Stylised facts and interpretations of the Eurozone sovereign debt crisis – the financing of the economy

Lunch presentation at the European Investment Bank

Luxembourg, 17 June 2015

Lorenzo Codogno

Visiting Professor at LSE, European Institute

+44 758 3564410

L.Codogno@lse.ac.uk

THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

The four legs of the crisis

- **The first leg of the crisis, i.e. contagion and GDP collapse:** Sharp drop in export and investment activity, markets turmoil. In mid-2009, a tentative V-shape recovery led by a rebound in global trade and significant growth in emerging markets.
- **The second leg, i.e. Greece + banking/debt crisis in Europe**: Increase in public debt, widening in government bond spreads, interbank market closure, frantic policy reaction.
- **The third leg, i.e. Italy:** Too big to fail, too big to be saved. A more gradual and difficult recovery. Eventually, accommodative monetary policy + softer fiscal policy, but also debt overhang and fallouts of the balance sheet recession.
- **The fourth leg:** Greece again and the unknown.

Many crisis at once

- **Exogenous shock:** The trigger was the subprime crisis in the US, hitting through trade and financial markets contagion.
- **Macroeconomic imbalances:** Typical emerging market crisis, just within the Eurozone, leading to 'stand-alone' solutions.
- **Banking crisis**: Dis-integration and fragmentation in financial markets; re-nationalisation of the banking industry.
- **Debt crisis:** Existing weaknesses coming to the fore.
- **A monetary/fiscal policy response failure:** Political/legal constraints, mistakes and delays, lack of interpretation model.
- **A governance/roadmap failure:** Simply not fit for the purpose.

Above all a crisis of governance

- **Revised fiscal framework (Fiscal Compact)**: Probably with the wrong timing due to the effects on aggregate demand in 2011-2013. Not enough policy coordination.
- **Europe 2020:** In need of deep revisions and inspiration. Attempt to find “common principles”. What do you do if a EZ member state does not want the reforms? (MIP?)
- **Macroeconomic imbalance procedure**: positive, a way to enforce reform implementation through the back door? Not enough attempt to coordinate policies. “Stand alone” solutions.
- **Emergency support mechanisms:** positive, although limited.
- **Banking union:** surveillance, a bit of resolution, what else?
- **Fiscal/Political Union:** totally missing.

What's next?

- **Macroeconomic imbalances:** Adjustment under way. Can we have coordination of policies at central level? What institution? How about political legitimacy (Greece)?

- **Debt deleveraging has not yet started.** What's the best way to achieve sustainability? Economic growth and simple rules based on public spending aggregates, but the debate has not yet started.

- **Europe 2020:** Mid-term review will likely disappoint. Mobility of labour (not feasible?) and Single Market initiatives not fully exploited: it would be an easy way to re-launch growth.

- **Capital market union:** positive, very long implementation.

- **Moving from rules to institutions:** What will the next move be, if any? Towards a fiscal/political union?

Is the Eurozone fit for the purpose?

- **What is the purpose?** Many different goals in the European capitals. Need for a clarification on the purpose.
- **Once the purpose is clarified, would it be feasible to agree on a roadmap?** A roadmap would help directing expectations of economic agents and policymakers. The Four Presidents Report quickly was put aside: can it be re-launched?
- **The model based on an enlightened elite no longer works.** Do we have a new working model (intergovernmental/ federalist)? Is Europe politically prepared for fiscal/political union? Schumpeterian political leadership?

How can the EU improve the financing of the economy?

- **The immediate concern for the financing of the economy:** Dealing with private debt overhang and the build up of non-performing loans. Possible policy initiatives.

- **The role of Juncker's Plan.** Can a public institution activate private money for investment? How effective is it likely to be?

- **Unintended consequences of a much tougher regulatory framework/QE etc.:** Reduced liquidity in financial markets risk producing problems for the financing of the economy. Need for countercyclical buffers.

The channels through which the ECB’s QE (or expanded APP) works

- **The expectation channel:** business and consumer confidence have increased recently.
- **The asset channel/portfolio rebalancing:** sharp rises in stock markets, spread compression, increase in risk appetite.
- **The traditional credit channel:** yoy credit growth still struggling in Southern Europe, and especially in Italy.
- **The exchange rate channel** (not explicit): the trade-weighted exchange rate of the euro has already weakened significantly.

ECB claiming victory, but also acknowledging heterogeneity

- “ECB’s monetary policy measures are helping to restore the **proper functioning of the monetary policy transmission”**.
- “Favourable developments in financial markets have led to lower bank funding costs, which have gradually been passed on to the **cost of external finance for the private sector**”.
- “The ECB’s monetary policy measures appear to have also promoted a narrowing of the cross country dispersion of borrowing costs, especially for NFCs, **although credit conditions remain heterogeneous across countries**”.

Economic Bulletin No.2, March 19

Is there a tradeoff between bank regulation and credit growth?

- "Banks have improved their capital ratios partly through higher equity issuance, but also through **deleveraging and tighter lending conditions** (stricter credit standard, higher spreads on loans)".

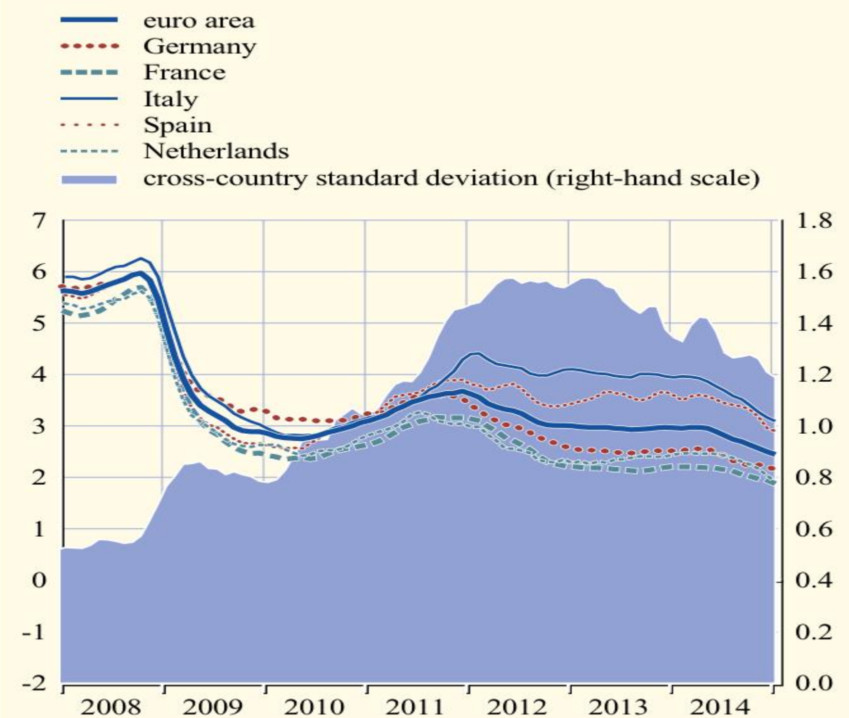
- "This emphasis on balance sheet adjustments and the market recent progress in bank capital ratio have helped **set the conditions for a sustained improvement in the bank lending channel of monetary policy**".

Economic Bulletin No.2, March 19

Cost of borrowing: slowly declining

Chart 35 Composite indicator of the cost of borrowing for NFCs

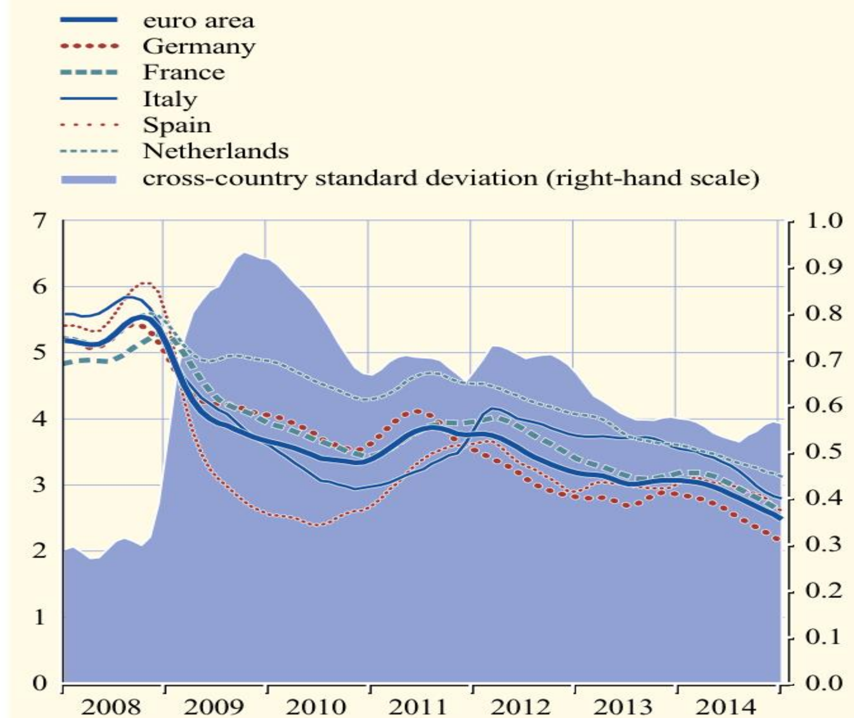
(percentages per annum; three-month moving averages)



Sources: ECB.
Notes: The indicator for the total cost of bank borrowing is calculated by aggregating short and long-term rates using a 24-month moving average of new business volumes. The cross-country standard deviation is calculated over a fixed sample of 12 euro area countries.

