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Centre for Progressive Policy Research
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Eurozone: crisis and prospects

Ladies and gentlemen, President Papantoniou,

I am very pleased to have been given the chance to address this audience on such a topical issue as the future of the single currency. Allow me first to begin with a diagnostic of the weaknesses that have become apparent in three key areas, namely the banking sector, the public finances and euro area's growth model. Second, I will turn to the policy measures that are being taken to address these very much inter-linked vulnerabilities.

Slide: Overview

Euro area vulnerabilities revealed by the crisis

The single currency created an institutional environment that was beneficial to increased capital mobility and to a convergence of interest rates through the disappearance of both exchange rate and country-specific risk premia. However, the nexus of stronger interdependencies between markets and actors also created a number of weaknesses that were underestimated.

Vulnerabilities in the financial sector

Let me first refer to the financial sector. The current crisis started as a banking crisis in the summer of 2007. While lack of market liquidity has been the immediate problem, the underlying cause was lack of confidence that banks would be capable of absorbing future losses from their loan books. In other words, the adequacy of banks' capitalisation was questioned, especially after almost a decade of strong bank credit expansion, which in some countries (Spain, Ireland) was heavily concentrated in a specific sector, e.g. real estate and construction.

Slide: Banking and sovereign crisis

From banking crisis to sovereign crisis

Second, the banking sector weaknesses quickly evolved into a crisis of public finances. Two transmission channels have been at work here. On the one hand, the freezing inter-bank market led to a credit crunch, which triggered a contraction in the real economy, implying high budgetary deficits already in 2008. On the other hand, public finances were impacted by emergency national financial safety nets, in terms of bank recapitalisations and guarantees. As

a result, the general government debt in the euro area has grown from 66% of GDP at the end of 2007 to 84% of GDP at the end of 2010. 15 countries out of the 17 members of the euro area are now in excessive deficit procedure. The high borrowing costs for some governments, together with the expectation that they could still rise, have made the issue of public finances sustainability a focal point for reflection and policy action.

Issues with economic growth

Slide: Imbalances and debt

The sustainability of public debt depends indeed on the state of public finances, but not only. Economic growth is of paramount importance here, and this brings me to the third area in which we can learn much from the current crisis. While the boom years were accompanied by strong growth rates, most of the growth appears to be unsustainable, as well as unequally distributed.

Slide: Uneven growth

By unsustainable growth I mean substantial investments which have given the illusion of deepening the capital structure of the European economy and of improving its external competitiveness, but turned out ex post to have gone in the wrong direction. The real estate and construction bubble in a number of European economies is a case in point. The high unemployment rates, up to 20.1 percent in Spain, with all the human hardship that they imply, are the sign of the massive adjustment that the production structure must undergo in order to correct the accumulated imbalances. It is also the case that the economic growth did not benefit equally all euro area countries, and that substantial growth differentials exist among regions within the same country.

Let me now turn to the ambitious policy actions, already taken or in preparation, which are addressing these vulnerabilities in the financial sector, in the sovereign debt markets and the real economy.

The Way Forward

In the financial sector, both the supervisory and the regulatory frameworks have been strengthened with the view of increasing their efficiency.

Slide: ESRB

Policy actions in the financial sector

The new EU-supervisory framework is a two-pillar system. At the macro level, the European Systemic Risk Board is responsible for the macro-prudential supervision. This macro-prudential oversight of the financial system within the whole EU is expected to give early

warnings and recommendations, in order to ensure proper monitoring and follow-up of systemic risks.

At the micro level, three European Supervisory Authorities have been created: the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Market Authority. The European Banking Authority, which is the successor of the Committee of European Bank Supervisors (CEBS), will be responsible, inter alia, for the coordinated stress tests at the European level. Within a consistent macro-economic scenario, and in cooperation with the ECB and the EC, the European Banking Authority is assessing banks' resilience and ability to absorb possible shocks, including credit risks and sovereign risks as bonds available for sale on the banking book will be stressed. The new stress test results of the European Banking Authority are due in May and should be robust as they will undergo a peer review.

