

ECONOMIC OVERVIEW

June 2013

 **Sabadell**

Department
of Economics
ESADE

Economic Overview

PROSPECTS

We stand by most of the forecasts published in the last *ESADE Economic Report* (January 2013). The peripheral eurozone countries (Italy, Spain, Portugal, Slovenia, Greece and Cyprus) will see negative growth in 2013 while the core countries (Germany, France, the Netherlands, Belgium, Austria, Finland and Ireland) will grow by less than 1%. Only the emerging eurozone economies (Estonia, Slovakia and Malta) will record higher growth.

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The Spanish economy will therefore shrink in 2013. Economic growth and job creation will not be possible until 2014. As the continent's financial and debt crisis recedes, European and Spanish authorities must take advantage of this opportunity for economic recovery.

Although financial tensions have eased, other factors will continue to put a strain on recovery.

PERIPHERY SHIELDED AGAINST SOARING RISK PREMIUMS

Since mid-2012, financing conditions have improved considerably and risk premiums on government bonds have gradually dropped throughout the eurozone periphery. From

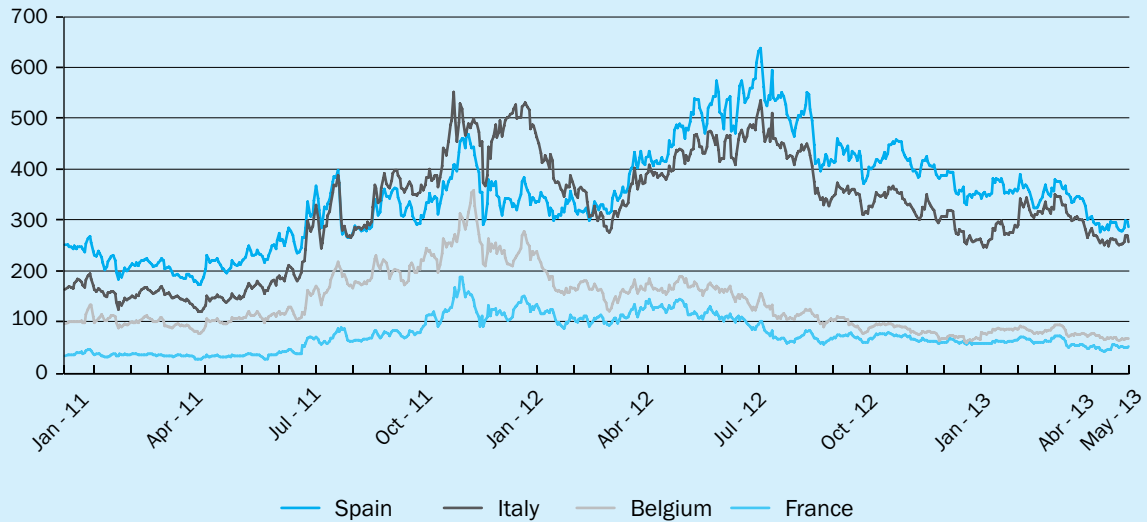
a peak of more than 600 points in August 2012, the risk premium on 10-year Spanish bonds fell to less than 300 points in May 2013. The premium on 10-year Italian bonds also dropped in the same period, from 520 points to less than 300 points.

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This improvement was brought about by a series of decisions by European institutions aimed at shielding the peripheral economies from spiralling financing costs. The general outline of this policy was established by the European Council and the European Central Bank (ECB) last summer.

In June 2012, the European Council declared that the continent needed to move towards a banking union and a more robust fiscal union under the European Stability Mechanism (ESM). The ECB shifted its strategy significantly in September 2012 by announcing its willingness to intervene in bond markets, through outright monetary transactions, in order to keep financing costs within reasonable limits and affordable for all eurozone countries. With this move, the ECB signalled that it would buy up large amounts of debt from any country that may require it. The ECB established no time limit or

RISK PREMIUM
Sovereign spreads compared with 10-year German bond



Source: European Central Bank and Bank of Spain

maximum amount for its bond purchases, requiring only that any country benefitting from such a purchase agree to a memorandum of understanding specifying the agreed conditions.

