European economic governance and the crisis management

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The new economic governance: a series of important decisions in less than one year

But serious issues remain to be addressed, however

✓**Crisis management:** countries’ and banks’ crisis
✓**Policy review :** growth regime

This requires agreeing on **well-identified policy priorities both at EU and member state level,** by tackling three broad challenges:

➢**worrying dynamics of public debt** in some member states,
➢**fragilities** in the euro area’s **banking system**,
➢structural reforms to improve euro zone **economic flexibility and growth**

The crisis revealed flaws in the Euro policy system

- Failure of surveillance: the SGP has not been able to ensure fiscal discipline and the BEPG have not avoided excessive divergences

- Lack of crisis management provisions: events show that the euro area was not ready to face a sovereign debt crisis in one of its members.

- Challenge to some basic assumptions: Threats to stability originate in government behavior and fiscal risks can be controlled by surveillance of budgetary deficits

A series of important decisions in less than one year

- F**inancial support for Greece** (April 2010)
- **Creation of the EFSF**
- **Security Markets Program** (SMP)
- **Reform of the SGP**
- New **macroeconomic surveillance**
- Liquidity / Insolvency regime for after 2013: **change in the Treaty for ESM**

But serious questions remain, however

Crisis management: countries' and banks' crisis

Policy review : growth regime

❑ Crisis management:

Policymakers must address worrying dynamics of public debt in some member states.

Different crises

- **Greece**: it's mostly fiscal since the government mismanaged the public finances for a decade (and manipulate the official data)

- **Ireland:** banking crisis and the private sector

- **Portugal:** structural shortcomings, low long term growth

❑ Common features

- Fiscal crisis management

- Strong linkages between banking and sovereign issues

❑ Crisis management:

The question is whether the new economic governance framework will succeed in solving the fiscal solvency challenge and restoring confidence in the euro area.

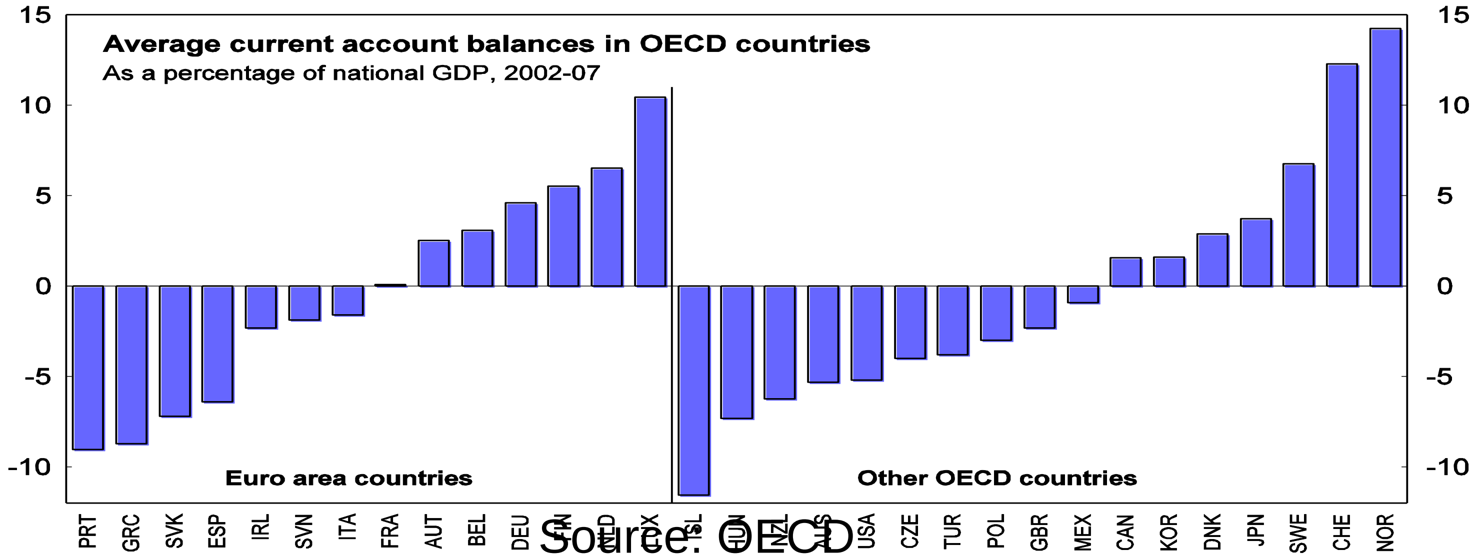
Germany and the creditor countries seem to believe that it will.

