

LESSONS OF THE EUROPEAN CRISIS FOR REGIONAL MONETARY AND FINANCIAL INTEGRATION IN EAST ASIA

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Overview



1. Introduction

2. The causes of the European crisis

3. Lessons for East Asia

4. Conclusions

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§ Europe currently faces a severe crisis

- The debt crisis in several member states of the euro area has raised doubts on the viability of European Economic and Monetary Union (EMU) and the future of the euro

§ Was European monetary unification a bad idea?

- While the launch of the euro in 1999 created a lot of interest in regional monetary integration and even monetary unification in various parts of the world, including East Asia, the current crisis has had the opposite effect, even raising expectations of a break-up of the euro area
- Crisis has highlighted the problems and tensions that will inevitably arise within a monetary union when imbalances build up and become unsustainable



§ The objective of this presentation is twofold:

- To review the causes of the European crisis and explain why the crisis of a small member accounting for less than 3% of the euro area's GDP could cause so much havoc
- To draw lessons that East Asian countries can pick up from the current Europe sovereign debt crisis so they can pursue further successful development and economic integration in the region

Overview



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2. The causes of the European crisis

3. Lessons for East Asia

4. Conclusions

The causes of the European crisis



§ What happened?

- The Greek tragedy and how it spread over to Portugal, Ireland, Italy and Spain ("PIIGS": Portugal, Ireland, Italy, Greece, Spain)

§ Underlying causes of the crisis

- Country-specific problems
- Banking crisis fuelling sovereign debt crisis and vice versa
- Mispricing of risk and misallocation of capital
- Imbalances in the euro area
- Lack of coherent and credible crisis response by European governments

The causes of the European crisis



What happened?

5 Nov 2009: George Papandreou's new Socialist government says the 2009 budget deficit will be 12.7% of GDP – more than double the previously published figure



8 Dec 2009: Fitch Ratings, which had cut Greece to A- when the higher deficit was revealed, cuts Greek debt to BBB+, the first time in 10 years it has been rated below investment grade

16 Dec 2009: Standard & Poor's cuts Greece's rating by one notch, to BBB-plus from A-minus, saying the austerity programme is unlikely to produce a sustainable reduction in public debt

22 Dec 2009: Moody's cuts Greek debt to A2 from A1 over soaring deficits

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The causes of the European crisis



§ The revelation of the real Greek fiscal situation at the end of 2009 raised serious doubts on the country's ability to repay its debt

- Rating downgrades and rising interest rates made it ever more difficult for the government to refinance itself, creating a downward spiral for the Greek economy
- Bail-out by other European countries and IMF failed to restore trust in Greek economy

§ Greek crisis has also raised concerns over debt situation of other periphery countries of the euro zone

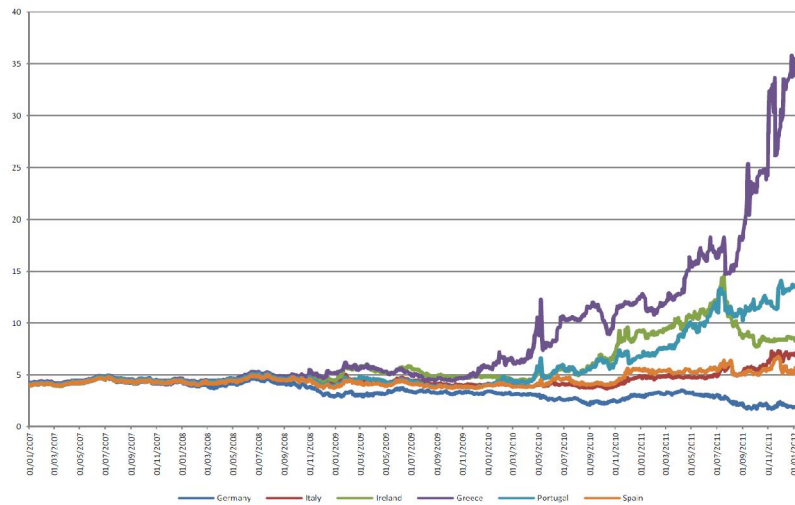
- Rising borrowing costs for several members of the euro area (the PIIGS) as trust in their ability to repay vanishes
- Increased focus on structural/competitiveness problems of PIIGS and imbalances within the euro area

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The causes of the European crisis



10 year government bond yields, January 2007 – January 2012



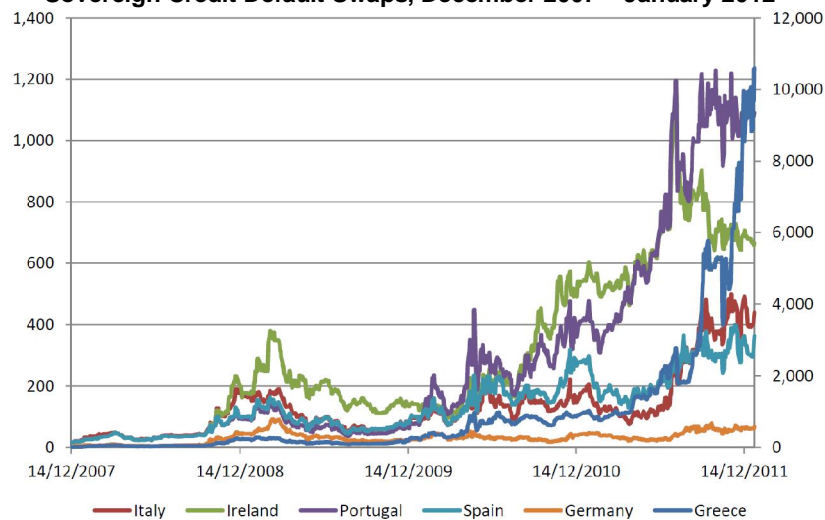
Source: Datastream

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The causes of the European crisis



