Europe in Post-Lehnam crises …..

Are we „on or off the track“?

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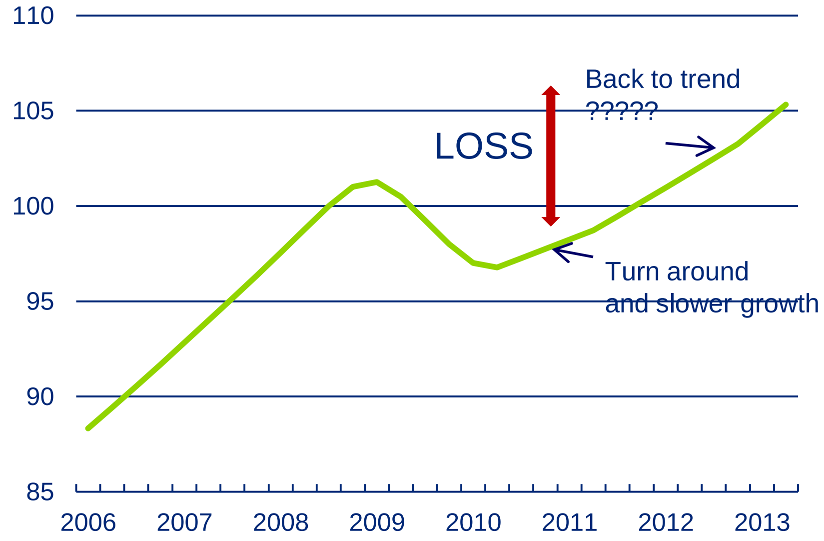
Economy of Europe

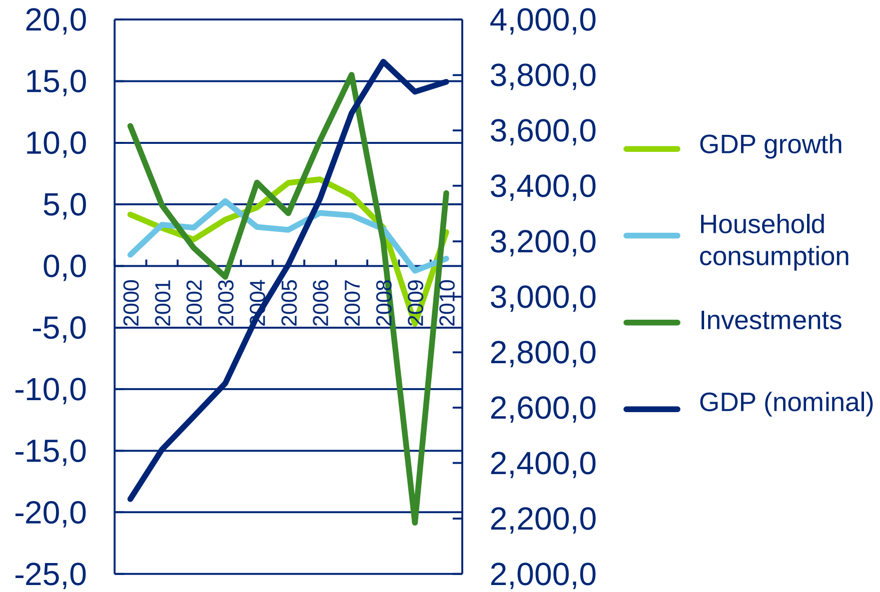
The Crisis – consequences still here

- The long-term impact of the recession on the economy – the difference between real development and an extrapolation of pre-crisis development is large
- The structure of growth is “disordered”
- The fiscal situation is not good, worse in countries facing banking crises

- Important for today:
  - Future real and potencial growth
  - Limited ability of governments to support the economy in case of crises

