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# Economic Governance in the euro area and the EU : Dealing with sovereign debt

Laurence Boone – Chief Economist

France

[Laurence.Boone@BarCap.com](mailto:Laurence.Boone@BarCap.com)

01 44 58 32 36

# Organisation of the presentation

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- **How did we get there**

- An unprecedented global financial crisis ..led to:
- An unprecedented debt increase...which led to:
- An unprecedented adjustment and risks for growth

- **The short term: adjusting without killing growth seeds**

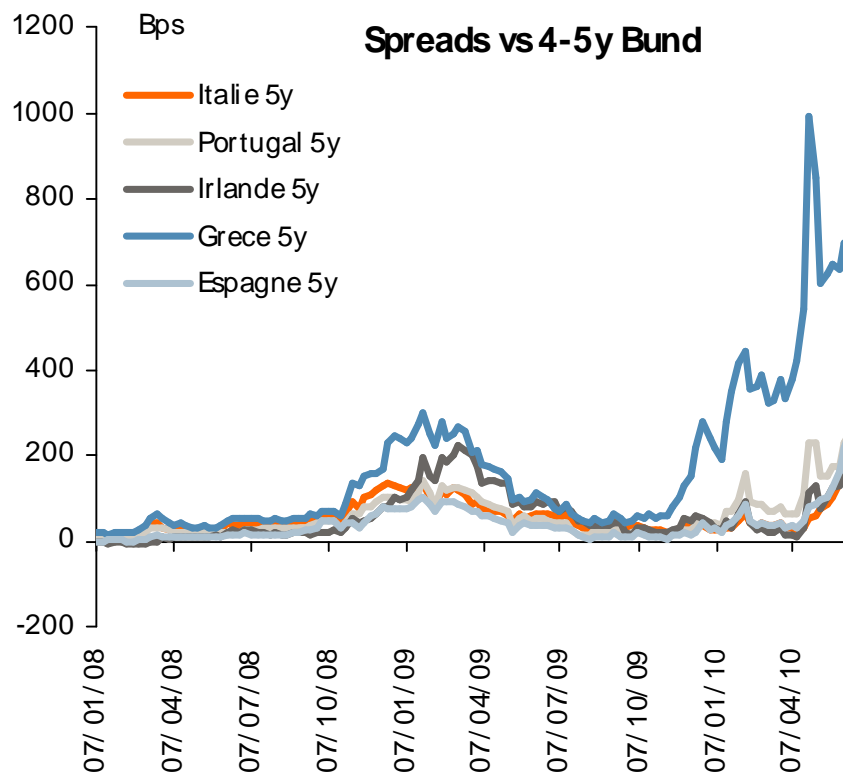
- Benign macro policy mix
- Competitiveness imbalances have started to decrease
- Not so tough adjustment overall
- Coordinating macro policies across the euro area, a necessity (the euro integration has worked)

- **The short to medium term: the “future” of the euro area**

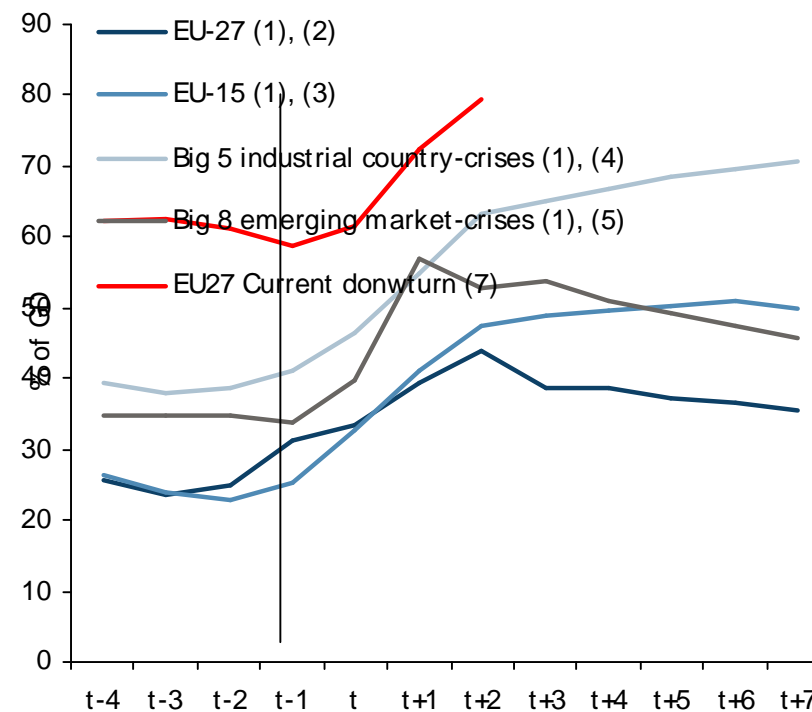
- The “mega” package: quantum leap towards more integration?
- Peer pressure is not enough
- Budget is a too narrow framework
- More policy integration, but how?

