



DG ECFIN

# EMU in times of economic and financial crisis

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1st Summer School on “EU Institutions and Policies” of the Veneto Region

Brussels, 17 July 2009



# Overview

1. Origins of the financial crisis
2. The impact on the financial markets and on the EU economy
3. The EU policy responses
4. SGP functioning in the crisis
5. The medium-term: exit strategies and potential growth
6. New EU Member States: economic and financial situation and euro prospects

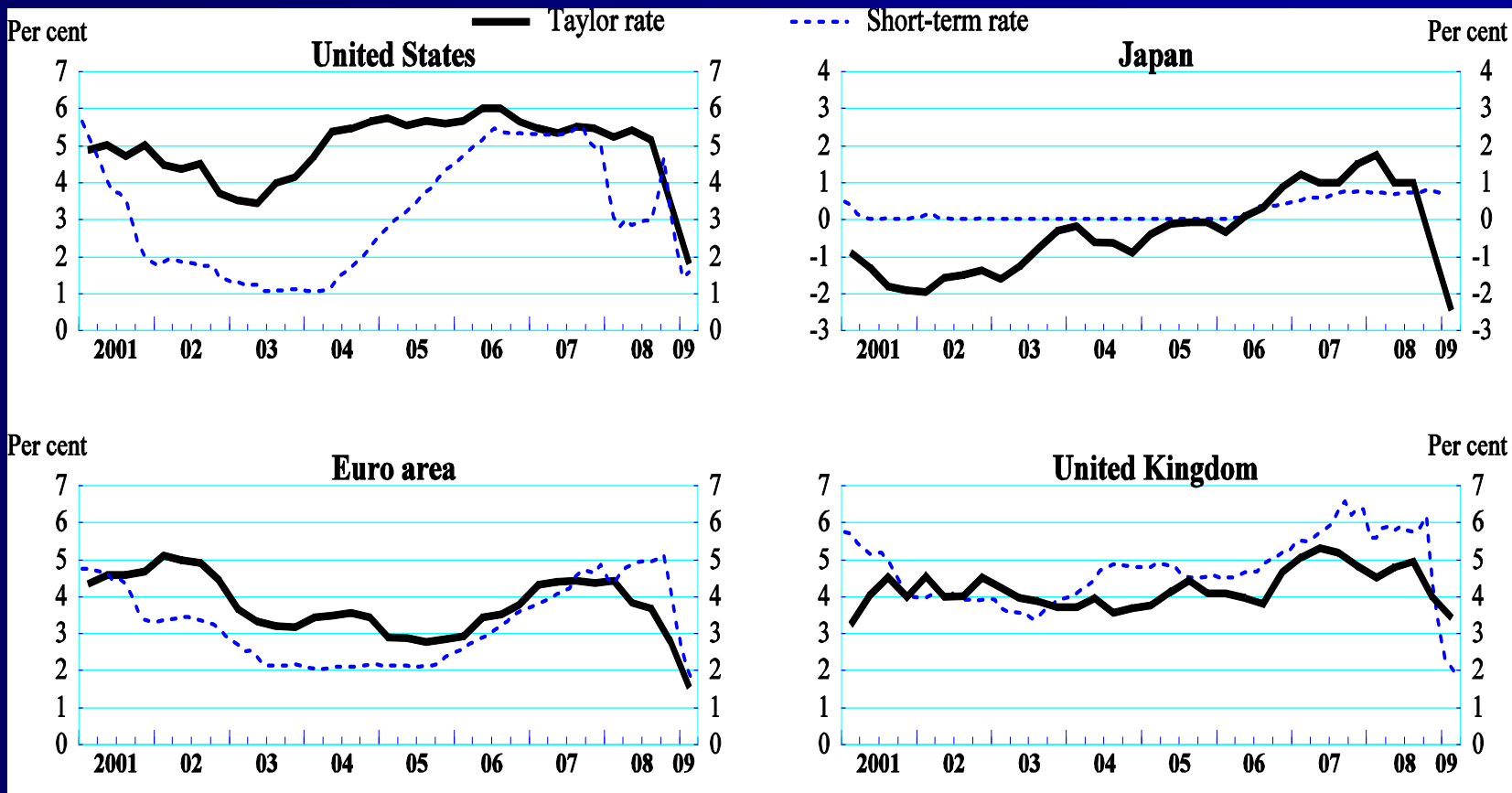


# 1. Origins of the financial crisis



# Macro factors

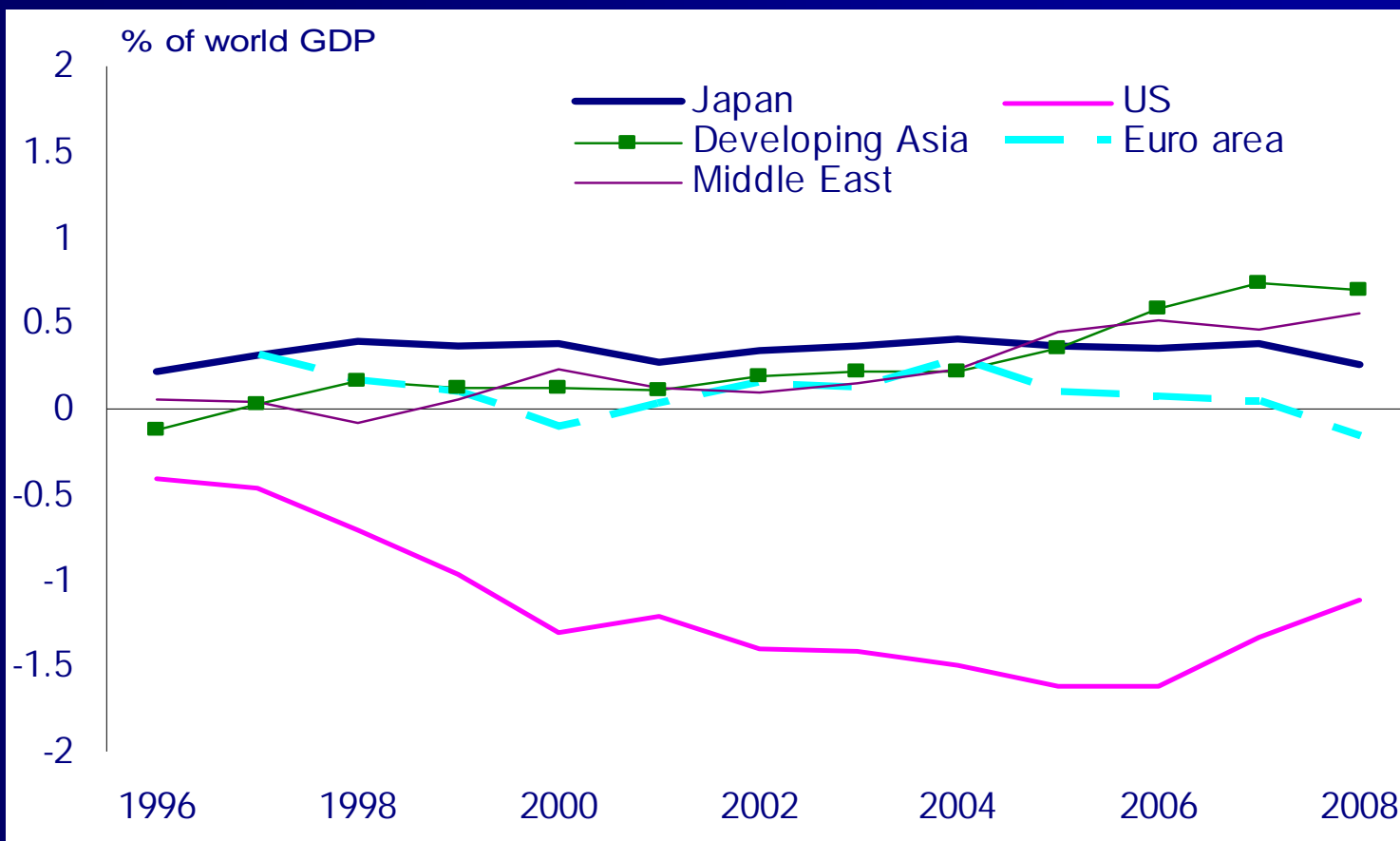
## *Too loose monetary policy*



Source: OECD



# Large global imbalances



Source: IMF, World Economic Outlook



## ... but also microeconomic factors

- ✓ Search for yield; increasing leverage
- ✓ Financial innovation
- ✓ Incentives structure
- ✓ Risk management ('liquidity risks')
- ✓ Supervisory deficiencies
- ✓ Role of rating agencies