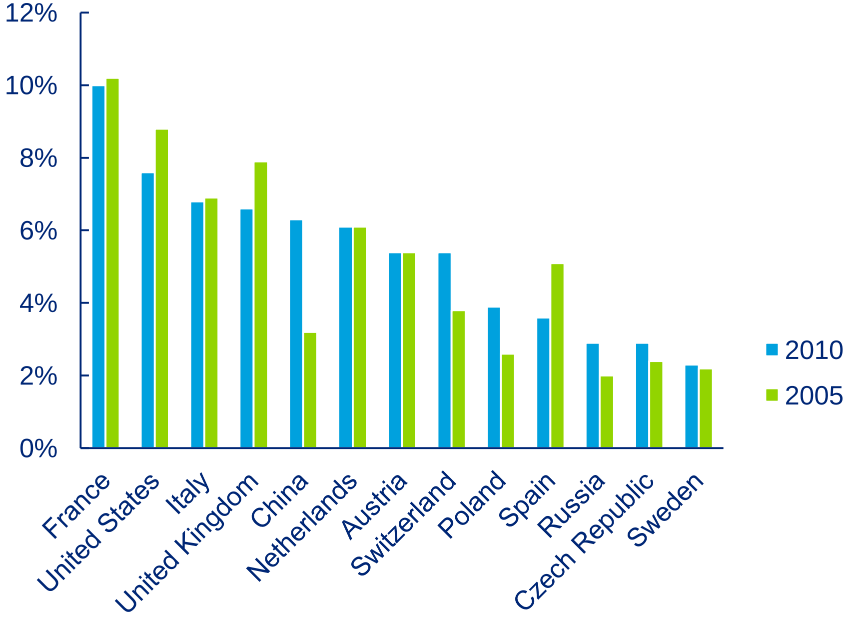
Cost of recession





What drives growth in EU?

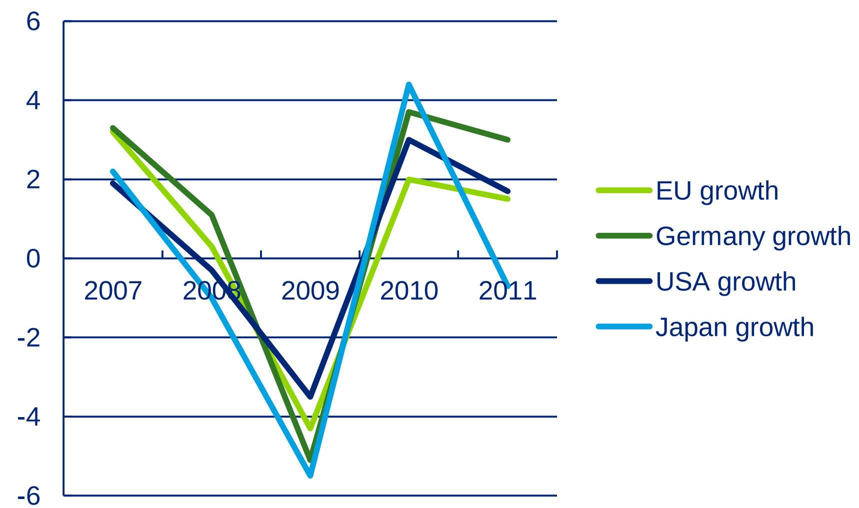
- Role of exports:
  - USA is example of relatively closed economy, Domestic demand is key driver
  - Export to GDP is 13%, imports 16%
- EU economy
  - In EU, there are many highly open economies, but EU exports to GDP are 16%, imports are the same
  - Around 60% of exports from Germany goes to EU
  - Exports to „3rd markets“ are growing fast, but the key driver of EU economy is also domestics demand of EU