# Spreads and debt to GDP ratios on the rise

## Evolution of spreads in selected euro countries

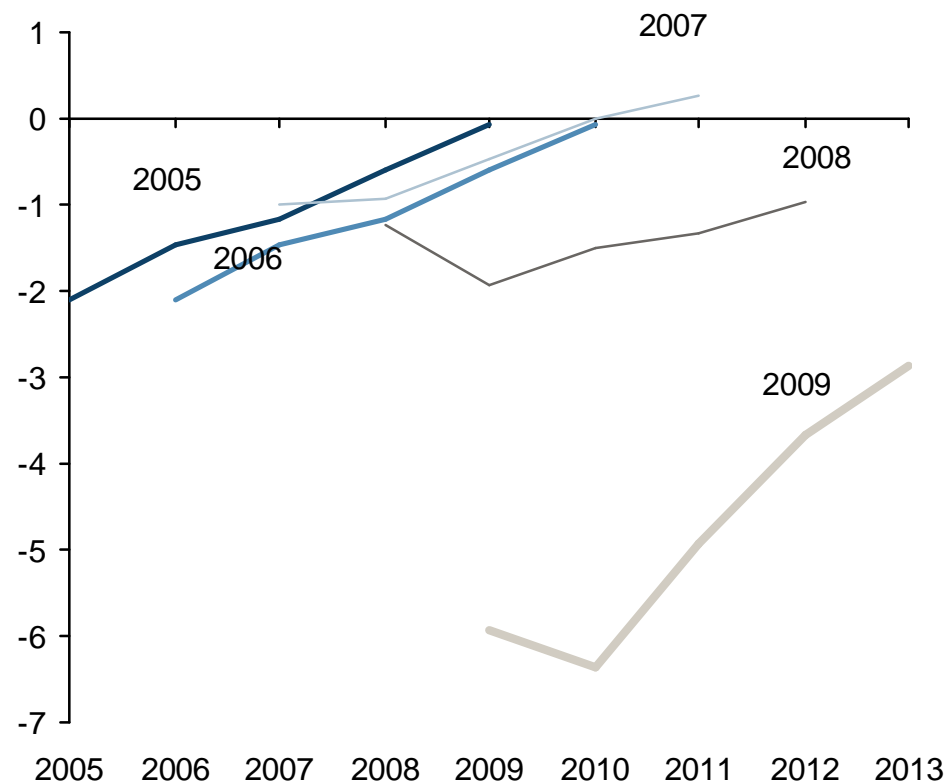
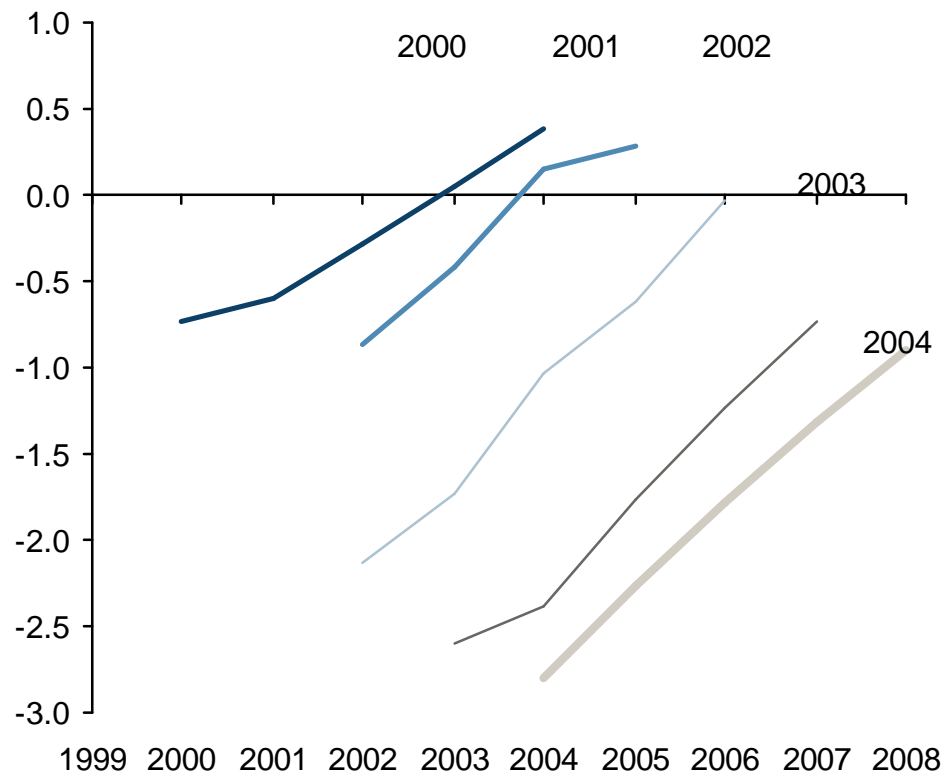


