Eurozone crisis and its impact on Ukraine

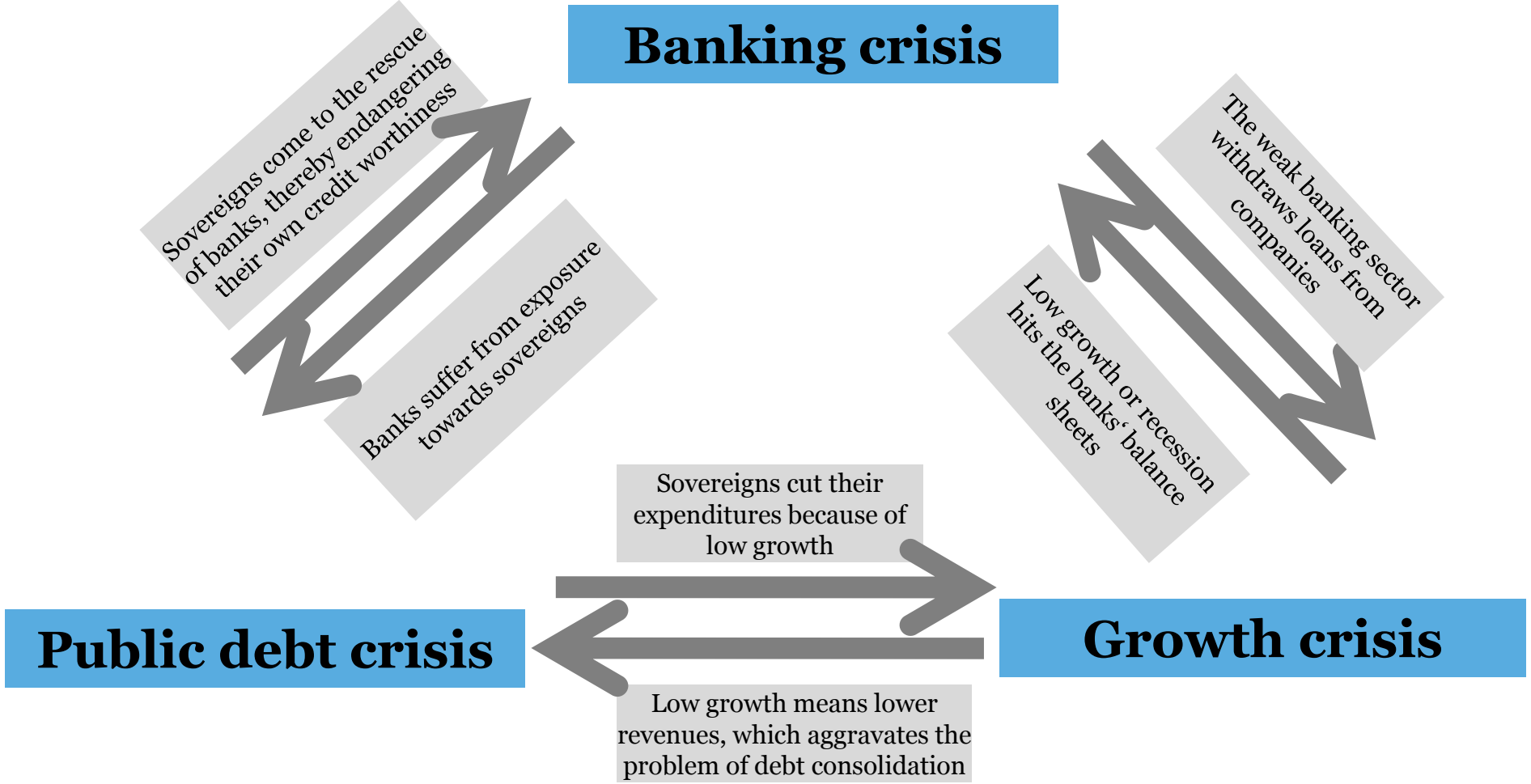
Ricardo Giucci, Robert Kirchner

German Advisory Group

Berlin/Kyiv, November 2012

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The Euro crisis = An ugly combination of public debt, banking and growth crisis



Source: IMF, BE

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Chronology of the financial crisis

July 2007	September 2008	Since spring 2010	
USA: Mortgage backed securities cannot be sold any more **„subprime crisis“**	→ Banks do not get any liquidity any more Lehman-bankruptcy **„banking crisis“**	→ Some sovereigns do not get any funding any more from the capital markets **„sovereign debt crisis“**	→ What will follow? Break-up of the eurozone? or Deepening of European integration?

