



Finding a Way out of the Crisis: The Role of the European Commission

István P. Székely and Sven Langedijk

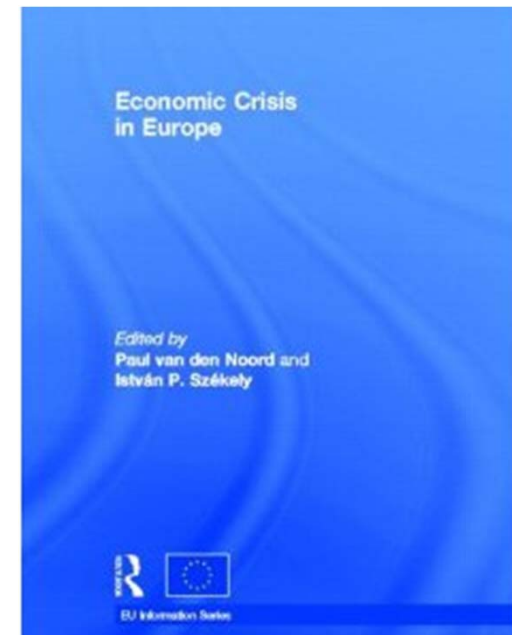


CESifo Seminar
Munich, November 28, 2011

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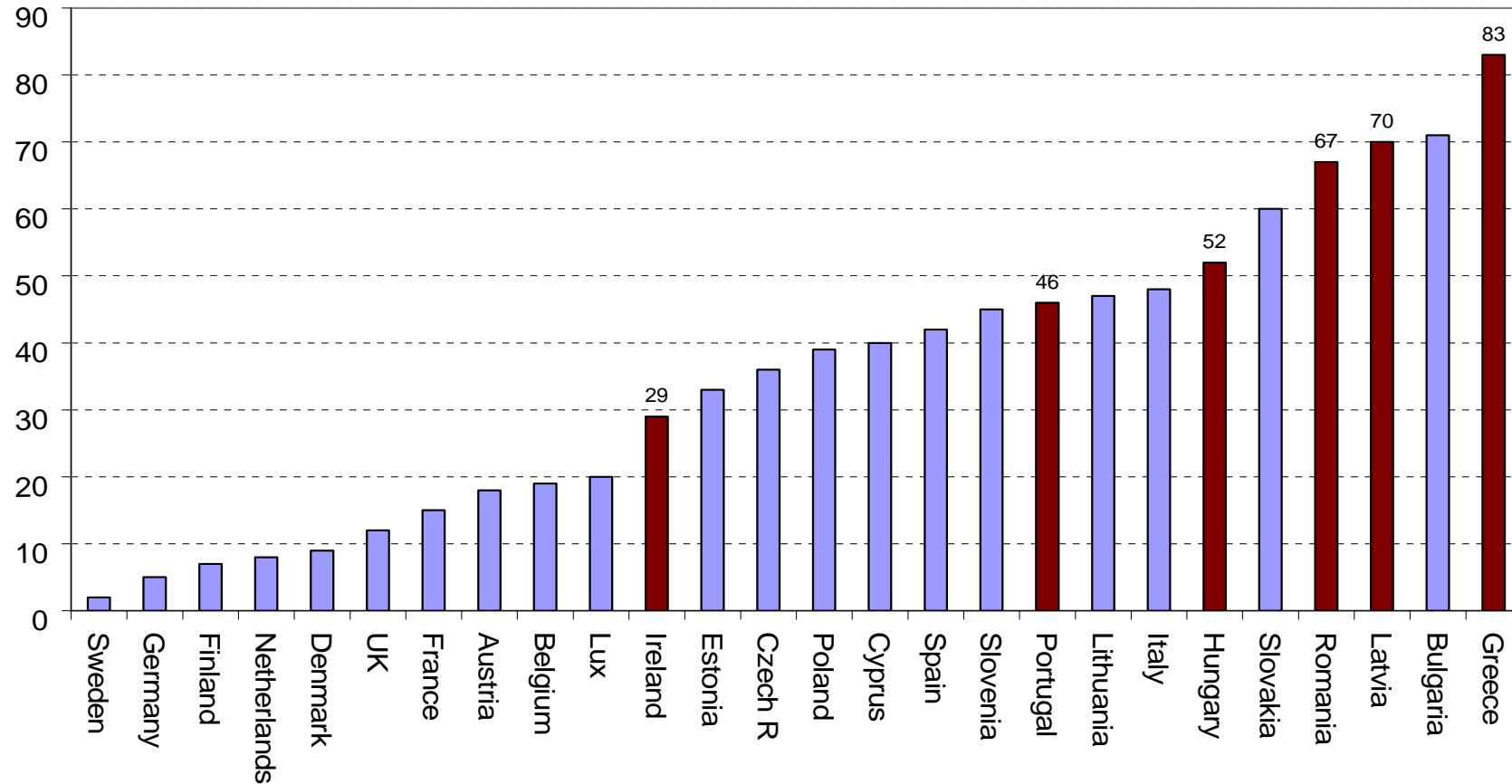
Crisis: Causes, consequences and responses

- EU growth in a long term perspective
- The failing European model of financial integration and convergence.
- Imbalances and bubbles in the EU
- Policy coordination and reforms: role of the European Commission



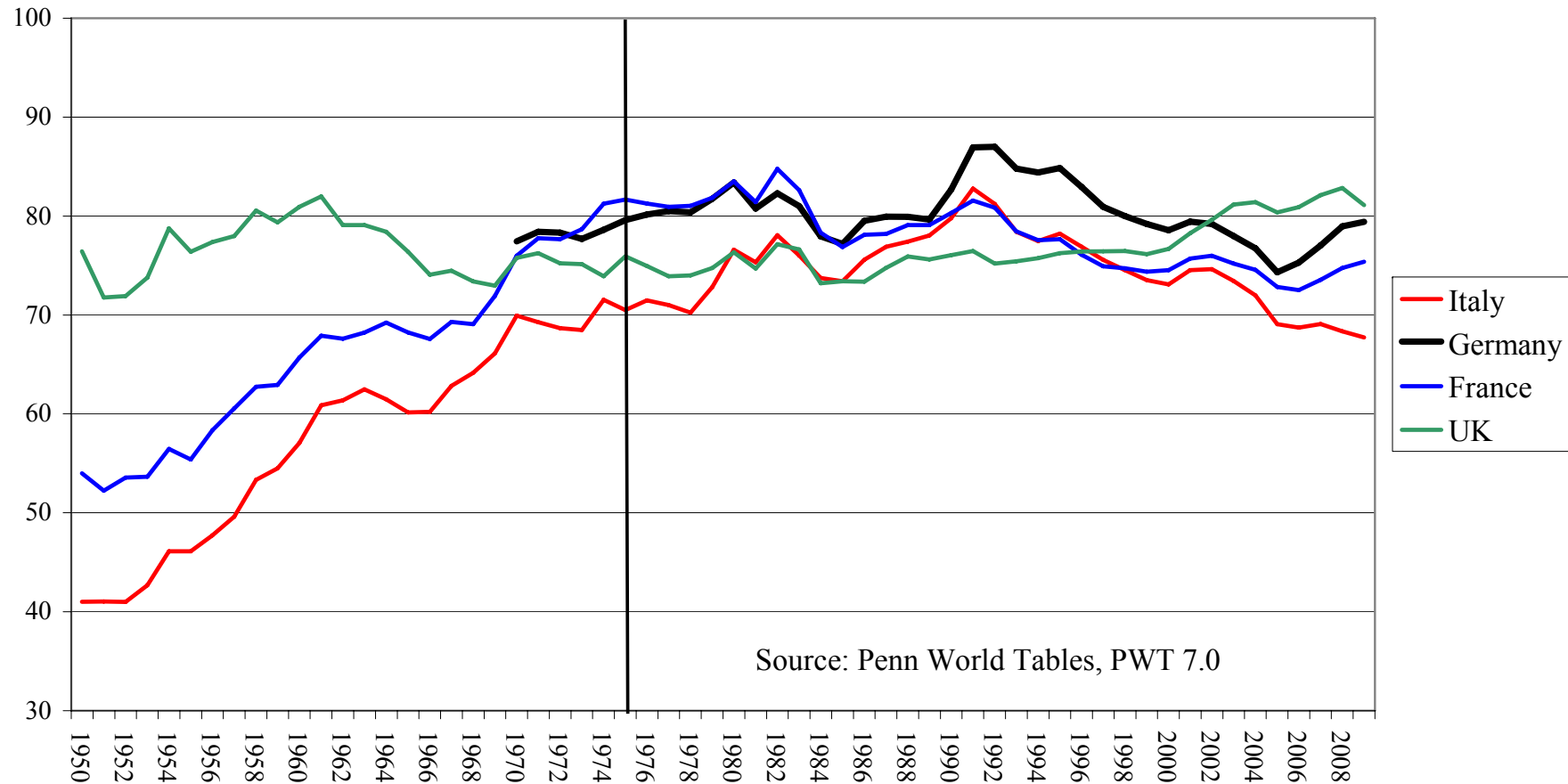
Europe's competitiveness

World Economic Forum Global Competitiveness, 2010



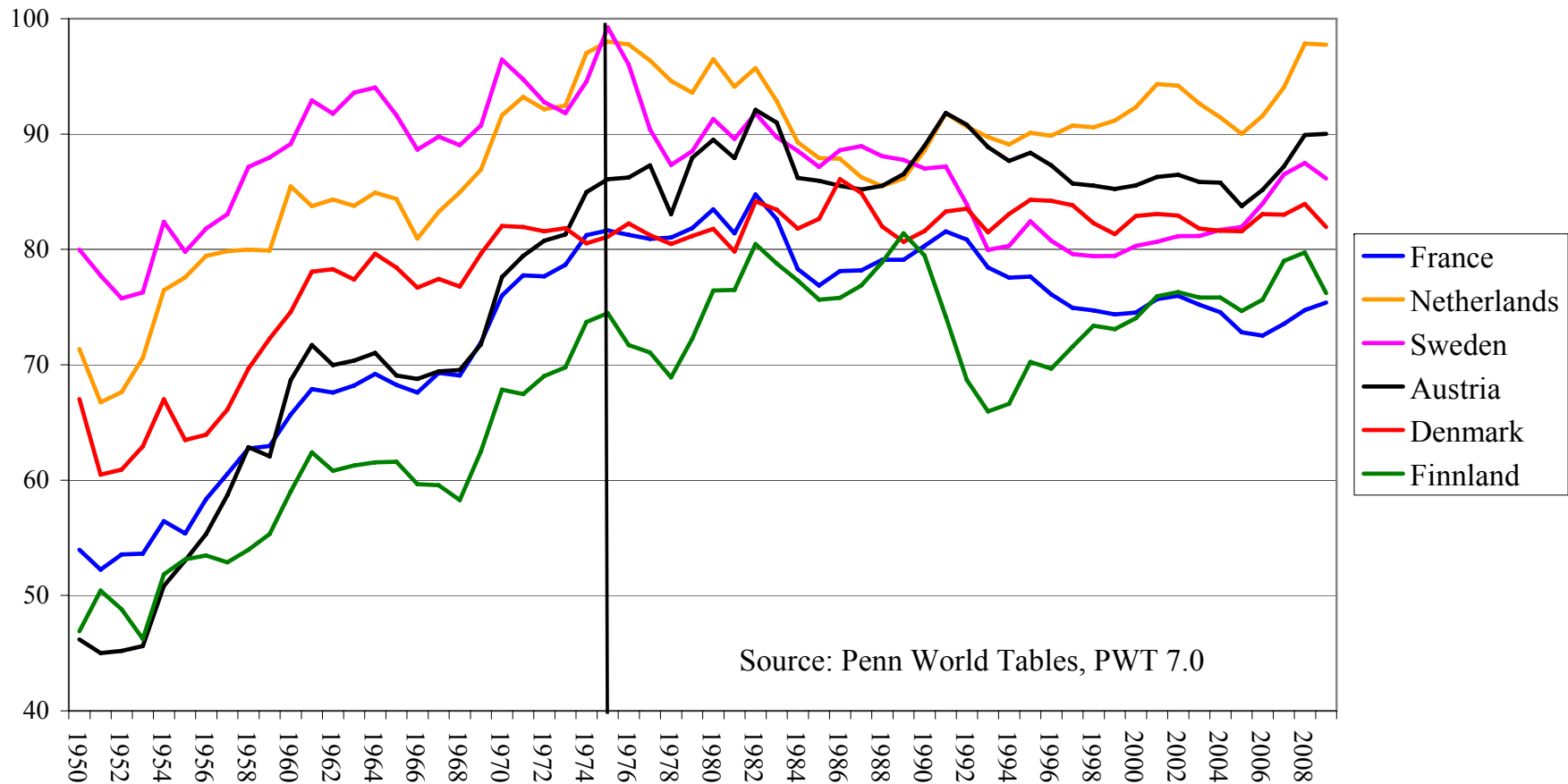
The history of Europe's catching up

Europe: Per capita GDP relative to the US, 1950-2009
(PPP, US=100)



The history of Europe's catching up

Europe: Per capita GDP relative to the US, 1950-2009
(PPP, US=100)

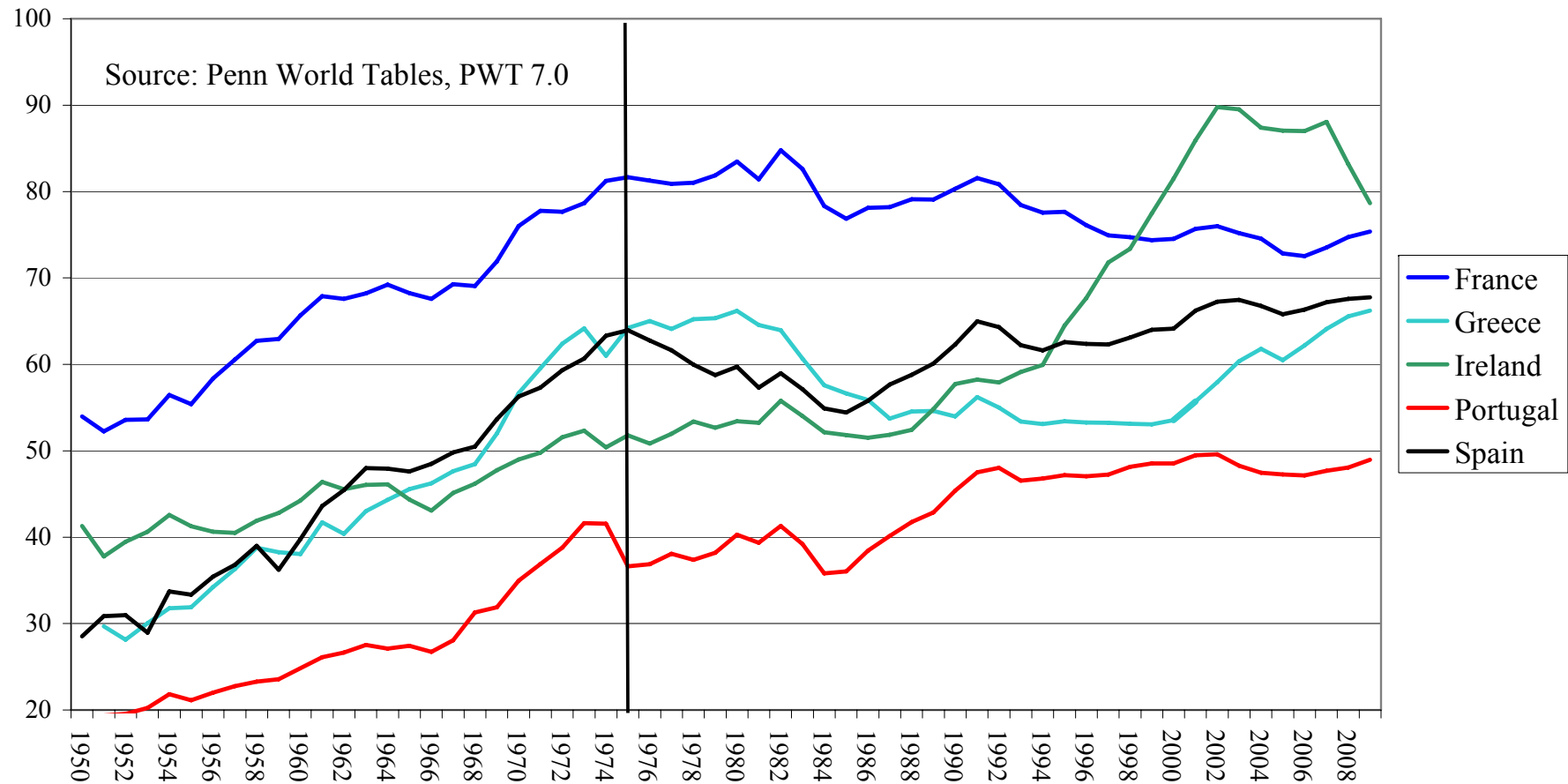


Source: Penn World Tables, PWT 7.0



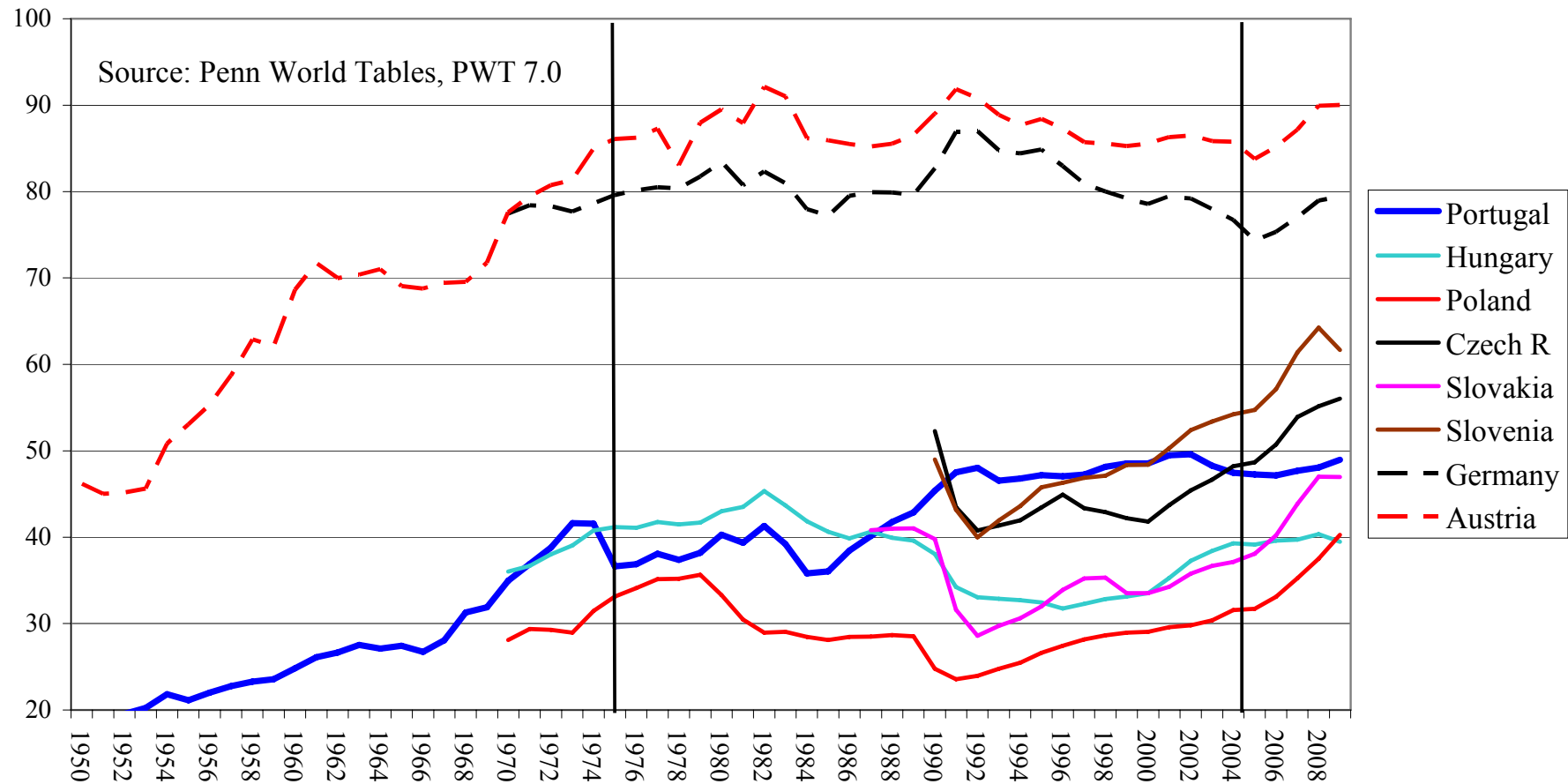
Catching up within the Euro Area

Europe: Per capita GDP relative to the US, 1950-2009
(PPP, US=100)



Catching up of CEE

Europe: Per capita GDP relative to the US, 1950-2009
(PPP, US=100)



The model of financial integration in Europe

- Rapid increase in cross-border holding of government securities
 - no longer exchange risk premium
 - no capital charge (risk free asset)
 - => massive under pricing of country risk
- Large capital exports to the periphery (including CEE) based in large part on market funding
- Worked well in the competitive capital exporting countries (former D-Mark zone) but much less so in the capital importing countries:
 - Money was indeed flowing downhill
 - **But** a considerable part got misallocated (and mispriced), as financial market channeling to productive investment failed.