On their reading, the crisis was the product of fiscal irresponsibility, so the adjustment passes through fiscal consolidation and structural reforms in the peripheral indebted countries

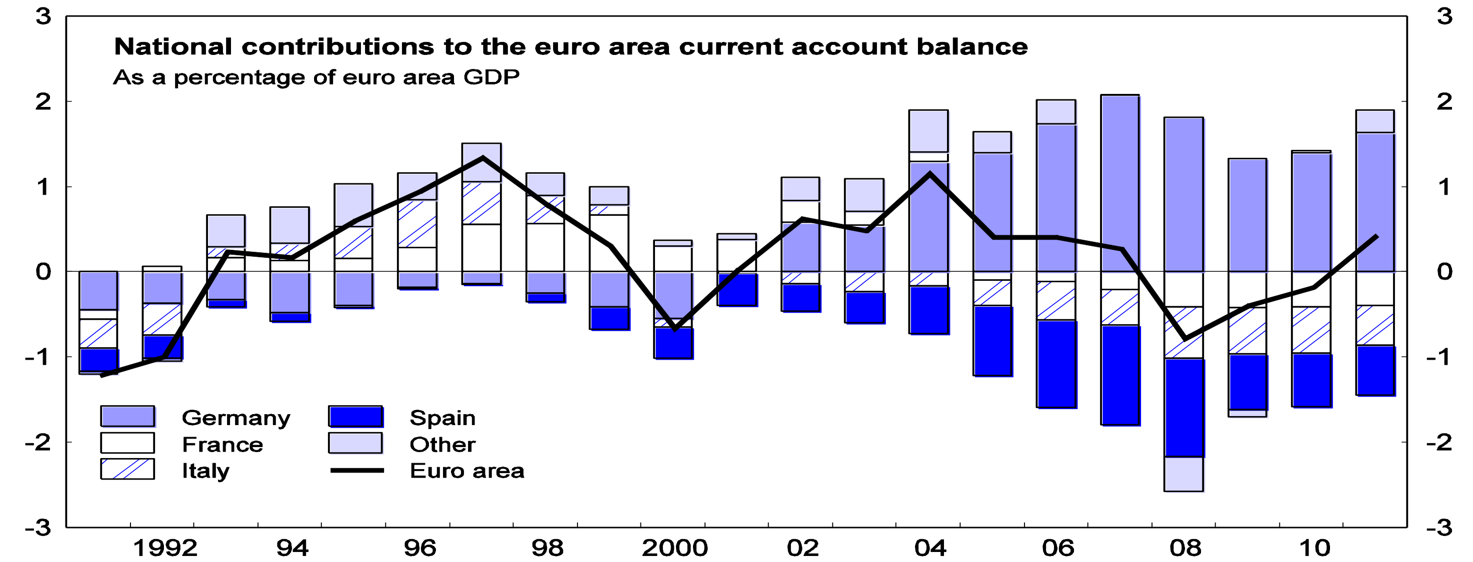
The problem with this strategy is twofold:

