



The European Economy: Out of Crisis, Finally?

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Alas, No

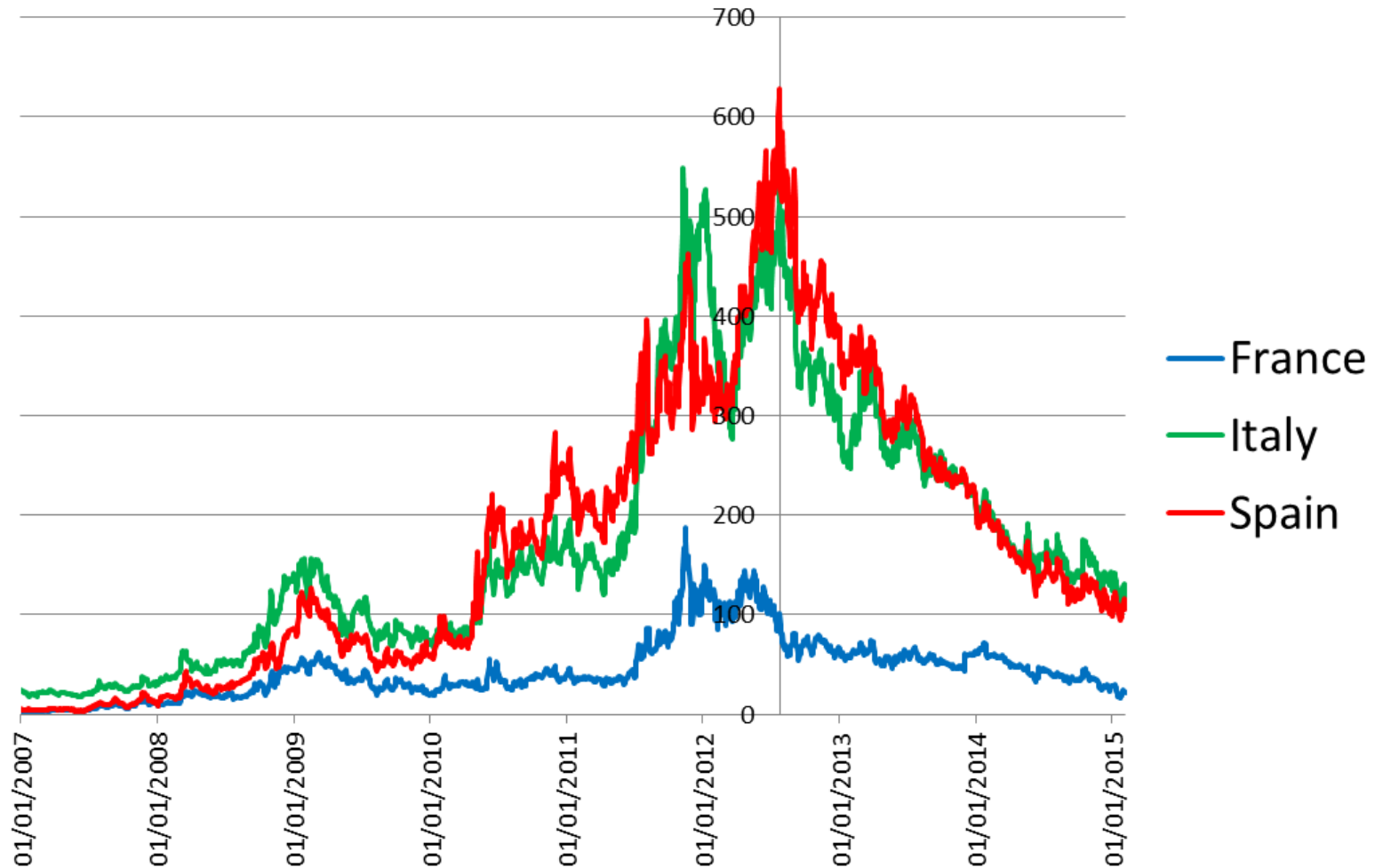
- Europe has several problems, narratives
 - Monetary: deflation
 - Fiscal: sovereign debt sustainability
 - Structural: sclerotic economies
 - Financial stability: banking system fragility
 - Political/institutional: democratic+executive deficits
- These problems feed each other
- Together they form “the European crisis”
- Policy responses have been substantial, but extremely slow and still insufficient

