaps channels
- Cross-country contagion

Banks' foreign claims located in Greece by European reporting countries, Quarter 2, 2011 (USD Billions)



Source: BIS

European banks' combined exposure to foreign claims located in affected countries, Quarter 2, 2011



Source: BIS

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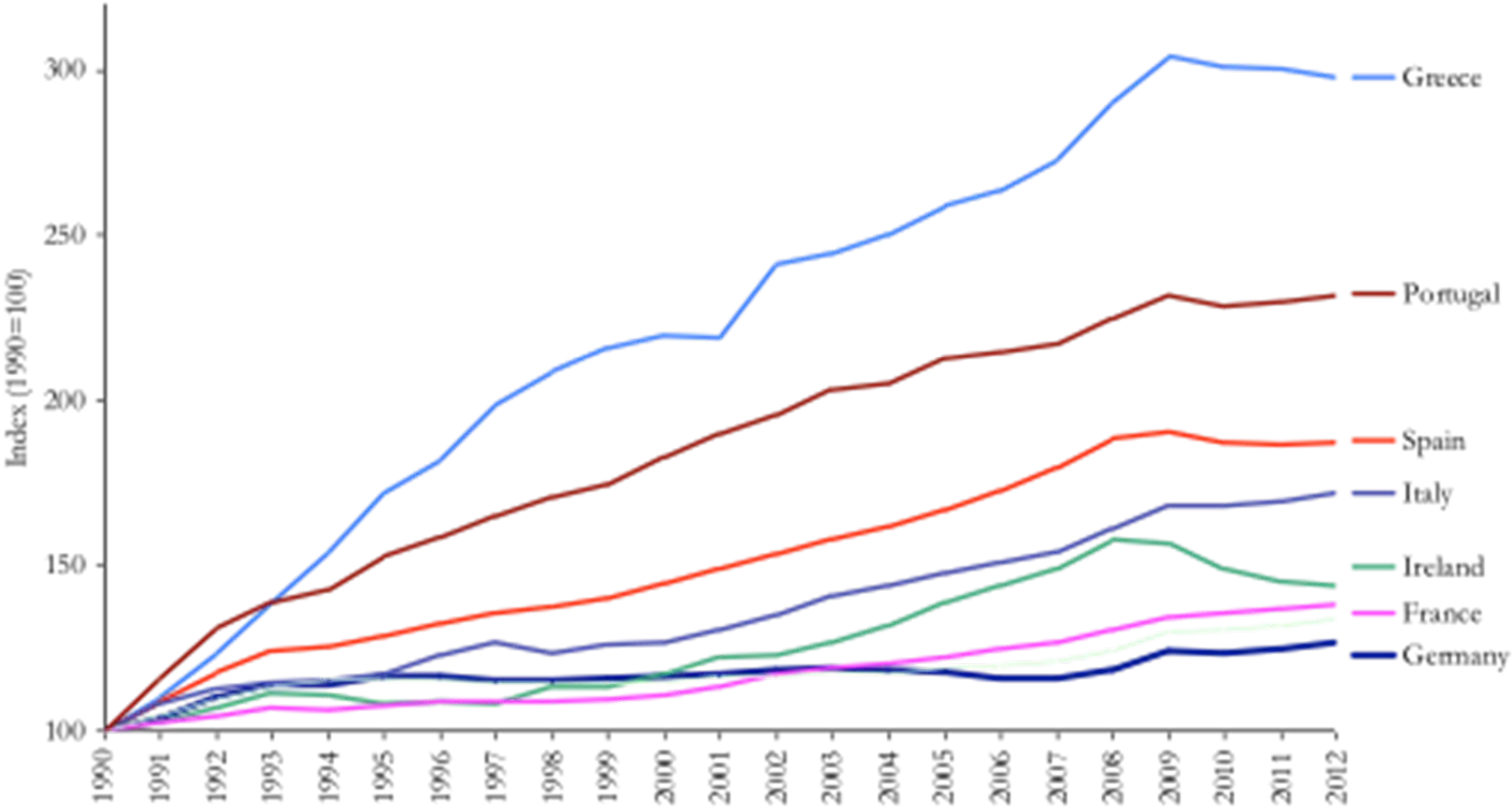
The long genesis of the euro crisis

- Long-standing problematic fiscal positions, under-performing economies and imbalances are the main causes of Europe's vulnerability to the global financial crisis and later to the sovereign debt crisis.