These signs of political determination to save the euro came as a welcome relief to international investors after several months of fear that certain countries could leave the eurozone or that the currency might break up entirely. Investor fear had been the primary reason for soaring risk premiums in some eurozone countries. The ECB's move put a stop to speculation against the sovereign debt of Italy and Spain, which had been driving up public-sector financing costs in those countries.

The creation of the ESM and the ECB's willingness to buy government bonds proved effective in protecting the peripheral economies, whose risk premiums have fallen to levels not seen since early 2011. This approach has been effective even

in moments of turmoil: after the uncertain result of the Italian parliamentary elections in February and the bungled bailout of the Cypriot banking sector in March, risk premiums spiked for a few weeks but quickly returned to their downward trend.

In the peripheral countries, financing has started to flow again to the public sector and to some large companies, but unfortunately remains scarce for small and medium-sized enterprises (SMEs).

Financing remains scarce for small and medium-sized enterprises (SMEs)

The strategy followed since the summer of 2012 has given the peripheral countries time to advance an EU-approved reform agenda. However, if the recession lasts much longer, the governments of those countries could steadily lose public support. This risk is less evident in Spain and Portugal,

whose governments enjoy greater parliamentary stability, but is glaringly obvious in Greece and Italy, whose parliaments must perform a complex balancing act in order to advance the structural-reform agenda. If the economy does not start to grow soon, the peripheral countries will be in trouble; European economic policy must therefore prioritise the revival of growth and job creation. Not all of the institutions involved – in particular the governments of the core countries – seem to have clearly grasped this fact.

European economic policy must prioritise the revival of growth and job creation

In short, this protective “shield” is intended to buy time, but it is not the final solution to Europe’s problems, the most serious of which is southern Europe’s prolonged recession and inability to reach the productivity levels of the core countries.

THE OPTIMISTIC VIEW

The governments of the core countries seem to believe that the groundwork for solving the crisis has already been laid. According to the optimists, the ECB-ESM “shield” has successfully reduced the market tensions that were driving up financing costs, and we need only wait for the structural reforms to take effect. In this view, “internal devaluation” – the restoration of competitiveness in less-productive countries by keeping prices and wages down – is working and economic growth will begin again in 2014.

However, even when the bond markets return to normal, the core countries – especially Germany – will stick to the austerity paradigm. They have no intention of boosting demand for the peripheral countries’ products by increasing public spending or salaries, because doing so would jeopardise the competitiveness of their industries – their most prized assets – in the global markets. This idea is firmly rooted in the core countries’ conception of how the European economy should

operate. An uncompetitive Europe, they believe, would be unable to sustain the welfare state – a hallmark of the continent for the past 50 years.

This conception is the polar opposite of current fiscal policy in the United States and Japan, which have no plans to balance their budgets in the near future.

The European authorities do recognise the need for some flexibility with regard to deficit goals. Deadlines for reducing deficits to 3% of GDP have been extended. An individual deficit-reduction approach has been adopted for each economy, and the European authorities have shown flexibility toward peripheral governments that are committed to advancing a reform agenda.

Deadlines for reducing deficits to 3% of GDP have been extended

THE PESSIMISTIC VIEW

According to austerity critics, fiscal adjustment policies not only fail to stimulate growth but actually lead to short-term economic contraction. In this view, reduced public spending has led to a drop in aggregate demand while tax hikes have reduced disposable income, pushing consumption down. These contractionary effects have been exacerbated by the fact that all of the countries in the area have implemented adjustment policies simultaneously. If the region falls into a deep recession, public deficits and debt could increase despite the tax hikes.

In the periphery, the contractionary effect of fiscal policies is compounded by the strength of the euro, which puts a damper on exports, makes credit unavailable to SMEs, leads to excessive indebtedness, and generally curtails the confidence of consumers and business owners.