Chart 36 Composite indicator of the cost of borrowing for households for house purchase

(percentages per annum; three-month moving averages)



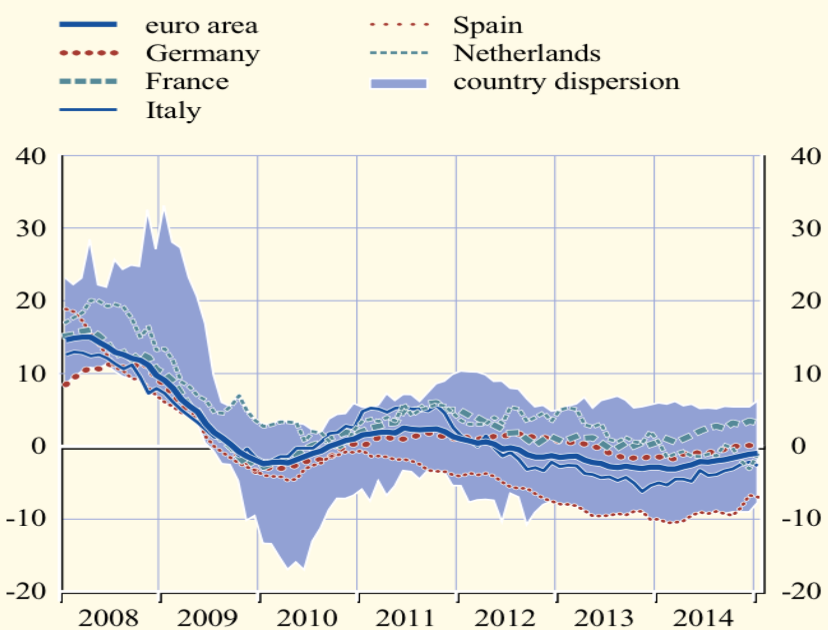
Sources: ECB.
Notes: The indicator for the total cost of bank borrowing is calculated by aggregating short and long-term rates using a 24-month moving average of new business volumes. The cross-country standard deviation is calculated over a fixed sample of 12 euro area countries.

Source: European Central Bank, Economic Bulletin No.2, March 19, 2015

Slow turnaround in loan dynamics

Chart 32 MFI loans to NFCs in selected euro area countries

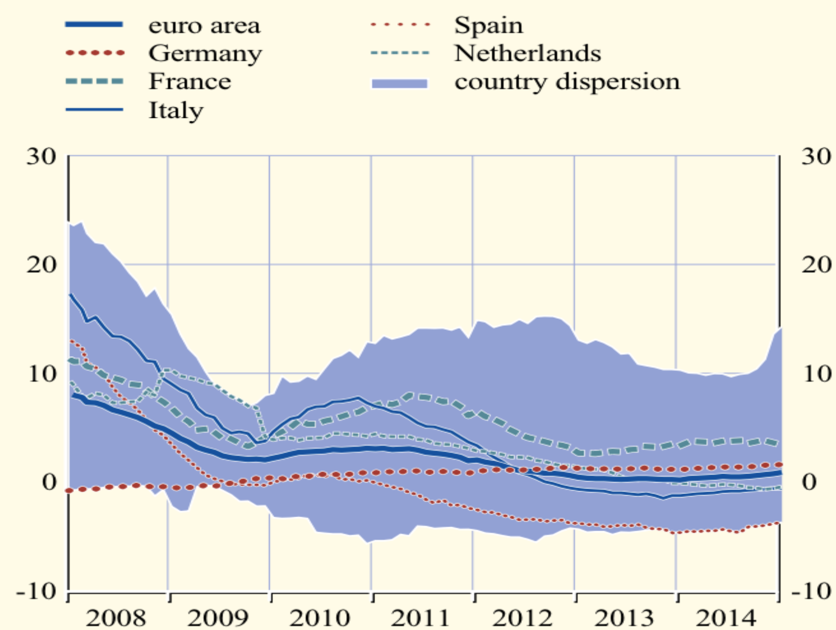
(annual percentage changes)



Source: ECB.
Notes: Adjusted for loan sales and securitisation. The country dispersion is calculated as a minimum/maximum over a fixed sample of 12 euro area countries. Flows adjusted for loan sales and securitisation as of January 2009.

Chart 33 MFI loans to households in selected euro area countries

(annual percentage changes)



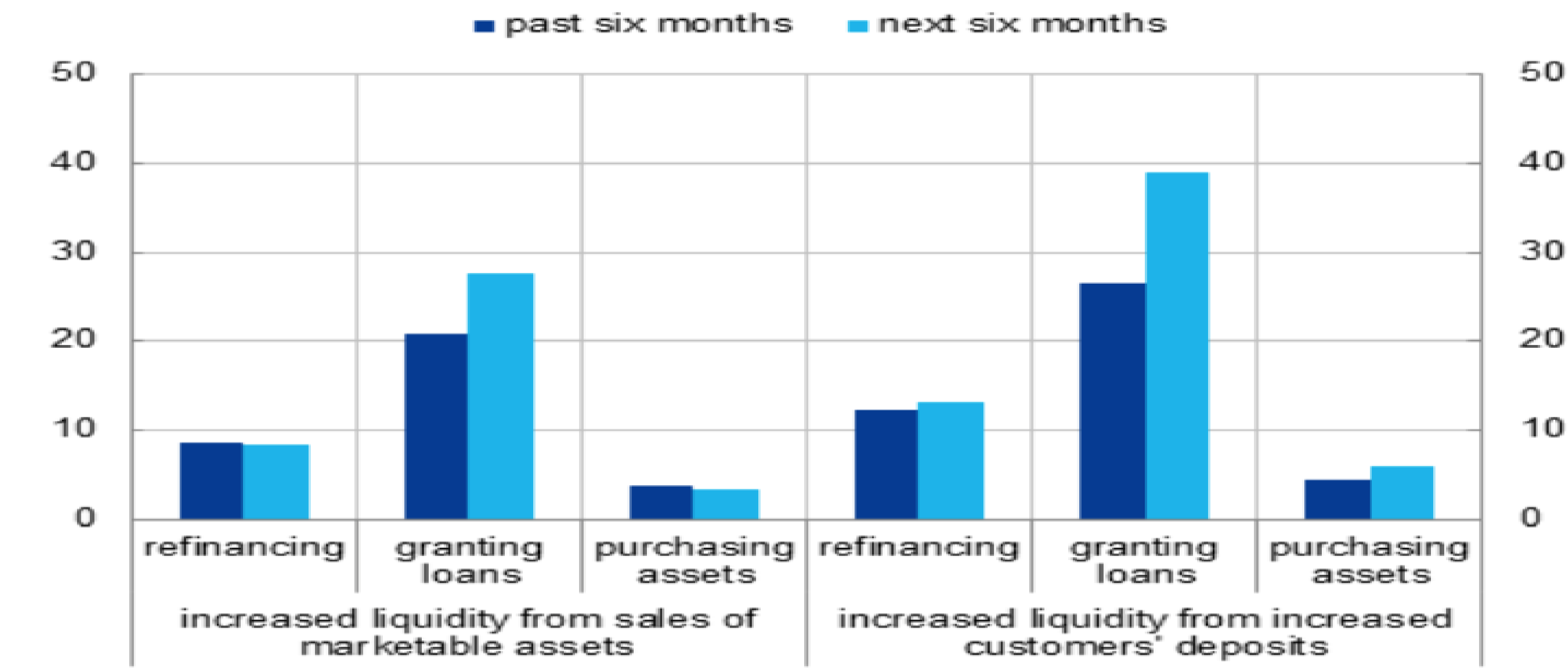
Notes: Adjusted for loan sales and securitisation. The country dispersion is calculated as a minimum/maximum over a fixed sample of 12 euro area countries. Flows adjusted for loan sales and securitisation as of January 2009.

