Euro Area: At a Turning Point

While the economies in the euro area have been recovering since 2014, with Scope expecting real GDP to grow on average by 1.7% in 2017 and 2018, the legacy of the financial crisis continues to present challenges: high public debt, economic and social malaise, and more recently, intensified political risk. It is Scope's view that while the fundamentals of the euro area are stronger than recognised, a still-fragile economic growth environment and an ageing population will make it challenging for euro area sovereigns to grow out of high levels of public debt.

Scope believes that the resilience of the euro area has improved much more in the course of the crisis than is commonly recognised. In addition to the ECB's increasingly active role, important achievements have been made such as the establishment of the European Stability Mechanism, the banking union, and the creation of a new macro-prudential framework with a strong single supervisory mechanism. These developments, together with the new macroeconomic surveillance, have all been decisive steps towards a more robust euro area architecture, substantially reducing credit risk in times of shocks.

Nevertheless, a substantial trend change towards declining public debt ratios can only be expected if the current economic recovery continues to broaden, supported by a reflationary, low interest rate environment. The ECB's unconventional monetary policy mix has helped to stabilise financial markets and support the economy. However, risk aversion, which has led to conservative lending after the crisis, as well as incomplete repair of the banking sector, continues to hinder cross-border lending and investment within the euro area.

The ECB's liquidity generation is unprecedented, as well as its 'interference' in European bond markets through its Asset Purchase Programme (APP). Scope acknowledges that a return to 'normal' will take time and comprise risk for financial markets and the economy. Even in a low interest rate environment, highly indebted countries continue to be limited in their ability to pursue fiscal stimulus due to ongoing high interest payments. There is also limited policy space to cope with adverse shocks.

Several years of job losses and economic malaise have eroded confidence in not only the European, but also the global economic model. This has led to an increase in political risk. The rise of anti-establishment political forces in the wake of this backlash complicates any consensus-based reforms and puts fiscal consolidation at risk.

Further implementation of European policy initiatives, as well as country-level reforms to enable a more balanced and dynamic economic recovery, remain substantial challenges. The euro area's future and risks may be less dependent on the actual degree of integration and more on concrete policies and institutional arrangements designed to ensure the euro's success, especially in difficult times.

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Related Research

Italy Outlook: Gradual Recovery with New Uncertainties
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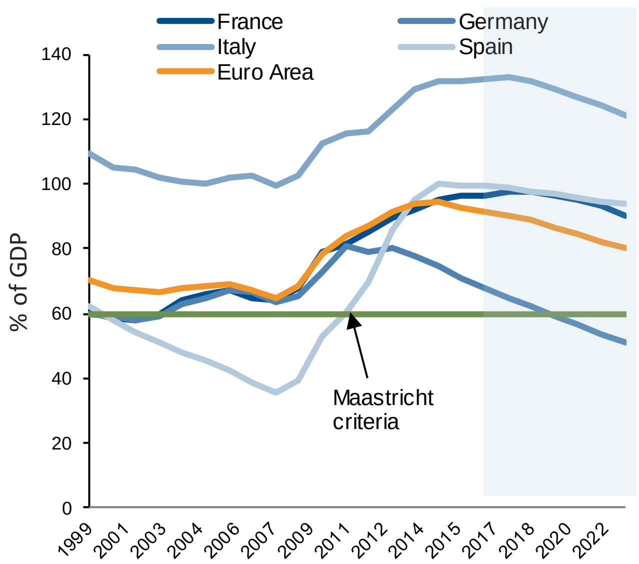
Challenging environment for sovereign debt

The 2008 financial crisis wreaked havoc among euro area government finances, setting the stage for the euro area's economy, monetary policy and public debt development to the present day.[1] Years of deflationary economic environment generated sharp increases in government debt in relation to nominal GDP that effectively wiped out moderate consolidation results since the inception of the Economic and Monetary Union.

