

EMU: Political and Economic Crises

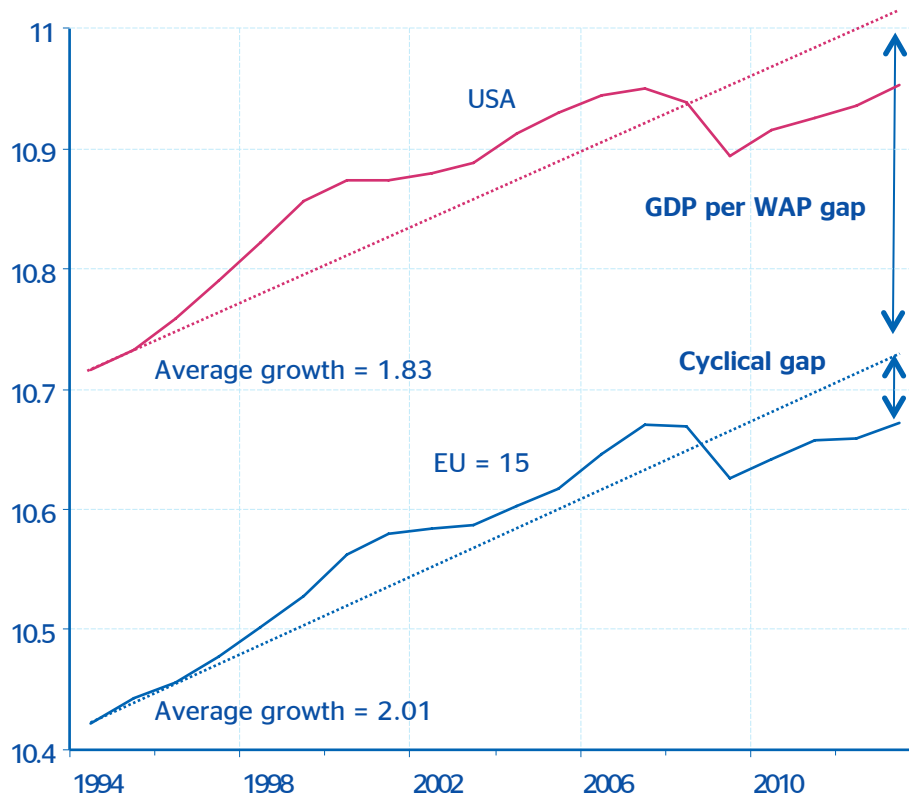
Rafael Doménech

GACE, Madrid, June 7, 2013

The European growth challenge

GDP per working-age population

Source: BBVA Research



Trend components estimated from 1970 to 2012

EU15 cyclical gap with the 1970-2012 trend:
around 5%

EU15 trend gap with the USA:
around 25%

Needed: (1) a recovery strategy in the short run, and
(2) a long-run growth strategy

A recovery strategy: a road map to a genuine EMU

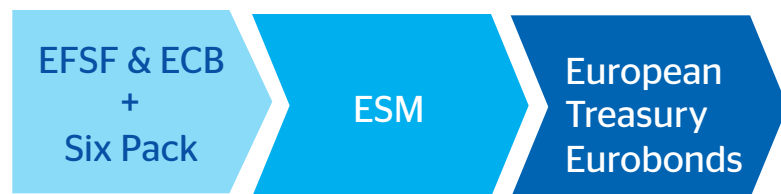
1. A road map to a genuine EMU: fiscal, financial, economic and political integration

2. Correction of imbalances in a very heterogeneous Europe

3. Balance between growth and austerity:
Focus on structural deficits as the Stability Treaty proposes

Short-term objective: to avoid the risk of an austerity-recession vicious circle and the doubts regarding sovereign debt solvency