Source: European Central Bank, Economic Bulletin No.2, March 19, 2015

Are banks eager to lend?

Purposes for which euro area banks use the additional liquidity from the expanded APP – overview

(average percentage of respondents per category)

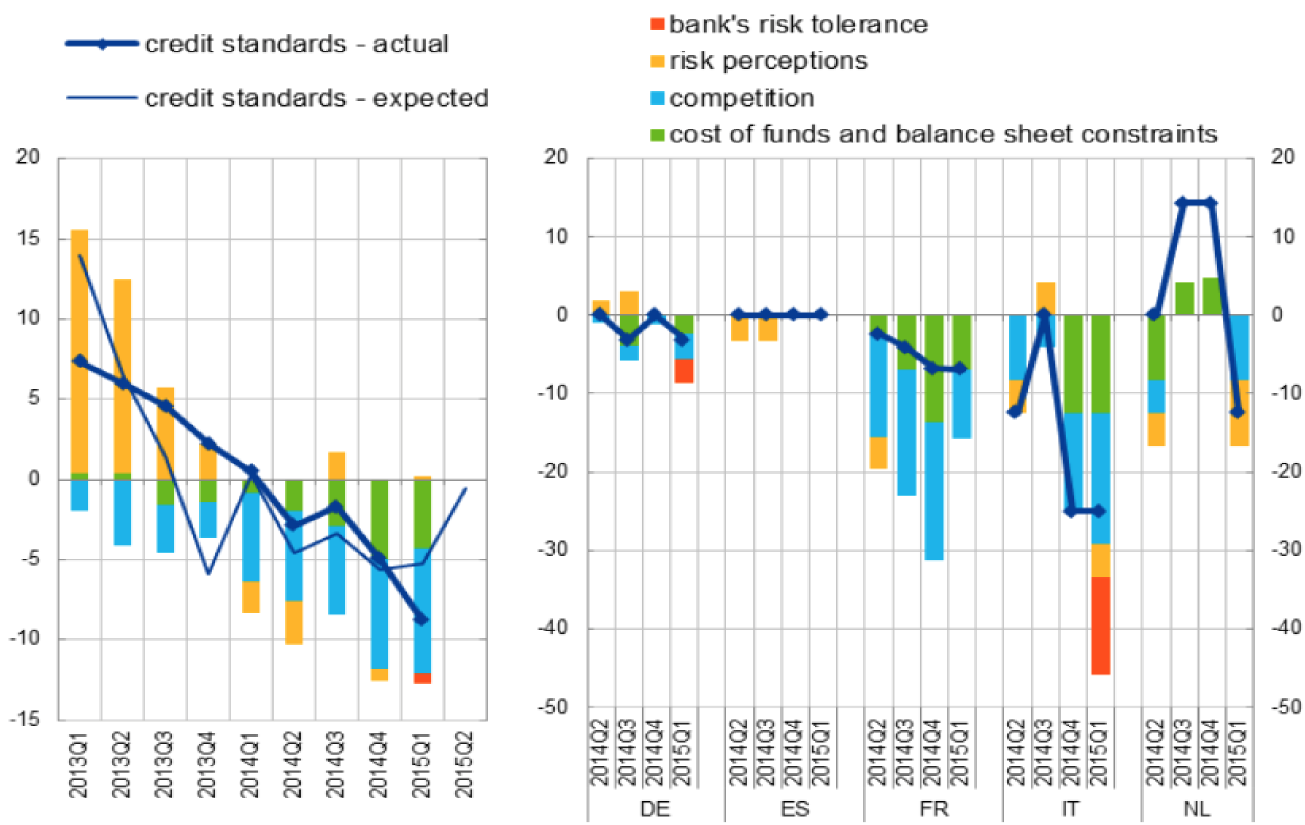


Source: European Central Bank, Bank Lending Survey, April 14, 2015

Receding credit supply tensions

Changes in credit standards applied to the approval of loans or credit lines to enterprises and contributing factors

(net percentages of banks reporting tightening credit standards and contributing factors)

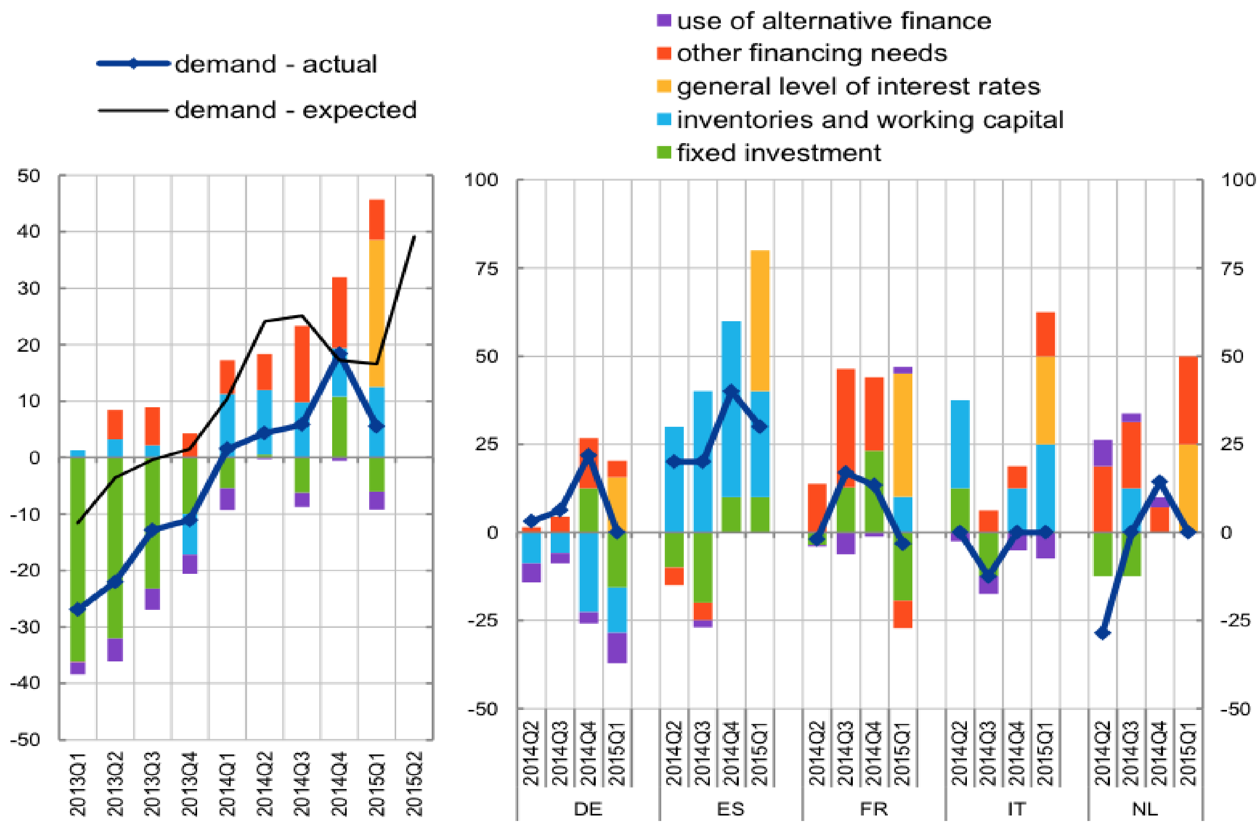


Source: European Central Bank, Bank Lending Survey, April 14, 2015

Demand gradually improving as well

Changes in demand for loans or credit lines to enterprises and contributing factors

(net percentages of banks reporting positive demand and contributing factors)