If economic growth and job creation do not materialise in 2014, the governments of the periphery could lose popular

support. This has already happened in Italy, where it has proven difficult to form a coalition willing to follow through with the reforms agreed to by the previous government and the European authorities.

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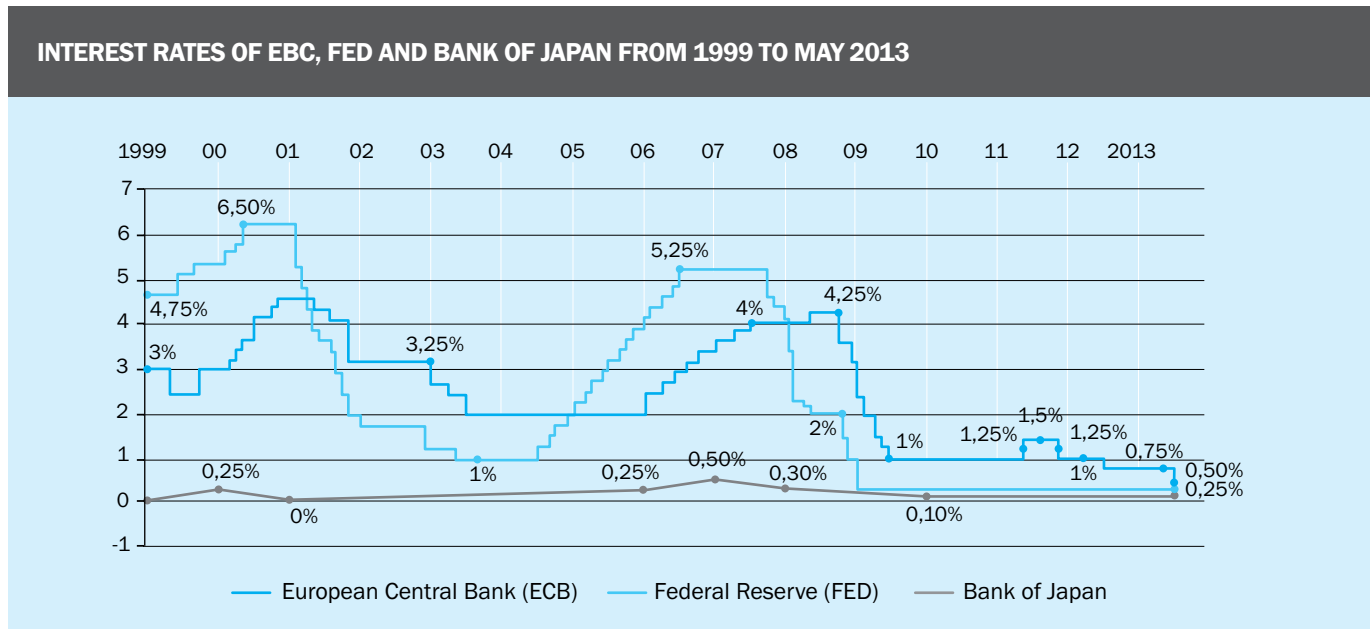
If growth is slow in coming – a likely scenario, as the reforms may not yield results for some time – the eurozone will face a huge dilemma once again. Either the peripheral countries will have to accept an extended recession with high unemployment rates, or the core countries will have to agree to stimulate demand in both the core and the periphery. Neither side shows signs of giving in. Tensions could flare once again, and speculation regarding the euro’s viability could affect the entire eurozone, as it did in 2011 and 2012.

ECB MONETARY POLICY

In May, the ECB cut the official interest rate to a record low of 0.5%. This was good news both for the peripheral countries, where many banks access financing through the ECB, and for the core countries, where growth was stalling. In addition, this move will prevent the euro from appreciating and further hampering exports.

Because average inflation in the eurozone has already fallen below the ECB’s target, the central bank has been able to guarantee unlimited liquidity for banks until at least mid-2014.

