



Euro-area challenges in the context of the financial and economic crises

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Outline of Presentation

- 1. Emerging macro-economic imbalances in the euro area in the years preceding the financial crisis
- 2. The financial and economic crises and their effects across the euro area
- 3. Responses & challenges
- 4. Conclusions



Part 1

- Emerging macro-economic imbalances in the euro area in the years preceding the financial crisis

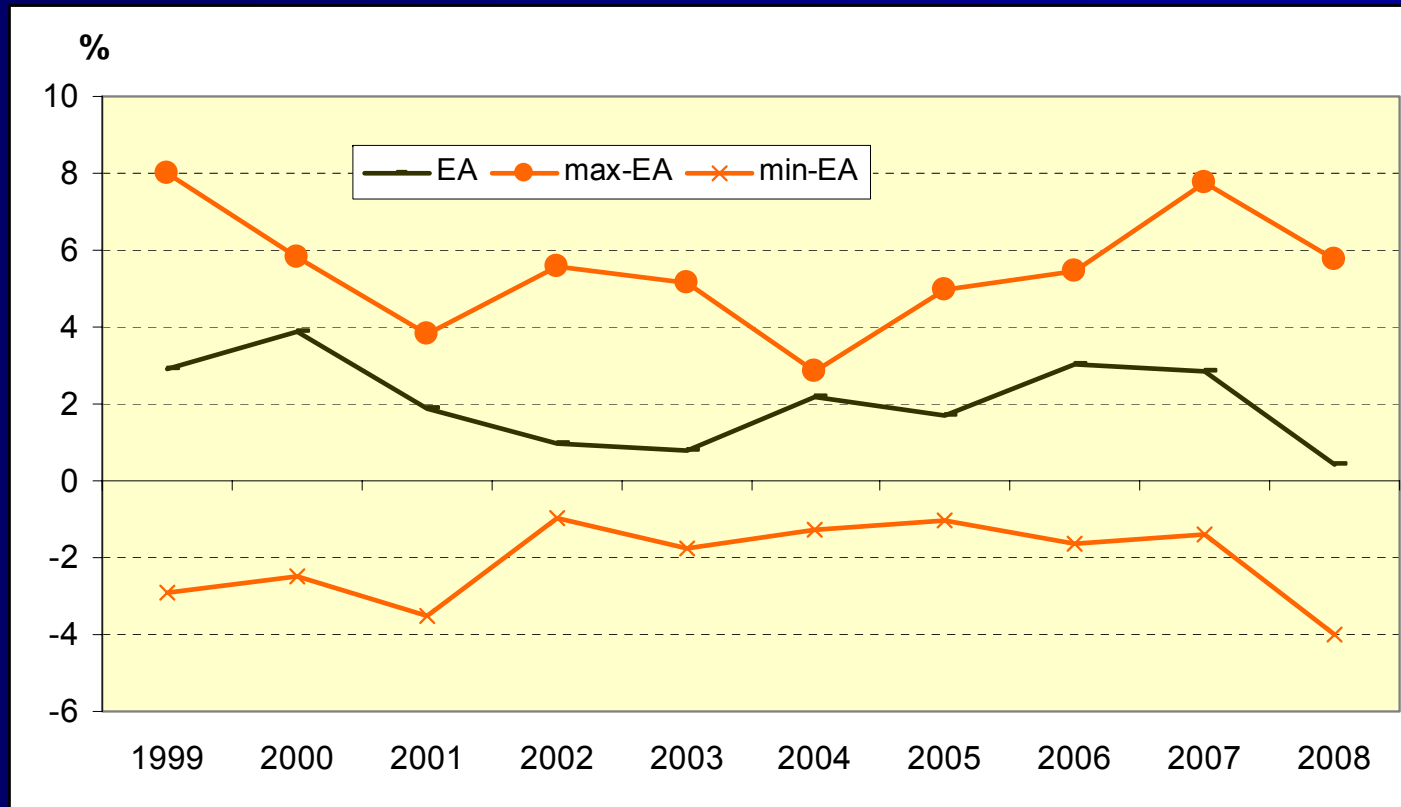


Growing imbalances

- GDP growth remained slow in some countries, due to unsatisfactory productivity performance [graph]
- Rising divergences in competitiveness and large current account imbalances [graph] [graph]
- Evidence of internal imbalances in some countries [graph] [graph] [graph]
- Generally, structural reforms were less ambitious and less frequent than in the rest of the EU
- Banking and financial markets remained predominately nationally organized and supervised

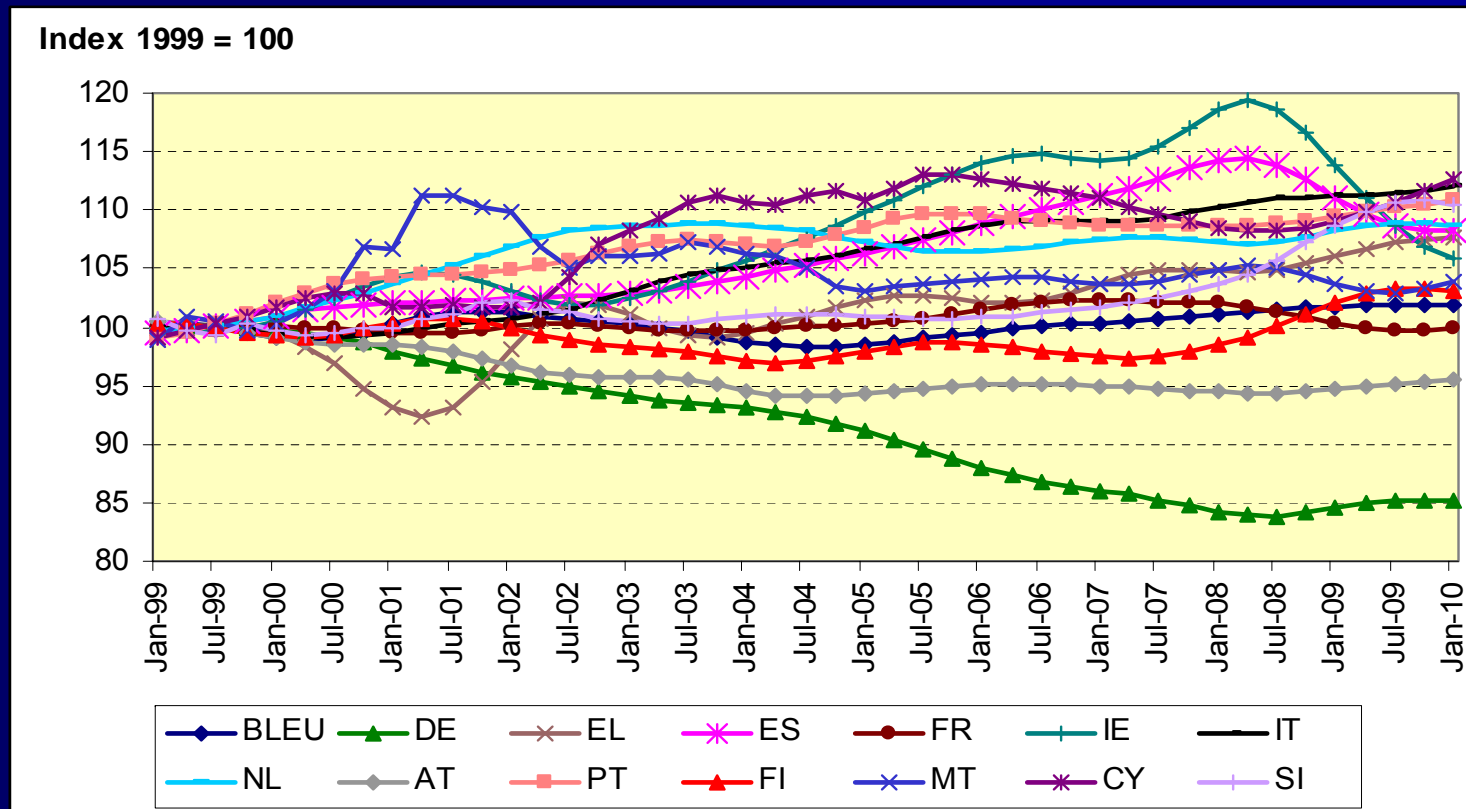


Growth range in the euro area, 1999-2008



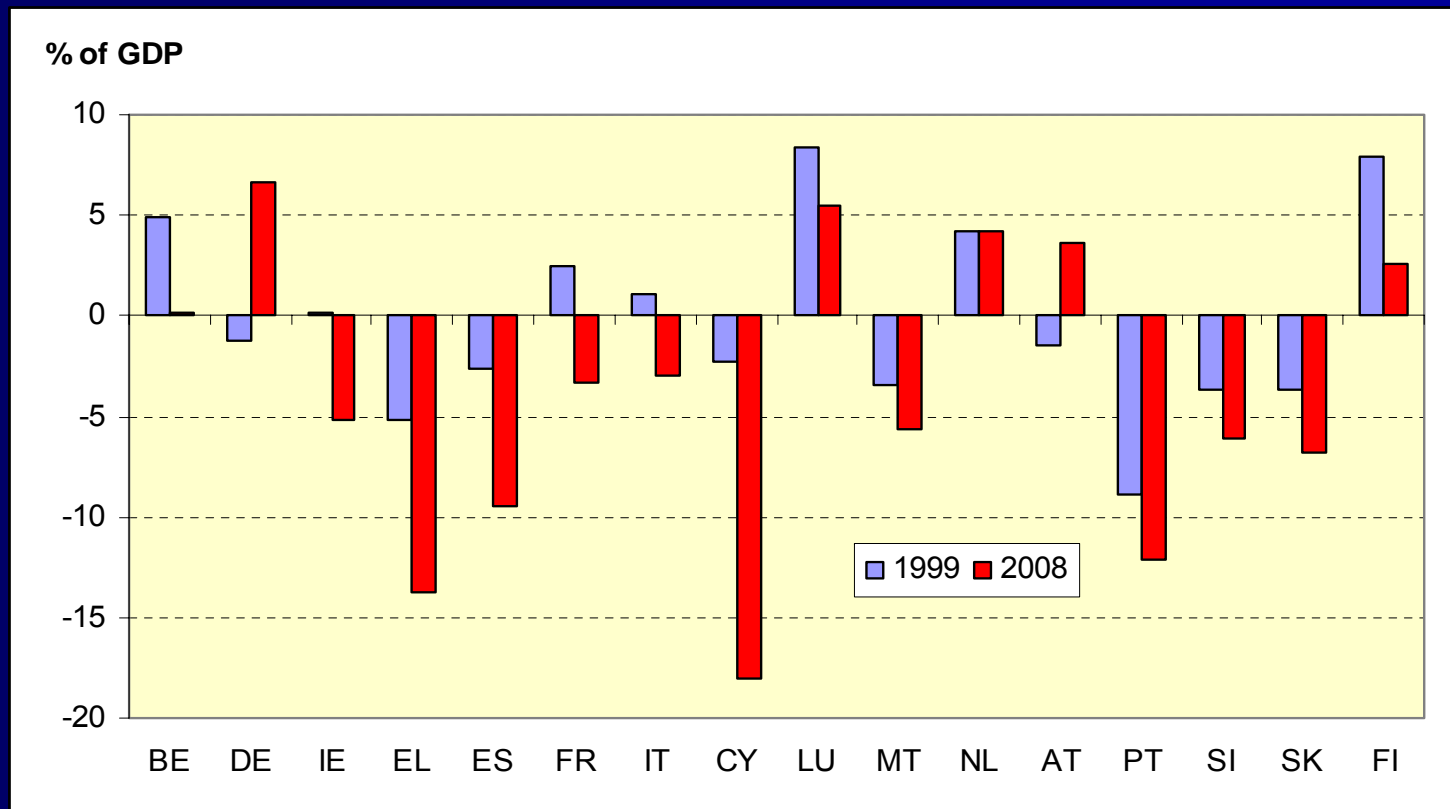


Competitiveness in euro-area countries (REER-ULC vs rest of euro area)