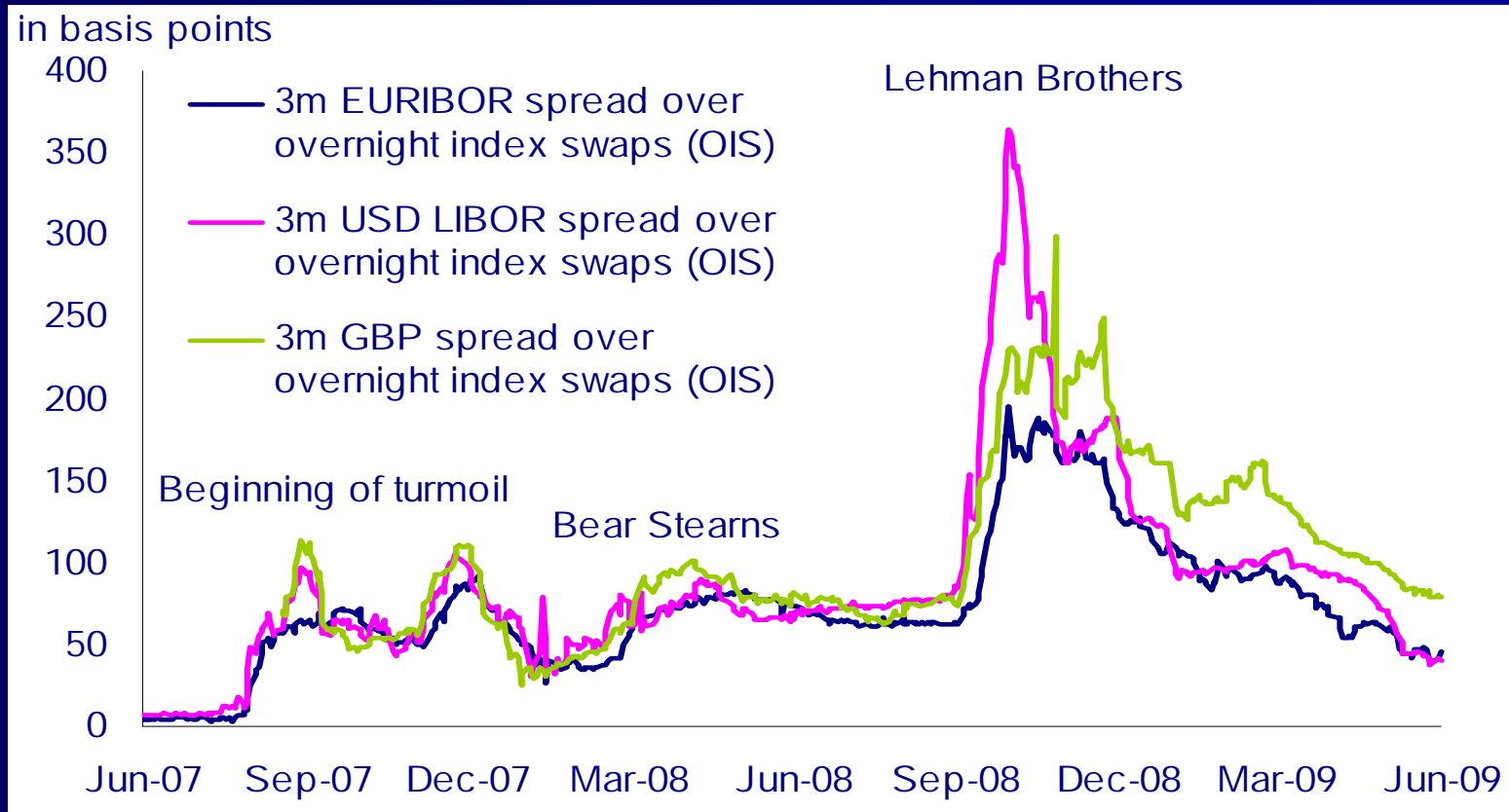


## 2. The impact on the financial markets and on the EU economy



# The collapse of Lehmann Brothers triggered a full-blown financial crisis

## Unprecedented money market stress

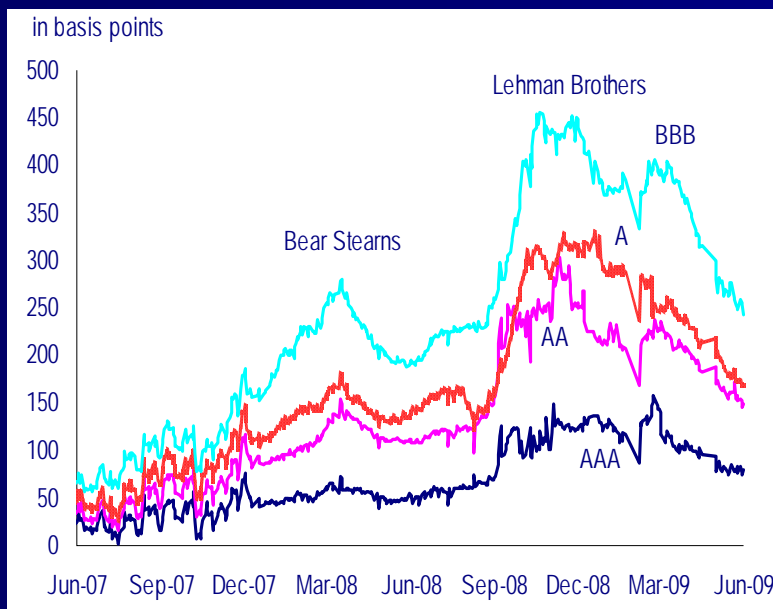


Source: EcoWin; Last value 2 June 2009

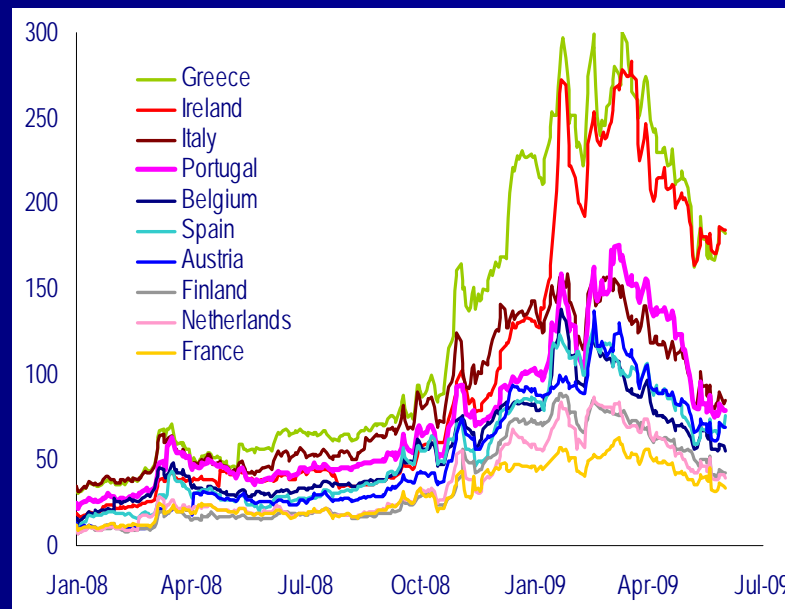


# Spreads of bond yields increased sharply

### Corporate bond spreads

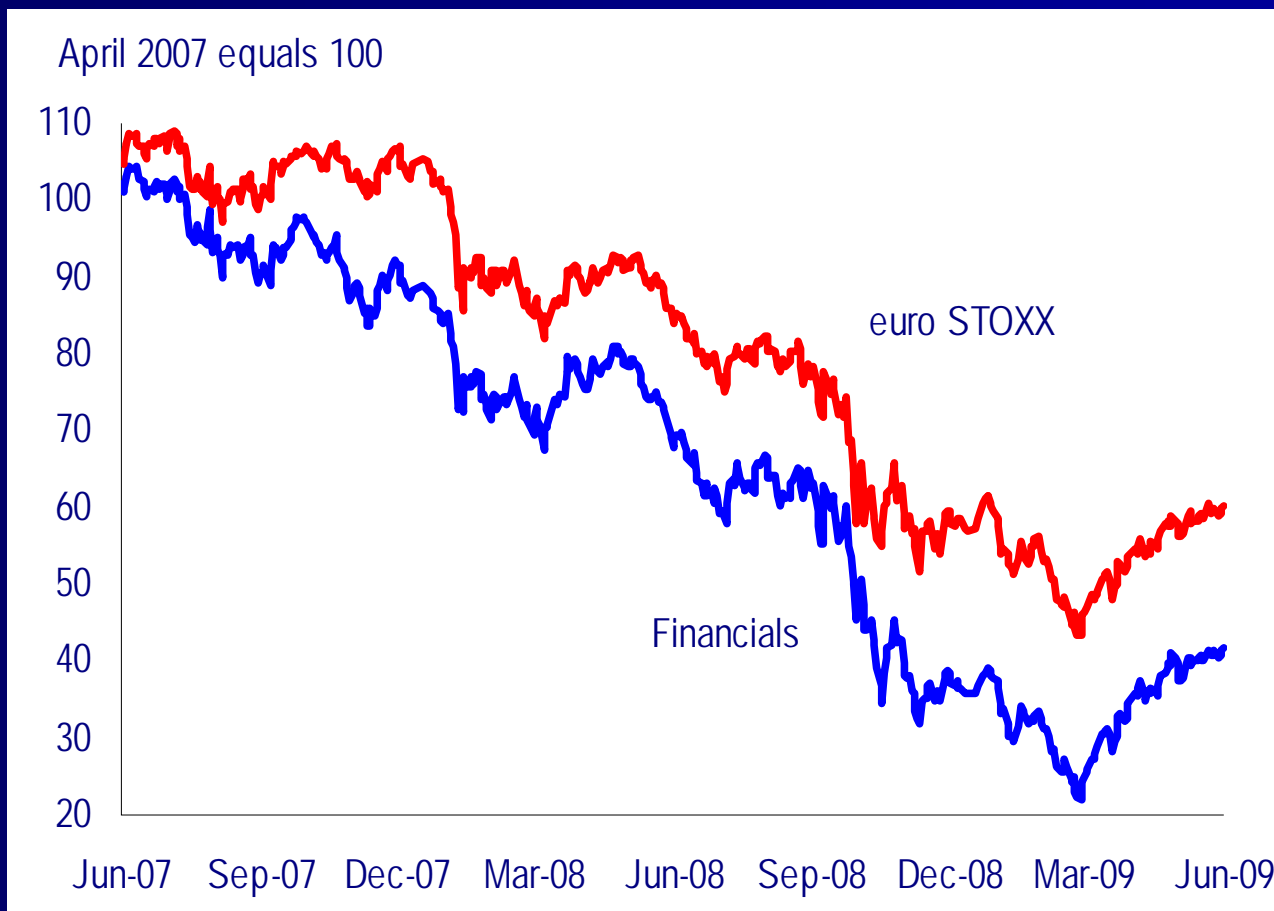


### Sovereign bond spreads





# Stock markets plunged



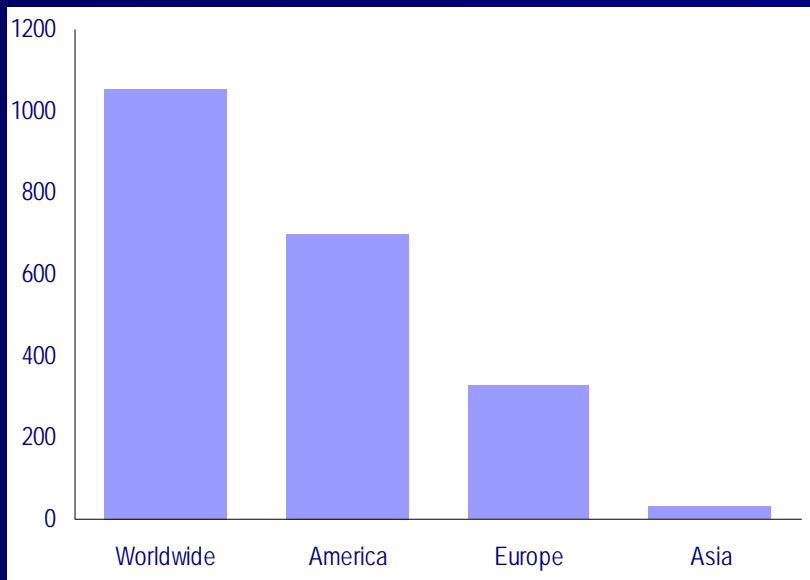
Source: Ecwin; Last value 11 June 2009



# Financial institutions proceeded with massive write-downs

## Effective write-downs

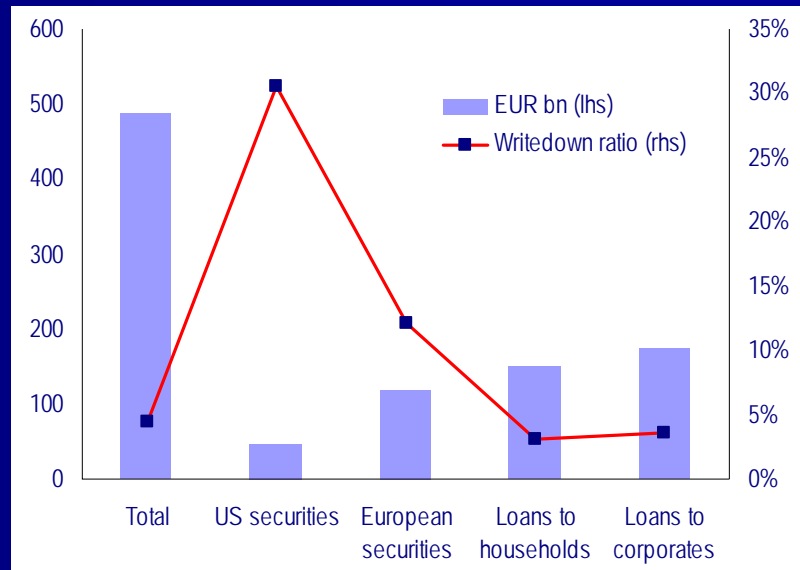
(All financial institutions) - EUR bn. (cut off date 28/05/2009)



Source: Bloomberg

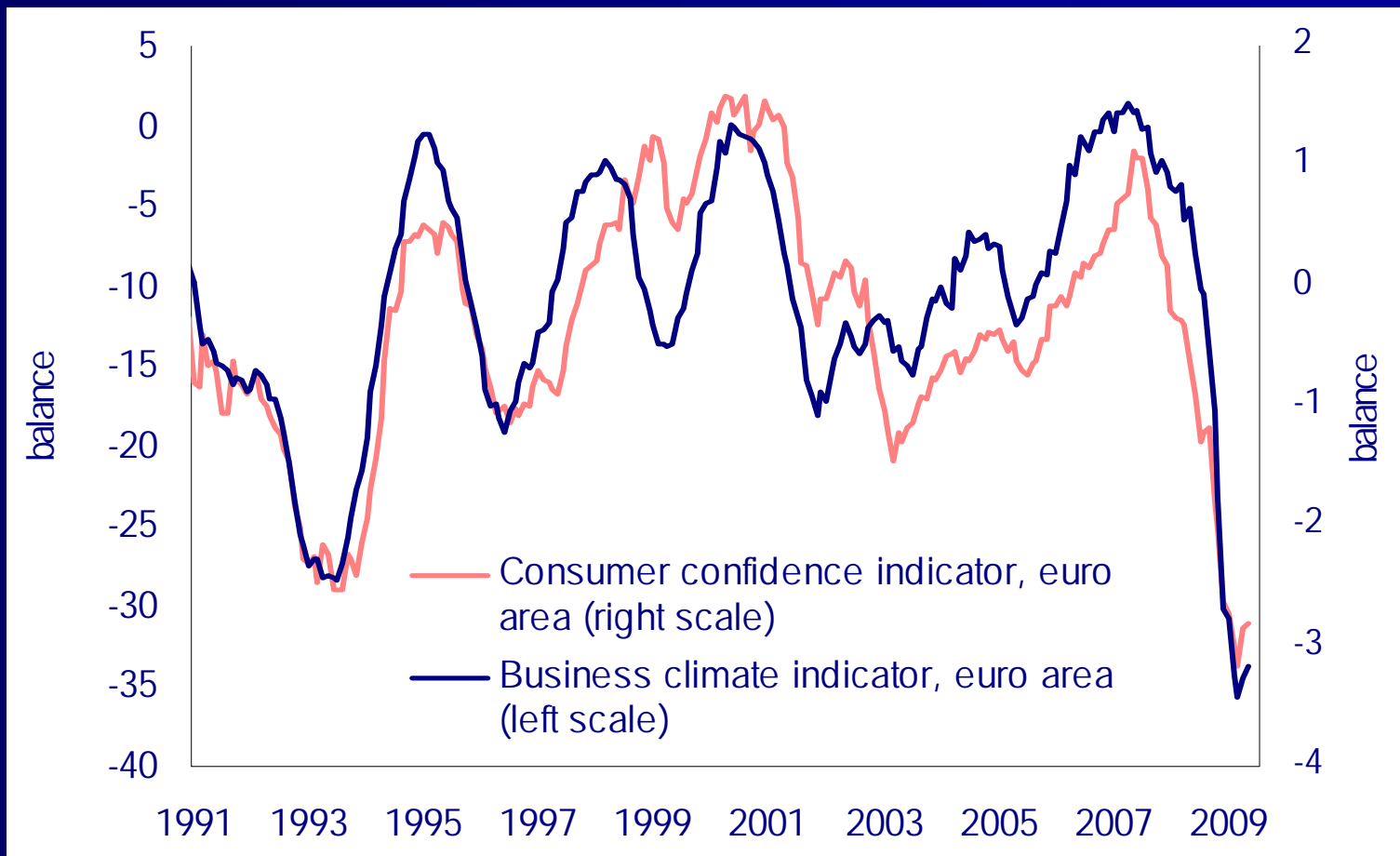
## EU write-downs estimates by origin of assets

All financial institutions. Total (past + forthcoming) EUR bn





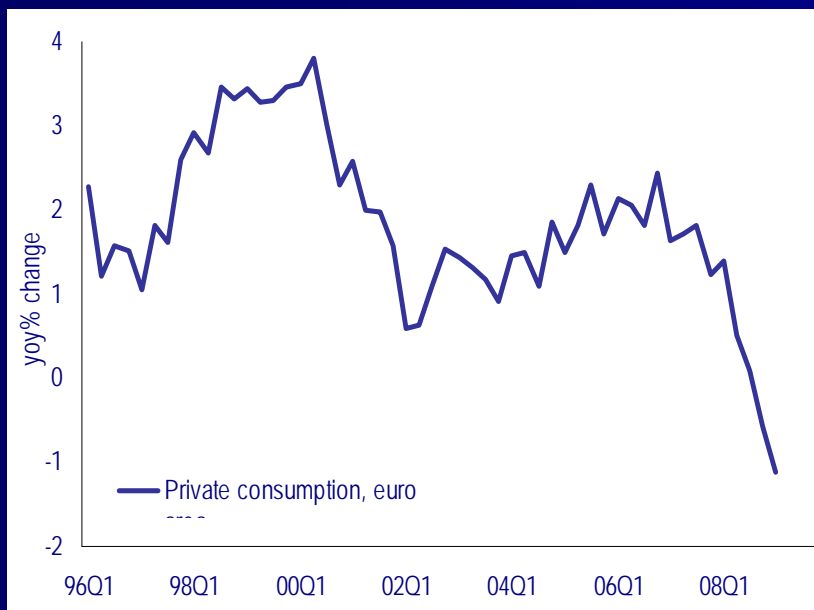
# Consumer and business confidence plummeted but bottoming out?