Sovereign Credit Default Swaps, December 2007 – January 2012



Source: Eurostat

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The causes of the European crisis



§ Underlying causes of the crisis

- Country-specific problems
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The causes of the European crisis



§ Causes of the crisis: Country-specific problems

- Greece: Desolate public finances due to a dysfunctional fiscal system, a massively oversized (and inefficient) public sector, and endemic corruption
- Ireland: Banking crisis!
 - In September 2008 the Irish government guaranteed all outstanding obligations of the Irish banking system as a reaction to the Irish banking crisis (these were initially €400bn. but have increased to €440bn.)
 - Ireland did not have a fiscal or debt problem before the crisis!
- Spain: Burst of housing bubble
 - Spain did not have a fiscal or debt problem before the crisis either

The causes of the European crisis



§ Causes of the crisis: Banking crisis fuelling sovereign debt crisis and vice versa

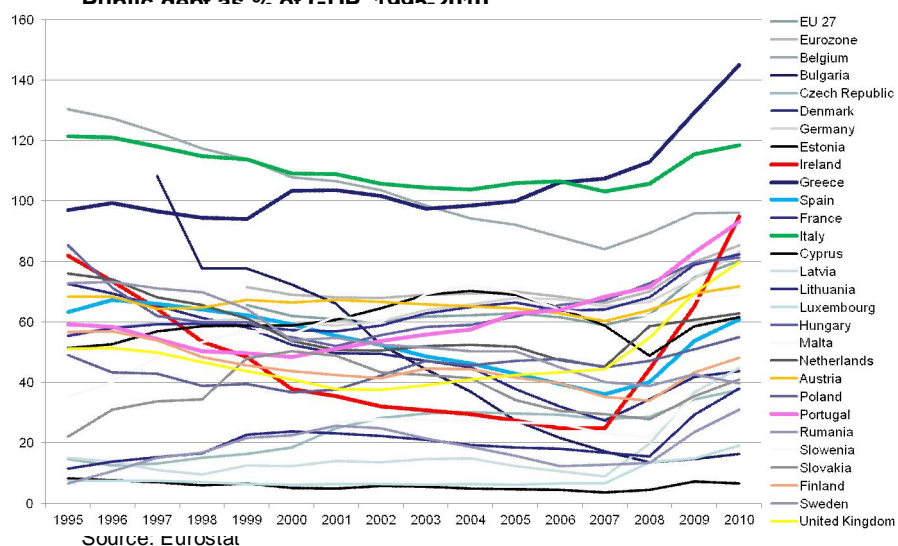
- Government bail outs of banking systems in the course of the global financial crisis has increase public debt
- Fiscal positions worsened as economies contracted and governments responded with anticyclical policies
- Between 2007 and 2010, the debt to GDP ration of the Eurozone increased from 66.3% to 85.4%
- Governments failed to recapitalise banks swiftly
- Sovereign risk has increased and worsens bank's assets
- Further bail outs (of banks and states) make things worse
- Vicious circle set in motion

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The causes of the European crisis



Public debt as % of GDP, 1995-2010

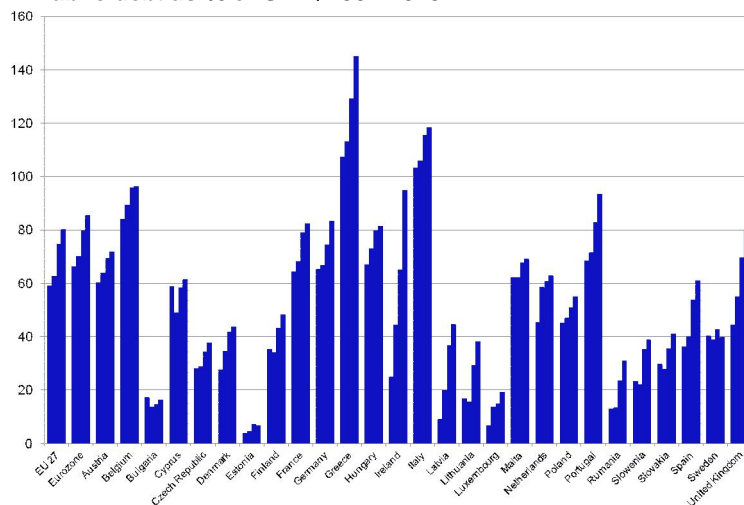


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The causes of the European crisis



Public debt as % of GDP, 2007-2010



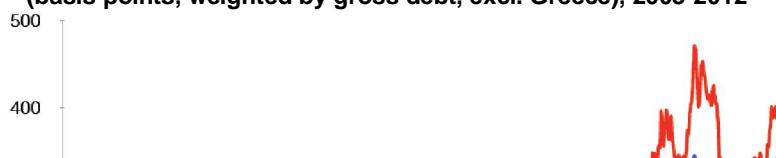
Source: Eurostat

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The causes of the European crisis



Credit default swap spreads of euro area
(basis points, weighted by gross debt, excl. Greece), 2008-2012



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