Roads to Survival

How EMU Break-up can be avoided

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Outline

1. Unfinished business

- ‘Double dip’ driven by fiscal squeeze and weak credit growth
- Core vs. periphery divergence is politically and economically unsustainable

2. Sovereign and bank solvency intertwined

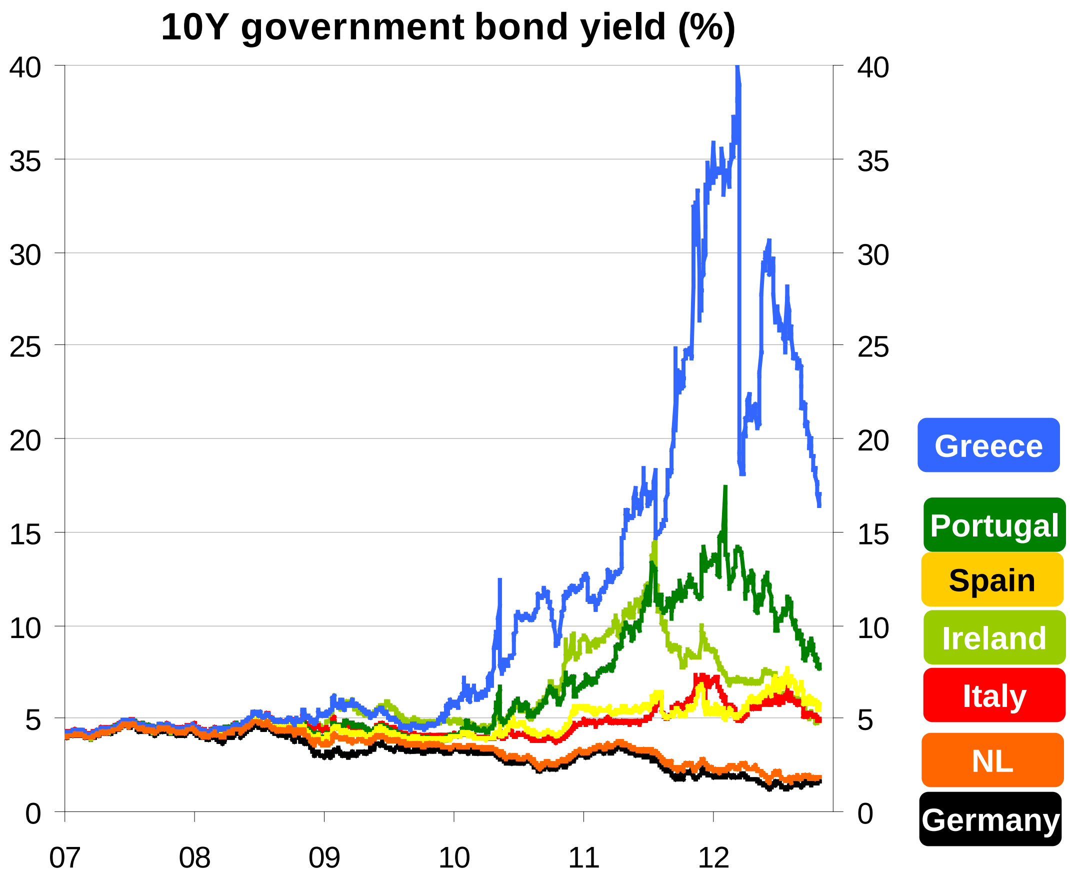
- Tougher capitalisation requirements are also hurting growth
- Banks remain reliant on ECB funding, exposed to government debt

3. There *are* Roads to Survival

- It is not just about fiscal discipline, or even external indebtedness…

  …*growth* (especially in the periphery) is crucial too – for now, it’s up to the ECB
- More resources will have to be transferred to the periphery
- Banking and funding union involve covert transfers…but fiscal union is the destination
- Will politicians secure popular support to trade sovereignty for solidarity?

Eurozone debt crisis – unfinished business



Four ways to bring down debt-to-GDP ratio

Δdebt =

Primary deficit + (Interest rate – GDP-growth) x Existing debt

1 Austerity / higher taxes

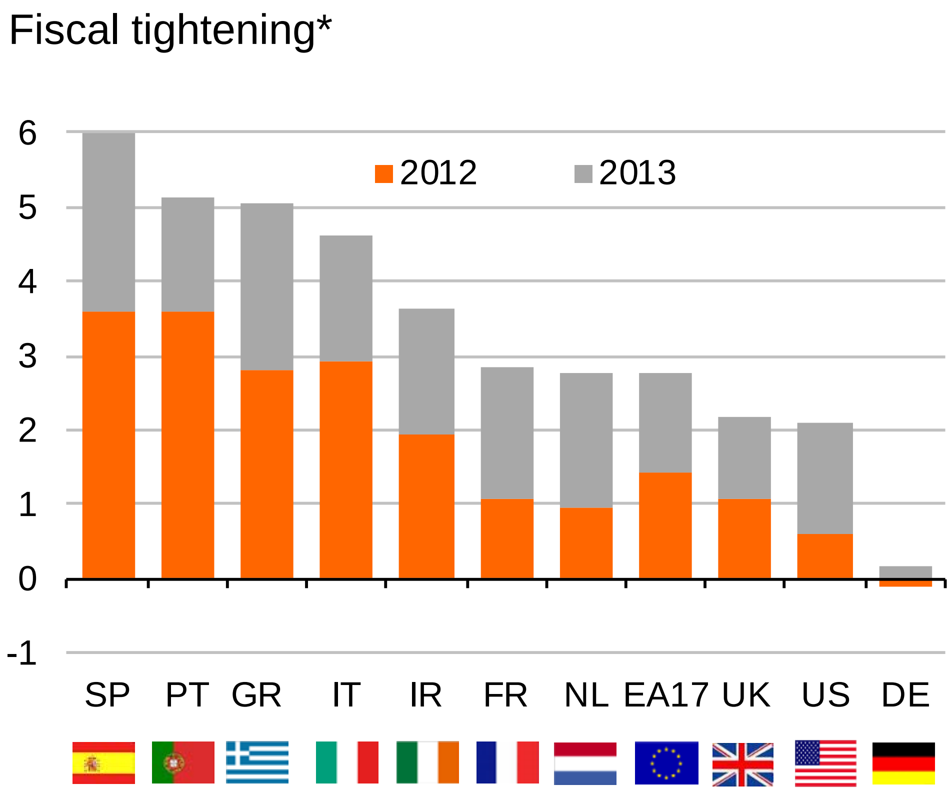
2 Lower interest rates

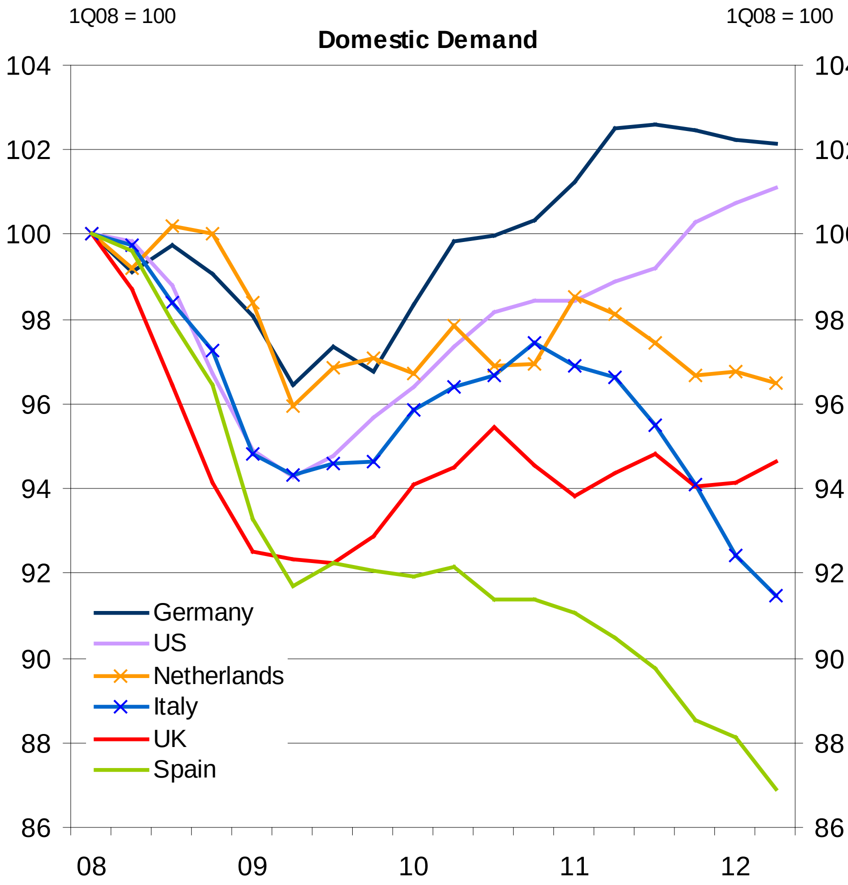
3 Faster real growth or higher inflation