Eight Years and Counting

- Before 2007: financial risk build-up
- 2007-2009: “subprime crisis”
 - US trigger; symmetrical impact, asymmetrical response
- 2009-2011: small periphery countries
 - Greece, Ireland, Portugal
- 2011-2012: contagion to large countries
 - Turning point in mid-2012: Banking Union + ECB action
- 2012-present
 - Slow banking system repair
 - Rise of deflation risk + political risk

The Mid-2012 Turning Point

Spreads over 10-year German Bund

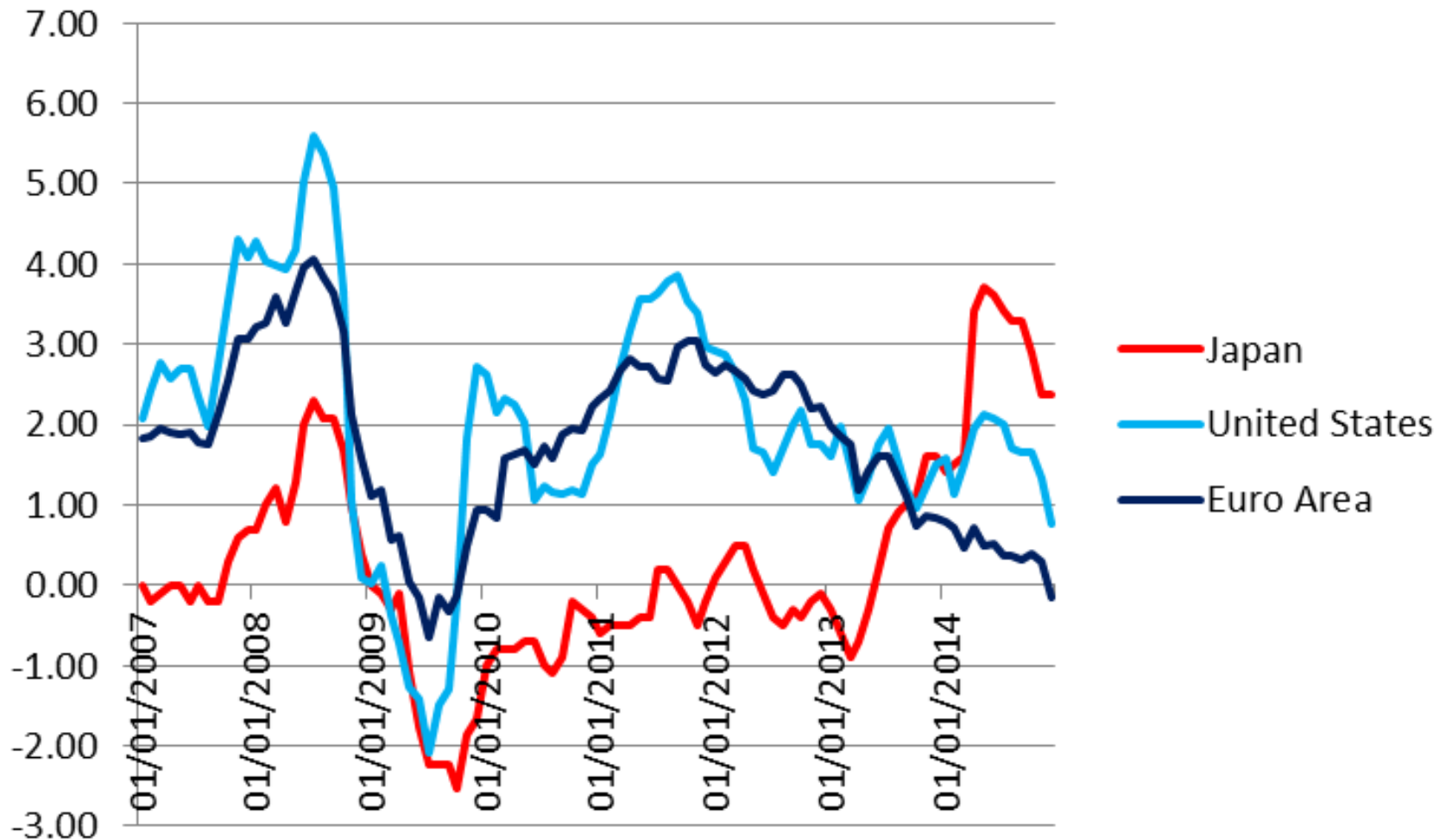


Monetary Issues

- Deflation risks on the rise
- Not only adjustment in periphery
- Complexity of QE in Eurozone
 - Article 123(1) of the Treaty on the Functioning of the EU:

“Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as ‘national central banks’) in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments.”

Headline Inflation Rates



Fiscal Issues

- Greek sovereign debt unsustainability
- Contagion patterns
 - Bank-sovereign vicious circle (Ireland, Spain)
 - Eurozone break-up / “redomination risk” (“periphery”)
 - Spillover of Greek debt restructuring (Cyprus)
- No federal taxing / borrowing capacity

Structural Issues

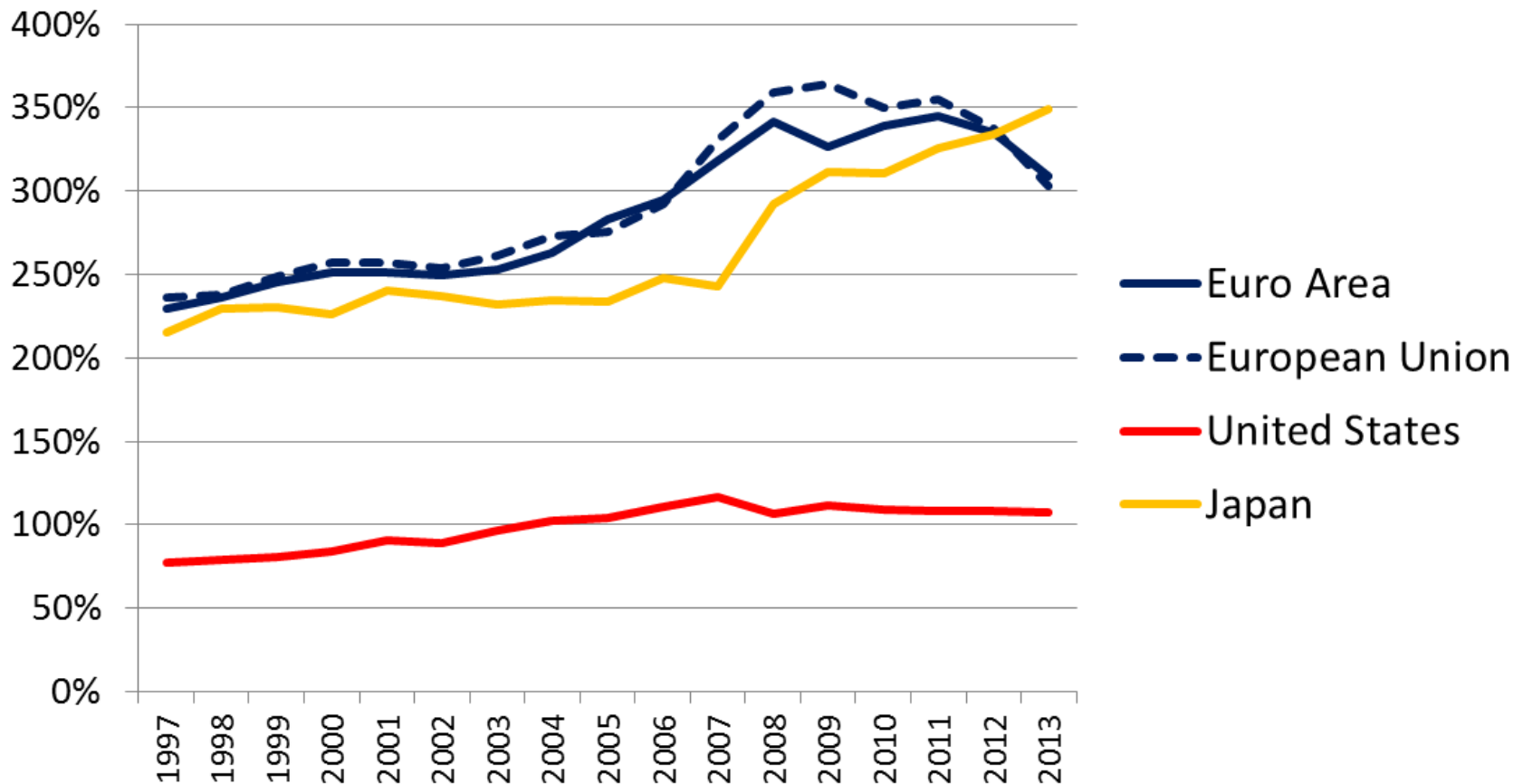
- Unfavorable business environment
 - Labor law / employment protection
 - Protection of incumbents / economic nationalism
 - Overregulation, e.g. digital services
- Insufficient access to finance
 - Bank-dominated system
 - Limited competition
 - Restructuring / insolvency frameworks