The model of financial integration in Europe

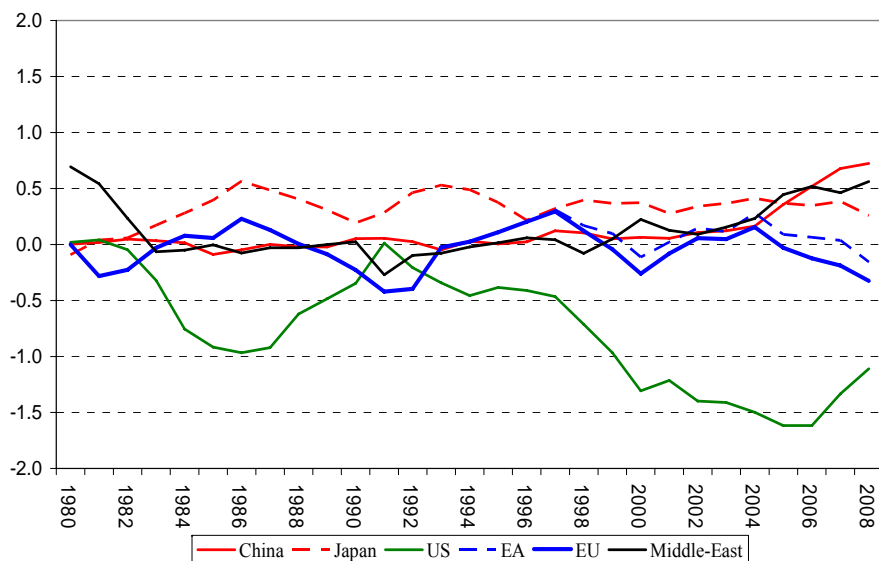
- Large outstanding (asset and liability) stocks with sizable maturity mismatch.
- CEE: mostly through European/global banking groups, also from countries in program (Greece) or experiencing difficulties (Italy)
- Euro area periphery: mostly through domestically-owned banks
→ fiscal burden



Financial integration and external imbalances

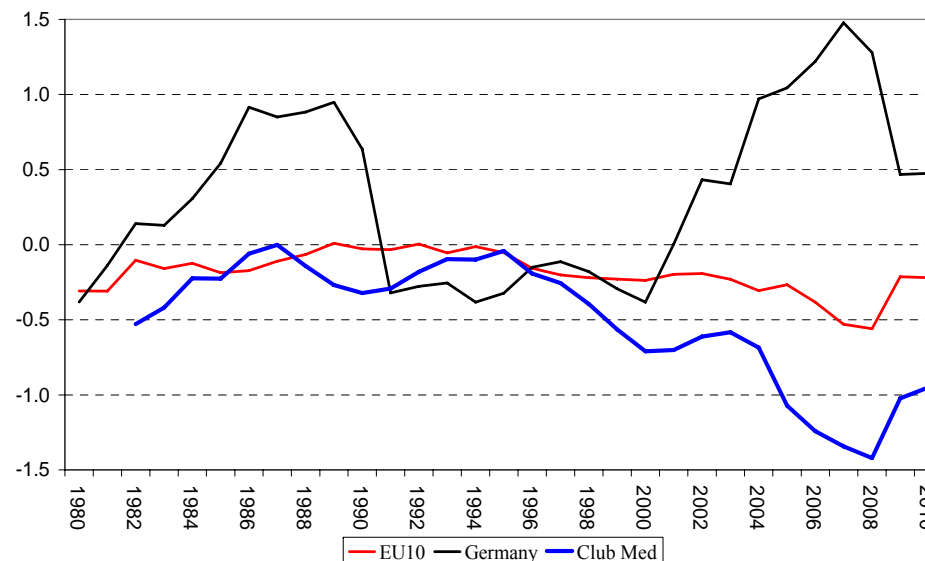
Global External Positions

(CA balance as percent of World GDP)



External Imbalances within the EU: the relative size of EU10

(CA balance as percent of EU GDP)

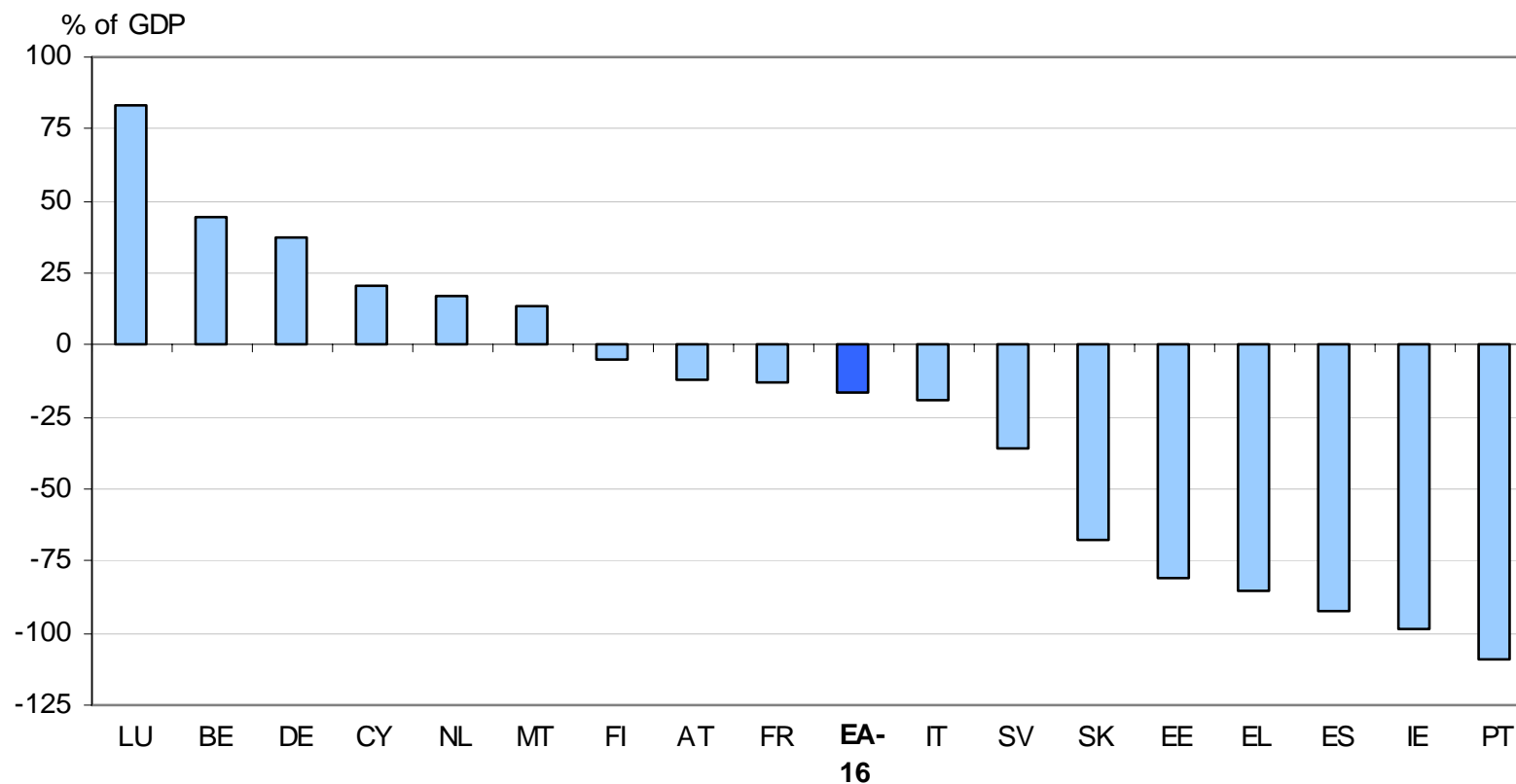


Source: AMECO, European Commission



External imbalance: How is it financed?

Net international investment position of euro-area Member States in 2009

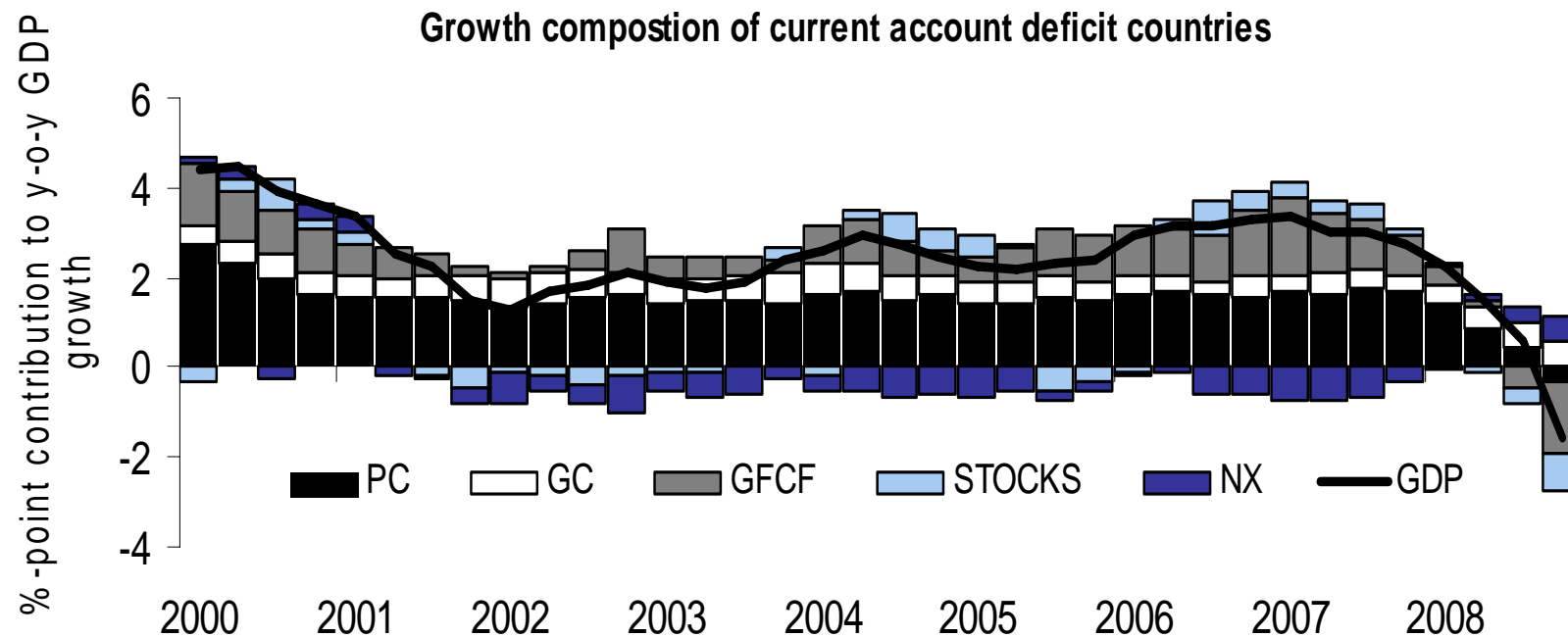


Source: Eurostat

Note: EA-16 includes all euro area members except Estonia



Misallocation of imported capital

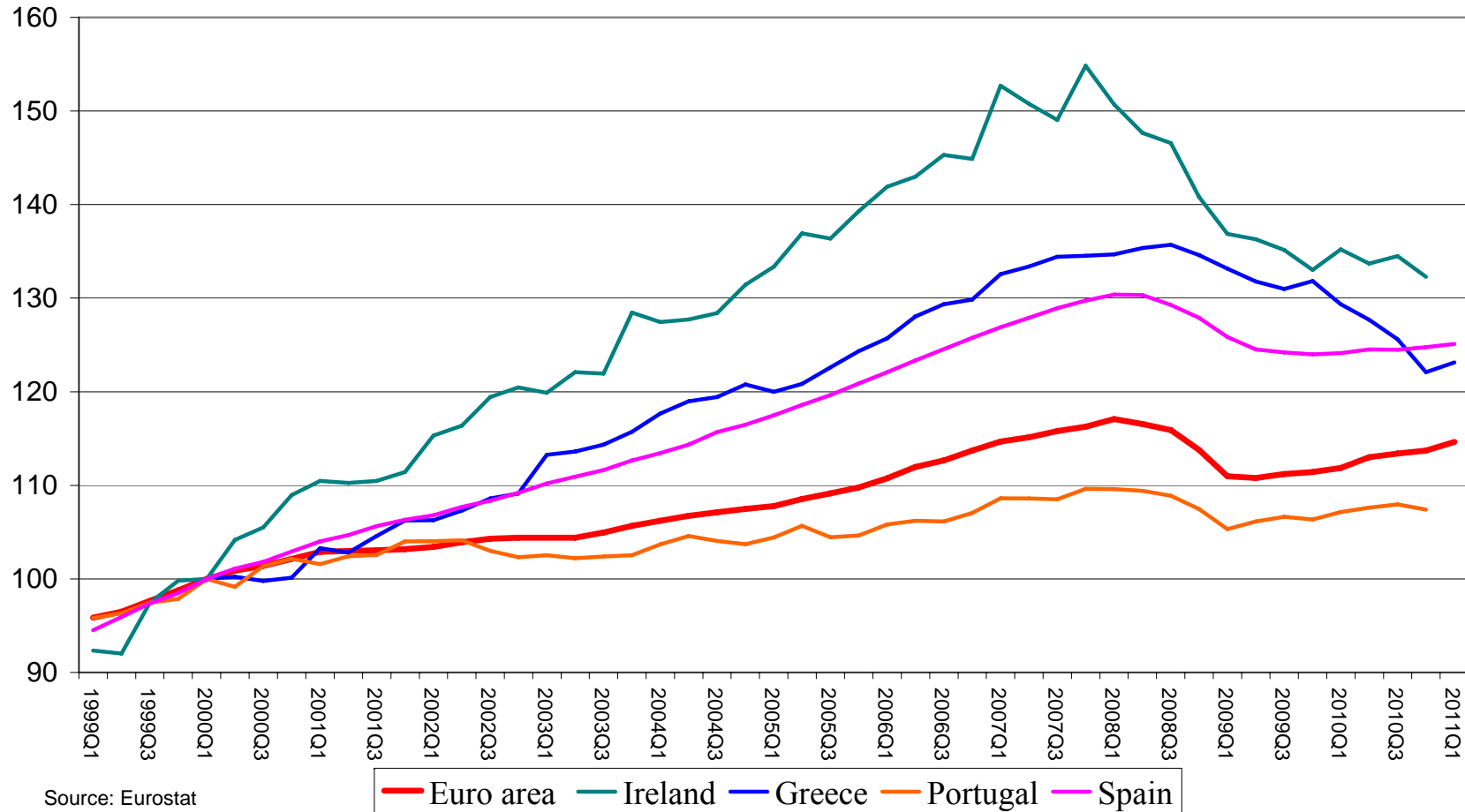


Note: weighted average of EU countries whose cumulative current account position over the period 1999-2008 was below that of the euro area. Source: European Commission



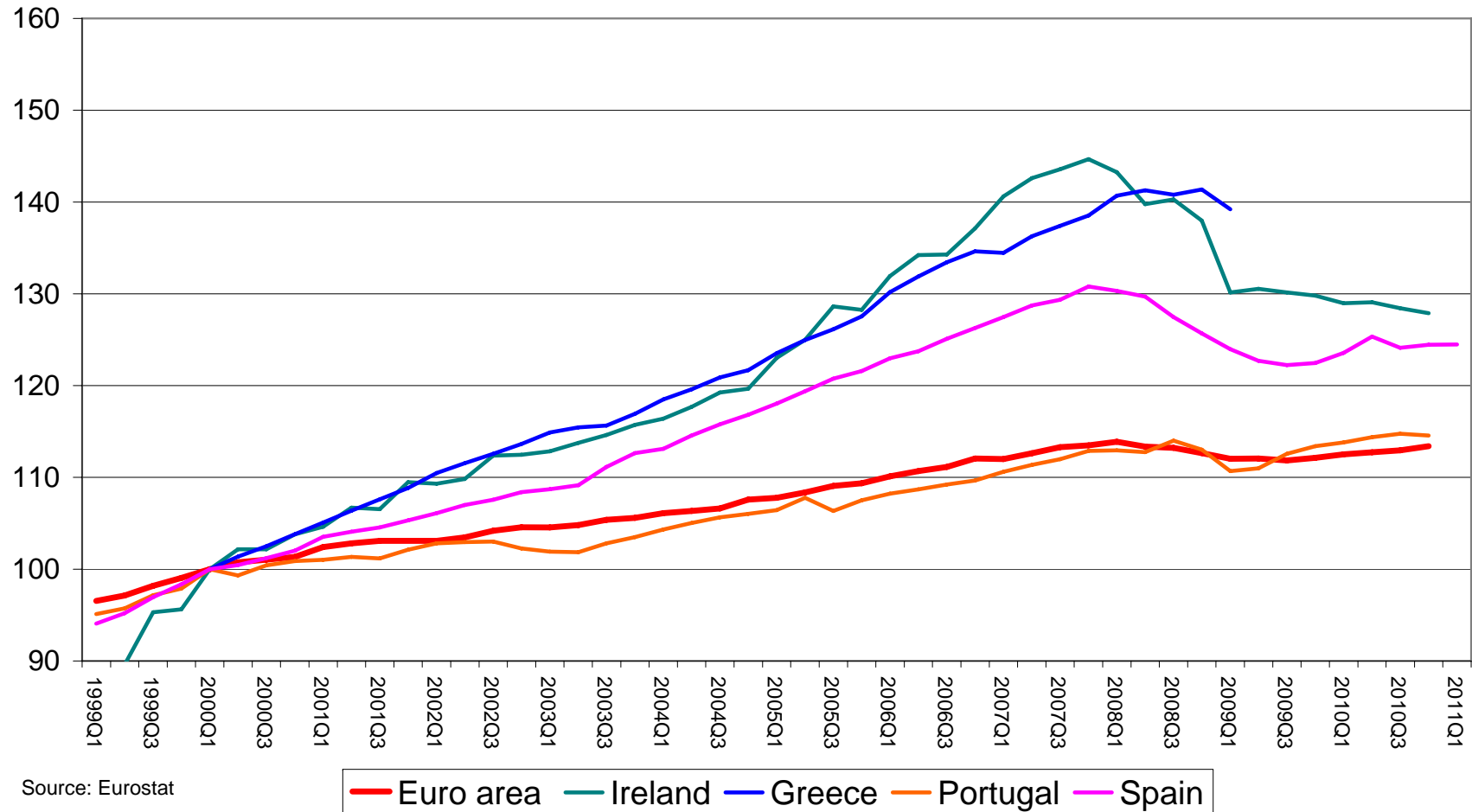
Result - Unsustainable growth

Real GDP, 1998-2011 (level Q1 2000 = 100)

