

***NOTE
for the***

***MACRO-ECONOMIC
DIALOGUE MEETING***

on January 31st, 2012

1. ECONOMIC DEVELOPMENTS

2011 was a turbulent year for the Eurozone, characterised by a rapid sequence of crisis events and policy responses. As the crisis escalated, confidence by economic actors fell sharply, affecting both the real and financial sectors.

Mostly as a result of the crisis, the recovery has now come to a halt. The outlook for 2012 and beyond is considerably bleaker than it was at the September Dialogue meeting and downside risks have risen significantly.

In fact, as late as November, the Commission¹ had still foreseen the Euro zone and the EU economies to grow slightly this year, by some ½ percentage point.

Employment was forecast to stagnate in both areas, after having begun to recover in 2011. Unemployment would stabilise at around 10 % (10.1 % and 9.8 %, respectively), with the long-term component rising.

Inflation had been expected to return to the ECB target level for the Euro area of somewhat below 2 % (1.5 ; and 2.0 % for the EU-27)², after soaring commodity prices had led to a temporary overshooting in 2011.

¹ See Commission Autumn forecast of November 10th, 2011.

² Yearly HICP averages.

The current account would remain broadly balanced (both areas) while intra-Euro zone imbalances would come down.

Meanwhile it has become obvious that the macro-economic corset will be even tighter than previously assumed. Three of these factors are related to the Euro crisis.

- Fiscal consolidation is now estimated to amount to a full 1 % of EU-GDP per year, implying a higher contractionary effect on the EU economies;
- Confidence by consumers, investors and financial markets is very low, holding back demand and lending to the economy;
- Effective borrowing rates are well above likely nominal GDP growth. In a context of high public and private indebtedness, this is a particularly unwelcome constellation.; and finally,
- World trade is likely to slow more than previously assumed.

The only expansionary effect of the crisis has come from the related downward pressure on the Euro. In effective terms, it depreciated by more than 7 % in 2010 and, after some strengthening during 2011, is now about 2 % lower than a year ago.³

Due to the dampening effect of the Euro area crisis and to slower growth in the emerging and developing economies, the most recent international forecast⁴ now expects the Euro zone to slide into a mild recession (minus 1/2 % points for 2012) and the EU to stagnate. For both areas, the downward revision is as high as 1 ½ % points. The recession would be deeper in the Members currently most exposed to financial market pressures.

2. THE EURO AREA CRISIS

2.1 The causes

There are essentially two causes:

- the lack of joint safety nets for sovereigns and banks (“good weather set-up”), and
- a particularly unfavourable coincidence of events (“bad weather”).

The lack of joint safety nets is mostly due to a political unwillingness in the run-up to EMU to touch on issues implying financial burden sharing. Complex EU decision procedures also contributed.

The particularly unfavourable coincidence was that the world financial crisis - which had a devastating effect on both banks and public budgets - broke out when divergences and imbalances between Euro zone Members were high. These divergences and imbalances were related to widening gaps in productivity and competitiveness, regional shifts of foreign direct investment flows, and in some MS, real estate bubbles and major bank bail-outs.

³ Yearly averages and November 2011 over November 2010; BIS calculations.

⁴ See IMF World Economic Outlook (WEO) of Jan. 24th, 2012.

2.2 *The dynamics*

By 2010, in the vast majority of EU countries, the 2009 recession and bank bail-outs had made fiscal imbalances unsustainable. Risk spreads which had not existed in the Euro area until September 2008, widened significantly in May 2010 when the Greek debt crisis broke out. “Contagion” effects and market gains from fluctuating spreads subsequently exposed several Euro zone Members to prohibitive borrowing conditions.

Today public debt levels are one third higher than before the crisis⁵ and are expected to rise further before coming down. 23 MS of the EU-27 are subject to an “excessive deficit procedure”.⁶

As banks hold large portions of public debt, their own soundness is directly related to market perception of such debt.

This interdependence has resulted in a vicious cycle, with financial risks simultaneously escalating for sovereigns, banks, investors and borrowers.

Turbulences on Euro zone sovereign debt markets have thus hurt the recovery in three ways – through less private spending, less bank lending and through additional fiscal contraction.

2.3 *The policy response*

The same two factors which left EMU incomplete when it was established have also characterised the crisis response: diverging immediate interests among its Members and complex decision procedures.

As a result, decision taking has been an arduous process. Rather than basing negotiations on a joint blueprint, the approach has been to negotiate step by step, and mostly after a problem had become acute. This has made the crisis unnecessarily costly, in terms of interest burden, financial support and economic activity.

The main intention has been to build up two common and equally strong pillars:

- close surveillance of MS’ economic policies, in particular fiscal policy; and
- common financial safety nets with shared risks and burdens.