- In addition, deteriorating competitiveness of the affected countries clearly manifested (prior to the crisis) in:
  - Unit labour costs
  - Consumer prices
  - Terms of trade / current account balances
  - Real effective exchange rates

Nominal unit labour costs (compensation per employee to real GDP per person employed)



Source: AMECO

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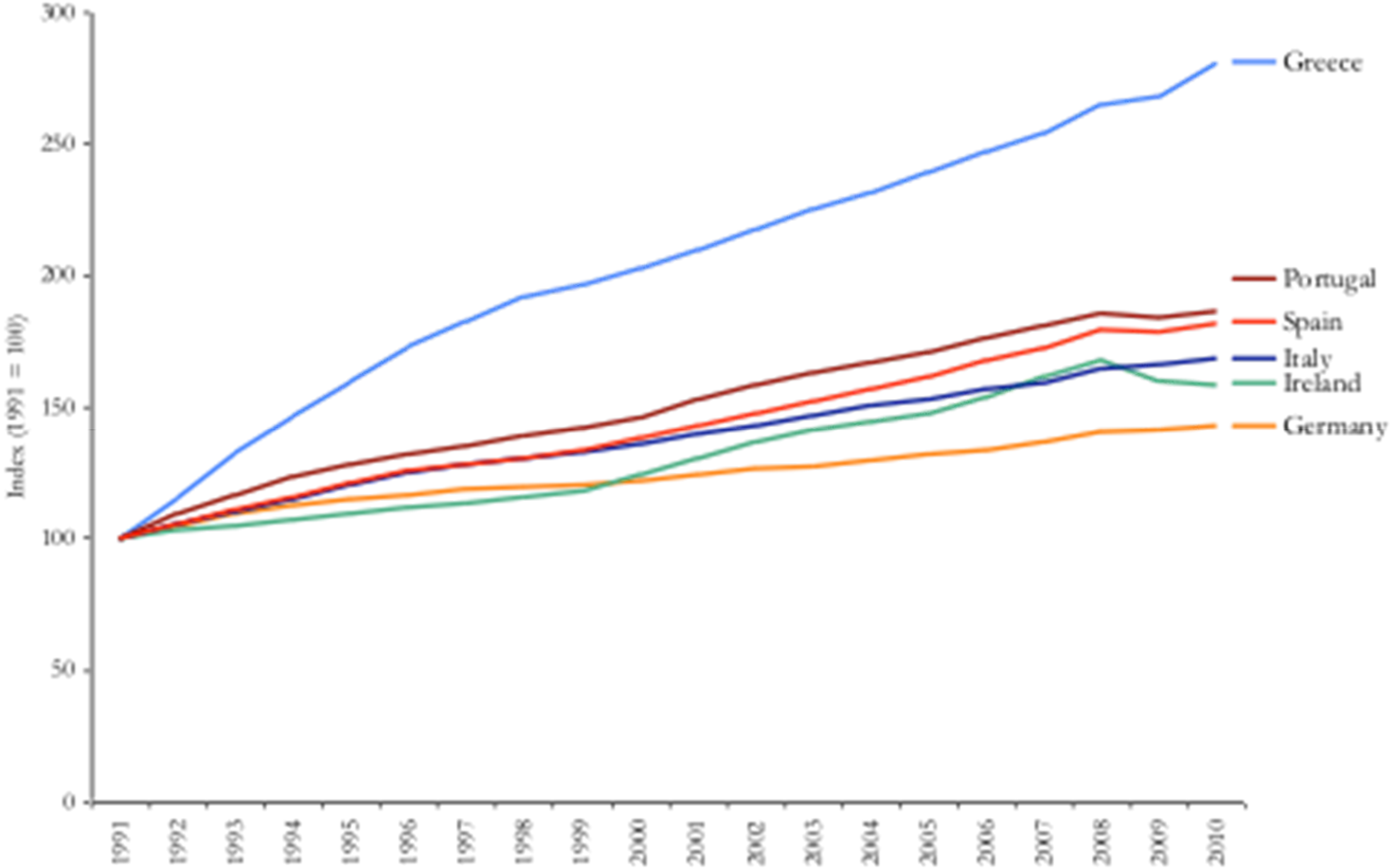
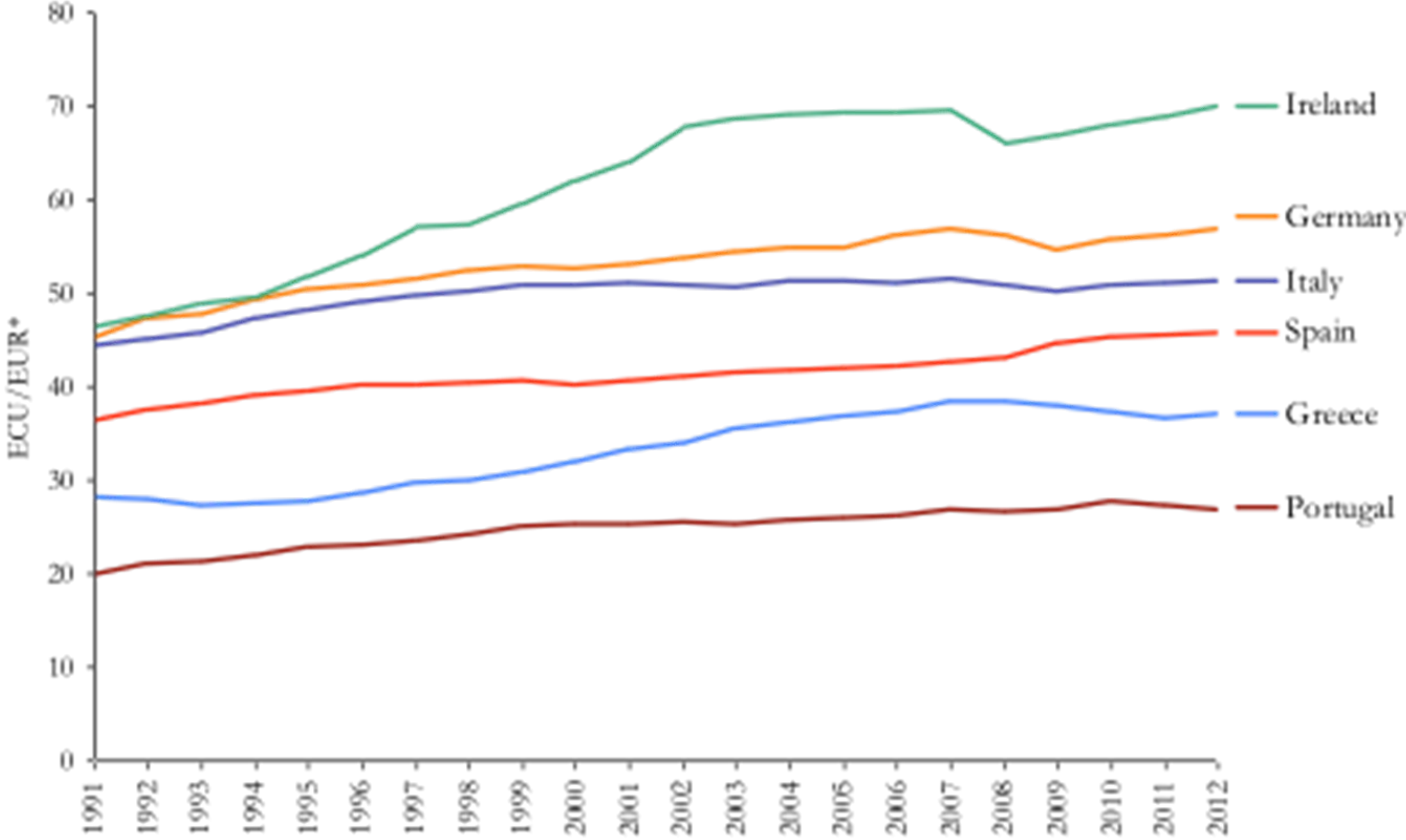
Inflation in the euro area (Consumer Prices Index, 1991=100)



