



Ministero dell'Economia e delle Finanze
Dipartimento del Tesoro

Financial crisis and contagion risks for the Euro Area

ABI Country Risk Forum

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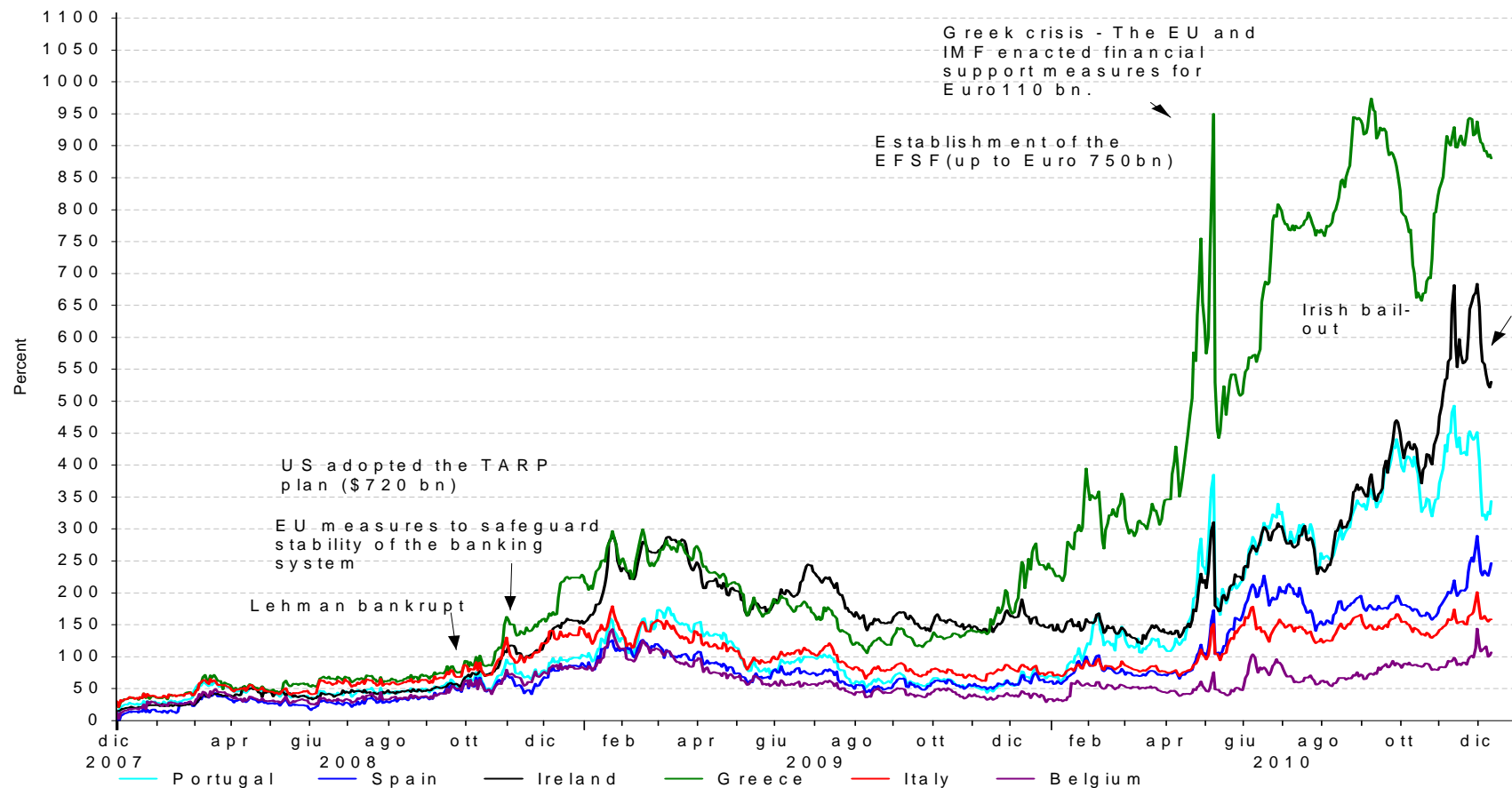
Economic and Financial Analysis Department of the Treasury

Financial crisis and contagion risk in the Euro Area

- Where do we stand? What are financial markets saying?
- Mind your debt: which debt should we look at?
- Macro imbalances: what is out of line and what is not?
- Policy response: a bird-eye view of policy initiatives.
- Will it be enough? Possible scenarios out of the crisis.

WHERE DO WE STAND? WHAT ARE FINANCIAL MARKETS SAYING?

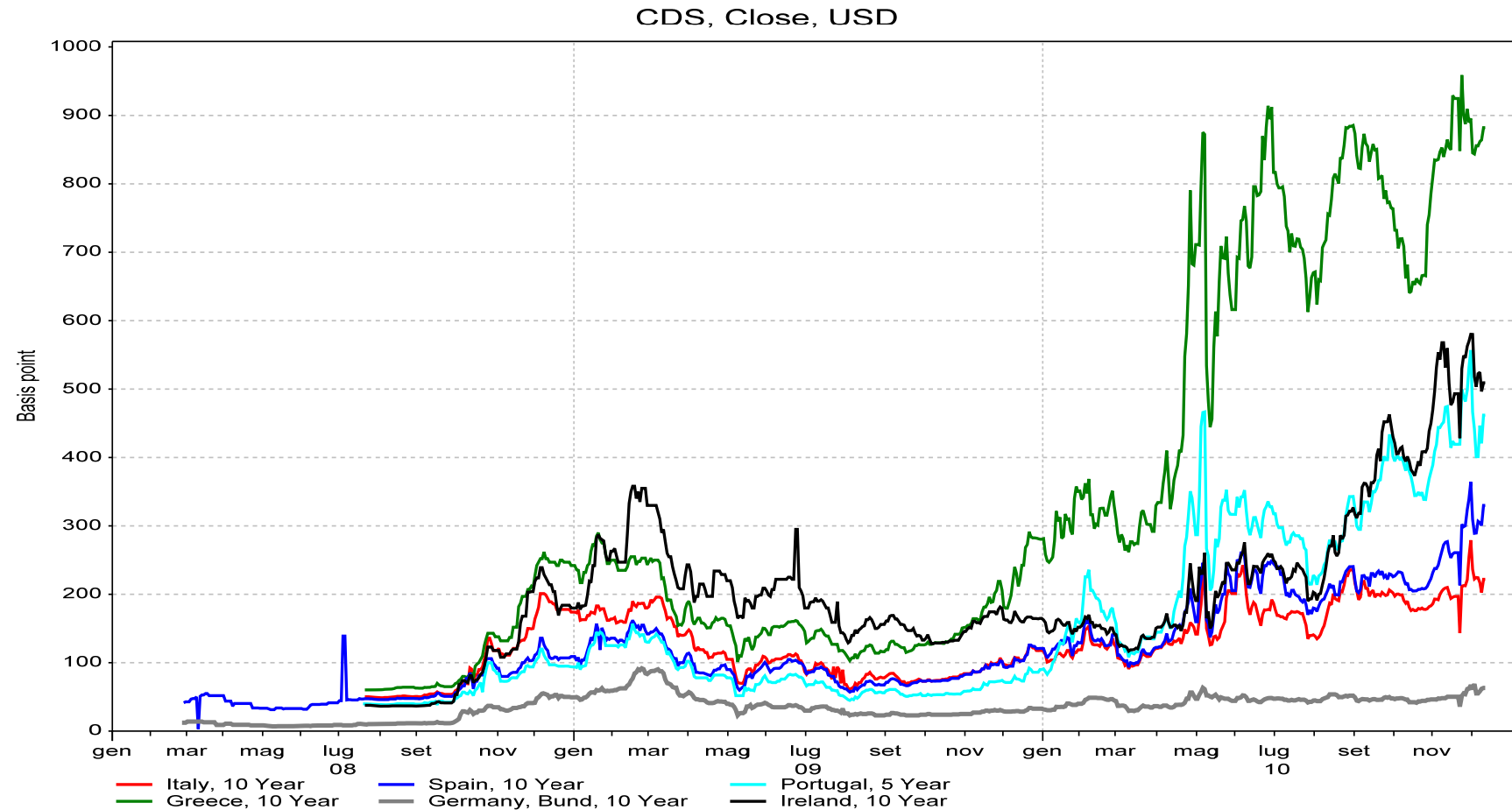
Severe impact on Eurozone government bond spreads



Policymakers have decided unprecedented market interventions but tensions in financial markets have not yet receded.

WHERE DO WE STAND? WHAT ARE FINANCIAL MARKETS SAYING?

CDSs on sovereign issuers under pressure as well

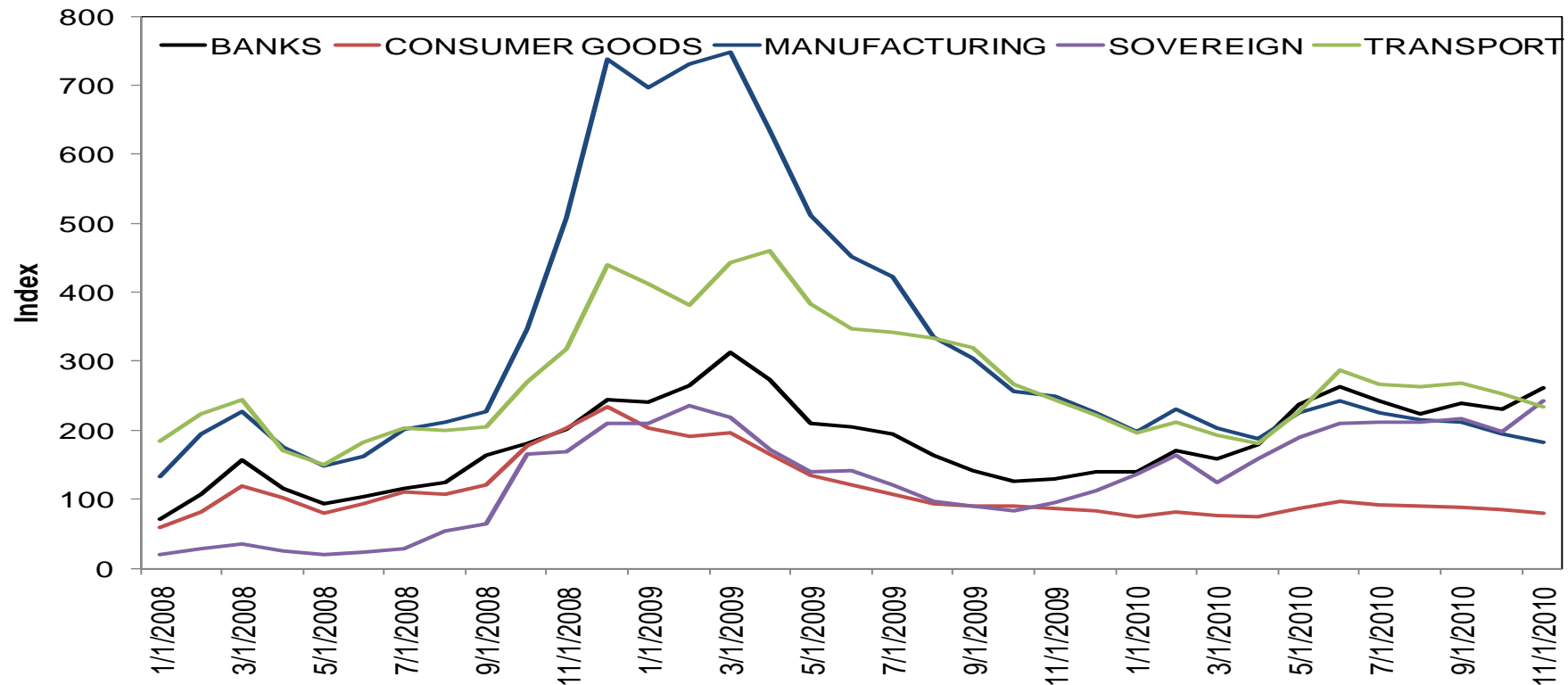


Source: Reuters EcoWin

Italy has weathered the storm better than other EU countries.

WHERE DO WE STAND? WHAT ARE FINANCIAL MARKETS SAYING?

