internal imbalances in the Eurozone

april 20, 2012

one view of the crisis

- Main cause is build up of domestic and financial imbalances leading to “ sudden stop’ in cross border financial intermediation

- RER appreciation is, at least partly, an endogenous response to capital inflows

- fiscal imbalances small in comparison to private sector financial imbalances

cross border capital flows were fragile and

- mainly interbank and short term
- Fueled and expansion of credit and bubbles

Euro Area Household Debt Ratios

Percentage of Disposable Income

	1999	2007	Change
Greece[a]	26	75	49
Ireland[b]	113	205	93
Portugal	95	143	48
Spain	66	118	52
Germany	107	95	-12
Memo:			
United States	88	122	33

Table 7 - Domestic credit (*) - ratios to GDP

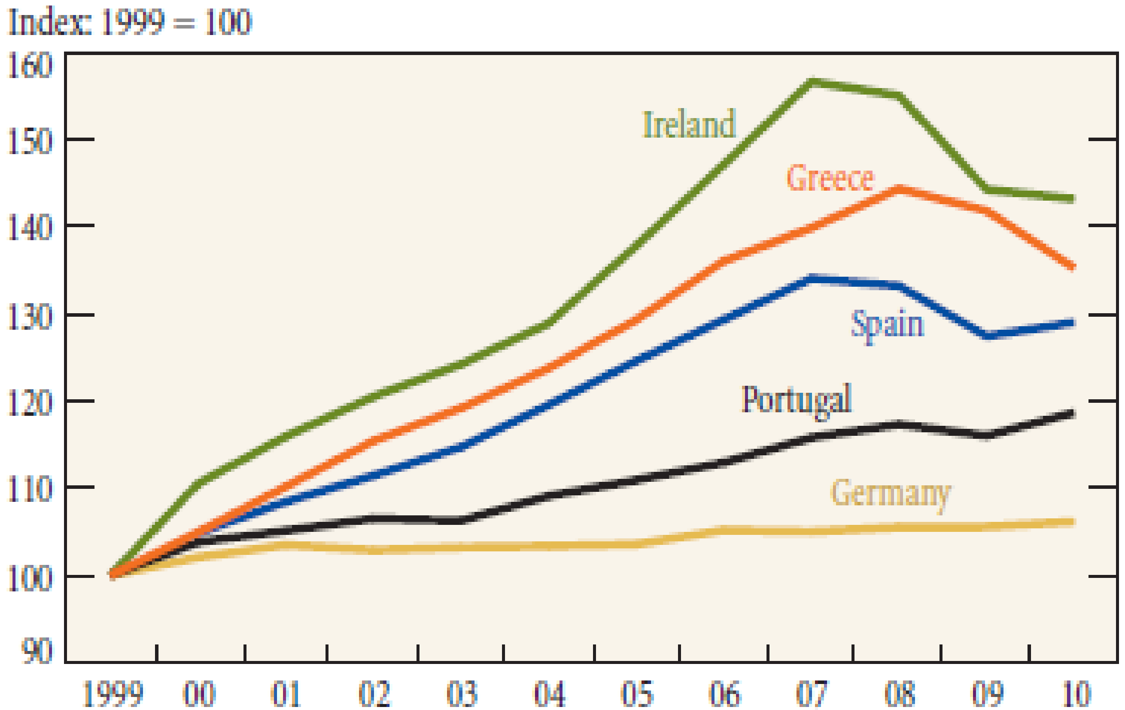
	Germany	France	Italy	Ireland	Greece	Spain	Portugal
2000	1,06	0,72	0,71	1,00	0,42	0,87	1,10
2004	1,01	0,76	0,78	1,26	0,62	1,11	1,24
2008	0,95	0,95	0,97	2,02	0,85	1,71	1,51

(*) outstanding amounts at the end of the period.