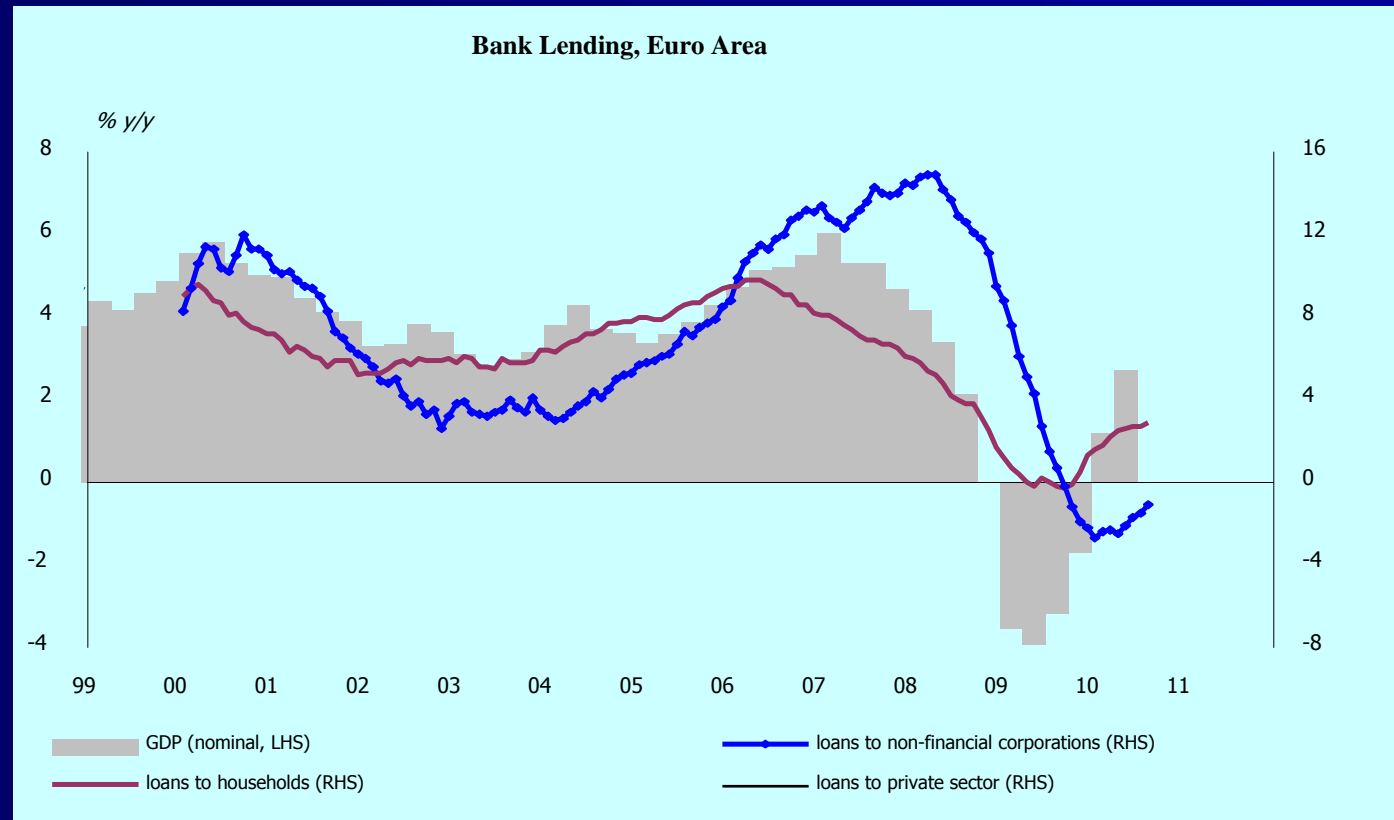


Current account balances in euro-area countries



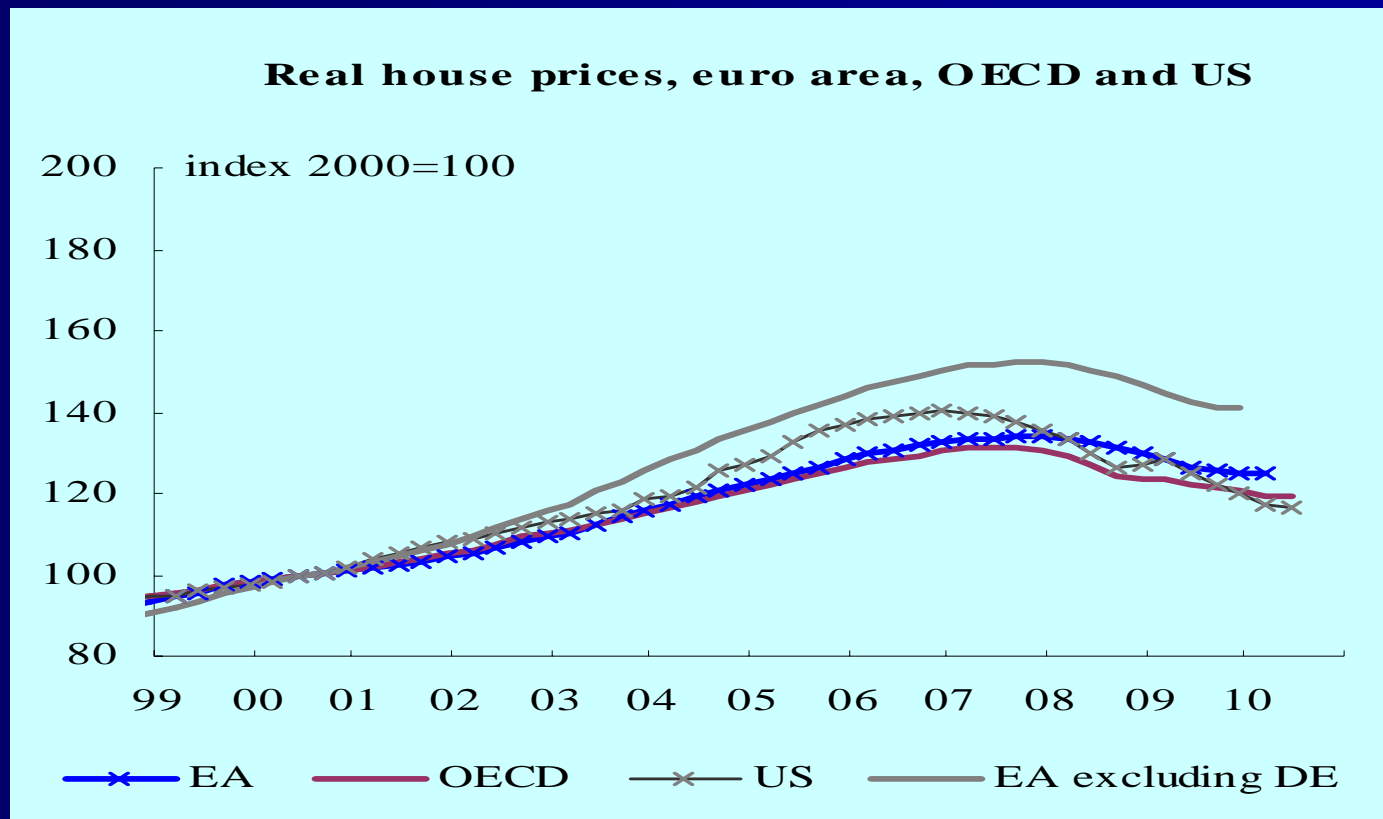


Bank lending



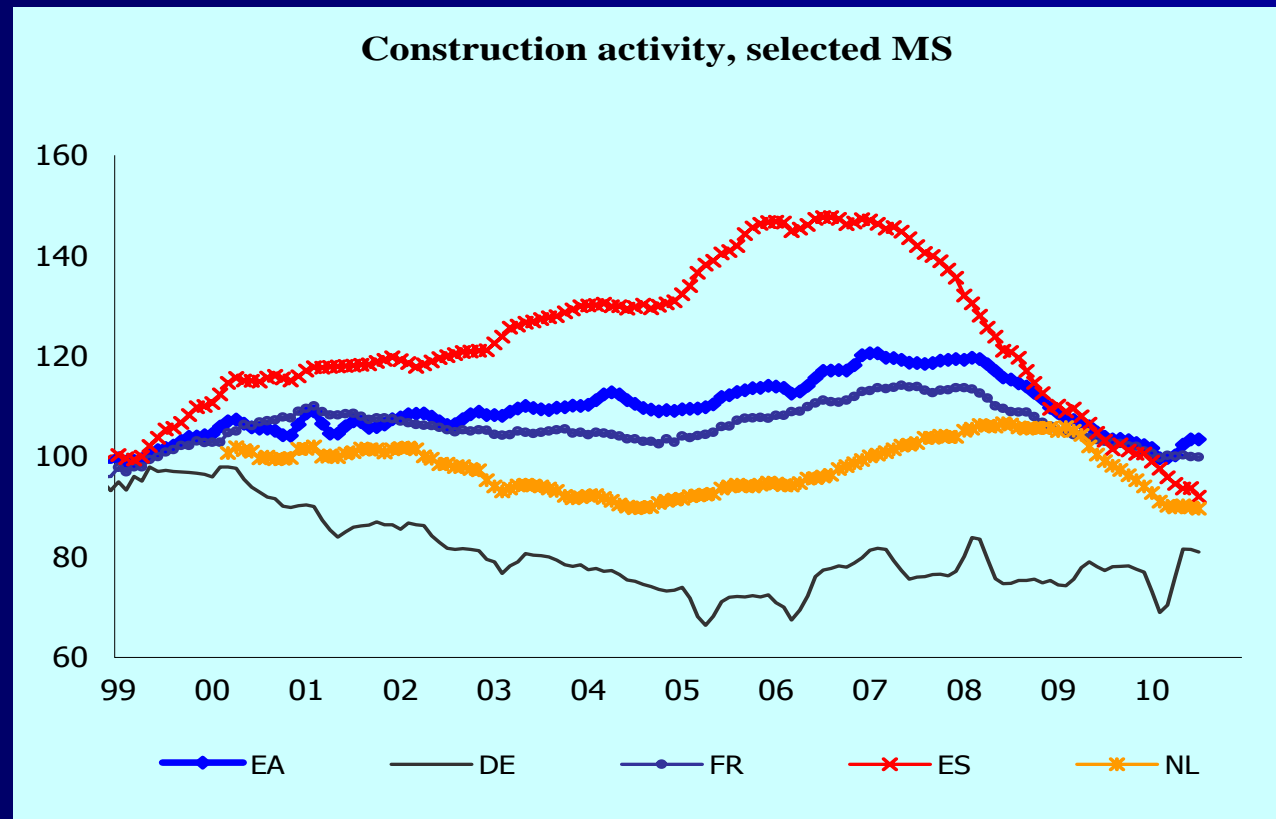


House prices





Construction sector





Part 2

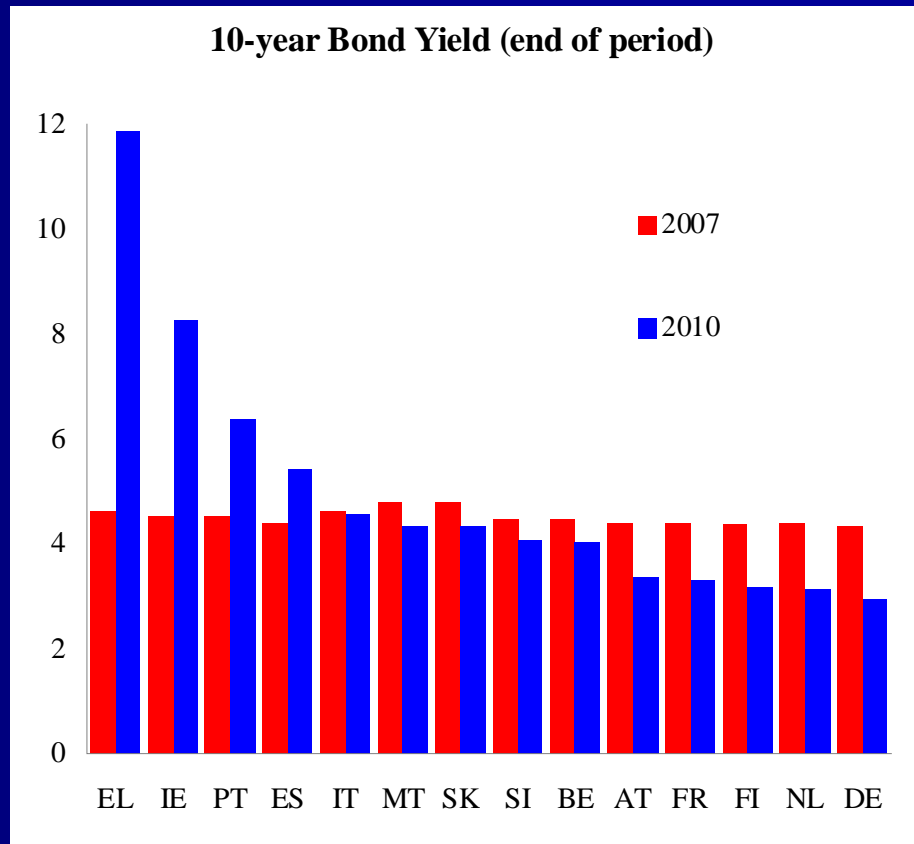
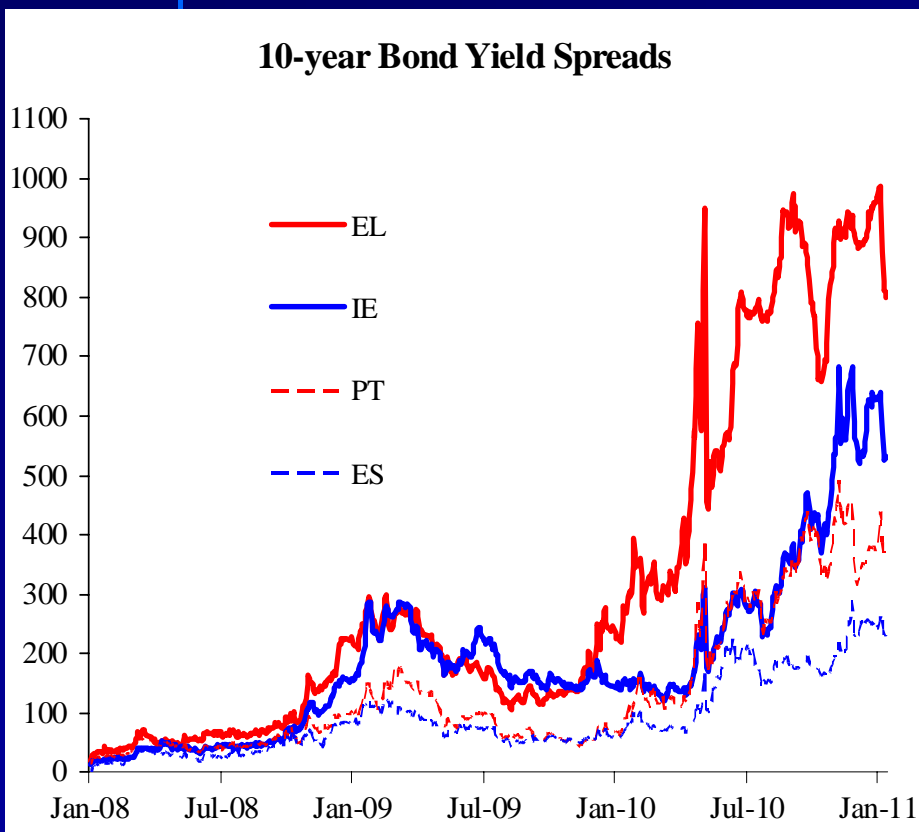
