Responses to the euro area crisis

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The Interactive Museum of Economics
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The crisis

In a nutshell

- **The crisis has been generated by excessive indebtedness and imbalances, whether in the public or private sector**

- **Depending on countries, excessive indebtedness has been compounded with**
  - **real estate and housing bubbles**
  - **divergent developments in competitiveness**
  - **financial / banking fragilities**

- **Rising country risk has resulted in market fragmentation, undermining some of the benefits of the monetary union**

Solutions

Short and long-term solutions

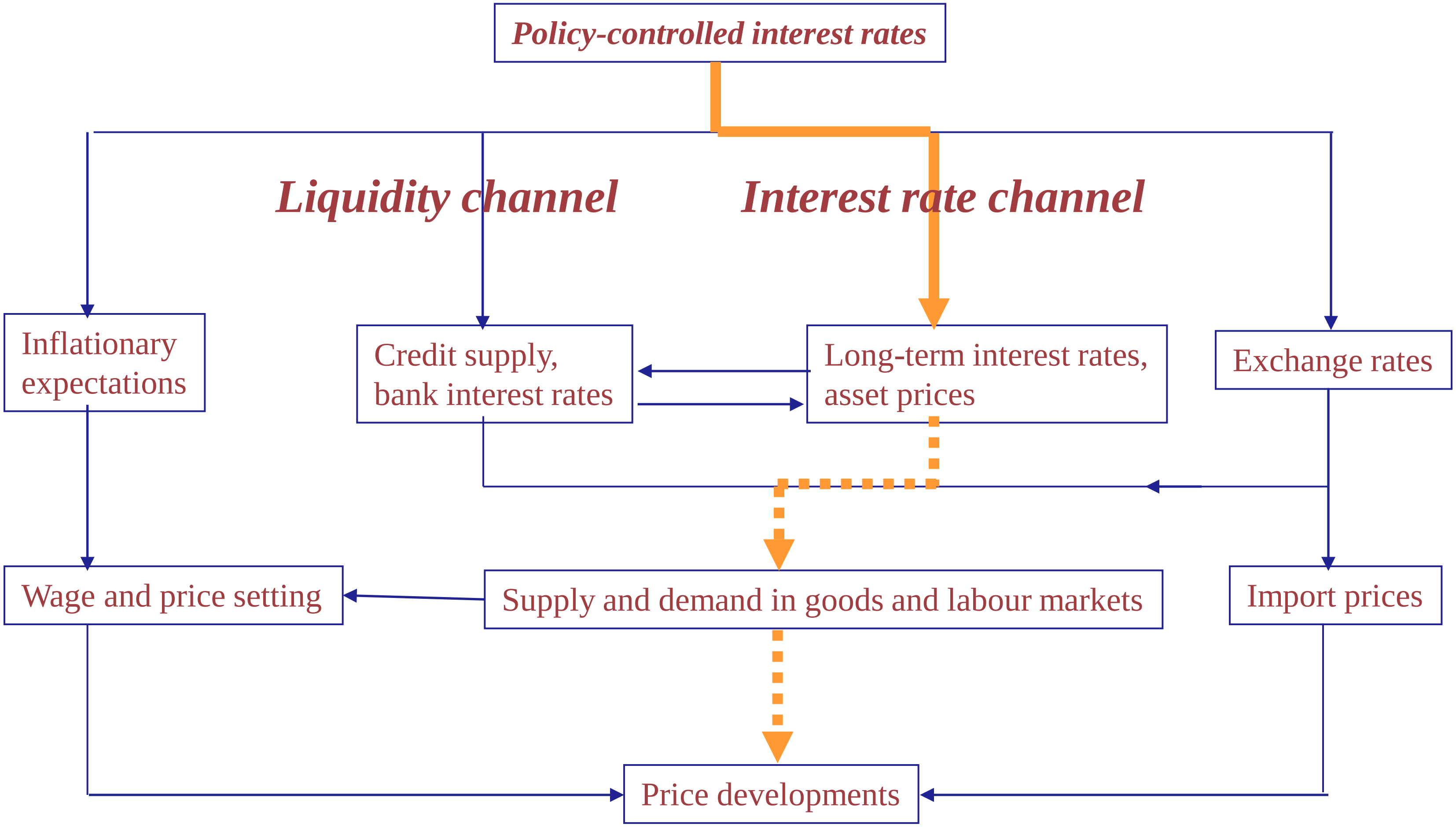
- Fiscal and monetary policy authorities in the euro area have taken a number of short-term measures to fight the crisis, which, although essential, are by their nature temporary

- Monetary union came with a strong and independent central bank, but without fully-fledged institutions in charge of economic, fiscal and financial policies

- Progress has been made towards improving governance and incentives, but long-term solutions require the creation of such fully-fledged institutions, based on a democratic process, and the fixing of fundamentals via structural reforms

