Europe’s Crisis

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Florence, May 9, 2012

Hint:
It's all about the banks

- To draw a line under its crisis, Europe needs to break two vicious spirals:
  - The sovereign-debt-banking system vicious spiral.
  - The contracting economy-banking crisis vicious spiral

The sovereign debt-banking crisis vicious spiral

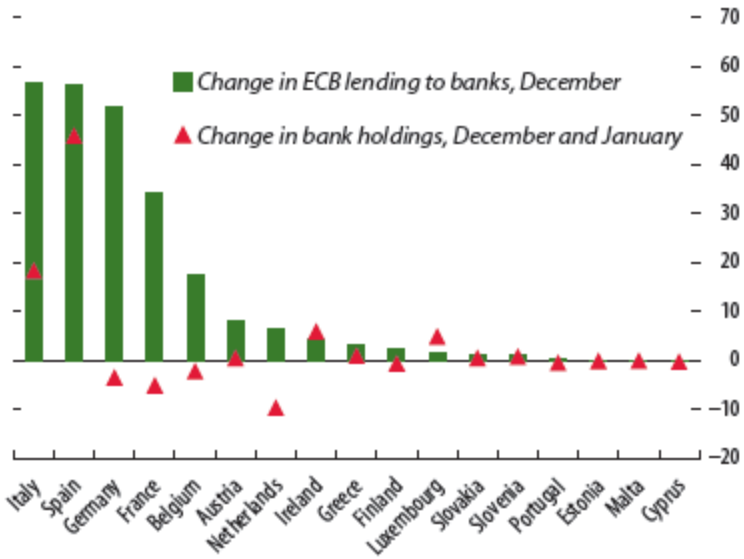
- Banks, as a result of moral suasion (read: “financial repression”) and favorable risk weights, load up on sovereign debt.
- Rising doubts about sovereign debt lead to credit downgrades and bank losses.
- But the resulting need to recapitalize the banks then only worsens the outlook for government debt.

What about LTRO, you might ask?

- Through LTRO 1 & 2, the ECB provided emergency liquidity against a very wide range of collateral for as long as 36 months.
- This took the specter of a funding (liquidity) crisis off the table.
- But it did not solve the sovereign debt crisis (something that it was not designed to do).
- Indeed, it made this particular vicious spiral worse by allowing Italian and Spanish banks to load up on their governments' bonds.

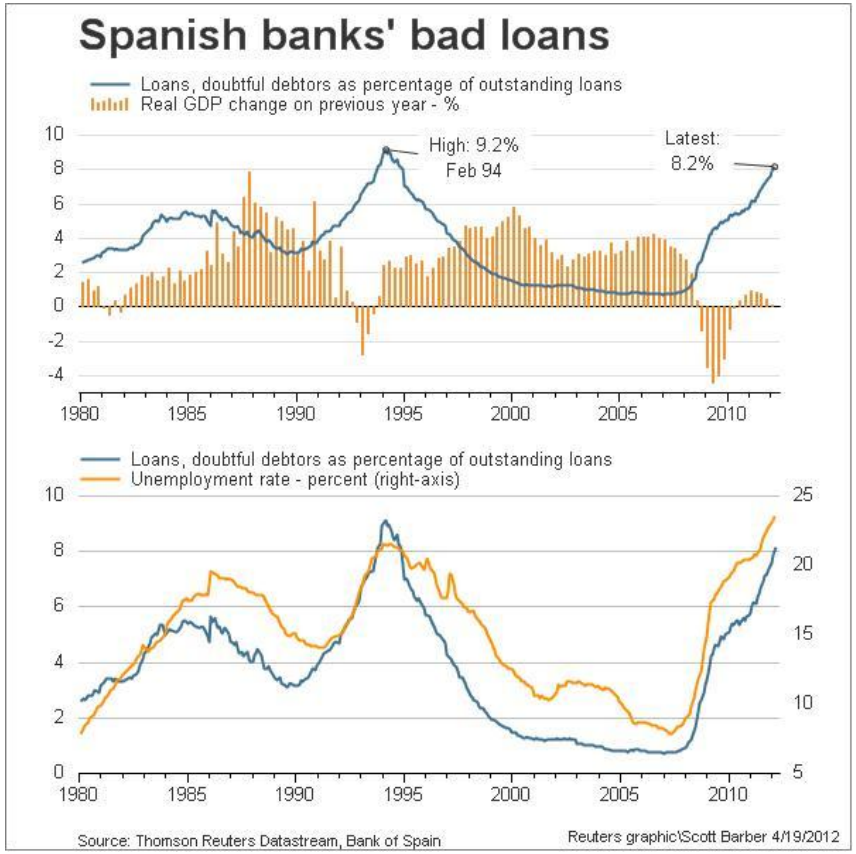
Figure 2.10. ECB Lending and Bank Holdings of Euro Area Sovereign Bonds, December 2011–January 2012

(In billions of euros)



The second vicious spiral connects recession and banking problems

- Recession makes for more nonperforming loans.
  - At right, “doubtful loans” are loans past due more than three months.
- Bad loans weaken bank balance sheets, making banks more reluctant to lend.
- Which worsens the recession, in turn worsening banking problems.
  - And not incidentally worsening the government’s finances.



