The European Paradox
and the specificities of the challenges ahead

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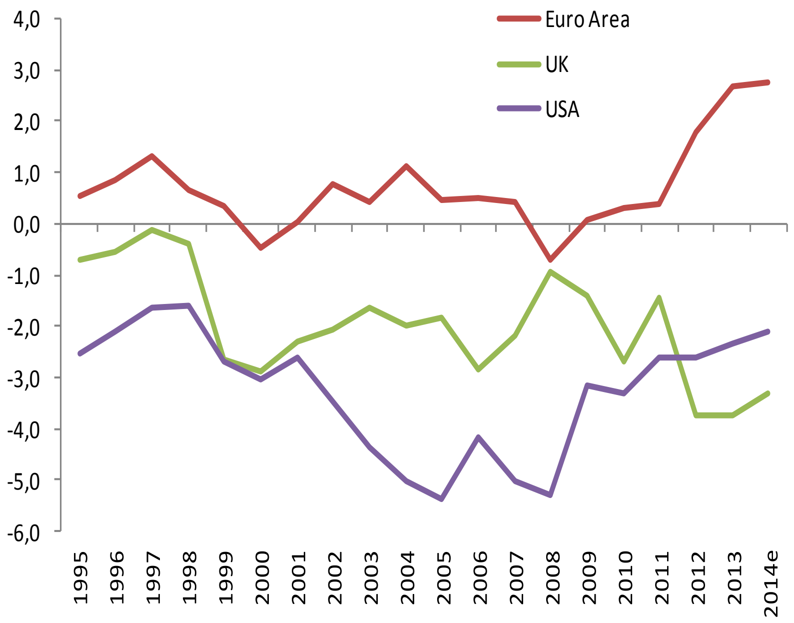
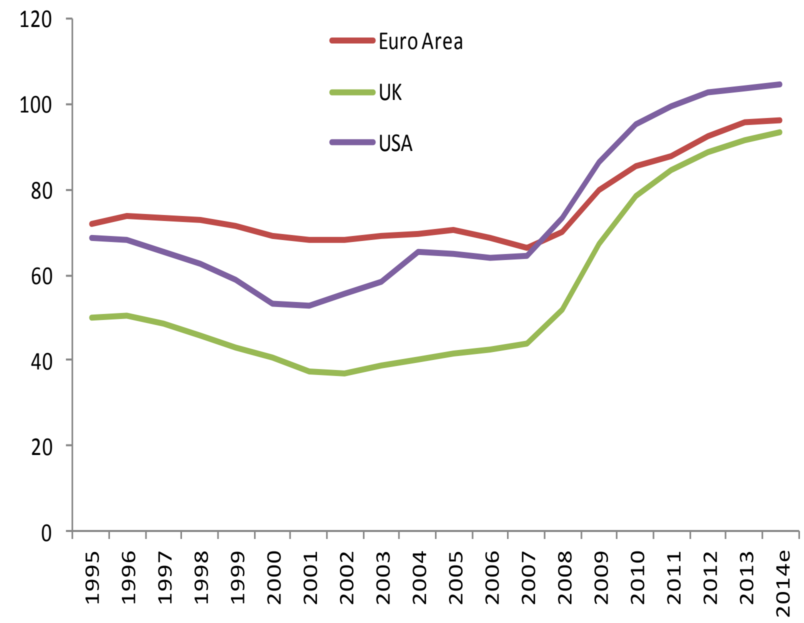
Euro Area has:

- **Current account surplus**
- **Public debt ratio lower than other advanced economies**

Current account balance
(percent of GDP)



Public debt
(percent of GDP)