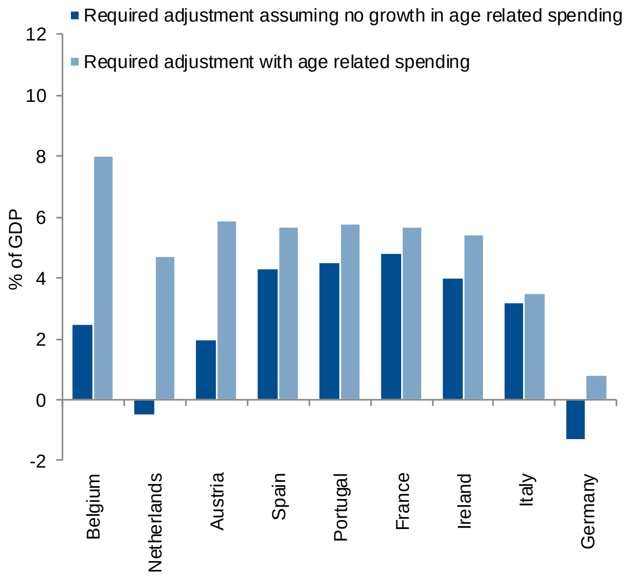
As a result, the debt-to-nominal GDP ratio increased from an average of 65% for the euro area in 2007 to just under 95% in 2014. Scope expects only a slight decline of this ratio to around 90% by the end of 2018.

Figure 1: Euro area government debt



Source: IMF

Figure 2: Structural adjustment needed until 2030



Source: European Commission, IMF

As a consequence, most euro area countries are now ill-prepared to tackle the increasing costs of an ageing population and reduce heavy public debt in a low growth environment. Figure 2 depicts the overall size of the structural primary balance needed to ensure medium-term sustainability, i.e. to reach the general debt target of 60% of GDP by 2030, with significant variation across member states. Moreover, in many countries, there is only limited appetite for continuing restrictive fiscal policies as economies continue to grow. Instead, governments may be inclined towards expansionary fiscal policies, both to support economic growth and counter the social and political damages of a prolonged economic crisis.

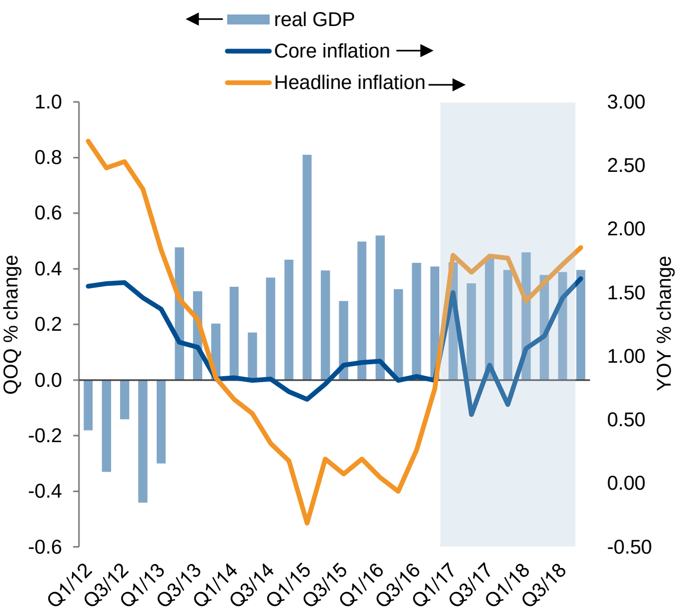
[1] European Commission: "Economic Crisis in Europe: causes, consequences and responses", July 2009

A long way out of the post-crisis economic discontent

During the crisis, bond spreads of peripheral governments rose. This was driven by concerns about the future of the euro area, rather than underlying credit fundamentals in countries such as Ireland, Spain, Portugal and Italy. Strong increases in public debt and important market liquidity shortfalls caused governments to cut spending, which intensified and prolonged the economic crisis.