So what must to be done?

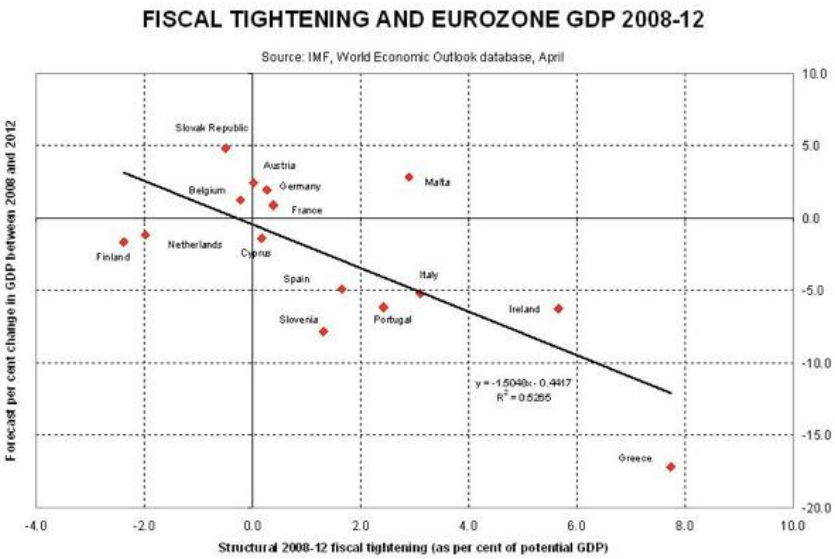
- If you agree with my diagnosis, the conclusion follows ineluctably:
- Bank recapitalization is the single most effective thing Europe can do to halt the operation of these vicious spirals.
  - Smoke and mirrors won't do.
  - €10 b. for Banxia won't cut it.
- And EFSF/ESM loans will help only if they are the joint liability of the shareholders, not if they are simply a liability of the Spanish government.
- I made this argument to Mme. Lagarde at Jackson Hole last summer. We may now be seeing movement.

The most important institution reform, in my view, is common bank regulation

- Real regulatory authority for the European banking authority.
  - Collapse of bank capital talks two weeks ago is a reminder of the problems with the status quo.
- A single resolution procedure and fund for bad banks.
  - I've been arguing this for a year.
  - I'm happy to hear speeches to this effect now from Mr. Draghi, Mr. Coure and Mr. Amussen.
  - But they continue to finesse two issues:
    - Where will member states come up with the €1-2 tr. needed? (Spanish banks alone may cost as much as €250 b. to recapitalize.)
    - And what about countries that are in the EU but outside the euro area?

And how's that fiscal consolidation working for you?

- Here is the percentage point decline in the cyclically-adjusted budget deficit from 2008 to 2012, together with the percentage change in GDP from 2008 to 2012.
  - With cyclical effects removed, we can think of this as the impact of policy on growth.
- Clearly, the effect is large.
- And so much for "expansionary fiscal consolidation."

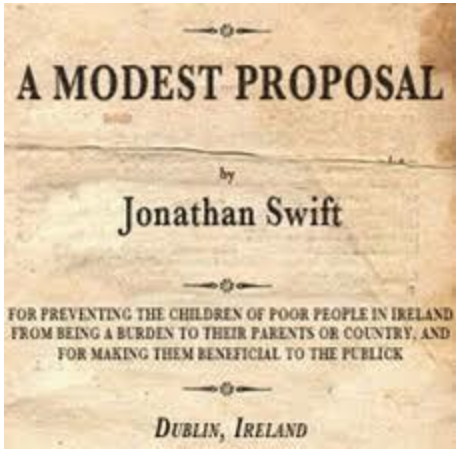


And that rebalancing?

- Relative to unsustainable 2007/8 levels, there has been rebalancing, but mostly through compression of Southern European imports from Germany.
- Now finally we seen Germany imports from Southern Europe above 2007/8 levels, but barely.

Economists know what should be done about this, of course

- Northern European countries with fiscal space should use it, at a minimum implementing balanced-budget increases in spending.
- Southern European countries should wed more short-term fiscal support with credible medium-term fiscal consolidation.
- (An additional €60 b. of off-budget EIB spending won't hurt, but it is a drop in the bucket.)
- And the ECB should do more to support economic growth.