- its diagnosis is too simplistic;
- the medicine prescribed may fail to work

External imbalances in the euro area have been large and persistent

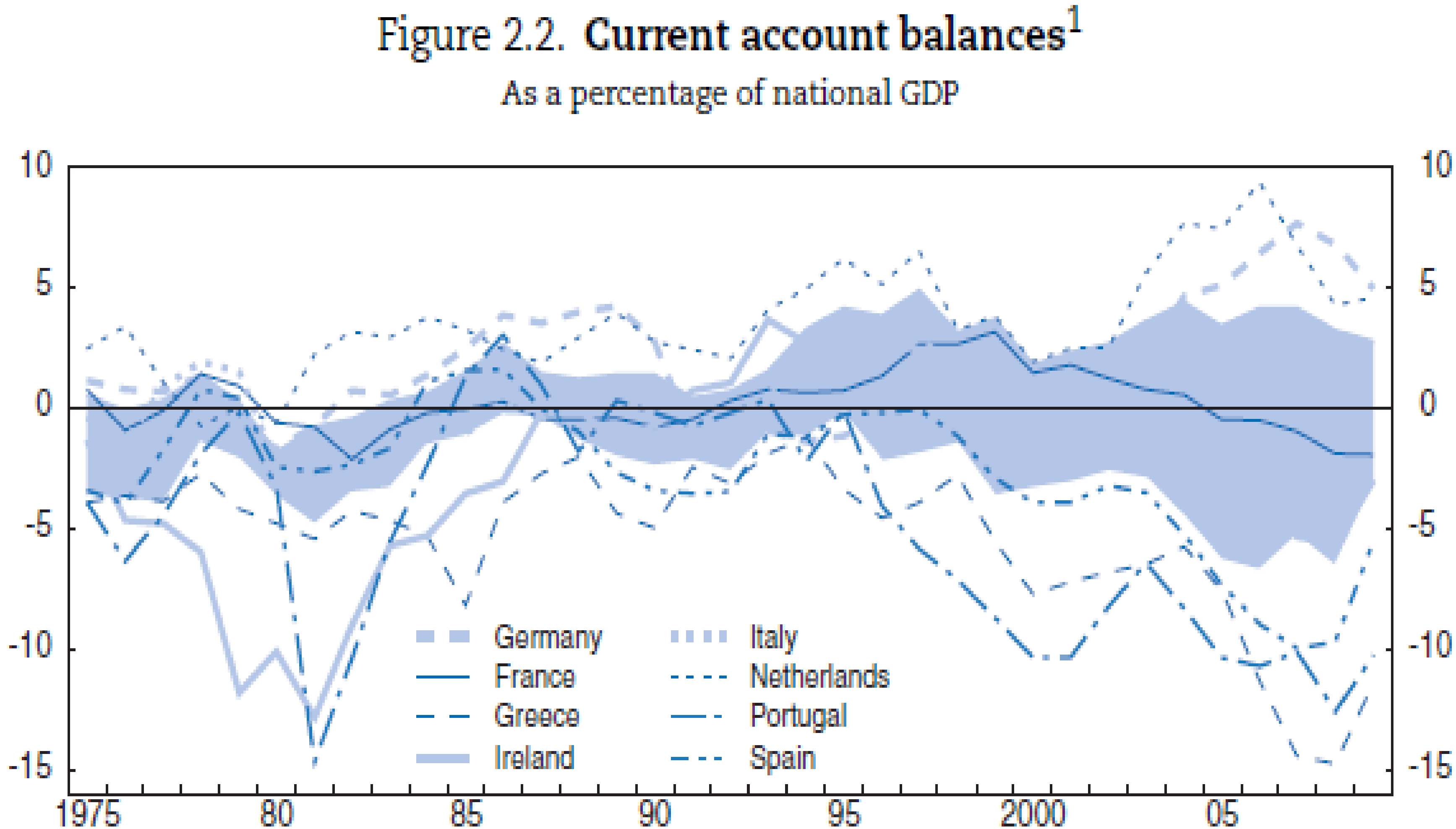


Source: OECD



Source. OECD

The German surplus and the Euro



Source: OECD

The sovereign debt crisis in the periphery is bound up with a banking crisis across the euro area as a whole

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The root cause of the debt problems in the eurozone is to be found in the unsustainable debt accumulation of the *private sectors (household and banks)*

European banks had $188 billion at risk from the government debt of Greece, Ireland, Portugal and Spain at the end of 2010, according to a recent Report from the BIS.

Some German banks are currently among the most involved in the region,

As such, they are not in the conditions to face any default on peripheral debt (to which they have large exposures).