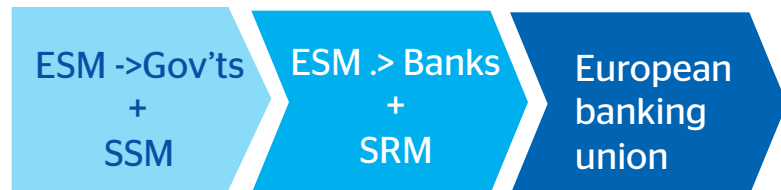
A recovery strategy: a road map to a genuine EMU



Very short run

Short to medium
run

Long run



Short run

Short to medium
run

Long run

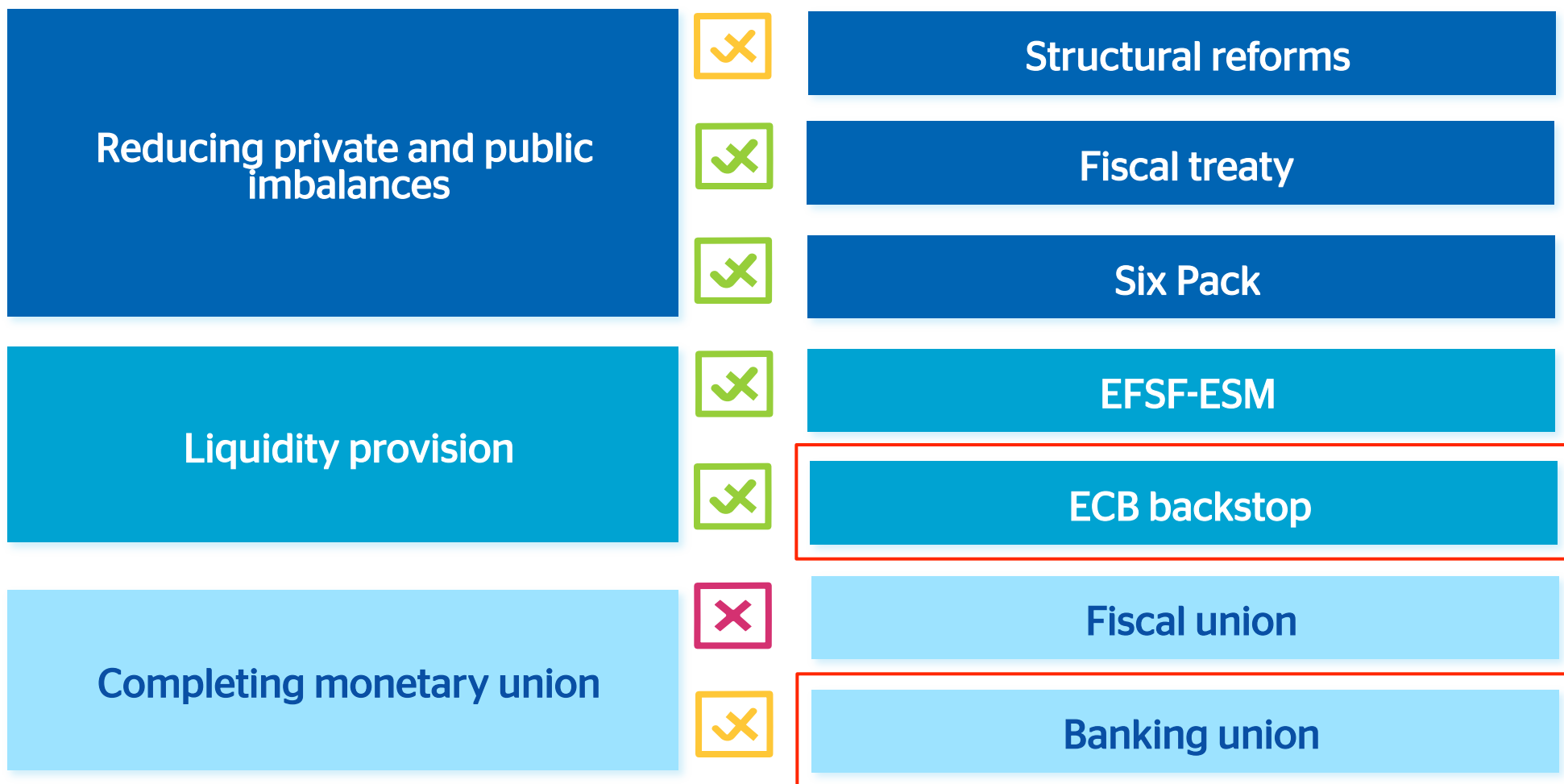
The solution has benefits but costs too -> long and tortuous process

