



The impact of the latest economic turmoil on European industry

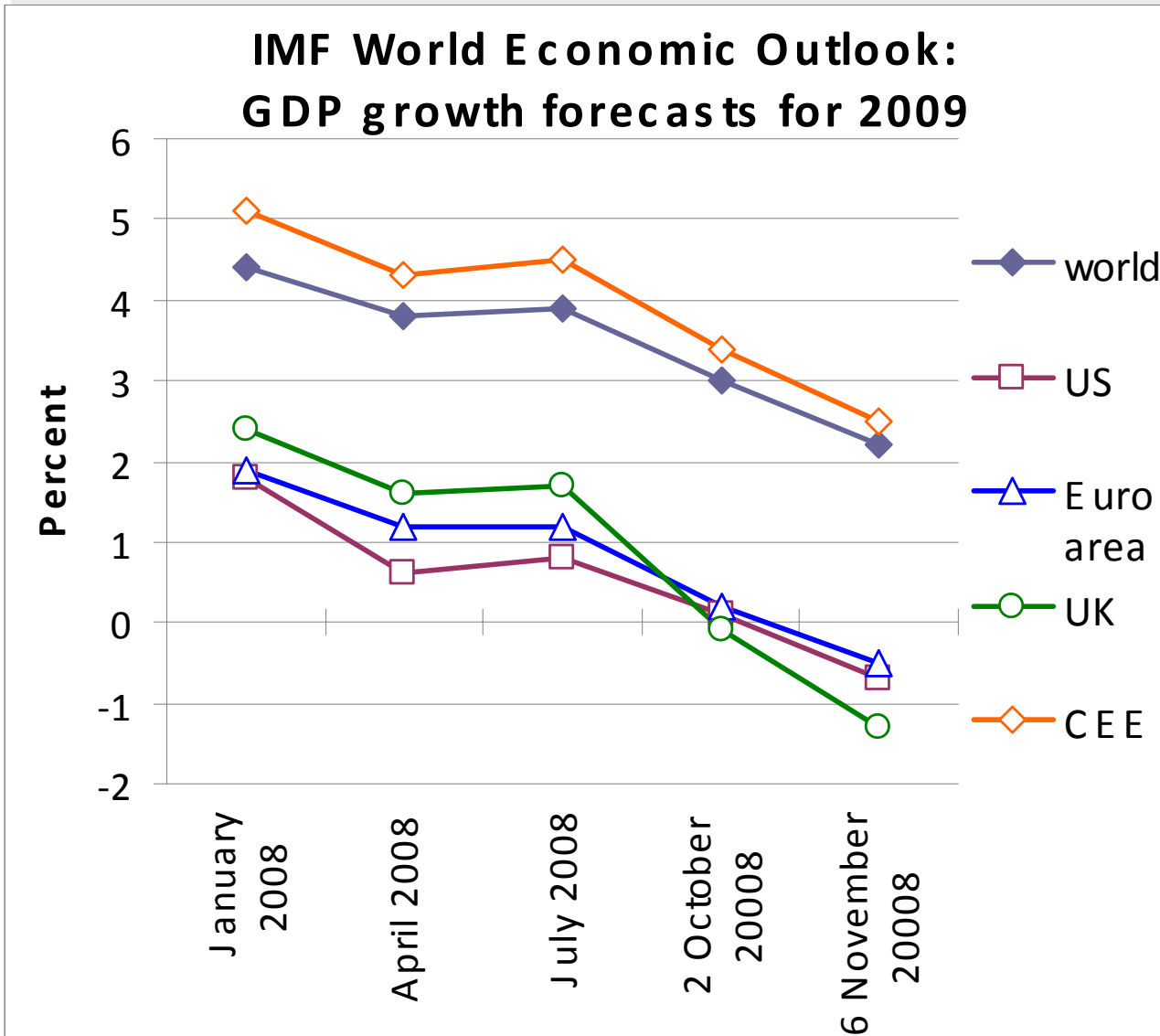