Source: BE

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C. What has to be done? Possible solutions to the Euro crisis

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A. Causes for the Euro crisis

1. High public debt in some member countries

2. High private debt in some member countries

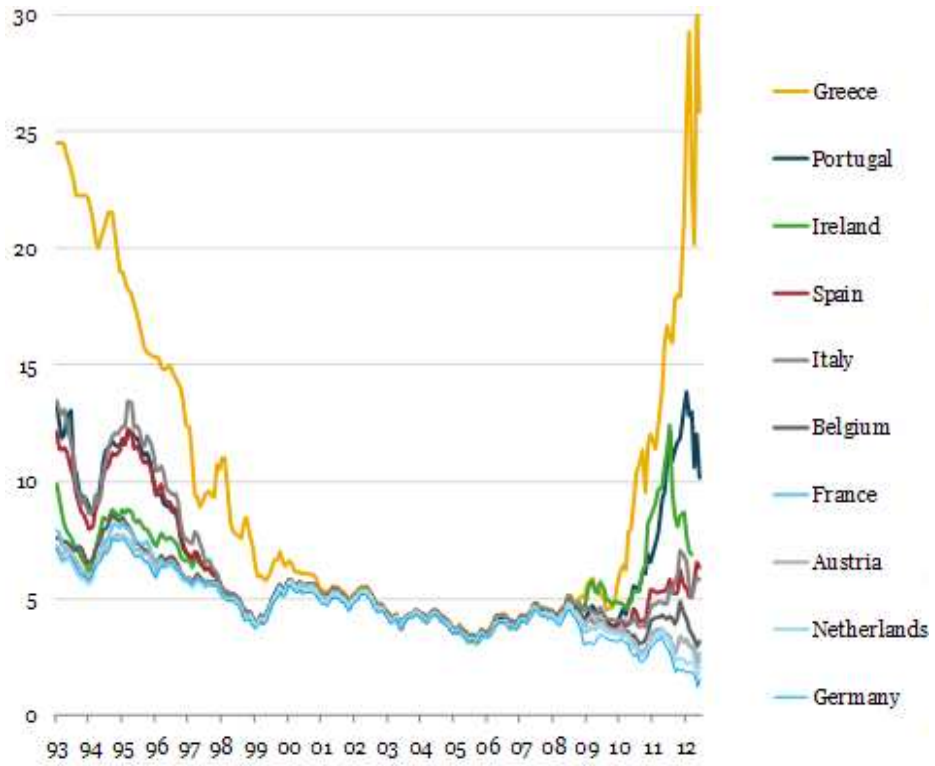
3. Loss of competitiveness in some member countries

4. At the level of the eurozone: Lax implementation of fiscal rules and absence of tools to support distressed member countries

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Reasons for high public debt: Lax fiscal policy taking advantage from lower interest rates

10 year gov bond yields



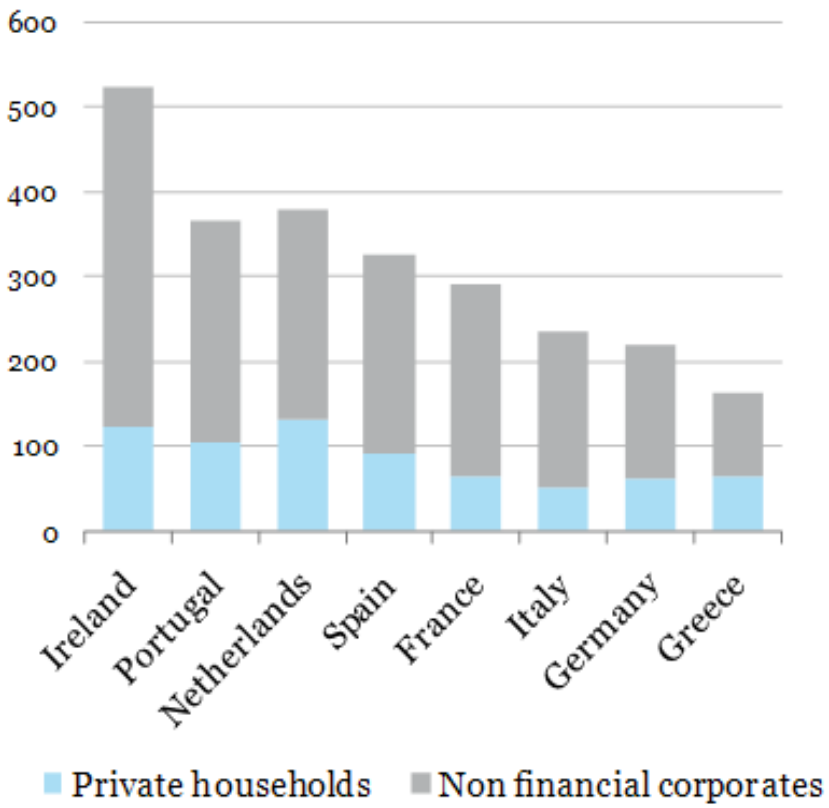
Source: Eurostat, Bloomberg

- As interest rates went down significantly prior to the start of the eurozone, some governments took advantage of the lower interest rate burden to increase spending and public debt
- Actually, no risk was assigned to bonds from Greece, Portugal and Italy in the period of 2001 to 2007, even though the fiscal problems were well known
- Thus, bond markets failed to act as vigilantes in 2001 to 2007
- Since 2008/2009 investors differentiate once again, as they did in the 90ties