And of course also CDSs on banks (but less than in the past)

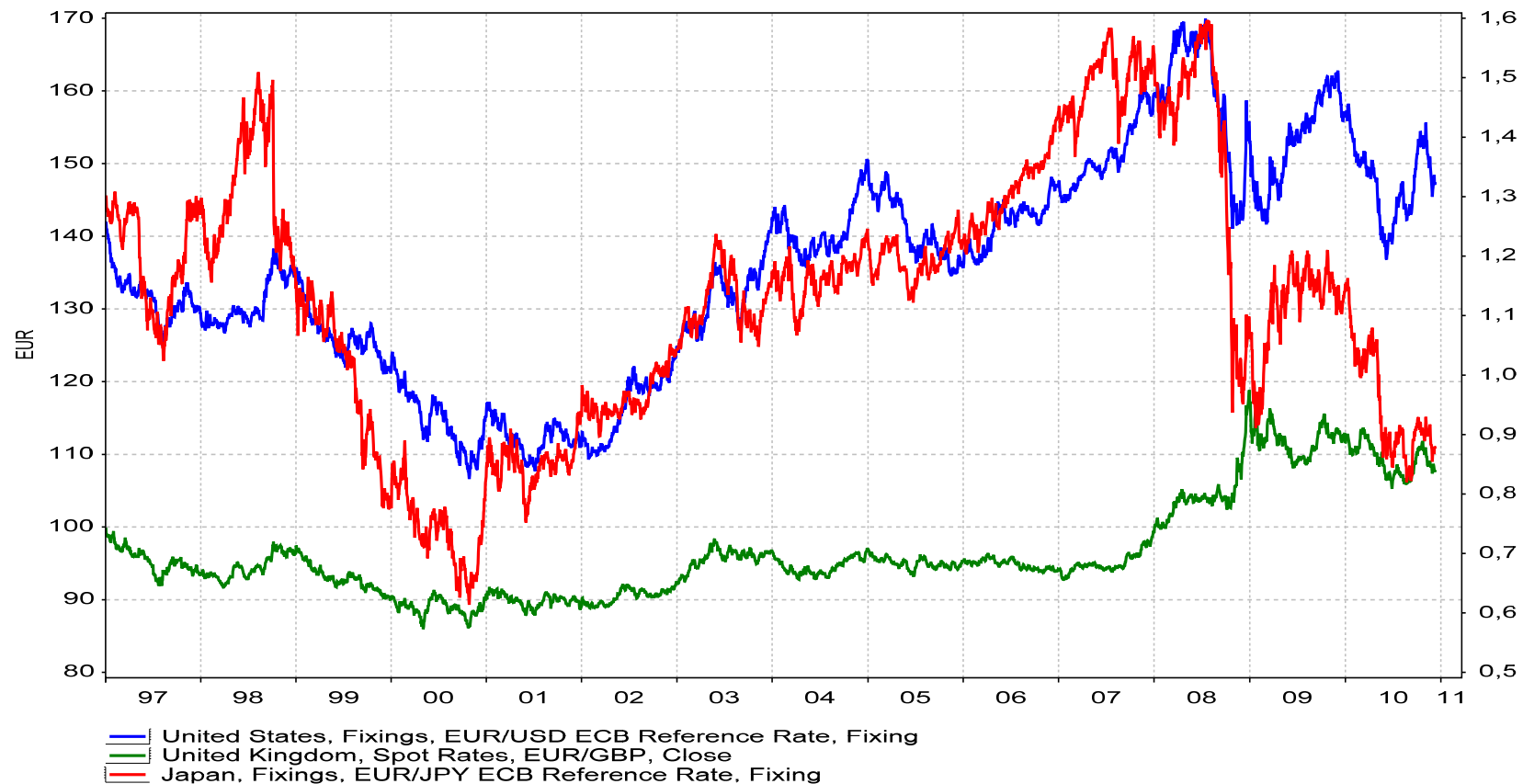


note: CDS 5Y; source: Thomson Reuters

Banking sectors in Eurozone countries are vulnerable to potential risks in sovereign bond markets, and the other way around. It is a catch 22! In Italy, banking sector risks have remained contained.

WHERE DO WE STAND? WHAT ARE FINANCIAL MARKETS SAYING?

Large swings in exchange rate markets

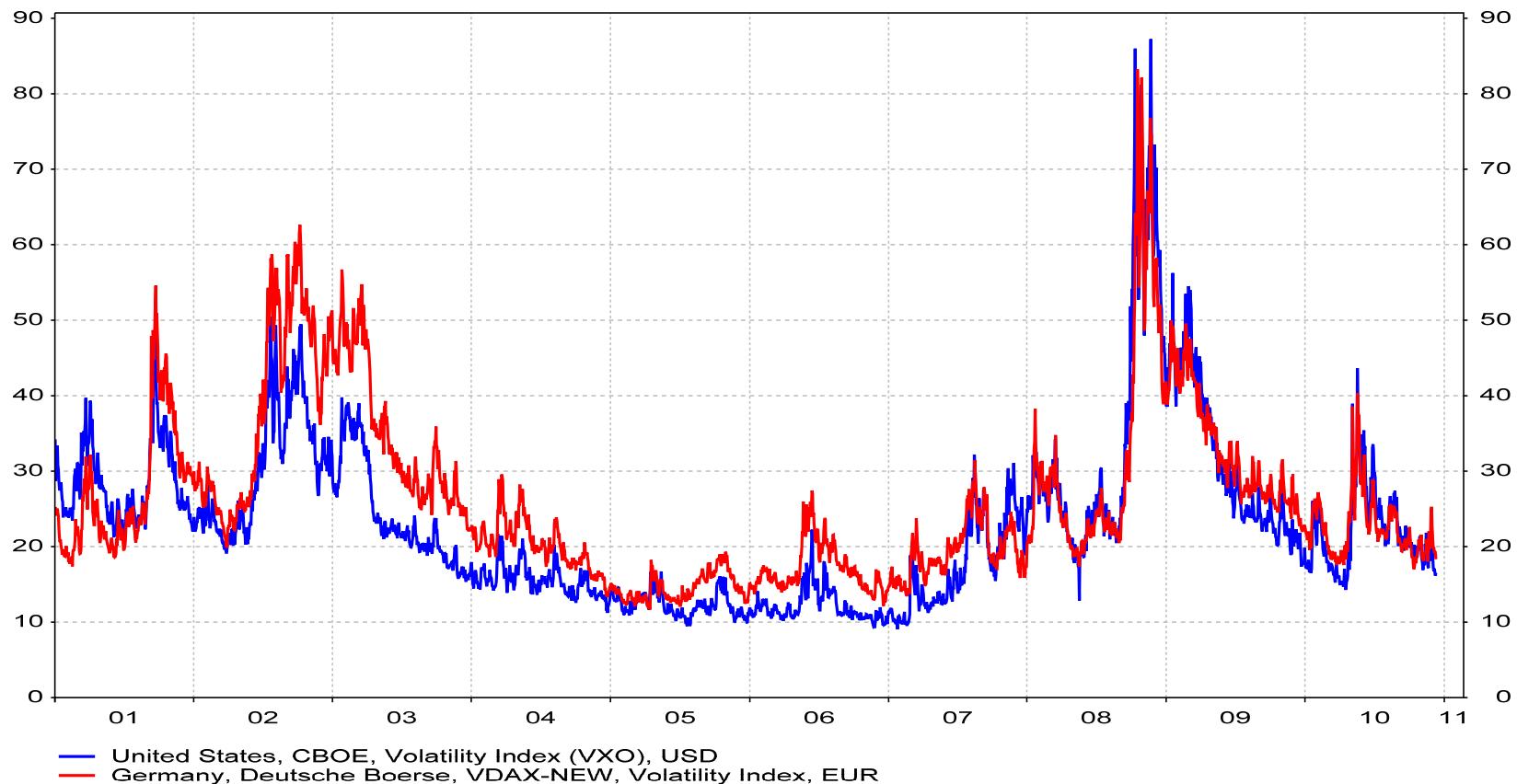


Source: Reuters EcoWin

Risk factors have played an increasing role.

WHERE DO WE STAND? WHAT ARE FINANCIAL MARKETS SAYING?

Volatility has declined, but markets remain fragile

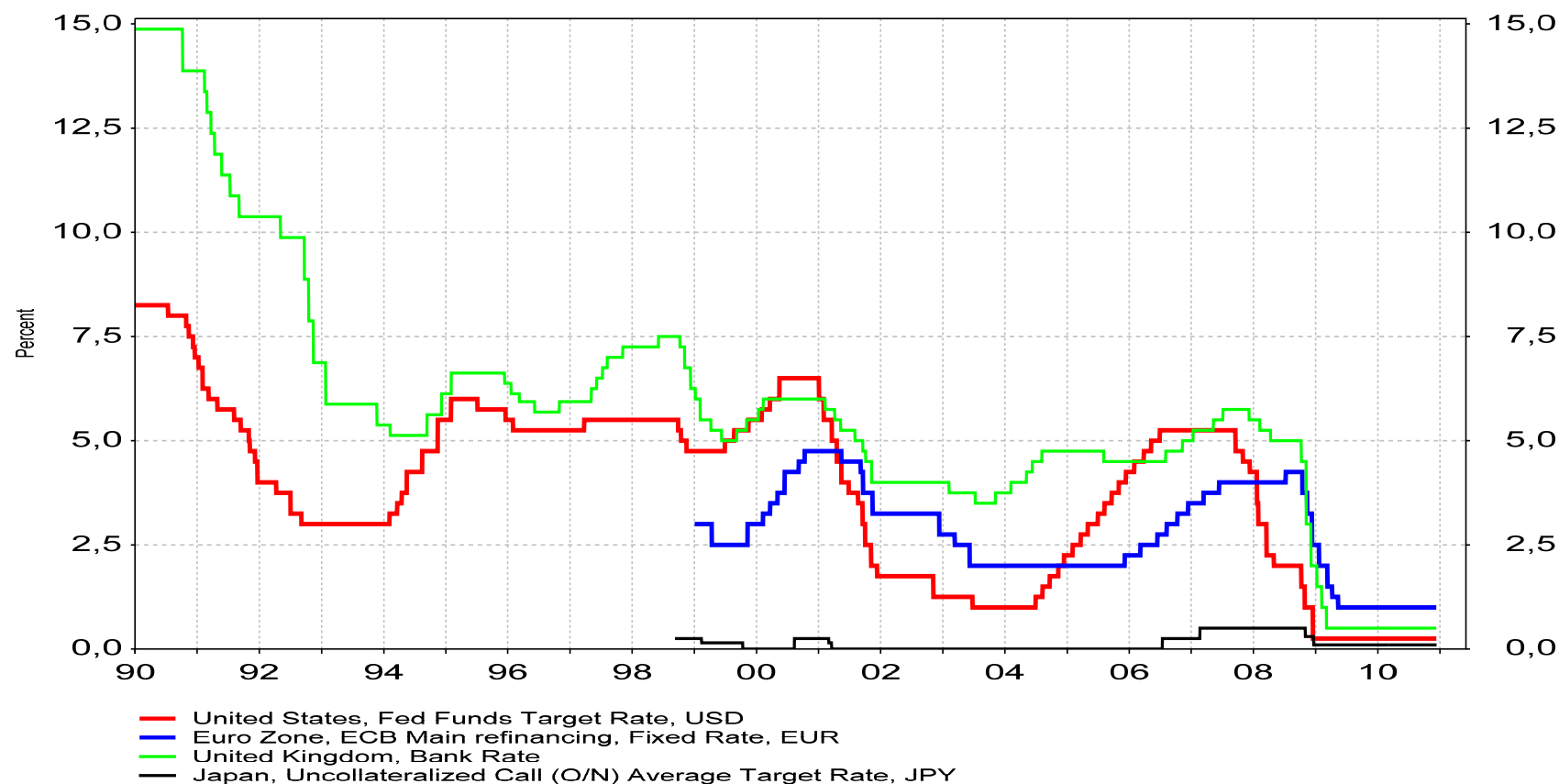


Source: Reuters EcoWin

Volatility in equity markets is almost back to its long-term average.

WHERE DO WE STAND? WHAT ARE FINANCIAL MARKETS SAYING?