Source: National Central Banks

Chart 5

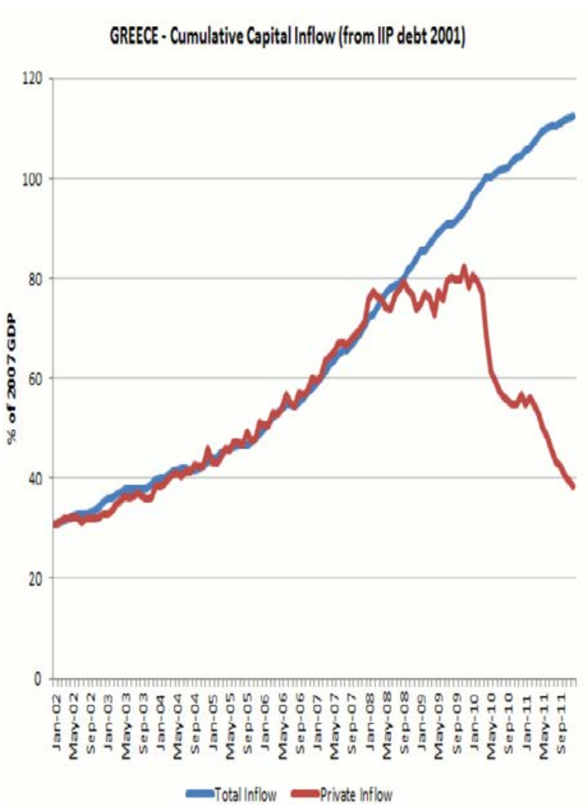
Private Real Consumption Spending

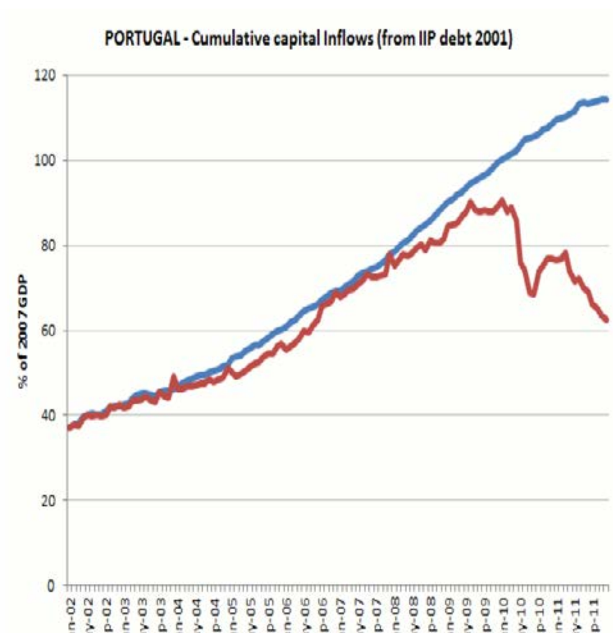


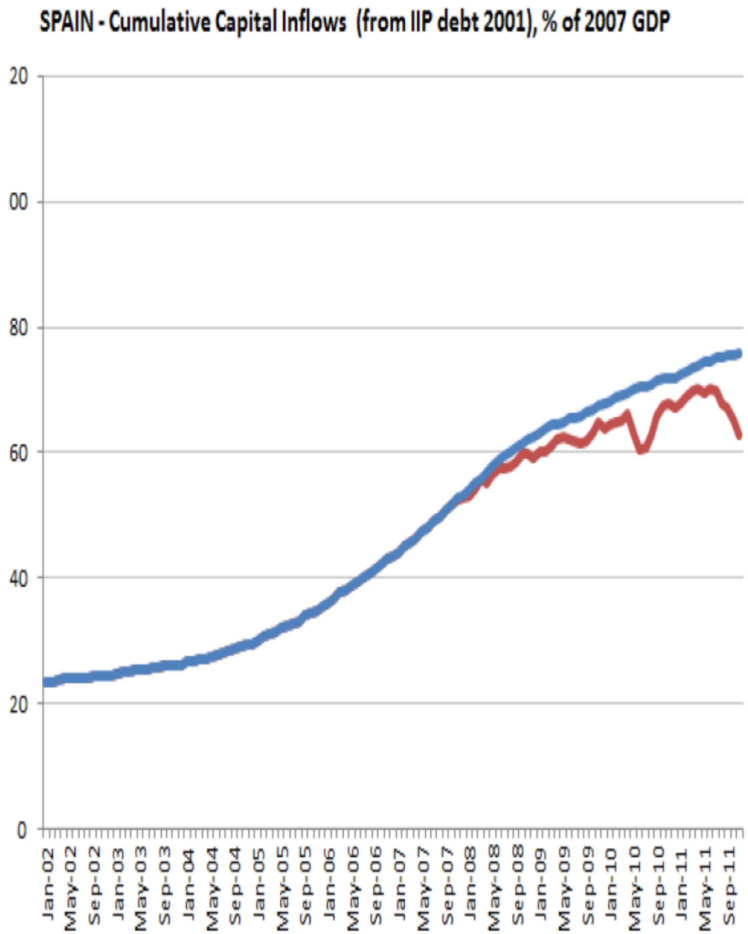
the illusion of perfect financial integration

