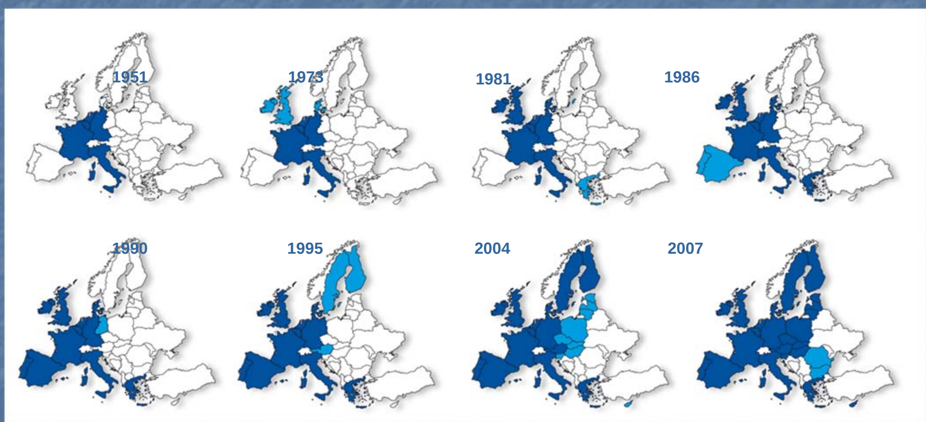
EUROPE AT A CROSSROADS

Fernando Ballabriga
ESADE

October 2012

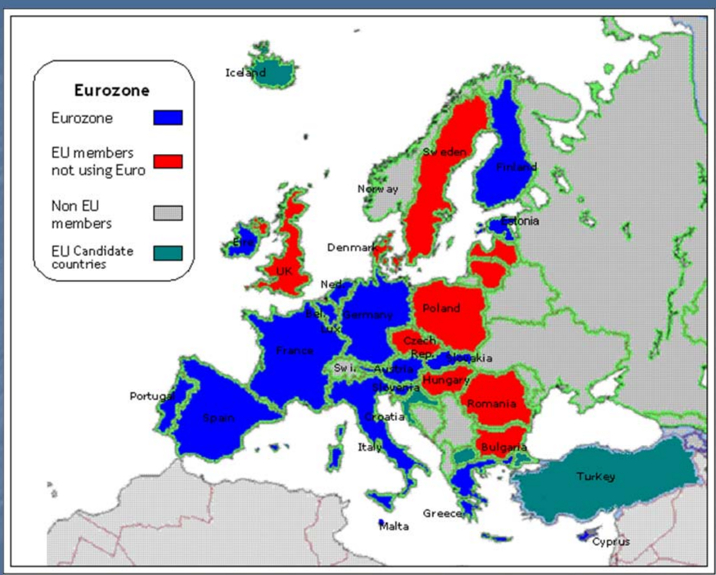
MBA FT II

From six to 27 countries



The 1999's daring step

- A monetary union is put in place
- A subset of EU countries became the EZ
- Countries joining gave up their monetary sovereignty



The euro umbrella

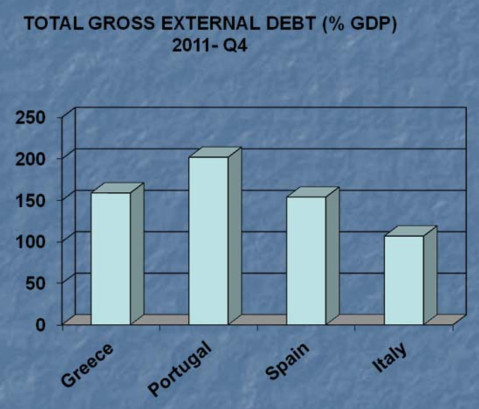
- The introduction of the € set the stage for a surge of cross-border lending-borrowing in the euro zone