Extremely loose monetary policy in advanced economies

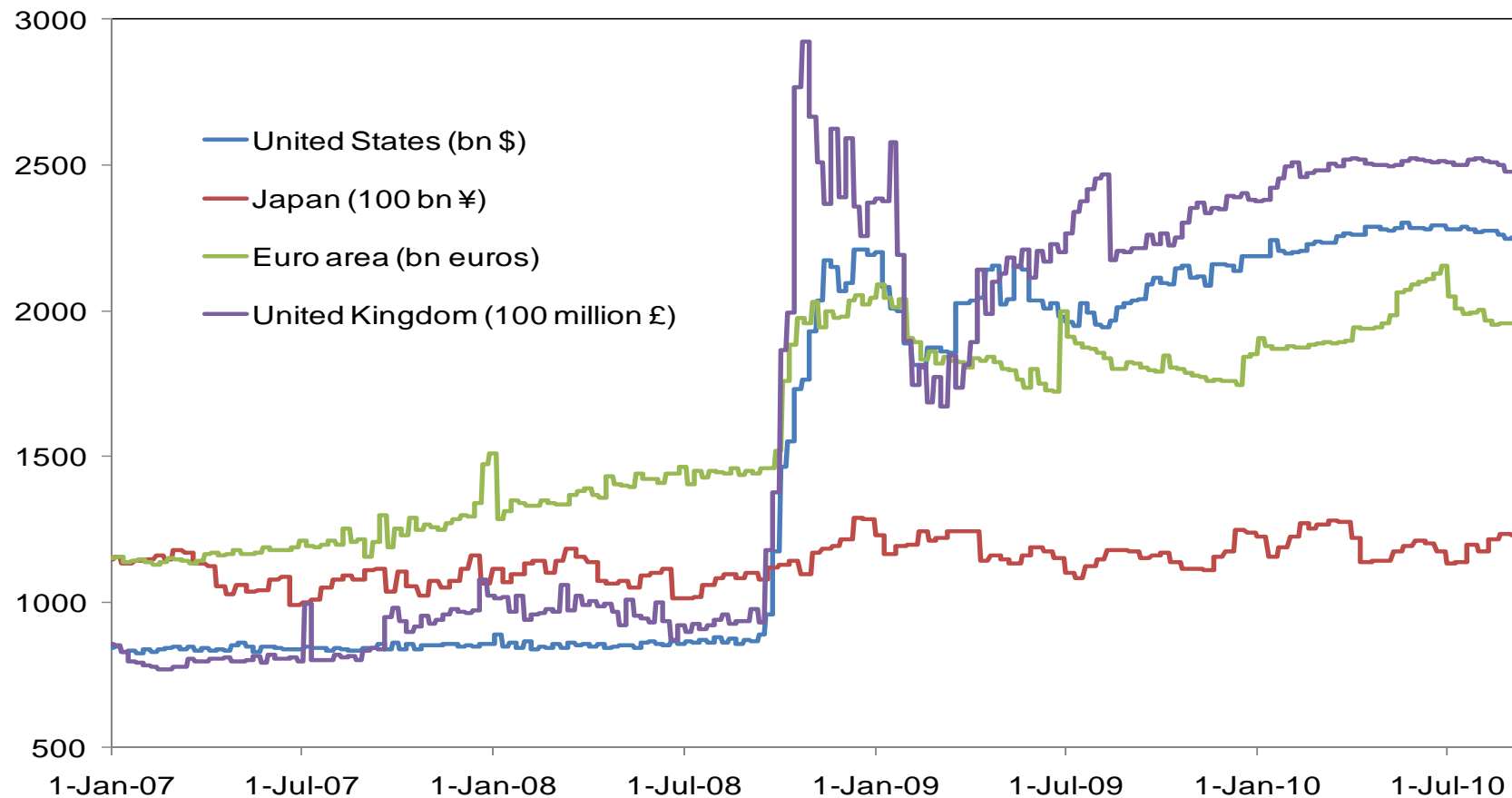


Source: Reuters EcoWin

Policy rates remain at historical lows and non-conventional measures have aggressively been introduced by many central banks.

WHERE DO WE STAND? WHAT ARE FINANCIAL MARKETS SAYING?

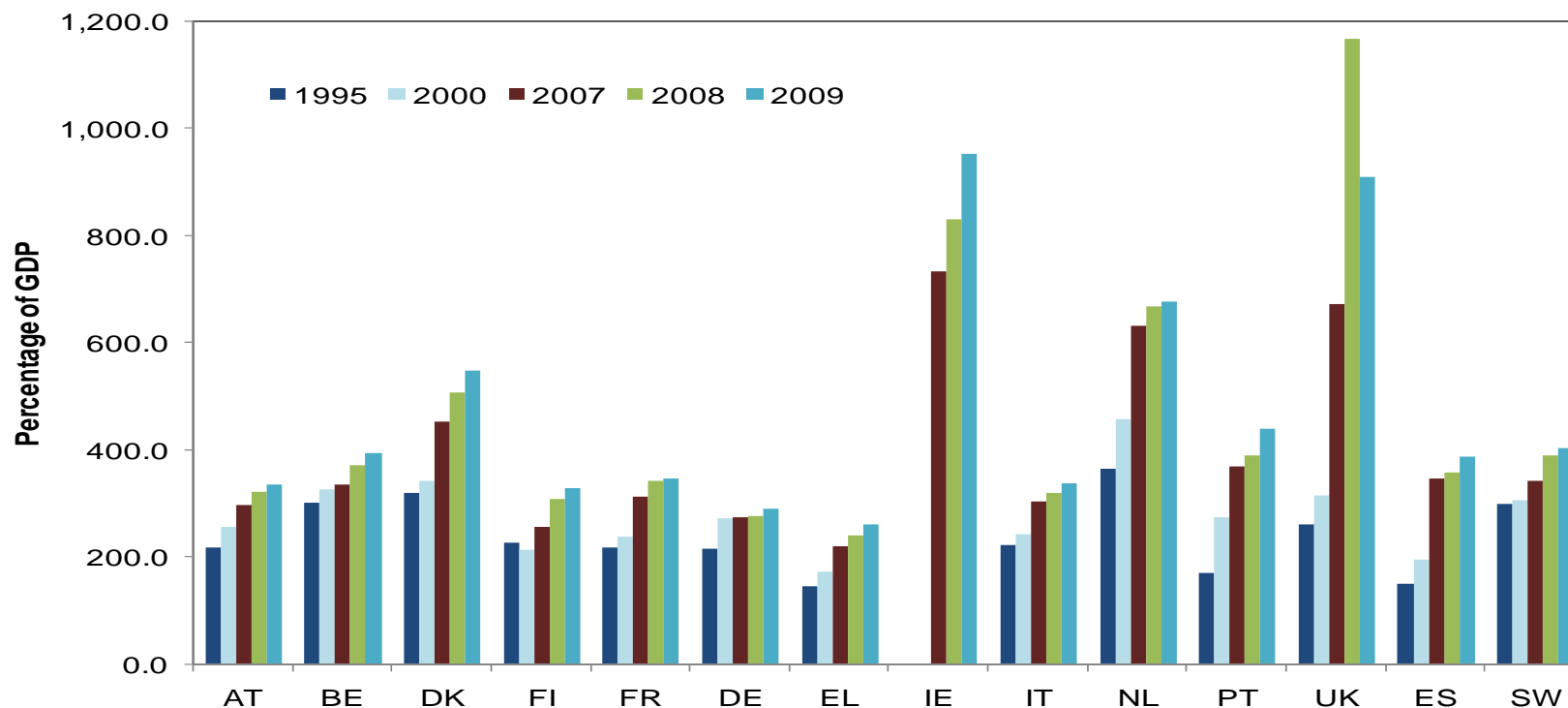
Sizeable expansion of central banks' balance sheets



Significant boost in balance sheets due to unprecedented and unconventional policy measures.

MIND YOUR DEBT: WHICH DEBT SHOULD WE LOOK AT?

Italy's overall debt (gov't + private) is relatively low



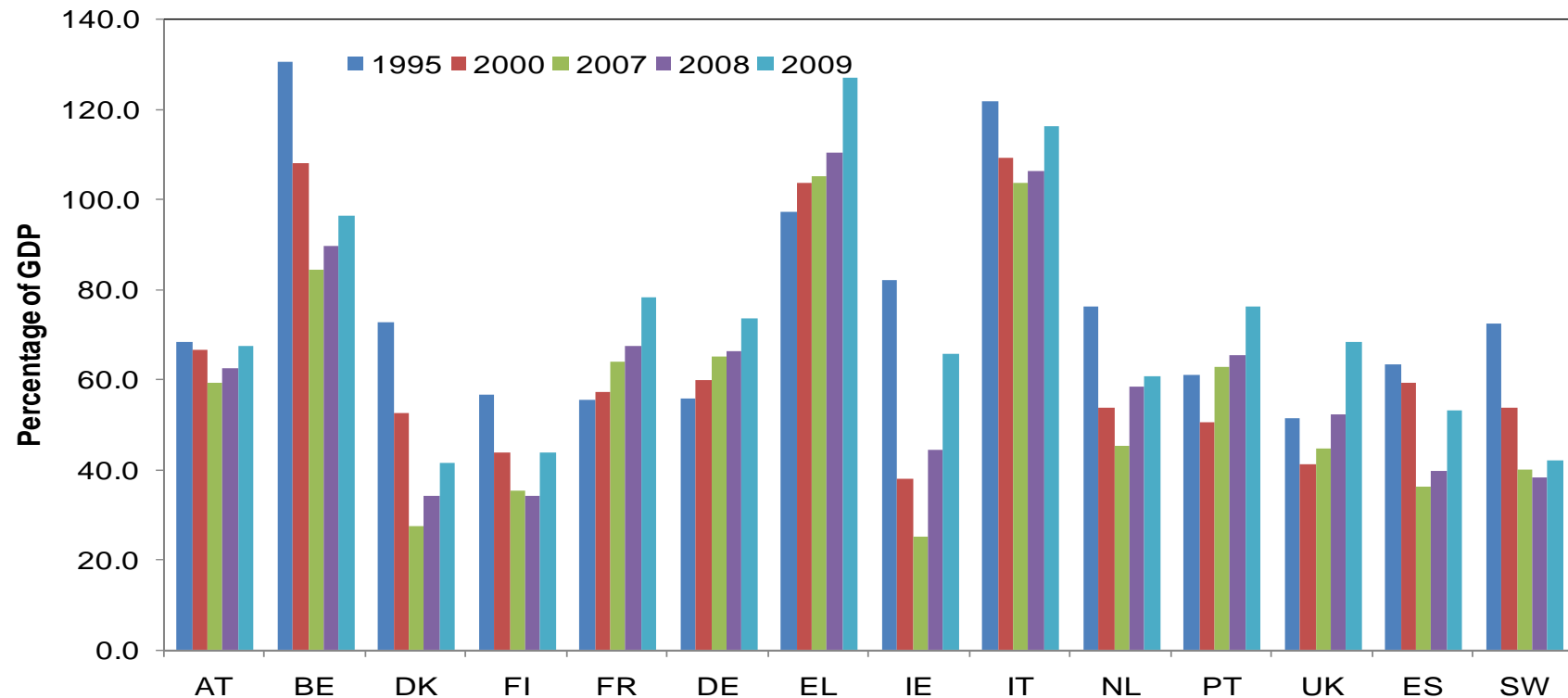
Source: Eurostat

In 1995 and 2000 data for Ireland are not available.

Italy's overall debt (gov't + private) was lower than most EU countries in 2009. It stood at 337.1% of GDP, among the smallest in the EU15exL (472.2% for EU15 ex-Luxembourg; in the private sector we include both financial and non-financial corporations as well as households).

MIND YOUR DEBT: WHICH DEBT SHOULD WE LOOK AT?