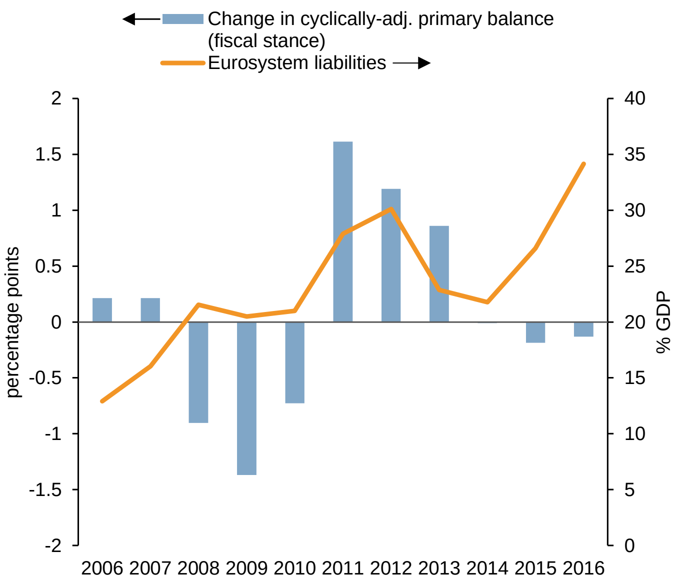
Simultaneous austerity policies in Europe had a deflationary impact on the euro area economy, resulting in increased unemployment and government debt in relation to nominal GDP. Thanks to the ECB's unconventional monetary policy and government shifts towards more neutral fiscal policies, the euro area economy recovered from 2014 onwards.

Figure 3: Euro area growth and inflation



Source: Feri AG/Scope Rating AG

Figure 4: Euro area fiscal stance and ECB liabilities



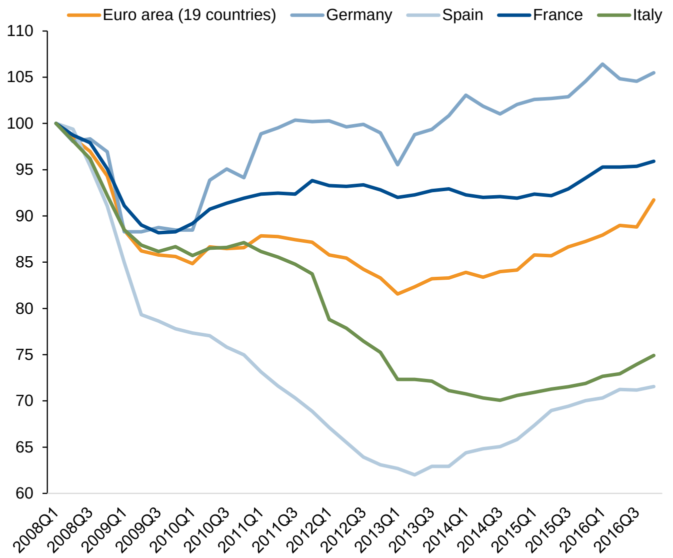
Source: ECB, AMECO, calculations Scope Ratings AG

Room for further broadening of the recovery

The recovery has gained strength since the second half of 2016. Improving labour markets, the ECB's accommodative policies and mildly expansionary fiscal policies have continued to support domestic demand. Growth expectations for euro area real GDP of around 1.7% seem fundamentally justified for the coming two years. Scope sees room for a further broadening of the economic recovery in the euro area through more synchronised policies that help to promote public and private investment.

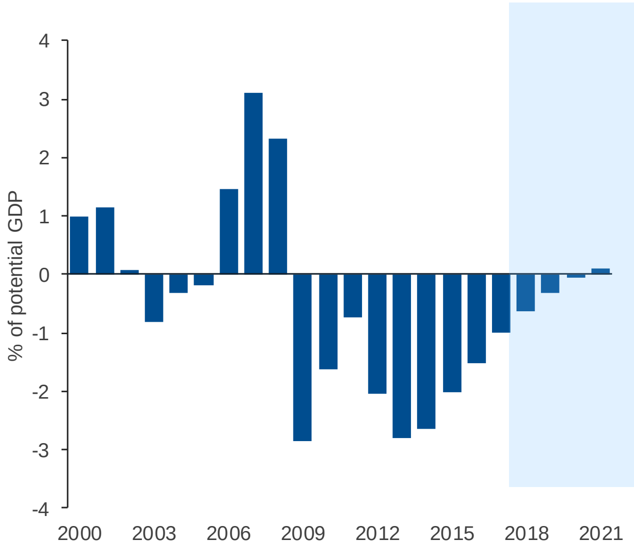
The recent switch to more growth-friendly policies can counterbalance some of the remaining risks and obstacles that dampen euro area growth. In the aftermath of the financial crisis, fiscal austerity often resulted in deep cuts to public investment and increases in labour taxes, which weighed on total factor productivity and hence potential GDP growth. Highly indebted countries continue to be limited in their ability to pursue fiscal stimulus due to approximately 3% to 4% of their GDP being spent on interest payments.