- The financial and economic crises and their effects across the euro area



Intensification of market tensions

In H2-2010 financial market tensions intensified in the euro area...

...with the widening of spreads affecting EL, IE, PT, ES and some other Member States

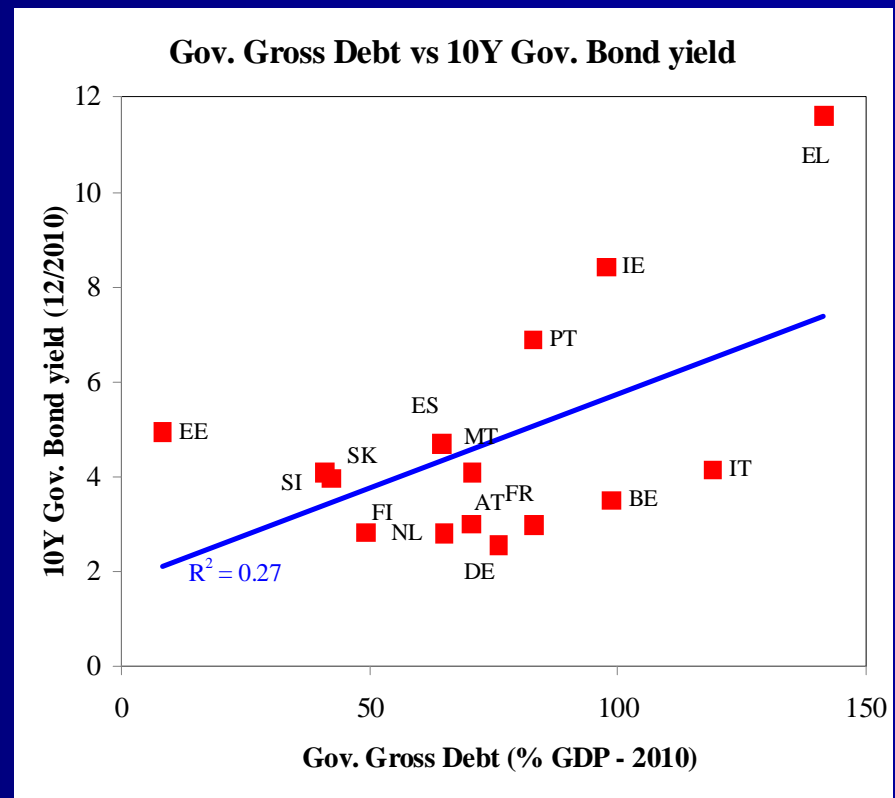
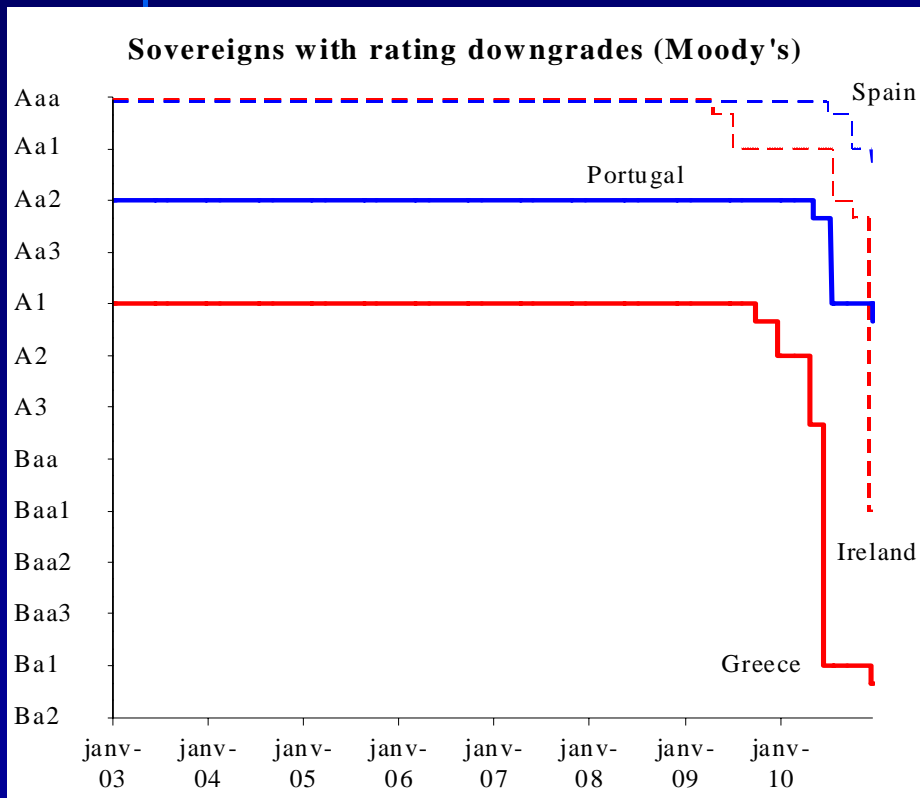