With respect to the regulatory reform, a comprehensive package, focused on more and better capital in the banking sector, was agreed by the Basel Committee on 12 September 2010. These refinements to proposals made by the Basel Committee in December 2009 (Basel III) are to be transposed as new requirements into EU legislation through the CRD4 in the spring of this year. The main topical areas will include i) an increase from 2% to 4.5% of the minimum common equity requirement; ii) the introduction of a new capital conservation buffer of 2.5%, thereby bringing the total common equity requirement up to 7%; iii) the introduction of a counter-cyclical capital buffer in the range of 0% to 2.5% and of a leverage ratio in order to limit excessive growth of banks' balance sheets. Implementation of these more stringent capital requirements will be achieved gradually by 2019, starting from 2013 after an observation period of two years.

Safeguarding the stability of sovereign debt markets

Slide: Sovereign safety nets

As the crisis moved from the financial sector to public finances, policy actions focused increasingly on safeguarding the stability of sovereign debt markets. This is the second set of safety nets that I would like to discuss. Europe must formulate a strong and systemic response to the crisis, to send a clear message to global markets and European citizens of the political commitment to economic and monetary union, and the irreversibility of the euro.

The European crisis response to the increasing problems with public finances began with the development of several financial assistance mechanisms. This started early on with a quadrupling of the resources for the balance of payment facility to € 50 billion, a mechanism

which has existed in the EU since the ‘70s. This mechanism is reserved for non-euro area EU Member States. A second step consisted in the adoption of the loan programme to Greece of € 110 billion in early April 2010. After the Greek programme EU Finance Ministers adopted on May 9th 2010 a financial rescue package worth € 500 billion in order to safeguard financial stability in Europe and to protect the Euro. This rescue package consists of the European Financial Stabilization Mechanism (EFSM/ € 60 billion) and the European Financial Stability Facility (EFSF/guarantees of € 440 billion by euro area members only). The EFSF is as a newly established agency that can make loans to states within the euro zone. This package is complemented by the International Monetary Fund which agreed to add up to 50% of the amount of the European rescue package. Assistance provided by the EFSF, the EFSM and the IMF is linked to strict policy conditions. Loans to a country in financial difficulty – as in the case of Greece and Ireland – will be accompanied by a detailed and demanding set of policy conditions. The final objective is to restore the long-term creditworthiness of the borrowing country and to improve its competitiveness. The country should return to normal market-level financing as soon as possible.

The EFSF has been created as a temporary crisis mechanism until 2013. The European Council decided in late October to prepare a permanent crisis resolution mechanism, which would be supported by a limited adjustment of the Lisbon Treaty. In late November, Euro Area Finance Ministers decided the broad outline of the new permanent crisis mechanism, called European Stability Mechanism (ESM). It will be the successor of the EFSM/EFSF. The funding and the lending activities of the ESM will be very similar to the operation of the EFSF. The key difference will be the involvement of private creditors in a crisis resolution on a case-by-case basis. It was agreed to follow established IMF policies in this respect, which means that debt reduction would only happen if a country becomes insolvent. Such a situation is expected to be rare. Remember that no industrialised, advanced economy has defaulted since World War II. The ESM would continue to provide loans to Euro Area Member States that face liquidity problems.

There is also a reflection on the creation of E-bonds, or European sovereign bonds, under a common issuance such as by a European Debt Agency (EDA). The Commission is well aware that Germany and some other Member States are opposed to the idea of an E-bond. From the Commission point of view it is an intellectually attractive idea, but it must be assessed carefully. While there is clearly merit in the idea, important challenges can be foreseen, from a legal, technical and political point of view.

In addition to these sovereign funding mechanisms, the ECB plays an important role and broadened the range of tools available to adapt monetary policy to the challenges of the crisis. The ECB decided to provide liquidity in unlimited volumes and with longer maturities to banks. In parallel, the ECB launched a programme to purchase euro-denominated covered bonds issued in the euro area. An amount of EUR 60 billion has been bought so far. Furthermore, up to date, the Eurosystem has purchased around EUR 75 billion of government debt from the secondary market as to help ensure a better functioning of the sovereign bond market.