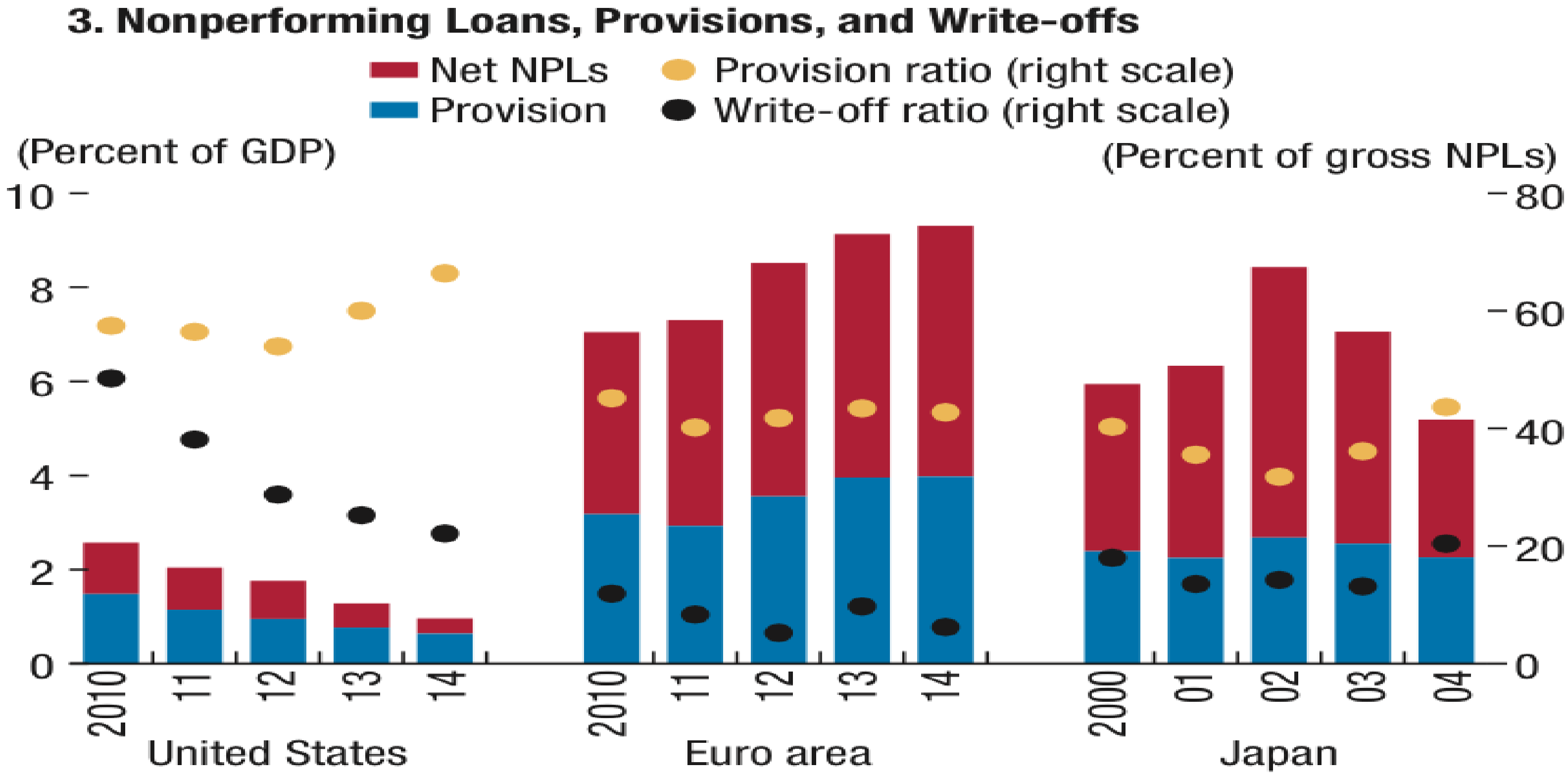
Source: European Central Bank, Bank Lending Survey, April 14, 2015

Can the current regulatory framework limit the recovery?

- According to the IMF, “median bank lending capacity [in the Eurozone] could be **limited to 1-3% on average a year**, though some individual institutions may be able to increase lending by more”.
- Thus the issue becomes: what country-specific/Eurozone policies are needed to **maximise the effectiveness of QE**?

IMF, Financial Stability Report, Spring 2015

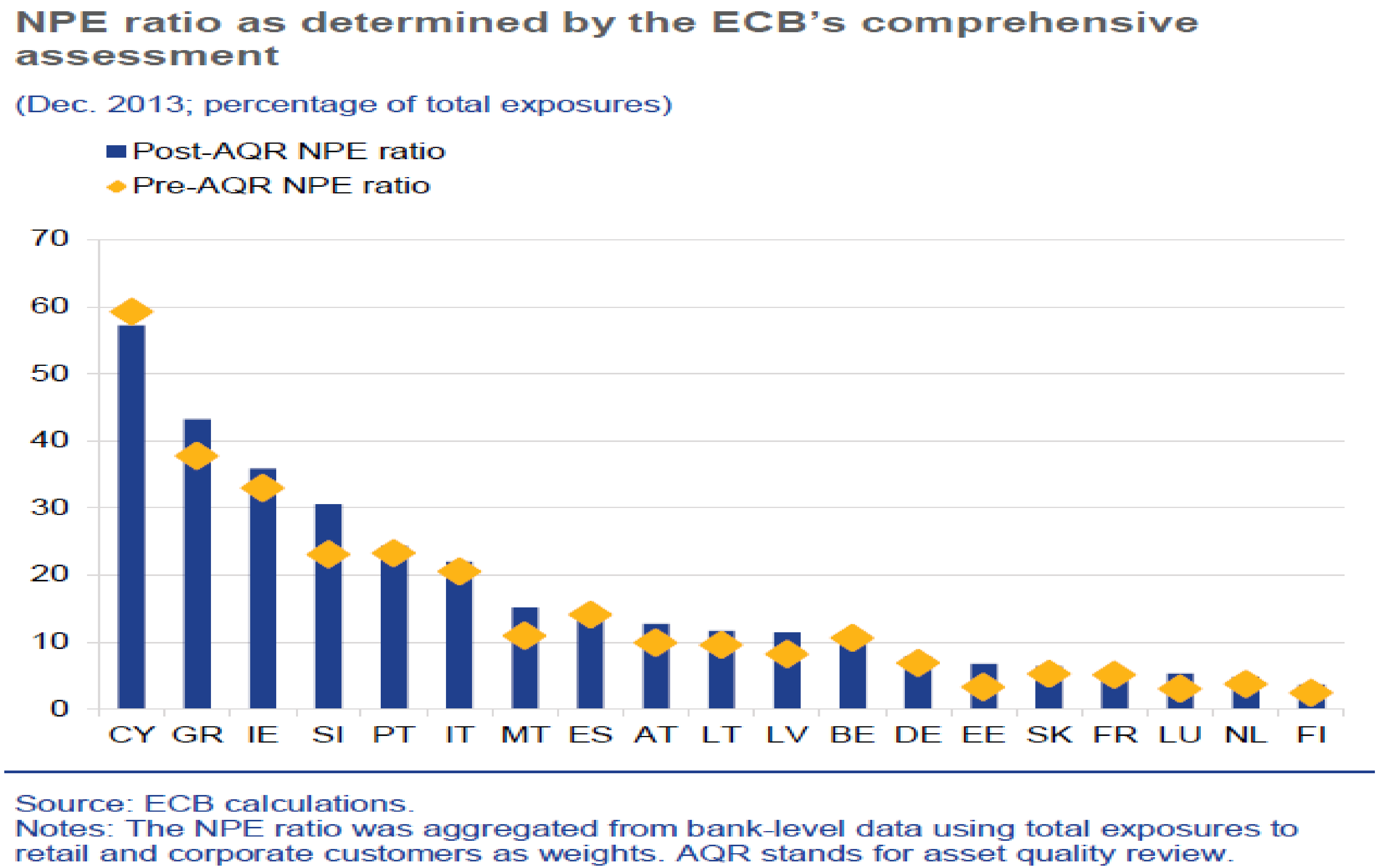
IMF: median bank lending capacity could be limited to 1-3% on average a year



Sources: European Central Bank; Financial Services Agency; and IMF staff calculations.
Note: NPL = nonperforming loan; net NPL = gross NPL plus provisions; provision ratio = provisions as a percentage of gross NPL; write-off ratio = write-offs as a percentage of gross NPL.

Source: IMF, Global Financial Stability Report, April 2015

The challenge of NPLs for the Euro area



Source: ECB, Financial Stability Review, May 2015

Why are NPL a major issue for credit growth?

- NLPs **absorb plenty of capital**, which if released can support fresh lending. **Market** for NPLs/distressed assets almost non-existent in most countries and in the overall Eurozone.
- Limited **incentives** to write off loans and limited involvement of **outside investors** in many countries. Slow pace of write-offs is an important factor in the build up of the stock of NPLs.
- In some countries: inefficient and lengthy **judicial process**. **Debt collection** and **collateral foreclosure** is a huge burden for banks requiring human and operational resources (plus legal and administrative costs).
- Banks stuck in a **bad equilibrium** of oversized balance sheets, low profitability, lack of resources to support new lending and new initiatives.

