Reforms and Re-Invention are the Way Forward for Europe: No to Bailouts, No to Austerity

Keynote at the 4th Limassol Economic Forum

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NASSER SAIDI
& ASSOCIATES

Agenda

- ✓ **Europe in a Changing Global Landscape**
- ✓ **Crises: Structural Reforms not Bailouts or Austerity**
- ✓ **Which Way Forward?**

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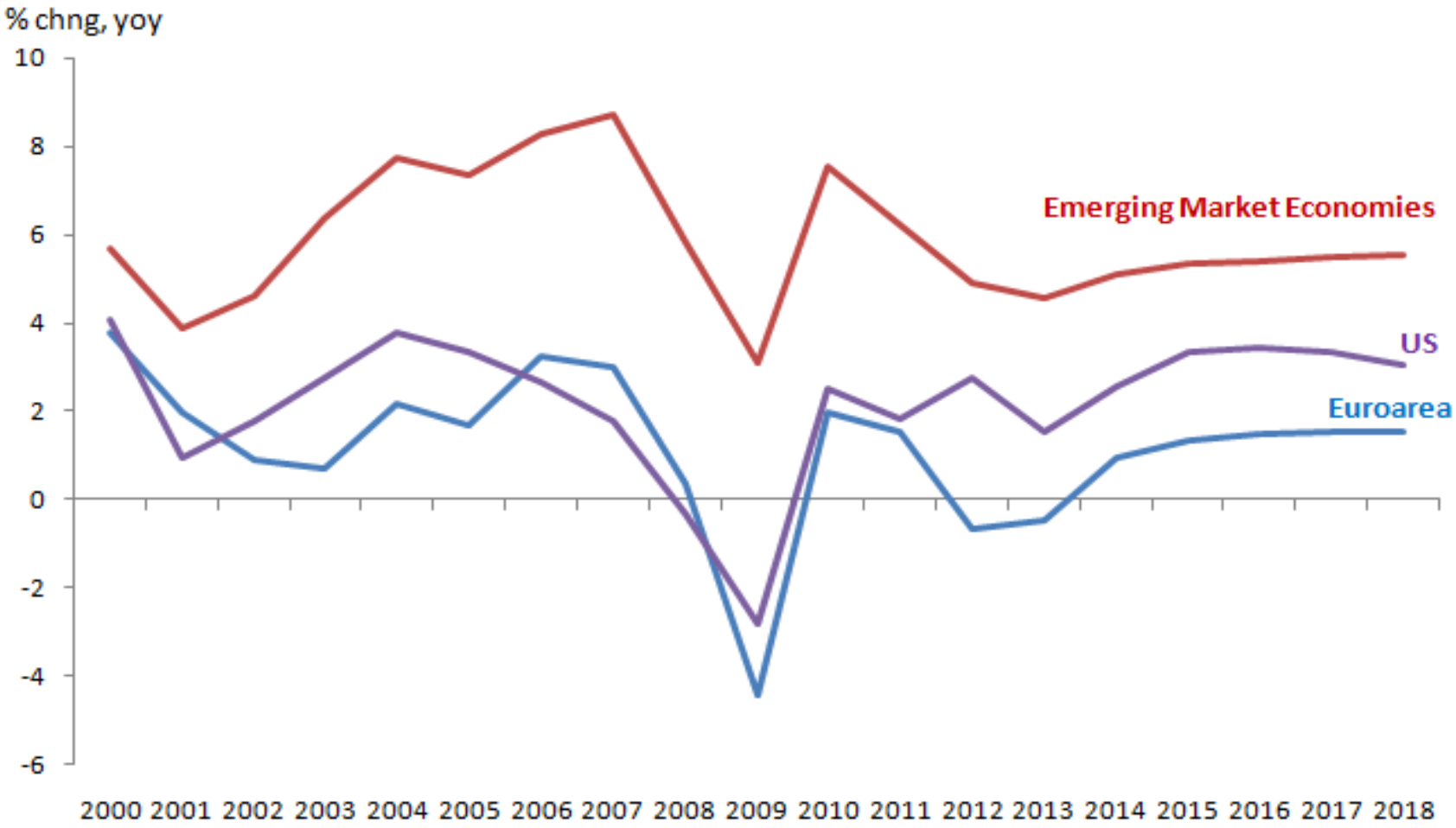
3-Speed Recovery from Great Contraction & Great Financial Crisis



Source: IMF World Economic Outlook, Oct 2013.

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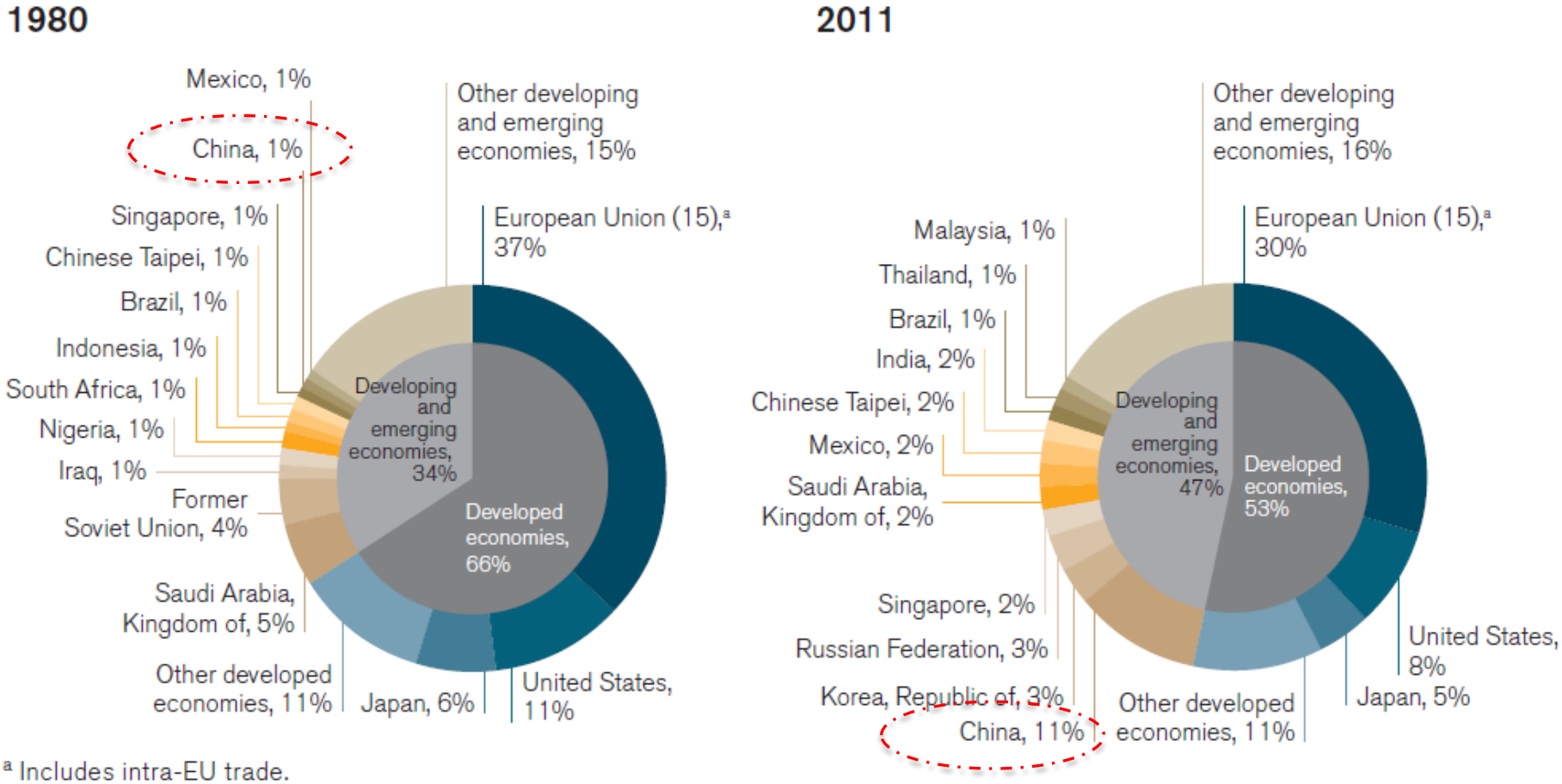
Trade: New Silk Road is emerging. Asia is EU's biggest trade partner

Shares of selected economies in world merchandise exports



[a] Includes intra-EU trade.