Hearing at the European Parliament

Zsolt Darvas

10 November 2008



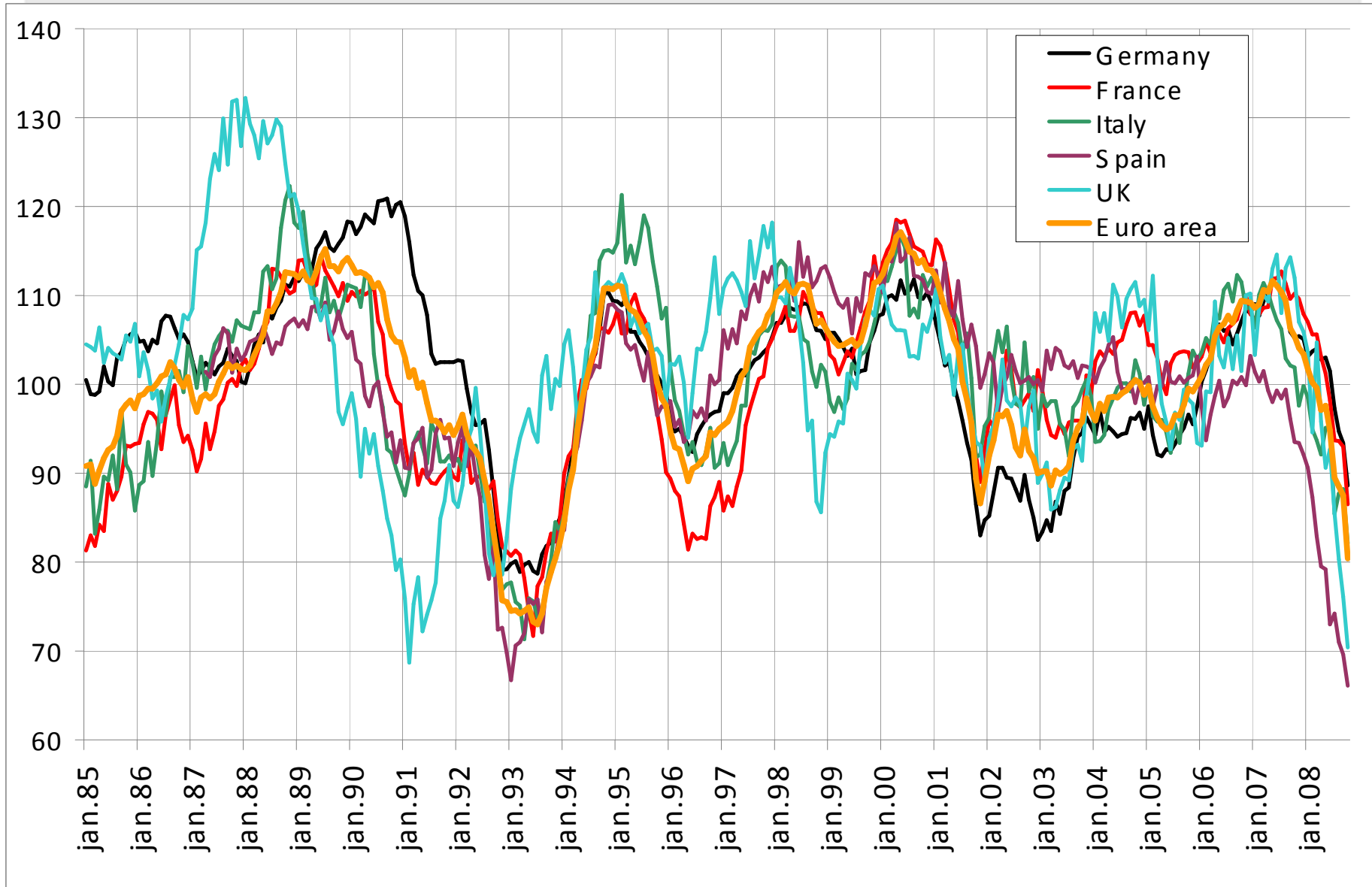
Big uncertainty about the future



