

Crisis in the Euro Area: Desperately seeking a comprehensive solution

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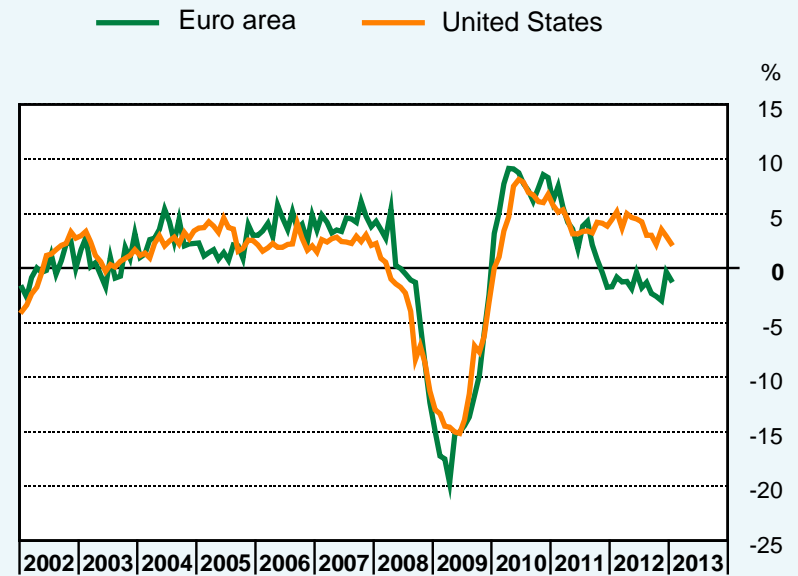
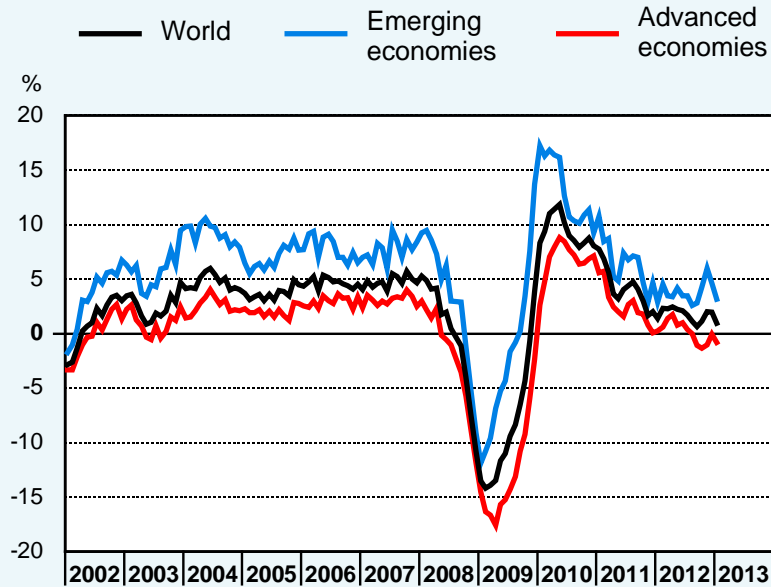


- 1. High debt stifles the global economy**
2. Three years of crisis in the Euro Area
3. Stable architecture and transition to the long-run

The global economy is affected by the Euro Area crisis and is likely to grow only moderately.

Development of industrial production

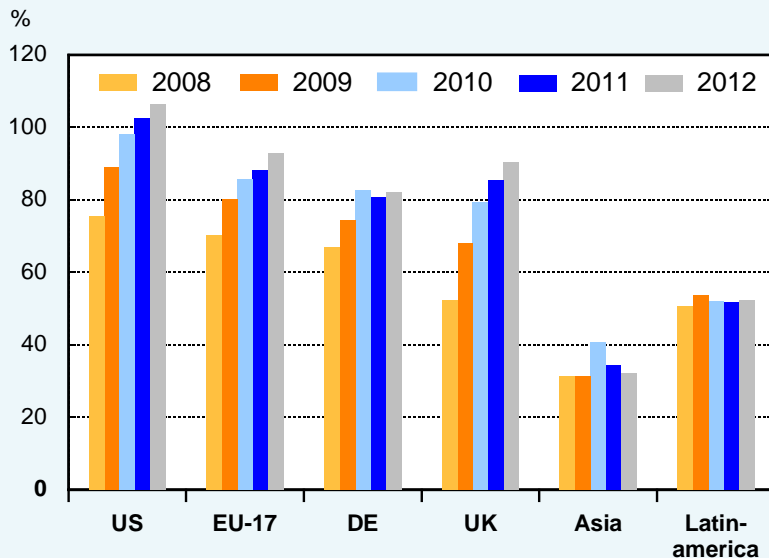
Changes over previous year in %



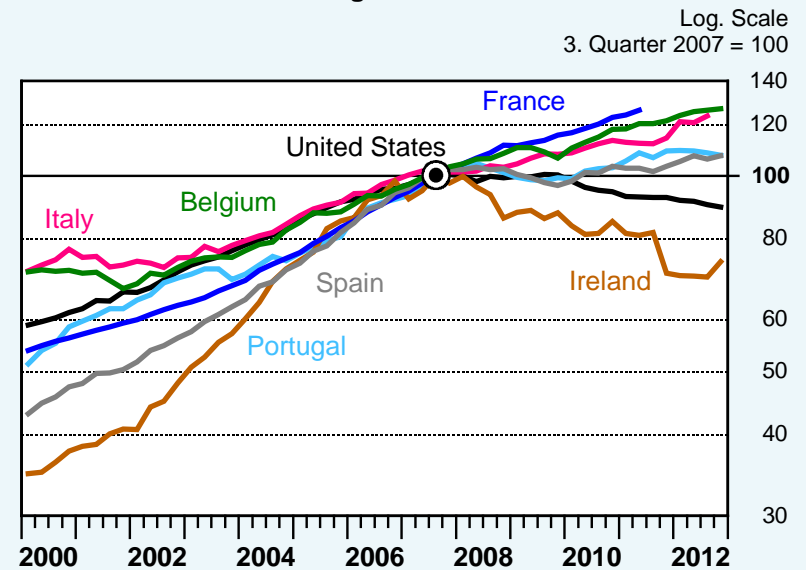
Both private and public debt pose severe obstacles to recovery.

