The euro-area crises: where have we come from and where are we now?

Lucrezia Reichlin
London Business School & Now-Casting Economics Ltd

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Where are we now in the euro area crisis?

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- Low volatility
- Low spreads on government debt
- Return of investment from abroad?
- Perhaps a recovery of the real economy …

Can we say that the crisis is over?

I WILL ARGUE THAT IT IS NOT

Where have we come from?

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- The euro area had two crises: the 2008 global recession and the 2011 debt crisis
- Policy was constrained by the imperfect governance structure of the monetary union
- Overall the loss of output was worse than in the US

The Euro Area had two crises - not the US

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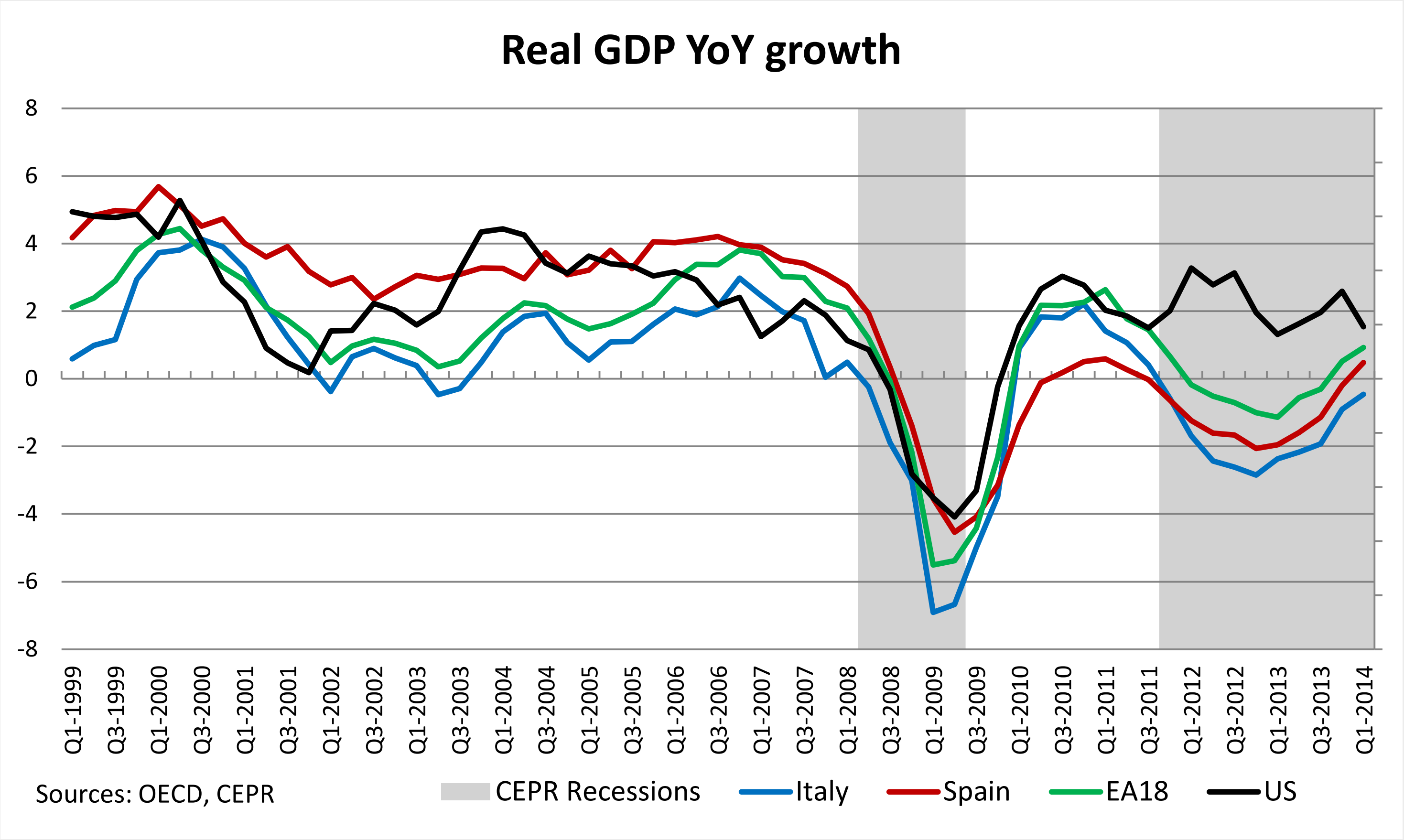
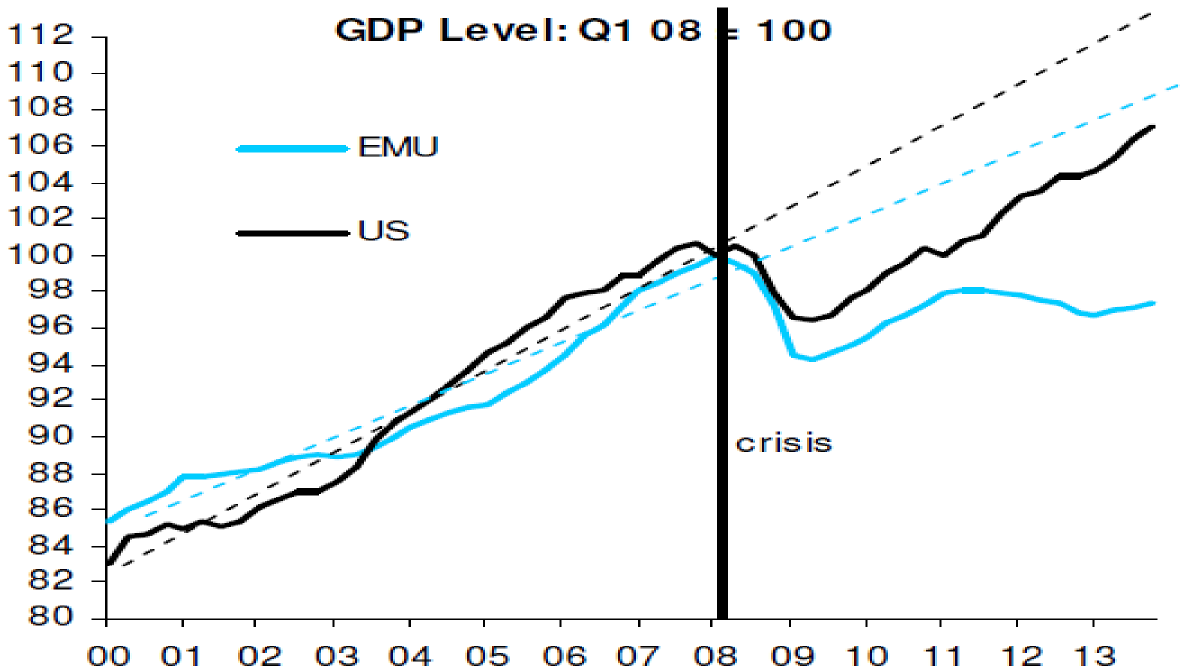


EA vs US since the crisis

Since 2008 the Euro Area had a larger loss of income than the US. Although the initial income shock was of similar magnitude neither economy is back to trend, but the EA is further off

Figure 4.2.11



Source: authors' calculations based on national accounts data.

Source: Buttiglione et al, 2014

Most countries in the Union are not back to the 2008 q1 peak

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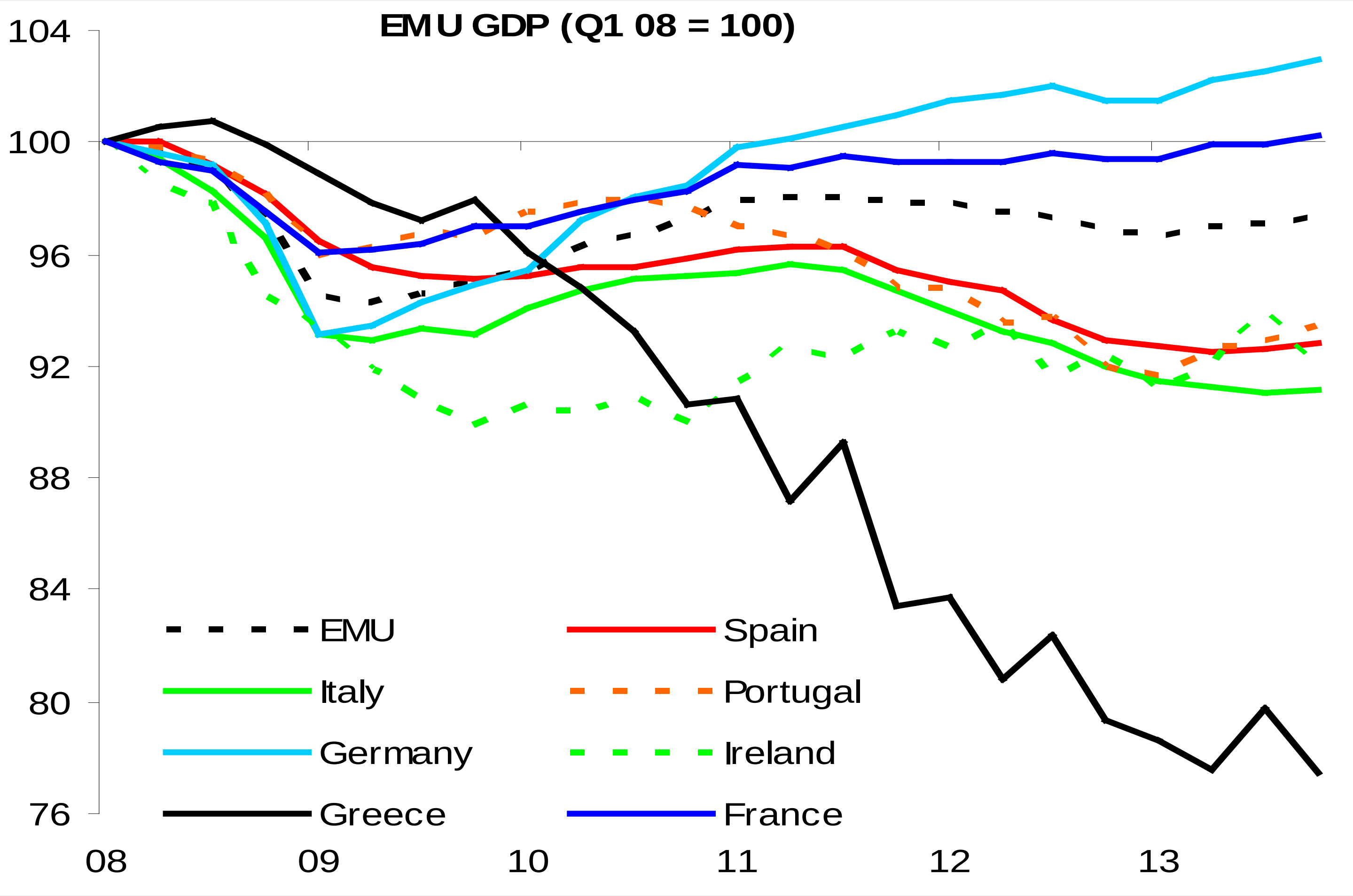

Employment has not recovered and it is still below the second recession peak everywhere but Germany

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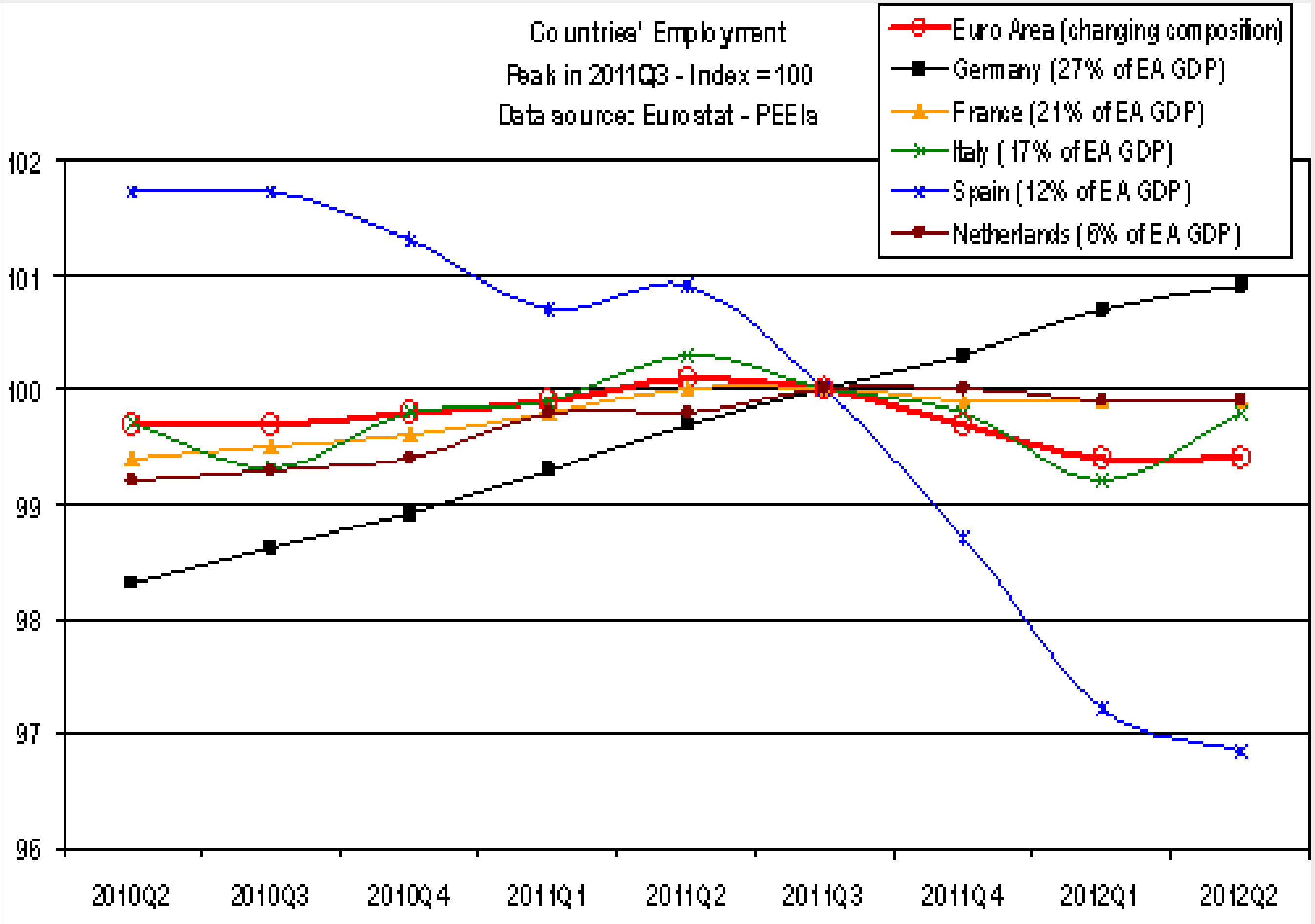