4 Sell-off assets or restructure/default

Diverging fiscal policy

Periphery – led by Spain – is tightening more than the core





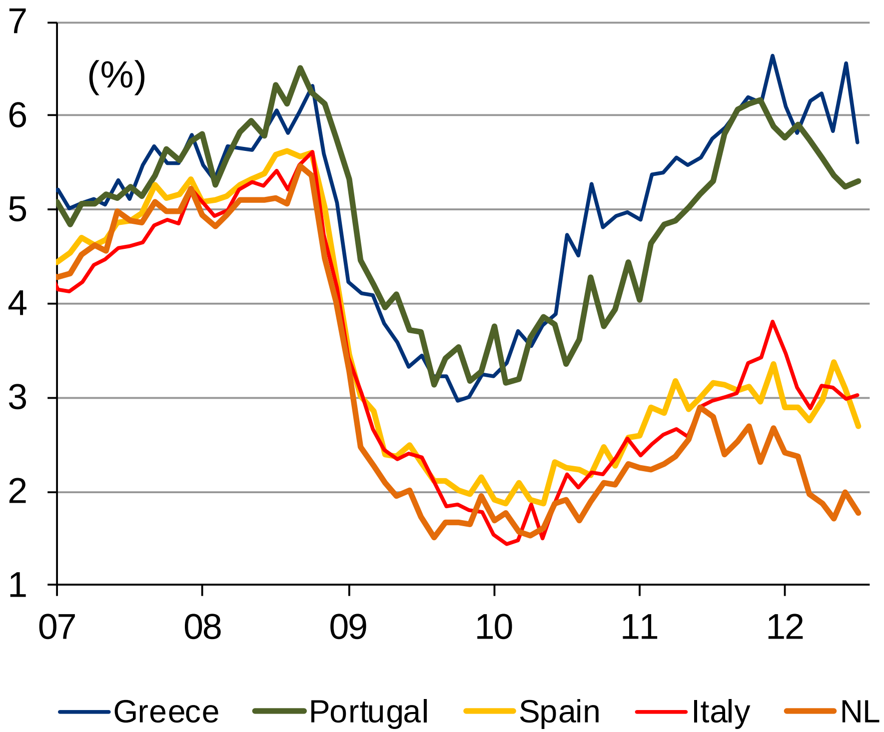
Source: OECD, ING

* % of potential GDP; annual change in underlying primary balance

Diverging interest rates

Markets are penalising, not rewarding, the peripherals for their fiscal austerity

Corporate lending rates*



* Loans over € 1m at floating rate and up to 1 year initial rate fixation

Source: ECB

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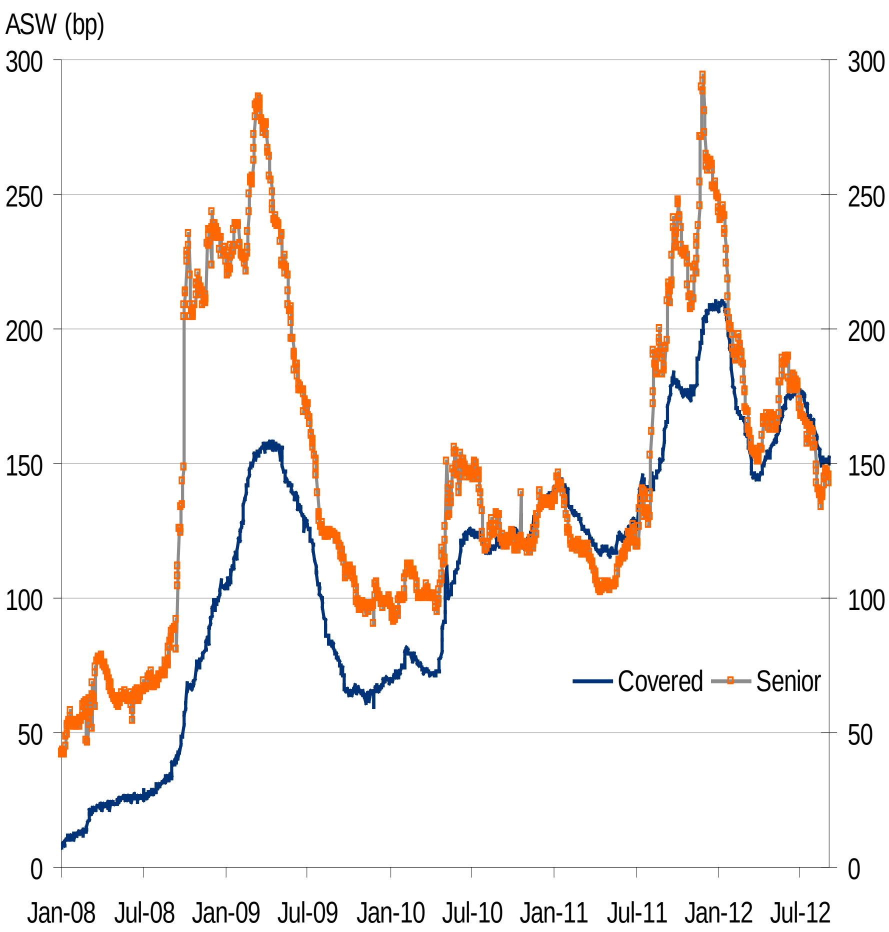
Bank regulation – strongly pro-cyclical

Bank funding costs rise (Asset Swap Spreads)



- Policy-makers are keen make the financial sector more robust.
- A key idea is for banks to increase capital, including counter-cyclical buffers…
- But the effect is strongly ***pro-cyclical***, adding to the weakness of growth

1. Higher bank funding costs – banks seen as 'uninvestable', with regulatory uncertainty
2. Pressure to increase holdings of government debt for liquidity buffers
3. Volume of lending is being squeezed
4. Capital markets are filling the gap – but does this make the *system* safer? Asset price volatility – the source of crises - could even be greater…

Draghi's pledge – "the euro is irreversible"

ECB OMT:

- To repair the effective working of monetary policy…
- …the ECB may undertake outright open market operations…
- …of unlimited size
- …focused on the short end of the yield curve (<3Y)…
- No yield cap
- ECB holdings no longer senior
- BUT…with strict conditionality attached