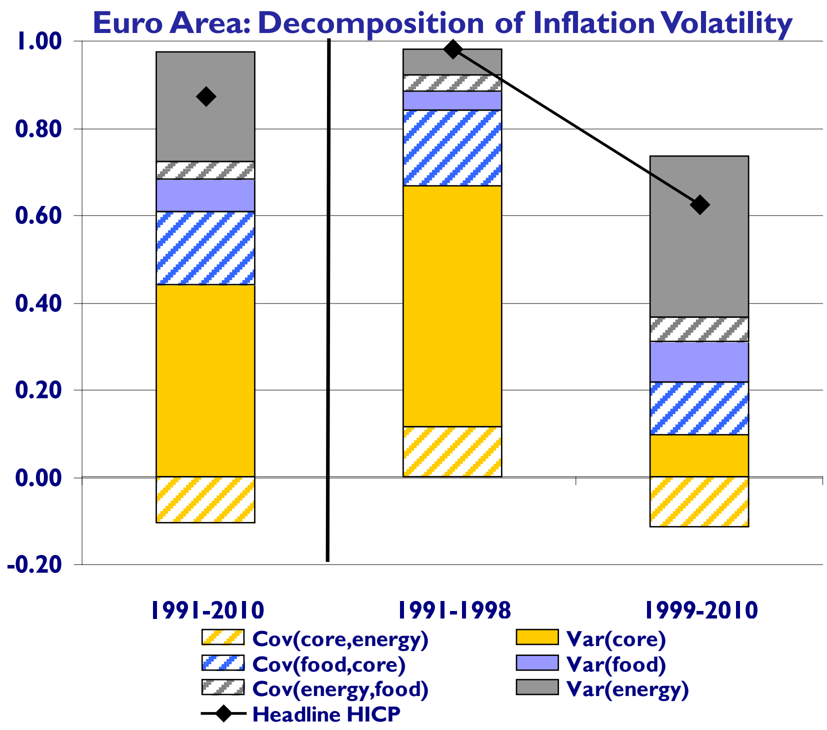
The responses from monetary policy

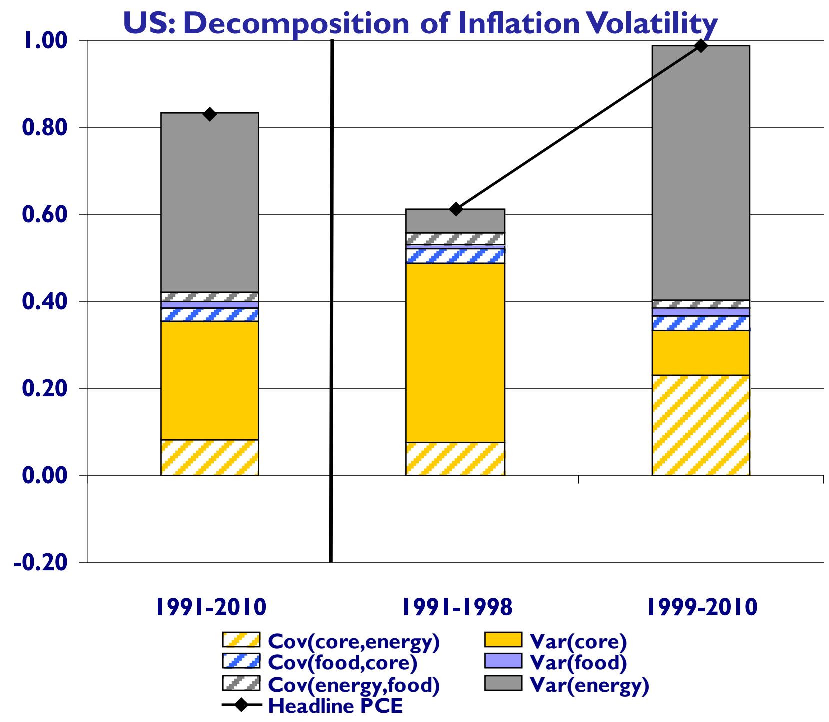
Monetary policy transmission channels



Price stability has been delivered

Energy price shocks and inflation volatility

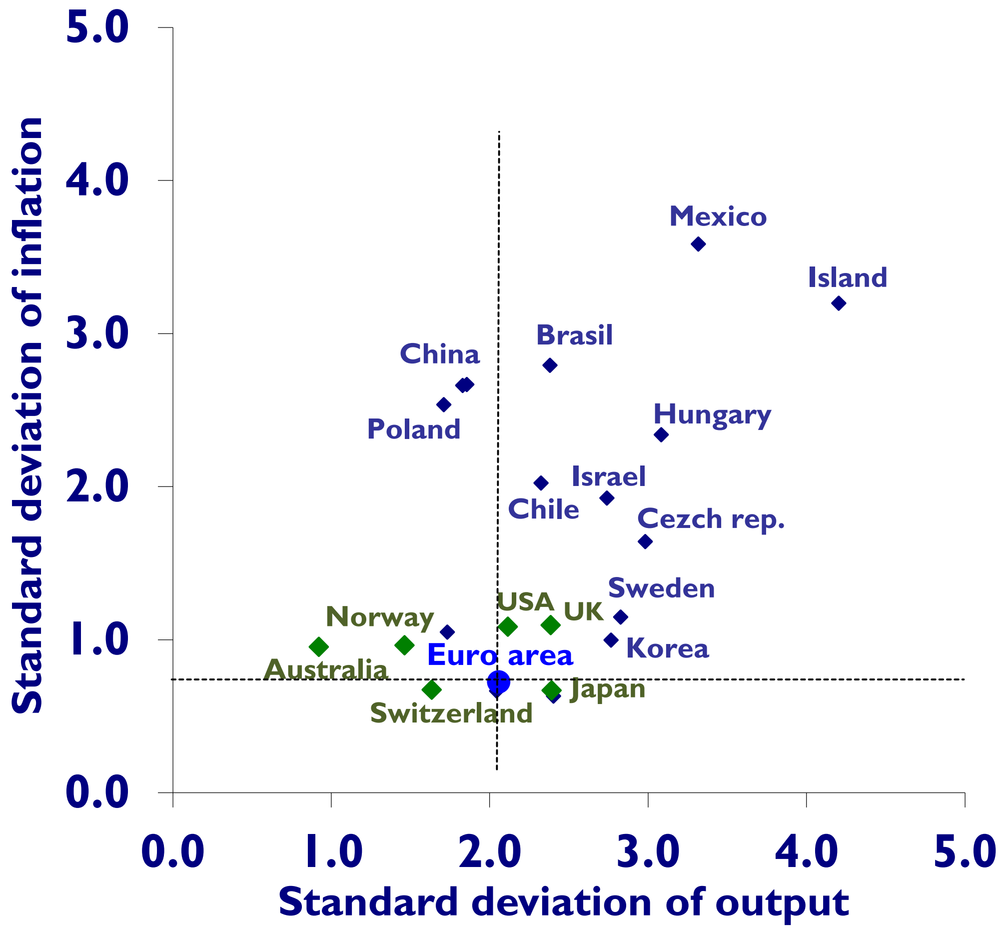




Inflation volatility falls despite larger energy price volatility

Larger energy price volatility boosts inflation volatility

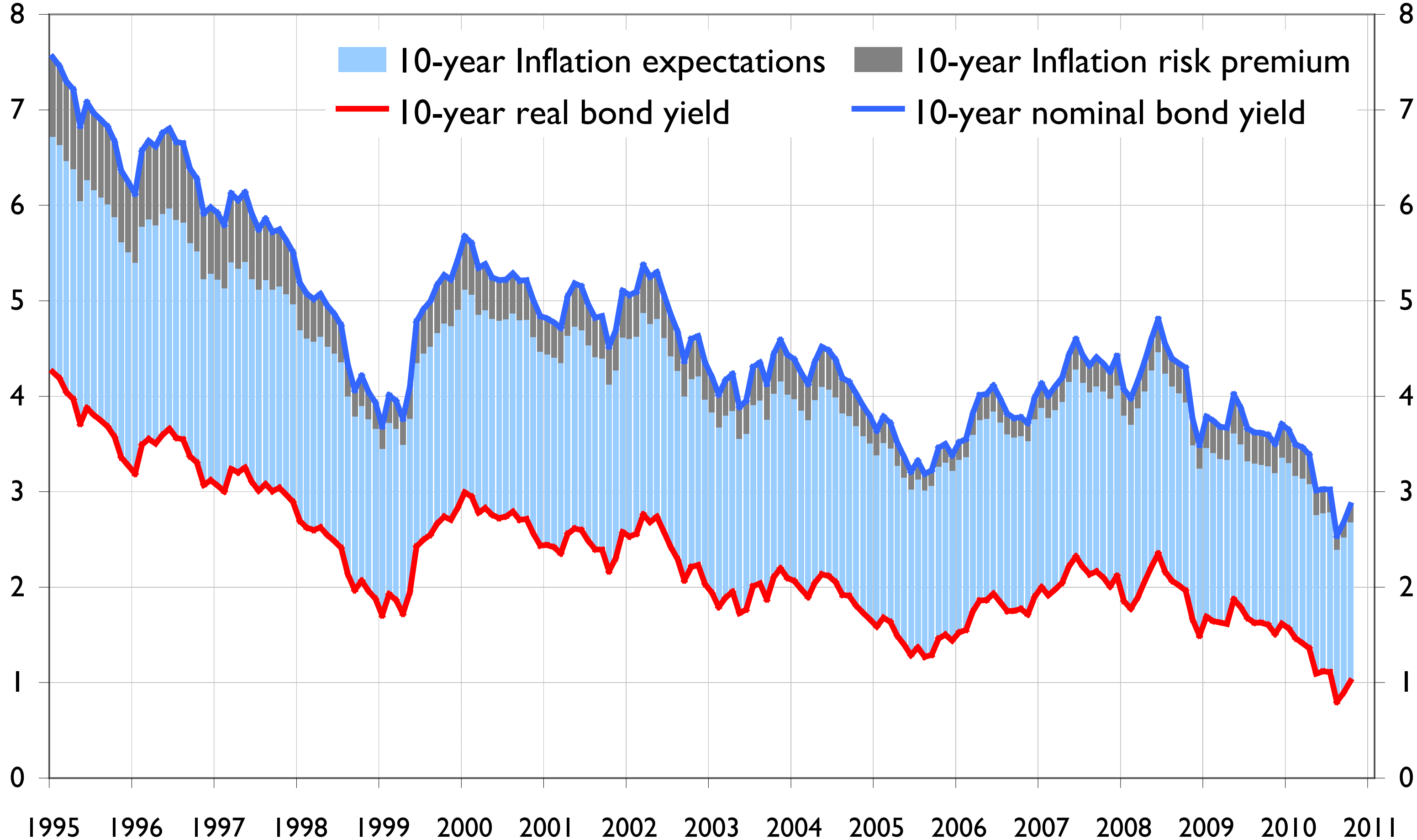
A stable macro-economic environment



Source: OECD and ECB calculations.
Note: Observations refer to the average annual output growth and inflation between 1999 and 2011.