A MODEST PROPOSAL

by

Jonathan Swift

FOR PREVENTING THE CHILDREN OF POOR PEOPLE IN IRELAND FROM BEING A BURDEN TO THEIR PARENTS OR COUNTRY, AND FOR MAKING THEM BENEFICIAL TO THE PUBLICK

DUBLIN, IRELAND

All this may be a mite bit controversial

- But Plan A is not working.
- And without a Plan B, Europe will be sucked back into its vicious spiral.
- Without growth, fiscal consolidation will not work. Banking problems will be back. At some point political support for painful reforms will dissolve.
- I find it scandalous that no one (not the ECB, not the Commission and not even the IMF) has fully spelled out a Plan B.
  - But, because I am a firm believer in the European project (and in the irreversibility of monetary union), I am still somewhere between confident and hopeful that this will happen.

And if the eurozone sticks to Plan A?

- Governments that have pursued austerity and structural reform, promising that growth would miraculously resume, will lose political support.
- The question, obviously, will then be whether their successors stay the course or unilaterally turn in a populist direction, abandoning the euro.
- My own work on the 1930s suggests that deep recessions do in fact breed support for populist, anti-system right-wing parties.

How, then, do I interpret last weekend's elections

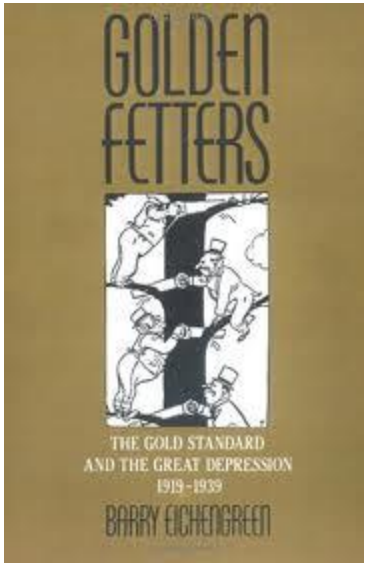
- Unavoidably, we will have to wait and see.
  - In France, it will be easier for Mr. Hollande to negotiate a Plan B than it would have been for Mr. Sarkozy, who would have had to go back on previous promises.
    - But Mr. Hollande will have to show that he is responsible in order to reassure Mrs. Merkel and Mr. Draghi.
  - In Greece, we saw a protest vote against austerity that is unlikely to produce a government.
    - We will now have to see whether responsible voters turn out in the next election, which will be a referendum on the euro.

That said, the current situation is different from the 1930s

- Unemployment is as high as in the 1930s (gulp!), but social safety nets are more extensive.
- Governments and societies will be reluctant to jeopardize the European project (there was no comparable political project in the 1930s).
- Governments and societies will be reluctant to jeopardize the single market (cross-border trade and lending had already collapsed in the 1930s).
  - There has been lots of posturing by the likes of Geert Wilders, but little action.
  - But I find it revealing that even though the Dutch government collapsed over austerity measures over a weekend in April, but the VVD then quickly reached agreement with three small former opposition parties to push through the proposed cuts.
  - Et vous, Mr. Hollande?

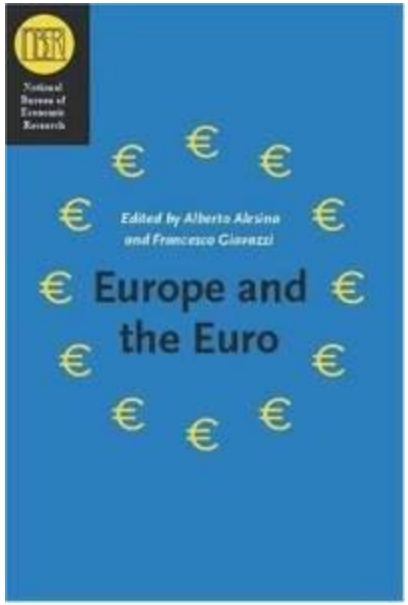
The current situation is also different in terms of the alternatives

- It is often argued that countries should exit the euro just as they exited the gold standard in the 1930s.
- I wrote the book on the latter, and the two are not the same.
- Exiting the euro will be significantly more expensive.



I was asked to write on euro exit in 2007 (how time flies…)

- There I argued it couldn't happen.
- Because the costs would be staggering, and no rational government would choose this alternative.
- I now appreciate that this conclusion was perhaps a bit overstrong.
- (I forgot that not all governments are rational.)
- But I think the point still stands.
  - It points to no euro collapse but to a lost decade absent a Plan B.



And longer term institutional reform?

- Over time, the euro-zone will have to strengthen its fiscal rules and assume joint responsibility for outstanding debts (just like all other monetary unions in history).
- But Mrs. Merkel and Mr. Draghi (contra Trichet) are right; fiscal union is a multi-year project.
  - In the short run, Europe needs growth so that governments can continue to fund themselves while long-run solutions are crafted – and so the political will to take the next step remains.

- Thank you.