## Gross debt evolution vs previous crisis



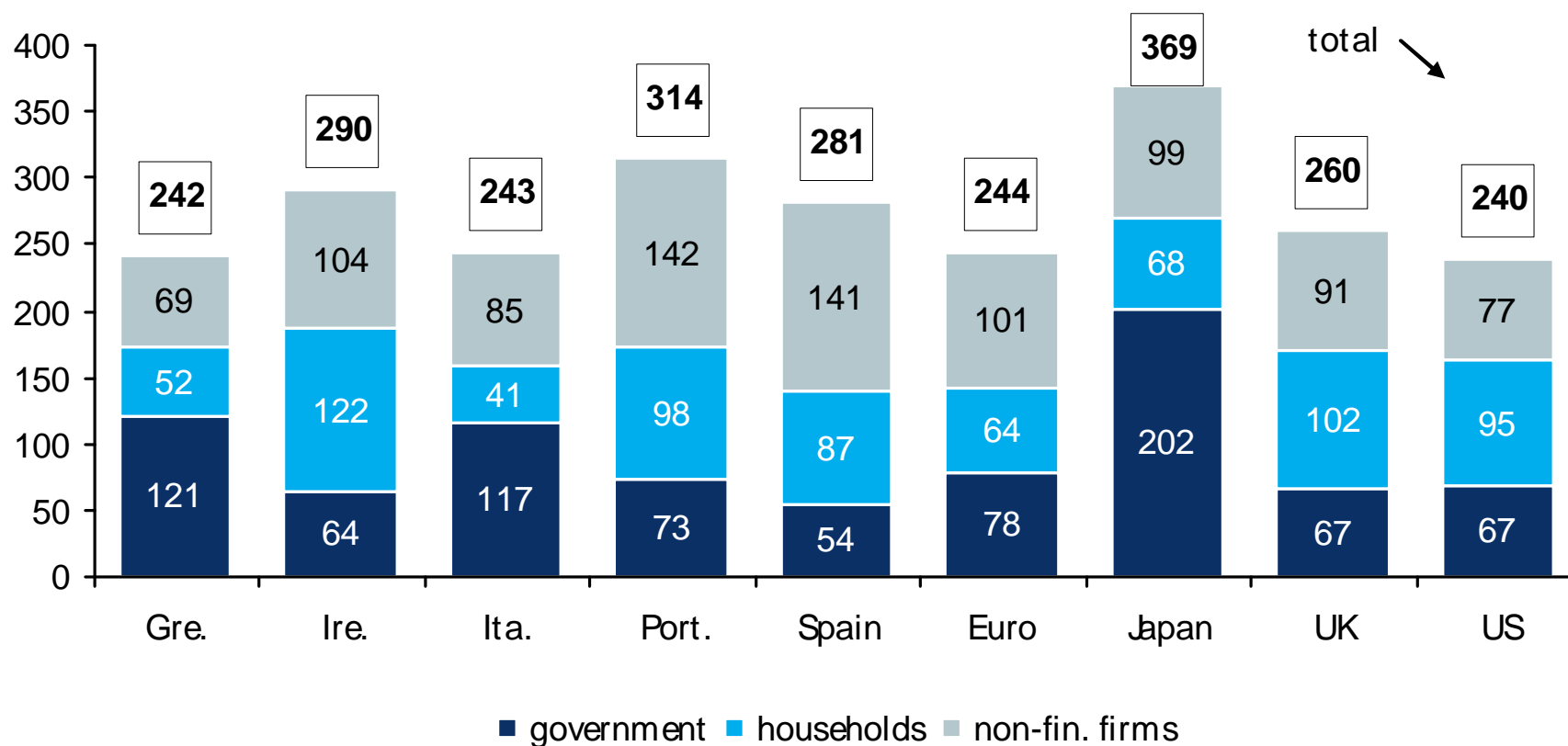
# With little appetite for fiscal adjustment

Budget deficit as a share of GDP across SGP



# Widespread indebtedness

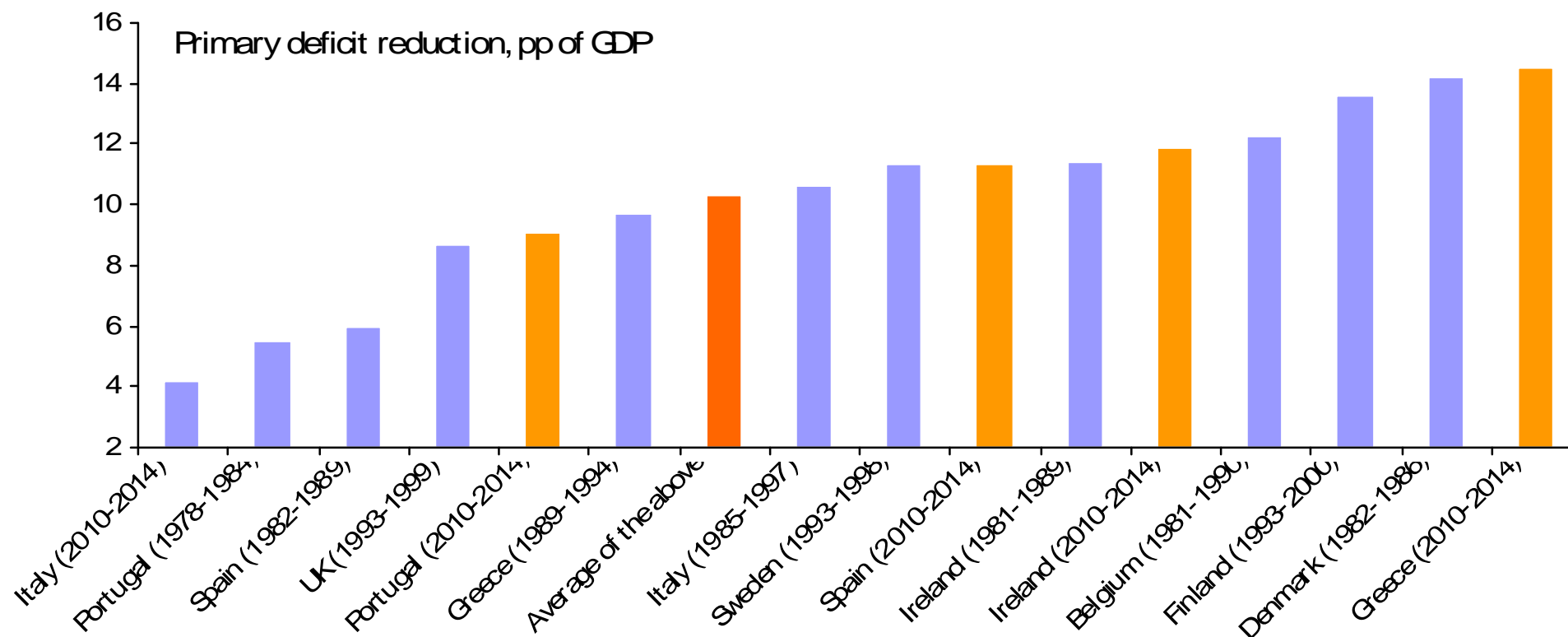
Gross interest rate liabilities (% GDP Q4 09)