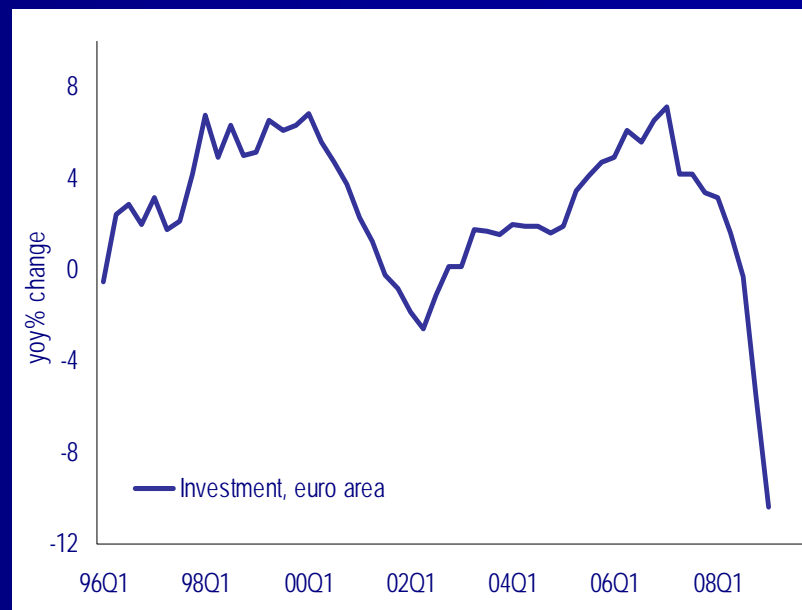
Source: DG ECFIN, last value: May 2009



# Contraction of consumption and investment



Source: European Commission, latest value: 2008Q4



Source: European Commission, latest value: 2008Q4



# Industrial production collapsed



Source: European Commission, last value: 2008Q4



# World trade collapsed but surveys point to turnaround

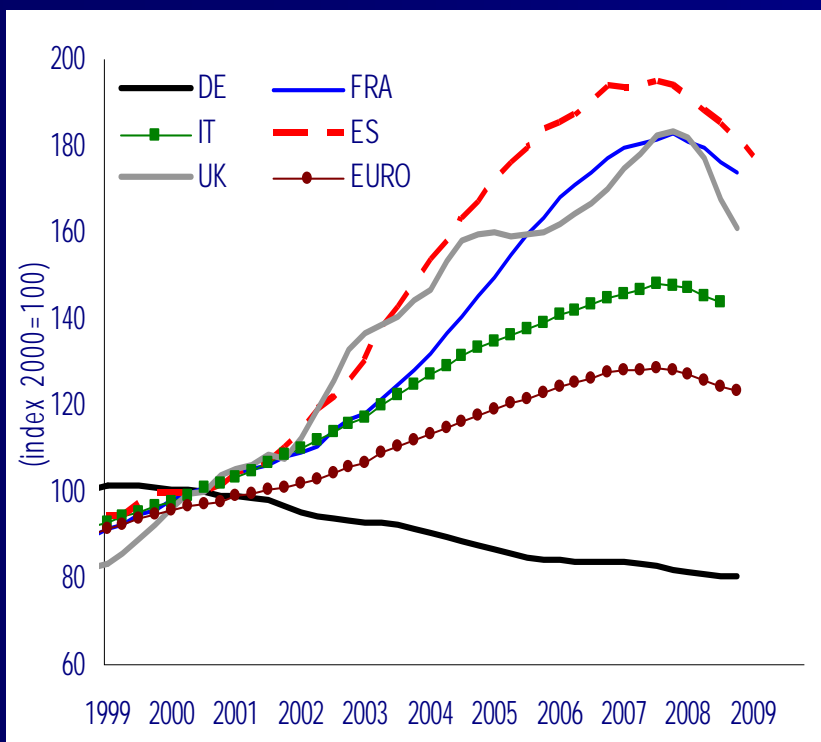


Source: CPB, last value: March 2009



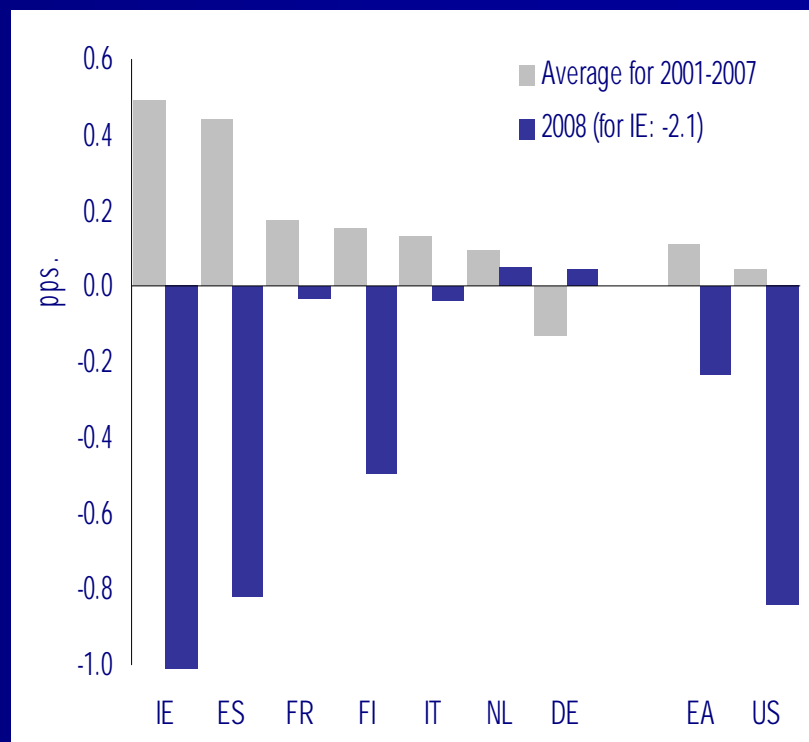
# Large housing corrections in some countries

Real house prices



Source: OECD

Contribution of housing investment to GDP growth



Source: European Commission



# Impact on the economy: What history tells us

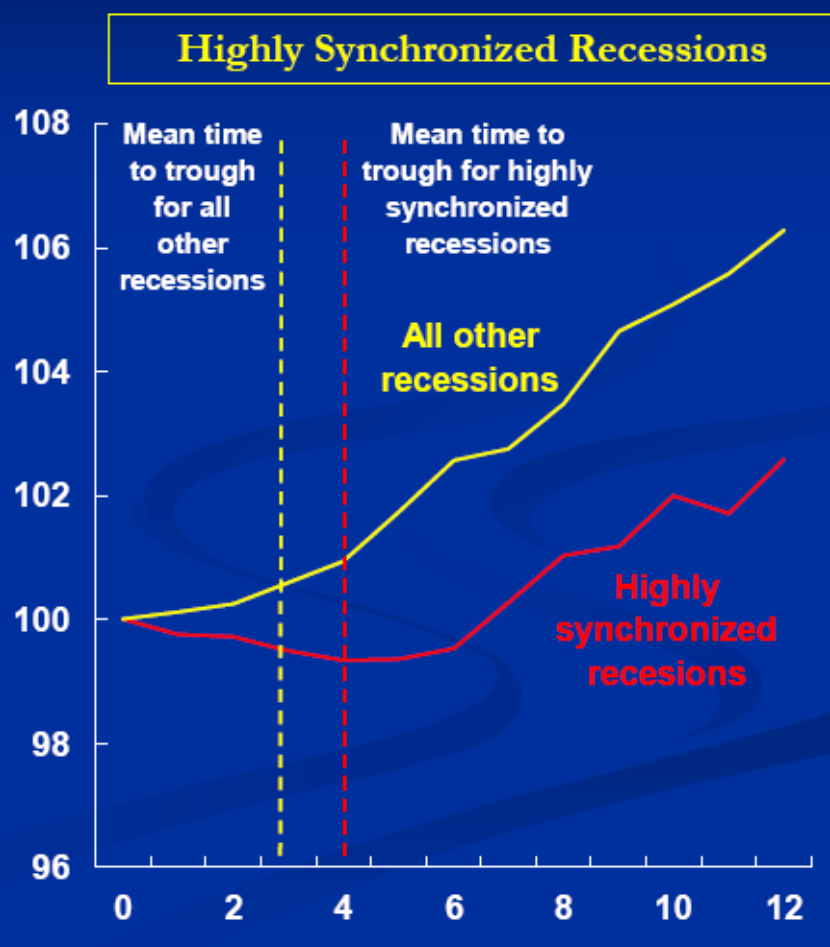
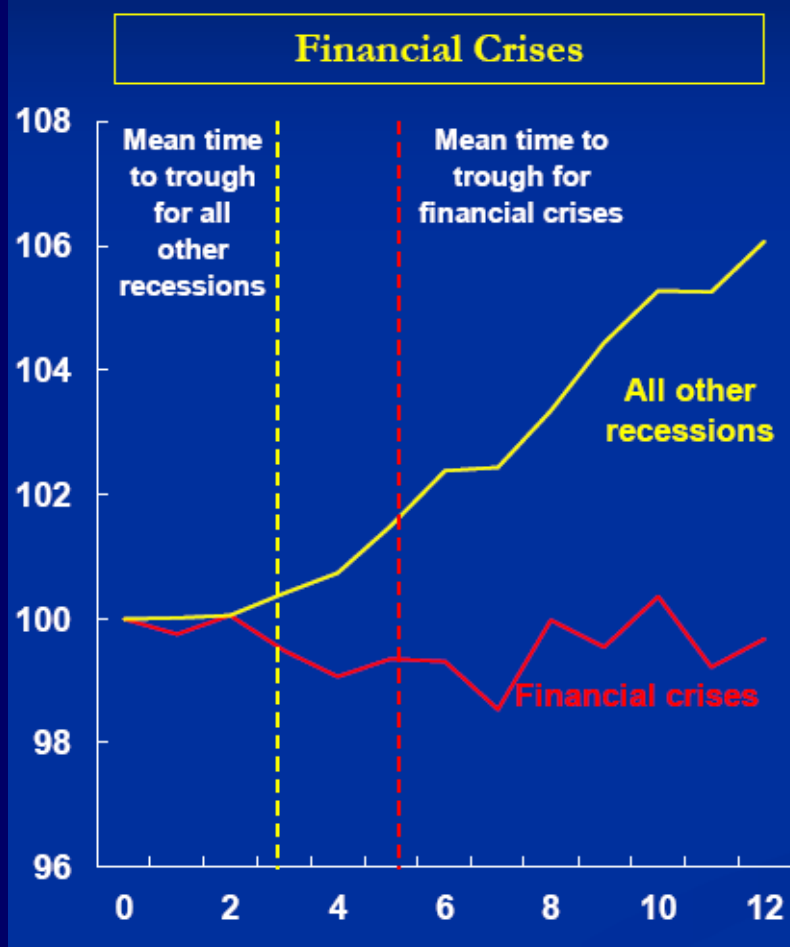
## Downturns following a banking crisis (% pts of GDP)

	<i>cumulative output gap</i>				<i>maximum fall in business investment</i>			<i>maximum fall in housing investment</i>		
	<i>year of banking crisis</i>	<i>in downturn following</i>	<i>average of other downturns</i>	<i>ratio</i>	<i>in downturn following the crisis</i>	<i>average of other downturns</i>	<i>Ratio</i>	<i>in downturn following the crisis</i>	<i>average of other downturns</i>	<i>ratio</i>
United States	1988	- 10,5	- 5,0	2,1	- 2,0	- 1,3	1,5	- 2,5	- 1,1	2,3
Japan	1997	- 11,9	- 6,3	1,9	- 5,5	- 4,3	1,3	- 5,4	- 1,0	5,2
Spain	1977	- 28,6	- 16,8	1,7	- 5,0	- 3,2	1,6	- 1,8	- 0,2	7,3
Finland	1991	- 27,1	- 8,1	3,3	- 9,1	-4,8	1,9	- 4,0	- 1,1	3,7
Norway	1991	- 11,0	- 5,2	2,1	- 5,6	- 6,5	0,9	- 3,2	- 1,3	2,4
Av.		- 17,8	- 7,4	2,1	- 5,5	- 3,8	1,6	- 3,5	- 1,0	4,0

