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Analysis of the Responses to the Eurozone Crisis

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Introduction

- The crisis has underlined the role of sovereigns as lenders of last resort, with a significant crystallisation of contingent liabilities
- It has forced developed countries to use extraordinary tools, combining monetary and fiscal policies
- It has forced governments to react to short-term market pressure and re-consider their long-term economic models
- How profound will de-coupling be the second time around?

So Far A Reactive But Evolving Policy Mix

- The euro area authorities' policy framework…
  - Crisis management measures through limited liquidity support provided by EFSF/ESM and theoretically unlimited liquidity support provided by ECB
  - And measures to encourage growth to sustain debt service including through 'internal devaluation' (wage cuts, price cuts) and related structural reforms
- …has failed to restore pre-crisis investor confidence…
  - There are too many threats to growth within/outside Europe, and unknowns around restructuring
- …which has led to increasing calls for institutional change – fiscal harmonisation and common debt issuance
  - Policy makers currently see this as a long term solution at best
  - And institutional change would take many years to design and implement

Market Expectations and Political Realities

- Perspective: the combined government debt of Spain, Ireland, Portugal and Greece amounts to approximately 17% of euro area GDP (nearly 40% if Italy is included)
- The euro area as a whole retains significant financial strength and has the necessary resources, incentives, and political cohesion needed to contain the growing financial pressures
- Our assumption that liquidity support for stressed sovereigns would be forthcoming has proven accurate (to date)
- Yet both ‘support fatigue’ and ‘austerity fatigue’ continue to constrain policy makers

Defaults and Exits are Highly Destabilising Options

- Policy paths for the euro area lead either to greater fiscal integration or to greater disruption, defaults and conceivably exit
  - We do not see a sustainable middle path
- We believe fear of contagion will continue to drive the authorities to take the necessary steps to preserve the euro area
  - Potential costs of not doing so – escalating defaults and ultimately exits – are very high given the difficulty of containing shocks
  - Defaults create a momentum which is difficult to reverse. Exit by any country would be highly destabilising
  - And exit by a large nation is politically and financially unthinkable. Its prospect will motivate politicians to take the necessary steps to prevent its occurrence