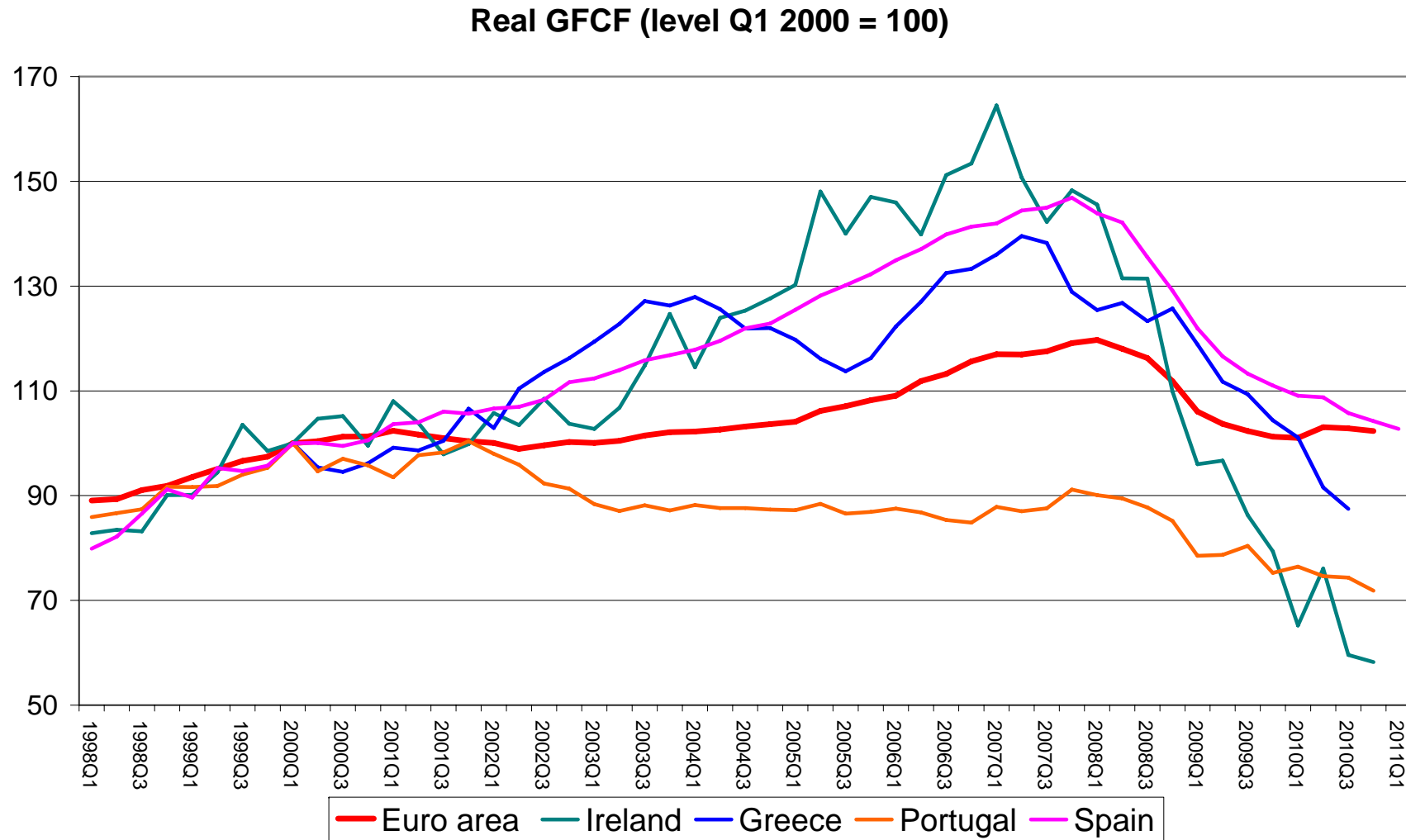


Misallocation: Excessive consumption

Real Household Consumption (level Q1 2000 = 100)

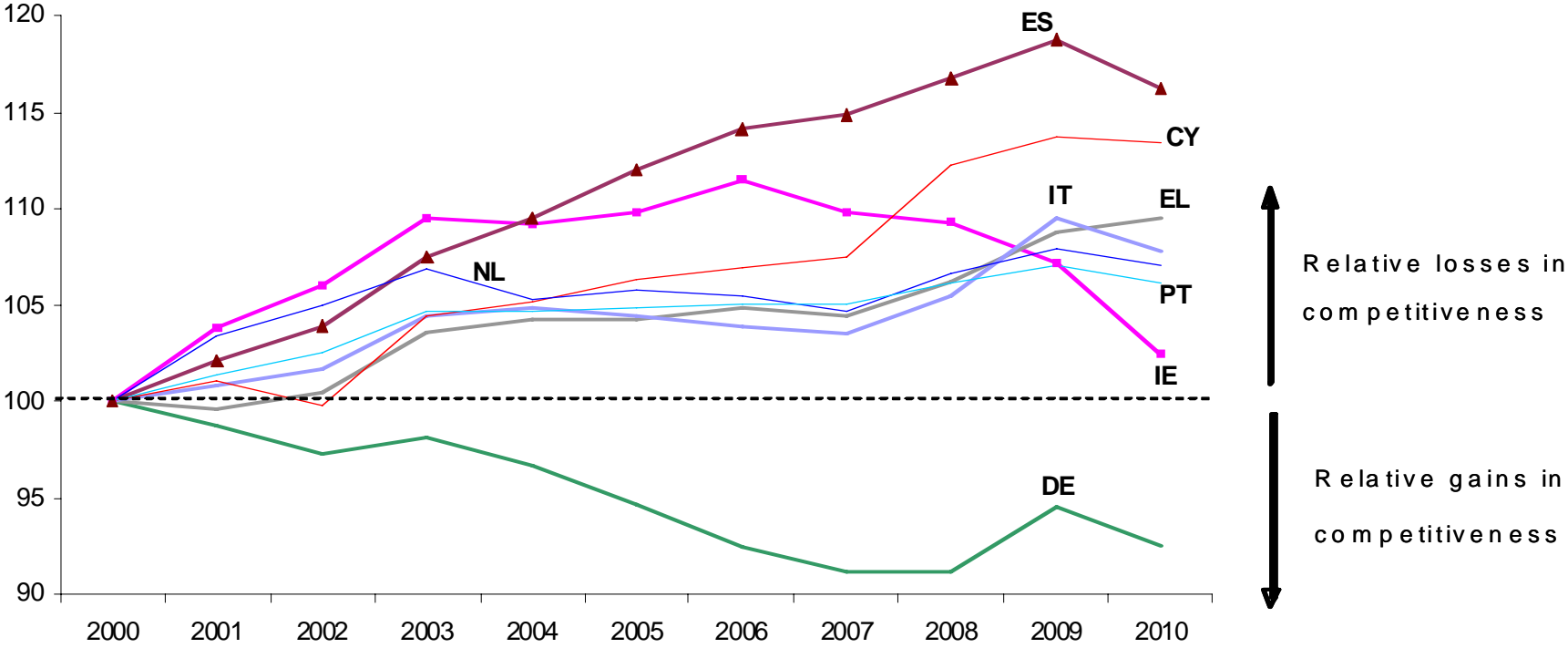


Misallocation: Excessive non-productive investment



Loss of competitiveness

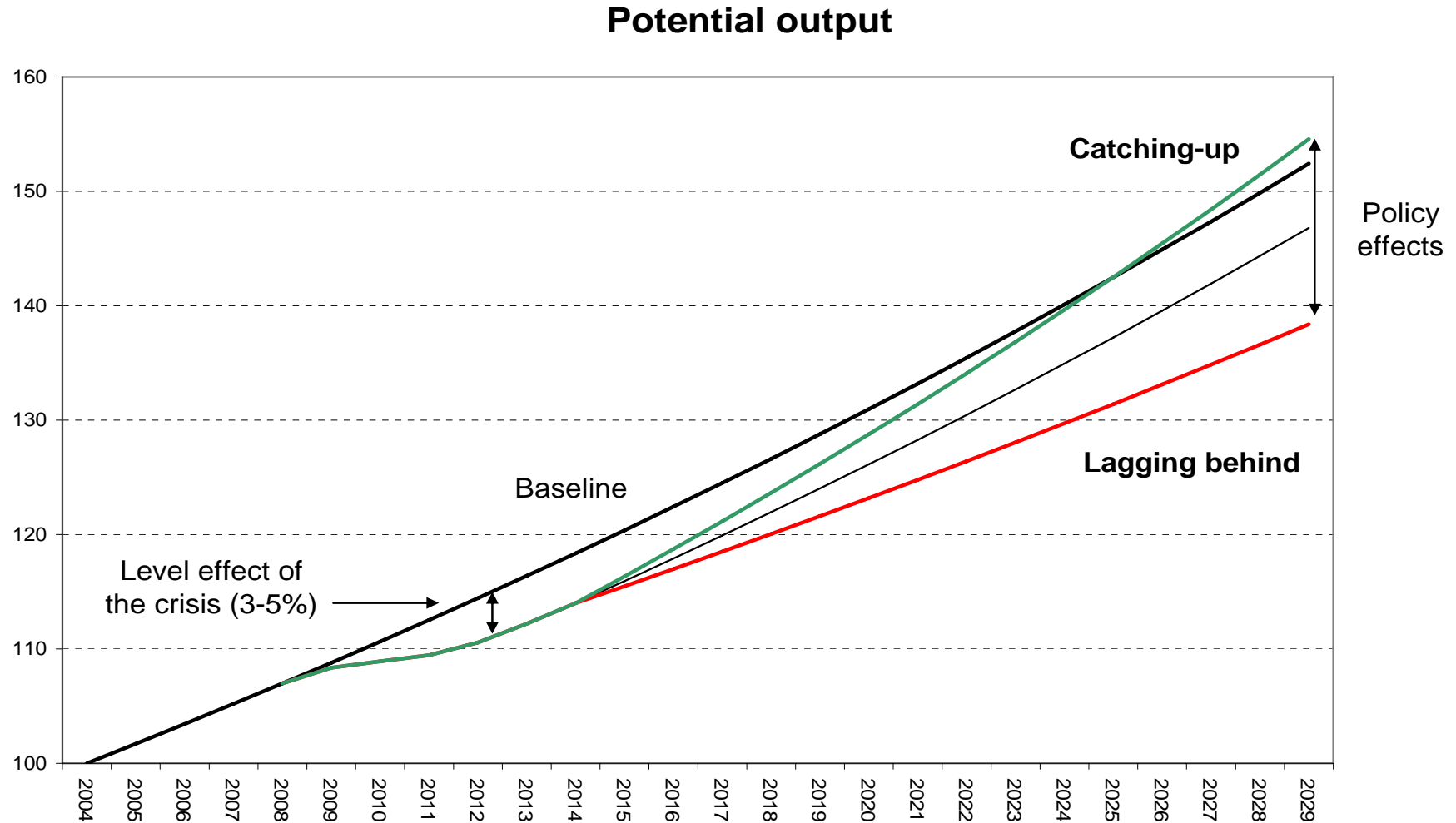
Price competitiveness relative to the rest of the euro area
 (ULC indices; 2000 = 100, increases represent losses in competitiveness)



Source: AMECO



The impact of the crisis on potential growth

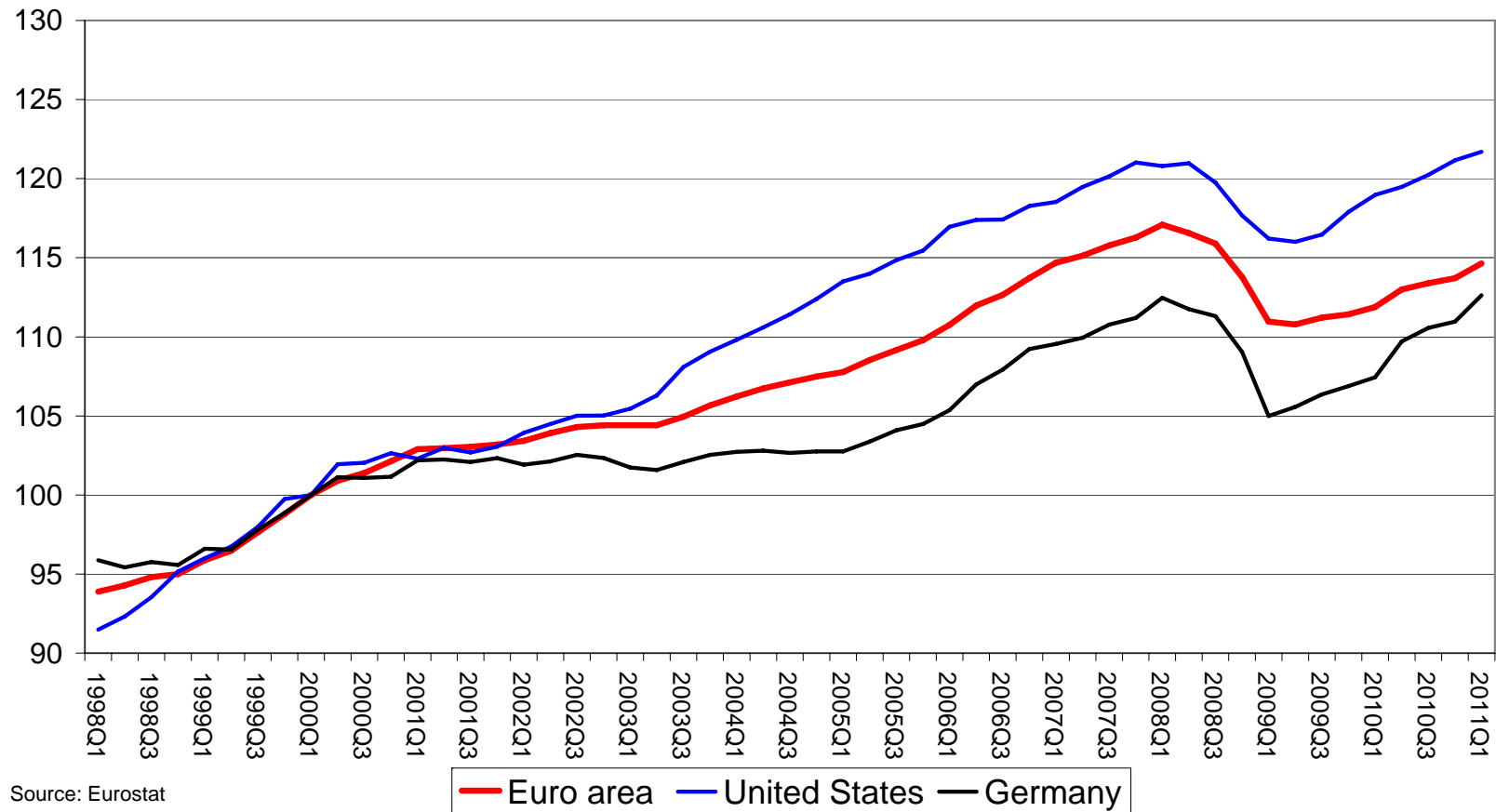


Source: European Commission Services



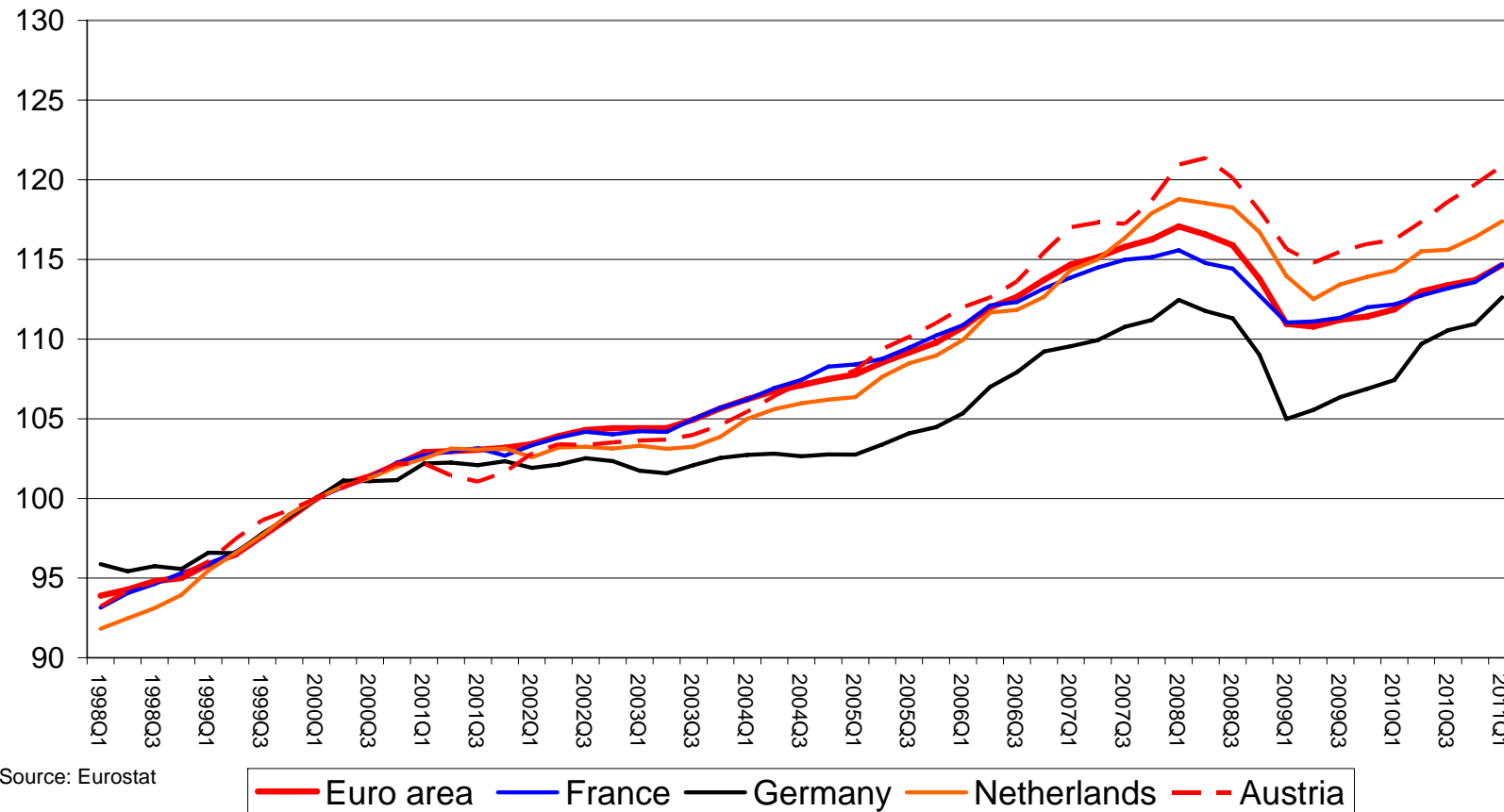
The impact of the crisis on (potential) output