Stable inflation expectations

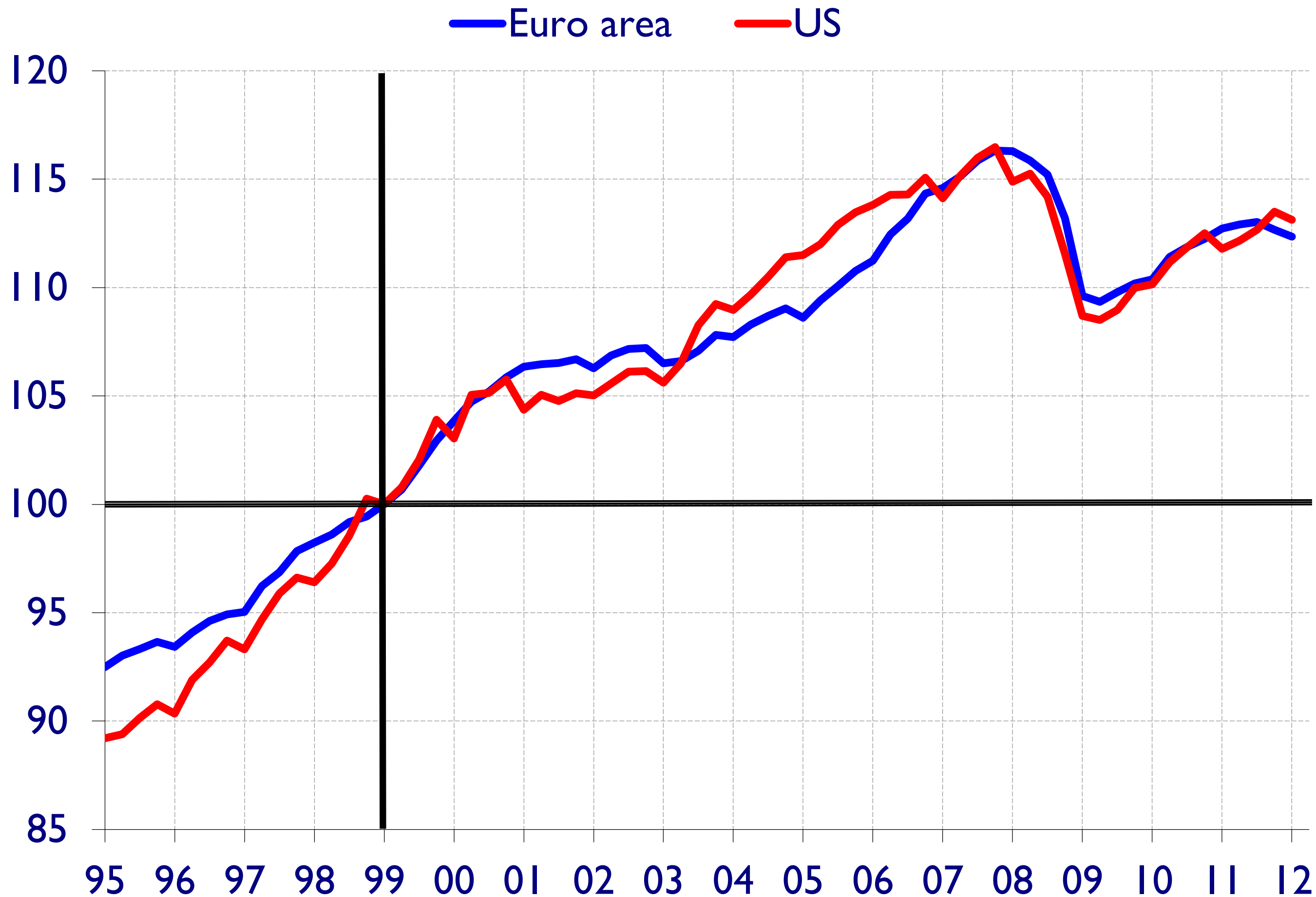
Point expectations and risk premium



Source: García, J.A. and T. Werner (2010), "Inflation risks and Inflation risk premia", ECB Working Paper No 1162.
Note: Inflation expectations are BEIR. Last observation: October 2010.

Strong growth performance

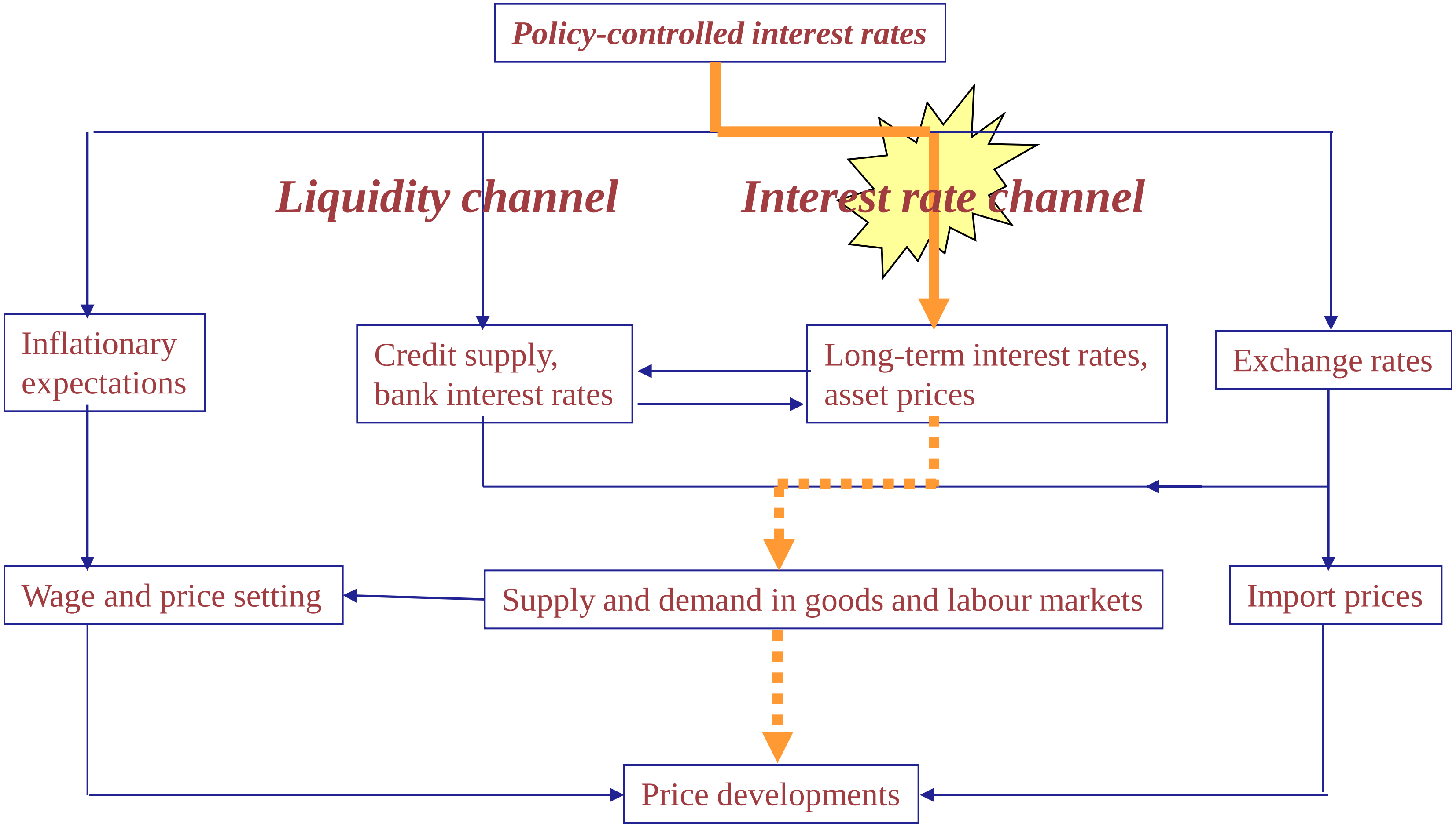
GDP per capita growth



Stability in euro area achieved with comparable average per-capita growth performance to the US

Sources: BEA, Eurostat. Notes: 1999Q1 =100. Last observation: 2012Q1.