Source: World Trade Report, 2013

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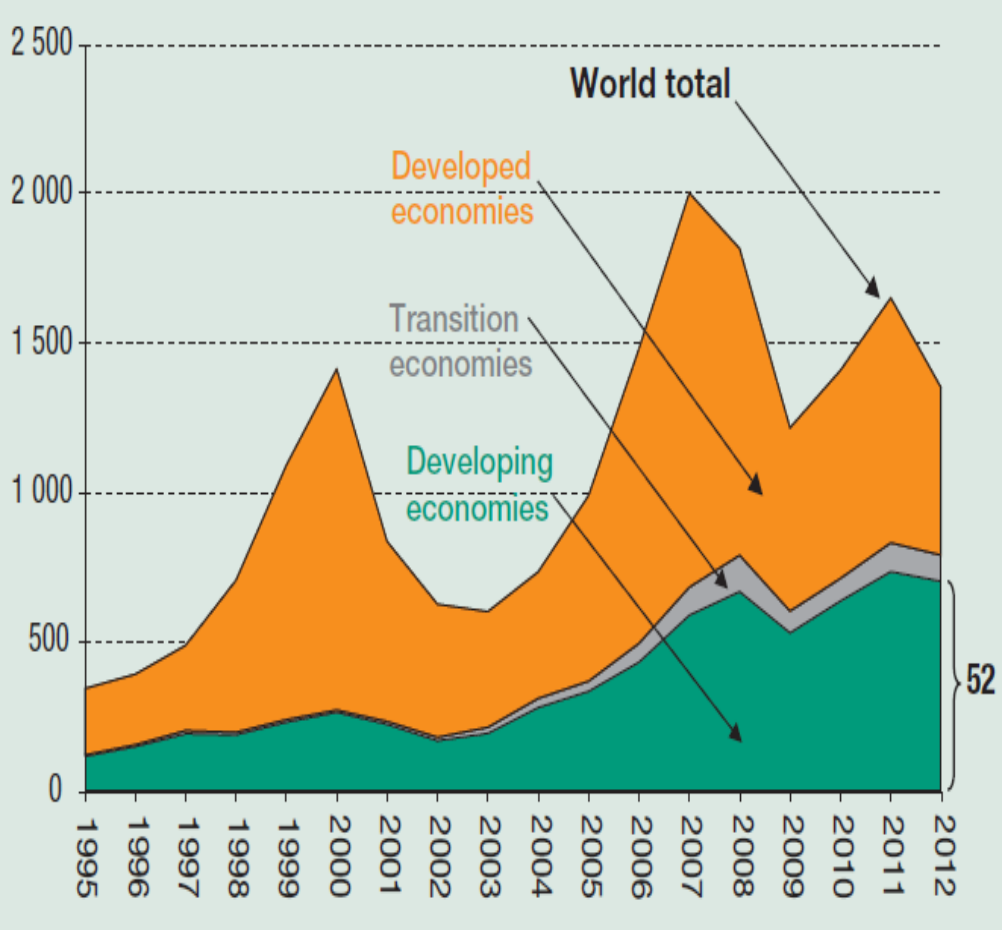
FDI Flows into EMEs Surpass Advanced & increasingly 'South-South' , 'EME-EME'

- Global FDI fell by 18% to $1.35 trillion in 2012
- Developing economies surpassed developed economies as recipients of FDI
- FDI flows to developing economies were much more resilient than flows to developed countries, recording their second highest level $703 bn or 52% of total flows
- Flows to developing Asia (30%) and Latin America (18%) remained at historically high levels.
- *China moved up from the sixth to the third largest foreign investor in 2012, after US and Japan*

Global FDI Inflows (1995-2012)



Source: World Investment Report, 2013

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Tectonic Shift in Global Economic & Financial Geography Towards EMEs

- ✓ **GDP**: EMEs account for more than 50% of World GDP; Asia 26%
- ✓ **Trade**: Emerging markets account for 47% of world trade; Asia 32%;
- ✓ **EME Capital Markets**: 25% of World Equity by 2012 from 8% in 1999;
- ✓ **New Wealth** being created in EMEs and will be deployed internationally; Of top 10 SWFs by asset size, EME nations account for 42%!
- ✓ **Investments**: 52% of FDI flows into EMEs; Asia 30%
- ✓ **Energy Markets**: OECD 40%; Non-OECD 60% (China dominant)
- ✓ **Tourism:** EME tourists & destinations increasingly dominant
- ✓ **Banking different so far**: OECD 77% of global bank assets in 2013, 85% of insurance premiums & hold over 90% of investible assets.

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EME shift also reflected in a Fiscal Divide between Advanced & Emerging Economies

- Fiscal Divide emerging due to:
  - Divergent Growth Patterns between Advanced and EMEs
  - Advanced Economy Entitlement Programmes /'Social Contract'/Welfare State concept are growing fiscal burden
  - Demographics are a major 'drag' on Europe economies & finances
- "Great Contraction" & Great Financial Crisis exacerbated the Fiscal Divide:
  - Structural
  - Cyclical losses of tax revenues & 'automatic stabilisers'
  - Bailouts & Fiscal Stimuli
- Fiscal Divide is the "Great Fiscal Crisis" for advanced economies:
    - Budget Deficits
    - Debt Levels

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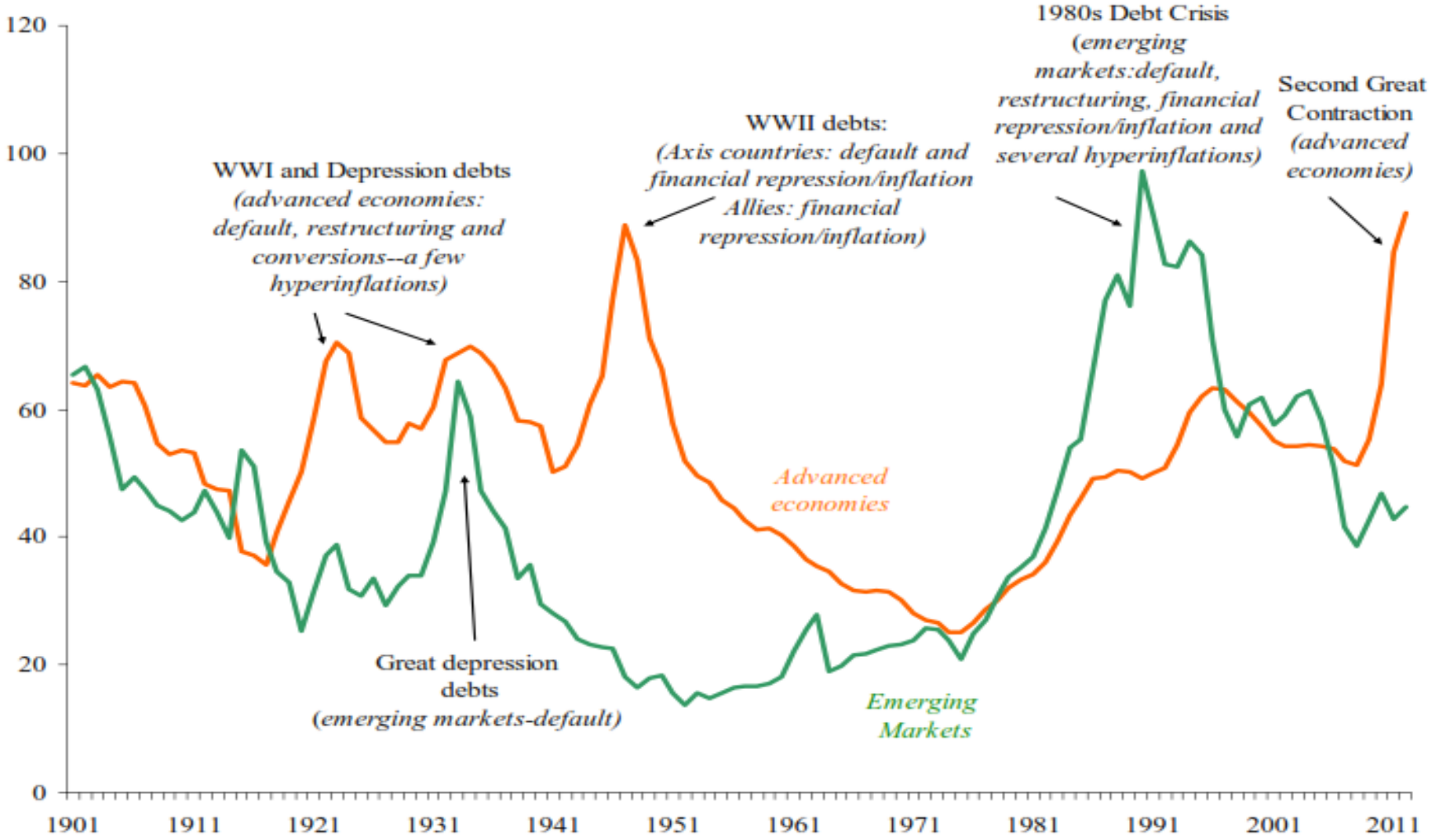
Surges in Central Government Public Debts and their Resolution: Advanced vs. Emerging-Market Economies 1900–2011 (% points)