Source: OECD

GDP at 2000 market prices (adjusted by terms of trade per person employed)



Source: AMECO

*1000 ECU/EUR- Weighted mean of t/t-1 national growth rates (weights: t-1 current prices in ECU/EUR)

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Greece Real Effective Exchange Rate (deflator: unit labour costs in the total economy, 12 trading partners)

Source: Eurostat

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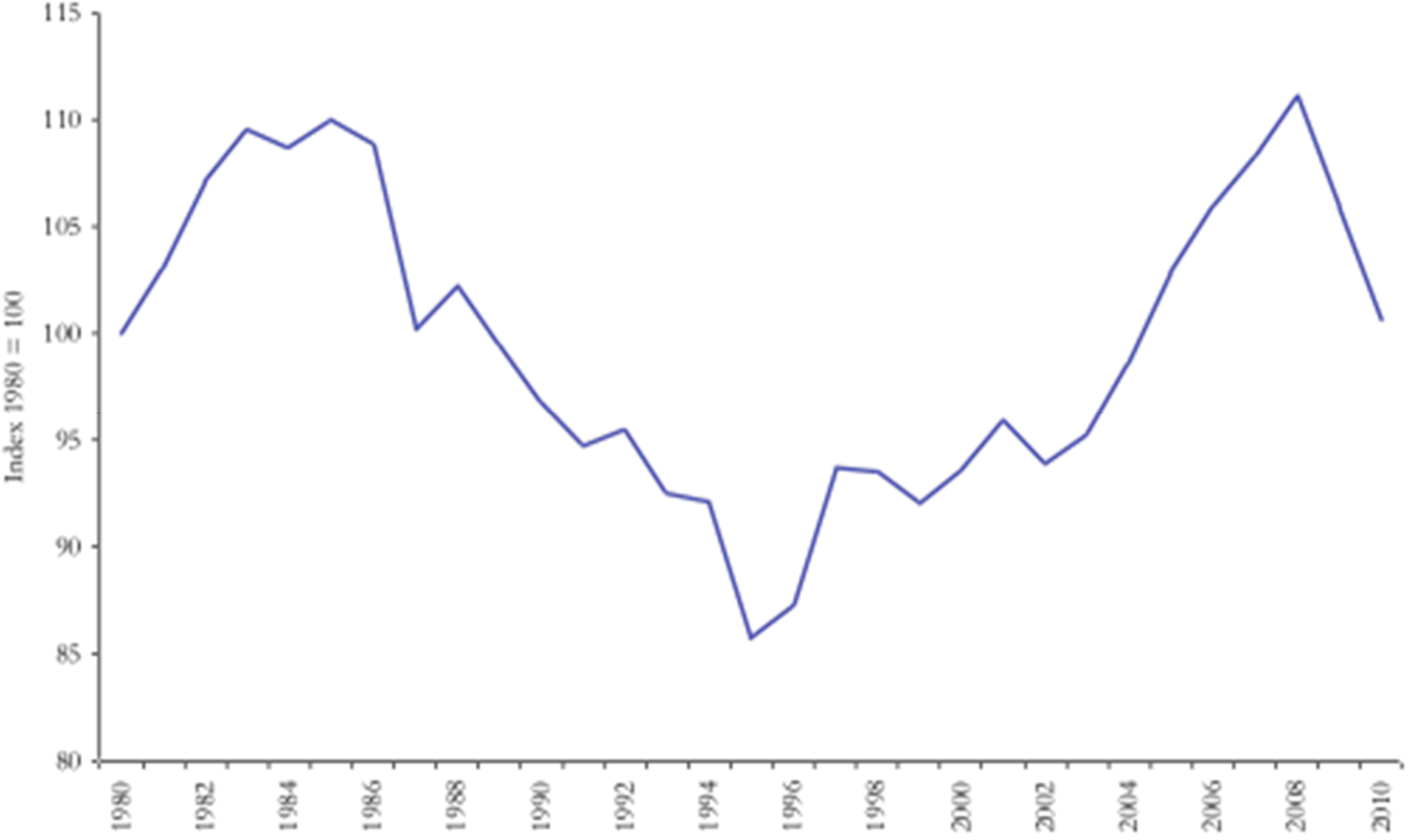
Ireland Real Effective Exchange Rate (deflator: unit labour costs in the total economy, 12 trading partners)