Downgrades by rating agencies

Rating agencies downgraded sovereigns of IE, EL, ES and PT

Developments in market sentiment only weakly correlated with public debt levels



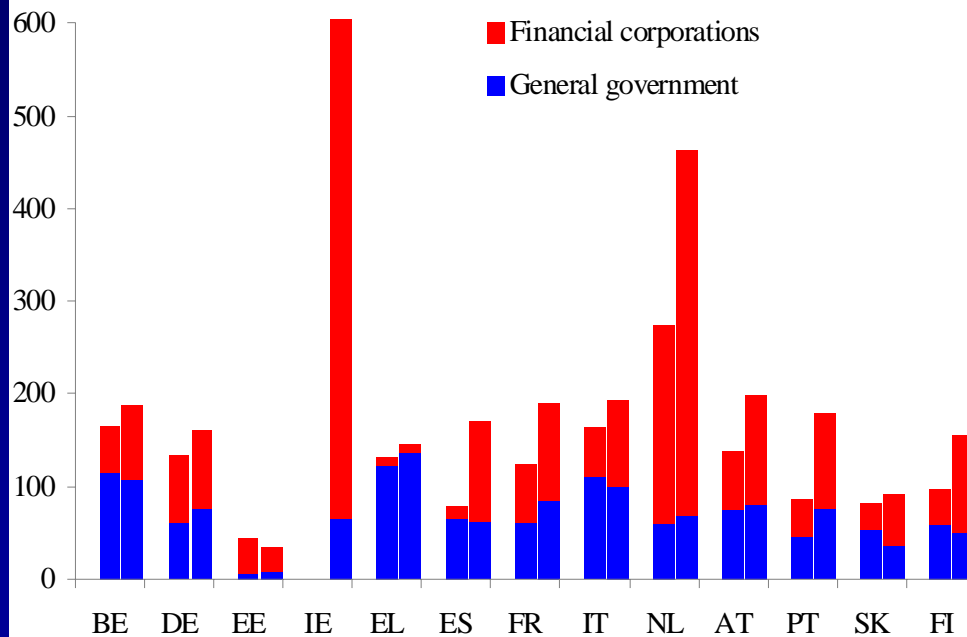


High private sector debt => risks for growth and financial stability

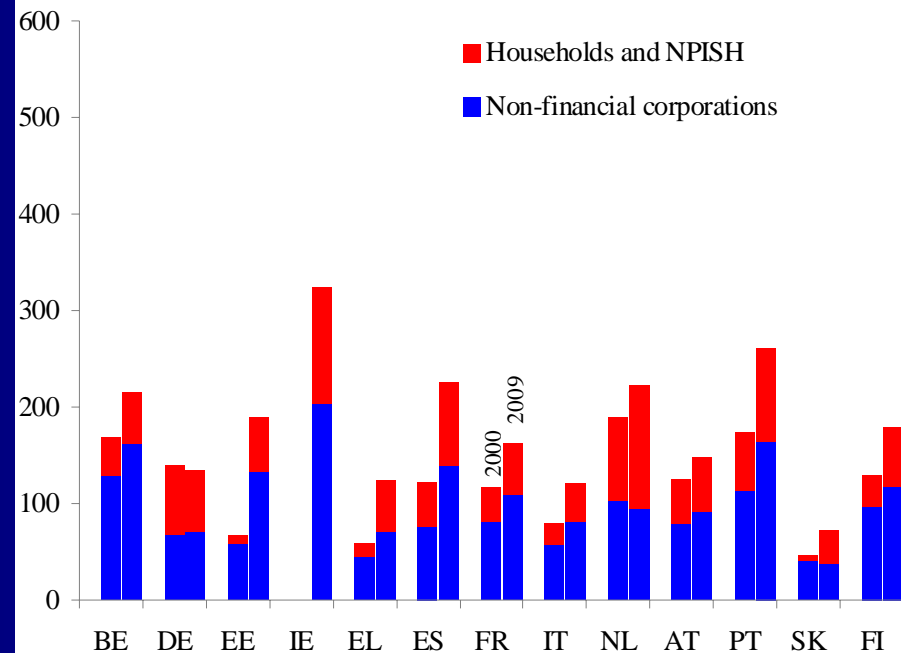
Given worsening financing conditions, high sovereign and financial sector debt => key sources of vulnerability

Large private sector debt (Hhs and non-financial corporations) a threat to bank profitability during the crisis

Sectoral debt levels, 2000 and 2009* (% GDP)



Sectoral debt levels, 2000 and 2009* (% GDP)

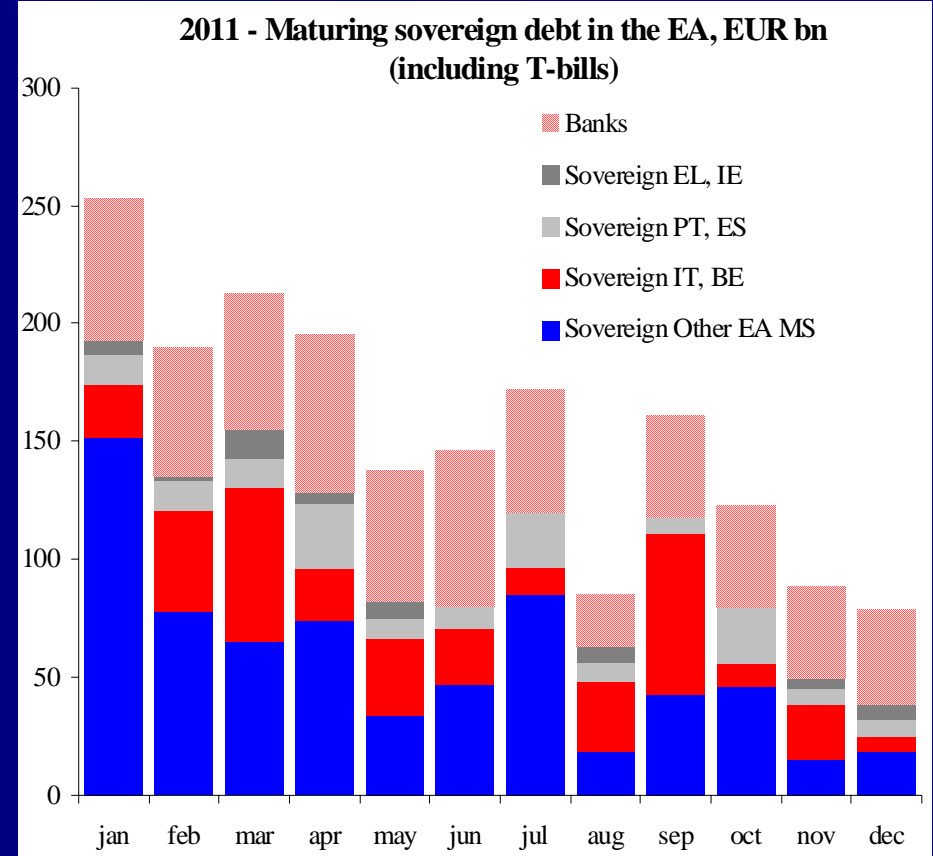
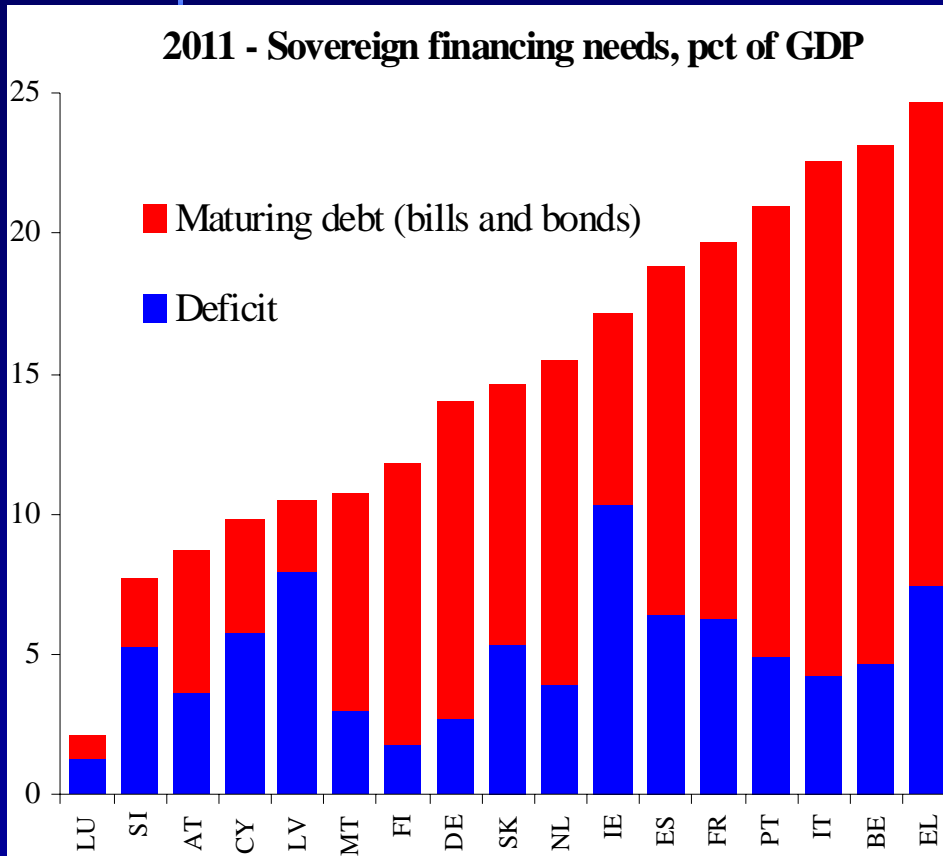




Large financing needs in 2011 => market concerns

For some Member States, sovereign financing needs are large in 2011

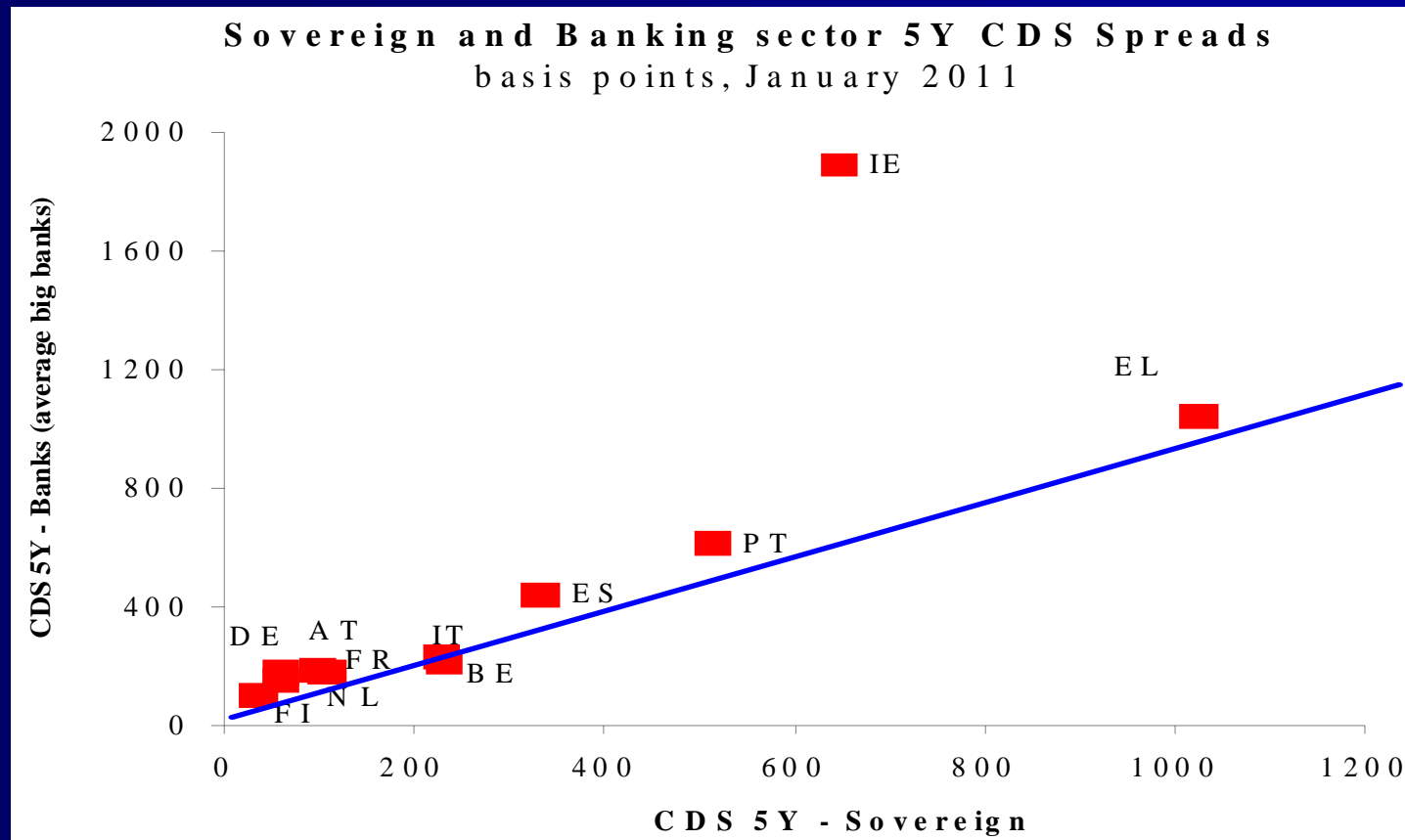
While euro-area banks will also need to tap international capital markets





