

# Achievements and challenges of the euro in the financial crisis - a perspective from Brussels

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## Overview

1. The impact of the crisis in the euro area
2. Policy responses
3. Conclusions

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## Main messages

1. The crisis is global and is hitting the euro area hard
2. It would have been worse without the euro
3. The euro area/EU are decisively addressing short- and longer-term challenges from the crisis
4. The euro brings important benefits but is a demanding policy framework and is no solution to all problems

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## Some key dates

- October 2008 European Council - Bank rescue packages
- December 2008 – European Council - European Economic Recovery Plan
- 4 March 2009 – COM communication – '*Driving European Recovery*'
- 13-14 March 2009 – G-20 finance
- 19-20 March 2009 – European Council
- 2 April 2009 – G-20 Summit
- May 2009 – Employment Summit
- June 2009 - European Council

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## 1. The impact of the crisis in the euro area

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## A snapshot of the root causes of the financial crisis

### 1. Exceptional macroeconomic conditions

- Excess savings in surplus countries ; Low risk perception and ample liquidity

### 2. Reliance on efficiency and rationality of markets:

- Financial innovation gone astray ; Poor risk management; Flawed incentive structure (credit ratings; executive pay)

### 3. Regulatory/supervisory weaknesses

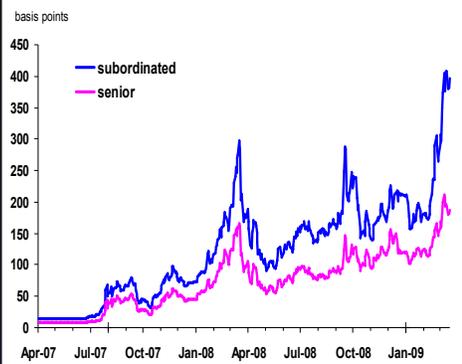
- Not taking into account macro dimension; Pro-cyclicality; Reliance on banks' own risk assessment: Liquidity risk not adequately covered

### 4. Weak international governance

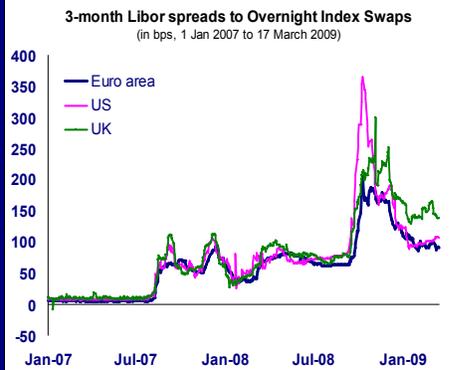
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## Loss of confidence in financials causes a dry-up of liquidity in financial market

Surge in default risk of financials (Itraxx index)



Money market standstill



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## The cost of financing for companies increases sharply (and household wealth falls)



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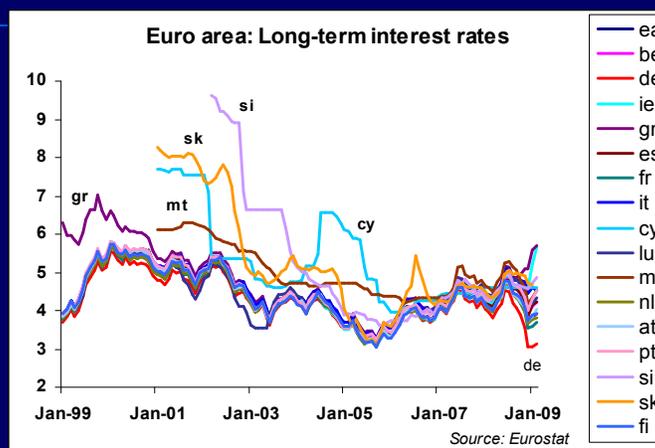
## Sovereign borrowers also affected

### Market widening of intra-euro area sovereign spreads

- Risk aversion: financial markets discriminate more between sovereign borrowers in terms of credit and liquidity risk
- Recession and bank rescue plans → Downgrade of many sovereign borrowers by rating agencies, including in the euro area
- Additional factors in current circumstances:
  - Increase in the supply of bonds in 2009
  - Supply of (quasi-) sovereign bonds increased with government guarantees to financial institutions

