Europe, ten years after the crisis: out of the tunnel?

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Outline

1. Readings of the crisis

2. Crisis response

3. Looking forward
1. Readings of the crisis
Let's remember. . .

Credit crunch and subprime crisis:
- August 2007: Money-market rates start deviating from policy rates
- Demand for MBS dries up
- Lenders depending on money markets and securitisation have funding problems
- Banks start tightening lending standards

Lehman (Sep. 2008); global financial crisis enters a new phase:
- Global asset prices collapse (safe-havens soar)
- Counterparty confidence breaks down: trade and confidence effects convert the crisis into a global problem
- Credit flows to euro-area periphery freeze
- Bubbles burst in some euro-area Member States

Sovereign debt crisis (April 2010):
- GR requests financial assistance (April 2010); Ireland (Nov 2010) and Portugal (April 2011) follow
- Late 2011: contagion to larger EA Member States
- March 2012: as the short-term impact of the ECB's liquidity boost fades, attention shifts back to the increasing links between sovereigns and banks
- June 2012: Spain requests financial assistance
Two questions:

(1) **What is the origin of the crisis?**

(2) **Why did Europe overcome it more slowly than the rest of the world?**
First question: Different readings of the origins of the crisis

(a) Fiscal profligacy in the South

(b) Financial regulation flaws

(c) Misallocation of resources
Origin of the EA crisis: my reading

• A "sudden stop" crisis following capital misallocation in pre-crisis years
• A banking crisis triggered a feedback loop: bank solvency concerns → higher bond yields and debt service → default worries → deeper recession
• The euro-area crisis was not a fiscal crisis (apart from Greece), but lack of fiscal space hindered the policy response during the crisis
• Heterogeneity in the euro area much larger than assumed before the crisis (different growth models)
• Structural divergences during the first 10 years of EMU led to divergent social and political preferences → ultima ratio mode
Resource misallocation in the pre-crisis period

Cumulative growth rate of non-tradable/tradable value added

Source: Commission calculations based on AMECO
Weakening external positions in some MS – Upon sudden stops, short-term flows were replaced by central bank lending

Central bank lending to EA credit institutions

NIIP (% of GDP)

* start in 2002, ** start in 2004

Source: Eurostat
Financial environment and policy uncertainty

Source: Bloomberg
Not a fiscal crisis but weak starting positions limited fiscal space
Second question: Why did the crisis lasted longer in the EA?

Different views:

• Austerity
• Structural factors
• Banks' weakness and banks-sovereign nexus
• Institutional incompleteness

They all played a role and they are linked
The crisis caught the EA in the middle of the river

- Insufficient EU capability (de facto) to enforce fiscal discipline in good times
- Weak non-fiscal surveillance
- Lack of financial backstops
- Perverse links banks-sovereigns
- No integrated financial regulatory infrastructure despite rapid financial market integration
2. Crisis response
A comprehensive crisis response

- Monetary, fiscal and structural policies
- Financial backstops: EFSF, EFSM, ESM
- Broadened surveillance: MIP, fiscal rules
- Financial integration: Banking Union and launch of Capital Markets Union

Massive changes by EU Standards, delivered under pressure
Standard monetary policy: gradual cut in rates (with short-lived hikes in 2011) to approach the ZLB

ECB policy and euro overnight rates
(last obs. 16 January 2017)

Source: IHS
Unconventional measures (forward guidance, fixed-rate full allotment, LTROs, asset purchases...)

Eurosystem - Main Balance Sheet Items

- Securities held for monetary policy purposes
- Lending to euro area credit institutions related to MPOs
- Euro-denominated deposit liabilities
- Banknotes in circulation
- TOTAL ASSETS
- TOTAL LIABILITIES
The pro-cyclical swing of the fiscal pendulum

Euro Area fiscal stance vs. Euro Area fiscal rules (% of potential GDP)

Source: European Commission spring forecast 2017
Structural reforms, but mainly in crisis-hit countries
Far-reaching institutional changes since 2011

Political economy: "ultima ratio"

- ESM
- 2-Pack
- Fiscal Compact
- SSM

Political economy: Better articulation of national/EA policies

- EFB
- Capital Markets Union
- SRM

- Five Presidents Report
- Communication on SGP flexibility
- Communication on EA fiscal stance
- Reflection Paper on EMU

CRISIS


POST-CRISIS

In sum: a difficult crisis aftermath, but brighter outlook

- **Slow recovery and lower growth**
  - Slower recovery in the EA vs US. But recently growth returned
  - Stubbornly low inflation
  - Weak total factor productivity
- **Weak banks**
  - High non-performing loans ratio, starting to come down now
  - Capital and liquidity buffers have been rebuilt
- **High debt legacy and a complex policy mix**
  - Limited fiscal space
  - Accommodative monetary policy: still needed
An incomplete recovery

- Erosion of potential growth
- Persistently low inflation
- "Excessive" external dependence
- Labour market slack
- Low "indigenous" growth
- External surplus

Investment gap
Fiscal and financial fragilities

- Public debt
- Deleveraging needs
- Fiscal space
- Budget deficit
- NPLs
- snowball risk
- Bank profitability space
- LT Interest rates
3. Looking forward
The journey is not over:

- Yes, crisis is over but the job is not yet done
- EMU deepening is an unfinished business
- Focus on new European public goods
- Key ingredient: trust
Completing EMU: bridging different views

Economic
- Solidarity
- Short-term response
- Discretion
- Demand (cyclical/macro)
- All MS (symmetric adjustment)
- Discipline
- Long term reform
- Rules
- Supply (potential growth struct. ref.)
- Only vulnerable MS (asymmetric adjustment)

Institutional
- National sovereignty
- Secondary law
- Community framework
- Only vulnerable MS (asymmetric adjustment)
- Political Union
- Treaty changes
- Inter-governmental
- Euro Area
- European Union
A new political synthesis is needed

Risk Sharing and risk reduction

Financial Union

Economic Union

Fiscal Union

Reforms and incentives

Sound budgets and fiscal capacity
New EU public goods

• The EU budget is a "relic of the past". It should focus further on the provision of genuine EU public goods

• Further EU involvement in defence, security, migration, climate change, R&D and cross-border infrastructure

• EA to strengthen macroeconomic stability. How?
  • Support to structural reforms for further structural convergence
  • Stabilisation function to reduce impact of large shocks
We have a window of opportunity: will politics follow? France, Germany and the others...