10 years later

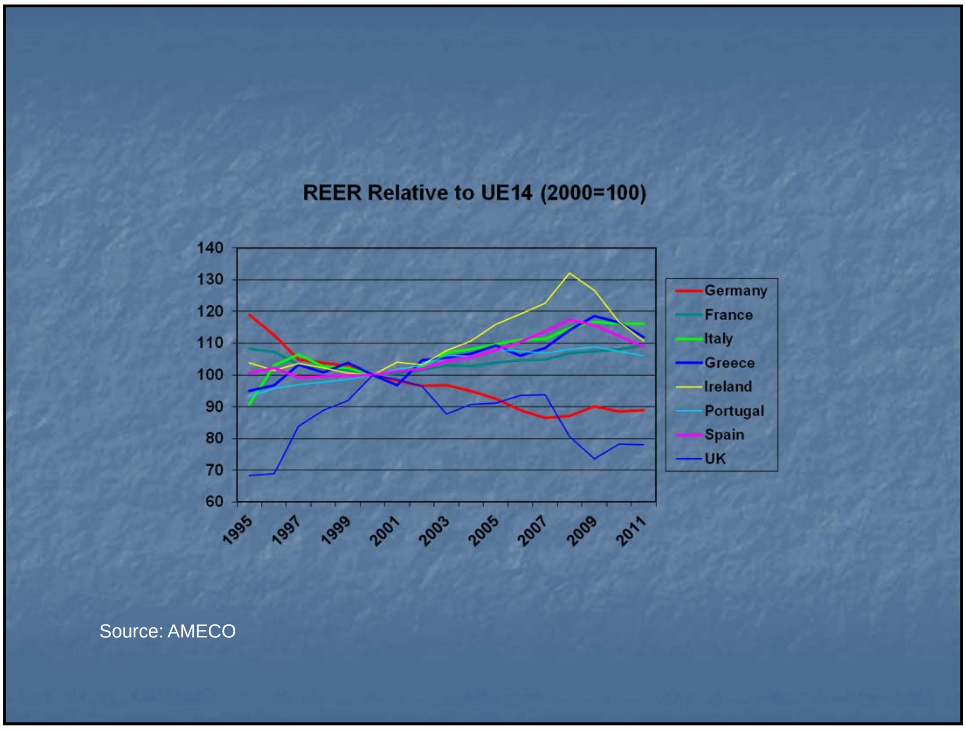
- Europe found itself split into creditors and debtors
- And with economic & financial imbalances beginning to impose their toll on debtors

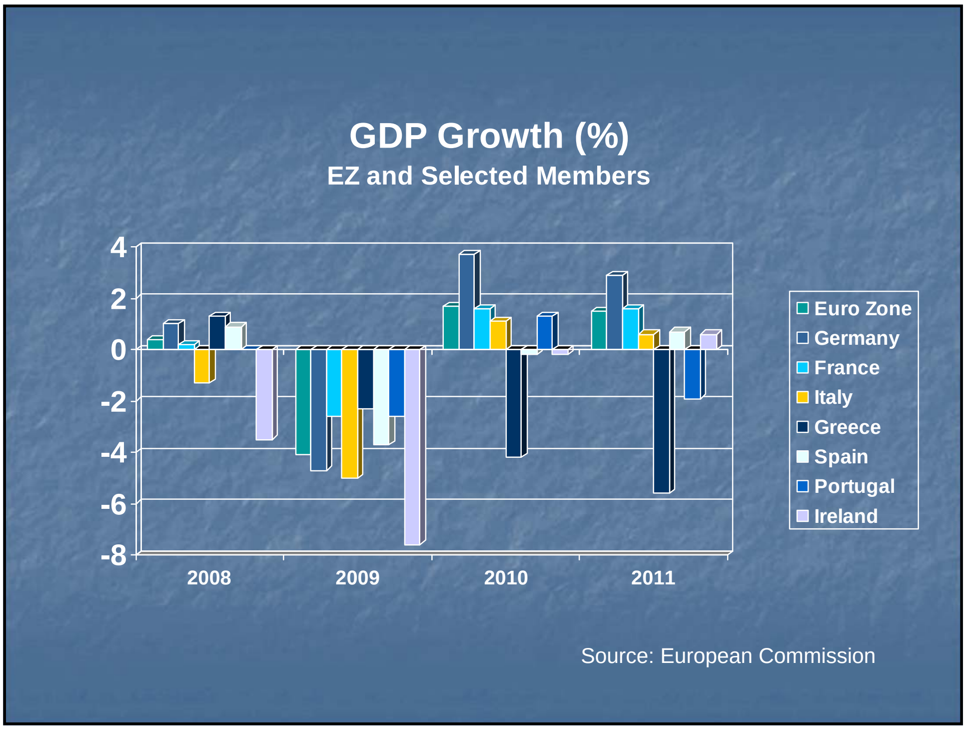
The vulnerability of debtor countries

- Indebted countries with financing difficulties
- With eroded competitiveness
- And difficulties to grow