IMF on Italy: What are the possible ways to help the recovery become faster?

- “First, regulators need to provide **clarity about regulatory standards**—and thus certainty for banks adapting business models—by promptly finalizing the calibration of recent requirements, including the leverage ratio, net stable funding ratio, and Total Loss-Absorbing Capacity requirements.”

Bergthaler, Kang, Liu, Monaghan, “Tackling Small and Medium Sized Enterprise Problem Loans in Europe”, IMF Staff Discussion Note, March 2015

IMF on Italy: What are the possible ways to help the recovery become faster?

- “Second, a number of actions are needed to comprehensively **tackle the burden of nonperforming loans**. Supervisors must continue to provide **strong incentives** for banks to maintain adequate provisioning levels and help **reduce the current gap between bank and market valuation of nonperforming loans**. This includes encouraging banks to develop and use specialized internal and external capacity for handling the stock of nonperforming assets, actively manage their provisions, and write off their nonperforming assets.”

Bergthaler, Kang, Liu, Monaghan, “Tackling Small and Medium Sized Enterprise Problem Loans in Europe”, IMF Staff Discussion Note, March 2015

IMF on Italy: What are the possible ways to help the recovery become faster?

- "Third, authorities should also ensure that **legal frameworks for bankruptcy** of firms and individuals continue to be reviewed and reformed, where necessary, and that institutional frameworks (judiciary and insolvency practitioners) and out-of-court procedures […] are adequately resourced and supported to **deal with large volumes of distressed debt**. Regulatory measures should also be taken to encourage the speedy disposal of problem loans by banks. In addition, an active **market for nonperforming loans** should be encouraged.

Bergthaler, Kang, Liu, Monaghan, "Tackling Small and Medium Sized Enterprise Problem Loans in Europe", IMF Staff Discussion Note, March 2015

IMF on Italy: What are the possible ways to help the recovery become faster?

- "Fourth, the resilience of the financial system should be strengthened by **diversifying the sources of funding from banks to capital markets**. A deeper and broader capital market would improve access to finance, particularly for smaller firms, and make financial markets more efficient. In the euro area, this would require **harmonization of company law, corporate governance, insolvency regimes, and taxation,** in line with the latest Capital Markets Union proposal by the European Commission."

Bergthaler, Kang, Liu, Monaghan, "Tackling Small and Medium Sized Enterprise Problem Loans in Europe", IMF Staff Discussion Note, March 2015

Well-functioning and liquid securitisation market

- **Securitisation:** enhance the **lending capacity** and banks and permanently broaden **funding options for SMEs**.
- **Impediments:** (1) regulatory framework (including liquidity risk standards and capital requirements), (2) fragmented national insolvency and debt enforcement regimes, (3) lack of harmonised credit information across EU countries, raise the cost of issuance and limit the investors base.

Aiyar, Al-Eyd, Barkbu, Jobst "Revitalizing Securitization for small and Medium-Sized Enterprises in Europe", IMF Staff Discussion Note, May 2015

Actions to support securitisation

- Encouraging greater **regulatory differentiation** among securities of varying underlying asset quality and structures.
- Developing the right **market infrastructure** and **facilitating cross-border investment**.
- Enhancing the scope of current **EU initiatives** for SME finance together with introducing a more nuanced treatment of SME-related **collateral for refinancing with the Eurosystem**.

Aiyar, Al-Eyd, Barkbu, Jobst “Revitalizing Securitization for small and Medium-Sized Enterprises in Europe”, IMF Staff Discussion Note, May 2015

My taking: A three-pronged effort

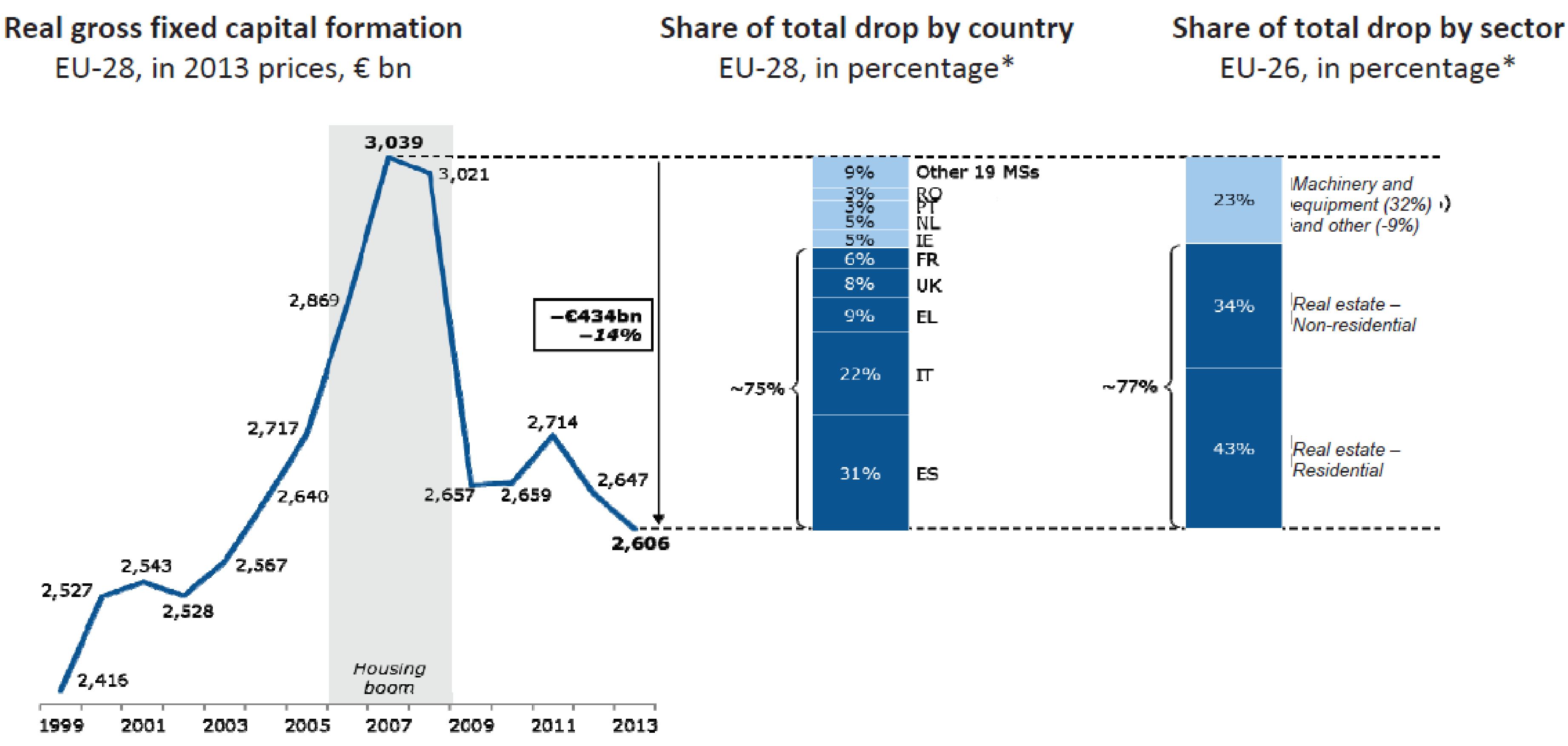
- Consider ways to support the setting up of **SPVs** by the private sector and sponsor a **public "bad bank",** in line with state aid legislation. Recent announcement by the Italian authorities seems to go in this direction. Other countries to follow?

- Where there are problems, improve **insolvency regimes** to make **debt collection and collateral foreclosure** faster and less expensive (immediate effect on NPV).

- Change **tax incentives** to speed up bank provisioning and write off loans in line and harmonise them across the EZ (no state aid). Tax deductibility without a court declaration of insolvency.

- A Eurozone framework for **debt/equity swaps**?