Problem 1: How to distribute the solution costs in the short term between the members?

Problem 2: How to design a time-consistent solution and the conditions to carry it out?

J. Andrés and R. Doménech (2012): "The solution to the Euro crisis: Back From the Future". Vox EU.

ECB backstop as a bridge towards banking union



The OMT program: sizeable “announcement effect”

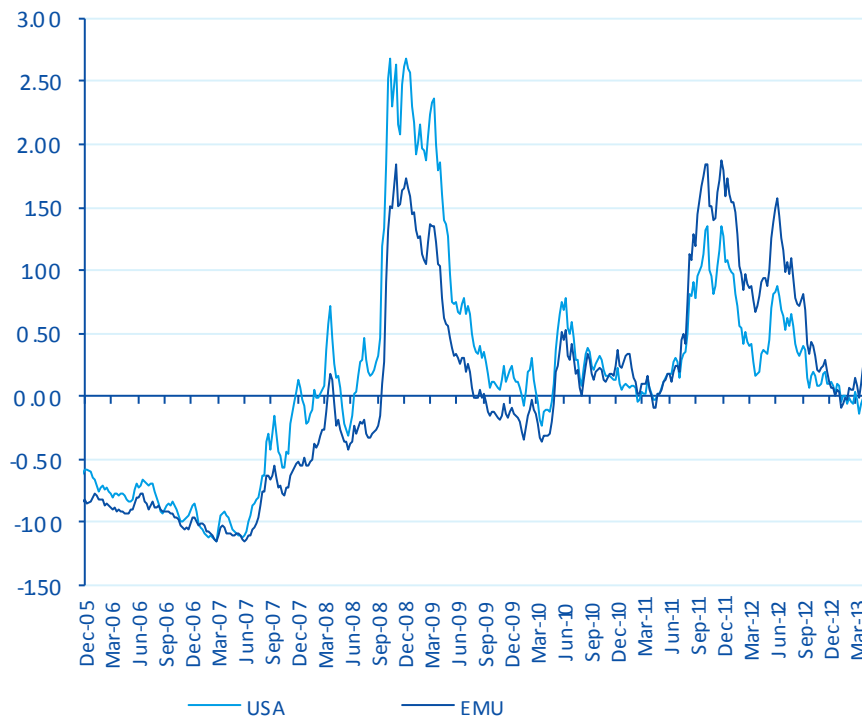
OMT program of sovereign bond purchases

- Only after official request of support to ESM
- Conditionality required
- Unlimited purchases of sovereign in secondary markets;
- 1-3 year bonds;
- Possibility of ESM to buy in primary market
- Designed to avoid countries losing market access
- ESM renounces to preference status

The OMT program: sizeable “announcement effect”

Financial Stress Index

Source: BBVA Research



ECB's OMT and banking union

Capital flows back to Europe and not only to public debt markets, also for private issuances