Public and private debt in selected economies¹⁾

Debt of public budgets²⁾



Outstanding household debt³⁾



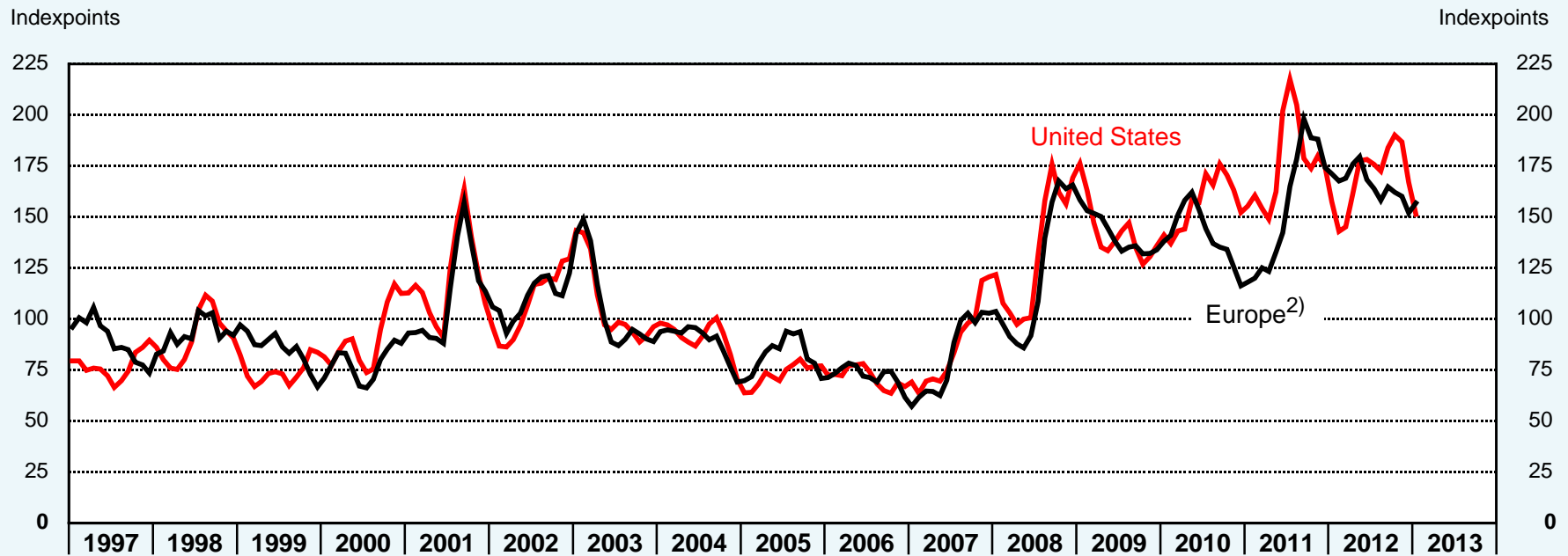
1) DE-Germany, UK-United Kingdom, US-United States.– 2) As a percentage of nominal GDP.– 3) In relation to the disposable income.

Sources: IMF, Thomson Financial Datastream

- The recovery from the housing bubbles and the developments on the labour markets are quite heterogeneous across countries.
- Recessions are much more dramatic after phases of credit booms – these are bad news.
- In the industrialized economies the scope for monetary policy is rather limited.

The economic uncertainty in industrialized economies remains stuck on a high level.

Policy uncertainty index¹⁾



1) Three-months moving average based on the uncertainty indicators of Baker, Bloom and Davis (www.policyuncertainty.com). The index is constructed from three types of underlying components: a) Frequency of using the word "uncertainty" in the media, b) Lists of federal tax code provisions set to expire in the coming years, c) Economic forecaster disagreement over expected inflation rates.– 2) France, Germany, Italy, Spain and United Kingdom.

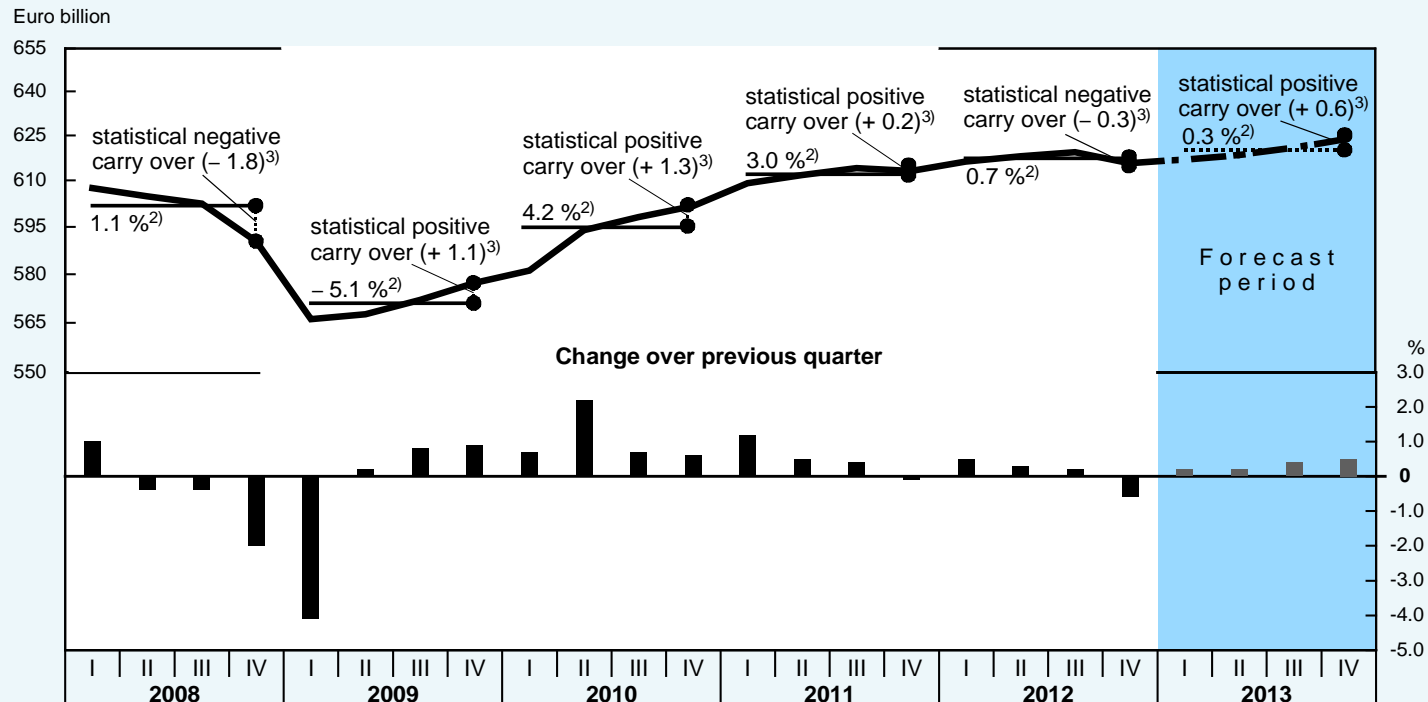
- Currently, the global economy is stabilized by relatively robust growth in the US, but there the fiscal cliff is still looming ahead; emerging economies were less affected by the crisis and have resumed strong growth.
- The Euro Area is in a recession that is inter alia characterized by a weak domestic demand; Germany and the rest of the Euro Area are quite heterogeneous in their economic development.
- The moderate outlook for worldwide economic growth already assumes a decrease of overall uncertainty.

The forecast for GDP growth in Germany is moderate, the output gap is roughly zero.