In the EA aggregate economy all components of GDP are still below the 2011q3 peak

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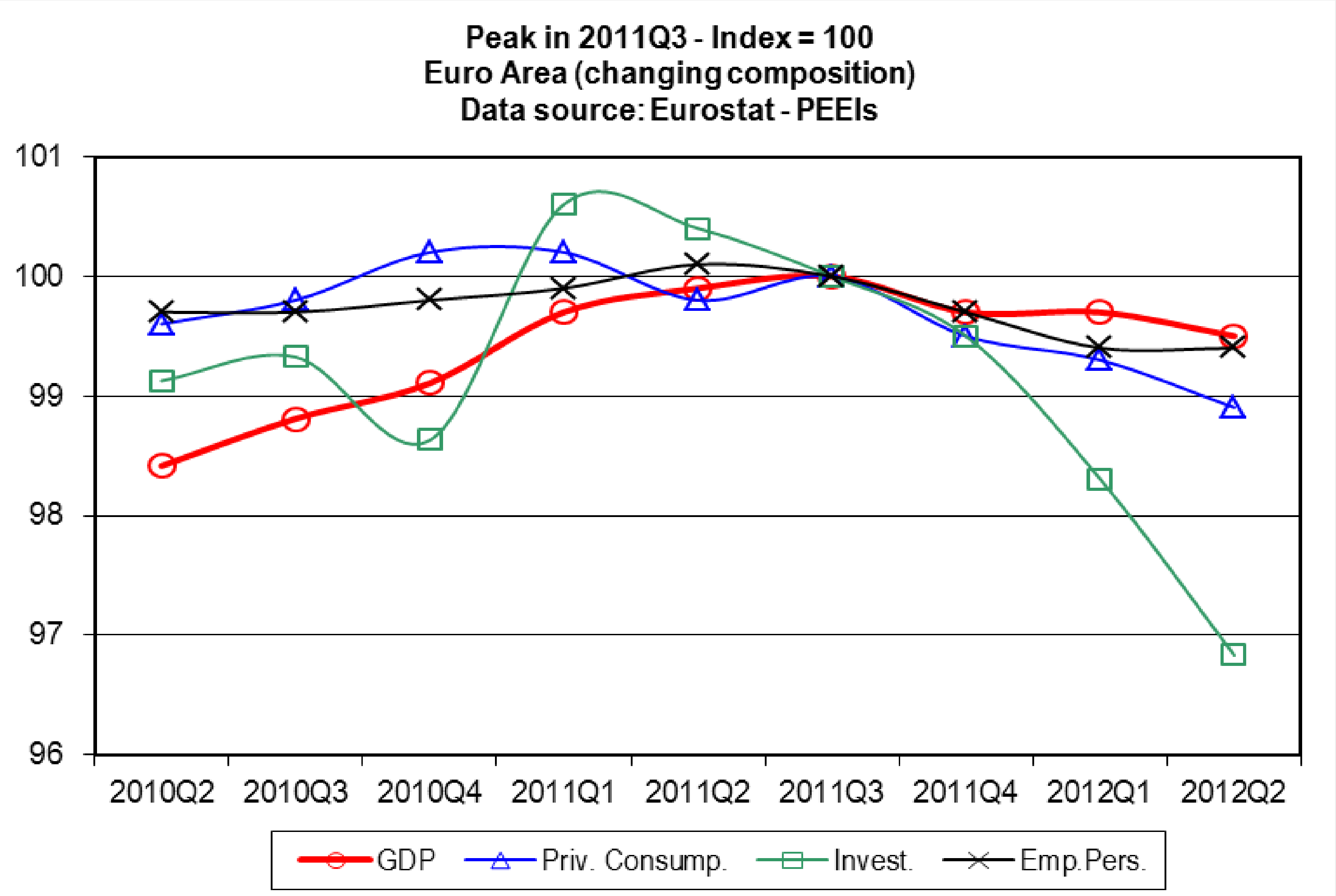

PRE-CRISIS ACCUMULATION OF RISKS

Capital flows:

- accumulation of private debt – leveraged banks and households
- Loss of competitiveness – displacement effect
- Macro imbalances

Low real interest rate

led to over-estimation of debt capacity – public debt

Real exchange rates

High in some countries due to nominal appreciation and loss of competitiveness

Imbalances

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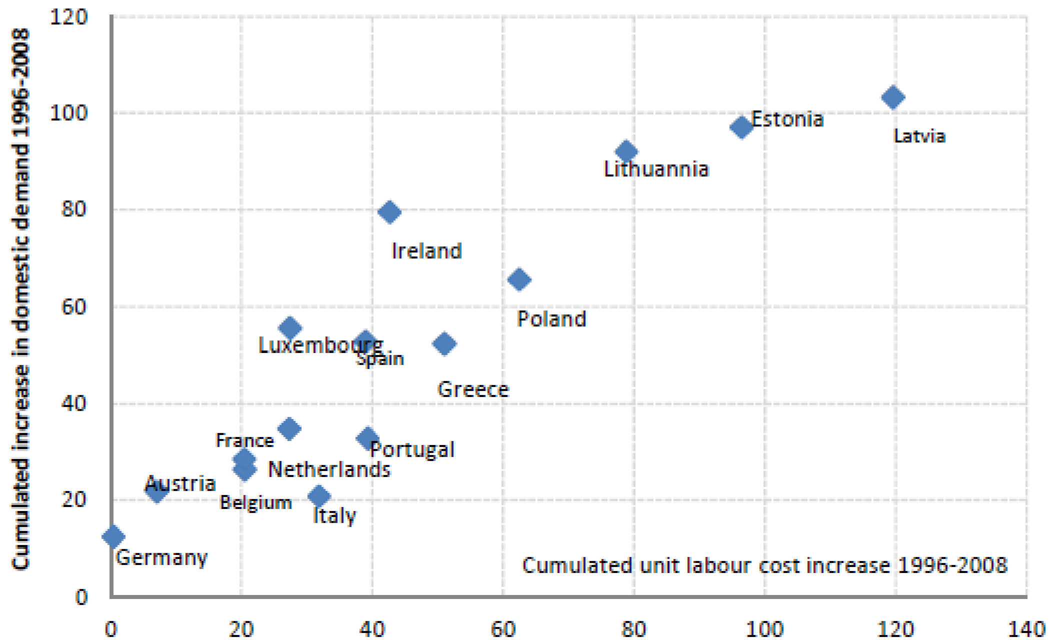
Deficit countries have lower income per capita: capital flows in the right direction - good imbalances!

However the “good imbalances” driven by productivity differentials turned out to be “bad imbalances” driven by domestic distortions: bubble-driven asset booms and unrealistic expectations of future growth

Loss of competitiveness positively correlated with growth in internal demand

Figure 6. Correlation between domestic demand and ULC



Source: European Commission Services (Ameco).

Note: ULC is nominal unit labour costs: total economy (ratio of compensation per employee to real GDP per person employed.)

Pre-crisis weaknesses

- Not a sovereign debt story for the aggregate

- Rather a heterogeneous (across countries) configuration of:
  - weak productivity (the periphery)
  - private debt - especially banks (Spain, Ireland, Portugal but also the big banks of core Europe)
  - public debt (Greece and Italy)

Combined with inadequate policy tools for crisis management

The problem with the Eurozone Treaty is that important pieces were missing when the crisis burst

Problems	
1. Ex ante incentives weak: EA level monetary policy, but national fiscal and banking supervision leading to over-borrowing/over-lending (private + public)	
2. Ex post discipline excessive: no mechanism for crisis resolution, hence not credible ex ante?	
3. No mechanism for resolving banking crises, hence diabolic loop between sovereigns and banks	
4. No lender of last resort mandate for ECB	

POST-CRISIS - Phase 1
The US and the Euro Area:

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- The policy response to the 2008 crisis in the two economies was very different and so has been the result

✓ Fiscal: In the US stimulus in 2009 – not in the EA

✓ Monetary: both the ECB and the Fed acted in a timely and aggressive way

✓ Banks: early recapitalization of banks in the US – no action in the EA

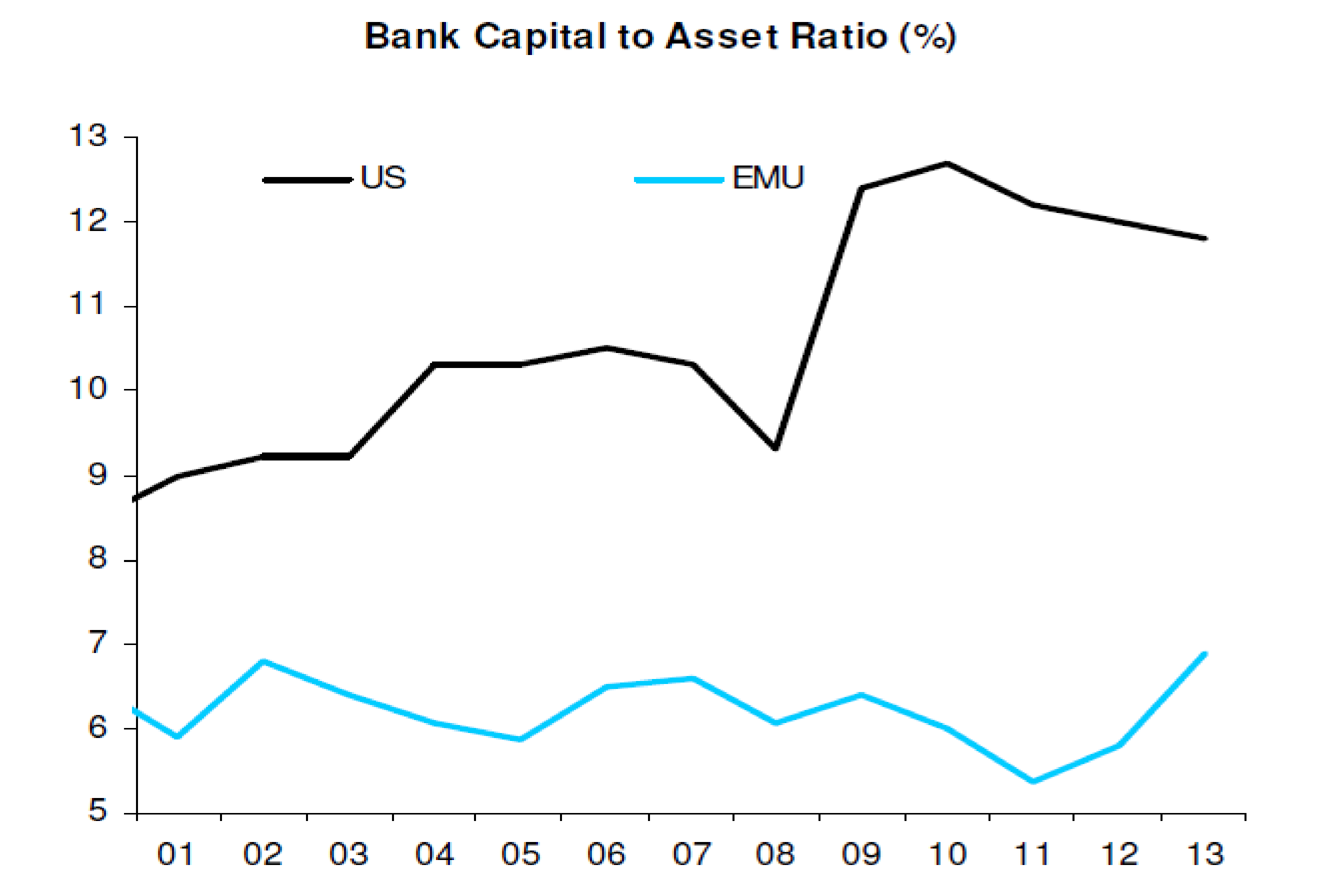
➢ Both economies started recovering in 2009q3

From the recovery to the debt crisis

- Given the loss of output in the recession and the weak recovery, public finances weakened even in those countries which had a sound fiscal position before the crisis (eg Spain ad Ireland)
- Delayed action to recapitalized banks protracted the uncertainty on the state of the banking sector … very little deleveraging in the private sector except for corporate