Assessing the size of the EU investment problem

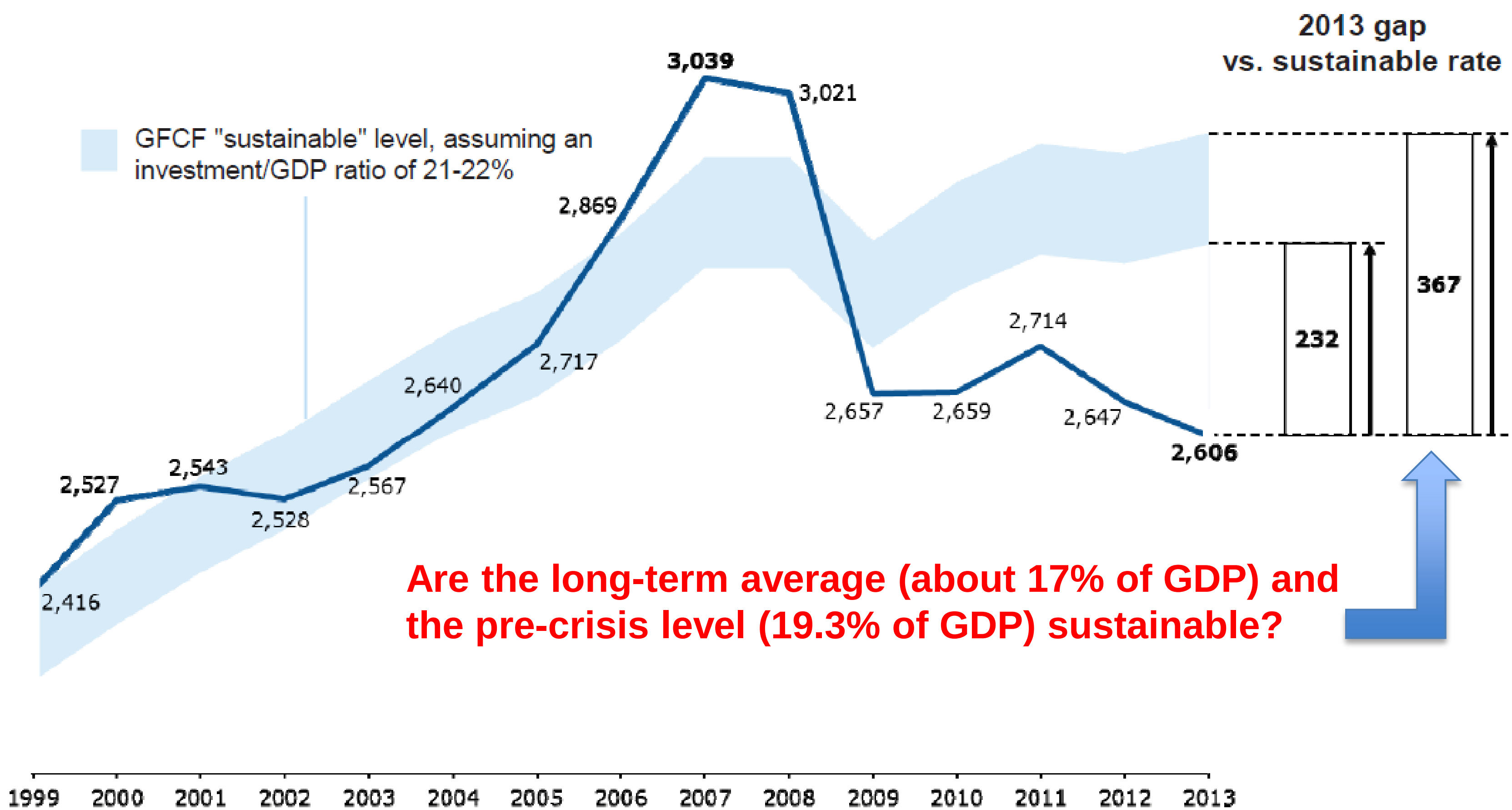


Source: European Commission, European Investment Bank, Factsheet 1: Why does the EU need an investment plan?

How sustainable is the pre-crisis trend?

Real gross fixed capital formation – Observed trend vs. "sustainable" level

EU-28, in 2013 prices, € bn



Source: European Commission, European Investment Bank, Factsheet 1: Why does the EU need an investment plan?

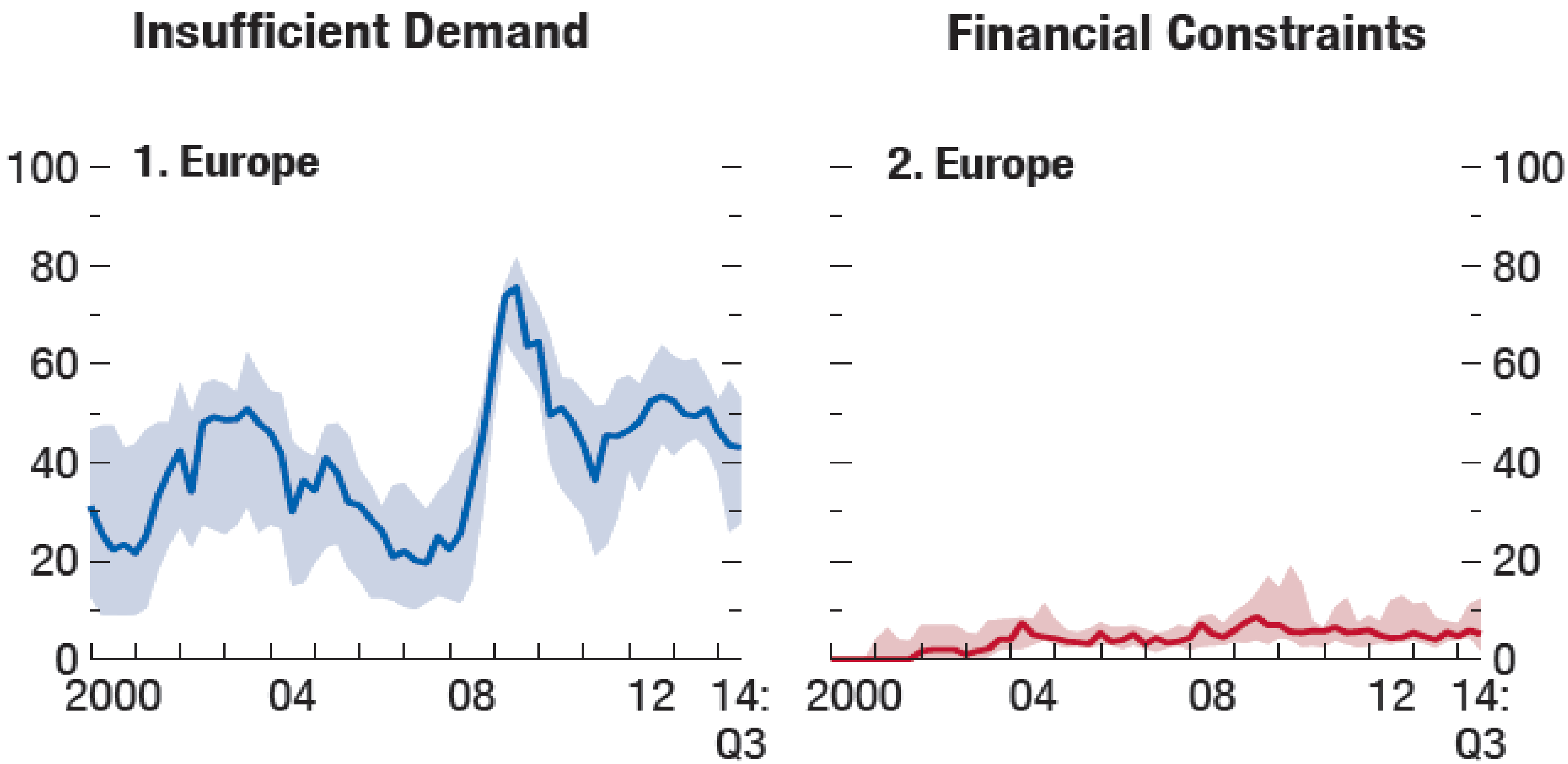
Why is investment not taking off?

- Low investor **confidence** rooted in low expectations about demand for goods sand services.
- The **fragmentation** of financial markets and the lack of sufficient risk-bearing capacity that is required to catalyse investments.
- **Uncertainty** of economic and political developments.
- Still high level of **indebtedness** in part of the EU economy.
- **Access to finance** in MSs most affected by the crisis.
- Reduced **risk-bearing capacity** due to bank constraints.

Source: European Commission, European Investment Bank, Factsheet 1: Why does the EU need an investment plan?

Juncker's plan: Is financing the real problem?