Growth forecasts for 2009 declined sharply

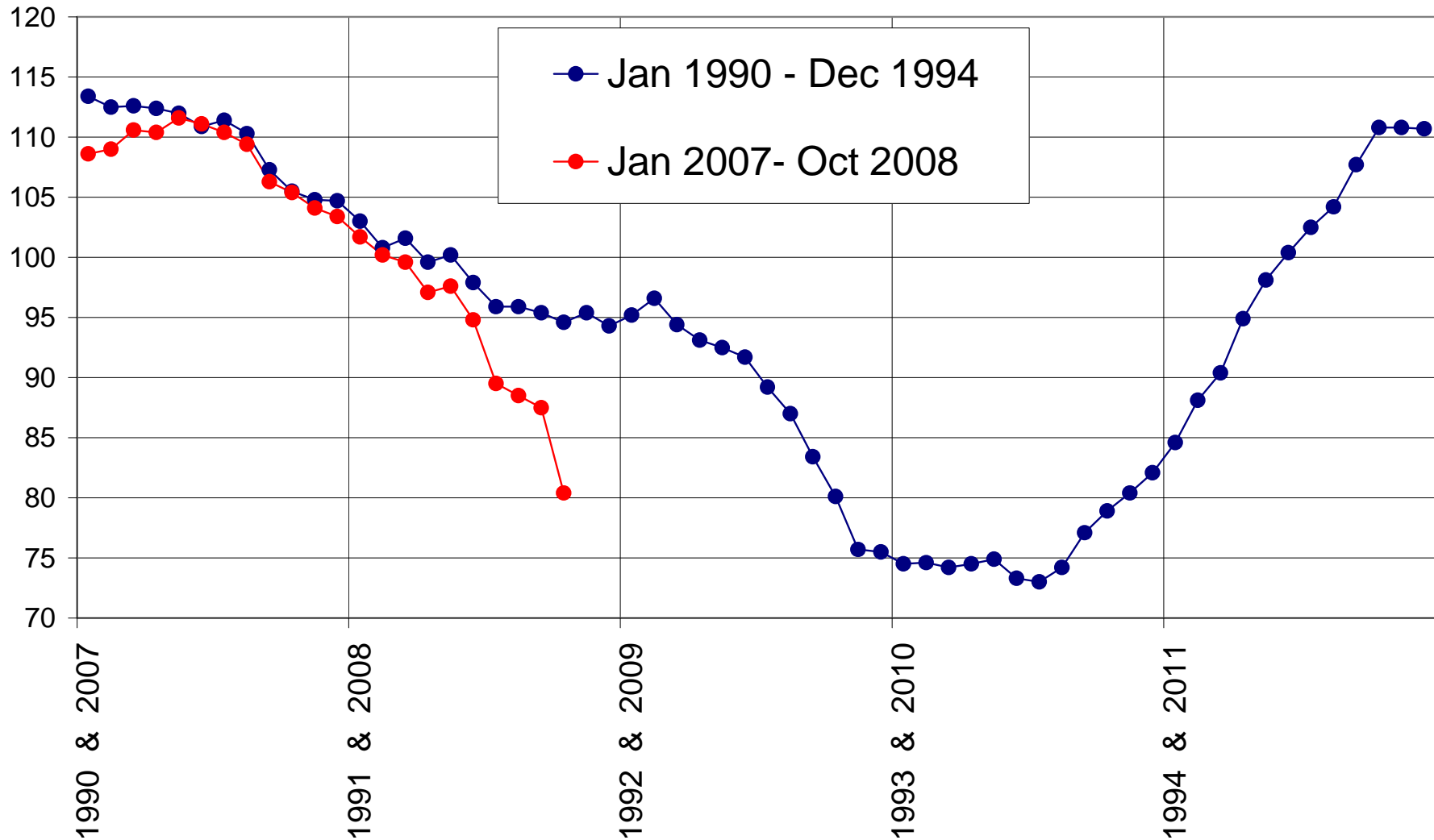


Economic sentiment, Jan 1985 – Oct 2008



