Future of Europe: the cycle, economic rebalancing and the ECB

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PART 1: THE DATA – A VIEW FROM NOW-CASTING

New Euro Area Slow-Down

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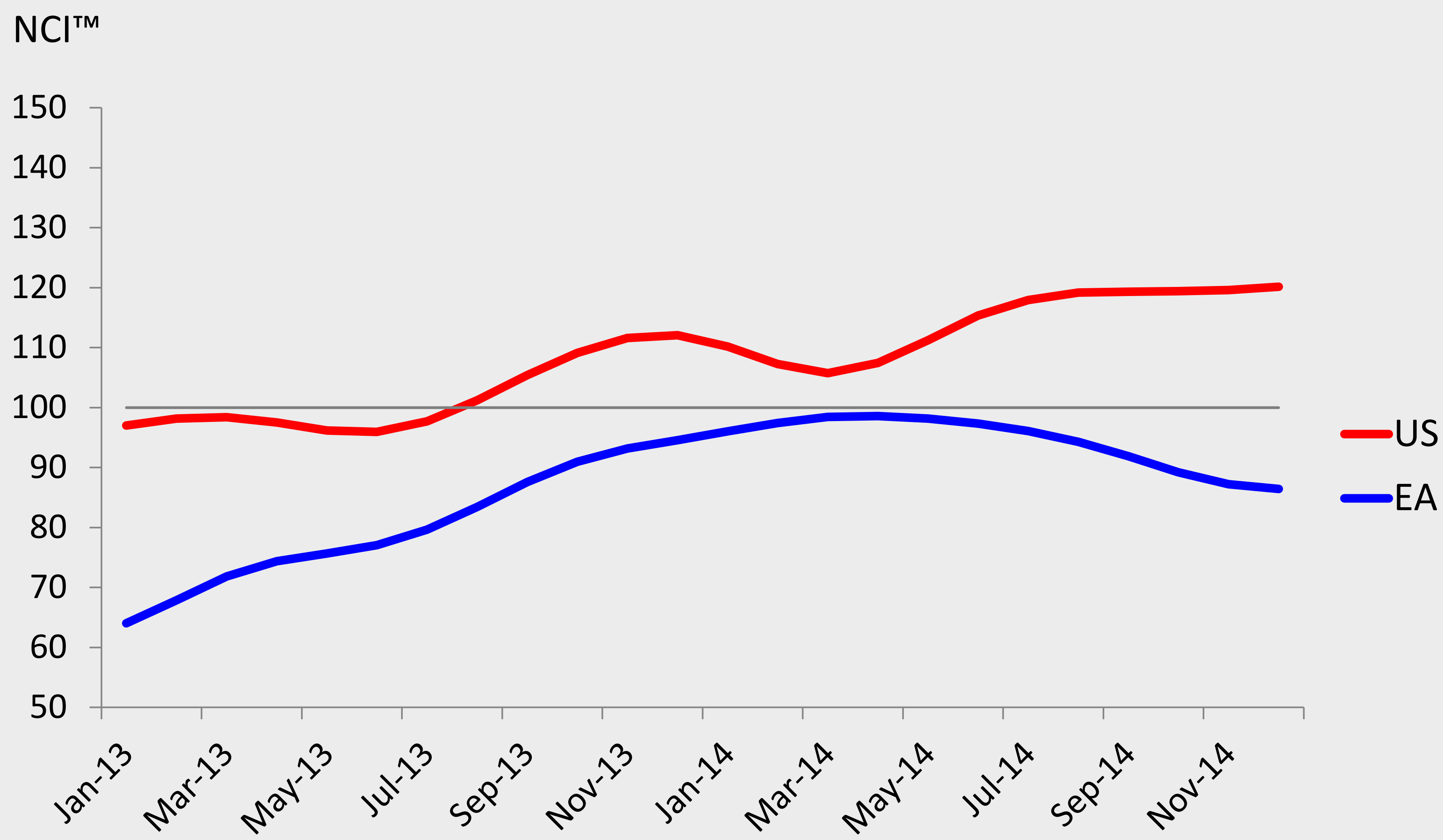

The euro area not out of its second recession since 2008

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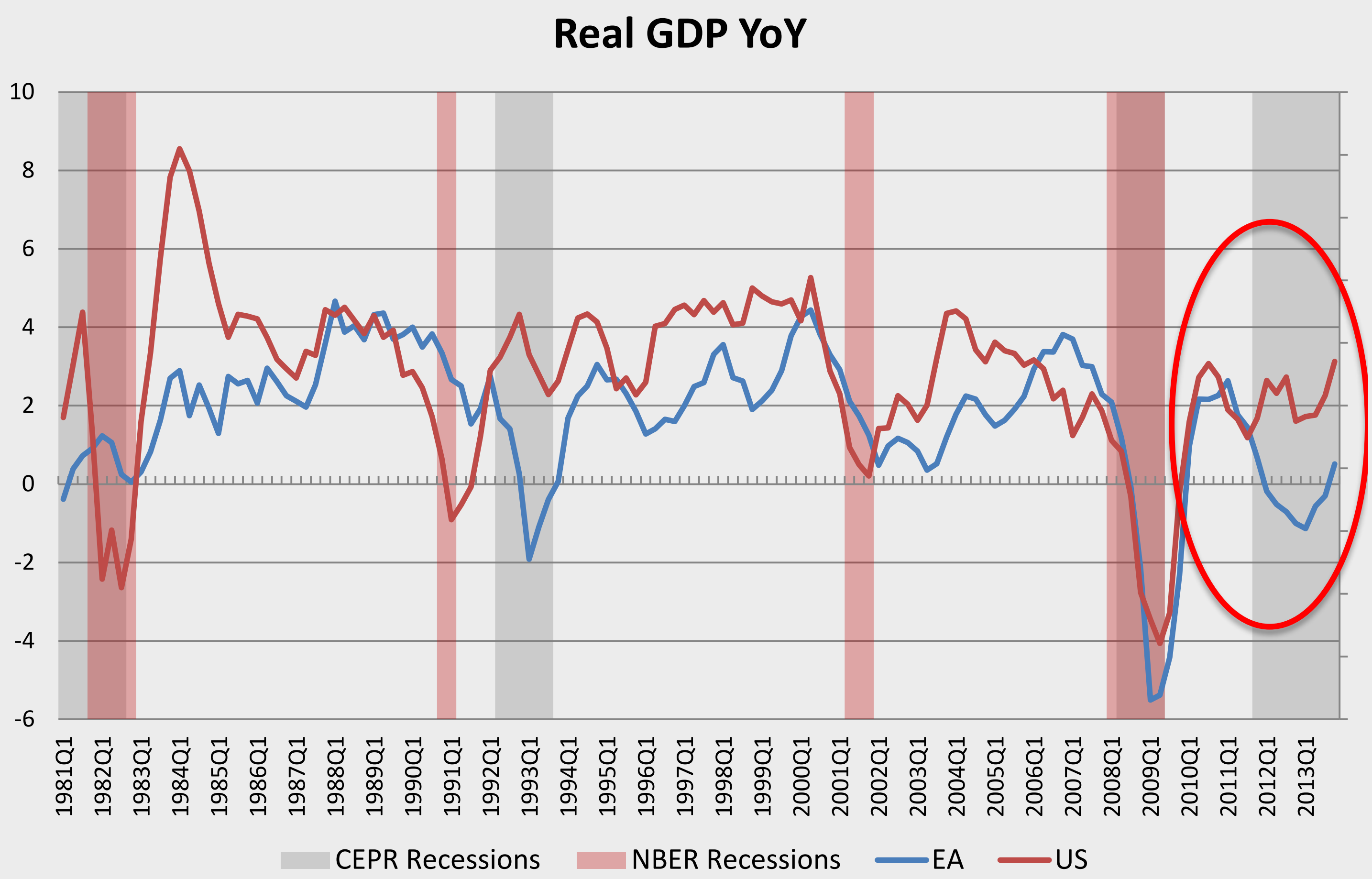