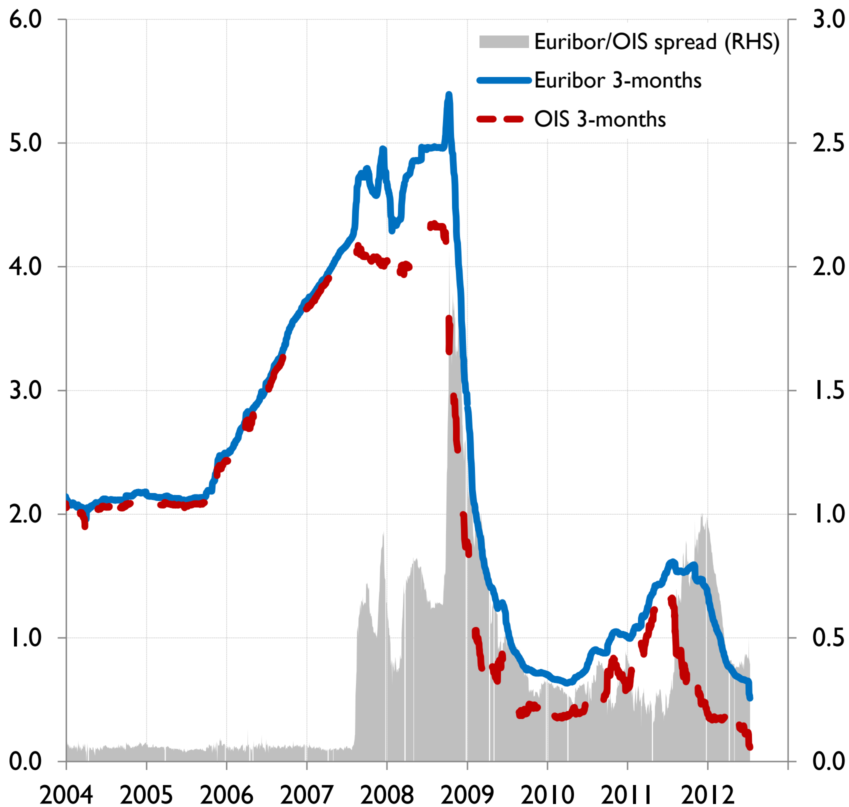
The crisis: Transmission impairments



Money market segmentation

3-m EURIBOR and EONIA/OIS

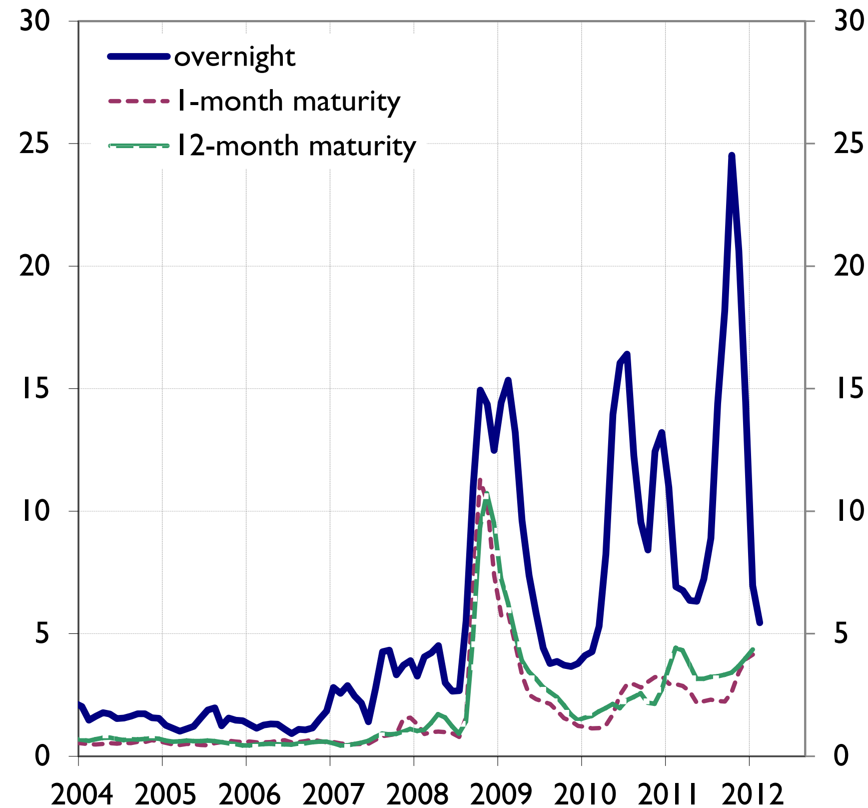
(in percentage points)