Financial Stability Issues

- Flawed financial integration framework
- Single market vs national banking policies
- Wrong incentives for prudential authorities
 - “Banking nationalism”
 - Risk build-up before 2007
 - Inability to restructure after 2007

Banking Development

Total Banking Assets (% of GDP)



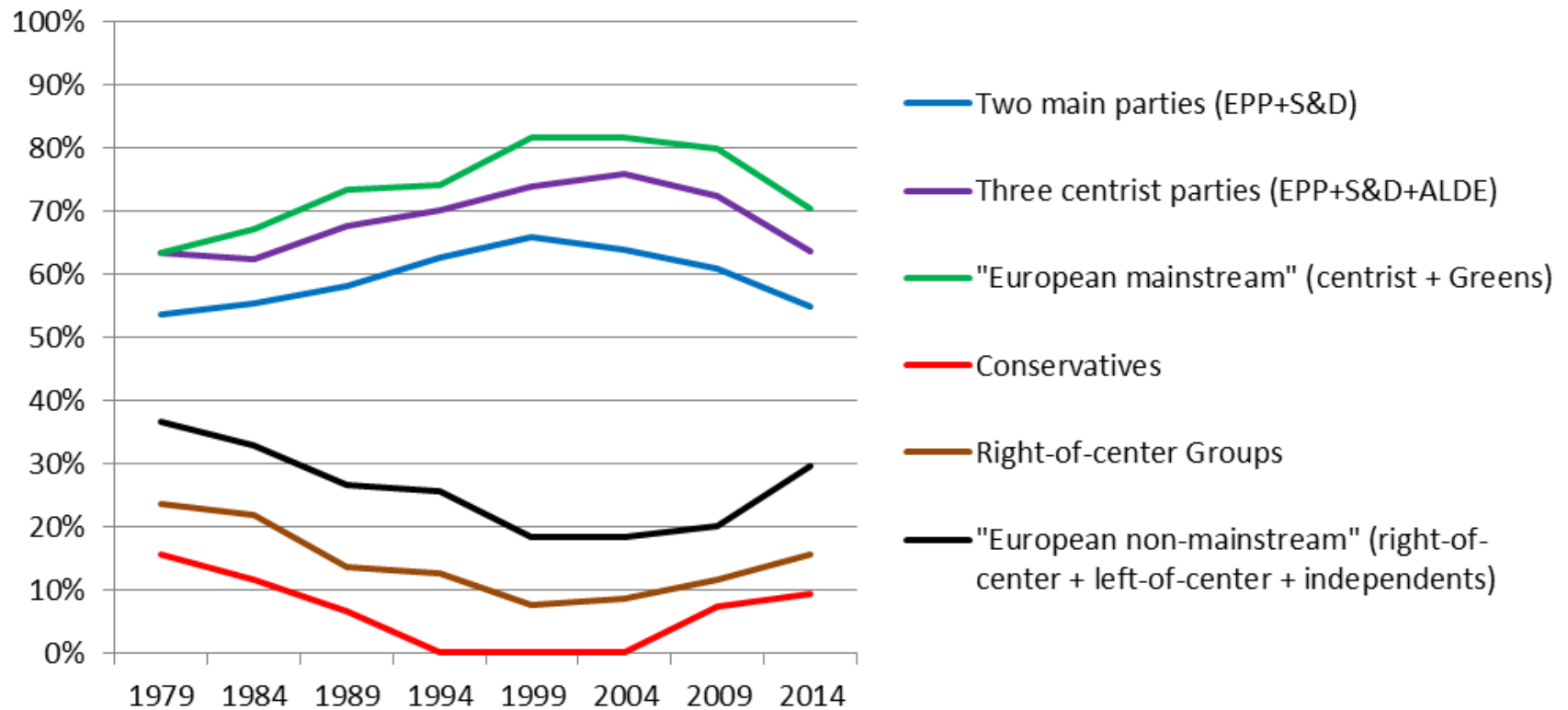
US figures include broker-dealers. Sources: European Central Bank, Eurostat, Federal Reserve Board, US Bureau of Economic Analysis, Bank of Japan; author's calculations with help from Anish Tailor