Reinvigorating growth

Slide: European Semester

Lastly, I would like to address the very concrete initiatives the EU has taken in order to reinvigorate growth. Remember that this is a key precondition for ensuring long-term sustainability of public debt. At the outset, sustainable and inclusive growth is the main aim of the Europe 2020 Strategy. In addition to the concrete flagship initiatives that will be implemented in the years to come, such as building a resource-efficient Europe and promoting an industrial policy for the globalisation era, the Europe 2020 Strategy will be complemented by an enhanced macro-financial surveillance of member economies through the European Semester.

Slide: Preventive dimension

The European Semester is a decisive step towards integrated economic governance in the EU, which goes much beyond the well-known pre-crisis fiscal surveillance in the framework of the Stability and Growth Pact. External macro-imbalances, loss of potential growth, as well as negative competitiveness trends are to become key areas of continuous enhanced surveillance and coordinated policy action. The European Semester includes a much stronger interaction between all European institutions and members states. The annual cycle starts with the publication, by the Commission, of the Annual Growth Survey in January, and leads, after debates in the Council and the Parliament, to integrated policy guidance by the EU Spring summit. Member states take due account thereof in the elaboration of their National Reform Programs and Stability and Convergence Programs, which are then submitted to the Commission in late April. This marks the beginning of the most active part of the country-specific surveillance, which concludes with the finalisation and adoption of policy guidance by the end of July. The implementation of decisions at national level in the second half of the year is then followed by a new round of the European Semester in the subsequent year.

Slide: Scoreboard

This broad process, encompassing fiscal, economic and financial sector policies, is to include a new specific procedure, namely the Excessive Imbalance Procedure. In a sense, the EIP broadens the scope of the existing EDP, and attempts to ensure that the right policy actions are taken, within a broad range of areas, in order to create the right conditions for compliance with the SGP. An Alert Mechanism through a scoreboard is to be introduced, which ensures consistent monitoring of external and internal imbalances, and may or may not call for an in-depth analysis of a country's situation. Should the alert mechanism and the in-depth reviews point to severe imbalances, the Council would adopt policy recommendations. An enforcement mechanism, including financial sanctions, is also foreseen in order to incentivise member states to correct economic imbalances within a reasonable timeframe, so that the EIP could be successfully closed. Discussions on the concrete features of the EIP are still ongoing within the Council and the Parliament. However, it is clear that, whatever the final shape of the EIP would be, it will quickly become a major tool for addressing issues such as low competitiveness and high indebtedness at a fundamental level.

Slide: Conclusion

Conclusion

The large and ambitious scope of policy actions I've just presented, in all three areas of banking, public finances, and the broader economy, show that much progress has been achieved already, but the work is not finished as he media and the public continue to focus on the crisis in sovereign bond markets. Remaining weaknesses that became evident through the crisis should not be negated, but addressed pro-actively. As often in the past, we see that a crisis can help to move European integration forward and overcome the difficulties. We see this happening again today.