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High private debt: Sharp increase

Private debt as % of GDP (as of end 2010)



Source: Deka

- Not only public, but also private debt created significant risks
- Private debt rose sharply, especially in Ireland and Portugal
- However, both regulators and markets were not worried about events
- Regulators: No setting of alarm bells
- Banks and markets: No risk differentiation and thus very low interest rates

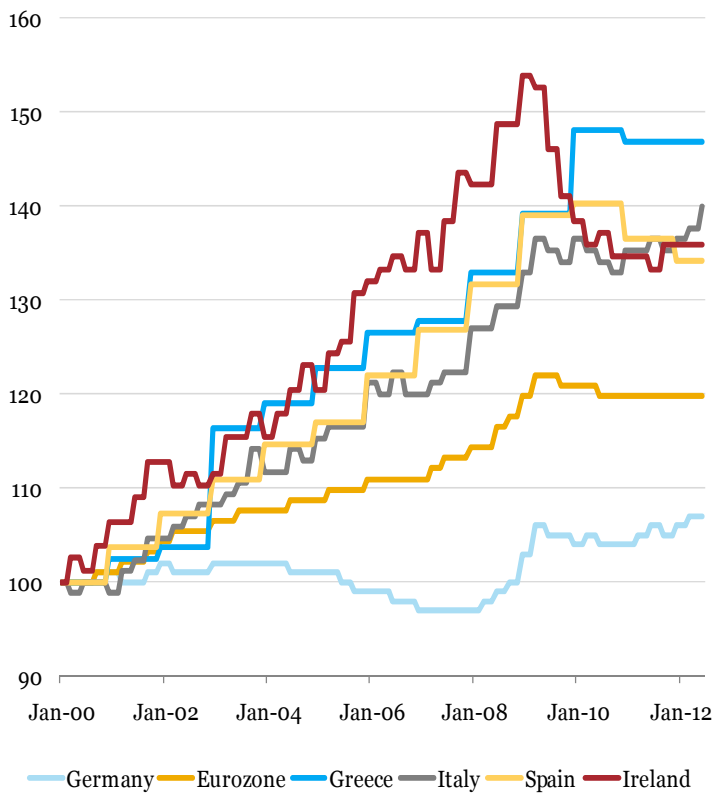
Relationship public-private debt

- Greece and Ireland are two extreme cases:
  - While Ireland had the highest private debt ratio of the countries listed here (in comparison to GDP), it‘s public debt was one of the lowest
  - In Greece the reverse issue is true: The private debt ratio is the lowest of the countries listed here, while the public debt ratio is the highest
- Note that Italy has relatively low debt, too

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Loss of competitiveness due to a significant increase of unit labour costs

Unit labor cost index (2000 = 100)