➢ The debt crisis hit the weakest country – Greece – in 2010

No stabilization of leverage: banks' capital



Source: authors' calculations based on FRED, ECB and FRB data

No stabilization of leverage: private and public debt

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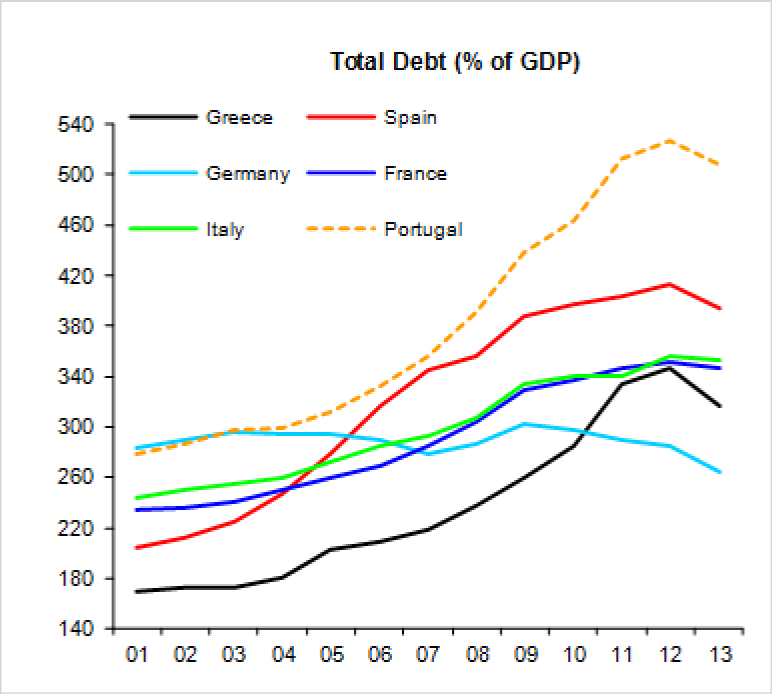
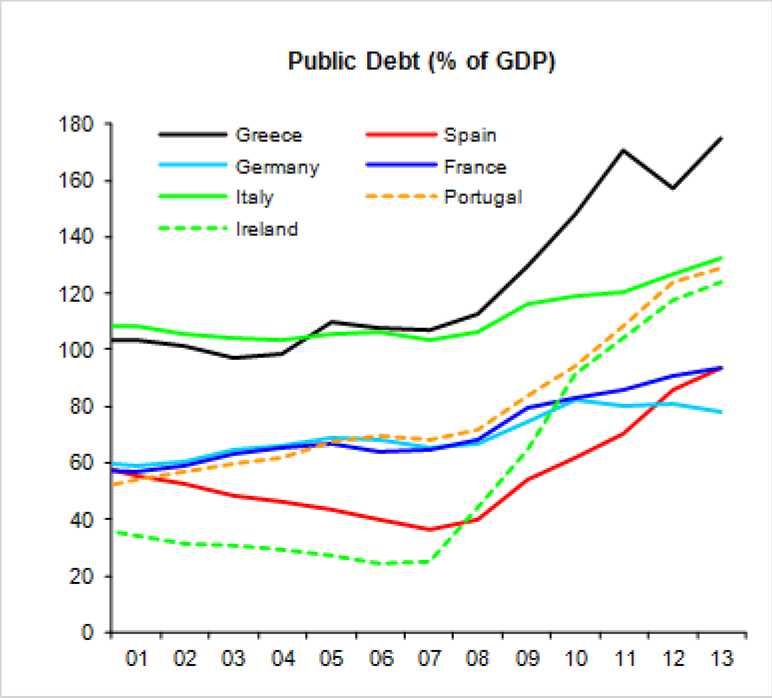
Total Debt as % of GDP



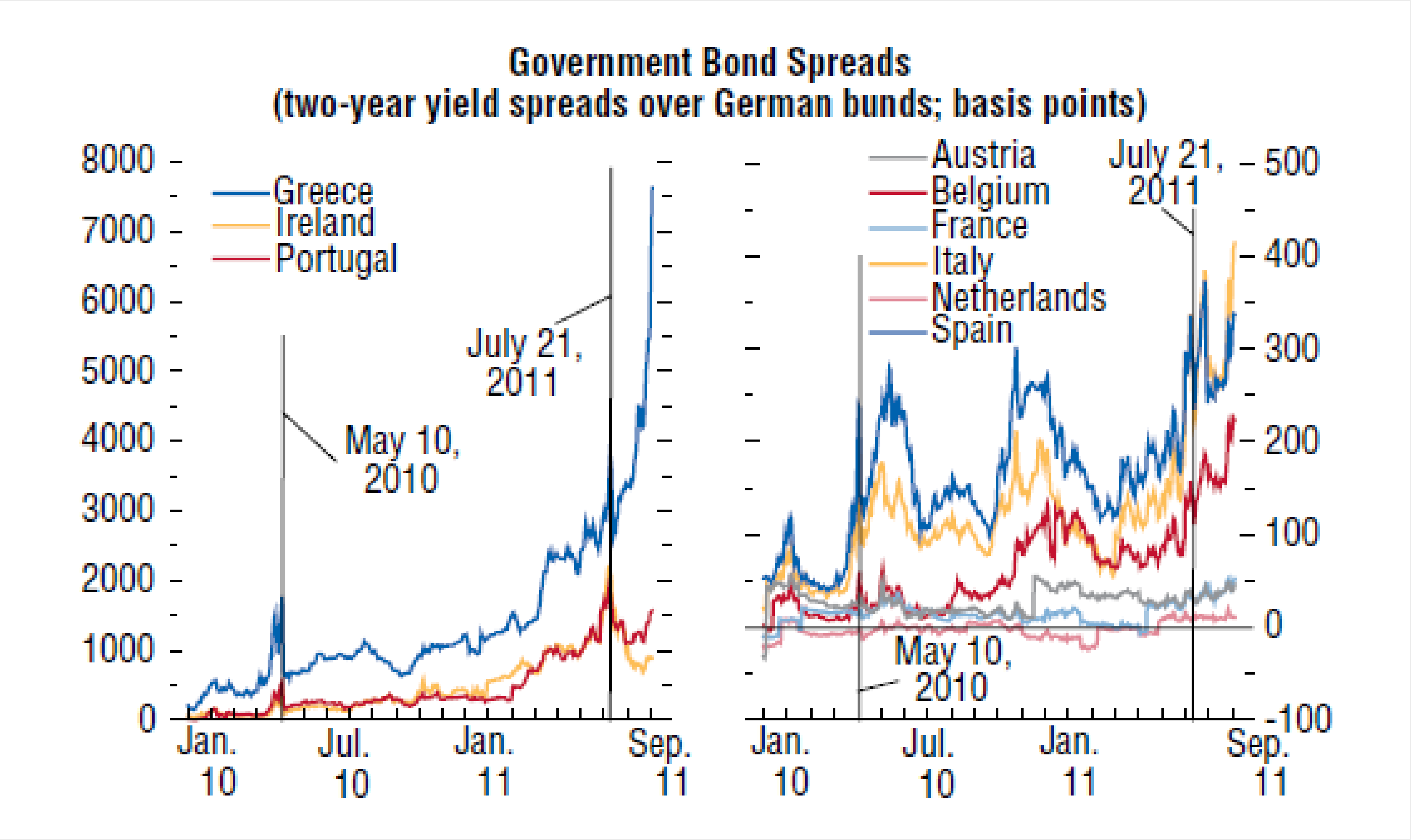
Public Debt as % of GDP



PHASE 2:
The response to the debt crisis

- Delayed and messy response to the Greek crisis
- Greece, Portugal and Ireland lost access to the market and entered a “program” under the Troika monitoring
- The market started doubting the soundness of the euro (redenomination risk)
- Contagion to Spain and Italy

Contagion: initially spreads up only in Greece, Ireland and Portugal. From July 2011: contagion spreads to Spain and Italy



Policy action in 2010-12 inadequate

- More liquidity measures by the European Central Bank (ECB) but not very effective since undercapitalized banks decreased lending – a solvency problem
- Delayed action to deal with bank solvency – national regulators
- No mechanism in place for orderly debt restructuring
- No backstop (lender of last resort) to deal with self-fulfilling liquidity crises

Result …….

Diabolic sovereign-bank loop

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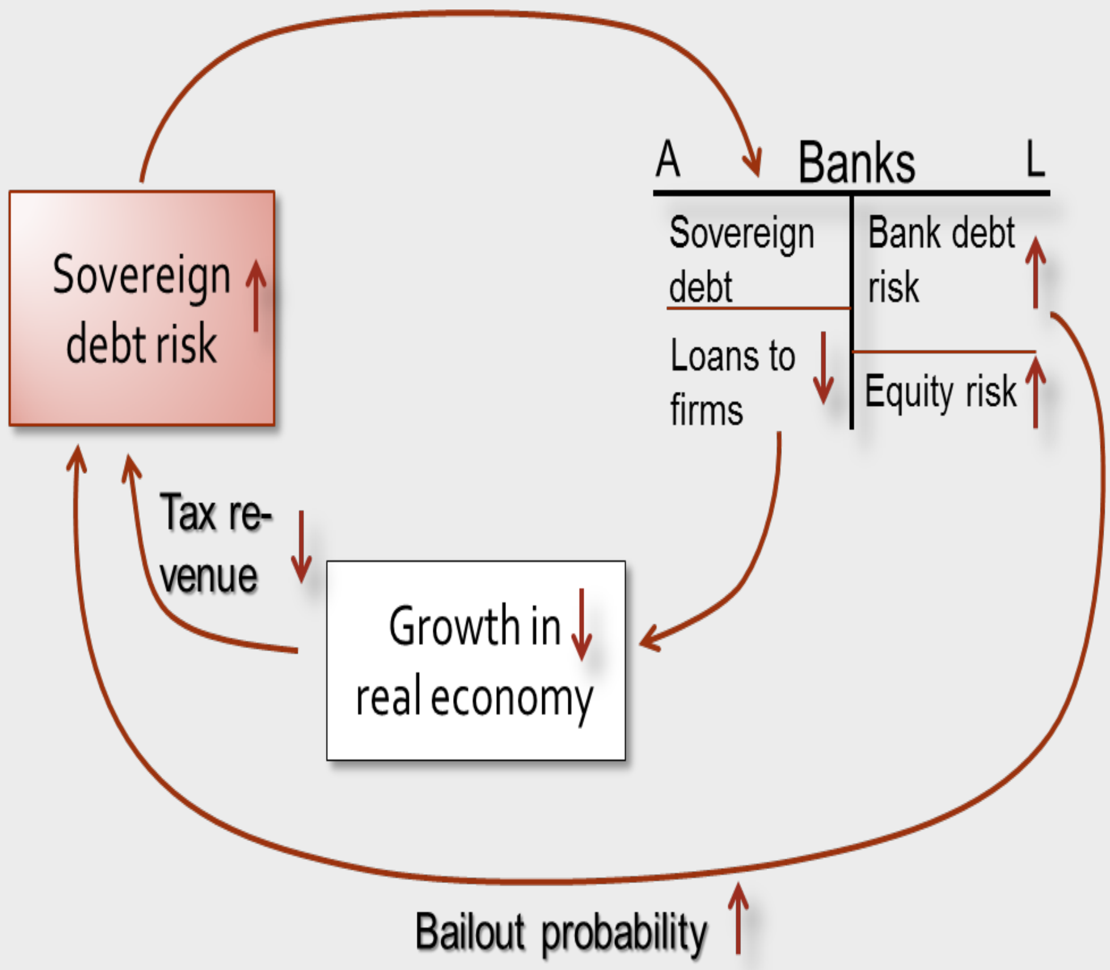

Triggers:

- Bank insolvency (Ireland, Spain, Cyprus)
- Public debt and slow growth (Greece, Portugal, Italy)

Credit deterioration after the second recession

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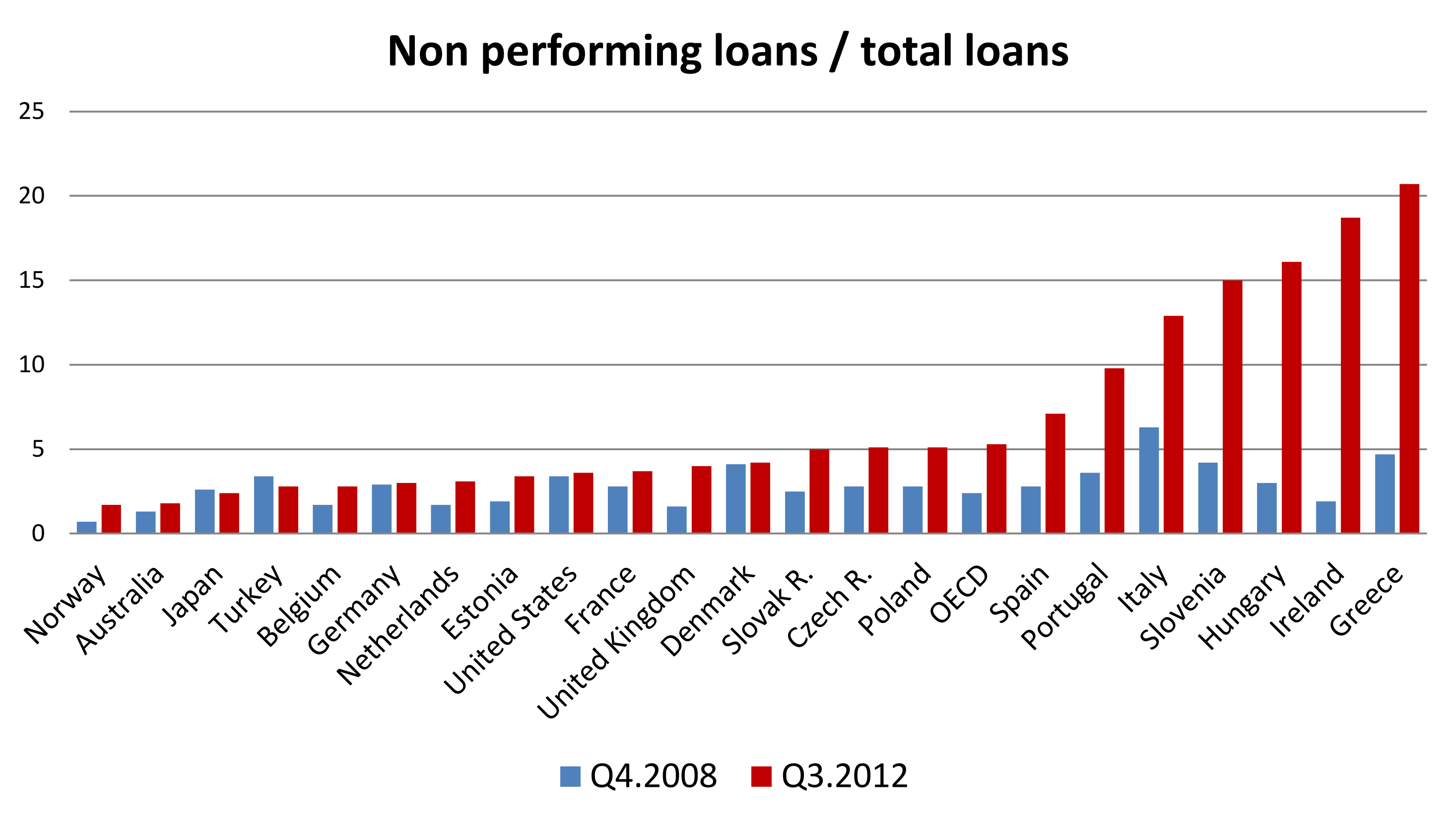
The second recession led to a deterioration of the stock of loans especially in the euro area periphery