Figure 5: Gross fixed capital formation (2008 Q1 = 100)



Source: Eurostat, calculations Scope Rating AG

Figure 6: Euro area output gap

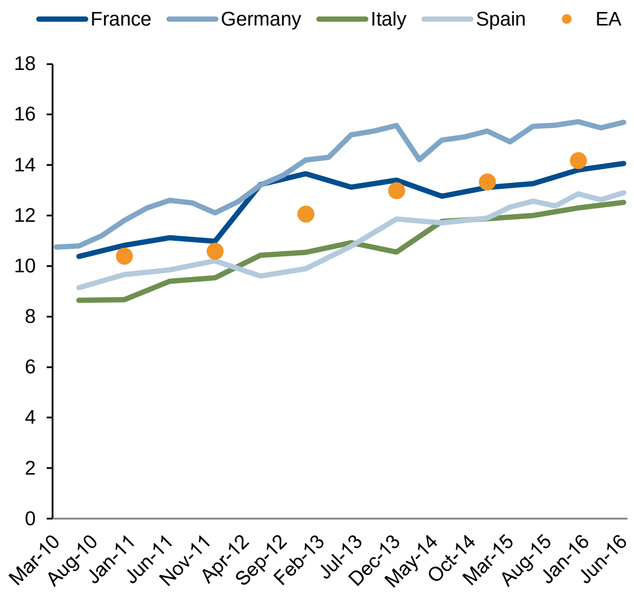


Source: IMF

Banks' central role to spur investment

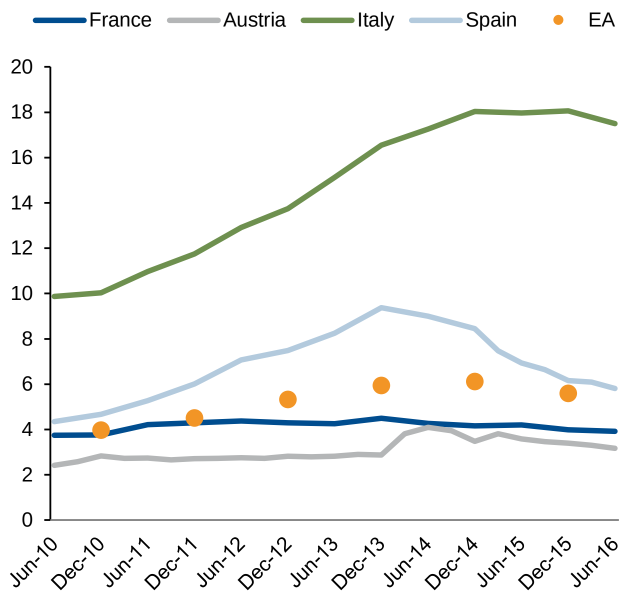
The crisis of confidence in the banking system during and in the wake of the crisis has also led to financial fragmentation in the euro area. This was the main trigger for improvements in rules for bank capital and oversight through the creation of the European banking union. The ongoing repair of the financial sector is important in order to strengthen confidence in those banks who continue to face low profitability and high stocks of nonperforming loans. Further harmonisation of bank regulation and reinforcement of deposit insurance are needed, as ongoing risk aversion continues to hinder cross-border bank lending and investment within the euro area.

Figure 7: Tier 1 capital (% of risk weighted assets)



Source: ECB, IMF

Figure 8: NPLs (% of total loans)



