House of Lords, European Union Committee, Economic and Financial Affairs Sub-Committee A: The euro area crisis

Written submission, Ruth Lea, Economic Adviser and non-Executive Director, Arbuthnot Banking Group, acting on an individual basis; 2 February 2013

Introduction, questions

1. In recent weeks a number of prominent figures such as José Manuel Barroso, Christine Lagarde and Mario Draghi have suggested that the eurozone has turned a corner. Do you agree? Do you think we are seeing the beginning of the end of this crisis?
2. Do you think the actions being taken by the EU institutions are sufficient to bring this crisis to a close? If not, what alternative actions would you say need to be taken?
3. Improving competitiveness through structural reforms is regarded as a necessary response to the crisis. Are these structural reforms working?
4. There are tentative signs that the Irish economy is on the road to recovery having pursued significant fiscal consolidation. Does this prove that austerity and structural reforms imposed as the price of bail-outs can work? Do you think the Irish economy is doing as well as is commonly claimed? Where do you stand on the so-called 'austerity v growth' debate?
5. We heard evidence last week in relation to some further country-specific issues:
   - In relation to Greece we were told that some form of major debt restructuring was inevitable. Do you agree? What, in your view, would it take to trigger a Greek exit from the euro?
   - We were told that France is in an economically vulnerable position. What is your assessment of the outlook for France?

Introduction, responses

(1) I agree that the Eurozone has turned the corner. Concerning the term "crisis" I will initially define it as the acute existential Eurozone crisis which intensified last summer. Speculation of a "Grexit" was at its height and there were acute pressures in the Spanish and Italian bond markets. I believe that <u>this</u> crisis has probably been resolved – at least for the time being. But there are other aspects of the Eurozone crisis, taken in a wider sense, that are far from being resolved. The highly indebted peripheral economies (Greece, Ireland and Portugal) still do not have full access to the capital markets and these economies (along with Spain and Italy) continue to struggle with recession (or sluggish growth at best).

(2) I attribute the checking of last summer's existential crisis to two factors which convinced the markets that the EU's institutions were, after all the speculation to the contrary, prepared to hold the currency bloc together. The first, and the more dramatic, was the July decision by ECB President Draghi to do "whatever it takes", followed by details of the ECB's Outright Monetary Transactions (OMT) programme, intended for countries like Spain and Italy. Even though there have been no bond purchases under the OMT to date (despite expectations of purchases of Spanish bonds), the ECB's "jawboning" dramatically changed market sentiment towards the peripheral Eurozone countries without a "shot being fired". But the ECB is in a good position to "fire many shots" if the need so arises. The second factor was the indication from the EU's institutions that they were seriously considering "genuine economic and monetary union" and push ahead with the sort of fiscal and economic union that is widely deemed necessary to hold the currency union together in the longer term. These two factors together are extremely powerful and should hold the euro together. But the big risk is that, with the ebbing of the existential crisis, the political will towards building genuine EMU will waver. Indeed it appears to be wavering.

(3) I am not aware of any comprehensive studies on the efficacy of the structural reforms attached to the bailout programmes for Greece, Ireland and Portugal or on the labour market reforms introduced by Italy (June 2012) and Spain (February 2012). But there is

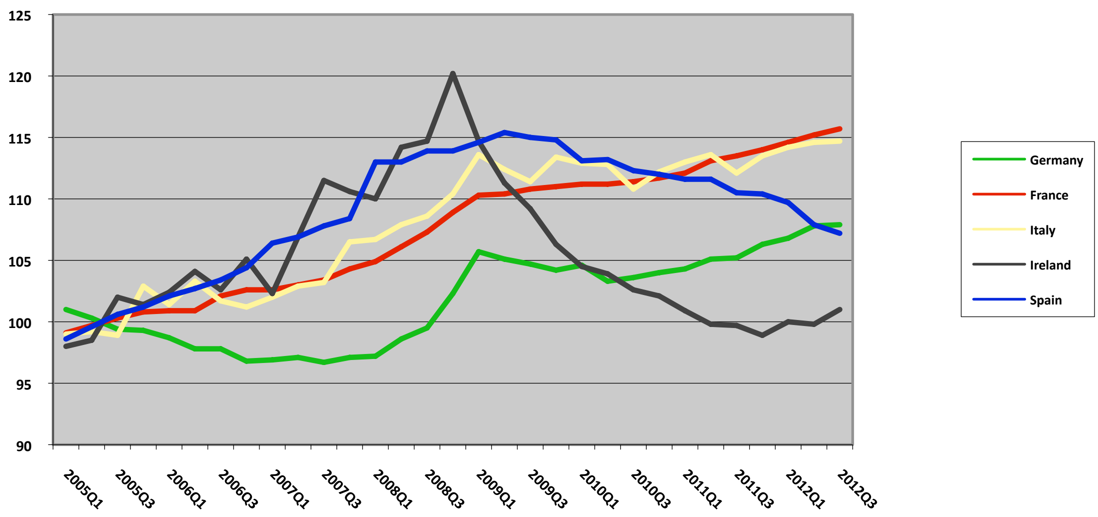
no doubt that some of the peripheral economies have significantly improved their competitiveness reflecting, I suspect, a combination of the imposed structural reforms and the ability, already present, of their economies to respond flexibly. The chart below shows Spanish ULCs have fallen 7% since their local peak, whilst Irish ULCs are back to the 2005 level. "Internal devaluation" is well advanced in Ireland. But note that Italy (ULCs 14% higher than in 2005) and France (15% higher) are continuing to lose their competitive edge against Germany.