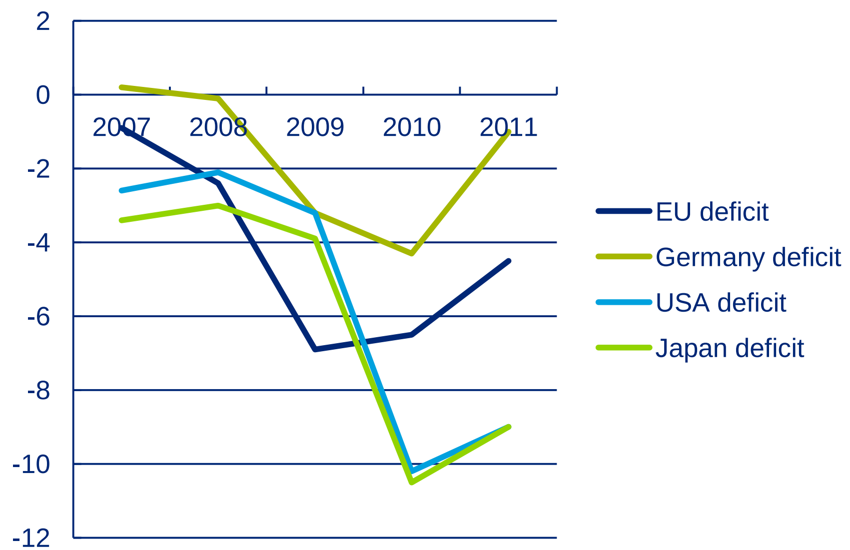


  - Single market of EU represents 20% of global GDP (PPP), has 500 milion of inhabitants

Post Lehman global development

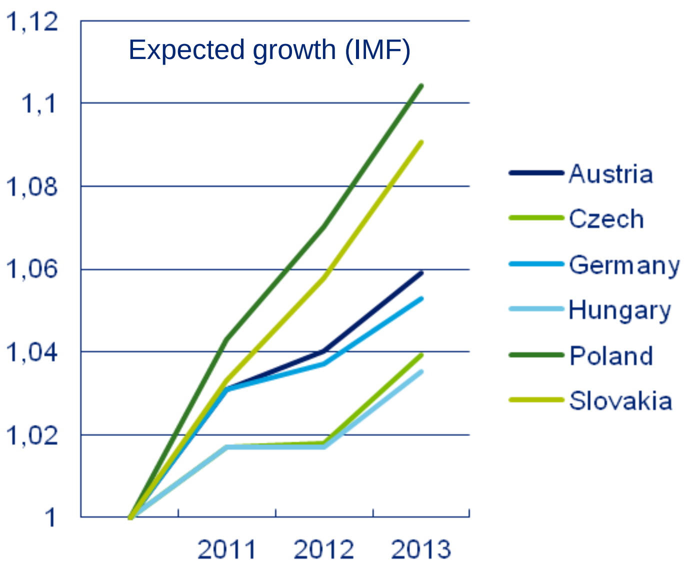
- Similar pattern of GDP development in Western economies
- Different approach to fiscal consolidation
- „Organized“ deleverage should be better than deleverage of all subject (financial sector, other private sector, government) at the same time
- Nevertheless, progress in consolidation counts - consolidation is costly in anycase…
- High potencial of fast growing economies should not be overestimated