Sources: ECB, Bloomberg

Cross-country standard deviation of unsecured interbank lending rates

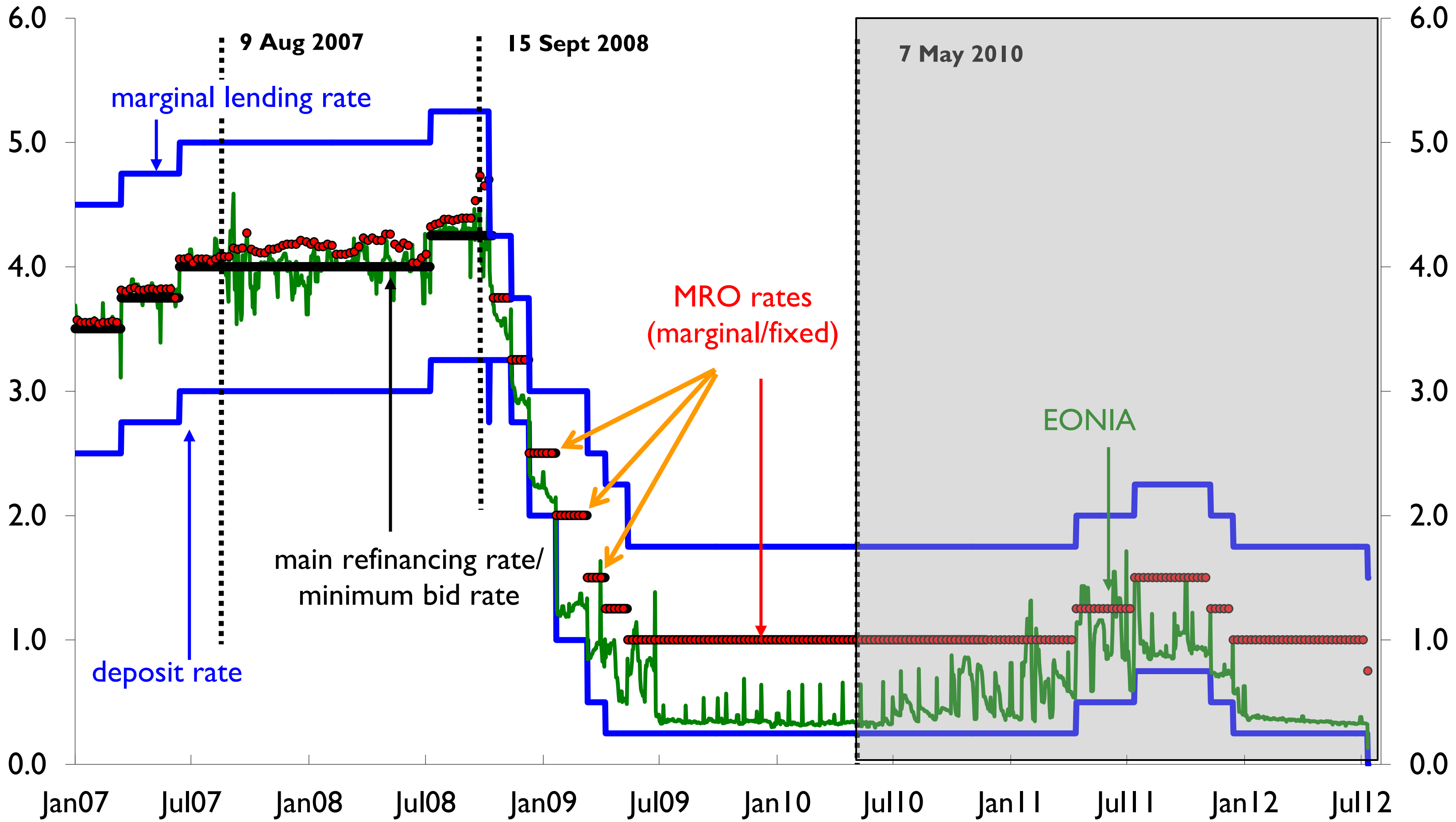
61-day moving average, basis points



Source: ECB Financial Integration Report April 2012, page 16

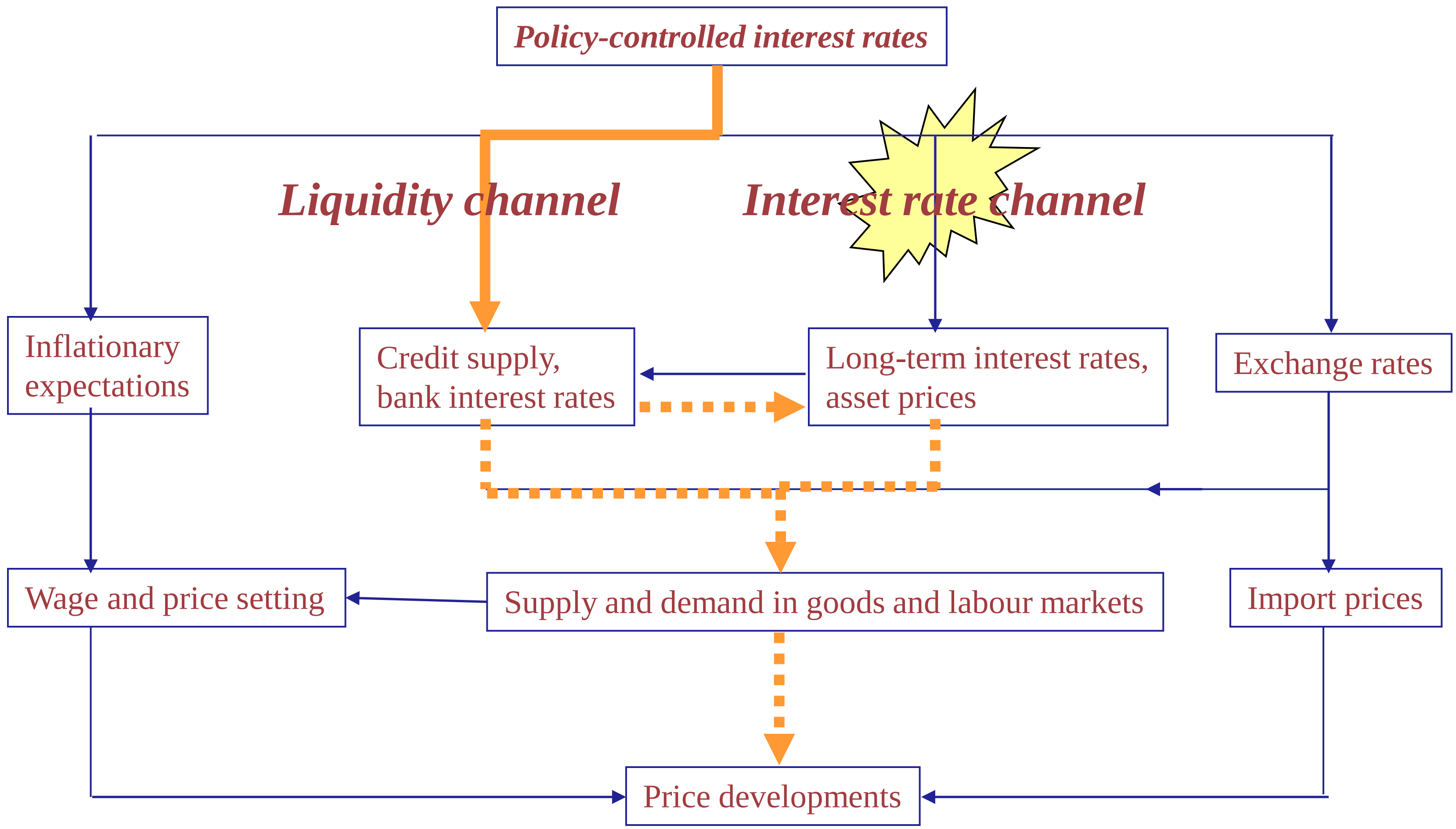
Monetary policy in the first phase of the crisis

Monetary policy response post-Lehman



Note: data in percent. The lower and the upper bound are the deposit facility and the marginal lending facility rate respectively. Last observation: 11 July 2012.

Transmission plumbing

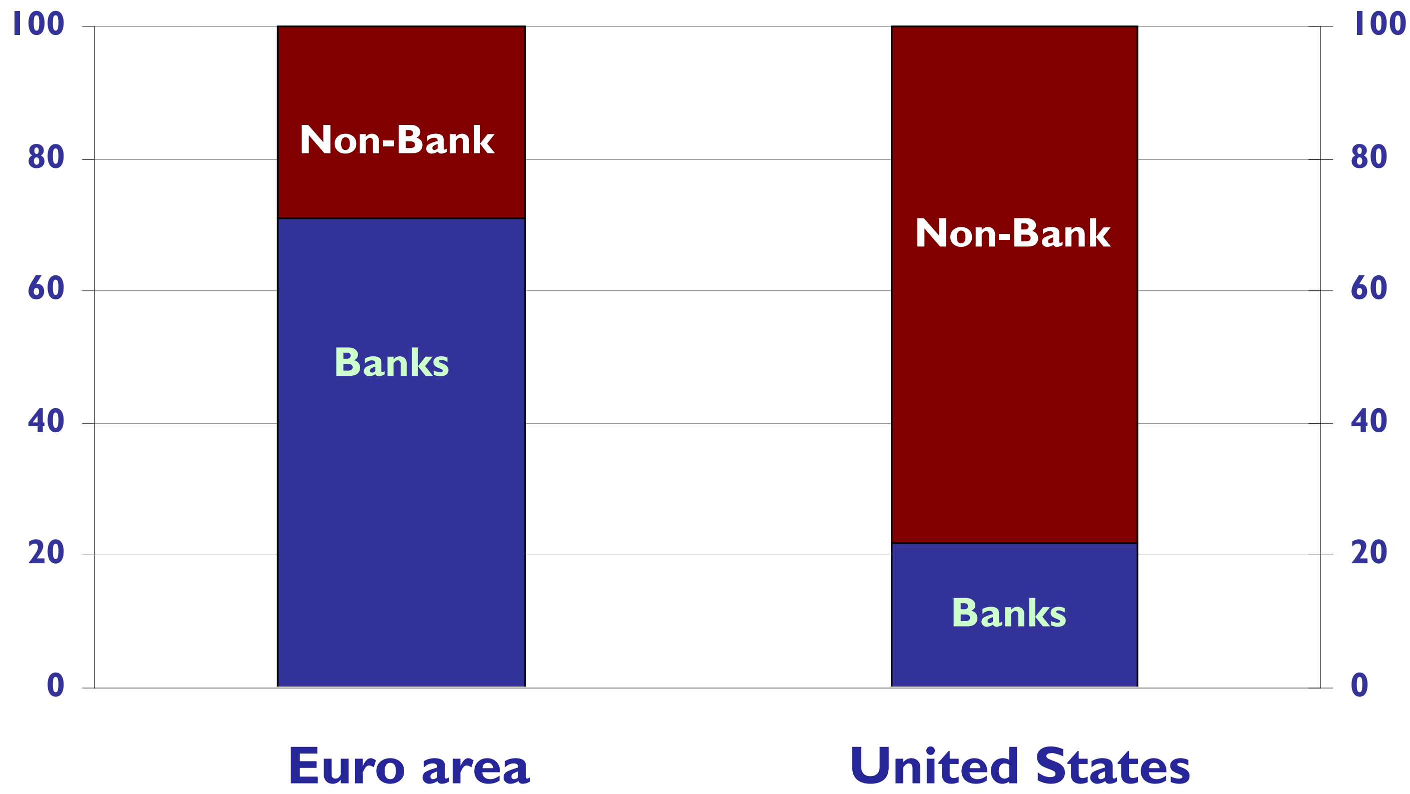


Monetary policy measures in the euro area

First phase of the crisis:

- Full accommodation of liquidity needs at a fixed rate
- Extended range of collateral for open market operations with stringent risk control
- Extended range of maturities for open market operations up to 1 year
- Provision of foreign currency denominated liquidity
- Outright purchases of covered bonds

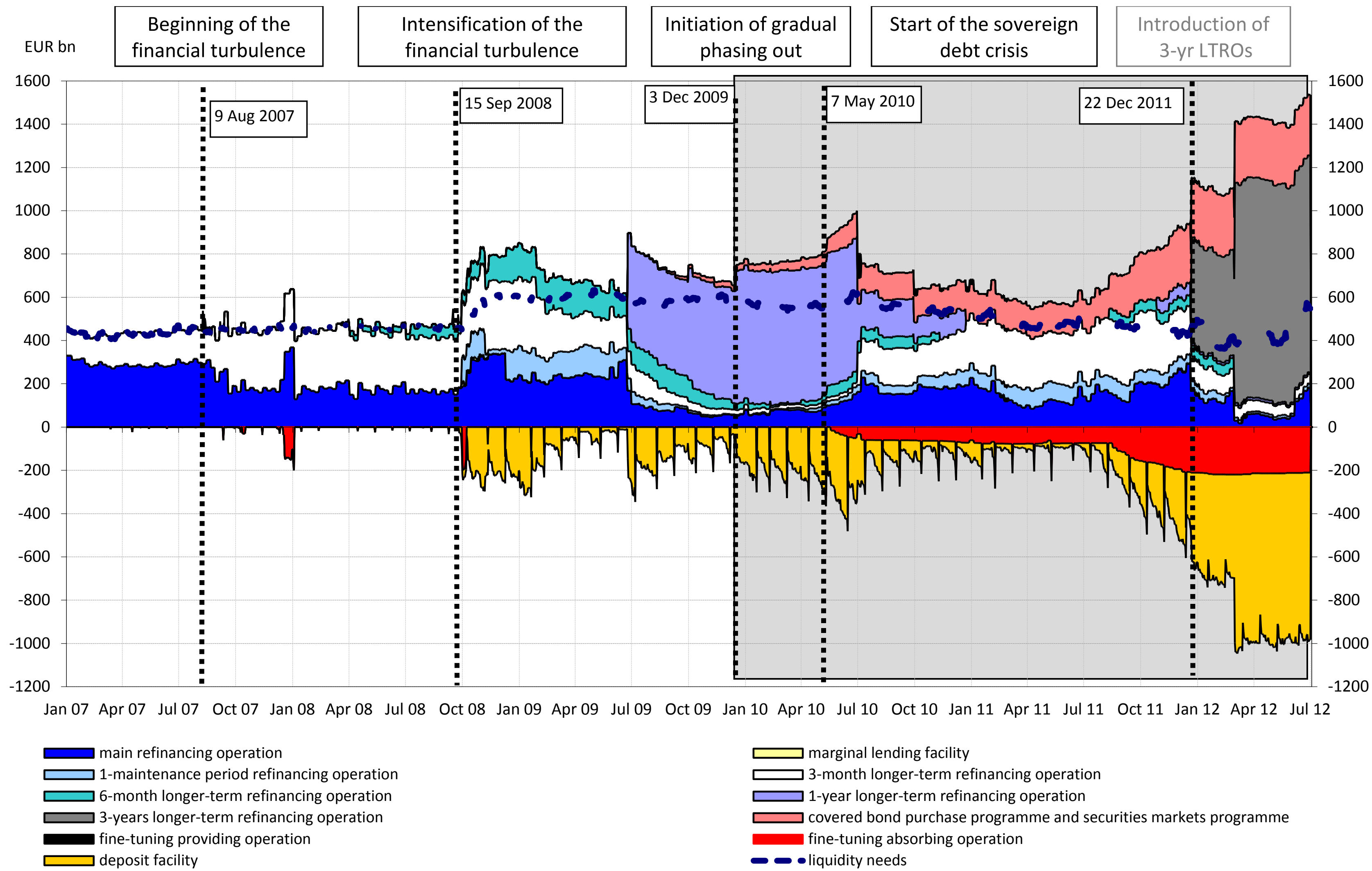
External financing for non-financial corporations



Source: ECB Monthly Bulletin April 2009
Note: Breakdown of the sources of external financing of non-financial corporations, in percent, average 2004 – 2008

Monetary policy in the first phase of the crisis

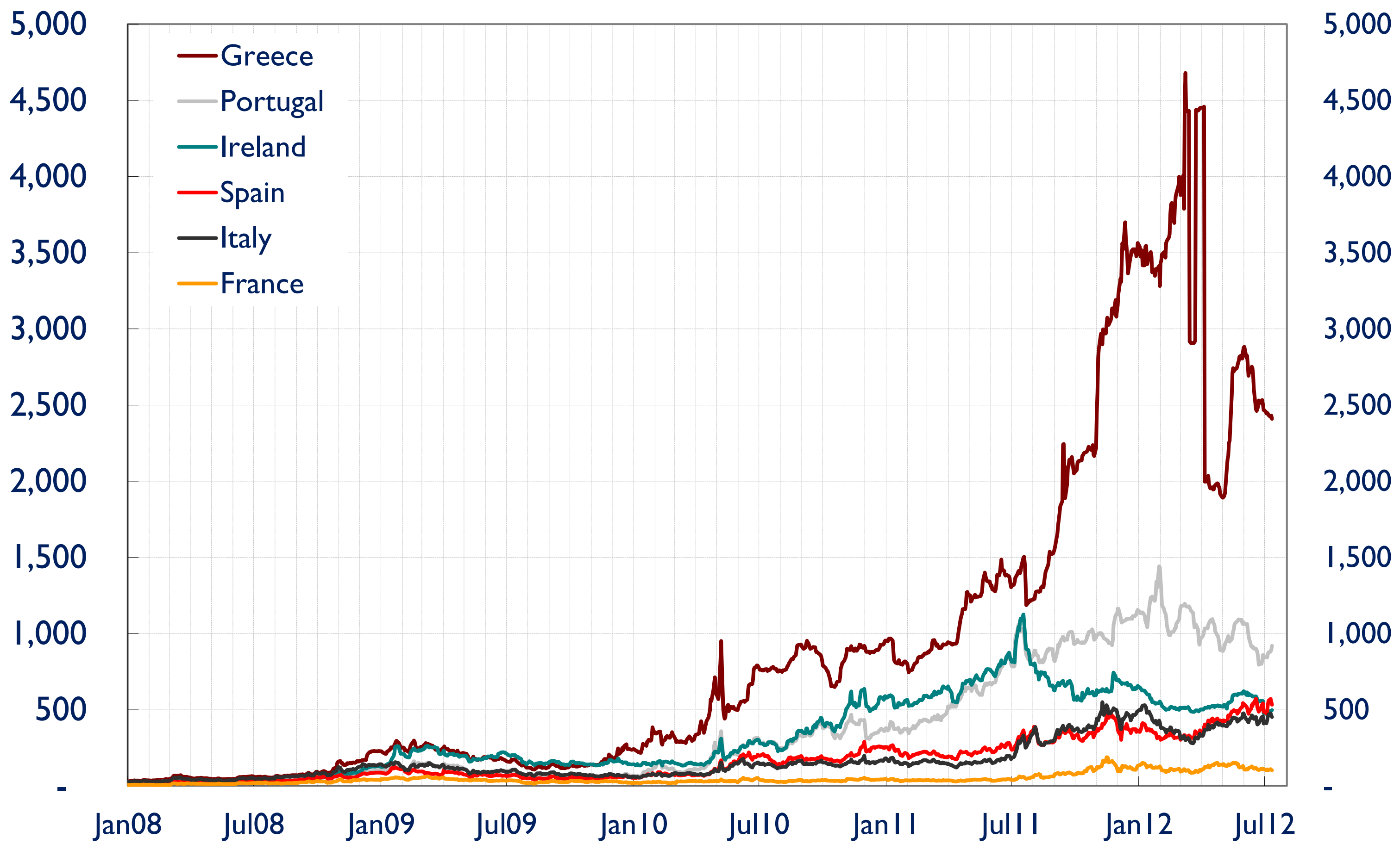
The Eurosystem balance sheet



Source: ECB. Last observations: 1 July 2012.