Source: Reinhart & Sbrancia (2011)

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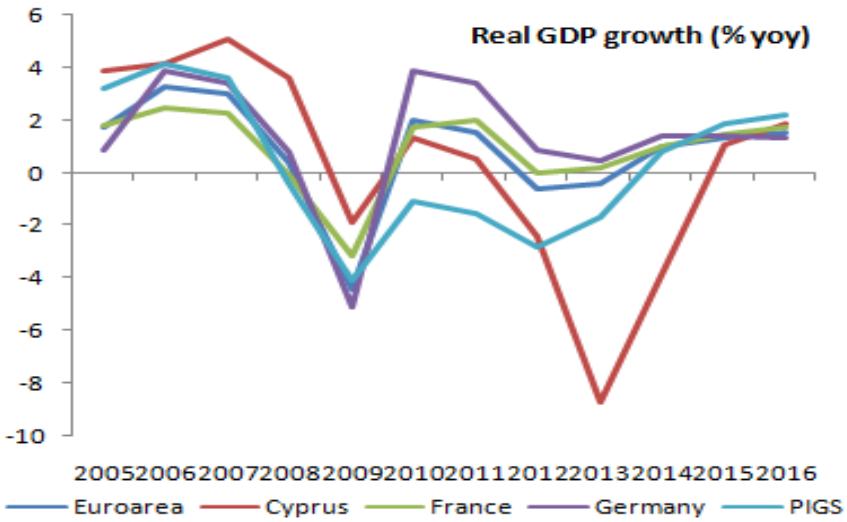
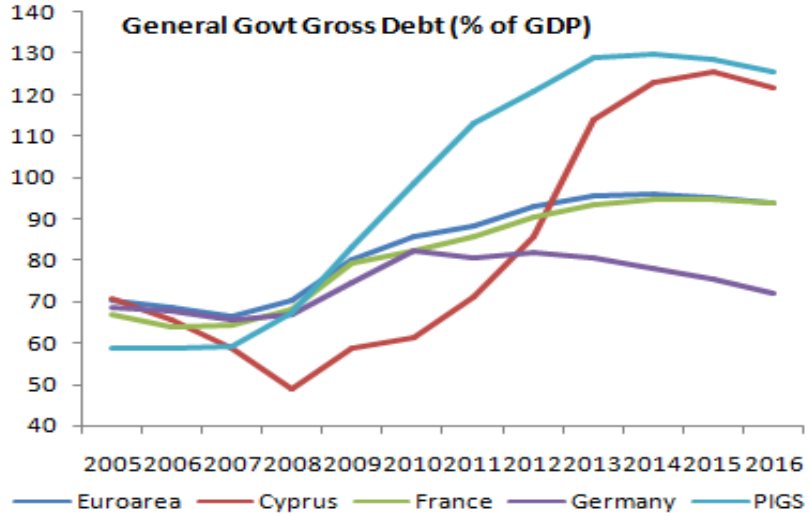
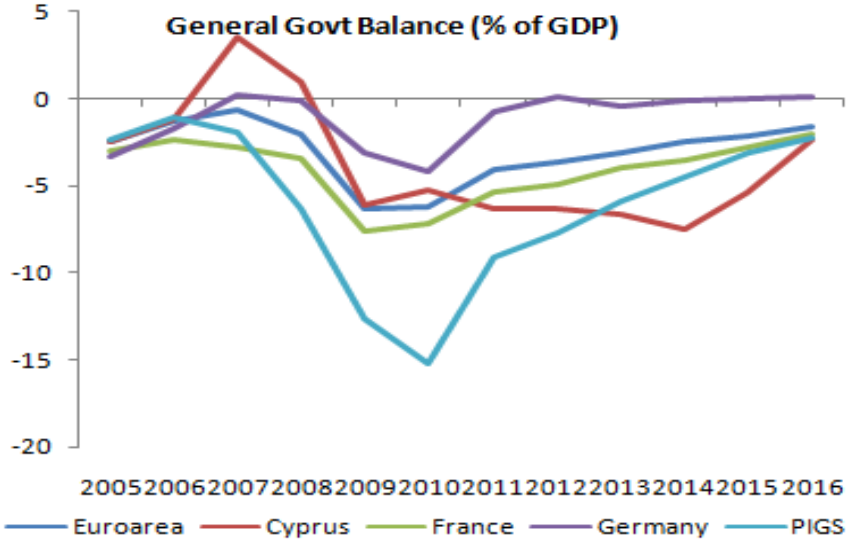
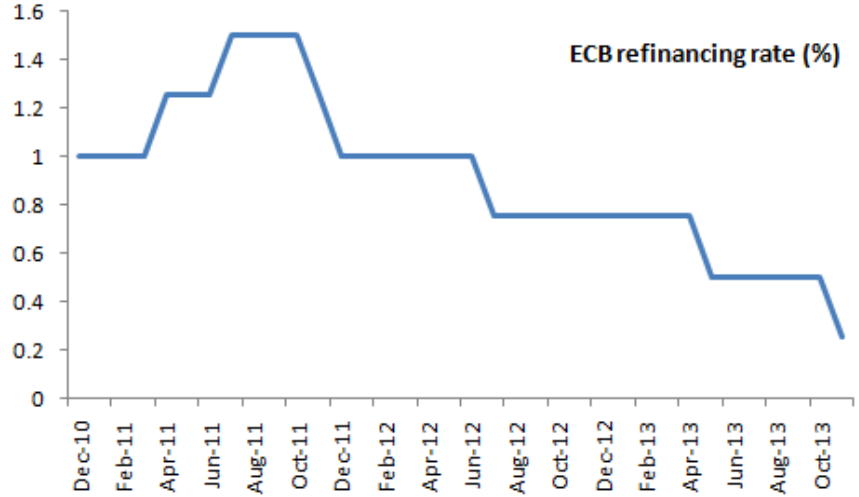
EU Economic Prospects & Performance: Anaemic Growth & Sick Public Finance