Real GDP (level Q1 2000 = 100)



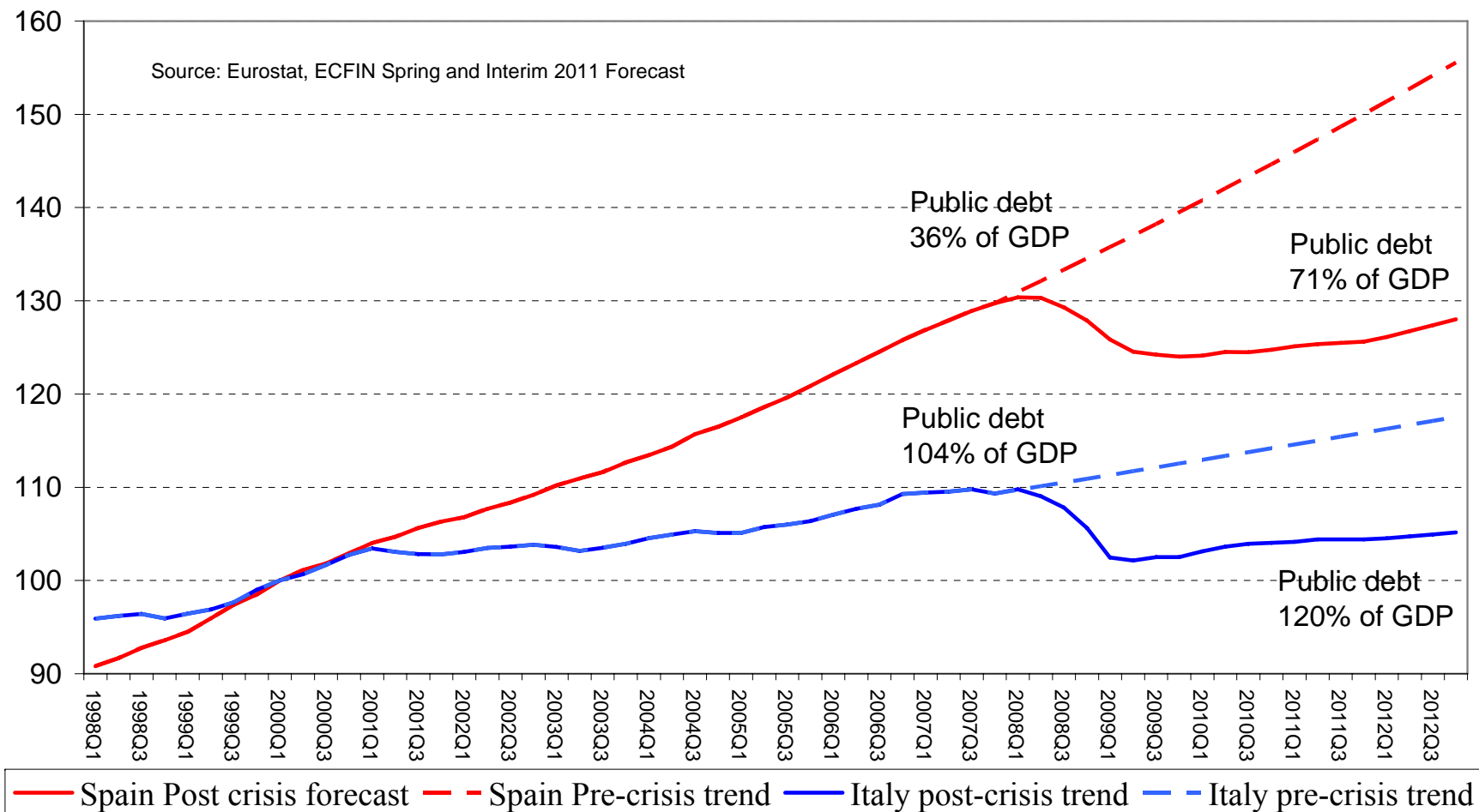
The impact of the crisis on (potential) output

Euro area countries: Real GDP, 1998-2012 (level Q1 2000 = 100)

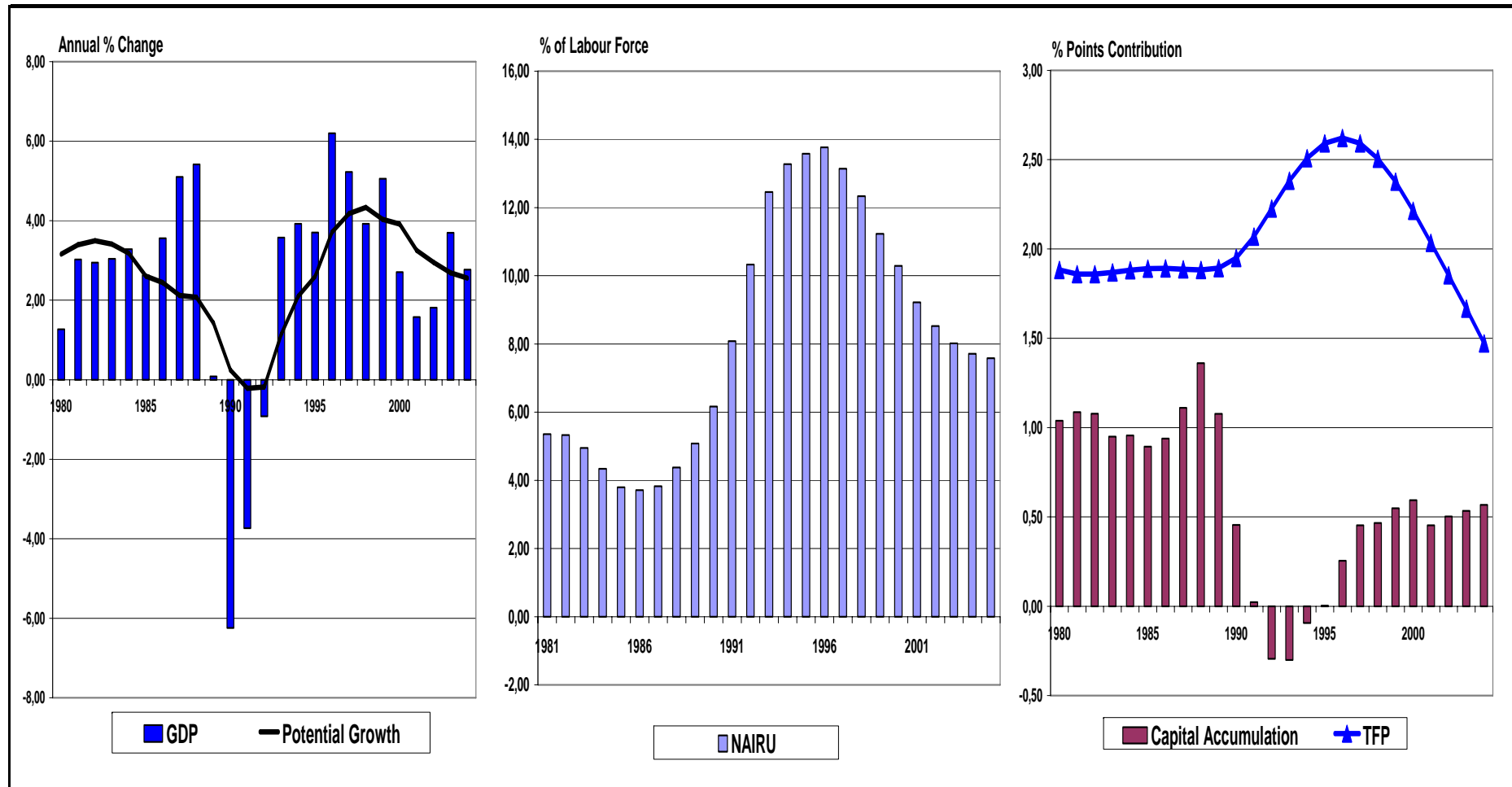


The impact of the crisis on (potential) output

Italy and Spain: Real GDP, 1998-2012 (level Q1 2000 = 100)

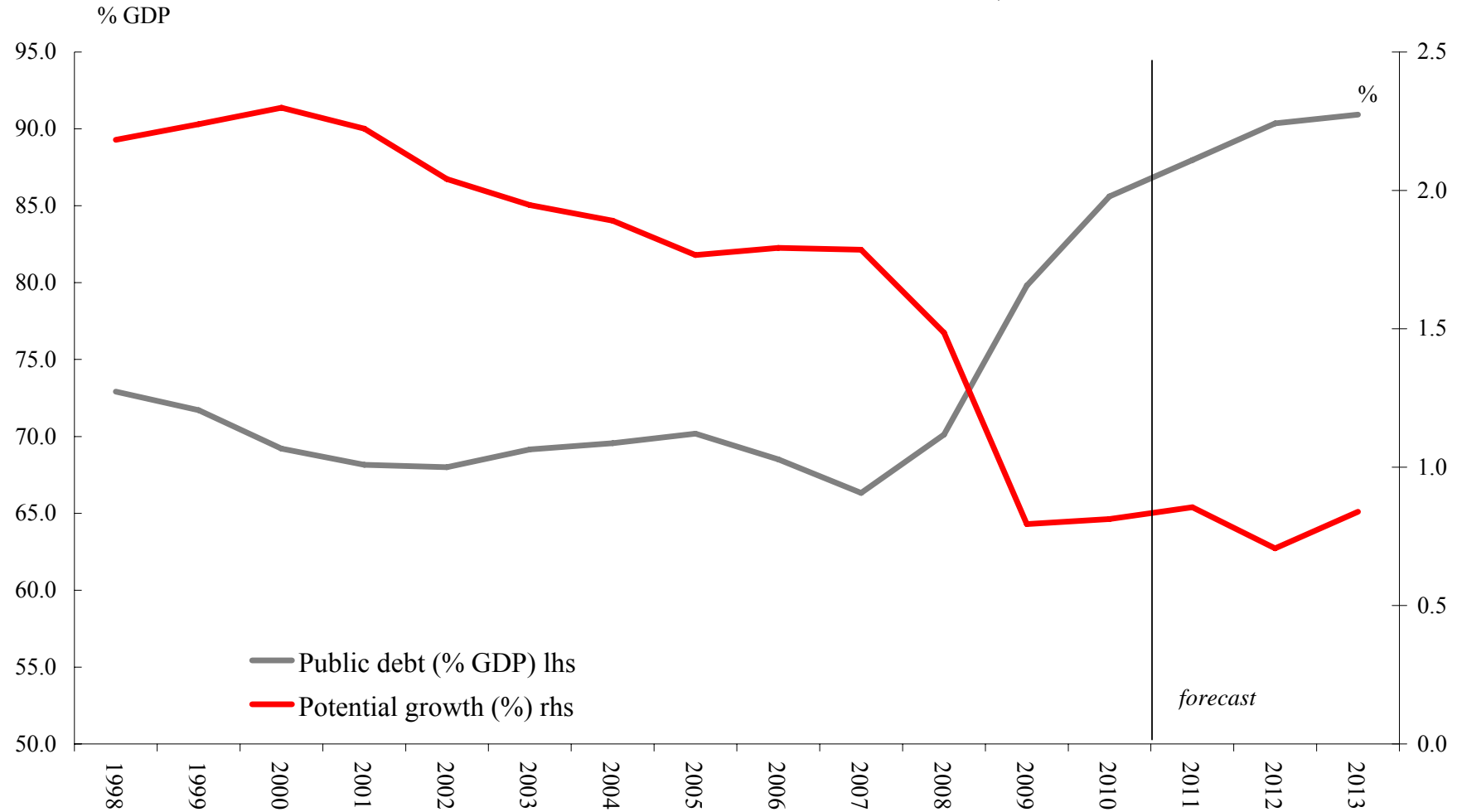


Finland's comeback: boosting TFP growth



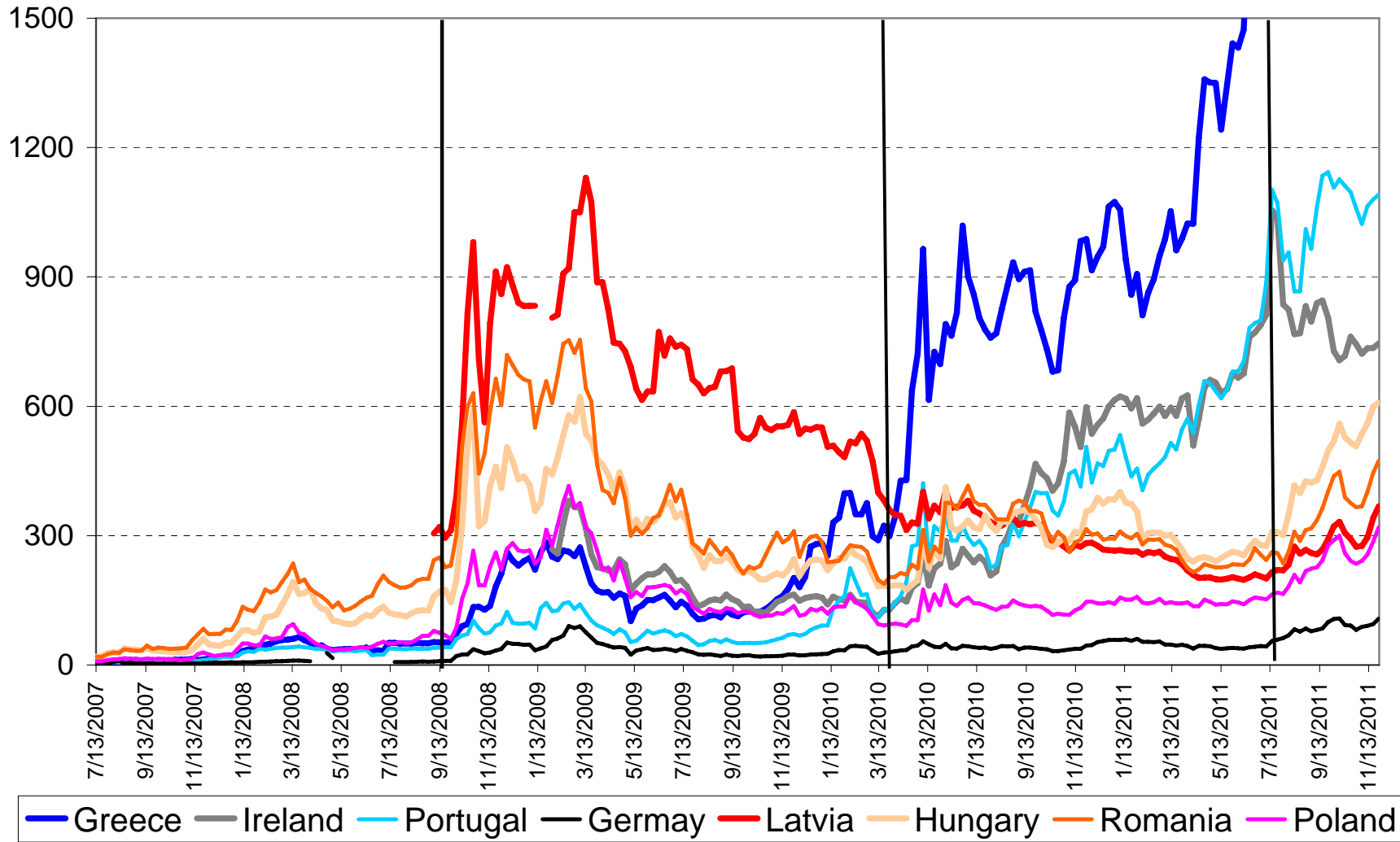
The impact of the crisis on debt dynamics

Euro Area: Public Debt and Potential Growth, 1998-2013



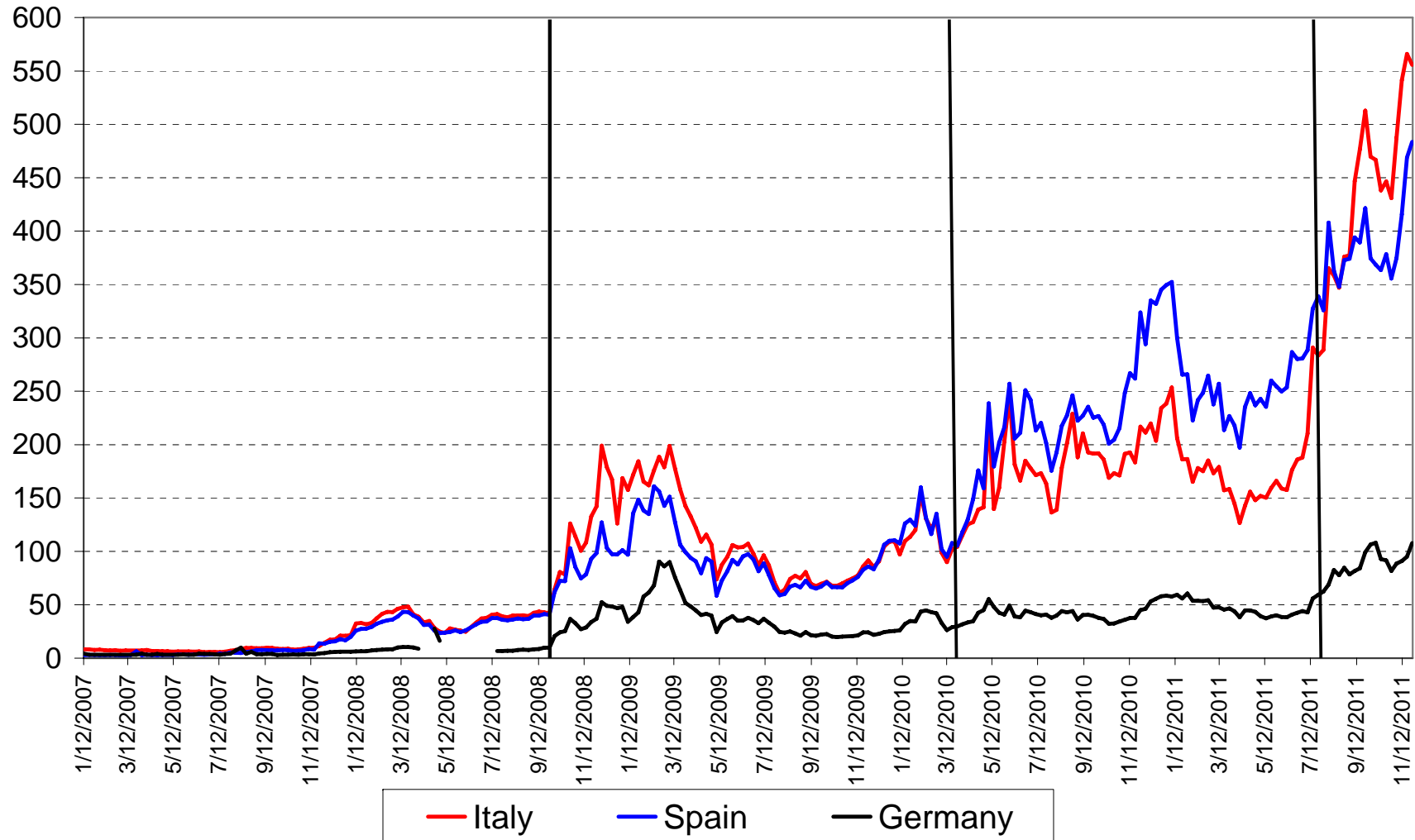
Crisis shifting around in Europe

CDS Spreads, 2007-2011



Crisis shifting around in Europe

CDS Spreads, 2007-2011



The model of financial integration in Europe: Where do we go from here?