Firm Survey Responses: Factors Limiting Production (%)

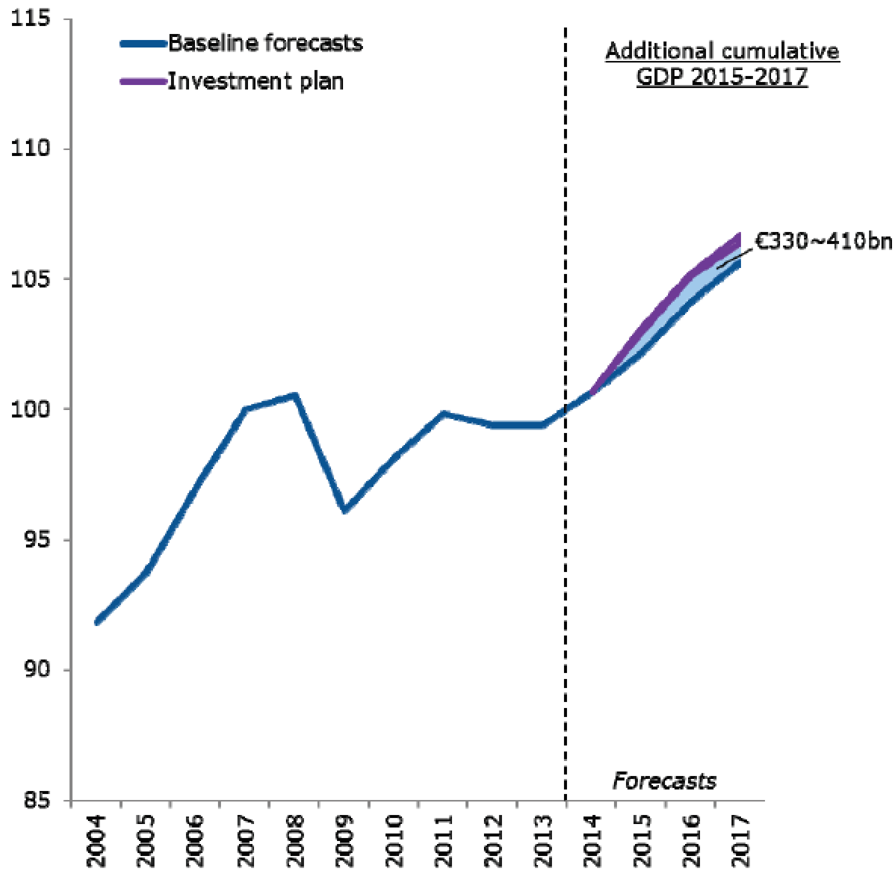


Source: IMF, World Economic Outlook, April 2015

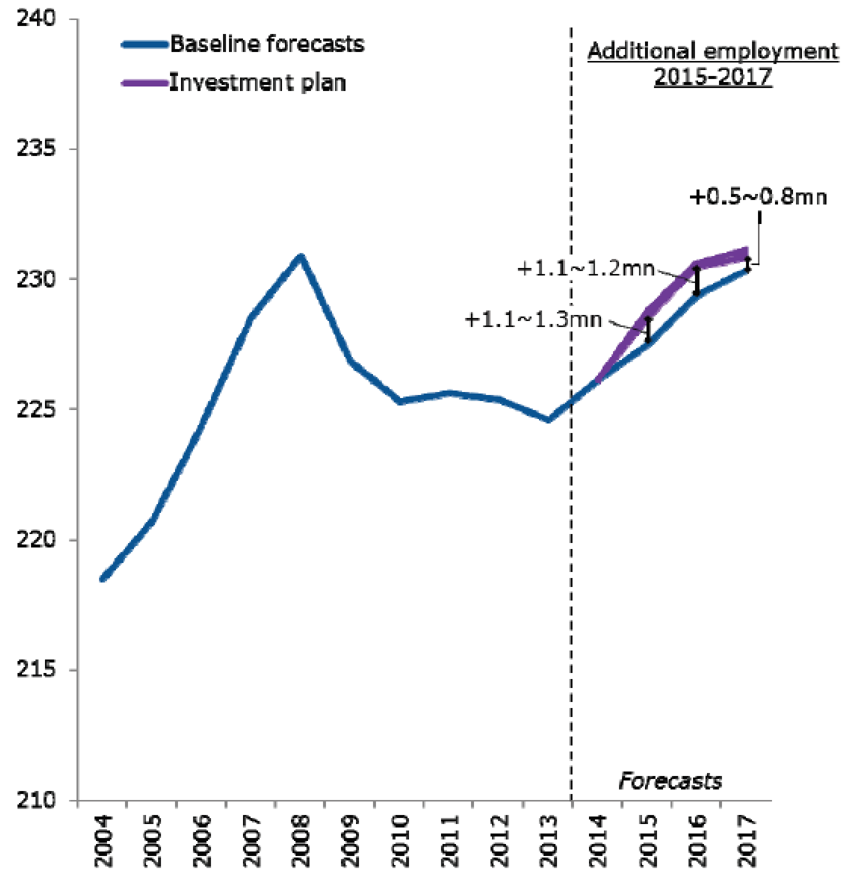
FINANCE FOR GROWTH - EU INVESTMENT PLAN

Juncker's plan: the potential impact

Real GDP
EU-28, index 2007=100



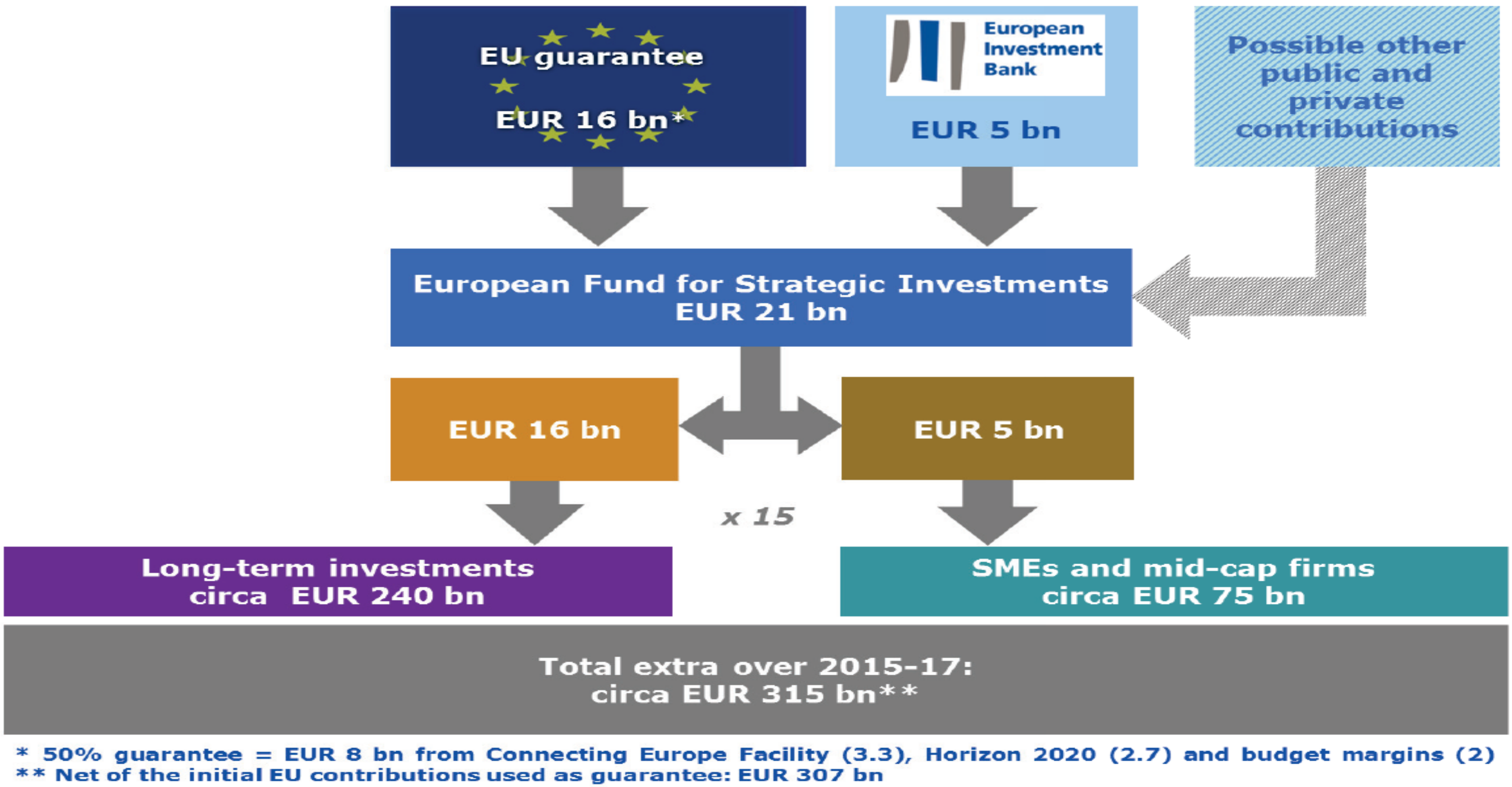
Employment
EU-28, millions of workers



Source: European Commission, European Investment Bank, Factsheet 1: Why does the EU need an investment plan?

