The Euro Area Outlook:  
Don’t exaggerate the risks

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Outline

1. The Euro Area Macro Outlook and the ECB Response Function

Key Risks:

2. Is European political consensus fraying? No!

3. Will creating a banking union on the fly cause a crisis? No!
The Euro Area Macro Outlook and the ECB Response Function

Growth Outlook:
In Short: 2013 will be another year of stagnation

- Economic contraction continues though 1H, before a modest recovery in 2H – about 0% for the year 2013
- No country is sanctioned and focus on “structural deficits” means actual consolidation will less rigorous

ECB Monetary Policy:
In Short: ECB will keep sitting on the fence

- Threshold for cutting rates is very high – headline inflation <2% and declining 18m inflation expectations NOT enough
- Main worry is persistent fragmentation – OMT alone has not been enough and bank creditor bail-ins might aggravate it
- Possible targeted interventions include new “non-standard measures”, including further ECB collateral changes
Is European Political Consensus Fraying?

**NO!** Despite the frequent protestations to the opposite, the European policy consensus for “current policies” will not change in the medium-term.

Hint; popular protests do not tumble euro area governments!

**Hegemon/”Deputies”:**
- Germany (2013)
- “Netherlands” (2016)
- “Finland” (2015)
- “Austria” (2013)
- “Slovakia“ (2016)

**Peripherals/”Others”:**
- Spain (2015)
- Ireland (2016)
- Portugal (2015)
- Greece (2016)
- Cyprus (2016)
- “France” (2017)
- “Belgium” (2014)
Italy – A Return of Permanent Political Instability?

• In Italian political history, stability is the EXCEPTION - Silvio Berlusconi was the first Prime Minister since WW2 that served a full term 2001-2006
• The “Political System” in Italy is remarkably resilient (for better or worse) – technocratic crisis governments are frequent (1991, 1995 and 2011-13)
• Election Result: 30% Berlusconi = the big winner (again a key political figure)  
  30% Bersani = the big loser (lost, when he should have won)  
  30% Grillo/M5S = Occupy Movement or Tea Party?  
  10% Monti = no longer a credible center-right candidate
• Election Outcome: Divided lower/upper house due to election law
• Prediction: New weak technocratic government led by “respected independent” with support of Berlusconi/Bersani
• Bottom Line: Monti’s fiscal tightening remains in place, structural reforms on standby, but OMT safety net still politically credible
Creating a Banking Union on the Fly

Banking Union is important to reduce disruptions and fragility in euro area banks, and is making rapid progress – **BUT:**

I. Massive change in the midst of bank balance sheet consolidation

II. Ad hoc responses in individual banking crises have set conflicting precedents – no fixed creditor ranking!

III. No automatic direct ESM recapitalization of banks – more limited ad hoc insurance against “loss of sovereign markets access”

IV. Outcome: A messy shift towards bail-ins of many more classes of creditors in the euro area (and even limited capital controls)
Bank Lending Remains Dominant and Declining

- Credit remains mainly bank intermediated in the euro area
- Limited growth of corporate bond markets in euro era
- Protecting insured depositors/taxpayers comes partly at the expense of the only credit intermediation channel - because
Bank Funding Remains Vulnerable

- EA bank bond issuance grew strongly since 1999 on back of government guarantee

- Risk of rising cost of capital for banks, while corporate bond markets remain small

- SMEs particularly at risk from a credit crunch
Creating a Banking Union on the Fly

“Current Implementation on Schedule”: 60%
Supervision/resolution agreed mid-2014/Deposit insurance?: Included in current outlook

Upside Surprise From Cyprus Mess: 30%
Grand bargain on resolution (Cypriot) + deposit insurance fund (joint)/ECB “ABS purchases” of packaged SME loans:
Peripheral credit crunch eases; fragmentation abates; confidence returns quickly = +0.2% 2013/+0.5% 2014

Downside Surprise From Cyprus Mess: 10%
Uninsured depositor flight from weak banks (periphery)/No agreement on resolution/No ESM Recap/No new ECB measures:
Peripheral credit crunch worsens; growths disappears; divergence continues = -0.5% 2013/-1% 2014