Source: BIS - JEDH


REER Relative to UE14 (2000=100)
140
130
120
110
100
90
80
70
60
1995
1997
1999
2001
2003
2005
2007
2009
2011
Germany
France
Italy
Greece
Ireland
Portugal
Spain
UK
Source: AMECO


GDP Growth (%)
EZ and Selected Members
4
2
0
-2
-4
-6
-8
2008
2009
2010
2011
Euro Zone
Germany
France
Italy
Greece
Spain
Portugal
Ireland
Source: European Commission

Solvency concerns

- The combination of these factors raises solvency concerns
- And leads to a progressive loss of access to financial markets
- Catching countries in a debt trap
- Spain & Italy are the most recent victims of this dynamics

THE ELUSIVE CONCEPT OF SOLVENCY

$$\frac{D_t}{GDP_t}$$

Confidence & self-fulfilling good and bad paths

- Confidence in solvency reinforces solvency
- Lack of confidence in solvency reinforces insolvency

A key source of the vulnerability

- The loss of monetary stabilization tools without well-functioning alternatives

The usual stabilization tool-kit

- Monetary policy
- Exchange rate policy
- Fiscal policy
- Market adjustment

The MU member tool-kit

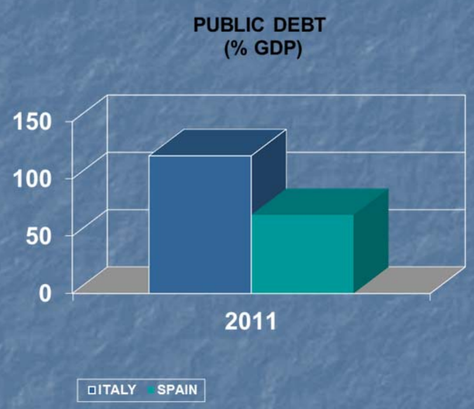
- National fiscal policy
- Market adjustment
  - labor mobility
  - price & wage flexibility

No 'federal' help

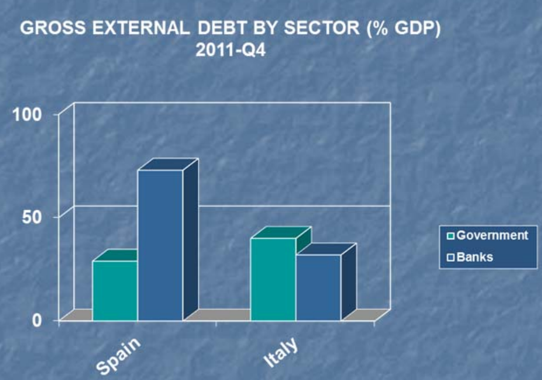
- Without federal fiscal stabilization support
- And with limited federal monetary support
- Adjustment is just being left to the market

Italy & Spain

- Both countries seem to be caught in a self-fulfilling bad path
- So they are both likely to apply for a European rescue



Source: AMECO



Source: BIS - JEDH

Is this rescue feasible?

- Two collective actions required
  - ECB acting as a lender of last resort in the public debt market
  - Real progress toward banking union

Not a free lunch though

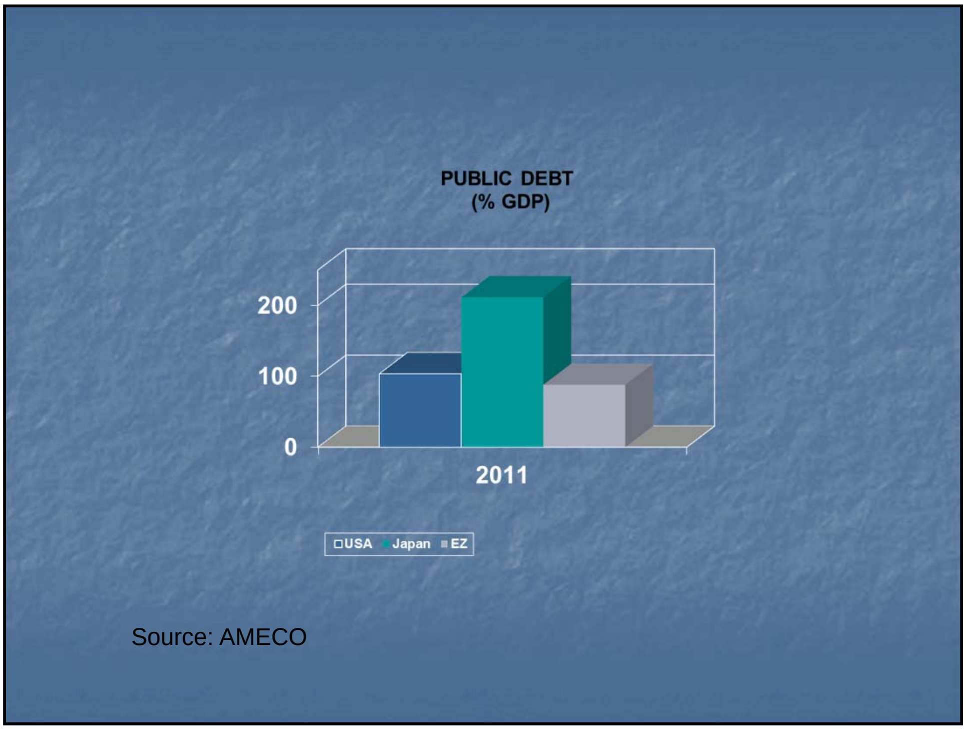
- The rescue will come with a loss of sovereignty over the remaining national policy tools
  - Fiscal policy
  - Structural reforms
- Deleveraging & adjustment will still take time and is likely to raise social tensions
- The handling of domestic politics will be complex and political coalitions with a focus on the essence will be also key