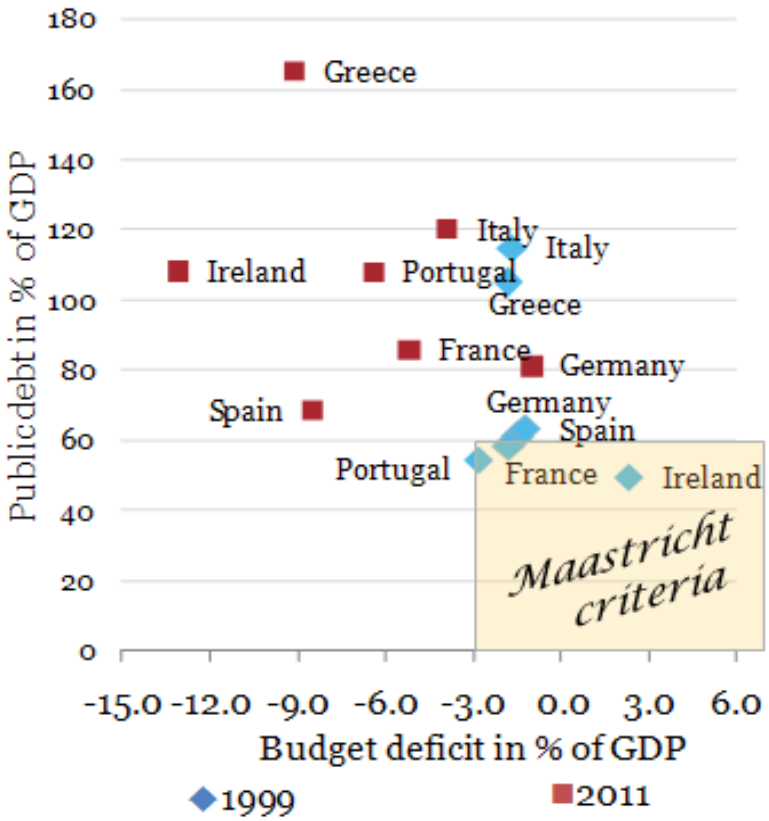
Source: Bloomberg

- In Ireland unit labour costs increased most. Interestingly, labour costs came down significantly after the eruption of the crisis, showing that the labour market is quiet flexible
- In Greece, the labour cost evolved with similar dynamism as in Ireland, without having been accompanied by a corresponding positive development of the economy
- Note that in Greece labour costs have barely come down during the crisis
- Spain and Italy (were labour costs even increased during the crisis) are faced with similar problems
- In Germany unit labour costs went down, partly due to Chancellor's Schröder “Agenda 2010”
- Before EMU: Loss in competitiveness in Southern countries regained through devaluation
- Since EMU: Exchange rate as an instrument of national policy does not exist anymore; thus, devaluation not possible anymore

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On the level of the eurozone: Lax implementation of fiscal rules and absence of tools to support member countries

Budget deficit and public debt 1999 and 2011, in % of GDP



Source: ECB

- To compensate for the flaws of the construction of the eurozone (amongst other things no political or fiscal union, limited labour mobility, no banking union), the founders of the eurozone defined the Maastricht criteria:
  - Budget deficit limit of 3% of GDP
  - Public debt limit of 60% of GDP
- However, only a few countries fulfilled these criteria at the start
- Most prominent countries not to fulfil these criteria: Italy and Greece
- Thus, fiscal rules existed and they were not bad, but they were not applied or implemented
- On top: The monetary union foresaw no tools for supporting member countries in financial distress

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B. What has been done so far to combat the Euro crisis?

1. Adjustment programs in some member countries
2. New measures to regain confidence
3. The role of the European Central Bank
4. The role of fiscal policy of the eurozone
5. Decision on a common banking supervision

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Adjustment programs (IMF-like programs) in some member countries: Austerity and reforms

Overview of adjustment programs in member states (as of July 2011)

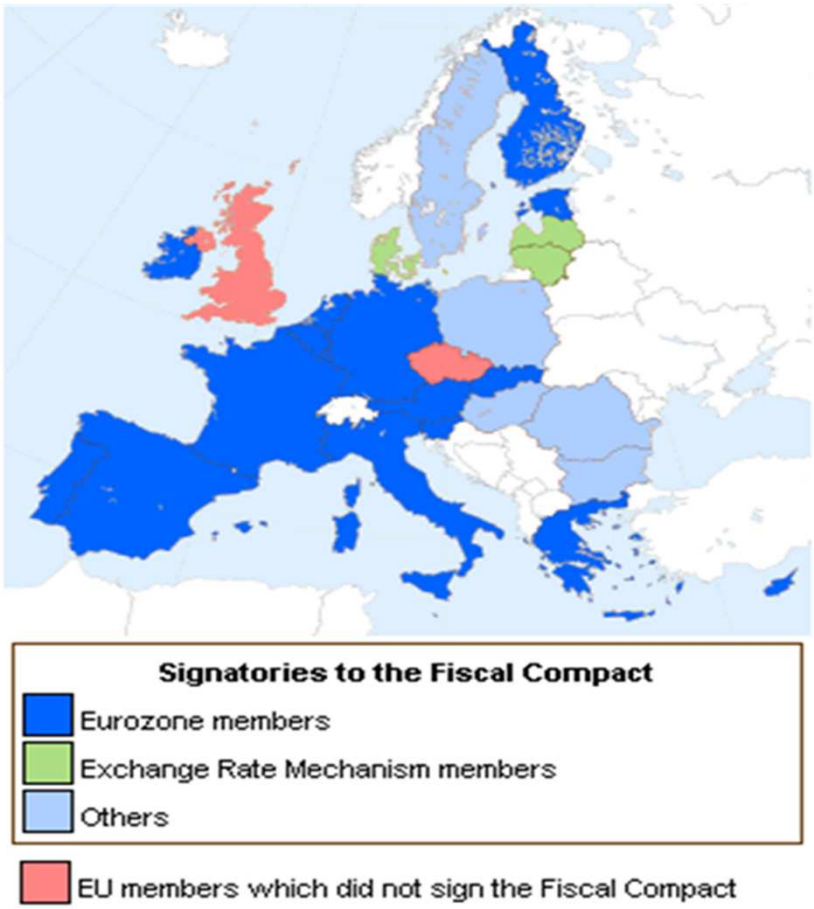
	Greece	Ireland	Portugal
Period covered by EU assistance	Assistance available up to June 2013.	Assistance available up to December 2013.	Assistance available up to June 2014.
Financial instruments	Bilateral loans from euro-area Member States	EFSF; EFSM; bilateral loans from the UK, Sweden and Denmark , Irish reserves	EFSF; EFSM
Amount granted by the EU	Up to € 80 bn	Up to € 45 bn	Up to € 52 bn
Total size of the assistance (including other lenders)	€ 110bn (30 bn from IMF)	€ 85bn (22.5 bn from IMF)	€ 78bn (26 bn from IMF)
Number of instalments under EU assistance	Up to 12 instalments	Up to 12 instalments	Up to 12 instalments
Amount disbursed under EU assistance so far	€ 38.5bn (4 instalments)	€ 15bn (2 instalments)	€ 6.5bn (1 instalment)
Main areas of policy conditionality	* Fiscal consolidation * Fiscal governance and reporting reform	* Fiscal consolidation * Labour market reform	* Fiscal consolidation * Banking sector recapitalisation and deleveraging
	* Reform of the public wage system	* Public administration and taxation reforms	*Prudential Capital Assessment Review
	* Pension reform	* Energy sector liberalisation	* National Recovery Plan to mitigate adverse effects on growth
	* Financial sector regulation and supervision reform	* Financial sector regulation and recapitalisation	* Labour market reform
	* Other structural reforms (related to Europe 2020 agenda)	* Other structural reforms (related to Europe 2020 agenda)	* Other structural reforms (related to Europe 2020 agenda)