Source: OECD

Credit crunch in 2011-12

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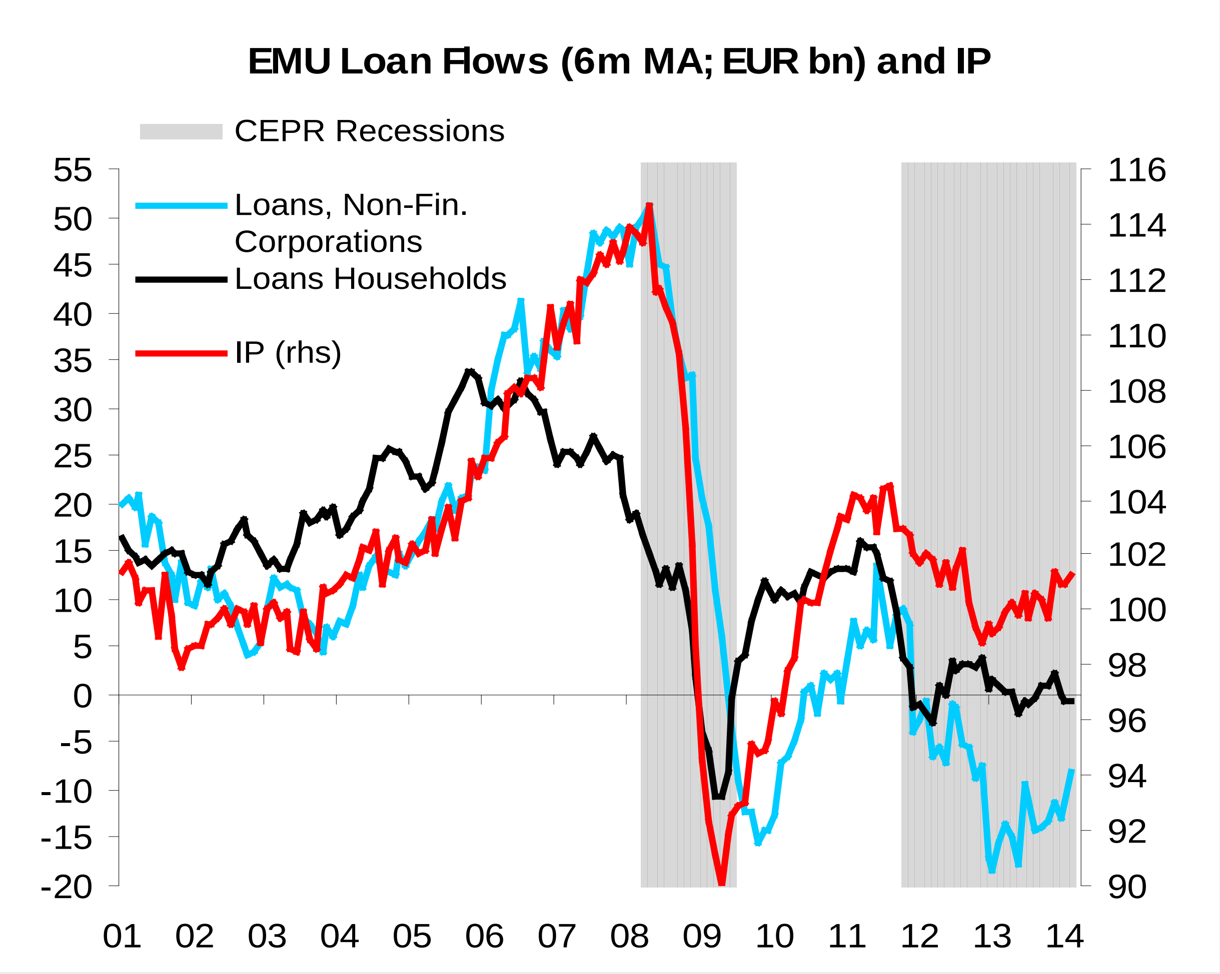

Financial repression: banks buy government bonds

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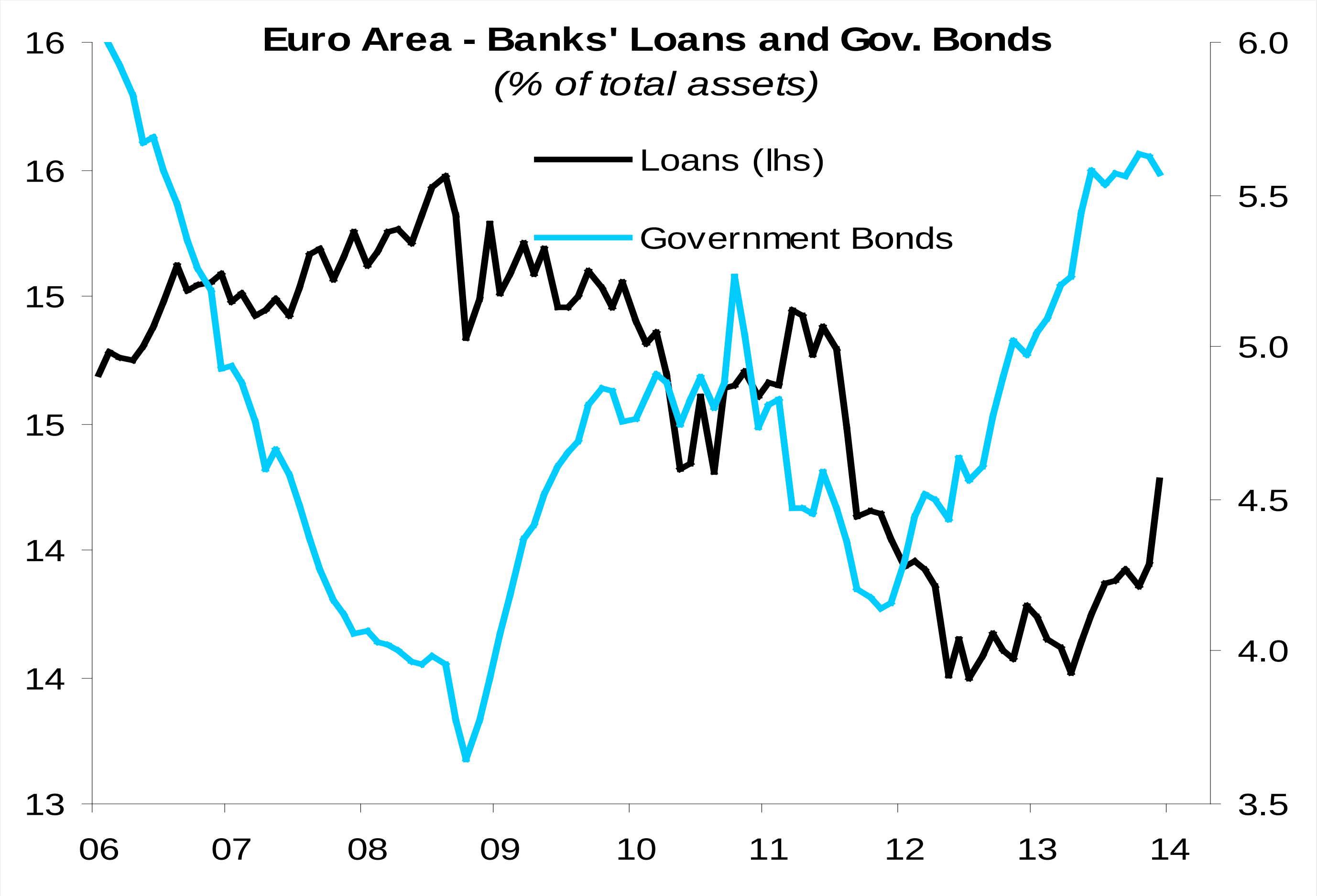

Since then … some progress in governance

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Problems	Progress
1. Ex ante incentives weak: EA level monetary policy, but national fiscal and banking supervision leading to over-borrowing/over-lending (private + public)	Banking Union and launch of AQR
2. Ex post discipline excessive: no mechanism for crisis resolution, hence not credible ex ante?	None
3. No mechanism for resolving banking crises, hence diabolic loop between sovereigns and banks	Incomplete: the Banking Union has non credible resolution fund
4. No lender of last resort mandate for ECB	Not clear: Draghi's announcement of OMT in 2012 went a long way to take away "redenomination risk" but uncertainty on future action remains

However the macro adjustment led to compression of internal demand

- Emphasis on fiscal consolidation but increase in public debt to GDP ratio
- Contraction of internal demand and external surplus
- Increased corporate savings and collapse of investment

Contrast this with the US story ..

Contrast this with the US story

The US

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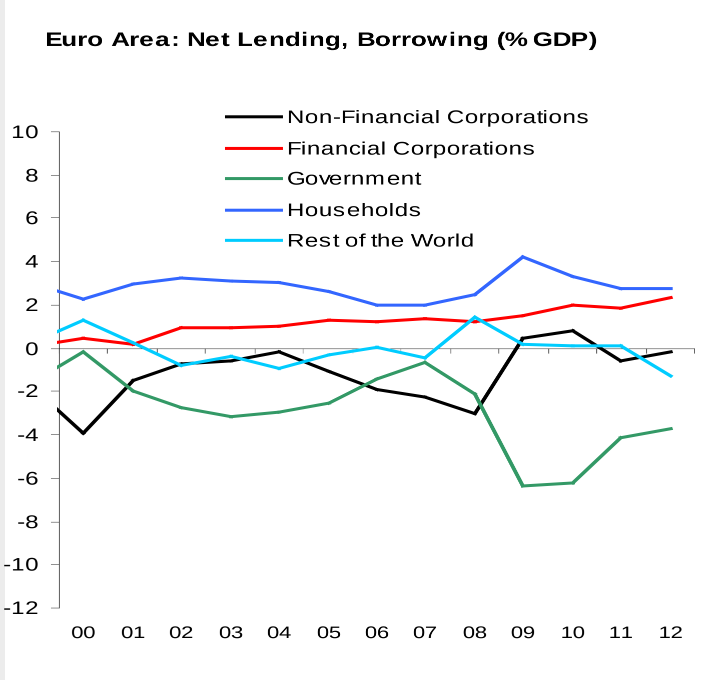
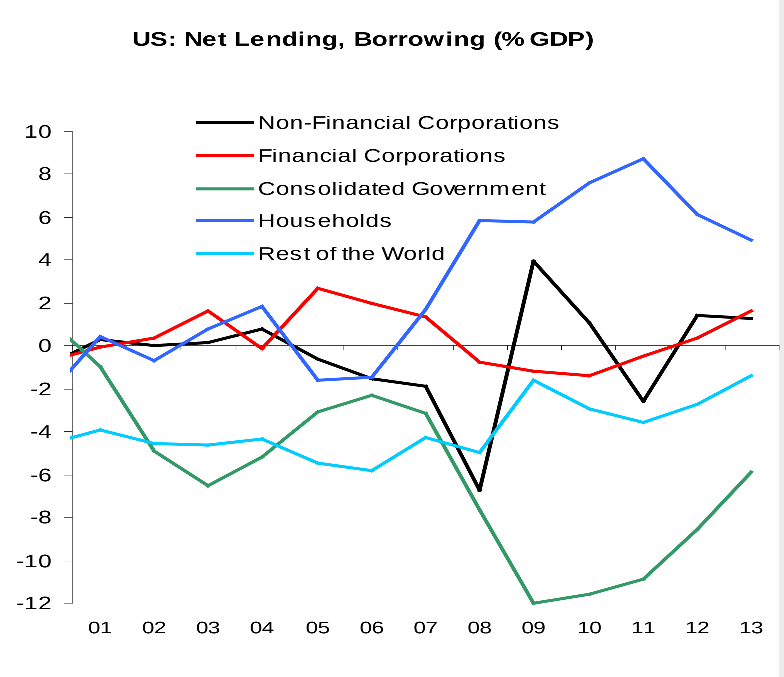
- The large shock on households' assets related to collapse in housing prices led to deleveraging and increase in saving
- Early deleveraging by banks (recapitalization at an early stage)

The increase in private saving was compensated by a decrease in public saving explained by aggressive fiscal policy in the early stage

- Aggressive monetary policy led to a rebound in asset prices
- By 2011 private balance sheet repaired but increase in public debt

The Euro Area and the US Sectoral Flows





In the Euro Area most of the adjustment is in non-financial corporations

In the US the increase in households' savings is mirrored by a decrease in public saving

Where are we "really" now?