Increasing pessimism about 2014 GDP growth

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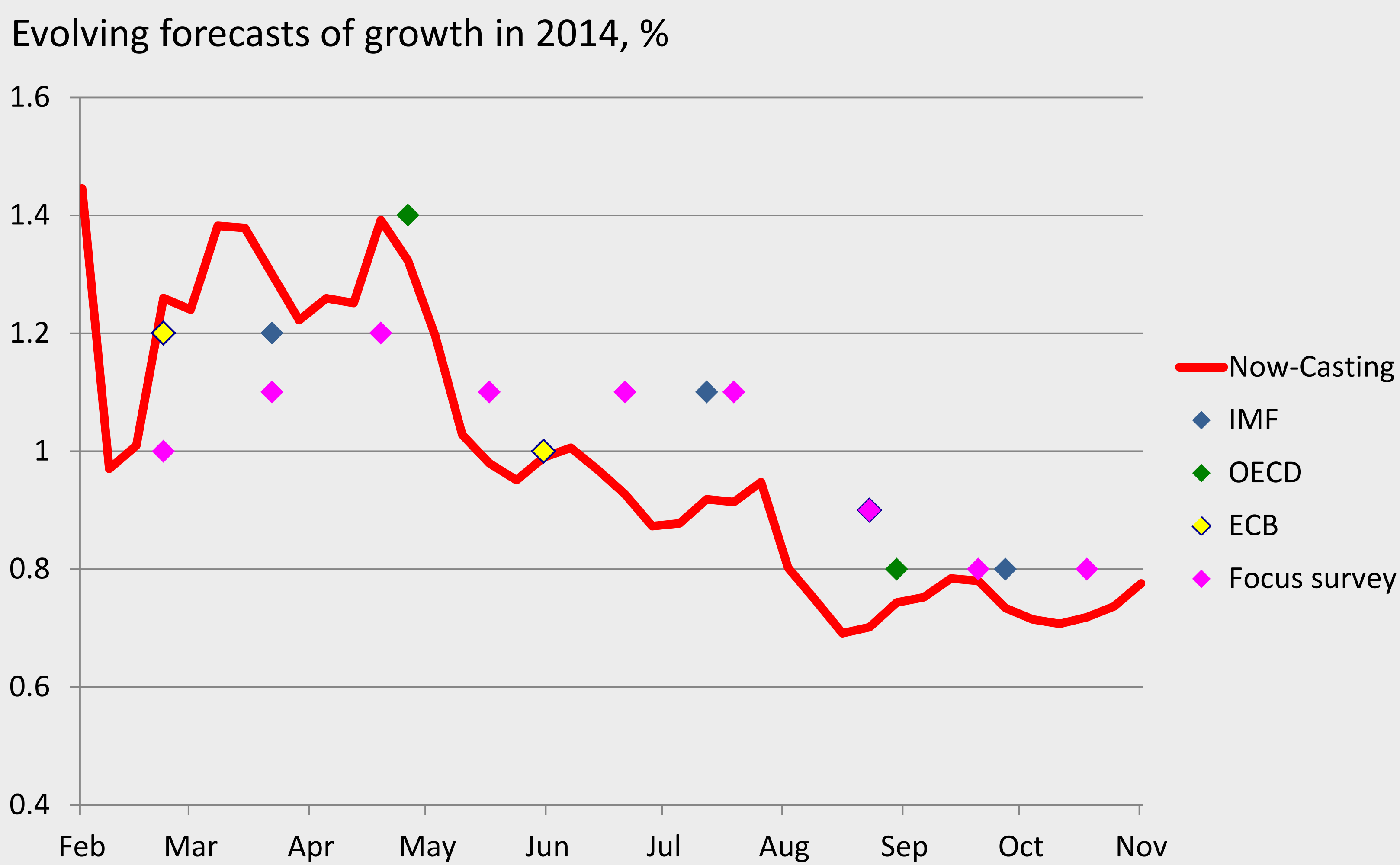

We now know Q3 – the market has been too optimistic for Germany and Italy

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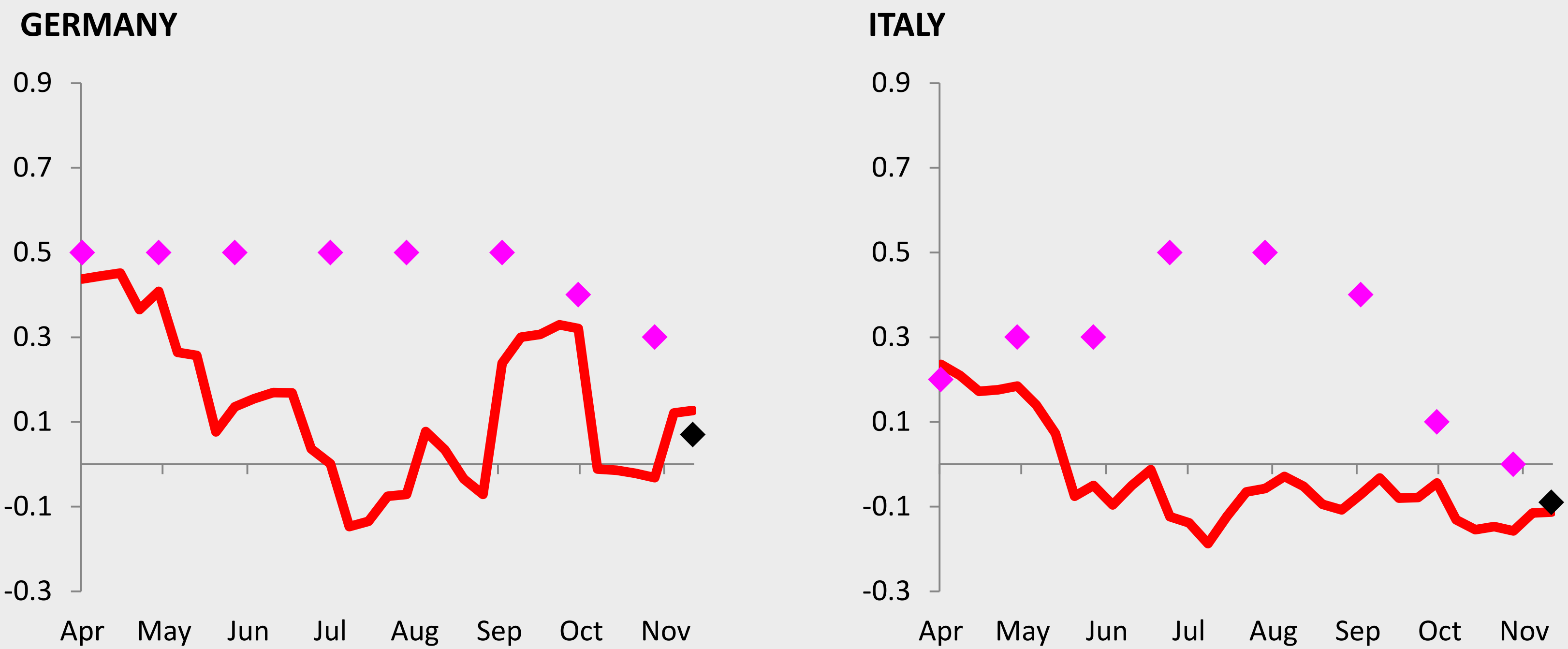
% GDP growth in Q3 2014, QoQ



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Focus survey of independent forecasters

Out-turn (first official estimate)

.. while for France market forecasters were closer but eventually adjusted too far down

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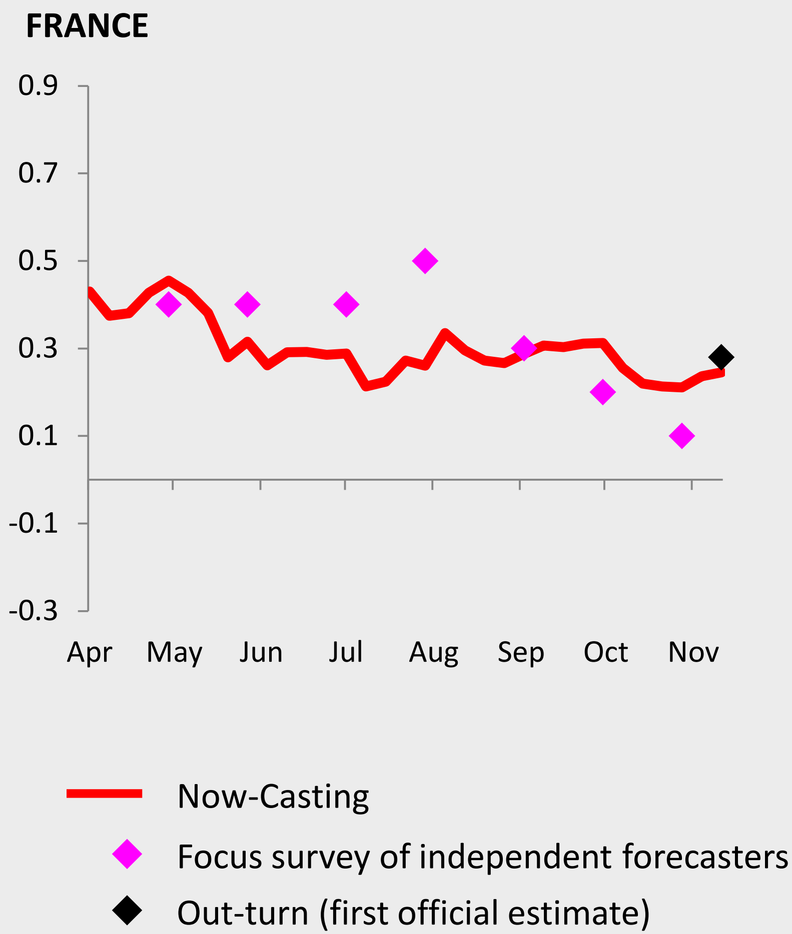
% GDP growth in Q3 2014, QoQ



We think market forecasters are too optimistic for Q4 – for Germany and Italy ..