Source: IMF, ECB

Budget Deficits: Mostly Red Ink

Source: The Economist

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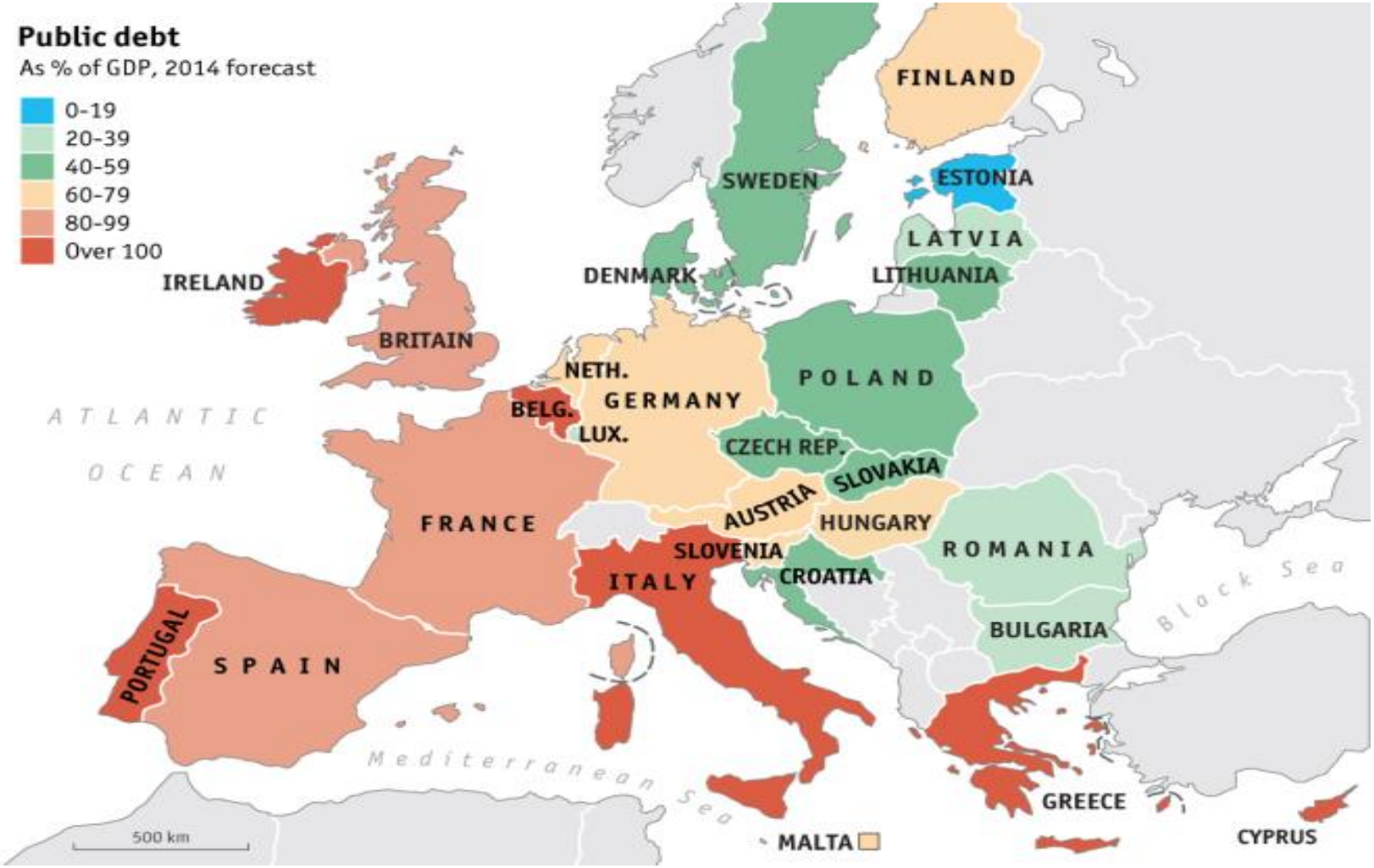
Fiscal Worries: Growing Debt Burdens



Source: The Economist

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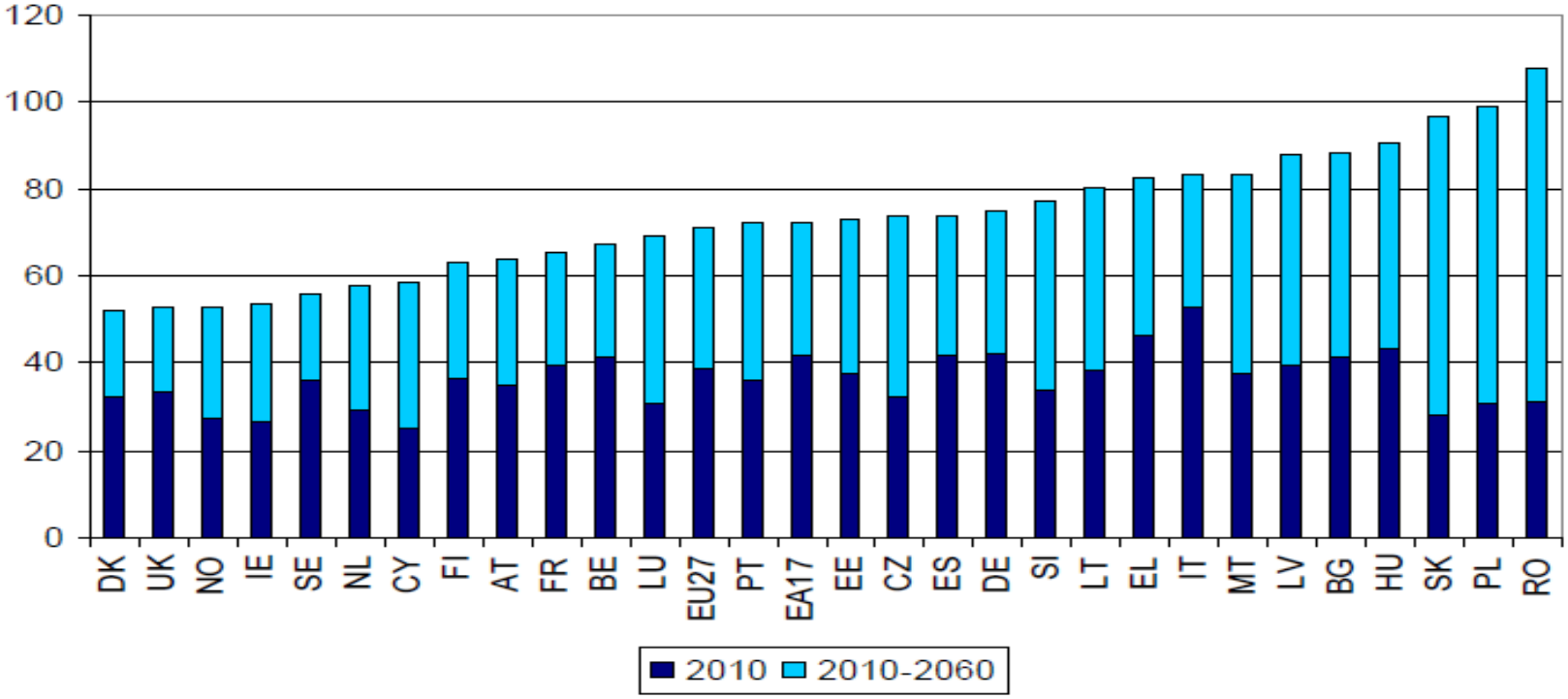
Europe's Looming Demographic Crisis & Secular Stagnation

Europe's ageing trend will: (a) Significantly increase dependency ratio; (b) Negatively affect macroeconomic performance: slower growth from declining labour supply & greater fiscal stress from entitlements & age-related government spending.

Effective economic old-age dependency ratio, EU



Source: The 2012 Aging Report, European Commission

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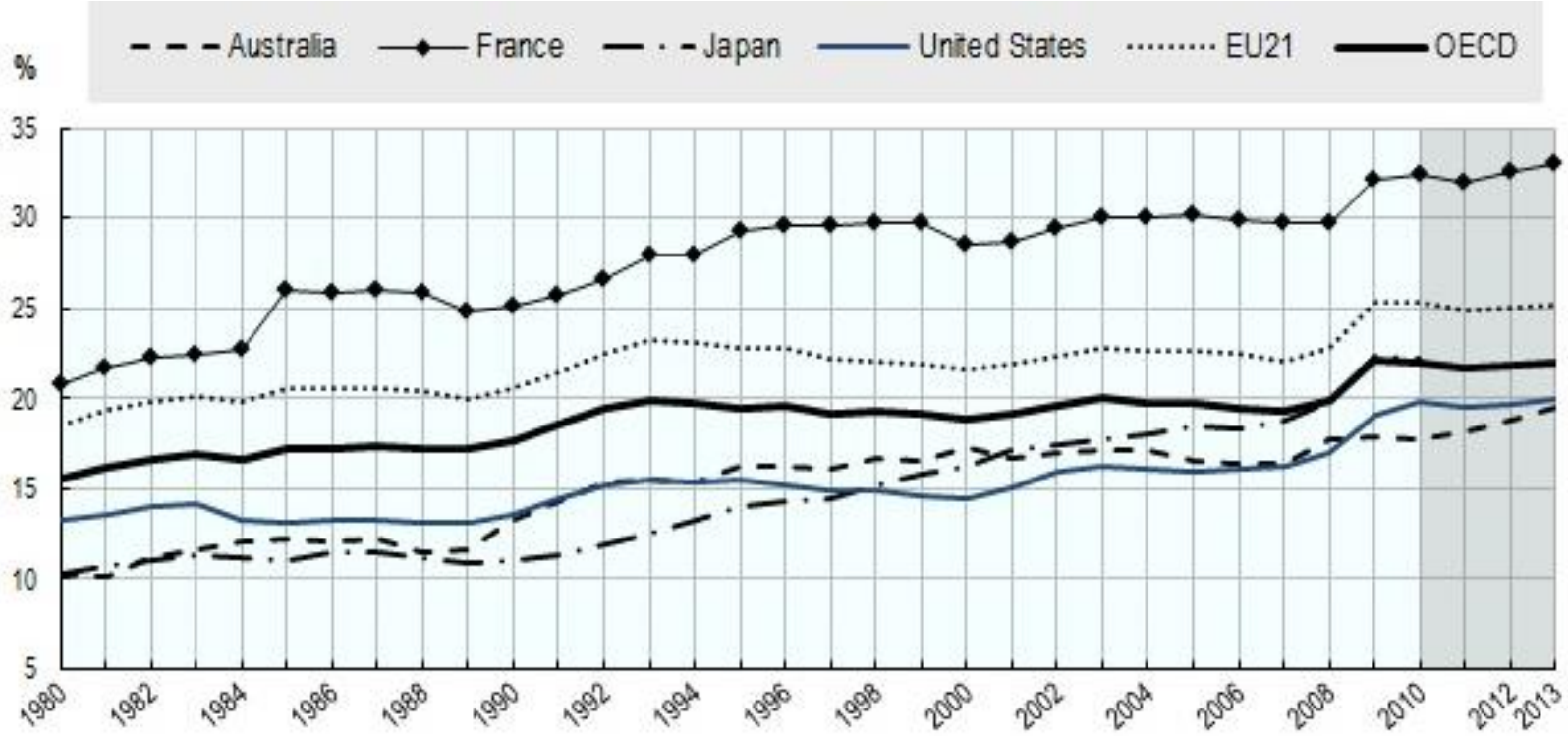
Public Social Spending: 1980-2013