Schaubild

Economic Prospects in Germany

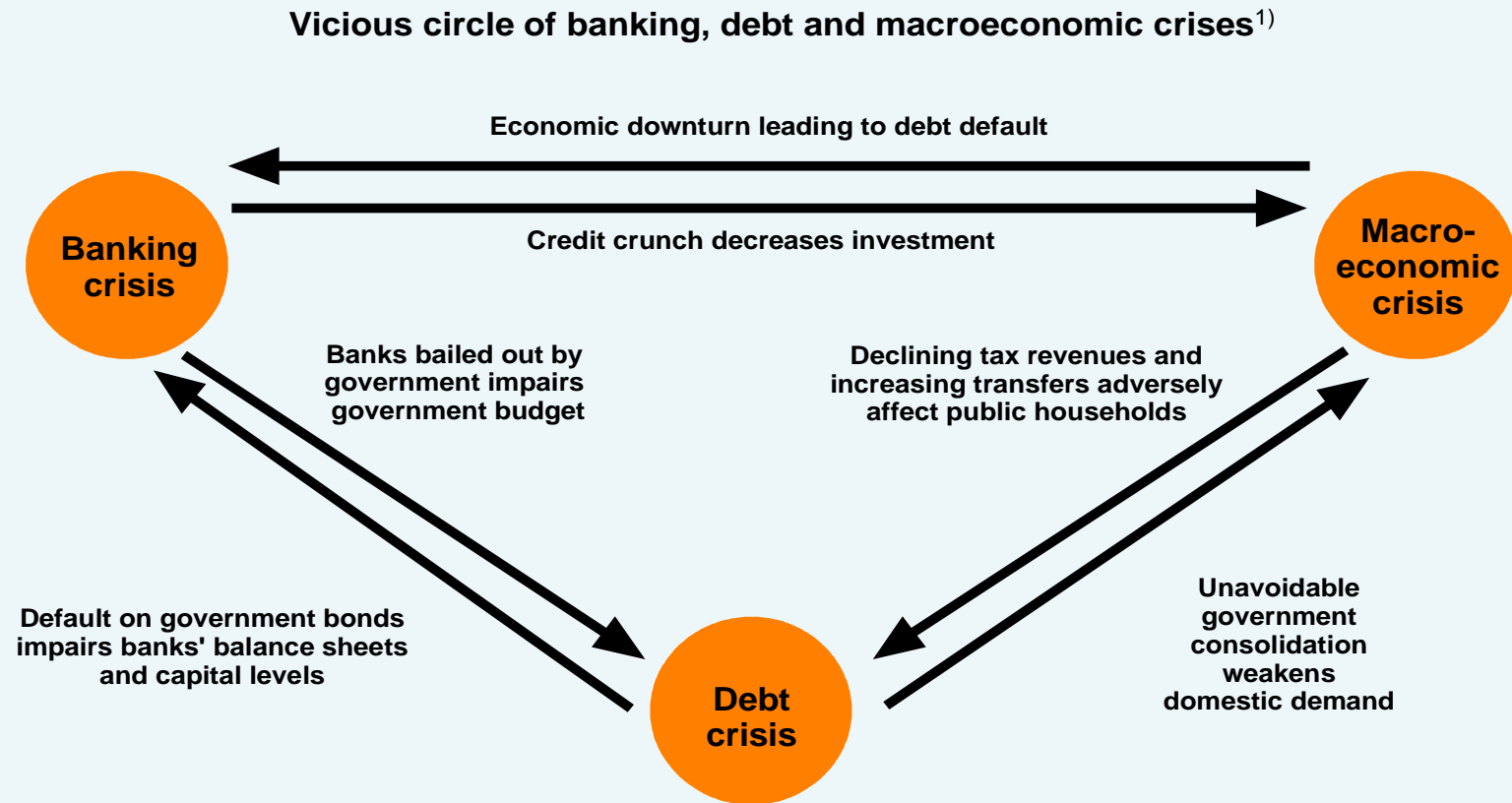
Gross Domestic Product¹⁾ price-adjusted
Chained volume values



1) Seasonally adjusted.– 2) Annual averages: changes over previous year.– 3) Percentage difference between the absolute level of the gross domestic product in the last quarter of the year t and the average level of the quarters in the year t (see JG 2005 box 5).

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A vicious circle of three interrelated crises has led to a systemic crisis of confidence.



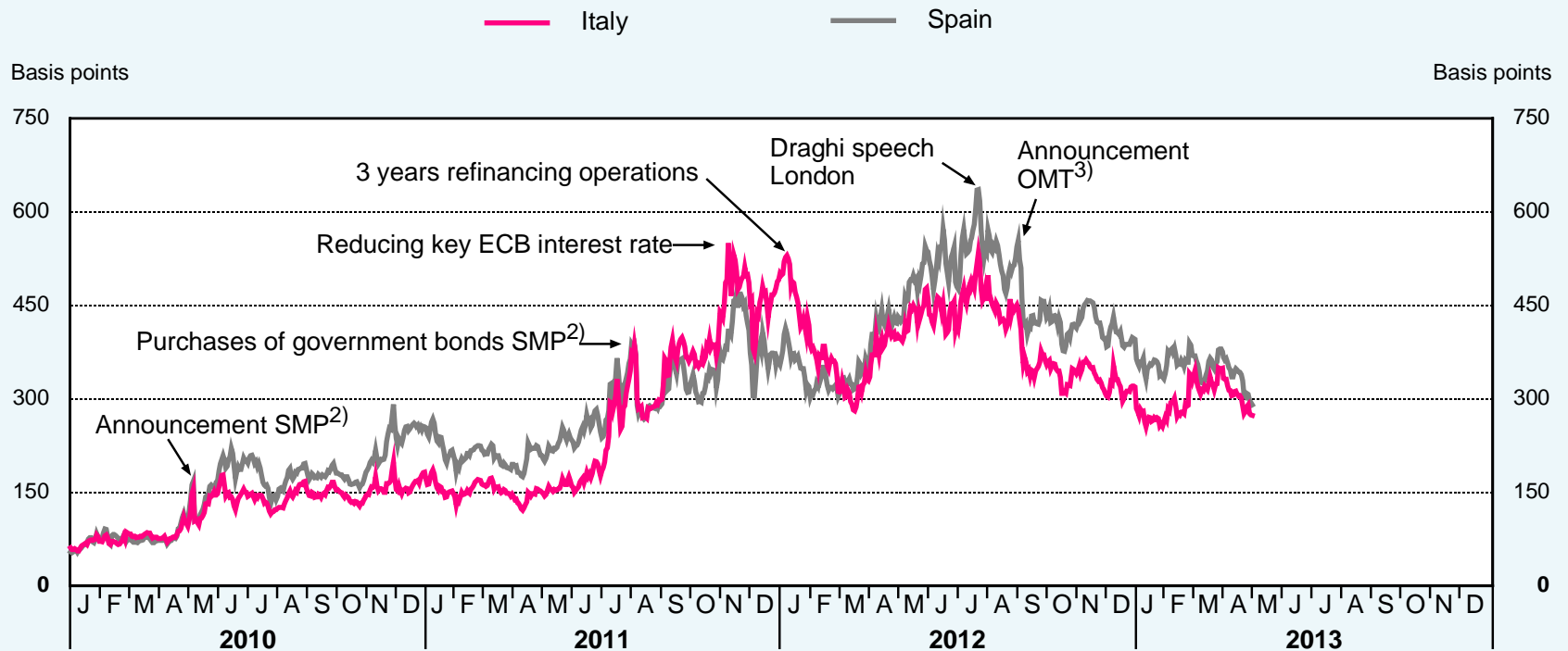
1) Illustration according to Shambaugh (2012).