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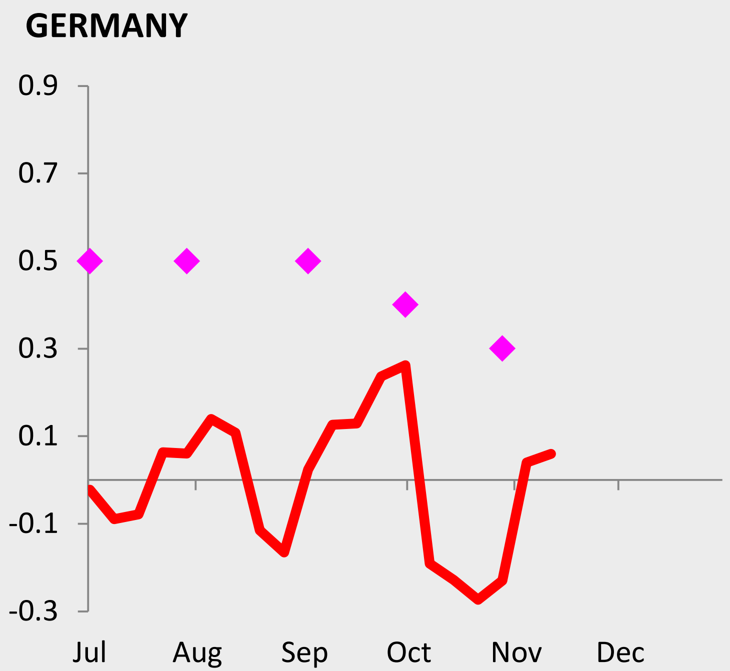
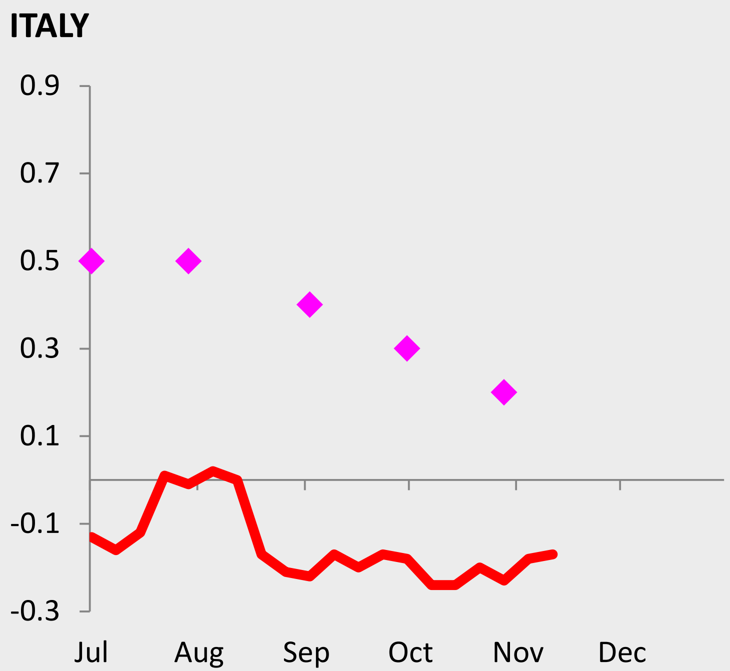
% GDP growth in Q4 2014, QoQ





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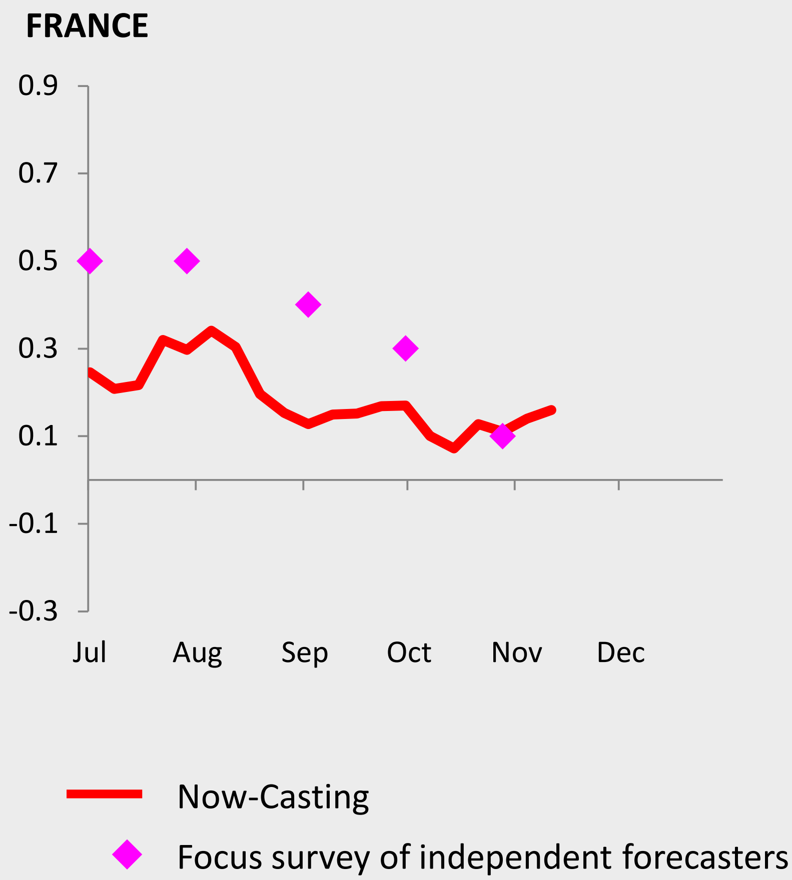
Focus survey of independent forecasters

.. but not for France

% GDP growth in Q4 2014, QoQ



Significant fact is the slow-down of Germany
What are the data saying?

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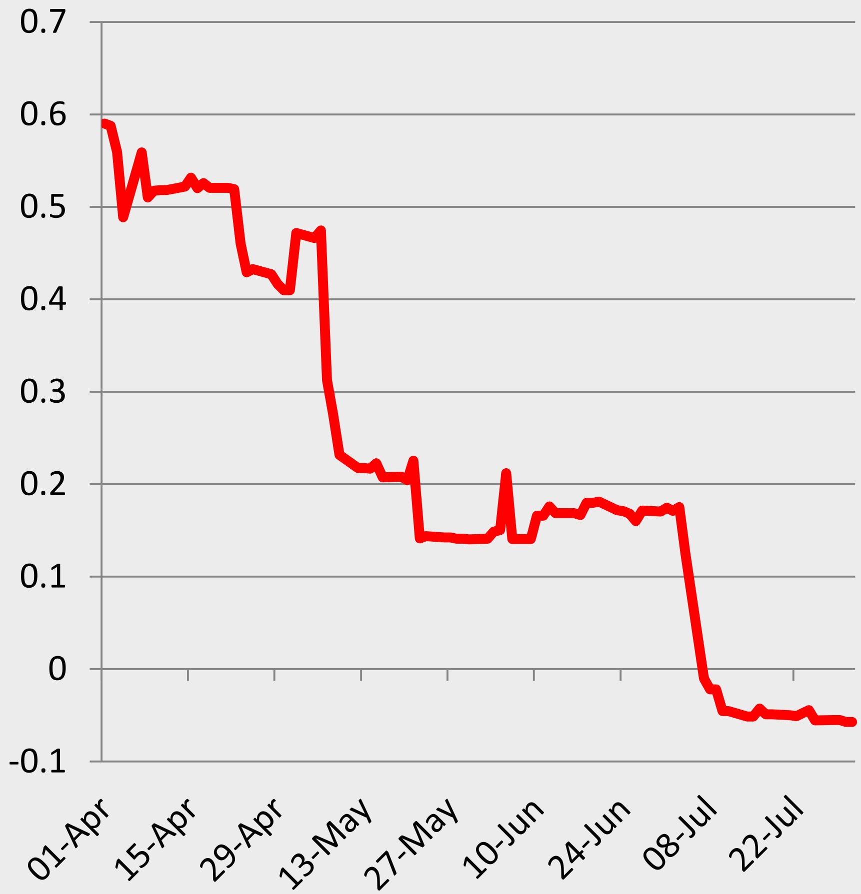
Evolving prediction of growth in Q2, 2014