Source: European Commission

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New measures to regain confidence: The Fiscal Compact

Countries which agreed to comply with the Fiscal Compact



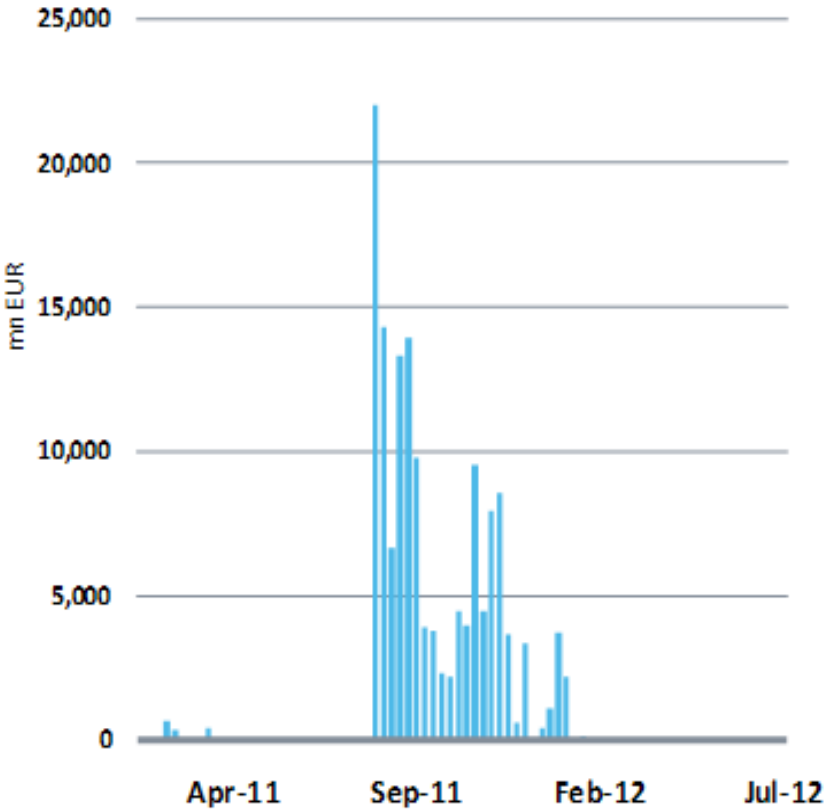
Source: Wikipedia, European Commission

- While signed by almost all EU countries (exceptions: UK and Czech Rep.), some member states have still to ratify the Fiscal Compact
- Germany: President signed respective law immediately after positive decision by Constitutional court on September 12th
- The Fiscal Compact is planned to be implemented on January 1st 2013
- The core element of the Fiscal Compact is a debt limit, which has to be introduced in the legal system of each country
- In particular: No structural budget deficit exceeding 0.5% of GDP
- Markets so far seem not too impressed with the concept
- **Own view:**
  - Anchoring of prudent fiscal policy
  - Long-term effect
  - Very important measure, which shows that the eurozone is changing