Euro Crisis: Status quo

- Mutual influence of the issues to be solved complicates the efforts for a solution: actually, the responsibility for a solution is lying with fiscal policy.
- Aggravation of the crisis through short-sighted crisis management and continuous deepening of the toxic relation between banks and governments: increasing pressure on the ECB.
- Autumn 2012: Calming of the financial markets by the announcement of an OMT program by the ECB, tacitly tolerated or very welcomed by fiscal side.

A worst case scenario – such as the support of Italy and Spain by the EU bail-out package – has been prevented by the intervention of the ECB.

10 years bond yields spreads for Italy and Spain¹⁾



1) Difference of respective countries government bond yields to german government bond yields.– 2) Securities Markets Programme.– 3) Outright Monetary Transactions.

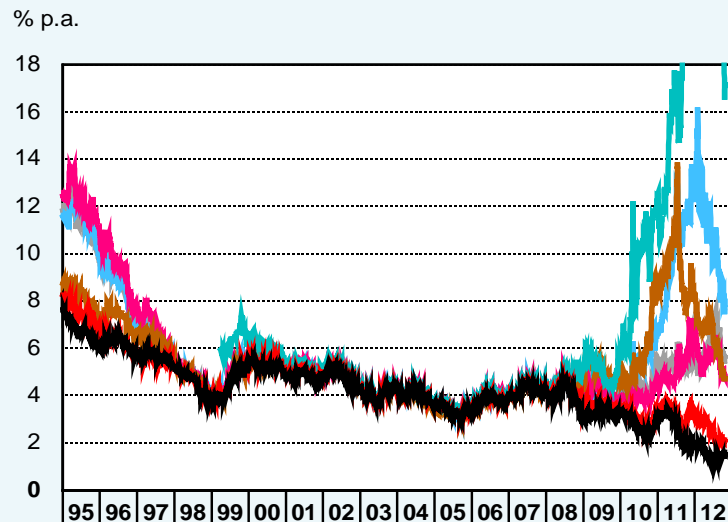
Source: Thomson Financial Datastream

By now, interest rate spreads of government bonds respond to the level of debt in the Euro Area.

10 years government bond yields and estimated marginal influence of debt-to-GDP ratio

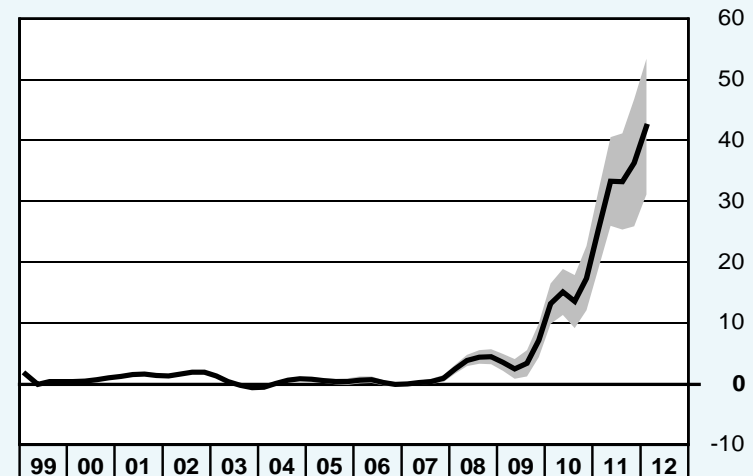
10 years government bond yields of selected countries in the Euro area¹⁾

Germany France Greece³⁾
Ireland Italy Portugal Spain



Estimated marginal effect of debt-to-GDP ratio on risk premiums to Germany²⁾

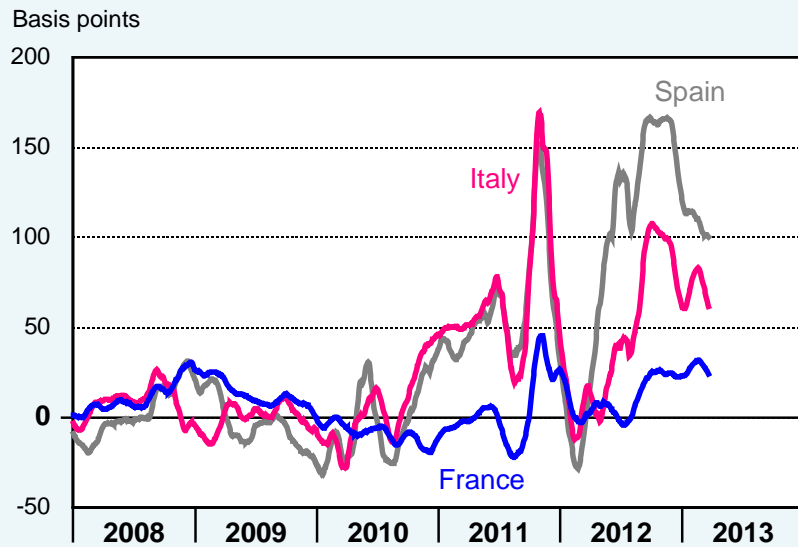
95% confidence band



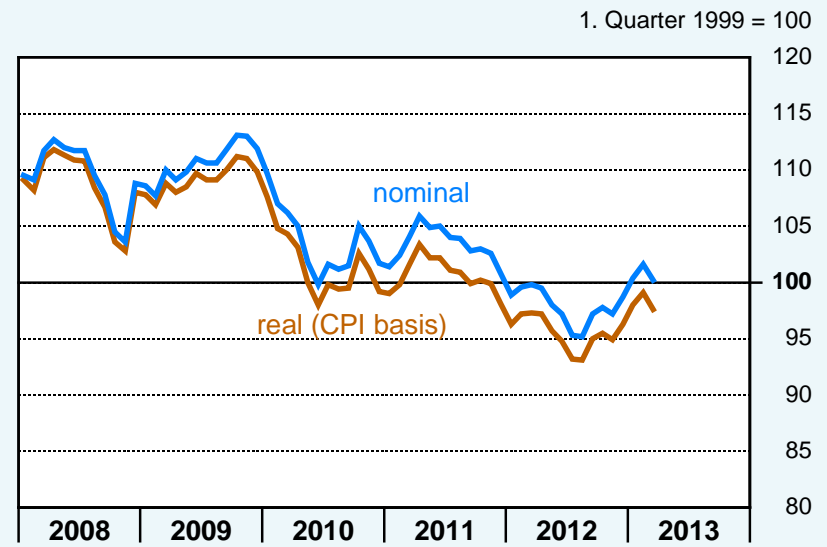
1) Source: Thomson Financial Datastream.– 2) Estimates for the Euro area (excluding Luxembourg) according to the method of Bernoth and Erdogan (2012). An increase of the debt-to-GDP ratio by one percentage point effects an increase of risk premiums of x basis points. The estimation includes as further explanatory variables the difference of the expected budget deficit in Germany in the following year (OECD Economic Outlook) and a measure for the general risk aversion (yield spread of US corporation bonds with Baa rating to US government bonds).– 3) From 05.09.2011 to 12.10.2012 permanent over 18 % p.a.; figures inbetween not been given for enhanced legibility.