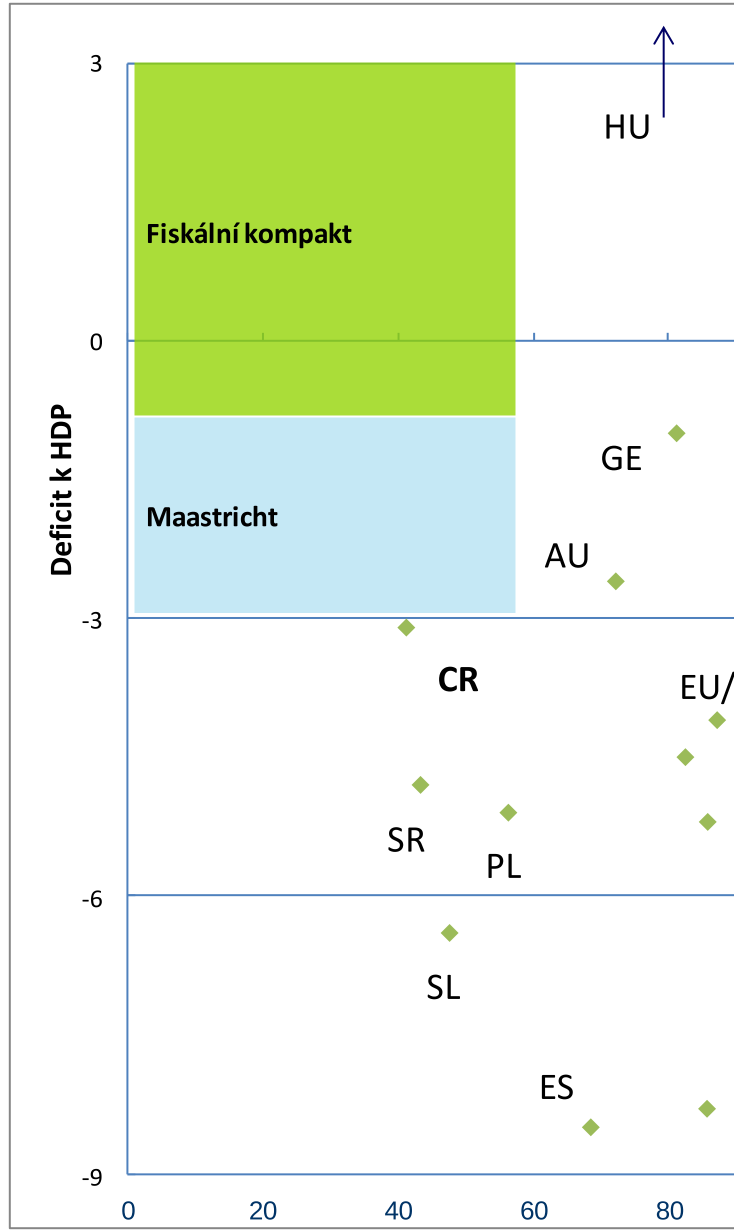




EU: Fiscal situation Examples…

- Most countries pay prices for wrong fiscal policy before crises
- High level of debt and high deficits in general sense
- Results far away from „targets“
- Prospects for growth can be different





Fiskální notifikace 2011	Dluh	Deficit
Euro	87,2	-4,1
EU27	82,5	-4,5
CR	41,2	-3,1
Germany	81,2	-1
Spain	68,5	-8,5
France	85,8	-5,2
Italy	120,1	-3,9
Hungary	80,6	4,3
Austria	72,2	-2,6
Poland	56,3	-5,1
Slovenia	47,6	-6,4
Slovakia	43,3	-4,8
UK	85,7	-8,3

Monetary policy - Euro: Good or bad project?

Important remark: Role of monetary policy

- Economic Crises as well as Crises of Eurozone have lead to misinterpretation of the Monetary policy
  - *It can hardly „make country better“*
  - *It can not solve fundamental problems of the economy*
  - *Wrong choice in combination with economic situation and financial markets can make things bit worse in short run*
  - *And vice versa*
  - *In long run flexible economy can deal with different regimes*