- Higher unemployment + social assistance benefits => jump in public social spending-to-GDP ratios: from 19% in 2007 to a peak of 22.1% of GDP in 2009 average across OECD
- Highest public social spending-to-GDP ratio is in France (33% of GDP); the welfare state also absorbs more 30% of the economic resources in Belgium, Denmark and Finland.
- Decline in public social spending was largest in Greece, falling from 24% of GDP in 2009 to an estimated 22% in 2013.



Source: SOCX, www.oecd.org/els/social/expenditure

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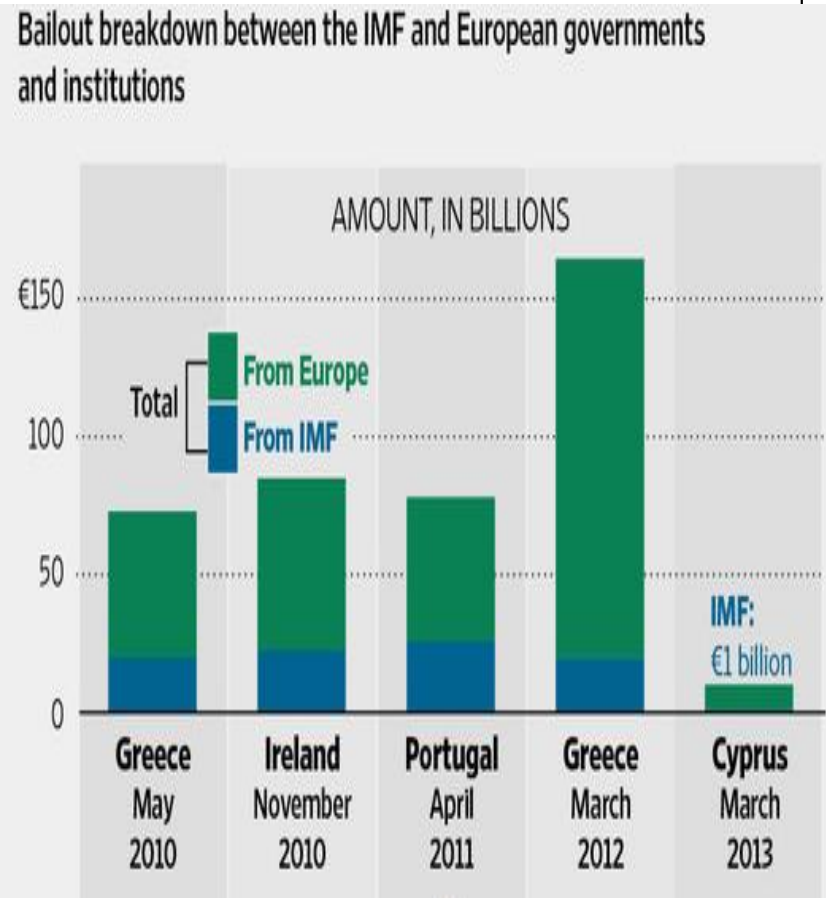
Bailouts: Across Banking Crises, Fiscal Costs, net of recoveries, associated with crisis management average 13.3% of GDP

Financial Sector Support (as % of GDP)

	Impact on gross public debt and other support	Recovery to date	Impact on gross public & other support after reco
Belgium	7.4	1.5	5.9
Cyprus	10	0	10
Germany	12.8	2	10.8
Greece	19.7	4.3	15.4
Ireland	40.5	4.4	36.1
Netherlands	14.6	10	4.6
Spain	7.3	2.9	4.4
UK	6.7	1.5	5.2
US	4.8	4.2	0.5
Average	7	3.7	3.3
$USD bn	1,729	914	815



Source: IMF Fiscal Monitor, Apr 2013, European Commission

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27 Things you may not have known about banking crises

Systemic Banking Crises: A New Database, IMF Working Paper, Nov 2008

1. In 55 per cent of cases, the banking crisis coincides with a currency crisis.
2. Bank runs feature in 62 per cent of the crises.
3. Banking crises are often preceded by credit booms, in 30 per cent of the cases.
4. Non-performing loans average about 25 per cent of loans at the onset of the crisis.
5. Macroeconomic conditions are often weak prior to a banking crisis.
6. Extensive liquidity support is used in 71 per cent of crises.
7. Peak liquidity support tends to be sizeable and averages about 28 per cent of total deposits.
8. Blanket guarantees are used in 29 per cent of crises, often introduced to restore confidence even when previous explicit deposit insurance arrangements are already in place, lasting for an average of 53 months.
9. Prolonged regulatory forbearance - where banks, for example, are allowed to overstate their equity capital in order to avoid the costs of contractions in loan supply - occurs in 67 per cent of crises.
10. In 35 per cent of cases, forbearance takes the form of banks not being intervened despite being technically insolvent, and in 73 per cent of cases prudential regulations are suspended or not fully applied. Existing literature on forbearance shows it is counterproductive, with banks taking on additional risks at the future expense of the gove11. In 86 per cent of cases, government intervention takes place in the form of bank closures, nationalizations, or assisted mergers.
12. 51 per cent of crisis episodes have experienced sales of banks to foreigners.
13. The more bank closures there are, the higher the fiscal costs.
14. A blanket guarantee, however, reduces the instances of bank closures.
15. Bank restructuring agencies are set up in 48 per cent of crises.
16. Asset management companies are set up in 60 per cent of cases to manage distressed assets.
17. In 76 per cent of episodes, banks were recapitalised by the government, mostly with cash, government bonds or subordinated debt.
18. Recapitalisation programs are usually accompanied with some conditionality.
19. To the extent that debt relief schemes are discretionary, they run the risk of moral hazard as debtors stop trying to repay in the hope of being added to the list of scheme beneficiaries.
20. Average net Recapitalisation costs to the government amounts to 6 per cent of GDP.
21. On the bright side, recapitalisations tend to be associated with lower output losses.
22. Monetary policy tends to be neutral during crisis episodes, while fiscal policy tends to be expansive.
23. Average fiscal costs, net of recoveries, associated with crisis management average 13.3 per cent of GDP.
24. The average recovery rate is just 18 per cent of gross fiscal costs.
25. Real GDP losses average 20 per cent relative to trend during the first four years of the crisis.
26. There is a negative correlation between output losses and fiscal costs: the higher the fiscal costs, the smaller the loss of output
27. Inflation and currency devaluation help reduce the budgetary burden and thus have been a feature of the resolution of many crises in the past.

