

# The euro crisis: is the policy response effective?

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# Sovereign debt crisis: The run-up

Weak fiscal positions

Macroeconomic imbalances

Strong increases in private debt

Shock absorbing capacity of banking systems insufficient

Feedback between fiscal position and financial crisis



Possible overshooting of financial markets, spill over

Governments reached fiscal limit

Lack of crisis resolution framework

# Sovereign debt crisis: Deficiencies in the pre-crisis framework

**SGP, market discipline, prohibition of monetary financing, no bail-out**

**Great moderation, neglect of country perspective**

Weak fiscal positions

Macroeconomic imbalances

Strong increases in private debt

**Lack of macroprudential perspective, weak regulation**

Shock absorbing capacity of banking systems insufficient

**Weak crisis resolution framework**

Feedback between fiscal position and financial crisis

Possible overshooting of financial markets, spill over

Governments reached fiscal limit

Lack of crisis resolution framework

# Sovereign debt crisis: Policy responses

## macroeconomic adjustment

Weak fiscal positions

Macroeconomic imbalances

Strong increases in private debt

reformed SGP, fiscal compact

macroeconomic surveillance

macroprudential mandates at the national level, ESRB

Shock absorbing capacity of banking systems insufficient

## banking union, financial regulation

Negative feedback between fiscal position and financial crisis



SMP, OMT

Possible overshooting of financial markets, spill over

Sovereign debt crisis in several countries

Lack of crisis resolution framework

EFSF, ESM

Monetary Policy

# Policy responses: Is it effective?

## Financial market tensions

Tensions have receded, tail risks have declined.

Due to progress in adjustment, plans for banking union, OMT

## Macroeconomic adjustment

Fiscal deficits declining: targets missed, but structural improvements, debt ratios increasing

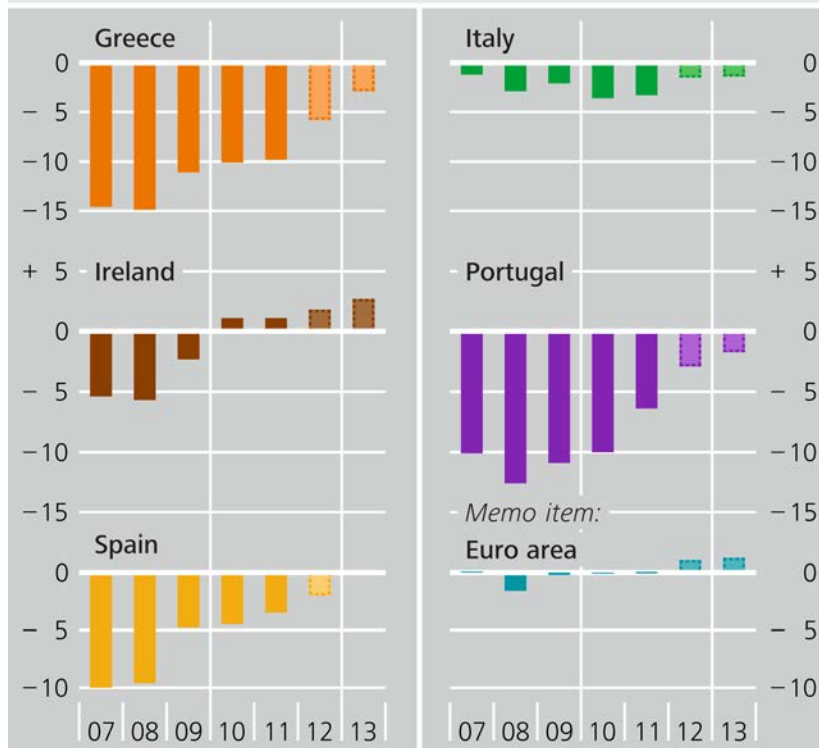
Adjustment processes progress: Current account deficits are shrinking, competitiveness improves, intra-EMU rebalancing