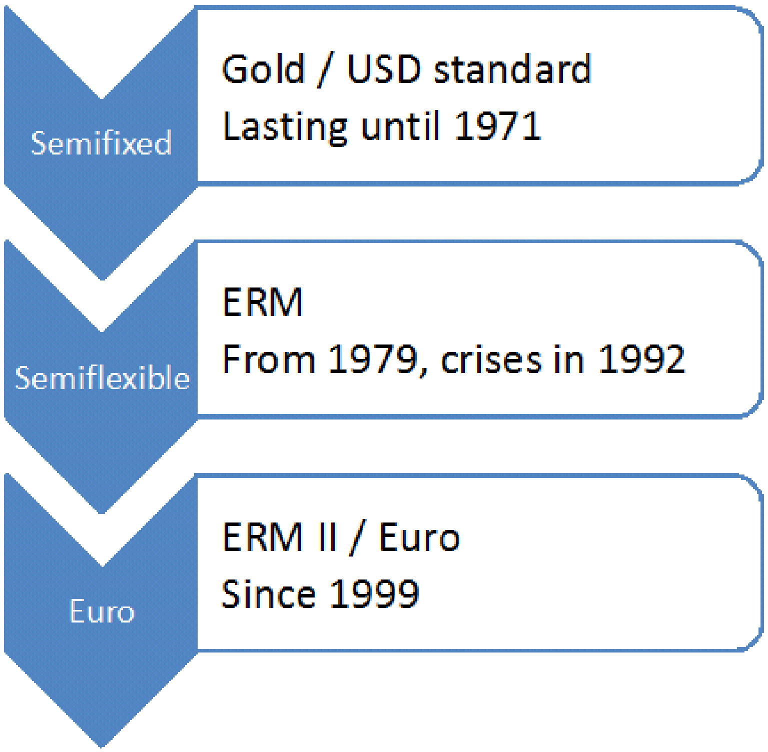
Euro project – wrong since early beginning?

- The euro is a political project, a and what are the implications?
- It is a successful project?
- Has it ignored certain basic rules necessary for good function?
- Are the roots of today's problems clear?
- Do we know how to fix it?
- Is support for countries in trouble good think?
- The collapse of the euro would be solved or the EU today's problems?

- *Sure, what else should it be?*
- *Yes, at least from technical point of view.*
- *No „systemics errors“, problems with political responsibility under estimated*
- *Yes to great extend, combination of bad fiscal policy and weak growth key*
- *Yes, to great extend (fiscal responsability and competitiveness)*
- *Yes, if it „buys time“ for good reforms*
- *Surely not*

Euro – no fall from blue sky…

- Eurozone was created after existence of ERM semi fixed arrangement (since 1979)
- This system gain credibility thank to euro project, that represents exit from this unstable system
- In last decade, volatility and large cross boarder movements of capital made other than „corner choices" difficult
- Cross border capital flows make independent monetary policy „difficult", exchange rate does not follow „interest parity" rule



Euro – „burning house, no exit“?

- Original rules were „reasonable“ from economics point of view (SGP, no bail out, ECB set up)
- Key problems were
  - Weak respect for the rules (mainly fiscal)
  - Weak economics growth, making fiscal situation even more difficult

- Market position of euro is strong (too much, sometime), 26% of FX reserves (allocated) are denominated in Euro
- Risk reduction (country risks) was too extensive and „free“
- Now it seems, that market correction is „overdone“

Life without euro …. ???

- Back to ERM? (not credible, not feasible)
- Super euro? (only Germany plus few – not solve problems, create new one)
- Floating experiment? (high volatility expected)

- What is better, more stable arrangement?

- If competitive devaluations are possible, can Common market in practice survive?

- Ps: cost of „dismantling of euro“ are impossible to estimate, but likely are huge in most cases

Anatomy of crises…

Today's crisis

- Two major risks – „negative feedback loops“
- Difficulties of fiscal consolidation in recesion:

Fiscal tightening – Weaker growth – More fiscal austerity – Even weaker growth

•Contagion between bank and states:

States or Banks – Banka or States – States or Bank – Economy

- Other aspects
  - Support for weaker states during crises worked well in most cases
  - Greek program does not work according to plan
  - Any events, that can cause contagion (f.e. exist of Greece from …..) makes situation worse
  - EU politicians are behind the market most of the time

Different crises from 2008….

Bad News and…

- Politics
- Government debt
  - Too high
  - The growth of interest (key risk)
  - Limit the ability of anti-cyclic and support policies
- Financial sector
  - High volatility of markets
  - Exposure to government debt
  - Impacts of slow growth and regulation
  - Difficulty in obtaining capital
- Economy
  - The slowdown of growth is expected
  - Many risk factoes relevant today

…Some Good News...