However, the interest-rate cut did nothing to address one of southern Europe’s most pressing problems: the unavailability of credit for SMEs. For the past few months, the ECB has considered taking unconventional steps to reactivate the flow of credit, but no decision has yet been reached. One possibility is that banks that accept ECB loans will be required to make credit available to SMEs.



Source: European Central Bank, US Federal Reserve and Bank of Japan

Hard-liners at the ECB and the Bundesbank oppose measures of the sort, claiming that the periphery is not suffering a true credit crunch (last year's bank recapitalisation, they argue, was sufficient to start credit flowing again). Instead, they see a lack of demand for credit: the expectations of households and companies are simply not good enough to justify further indebtedness. The hard-liners are also sceptical that monetary policy can have an expansionary effect in the current situation. This opinion can become a self-fulfilling prophecy: if the credit crunch is not resolved, the economy will shrink and more companies will become ineligible for credit. It would be wrong, however, to use such developments to justify the initial crunch.

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The ECB has shown a willingness to intervene verbally in order to avoid excessive appreciation of the euro. In other words, the central bank is prepared to threaten to inject liquidity into the eurozone in order to discourage speculative trading of the euro, which pushes up the currency's value.

CYPRUS: A DANGEROUS PRECEDENT

In March 2013, after protracted negotiations, the long-awaited €10 billion bailout deal was reached for Cyprus's banking sector. Unfortunately, the initial announcement rattled observers with the implication that a levy would be imposed on all bank accounts, even those with a balance of less than €100,000. Europe's decision-making process had once again led to subpar results.

The Cypriot banking sector was unique in several ways: it was vastly oversized, it was heavily exposed to Greek debt, and it had many clients from outside the eurozone, in particular



Cypriot citizens in front of a Laiki Bank office

from Russia. After the real-estate bubble burst, Cypriot banks gorged on deposits by non-resident investors seeking favourable tax laws and low transparency standards.

Because of the peculiar nature of Cyprus's banks, a unique bailout approach was needed. Over the course of several months of negotiation, it became clear that bank shareholders, bondholders and large depositors (with a balance of more than €100,000) would all need to take a hit in order to save the country's banking sector. However, shortly after an agreement was reached with the Eurogroup, the president of Cyprus made an announcement implying that all account holders – even small depositors – would lose money. Such a deal would have crossed an implicit red line: the absolute security of small deposits.

Within days, the president's proposal was reversed by the Cypriot parliament. Even the ECB, which supposedly had not been informed of the terms of the deal, pressured Cyprus to drop the initial proposal. Finally, a deal was reached under which Cyprus agreed to raise taxes, apply harsh conditions to its financial sector and even dismantle Laiki Bank, the country's second-largest financial institution. Shareholders, bondholders and uninsured depositors participated fully in the bailout, incurring huge losses. Deposits of less than €100,000 were transferred to the country's largest financial institution, the Bank of Cyprus, which itself will be subjected to a restructuring and recapitalisation plan aimed at reaching a capital ratio of 9%. Shareholders and bondholders have been forced to trade their assets for bank shares. Up to 60% of deposits larger than €100,000 will be converted into shares and, therefore, will be subject to losses under the bailout terms. Deposits of less than €100,000 will remain untouched.

Although risk premiums increased slightly for a few weeks, the rest of the eurozone has managed to avert contagion from the Cyprus banking crisis. Nevertheless, the bungled handling of the bailout sowed uncertainty throughout southern Europe's

financial sector. As a result, it may prove more difficult to generate trust in future episodes of financial tension.

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URGENT NEED FOR BANKING UNION

As tensions have eased in the financial markets, Europe's progress toward a banking union has slowed. The ongoing recession and the Cyprus crisis have made it clear, however, that a banking union is fundamental to the proper functioning of the eurozone.

Furthermore, the current situation – a credit crunch confined to southern Europe – runs counter to the eurozone's principle of market unity and must be corrected swiftly.