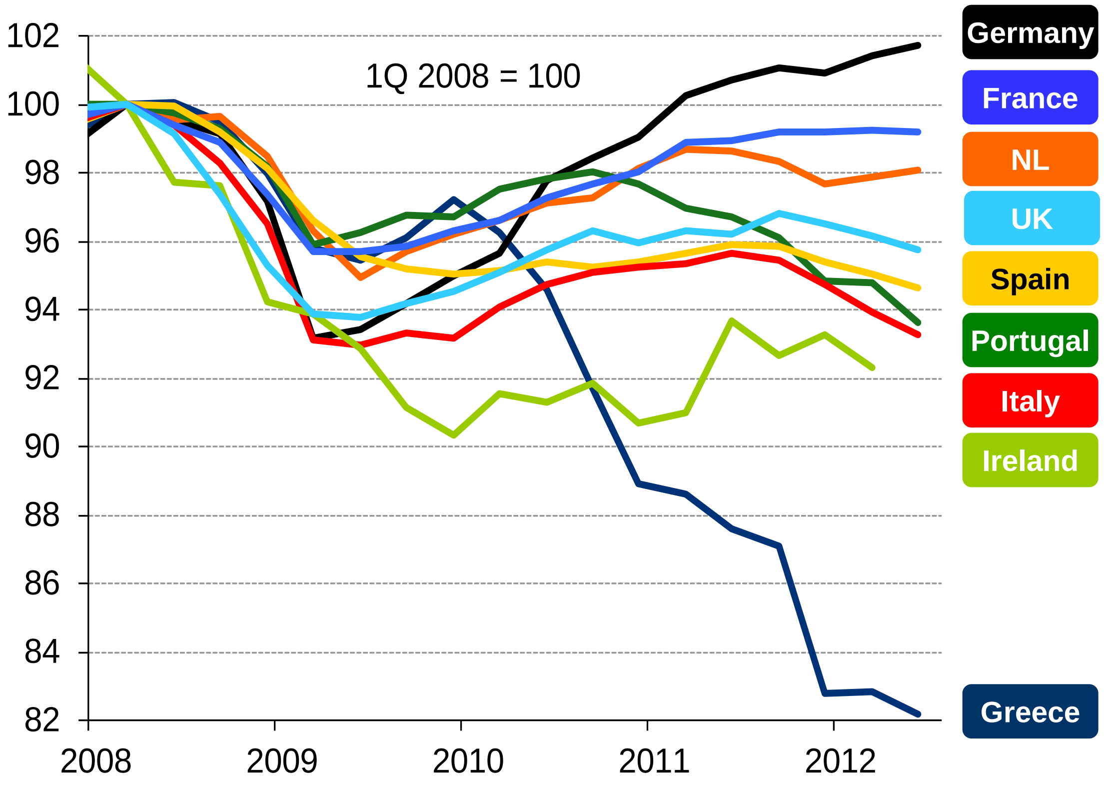
So first, Spain has to ask for a bail-out…

"There is no going back to the Lira or the Drachma or any other precursor currency"

Eurozone: widening economic divergences

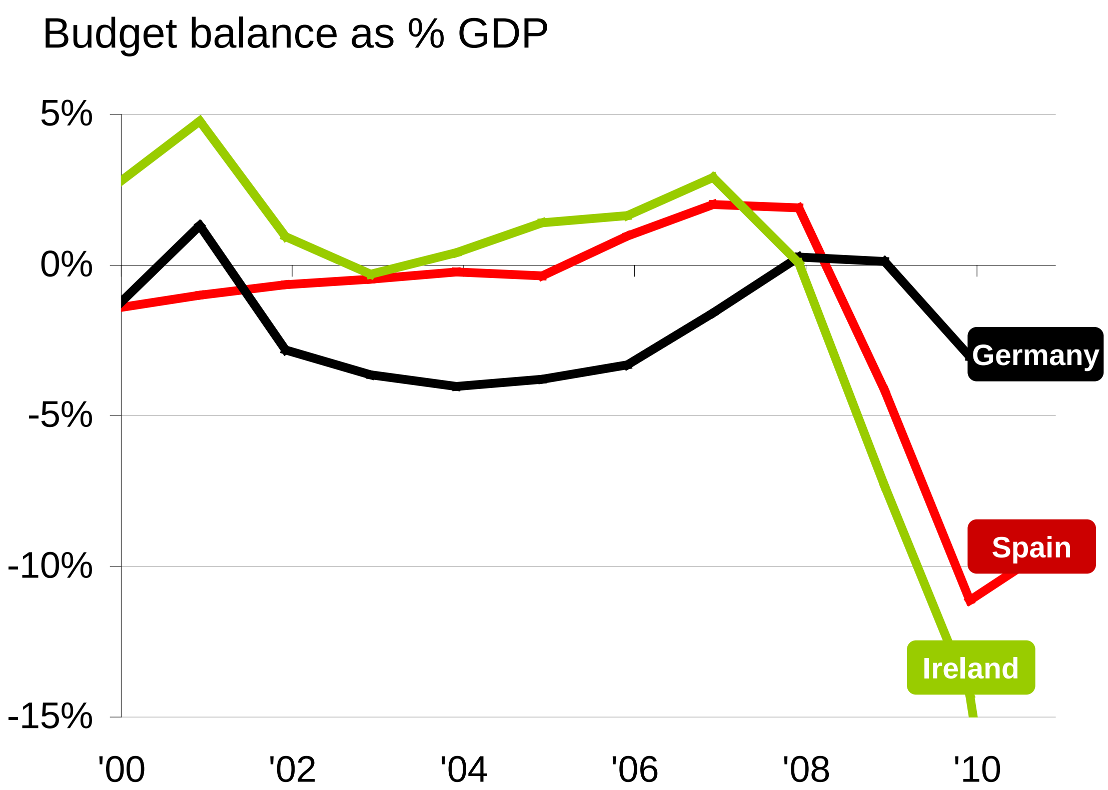
Greek experience is ominous…

Real gross domestic product (GDP level)