Public debt is high in Italy, but not rising fast

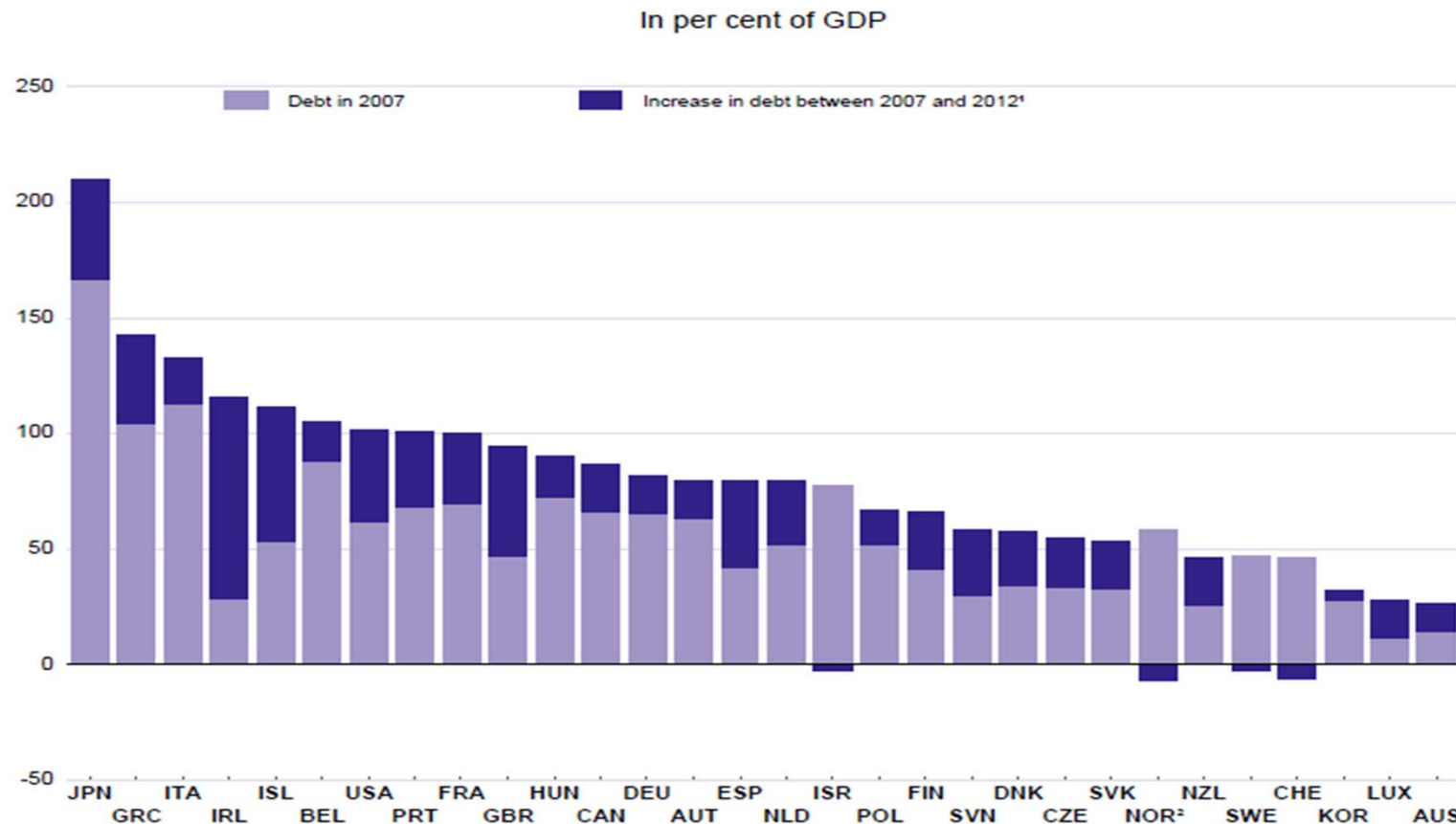


Source: Eurostat

In 2009, public debt stood at 116.0% versus an average of 72.1% of GDP in the EU15exL. However, the increase due to the crisis has been far less pronounced than elsewhere.

MIND YOUR DEBT: WHICH DEBT SHOULD WE LOOK AT?

Debt/GDP ratios at historical highs almost everywhere



1. This includes cumulated deficit for 2008-12, debt-increasing equity participations in companies and the impact of GDP growth.

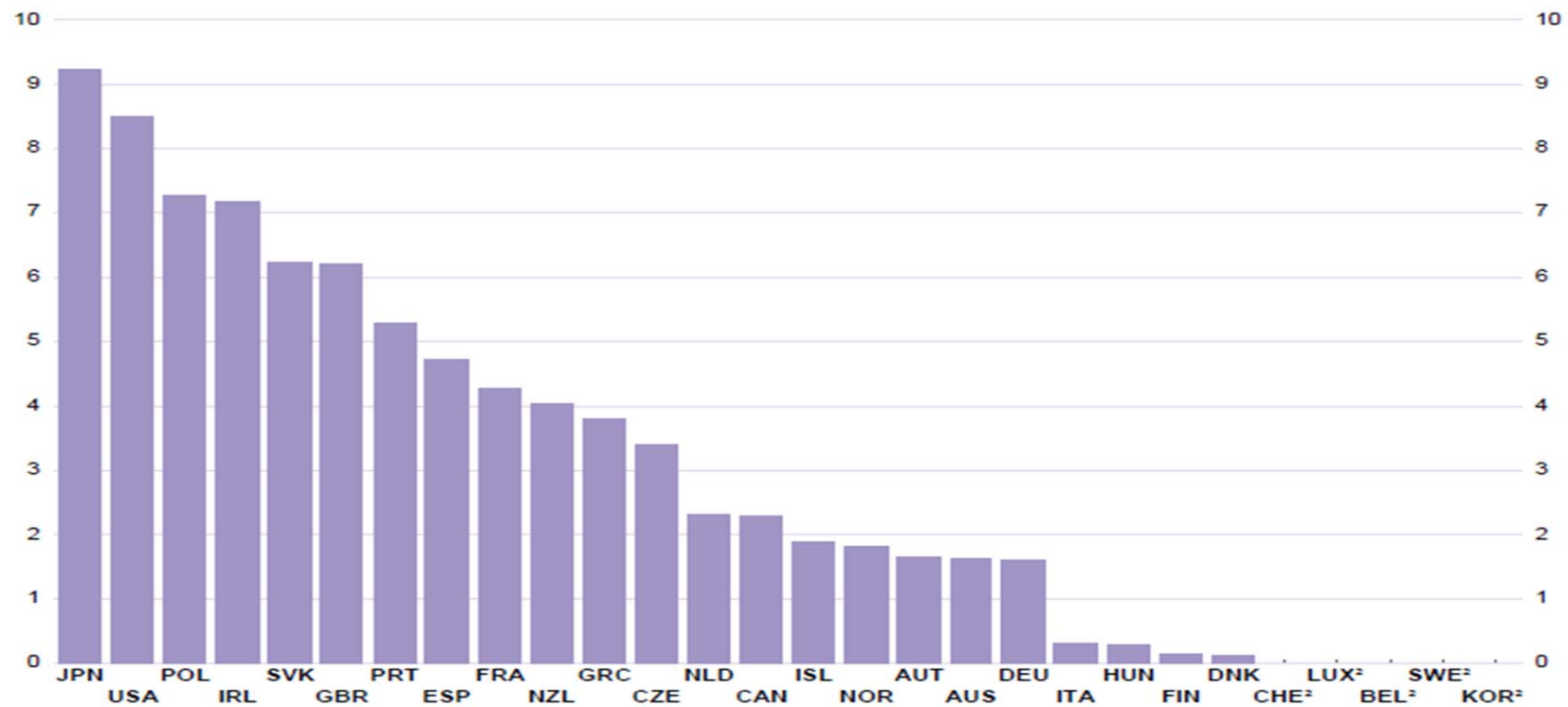
2. Cumulated deficits correspond to mainland only.

Source: OECD Economic Outlook 88 database.

MIND YOUR DEBT: WHICH DEBT SHOULD WE LOOK AT?

Stabilising debt/GDP ratios will be a daunting task

Required change in underlying primary balance to stabilise debt by 2025, ¹
in per cent of potential GDP



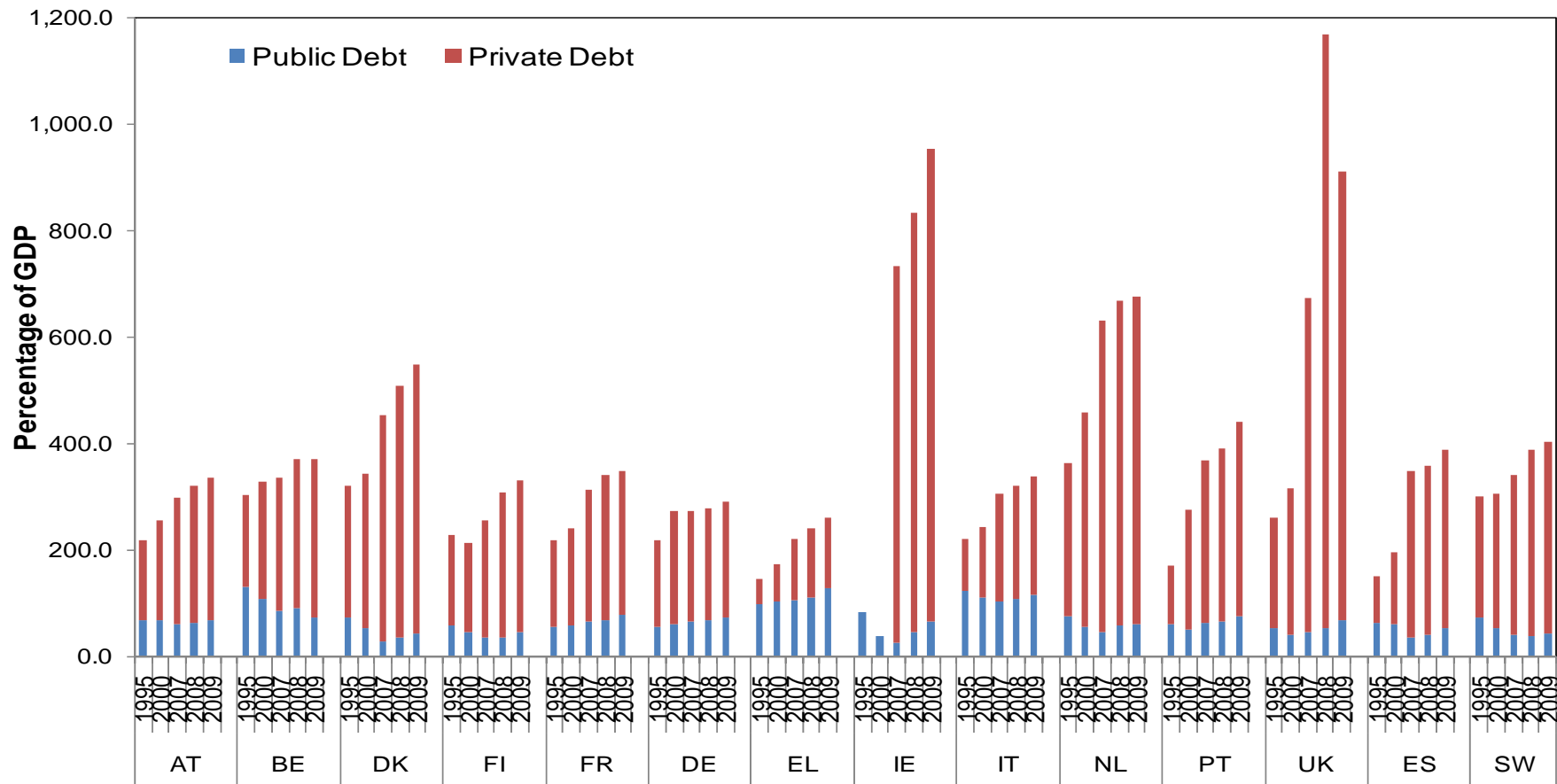
1. Change in the underlying primary balance between 2010 and 2025, based on gradual but steady consolidation paths (as set out in OECD Economic Outlook, No. 88, November 2010, Chapter 4).

2. No consolidation is needed to achieve the target.

Source: OECD Economic Outlook, No. 88, November 2010.

MIND YOUR DEBT: WHICH DEBT SHOULD WE LOOK AT?

But it is private debt at the root of the crisis!