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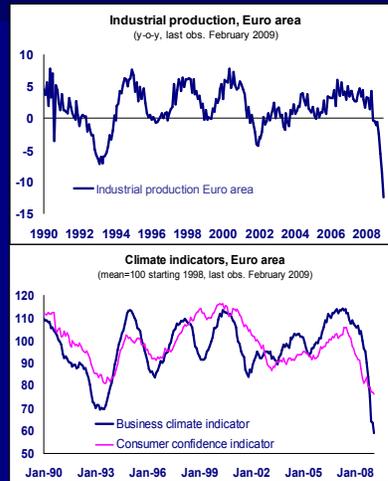
## Increasing intra-euro area sovereign spreads



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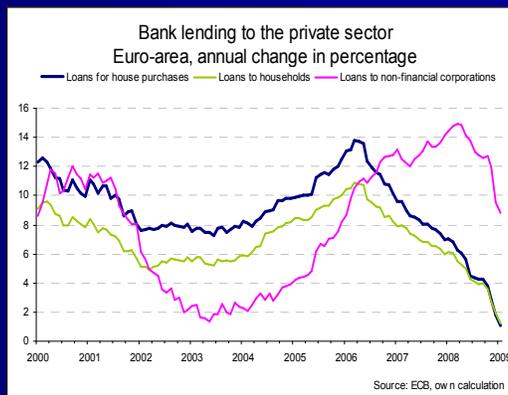
## Rapid and strong spillover from financial sector to real economy (1)

1. Strong deterioration of main economic indicators (output/IP; confidence; unemployment; trade; investment...)
2. Rapidly falling inflation
3. Downward adjustment of growth forecasts by all public and private institutions
4. High uncertainty



## Adverse feed-back loop via shortage of credit for households and companies

- Sharp deceleration in lending
- Due to demand and supply factor (eg shortage of bank capital)
- Ensuring flow of bank lending is key to recovery
- Key also to political acceptability of bank support
- Lower policy rates are being passed through to bank lending rates



## 2. EU policy response

- Principles
- Short-term
- Medium-term challenges

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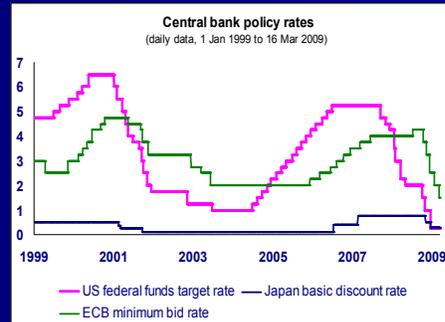
## EU policy response - Principles

- Short term: preserve financial stability and support demand and employment
- Medium-term: strengthen macro-financial stability at the EU and global level
- Guiding principles:
  - Single Market
  - Budgetary discipline and long-term sustainability of public finances
  - Open trade
  - Low-carbon economy

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## Monetary Policy – unlimited liquidity to banks and interest rate cuts

1. Policy rate cuts
2. Expanding central bank balance sheets  
(Temporarily) unlimited liquidity provision
  - Extension of average lending maturity
  - Widening of eligible collateral
  - Foreign currency swap lines
3. Coordination between central banks



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## Coordinated government support to the financial sector

1. Guarantee schemes
2. Capital injections
3. Impaired assets
4. Nationalisations

Key to have measures that are consistent with Single Market:

- ⇒ European Council (October 2008): coordinated EU response
- ⇒ Guidelines on rescue packages of October 2008
- ⇒ Guidance on the treatment of impaired assets of 25 February
- ⇒ Continuous monitoring system in place via Ecofin Council

Financial meltdown has been avoided

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## National and EU support to demand