Sovereign spreads and bank spreads

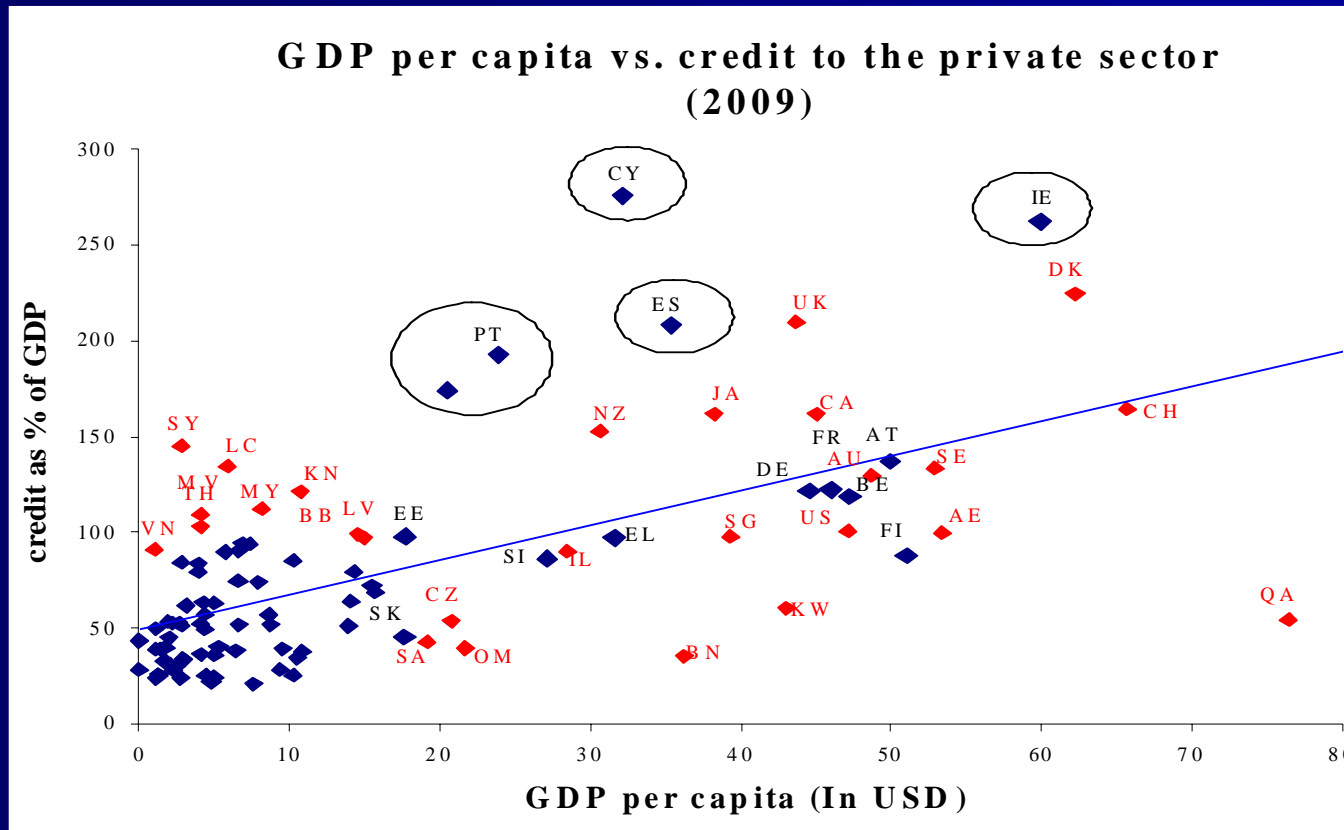
In some vulnerable MSs, the increase of sovereign spreads pushed banks spreads up (and vice versa in some other MSs)





Need for deleveraging in some MSs

In some previously “catching-up” EA Member States, the increase in credit during the boom phase went far beyond balanced and growth-friendly financial deepening



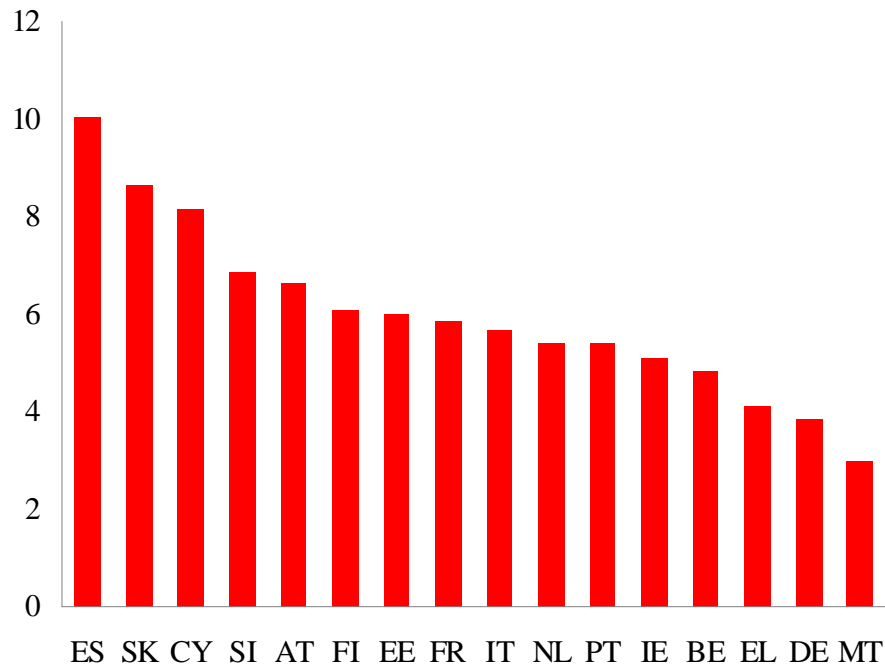


Needed sectoral and asset price adjustments weigh on growth

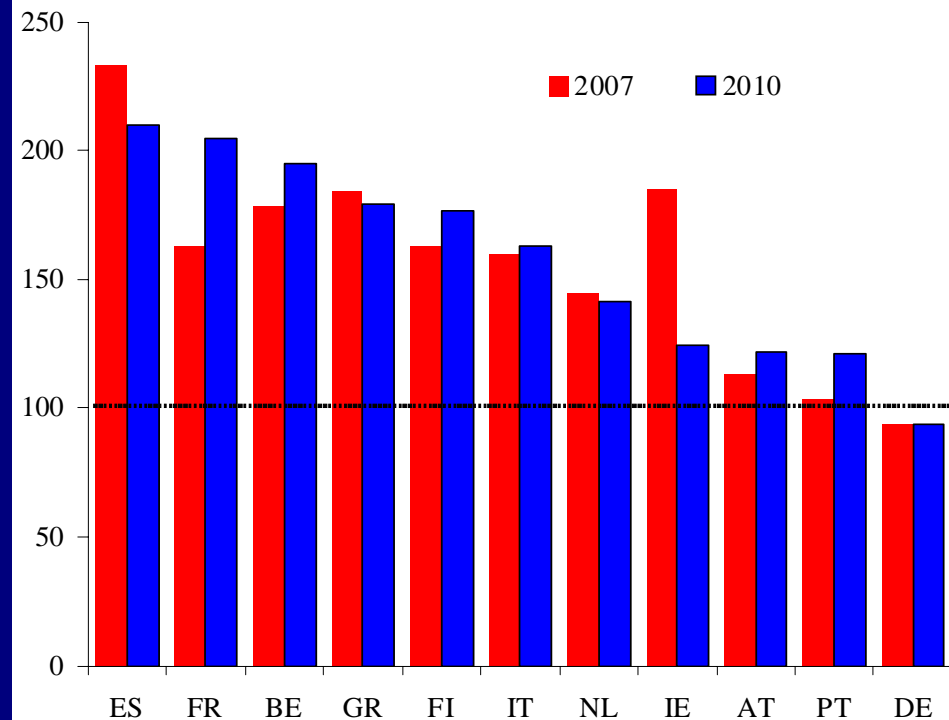
Important sectoral adjustments are necessary, which is a key challenge for labour markets

Asset prices will also need to adjust, which will weigh on growth and government revenue

Share of the construction sector in GDP, 2009
% of GDP



House prices
2000 = 100



DE = 2009



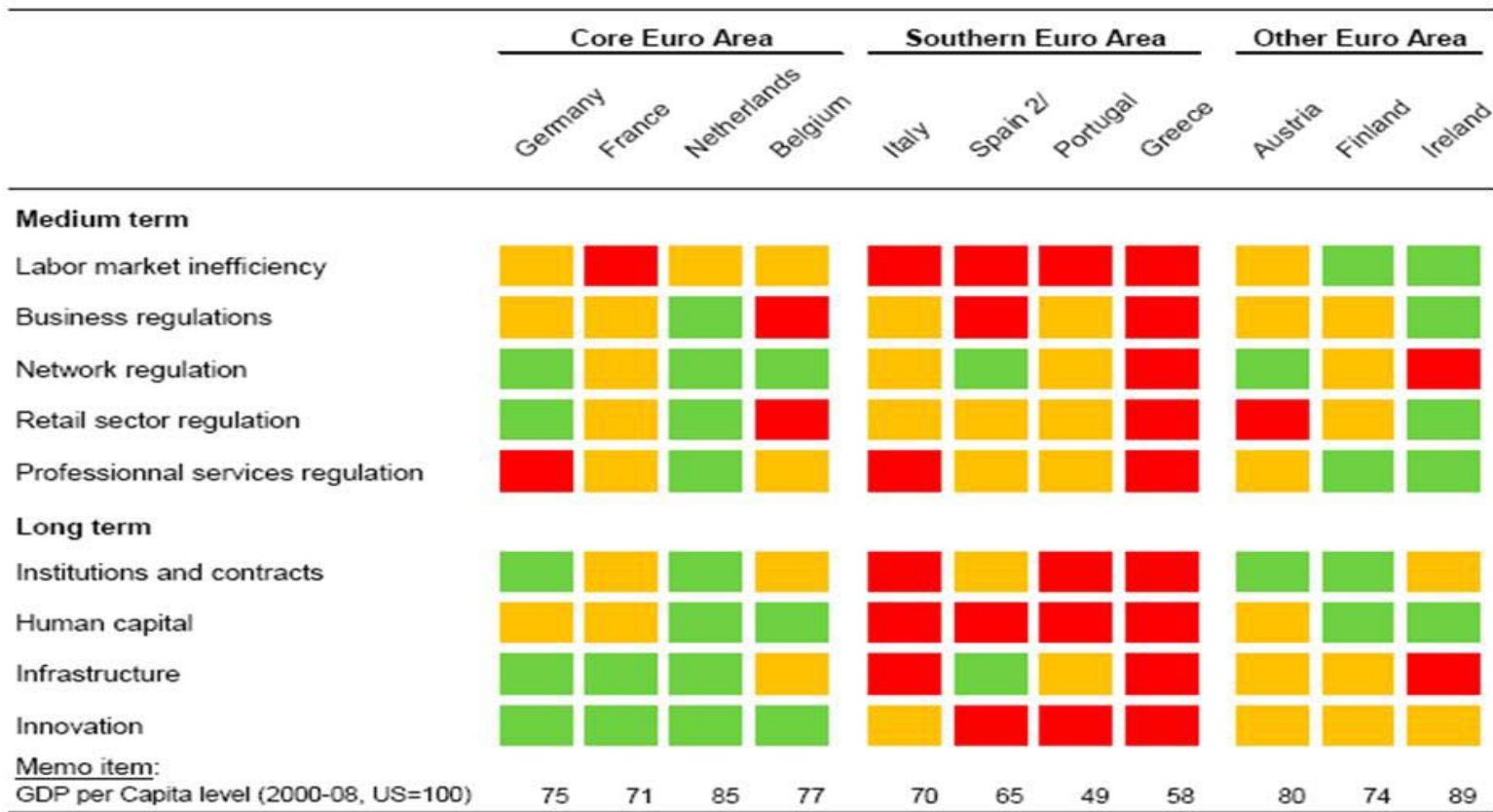
Common challenges but reform needs in the four Member States not identical