- capital flows from ‘North’ to ‘South’ seen as an engine of convergence
- implicit assumption: cross border same credit risk than domestic
  - All banks are (equally) backed by the sovereign
  - All sovereigns back each other (ignorance of the “no bail out”)
- Nothing done to compensate for divergent real interest rates (the Walters’critique)

the crisis : a collapse of cross border financial intermediation






SPAIN - Cumulative Capital Inflows (from IIP debt 2001), % of 2007 GDP
20
00
80
60
40
20
0
Jan-02
May-02
Sep-02
Jan-03
May-03
Sep-03
Jan-04
May-04
Sep-04
Jan-05
May-05
Sep-05
Jan-06
May-06
Sep-06
Jan-07
May-07
Sep-07
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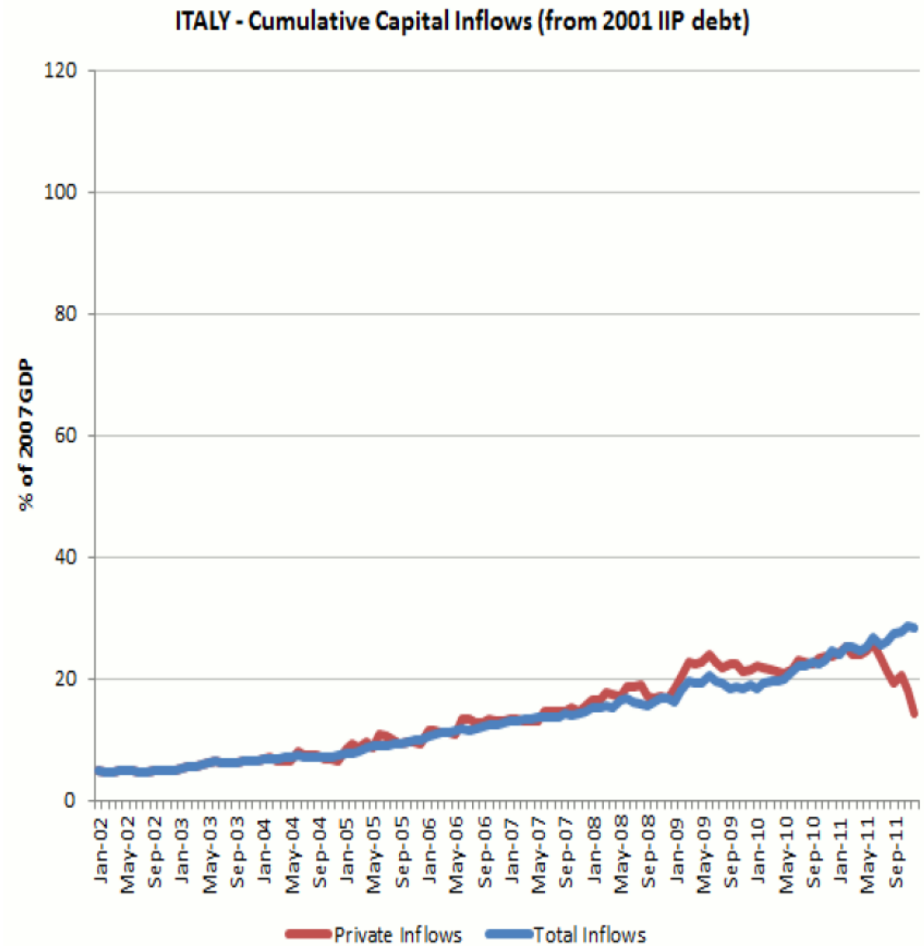
Jan-11
May-11
Sep-11