The euro area's policy response

European governments have so far been reluctant to confront such problems

In the wake of the crisis it has focused on three aims.

The first is to **ensure the provision of liquidity** to chronically indebted states and prevent contagion to other vulnerable economies.

The **second is to implement ambitious austerity plans and economic-social reforms** to ensure in peripheral countries a return to primary budget surpluses.

The third is to **delay any restructuring of unsustainable debts, both sovereign and private sector**

But this strategy is extremely risky and prone to a large economic or political accident

A serious comprehensive approach to crisis resolution

requires agreeing on well-identified policy priorities both at EU and member state level, by tackling three broad challenges:

First, they must confront fragilities in the euro area's banking system.

Second, they must address worrying dynamics of public debt in some member states.

Third, they must implement bold structural reforms to improve economic flexibility and boost growth

Address the fragilities of the Banking sector

A serious approach to crisis resolution

should focus on a comprehensive **European Union-wide plan to restructure and/or recapitalise troubled banks**

It is hard to estimate the **exact amount it will cost to recapitalise** the European banking sector . **Who will pay?**

Last year's bank stress tests came up with only €3.5bn – a misrepresentation of facts.

It is thus crucial **the next round of stress tests.** Will it work?

Address sovereign debt crisis

Previous assurances that haircuts on existing debt would not be **allowed will look increasingly untenable,**

Indeed, **in the cases of Greece (and Ireland ?)**, the primary surplus required to service their rising debts would be too much to afford.

The issue is likely to come to a head when the **ESM becomes operational in 2013**.

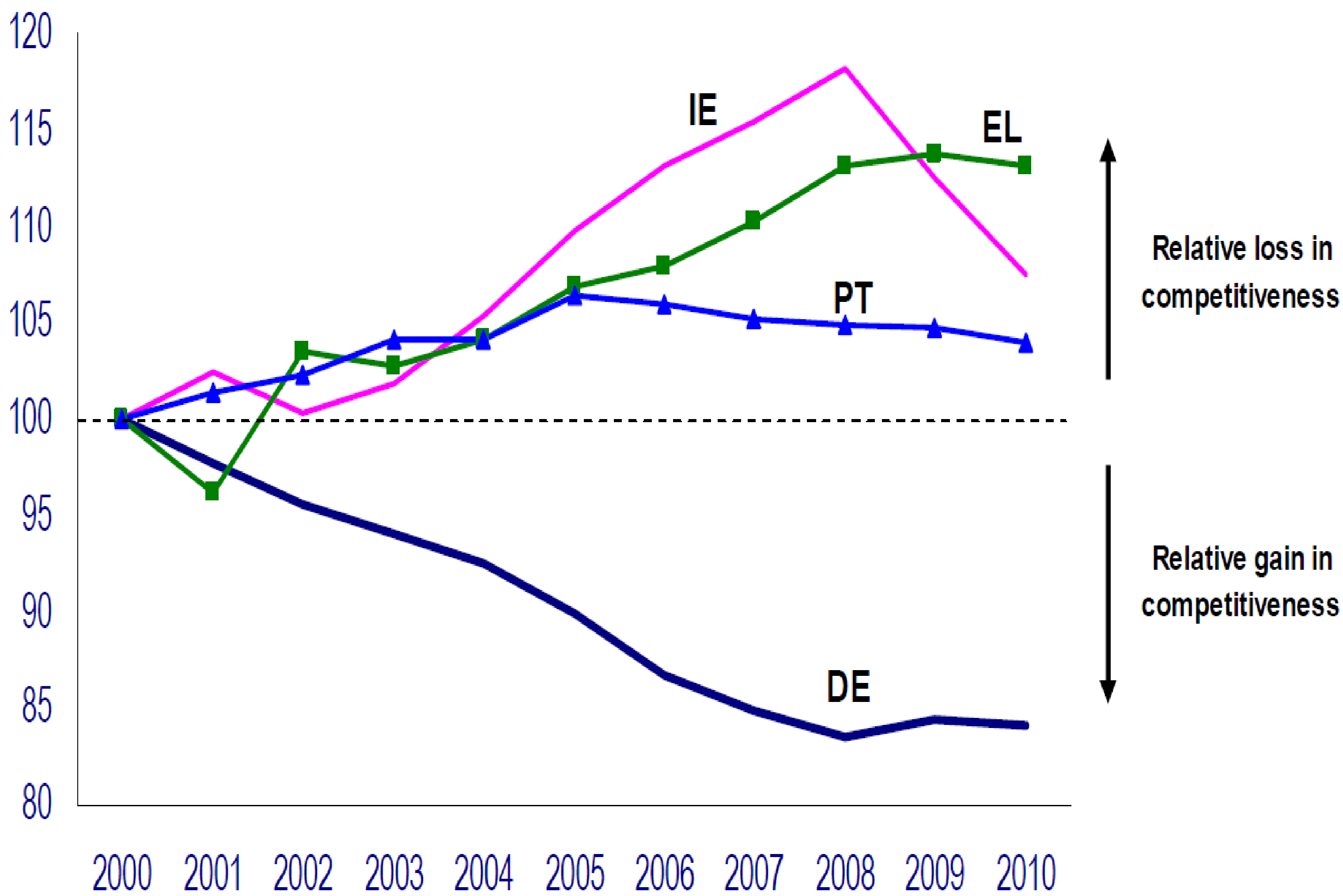
Given that Greece (and Ireland) will not be in a position to access financial markets on sustainable terms by then, **one could expect them to request a continuation of emergency funding from the EFSF and ESM.**