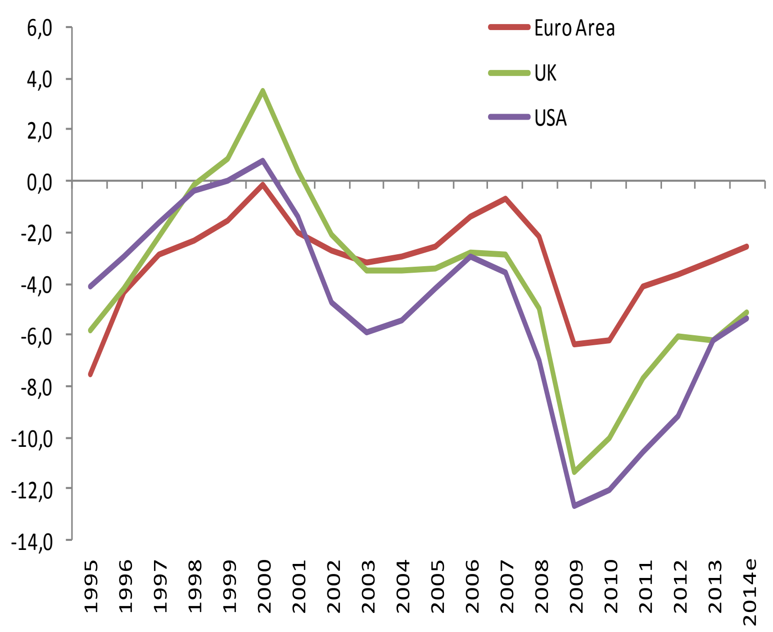


 Source: AMECO.

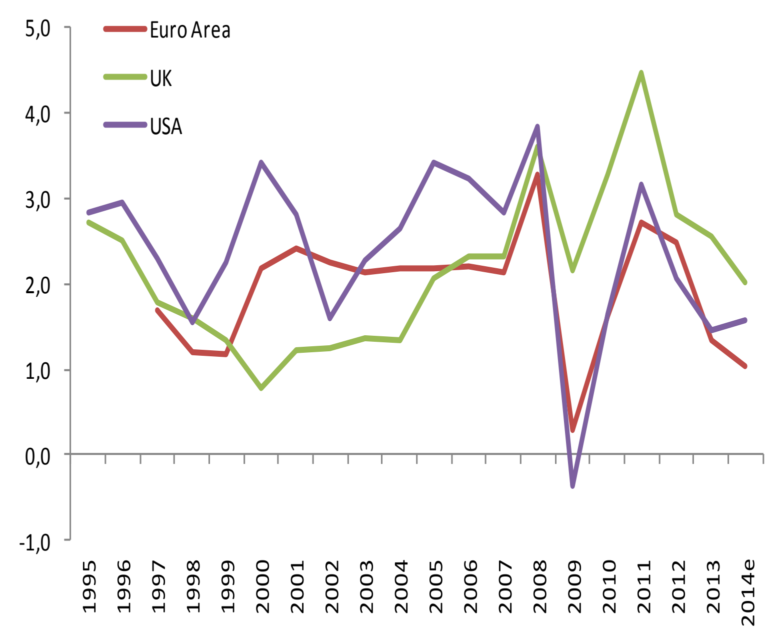
Euro Area has:

- **Fiscal deficits lower than other advanced economies**
- **Low inflation in line with other advanced economies**

Fiscal Balance
(percent of GDP)



Inflation
(YoY, per cent)

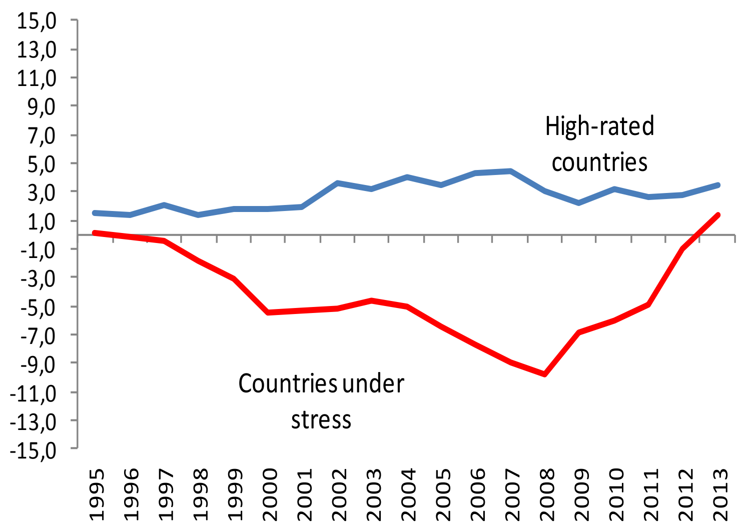


Source: AMECO.