Centre for Progressive Policy Research

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Athens

Eurozone: crisis and prospects

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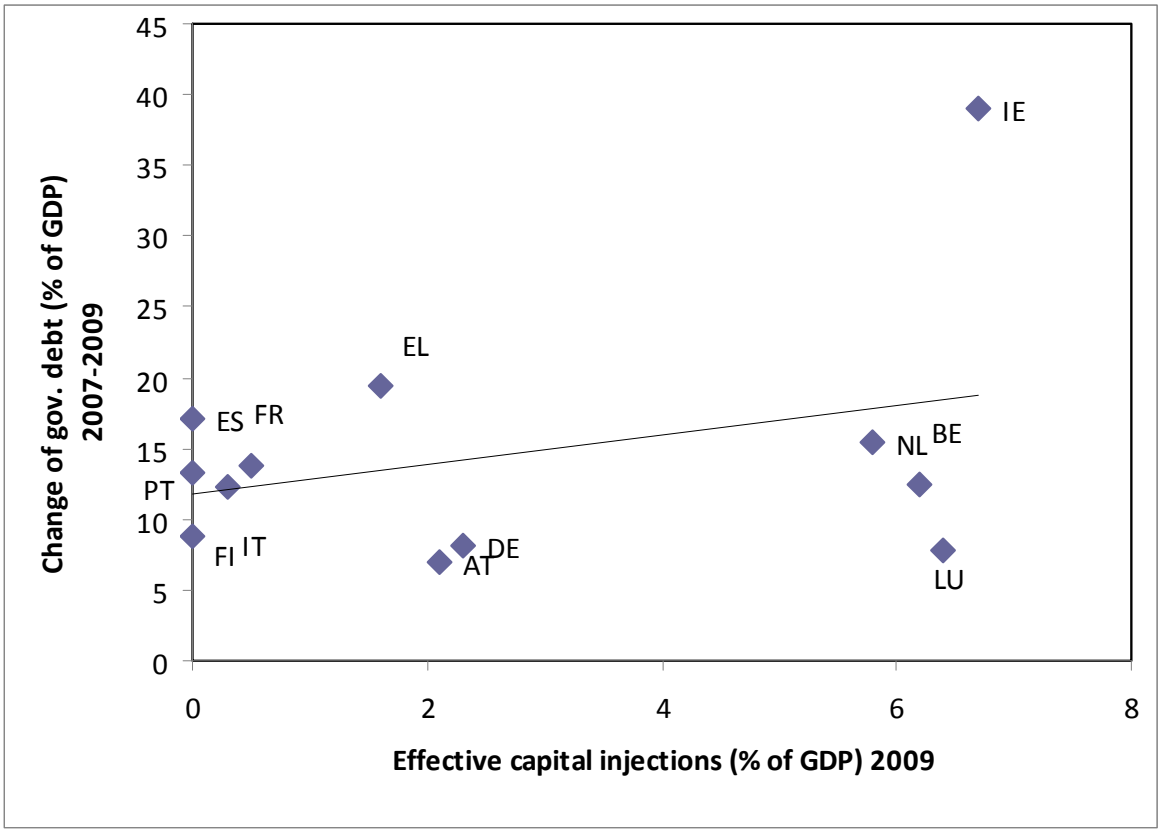
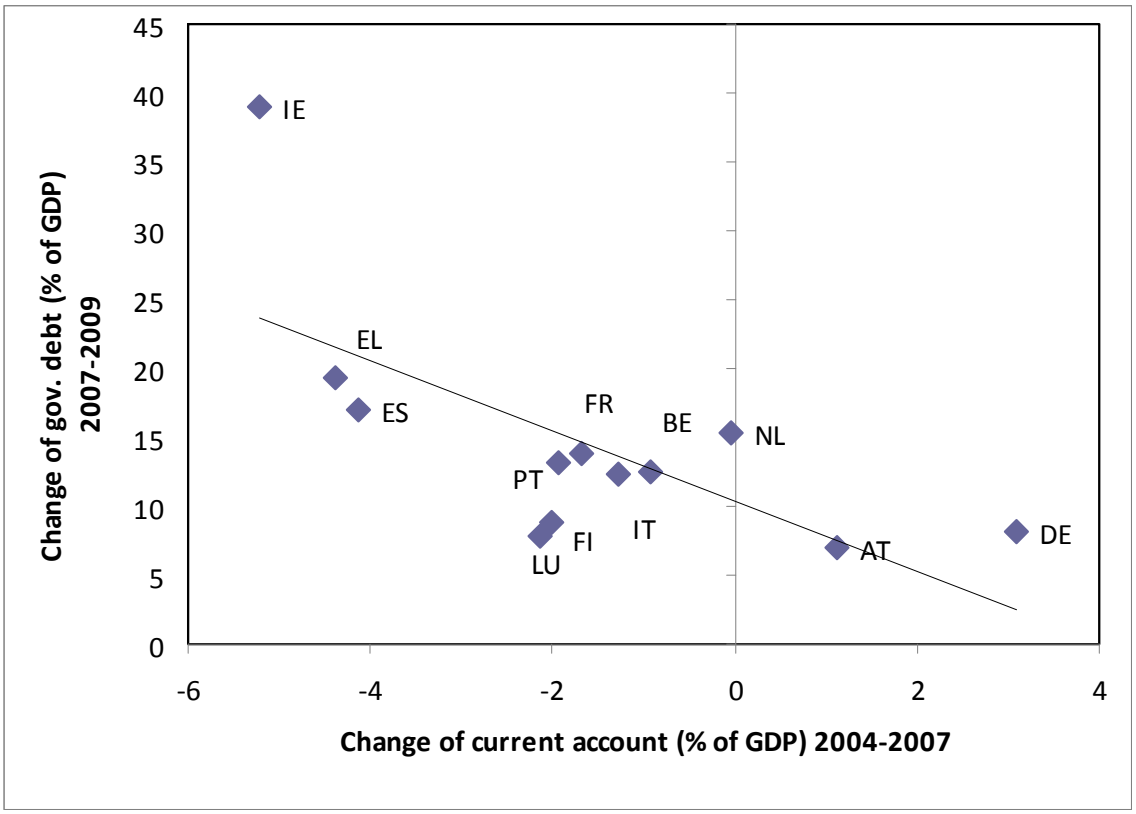
The crisis revealed weaknesses in three areas which the EU is addressing