Second Greek bailout: a decisive movement against euro break-up risks

Financial stress eased despite recent risky events in Cyprus, Portugal and Italy

Six Pack: reinforcing the SGP with macro surveillance

Application	<ul style="list-style-type: none">• Approved in December 2011• Applies to EU27, with some specifics for eurozone (on sanctions)
Fiscal side: Strengthening the SGP	<p>Reinforcing the Excessive deficit Procedure (EDP):</p> <ul style="list-style-type: none">• It defines what is a “significant deviation” of budget balance from medium-term objective or its adjustment towards it• Launches an EDP when debt ratio does not diminish towards 60% at a satisfactory pace (not only when deficit is above 3% as was the case so far)• Sanctions are reinforced: Sanctions by the Commission are adopted by the Council unless a qualified majority (QM) of countries are against it. (Until now, a QM was needed to approve sanctions).
Other macroeconomic imbalances	<ul style="list-style-type: none">• Macroeconomic Imbalance Procedure: Extends surveillance to other imbalances of the private sector and the external accounts.• European Semester: The aim is to identify imbalances earlier on (roughly from January to June) to end up with recommendations on budget and structural reforms to be incorporated in budgetary process in the fall.

Six Pack: reinforcing the SGP with macro surveillance

External imbalances	Current account balance (% GDP, 3-year moving avg)	-4% to +6%
	Net international investment position (% GDP)	-35%
Competitiveness	Export market shares (5 year % change)	-6%
	Nominal unit labour cost in value (3 year % change)	+9%
	Real effective exchange rate, CPI based (3 year % change)	+/- 5%
Private sector imbalances	Private sector debt (% GDP)	160%
	Private sector credit flow (% GDP)	15%
Other	Real house prices, consumption deflator based (growth)	6%
	General government sector debt (% GDP)	60%
	Unemployment rate (3 year moving average)	10%

Imbalances for the eurozone as a whole are not large ...

Imbalances: the EZ vs the UK and the US

(% GDP)

Source: AMECO, Haver, IMF, national sources and BBVA Research

		EZ	US	UK
Public deficit	2011	-4,4	-9,6	-8,9
Public debt	2011	87,6	100,0	84,8
Household debt	2010	67,3	92,1	106,1
Firms' debt	2010	119,1	74,6	123,7
Current account balance	2011	0,1	-3,1	-2,7
Net external debt	2010	-7,2	-17,0	-13,9

The eurozone shows high internal heterogeneity but lower aggregate imbalances ...

... than the US or the UK ...

... for the public, private or external sector

... but very heterogeneous

Macroeconomic imbalances in the eurozone (*Six pack*)

Source: BBVA Research, Eurostat y Haver

	Bélgica	Dinamarca	Alemania	Irlanda	Grecia	España	Francia	Italia	Holanda	Austria	Portugal	Finlandia
Cuenta corriente	-0,6	3,9	5,9	-2,7	-12,1	-6,5	-1,7	-2,8	5	3,5	-11,2	2,1
PI Neta	77,8	10,3	38,4	-90,9	-92,5	-89,5	-10	-23,9	28	-9,8	-10,8	9,9
Tipo de cambio real	129	0,95	-2,95	-5,03	3,94	0,55	-14,1	-0,99	-0,98	-133	-2,43	0,26
Cuota de exportaciones	-15,4	-15,3	-8,3	-12,8	-20	-11,6	-19,4	-19	-8,1	-14,8	-8,6	-18,7
CLU	8,5	11	6,6	-2,3	12,8	3,3	7,2	7,8	7,4	8,9	5,1	12,3
Precio vivienda	0,38	0,6	-0,99	-10,5	-6,82	-4,27	3,61	-1,54	-2,86	-147	0,13	6,64
Crédito privado	13,1	5,8	3,1	-4,5	-0,7	14	2,4	3,6	-0,7	6,4	3,3	6,8
Deuda privada	233	244	128	341	124	227	160	126	223	166	249	178
Deuda pública	96,2	43,4	83,2	92,5	145	61	82,3	118	62,9	71,8	93,4	48,3
Desempleo	7,7	5,6	7,5	10,6	9,9	16,5	9	7,6	3,8	4,3	10,4	7,7

Fiscal union: postponed after German elections

State of the play

At the December summit, all focus on banking union.
Progress towards a fiscal union has been delayed