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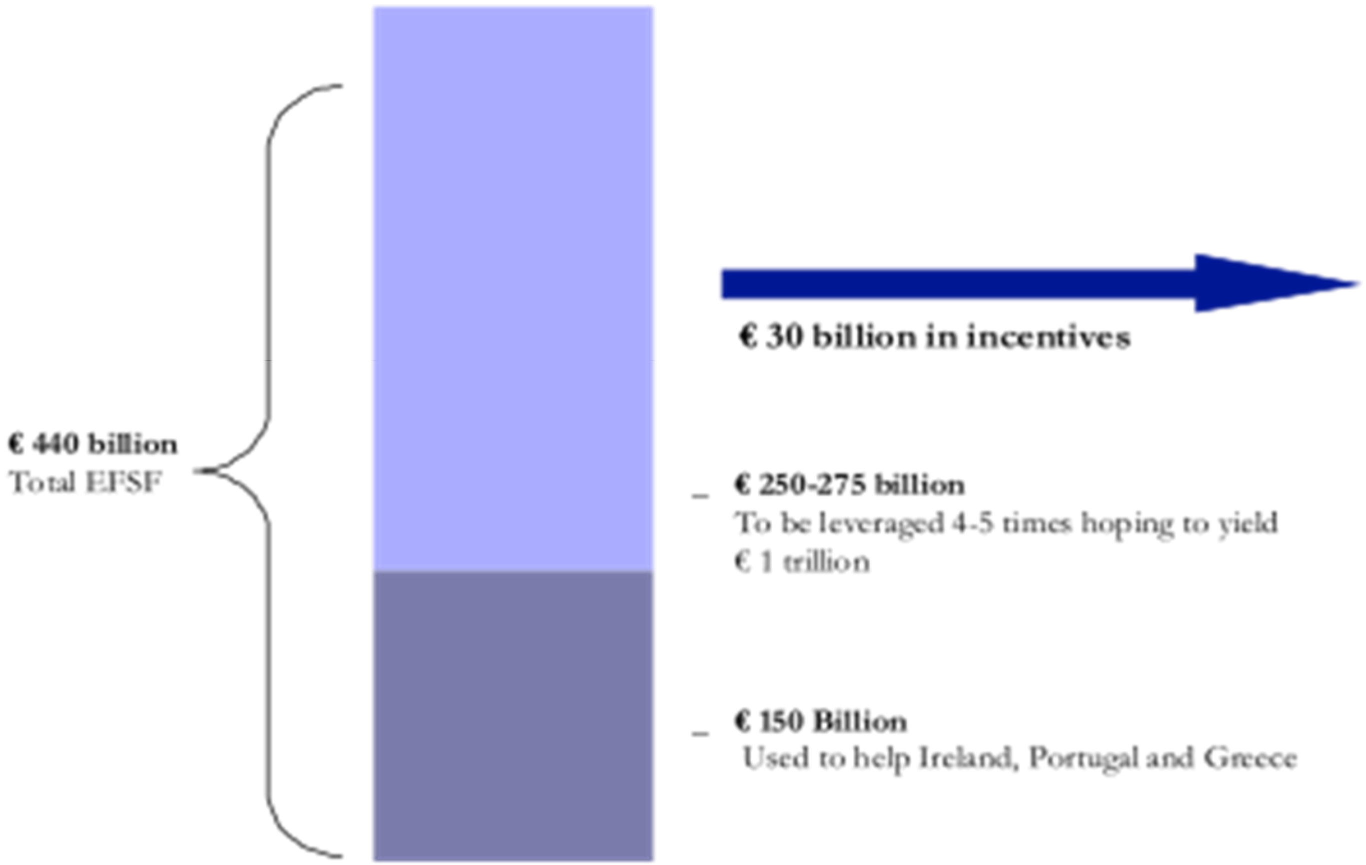
Source: Eurostat