- The banking sector
- Public finances
- The euro area's growth model

The banking crisis became a sovereign crisis

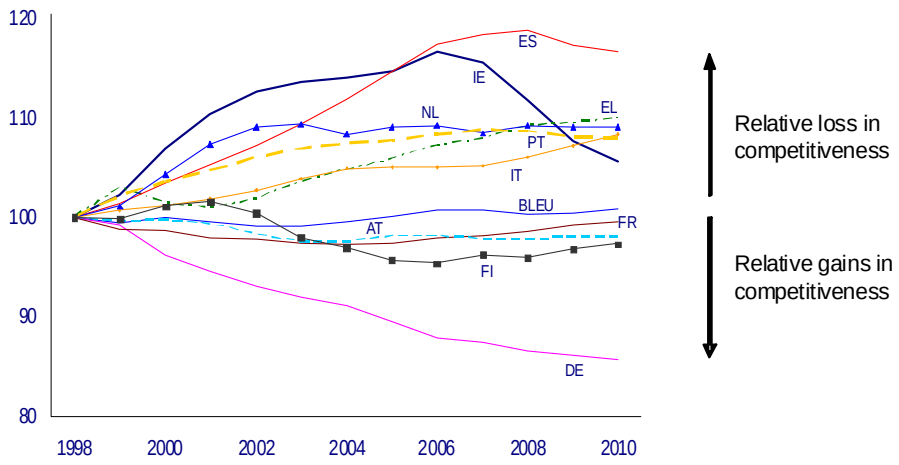


External imbalances translated into debt

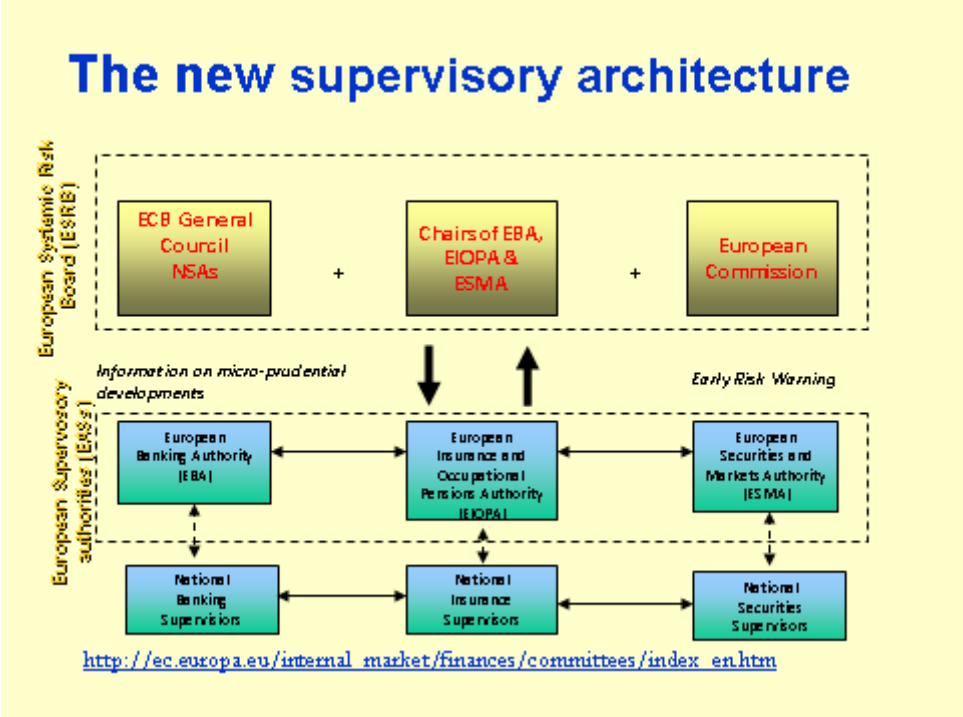


Macroeconomic imbalances

Trends during the past decade in price and cost competitiveness among the euro area member states show strong divergences