	Greece	Ireland	Portugal	Spain
(+)	No real estate bubble Banking sector more robust than expected Adjustment already well under way	Flexibility of the economy Adjustment well advanced	No housing boom Banks have been resilient to the crisis Fiscal adjustment has made a good start	Strong institutions Lower-than-average government debt Adjustment already under way
(-)	Very high public debt Structural rigidities High external debt (public) Competitiveness Weak institutions	Need to restore confidence in the banking sector Very high private and external debt Large government deficit	Important structural rigidities Large external imbalances Competitiveness High private and external debt	Real estate prices still have to adjust Competitiveness High private and external debt Labour market rigidities



Structural reform needs also very different across Member States

Structural Reforms Gaps in European Economies: A Heatmap 1/



Sources: OECD; World Economic Forum; Fraser Institute; and IMF staff calculations.

1/ See IMF, 2010d for a description of the methodology, and of the detailed components of the labor market heatmap.

2/ The indicators do not incorporate the labor market reform implemented in Spain in 2010.



Part 3

- Responses and challenges



Strong policy response at EU level, unprecedented actions

- May 2010: joint package for Greece, EUR 110 bn
- June 2010: EU financial safety net: EFSM, EFSF, IMF, 750 bn
- Sept 2010: COM presents Economic Governance Package
- Nov 2010: joint programme for Ireland, EUR 85 bn
- Unconventional measures by ECB (SMP, liquidity provision)
- Cooperation with IMF to maximise resources and credibility
- Dec 2010: HoS commit to do “whatever it takes” to preserve financial stability in the euro area



Adjustment strategies in vulnerable euro-area Member States

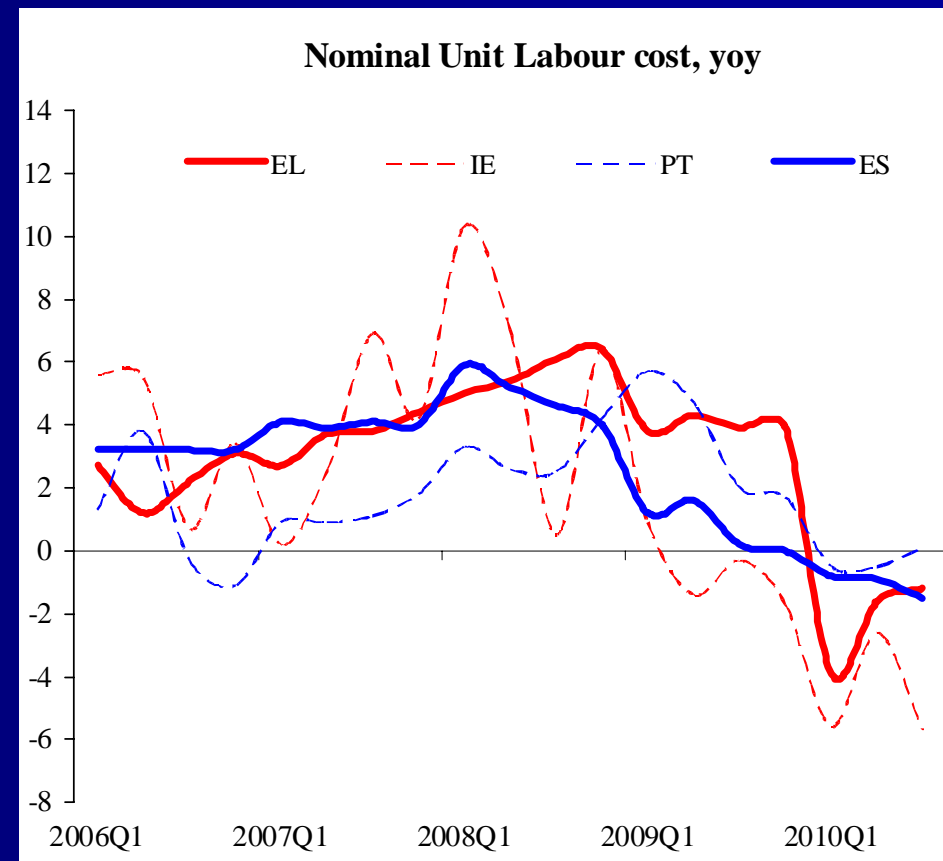
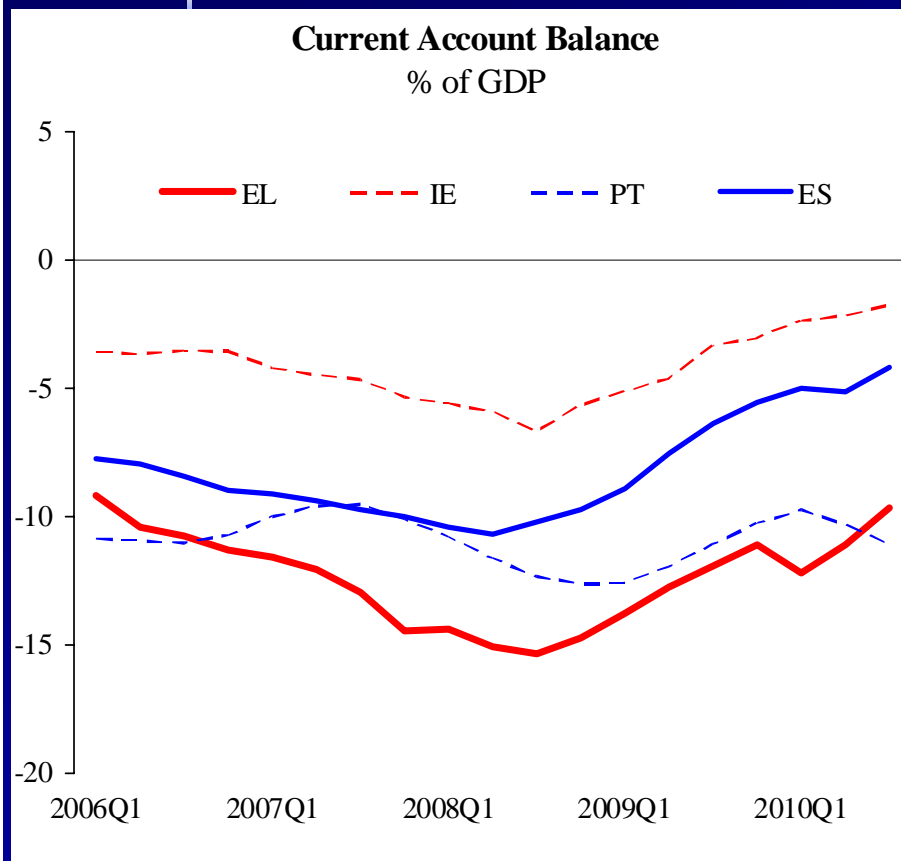
Greece	Ireland	Portugal	Spain
<p>Fiscal</p> <p>Deficit ↓ from 15 to 3% of GDP over 2009-14</p> <p>Measures worth 20% of GDP over 2010-14</p> <p>Front-loaded, structural adjustment</p> <p>Primary surplus above 5% of GDP until 2020</p> <p>Institutional reforms</p> <p>Structural reforms</p> <p>Deep labour and product market reforms</p> <p>Pension and health care reforms</p> <p>Financial sector</p> <p>Creation of the Financial Stability Fund</p>	<p>Fiscal</p> <p>Measures worth 9% of GDP over 2011-14</p> <p>Front-loaded, structural adjustment</p> <p>Structural reforms</p> <p>Labour market reform, reforms to increase competition</p> <p>Financial sector</p> <p>Reorganisation of the sector, winding down unviable banks</p> <p>Increase in capital buffers, rigorous stress-testing</p> <p>Strengthening of banking supervision and resolution</p>	<p>Fiscal</p> <p>Deficit ↓ from 9.3 in 2009 to 3% of GDP in 2012</p> <p>Measures worth 5% of GDP in 2011 budget</p> <p>Strengthening of the fiscal framework, address losses in SOEs</p> <p>Structural reforms</p> <p>Reforms of labour and product markets to foster adjustment, competitiveness and growth</p> <p>Reforms of housing market</p> <p>Financial sector</p> <p>Surveillance of banks</p>	<p>Fiscal</p> <p>Deficit ↓ from 11 to 3% of GDP between 2009 and 2013</p> <p>Tight control on regional and local authorities</p> <p>Structural reforms</p> <p>Labour market reform to reduce market duality</p> <p>Reforms of product and services markets</p> <p>Reforms of pensions</p> <p>Financial sector</p> <p>Downsizing and reorganisation (FROB)</p> <p>Reform of the savings bank law, stress tests</p> <p>Tougher provisioning requirements</p>



External adjustment proceeding, but at varying speeds

Current account imbalances gradually being reduced ...