Government bonds spreads, CDS spreads and effective exchange rate

Differences of government bonds spreads and CDS spreads between selected countries and Germany



Effective exchange rate (EER-20)



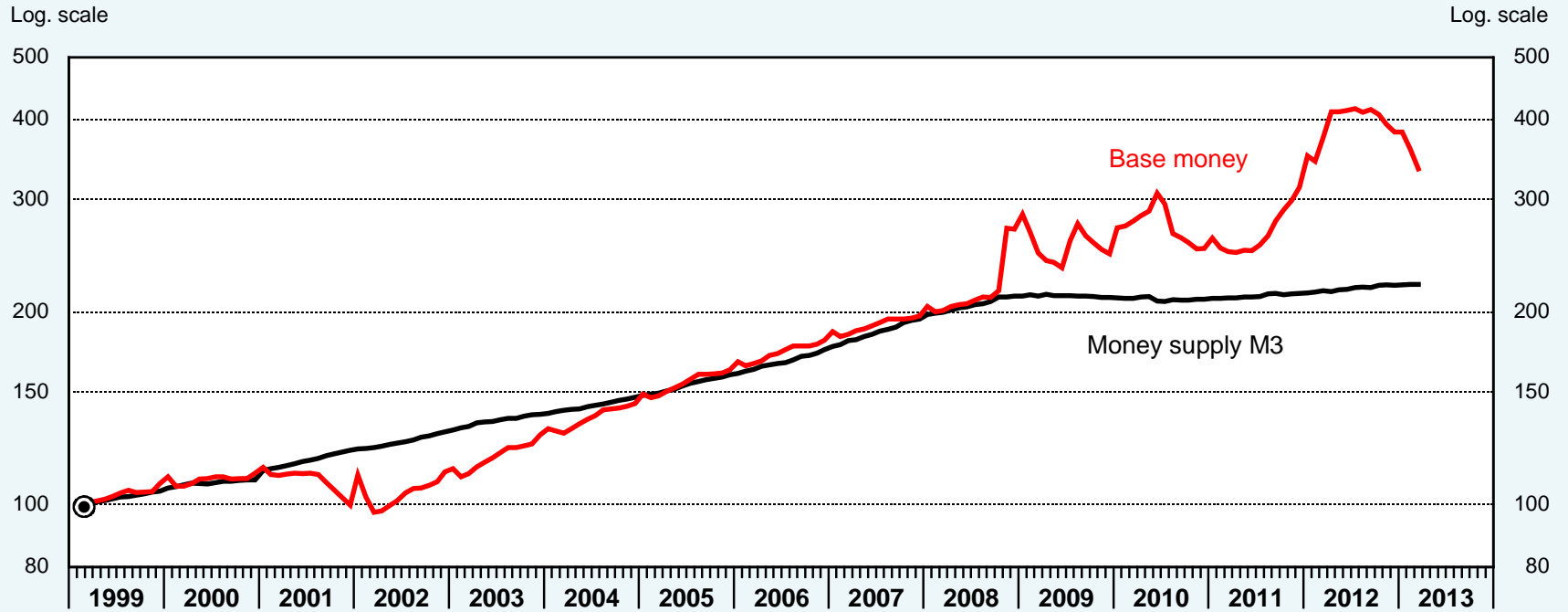
1) Own calculations: 30-day moving average; Differences of Government Bond Yield Spreads and CDS Spreads with 3 year maturity between selected countries and Germany.– 2) Weighted of the average from the Effective exchange rate (EER-20).

Sources: ECB, Thomson Financial Datastream

- There is concern among depositors about the security of their bank deposits in GRE, POR, ESP (and ITA).
- The ECB serves as a primary source of funds of the banks in the crisis countries: TARGET2 balances as a symptom of the crisis.
- Public capital inflows compensate for the retreat of private capital from the crisis countries: Painful and sudden adjustment processes have been avoided so far.

Base money and money supply M3 in the euro area

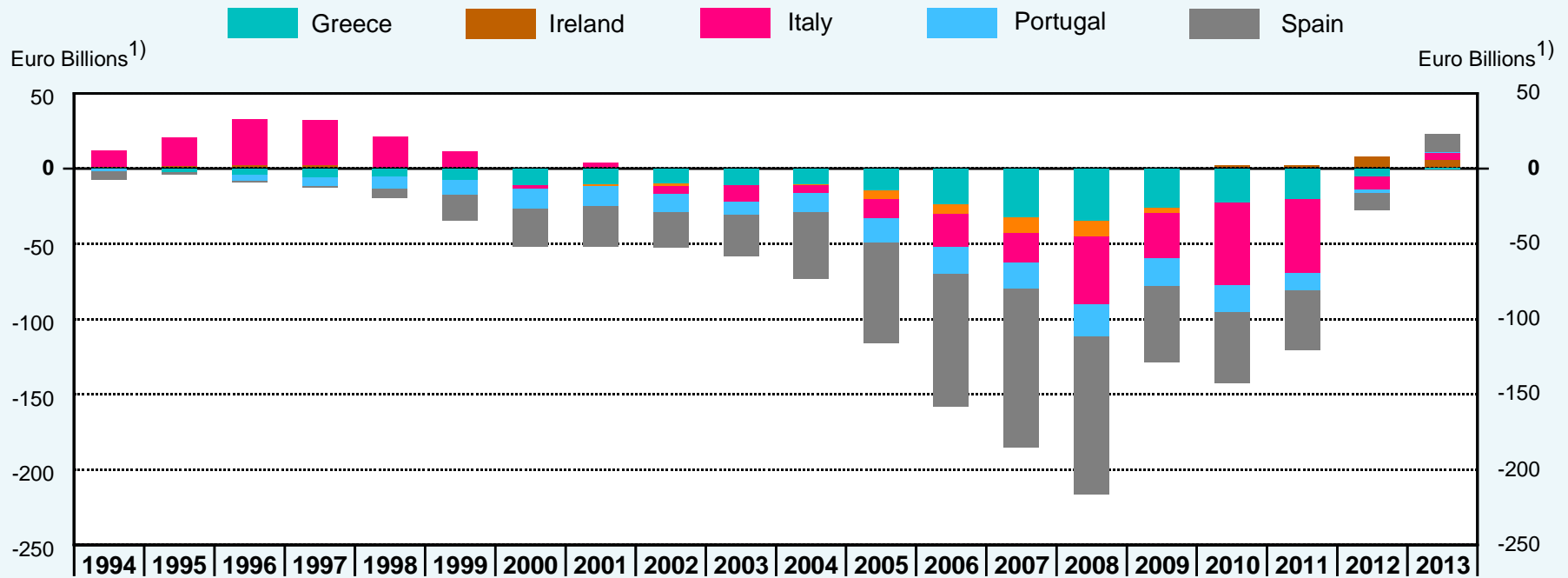
February 1999 = 100



Source: Thomson Financial Datastream

The current account balances of the crisis countries have been improving significantly.