- Supervisory reaction:
 - EBA: Increasing the capital of systemic banks, capital charge against sovereign papers
 - Austria: limiting lending to deposit base (110%) in subsidiaries
- Financial system restructuring under EU-IMF programs
 - Greece: Restructuring and deleveraging (→ Romania, Bulgaria)
 - Ireland: Recapitalizing, restructuring, deleveraging
- Market pressure, the need to raise fresh capital
 - Unicredit's new group strategy: refocusing their activity in Emerging Europe



Tackling the crisis:

The role of the European Commission at the global level

- Coordination of the policy answers (G20, IMF)
 - Fiscal stimulus
 - Strengthening country surveillance
 - Strengthening policy coordination and the global level
- Reform of the global financial system (G20, IMF, FSF)
 - Bailing out banks
 - Stress tests
 - Bank recapitalization
 - Strengthening prudential regulation, supervision and supervisory cooperation at the global level



Tackling the crisis:

The role of the European Commission in Europe

- Coordination of economic policy reaction, particularly fiscal stimulus
European Economic Recovery Plan (November 2008)
<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2008:0800:FIN:EN:PDF>
- European stress test and recapitalization of banks (EBA)
- Strengthening country surveillance: European Semester
- Strengthening economic policy coordination (6-pack)
- Accelerating growth-enhancing structural reforms: Europe 2020
- Second European stress test, follow up bank recap



Crisis on the periphery: The role of the European Commission

➤ CEE:

- Increasing the BoP facility (Dec 2008 €12 → 25 bn, May 2009 → €50 bn)
- EU-IMF programs (Hungary, Latvia, Romania)

➤ Euro area periphery

- Greece: coordination of bilateral loans, program design and monitoring
- EFSF-EFSM design, EFSF reforms
- EU-IMF programs (Ireland, Portugal)



Crisis on the periphery: EU-IMF programs

➤ Central-Eastern Europe

- Hungary (€20 bn) 2008 (Oct) – 2010 (July)
- Latvia (€7,5 bn) 2008 (Dec) -
- **Romania** (€20 +5 bn) 2009 (June) -

➤ Euro area periphery

- Greece (€110 bn + ?) 2010 (May) -
- **Ireland** (€85 bn) 2010 (Nov) -
- Portugal (€78 bn) 2011 (May) –

➤ Euro area core

- **Italy** – enhanced surveillance 2011 (Nov)



Ireland: EU-IMF program

➤ Program

http://ec.europa.eu/economy_finance/publications/occasional_paper/2011/op76_en.htm

- Reform of the banking system
 - Restoring healthy public finances
 - Growth enhancing structural reforms
- ## ➤ Use of money
- Recapitalizing the banking sector €35 bn
 - Budget financing €50 bn
- ## ➤ Funding:
- EFSM €22,5 bn EFSM and bilaterals €22,5 bn
 - IMF €22,5 bn
 - Own funds: €17,5 bn



Reform of the banking system

➤ PCAR

- Recapitalization of viable banks (€24 bn)
- Winding up or merging with other banks non-viable banks
- Strengthening cooperative banks

➤ PLAR

- Deleveraging of the banking system
- New funding structure
- Strengthening prudential regulation and supervision



Fiscal consolidation and sustainability

➤ Fiscal consolidation

- 2011 budget
- 2011-15 M-T fiscal adjustment, 2015: 3% deficit
- Spending review

➤ Restoring sustainability

- Fiscal Responsibility Bill
- Binding medium-term fiscal framework
- Fiscal Advisory Council



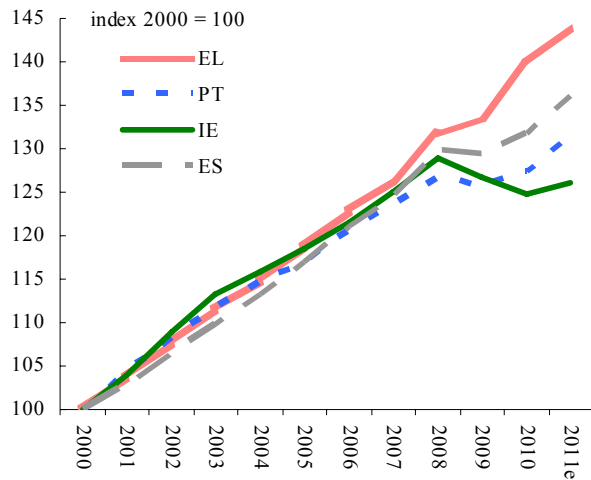
Growth enhancing structural reforms

- Strengthening competitiveness
 - Focus on non-tradable sector
- Labor market reforms
 - Institutional reforms
 - Labor force participation and employment
 - Wage formation and negotiation
- Social welfare system reform
- Product market reforms
 - Sheltered professions
 - Retail trade regulation
 - SOEs reorganization and privatization

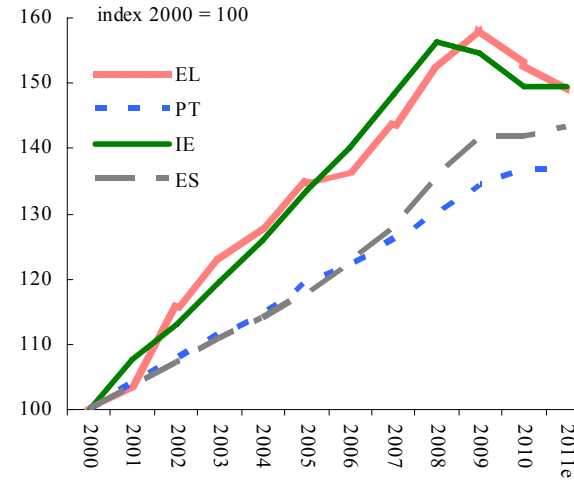


Unwinding of imbalances - Ireland has come a long way

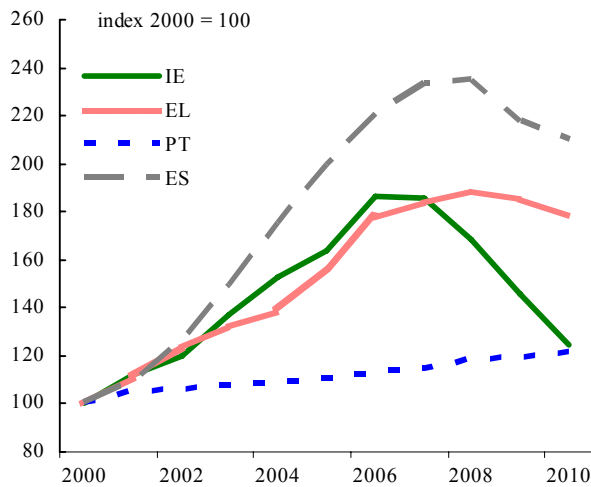
Consumer price developments (HICP)



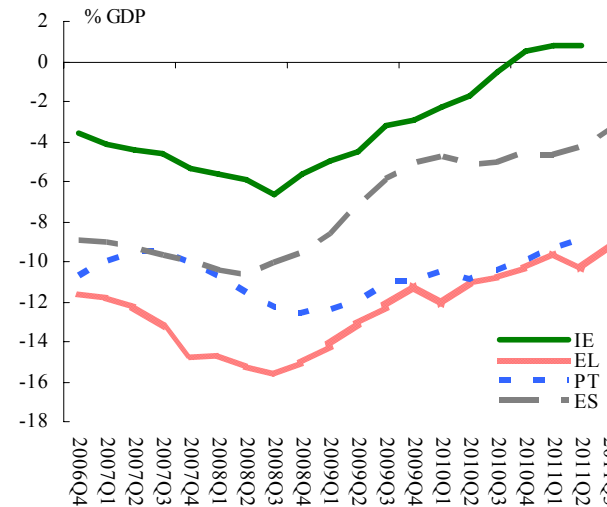
Nominal compensation per employee



Nominal house prices



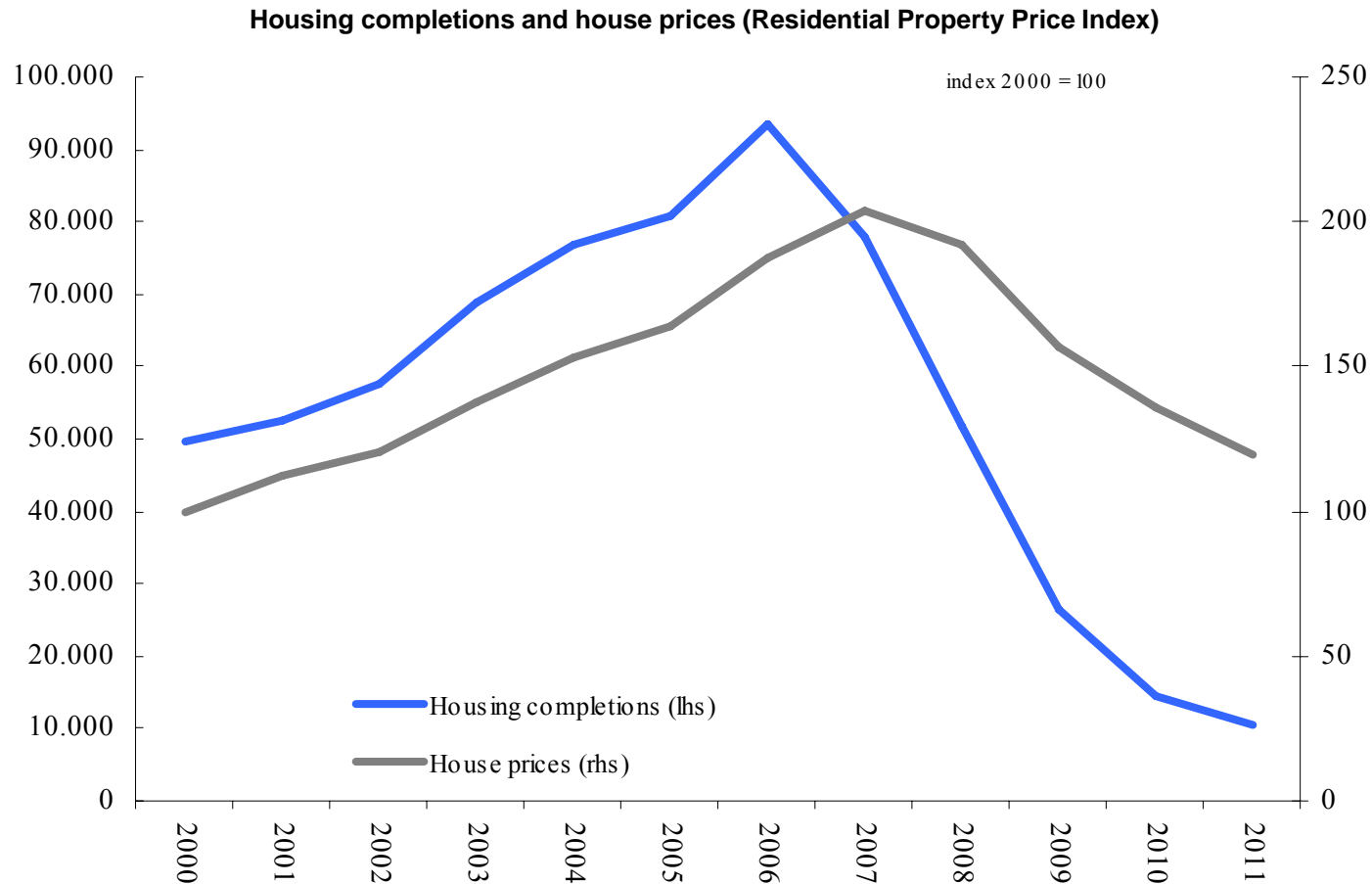
Current account balance



Source: AMECO, Eurostat

Unwinding of imbalances- housing

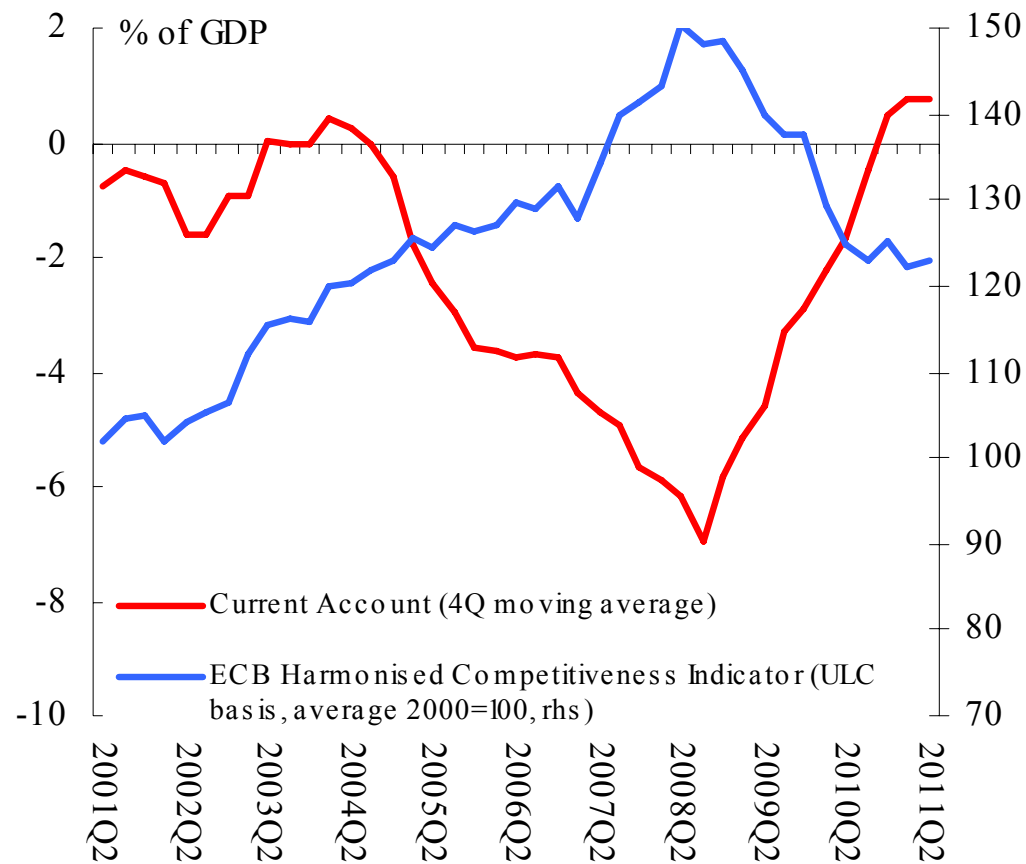
Prices and flows adjusted, but stock problems remain



Source: CSO



External imbalances – Competitiveness

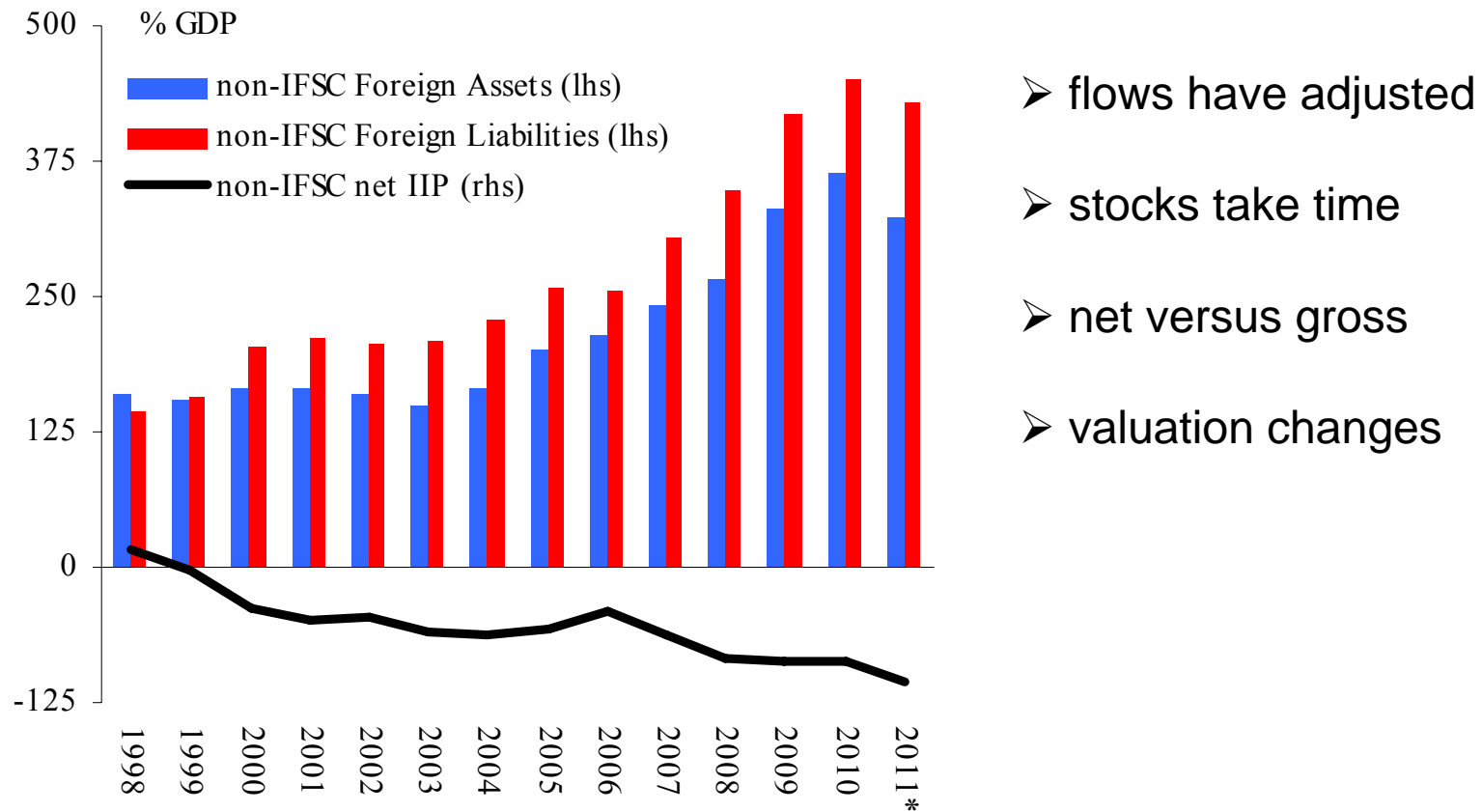


➤ ULC and REER back to the level of 2002-2004 (depending on measure)