... reflecting, inter alia, ongoing adjustments in cost competitiveness

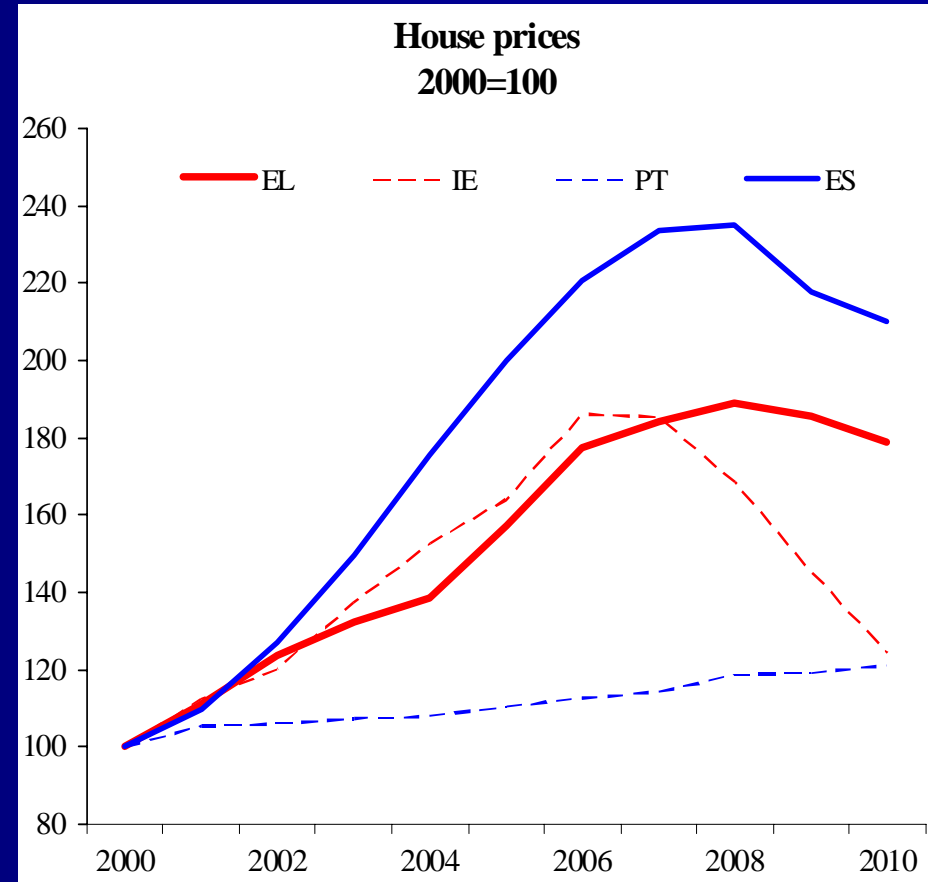
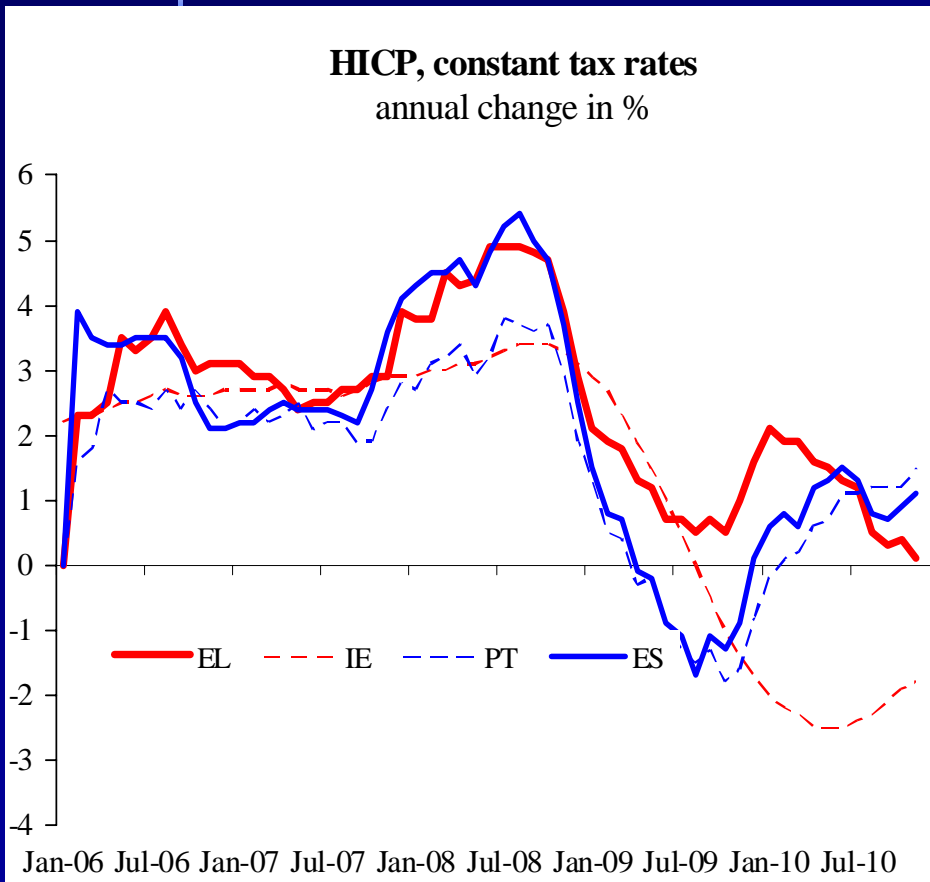




Price levels gradually adjusting in IE, EL, ES and PT

Adjustment of prices is also well underway. Not only prices of goods and services...

...but asset prices, although the speed of adjustment varies considerably across Member States



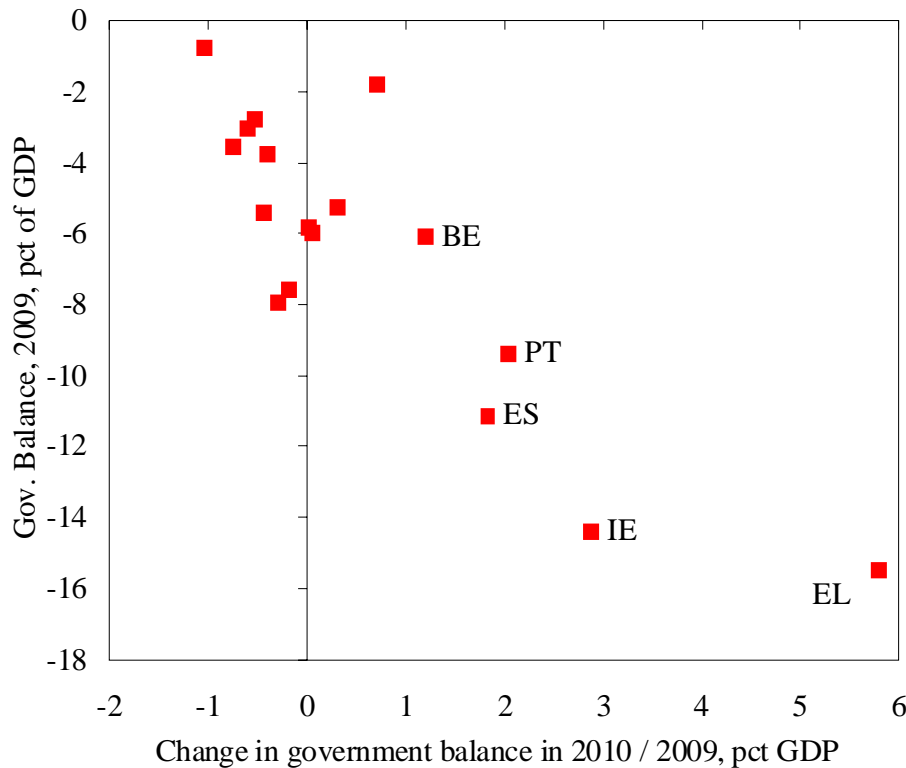


Fiscal adjustment has started in IE, EL, ES and PT

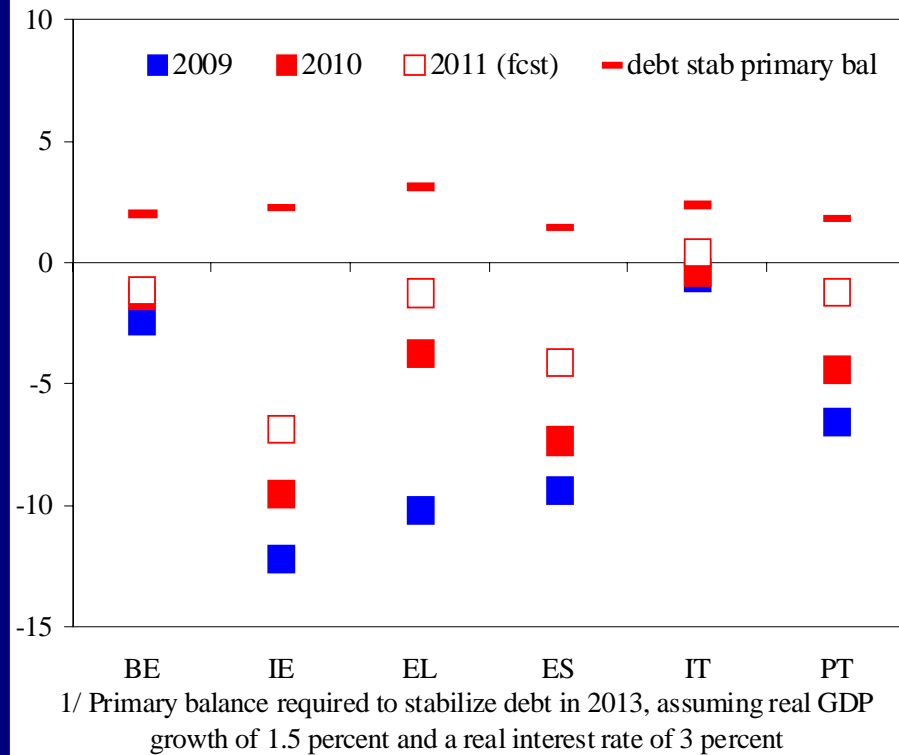
High deficit Member States also those that made the largest fiscal efforts in 2010...

...placing them on the right track to stabilise government debt in a couple of years

Level and change in the government balance in the Euro area Member States



Primary balance and debt stabilising primary balance 1/

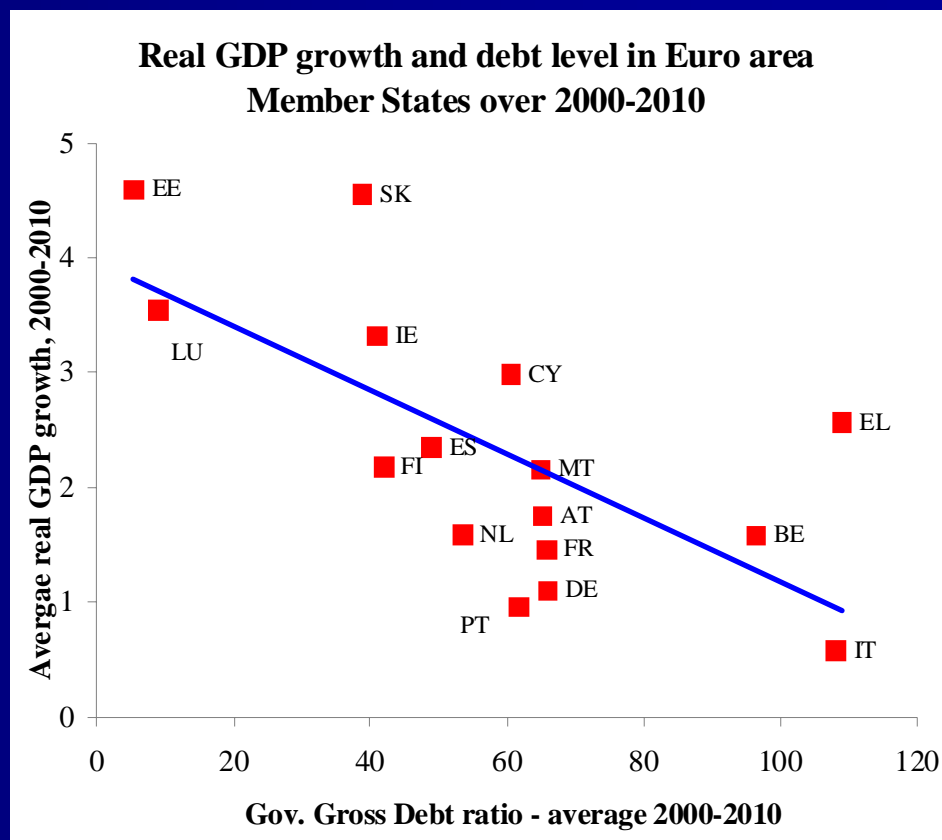
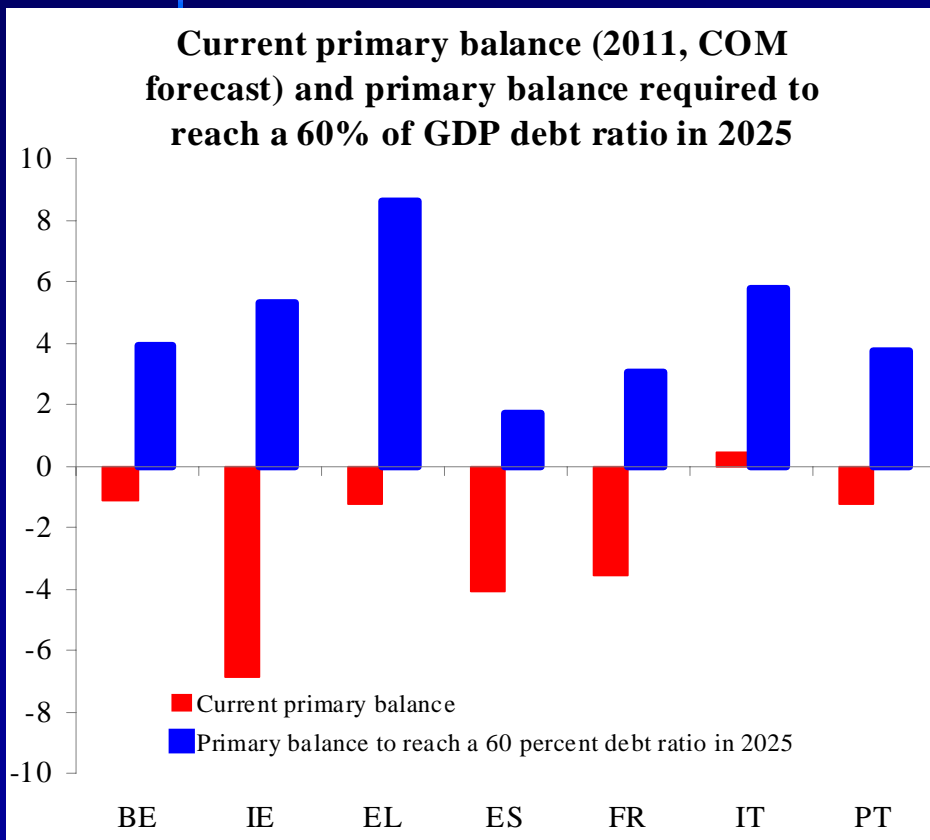