Over the past few months, progress has been made towards the creation of a Single Supervisory Mechanism. It is crucial that Europe move down the path prescribed by the European Council in June 2012: the creation of a single banking authority, a single deposit guarantee fund, a single financial-institution resolution fund, and clear rules about how losses should be shared among creditors in future financial crises.

The current situation – a credit crunch confined to southern Europe – runs counter to the eurozone's principle of market unity and must be corrected swiftly

The creation of a deposit guarantee fund to spread risk evenly throughout the eurozone would send a clear signal about how far Europe is willing to go.

FISCAL UNION: MAYBE LATER?

No details have emerged about Europe’s progress toward a more robust fiscal union, and no timeline has been set for the process. This objective has been placed on the back burner, but it will likely re-emerge as a priority if the debt crisis rears its head once again.

Under a fiscal union, the debt of all eurozone countries would be shared, albeit partially. In return, the member states would give European institutions veto power over their budgets.

The most likely form of fiscal union for Europe is a redemption fund of the sort proposed by the German Council of Economic Experts. In any event, it will be a major political challenge – in the core countries as well as in the periphery – to get parliaments and the public on board with such a proposal.

THE SPANISH ECONOMY

In late April, the Spanish government unveiled a new four-year stability and reform plan. A few days later, the European Commission extended Spain’s deadline for reducing its public deficit to 3% of GDP from 2014 to 2016. On announcing this two-year extension, Oli Rehn, the European Commissioner for Economic and Monetary Affairs, explicitly recognised Spain’s deficit-reduction efforts and structural reforms. The extension was justified on the grounds that the bursting of the real-estate bubble had created special difficulties in the Spanish economy.



Oli Rehn, European Commissioner for Economic and Monetary Affairs

This change forms part of the European Commission’s strategy: once the bond markets have been calmed with the stopgap measures described above, fiscal adjustment timelines can be loosened for particular countries in exchange for serious commitments to reform.

Spain’s new stability plan, announced in late April, contained various reform commitments of this sort. Some commitments were aimed at controlling the public deficit. For example, an income tax hike initially intended only for 2012 and 2013 was extended to 2014. Environmental taxes, special taxes and bank deposit taxes were also increased, and tax deductions for businesses were slashed.

Other reforms had to do with pensions. The government decided not to raise the retirement age beyond 67 years, but it did change the pension calculation formula in ways that will ensure lower payouts in the future.

Spain also committed to saving €8 billion per year in public administration costs, although the general outline of these reforms has yet to be announced. The government also announced a legislative rationalisation plan, changes in educational regulations and greater liberalisation of professional services.

The Spanish government raised taxes and committed to structural reforms in exchange for looser deficit-reduction deadlines

In mid-May, the European Commission granted Spain permission to maintain a public deficit of 6.5% of GDP in 2013, pushing the 3% target back to 2016. In exchange for this flexibility, the European Commission asked Spain to ratchet up reforms related to pensions, the tax structure and the liberalisation of professional services.

ABOUT THIS PUBLICATION

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ABOUT ESADE

Founded in 1958, ESADE now has campuses in Barcelona, Madrid, Buenos Aires, São Paulo and Munich and collaboration agreements with over 100 universities and business schools worldwide. Each year, more than 10,000 students participate in its courses (MBA and Executive Education, as well as undergraduate and master's programmes in law and business administration). Its business park, ESADECREAPOLIS, is a pioneering innovation centre where the university and business worlds unite. With a clear international outlook, ESADE was ranked near the top of the main business-school rankings in 2010 (*Financial Times*, *Wall Street Journal* and *BusinessWeek*). ESADE currently has a network of more than 44,000 alumni occupying positions of responsibility in enterprises around the globe. Since celebrating its 50th anniversary, ESADE has adopted "Inspiring Futures" as its institutional motto to illustrate the goal of fostering a spirit of renewal in the fields of business and law.

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