Comment

Europe drags its feet

This is the first instalment of a two part assessment of the euro area's prospects.

- *The extended crisis in the euro area has cooled somewhat but is probably far from over*
- *Recovery is still elusive and inflation threatens to fall to uncomfortably low levels*
- *Meanwhile, the financial sector remains acutely dysfunctional*
- *The situation calls for a series of bold, mutually reinforcing, policy departures*
- *But the response is likely to remain incremental, risking more social and political turmoil*

Crisis management

The euro area's crisis has faded but isn't over

Outwardly, since the middle of last year and Mario Draghi's assertion that the ECB stood ready to do "whatever it takes" to preserve the euro, the euro area crisis has simmered down, the virulent negative feedback loops between banks and sovereigns subsiding. What is more, within the political mainstream, the overarching commitment to the single currency project and gradual European integration in general appears to remain firm. And nowhere is this more apparent than in Germany, where the perception endures that there remains no viable alternative.

But this commitment continues to represent rather different things in different countries, and what it might ultimately boil down to in practice therefore remains obscure. In the meantime, the macroeconomic situation in the region is still deeply troubling. Hence, the question of whether policy-makers will ultimately do enough to sustain the euro remains moot, and it would be a surprise were there not to be further iterations of the crisis before the issue is settled one way or another.

To shine some light on Europe's unenviable situation and identify the key developments to watch, we would suggest that there are six over-lapping areas of particular importance:

1. The real economy

Deleveraging has left the real economy moribund

The latest business surveys suggest that the euro area economy has continued to contract in the current quarter, with the southern members disproportionately weak. This would represent a seventh successive quarterly decline in real GDP. Against this background, the area-wide unemployment rate has escalated to a record 12.1% of the workforce, but the average in the periphery is closer to 19%, and in some countries, such as Greece, Spain, and Italy, joblessness has reached levels unseen since the 1930s, with the young suffering disproportionately. Nor is there any likelihood of an early turnaround in the situation.

Yes, the deep depressions in the periphery have helped to narrow cost differentials with the core and reduced once egregious external imbalances within the euro area significantly. Indeed, many of the more depressed countries are now close to current account equilibrium. But for most the competitiveness gap with Germany remains large and the latter's own external surplus is still running at the equivalent of some 6% of GDP. Furthermore, southern Europe is now confronted by a "lost generation" and all the lasting economic, social and political dislocations that go with it.

Much of the explanation for the protracted weakness of output and its geographical distribution within the euro area can be traced to the relative intensity of a severe credit crunch and extended fiscal consolidation. Recent years have seen both the private and the public sectors simultaneously looking to deleverage but making slow progress in doing so. The burden of total debt has remained extremely onerous and has weighed heavily on borrowing and lending behaviour and on the ability and willingness to spend.

In the private sector, despite the efforts of firms and individuals, since 2007, both corporate and household liabilities have continued to escalate relative to GDP (pan-euro area household indebtedness is now higher than in the US and the differential is particularly wide in some of the more distressed economies like Spain, Greece and Ireland), while the financial sector has also struggled to reduce the size of its balance sheet. Part of the problem has been the weakness of nominal growth and a fragmentation of financing conditions that has greatly elevated peripheral borrowing costs, if credit is available at all. But the issue has been further compounded by poor corporate profitability, which has left the business sector highly dependent on the continued

extension of credit; the inertia in European bankruptcy laws, which has kept more companies and households nominally solvent than would, for example, have been the case in the US, and the fact that many banks have continued to lend to distressed firms and households rather than realise losses on their loan books.

Until private sector indebtedness is reduced significantly, serious headwinds to growth will remain.

2. Inflation

Inflation threatens to become uncomfortably low

Headline annual euro area HICP inflation fell to a mere 1.2% yoy in April from 1.7% in March and a recent high of 3%, while the core measure dropped to a mere 1.0% from 1.5% in March. Both outturns are, of course, well below the ECB's inflation target of "2% or just under". Part of these declines may reflect distortions resulting from the timing of Easter, but the fact is that underlying price pressures in the euro area are extremely muted and are likely to remain so for the foreseeable future. And this will do nothing to facilitate the process of deleveraging.

The weakness of global commodity prices, and in particular energy costs, together with the strength of the euro over recent months, will continue to exert downward pressure on consumer price inflation in the short term. Meanwhile, given the enormous slack in the labour market and the potential for it to escalate further, hourly labour cost growth (latest 1.3% yoy) is set to remain historically low, if not plumb new depths.

With broad monetary growth and bank lending also largely moribund, the implication is that both headline and core inflation will probably average out below 1% over the next 18 months and, could feasibly dip to a mere 0.5%. Indeed, in the event of another large negative demand shock, outright deflation would beckon.