Source: OECD, 2008



# Road to recovery may be long

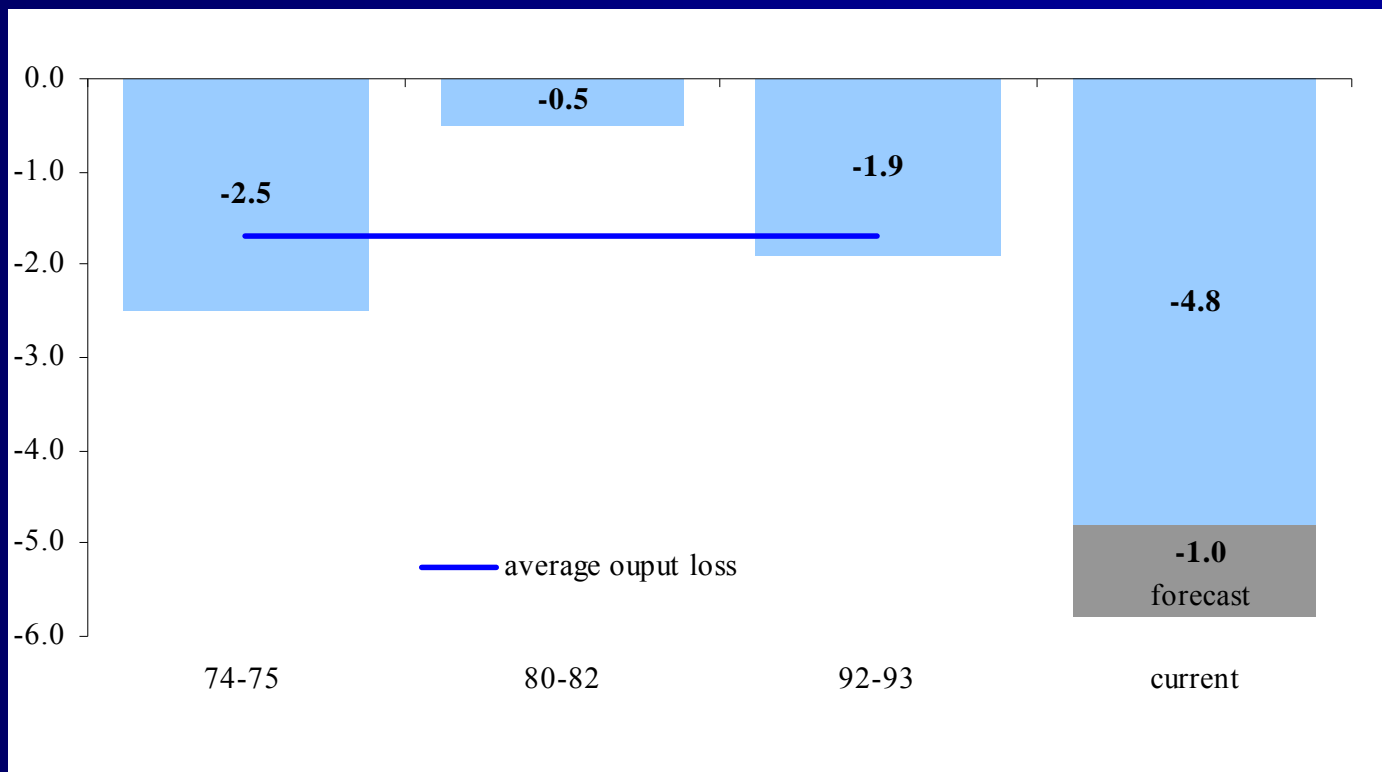


Source: IMF, World Economic Outlook



# Current recession set to be the deepest for decades

Total output loss from peak, %



Source: European Commission



# A synchronised, global recession

y-o-y % change	2007	2008		2009		2010	
		Spring	Jan-09	Spring	Jan-09	Spring	Jan-09
World	<b>5.1</b>	<b>3.1</b>	3.3	<b>-1.4</b>	0.5	<b>1.9</b>	2.8
US	<b>2.0</b>	<b>1.1</b>	1.2	<b>-2.9</b>	-1.6	<b>0.9</b>	1.7
Japan	<b>2.4</b>	<b>-0.7</b>	-0.1	<b>-5.3</b>	-2.4	<b>0.1</b>	-0.2
China	<b>13.0</b>	<b>9.0</b>	9.7	<b>6.1</b>	6.8	<b>7.8</b>	8.0
EA	<b>2.7</b>	<b>0.8</b>	0.9	<b>-4.0</b>	-1.9	<b>-0.1</b>	0.4

Source: European Commission



## Grim outlook in the euro area

yoy % change	Italy			Euro area		
	2008	2009	2010	2008	2009	2010
GDP	-1.0	-4.4	0.1	0.8	-4.0	-0.1
Consumption	-0.9	-1.7	0.2	0.5	-0.9	-0.3
Total investment	-3.0	-12.3	-0.6	0.0	-10.4	-2.7
Employment	-0.1	-3.3	-0.6	0.7	-2.6	-1.5
Unemployment rate (% labour force)	6.8	8.8	9.4	7.5	9.9	11.5
Inflation	3.5	0.8	1.8	3.3	0.4	1.2
Government balance (% of GDP)	-2.7	-4.5	-4.8	-1.9	-5.3	-6.5
Government debt (% of GDP)	105.8	113.0	116.1	69.3	77.7	83.8
Current account balance (% of GDP)	-3.0	-2.6	-2.7	-0.7	-1.2	-1.3

Source: European Commission



# Considerable uncertainties

	Downside risks	Upside risks
External	<p>Negative feedback loop from deteriorating real economy to financial sector</p> <p>Protectionism</p> <p>Disruptive exchange-rate developments</p>	<p>Stronger impact on confidence of recovery packages</p> <p>Faster adjustment in global inventory cycle, US housing sector, recovery in Emerging Markets (incl. China)</p> <p>Commodity prices weakening further</p>
Domestic	<p>Negative feedback loop from deteriorating real economy to financial sector</p> <p>External/domestic vulnerabilities in some MS exacerbated by current crisis</p>	<p>Stronger impact on confidence of recovery packages</p> <p>More favourable consumer response to lower inflation</p>

Source: European Commission



## 3. The EU policy response

- 3.1. Central Bank actions**
- 3.2. Government financial rescue packages**
- 3.3. Towards a new EU financial architecture**
- 3.4. The European Economic Recovery Plan (EERP)**



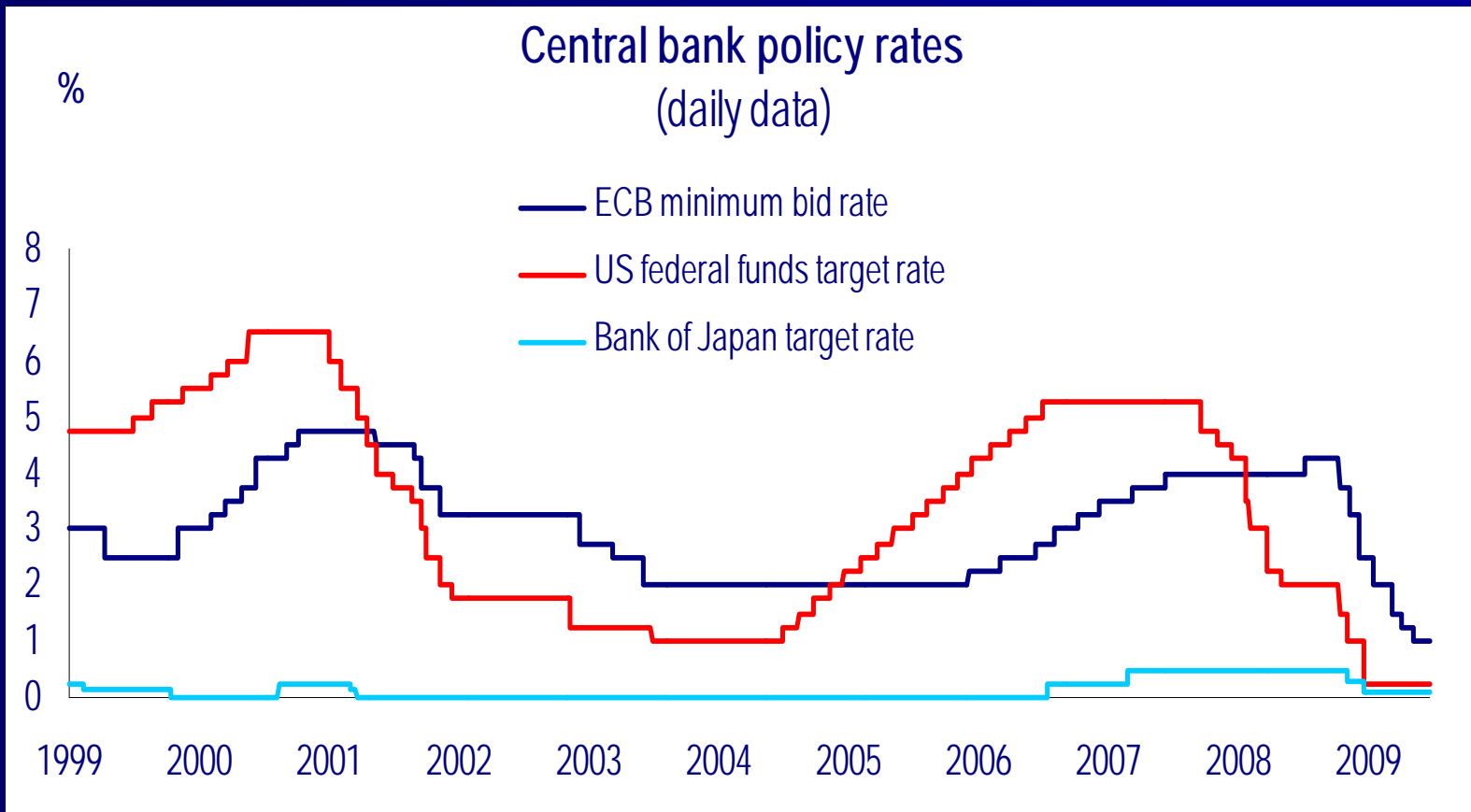
## Conventional Tool (1)

### Prompt and decisive interest rate cuts:

- ✓ A cumulative 325 bps reduction between since October 2008, from 4.25% to presently 1.0%
- ✓ The move fully in line with the ECB's strategy (receding inflationary pressures and the abrupt contraction in the economic activity)
- ✓ The ECB's definition of price stability has proved to be an asset, acting as a safeguard against both high inflation and deflation



# Conventional Tool (2)



Source: EcoWin

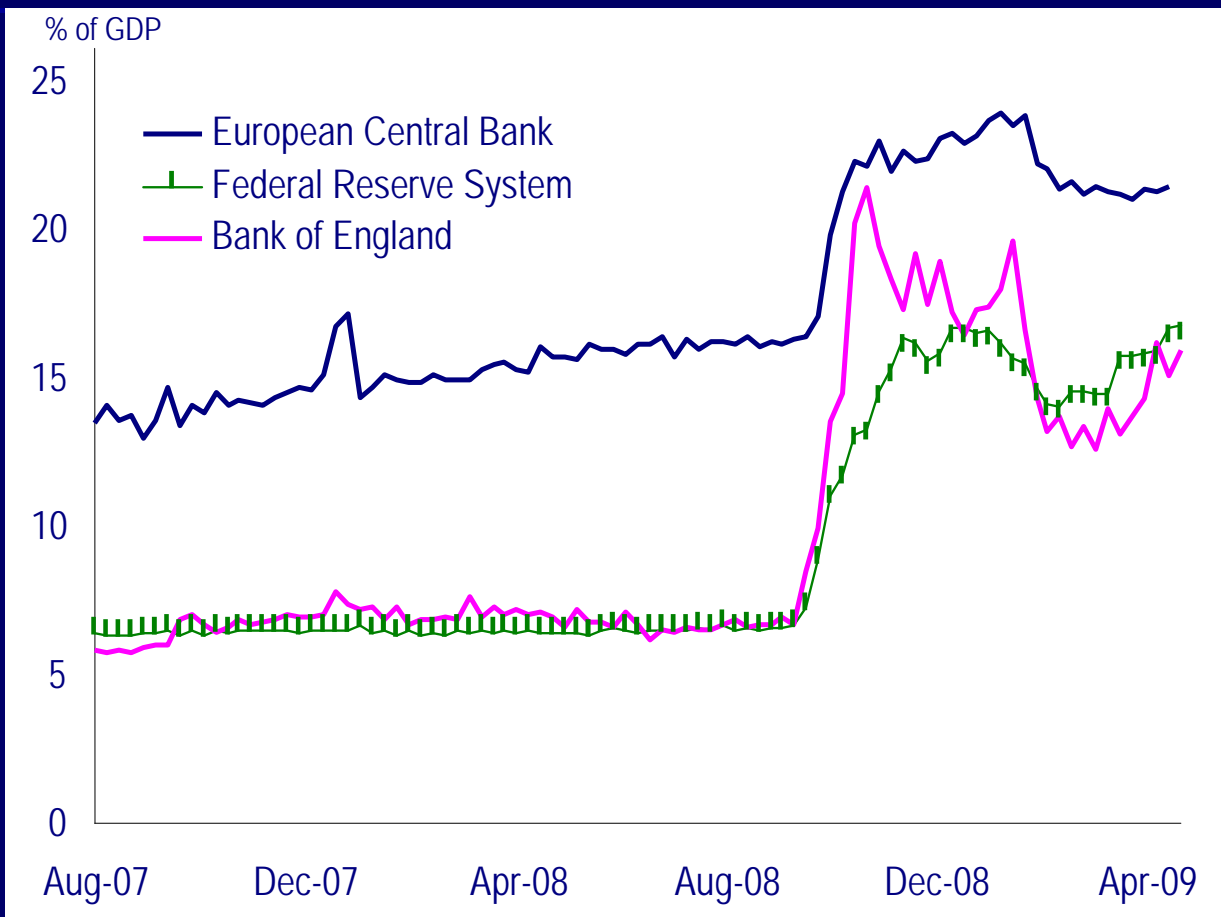


## Unconventional Tools (1)

- 1) Switch from variable-rate to fixed-rate tender procedures with full allotment
- 2) Changes in the interest rate corridor
- 3) Temporary extension of the list of eligible collateral
- 4) Introduction of 6-month LTROs and 12-month VLTROs
- 5) US dollar injections  
repos with 7-day, 28-day and 84-day maturity, introduction of a swap line between the Fed and the ECB
- 6) Provision of the euro liquidity to foreign financial institutions  
Hungary's central bank, Poland's central banks (repos)  
SNB, the Fed and Riksbank (swaps)
- 7) Attribution of eligible counterparty status to the EIB
- 8) Purchases of euro-denominated covered bonds (EUR 60 bn)