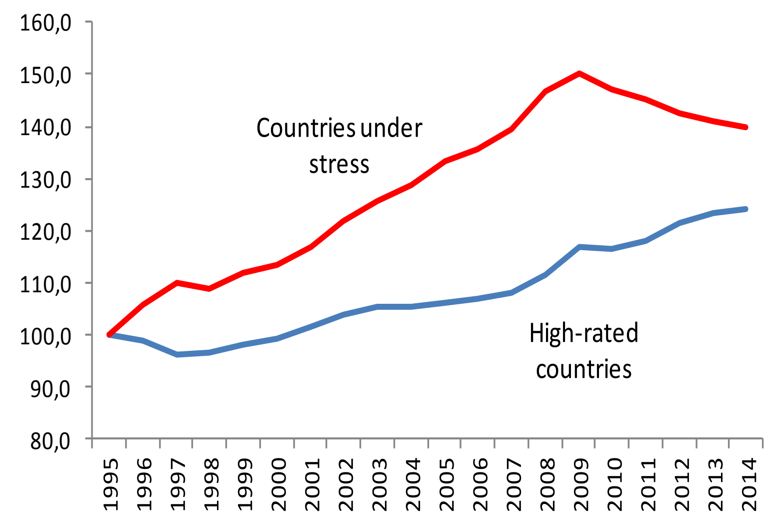
But, large internal imbalances were built up in the years prior to the crisis:

- **Countries under stress: accumulated significant external deficits and competitiveness losses**
- **High-rated countries: registered persistent current account surplus**

Current account balance
(percent of GDP)



Nominal Unit Labour Costs
(index, 1995=100)

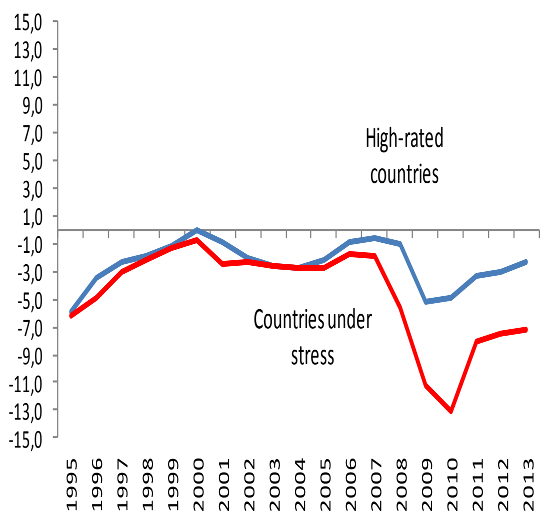


Note: High-rated countries include Belgium, Germany, France, Netherlands and Austria; Countries under stress include Greece, Ireland, Italy, Spain and Portugal.

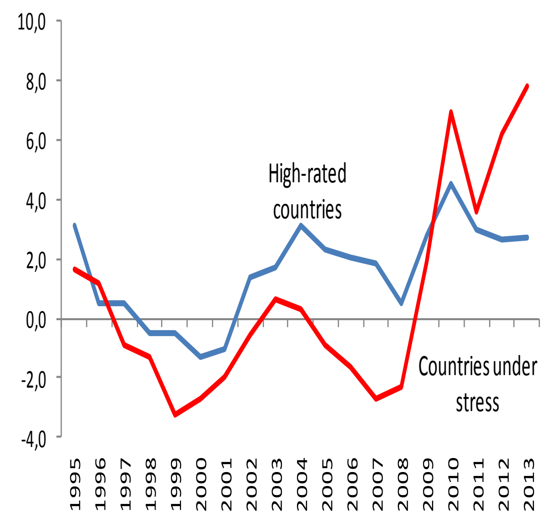
 Source: AMECO.

- **Countries under stress: budget deficits; significant accumulation of debt by the private sector**
- **High-rated countries: budget deficits (more moderate); the private sector maintained (in general) a net lending position**

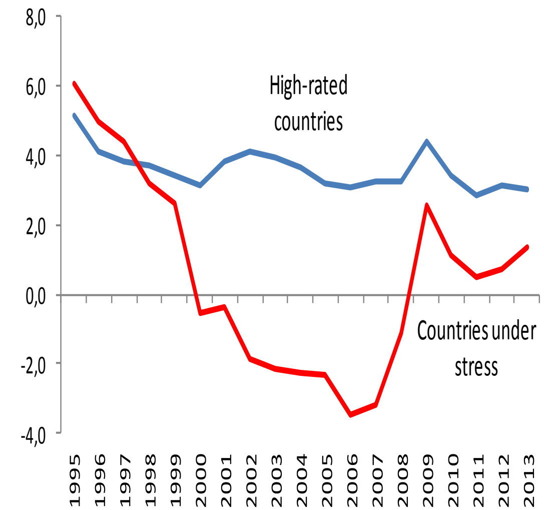
Fiscal balance
(percent of GDP)