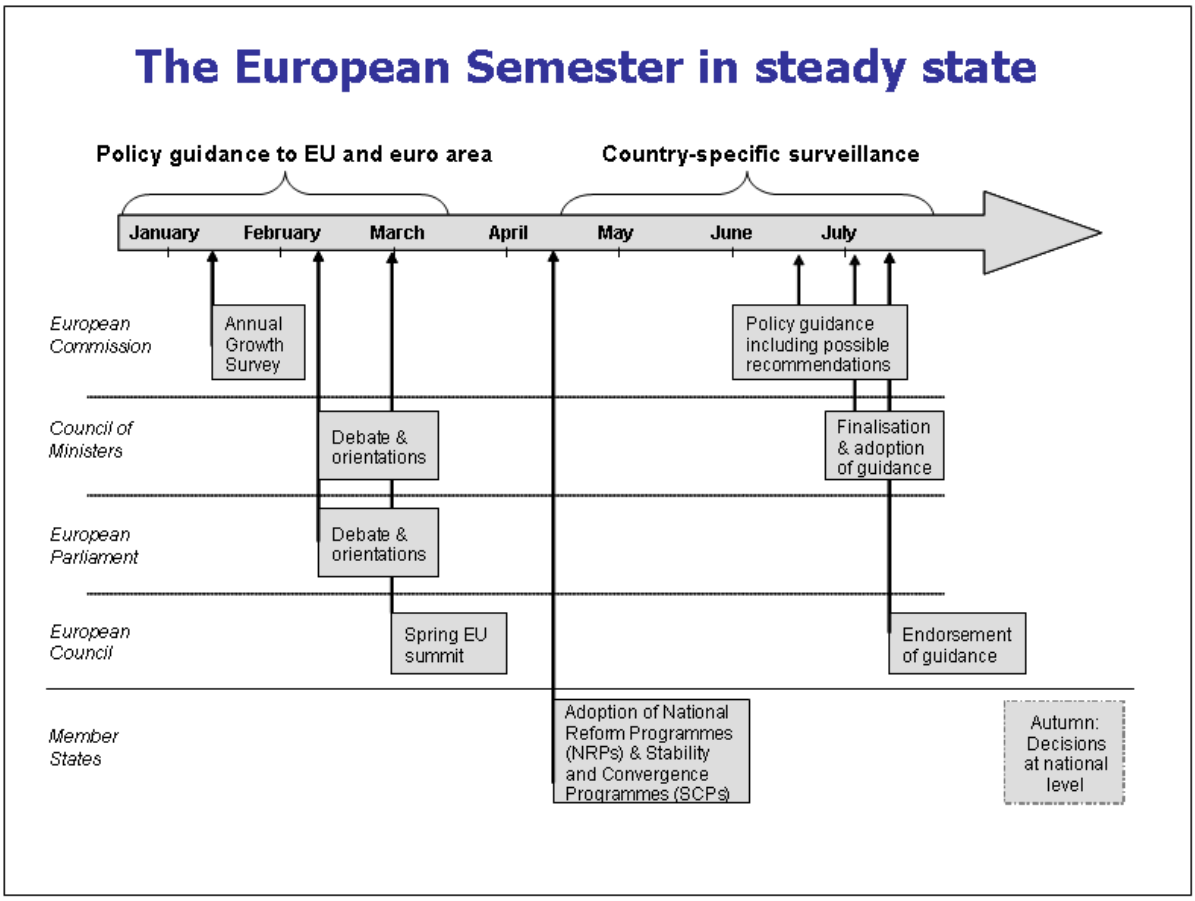


The new financial architecture

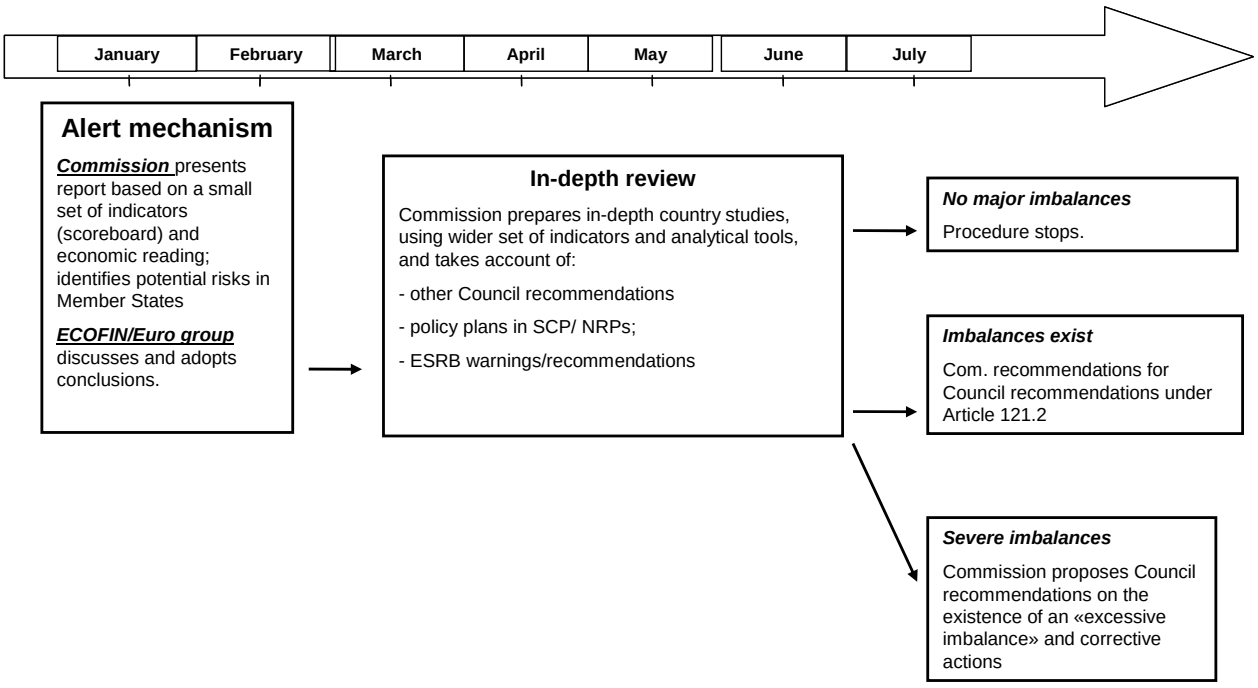


Stabilising sovereign bond markets

- The balance of payments facility increased to EUR 50 bn
- Greek support package of EUR 110 bn
- EFSM of EUR 60 bn
- EFSF of EUR 440 bn
- ESM
- Broadening of policy tools of ECB