EMU 'on the brink'

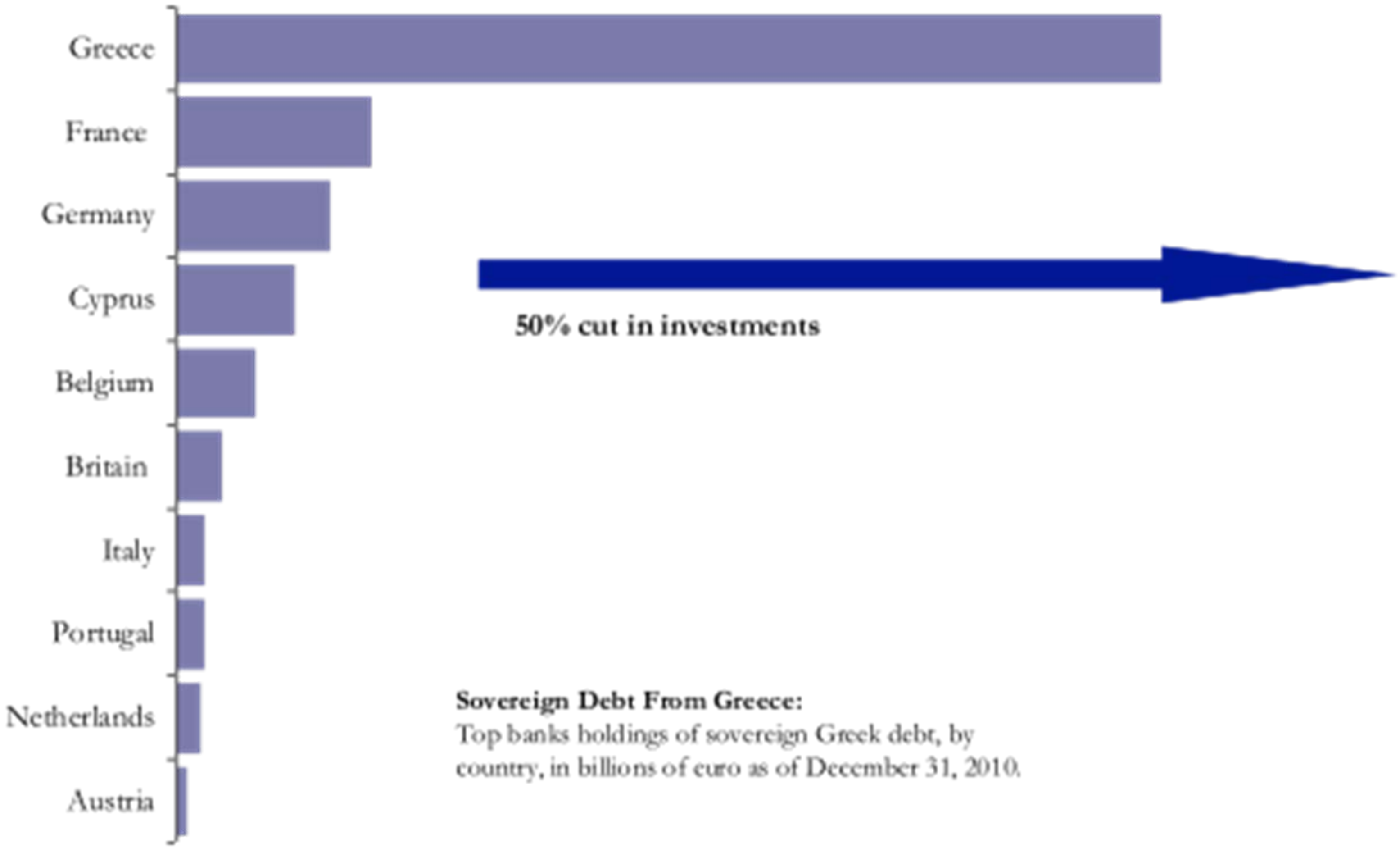
- The general consensus is that Greece is now insolvent.
- Indicators of debt sustainability point towards a Greek default:
  - public debt-to-GDP (165.6%),
  - public debt-to-government revenues (about 400%), and
  - benchmark government bond yields (10-year bond yield at about 28%)
- Spreads on Italian (and Spanish) debt are getting close to the point where sustainability issues are raised.
- Credit rating agencies have also warned about the risk of a downgrade to France's rating owing to French banks' exposure to a Greek default and their reliance on wholesale funding.
- However, the German fiscal position as well as the growth prospects have a kept a lid on its sovereign borrowing.