# Unconventional Tools (2) - Balance Sheet Comparison



Source: European Commission, FED, ECB, BoE



## A set of measures to support financial stability

- ✓ Guarantee schemes
- ✓ Capital injections
- ✓ Impaired asset purchases
- ✓ Nationalisations

## Other measures to support financial stability

- ✓ Increased depositor protection
- ✓ Restrictions on short selling of equities
- ✓ Changes in accounting rules



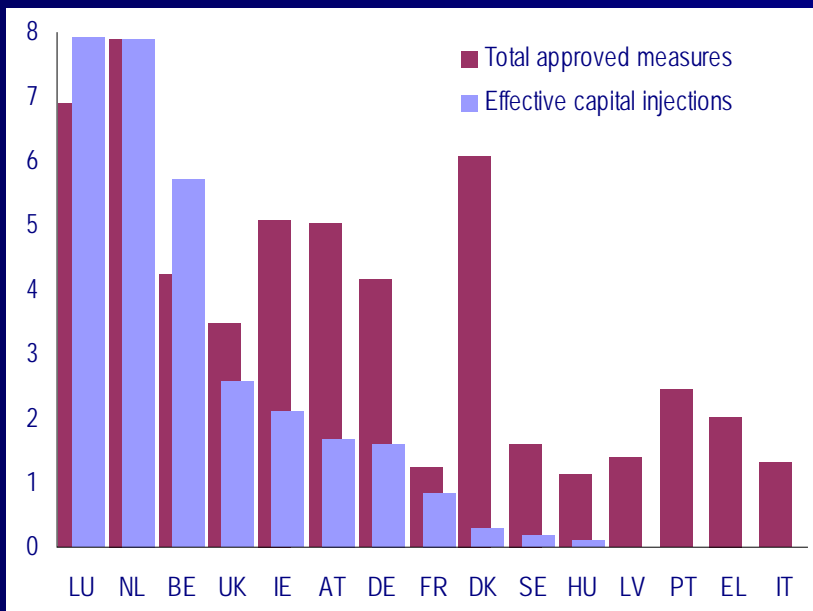
	Recapitalisation		Guarantee on bank liabilities		Relief of impaired asset		Liquidity and bank funding support		Total	
% of 2009 GDP	Total measures approved	Effective measures	Total measures approved	Effective measure	Total measures approved	Effective asset relief	Total measures approved	Effective measures	Total measures approved	Total effective measure
<b>EA</b>	3.0	1.9	20.5	8.7	0.4	0.4	2.5	2.6	<b>24.6</b>	<b>12.0</b>
<b>EU</b>	2.9	1.8	24.6	8.1	0.6	0.6	0.5	0.8	<b>30.5</b>	<b>13.0</b>

- i. Restoring normal functioning of financial markets is a necessary condition for the success of any exit strategy
- ii. Immediate priority: reduce the uncertainty over the quality of assets in banks' balance sheets
- iii. Medium-term objective: restore the profitability in the banking sector without compromising the efficiency
- iv. State aid should be made conditional to restructuring and an orderly exit of the government from the banking sector across MS should be envisaged.

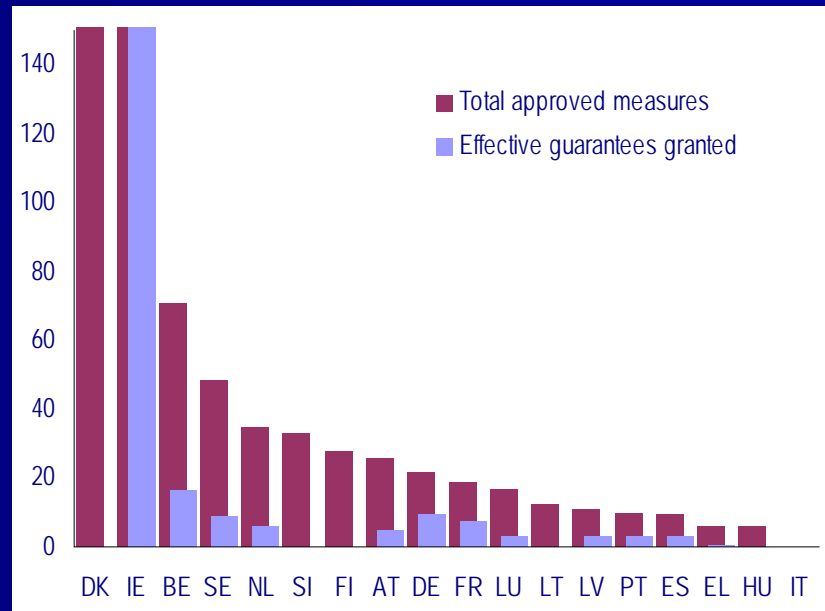


# Capital injections and guarantees on bank liabilities (in % of GDP)

### Capital injections



### Guarantees of bank liabilities



Source: European Commission



## Preliminary assessment:

- ✓ Member States have implemented sizeable support measures
- ✓ Measures have been effective in stabilising markets
- ✓ Banking sector remains under stress
- ✓ Need to deal with impaired assets and clean banks' balance sheets



## Towards a new EU financial architecture

- ✓ **Ensuring reinforced regulation**
  - i. Increasing transparency, incl. clear and timely disclosure
  - ii. Enhancing and enforcing independent risk control mechanisms
  - iii. Promoting proper risk-management incentives regarding securitisation
  - iv. Strengthening capital adequacy rules
  - v. Extending regulatory framework (derivatives markets, hedge funds)
  - vi. Reducing pro-cyclicality – Basel II, valuation
  
- ✓ **Ensuring adequate supervision**
  - i. Reinforcing prudential framework
  - ii. Developing early warning system
  - iii. Designing early intervention scheme
  - iv. Establishing integrated EU system of supervision (Larosière Report)



## Towards a new EU financial architecture

Building on the recommendations of the de Larosière Group, the Commission proposes a new Supervisory framework for the EU

### On macro-prudential supervision:

Establishment of a European Systemic Risk Board (ESRB) that will:

- collect and analyse all information relevant for monitoring and assessing potential threats to financial stability that arise from macro-economic developments and developments within the financial system as a whole;
- identify and prioritise such risks;
- issue risk warnings where risks appear to be significant;
- where necessary give recommendations on the measures to be taken in reaction to the risks identified;
- monitor the required follow-up to warnings and recommendations, and
- liaise effectively with the IMF, the FSB and third country counterparts.



# Towards a new EU financial architecture

## On micro-prudential supervision:

Establishment of a European System of Financial Supervisors (ESFS) that will:

- ensure a single set of harmonised rules
- ensure consistent application of EU rules
- ensure a common supervisory culture and consistent supervisory practices
- ensure a coordinated response in crisis situations
- collect micro-prudential information
- undertake an international role
- it will be given the responsibility for the authorisation and supervision of certain entities with pan-European reach, e.g., credit rating agencies and EU central counterparty clearing houses



# The European Economic Recovery Plan

## Main features:

- i. Overall size: 1.5 % of GDP
- ii. Coordinated stimulus: at Member State level size determined by fiscal space
- iii. Timely, temporary, targeted – sectors most hit (e.g. construction)
- iv. Time-consistency: ST (stabilisation); LT: (growth; job creation; social protection; green economy)
- v. Credible commitment to medium-term fiscal adjustment and sustainability



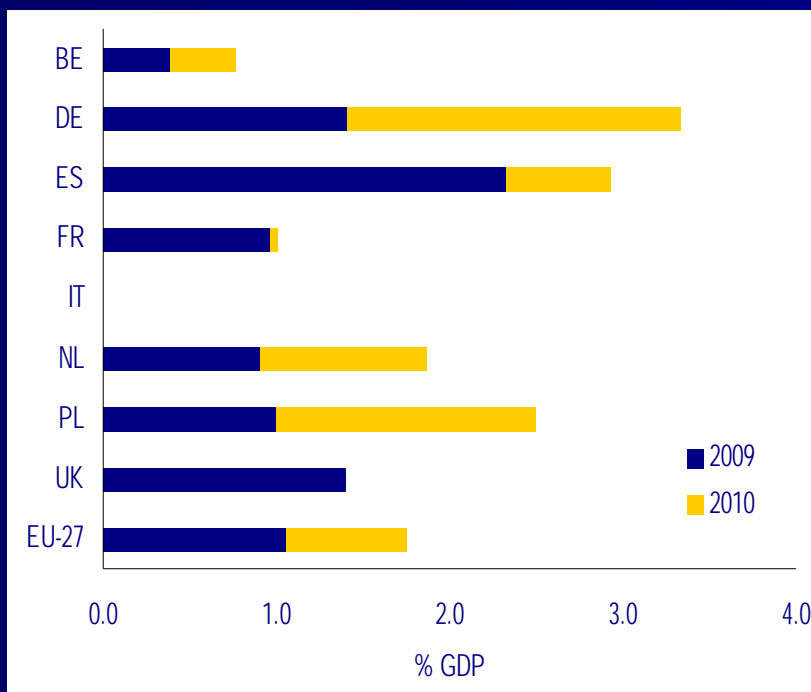
## (iii) The European Economic Recovery Plan Fiscal stimulus (June 2009)

- ✓ Fiscal stimulus of 5% of GDP combining discretionary spending and automatic stabilisers
- ✓ Member States' contribution of cca. 1.8% of GDP, with considerable variability across Member States, both in terms of size and focus (*hyperlink*)
- ✓ Measures are broadly in line with principles (3Ts)
- ✓ Measures have contributed to put a floor to the recession
- ✓ The EERP measures are estimated to contribute some 1% to GDP in 2009.

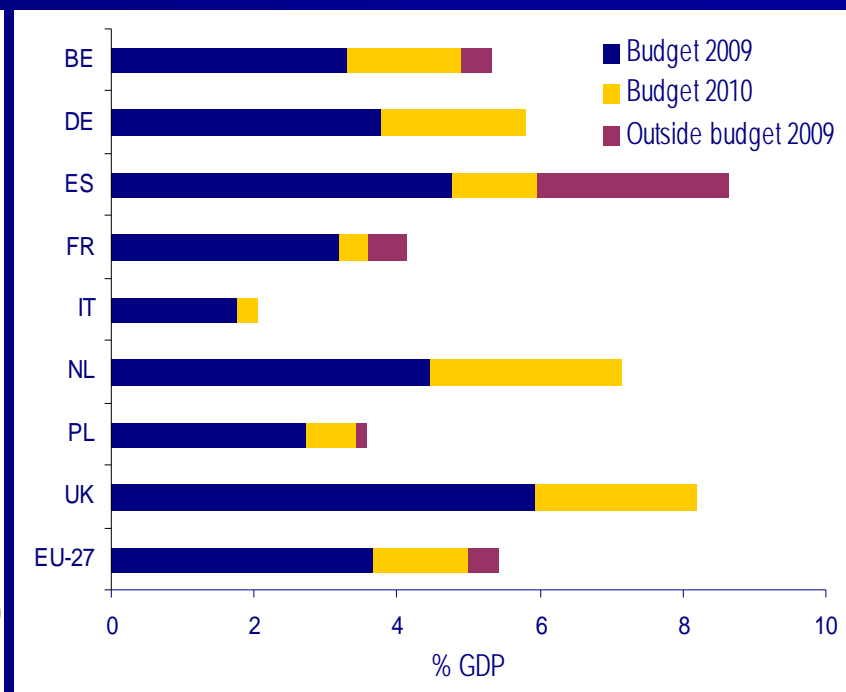


# (iii) The European Economic Recovery Plan

### The fiscal stimulus package



### Total budgetary support to economic activity

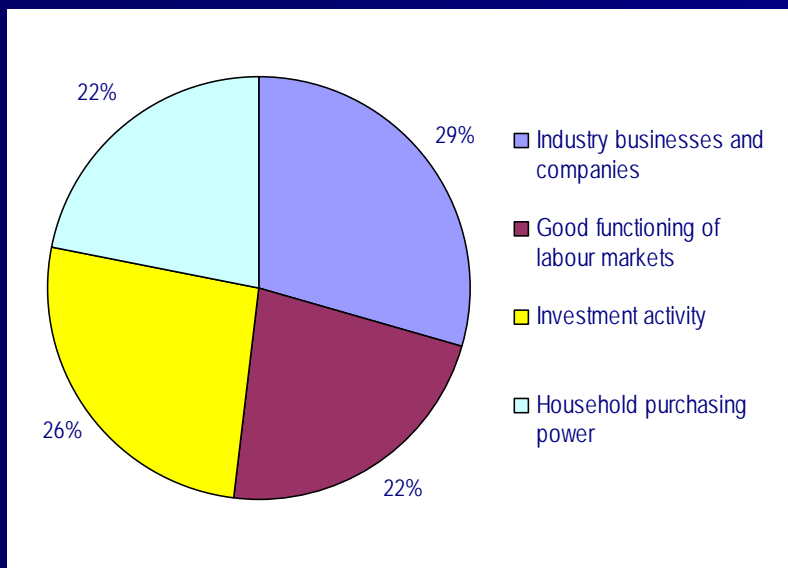


Source: European Commission

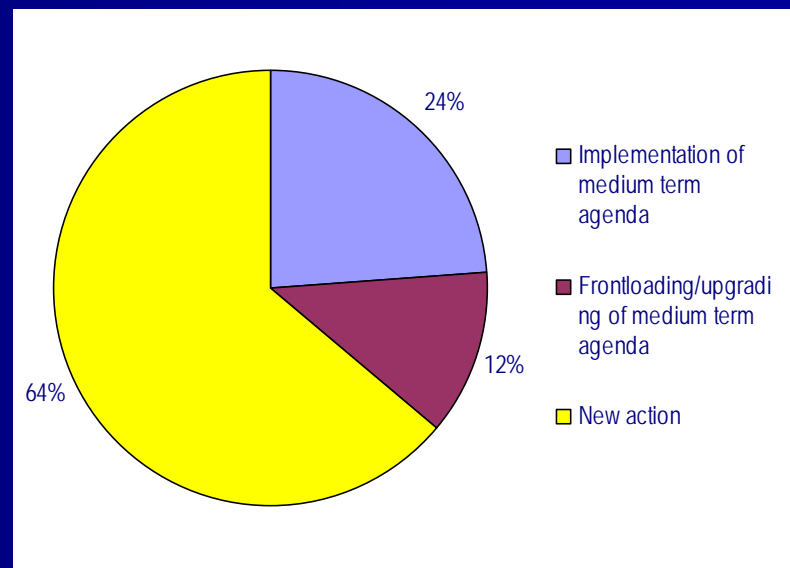


# (iii) The European Economic Recovery Plan: structural support

The EERP measures by type of support (EU27)