(4) Ireland's exports have picked up, supporting modest economic growth, and the country continues to attract Foreign Direct Investment (FDI), attracted by the low corporate tax rate. At one level, Ireland's case supports the view that the EU-IMF austerity and structural reforms policy can "work". Claims that the Irish economy is showing some improvements seem justified. However public sector debt levels are very high (and rising), the housing market is shattered and unemployment is increasing reflecting the sluggish growth. I have little doubt that the tough fiscal consolidation packages imposed in Ireland have held back the country's growth, but the controversial "austerity and reform" conditions were the EU-IMF's price that Ireland had to pay for the bailout. Ireland's bailout funding runs out at the end of this year and debate about exiting the bailout programme is intensifying. If Ireland could continue to grow and successfully exit the programme, then this "success" would surely be seen as a vindication of the tough "austerity and reform" policies.

(5) Greece and France:

- Greek debt levels (over 150% of GDP in 2012Q3, Eurostat), combined with very poor growth prospects, suggest that Greece will have little chance in hitting the targeted 124% of GDP in 2020 (and "lying substantially below 110% in 2022") unless there are further debt write-offs. Given last summer's commitment to Greece as a member of the euro, it is difficult to see Greece leaving against its volition. But, if recession continues as I expect, a Greek Government could decide to leave.
- There have recently been two reports voicing concern about France's competitiveness: the IMF's country report and a report by businessman Louis Gallois. Both called for cuts in labour costs. More specifically, France's "competitiveness gap" with Germany is very significant (evidenced by Germany's very large current account surplus with France) and, as pointed out above, France is continuing to lose its competitive edge against Germany. France's lack of competitiveness, combined with a tough 2013 budget, suggest a discouraging economic outlook for France.

Chart: selected Eurozone countries, unit labour costs (2005=100)



Source: ECB, Statistical Warehouse, unit labour costs, seasonally adjusted data. Greece and Portugal have also shown modest falls in ULCs since 2005 (correction: their local peaks since 2005).

Short term measures for tackling the crisis, questions
European Stability Mechanism (ESM)

6. There is much debate over whether the European Stability Mechanism (ESM) should be used to cover "legacy assets" from past banking crises. There are also reports that the European Commission has proposed to have Member States make good the losses of private banks before they are recapitalised by the ESM. What is your view on these developments?
7. Is it of concern that the ESM and the European Financial Stability Facility were downgraded by Moody's in December? What assessment would you make of the impact of Credit Rating Agencies assessments? Do you perceive any decline in their influence?

The ECB and Outright Monetary Transactions

8. Do you think Mario Draghi's commitment to Outright Monetary Transactions has led to complacency amongst the EU institutions and Member States about the stability of the eurozone?
    - The borrowing costs for Italy, Spain and other countries with distressed bond markets have fallen since the pledge. How sustainable is this situation?
    - We understand that a bond-buying programme would be suspended if a country were to stray from its agreed reforms. Do you think this is a credible threat? Do you perceive any risks to this approach?

Short term measures for tackling the crisis, responses

(6) These two issues highlight the fault-line in the Eurozone between the peripheral economies which have experienced banking crises (notably Spain and Ireland), in need of financial support, and the northern countries (notably Germany, Finland and the Netherlands), who are *de facto* expected to provide it. Whilst not knowing how the specific issues quoted above will be resolved, I would expect they will be resolved in favour of the northern countries. The ESM will probably not be used to cover "legacy assets" and the European Commission's proposal on bank losses will probably prevail.

(7) The markets appeared to react to Moody's decision to downgrade the EFSF and the ESM, following the French downgrade, with equanimity. (The markets also responded to the US downgrade in August 2011 with similar equanimity.) The impact of the Credit Rating Agencies on investors' decisions does appear to be declining. They lost much credibility over their over-generous ratings for mortgage-backed securities during the financial crisis, for which they have heavily criticised.