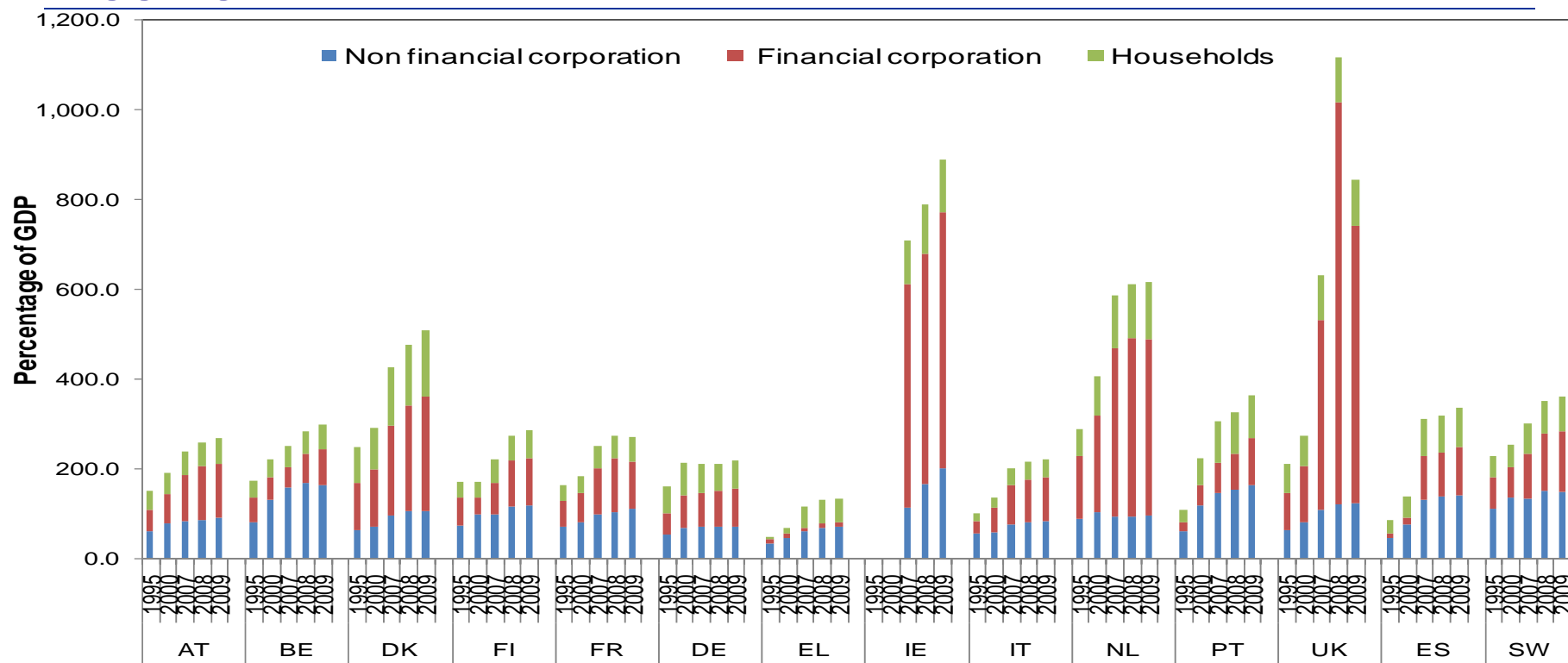


Source: Our calculations on Eurostat data

Private debt-to-GDP was lower in Italy than in most other EU countries in 1995-2009. In 2009, it was 221.1% versus an average of 400.1% of GDP for EU15exL.

MIND YOUR DEBT: WHICH DEBT SHOULD WE LOOK AT?

Digging into private debt: what matters?



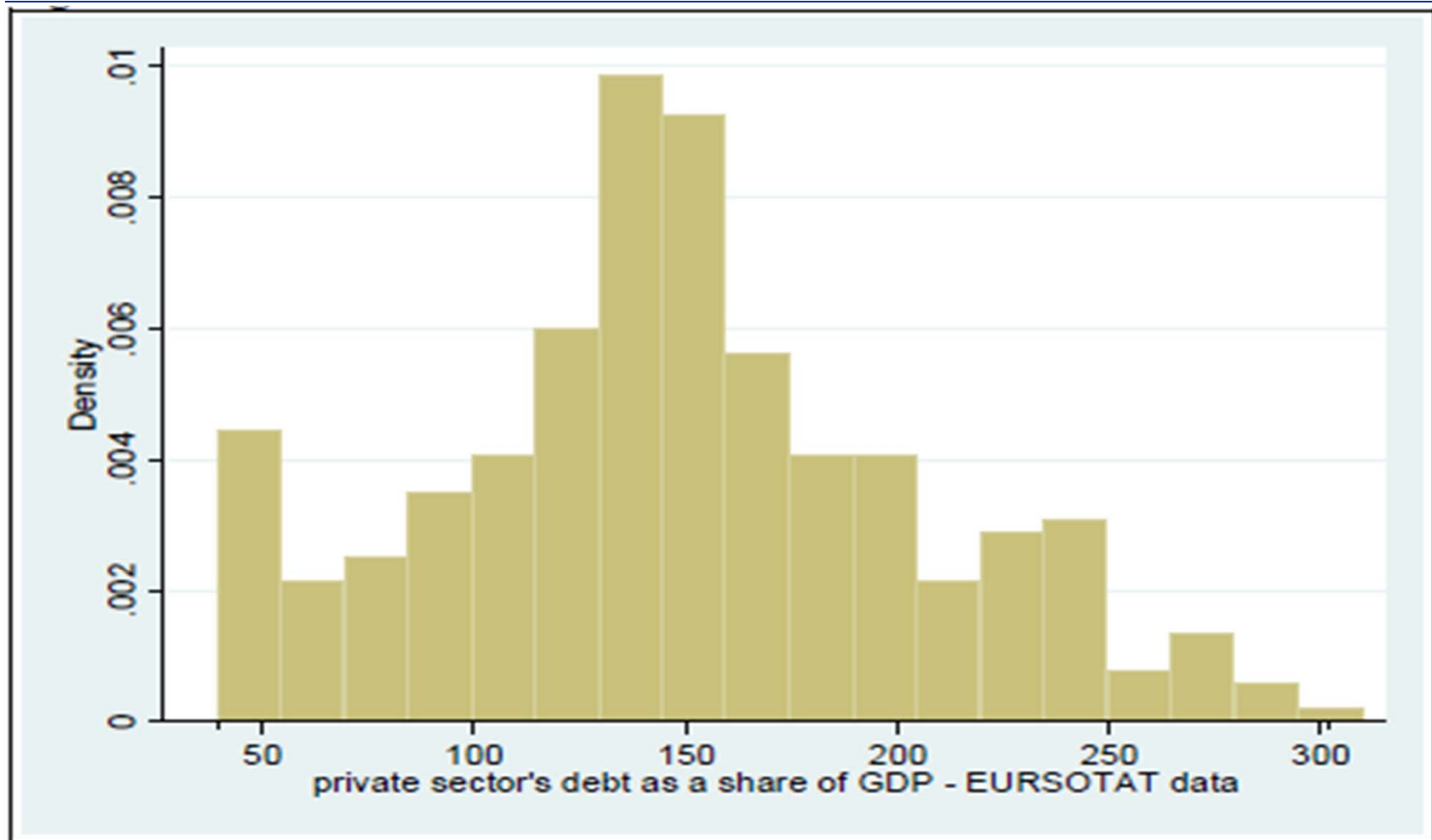
Source: Our calculations on Eurostat data

In 1995 and 2000 data for Ireland are not available.

In 1995-2009, Italy's private debt was far below the EU15exL average. In 2009, household debt was about half of the EU15exL average (42.2% vs 81.5% of GDP); debt of non-financial corporations stood at 82.8% (vs 119.7%); debt of financial corporations was 96.1% (vs 198.9%).

MIND YOUR DEBT: WHICH DEBT SHOULD WE LOOK AT?

Digging into private debt: is it really evil?



MIND YOUR DEBT: WHICH DEBT SHOULD WE LOOK AT?

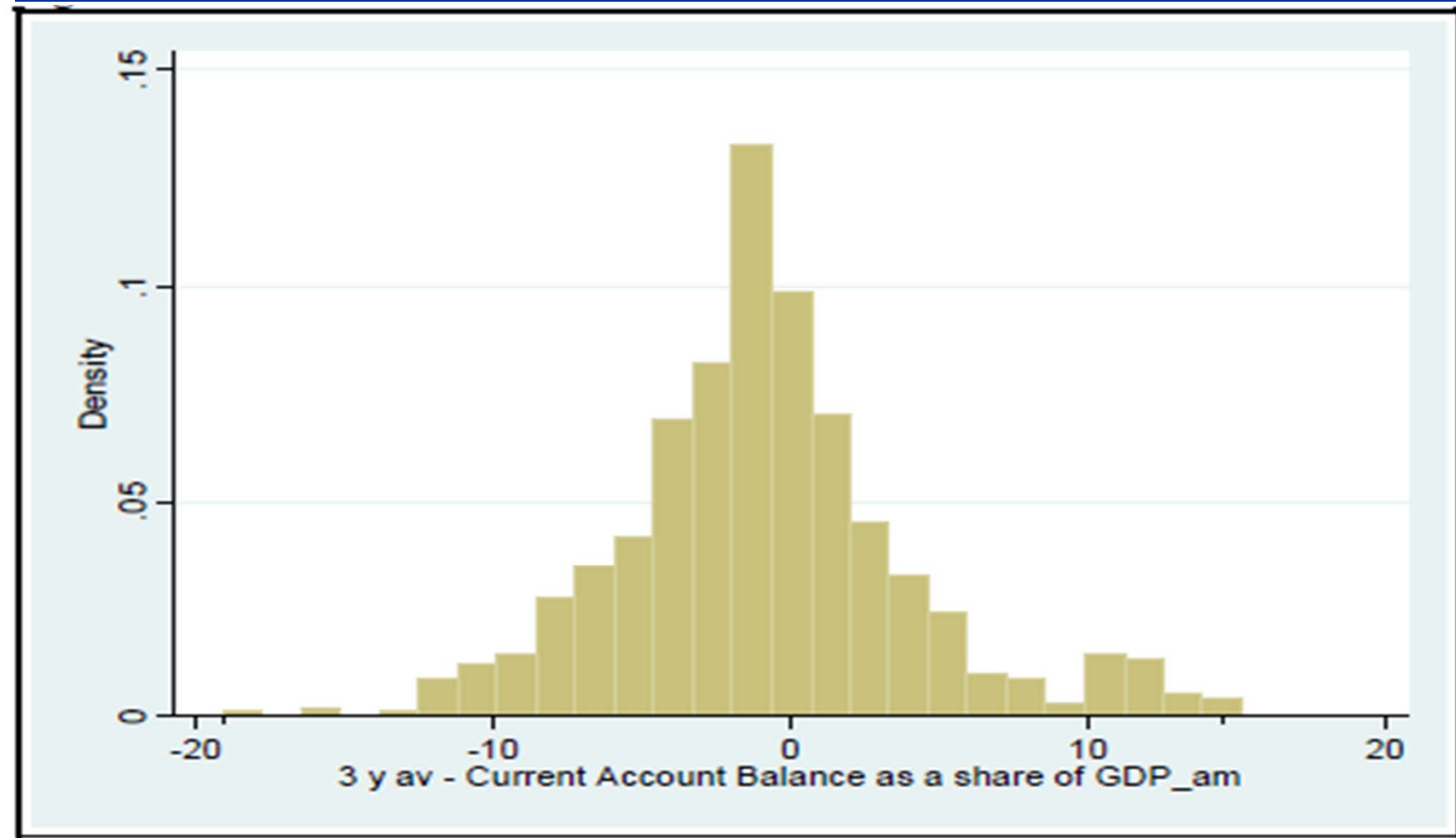
An oversized financial sector?



Source: The Banker Database; OECD Economic Outlook 88 database; and OECD calculations.

MACRO IMBALANCES: WHAT IS OUT OF LINE AND WHAT IS NOT?