ITALY - Cumulative Capital Inflows (from 2001 IIP debt)
% of 2007 GDP
120
100
80
60
40
20
0
Jan-02
May-02
Sep-02
Jan-03
May-03
Sep-03
Jan-04
May-04
Sep-04
Jan-05
May-05
Sep-05
Jan-06
May-06
Sep-06
Jan-07
May-07
Sep-07
Jan-08
May-08
Sep-08
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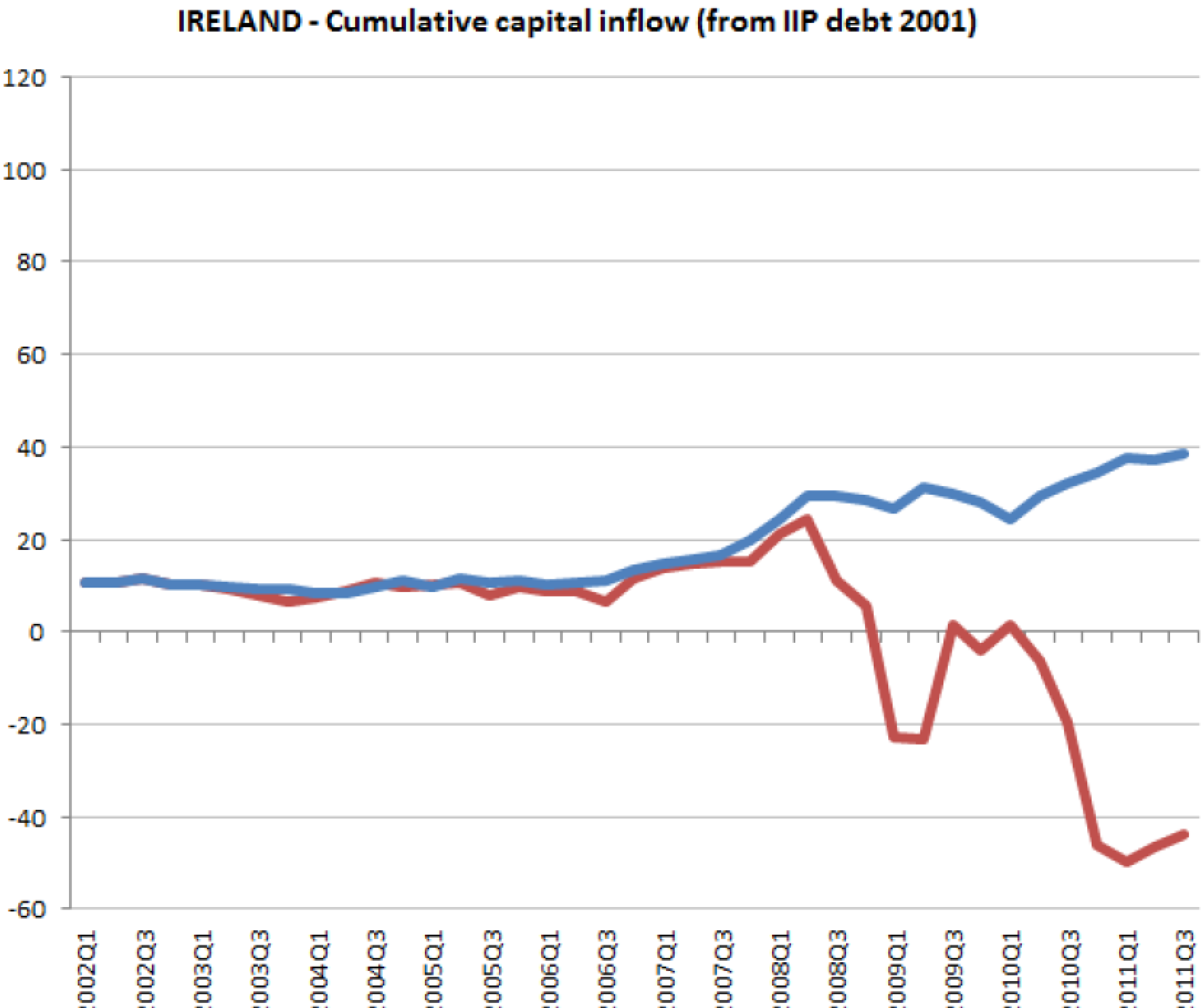
May-10
Sep-10
Jan-11
May-11
Sep-11
Private Inflows
Total Inflows


IRELAND - Cumulative capital inflow (from IIP debt 2001)
120
100
80
60
40
20
0
-20
-40
-60
2002Q1
2002Q3
2003Q1
2003Q3
2004Q1
2004Q3
2005Q1
2005Q3
2006Q1
2006Q3
2007Q1
2007Q3
2008Q1
2008Q3
2009Q1
2009Q3
2010Q1
2010Q3
2011Q1
2011Q3

Pr. Sinn’s arguments

- A very important point : as a result of the crisis, cross border financial intermediation done through public - rather than private- channels
- Three questions :
  1. should the payment system be used as an instrument for conditionality ?
  2. frictions and limits in the payment system equivalent to capital controls? A step back to the 80s.
  3. Macro-economic consequences : a constraint on German exports and capital inflows in Germany

the PSI : a good policy choice ?