Current account balances in the crisis countries



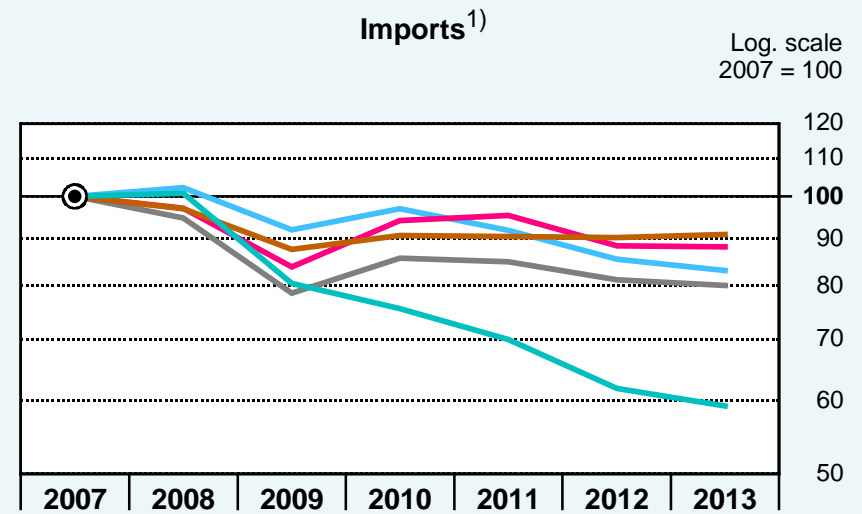
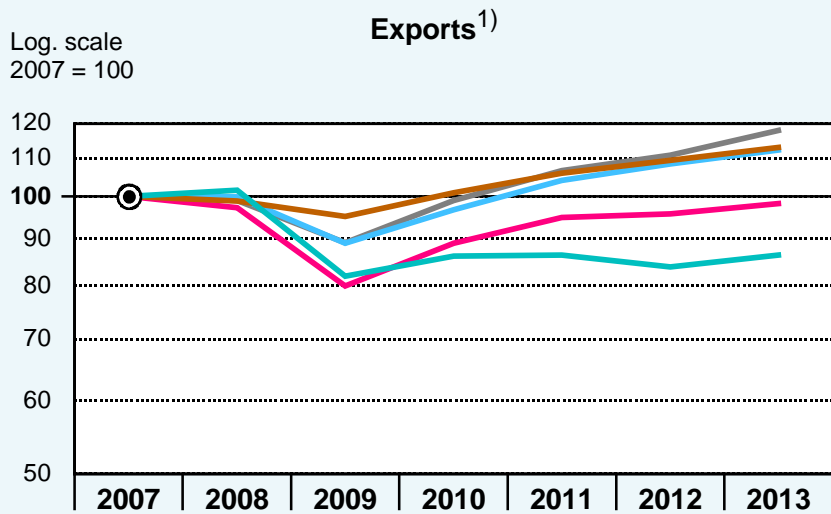
1) Original data of IMF in US Dollar, calculated in Euro with the year average exchange rate.

Sources of basic data: ECB, IMF

Adjustments have been made through decreases in income and improving exports.

Evolution in trade volume in the crisis countries

Greece Ireland Italy Portugal Spain



1) Goods and services.

Reducing private and public levels of debt

- » Change in the debt ratio (stylized):

$$\Delta \left(\frac{B_{t+1}}{Y_{t+1}} \right) = - \frac{\text{Primary Balance}_t}{Y_t} + (r_t - g_t) \frac{B_t}{Y_t}$$

- » Potential solutions to reduce the high public levels of debt (Reinhart und Sbrancia, 2011):
 - Stimulation of economic growth / structural reforms
 - Consolidation of public households
 - Default and restructuring
 - Unexpected increases in inflation
 - Financial repression (Experience of the years from 1945 to 1970)

High interdependence of the different options ...

- Credible consolidation can lead to a stimulation of economic growth.
- Structural reforms implemented to stimulate economic growth could weaken the fiscal positions even further.
- The impact of default of large / systemically important actors in the Euro Area are impossible to predict.
- Inflation is at least not directly influenced by fiscal policy, unless the ECB loses its independence through taking over fiscal functions.

High economic heterogeneity complicates the choice set

- In some member countries such as Spain or Ireland high and strongly increasing public debts are accompanied by high private debts.
- High external debt has led to a sectoral deformation and requires not only a reduction in private debt but also a sectoral reallocation which is complicated by the structural deficits.
- The ECB is confronted with 17 sovereign states that have different interest and that are probably inclined to using the ECB as a quasi-fiscal instrument.

State of play: symptoms masked, causes unsolved

- Announcement of the OMT program by the ECB:
 - » The pressure to implement economic reforms and to consolidate was strongly reduced in the crisis countries.
 - » The ECB is taking over quasi-fiscal functions.
 - » Fatal long-run incentives: from now on, market participants always count on interventions by the ECB in case of a (national) crisis.

- Two of the three crises were appeased by the ECB: The macroeconomic crisis remains unsolved and may become a new risk factor for the banking and debt crisis.