Measures by type of action (EU 27)



Source: The EPC-ECFIN Structural reform stimuli database, DG ECFIN analysis

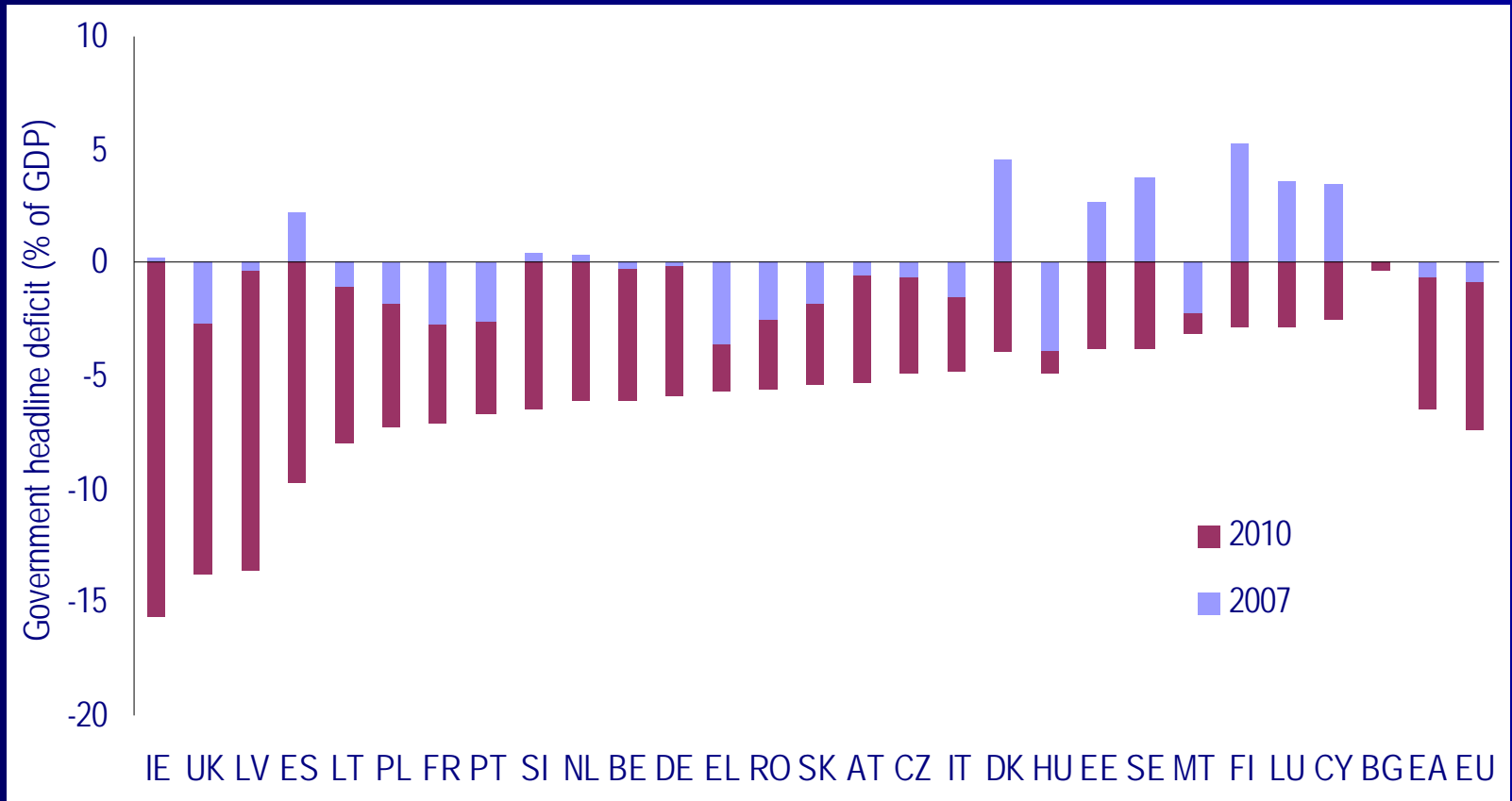


## 4. SGP functioning in the crisis



# Sharply deteriorating public finances

## General government headline deficit (% of GDP)

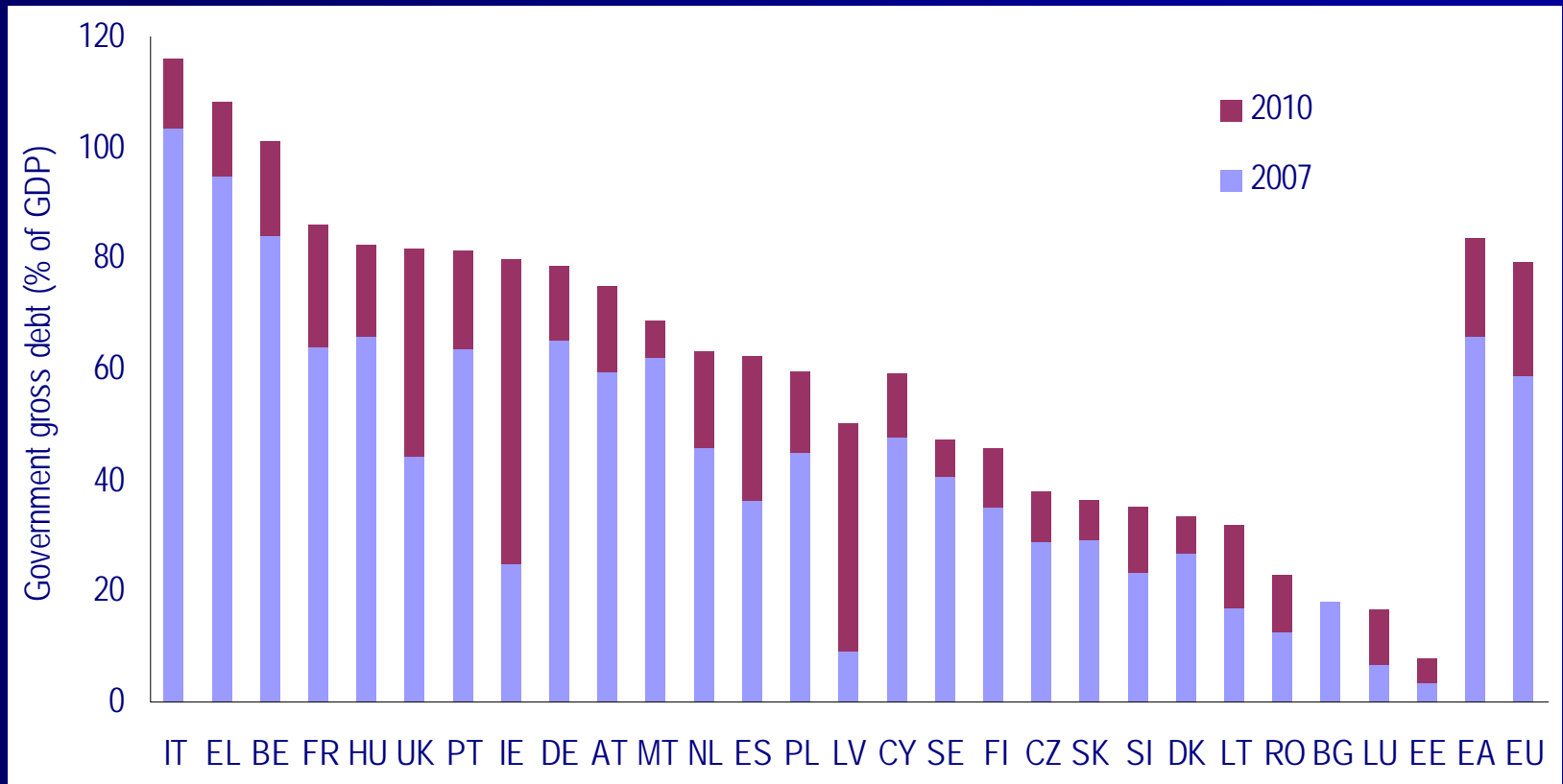


Source: European Commission



# Sharply deteriorating public finances

## General government gross public debt (% of GDP)



Note: For Cyprus the public debt-to-GDP ratio is projected to fall by 1.3 percentage points by 2010.

Source: European Commission



## Explanations for the deterioration

The dramatic deterioration in fiscal positions is related to the steep fall in GDP growth:

- ✓ Demand shortfalls are addressed by letting automatic stabilisers play and through discretionary fiscal stimulus measures
- ✓ The financial sector and its intermediation function are supported by public guarantees and recapitalisation measures
- ✓ Disproportionately (to GDP) high revenue shortfalls likely for tax bases previously linked to asset booms



# The short term: Excessive Deficit Procedures

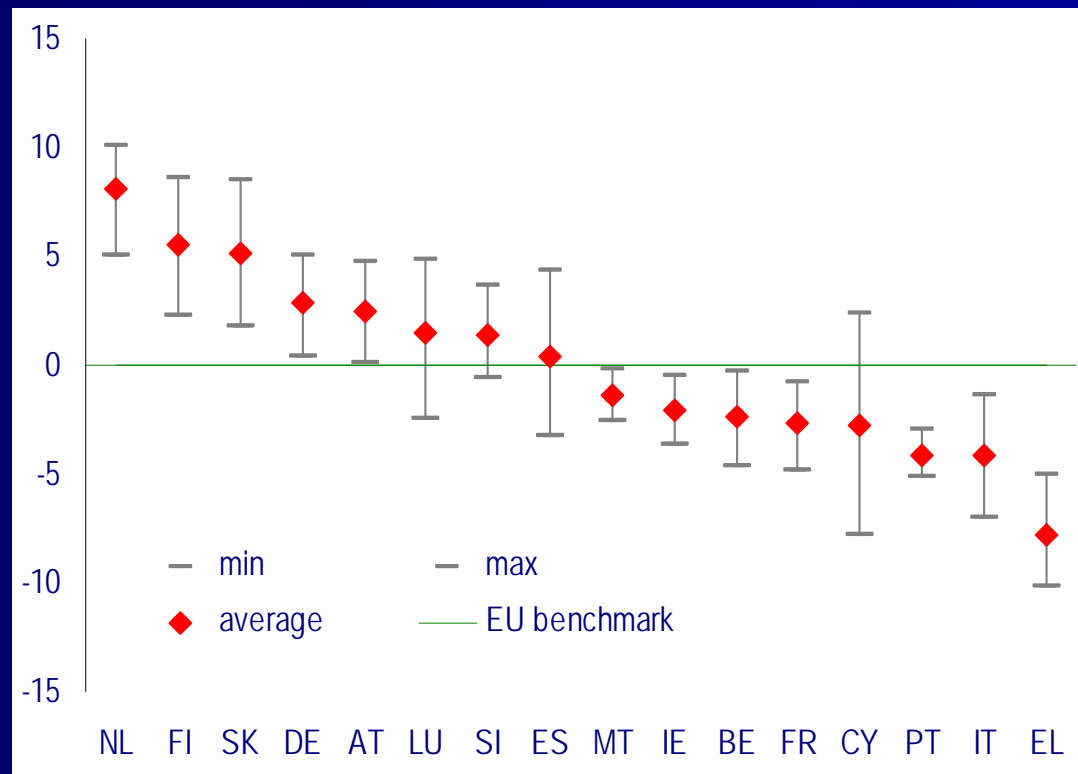
Country	EDP initiated	Deadline for correction
Greece	2009	2010
Spain	2009	2012
France	2009	2012
Ireland	2009	2013
United Kingdom	2008	2013/14
Malta	2009	2010
Lithuania	2009	2011
Poland	2009	2011
Romania	2009	2011
Hungary	2004	2009