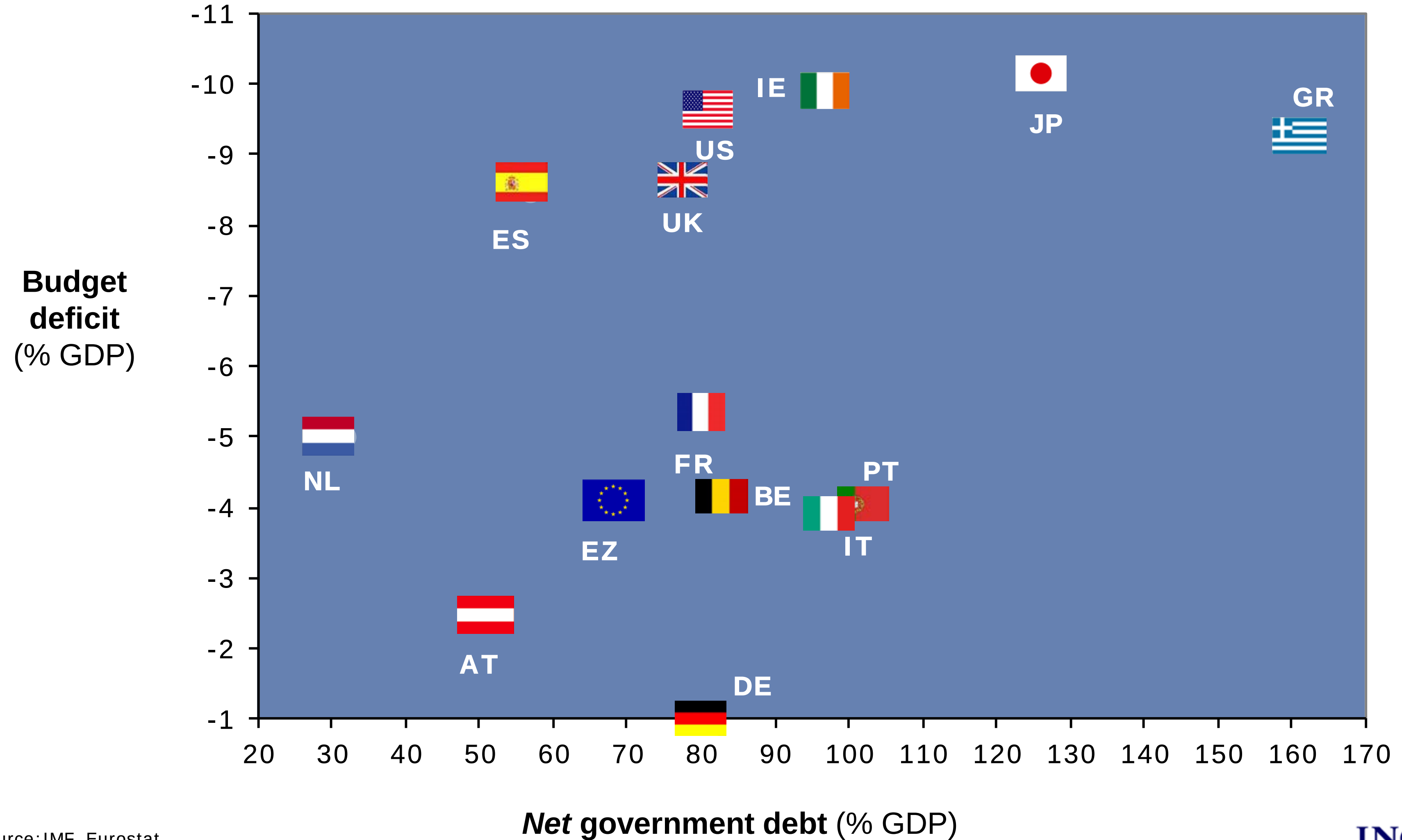


Crisis not solely caused by fiscal indiscipline

Spain and Ireland ran budget surpluses on the eve of the crisis



Debt/deficit Eurozone lower than in US & JP

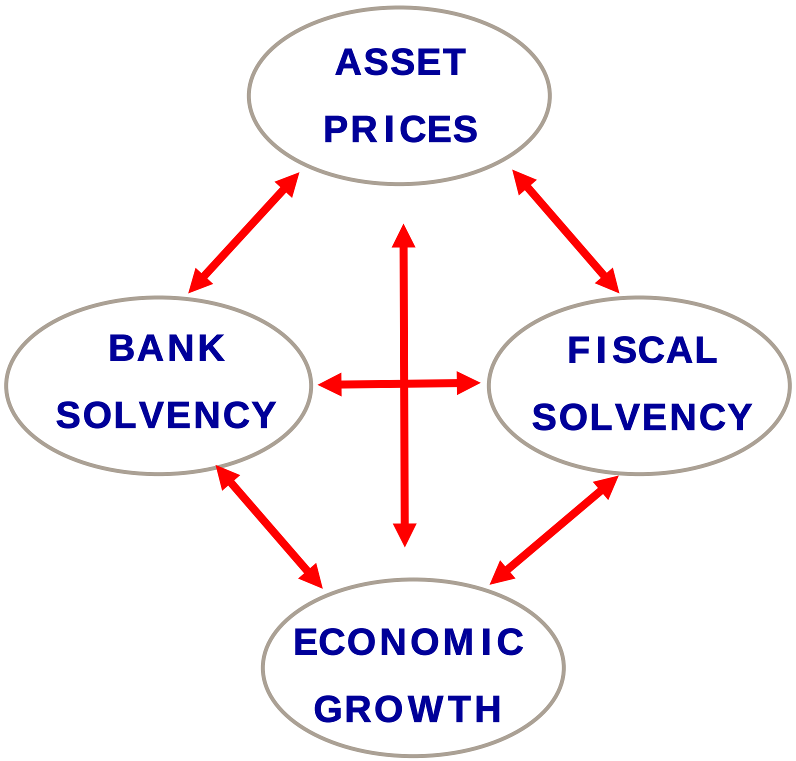


Source: IMF, Eurostat

Sovereign and bank debt solvency intertwined

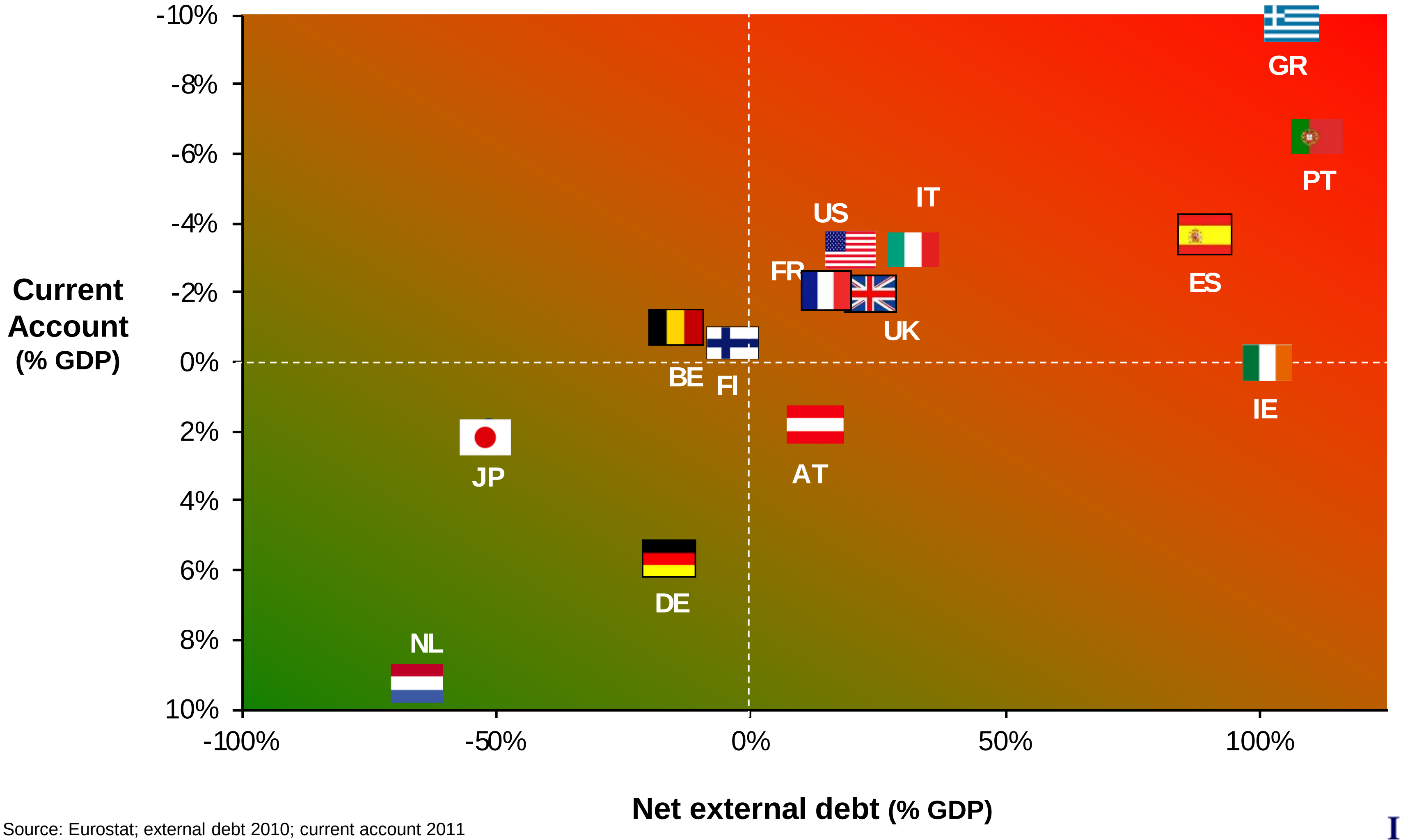
Solvency is threatened by falling asset prices and growth

The Deleveraging 'Doom Loop'