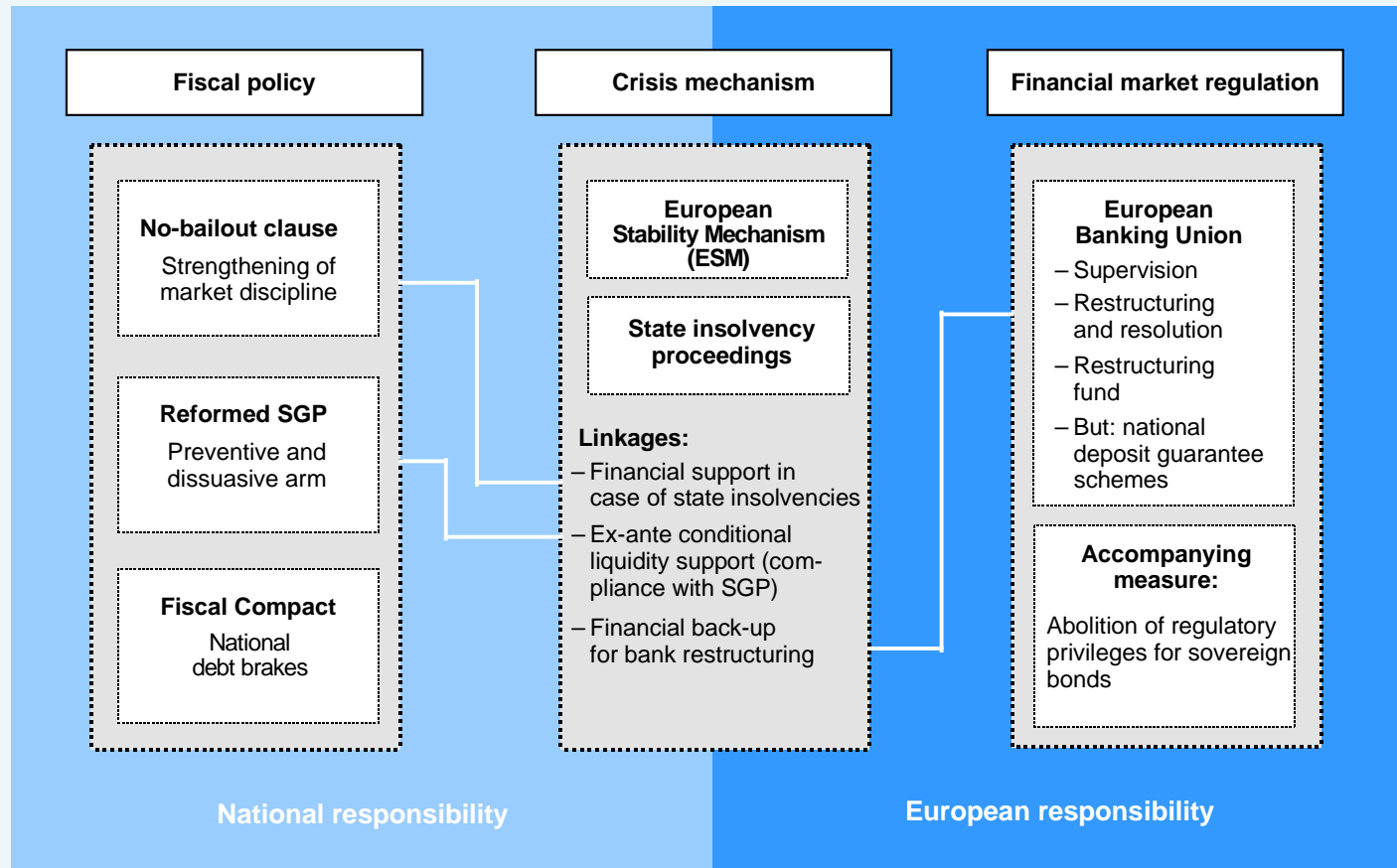
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Principles of a comprehensive solution

- Systemic crises need systemic solutions: The sum of several partial solutions, such as the intervention by the ECB and the long-run reforms of the European institutions, does not meet the requirements.
- Liability and control have to be aligned at the same level, both concerning the strategy for overcoming the crisis and the design of a long-run regulatory framework.
- A comprehensive solution requires the design of a long-run regulatory framework and the design of a transition path without violating and hence questioning the long-run principles.

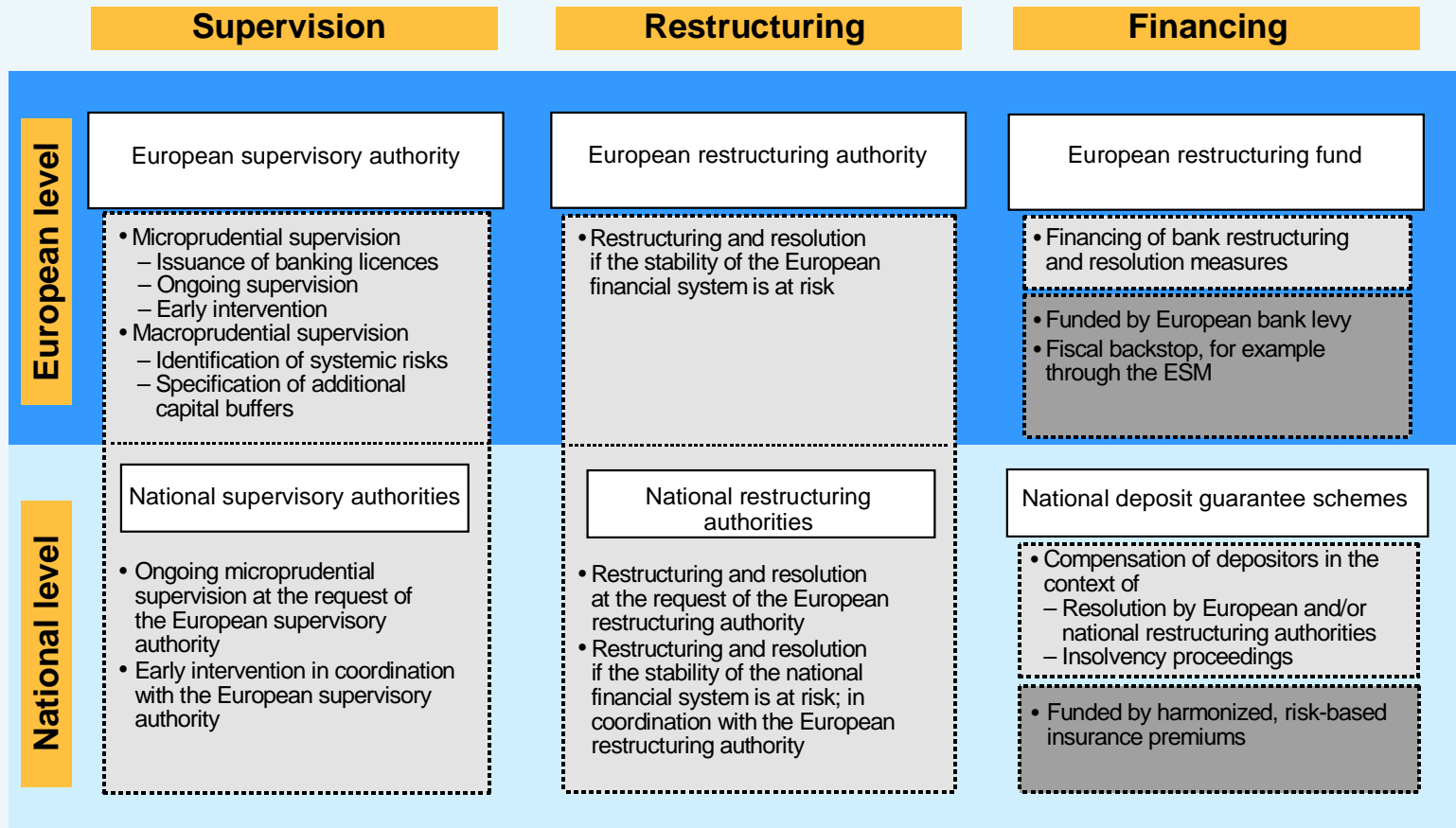
Liability and control have to be aligned at the same level, but on different levels depending on the subject.