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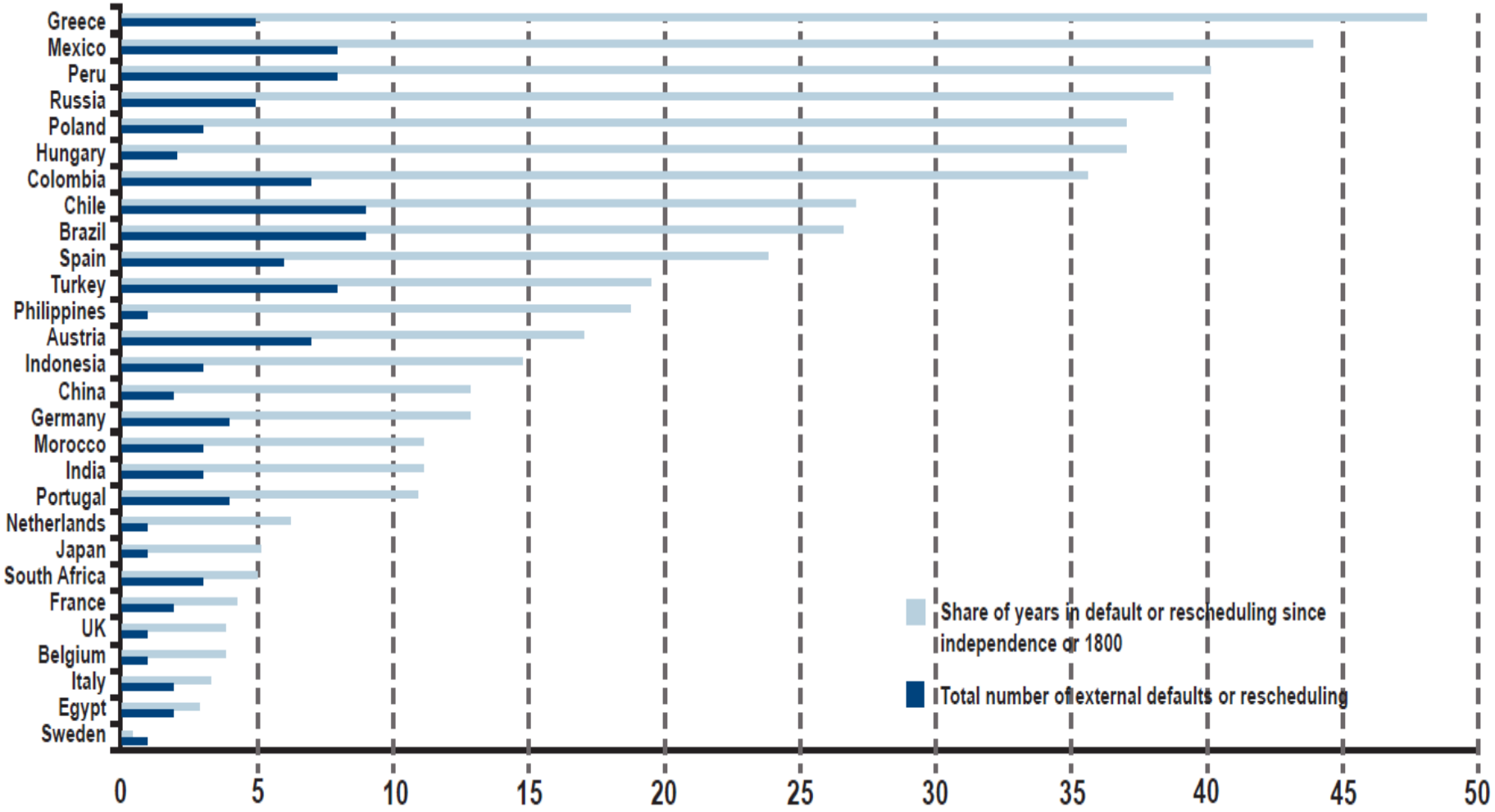
Defaults, Rescheduling & Inflation? Everyone in Europe has been at it!

	Since independence or 1800			Since 1800*		
	Share of years in a banking crisis	Share of years in default or rescheduling	Total number of defaults and reschedulings	Share of years in which inflation exceeded 20%	Share of years in which inflation exceeded 40%	Number of hyperinflation years
Austria	2	17	7	21	12	2
Belgium	7			10	7	
Denmark	7			2	1	
Finland	9			6	3	
France	12		8	6	2	
Germany	6	13	8	10	4	2
Greece	4	51	5	13	5	4
Hungary	7	37	7	16	4	2
Italy	9	3	1	11	6	
Netherlands	2	6	1	1		
Norway	16			5	2	
Poland	6	33	3	28	17	2
Portugal	2	11	6	10	4	
Spain	8	24	13	4	1	
Sweden	5			2		
United Kingdom	9			2		

Source: Reinhart and Rogoff (2009)

External Sovereign Debt Defaults & Rescheduling: 1800-2010



Source: BofA Merrill Lynch Global Equity Strategy, Reinhart & Rogoff: This Time is Different.

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Austerity and/or vs. Growth?

- Debate between ‘Austerians’ and ‘Neo-Keynesians
- Austerity has been largely ineffective in its goal of reducing debt levels or restoring growth in peripheral countries: fiscal rectitude has not generated consumer or investor confidence
- Austerity has become a political nightmare amidst rising youth unemployment and historically high income and wealth inequality.
- Shift to Right Wing populism and failure of the Centre parties is destabilising
- By slowly moving to end austerity, the Euro zone periphery will have to accept higher budget deficits.
- Europe needs to undertake structural reforms for fiscal credibility and sustainability. Austerity vs. growth Debate is sterile.

- “Countries which experienced low potential growth, because of fundamental structural problems such as literacy or low productivity growth, *accumulated an excess of public and private debt before the crisis* to try to sustain their standards of living and their welfare systems, *which turned out to be unsustainable and required a sharp adjustment* when the crisis broke out.” (my emphasis) Bini Smaghi (2013)

Bini Smaghi (2013)- “Austerity and stupidity”, voxeu, Nov 2013

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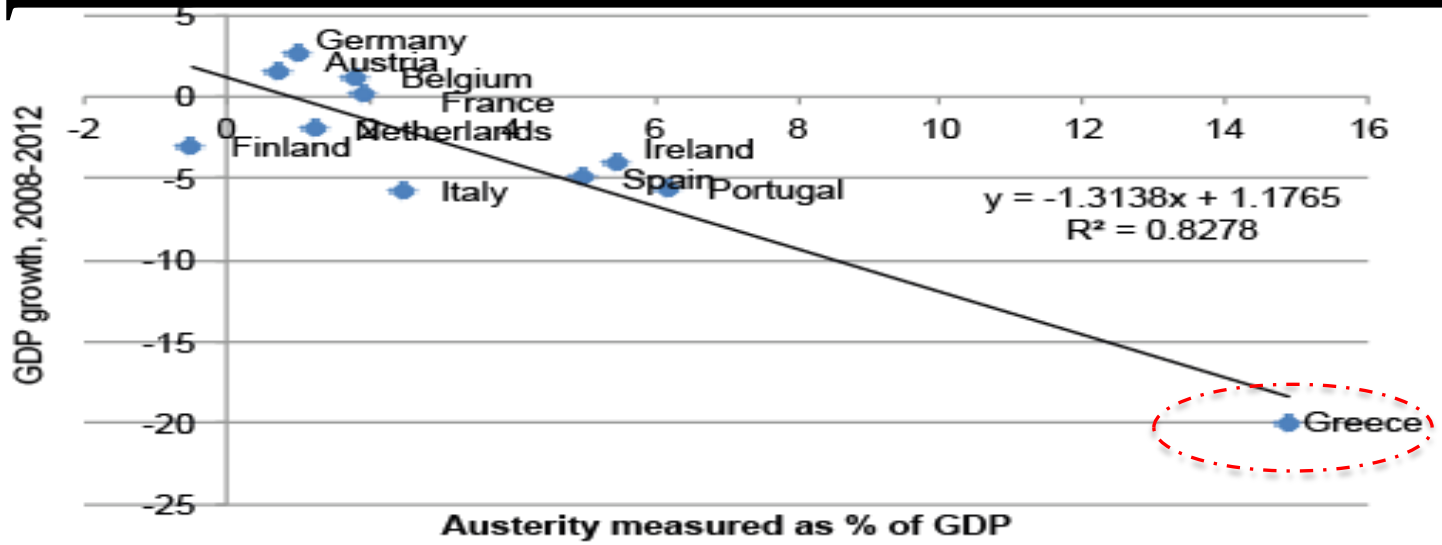
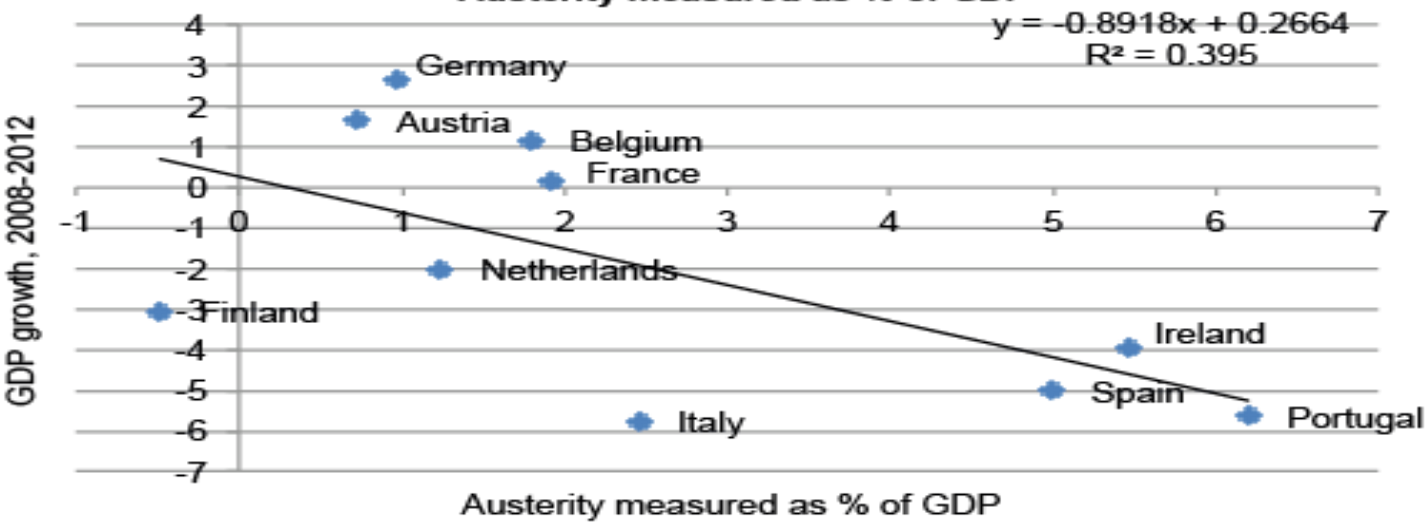
Austerity vs. Growth: a Greek Story?