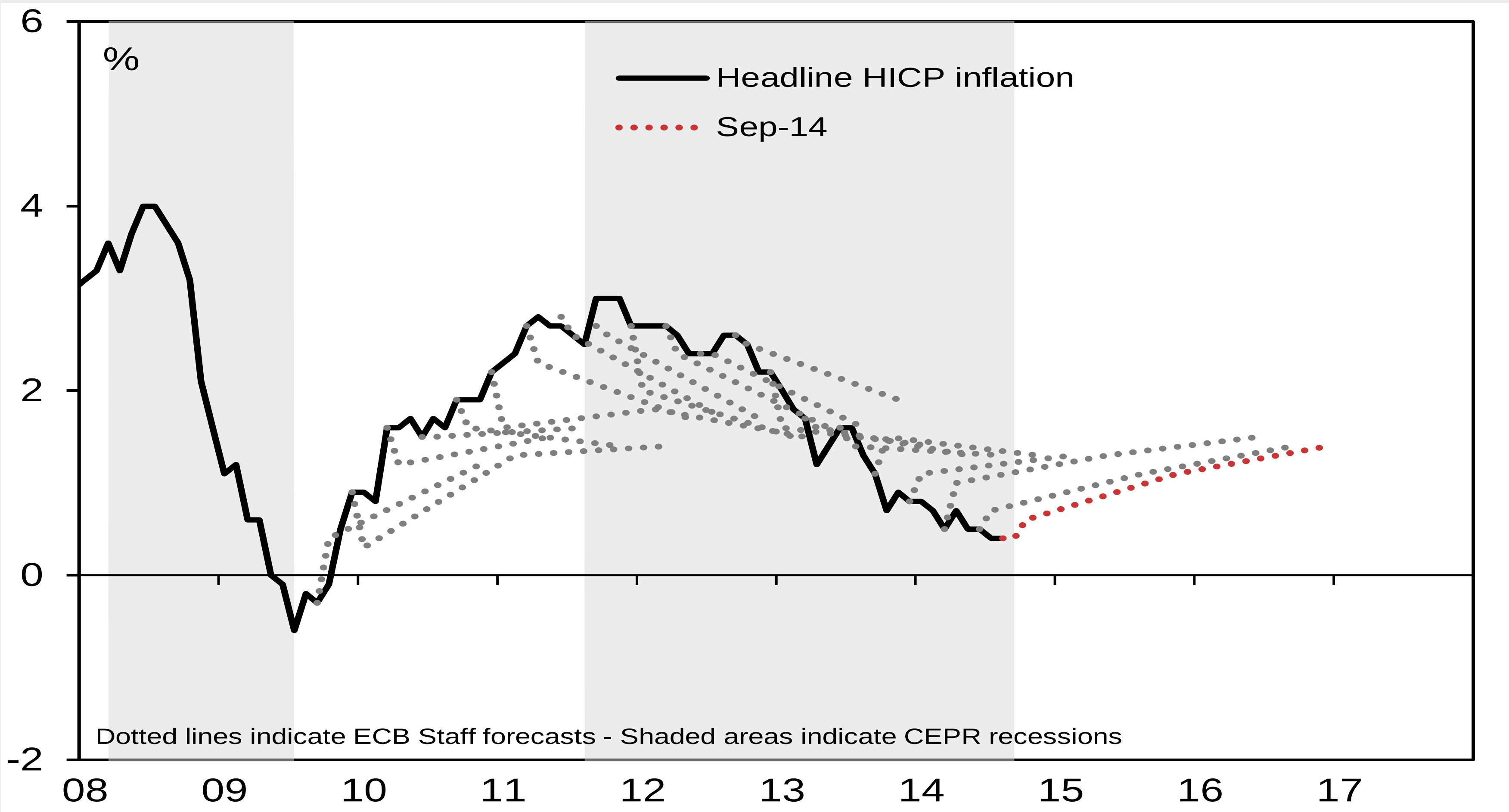
% GDP growth, QoQ



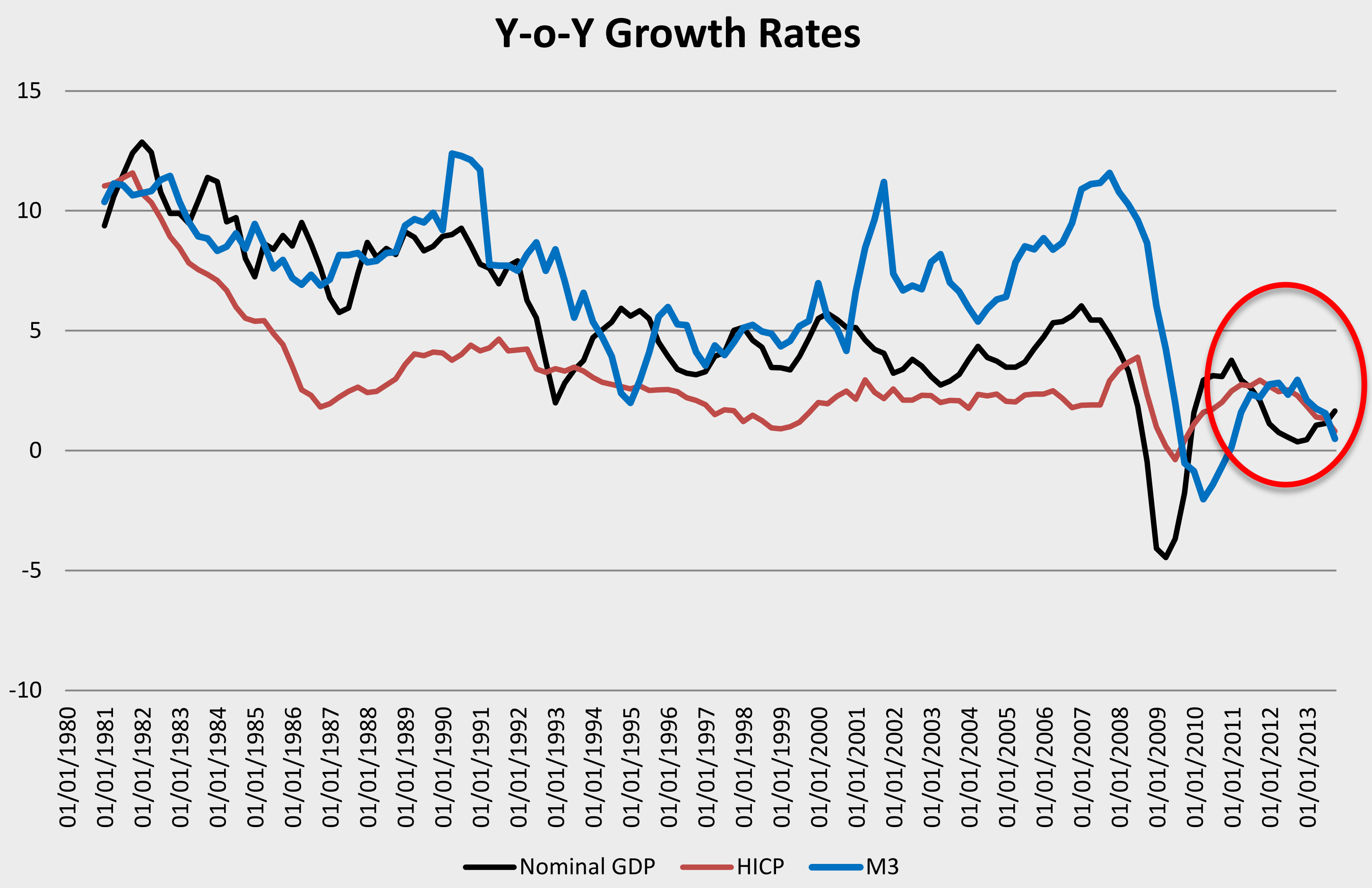
Impact of data releases on Q2 now-cast

Date	Release	Ref month	Impact
4/4	Germany: Industrial Turnover	Feb	-0.01
24/4	Germany: Ifo	Apr	-0.01
24/4	France: Business Climate Ind	Apr	-0.02
23/4	Germany: PMI: Services	Apr	-0.02
23/4	France: PMI: Services	Apr	-0.05
23/4	France: PMI: Manufacturing	Apr	-0.05
5/5	Germany: Car Registrations	Apr	-0.01
7/5	Germany: Industrial Turnover	Mar	-0.07
7/5	Germany: Orders	Mar	-0.08
7/5	France: Industrial Production	Mar	-0.01
8/5	Germany: Industrial Production	Mar	-0.02
9/5	Germany: Imports	Mar	-0.01
9/5	Germany: Exports	Mar	-0.03
	..... Etc.		

Inflation and inflation expectations



Long-run decline of nominal GDP growth, and recent weakening of M3 growth and HICP inflation



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PART 2: REBALANCING - THE MACRO-ECONOMIC ADJUSTMENT

Why the persistent weakness?

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1. Rebalancing from debt overhang
2. Weak support from fiscal and monetary policy
3. Secular decline in investment due to demand and supply factors

On debt overhang

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- As in other DMs, gross debt to GDP ratios in all sectors stabilized but not declined …

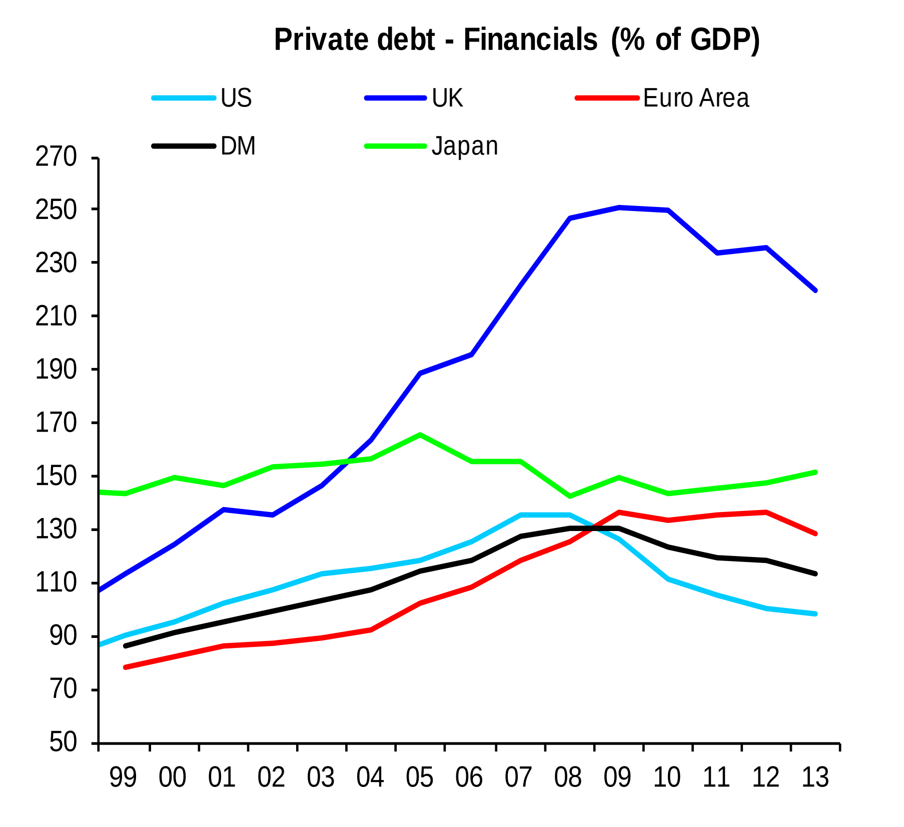
However:

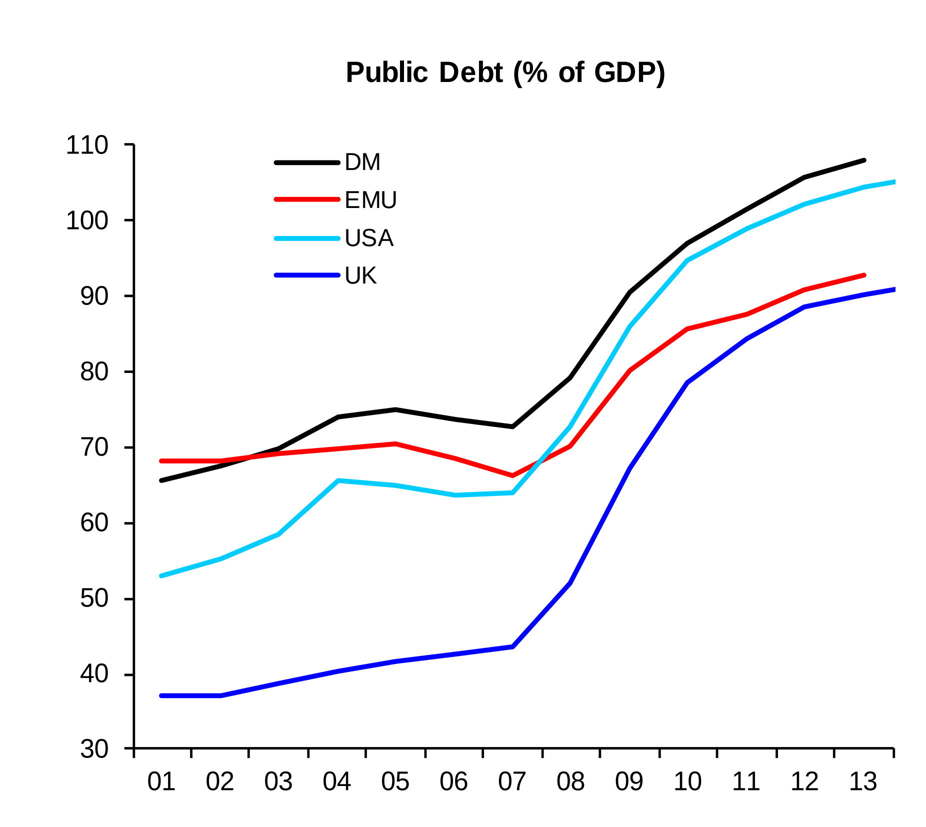
- Not a problem in household sector (net debt was not hit by the crisis as in the US and it is relatively low)
- Corporate has already adjusted

Problematic issues:

- Banks adjusted late and they are still in the deleveraging process …
- Public sector debt to GDP ratio lower than in other DMs but not stabilized …. Ultimately a redistribution problem

In the Euro Area the adjustment in the financial sector only started in 2013 while public debt is still increasing

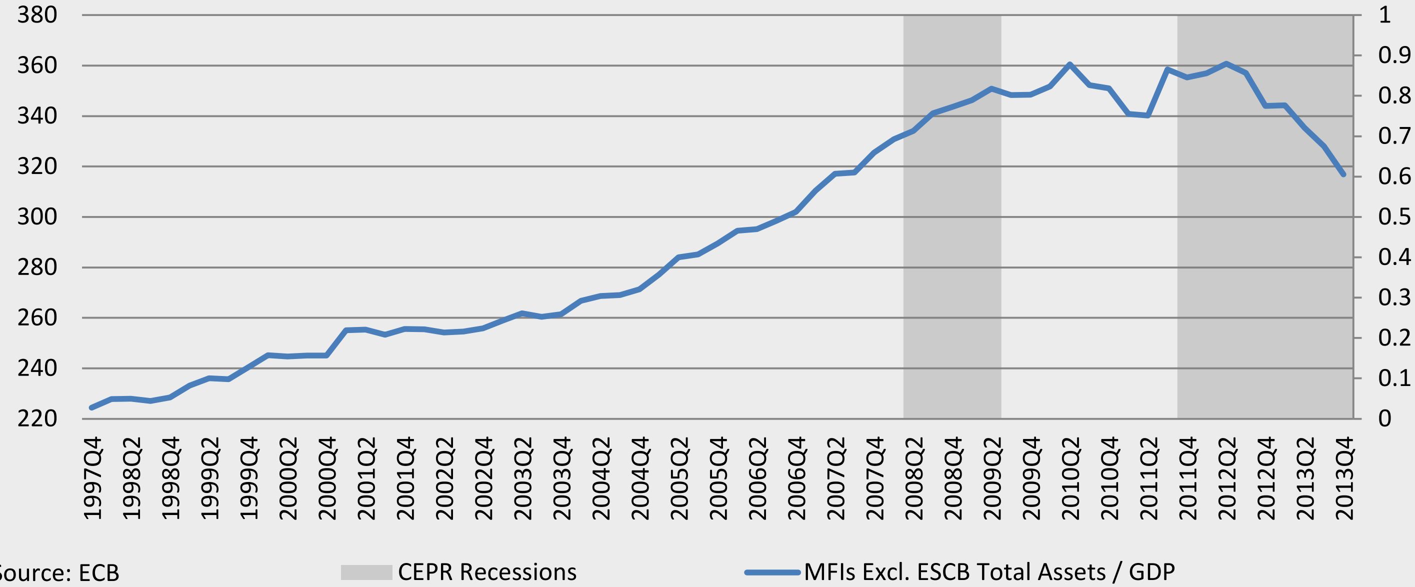




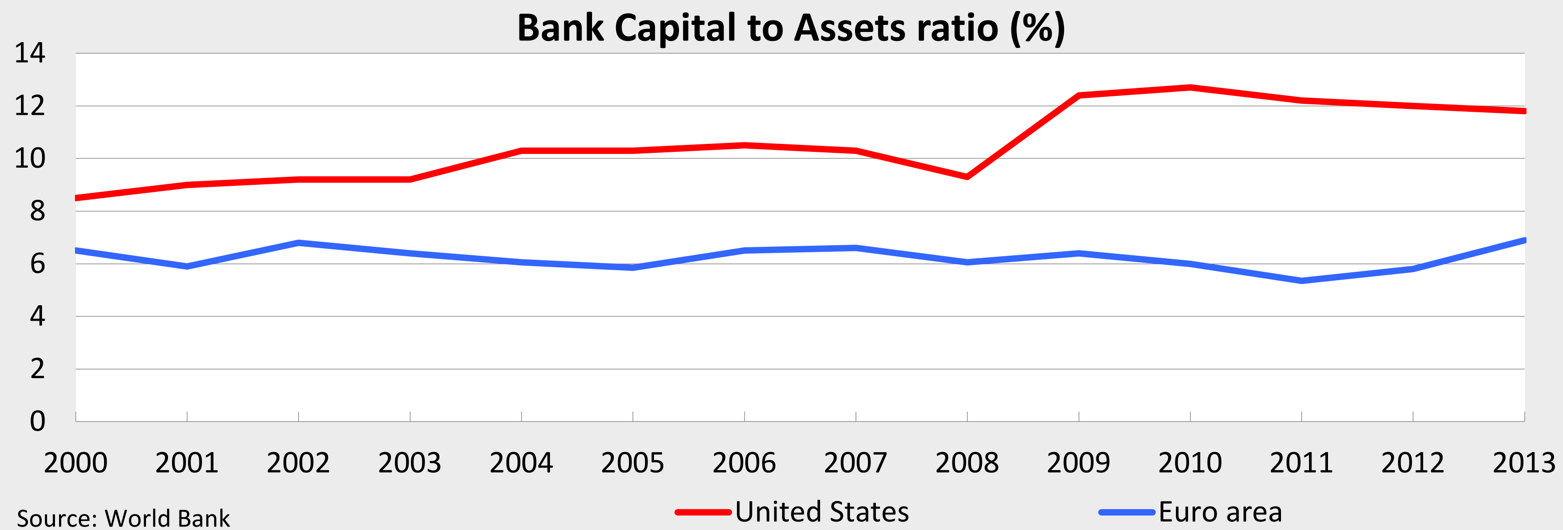
Source: Authors' calculation based on OECD, IMF and national accounts data. See Data Appendix at the end of the report.

Note: DM = developed markets; EM = emerging markets; EMU = Eurozone .