European Financial Stability Facility



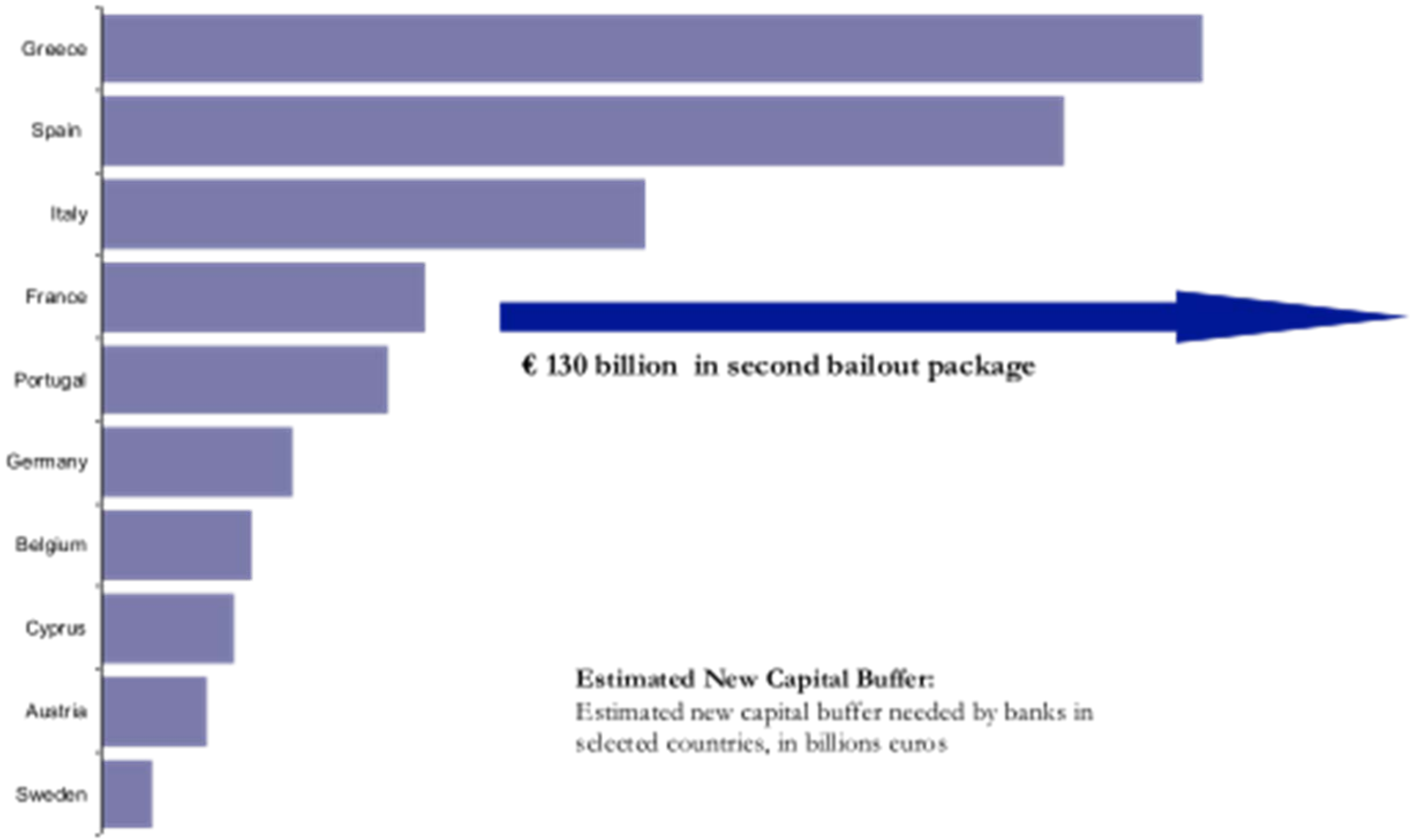
Source: EFSF, Eurostat, EBA, WSJ and Reuters