Political/Institutional Issues

- National/European competencies mismatch
 - Interdependencies from single market & monetary union
 - Collective-action challenges e.g. fiscal, structural, banks
 - No ability for authoritative European decision-making
 - Exceptions are limited: ECB, competition policy
 - Failure of institutions rather than of leadership
- Executive deficit / democratic deficit
 - European Parliament composition + competencies
 - No collective accountability of European Council
- Geographical tiering compounds complexity
 - Eurozone / other non-euro / UK

“Rise of the Populists”

Share of total Members of the European Parliament



Policy Responses

- Five arrows?
- Not directly comparable with one another (like in Japan)

Monetary Response

- QE announced January 22
- Legally robust
- Too early to assess impact
 - First indications broadly positive

Fiscal Responses

- Assistance programs
 - Ad hoc: bilateral loans to Greece, EFSF (2010)
 - European Stability Mechanism (2012)
 - Strict size limit EUR 500bn
 - Challenge of prolonged use in Greece
- Revised fiscal rules
 - European Semester, fiscal compact (2011-12), etc.
 - Current test with France
- Investment plan
 - Unlock “at least EUR 315bn over 2015-2017”

Structural Responses

- National structural reforms
 - Mixed picture
 - Successes in Spain & Portugal
- European structural projects
 - “Capital Markets Union”
 - “Digital Single Market”
 - “Energy Union”
 - Level of ambition not yet clear

Banking Responses (1/2)

- “Single Rulebook” & new agencies (2011)
- Banking Union: Eurozone + (maybe) others
- Supervision by the ECB
 - “Single Supervisory Mechanism”
 - 120 “significant credit institutions” + ca. 3,500 others
 - In place since November 2014
- New crisis management framework
 - “bail-in”: junior debt now, senior from January 2016
 - Single Resolution Board & Fund: operational 2016
 - Deposit insurance: harmonization of national schemes

Banking Responses (2/2)

- SSM (ECB supervision) is a game-changer
 - Restricts banking nationalism & financial repression
- Major uncertainties on future crisis management & resolution framework
 - Bail-in in practice vs theory
 - Direct bank recapitalization by ESM
 - Use of Single Resolution Fund (& national funds)
 - Deposit insurance in fiscally stressed countries
 - National responsibility for ECB supervisory failures?

Institutional Responses

- Multiplication of new agencies
 - EBA, EIOPA, ESMA, ESRB, ESM, SSM, SRB
- EU democratic aspirations
 - European Parliament election May 2014
 - Election of “lead candidate” Jean-Claude Juncker
 - Implication for next election in 2019
- Prospects for Treaty change
- Challenges to EU integrity
 - “Grexit” and “Brexit”

