Euro-zone crisis

Some issues
What has happened? – A recap of recent events

- Fiscal compact signed by member nations and likely to come into force by January 1, 2013

- The ESM treaty was approved by the German constitutional court ensuring that the ESM comes into force by October 8, 2012.

- The ESM is permitted to directly purchase sovereign debt and a proposal was made in the last EU Summit to directly recapitalize EU Banks.

- The ECB introduces a new sterilized open ended bond purchases program – Outright Monetary Transactions (OMT) – but ECB intervention only likely if member nations formally request for aid from the EFSF/ESM and are put on an austerity program.

- Spain introduces ambitious austerity program in order to cut its fiscal deficit from 8.5% of GDP in 2011 to 6.3% to GDP in 2012 and 4.5% of GDP in 2013.
What are the challenges?

Will the OMT program address the growth versus austerity paradox?

The vicious cycle of austerity and growth could worsen the public debt to GDP ratio likely to continue in 2013/14

What happens if a country misses its public debt to GDP targets? Will the ECB then stop intervening in the bond markets?

Grexit is still a realistic possibility; How will it be handled?

Are core Euro-zone nations ready to take firm steps towards a banking/fiscal union?
Thoughts on debt mutualization

The problems:
- Moral hazard—main obstacle to debt pooling
- Stronger countries end up paying higher interest rates on debt

Principles that should be followed:
- Needs to be partial—National governments need to remain responsible to reduce deficits.
- Internal transfer mechanism—Less creditworthy nations should compensate the more creditworthy ones.
- Tight monitoring of fiscal progress.
Why banking union over fiscal union?

A banking union is more viable than a fiscal union for the following reasons:

- Easier to sell politically particularly in the core nations
- Useful in breaking a vicious cycle between the banking sector and sovereign nations

But key questions:
- When will it be up and running?
- What form will it take?
- How many more deliberations/debates will EU policymakers need to resolve differences?
- Will EU policymakers follow the proposals made by the European Commission President Barroso?
Key features that the banking union needs to have

Five pillars of the banking union:

- Stringent capital standards
- Regulatory oversight with powers to intervene
- A European deposit insurance scheme
- A banking resolution fund/ESM
- Mechanism to wind up banks
What is the fair value of the EUR?

The EUR needs to balance the divergent economic compulsions of the core and the periphery.

<table>
<thead>
<tr>
<th>Current account deficit as a % of GDP</th>
<th>2010</th>
<th>2011</th>
<th>2012F</th>
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</thead>
<tbody>
<tr>
<td>Germany</td>
<td>6.1</td>
<td>5.7</td>
<td>5.2</td>
</tr>
<tr>
<td>France</td>
<td>-1.7</td>
<td>-2.2</td>
<td>-1.9</td>
</tr>
<tr>
<td>Netherlands</td>
<td>6.6</td>
<td>7.5</td>
<td>8.2</td>
</tr>
<tr>
<td>Spain</td>
<td>-4.6</td>
<td>-3.7</td>
<td>-2.1</td>
</tr>
<tr>
<td>Italy</td>
<td>-3.5</td>
<td>-3.2</td>
<td>-2.2</td>
</tr>
<tr>
<td>Greece</td>
<td>-10.0</td>
<td>-9.7</td>
<td>-7.4</td>
</tr>
<tr>
<td>Ireland</td>
<td>0.5</td>
<td>0.1</td>
<td>1.0</td>
</tr>
<tr>
<td>Portugal</td>
<td>-10.0</td>
<td>-6.4</td>
<td>-4.2</td>
</tr>
</tbody>
</table>

Source: IMF

Liquidity injection by the Fed’s QE 3 program likely to result in EUR appreciation.

Does the ECB need to respond by unsterilized asset purchases?

Source: ADB