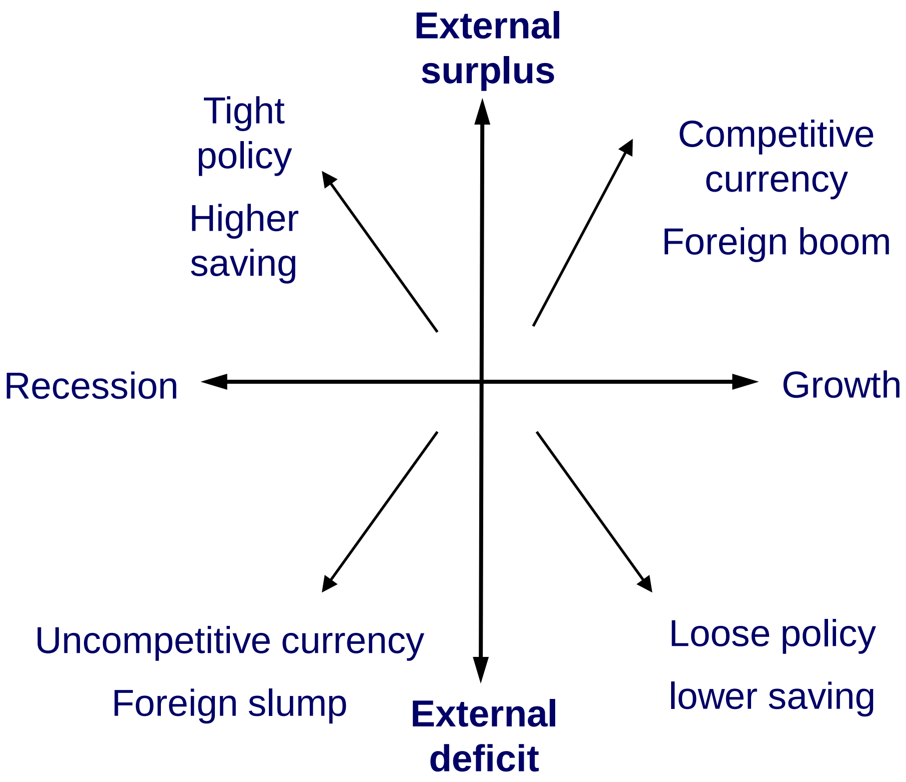
- The sovereign debt crisis is more a ***symptom*** than a cause: it stemmed from the financial crisis.
- Excessive ***private*** borrowing (leverage) exacerbated the downturn…
- BUT it's not just about debt, since **asset prices** …
  1. fuelled debt, just as debt fuelled asset prices
  2. precipitated the bust
  3. may drive a deleveraging doom loop if they fall further
- Bank and fiscal solvency are intertwined: banks still depend on ECB/state support, weak bank lending may hurt economic growth and public finances, banks are big buyers of public debt…
- Financial stability, fiscal and monetary policy are all intertwined…
- Central banks are now targeting asset prices

Peripheral countries are large net debtors…



Source: Eurostat; external debt 2010; current account 2011

And it's not just about external balance…



- In principle, external balance can be achieved through squeezing domestic demand – fiscal restraint can deliver this...
- BUT if this is at the expense of growth and employment, it will ultimately be economically and politically unsustainable
- As Jan Tinbergen pointed out, each policy objective needs a policy instrument…
- Without the exchange rate, regaining competitiveness is tough

Eurozone debt crisis – reality check

***The Paradox of Merkelism* – attempts to limit the costs to the core countries have served to increase them!**

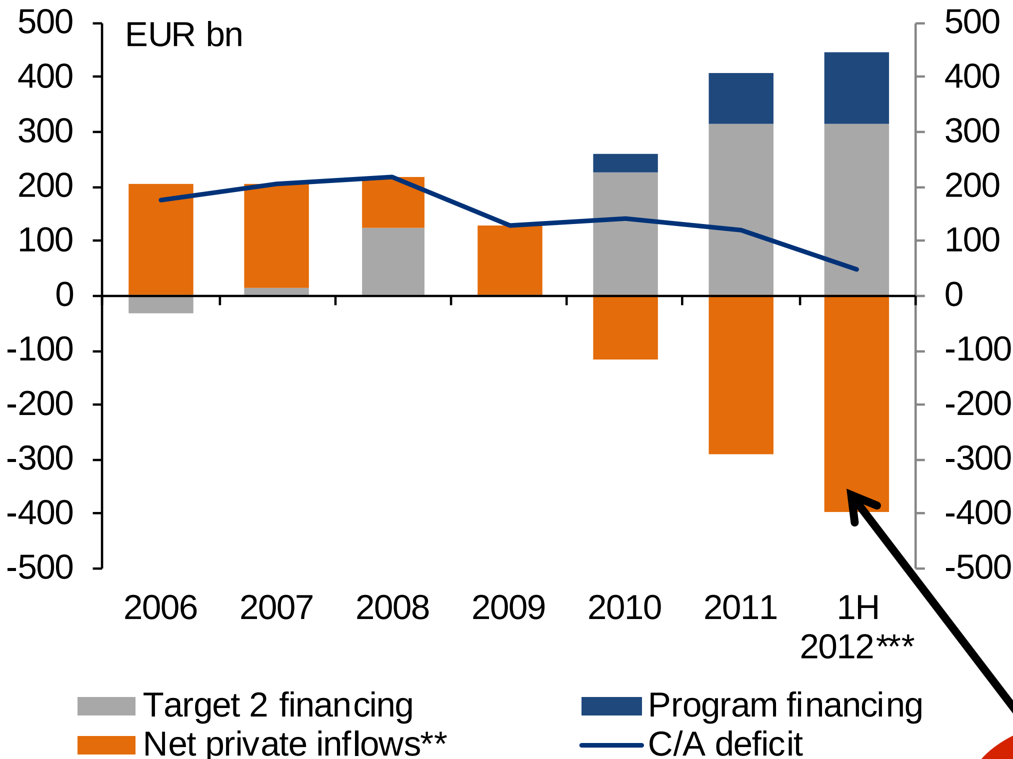
1. ***Debt restructuring*** – core country creditors have already taken losses: there could be more to come...
2. ***Transfer Union*** – much bigger fiscal transfers from the rich to the poor
   - ECB funding (covert)
   - Common bond issuance (covert)
   - European taxes/transfers

Politics will decide how losses are divided between bond holders and tax payers…

Capital flight – financed by the ECB

Markets are penalising, not rewarding, the peripherals for their fiscal austerity

Peripheral* Eurozone Balance of Payments: Private Capital Takes Flight



25% of the periphery's GDP

* Sum of Greece, Portugal, Ireland, Spain and Italy ** Calculated as residual *** Non-annualised

Source: National central banks, IMF, European Commission, ING estimates

EMU – Roads to Survival

- Fiscal austerity alone will not ensure the survival of EMU. So what to do?
- **Reform** – structural, or *supply-side* reform could stimulate economic growth. this is the road favoured by Germany and NL.
- **Reflation** – loosen macro policy to boost *demand*.
- **Redistribution** – boost the periphery with resource transfers from the core, either covert or contingent (e.g. ECB funding or bail-out loans) or explicit fiscal transfers .