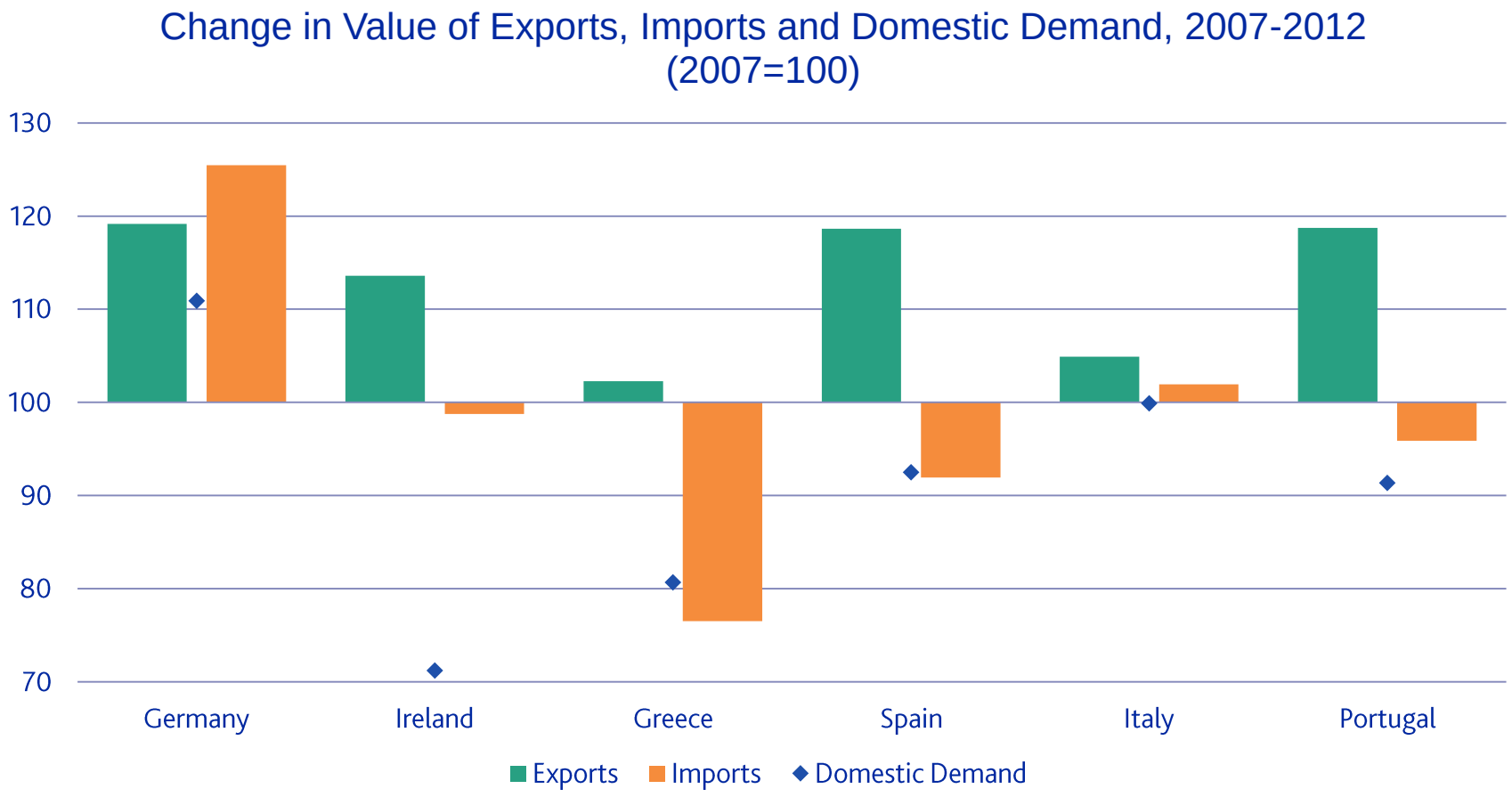
Integration Comes at a Cost

- High-level progress has been made on building blocks, such as allowing the ESM to recapitalise banks directly once a single banking supervision framework is in place
- Collective responsibility for supervising and supporting banks could be a meaningful step towards fiscal transfers
- The combined ESM/EFSF framework in its current form may not be sufficient
- The contingent liabilities for supporting countries continue to rise in magnitude and will invariably lead to a deterioration in their creditworthiness
- While policy makers will ultimately succeed in normalising sovereign debt markets, the transitional period – which could last a number of years – could well see further shocks, with the risk of policy accidents and rising sovereign defaults the longer the crisis persists

Structural Reforms Have Improved External Imbalances in the Periphery But Full Resolution May Still Take Years