This would require the creditor countries to confront the issue of their solvency so:

- or they agree **to an indefinite provision of funds** that would be unlikely ever to be repaid
- or agree to **allow Greece and Ireland to a full debt restructuring**, accepting the consequences
- or a **common solution such as eurozone bond**

Figure 2: Real effective exchange rates (based on unit labour costs) relative to the rest of the euro area

(indices; 2000 = 100, increases represent losses in competitiveness)



Source: European Commission

The lack of a growth strategy

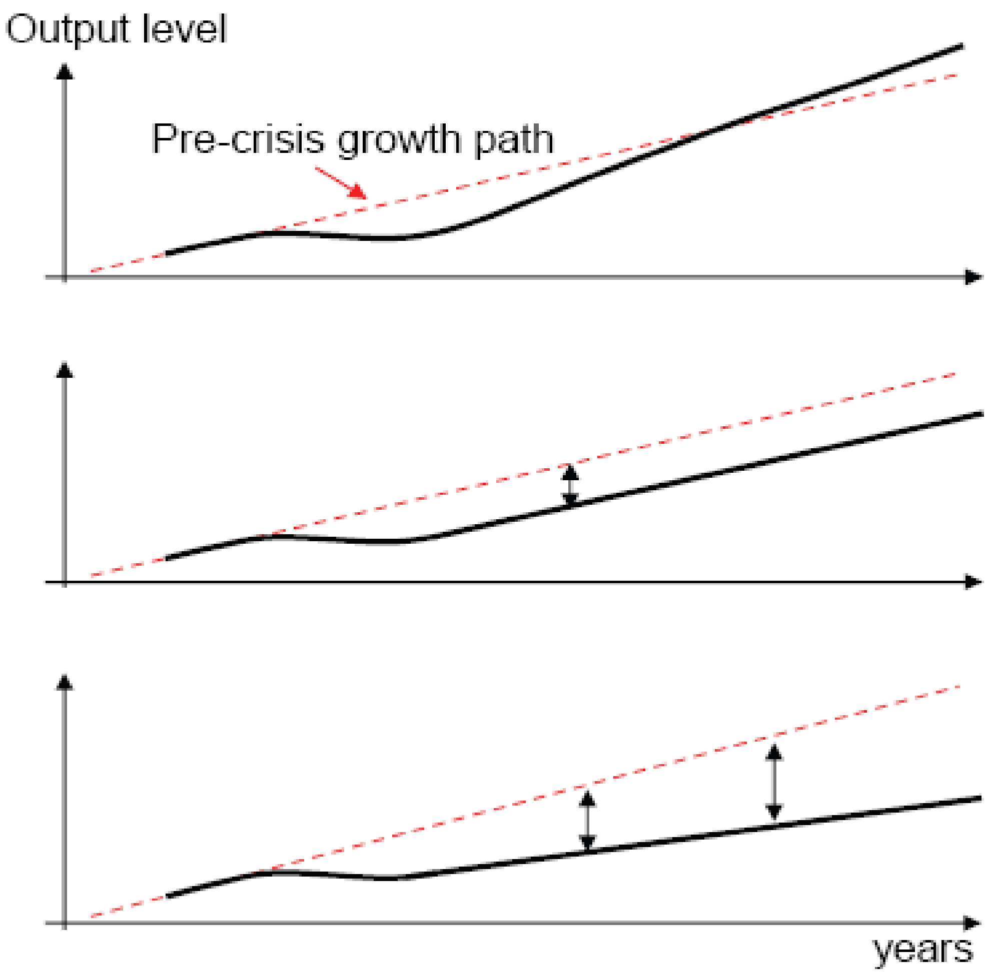
Ultimately how to foster growth revival in crisis countries and in Europe as a whole **is the most important goal to be achieved**