Benefits

- Eliminate moral hazard
- Reestablish market discipline on sovereigns

Costs

- Doubts on “OECD “sovereigns ***willingness*** to pay
- Solvency liquidity spirals on sovereigns
- Floor on banks funding costs
- Loss of store of value

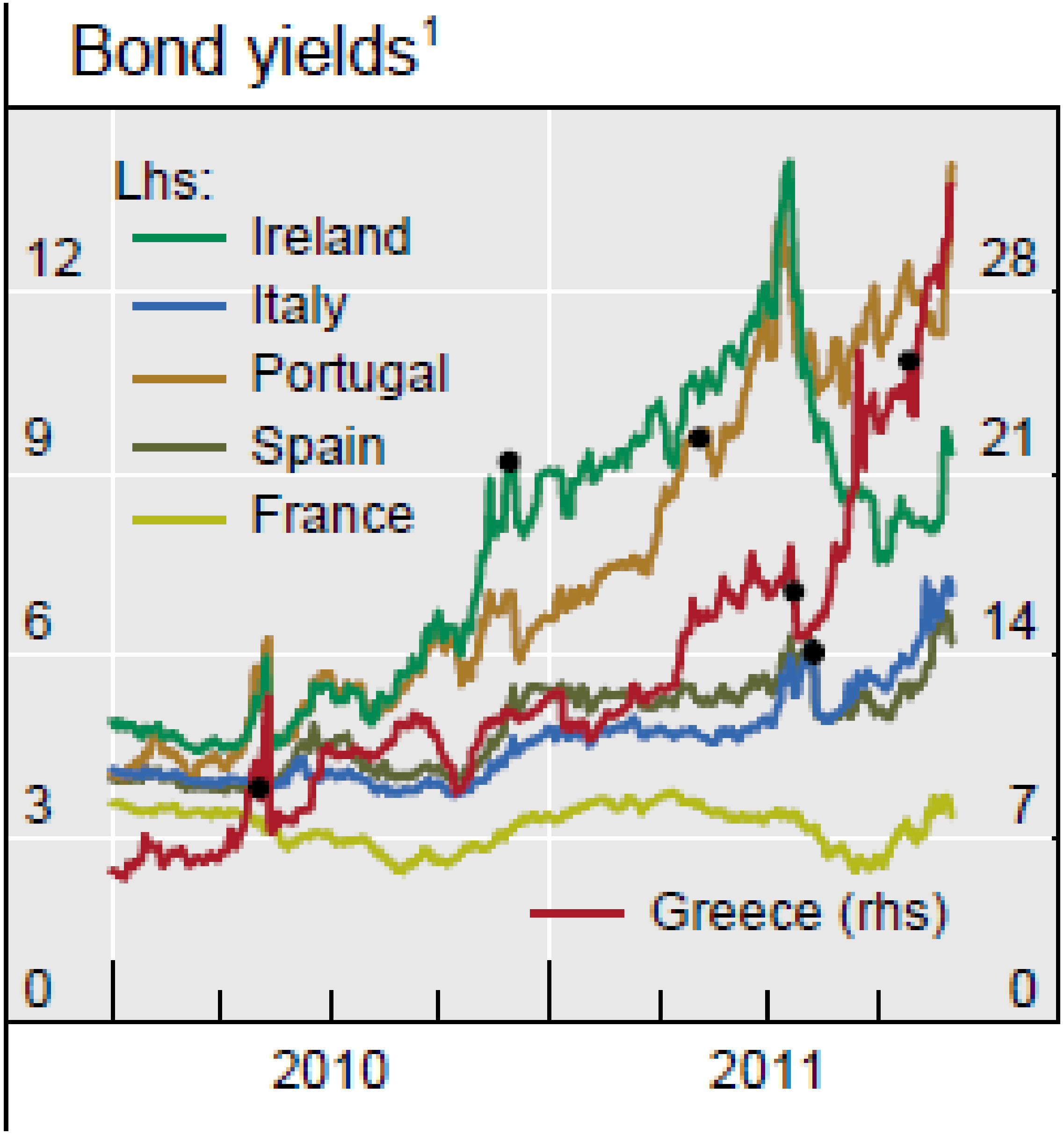
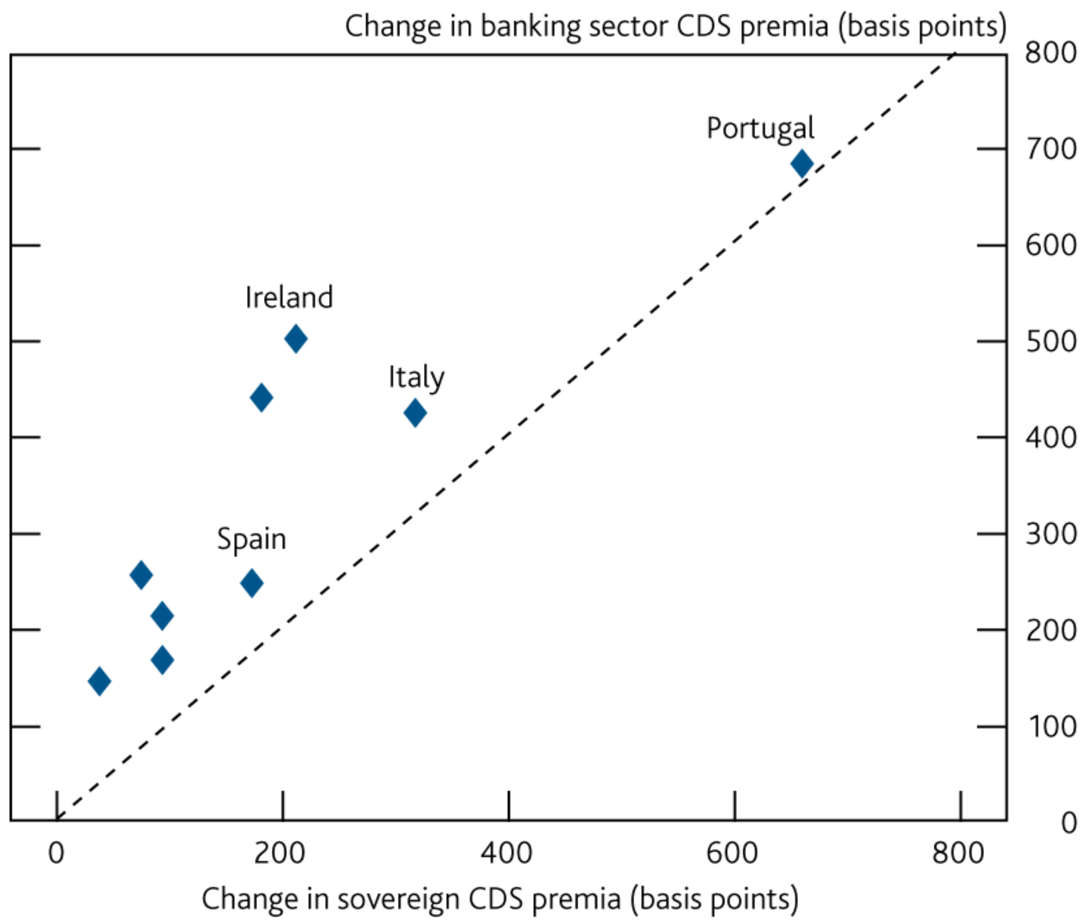

Bond yields[1]
Lhs:
Ireland
Italy
Portugal
Spain
France
Greece (rhs)
12
9
6
3
0
28
21
14
7
0
2010
2011