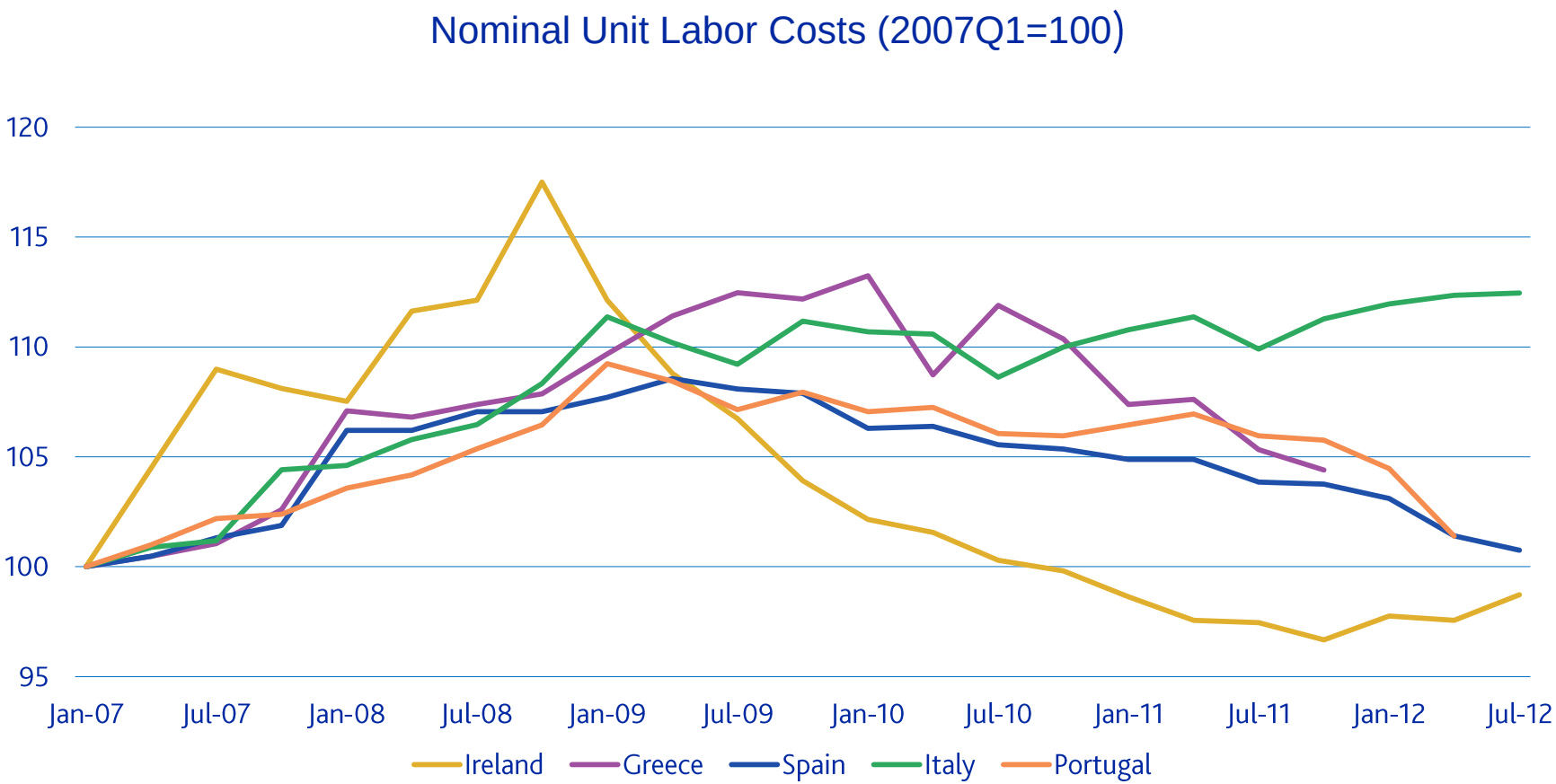
- The unwinding of accumulated vulnerabilities has already started in euro area countries most affected by the current crisis, even in those without formal external adjustment programmes
- The ongoing global financial crisis has triggered a reversal of current account imbalances within the euro area
  - Adjustment initially driven by a contraction in imports but increasingly by stronger exports due to improved competitiveness
- Divergence in competitiveness (in terms of labor costs) has narrowed in the past few years for some (Ireland, Spain and Portugal) but not others (Italy)
  - Competitiveness gains are partially the result of improvements in productivity that relied mostly on employment falling faster than output
- Increasing competitiveness in a sustainable fashion will depend on the effective implementation of structural reforms

Adjustment Underpinned by Growth in Exports



Source: Eurostat and Moody's Investors Service

Divergence in Competitiveness Narrowing



Source: Eurostat, IIF and Moody's Investors Service

Effective Implementation of Structural Reforms Key to Increasing Competitiveness

- Conditions of support programmes comprise a wide-ranging structural reform agenda
  - Largely structural reform programmes in Greece and Portugal; fundamentally limited financial-sector reform programmes in Ireland and Spain
- There is a considerable degree of implementation risk
  - This can be mitigated by significant domestic commitment and ownership of the reform process, eventually shored up by continued external reform anchors and possibly support
- Past examples (e.g. Nordics in the 1990s) show that the complete unwinding of accumulated imbalances may still take several years; especially when nominal devaluation is not available as a short-term tool

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