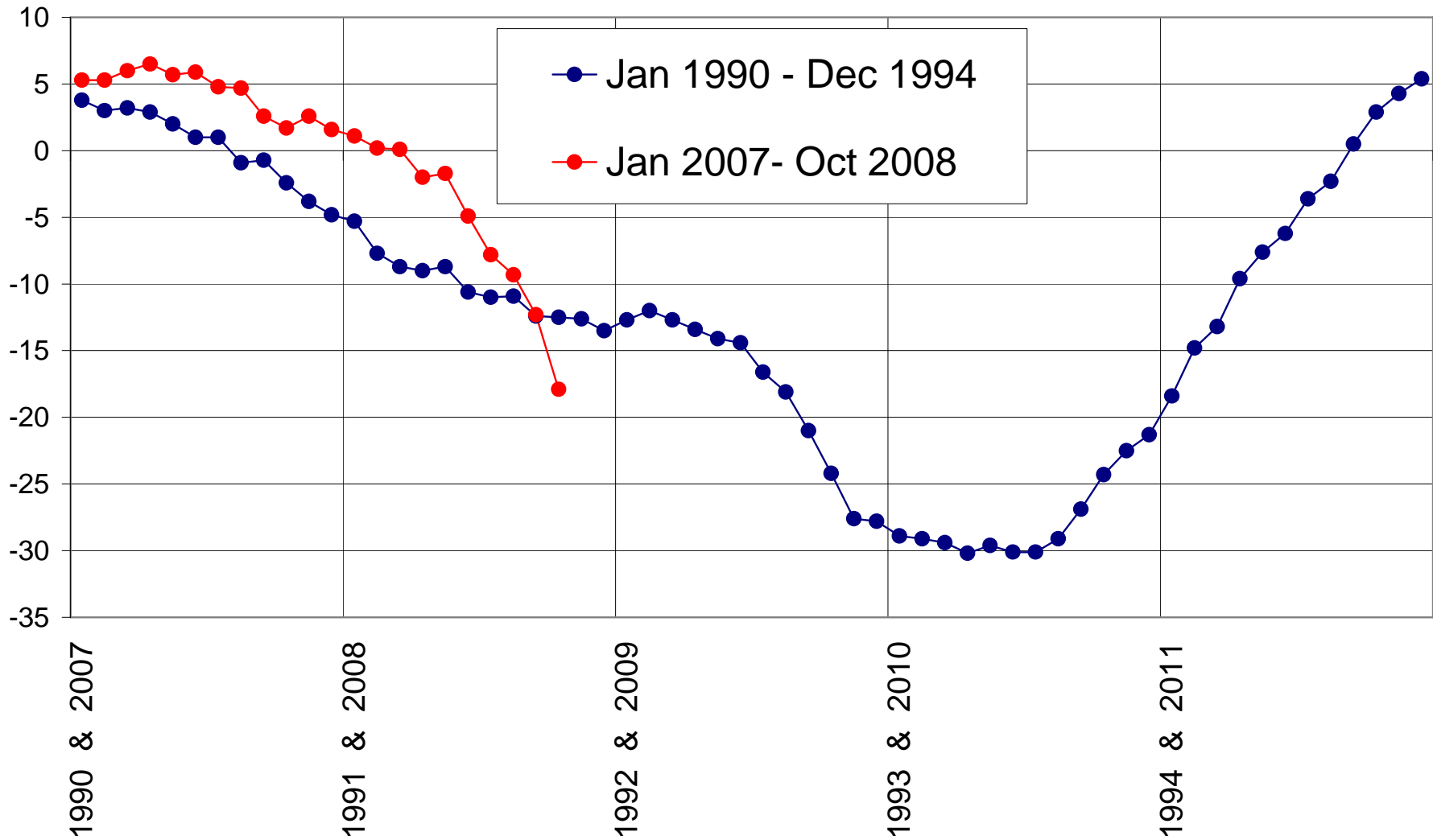


Euro Area: Economic sentiment, Comparison of 1990-1994 with 2007-2008