Net lending (+) or net borrowing (-) by corporations
(percent of GDP)



Net lending (+) or net borrowing (-) by households
(percent of GDP)

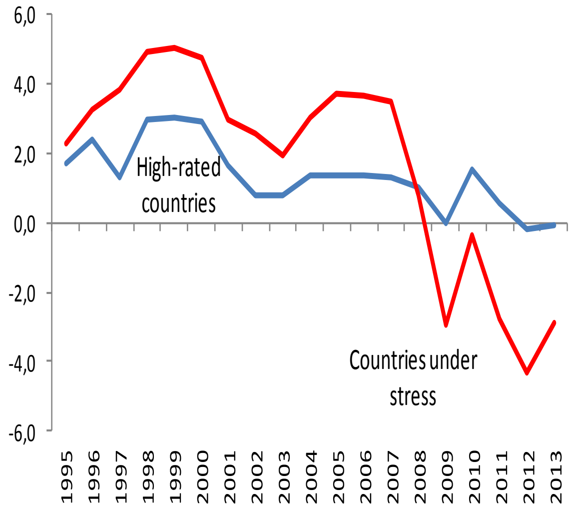


Note: High-rated countries include Belgium, Germany, France, Netherlands and Austria; Countries under stress include Greece, Ireland, Italy, Spain and Portugal.

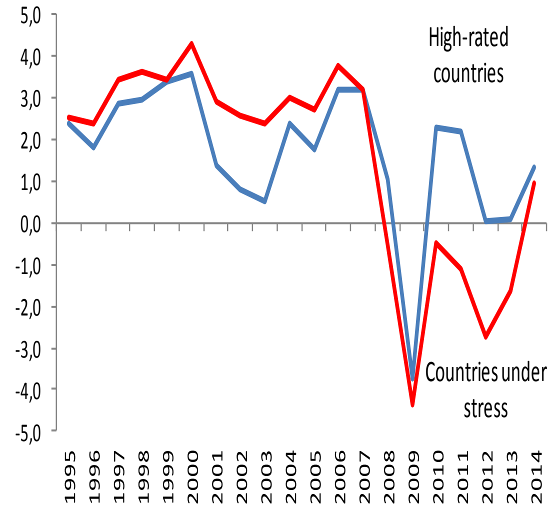
 Source: AMECO.

- **Countries under stress: an economic growth model based on the dynamics of the domestic demand, which proved unsustainable**
- **High-rated countries: more favourable growth performance**

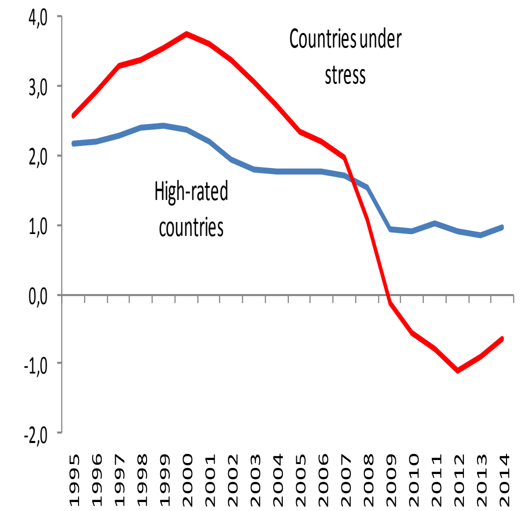
Private consumption
(YoY, per cent)



Gross Domestic Product
(YoY, per cent)



Potential Output
(per cent)