Delayed adjustment of banks b/s size and capital ratio



Source: ECB



Source: World Bank

EMU and the US: a different shocks for the household sector – not much need of adjustment in the EMU

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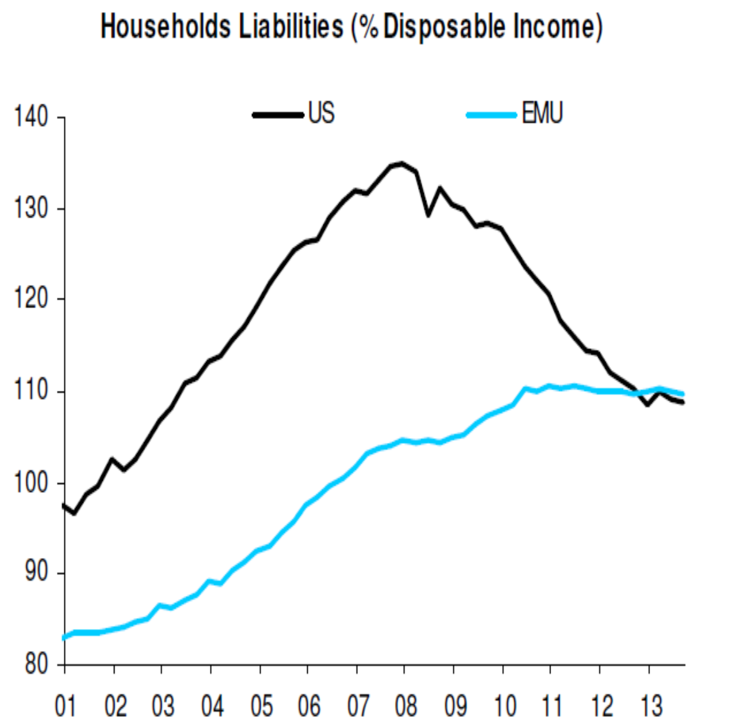
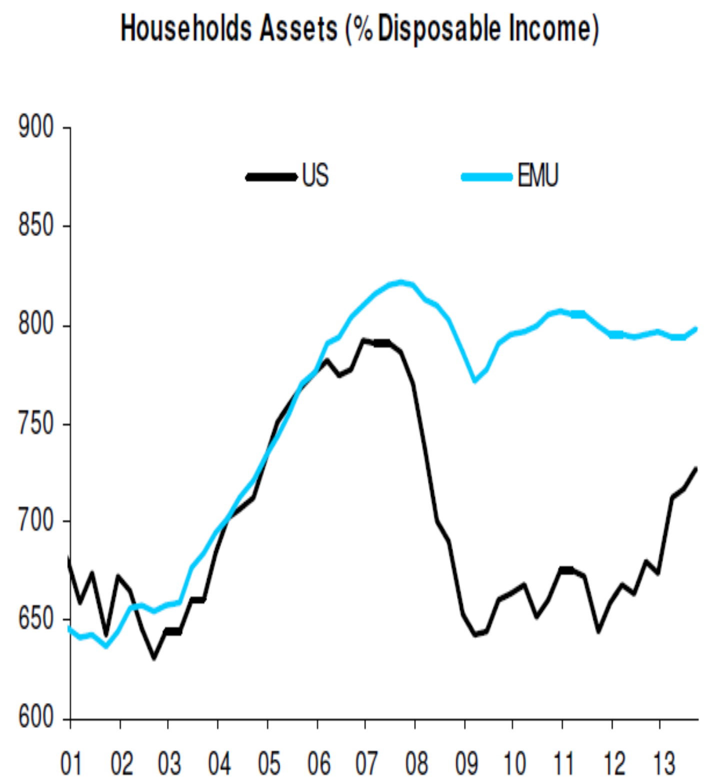
Figure 4.2.3





Source: Geneva Report, 2014

Public sector adjustment: three recessions compared

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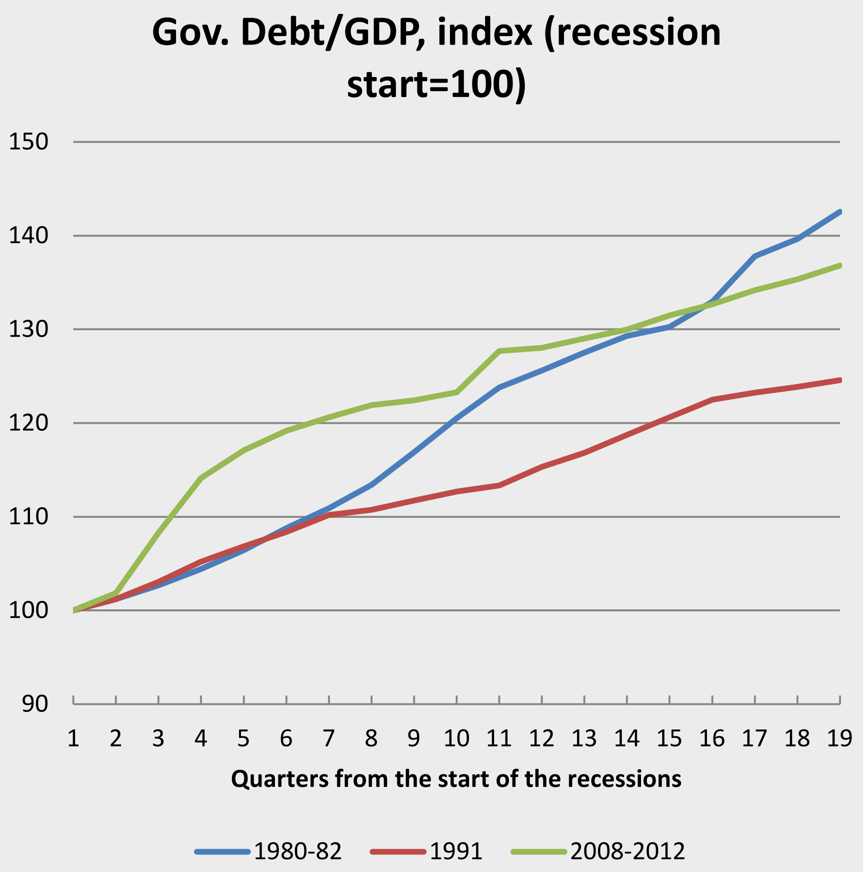
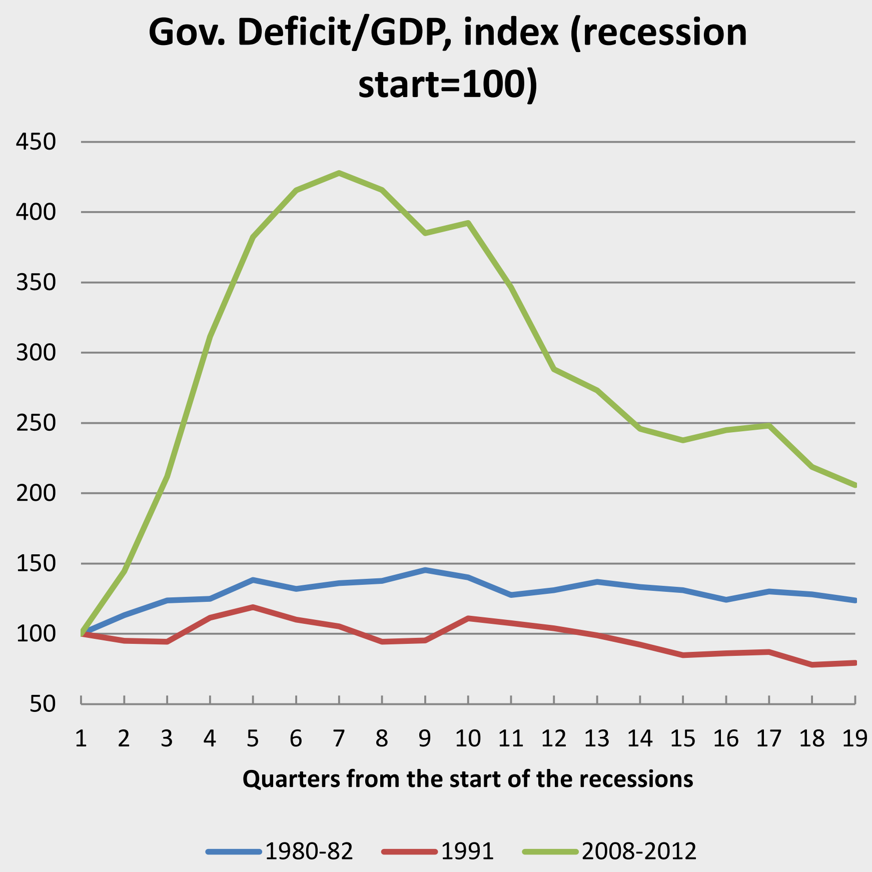
DELEVERAGING SINCE 2009q4 – WILL IT CONTINUE?