In the approach to new economic governance **insufficient attention has been devoted to policies capable of raising actual and potential growth rates** and correcting competitive imbalances

The European Union needs a comprehensive political deal not only to stabilise public finance, **but also to raise growth on a sustainable basis.**

What is needed **is a substantial increase in the EU output growth rate,** which has been persistently low for too long a time

Where do we want Europe in 2020?



« Strong recovery »

a full return to earlier growth path and a capacity to go beyond

« Sluggish recovery »

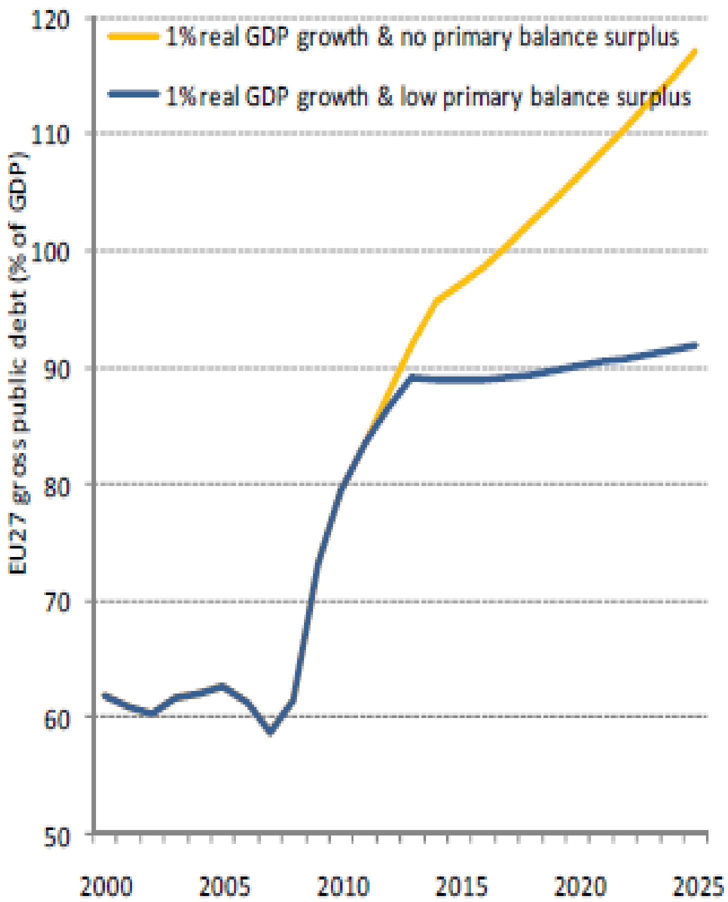
a permanent loss in wealth and stagnation on a lower growth path