➤ CA back in surplus

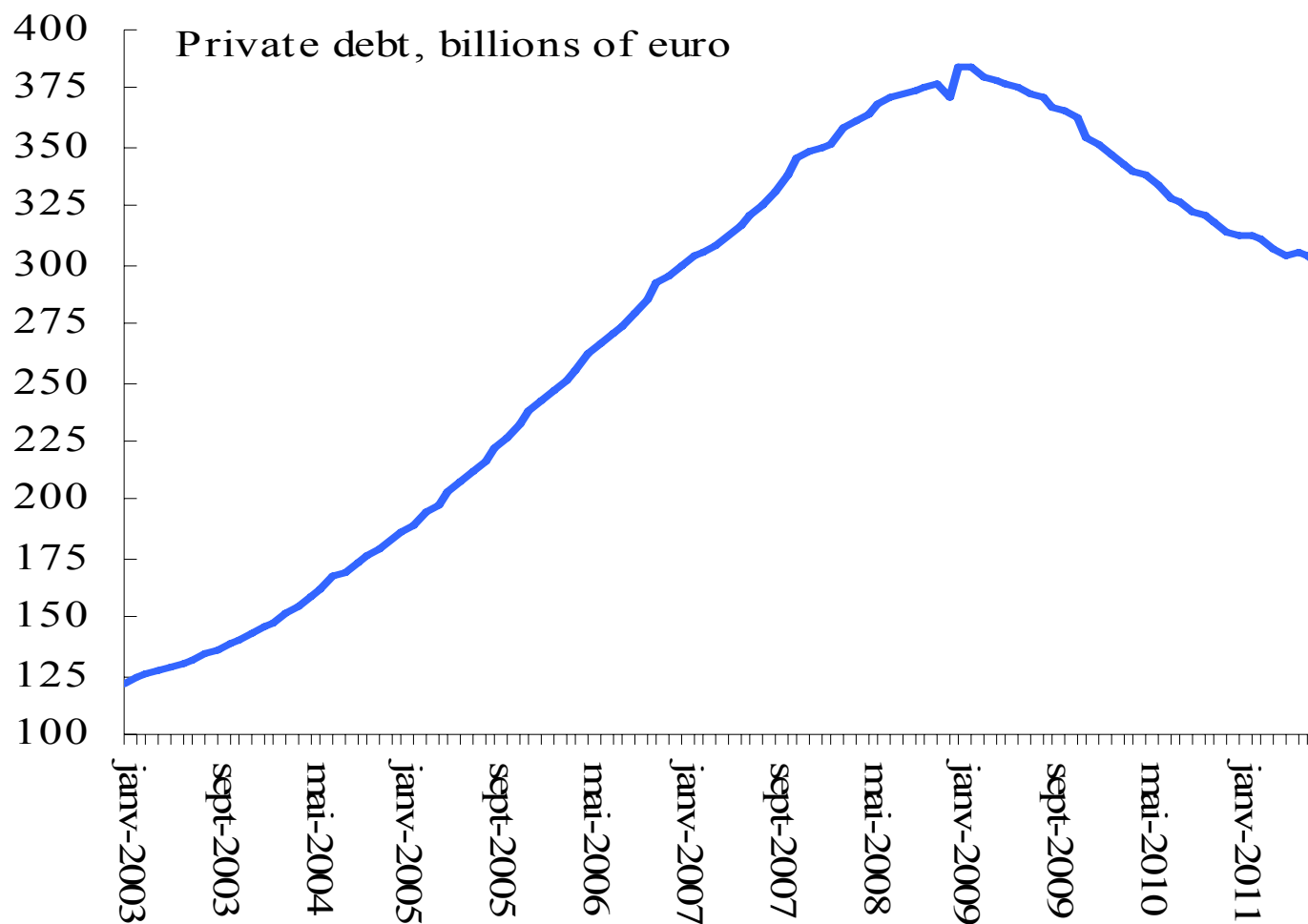


External imbalances – International investment position (non IFSC)



Source: CSO

Financial imbalances – private sector deleveraging

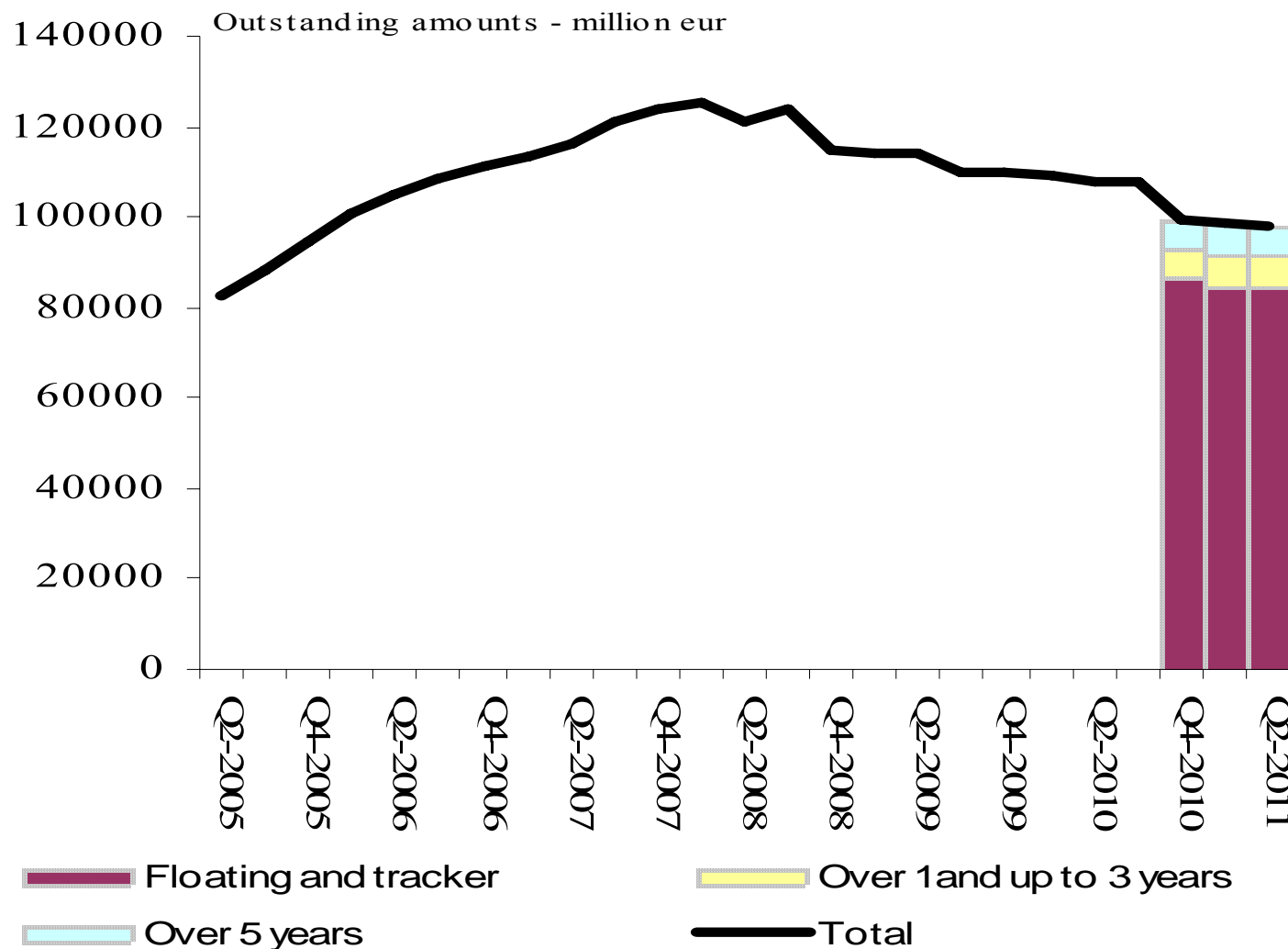


Source: CBI



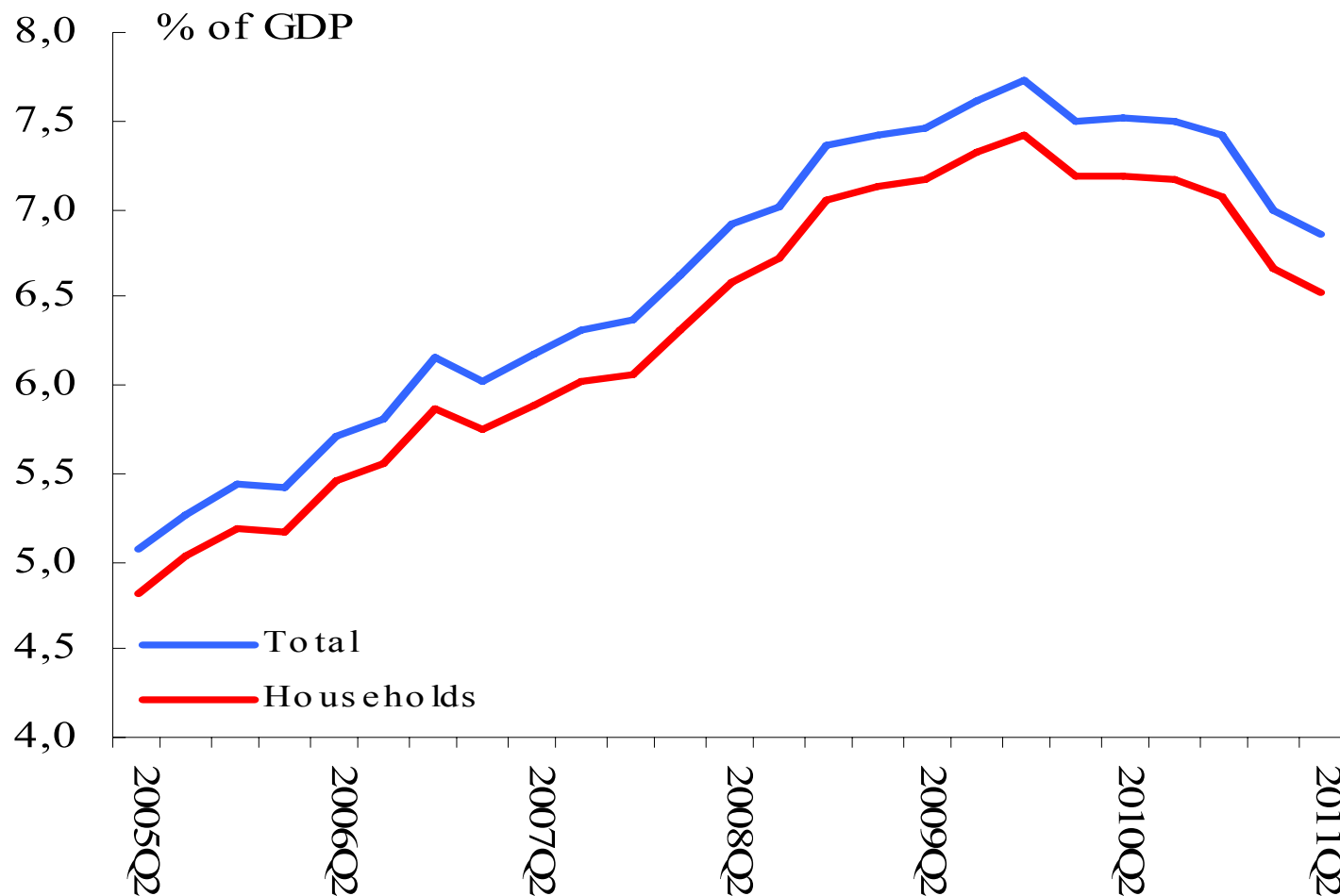
Financial imbalances – household deleveraging

