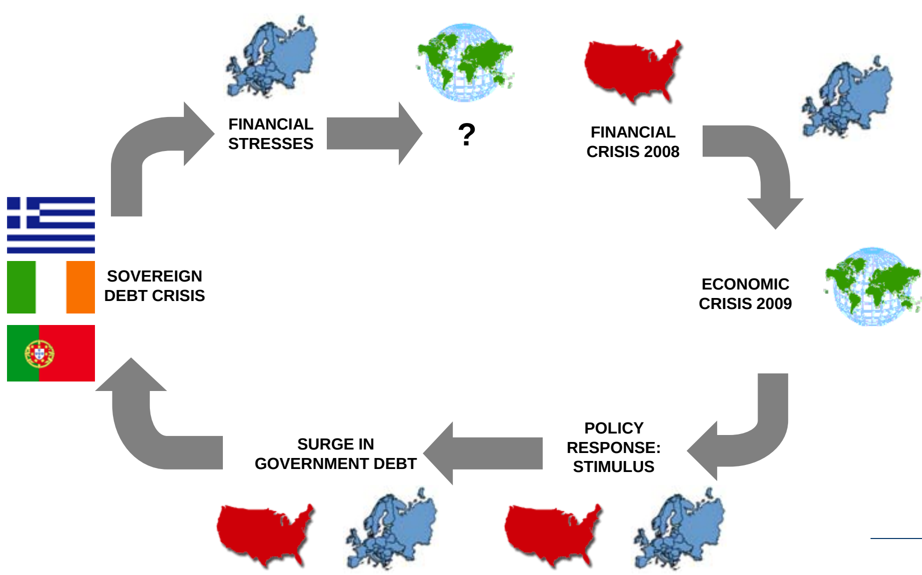
What this presentation will cover

- Understanding the euro crisis: Key concepts
- Impact of the crisis on the euro area economy
- Policy responses - what Europe is doing to end the crisis

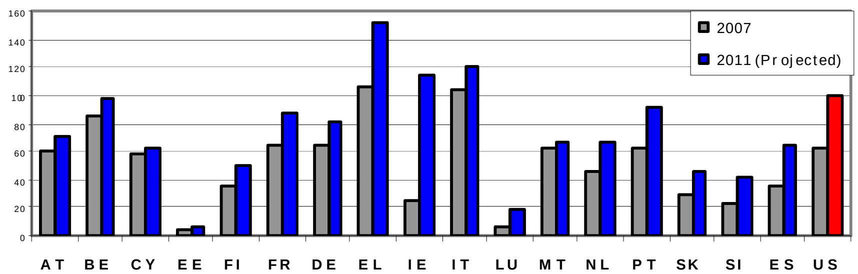
Understanding the euro crisis: key concepts

The never-ending crisis?



Government (sovereign) debt levels ballooned

Debt to GDP
in the Euro Area Countries and the US
(as % of GDP)



Key Economic Concept: Bond Spreads

Governments borrow by issuing bonds

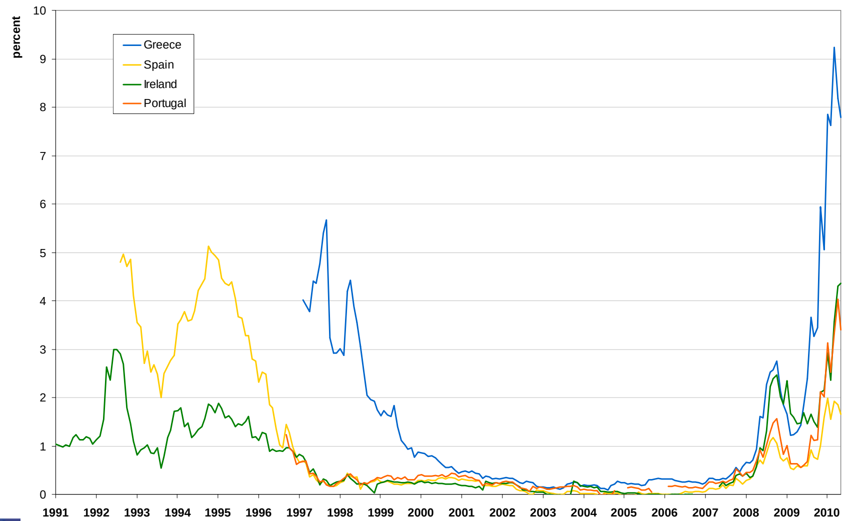
Less riskier borrowers can borrow more easily

Markets try to distinguish between borrowers

The <u>spread</u> is the difference in interest rates that markets charge different borrowers

When investors get nervous, spreads start to widen

The role of financial markets



Source: Bloomberg

The origins of the Greek crisis

Greece's euro membership marked by consumption, investment booms

Wages rise faster than productivity, competitiveness deteriorates

Low interest rates fuel credit growth

Poor fiscal discipline and weak institutions

Large revisions to budgetary statistics

Unsustainable pension, health systems

Other euro area countries have come under pressure as Greece's woes spread

Many countries were confronted by large costs from rescuing their financial sectors