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NOW-CASTING RECENT VIEW

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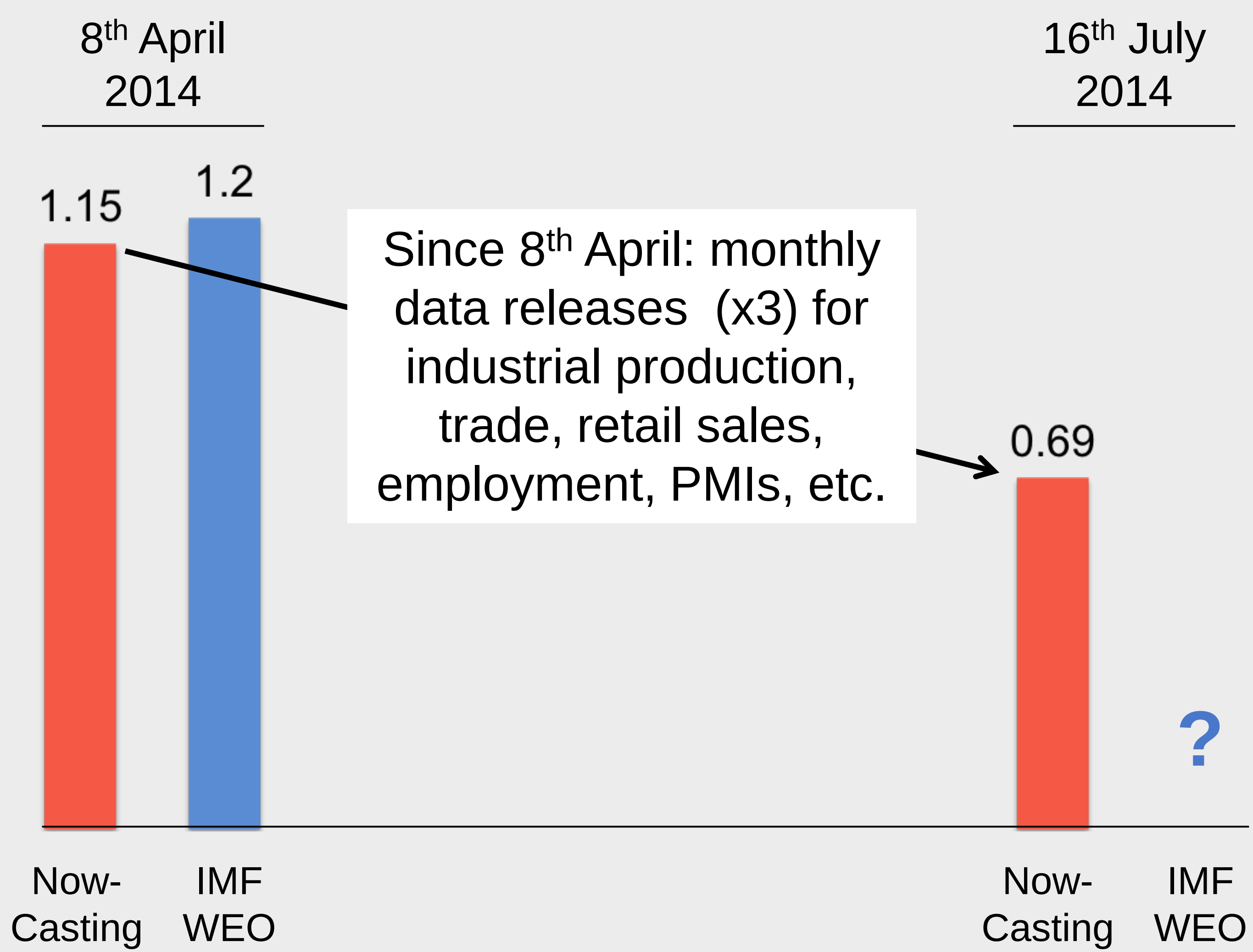
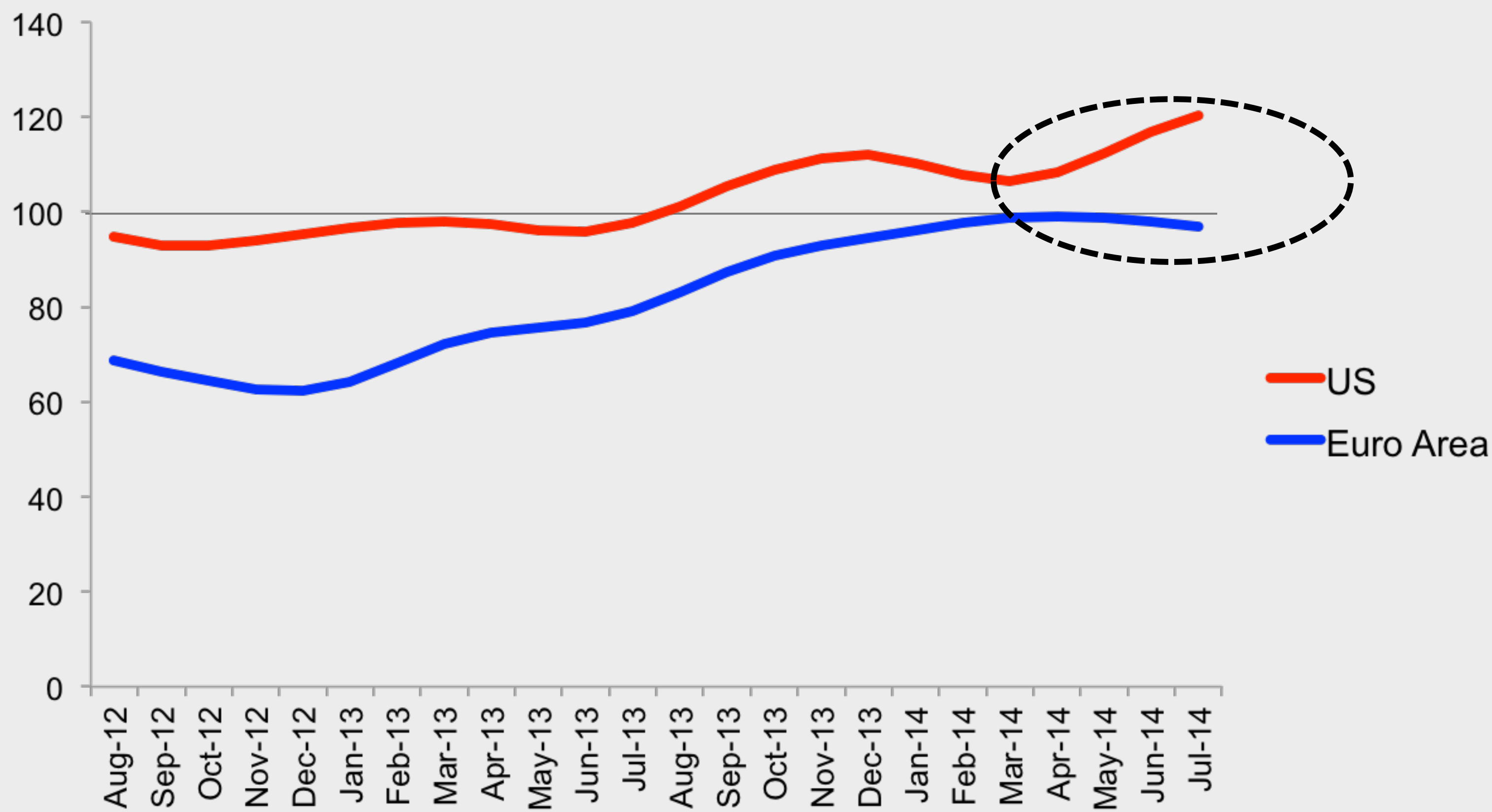
Forecast GDP growth for the Euro Area in 2014



The real economy:
US vs EA NCI™

Very recent data show a weakening of economic conditions in the Euro Area and a strengthening in the US, as shown by the Now-Casting coincident indicator



Inflation has been declining since the second recession

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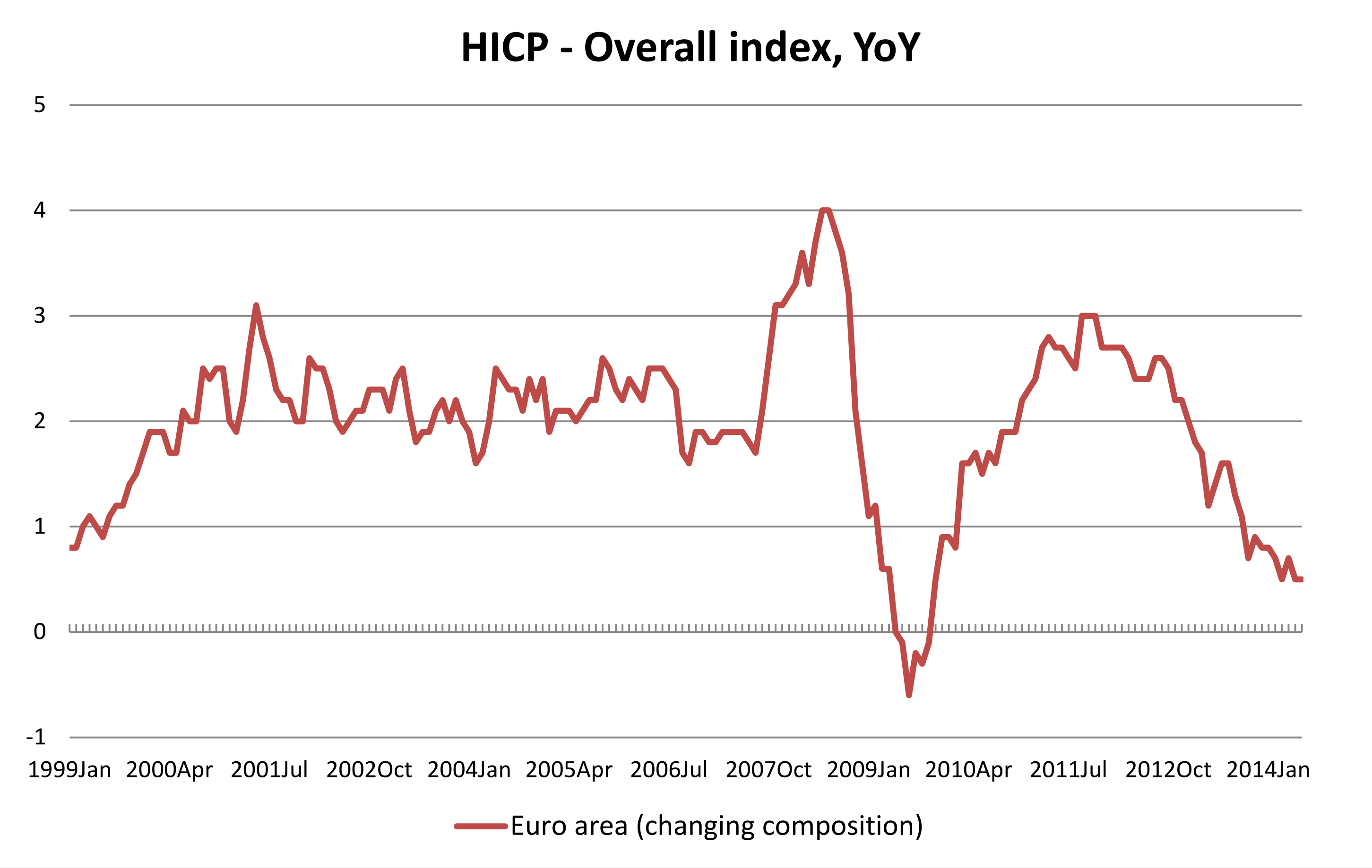

Source: ECB

In this context, the ECB has been downsizing its balance-sheet ….
Although further action just announced

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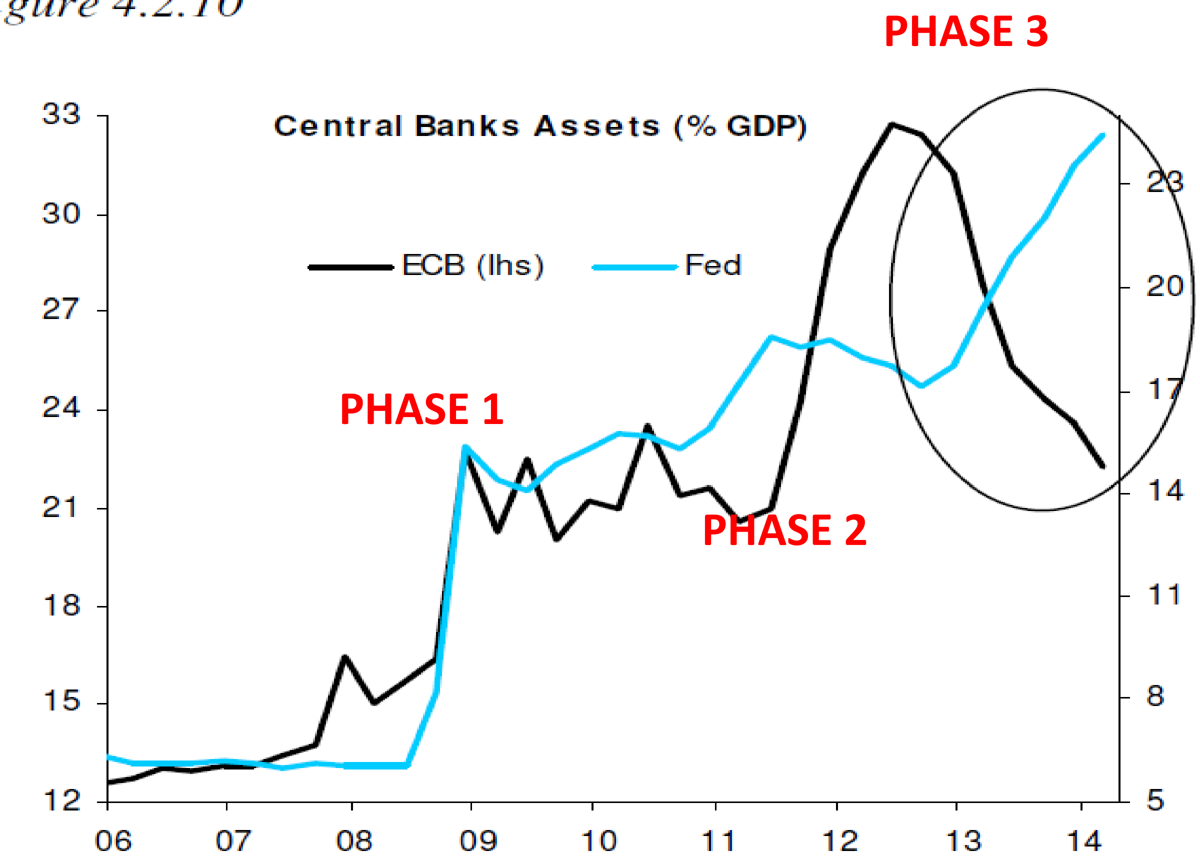
Figure 4.2.10



Source: authors' calculations based on ECB, FRB and national accounts data.