Private Sector voluntarily write off 50% of its investment in Greek bonds to reduce Greece's debt by € 100 billion.



Source: EFSF, Eurostat, EBA, WSJ and Reuters

Banks: European banks recapitalised to raise around € 130 billion by June 2012



Source: EFSF, Eurostat, EBA, WSJ and Reuters

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The diagnosis

- The problems – fiscal burden, contagion and lack of growth – are interlinked
- Firstly, root cause of the problems in the eurozone periphery countries is their lack of competitiveness
- Secondly, Europe's fiscal problems cannot be addressed without a return to growth
- Finally, in its current form the EFSF is simply not large enough to fulfill the stabilisation role

Solution

- **If the euro survives in its current form, addressing these competitiveness issues requires:**

  - **<u>A comprehensive fiscal strategy:</u> that balances the immediate need to support growth with the imperative for a credible medium term plan to reduce deficits and debt**

  - **<u>Structural reforms:</u> to maximise growth potential in individual countries**

  - **<u>Maintain competitiveness:</u> reforms that ensure the real exchange rates can adjust with ease**

Structural Reforms

1. An effective fiscal coordination mechanism

2. Better balance of responsibilities between surplus and deficit countries within the eurozone for correcting payments imbalances.

- However, it is clear that these are very difficult political problems that test the balance between:
  - member states and the central bodies (the Commission, the ECB and the European Parliament)
  - 17 members of the eurozone and the full 27 members of the European Union

The alternative

- The balance of costs and benefits from membership of the single currency are spread unevenly between its members.

- Nevertheless, the benefits of the EMU membership are large especially for smaller countries.

- Ultimately, if the cost-benefit equation shifts too far, it could force the break-up of the euro, either by forcing out some of its weaker members or by encouraging the stronger members to leave because they are not prepared to accept the consequences for themselves.

- But this would potentially reverse the trend towards greater integration at all levels within Europe and for that reason, it would only come about as a last resort.

- THANK YOU

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