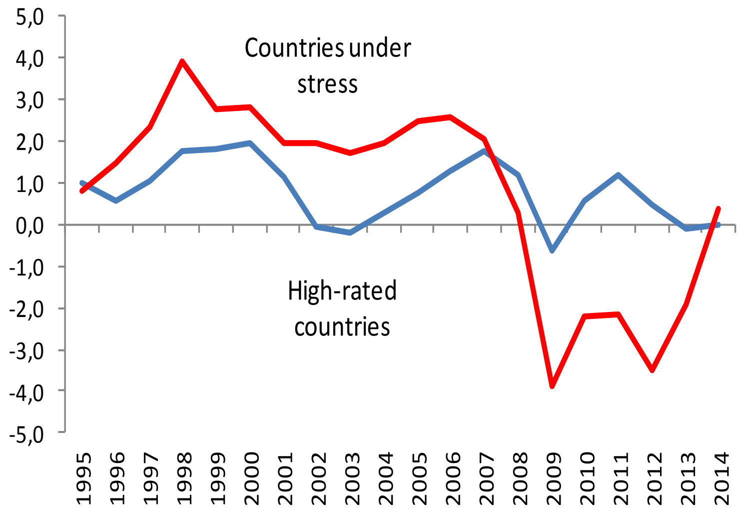


Note: High-rated countries include Belgium, Germany, France, Netherlands and Austria; Countries under stress include Greece, Ireland, Italy, Spain and Portugal.

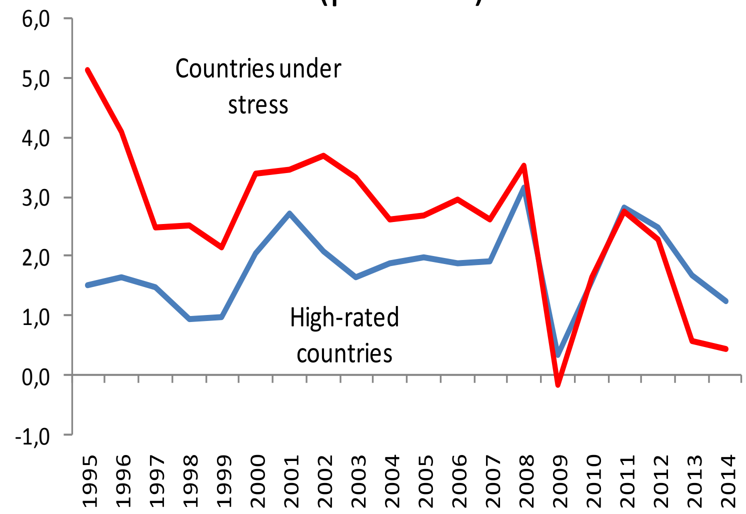
 Source: AMECO.

- **Countries under stress: higher non-sustainable employment growth (e.g. construction and retail); higher inflation rates**
- **High-rated countries: moderate but more stable employment growth rates**

Employment
(annual rate of change, per cent)



Inflation
(per cent)



Note: High-rated countries include Belgium, Germany, France, Netherlands and Austria; Countries under stress include Greece, Ireland, Italy, Spain and Portugal.

 Source: AMECO.

Euro Area Member States with very different starting positions

The two crises: financial crisis + debt crises affected differently the different Member States

The crisis revealed that the institutional framework of the euro area was not adequate to ensure macroeconomic and financial stability and to deal with the crisis

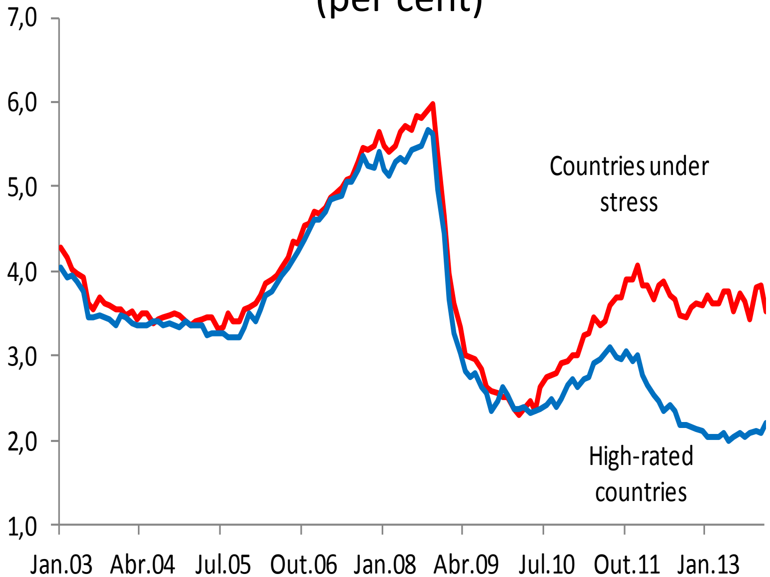
Fragmentation of the Monetary Union:

- Stop of external finance to some sovereigns;
- "renationalization" of the banking system;
- Corporations and households of Member States face very different financing costs depending on their geographical location in spite of identical risk/return.