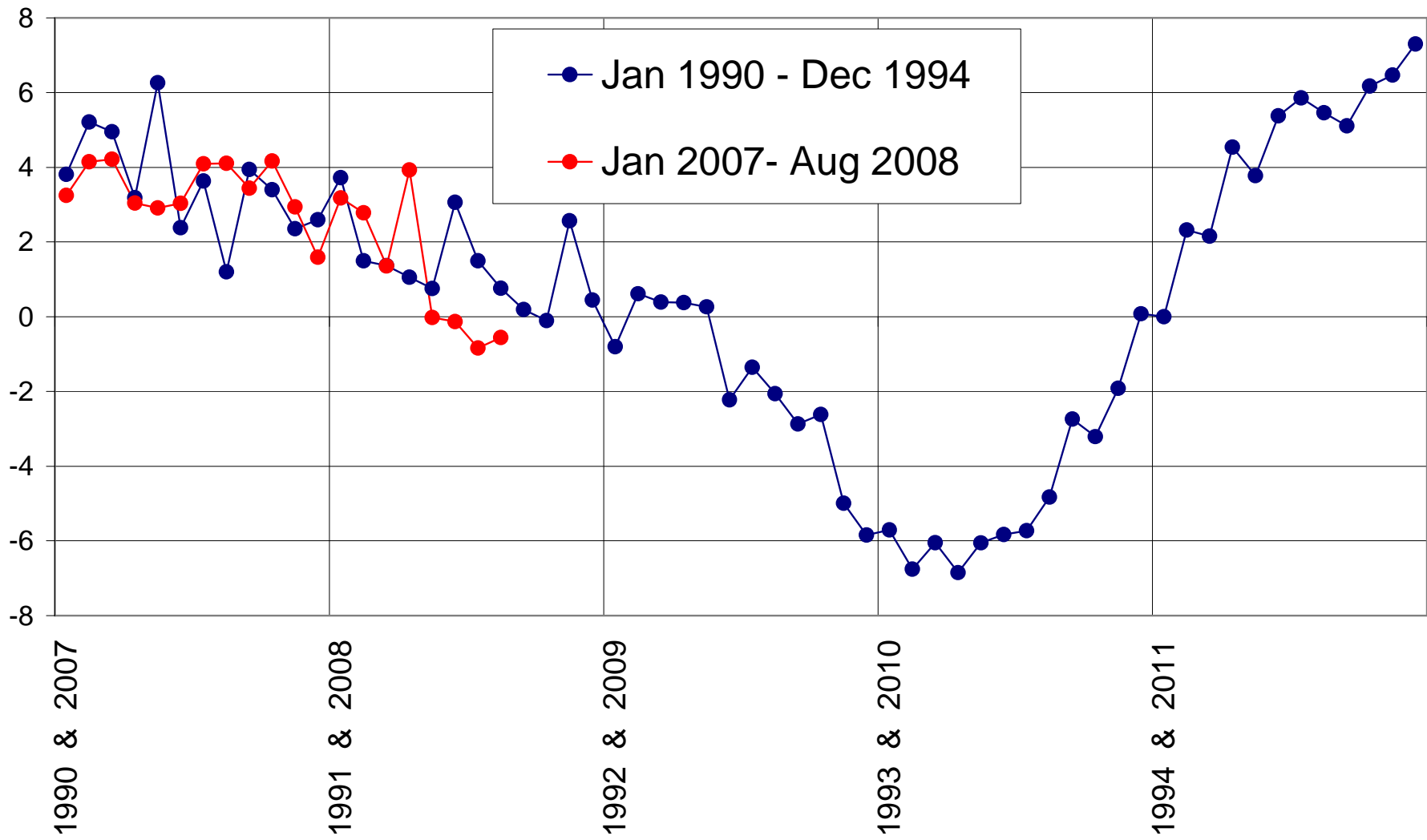


Euro Area: Industrial confidence indicator, Comparison of 1990-1994 with 2007-2008