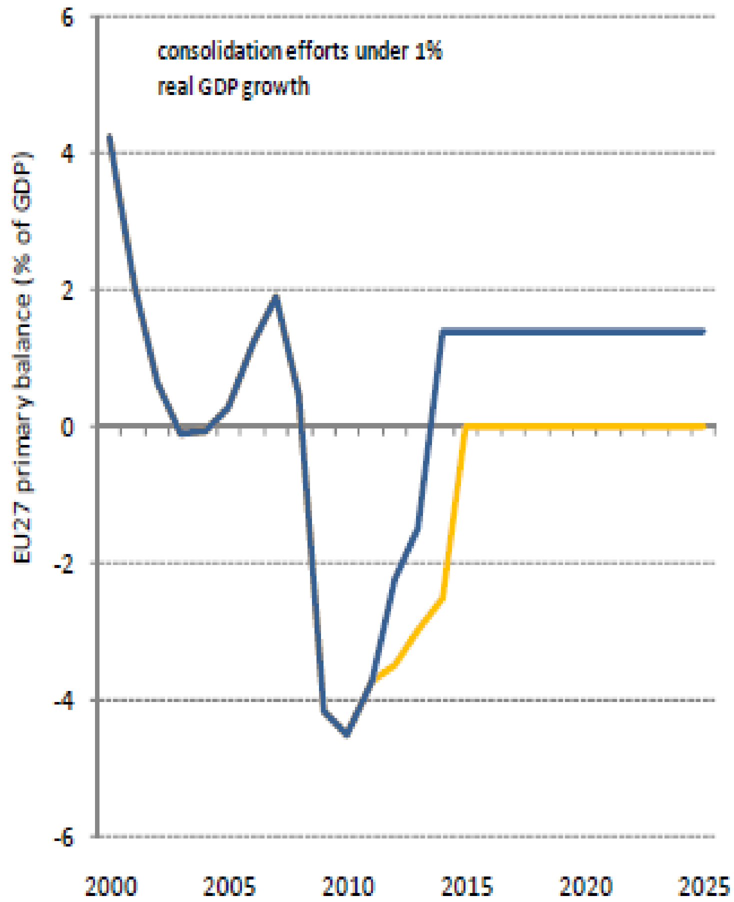
« Lost decade »