Buttiglione et al, 2014

Debt stabilization

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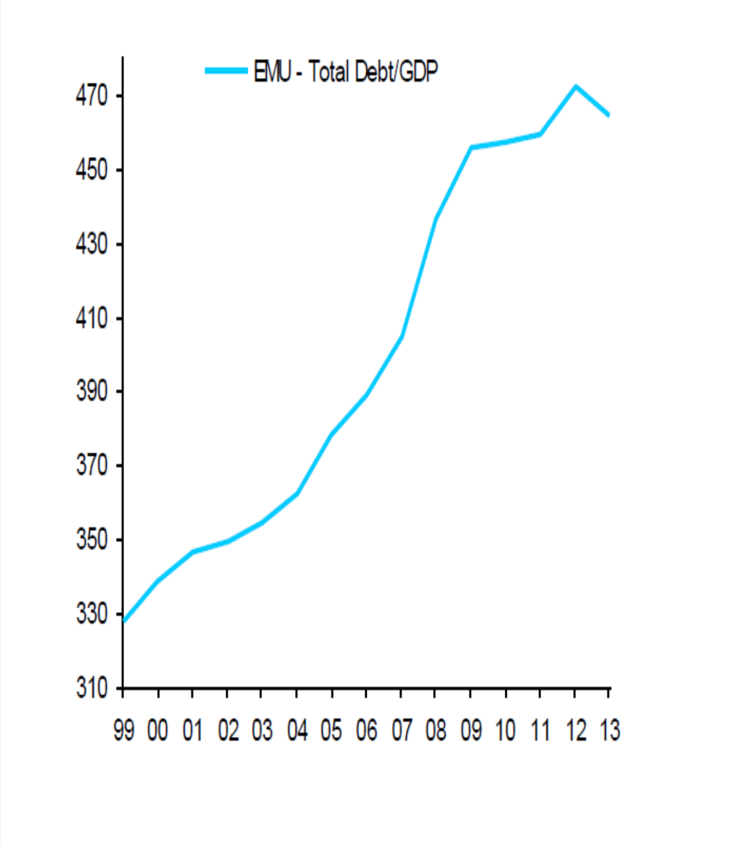
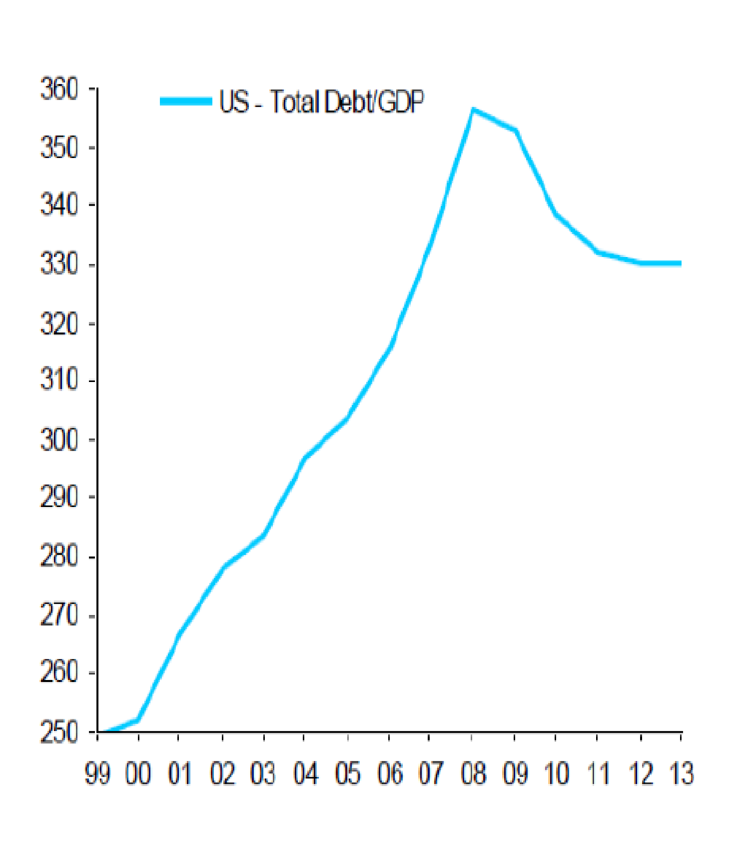
In the euro area debt stabilization just started while it is well underway in the US





Private debt in the Euro Area is relatively low but not adjusting

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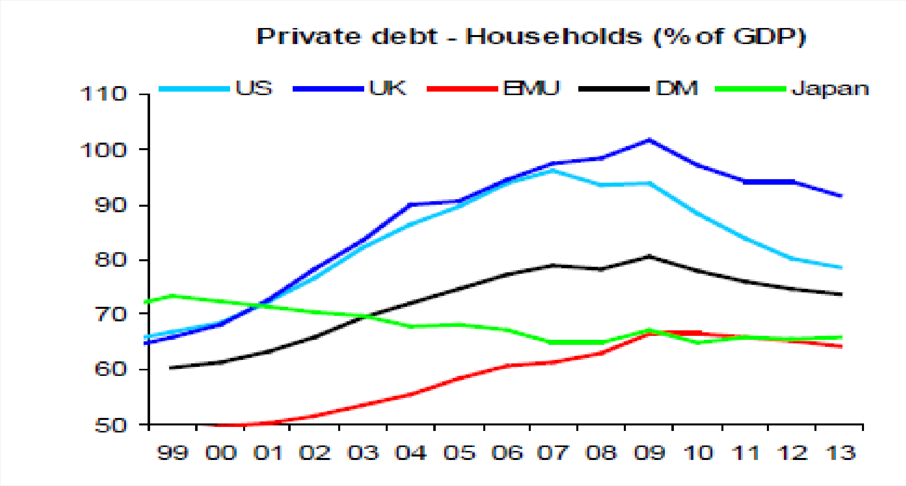

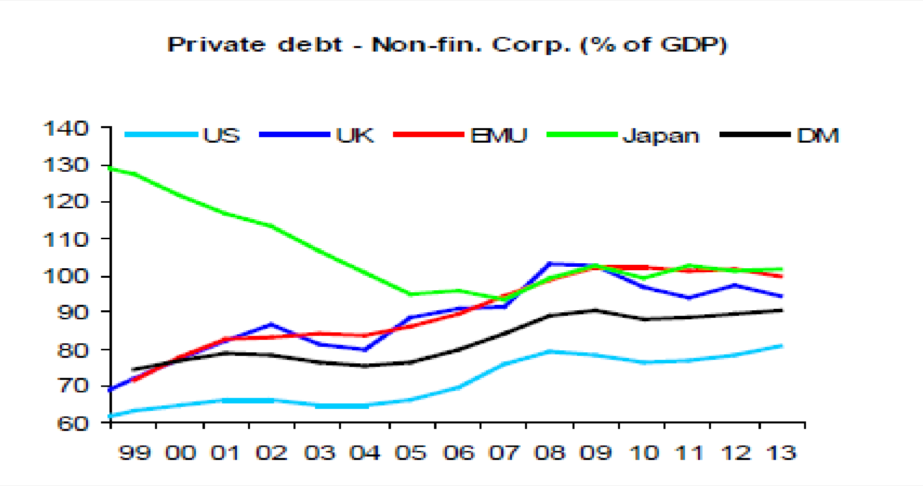

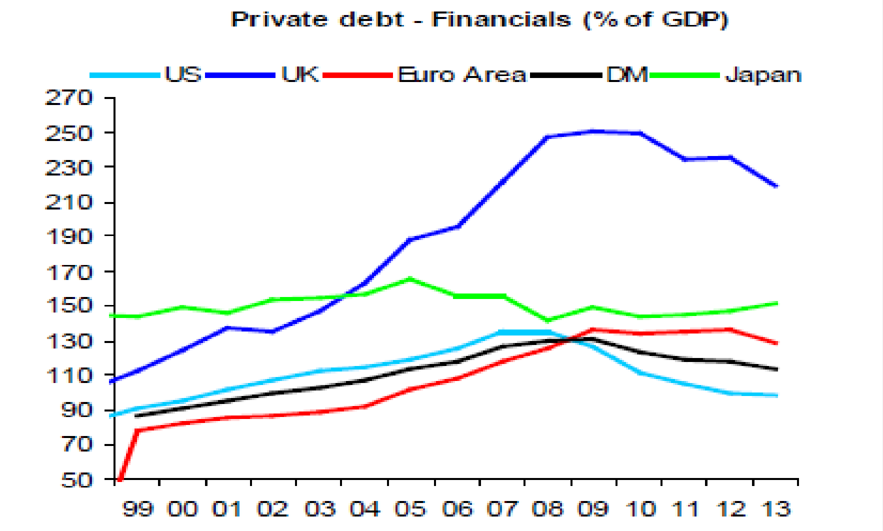

Notwithstanding fiscal austerity public debt still rising

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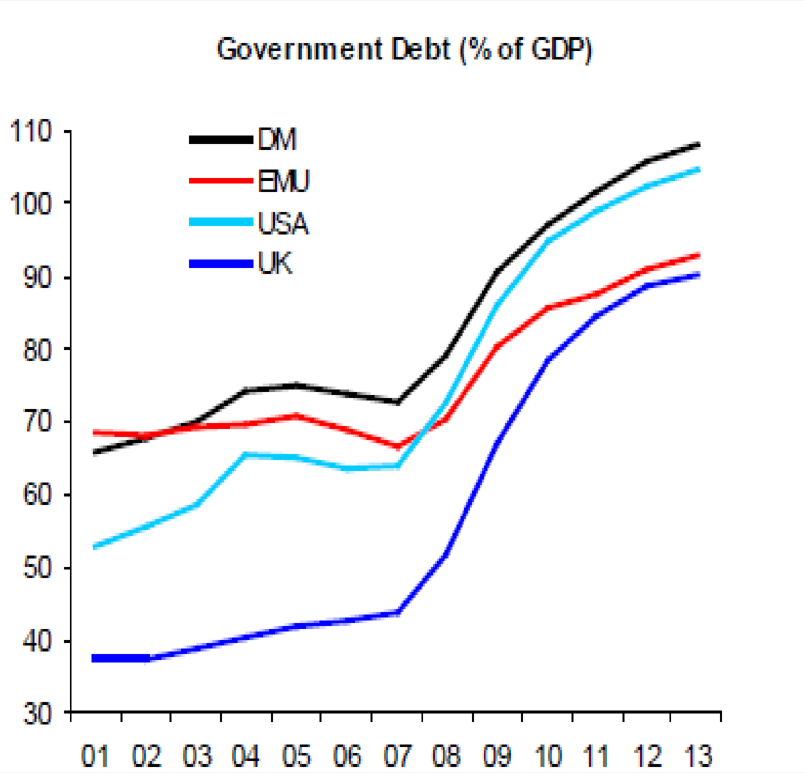

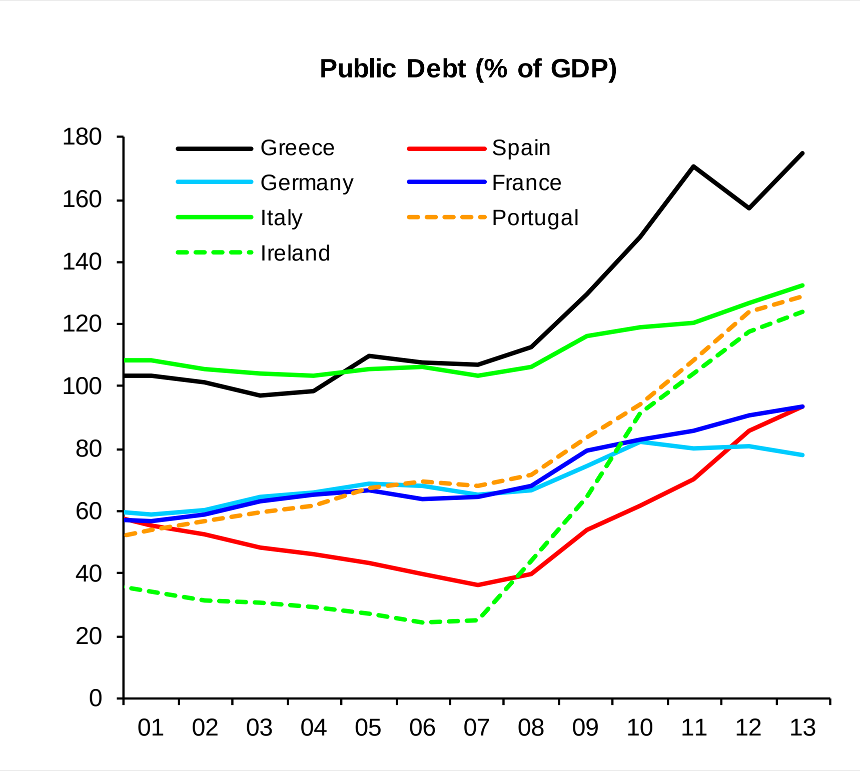

So, for the future …

Is debt sustainable?