Credit Advanced to Irish Resident Private Households for House Purchase



Financial imbalances – household deleveraging

Outstanding indebtedness on credit cards

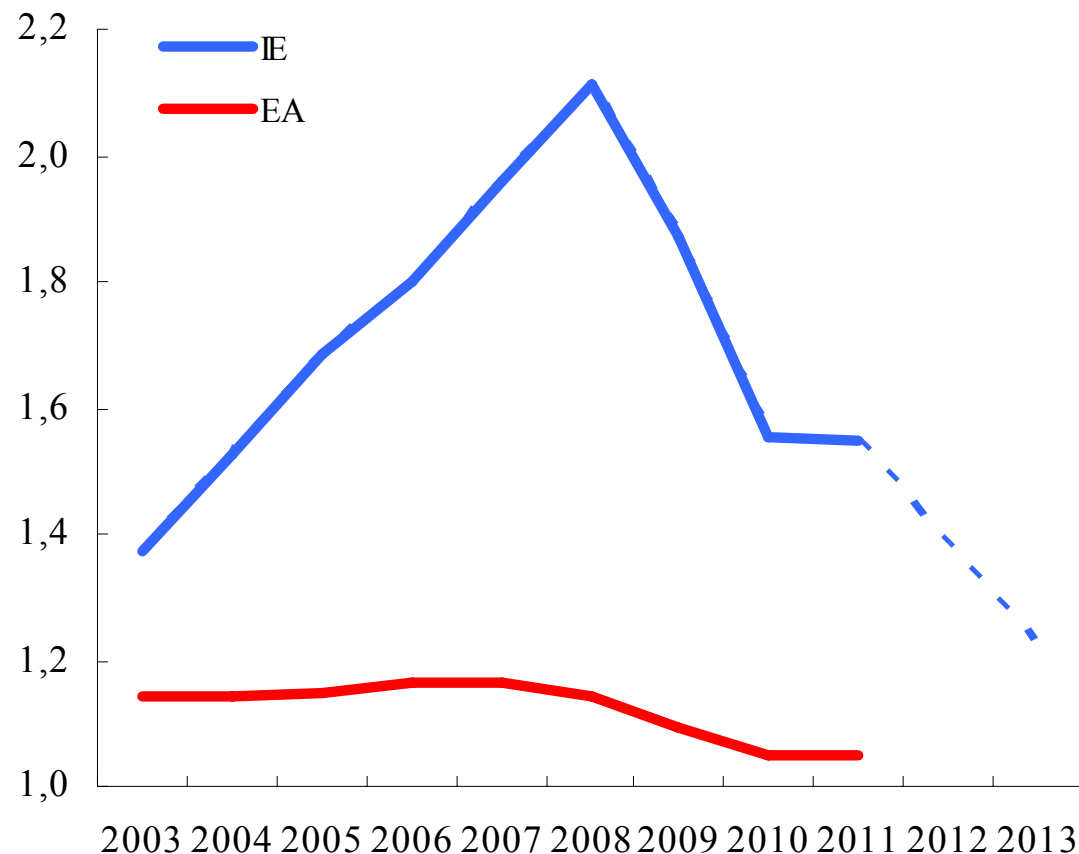


Source: CBI



Financial imbalances – deleveraging banks

Loan-to-deposit ratio domestic banks



➤ deleveraging target under programme LTD 122.5 % in 2013

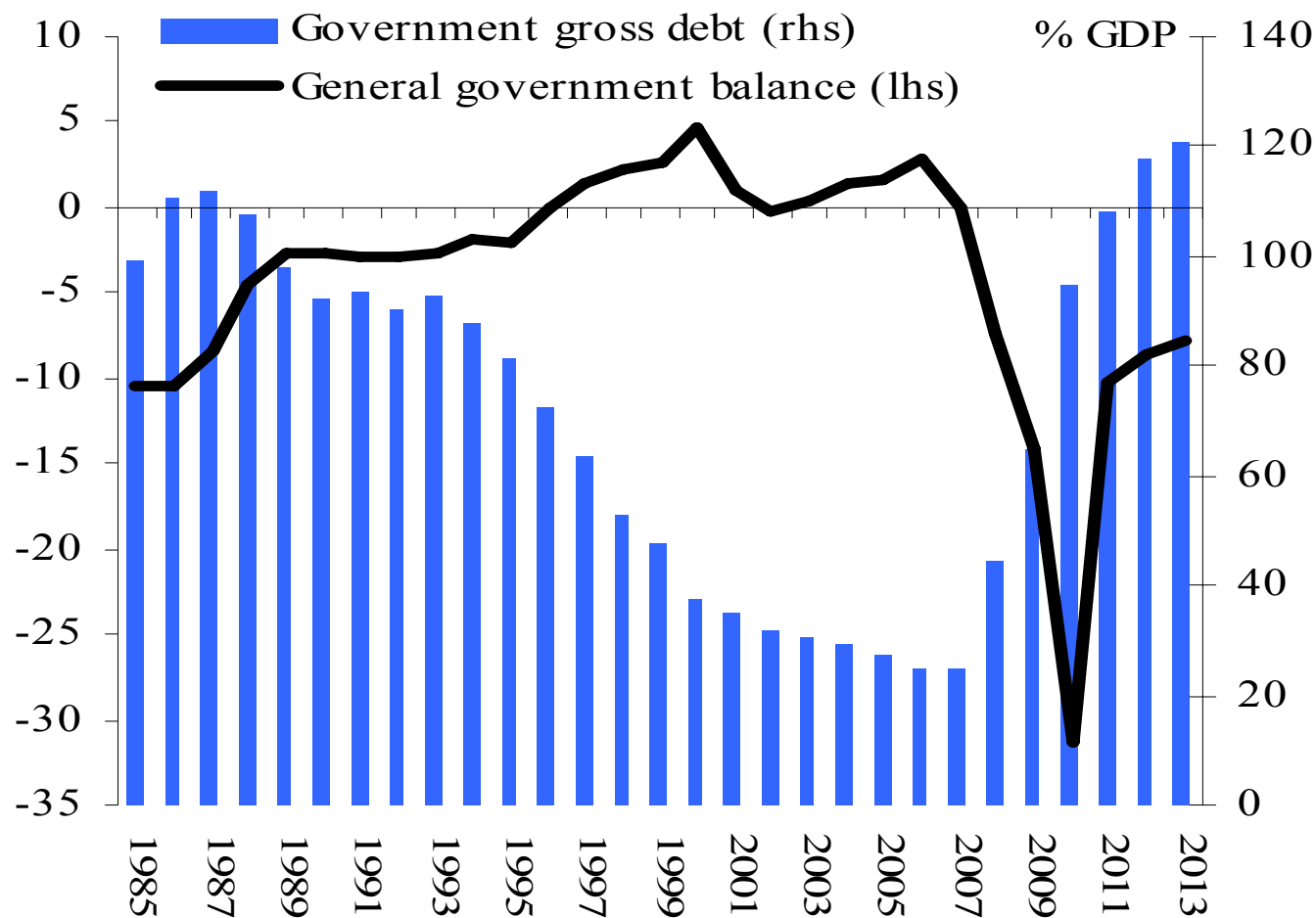
➤ disposal of non-core assets

➤ run-off of loans

➤ ensuring credit provision to domestic economy on core portfolio



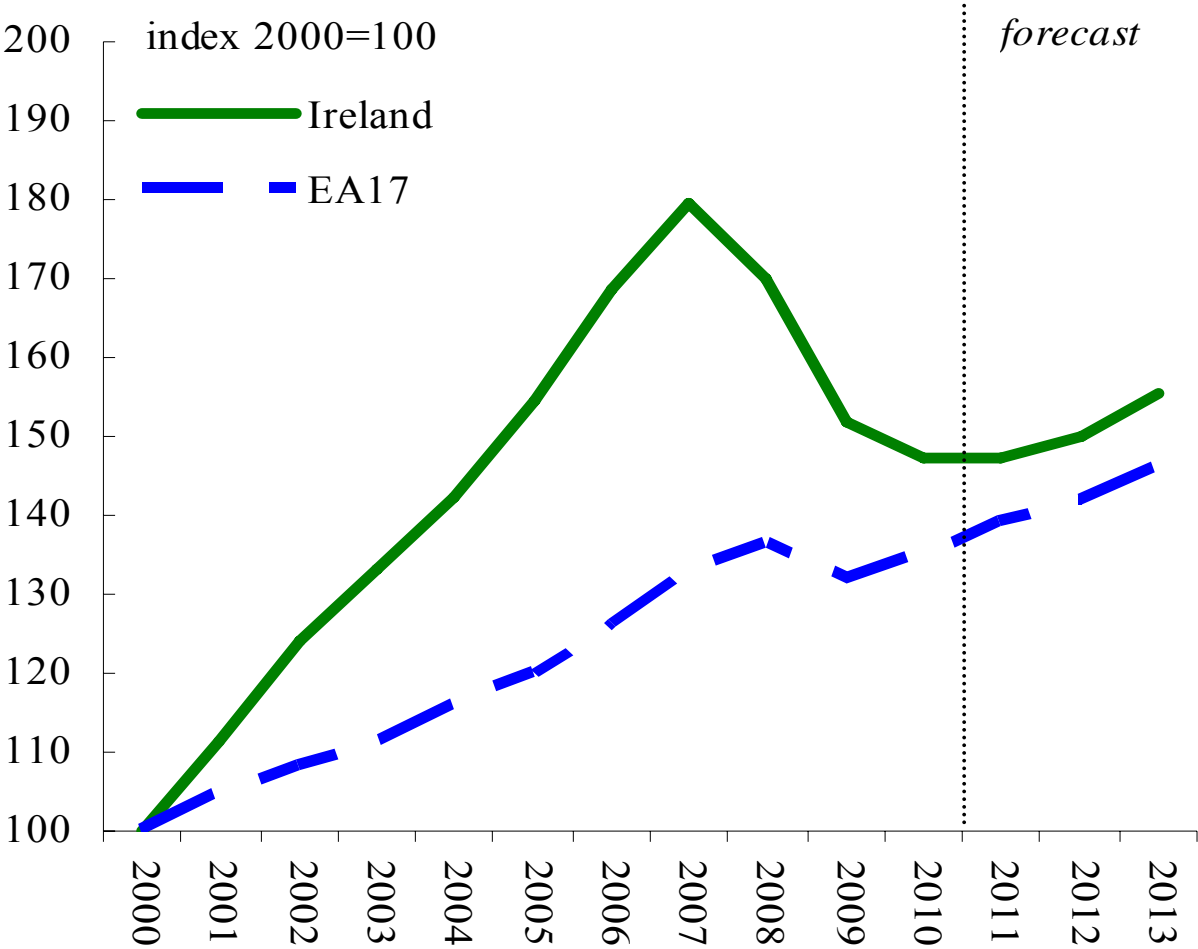
Fiscal imbalances – Deficit and debt looked fine in 2007



Source: AMECO

Bubble in nominal GDP

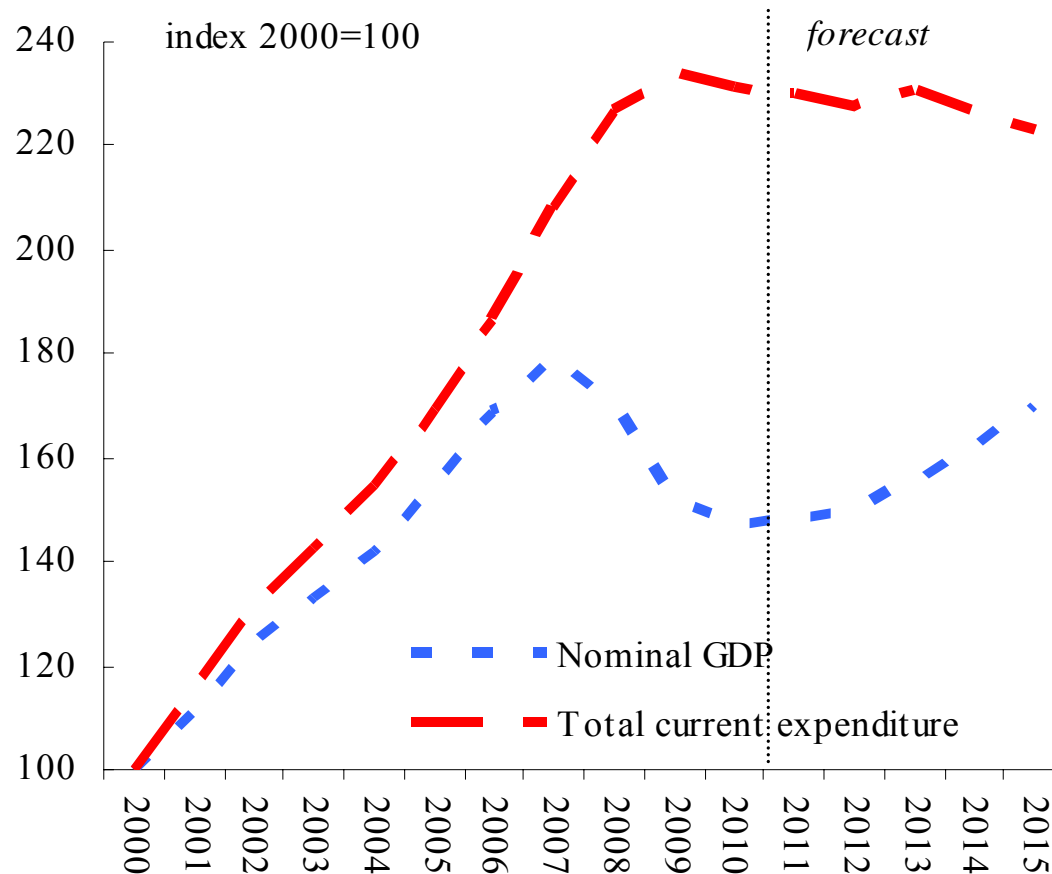
Underlying developments explain current fiscal challenges



Source: AMECO

...but public expenditure grew even faster

Underlying developments explain current fiscal challenges



➤ Nominal expenditure outpaced fast GDP growth

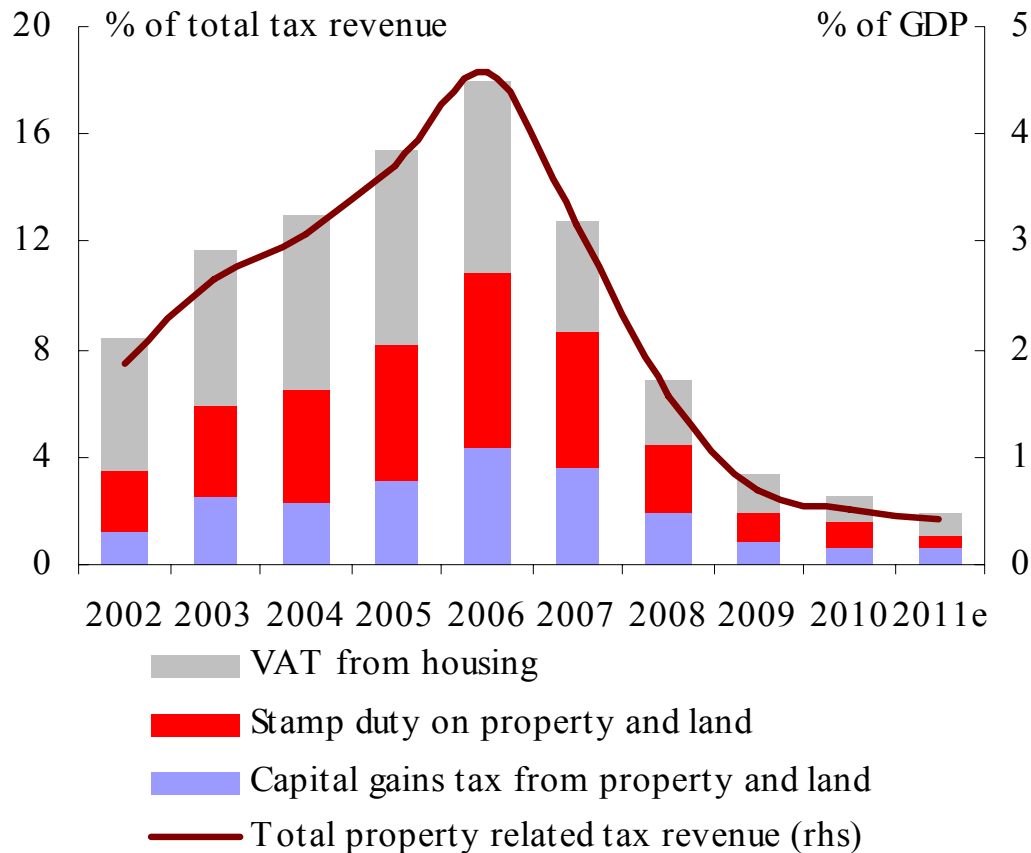
➤ As GDP collapsed, expenditure at first continued to expand

➤ Nominal expenditure reductions 2009-2015



Revenues relied on unsustainable base

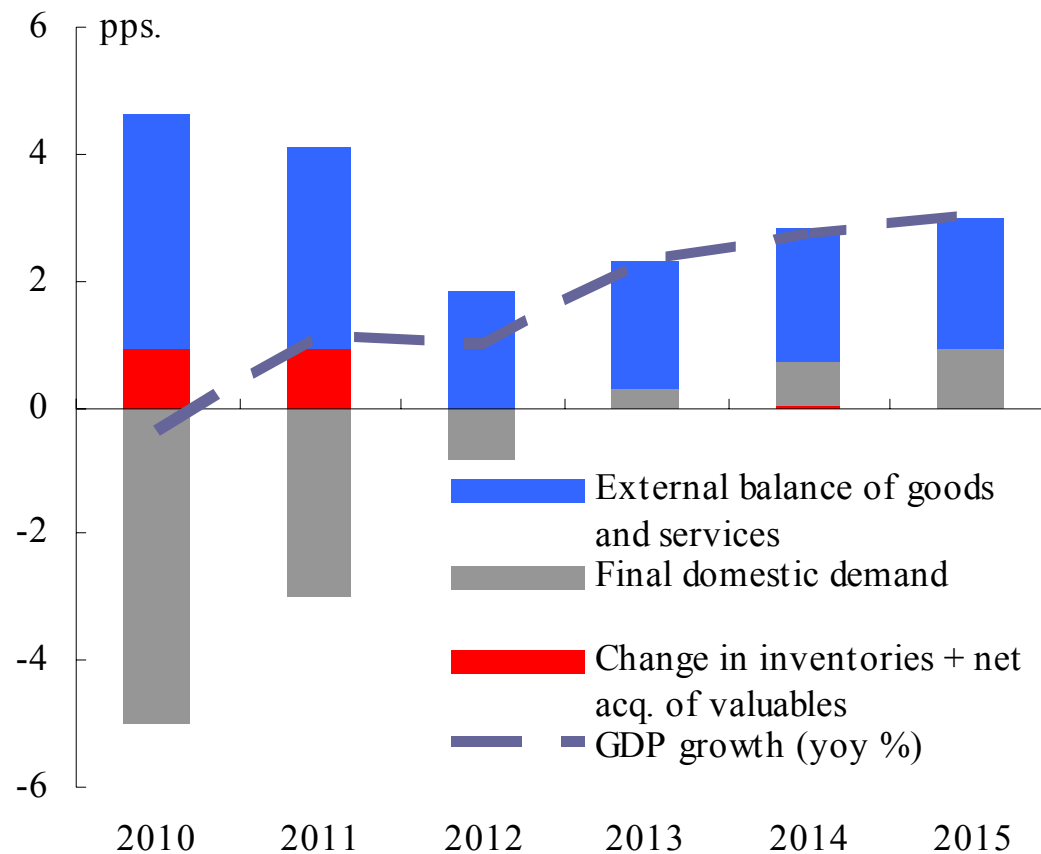
Underlying developments explain current fiscal challenges



➤ revenues relied on unsustainable base, housing price and construction bubble



Growth outlook important for programme success



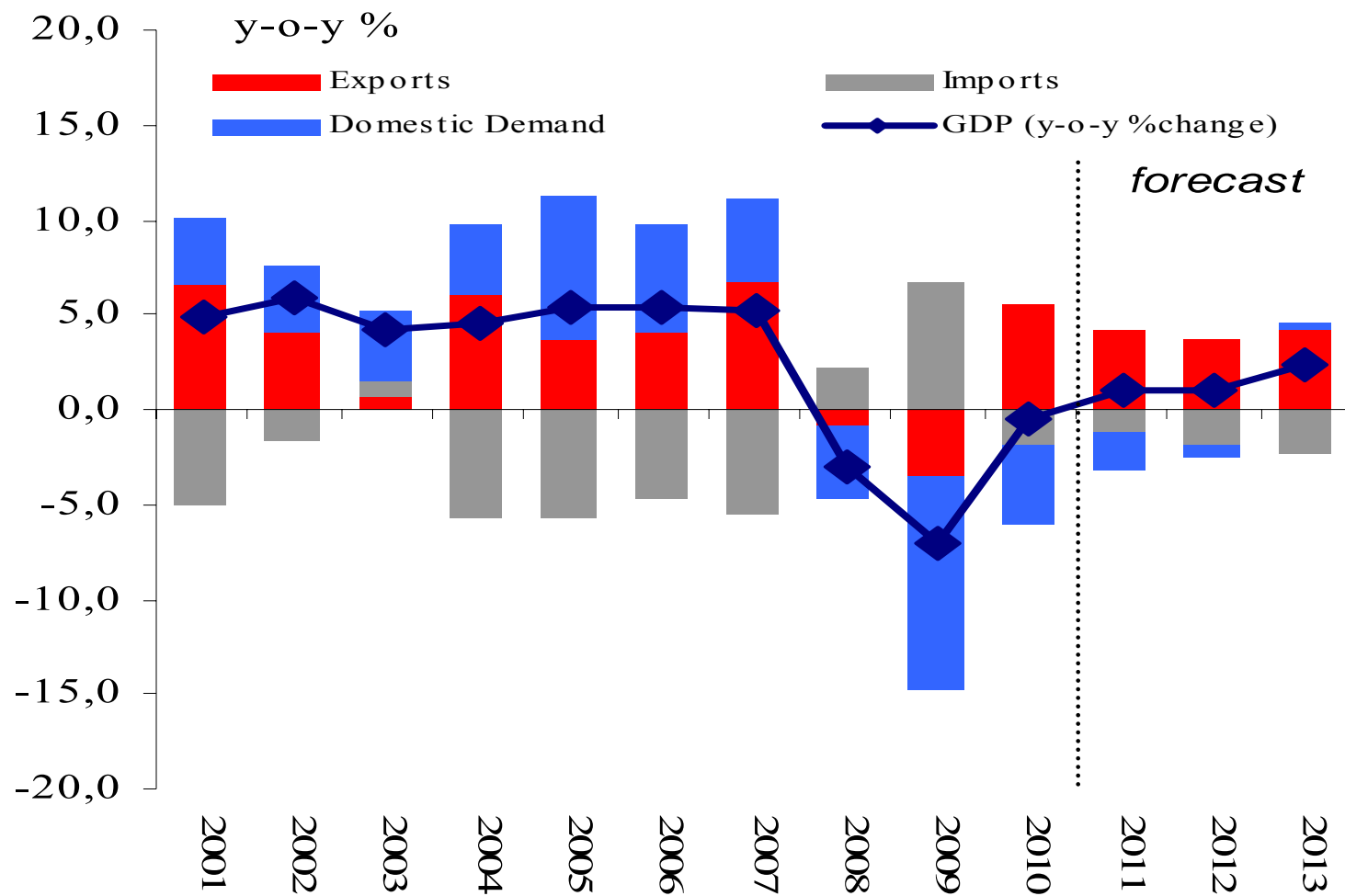
➤ export based growth

➤ weak domestic demand until 2015 (deleveraging and consolidation)

➤ upside risks ?