- Financial sector
  - Stripped of some risky assets
  - Higher capital increases stability
  - Progress in regulation can help
- Economy
  - The current sluggish recovery is not surprising
  - Firms are unusually strong financially and are more flexible
  - Also the response to downturn of demand could be „more organised“

Password: *„deleverage“*

- Growth of debt of all agents in the economy before crises was not sustainable, crises was due to „balance sheets“ problems
- Deleverage must take place in financial sector, other private sector and governments
- Deleverage imply weaker growth
- If all agents deleverage at the same time, the consequences will be substantial
- Banks must be „fixed“ first , to be able to serve economy
- Government in theory can be the last
- But „too much of hesitation“ with fiscal consolidation can be also costly

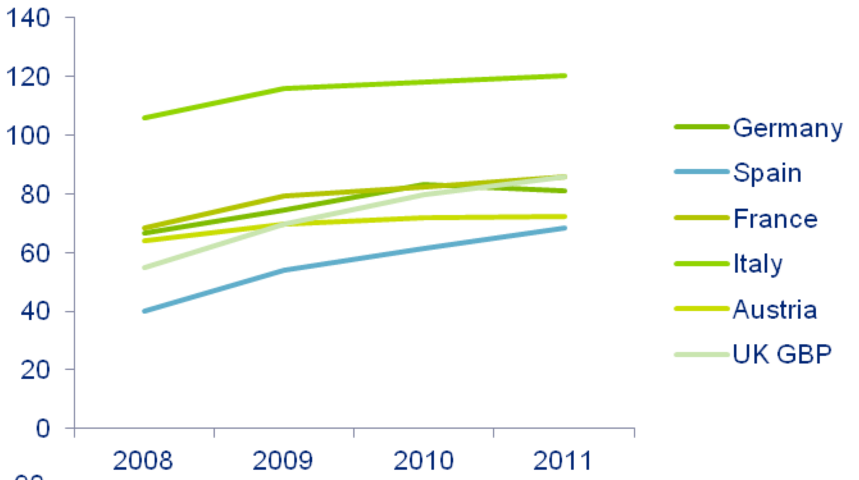
- Better regulation and supervision of financial sector is „must“, but will be hard to reach

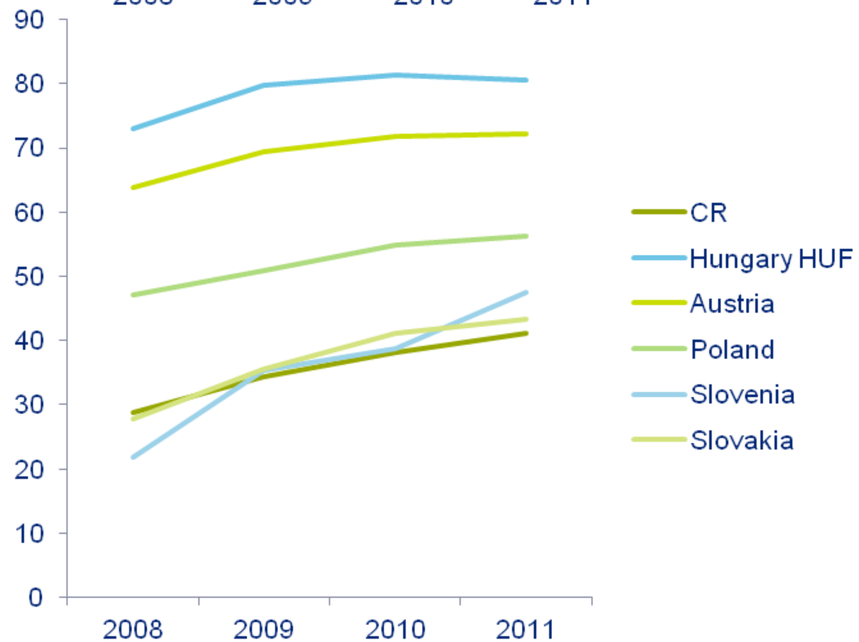
Progeress on the way?