# Policy responses: Is it effective?

## Macroeconomic adjustment

### Current account balances

as % of GDP



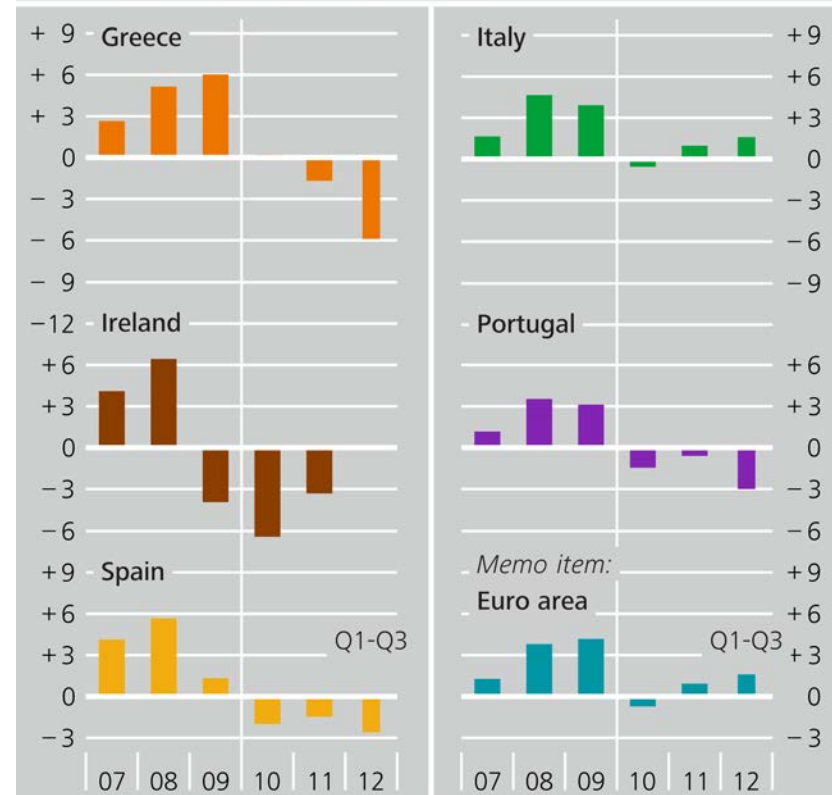
Source: IMF. 2012 and 2013 forecast figures from the World Economic Outlook, October 2012.

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### Unit labour costs in the economy as a whole

Nominal, year-on-year percentage change



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# Policy responses: Is it effective?

## EMU governance framework

Strengthening of the pre-crisis fiscal framework. Focus on strengthening rules, less on enforcement from the EMU level (e.g. fiscal compact)

Most important initiatives focus on integration of the financial sphere: banking union, macroprudential mandate.

## EMU crisis resolution framework

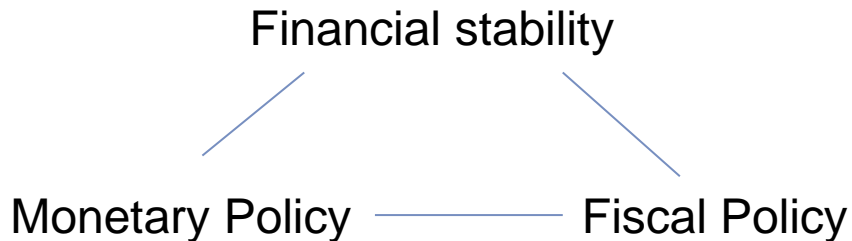
EFSF, ESM.

But bulk of short-term crisis response handed over to monetary policy.

# Policy responses: The appropriate role for monetary policy

## Monetary policy in the crisis: a tale of two perspectives

Some unpleasant considerations beyond a Sargent-Wallace world:



- Using central banks' balance sheets as policy instrument means walking a thin line between monetary and fiscal responsibilities. This is especially relevant in a monetary union.
- In EMU: Shifting burden between taxpayers of different member states
  - Redistribution of risks is domain of democratically legitimized institutions, ie parliaments
  - Important difference compared to non-EMU central banks



## Policy responses: Where do we stand?

A multifaceted approach to strengthen the framework.

Adjustment in crises countries.

Banking Union in the making.

A further jump into political union with more integration seems unlikely.

Risk-sharing in the traditional fiscal sense is politically costly. And it is difficult to get public support. Natural tendency to use a less costly avenue: .