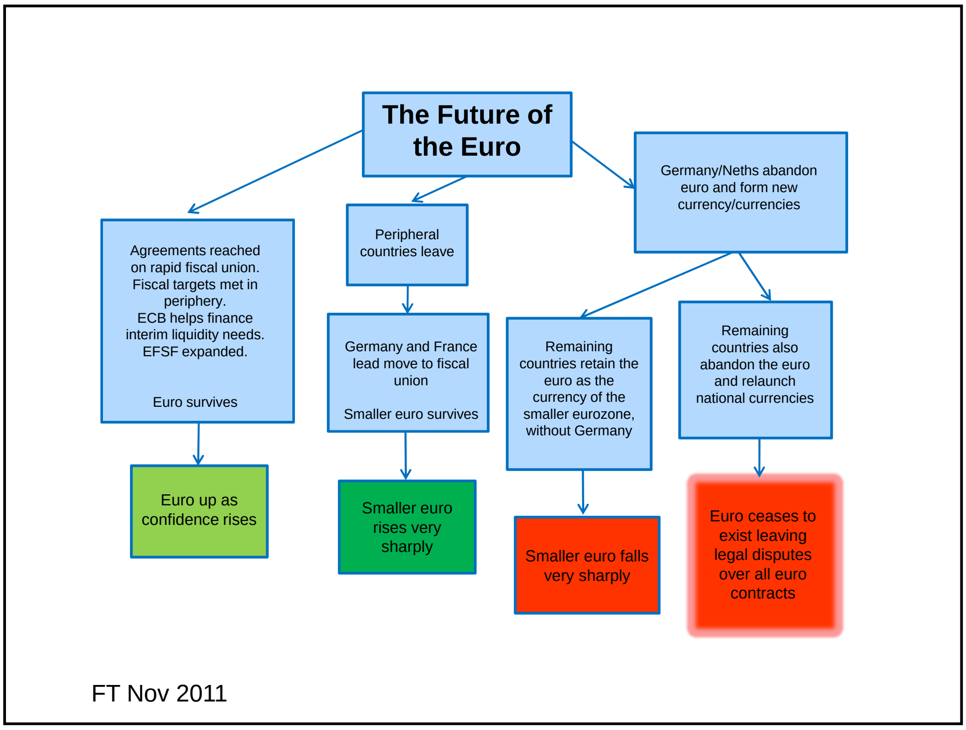
Will it be successful?

- With its negative impact on growth the strict focus on austerity reinforces the self-reinforcing bad equilibrium outcome, making it more likely
- So to increase the chances of success austerity and reforms must be accompanied by a third collective action
    - Euro-wide monetary policy stimulus
- A potential positive inflation differential in the EZ core and a weaker euro will be of great help for the necessary correction of the competitiveness erosion in the periphery
- But the lack of a federal fiscal structure complicates this option because it requires intergovernmental coordination

