Managing Crisis in the Eurozone: What the past tells us about the present?

LSE PowerBreakfast, 25 March 2020
View from the office: a peripheral Finn at forced telework
WALKING THE HIGHWIRE
Rebalancing the European Economy in Crisis

OLLİ REHΝ

With a foreword by MARK CARNEY

KUILUN PARTAALTA
Näin euro pelastettiin
Euro area real GDP, 2008-2022

Euro area real GDP and ECB forecast.

Index, 2008Q1 = 100


0.4 -4.4 2.1 1.6 -0.9 -0.3 1.4 2.1 1.9 2.4 1.2 0.8 1.3 1.4

Euro area, changing composition. Figures next to the line are annual growth rates. Forecast does not include the impacts of COVID-19 pandemic that will be substantial.

Sources: Eurostat and ECB.

35781@eabK/TmdMPEy(en)
Rebalancing of the Eurozone economy, 2007-21
Balance of current transactions with the rest of the world

% of GDP


2005 2010 2015 2020

* Surplus countries: AT, BE, DE, FI, NL
** Deficit countries: FR, IT, ES, PT, IE, GR

Sources: European Commission, Macrobond.
34020@Chart9 (2)

Forecast for 2019 - 2021
The “Impossible Triangle” of the Eurozone

Washington (IMF)  Frankfurt (ECB)  Berlin (DE)

EC = the European Commission

EC = common territory to take decisions

EC = efforts to leave red lines and come to common ground
Lessons learned from the euro crisis


2. Financial stability was badly neglected at Maastricht:
   • Need a ”big bazooka” to tame financial turbulence. ECB + ESM.
   • Banking union is key break the bank-sovereign nexus.

3. We need a better policy mix between monetary and fiscal policy – both in normal times and especially in crisis times.

4. While better economic policy coordination is a worthwhile goal, EA member states should still stay responsible for their economies and keep them in good shape. Resilience, flexibility, productivity.
The coronavirus pandemic, economic consequences and policy responses

Olli Rehn, Governor
Bank of Finland
Comparison of the two crises, at this stage

• The corona crisis is NOT caused by large macro imbalances
• Banks in the euro area are better capitalized
• Reaction to the crisis has been quicker now
  • ECB is employing its big bazooka
  • Germany is launching a large-scale fiscal stimulus
• But the effect of the corona pandemic is wider in scope – a direct hit to the real economy and to the society at large
  • Seemed like a supply shock, but is as well a massive demand shock
  • In last weeks, has been a severe financial shock
• Bottom line: uncertainty dominates until the people can see and trust that the pandemic is brought under control?
Reinforcement of capital buffers – now and then

Weighted Capital Ratios of European Banks

Source: EBA

Total capital ratio and Tier 1 capital ratio of euro area banks

Source: ECB.
A very sudden shock: e.g. the Chinese economy contracted sharply in January and February
Stock markets down with a steep and sudden fall – different from the dotcom and financial crisis

DOTCOM  GFC  COVID-19

S&P 500’s peak = 100

Working days after the S&P 500’s peak

-49.15 %

-56.78 %
The ECB’s monetary policy decisions 18 March 2020

• Launch of a new asset purchase programme, the Pandemic Emergency Purchase Programme (PEPP)
  • Flexible purchases of securities totalling EUR 750 billion, conducted until the end of 2020
  • Includes all the asset categories eligible under the existing asset purchase programme (APP)
  • The ECB is fully prepared to increase the size of the programme and adjust its composition
  • Securities issued by the Greek government also eligible for purchase
• Expansion of the range of eligible assets under the corporate sector purchase programme (CSPP)
• Easing of collateral standards in refinancing operations
➢ The Governing Council will do everything necessary within its mandate to support all euro area citizens through this extremely challenging time.
Germany’s planned supplementary budget (EUR 156 billion) will have a significant impact on the fiscal stance in the euro area.

<table>
<thead>
<tr>
<th>Country</th>
<th>Impact on Public Deficit (% of GDP)</th>
</tr>
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<tbody>
<tr>
<td>Spain</td>
<td>1.0</td>
</tr>
<tr>
<td>Italy</td>
<td>1.0</td>
</tr>
<tr>
<td>France</td>
<td>2.0</td>
</tr>
<tr>
<td>Germany</td>
<td>5.0</td>
</tr>
<tr>
<td>Euro area</td>
<td>2.0</td>
</tr>
<tr>
<td>United States*</td>
<td>5.5</td>
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</tbody>
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*US is approximated based on the 1 trillion dollar fiscal package on which details have not yet been decided.
Concluding remarks: Health first – but damage to the economy must be mitigated, whatever it takes