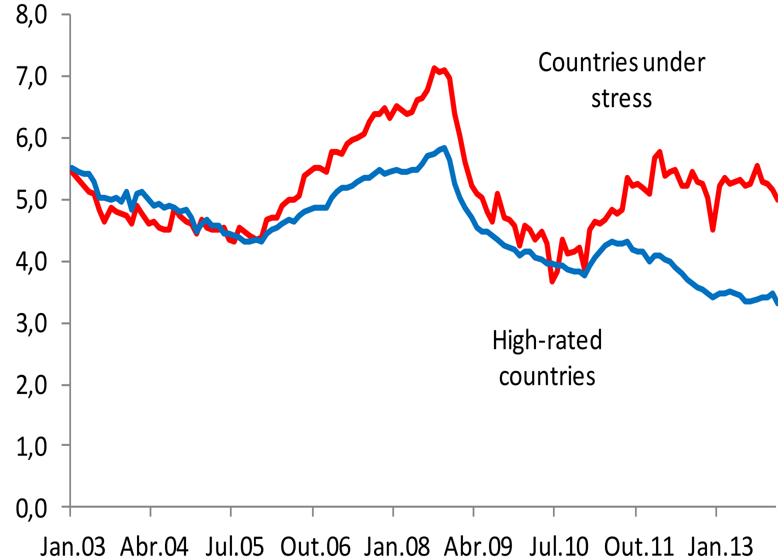
Financial Fragmentation in the context of the crisis:

- **Non- financial corporations and households in countries under stress face higher financing costs; negative implications for competitiveness of corporations of countries under stress**

Interest rates on new MFI loans to non financial corporations
(per cent)



Interest rates on MFI loans to households
(per cent)



Note: High-rated countries include Belgium, Germany, France, Netherlands, Austria and Finland; Countries under stress include Greece, Ireland, Italy, Spain, Portugal and Cyprus.

 • Source: ECB MFI interest rates statistics and Banco de Portugal calculations.

The European Response

Immediate Response

- **Eurosystem** provided significant amounts of **liquidity to banks**
- **Official finance to sovereigns** were provided in the context of Adjustment Programmes
- **Firewalls** were created: **EFSF/ESM**

Further response

- **Reinforced governance, surveillance and coordination framework:**
  - Reinforced **Stability and Growth Pact** ("Six-Pack")
  - Set up the "**European semester**" of integrated multilateral economic and budgetary surveillance
  - Introduce a new procedure for macroeconomic surveillance: **Macroeconomic Imbalance Procedure** ("Six-Pack")
  - **Enhance economic surveillance**, **coordination, integration and convergence** amongst euro area Member States ("Two-Pack")
  - **Treaty for Stability, Coordination and Governance** further strengthens budgetary discipline and economic governance among these Member States (entered into force on 1 January 2013)
- **Reinforced financial integration: creation of the Banking Union**

Lessons to take:

1. **Unsustainable economic policies will pass wrong signals that will induce:**

   - Misallocation of capital and labour

   - Default of economic agents that followed the misleading policy signals

   - Sub-optimal economic growth (stop and go)

2. **The absence of an integrated economic and fiscal policy leads to:**
   - Financial fragmentation

   - Limited ability of common monetary policy to stimulate demand and investment

3. **A successful integration process calls for greater coordination of fiscal policy, economic policy and policy in general and new steps in fiscal and economic integration**

   - Need for institutional arrangements to deal with unsustainable and inconsistent policies followed by countries that are part of the integration process

   - Need for stronger mechanisms that reinforce policy coordination taking into account the imperative of the whole over its parts and the need for a sustainable equilibrium of each part

   - Need for new steps in fiscal and economic integration and in policy democratic legitimacy

Challenges that need to be tackled ahead

Responsibility

It is not possible to reinforce the area as a whole without the acceptance by the parties of the rules resulting from the whole

Solidarity

It is not possible to guarantee the stability of the whole without policy instruments to absorb shocks that Member State are subject

Common shocks		**Common approaches** to deal with idiosyncratic effects
Idiosyncratic shocks	**Not resulting from local policies**	**Common approaches** to deal with idiosyncratic effects
Idiosyncratic shocks	**Resulting from local policies**	**Responsibility Approach** (even if solidarity is justified)

Thank you.

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