The "Treaty on Stability" and the "Six pack" appear to be sufficient for now

The key would be an agreement between Germany (accept eurobonds) and France (accept additional EU control of national budgets)

Options for eurobonds

Neither necessary nor sufficient, but convenient as insurance mechanism

1. Blue/red bonds to maintain market discipline
2. Eurobills (mutualize only part of short-term debt)
3. Debt Redemption Fund (proposed by German institutes): Temporary insurance of debt over 60% of GDP

Banking union (I): the benefits

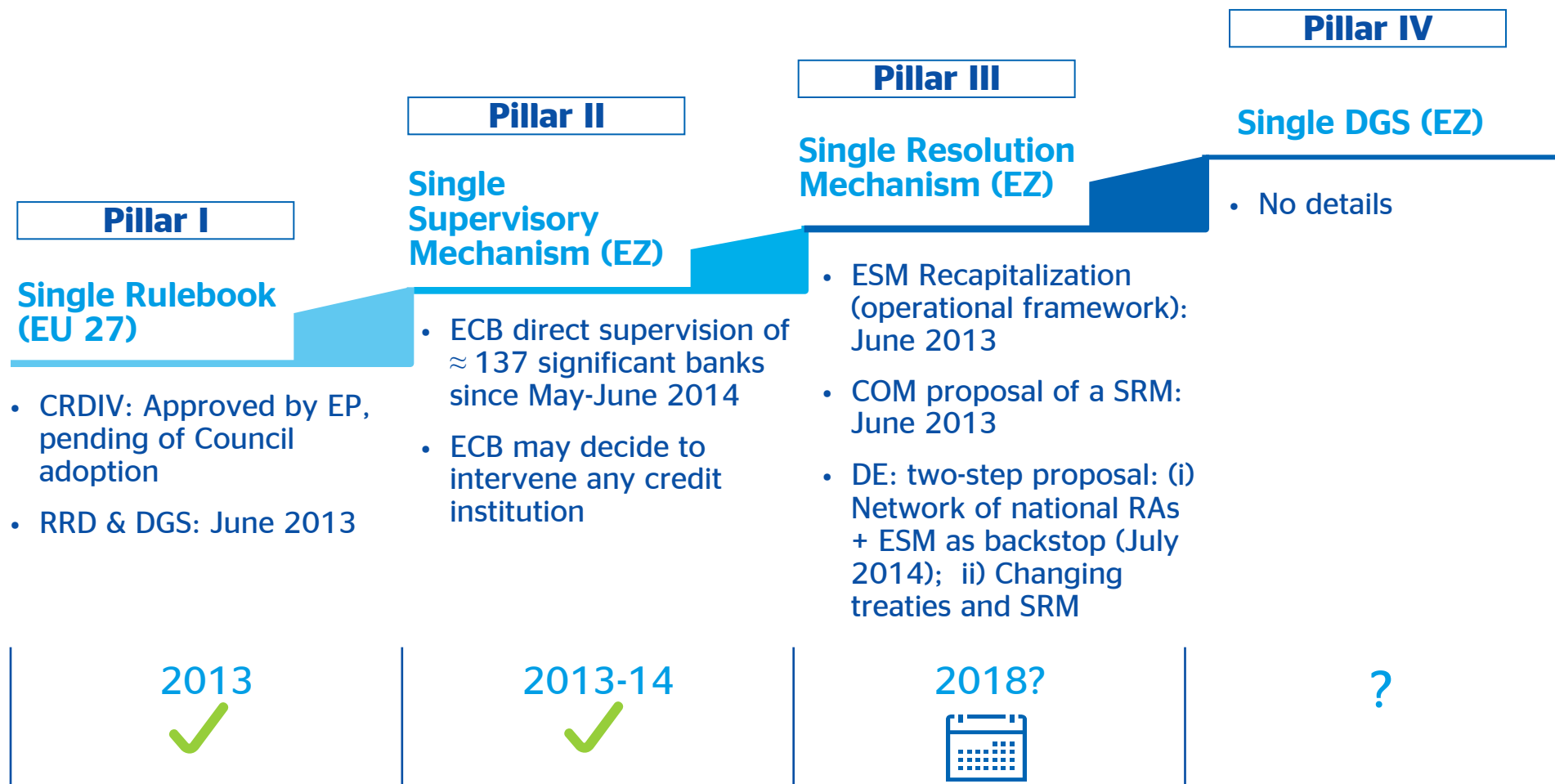
Single supervision reduces banking fragmentation and restores interbank market