• Protecting public health must take precedence during a pandemic.
• But contingency measures to contain the virus have brought the global economy to an abrupt halt. Public authorities, including the central banks, will inevitably have to play a key role in mitigating the economic damage.
• Immediate challenge: secure the financing of businesses, esp. SMEs, and liquidity in the financial system. Next act: soften the blow to employees, save jobs and protect domestic demand. E.g. the Nordic way.
• Thus fiscal policy will inevitably have to play a stronger role from now on. Better in a coordinated way in Europe.
• Comprehensive recovery of economic output and confidence will only begin once people trust that the pandemic is under control.
Thank you!
- And the floor is yours!
Walking the Highwire
Rebalancing the European Economy in Crisis

- Written by the former Vice President of the European Commission, responsible for Economic and Monetary Affairs, 2010-2014
- Covers all aspects of the Euro Crisis at the level of the EU and the member states, in both crisis countries and creditor states
- Explains how the Euro was saved through second-best solutions

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O. Rehn
ECB monetary policy measures on 12 March will support lending conditions for households and firms

1) Additional longer-term refinancing operations (LTROs)
   • Immediate liquidity support to the euro area financial system

2) Targeted longer-term refinancing operations, series III (TLTRO III)
   • Considerably more favourable terms for all outstanding operations from June 2020 to June 2021
   • Ensures smooth bank lending to households and small and medium-sized enterprises

3) Net asset purchases (APP)
   • Additional net asset purchases of EUR 120 billion until the end of the year, to ensure a strong contribution from the private sector purchase programmes
   • Secures readiness to prevent market disruptions under all asset purchase programmes
   • Supports the availability of market-based funding for businesses
Fiscal policy measures – euro area

• National level
  • Announced increase in public spending so far about 1% of GDP
  • Germany planning a stimulus package of EUR 156 billion (4.5% of GDP)
  • Automatic stabilisers allowed to operate
  • Liquidity support for SMEs, about 10% of GDP
  • Support for workers with income losses

• European level
  • Coronavirus Response Investment Initiative (CRII) EUR 37 billion (0.3% of GDP, redirected from structural funds)
  • EUR 8–20 billion working capital lending to SMEs (0.06–0.16% of GDP)
  • Additional investment of EUR 20 billion into small firms by EIB (0.16% of GDP)

• Stability and Growth Pact
  • The coronavirus pandemic qualifies as an unusual event outside the control of governments, meaning the related temporary and targeted measures are not regarded as detrimental
  • On 20 March, the European Commission proposed the activation of the general escape clause, which permits deviation from the MTO adjustment path in case of a severe economic downturn
"Small States in World Markets" vs. the transformation of the world economy in the 80s/90s

INTERNATIONAL SYSTEM

International Security Order

Politico-Economic Integration

International Economic And Monetary Order

SMALL STATE

Smallness
- Openness (Neutrality)

History
- proportional representation
- national unity

ECONOMIC LIBERALISM
- free trade
- not free flow of capital

DEMOCRATIC CORPORATISM
- social partnership
- centralized interest
intermediation
- tripartite corporatist
networks

POLICY TOOLS
- regulated interest rate
- high public saving rate
- credit-based financing of
investment
- solidaristic wage formation

POLITICAL-ECONOMIC PERFORMANCE
- rapid/stable growth
- high rate of investment
- close to full employment
- high productivity and
competitiveness
- political legitimacy


Source: IMF, OECD and Macrobond.
Government deficit in Euro area 2000-2018*

*Shadowed area indicates forecasts. 
Source: European Commission.
Development of NPLs in selected euro area countries

Amount of non-performing loans in large banks in selected countries

- IE
- GR
- DE
- ES
- FR
- IT
- PT
- Other euro

EUR billion

Source: SSM.

Gross non-performing exposures (NPE), % total bank exposures

Lähde: Euroopan keskuspankki.
ECB Banking Supervision measures in response to the corona virus

• The ECB announced on 12 March measures that provide its directly supervised entities flexibility in the fulfilment of certain additional capital and liquidity requirements, incl. fulfilment of the Pillar 2 additional capital requirement.
  • Applies also to Finnish banks directly supervised by the ECB

• In Finland, the Board of the Financial Supervisory Authority (FIN-FSA) decided on 17 March to decrease the capital requirements that are subject to national decision-making by one percentage point, applicable to all banks.
The Bank of Finland’s new measures to alleviate the impacts of the corona virus pandemic: purchases of commercial paper

- The purpose is to increase the supply of funding to businesses and preserve jobs as part of national and euro area crisis measures.

- The Bank of Finland launched on 17 March purchases of commercial paper. The size of the programme is initially EUR 500 million.

- The Bank of Finland Board decided on 18 March to increase the size of the programme to EUR 1,000 million, i.e. EUR 1 billion.

- The purchases will also indirectly ease the funding conditions for small companies, as banks can free up credit lines for other customers.