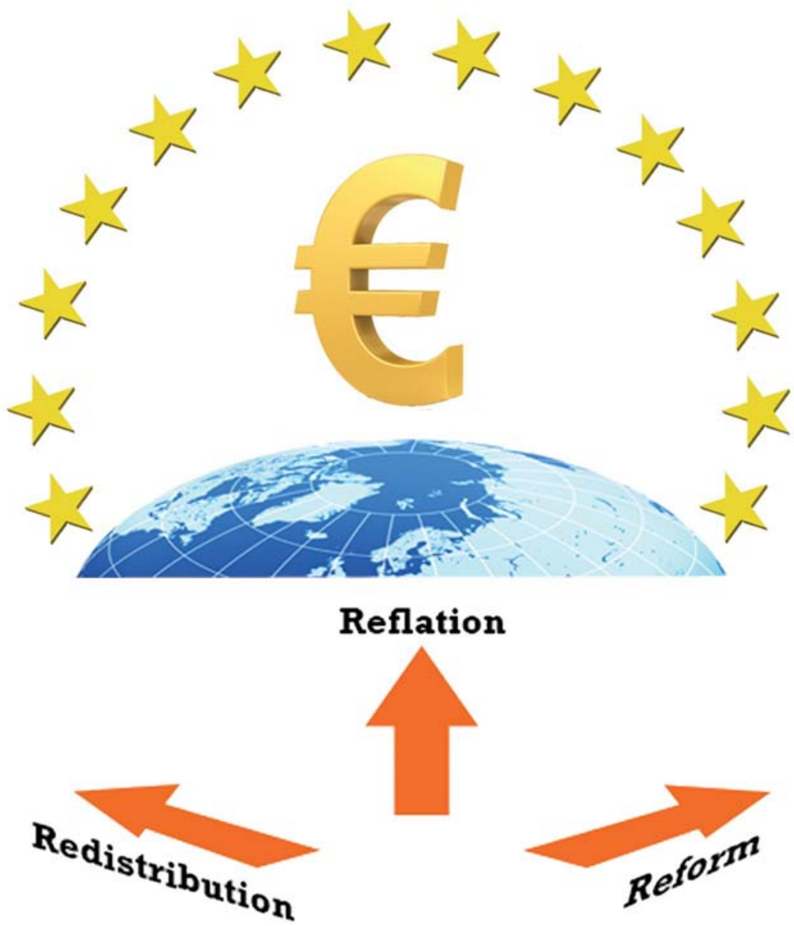
June 2012

# Roads to survival

## How EMU break-up could be avoided




- A road to the EMU's survival is possible. We describe six scenarios based on three dimensions: reform, reflation and redistribution
- Fiscal austerity has become 'Too Big to Succeed': our *Austeria* scenario is a road to more defaults
- Banking union and funding union - in *Draghia and Bondia* - could break the link between bank and sovereign solvency. Fiscal discipline may create momentum towards a *Europhilia* fiscal union scenario
- Whether or not Greece leaves EMU, the pace of policy change is accelerating

Mark Clifffe

Eurozone & Economic Strategy team

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Eurozone & Economic Strategy Team

**Mark Cliffe**
Global Head of Financial Markets Research
London +44 20 7767 6283
mark.cliffe@uk.ing.com

**Peter Vanden Houte**
Chief Economist, Belgium, Eurozone
Brussels +32 2 547 8009
peter.vandenhoute@ing.be

**Teunis Brosens**
Amsterdam +31 20 563 6167
teunis.brosens@ing.nl

**Carsten Brzeski**
Brussels +32 2 547 8652
carsten.brzeski@ing.be

**Fabienne Fortanier**
Amsterdam +31 20 576 9450
fabienne.fortanier@ing.nl

**Padhraic Garvey**
Amsterdam +31 20 563 8955
padhraic.garvey@ingbank.com

**Alessandro Giansanti**
Amsterdam +31 20 563 8801
alessandro.giansanti@ingbank.com

**Philippe Ledent**
Brussels +32 2 547 3161
philippe.ledent@ing.be

**Maarten Leen**
Amsterdam +31 20 563 4406
maarten.leen@ing.nl

**Tom Levinson**
London +44 20 7767 8057
tom.levinson@uk.ing.com

**Manuel Maleki**
Brussels +32 2 547 3995
manuel.maleki@ing.be

**Julien Manceaux**
Brussels +32 2 547 3350
julien.manceaux@ing.be

**Paolo Pizzoli**
Milan +39 02 89629 3630
paolo.pizzoli@ing.it

**Chris Turner**
London +44 20 7767 1610
chris.turner@uk.ing.com

**Martin van Vliet**
Amsterdam +31 20 563 9528
martin.vanvliet@ing.nl



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## How an EMU break-up could be avoided