3. Monetary policy

The available monetary policy options are limited

The combination of continued recession, rising unemployment, sub-target inflation and weak money and credit data has belatedly brought the ECB back into play. The Governing Council's latest 25bp refinancing rate cut, which reduced the central bank's key policy rate down to a new low of 0.5% from a recent (2008) high of 4.25%, was largely a symbolic move. *Eonia* rates were already close to zero. But the concomitant 50bp reduction in the marginal lending facility rate may provide a little relief to the hard pressed peripheral banking sectors.

ECB President Draghi's subsequent assertion that he and his colleagues remain ready to do more, was encouraging, and suggests that there is more monetary accommodation to come. But unfortunately, many of the other remaining potential policy options are either unlawful under current treaties or have in the past been publicly characterised by the central bank as undesirable or of limited effectiveness. Hence, if one or more of them is embraced, at least a portion of humble pie will have to be swallowed. And, as was the case in Japan under its old central bank regime, question marks may well linger about the ECB's commitment to such initiatives and therefore dilute their impact.

Mr. Draghi went on to say that there were no insurmountable technical obstacles to the imposition of a negative deposit rate. However, this hint of negative policy rates was interpreted by many as merely a ruse designed to encourage a lower euro exchange rate and that it will never be realised. And even if Mr. Draghi's comments are to be taken at face value, the danger is that banks might seek to offset the consequent cut in their earnings by reducing their own term deposit rates or by increasing the rates they charge existing borrowers. Alternatively, they could step up their LTRO repayments to minimise the penalties they face, in the process draining liquidity and further encumbering credit growth. There is certainly little evidence from Denmark's recent experiment with a negative (-0.2%) deposit rate of any positive impact on lending activity.

The President also made clear that further action to help small and medium sized companies (SMEs) was already being examined. The adoption of collateral enhancement mechanisms and the setting up of a form of joint venture with the European Investment Bank (EIB) to encourage lending to the SMEs look like the most likely initiatives to emerge, but how large will the programmes be; what will they mean for the EIB's credit rating, and how much of the additional credit risk (if any) will the ECB be willing to shoulder on its balance sheet? The answers to these questions will determine the effectiveness of such departures and the response in the market.

Turning to other possible alternatives, outright quantitative easing looks highly unlikely in the absence of the situation really taking a further turn for the worse. It would appear to be legal as

long as the related asset purchases are confined to the secondary debt markets, but the Bundesbank would be most reluctant to embrace this tactic. There are also the matters of how the purchases would be structured (GDP-weighted?) and where they would leave the existing (but so far unused) OMT programme. Meanwhile, any explicit forward guidance on policy rates would, under the ECB's charter, necessarily have to be purely framed within certain inflation thresholds, while in any case interest rates are already effectively stuck at zero out to the three year maturity.

The bottom line is that, in part because of the euro area's own self–imposed preferences and constraints, its monetary policy options now would seem to be limited and lack bite.

4. Fiscal policy

The tone of fiscal policy has become more flexible …

Some euro area countries began to tighten fiscal policy in 2009 and the region-wide budgetary stance has been persistently contractionary to the tune of 1-1.5 percentage points of GDP per year since 2010. The adjustments have been particularly onerous in the crisis-hit periphery, where the consolidations have run to many multiples of the average. In Greece, for example, the cyclically adjusted primary balance has already improved by a staggering 16 percentage points of GDP, which is one of the largest fiscal adjustments on record. But the net effects on headline, broadly defined, budget deficits and outstanding public sector debt ratios have been disappointing relative to initial expectations and targets. The IMF still expects the overall euro area budget deficit to be around 3% of GDP this year and the burden of gross general government liabilities, currently some 93% of GDP, to continue to rise until 2015. Moreover, the risk to these forecasts is that they are unduly optimistic.

This should hardly come as a surprise when such a closely integrated group of trading partners as the euro area economies are all adopting much the same fiscal stance, the private sector (including the banks) is also seeking to deleverage, and policy rates are butting against the zero bound. In such circumstances, the effectiveness of any fiscal impulse is bound to be amplified.

Further consolidation equivalent to around 1 percentage point of GDP is programmed for this year. But it would appear that lessons have belatedly been learned from the events of the last few years. There has been a noticeable and welcome shift in tone from policy makers at the European Commission and more broadly about how the fiscal adjustment should be calibrated with respect to the business cycle. The suggestion is that, if growth continues to disappoint, countries will be given more time to hit their fiscal targets.