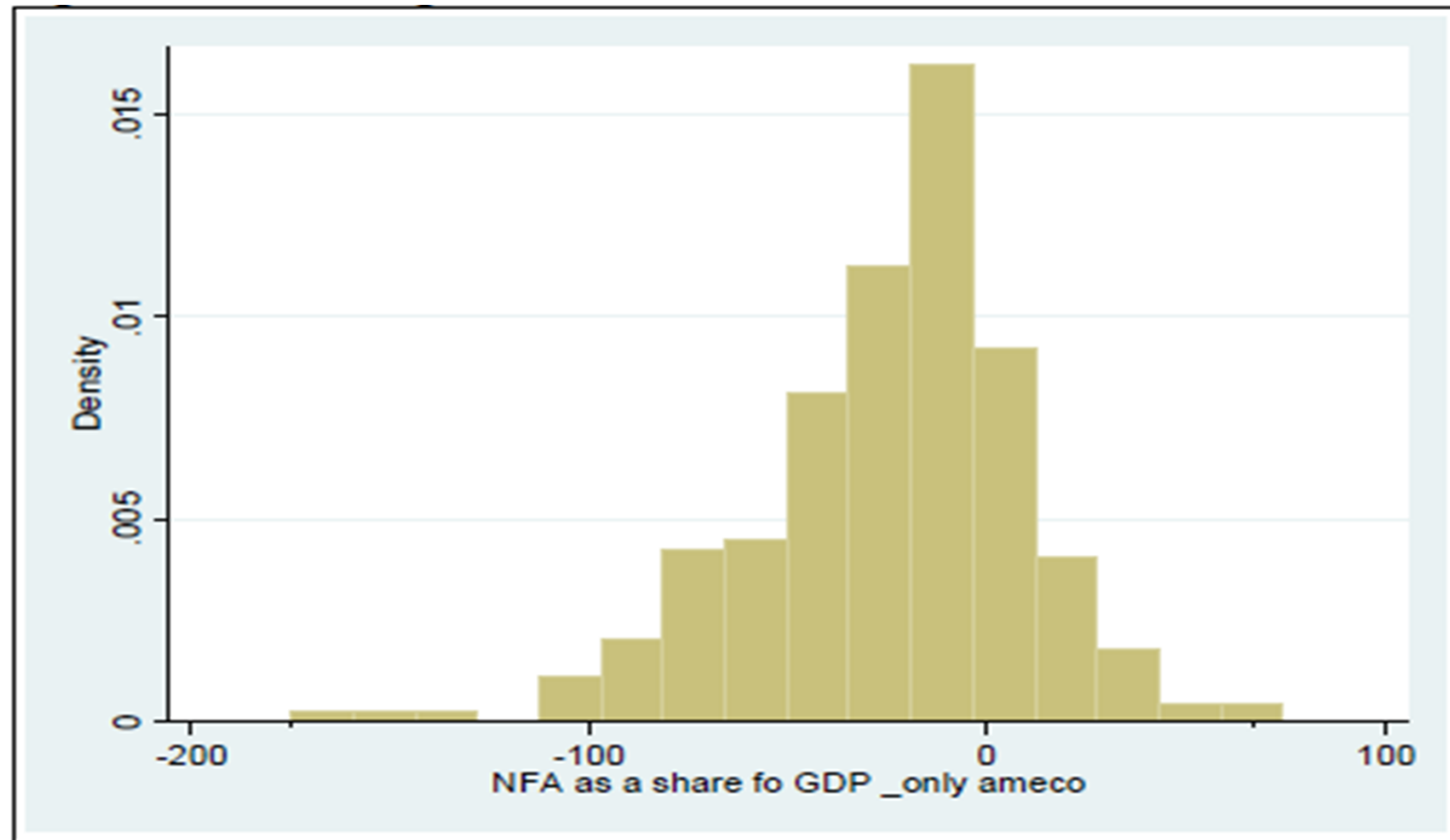
The current account may not be the most relevant variable



Source: European Commission

MACRO IMBALANCES: WHAT IS OUT OF LINE AND WHAT IS NOT?

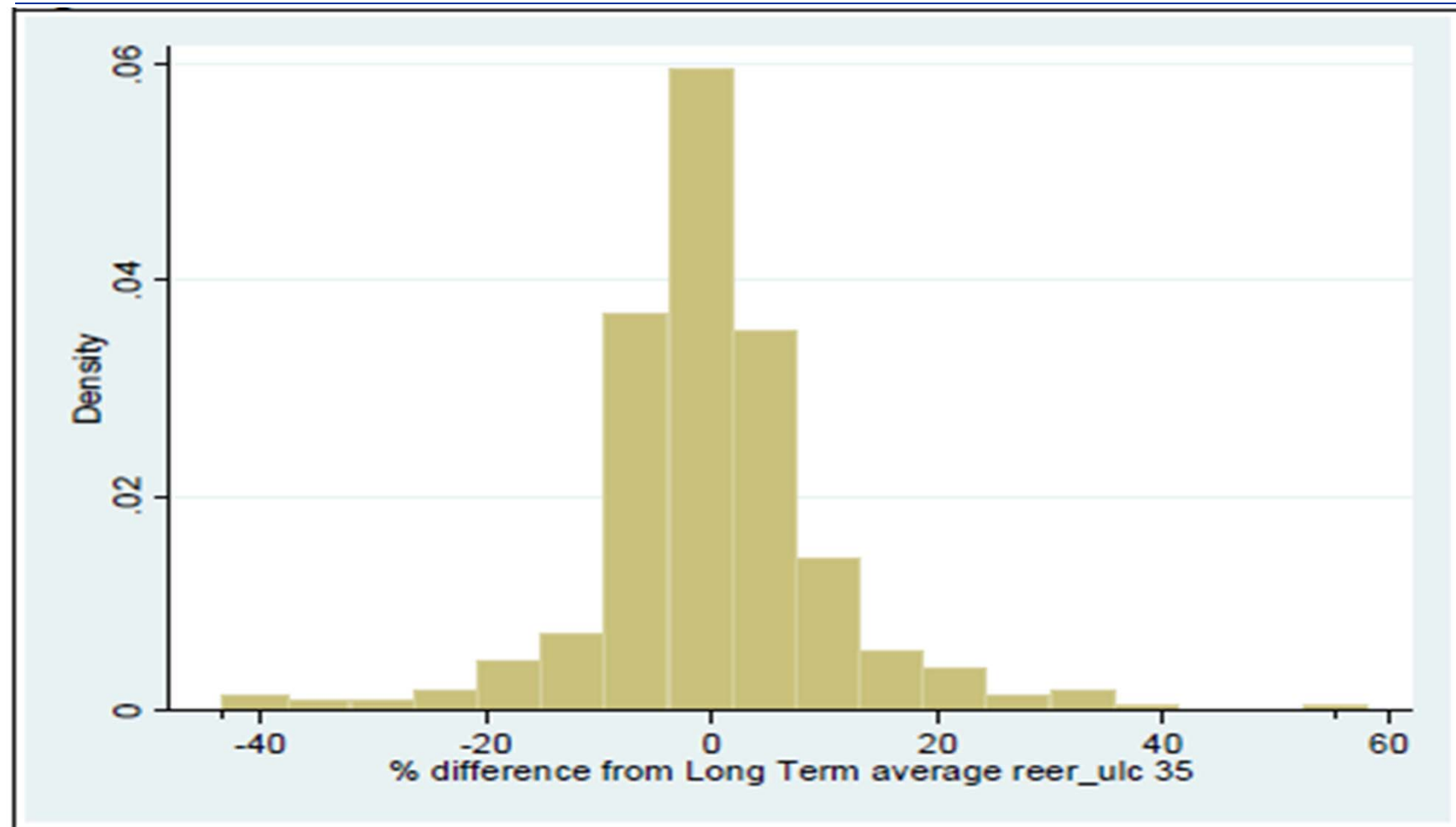
Net foreign assets: desirable FDI or taxing debt servicing?



Source: European Commission

MACRO IMBALANCES: WHAT IS OUT OF LINE AND WHAT IS NOT?

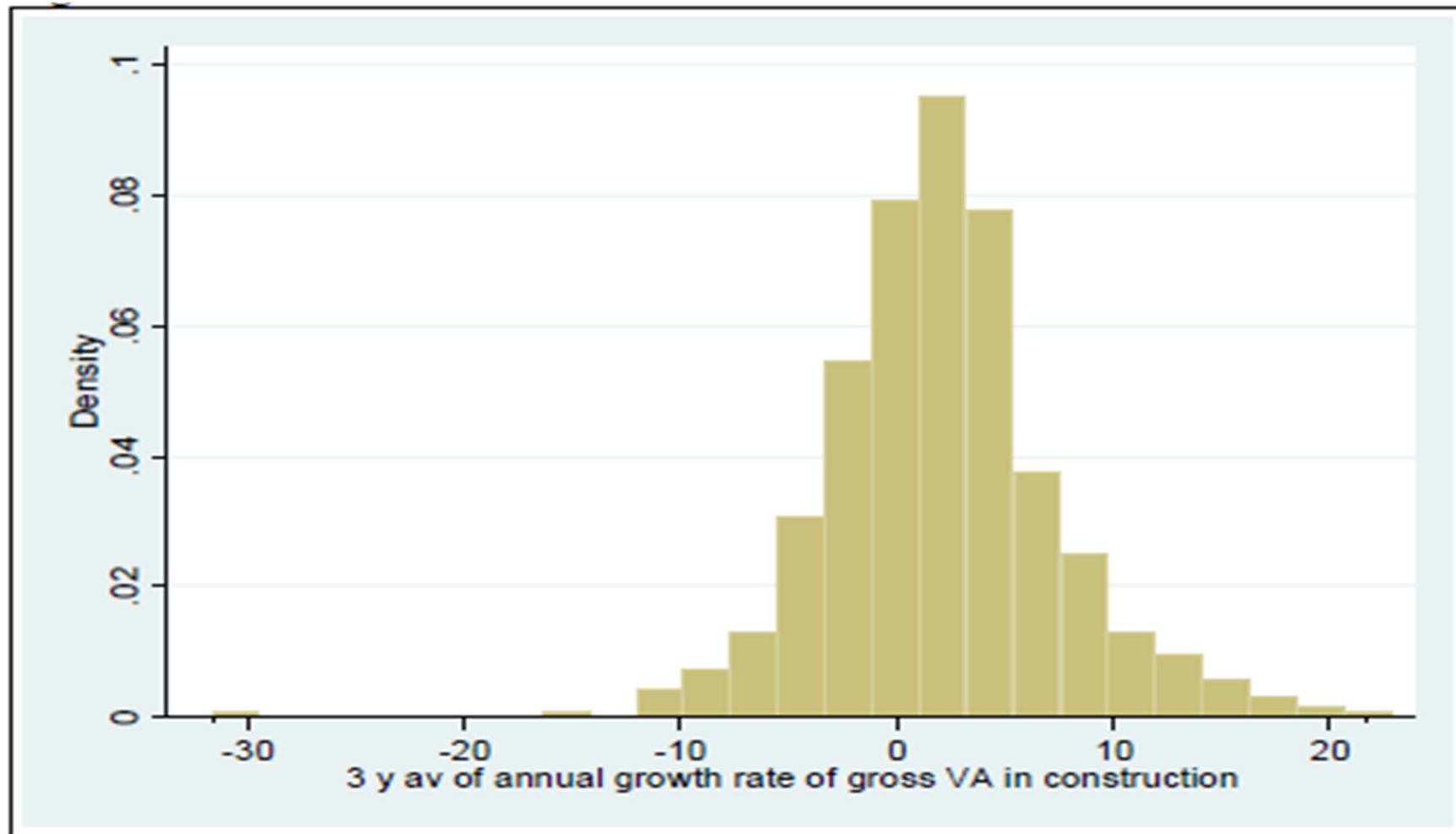
REER: not the same meaning when inside/outside the EMU



Source: European Commission

MACRO IMBALANCES: WHAT IS OUT OF LINE AND WHAT IS NOT?