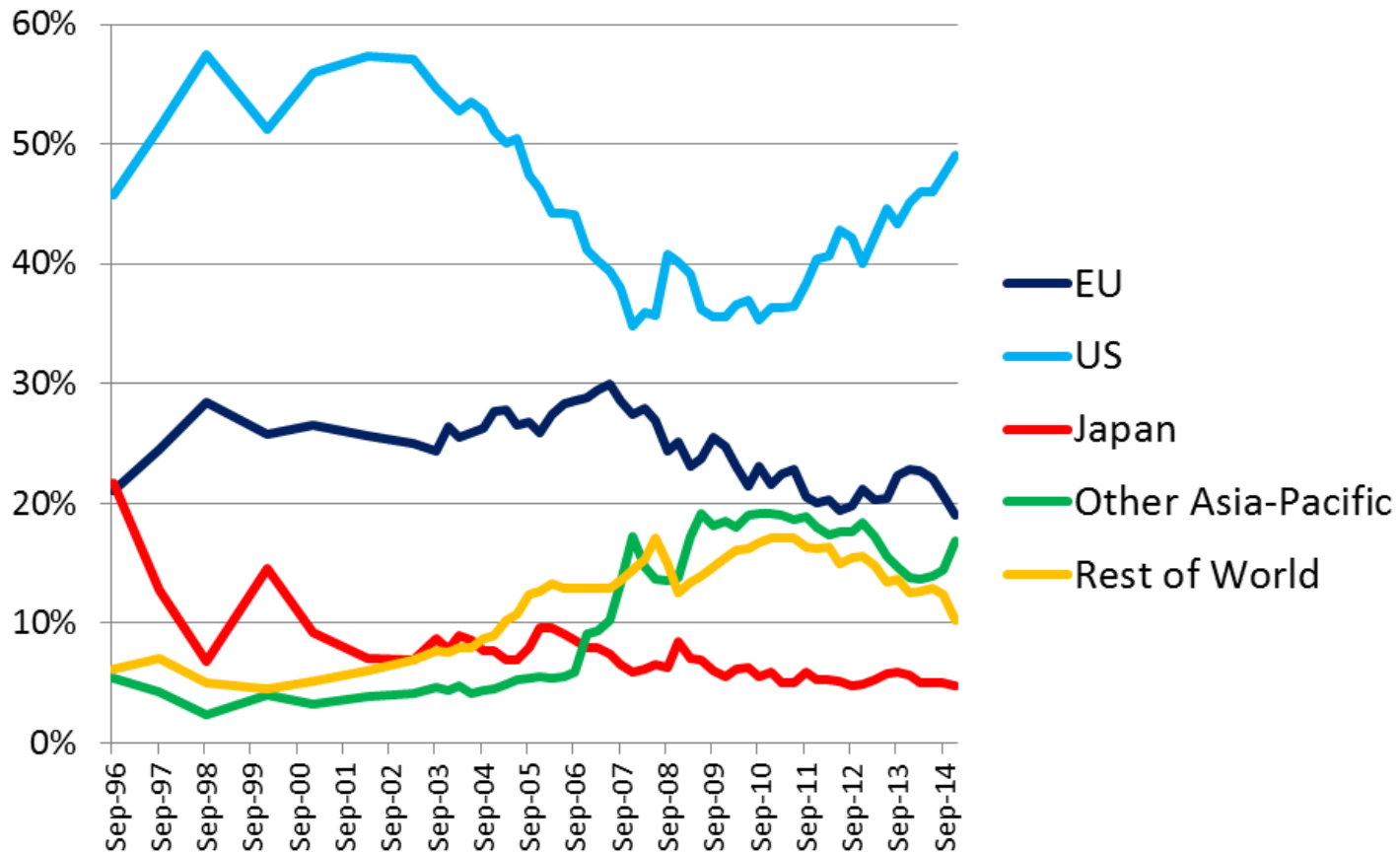
Wrap-Up

- Monetary reaction: belated but promising
- Fiscal architecture: still flawed
- Structural reform: insufficient
- Banking: regime change, effects unfolding
- Institutions: major questions unresolved

Concluding Remarks (1/3)

- EU a slow mover in a fast-changing world...

Aggregate Market Value of Companies in FT500 List



Concluding Remarks (2/3)

- ... but also a radical political innovator: EU institutions are unprecedented and endogenous

Concluding Remarks (3/3)

- “As long as Europe’s not sorted out, nobody worries about Japan”



Thank You For Your Attention

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