

# 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 a(nother) 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 be 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**

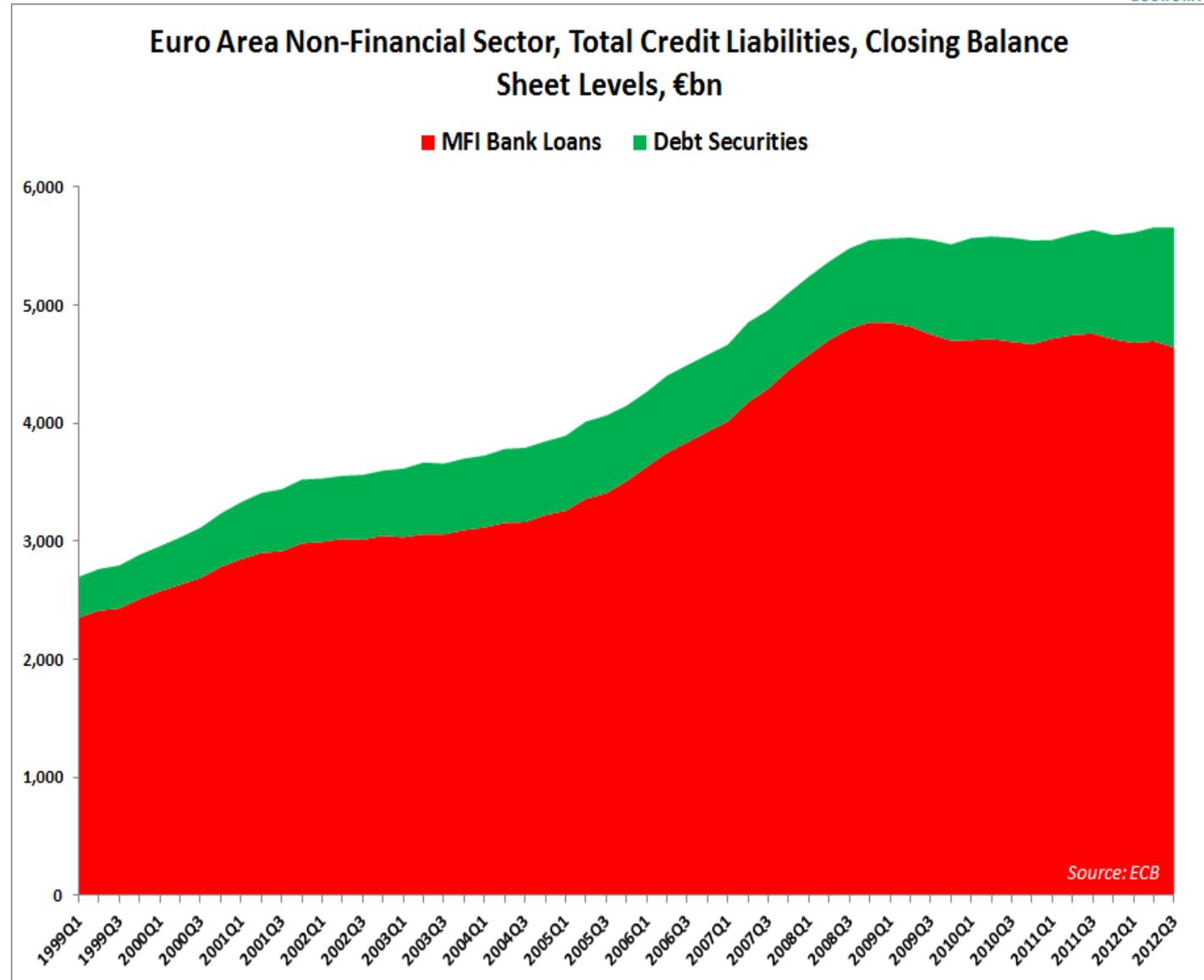
# Creating a Banking Union on the Fly

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)**