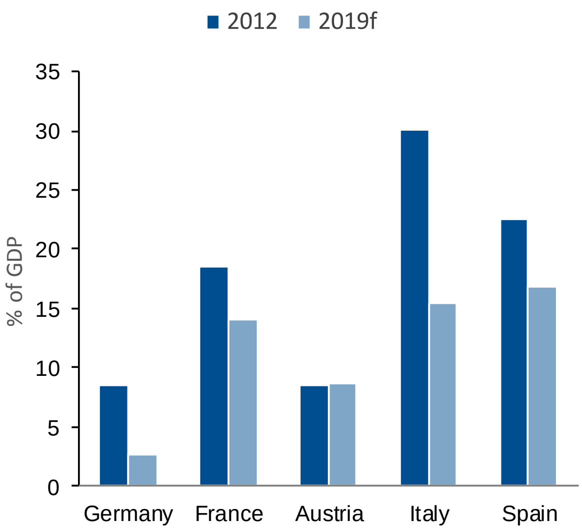
Source: ECB, IMF

Confidence depending on the new lender of last resort

The crisis and subsequent reforms not only changed the game for the banking sector. The ECB's initial focus on strict conditionality of financial support was seen as a lack of determination to protect the euro area by any means necessary. This changed in 2012 with the ECB's decision to defend the euro, "whatever it takes". Now, the ECB became a true lender of last resort, like other major central banks, ready to provide liquidity during times of market turmoil. This was a pivotal moment during the euro crisis, as it eliminated fears of a euro breakup.

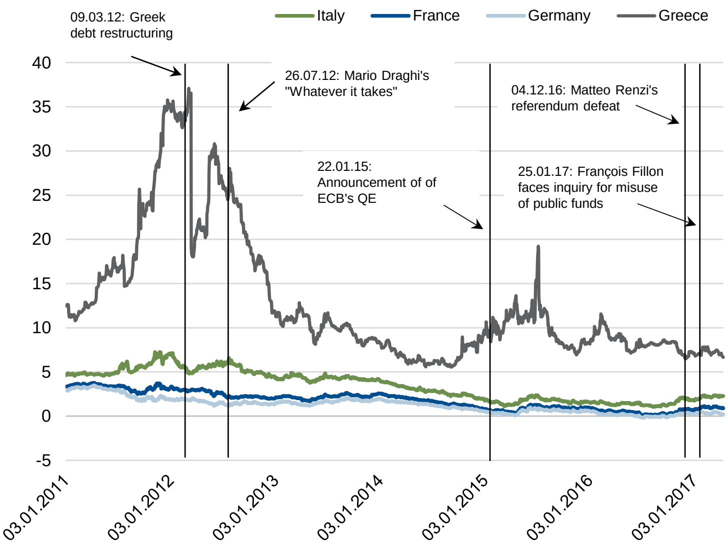
As a consequence, the concern of redenomination risk was quickly reduced. The more government bond yields rose as a result of unrest in financial markets, the more they fell after the ECB's decision – even with deteriorating economic and credit fundamentals[2]. The euro area was taken out of a 'bad equilibrium' where negative expectations had led to a self-fulfilling downward spiral[3]. Finally, the ECB's decision in March 2015 to launch large-scale bond-buying programs served to strengthen European business and consumer confidence.

Figure 9: Gross financing needs



Source: IMF

Figure 10: Bid yields to maturity and euro governance



Source: Scope Ratings AG

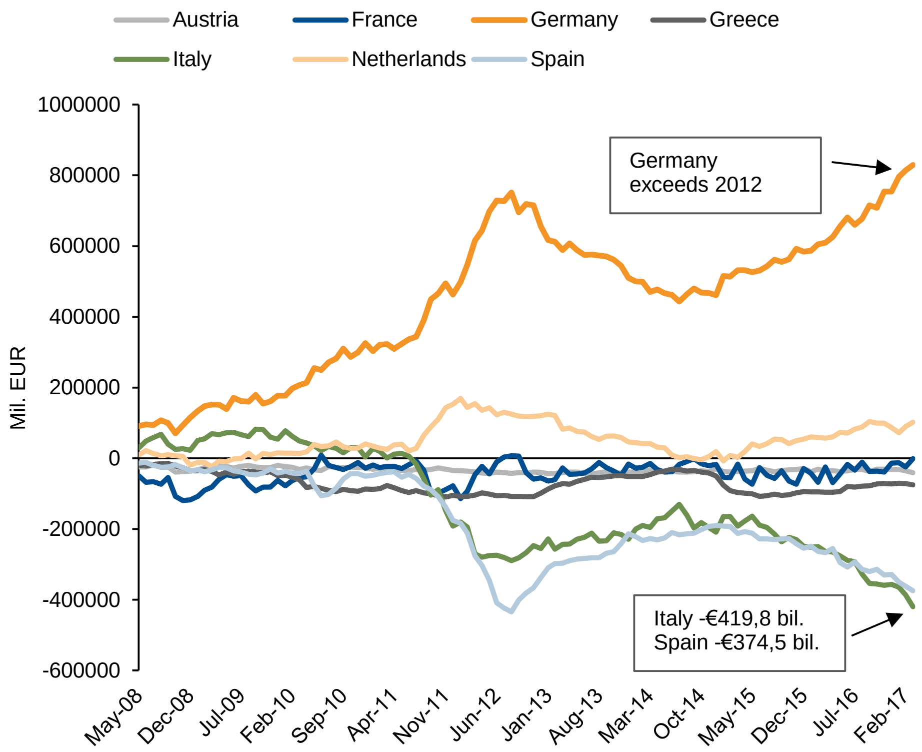
Upward trend in TARGET2 balances: this time is different