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The role of the ECB: Purchase of government debt

Monthly purchases of government debt



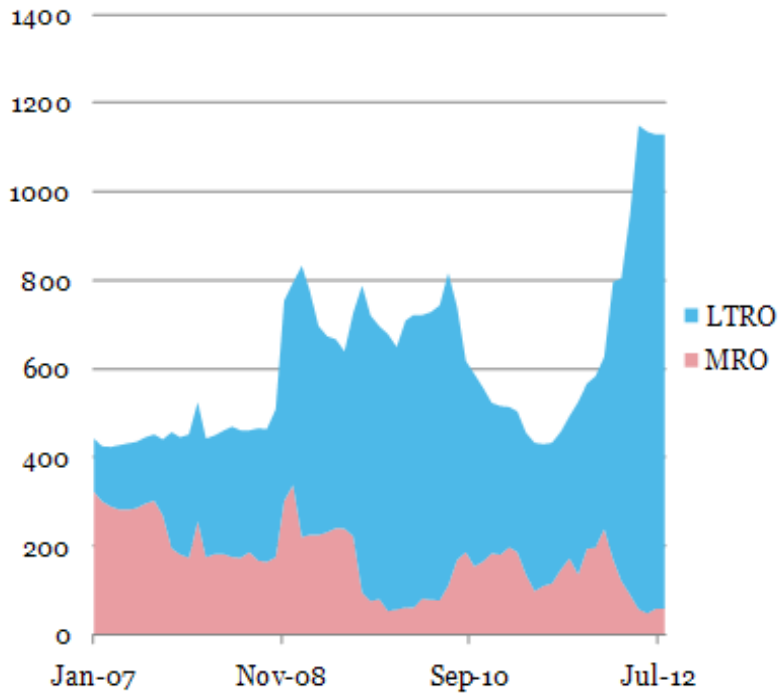
Source: IMF, Bloomberg

- ECB: Purchases of gov bonds of troubled countries on the secondary market (more than EUR 200 bn), followed by a hot public debate
- Pro purchases: Central banks US, UK & Japan are heavily engaged in those transactions
- Contra purchases:
  - Implicit monetisation of public debt
  - Quality ECB's balance sheet suffers
  - Liquidity injected creates asset price bubbles and increases the risk of inflation
- 6th Sep 2012: ECB announces that it will restart buying short-term gov bonds (1y-3y) "Outright Monetary Transactions (OMT)" without ex-ante limits
- Conditions: Adjustment program in place, EFSF/ESM also engaged in purchases of bonds
- **Own view**:
  - Purchase of gov bonds certainly not ideal
  - But: Fiscal tools at the level of the eurozone still not working properly
  - Thus: Purchases of gov bonds as an emergency measure until proper fiscal tools are in place

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The role of the ECB: Long term refinancing operations (LTRO)

Refinancing operations (RO) ot the ECB, in bn EUR



LTRO = Long term RO;

MRO = Main (short term) RO

Source: IMF, Bloomberg

- Normal times: ECB provides liquidity to the market through short term repo transactions
- Duration: 2 weeks to a maximum of 3 months
- Crisis times: Extension to up to 3 years
- Reason: Funding problems of banks, recently especially in Spain, Italy and France
- Currently: Eurozone banks refinance more than EUR 1,100 bn through the ECB, almost three times the amount of 2007
- LTRO partly used by banks (especially in Spain) to buy gov bonds; significant interest rate spread
- Impact: First risk premiums down, but after a few months effect vanished
- **Own view**:
  - Ambiguous instrument
  - Who is targeted? Banks or sovereigns?
  - If sovereigns: Right instrument?
  - On top: Additional risks for banks and adverse sovereign-bank-link increases

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Eurozone fiscal policy: New instruments had to be created

Original architecture of European Monetary Union (EMU):

- No eurozone fiscal tools foreseen to support distressed countries
- And: No IMF-type institution within the EU or the EMU to rescue countries

As Greece got in trouble:

- Bilateral loans from Euro members
- Setting up of a troika, consisting of EU Commission, ECB and IMF

Thus: Need to create new instruments and institutions to support countries in need

But: Huge time pressure, since Euro crisis in place; not an easy task

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Overview of new instruments: EFSM, EFSF and ESM