a permanent loss in wealth and an eroded potential for future growth

Source: European Commission

Public debt scenarios:
I. weak growth, insufficient consolidation

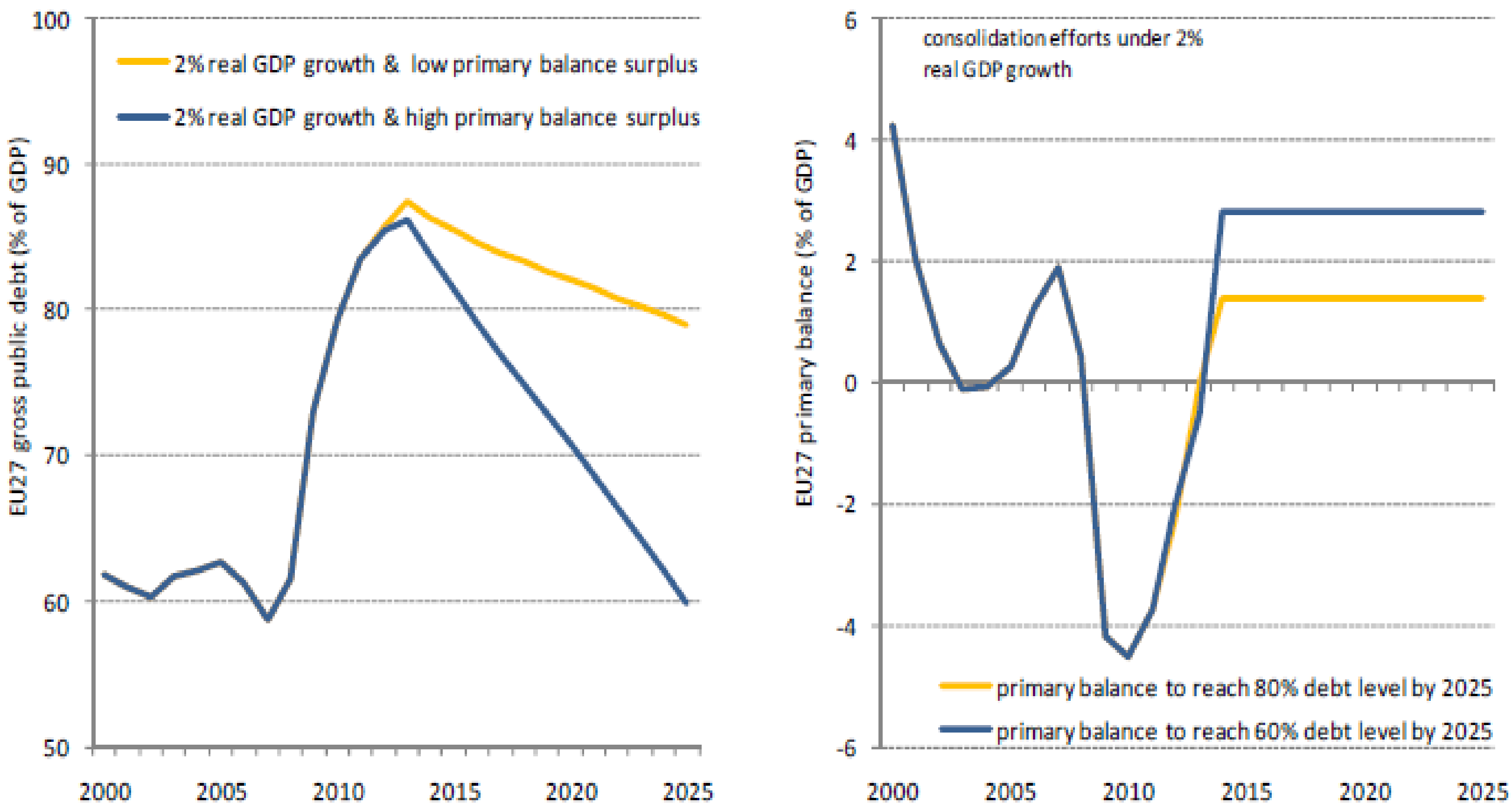




Source: BUSINESSEUROPE based on European Commission (AMECO) and calculations of Federation of Austrian Industries (IV)

GO FOR GROWTH

Debt consolidation scenarios:
II. sustained growth, sufficient consolidation



Source: BUSINESSEUROPE based on European Commission (AMECO) and calculations of Federation of Austrian Industries (IV)

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What is needed to improve adjustment mechanisms

More balanced growth requires looking at both **competitiveness (Euro area relative performance)** and **stronger growth (Euro area absolute performance)**

In this perspective the EURO area needs **structural adjustment (supply side reforms)**, but also a **recovery in demand.**

Unfortunately, the market cannot produce a demand recovery rapidly by itself due to **current imbalances and divergent growth pattern** (Strong and Weak Countries Groups)

And it **cannot produce structural adjustment at all** until a demand recovery is well under way.

Structural reforms and effective adjustment mechanisms

- *Structural reforms to strengthen key markets (products, service, housing) to increase investments, boost growth*

- *Effective mechanisms to address long term external imbalances including in surplus countries since CA imbalances lead to asymmetric adjustment in monetary unions too*

A substantial increase in investments for the single market infrastructures would bring great benefits by boosting demand in the short term and by raising the Union's potential output in the long term.

CONCLUSIVE REMARKS

A broader political deal on economic policies and economic governance is needed to restore confidence in the long-term future of the euro area

This requires agreeing on well-identified policy priorities both at EU and member state level, by tackling three broad challenges:

First, they must address worrying dynamics of public debt in some member states.

Second, they must confront fragilities in the euro area's banking system.

Third, they must implement bold structural reforms to improve economic flexibility, while also correcting the institutional weaknesses (current account imbalances) that allowed the crisis to take root in the euro's first ten year

THE END

THANKS