1. European Economic Recovery Plan (EERP)
  - Coordinated response
  - Short-term fiscal boost with long-term perspective ("smart" investments and structural measures)
  - Country-specificity and respect of fiscal sustainability
  - Combines national fiscal stimulus and EU funds (eg EIB funds, structural funds)
2. Positive interim assessment (Communication 4 March 2009):
  - Fiscal support (discretionary measures and automatic stabilisers) amounts to around 3.3% of GDP in 2009-2010
  - 500 national measures reviewed are broadly in line with the principles of the EERP

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## Financial assistance to non-euro area Member States (1)

- Deterioration of economic and financial situation since mid-2008
- Slowdown after several years of high growth (in some cases to the point of overheating), accompanied in some cases by serious financial stress and a reduction in capital inflows
- Largely different country situations; role of common (e.g. external financing conditions, external demand) vs. country-specific factors (e.g. accumulated imbalances and vulnerabilities)

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## Financial assistance to non-euro area Member States (2)

- Local banks face problems of liquidity for (external funding, stability of deposits) and solvency (credit losses in the downturn, asset valuation, currency mismatches)
- Euro area banks highly exposed to NMS; concern about contagion and 'financial protectionism'
- EU financial assistance provided to Hungary, Latvia (and being discussed with Romania) by EU/IMF/WB, bilateral donors
- Long-term prospects and fundamentals remain strong

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## EU policy response : Addressing medium-term challenges:

- Strengthening macro-financial stability
- Reversing fiscal and monetary expansion
- Intra-euro area divergences
- Successful euro enlargement

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## Strengthening macro-financial stability (1)

1. Bank support measures contribute to restore confidence in (while uncertainty about "bad assets" remains)
2. 'de Larosière' high-level group on financial supervision points out lack of sufficient coordination between national supervisors and makes proposals on
  - Macro-prudential supervision: European Systemic Risk Council, chaired by the ECB
  - Micro-prudential supervision: European System of Financial Supervision→ Commission will present a European financial supervision package in May 2009 aiming at having the new bodies in place in 2010

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## Strengthening macro-financial stability (2)

3. Steps taken on deposit guarantees, credit rating agencies, capital requirements, derivatives
4. Proposals on hedge funds, private equity, executive remuneration by April 2009
5. Agreement to double the ceiling of the EC facility for financial assistance to non-euro area Member States and increase IMF resources (March 2009 European Council)
6. United EU position on global actions for better international governance (G-20)

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## Successful euro enlargement

1. Euro area is open to all EU Member States that fulfil the criteria. 4 out of 12 New Member States have already joined the euro
2. Crisis has led to calls for accelerated euro accession procedure
3. Criteria to join remain unchanged (confirmed by 1 March informal EU Summit)
  - Benefits are not unconditional and newcomers have to be in a position to compensate the permanent loss of independent monetary policy and the exchange rate
  - Convergence criteria are based on a sound economic rationale, to prepare a country for euro membership

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## 3. Conclusions

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## Conclusions (1): What role for the euro in the crisis

1. Economic situation remains extremely fragile
2. The euro has offered resilience against the crisis:
  - Absence of exchange-rate turbulence
  - Swift ECB actions (no need to coordinate 16 NCBs)
  - Availability of central bank liquidity in an international currency
  - Impulse to EU coordination
  - Member States entered crisis with sounder fiscal positions thanks also to EMU policy framework
3. But the euro cannot by itself solve imbalances at the national level (such as credit-driven housing bubbles) or solvency problems in the banking sector

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## Conclusions (2): Ensuring a well functioning euro area

1. Attraction of the euro has increased in many countries (DK, PL, IS...) ...
2. ... at the same time as concerns on its long-term viability have re-emerged in some quarters
3. The euro is here to stay and might come out of the crisis with even stronger foundations
4. The euro area's worth derives from the quality of its components:
  - The benefits from euro membership are conditional on countries' ability to adhere to common rules and to support the common policies
  - The convergence assessment framework remains a key element of the EMU construction to guarantee a degree of homogeneity and readiness

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## **Thank you for your attention**

Further information can be found on:

[http://ec.europa.eu/economy\\_finance/focuson/focuson13254\\_en.htm](http://ec.europa.eu/economy_finance/focuson/focuson13254_en.htm)