**Doubts are mounting over whether fiscal austerity and structural reform will lead to the EMU's survival**

Following a period of calm in financial markets, doubts are resurfacing about whether the EMU can retain its current membership. Dramatic intervention by the European Central Bank in December dispelled fears about the funding of peripheral banks and sovereigns only temporarily. Amid chaos in Greece and mounting problems in the Spanish banking sector, many are sceptical that the combination of fiscal austerity and structural reform constitutes a convincing road to survival. The fear is that weakness in economic growth, concentrated on the Eurozone's peripheral members, will undermine the ability of the periphery to regain access to the markets, not to mention popular support.

**The roads to survival can be mapped on three dimensions**

However, we argue in this report that there are a number of different potential roads to survival. These can be mapped on three dimensions:

1) **Reform** – Structural, or supply-side reform could stimulate economic growth. Such reforms could be micro in nature, eg, liberalising product or labour markets, or macro, as in dramatically reducing the size of the public sector.

2) **Reflation** – The thrust of macroeconomic policy could be loosened. This could come from the monetary side (ie, through aggressive quantitative easing or a competitive devaluation) and/or the fiscal side (either in the core such as Germany and the Netherlands, or the peripheral members such as Italy and Spain).

3) **Redistribution** – The burden on the periphery could be relieved by resource transfers from the core. Such transfers can be covert, through cheap ECB funding or common "Euro" bonds, or explicit, through revenue transfers, progressive taxation or central funding of public spending in the periphery.

**The crisis has deepened the controversies over the respective policy options**

Each of these three 'R's is controversial, presenting both economic and political challenges. The unprecedented nature and depth of the financial crisis, and the ensuing sovereign debt crisis, has deepened the controversies over the efficacy and fairness of the respective policy options. In the process, ancient political and economic animosities have been revived. The debates are complex because they concern:

1) Scale – How far should policy be changed?

2) Direction – Should fiscal policy be tightened to reduce short-term funding needs, or loosened to stimulate growth?

3) Timing and sequencing – Should austerity be postponed in favour of short term relief?

4) Burden-sharing – Who should be picking up the bill? The rich or poor? Core or periphery?

In order to shed light on this debate, we first outline a number of medium-term scenarios based on the dimensions described above. We then evaluate their potential economic and financial market impact, before concluding with some remarks about the likely feasibility.

## Plan 'A' for austerity is in trouble

**'Paradox of Merkelism' – aiming to bolster the EMU through fiscal austerity and reform is having the opposite effect**

In our report, '*EMU Break-up: Pay Now, Pay Later*' (December 2011), we described the 'Paradox of Merkelism', whereby the attempt to bolster EMU through insistence on fiscal austerity and reform was having precisely the opposite effect. Since that report was published in December, the deterioration in the economic and political climate has reinforced our concern.

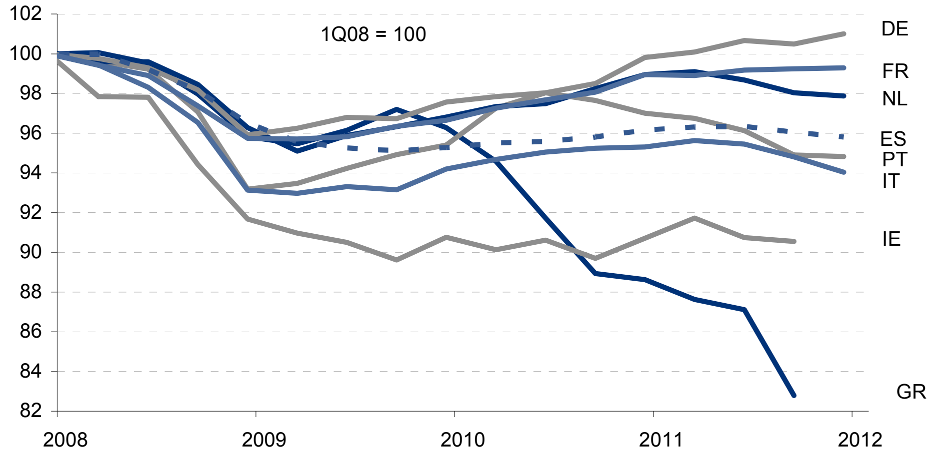
**Weak growth is raising doubts about meeting budget-deficit targets**

Economic growth, particularly in the Eurozone's periphery, continues to disappoint. This in turn has undermined asset prices and the solvency of the banks. Weak growth is unnerving financial markets because it raises doubts about the ability of governments to deliver on their budget deficit-reduction targets. Crucially, those doubts are more political than economic, as popular support for austerity has fallen faster than economic activity.