Six Survival Scenarios – the policy mixes

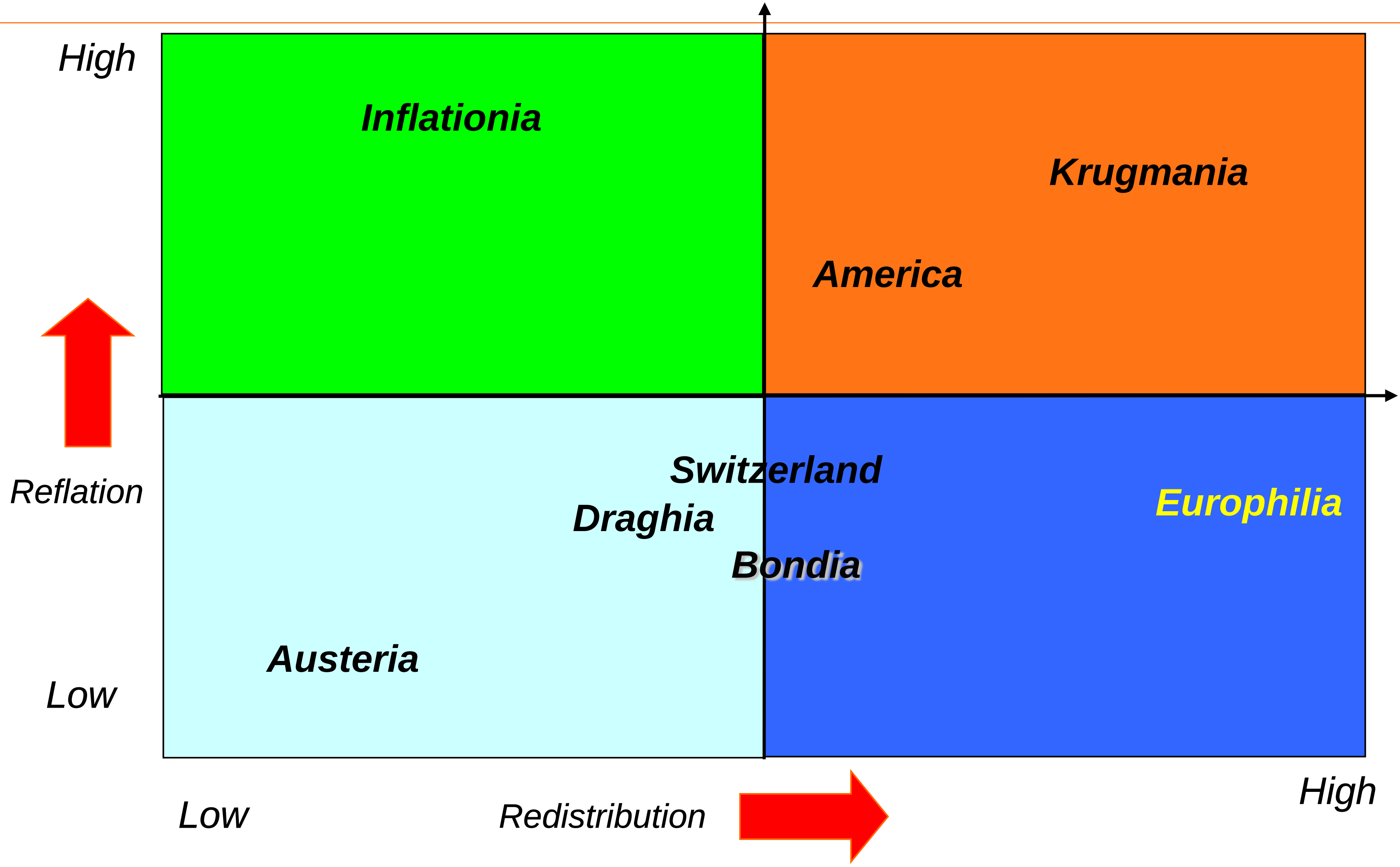
The scenarios involve different combinations of policies:

Scenarios

Policy measures	Austeria	Draghia	Bondia	Europhilia	Inflationia	Krugmania
Reform - Product/labour market	●	●	◐	◐	○	◐
- Finance/ funding	○	◕	●	●	●	●
Reflation - monetary policy: QE	○	●●	○	○	●●●	●
- monetary policy: rate cuts	◐	◐	○	○	○	○
- € depreciation	◕	●◐	◐	▨	●●	●
- fiscal loosening	▨▨	▨	▨	○	●	●
Redistribution - fiscal transfer	○	○	○	●	◐	●

○=not applicable ● =applicable ◐ =partly applicable ▨ =applicable *in reverse*

EMU Survival: Reflation vs. Redistribution

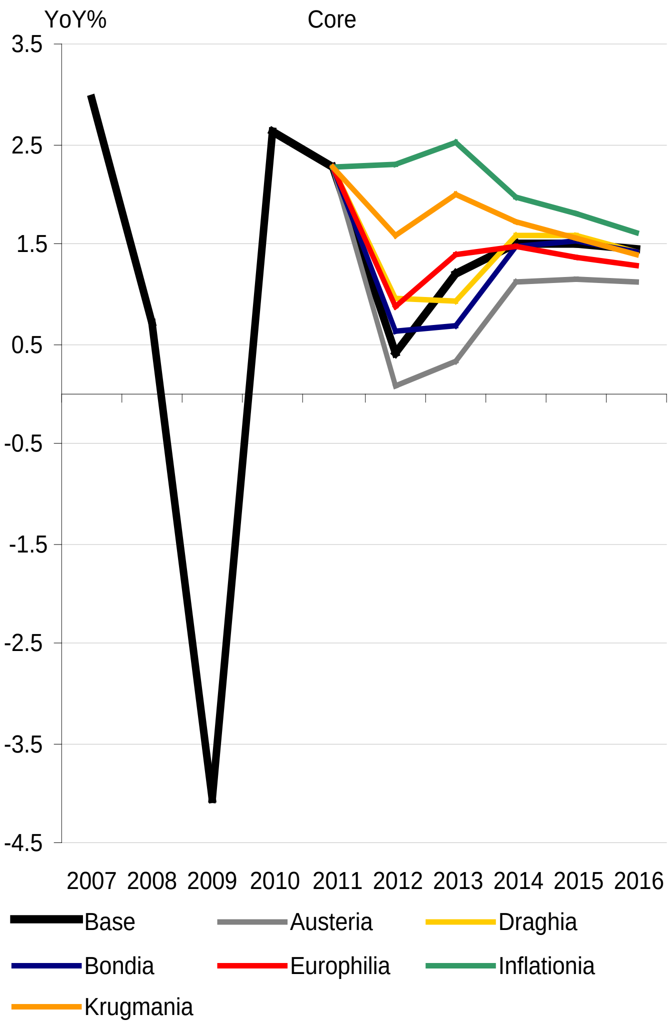


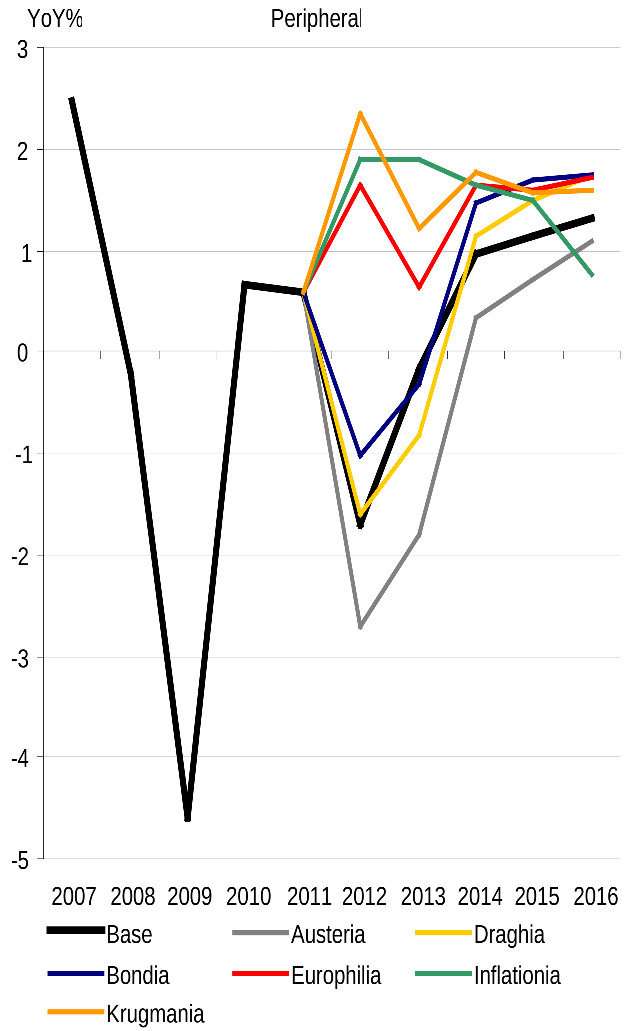
Scenario impact scoreboard

Scenario	**Output**	**€**	**Yields**		**Spreads**
			Core	Periphery	
Greek exit	↓↓→↓	↓↓→↓	↓↓→↓	↑↑→●	↑↑→●
Austeria	↓→↓↓	↓→↓	↓→↓	↑→●	↑→●
Draghia (banking union)	↑→↑	↓→↑	●→↑	↓→↓↓	↓→↓↓
Bondia (funding union)	●→↑↑	●→↑	↑→↑↑	↓↓→↓↓	↓↓→↓↓
Europhilia (from transfer union to fiscal union)	↑→↑↑	↑→●	↑→↑	↓→↓↓	↓↓→↓↓
Inflationia (*aka* Outer Draghia)	↑↑→↑↑	↓↓→↓↓	↑→↑↑	↑→↑↑	●→↑
Krugmania	↑↑→↑↑	↓↓→↓	↑→↑	↑→↑	●→●