… but it still lacks symmetry and coherence

However, there remains a serious lack of symmetry and a shortage of imagination in the way that fiscal policy is being conducted. For example, the output costs of the adjustment could have been significantly reduced if peripheral consolidation had been counterbalanced by some expansion in the core and in particularly Germany. Meanwhile, a stronger focus on much needed pension reforms, which deliver significant debt sustainability gains over the longer term while exerting rather less of an impact on short term demand, would have been wise.

Even more importantly, perhaps, it remains difficult to see how some euro area economies will be able to bring their public finances entirely to heel without resort to more debt mutualisation, write offs and financial repression.

5. Banking reform

The banks desperately need recapitalisation

The euro area banking system remains under intense duress, with confidence in individual financial institutions low and the monetary policy transmission mechanism seriously compromised. Over the longer term, a movement towards more capital market-based financial intermediation may well ease the situation, but, for the foreseeable future, the European financial system will remain overwhelmingly bank dependent. The experience of Japan over the last two decades or more amply illustrates how a combination of bank sector fragility and a large private sector debt overhang can have extended negative consequences for growth. The strengthening of the bank system and in particular the achievement of a viable banking union are therefore most urgent.

Before the ECB takes over supervisory responsibilities for the euro area and conducts its own comprehensive assessment of the entities brought under its purview, it would make sense for national authorities to recognise the extent of outstanding bad loans – estimated to run to several hundreds of billions of euros - as well as the cost of the removal of the implicit state guarantees on bank liabilities. They should then recapitalise undercapitalised banks and resolve insolvent entities, in the process imposing some losses on unsecured creditors (especially bondholders). It would also be sensible for the European Commission to announce that, provided such action is taken within a

specified time scale – say the end of this year, the fiscal costs of such recapitalisations will be deemed to fall outside existing fiscal deficit reduction protocols.

Thereafter, movement towards a truly viable banking union, with a single bank resolution mechanism and a viable fiscal backstop, extending to area-wide deposit insurance, should be prioritised. And one hopes that following this September's federal elections, the German government's obduracy on some aspects of these issues will recede.

6. Structural issues

Structural policy is of little use in the short term

Most structural policies do little or nothing to support final demand in the short term. Indeed, they can actually initially depress real activity, as the costs of such initiatives are typically narrowly focused and immediate, whereas the benefits are spread thinly and accrue over many years. That said, the liberalisation of labour and product markets is vital to reallocate factors to the most efficient firms and sectors, transform the euro area's relatively weak productivity performance, diminish relative labour cost disparities and improve the ability of the economy to absorb shocks over the longer term.

That the various financial support packages applied to beleaguered peripheral economies have all included numerous structural *quid pro quos* is constructive. However, much work remains to be done. For example, long standing issues such as insufficient investment in human capital, excessive reliance on relatively low productivity construction-related and traditional service activities, inefficient public administration and educational standards will all have to be tackled.

Other aspects of the prevailing conjuncture have exacerbated the area's structural shortcomings too. For example, the increased cost and reduced availability of capital have depressed private investment and the assimilation of new technologies, fiscal consolidation has greatly curtailed public infrastructure spending, and the general sense of uncertainty over the economic and financial outlook has encouraged caution on the part of business managers and consumers.

Time is marching on

The euro is not under immediate threat …

Thus the euro area's economic problems remain many and various. They relate to both demand and to supply; to the real economy and the financial sector; and to prices. Moreover, to a significant extent they are self-reinforcing. However, the single currency is not in imminent danger of collapse. To be sure, there have been many crises; and they may well continue. Arguably, Europe, being a collection of individual and individualistic nations, needs crises in order to proceed. And certainly the rolling crises of recent years have not only each been ultimately defused, but they have indeed been put to good use. Important, if partial and painful, progress has been made towards fiscal sustainability; in addressing disparities in competitiveness; and in fostering a number of areas of much needed institutional change. And along the way Germany and the European Commission have proved more flexible than many earlier thought likely, while policy thinking, not least at the ministerial level, has become more coherent and less ad hoc.

In short, progress has been made towards the creation of a more workable currency union, and more will be made in the coming months and years.

… but the longer term prognosis remains unclear

That said, this progress is likely to remain frustratingly laborious. Such is the nature of euro area decision-making. The prospect is therefore of a further extended period of stagnation and intermittent turbulence, both financial and otherwise. Europe's safety nets will take some of the edge off the resultant social hardship, but we doubt they will be sufficient to prevent a further atomisation and polarisation of the political landscape, and in particular to quash the rise of the extreme right. Hence, the question remains: will the pace of policy adjustment and reform and social support programmes prove sufficient to sustain commitment to the euro project beyond the short term?

We will try to shine further light on this subject in part two of this *Comment*.■

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