(8) As I've already indicated, the big risk is that the ebbing of the existential crisis will mean that the political will to build "genuine EMU" will waver. There was already evidence of complacency setting in at the December 2012 summit.

- Borrowing costs: I would not claim to be an expert on the bond markets of the peripheral Eurozone. But, on balance, I take the view that the ECB's OMT programme, if/when utilised, could keep a lid on bond yields for the countries actively involved in the programme. Countries would of course have to request a bailout and agree to an austerity and reform programme in order to be eligible.
- If the markets were destabilising the Eurozone in a renewed financial crisis, I believe that it would be politically "highly unlikely" for the ECB to withdraw support even if the country in question were flouting the conditions of its agreement. The ECB's first task under these circumstances would surely be to douse the flames. The risk would be that the ECB (and the other EU institutions) would be held "hostage" to the crisis and the country (or countries) flouting the rules would be seen to act with impunity.

Long term measures for tackling the crisis, questions

'Genuine' Economic and Monetary Union

9. Last month we published our report on European Banking Union. How do you envisage the banking union agenda being taken forward during 2013?
10. One of the major responses to the crisis has been to focus on creating a 'genuine economic and monetary union'. This involves greater integration in the financial, fiscal, economic and political domains. Do you agree with this approach? What risks do you foresee?
11. The Commission's recently published Blueprint for a Deep and Genuine Economic and Monetary Union set out a detailed plan for achieving this vision. The main focus of the Blueprint was on the steps needed towards achieving fiscal union. This is seen by many as necessary to resolve the crisis. Do you agree? Do you think it will it be possible to overcome the political resistance to fiscal union?
    - Few of the Blueprint's more ambitious initiatives made it into the December European Council conclusions, such as the proposed fiscal capacity and common issuance of debt. What does this indicate about the shape of the debate in the months ahead?
    - Last month we published our report on European Banking Union. How do you envisage the banking union agenda being taken forward during 2013?
12. What do you think will be the implications of a 'genuine economic and monetary union' for the UK? How should the UK Government respond to these developments?

Long term measures for tackling the crisis, responses

(9) Whilst I shall be following the political developments in the European Banking Union with great interest, I do not claim any special expertise on how the banking union agenda will develop this year.

(10) I believe that the creation of "genuine economic and monetary union" is the right way forward for the Eurozone. Integrationist policies, including the pooling of debt and major transfers of funds from the richer to the poorer regions through a redistributive Eurozone budget, strike me as ultimately the only way to cement the currency bloc. The major risk is that the richer northern countries (including Germany, Finland and the Netherlands), under pressure from their electorates, baulk at this potential commitment to the weaker countries. The chances that the richer northern countries will resist the commitment are

significantly augmented by the absence of a sense of "demos" within the Eurozone. It should be added that the weaker southern countries may also baulk at the notion of fiscal union, not wishing to see their sovereign countries subsumed into a political union, dominated by north European countries.

(11) I broadly agreed with the aims of the Blueprint as a way of achieving the necessary fiscal union. Whether or not political resistance to fiscal union can be overcome will depend, at the end of the day, on how determined the Eurozone's Member States are to develop an internally stable and robust currency bloc and how much sovereignty they are prepared to cede to Eurozone institutions in order to achieve this. As matters stand at present it is, I believe, quite impossible to know how events will ultimately develop.

- In many ways the December summit was a damp squib, complacency and national interests seemed to take precedence over the serious consideration of the Blueprint's recommendations. All the indications so far are that this is likely to spill over into the debate in the months ahead. It should also be noted that German elections are due in September 2013. But whatever is, or is not, achieved of the Blueprint's initiatives this year, I expect the EU's institutions to doggedly work away at the plan, promoting it whenever they can and waiting for more auspicious times.
- I was greatly impressed by your report on European Banking Union. Concerning developments in European Banking Union this year please see (9) above.

(12) If "genuine economic and monetary" does move ahead then, as your report on European Banking Union implied, there are likely to be two inter-related consequences. Firstly, it will difficult to maintain the parity of treatment between the increasingly powerful Eurozone institutions and the EU27 institutions. (Your report quoted the ECB and the EBA.) The EU27 institutions will lose influence to the Eurozone institutions, not because of some anti-British dastardly plot, but because of the increasing concentration of power and decision-making in the Eurozone. Secondly, the UK risks marginalisation as Eurozone integration proceeds. Your report specifically referred to the UK financial services industry where "a degree of marginalisation will be inevitable as the euro area…take steps towards deeper integration".[1] The British Government's initial response should be to preserve our influence as best we can – the "double majority" ruling in the EBA being a case in point. But further out, my preference would be for the Government to negotiate a much looser relationship with the EU altogether, based on trade and mutually beneficial agreements.

Reference

1. House of Lords, "European Banking Union: key issues and challenges, report", December 2012.