**The political backlash has not been confined to the periphery**

The political backlash has not been confined to the periphery. In France, President Sarkozy has been replaced by Francois Hollande on the back of pro-growth rhetoric, while in the Netherlands, the coalition government fell after arguments over how to cut the budget deficit. Even in Germany, where the public has fewer doubts about the need for fiscal discipline, the CDU-led coalition is struggling in the face of criticism of its handling of the crisis.

Fig 1 Eurozone GDP 2008-12 (indices 1Q08=100)




Source: Ecowin

**Chancellor Merkel is being forced to respond to growing hostility elsewhere**

While mainstream opinion in Germany is still solidly pro-Euro, Chancellor Merkel will be acutely conscious that elsewhere hostility is growing. Moreover, hostility is growing not just towards austerity and the euro, but to Germany itself. Her description of progress to integration being a marathon is in the process of being overtaken by events. Despite the continued insistence on the need for fiscal austerity, the intensification of the crisis is forcing Germany to show flexibility in the pursuit of its overriding goal of sustaining EMU. “Exceptional circumstances” are being invoked to justify slowing the pace of deficit reduction. Moreover, there are unconfirmed reports of a reform-oriented six-point plan to boost growth, including privatisation and special economic zones. German policy-makers are risking domestic ire by signalling tolerance for German inflation above 2% in the interests of Eurozone rebalancing.

## Politics and probability – Will voters support EMU?

**Supposedly ingrained policy principles may change if the pressure is strong enough**

Recent events show that economic and political pressures can and do lead to significant policy shifts. Supposedly ingrained policy principles may be bent or even broken if the pressure becomes sufficiently intense. This is something that economic and financial market forecasters are prone to overlook. Thus, many of the policy options that might support EMU, such as fiscal transfers or common Eurobonds, are typically dismissed on the grounds that “Germany would never agree to it”. While in normal circumstances this may be a useful starting point for forecasting purposes, at least in the short term, we are clearly not in normal circumstances now.

**Our initial focus is on the *impact*, not the *probability*, of policy options…**

**…only later do we ask what would make them feasible**

In any case, as with our previous work on the impact of a possible break-up of the EMU, our purpose here, at the outset, is not to look at the ***probability*** of the policy options, but rather to assess their ***impact***. After all, high impact events are worth preparing for, even if their probability might seem low. Accordingly, our approach is to avoid rushing to judgement on the political feasibility of the policy options. Having assessed their impact, we are then ready to ask the question: in what economic and political circumstances would such policy options become feasible? Only after this, as a third stage, can we address the question of the likelihood of these options occurring.

**The outcome will be determined more by politics than economics**

Later, we analyse the macroeconomic and financial market impact of alternative roads to the survival of the EMU. But before we do so, it is worth noting that the answer to the second question about the circumstances that might make differing policy options feasible are likely to be determined more by politics than economics. This has three important implications:

1) If the political will is strong enough, even radically worse economic circumstances may be tolerable. Indeed, the high level of popular support for continued Eurozone membership in Greece, despite the horrendous downturn in the economy, is a vivid illustration of this point.

**Economic forecasters tend to assume away or ignore political change**

2) Economic forecasters are not necessarily well qualified to pronounce on the likelihood of crucial policy shifts, since they tend to assume away or ignore the possibility of political change.

**Policies are more likely when they involve smaller immediate or explicit costs**

3) Policy options are more likely to be adopted when they involve smaller immediate or explicit costs to the voters than the alternatives. Thus, voters in the core countries have reacted badly to the idea that their taxes might be used to bail-out the periphery. The covert, contingent or involuntary transfers involved in monetary policy easing (whether of the conventional or unconventional kind), loan guarantees, or emergency bail-outs are more easily 'sold' to a sceptical public than explicit upfront fiscal transfers.

**Further monetary easing is likely to come through faster than fiscal transfers**

The final point is also worth keeping in mind when assessing not just the likelihood of the various scenarios that follow, but also their timing. Clearly, some political changes take longer to emerge, not least because they can be held in check by the electoral calendar. For example, options like further monetary easing are likely to come through faster than the introduction of Eurobonds or fiscal transfers.