Investment

- Investment is strongly pro-cyclical but weakness since 2008 goes beyond historical pro-cyclicality
- Combination of high real long-term interest rates, NFC increase in savings, fiscal contraction since 2009q4, banks shifting asset composition from loans to sovereign bonds

The problem is investment

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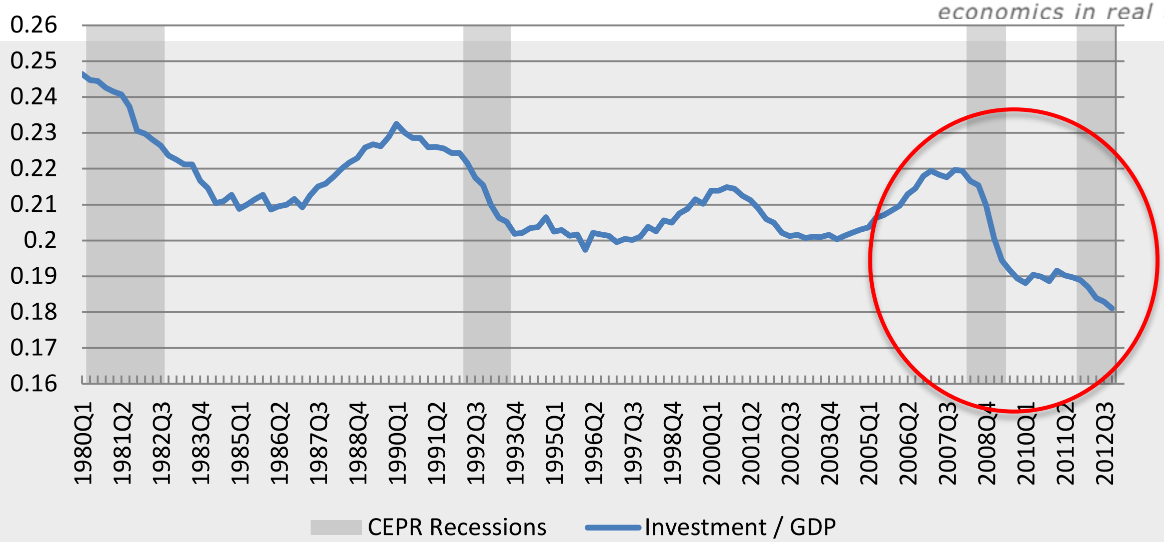
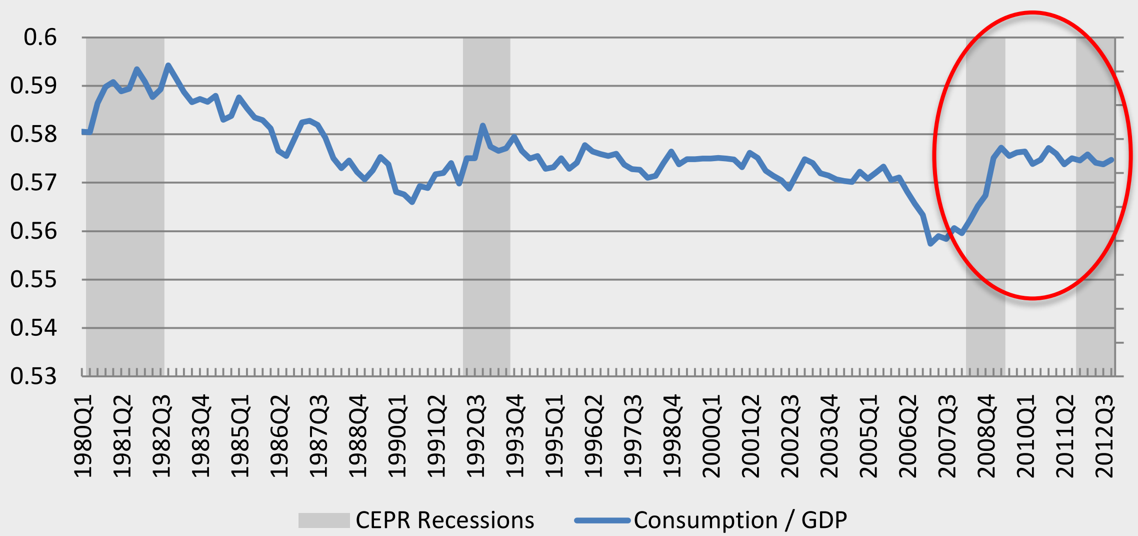
Investment / GDP (%)



Consumption / GDP (%)



Zero lower bound and risk premia

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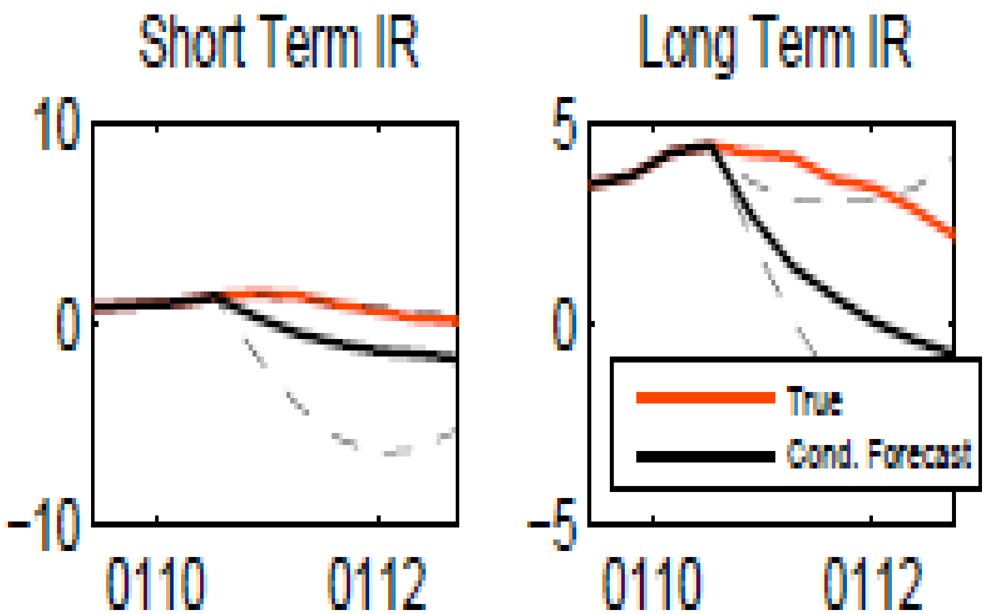

Although long term rates have declined recently, real interest rates have not

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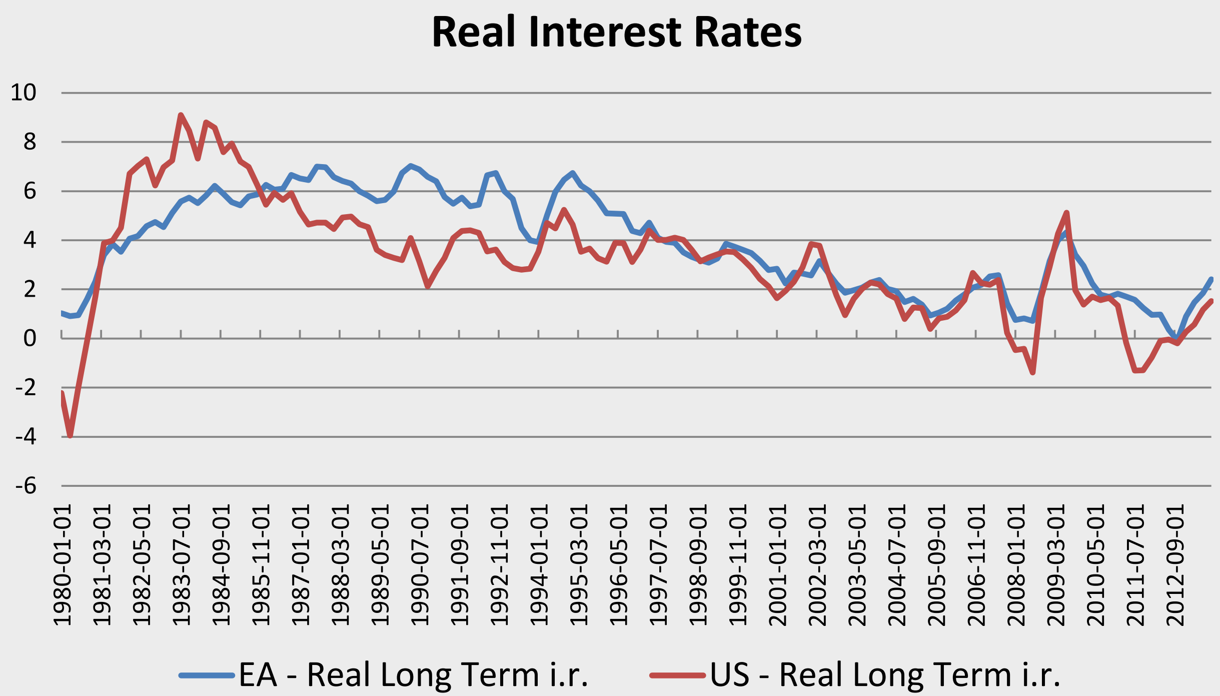
Historically declining but upward pressure since the crisis: lower bound, declining inflationary expectations, risk premia



Summarizing

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- Debt overhang still weighing
- Will affect public sector and banks
- Protracted stagnation ahead if investment not supported …. With potential financial stability issues (debt stabilization)

➢ The crisis is not over!

PART 3: THE ECB – WHAT IS AT STAKE?