Correction of the fiscal deficit on the way

- In old EU countries, more aggressive fiscal policy in 2009, but correction starts already in 2010
- In CEE different pattern, improvement in Hungary is „one off“
- Some countries are able to continue in growth while they are consolidating budgets

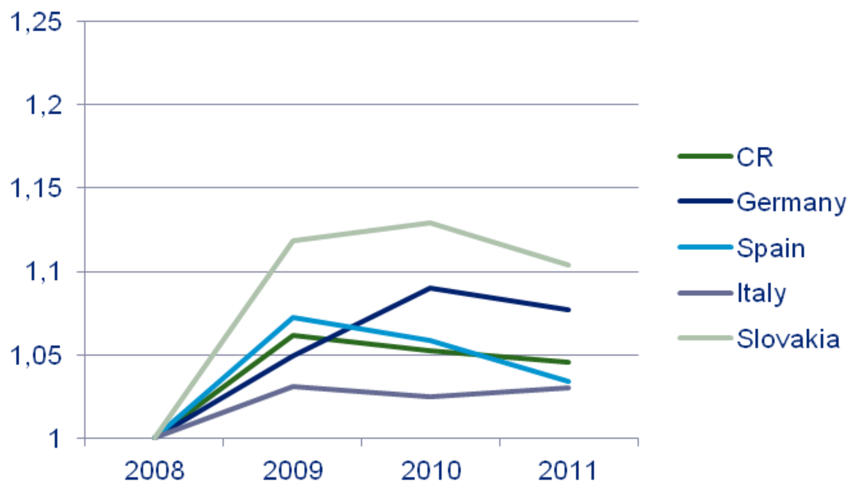
Stabilize the debt - not easy

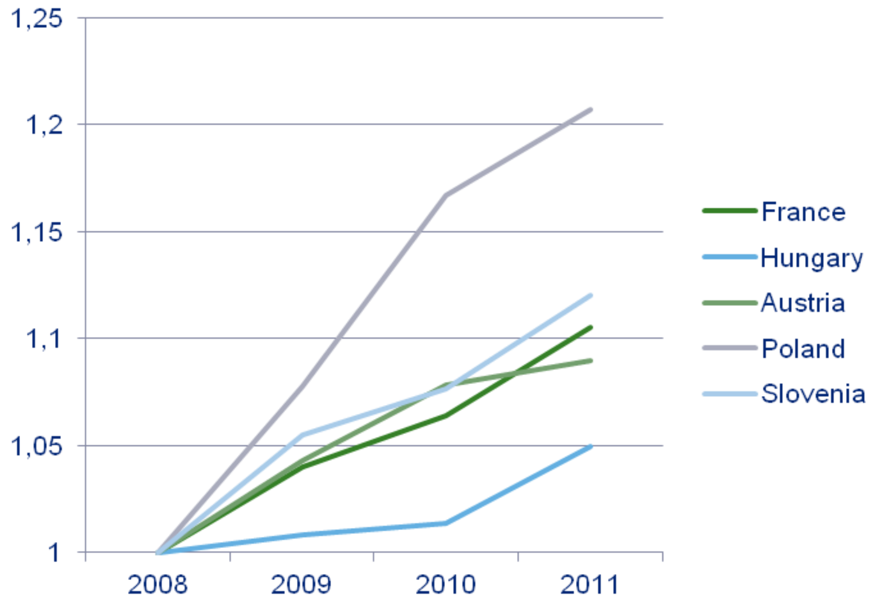




- The level of debt to GDP has increased significantly since the beginning of the crisis
- High debt means higher dependance on cost of detb
- In some countries, there is a substantial deceleration of their increase, in some cases even under conditions of slow growth
- The economies of the new EU members are with exception of Hungary, considerably less indebted, stabilization seems to be on the way
- Growth of debt in Slovenia (also Spain and UK) raises concerns, improvement of Hungary „artificial"

Reforms are not popular….work is hard, progress differs….