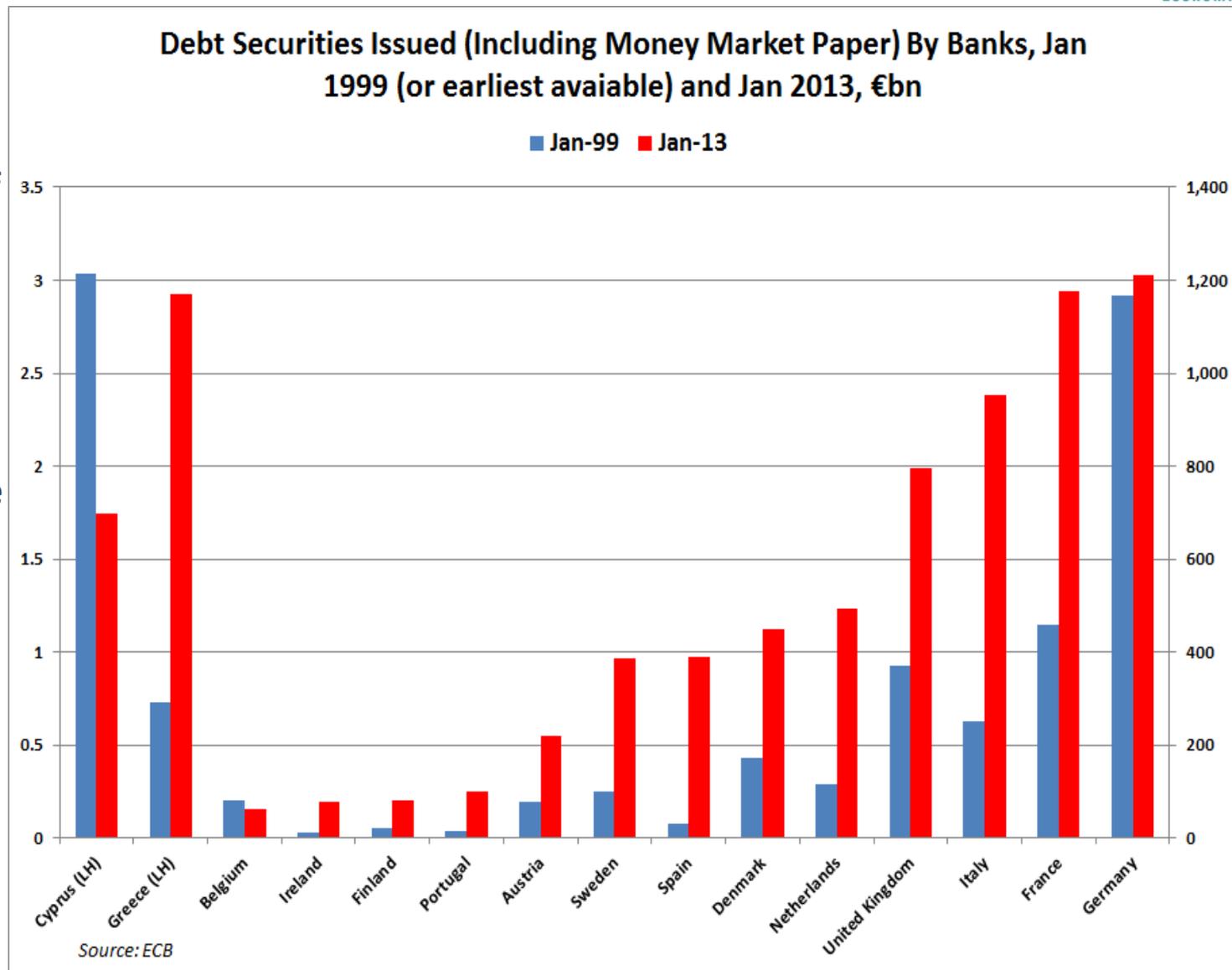
# Bank Lending Remains Dominant and Declining

- Credit remains mainly bank intermediated in the euro area
- Limited growth of corporate bond markets in euro era
- Protecting insured depositors/tax payers 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**