Debt capacity depends on future stream of discounted income

- Future output level:
  - potential output growth
- Outlook of real interest rate:
  - nominal interest rate
  - unexpected inflation

Historical decline of output growth and its potential

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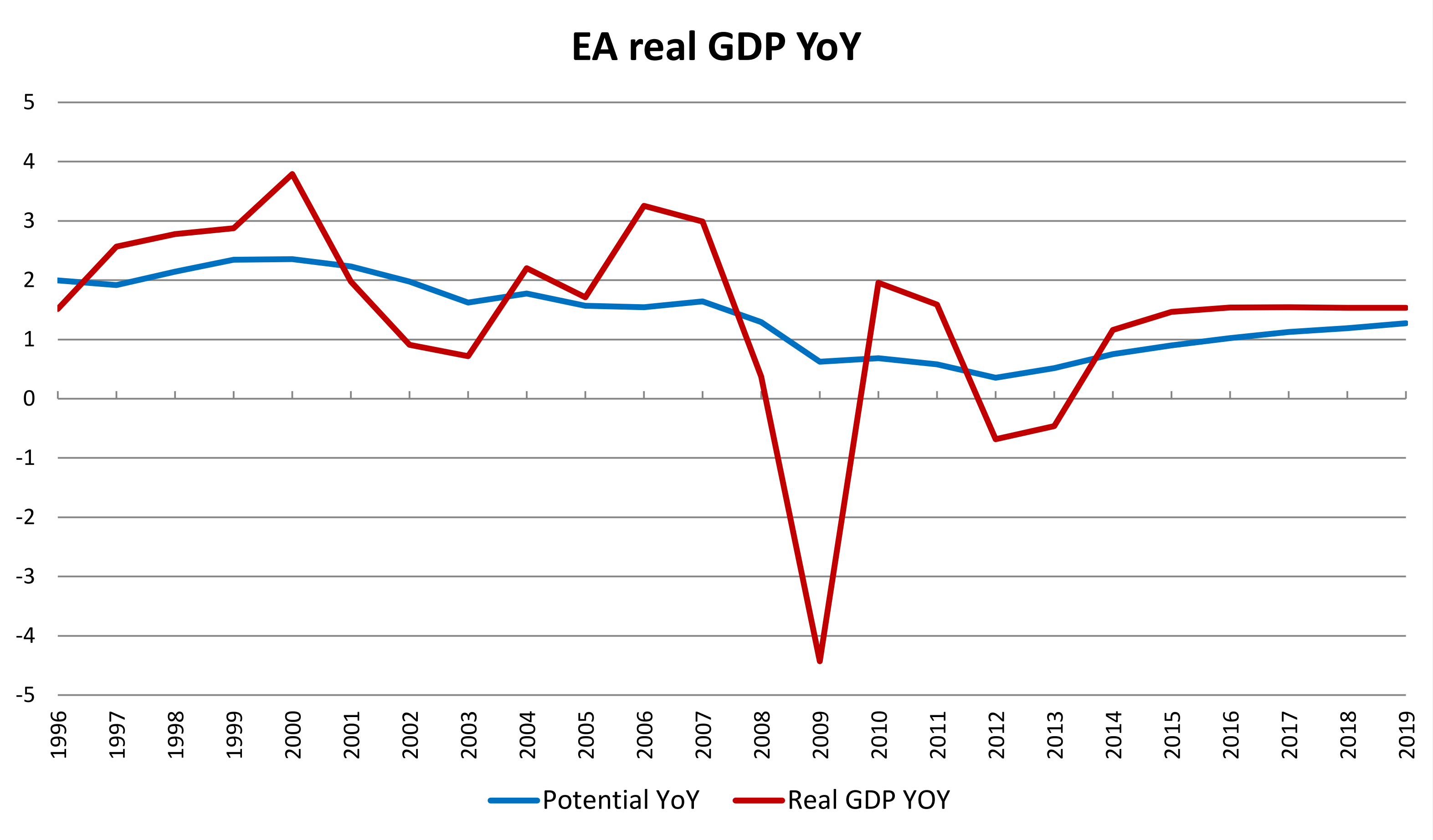
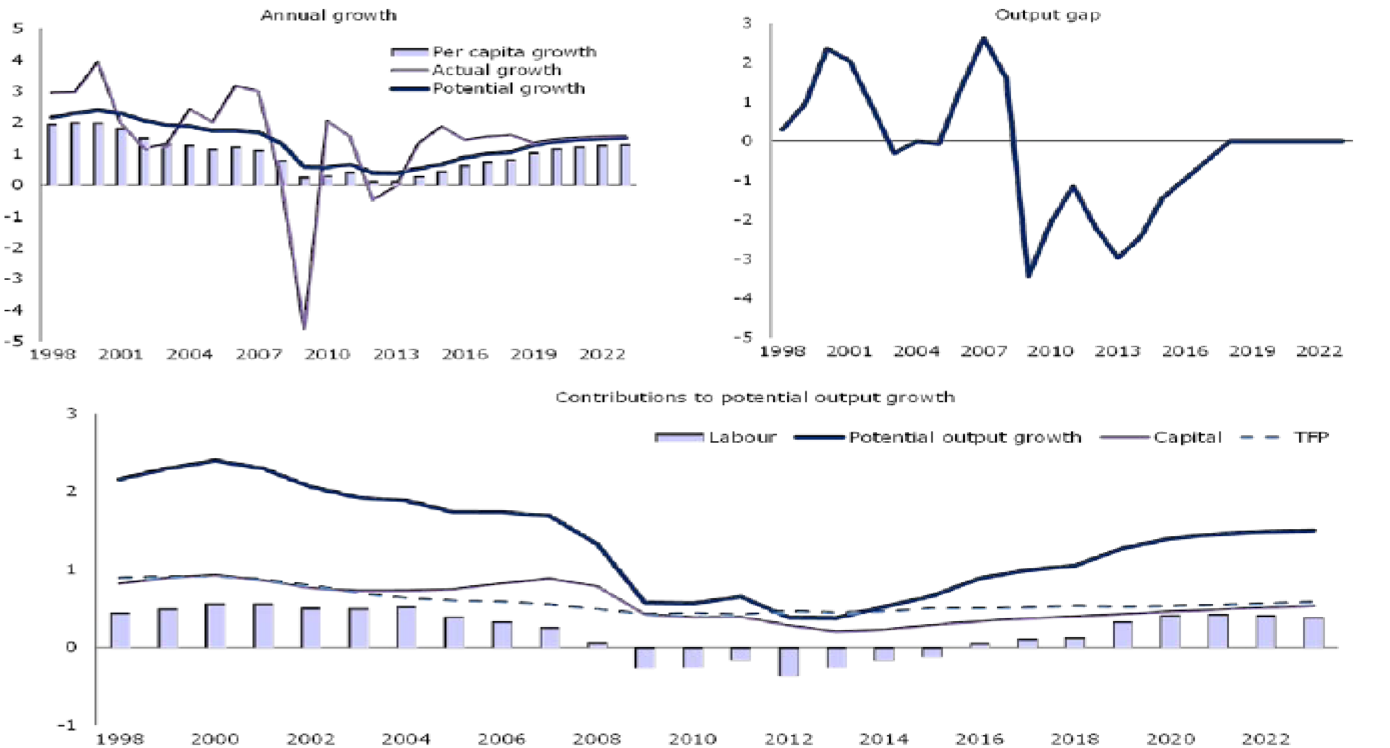


Potential output growth reduced

The European Commission estimates potential output growth to be 1 % pt lower in the next 10 years than in the 10 years before the crisis

Graph I.1: **GDP, potential and per capita income growth, output gaps, euro area**
(1998-2023, in %)



Source: DG ECFIN.

Weak demographics

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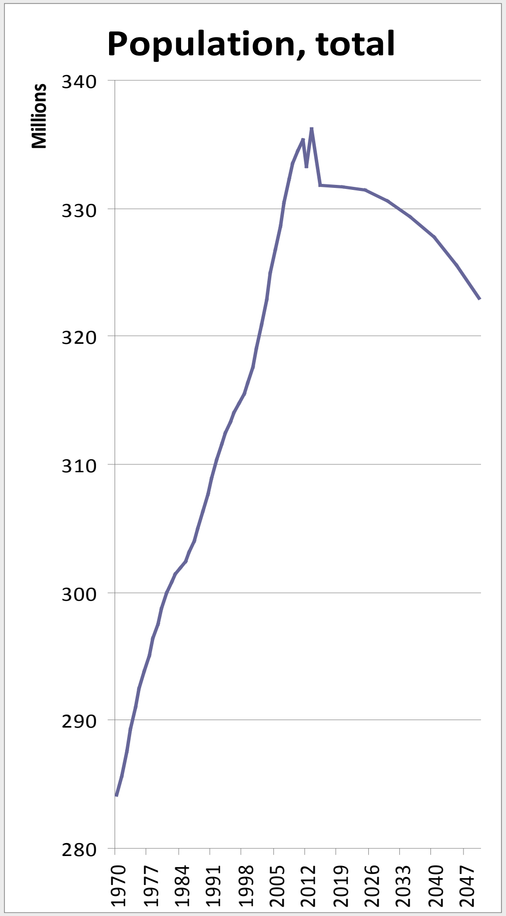
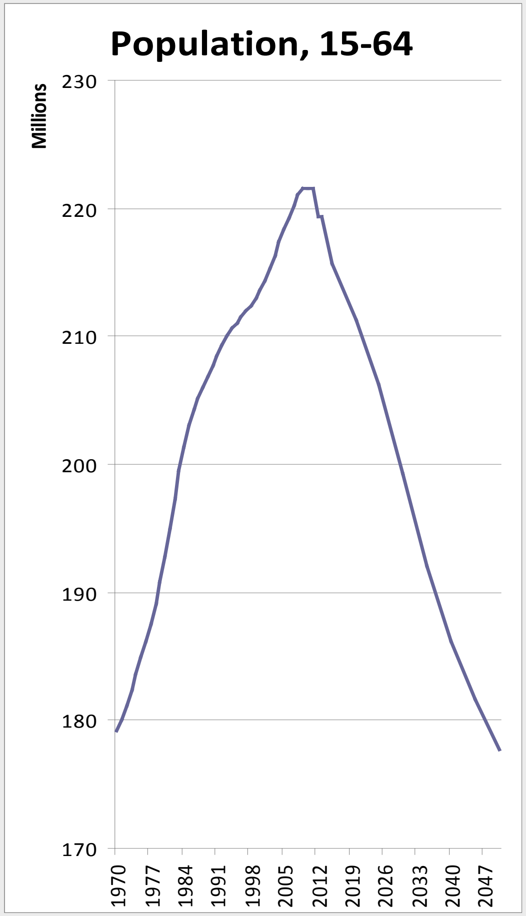
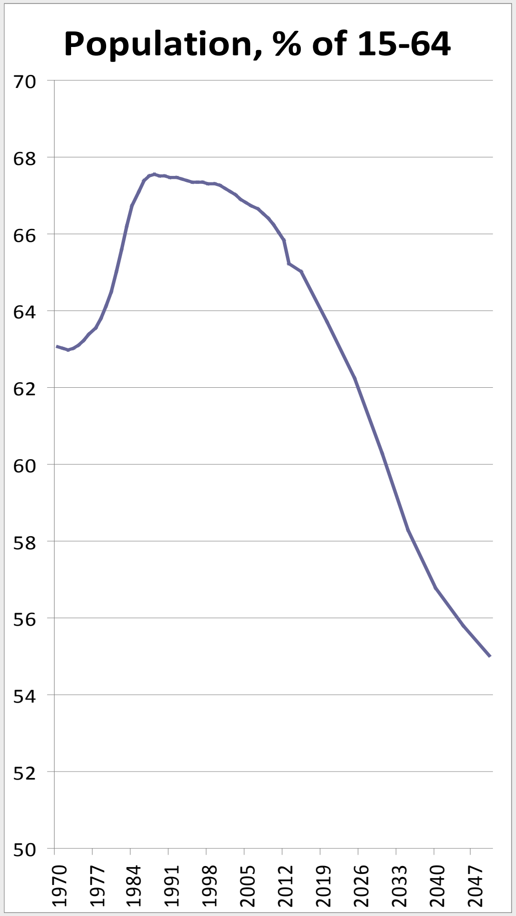
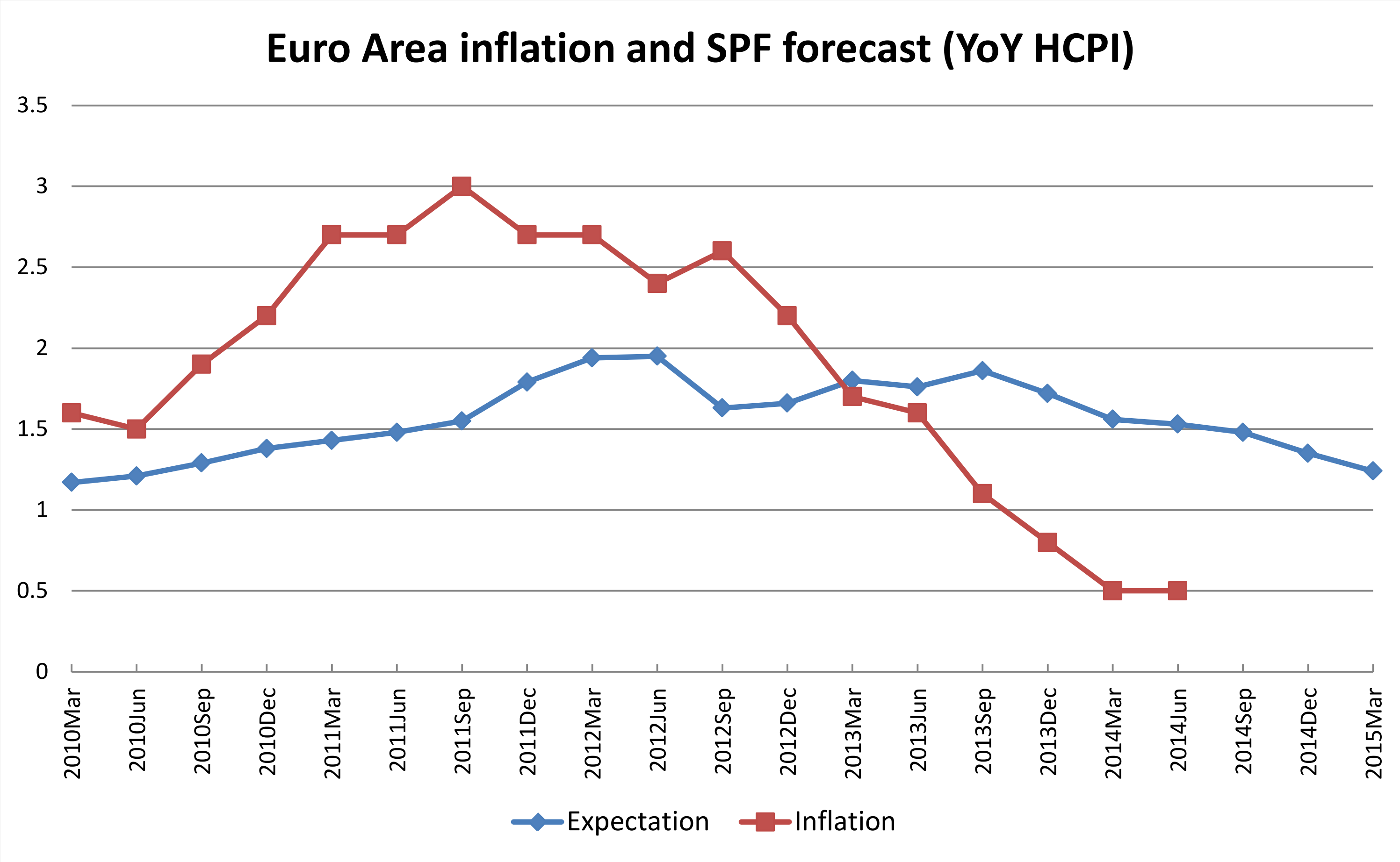