Including Greece



Excluding Greece

Source: Bini Smaghi (2013)- "Austerity and stupidity", voxeu, Nov

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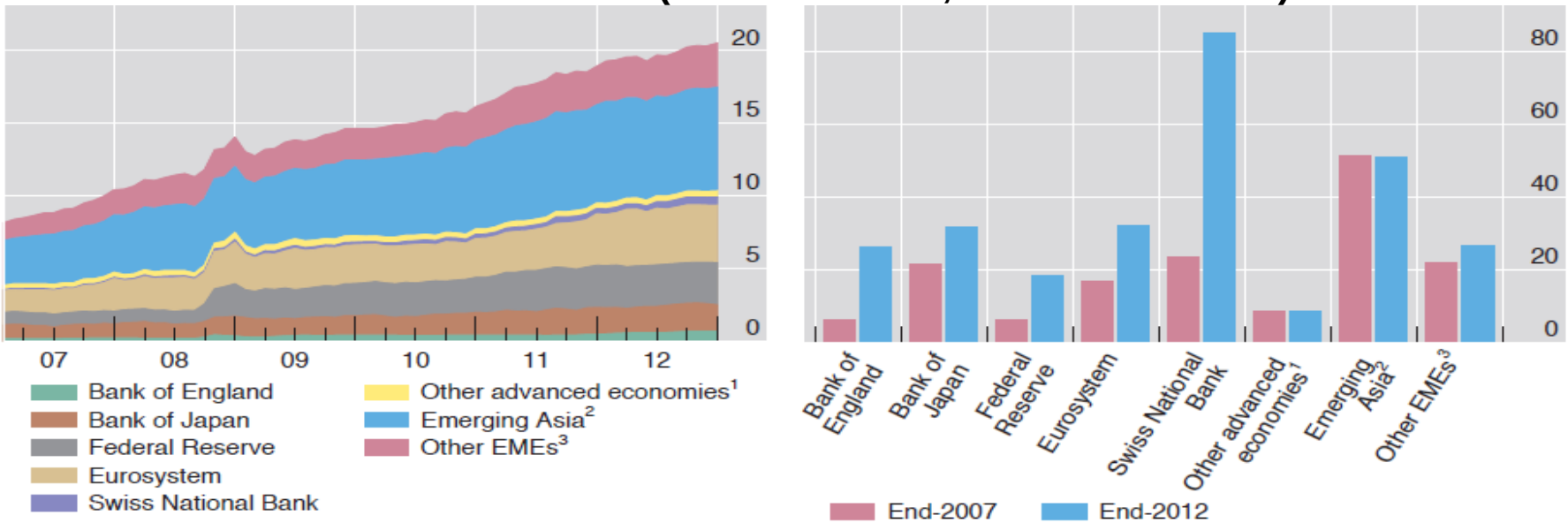
Next Crisis: Bloated CB Balance Sheets

- Unconventional money & credit policy have **not resulted in economic recovery/ job creation**, despite low interest rates; Low interest rates have **raised risk appetite & led to rising capital flows to EMEs** resulting in asset price inflation & volatility and threatening world's 2nd engine of growth;
- Credit has been encouraged at a time of exceptionally low interest rates; but interest rates will edge higher, cost of debt rises, asset/bond prices fall => *How will CBs tackle deleveraging?*

Total Central Bank Assets (LHS in USD trn; RHS as % of GDP) *Source: BIS*



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Lessons from Eurozone Crisis

Some lessons emerging from the Eurozone crisis:

1. Loose Monetary, Fiscal Policies are Not a Substitute for Structural Reforms
2. Confluence of global structural shift and ‘Great Contraction” & GFC
3. Small economies with large financial centres and inadequate supervision & regulation are highly vulnerable to external shocks and to banks becoming hedge funds (Ireland, Iceland, Cyprus, Greece). Banking & tax policies need to ensure that the banking and financial system does not become big in relation to the size of the economy and limit cross-border exposure.
4. Taxing “insured deposits” or nationalising pension funds is a recipe for financial disaster and bank runs. Reneging on pledges destroys confidence.
5. TBTF & TITF and badly resolved banking sector crises can threaten long-term economic prospects. An effective Eurozone Banking Union requires Supranational Supervision and Single Bank Resolution mechanism.

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Pre-Crisis Europe benefited from exceptional, non-repeating growth drivers

1. Creation of EU Single Market
2. Merger and integration of Central & Eastern Europe: cheap labour, new investment opportunities, growing internal market
3. Great Moderation: Real growth, low global inflation & less volatile economic environment encouraging investment
4. 3rd Industrial Revolution: computers, internet, mobile telecommunication from 1960 to present raised productivity growth & facilitated shift to services economy
5. Globalisation: outsourcing to EMEs/China - led to lower production costs, cheaper products, improvement in living standards & drove down inflation

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Europe: Headwinds & Challenges

1. Tectonic shift in global economy –output, trade, wealth creation, investment- towards EMEs/Asia & China
2. ‘Demographic dividend’ in reverse motion: lower population growth, ageing population, declining labour supply, rising dependency ratios
3. Demographics & existing Social Contracts imply Unsustainable Fiscal paths
4. Plateau in educational attainment
5. Rising Inequality: Growth in *median* real income has been substantially slower than growth rates of *average* per-capita income
6. Interaction between globalisation and ICT
7. Energy and the Environment
8. Twin Household & Government Deficits
9. Past drivers of economic growth exhausted: need new growth & development paradigm
10. Political divisions and lack of vision and leadership