Note: Arrows show direction of impact in years 1-2 -> *years 3-5* (● = no change)

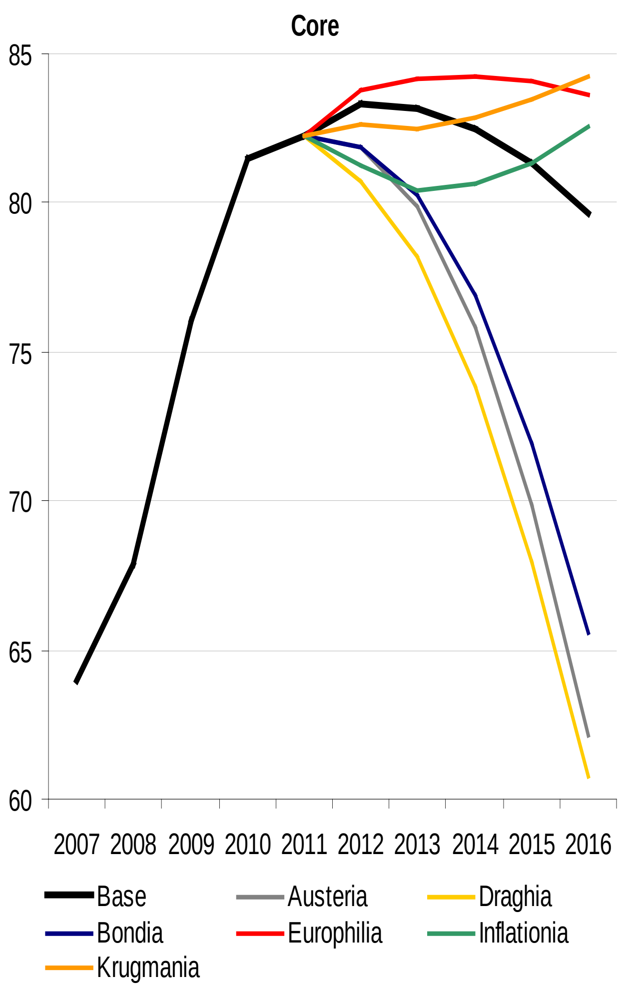
Growth benefits, except in *Austeria*

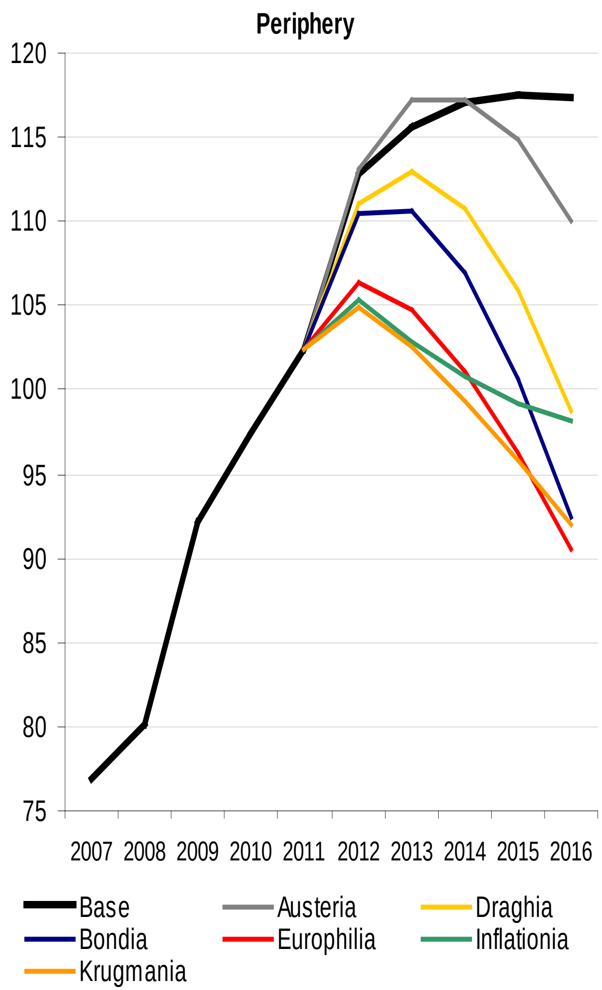




- The *Austeria* scenario depresses activity in the short term. The others boost GDP, with the biggest gains in *Krugmania* and *Inflationia*
- Reflation and euro depreciation lift activity generally, while transfers benefit the periphery
- Sustained stimulus is required to maintain the growth advantage of the more reflationary scenarios in the long term
- The initially adverse effects of labour and product market reform are turned in sustained gains to output growth in the longer term…
- …nevertheless, the *Austeria* scenario fails to make up for lost ground relative to other scenarios

Public Debt-to-GDP – *Draghia* wins…





- *Bondia* and *Draghia* s result in the largest falls in debt to GDP profiles, to c.75% after 5 years: for the core countries, the ratio falls close to 60%
- Fiscal transfers in *Europhilia-, Inflationia* and *Krugmania* result in relative deterioration in the debt profiles for the core, with ratios staying above 80%, while the periphery sees falls below 100%
- Debt the periphery in *Austeria* scenario shows no significant decline as weak nominal GDP growth offsets budget cuts, implying that debt relief/default would be likely

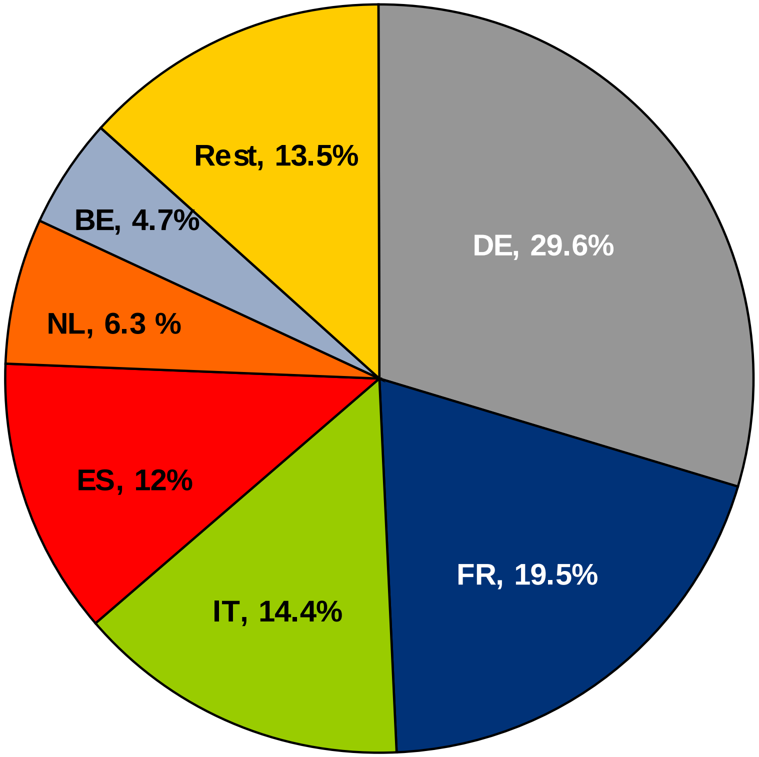
Banking Union – breaking the sovereign link