Two potential polarized outcomes

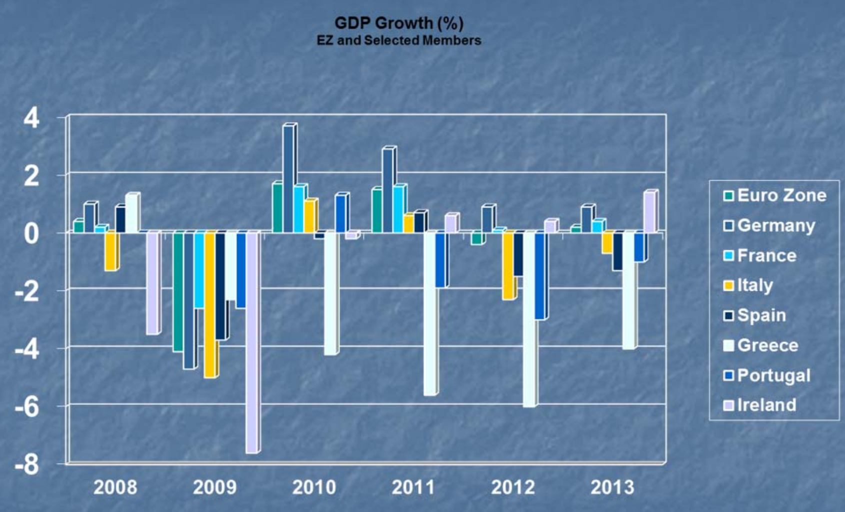
- A deterioration of the situation in Spain & Italy can lead to extremes
    - A swift move toward debt mutualization
    - A break up or disappearance of the euro


PUBLIC DEBT
(% GDP)
200
100
0
2011
USA Japan EZ
Source: AMECO


The Future of the Euro
Agreements reached on rapid fiscal union. Fiscal targets met in periphery. ECB helps finance interim liquidity needs. EFSF expanded.
Euro survives
Euro up as confidence rises
Peripheral countries leave
Germany and France lead move to fiscal union
Smaller euro survives
Smaller euro rises very sharply
Germany/Neths abandon euro and form new currency/currencies
Remaining countries retain the euro as the currency of the smaller eurozone, without Germany
Smaller euro falls very sharply
Remaining countries also abandon the euro and relaunch national currencies
Euro ceases to exist leaving legal disputes over all euro contracts
FT Nov 2011

Non-cooperative and cooperative options

- Cooperation might be easily rejected in crisis times, but the options seem clear
  - High risk of irreparable damage to the European integration process and a fragmented Europe for the future
  - Or the future United States of Europe



Source: European Commission (2008-2011)
IMF forecast (2012-13)

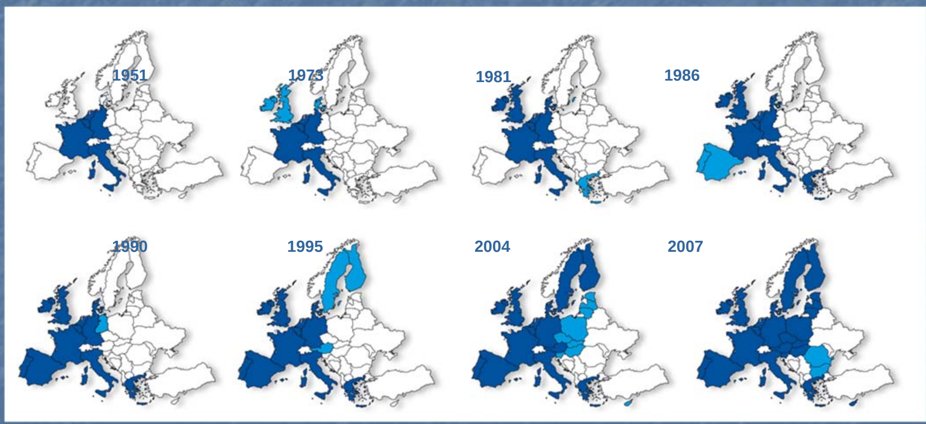
The beginning

WW II destruction in Europe

The beginning

- The modern-day European Union has its historical roots in World War II
- Europeans were determined to prevent such killing and destruction ever happening again
- To that end they decided to tie countries together by forcing closer industrial and economic cooperation
- As a first step six European countries put their heavy industries (coal & steel) under a common management so none could make weapons of war to turn against the other
- This led to the Treaty of Paris, creating the European Coal and Steel Community in 1951
- Since then European integration have grown in response to new challenges and many more countries have joined

From six to 27 countries



The Nobel Peace Prize 2012 European Union (EU)

European Union (EU) "for over six decades contributed to the advancement of peace and reconciliation, democracy and human rights in Europe"