A single resolution scheme with participation of the private sector increases incentives for Germany to mutualise part of resolution funds

Banking union helps breaking the loop between banking and sovereign risk

Convergence of financing costs and evolution towards trans-european banks

Banking union (I): the initial agenda



Banking union (III): the state of the play

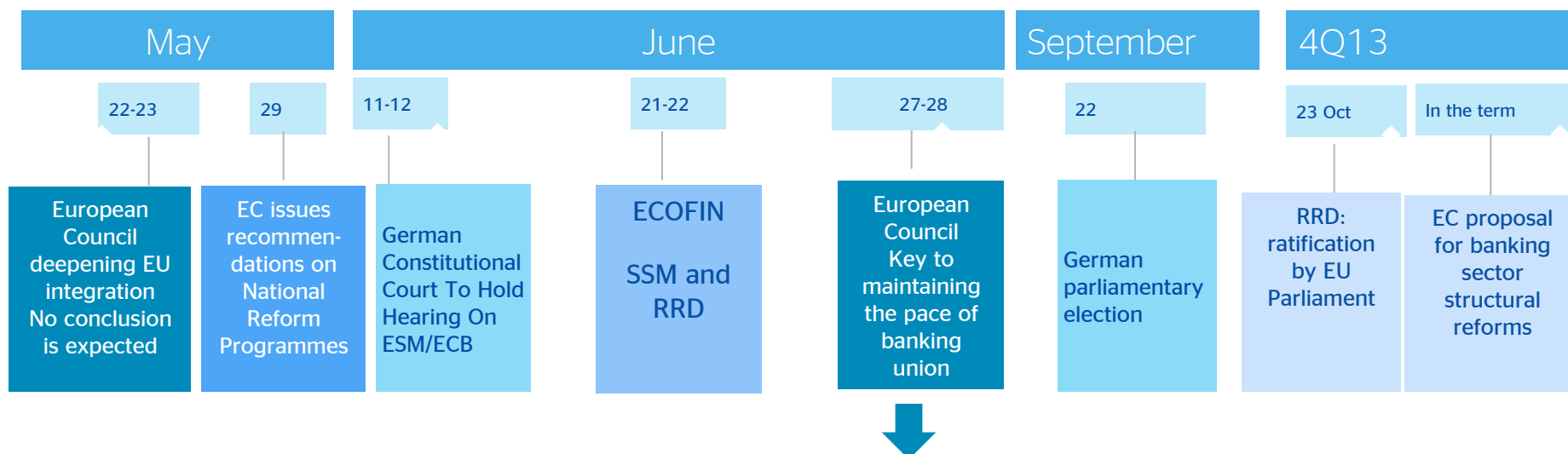
The problem lies in the transition: single supervision without single resolution

The legal basis is weak
A reform of the Treaty may be needed

Implies profound change in supervisory culture, gradual transition likely

Other changes are likely for a decoupling of sovereign and banking risk

Event calendar



Definition of legacy assets (+ effective SSM will have the possibility to recapitalise banks directly). It is key as a transitory resolution fund

Proposal from the Commission for a SRM. Germany defends a two-step strategy with a weaken SRM now and Treaty reform later on

This decisions are related to RRD (Resolution an Recovery Directive) where the debate is on the deposits preference and bail-in instruments. To be decided on June 21, ECOFIN

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