Scope views the current upward trends in TARGET2 balances not as a symptom of increased stress, but rather as the result of liquidity flows generated by the ECB's APP and expansionary measures, such as LTROs and TLTROs. This stands in sharp contrast to increases during mid-2007 to late 2008, as well as from mid-2011 to mid-2012, when financial market fragmentation caused by financial and sovereign debt crises led to increases in these trends. A large majority of bonds purchased by national central banks under the APP were sold by non-resident counterparties. Approximately half of these bonds were sold by counterparties outside the euro area, for which settlement via TARGET2 access was done by the Deutsche Bundesbank. This led to substantial increases in the Deutsche Bundesbank's TARGET2 balances with the ECB.[4] However,

[2] Please see Paul de Grauwe, Yuemei Ji: "More evidence that financial markets imposed excessive austerity in the eurozone", CEPS Commentary, 5 February 2013.
[3] Please see Paul de Grauwe "Self-fulfilling crises in the Euro zone: an empirical test" June 2012.
[4] See the box entitled "TARGET balances and the asset purchase programme", Economic Bulletin, Issue 7, ECB, 2016, available at http://www.ecb.europa.eu/pub/pdf/ecbu/eb201607.en.pdf and the box entitled "The impact of Eurosystem securities purchases on the TARGET2 balances", Monthly

liquidity created by the APP is largely concentrated in a few countries, such as Italy and Spain. This indicates ongoing risk aversion as well as conservative risk management among banks that continue to hinder interbank redistribution of liquidity within the euro area.

Figure 11: TARGET2 balances



Source: ECB

Reflating the economy may have worked...

The ECB's more active stance has led interest rates to drop to unprecedented low levels, with the headline deposit rate negative since mid-2014. Fears of deflation triggered unconventional policy tools: deposit rates heading further into negative territory and additional credit easement via LTROs, with quantitative easing (via the APP) to include sovereign bonds from March 2015 and non-bank corporate bonds from June 2016. The APP in particular helped to keep interest rates down in the countries that were hit hardest by the crisis (largely the non-core EMU members), helping their economies to recover.

...But the ECB's role and approach is not without risks

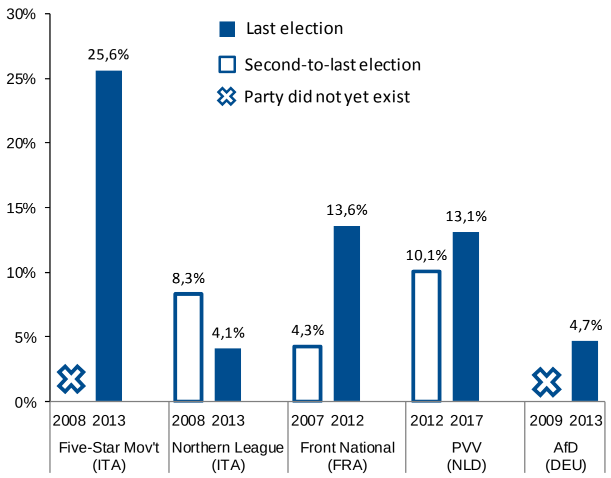
These activist policies successfully stabilised the euro area. However, the affordability of record high public debt in the euro area, as well as the outlook for economic recovery, are heavily dependent on the intensity and duration of the ECB's applied policy tools. The effective 'sub-contracting' of euro area stability to the ECB does not, however, come without risks: central bank intervention in bond markets strongly influences the long end of the yield curve, greatly impacting financial and economic choices. The level of expansion of the ECB's balance sheet to create liquidity is unprecedented. Scope recognises that the return to any kind of "normal" in monetary policy and interest rates will take time, and presents risks for financial markets and the economy.