Source: European Commission



# Fiscal space differs across countries

Level and variability of fiscal space in euro area



Source: European Commission



# 5. The medium term: Exit strategies and potential growth



# The medium term: exit strategies and potential growth

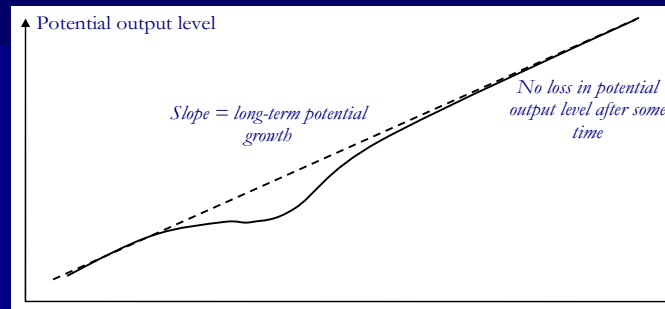
1. Set ambitious and realistic budgetary targets
2. Spell out the consolidation measures being envisaged beyond the next year
3. Strengthen national medium-term budgetary frameworks and rules
4. Implement structural reforms to ensure long-term sustainability



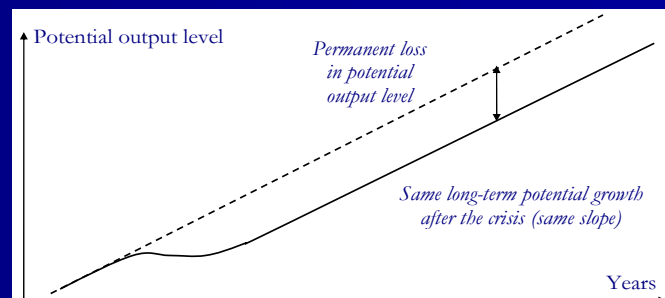
## The impact of the crisis on potential growth

- ✓ Critical challenges for the EU are to prevent hysteresis effects on the labour market and to avoid permanent damage to R&D, innovation and risk taking
- ✓ Past crises (e.g. SE and FI) show that policy responses matter
- ✓ Different scenarios are possible i.e. a full return to earlier path, a permanent loss in level terms only or a permanent loss on growth rates

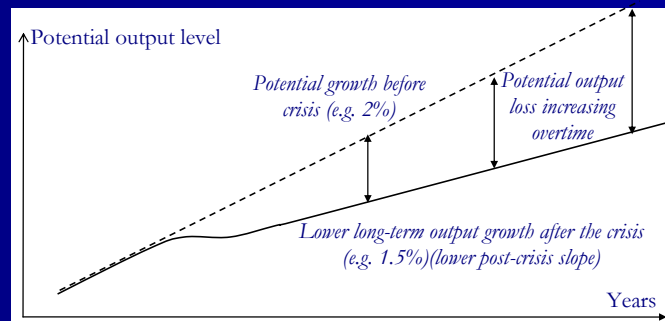
Case No 1: Full return to earlier path



Case No 2: Permanent loss in GDP level



Case No 3: Permanent loss on growth rates



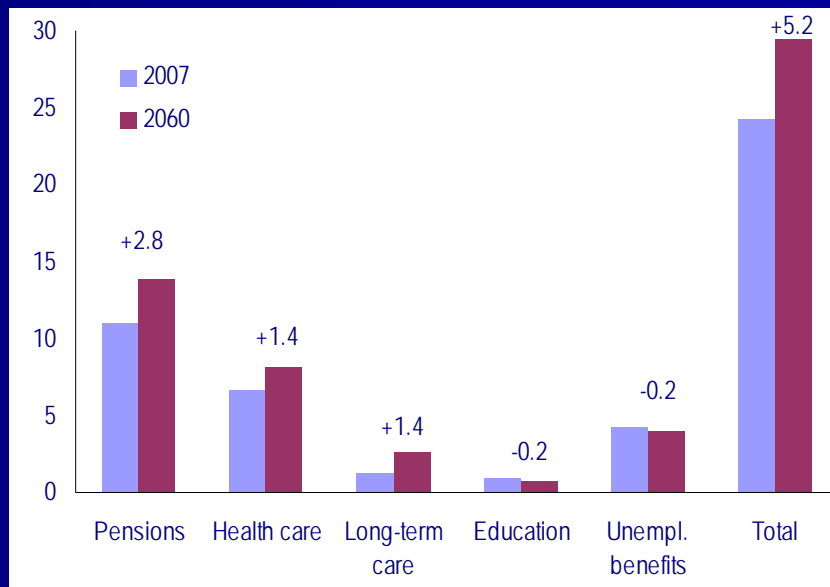
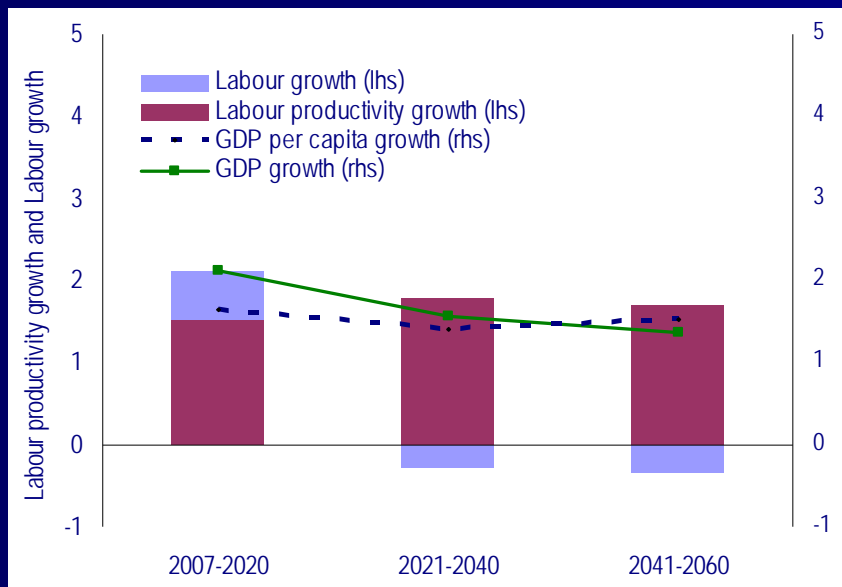


## Designing Lisbon strategy for the years to come

- ✓ Productivity challenge to improve potential growth outlook
- ✓ Green innovation to foster transition to low-carbon economy
- ✓ Cost-efficiency is the key given the pressure on public finances and less resources for private investment



# The economic consequences of ageing populations: projections for the EU



Source: European Commission

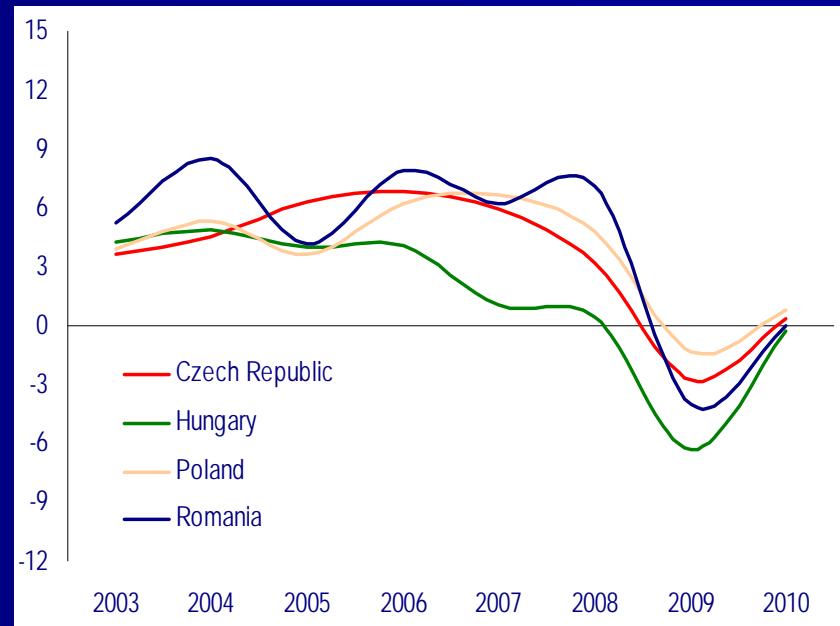
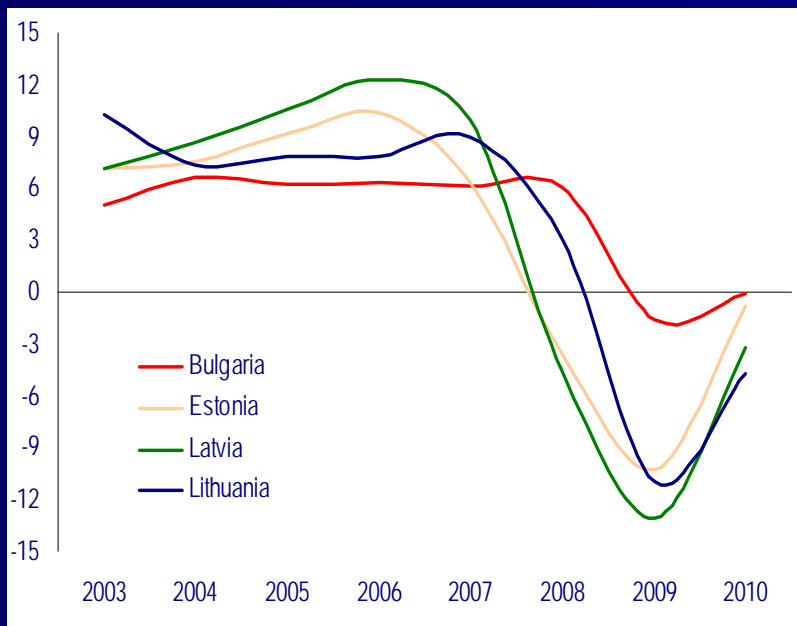


## 6. New EU Member States: economic situation and euro perspectives



# Crisis led to broad-based and severe economic downturn in NMS

Real GDP growth, % y-o-y

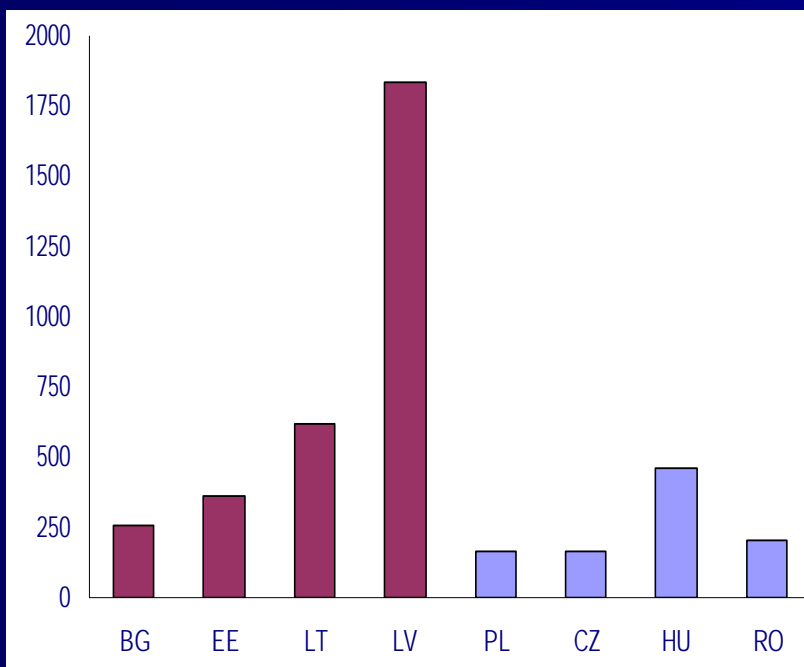


Source: European Commission



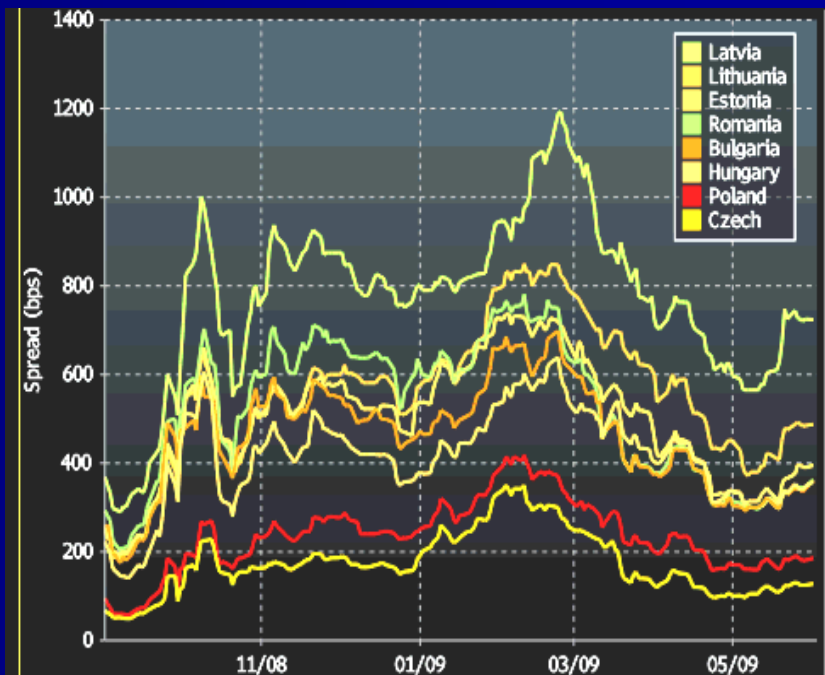
# Tighter financial market conditions, with increased spreads