Challenge is not only to stabilize debt, but to reduce it significantly

Member States will have to aim for a rapid reversal of debt increases ...

... since stabilising debt at very high levels would not be satisfactory given possible effects on growth



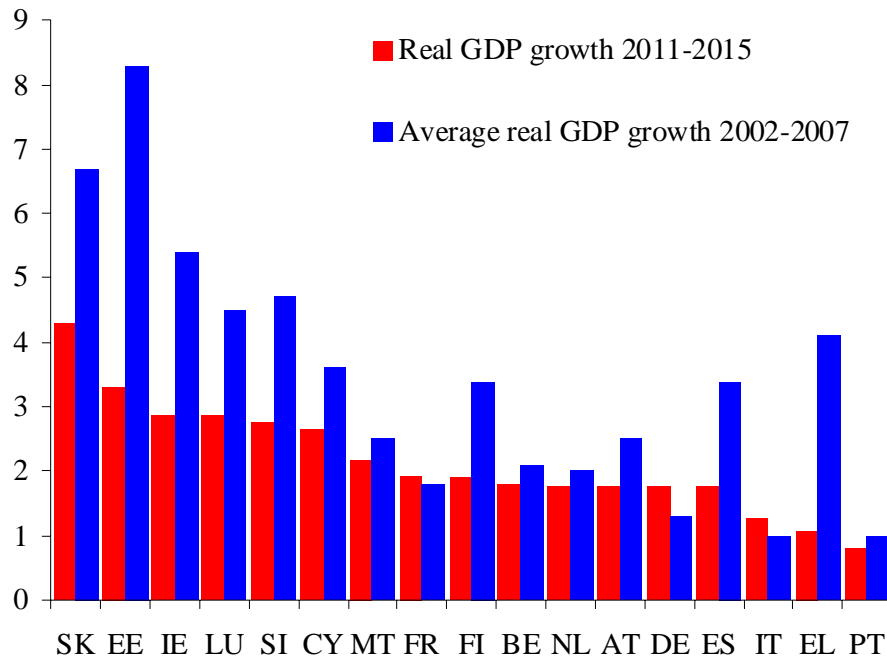


Adjustment more challenging in several euro-area MSs due to low real and nominal GDP growth

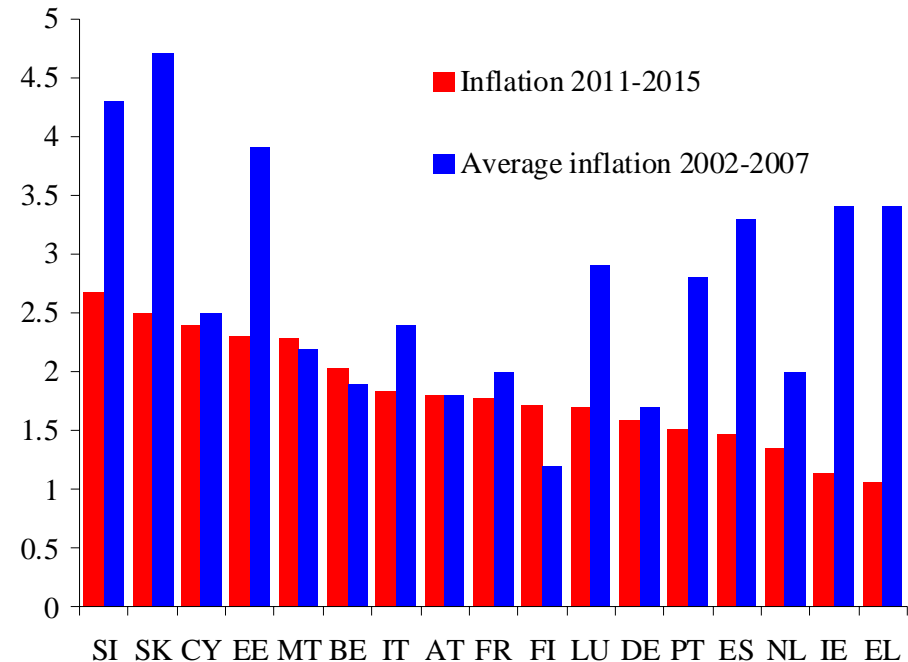
Deleveraging, external and sectoral adjustments will weigh on real GDP in some euro-area Member States...

...while the adjustment of competitiveness and price levels will keep inflation below the euro-area average

Real GDP growth 2011-2015
(IMF WEO forecast), average yoy change



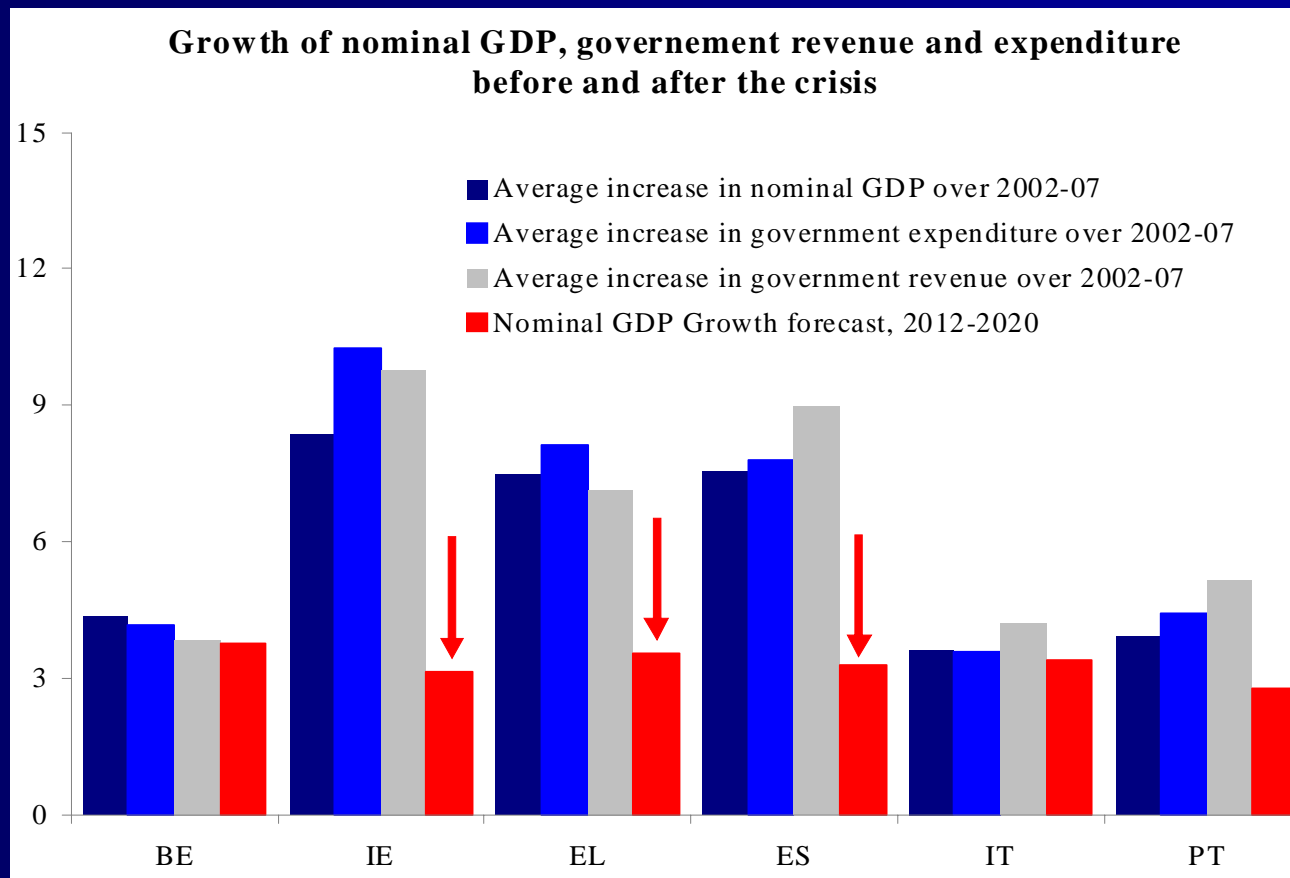
CPI inflation 2011-2015
(IMF WEO forecast), average yoy change





Some MSs will face much lower government revenue growth

In some euro-area Member States, nominal GDP and government revenue growth will be much lower than during the boom phase. Fiscal adjustment will require pronounced expenditure restraint, structural reforms and stronger fiscal institutions





Why do markets remain so sceptical ?

- The adjustment will be long, and we are only at the start
- Concerns about the lending capacity of the EFSF persist
- The price of assistance loans is considered too high, undermining debt sustainability
- Communication on “private sector involvement”
- Uncertainties on the health of banking sectors, 2010 stress tests considered not credible
- EA economic governance perceived as too weak



Part 4

- Conclusions



Conclusions

- Adjustment and overcoming the crisis will take time
- The adjustment is progressing, but has not yet convinced markets due to ongoing concerns
- Discussion on government debt restructuring in EA
- However, comprehensive response now being discussed by leaders should remove these concerns
 - Renewed commitments by MS to implement reforms
 - Improvements in fiscal governance at Member State and EU levels
 - Fixing banking sector issues (stress tests, addressing problems)
 - Credible financial backstops (EFSF, pricing, ESM)



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