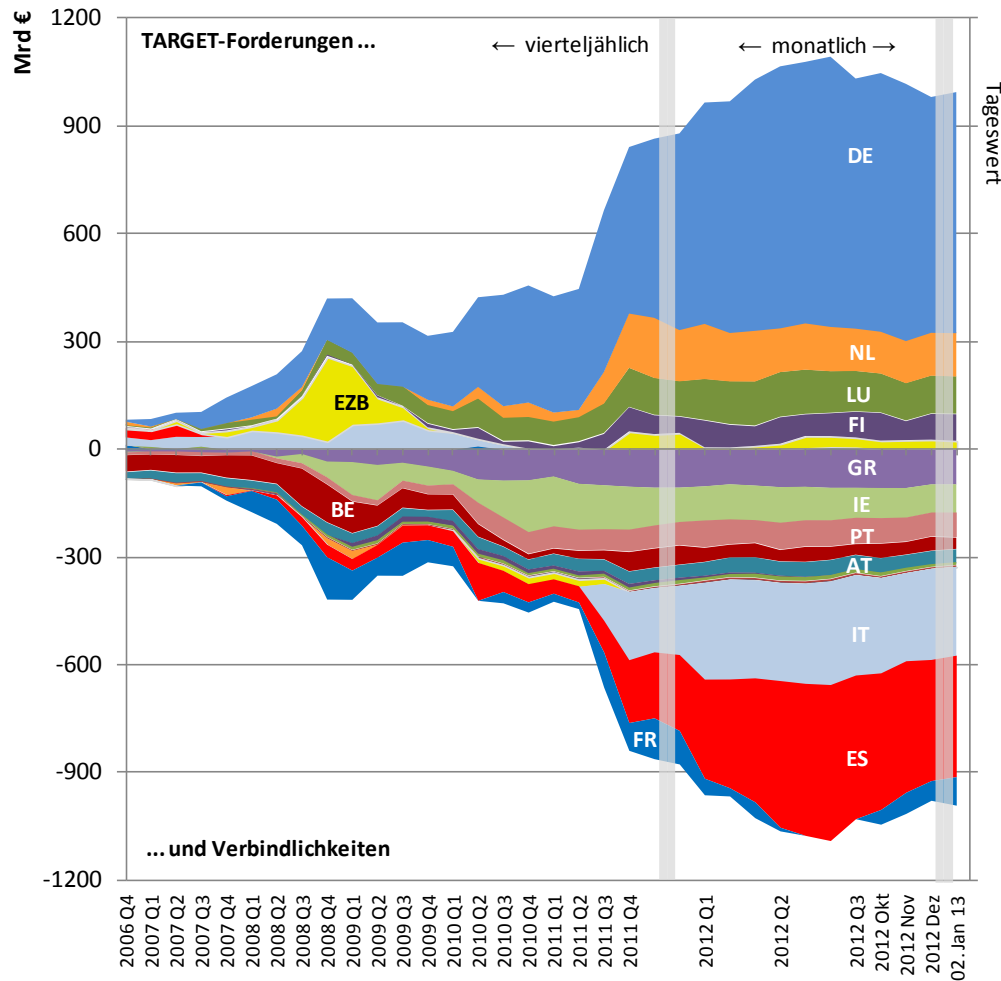
Will it work?

# Background slides



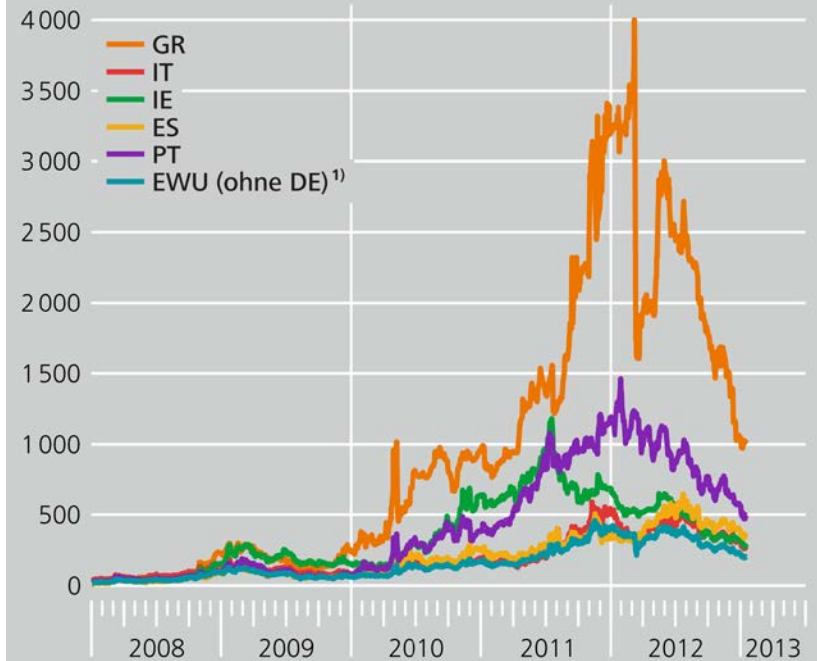
# Policy responses: Is it effective?

## Financial market tensions



## Spreads

### 10y Bund-Spread



<sup>1)</sup> Durchschnitt der Umlaufrenditen in den EWU-Teilnehmerländern (BIP-gewichtet), ohne Deutschland.

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