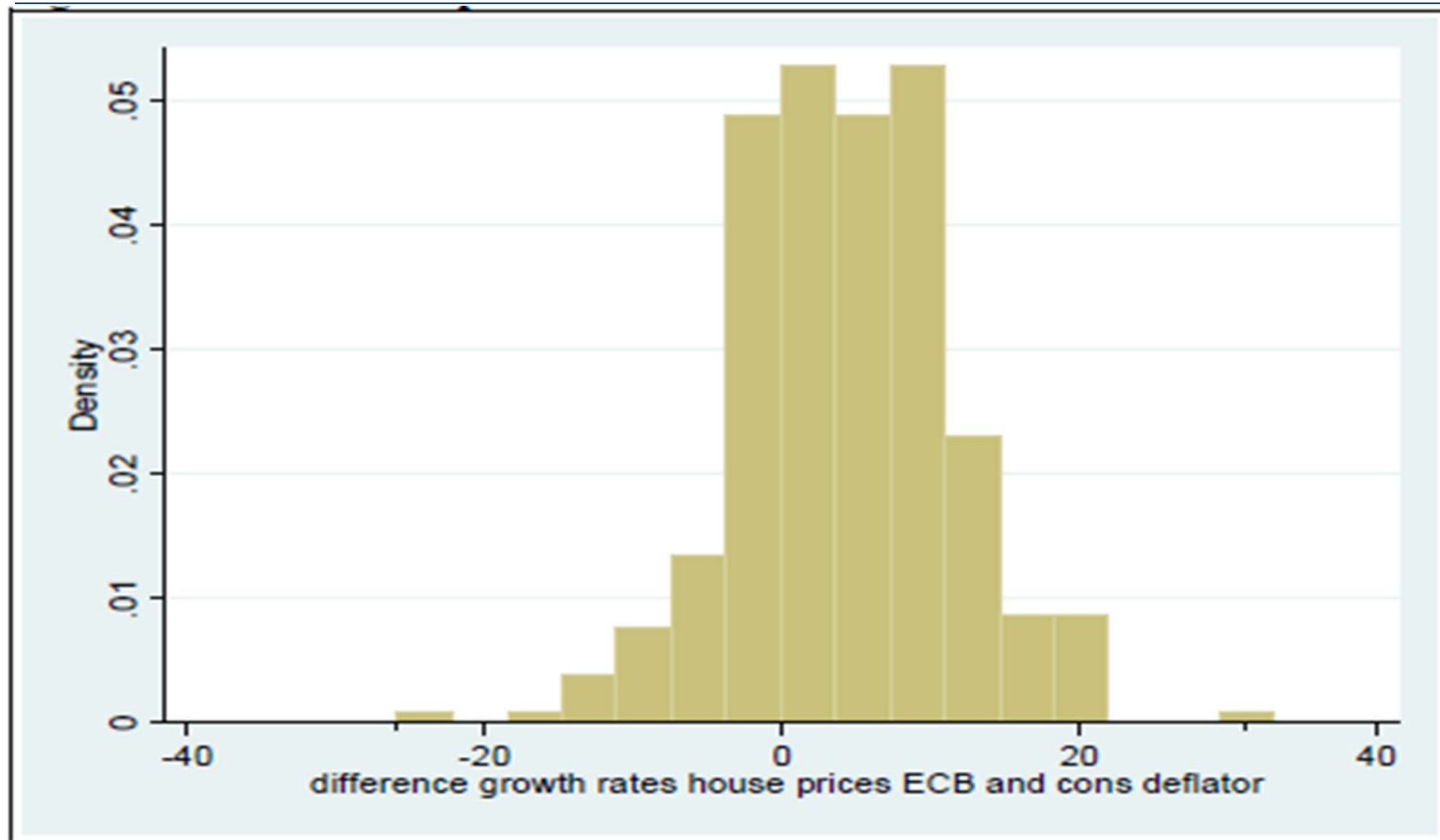
Share of construction in total VA: look at the composition



Source: European Commission

MACRO IMBALANCES: WHAT IS OUT OF LINE AND WHAT IS NOT?

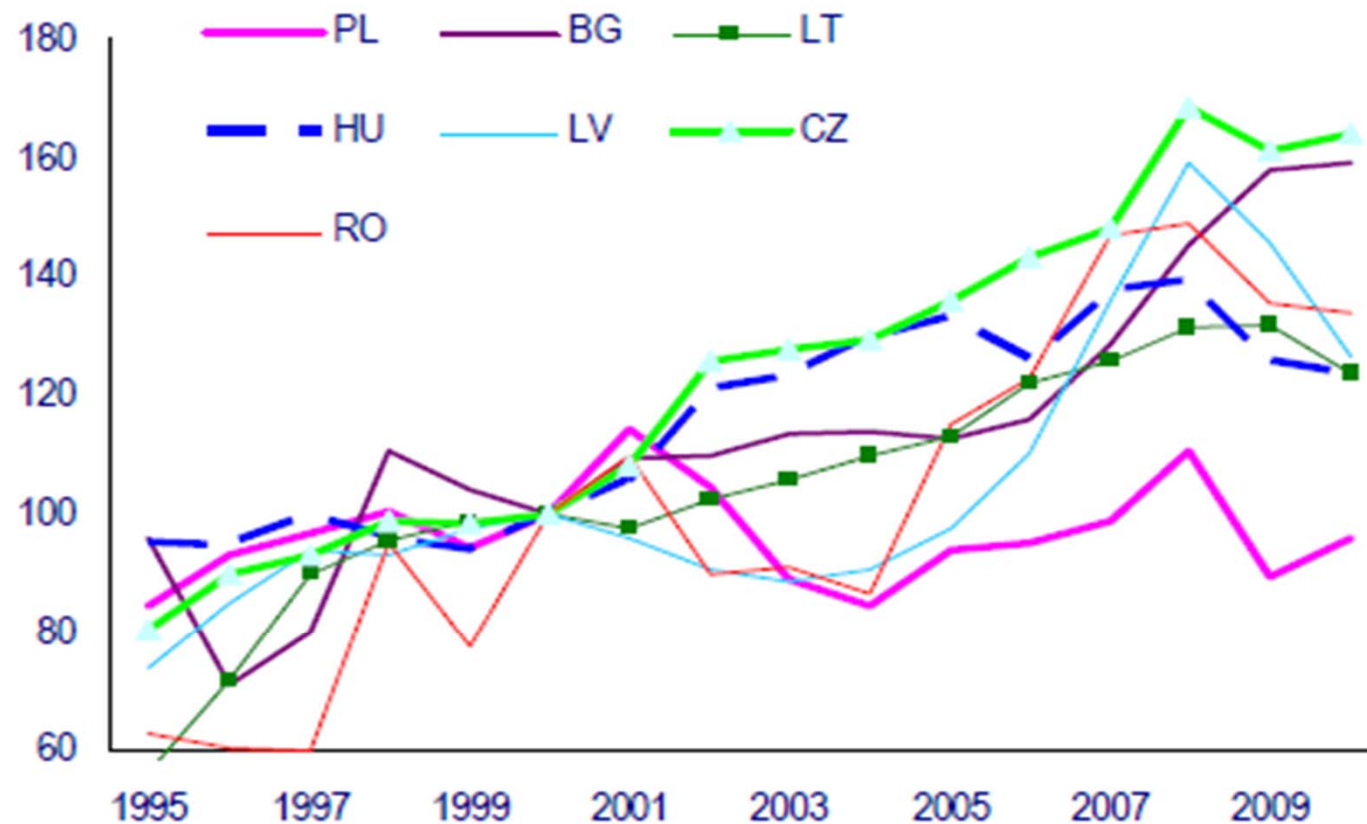
House prices: bubbling out in real or nominal terms?



Source: European Commission

MACRO IMBALANCES: WHAT IS OUT OF LINE AND WHAT IS NOT?

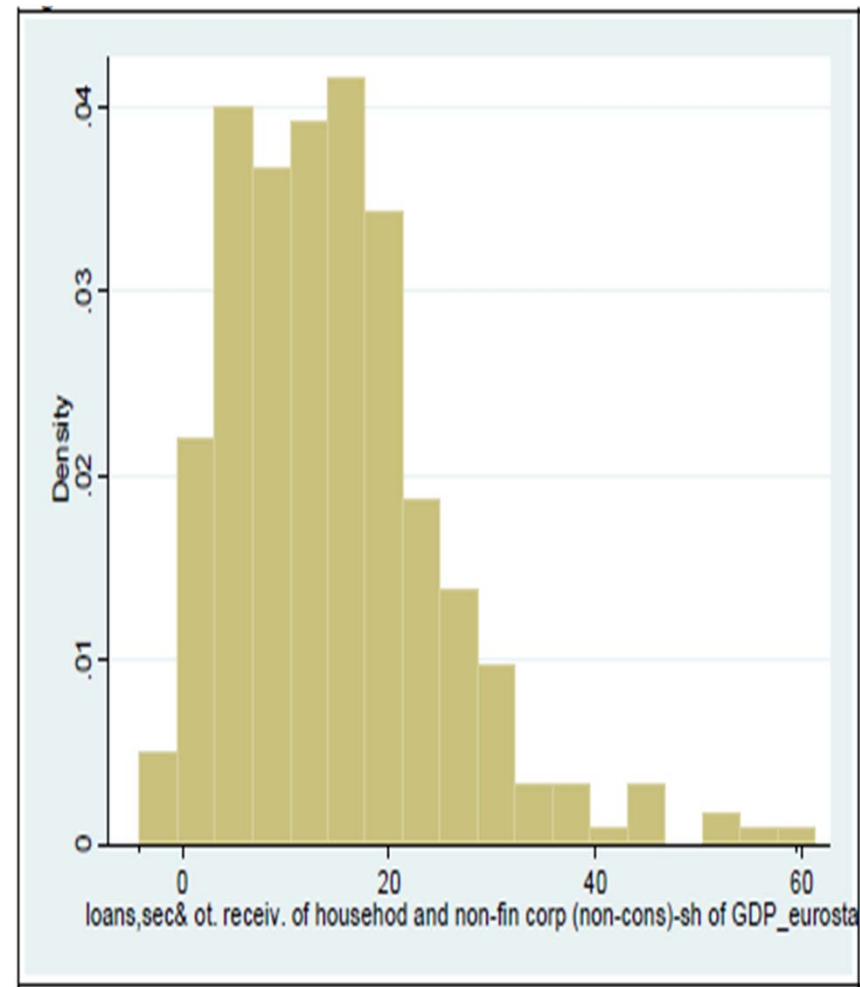
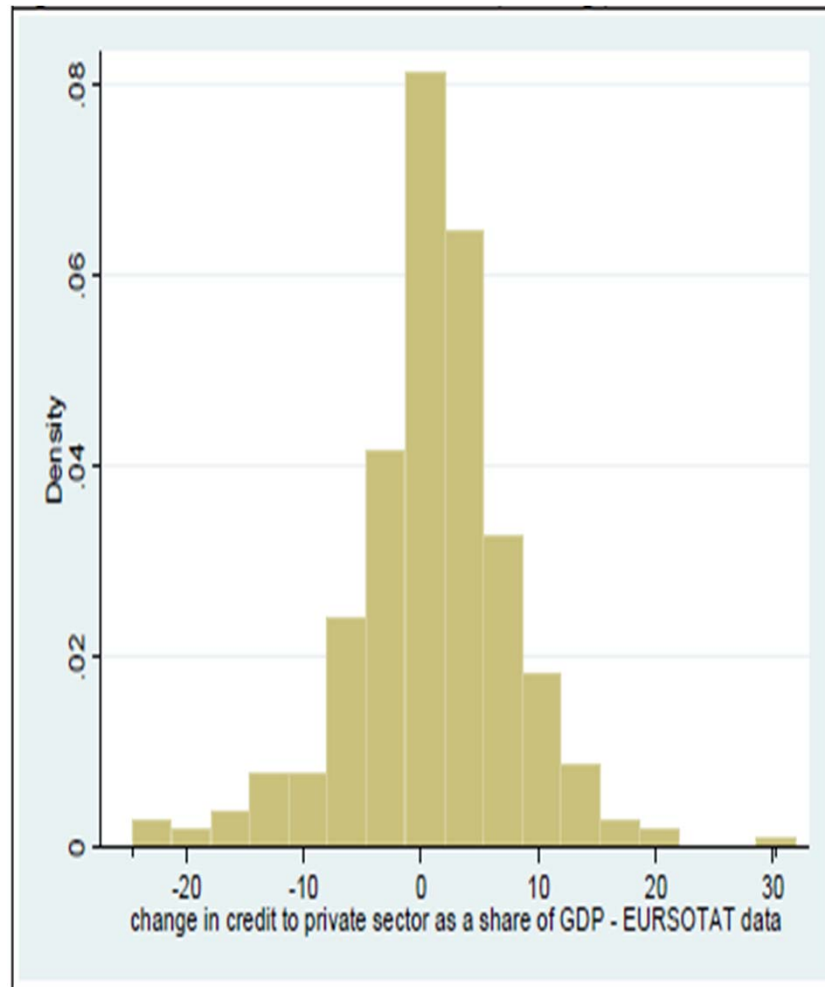
REER: catching-up needs to be taken into account



REER based on ULC indicator, relative to 35 trading partners, double export weights. Data for 2010 are based on spring forecast numbers.
Source: Commission Services.