- Budget reforms affecting the people and have a major impact on the political situation, some people do not (want to) understand the situation
- Ability to reform the expense side is the key to sustainable development
- Reduction in spending of states is needed, the data (nominal) clearly shows the diversity of the situations and the access of Governments to fiscal consolidation
- Growth make reforms easier, but issue of sustainability is „tricky“
- Considerations of fiscal-stimulus from budget would be thereticaly possible only for some states

EU: New architecture?

EU model tested by crises

- Main weak points seems to be clear:
  - Weak enforcement of fiscal discipline
  - Competitiveness on decline in some states, Slow growth is consequence
  - Ability to deal with banking and financial crises limited (problems with cross border problems with multinational banks and also size of crises)

- Limitations in crises management:
  - IMF is likely not very enthusiastic about lending huge sum of money to highly developed countries
  - ECB play too large and partly controversial role in dealing with crises
  - **Europe (policy makers in EU) should find its own way how to make Europe stable**
  - So far, progress is limited, but still better, than „appearance“
  - None single policy or decision would solve all the problems, stabilization will take time

What was done…

- Substantial changes in „economics governance model of EU“
    - Six pack (including MIP)
    - Two pack
    - Fiscal treaty

    http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm

- Temporary mechanism
    - Troika, cooperation with IMF
    - EFSM, EFSF, ESM

  http://en.wikipedia.org/wiki/European_Stability_Mechanism

- Others

Summer Euro Menu on the table

- Banking Federation / Union
  - Shape and details not clear
  - European regulation of European bank make sense and is effective
  - EU wide deposit insurance as well
  - Allocation of the costs of large „European“ interventions (via any kind of EU funds) can be tricky

- Fiscal Federation
  - Shape and details not clear
  - Now: EU budget exist, even with „own revenues´“, fiscal transfers exists, some taxes are harmonized, rules for fiscal policy exist from beginning etc.
  - More „harmonization“ in some cases make sense, but not in all (taxes should also reflect debt)
  - Euro-bonds, if done properly, can help. Increase moral hazard can be limited
  - Extending role of ESM will be tricky

Where we stand….

- Council and EC has reached substantial progress in setting up rules and principals, that can make EU economies more competitive and stable into the future
- Still, how the system will be functioning in the future, and robustness of the implementation of the procedures „de facto“ is not clear

- Progress in dealing with short term problems is much more limited, short term political factors prevail
- Conflict of
    - Reforms first and than ask for support
    - Receive support to get time for reforms

  is hard to solve
- **But bright distant future can be reached only via near future**

Possible development

- Crises is not over, time is running fast
- Decisions must be taken, no decision is decision

- Many EU countries consider EU integration as very important project for their future
- EU leaders can decide to spend less time to convince „trouble makers“ and multi speed Europe can be reality
- Even limited „disintegration“ can start the process, that would be hard to manage and can change Europe substantially

- During crises, it is not surprising, than some strategical decisions can be taken. This process „is not nice“

EU – where is *Nash equilibrium*?

- Each member of Union can value different part of EU integration differently
- EU integration process is formed from more than one policy:
  - Political implication (more stability, security or influence)
  - Common market (asymmetrical benefit for different states)
  - EU fiscal transfers (cohesion and agricultural transfers)
  - Other common policies
  - Schengen system
  - .....
- Czech assumption, that „what even happens, the common market will stay“ can be very wrong. Cost and benefits of this policy are not same for each state and also are changing in the time
- Today, it is hard to say, how EU for tomorrow will look like…

…too many players,
too many varinables,
too many interests…

Future of Europe?

Thank you…

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