Mutualising risk via Eurozone-wide…

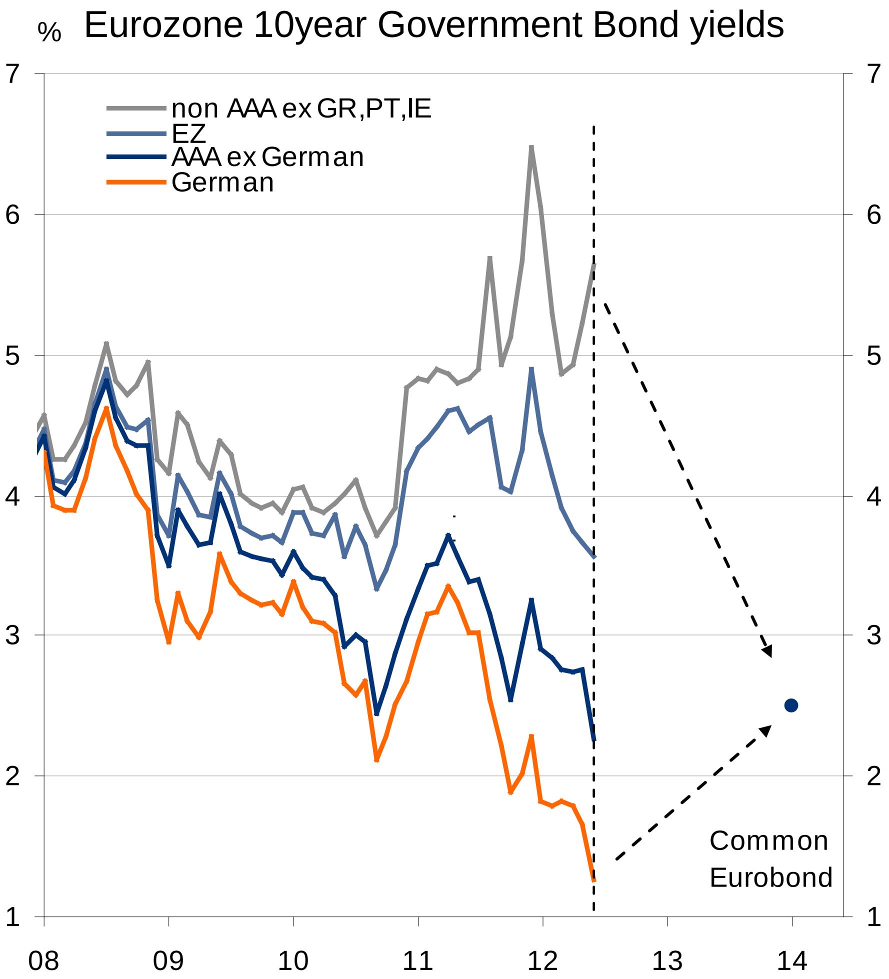
- Regulation and Supervision
- Deposit Guarantee
- Recapitalisation
- Resolution funds

- *lower bank risk = lower spreads*
- *more, and cheaper, credit*
- *lower sovereign risk = lower spreads*
- *bank funded? Core government back-stop?*

Share of Eurozone deposit base

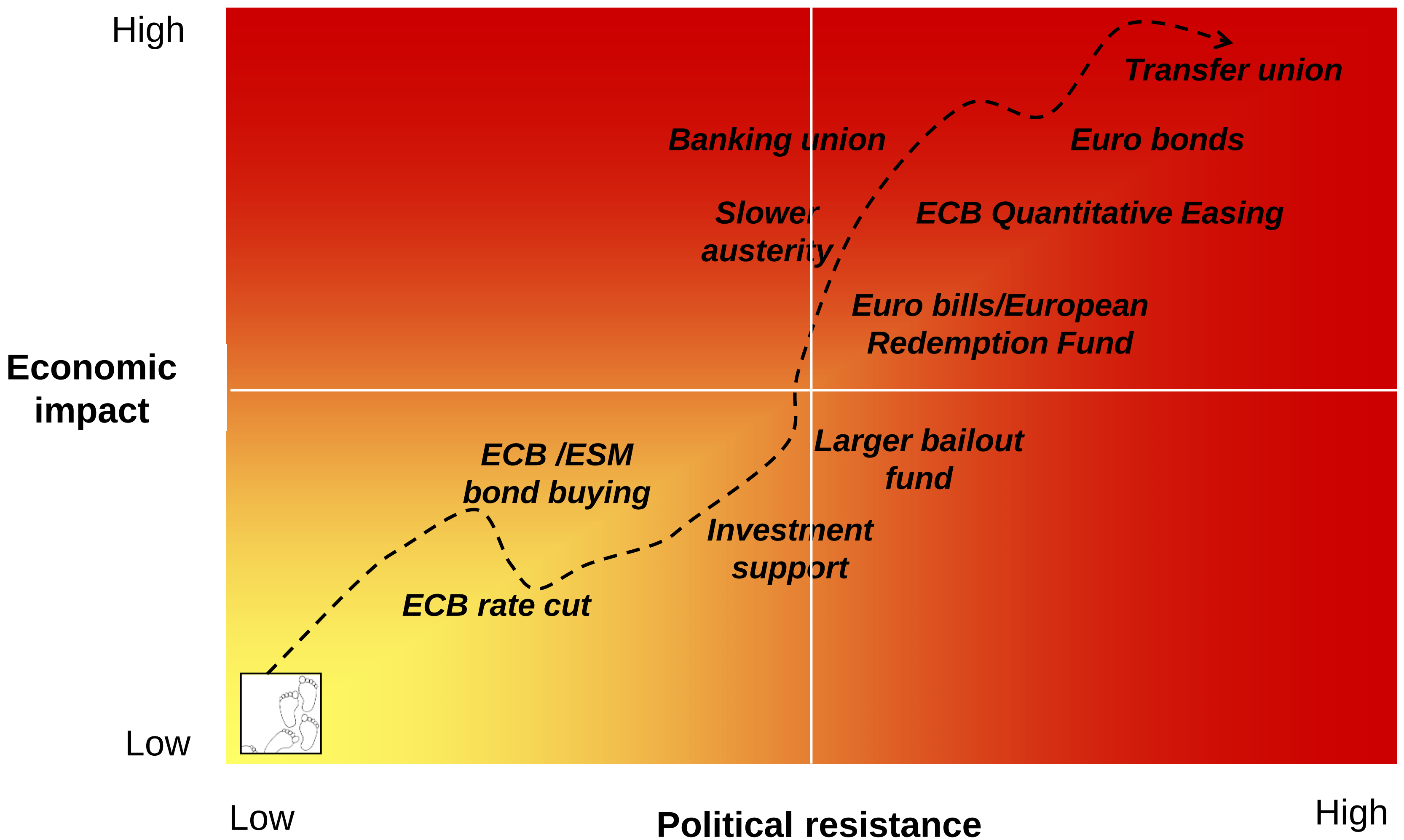


Common Bonds = massive yield convergence



- The German government does not rule out common bonds on principle, but sees them as a long term option, once fiscal union is agreed. Crucially, the SPD is supportive…
- The implied mutualisation of risk is a massive contingent transfer, and there is an implicit transfer arising from yield convergence…
- …peripheral yields would plunge, while the core yields would rise…
- …BUT this would be a ‘positive sum game’ as weighted average yields would likely fall…
- …so long as moral hazard – fiscal ill-discipline – is addressed with binding commitments

A possible route? Discipline before Solidarity



Summary

1. **Macro-policy is tight = pro-cyclical**
   - Fiscal policy is tight and credit creation dysfunctional
2. **Economic growth is weakening and diverging**
   - This politically and economically unsustainable
3. **EMU's Road to Survival – 'solidarity' in return for 'discipline'**
   - It is not just about fiscal discipline, or even external indebtedness
   - Growth, especially in the periphery, is crucial too
   - Monetary policy to be loosened further – and austerity scaled back?
   - More resources will have to be transferred to the periphery
   - Banking and funding union involve covert transfers…but fiscal union is the destination. The challenge is to secure popular support…
   - The 'Grand Bargain' = transfers from the core *if* the periphery shows discipline