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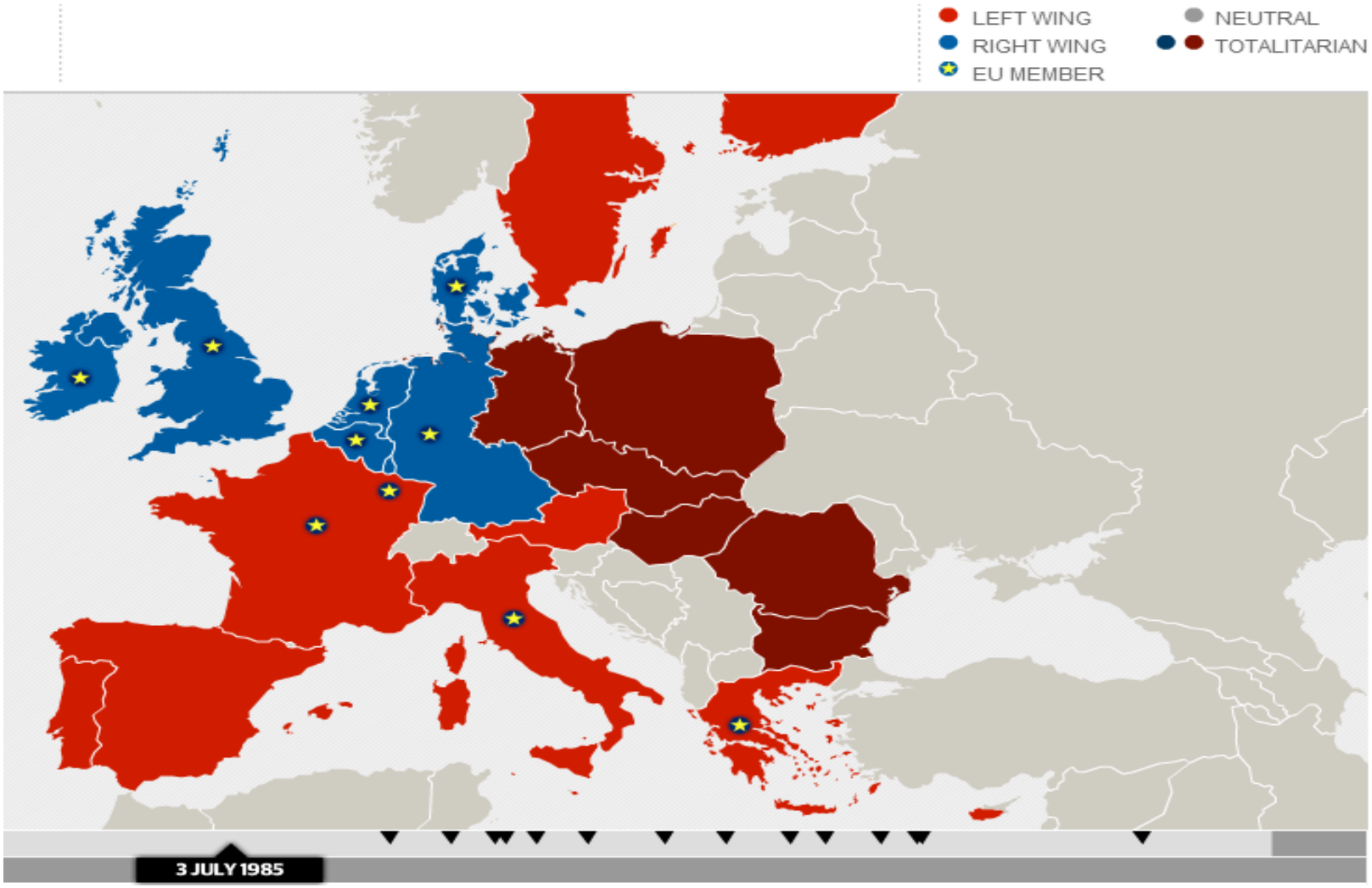
Politics Snapshot, July 1985: varied landscape



Source: The Guardian

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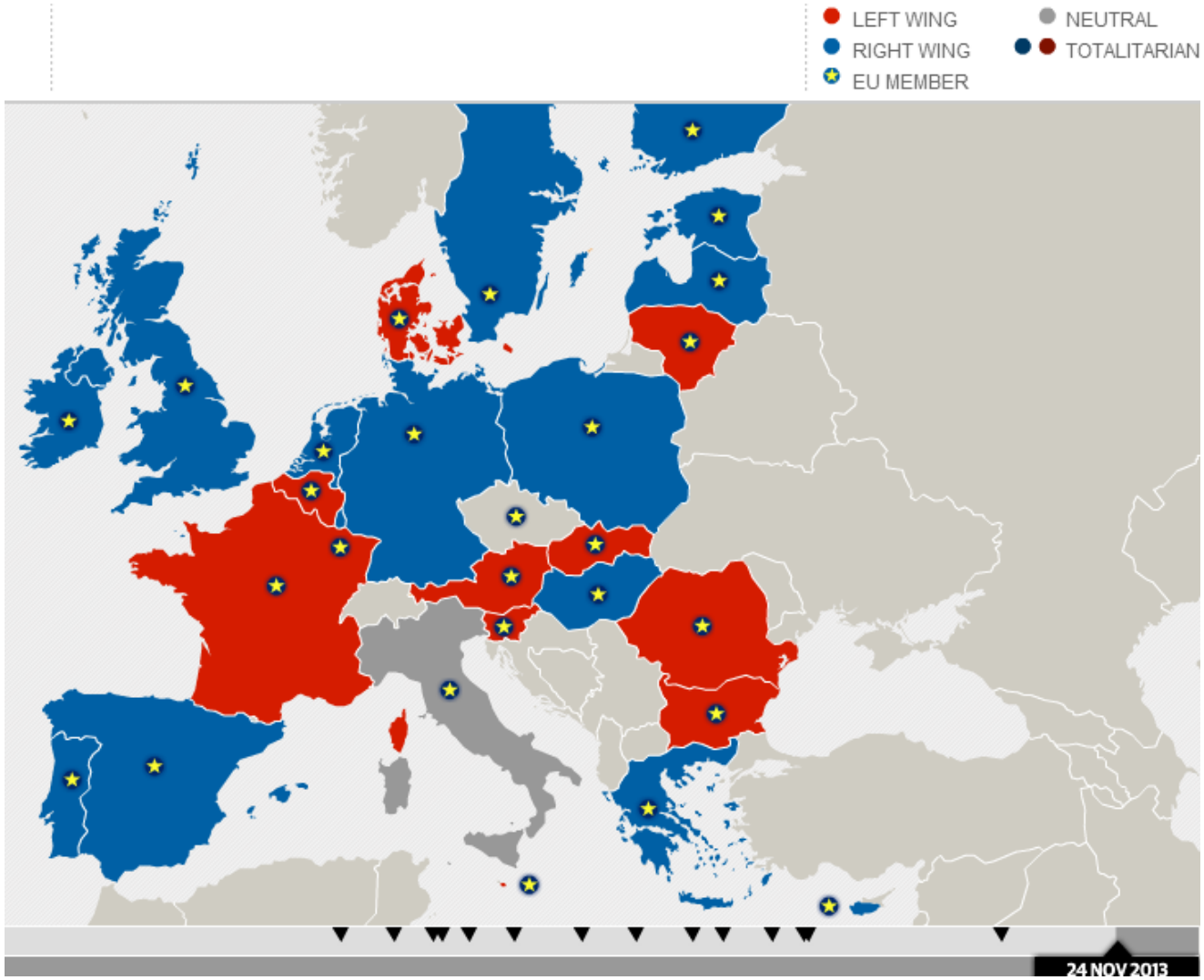
Politics Snapshot, Nov 2013: Revival of Right Wing Populism? Failure of Centre?



Source: The Guardian

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New Development Model I: Structural Internal Reforms

(A) Labour Markets

- ✓ Foster job creation through flexible labour market conditions
- ✓ Remove barriers to Labour Mobility within EU
- ✓ Reform, Liberalise & Target Immigration policies
- ✓ Focus on investments generating productivity growth

(B) New Social Contracts: revise entitlement programmes & age to retirement

(C) Common Agricultural Policy: inefficient & preventing innovation & growth

(D) Monetary/Banking Union

- ✓ A fuller banking union would solidify efforts on banks' balance sheets & reverse fragmentation; Clear rules on the role of bail-ins will reduce uncertainty for private investors
- ✓ Effective Single Supervisory Mechanism is essential for systemic supervision; but needs a strong Single Resolution Mechanism

(E) Single Eurobond Market required to achieve breadth, depth & liquidity

(F) Fiscal/ Federal Fiscal Union

- ✓ Budgetary frameworks;
- ✓ Implementation and enforcement.

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New Development Model II: Focus on EMEs

- ✓ Rediscover Asia & Africa by contrast to Trans-Atlantic FTA
- ✓ Europe should integrate into the emerging 'New Silk Road' supply chain
- ✓ Europe should partner with China & facilitate Yuan as 3rd global currency and emergence of 'Redback market'; Learn Mandarin
  - ✓ Expand mandate & role of EIB, EBRD to Africa, ME, EMEs
  - ✓ Free Trade & Investment Agreements with GCC, ASEAN, India, China
  - ✓ Help set-up an Arab Reconstruction & Development Bank with GCC, IsDB, AfDB, IFIs. Infrastructure expenditures for region exceed $2 tn.

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Thank you

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