Report, Vol. 68, No 3, Deutsche Bundesbank, March 2016, available at https://www.bundesbank.de/Redaktion/EN/Downloads/Publications/Monthly_Report/2016/2016_03_monthly_report.pdf?__blo b=publicationFile.

Political backlash is a new risk factor

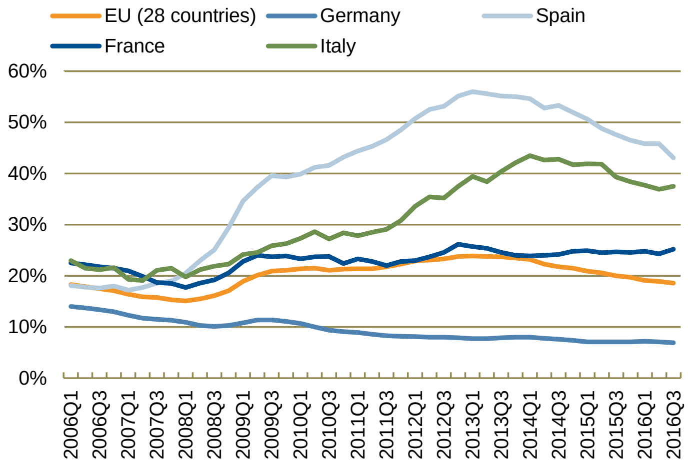
Financial markets have been stabilised, and a broadening economic recovery is under way. However, the slow and uneven recovery has led to social discontent that underscores the fact that the euro area under pressure has not been able to keep its fundamental *raison d'être* of generating economic growth and jobs to improve living standards for Europeans. This has led to a political backlash: economic dissatisfaction and social frustration (not only in Europe, but also in the US) led, in 2016, to the unexpected strength of anti-establishment and anti-globalization forces in the US and Britain. In addition, populist parties in Europe, many of whom did not exist before the crisis, have been on the rise.

Figure 12: Eurosceptic parties on the rise



Source: European Election Database

Figure 13: Youth unemployment



Source: Banca d'Italia, Bruegel, Bloomberg

Pressure on establishment to search for reforms

This places further pressure on established political parties to reform the European model. It also complicates coalition building needed to reach agreements on economic policies. In France, the established political forces did not make it into the second round of the recent presidential elections, unprecedented in French post-war history. It remains unclear to what extent the newly elected president Mr Macron will be able to form a majority in parliament and to implement his policy agenda. In Italy the growing fragmentation of political parties is further complicating reform actions[5]. In Spain it took 10 months and 2 general elections to establish a new government. Even in Germany – the biggest euro area economy and the euro area safe haven – the recent entry of the Eurosceptic AfD party in regional parliaments has changed the political landscape.

Important turning point for the euro area

The history of European integration is one of concrete cooperation and agreements that often originated in times of stress and crisis. The recent intense economic and political crises in Europe are indicators that a new wave of reforms and initiatives is needed. The euro area's future may depend less on the actual degree of integration and more on concrete arrangements to ensure that the common currency performs well in difficult times.

[5] Please see Scope's commentary: "Italy Outlook: Gradual Recovery with New Uncertainties", March 2017.

Scope believes that the resilience of the euro area during the financial crisis is much stronger than commonly recognised. The crisis led to a learning process resulting in improvements to the euro area architecture and governance risk. This has substantially reduced euro area credit risk in times of shocks. The decisive steps taken by the ECB as the European lender of last resort as well as the banking union, and the establishment of programmes such as the European Stability Mechanism and Outright Monetary Transactions have affirmed confidence in the functioning of the euro area. Further economic and fiscal policies in Europe to enable a more balanced and dynamic economic recovery of euro area member states would be viewed as credit positive. A solid economic recovery will be needed to get a grip on fiscal and political risks.

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