	EIB	EFSM	EFSF	ESM
Full name	European Investment Bank (in place before crisis)	European Financial Stabilisation Mechanism	European Financial Stability Facility	European Stability Mechanism
Legal Foundation	International Financial Institution	Supranational administrative body	Private company	International Financial Institution – multilateral lending institution
Mandate	EU‘s long term lending institution	Provide financial assistance to countries in difficulty	Provide financial assistance to countires in difficulty	Provide financial assistance to countires in difficulty
Shareholders	27 EU member states	27 EU member states	17 euro-zone member states	17 euro-zone member states
Contribution key	According to their economic weight	According to their economic weight	According to their share in the ECB‘s capital	According to their share in the ECB‘s capital
Support to bondholders	Explicit and irrevocable obligation for EIB‘s sharehlders to pay their own share of the callable capital	EU‘s budget and ultimately explicit and unconditional guarantee of the 27 members	Explicit, irrevocable and unconditional guarantee of the members	Explicit, irrevocable and unconditional obligation to pay the share of callable capital
Preferred Statuts?	Yes, preferred creditor status / access to ECB‘s liquidity	No	No	Yes, preferred creditor status, but junior to IMF
Lending capacity	Outstanding loans and guarantees are capped at 250% of the subscribed capital and reserves	EUR 60 bn, EUR 11.5 bn still at disposal	EUR 440 bn (EUR 192 bn are already committed to Ireland, Portugal and Greece	EUR 500 bn
Instruments	Loand and guarantees for loans	Loans and grants	Loans, precautionary credit lines, bonds purchases	Loans, precautionary credit lines, bonds purchases

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Common supervision of banks

- EU summit end June 2012: Decision to centralise banking supervision in the eurozone

Background:

- Intention of providing direct financial support from eurozone to Spanish banks
- But: Eurozone has no direct influence on Spanish banks, since banking supervision is still a national matter („incomplete monetary union“)
- Thus: Eurozone would provide the money, but have nothing to say; not acceptable
- Decision: Direct financial support to banks, but only after direct influence in form of a common banking supervision is in place, probably under the ECB
- Planned start of common supervision: January 2013 (rather ambitious)
- **Own view**: Common supervision makes sense, but many questions remain
- In particular: First step towards a banking union, incl. common deposit guarantee scheme and common bank resolution institution? Or only common supervision?

Source: European Commission, BNP

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C. What has to be done?
Possible solutions to the Euro crisis

1. Short term stabilisation measures

2. Long term stabilisation measures

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Short term stabilisation measures

Voluntary debt restructuring (same face value, but longer maturities with credit enhancements)

Pro

Reaching the target of a sustainable debt level faster

Lessening the burden of tax payers

Contra

Risk of an acceleration of capital flight

Negative effects on balance sheets of financial institutions

Eurobills bills with maturity of 3 to 12 months, backed by all eurozone members

Pro

Short-term liquidity problems could be avoided

First step towards more comprehensive long-term Eurobonds

Contra

Increasing the reliance on short-term debt, thus increasing the vulnerability to interest rate increases

Source: BE

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Long term stabilisation measures: A banking union

As of now: Banking sectors are a national, not an eurozone issue; no common policy

Possible measure: Creation of a banking union, consisting of 3 elements

i. Deposit guarantee scheme
ii. Single eurozone supervisor of banks
iii. Common resolution fund

Own view:

- A banking union would strengthen the yet incomplete monetary union
- However, the goal of banking union is quite ambitious, given significant differences in regulation and structure of banking sectors throughout the eurozone
- Also distributional aspects between member countries need to be addressed

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Long term stabilisation measures: Stronger fiscal integration

- For a monetary union to work properly, a certain degree of fiscal integration is required
- This is especially true for EMU, given the rather low labour mobility between countries
- How does this work? Negative economic shocks to single members are partly absorbed by other members through common fiscal instruments; in such a way, the likelihood of strong macroeconomic misbalances is reduced
- How stronger fiscal integration? How more risk sharing?
  - Eurobills: Eurozone securities with short term maturities
  - Eurobonds: Eurozone securities with long term maturities
  - Increase of transfers (“transfer union”)
  - Rescue funds
- **Own view**:
  - A higher degree of risk sharing makes sense
  - Common debt would help to reduce current pressure on sovereigns
  - But: Incentives to keep up reforms and fiscal consolidation have to be maintained
  - Key question: How to create more stability without reducing incentives for reforms?

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D. Impact on Ukraine

- As stated in the beginning, the Euro crisis is a very complex phenomenon consisting of
  - public debt crisis,
  - banking crisis and
  - growth crisis
- Each component has its own implications for Ukraine:
- Public debt crisis: Lower-rated sovereigns like Ukraine experience more difficult access to international capital markets/must pay higher interest rates
- Banking crisis: Eurozone banks are cutting back cross-border lending in order to improve their balance sheets and concentrate on home markets
  - This effect is particular strong in EMEA countries (incl. Ukraine), whose economies are very dependent on foreign banks
- Growth crisis: The economic recessions in many Eurozone countries, and the related slow-down in global growth have negative implications for Ukraine's exports, in particular metals/steel
  - Growth slowdown clearly observable in Ukraine during 2012