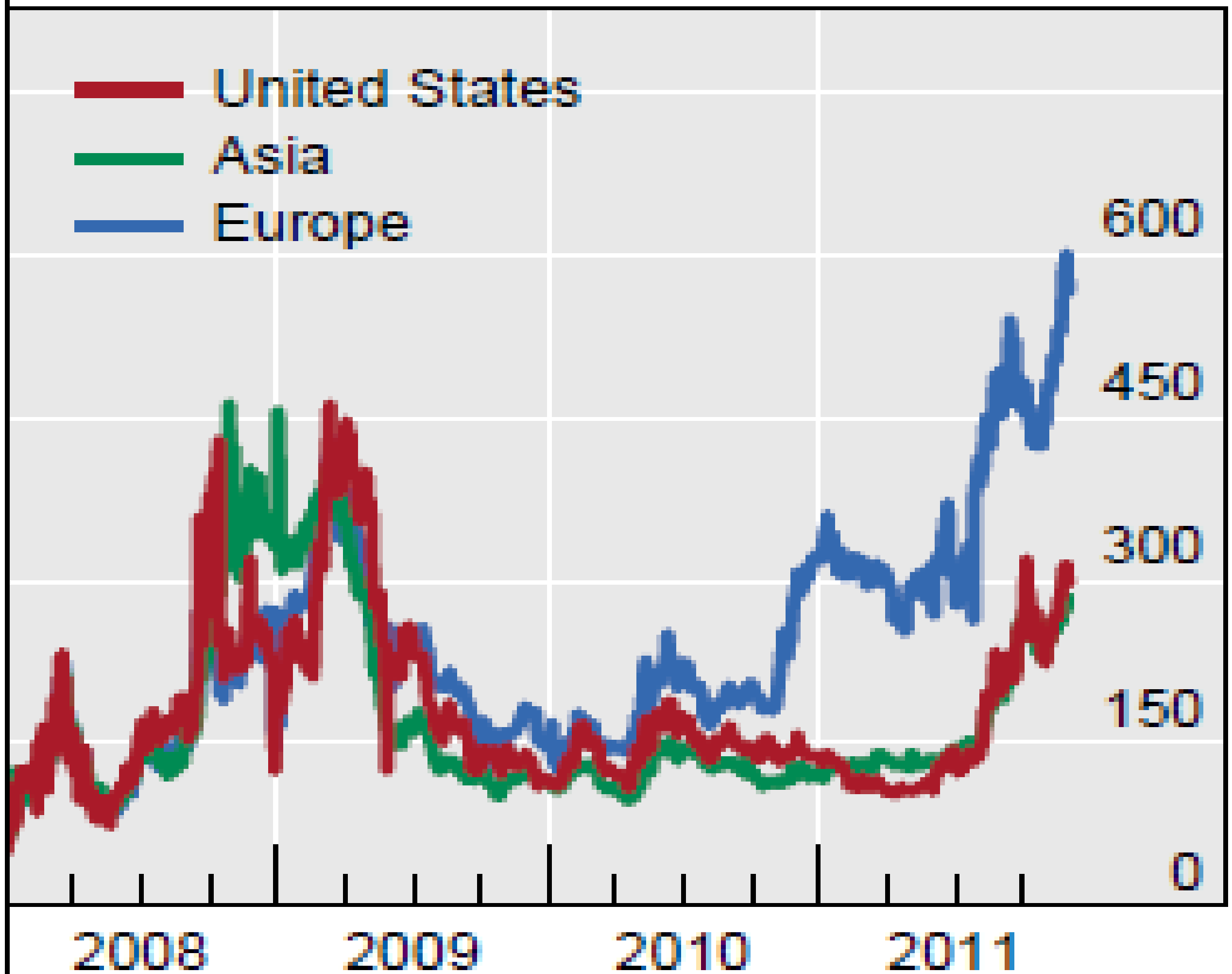
Chart 5.2 Changes in sovereign and banking sector CDS premia(a)(b)(c)(d)