5

Note: data end 2009. Interest rate liabilities ("credit market liabilities") = loans plus securities other than shares shown on a consolidated basis other than for Ireland and the UK (though the UK series has been adjusted to produce an estimate of how the consolidated data for bank lending might appear). Source: Haver, Barclays Capital

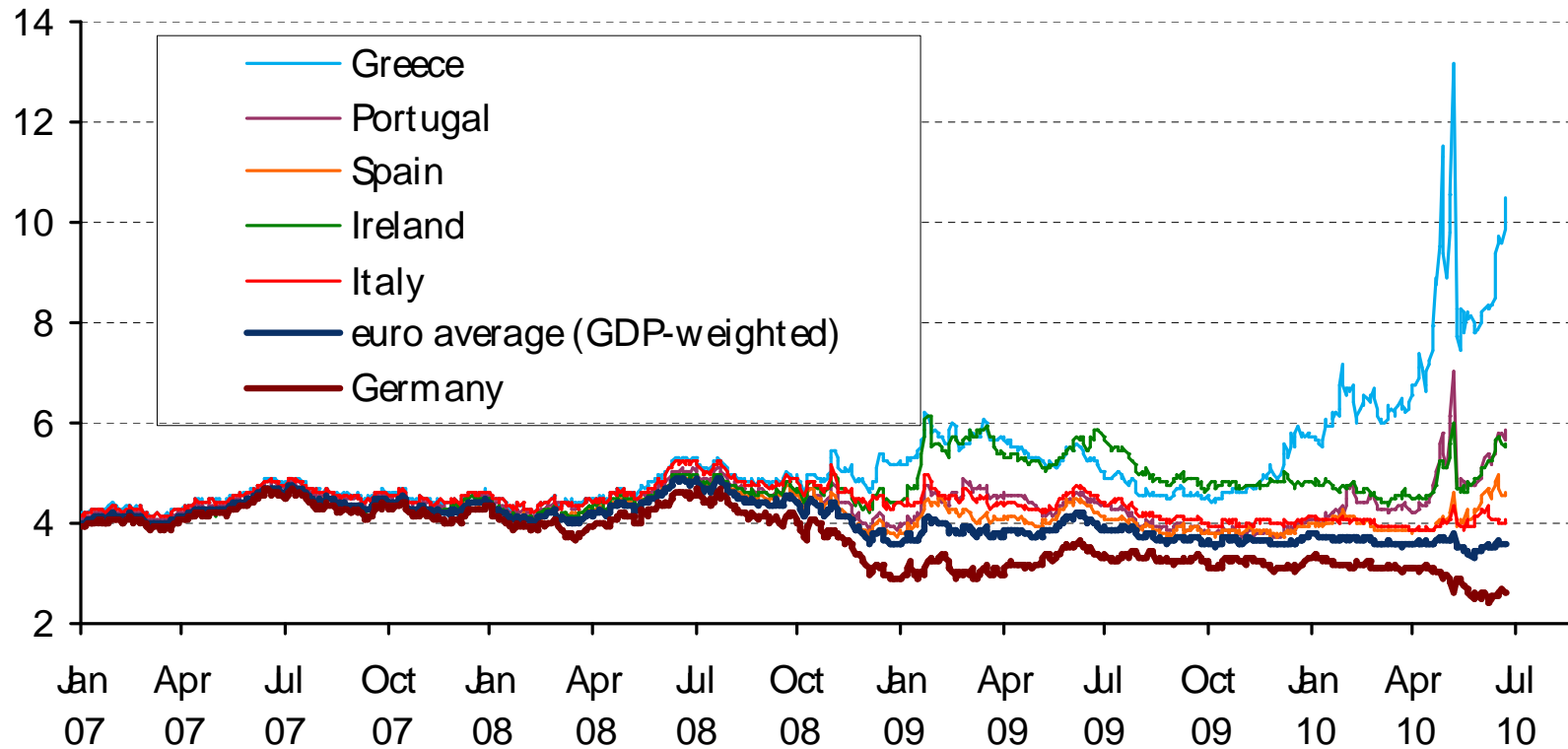
# Adjusting: a long term strategy



- **Adjusting takes on average 8 years**