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Possible Policy Reactions (1)

- What is today's adequate policy response to these challenges?
  - While Ukraine cannot influence developments in the Eurozone, it can prepare itself and thus cushion any negative impact as far as possible
- Important area: Exchange rate policy
  - Classical instrument for short-term adjustment
  - Problems in Eurozone countries (where this instrument is not available anymore) show the significance of this instrument
  - But: Ukraine not willing to use this instrument, despite strong pressure on the FX market
- Our view:
  - FX flexibility in general a good idea, but especially with regard to possible future shocks originating from the Eurozone
  - Thus, in the short term the most important adjustment instrument
  - "Waiting" is dangerous as it may require a bigger adjustment later on, which may be more difficult to implement without creating panic

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Possible Policy Reactions (2)

- Further crucial area: Fiscal policy
  - The observable difficulties in raising new debt support the case for a low budget deficit
  - Ukraine made significant fiscal consolidation efforts after the crisis 2009, but questions regarding a “softer” fiscal stance have arisen in view of the upcoming parliamentary elections
- Our view:
  - There are no alternatives to a continuation of the path of fiscal consolidation – developments in the Eurozone support this view
  - Again, such a strategy is good in general, but it creates also necessary space for policy reaction in case the Euro crisis worsens

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E. Final thoughts

- Euro crisis is a very complex phenomenon consisting of
  - Public debt crisis, banking crisis and growth crisis
  - On top: Adverse links between these crises
- Since the appearance of the crisis a lot has been done
- In particular: Fiscal consolidation in the eurozone much more successful than in US

  (US: Expected budget deficit 2012 = 7.8% of GPD, public debt to GPD = 101.5%)
- However, this has not been enough to settle the issue; a worsening cannot be excluded
- But a worsening of the crisis would have a very negative impact on the world economy
- Any solid, long-term solution to the crisis needs to achieve 2 very different goals:
  - Financial stabilisation, i.e. better access to debt markets in the short term
  - Continuation of fiscal consolidation and reforms in the short and long term
- Key problem for finding “the” solution: As soon as more financial stability is achieved and sovereign risk premiums drop, the pressure on reforms falls immediately
- Consequently: Solving the problem with one big shot might not be possible
- Instead: Need to implement a number of consecutive steps (step by step approach)

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Outlook: Eurozone seems to be at a crossroads

Scenario 1: Strong Euro

- Crisis is used to improve economic policy and strengthen eurozone architecture
- Result: Stronger Euro than before, since weaknesses of the past put aside

Scenario 2: Weak Euro

- Eurozone institutions (ECB, ESM) are used to monetise national gov debt
- Result: Higher inflation and weaker Euro

Scenario 3: No Euro

- No compromise between core and peripheral countries on how to solve the crisis
- Break-up of monetary union, with unknown consequences

Own view:

- Scenario 1 would be our preferred scenario
- Scenario 3 rather unlikely (in the medium term), because of high cost of break up

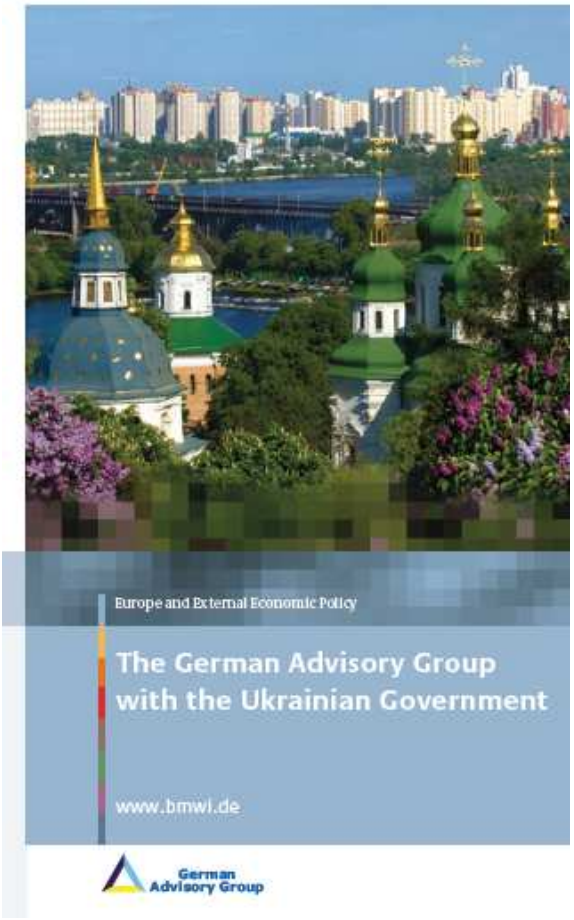
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