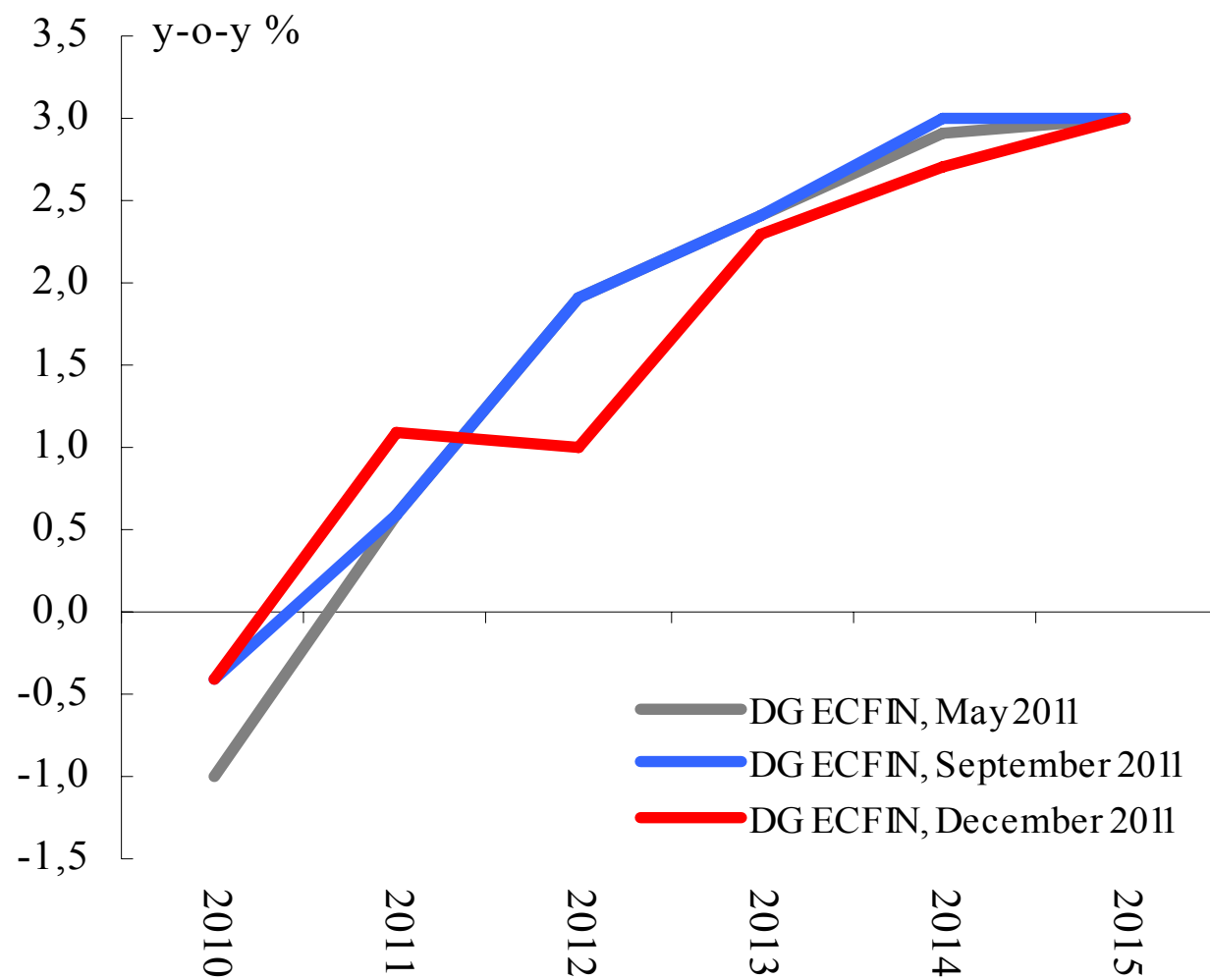
Contributions to GDP growth



Source: AMECO



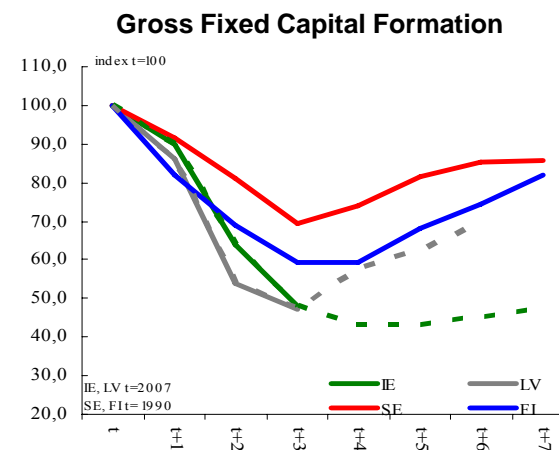
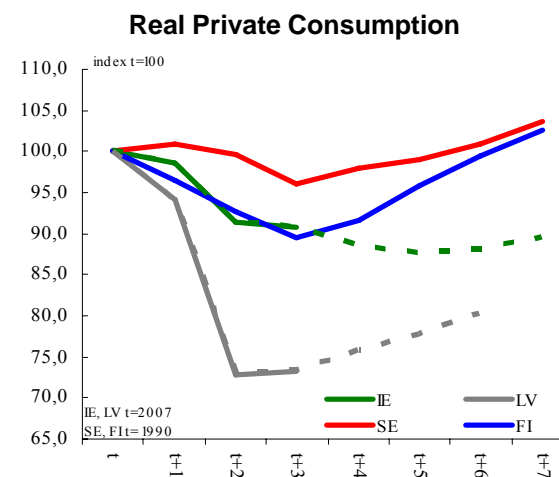
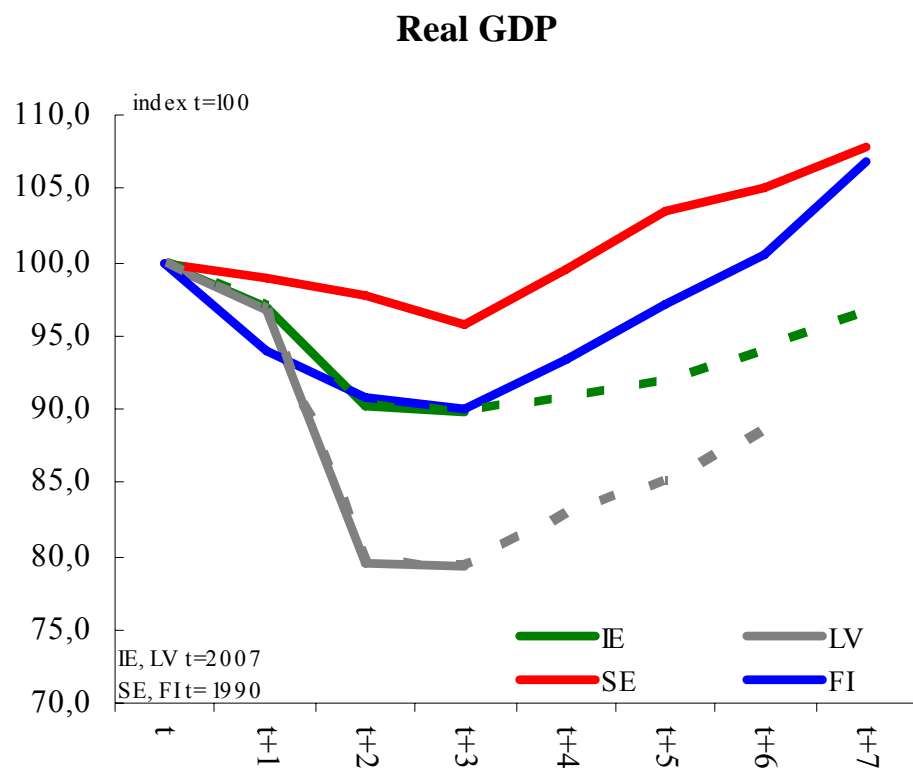
Relatively stable macro-framework – risks in 2012



Source: Commission Services



Upside risks – experiences with financial crisis adjustment show scope for upside



Source: AMECO

Thank you for your attention!



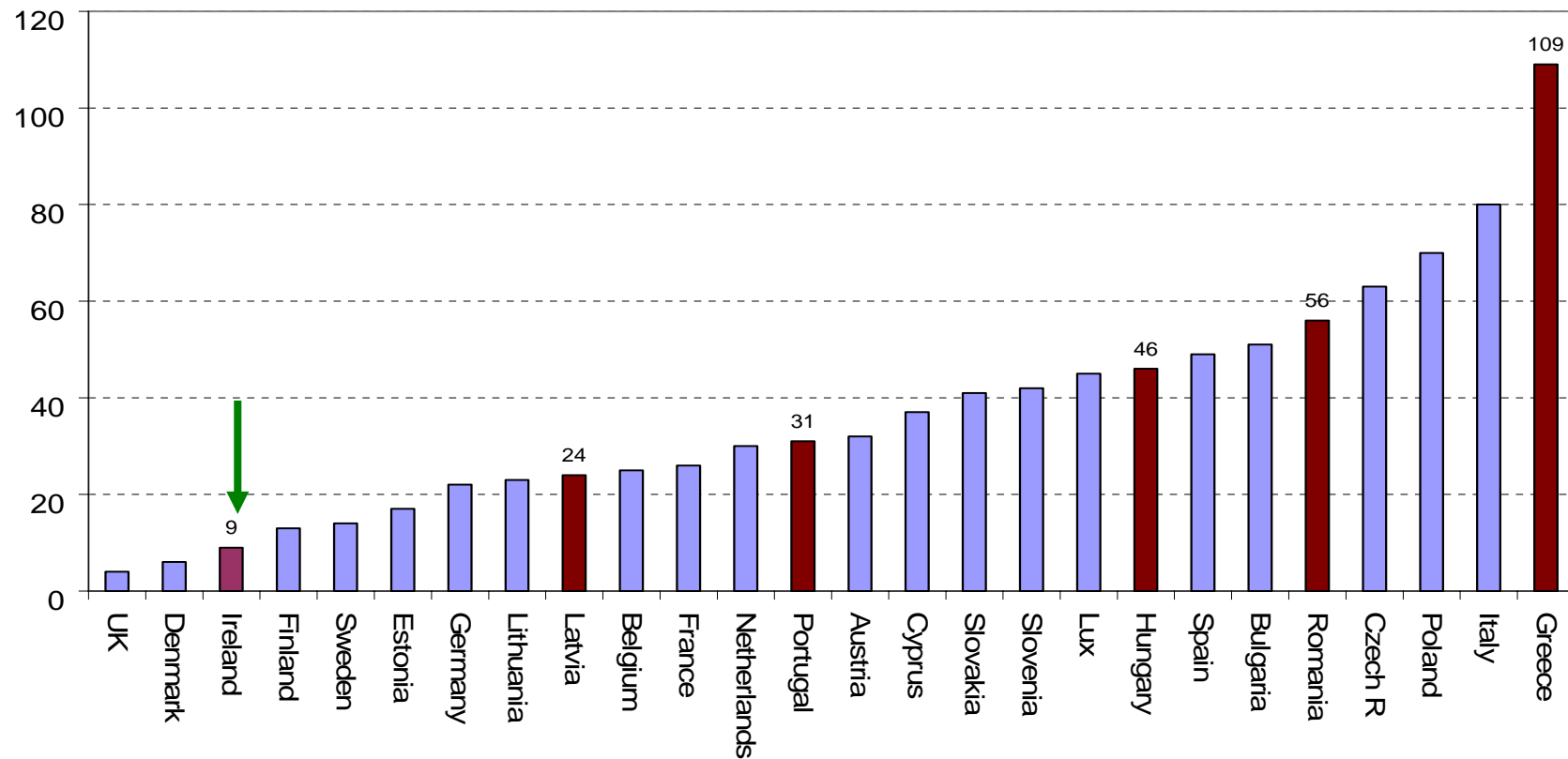
Additional Information

- The report of the European Commission on the crisis
http://ec.europa.eu/economy_finance/publications/publication12682_en.pdf
- EU-IMF program for Latvia
http://ec.europa.eu/economy_finance/eu_borrower/balance_of_payments/latvia/latvia_en.htm
- EU-IMF program for Romania
http://ec.europa.eu/economy_finance/eu/countries/romania_en.htm
- Financial assistance for Greece
http://ec.europa.eu/economy_finance/eu/countries/greece_en.htm
- EU-IMF program for Ireland
http://ec.europa.eu/economy_finance/eu/countries/ireland_en.htm
- EU-IMF program for Portugal
http://ec.europa.eu/economy_finance/eu_borrower/portugal/index_en.htm

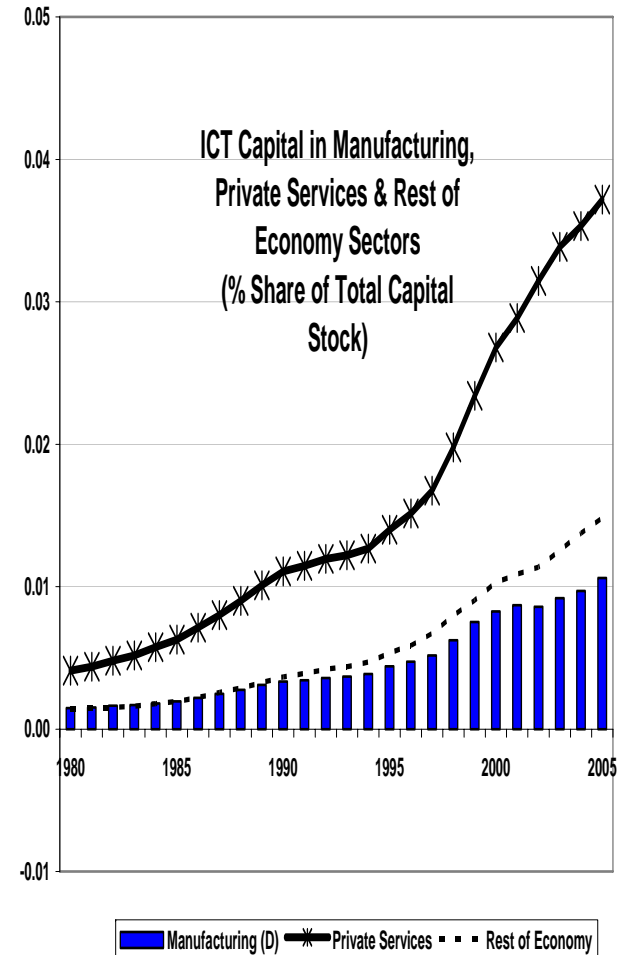
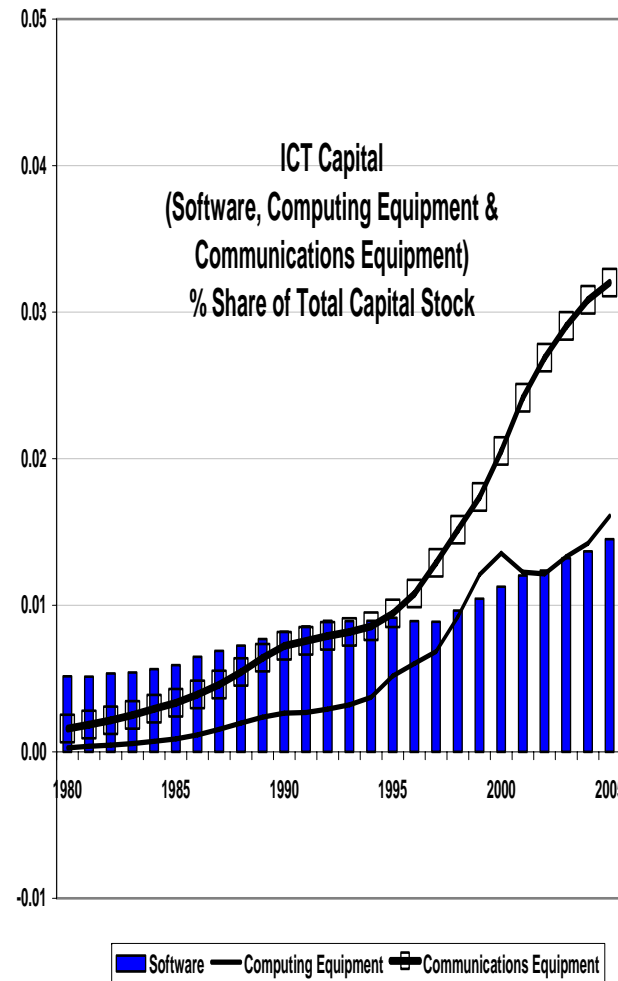
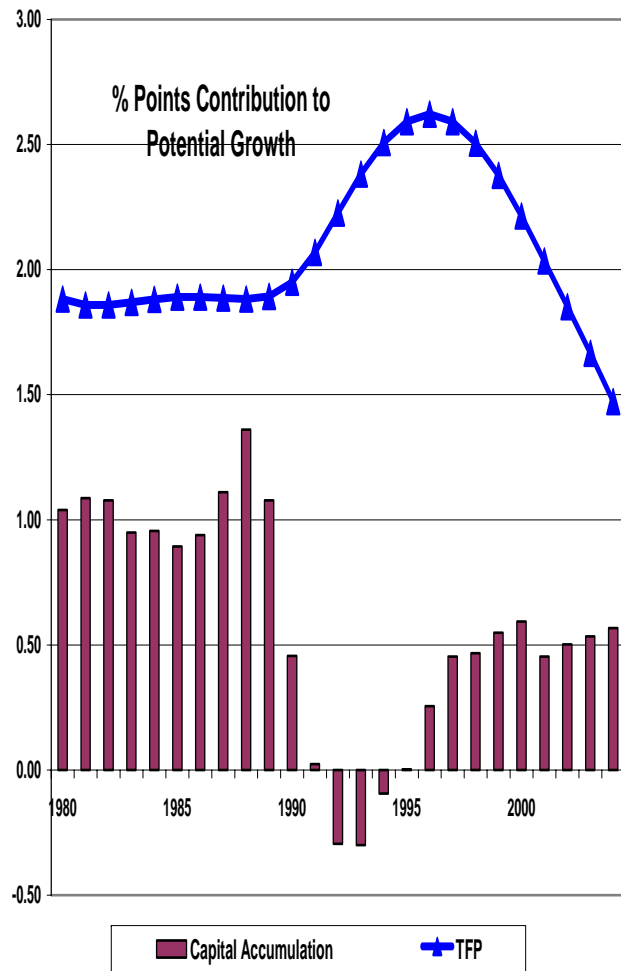


Competitiveness: Business environment

Doing Business Ranking, 2011

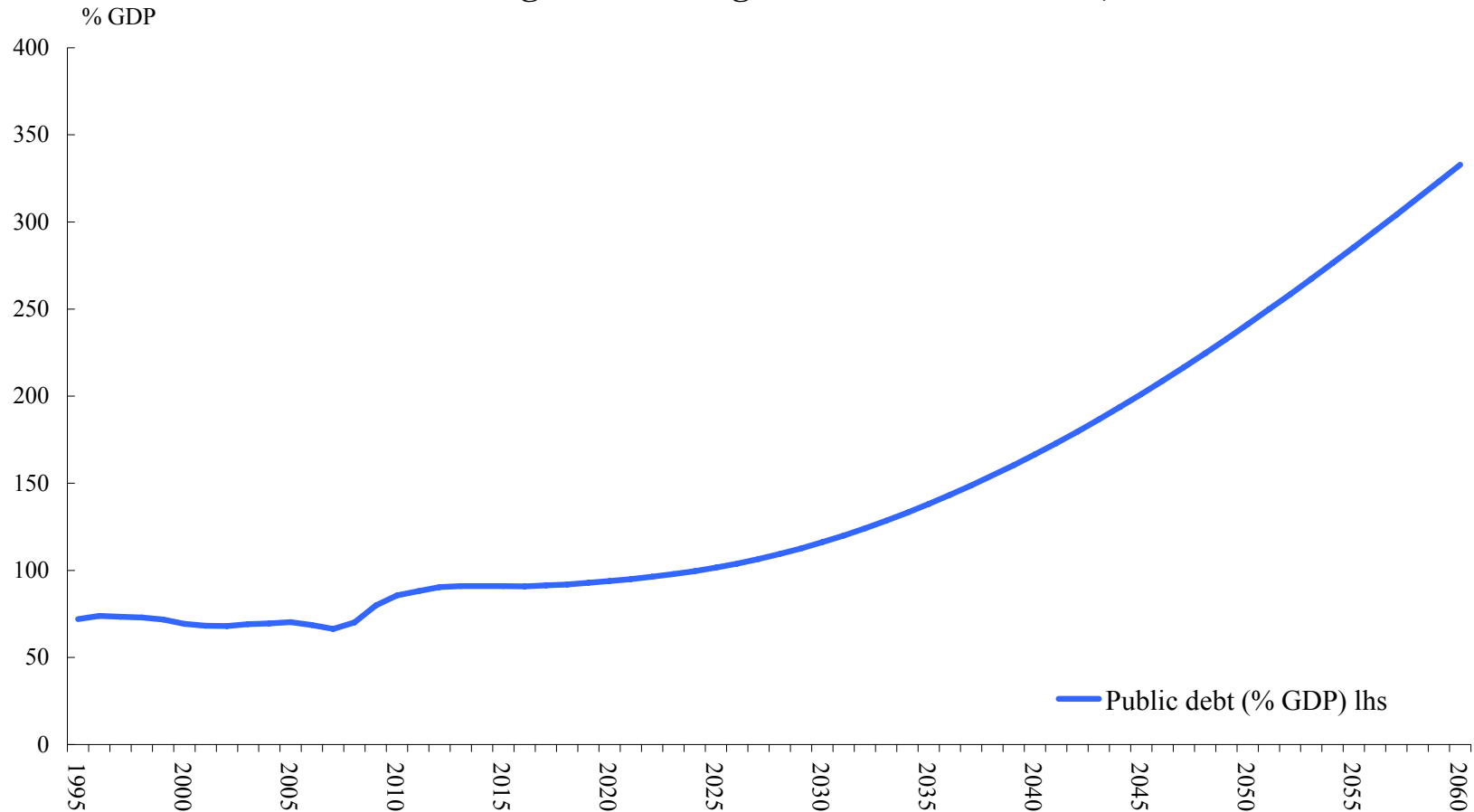


Not the amount but the efficiency of investment that matters



Euro area long-term debt dynamics

Euro Area: General government gross debt as % of GDP, 1995-2060



Asset price bubble and adjustment longer series

Ireland: House prices, 1996-2011 (2003=100)