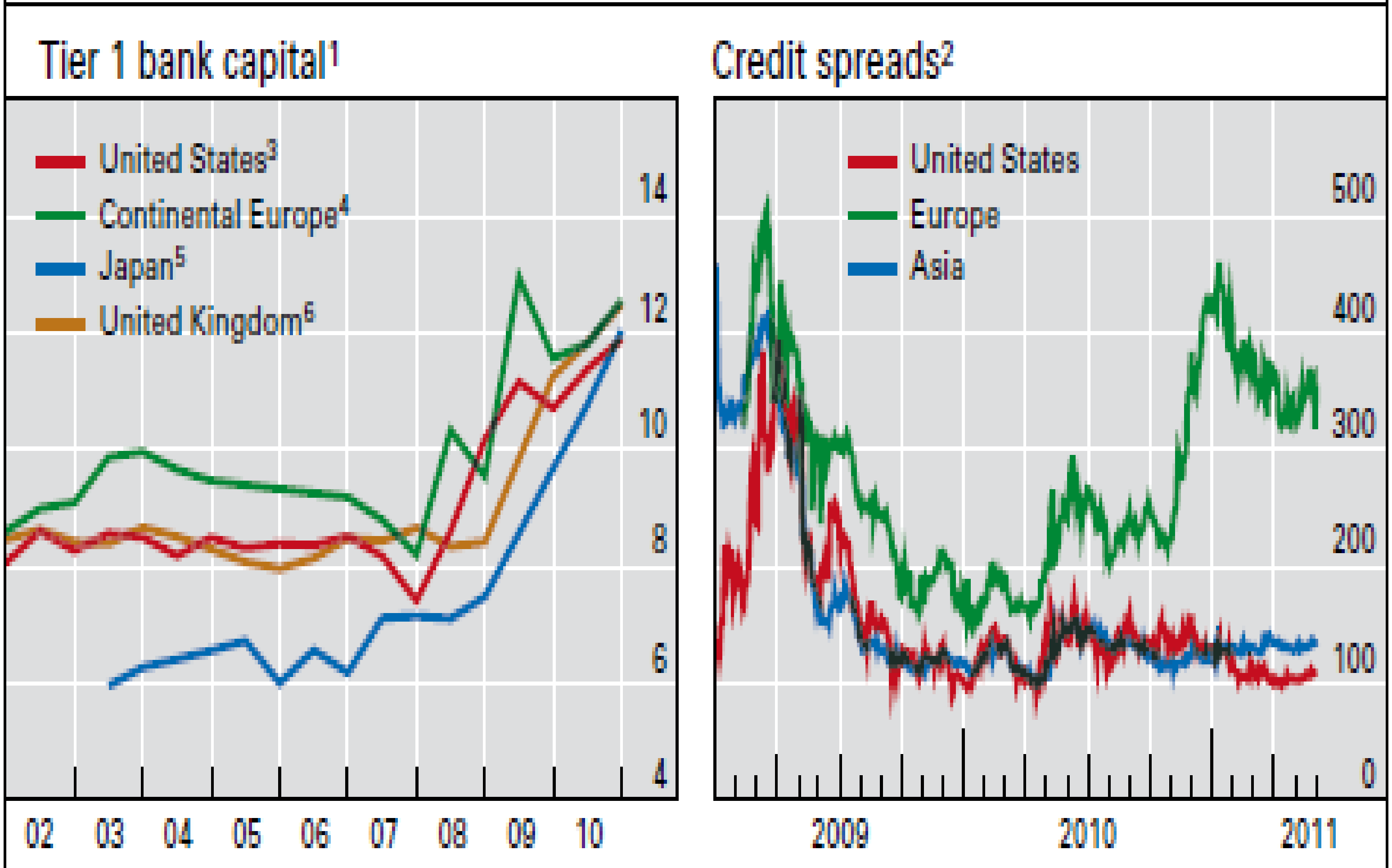
Sources: Capital IQ, Markit Group Limited, Thomson Reuters Datastream and Bank calculations.

(a) The change is measured from 22 November 2010 to 22 November 2011.
(b) The other countries included, in addition to those labelled on the chart, are Austria, Belgium, France, Germany and the Netherlands.
(c) Banking sector CDS premia are asset-weighted.
(d) Five-year senior CDS premia

Bank credit spreads[1]



Bank capital ratios and credit spreads



what should be done ?

- strong micro and macro supervision at the euro area level (more important than surveillance of fiscal policies)
- + resolution mechanisms and funds at the euro area levels
- New stores of values
  - Implicit fiscal transfers : eurobonds- bills ?
  - Financial innovation esBies

is the euro a new gold standard?

- No mechanical or institutional constraint on the issuance of (base) money
  - ECB has a regime of unlimited liquidity provision since October 2008 (VLTRO only extended the maturity)

- But no fiscal backing : puts a theoretical cap on the amount of base money

- Unless sufficient capital to substitute for it.

- Two views of a Central Bank's net worth
  - Buiter : total of discounted seignorage
  - Sims : must be able to redeem existing money stock with losses < capital