Euro Area: Industrial production (% annual growth), Comparison of 1990-1994 with 2007-2008





Global financial turmoil

- **Lot of stress / contagion / panic**
 - Extreme preference for liquidity
 - Extreme volatility of stock, forex markets
 - Violent upward adjustment of risk premia
 - Major distortions in relative prices of financial assets

- **Confidence shock strongly impacts the economy**



Channels

Negatives

1. Wealth
2. Credit constraints
3. Access to liquidity, cost of capital and deleveraging
4. Financial turmoil in emerging world and falling global demand

Positives

1. Lower commodity prices
2. Lower inflation
3. Lower euro



1. Wealth

- **Negative shock to private sector wealth affects consumption, investment**
- **First-order issue in the US**
 - Major decline in house and stock prices
 - Wealth-based consumption (mortgage equity withdrawals)
 - No-recourse mortgages vulnerable to negative equity
 - Pensions (defined contributions)
 - **Protracted adjustment of household sector is likely**
- **Less important in Europe**
 - Equity ownership less widespread, PAYGO pensions regimes
 - Moderate decline in house prices (no decline in De, large in UK IE ES)
 - Weaker link with consumption
 - **Uneven effect within Europe**



2. Credit constraints

- **Shock**

- Negative initial shock to the asset side of bank balance sheets

- **Financial multiplier**

- Deteriorating balance sheets lead banks to lend less
- Deteriorating value of assets leads to further tightening of credit
- Amplified by dysfunctional interbank market

- **Effect**

- Lesser willingness to lend, credit constraints across the board
- Risk of vicious circle

- **Responses**

- Recapitalisation plans
- Guarantees



3. Access to liquidity, cost of capital and deleveraging

- Extreme preference for liquidity: difficult to get from outside
- Lower equity prices & higher corporate bond spreads → higher cost of new capital in comparison to existing stock
- Adjustment in balance sheet structures, lower investment, lower demand for credit
- Temporary overshooting (rush for liquidity)



4. Financial turmoil in emerging world and falling global demand

- **Contagion to emerging countries since end-September**
 - Capital flow reversals
 - Sovereign spreads
 - Domestic credit markets
 - IMF programmes
- **Effects on Europe**
 - Trade exposure
 - Financial exposure



The positives

- **Reversal of commodity price shock**
- **Effects of lower inflation**
 - Income transfer to households
 - Frees central bank from policy dilemma
- **Lower euro**
- However, the positives merely correspond to the correction of previous negative shocks