In the context of the first pillar, three subsequent initiatives were taken which frame MS’ economic policies in fairly stringent numerical and procedural terms (“Sixpack”, which extends surveillance to macro-imbalances; “Euro Plus Pact” and “Fiscal Compact”⁷). Resuming the “balanced budget” objective pursued before the financial crisis, structural budget deficits should remain below ½ % of GDP. MS should enshrine this requirement at

⁵ Between 2007 and 2011, the debt-to-GDP ratio rose from 66.3 % to 88 % in the Euro zone and from 59 % to 82.5 % in the EU-27.

⁶ See art. 126 of the TFEU; the remaining four MS are Estonia, Finland, Luxembourg and Sweden.

⁷ The first two packages are already in force. The “Fiscal Compact” is expected to be signed in March, as an inter-governmental Treaty, with the ultimate objective to include it in the EU-Treaty.

constitutional level (“debt brake”). Exceeding the 3 % deficit ceiling should automatically trigger consequences (“reversed QMV”).

In the context of the second pillar, two temporary financial facilities⁸ have been established to support sovereigns and banks experiencing financing difficulties. A third permanent facility is to become operational in July 2012.⁹ Its precise size is still subject of vivid debate. “Programme countries” will also benefit from a temporary increase in co-financing rates from the EU Budget.

Important crisis support has also come from the ECB, in the form of bond purchases, its policy on collateral, and of ample and longer-term liquidity provision to banks.¹⁰

To restore market confidence in the banking sector and to ease funding pressures, the European Banking Authority (EBA) recommended that banks build up temporary capital buffers and attain by end-June 2012 a capital ratio of 9 %, ¹¹ without disrupting lending into the real economy.

2. WHAT POLICIES?

It appears that sufficient funding of the EFSF/ESM facilities, complemented by IMF resources and operating on the basis of conditionality with joint EU/IMF backing will finally anchor market expectations and thus end nearly two years of sovereign debt crisis.

The more general objective, to be achieved over the medium term, must be to restore confidence in the financial system through better regulation and sufficiently equipped common institutions, and to avoid that public debt burdens weigh too heavily on the recovery.¹² A full-fledged “Fiscal Union” will also require decisions on Eurobonds,¹³ the appropriate size of the EU budget, common taxes and the power of the EU to raise debt.

In the short term, other than ending the Euro crisis, all levers should be used to counter the restrictive impact of fiscal consolidation and to avoid a “double dip” recession.

⁸ The two temporary credit facilities are the “European Financial Stabilisation Mechanism” (EFSM) and the “European Financial Stability Facility” (EFSF), with the authority to raise up to € 60 billion and € 40 billion, respectively. They extend medium (and, since July 2011, also long-term) loans on favourable terms, linked to strict policy conditionality and also involving the IMF. In July 2011, the instruments of the EFSF were considerably enlarged.

⁹ This “European Stability Mechanism” (ESM) will be established as an inter-governmental organisation under international public law, and based on an amended art. 136 of the TFEU. As is the case for the revamped EFSF, its instruments will include loans, bond purchases in primary and secondary markets, precautionary programmes and bank recapitalisation. The draft agreed by EU Finance Ministers on Jan. 23rd also includes the possibility of private participation in cases of debt restructuring (“collective action clauses”).

¹⁰ In addition “Target” balances, reflecting net payment flows between Euro zone countries, had the effect of loosening the external constrain for deficit countries.

¹¹ “Core Tier 1 ratio”; recommendation of Dec. 8th, 2011.

¹² In this context, the Managing Director of the IMF has recently suggested to unify banking supervision, establish a single bank resolution authority with a common backstop, institute a single deposit insurance fund and complement the “Fiscal Compact” by more risk sharing, be it in the form of Euro area bonds or bills or a debt redemption fund (e.g. as recently proposed by the German Council of Economic Advisers). See IMF homepage, speech of Ms. Lagarde in Berlin on Jan. 23rd, 2012.

¹³ See Commission “Green Paper on the Feasibility of Introducing Stability Bonds”, COM(2011) 818 final of Nov. 23rd, 2011.

The most important contribution can come from monetary policy. In November and December, the ECB brought the main policy rate already back to 1 %, reversing the premature increases of April and July by ¼ points each. As also urged by the IMF, current “non-standard” measures should be continued.

More attention needs to be given to transmission channels, to ensure that policy rates translate adequately into lending rates and that higher capital requirements by banks do not unduly restrain credit extension.

The reduction in public investment related to fiscal consolidation should be compensated by relying more on other financing instruments, including those suggested by the Commission in the context of the EU Budget.¹⁴

Incomes policy could make a contribution to more solid and more balanced growth by linking wages more closely to productivity developments.

Over the medium and longer term, structural improvements as suggested in this year’s Annual Growth Survey” will also help.

Overall the problem remains that macro-policies will remain pro-cyclical in an environment of stagnation, high unemployment and growing social vulnerabilities.

¹⁴ See CEEP contribution to the September 2011 meeting.