- **GDP growth p.a. is positive on average thanks to**
  - Exchange rate depreciation
  - Declining interest rates
  - Strong social consensus

# Monetary policy: unusually low rates

## Benchmark 10Y government bond yields (%)



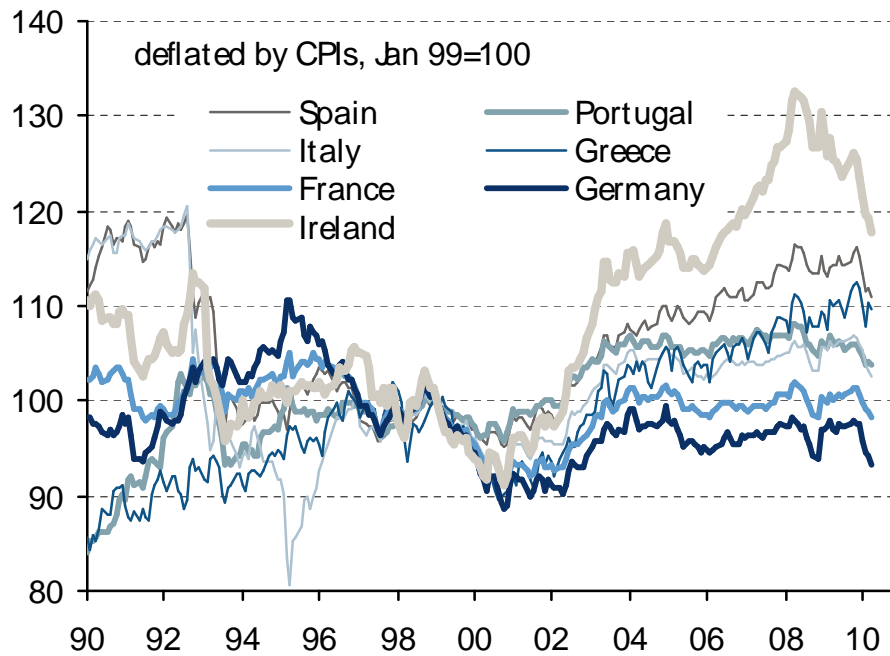
source: Barclays Capital

updated: 24 June 2010

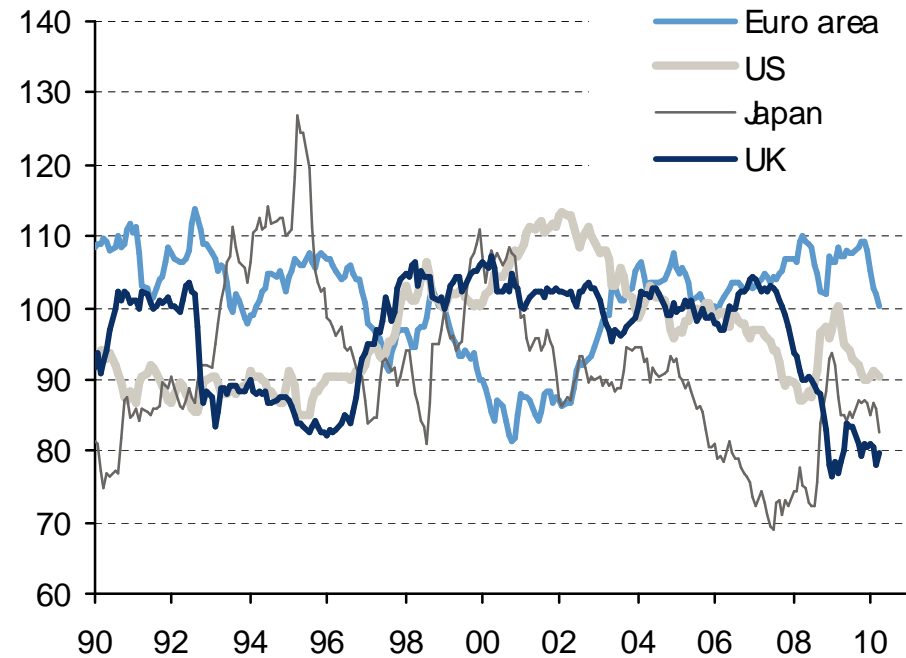
# Competitiveness: has started to improve