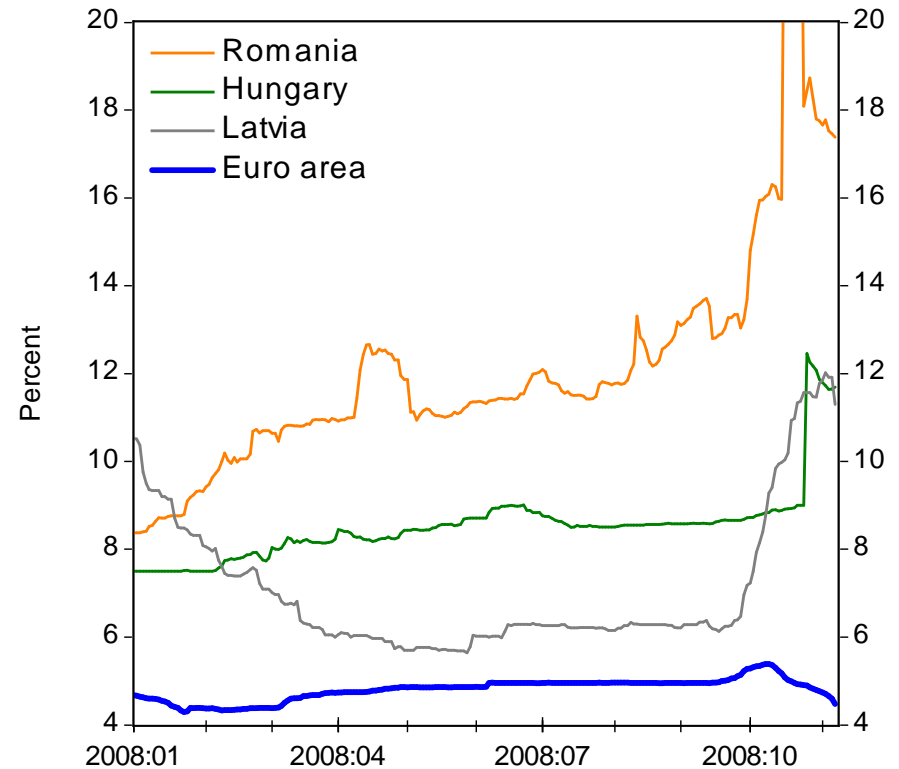
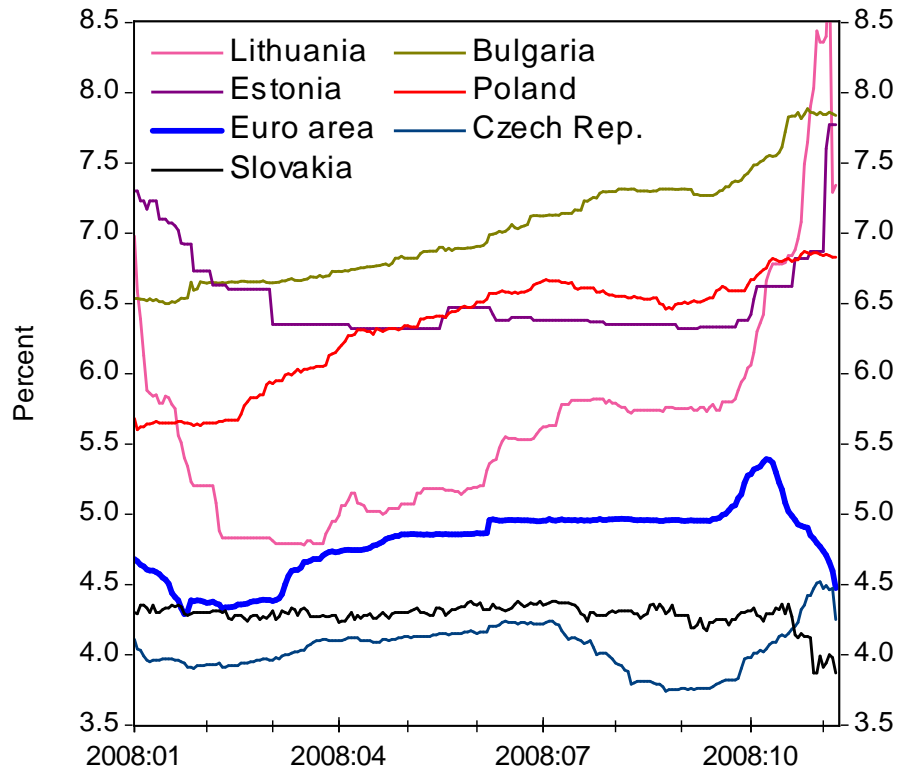


New member states of the EU

- **Difficulties in external financing** - risk of a sudden stop in capital inflows to countries
 - having huge current account imbalances (Baltics, Bulgaria, Romania)
 - in which government heavily rely on foreign financing (Hungary)
- Most of the banking system in the New Members states of the EU (NMS) are owned by **European banks**: these EU banks face liquidity problems at home
- **Rising risk premium**
- **Tighter credit conditions**
- **Economic slowdown in major trading partners (Euro area)**



Three-month interbank offered interest rates, 2 January – 7 November, 2008



Note: the Romanian rate peaked at 49.81% on 20 October 2008, but for better readability of the right hand side panel the vertical axis has a 20% cut-off.



Thank You For Your Attention

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