MACRO IMBALANCES: WHAT IS OUT OF LINE AND WHAT IS NOT?

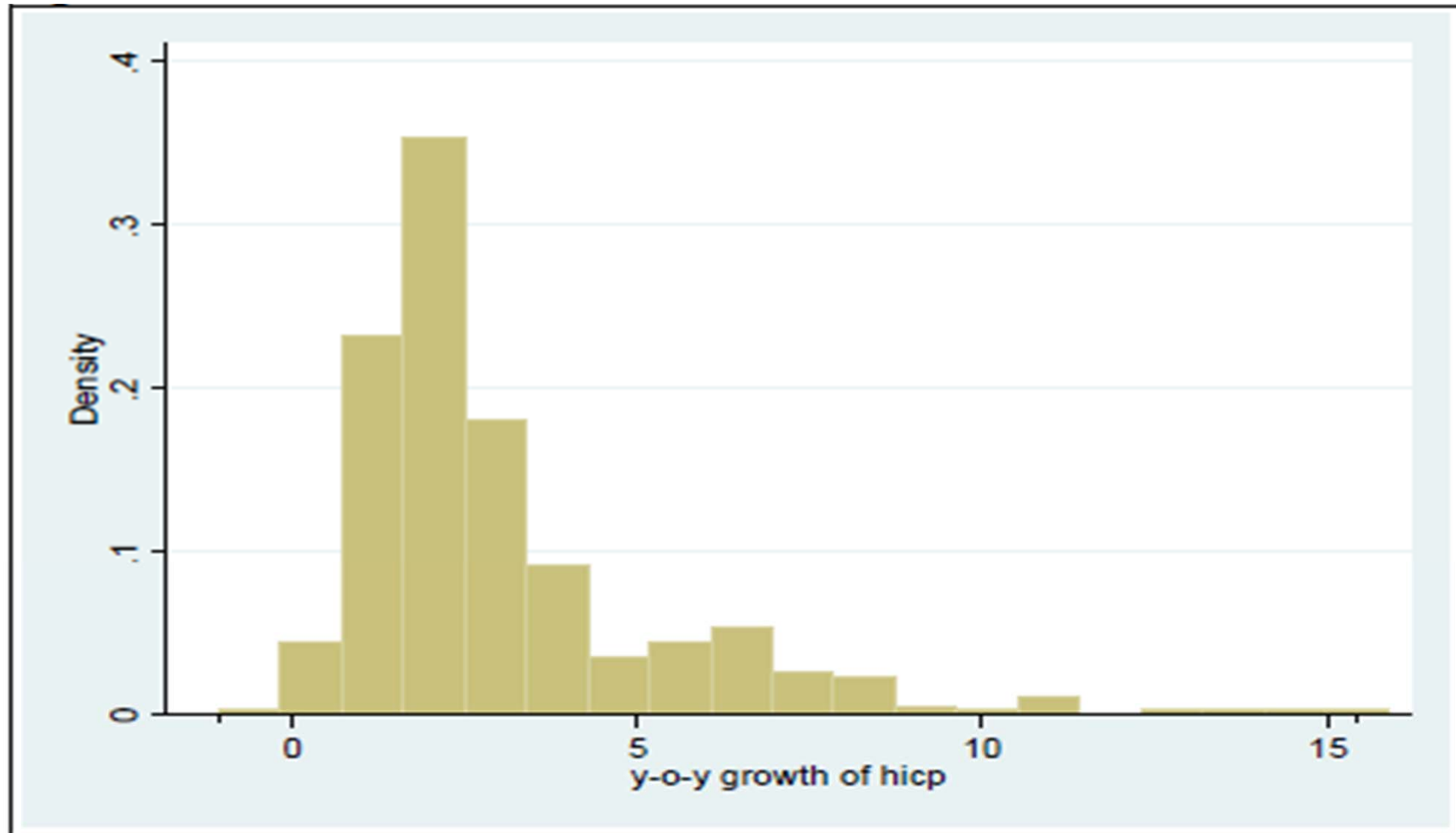
Private credit as a share of GDP: a development sign?



Source: European Commission

MACRO IMBALANCES: WHAT IS OUT OF LINE AND WHAT IS NOT?

HICP: what about Balassa-Samuelson?



Source: European Commission

POLICY RESPONSE: A BIRD-EYE VIEW OF POLICY INITIATIVES

Catching three birds with one stone



According to the OECD, an appropriate mix of fiscal consolidation and structural reforms would address at the same time poor economic growth, rising budget balances and current account imbalances.

Significant steps at EU level for the financial sector

- European Systemic Risk Board (ESRB) and three European Supervision Authorities (ESAs) for: 1) banks, insurance (CEBS); 2) pensions companies; 3) securities and markets.
- The Council of European Union extends to Ireland the European Financial Stability Mechanism (EFSM).
- Constant action by the ECB to ensure regular functioning of money and credit markets.
- Further steps ahead to improve economic governance (European Semester), including better budgetary discipline and macroeconomic imbalances procedure.

EU governance reforms: the state of play

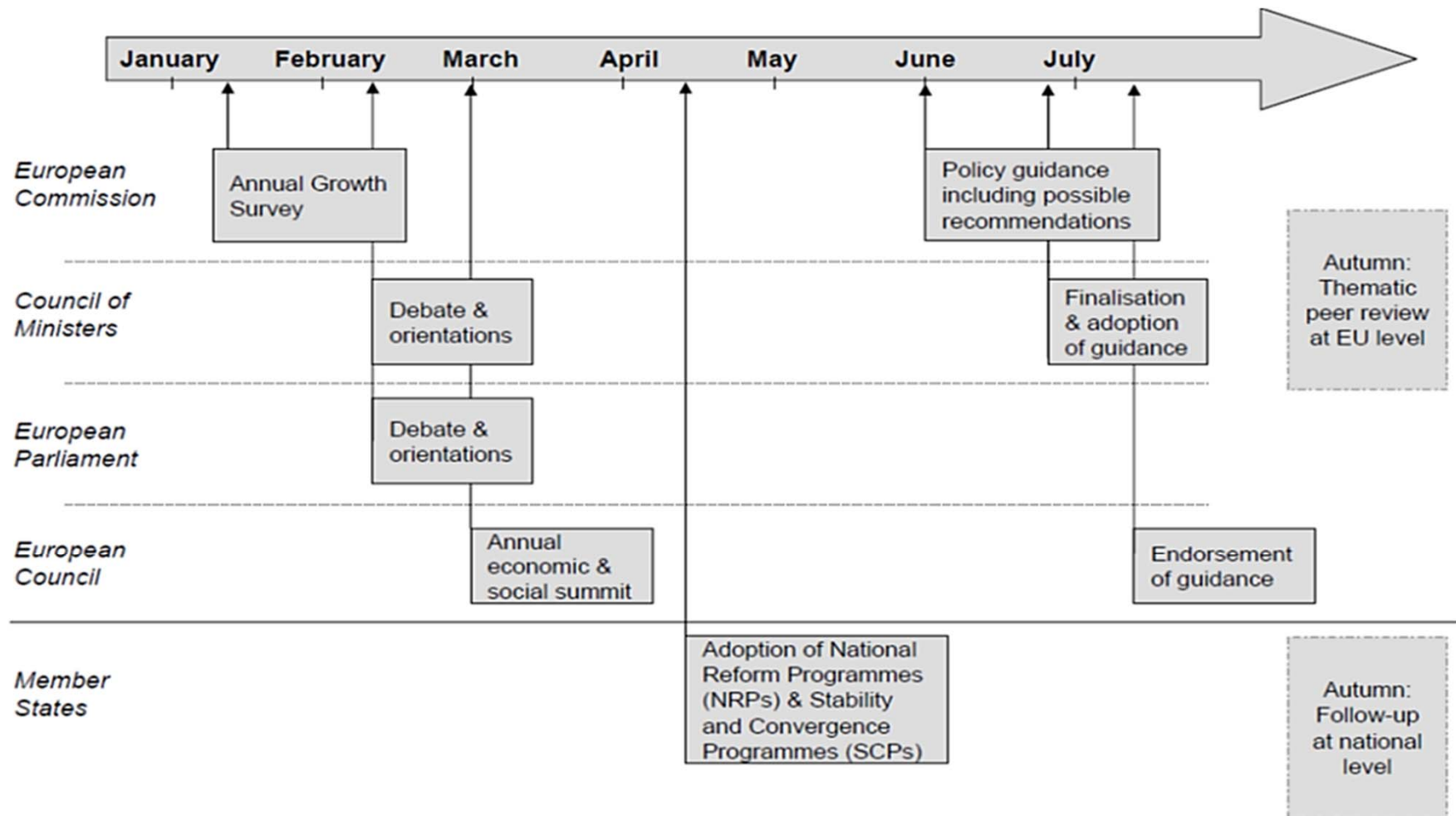
- The strategic elements for a revised EU governance and a concrete toolbox were outlined in two Commission's Communications (12 May - 30 June 2010).
- ECOFIN endorsed the European Semester (7 Sept 2010).
- Task Force on Economic Governance Report issued end October, contributed to above Commission legislative proposals.
- Legal instruments were proposed in the Commission's legislative package of (30 Sept 2010) with 3 main objectives.

EU governance reforms: the state of play (cont'd)

- (1) Reinforcing MS' compliance with the Stability and Growth Pact (SGP) and fiscal policy coordination. Series of preventive and corrective measures are proposed, including a range of sanctions to be applied in the case of breaches.
- (2) Broadening economic surveillance in order to prevent, detect and correct macroeconomic imbalances and divergences in competitiveness.
- (3) Strengthening national fiscal framework by providing minimum requirements and Peer Review mechanisms for MS.

The timing of the European semester

Integration between budgetary discipline (SCPs) and Growth enhancing reforms (Europe 2020 Strategy)



Fiscal surveillance: strengthening SGP and fiscal framework

- Increasing effectiveness of SCPs assessments through better ex-ante coordination.
- Improving compliance with the rules of the SGP through better incentives and sanctions.
- Addressing high public debt, making the debt criterion effective in order to safeguard long-term fiscal sustainability.
- Strengthening national fiscal frameworks through specification of minimum requirements for domestic fiscal frameworks, moving from annual to multi-annual budgetary planning and organizing Peer Reviews on regular basis.

SGP: Sanctions under the preventive arm

In case of deviation from the adjustment path:

- Early warning by the Commission
- Council recommendation (within one month) setting a deadline for correcting the deviation. The recommendation may be made public.
- Interest-bearing deposit amounting to 0.2% of GDP applies if no appropriate action is taken within a maximum of five months (three months in serious cases).

SGP: Sanctions under the corrective arm

When MS are placed in Excessive Deficit Procedure (EDP):

- Non-interest bearing deposit to be applied immediately for MS already subject to financial sanctions under the preventive arm.
- For MS not sanctioned under the preventive arm, the Council to adopt a recommendation setting a deadline for effective action.
- To reduce discretion in enforcement, a reverse vote mechanism to be introduced when imposing sanctions at every step of EDP: the Commission proposal would be considered adopted unless the Council turns it down by qualified majority.

Preventing and correcting macroeconomic imbalances

- Alert mechanism: a scoreboard composed of a set of indicators and thresholds, complemented by experts' economic analysis.
- A list of MS deemed at risk of imbalances as indicated by the Commission, providing country-specific in-depth reviews.
- In case of certified excessive macroeconomic imbalances, MS are subjected to the Excessive Imbalance Procedure (EIP).
- The Commission then releases preventive recommendations for MS which are obliged to adopt a corrective action plan.
- If a MS repeatedly fails to act in compliance with the Council recommendations, it will have to pay a fine.

WILL IT BE ENOUGH? POSSIBLE SCENARIOS OUT OF THE CRISIS

Possible ways to stop the contagion