## Real effective exchange rates (Jan 99=100, deflated by CPIs)

### Euro area countries



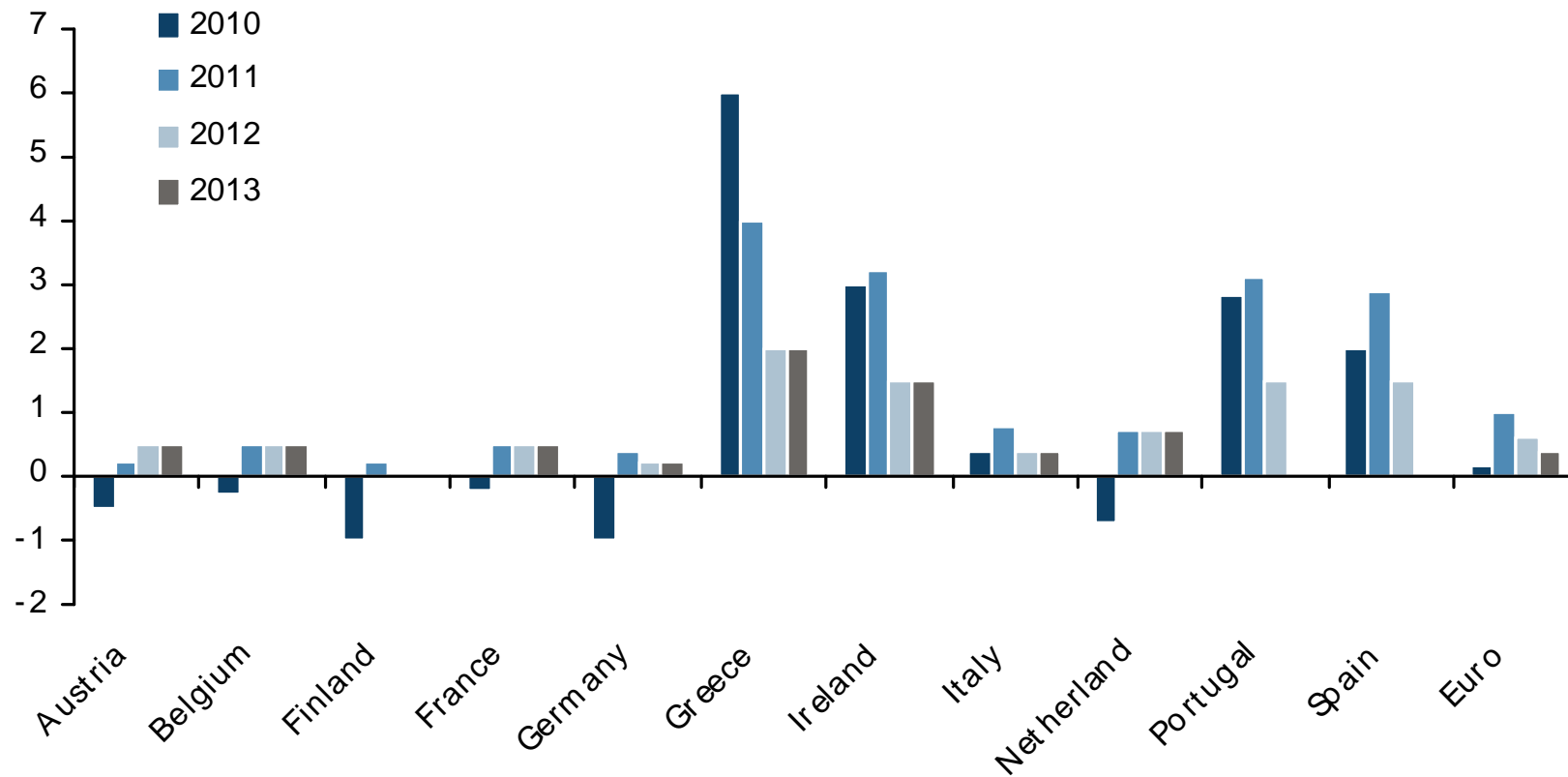
### International comparisons



source: OECD Latest months: April 2010

# Adjustment is remains moderate on the whole

## Fiscal effort (pp of GDP)



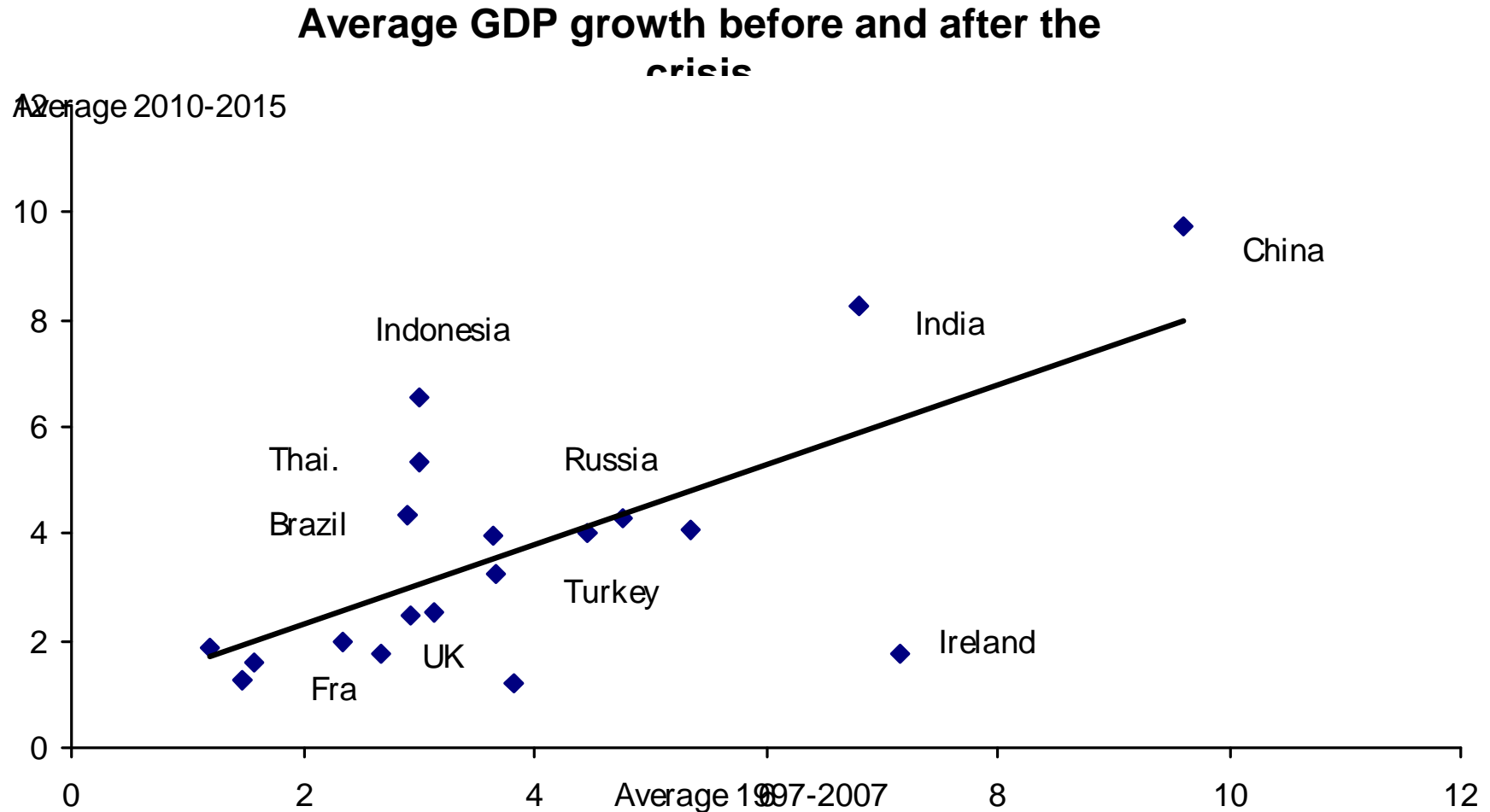
## A 1 % of GDP fiscal reduction is largely offset by the 10% euro depreciation

	Year 1	Year 2	Year 3	Year 4	Year 5
<b>Public expenditures reduction (1% of GDP)</b>					
GDP level	-0.8	-0.8	-0.5	-0.3	-0.1
Inflation	-0.2	-0.3	-0.4	-0.1	0
Government net lending (% GDP)	0.6	0.4	0.4	0.4	0.3
Current account (% GDP)	0.4	0.3	0	-0.2	0
<b>10% depreciation in the euro</b>					
GDP level	0.7	1.3	1.7	1.8	1.6
Inflation	0.3	0.7	1	0.9	0.9
Government net lending (% GDP)*	0	0	0	0	0
Current account (% GDP)	0.3	0.2	0.5	0.8	1

*Note: \* the effect on fiscal balance is offset by the monetary rule triggering higher interest rates and therefore higher interest rate payments. Please note that this relies on the symmetry of fiscal multipliers.*

*Source: the OECD's new global model, Economic Department Working Paper N° 768 .  
[http://www.ois.oecd.org/olis/2010doc.nsf/LinkTo/NT00002AAE/\\$FILE/JT03282998.PDF](http://www.ois.oecd.org/olis/2010doc.nsf/LinkTo/NT00002AAE/$FILE/JT03282998.PDF)*