The ECB is facing two issues

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ISSUE 1

Financial market segmentation impairing transmission of monetary policy

- In a monetary union, a crisis takes the form of home bias leading to financial fragmentation
- Financial fragmentation not over
- In particular banks have large holding holdings of their own sovereign inducing correlation between bank and sovereign risk (diabolic loop)

Home bias in sovereign holdings by banks

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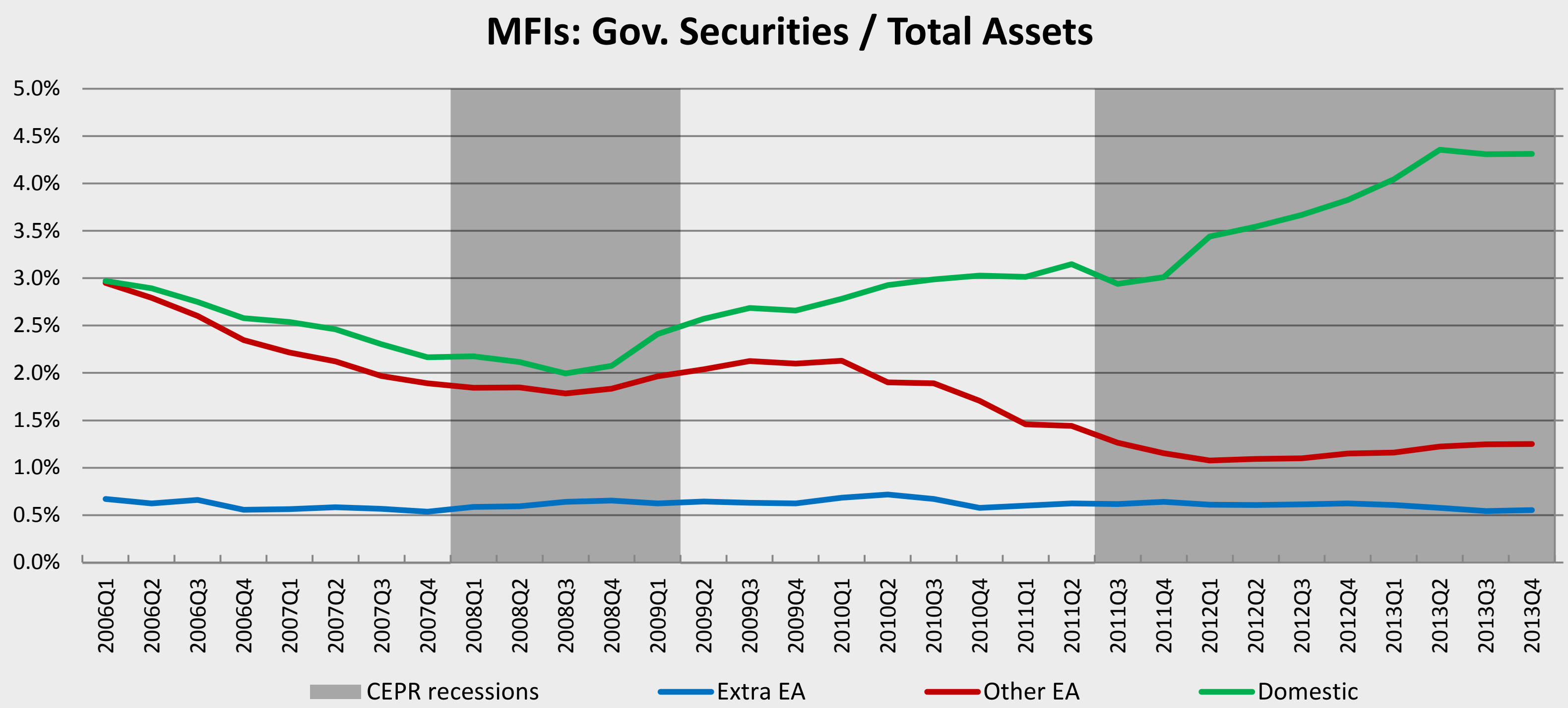
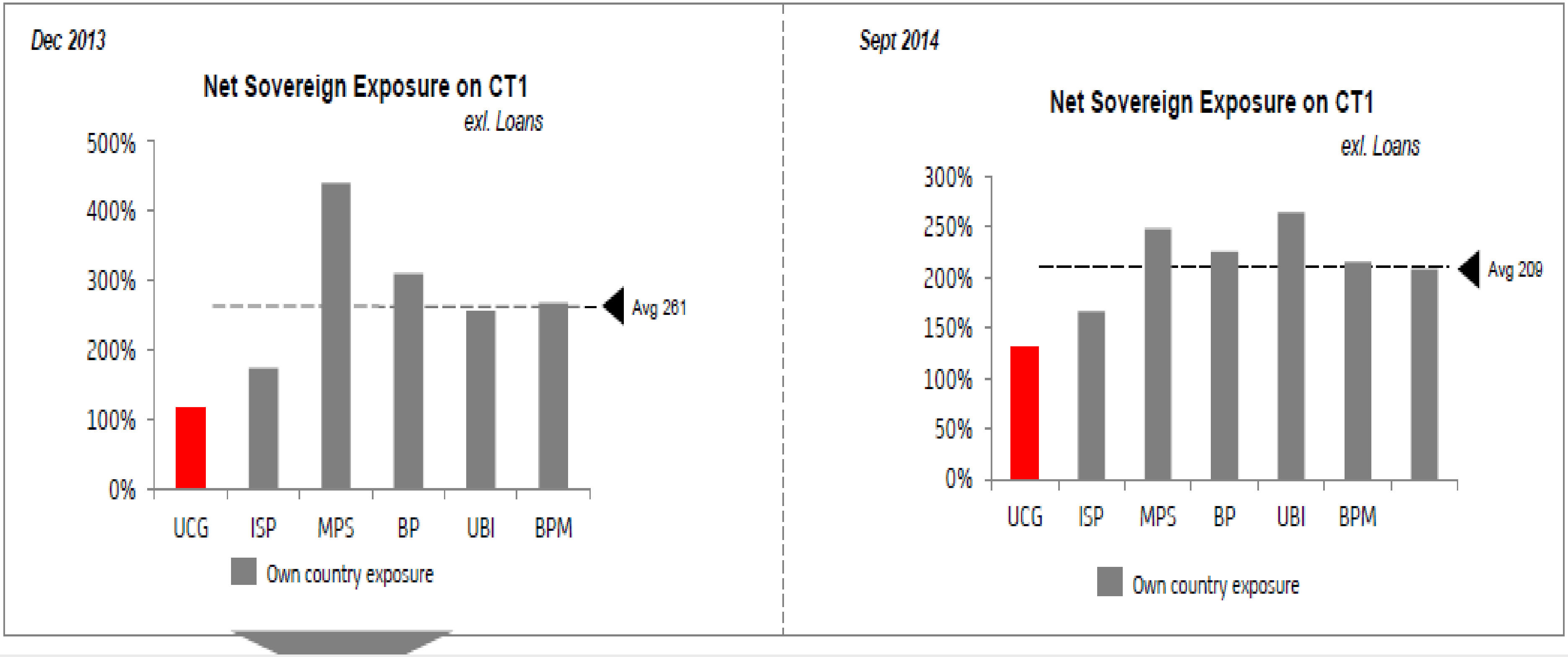


Source: ECB

Italian banks – exposure on own sovereign



Diabolic loop mechanism well understood - yet ….

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… little has been done to avoid it

- This is worrying because the solvency of sovereigns is by no means assured
- Sustainability calculations in particular for Italy are worrisome
- *“Risk on-risk off”*

➢ The market is disregarding these doubts because of the perceived guarantee provided by the ECB.

➢ But were the doubts to return on the market, yields could quickly increase again, hitting hard the balance sheets of banks

ISSUE 2: THE ECB NEED TO DO MORE ..

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QE: WHAT IS AT STAKE?

- With QE the ECB will end up buying a large proportion of government debt
- Which means assuming sovereign\credit risk in balance sheet
- Which will make restructuring impossible in any state of the world

➢ QE would effectively mean the ECB is insuring the private sector from sovereign risk.

➢ This would eliminate market discipline, as the threat of debt restructuring would be eliminated.

What can be done?

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- ON ISSUE 1:

Need to force the banks to diversify the geographical origin of the sovereign fixed income portfolio

(For the functioning of the EMU it is crucial that banks have a diversified portfolio of sovereign debt)

- ON ISSUE 2:

….. Need to have a safe asset and deal with the moral hazard problem

Garicano-Reichlin proposal

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A SAFE ASSET FOR QE

Monetary Policy Aspect

- QE should use of a synthetic safe bond formed by the senior tranches of a set of national bonds in fixed proportions

Regulatory Aspect

- The ECB and the Single Supervisory Mechanism (SSM) would announce that only the senior tranche of the security so produced could be counted as risk-free for the purposes of the risk weighting and liquidity coverage ratio calculations, which implies changing the current treatment of sovereign bonds for these purposes.

Advantages

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- It reduces substantially the geographic bias in the flight to safety, as the safe asset would be (regulatorily) a Europe wide one
- It eliminates the moral hazard that the “risk on/risk off” mechanism induces: governments CAN default in this world, as the banks are protected from the fallout—markets will thus monitor the governments instead of second guessing the (bailout) intentions of the ECB
- it eliminates the diabolic loop, since a sovereign in trouble does not jeopardize its own banks
- It reduces geographic segmentation of the Eurozone markets
- It creates a large safe asset potentially to be targeted by QE

It is important to emphasize here that this synthetic debt would not involve any risk sharing among different governments or any debt mutualization : each government would continue to issue its own debt and face its own interest rates in the market.

Conclusion

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- The euro area is still a risky place
- New creative solutions are needed to make it safer …
- But they need to hurry!

END