Second phase of the crisis: credit risk shocks

Sovereign bond spreads



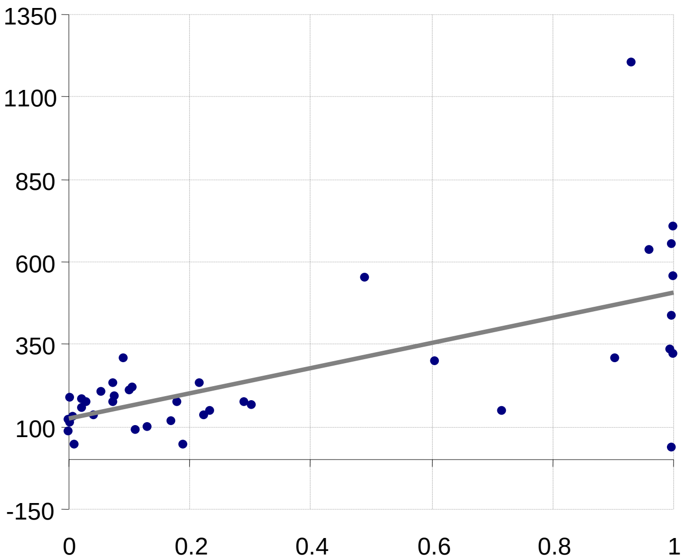
Sources: Thomson Reuters Datastream and ECB calculations. Note: bond yield spreads are vis-à-vis the German 10-year government bond, end-of-day data (last value 11 Jul 2012, 17:00 CET).

Transmission with credit risk shocks

Sovereign credit risk and bank CDS

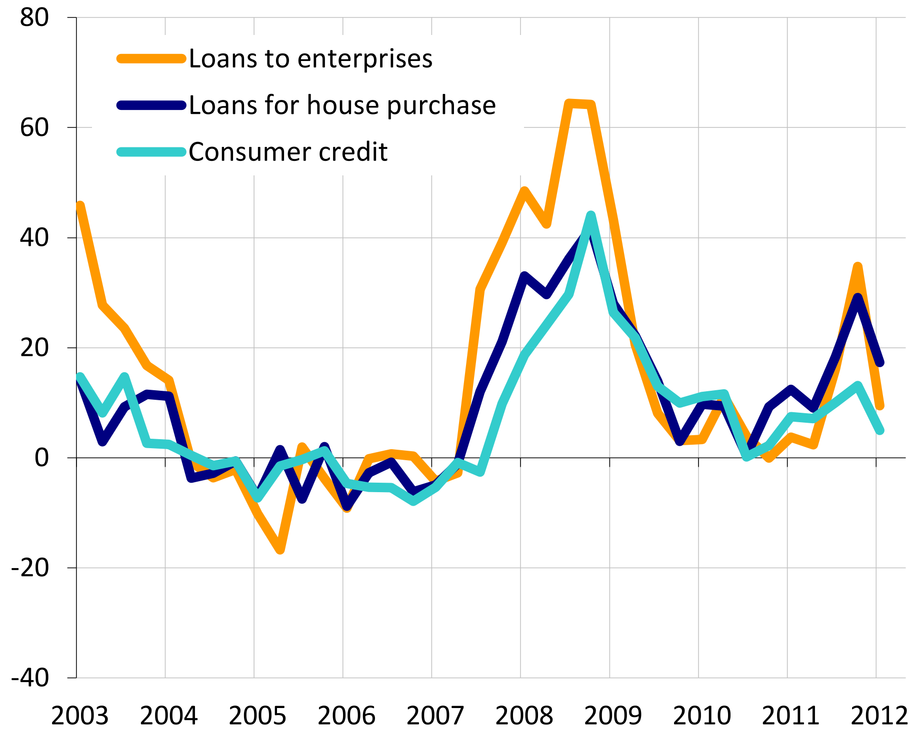
Annual change in individual bank CDS in 2011 and exposure to stressed sovereigns

(in b.p.; portfolio share)



Source: EBA (8 December), Datastream, ECB calculations. – Notes: Annual changes in banks' CDS (x-axis) vs. proportion of banks' sovereign exposure to countries under stress relative to their overall direct sovereign exposures (y -axis). – 4 3 EU banks from Dec'11 EBA sample (correlation 66%).

Banks Lending Standards *(Net Percentage)*



Source: BLS

Monetary policy measures in the euro area

First phase of the crisis:

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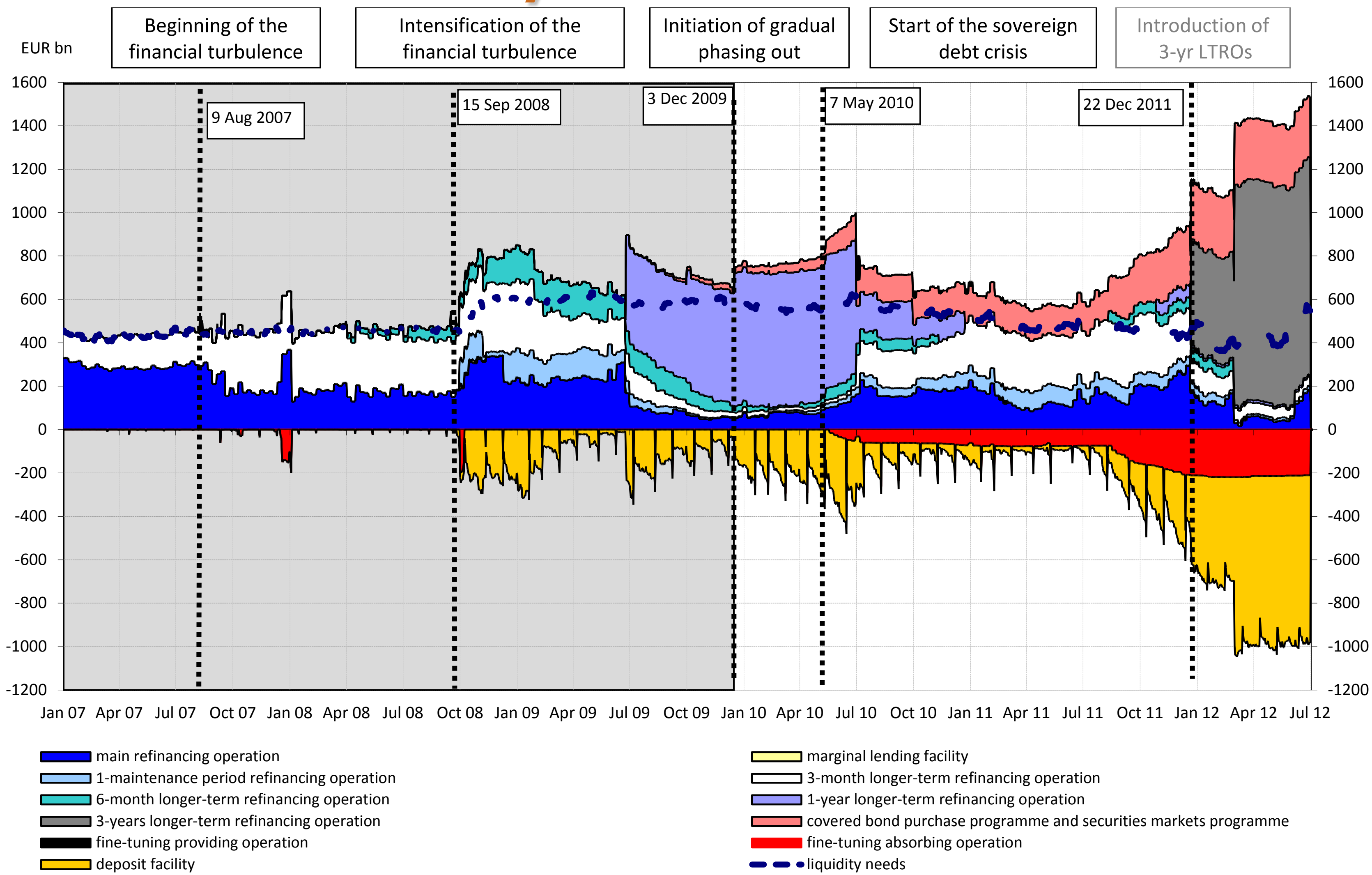
- Extended range of maturities for open market operations up to 1 year
- Provision of foreign currency denominated liquidity
- Outright purchases of covered bonds

Second phase of the crisis:

- Securities Markets Programme: Intervention in dysfunctional segments of the securities debt market
- Lower minimum reserve requirements
- Further extension of collateral for open market operations with stringent risk control
- Refinancing operations (“LTROs”) with a maturity of 3 years

Monetary policy in the second phase of the crisis

The Eurosystem balance sheet



Source: ECB. Last observations: 1 July 2012.