**NMS: 3-m interest rate spread to the euro area Euribor, change between 1 July 08 and 15 June 09 (in basis points)**



Source: EcoWin, European Commission

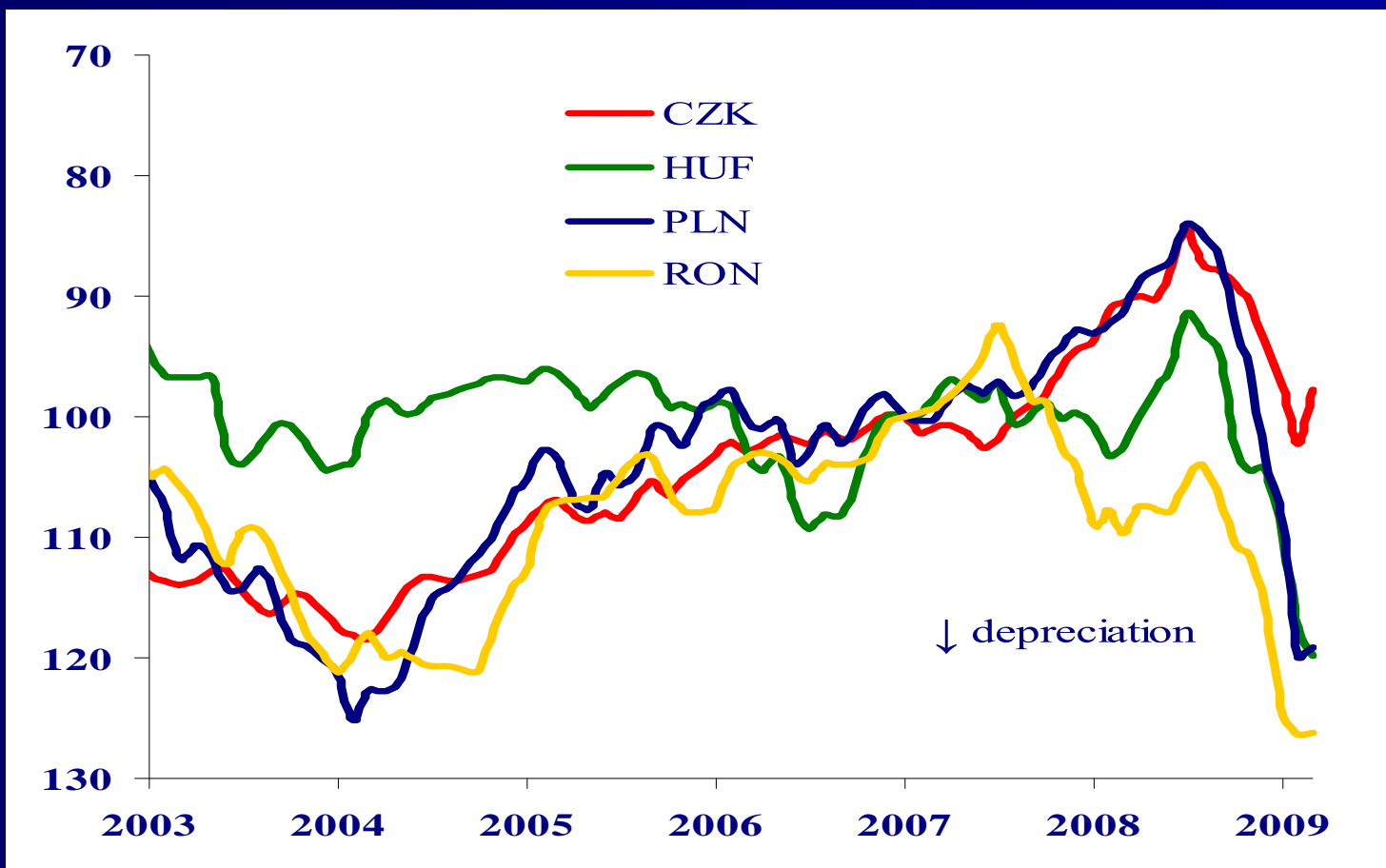
**5-year credit default swap (CDS) spreads**





# Depreciating exchange rates

- Nominal exchange rates vis-à-vis the euro, monthly averages (inverted scale)



Source: European Commission



## BoP assistance to New MS

- Some MS face large short-term external financing needs, amid sizeable external imbalances and large debt stock
- EU medium-term assistance facility is available to help contain risks of a BoP crisis, conditional on strong policy commitments to work out underlying imbalances
- Commission raises funds on the market and on-lends to the MS. Facility ceiling raised from 12 bn to 50 bn € since late 2008
- Financial assistance is provided in the context of broader international financing packages
- Flanking commitments by parent banks – reflects home-host responsibilities



## Three countries have received EU BoP assistance

Billions of €	Hungary	Latvia	Romania
Total assistance package	20	7.5	20
EU (Art. 119)	6.5	3.1	5
IMF	12.5	1.7	12.95
Other multilaterals	1	0.5	2
Bilaterals	...	2.2 (1)	...

*Note: Contributions by SE, DK, FI, NO, CZ, PL, EE.*

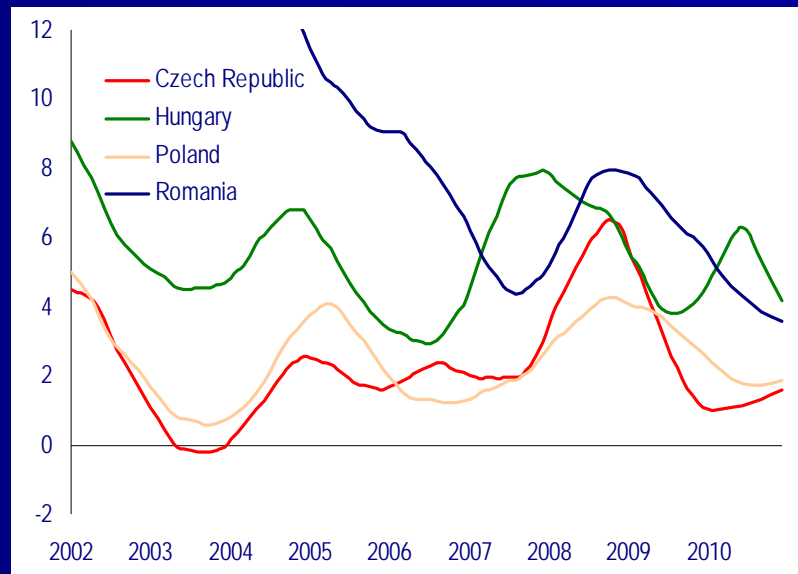
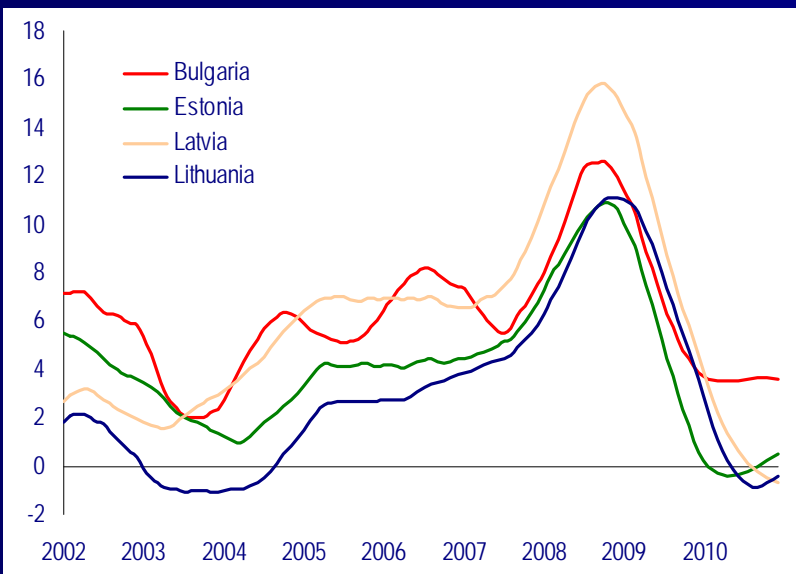
*Source: European Commission*



# Outlook for convergence (1)

Inflation dropping fast amid economic downturn (though in some cases XR depreciation counteracts)

HICP inflation, 12-month average, % y-o-y



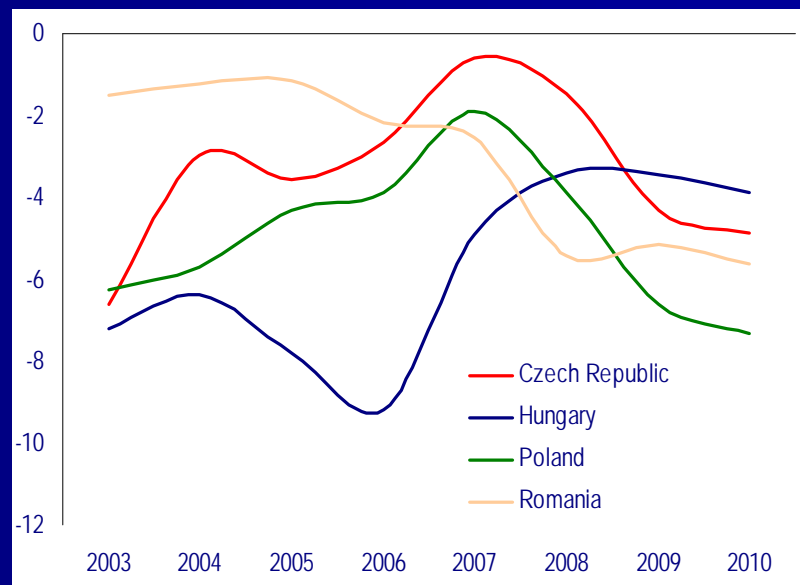
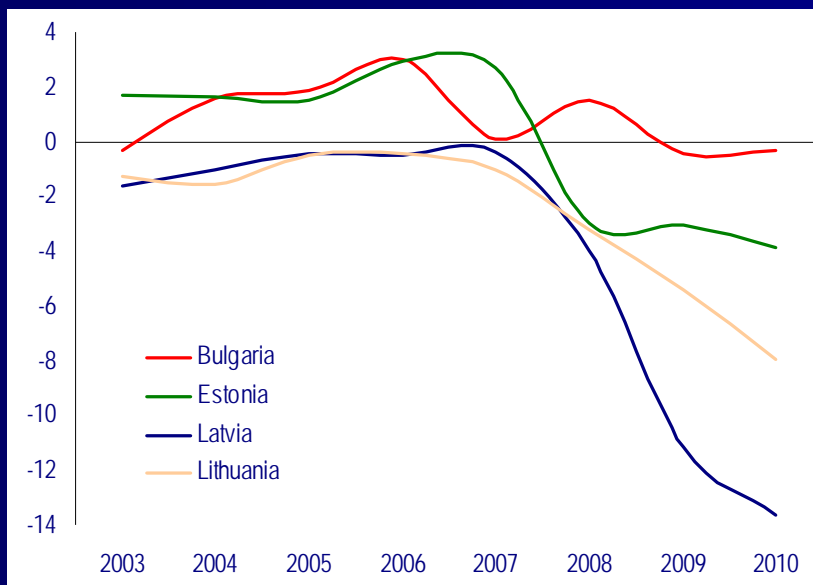
Source: European Commission



# Outlook for convergence (2)

Fiscal positions deteriorating rapidly (overestimation of structural positions during the boom amplifies reversal)

General government deficit, % of GDP



Source: European Commission



# Outlook for convergence (3)

Respect of Maastricht indicators (May 2009) - overview						
	Inflation (%)	Long-term interest rates (%)	Budget Balance (% of GDP)	Government debt (% of GDP)	Excessive deficit procedure	Exchange rates
Period	May-09	May-09	2008	2008		
Reference value	3.0	6.4	-3.0	60		
Non-euro area Member States						
						<u>ERM II entry</u>
Bulgaria	8.3	6.3	1.5	14.1	no	no
Czech Republic	3.7	4.7	-1.5	29.8	no	no
Denmark	2.8	4.0	3.6	33.3	no	01/01/1999
Estonia	6.8	8.4	-3.0	4.8	no	28/06/2004
Latvia	11.2	8.7	-4.0	19.5	no	02/05/2005
Lithuania	9.3	9.7	-3.2	15.6	yes	28/06/2004
Hungary	4.4	9.3	-3.4	73.0	yes	no
Poland	4.0	6.1	-3.9	47.1	yes	no
Romania	7.2	8.4	-5.4	13.6	yes	no
Sweden	2.8	3.5	2.5	38.0	no	no
United Kingdom	3.6	3.9	-5.5	52.0	yes	no

Note (1): Figures in shaded cells indicate compliance with the reference value.  
 Note (2): On 13/05/2009, the Commission has adopted recommendations to the Council on the existence of an excessive deficit for LT, PL and RO



## Towards an enlarged euro area

- ✓ The crisis has increased euro attractiveness
- ✓ NMS should pursue policies bringing them closer to the euro: strengthen fiscal discipline, correct macroeconomic imbalances, preserve financial stability and foster productivity and competitiveness
- ✓ Loosening entry criteria as suggested by some is not a promising avenue for economic and institutional reasons



# Concluding remarks

1. The EU is facing its deepest recession in a life time – first signs of bottoming out?
2. The EU has taken rapid and coordinated actions on the financial as well as on the economic side – consequent implementation is key
3. Key priorities:
  - tackling the banking crisis: full disclosure; systematic stress tests; credible commitment for restructuring; co-ordination at EU level
  - implement fully EERP; 2<sup>nd</sup> fiscal stimulus not warranted at this stage
  - develop exit strategy: (i) put public finances on sustainable path; (ii) withdrawal of temporary measures and focus on measures to raise potential growth; (iii) gradual withdrawal conventional and non-conventional measures and reflect on role of asset prices
  - reinforce policy co-ordination and surveillance
4. The euro has facilitated the handling of the crisis



# Thank you for your attention

Further information can be found on:

[http://ec.europa.eu/economy\\_finance/focuson/focuson13254\\_en.htm](http://ec.europa.eu/economy_finance/focuson/focuson13254_en.htm)