# Euro GDP growth projected on a moderate trend, but no deflation

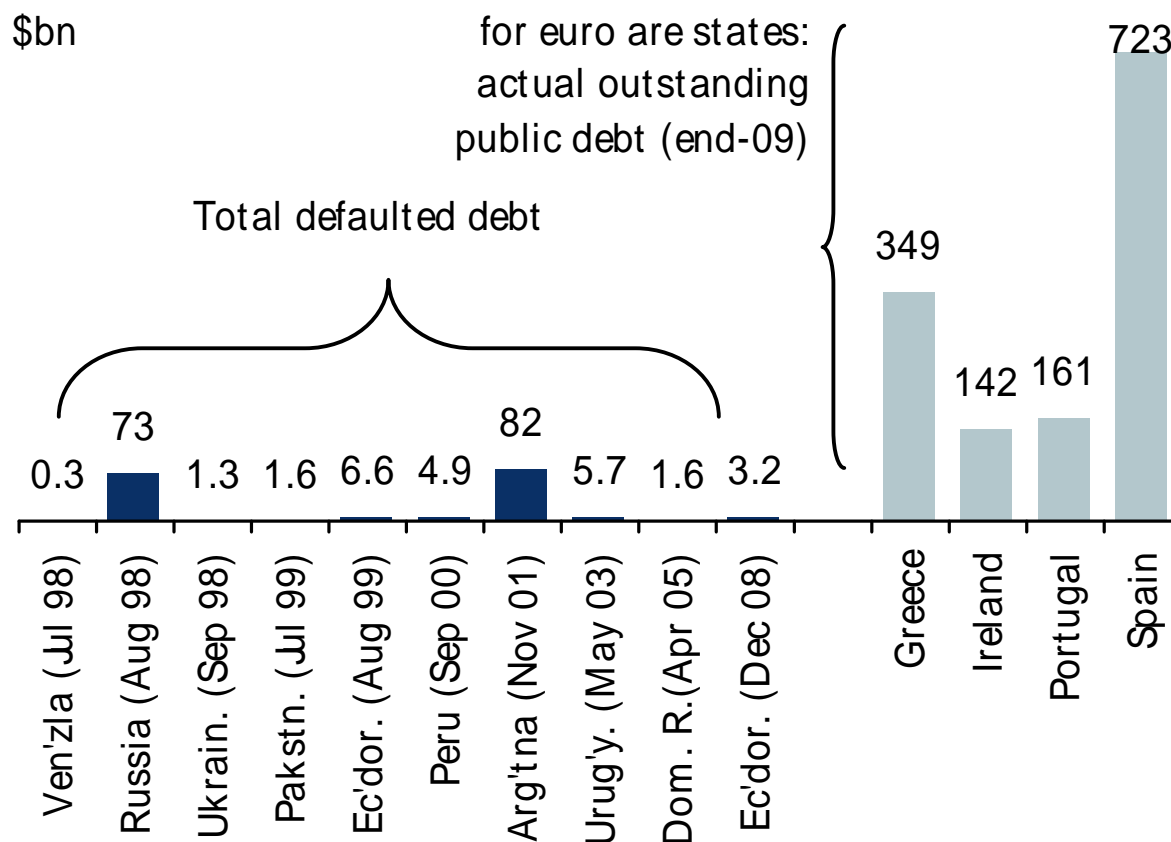


Source: IMF

## A common burden: euro integration has worked

	France	Germany	US
<b>Holdings of Greek assets</b>			
Amount (\$bn)	78.8	45.0	16.6
Share in the total external claims of the banking sector (%)	2.1	1.4	0.7
Share in total banking sector assets (%)	0.8	0.5	0.1
Banking sector capital and reserves (\$bn)	354.0	413.0	1,410.0
<b>Holdings of Greek, Portuguese and Spanish assets</b>			
Amount (\$bn)	334.9	330.4	79.3
Share in the total external claims of the banking sector (%)	9.1	10.1	3.2
Share in total banking sector assets (%)	3.6	3.7	0.6

# The implications of failure would be large vs previous events



# The EU/euro/IMF/ECB plan

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- **5 pillars plan: EC €60bn (already approved), €440bn (guarantees), IMF €220bn + participation, ECB QE, better fiscal surveillance.**
- **The €440bn SPV:**
  - Germany, France: up to close to 5 pp of their GDP for total participation
  - But guarantee is only 120% of each country's quote share
  - Temporary, with IMF/EU conditions
- **ECB QE:**
  - No upper limit on sovereign debt purchase on the secondary market
  - Purchase sterilised
  - Return to the crisis liquidity provision
- **A missing element:**
  - What if countries fail to adjust?
  - **What medium term budgetary, better, macro surveillance?**

## Medium term : (1) Strengthening enforcement

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- Fees and peer pressure have shown their limitations, need to redefine sticks and possibly carrots:
- **Tighter sanctions**
  - Targeting more directly EU support (CAP, structural funds)
  - Swifter implementation of sanctions
- **More incentives**
  - Easier channeling of CAP or structural and cohesion funds for investment
  - Common eurozone bonds (or guaranteed bonds) beyond a certain threshold of debt (Delpla and von Weisencker 2010)
  - Structural reforms and low interest rates needed
- **Fiscal variables are not everything: widen the scope of surveillance**
  - Competitiveness and current account
  - Employment
  - Credit growth rates and internal imbalances

## Medium term : (2) deeper and larger coordination ?

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- Budgetary integration does not seem to be on the agenda but:
  - A federal currency calls at least for a more coordinated fiscal process and countries aware of the “common welfare”
  - Financial backing system in case of crisis or difficult times could be made permanent
- A coordinated architecture resting on national implementation, and with a larger scope
  - In each country, an (independent) Committee would review the short-term (cyclical) adequacy of the budget, the long term sustainability of the public finances, the employment and growth developments as well as monitor the clarity of and research basis for government policy proposals (cf. Swedish committee, UK...etc)
  - Each national Committee would in turn report to the national parliaments and to a European Fiscal Committee that would evaluate and communicate on the aggregate result (cf. competition and financial policy)
- 16 • Official and publicized assessment of national fiscal stances and more largely of their economic policy, at the national level, and with implications for the euro as a whole

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