Reduced funding stress and lower volatility following the three-year LTROs

Implied stock market volatility in the euro area

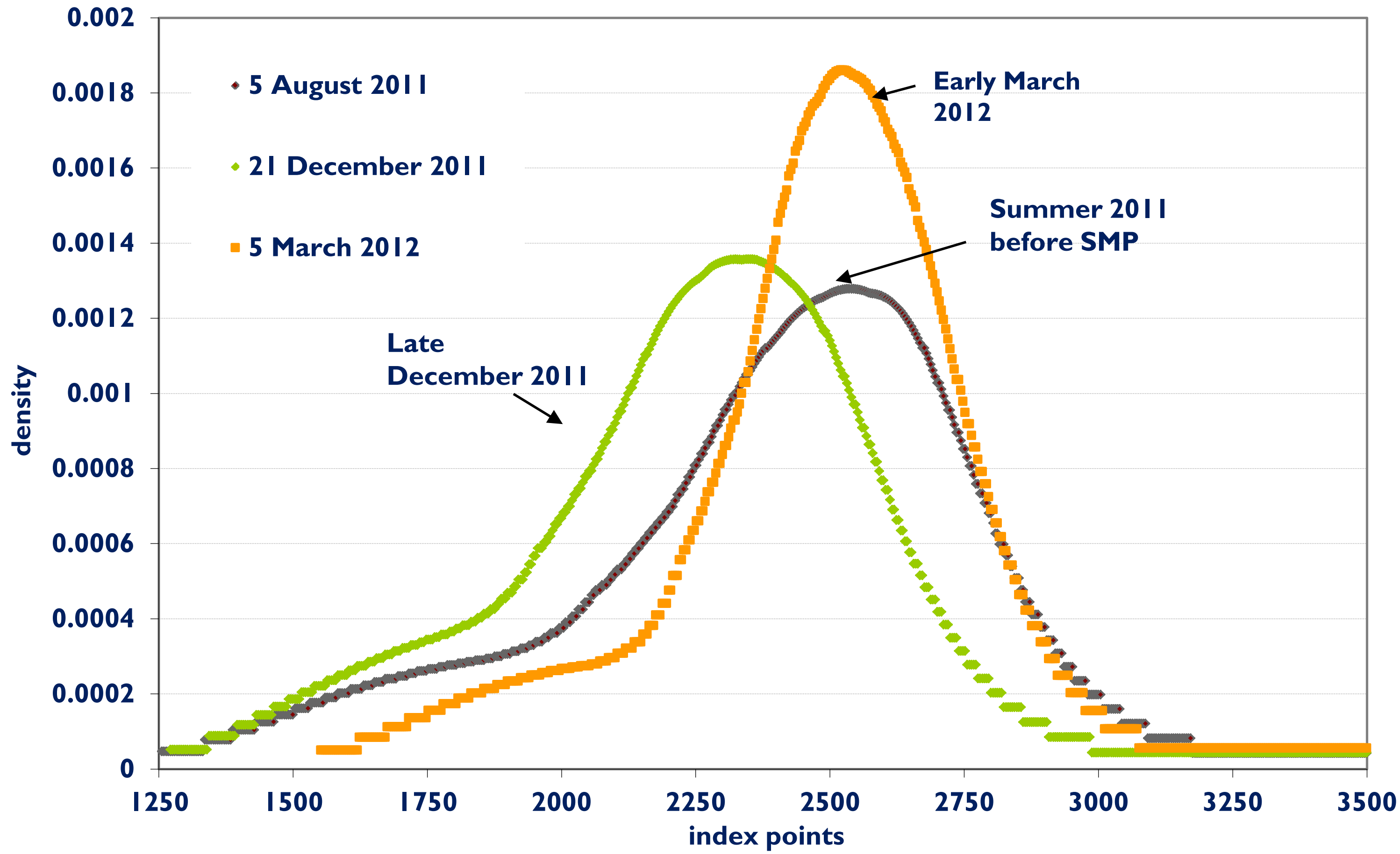
Sources: Bloomberg and ECB calculation.
Last observation: 11 July 2012

3 month Euribor-OIS spread (basis points)

Source: Bloomberg
Last observation: 11 July 2012

Lower tail risk following the three-year LTROs

Probability density function of Eurostoxx 50



Source: ECB, Bloomberg. Based on options on DJ Eurostoxx 50. PDF's show the probabilities that option market participants attach to different future underlying instrument outcomes. Option-implied PDFs contain information on risk and market uncertainty. Area under each line sum up to 1. Three-month horizon.

The responses from fiscal policy

A number of initiatives

- General principle:
  - Impose controls on national budgets and the insurgence of imbalances

    ⇒ build, on this basis, mechanisms for cross-country financial solidarity

- Safety nets are provided by EFSF / ESM
  - These funds ensure forms of ex-post cross-country risk sharing
  - EFSF lending capacity €440 bn and ESM €500 bn, with total combined lending capacity of €700 bn

- "Six-pack"
  - Macroeconomic surveillance procedure which will detect and correct divergences at an early stage
  - Increased automaticity

- "Two-pack"
  - Further strengthening of surveillance mechanisms in the euro area

A number of initiatives

- "Fiscal compact"
  - A balanced budget rule, concerning structural budget deficit and not its cyclical component, aimed to restore market confidence and the ability of national fiscal policy to smooth out the effect of adverse economic shocks
  - Fiscal compact requires national balanced budget rules to be enforced at constitutional level or equivalent

Structural reforms

- A number of Member States, and especially those under stress, have embarked on ambitious programmes of structural reforms, concerning
  - Labour markets
  - Product markets
  - Pension and health care system
  - Tax system
  - Public administration reforms and expenditure reductions
  - Business environment
    - Competition law
    - Sector regulators
    - Judicial system
  - Privatisations

A long-term perspective

The “four presidents’ report”

Four building blocks

1. An integrated financial framework

- **Key elements:**
  - **Single banking supervision**
  - **Common deposit insurance and resolution framework**

Four building blocks

2. An integrated budgetary framework

- Establish mechanisms that prevent and correct unsustainable fiscal policies
  - Common agreements on upper limits to annual budget balances and government debt levels for individual Member States
    - Issuance of sovereign debt beyond the commonly agreed level will have to be justified and receive prior approval

- Set up of a framework for budgetary discipline and competitiveness
  - Euro area fiscal body, such as a treasury office

Four building blocks

3. An integrated economic policy framework

- Promote economic integration
- Ensure that unsustainable policies do not jeopardise the stability of EMU
- Enforce the framework for policy coordination

Four building blocks

4. Strengthening democratic legitimacy and accountability

- **Promote mechanisms to make joint decision-making legitimate and accountable**

The European Council of end-June 2012

EU leaders have taken a number of steps based on the report

- **€120Bn "Compact for Growth and Jobs" and initiatives to complete the single market for goods and services**
- **Single supervisory mechanism for banks, involving the ECB**
- **Once the single supervisory mechanism is in place, the European Stability Mechanism (ESM) will be able to *directly* recapitalise banks, with strict conditionality and control**
- **The EFSF / ESM can stabilise government bond markets also for Member States which do not participate into IMF/EU programmes, with ex-ante conditionality**

Thank you for your attention