Actual inflation is below expectations



Source: ECB

As a consolation …

Real interest rates have been declining historically

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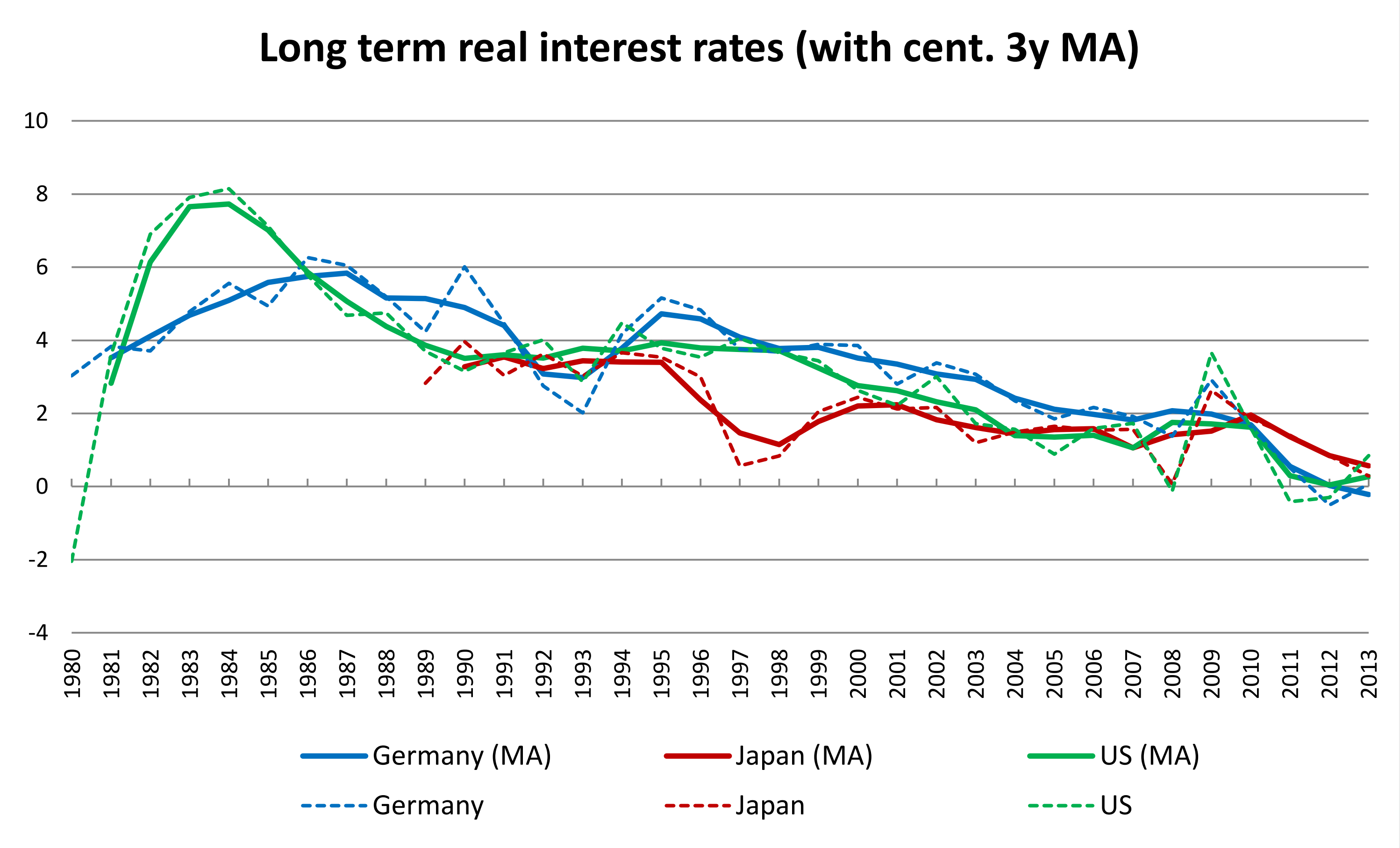
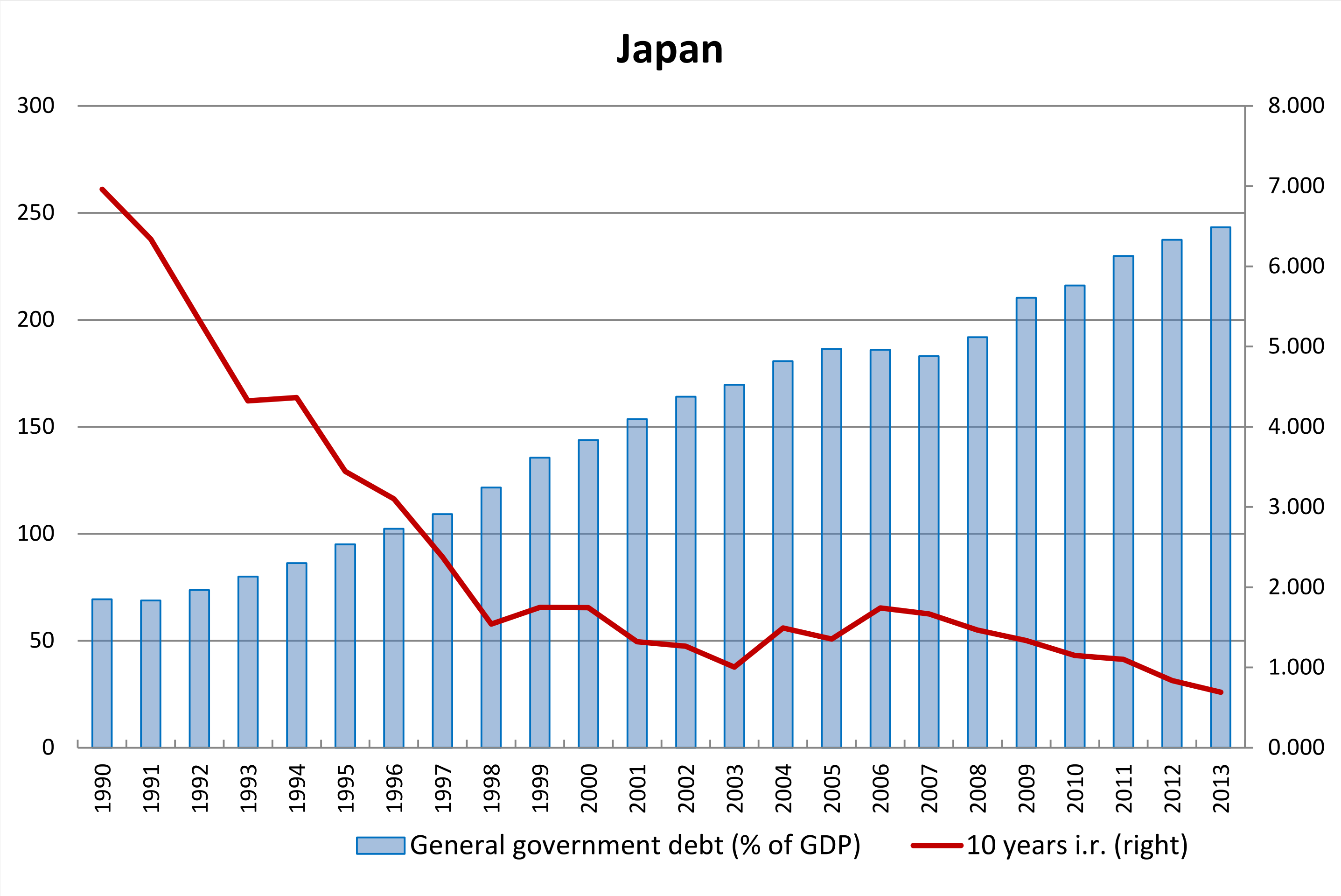


Source: OECD

And markets don't seem to care about debt



Source: IMF, FRED

And markets don't seem to care about debt

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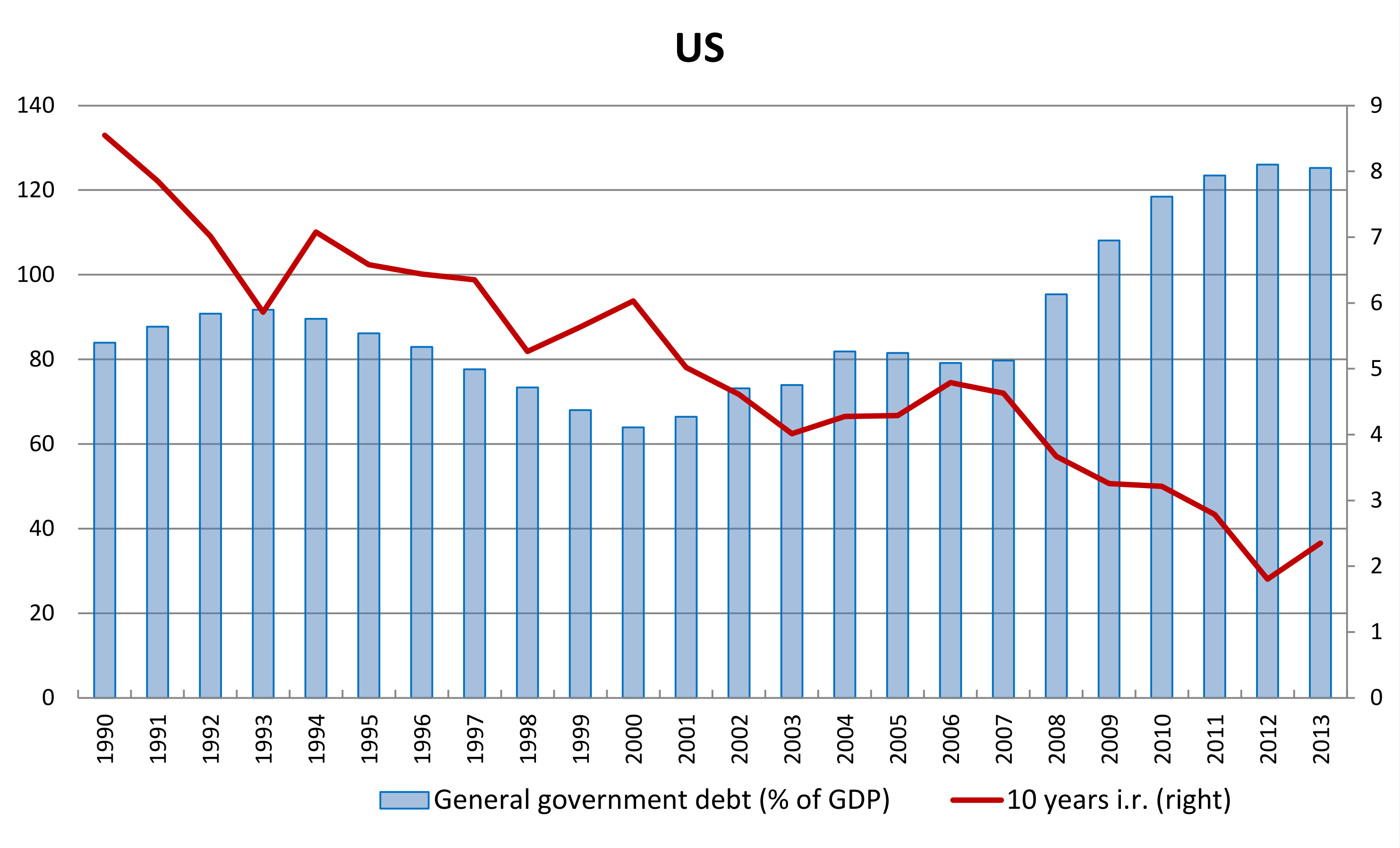
Source: IMF, FRED

And markets don't seem to care about debt



Source: IMF, FRED

But can we really relax?

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- Markets change their minds. Would the ECB be able to respond to a new self-fulfilling liquidity crisis like that of 2011/12?
- If potential output growth is in a declining trend so is the equilibrium real rate: the actual real rate – although low – may be above it
- Difficult to push it up at the lower bound and with declining inflationary expectations

Summing up

- The recession is not over in the euro area
- Some sovereigns will need to restructure – it may be messy given current institutional setup
- Delayed deleveraging by banks might lead to weak credit in the years to come

THE END

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