Juncker's plan: Will high leverage work?

A new European Fund for Strategic Investments (EFSI)



Source: European Commission, European Investment Bank, Factsheet 2: Where does the money come from?

EU INVESTMENT PLAN

Timeline: Are we getting there or missing deadlines?

December 2014 / January 2015

- The European Council and the Parliament should endorse the Investment Plan for Europe, including the decision to set up a European Fund for Strategic Investments and agree to fast-track the adoption of the relevant regulation.
- The Commission proposes the regulation in January 2015.
- The Parliament and Council discuss the regulation with a view to ensure its entry into force by June 2015.
- The European Investment Bank will re-direct parts of its operations to pre-finance and prepare the activities of the Fund.
- Member States should finalise the programming of European Structural and Investment Funds to maximise impact.
- Project identification is accelerated at EU level, based on the report of the Commission-EIB Task Force.
- First steps are taken by the EIB and key stakeholders to build an investment advisory "Hub".

By mid-2015

- The new European Fund for Strategic Investments is operational.
- The European Structural and Investment Funds produce their impact, in synergy with EU programmes.
- A transparent pipeline of projects is in place at EU level, which will be developed over time.
- The new investment advisory "Hub" is operational.
- Follow-up activities have started at EU, national and regional levels, together with relevant stakeholders.
- A dedicated website allows to monitor progress on the Investment Plan in real-time.

By mid-2016

- Progress will be reviewed, including at the level of Heads of State and Government.
- Further options may be considered ahead of the mid-term review of the Multi-annual Financial Framework.

Source: European Commission, European Investment Bank, Factsheet 5: What's next? A timeline

Some reflections: Catalyst or active promoter? What's the role of the public sector?

- When is the support of the Plan **needed** and **appropriate**?
- Can we separate the role of **catalyst** from that of **active promoter**? Can the projects go ahead anyway? Is there any interference with the **allocation of resources**?
- The case of **market failure** and the support for "**public goods**". Is there an interpretation model that is used in decision making?

Bottom line: Positive initiative, but not a game changer, and not even the start of something else

- Important for the **long-term prospects** of the EU economy. Unlikely to be a game changer for the economy over the near term, but it could support confidence and thus the recovery.

- What can be done by the **private sector** and what instead can only be done by governments (or a supranational institution)? Focus on the **quality** of investment.

- Dubious role as **countercyclical tool.** It never pretended to be. But it may turn out to be useful (see next point).

- Can it become a first, very tentative, attempt to have a centralised **European budget**? I doubt.

The liquidity paradox: A flood or a drought?

- **Liquidity problems** = a number of “flash crashes”, tail events, air pockets, sudden vacuums.
- **Warnings:** BIS, IMF, Blackrock, JP Morgan, Citi, etc.
- **Regulation** (leverage ratio and net stable funding ratio): has it driven up the cost of balance sheet and reduced appetite for risk, and thus endangered proper market functioning?
- Are **central banks’ distortions** also to blame? Or pro-cyclical investors? Illiquidity also in FX and equities.
- More “**herd behavior**”? More investors forced to mark to market, more concentration, less heterogeneity.

The liquidity paradox: “Phantom liquidity”

- Non-bank credit becoming more short-term. Investors with a **long-term horizon** are decreasing.
- Banks (JP Morgan): (1) **higher cost of balance sheet**, (2) **explicit constraints** for US banks as a result of the Volker Rule, (3) problems as a result of rescue operations.
- Brokers’/dealers’/market makers’ willingness to act as **liquidity providers** has waned due to (1) inability to use balance sheet for hedging and (2) inability to borrow securities freely (repo) as a result of **Leverage** and **Net Stable Funding Ratio** (NSFR) rules. **Depth of order books has reduced.**

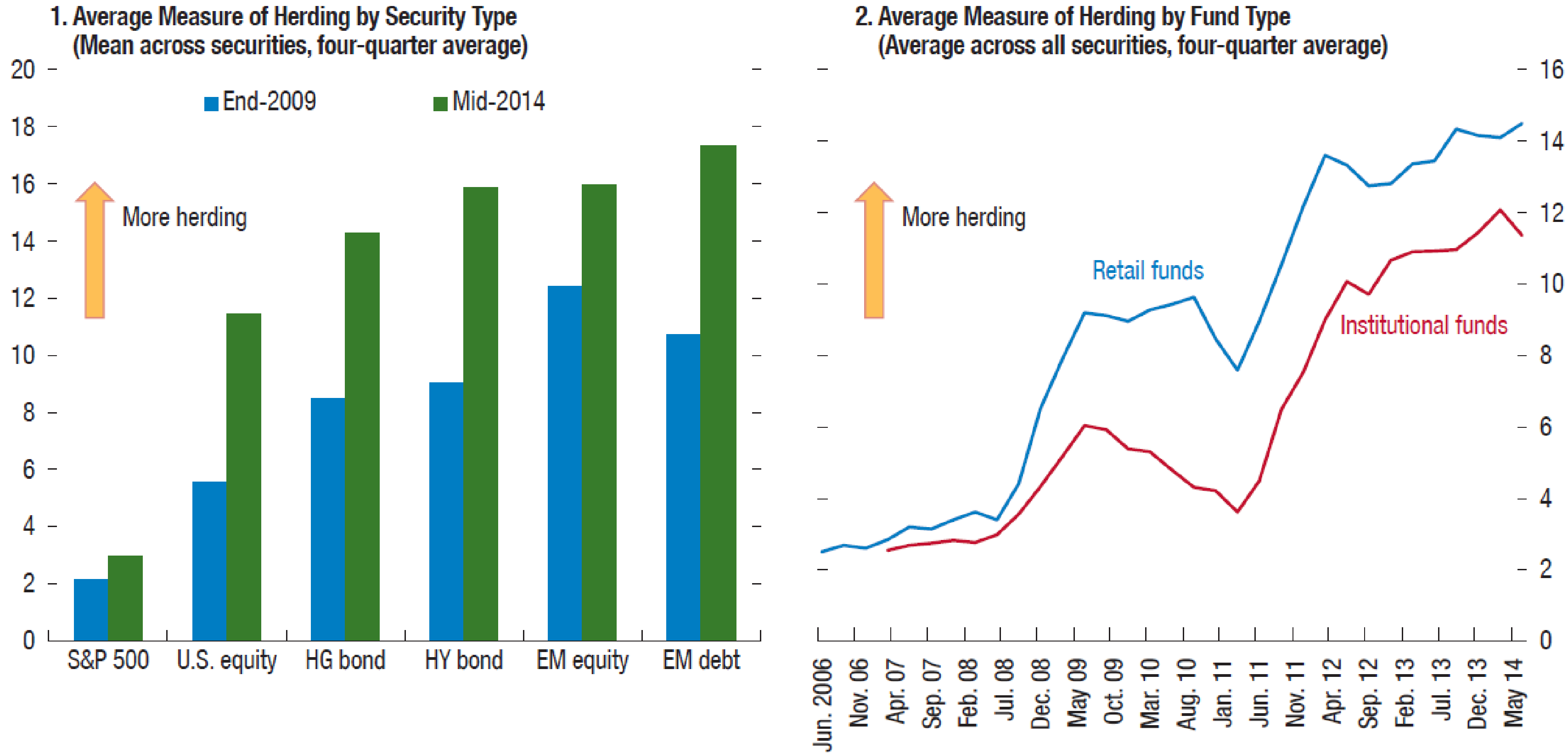
FINANCIAL MARKETS LIQUIDITY

Herd behavior likely linked to QE

Figure 3.13. Herding among U.S. Mutual Funds
(Percent)

Recently, U.S. mutual funds have been herding more in U.S. equity and corporate bond markets.

Retail funds tend to herd more than institutional funds.



Source: IMF, Global Financial Stability Review, April 2015

Why does it matter for the real economy?

- Herding behavior correlated with the scale of central bank intervention (fundamental valuations have broken down), i.e. **central bank's support to the real economy comes at a price of higher risk in financial markets.**

- Regulation + QE + (…) make = **market and bank long-term financing are more correlated than in the past.**

- **Need to develop countercyclical buffers and preserve long-term investments** from any future financial crisis as banks will not satisfy borrowers' need as they have in the past: can Juncker's Plan have a role?

Thank you for your attention

+44 758 3564410
lorenzo.codogno@lc-ma.com

www.lc-ma.com (not yet activated)

LC Macro Advisors