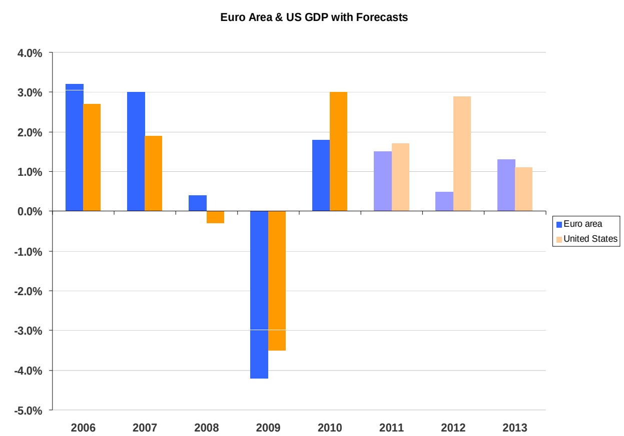
Some countries suffered from burst housing bubbles

Many countries face problems of slow growth and lack of competitiveness

In many European countries, population ageing presents a threat to fiscal sustainability

Impact of the crisis on the euro area economy

Euro area growth is slowing sharply



Source: European Commission Autumn forecast, November 2011

Hint: For explanations and updates, see "Current Economic Situation in the Euro Area" on the Resources page at ***http://www.euro-challenge.org/doc/2011/CurrentEconomicSituationOct2011.pdf***

The euro area economy as a whole will barely grow at all in 2012, with some countries in recession (negative GDP growth)

Unemployment (currently at 10.3%) is on the rise again, with big differences between countries (low in Netherlands, high in Spain)

Inflation is high but coming down due to slow growth

Europe's response to the crisis

Europe's response to the sovereign debt crisis

- **European Stabilization Program** 2010:
  EU-IMF assistance for Greece (€110 bn);
  Ireland (€ 85 bn); **Portugal** (€ 78 bn)

- **ECB** purchasing government bonds of troubled countries

- July 2011: EU agrees on new powers to the **European Financial Stability Facility** (€440 bn) and on 2nd program for Greece (€109 bn)

- **Strengthening "fiscal governance"** through tighter monitoring, EU oversight of national budgets

- "Euro Summit" October 26, 2011
- European Council Dec. 9, 2011

European Council

CONSILIUM

European Commission

European Parliament

European Central Bank (ECB)

International Monetary Fund (IMF)

Strengthening the "E" in EMU

Joint financial assistance for countries in difficulty (with strict policy conditions)

Greater co-ordination of economic policies

Boost growth: 'Europe 2020' strategy

Stronger, more effective fiscal rules, and stronger supervision at the EU level

What next?

More ECB action?
Increased funding?
Euro bonds?
Fiscal "union"?

Bold, difficult measures for affected countries

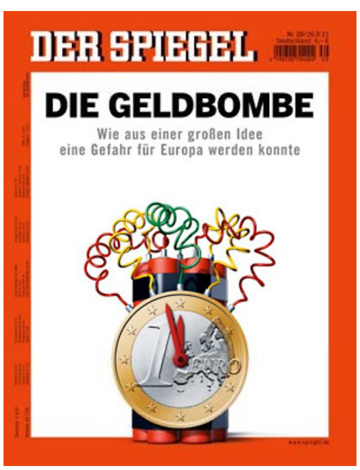
Joint EU-IMF programs aim to bring down debt and solve economic challenges (slow growth, lost competitiveness, banking sector issues).

Far-reaching structural reforms being adopted (e.g. landmark pension reforms)

Drastic cuts in public expenditure across all levels of government: necessary, but painful and unpopular.

Program designed to reduce government deficits and stabilize debt (good) can have a negative impact on growth in the short run (bad)

Bold, difficult measures for the euro area



Germany's *Der Spiegel* magazine asks "how a big idea became a threat to Europe"

Will all euro area countries (17) endorse moving toward greater fiscal and economic union? (National sovereignty issues?) How will the "euro-outs" react?

Economically stronger Member States (like Germany) are wary of having to foot the bill for the weaker ones

Concerns about the ECB supporting individual countries ("moral hazard"? Fear of eventual inflation?)

The euro-skeptic view: euro break-up inevitable?

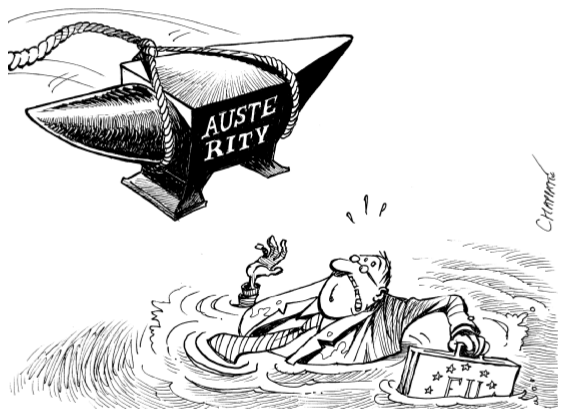
Doomed from the start?

European countries too different?

Public debt levels not sustainable and austerity measures too severe?

Leaving the euro would help?

EU response too little, too late?



The case for the euro

Strong political commitment of leaders to defend the euro

Break-up or shrinking of the euro area would involve huge costs, make it harder for countries to borrow.

Governance of euro area is being strengthened, flaws fixed

More sustainable public finances and economic reforms will help countries

"The euro is at the core of our European project."

Statement by Heads of State or Government of the euro area and EU institutions, Oct. 26^{th}, 2011