Long-run institutional framework for the euro area



A banking union requires authorities on the European level, but no European deposit insurance.

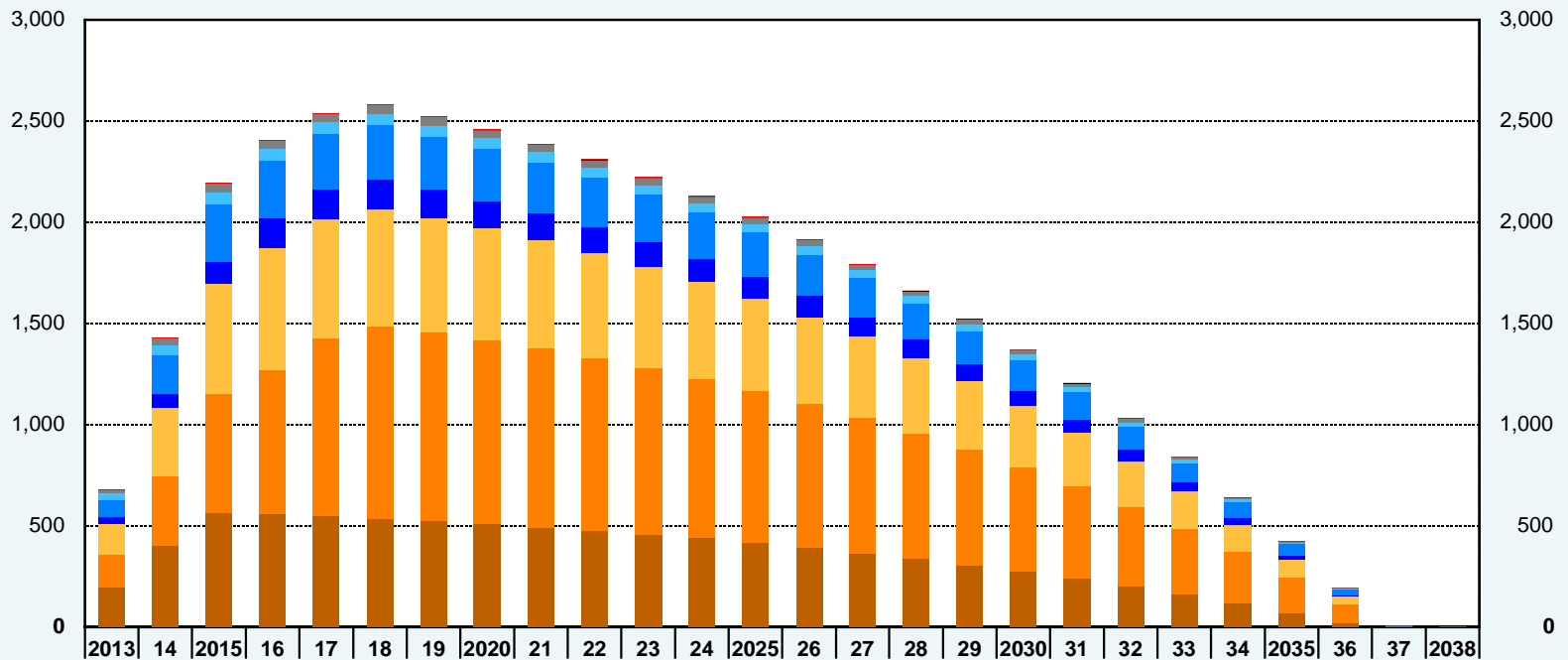
Structure of the Banking Union



The debt redemption pact can serve as a fiscal bridge, limited with respect to volume and duration.

Debts in European Redemption Fund by country¹⁾

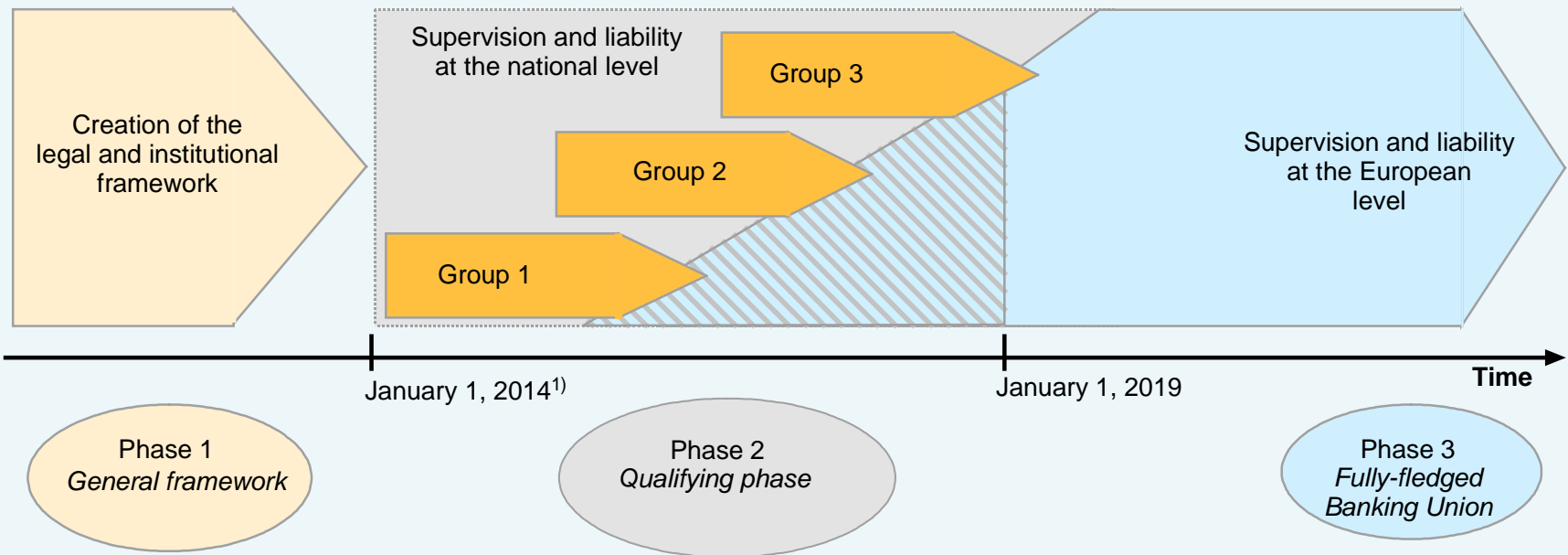
Euro billion



1) Own calculations. Assumed starting date of the ERP: 1.1.2013; basic data: EU commission, AMECO database, 26.7.2012.

The transition to a banking union needs time and fiscal backing during the time of transition.

The transition schedule to the Banking Union



1) If the legal and institutional preconditions - including the modification of the EU treaties - are not fulfilled as of 1 January 2014, phases 2 and 3 will start later, accordingly.