Preventive dimension



Suggested list of potential scoreboard indicators (work in progress)

	External imbalances								Internal imbalances				
	External position		Competitiveness						Housing		Indebtedness		
	Current Account as a share of GDP	Net Foreign financial assets as a share of GDP	REER-IC35 (ULC deflator)		Export Market shares	ULC	HICP		Construction VA	House Prices	Private sector debt as share of GDP	Private sector credit as share of GDP	Public sector debt as share of GDP
Countries	**All**	**All**	**EA**	**Non EA**	**All**	**All**	**EA**	**Non EA**	**All**	**All**	**All**	**All**	**All**
Thresholds	**-/+4%**	**-45%**	**-/+4%**	**-/+7%**	**-9%**	**4%**	**3%**	**5%**	**4%**	**9%**	**180%**	**5%**	**+60%**
Computation of Thresholds	Lower quartile and symmetry	Lower quartile	Lower and Upper quartiles	Lower and Upper quartiles	Lower quartile	Upper quartile	Upper Quartile	Upper quartile	Upper Quartile	Upper quartile	Upper quartile	Upper quartile	-
Data Transformation	3 y back. av.		% difference from LT average			First differences	First differences		% change (3 y back. Average)	% change	-	y-o-y change	-
Years used to compute the thresholds	1970-2007	1970-2007	1995-2007		3 years % change	First year available-2007	First year available-2007		1970-2007	First year available-2007	1994-2007	1995-2007	-
Data sources	"Balance of current transactions with the rest of the world (National accounts)" as a share of GDP, source EUROSTAT. The series starts in 1970 and ends in 2009. For this indicator the Balance of Payment "Current Account" (993) as a share of GDP, source EUROSTAT, will also be considered	"Net financial assets; total economy" as a share of GDP, source EUROSTAT database. The series includes all the available observations between 1980 and 2007. For the countries whose NFA data are missing data on the Net International Investment Position ratio on GDP, source EUROSTAT, Balance of Payment Statistics, were used. The possibility of using only IIP ratio on GDP will be considered.	"Real effective exchange rates, based on based on unit labour costs deflator. Performance relative to 35 industrial countries; double export weights", source EUROSTAT database. The series starts in 1995 and ends in 2009.		Share of exports of goods in world exports Source: COMEXT< EUROSTAT and IMF direction of trade statistics for world trade in goods. To include also trade in services Balance of Payment data (current account, goods and services, credit)will be considered, source EUROSTAT and IMF direction of trade statistics for total trade in goods and services.	Nominal unit labour costs; total economy - Performance relative to the rest of 35 IC; double export weights 2000=100 Source: DG ECFIN calculations. The possibility of using the ULC index will be considered.	Harmonised consumer price index (Overall index) 2005=100 Source: EUROSTAT		Gross value added at 2000 prices; building and construction", source EUROSTAT database. The sample starts in 1970 and ends in 2007. The possibility of subtracting "civil engineering VA from the total will be considered.	Experimental House Prices Index, Source EUROSTAT. Annual data for this series starts in 2005 and ends in 2009. For the countries and the years whose data are missing the House Price indicator compiled by the ECB, deflated by the consumption deflator (source EUROSTAT) will be used.	Sum of Loans, Securities other than shares and other accounts /payable of Households and non-financial corporations; Source: Balance sheets EUROSTAT. The series comprises observations between 1994 and 2009, with missing values.	Sum of Loans, Securities other than shares and other accounts payable of Households and non-financial corporations. Source: Financial Accounts Transactions EUROSTAT The series comprises non-missing observations between 1994 and 2009 with missing values.	EDP – treaty definition

Conclusion

Much progress has been achieved already, but the work is not finished as he media and the public continue to focus on the crisis in sovereign bond markets.