## It's not just about debt; growth is important, too

**It is hard to define precisely what needs to happen for the EMU to survive…**

**…because politics and popular support are crucial**

As things stand, the outlook is bleak: not only is the Eurozone in recession, but divergences between the core (especially Germany) and the periphery are widening under the influence of fiscal austerity. Incumbent governments are falling. It is therefore doubtful whether the current policy mix is fiscally, economically or politically sustainable. However, it is hard to define precisely what needs to happen for the EMU to survive in its current form. This stems from the fact that sustainability is ultimately more a political than an economic question. Without popular support, EMU will die. The financial markets are increasingly conscious of this, as the credibility of fiscal consolidation has been challenged less by lack of implementation of fiscal tightening, but by the attendant damage to economic growth and popular support.

**BUT the pursuit of fiscal sustainability alone will not be enough**

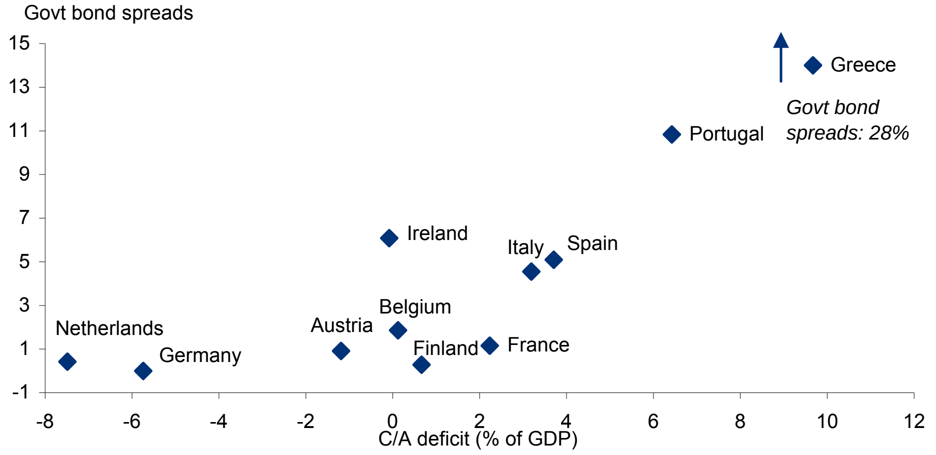
It should be clear by now that the pursuit of fiscal sustainability alone will not be enough to secure the EMU's survival. This is not simply a sovereign debt crisis. But nor is it, as some have argued, merely a balance of payments crisis. True, the latter perspective gets closer to the roots of the Eurozone's problems – after all, the troubles of countries like Spain and Ireland originated in excessive private sector borrowing rather than public sector borrowing. Moreover, bond markets are now recognising this. The widening of sovereign bond spreads in the Eurozone has become more closely related to members' current account imbalances and external indebtedness (see Figure 2).

**The bond markets are now conscious of external debts…**

Yet these external imbalances cannot be sustainably reduced purely on the back of weak growth in the deficit nations of the periphery. Weak growth will surely reduce deficits by reducing import demand. But, as we have been seeing in dramatic fashion in Greece and Spain, it also just as surely leads to rising unemployment. Policy-makers and politicians cannot ignore this.

**…yet these external imbalances cannot be sustainably reduced purely on the back of weak growth**

Fig 2 Eurozone government bond spreads vs current account balances




Source: IMF, Ecowin

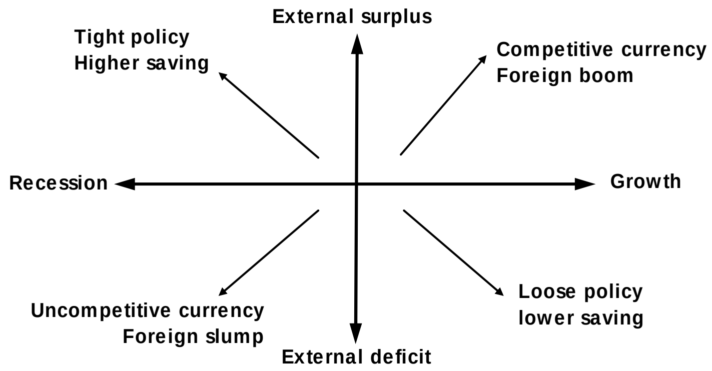
**Tinbergen's dilemma: how to reconcile external balance with internal balance**

This is a reminder that the central problem of macroeconomic policy is how to reconcile external balance – where the country is able to finance its foreign debts – with internal balance – where the economy is running at full employment with low inflation. This is a problem addressed by the Nobel Prize-winning Dutch economist Jan Tinbergen 60 years ago. He pointed out that two policy objectives cannot be achieved with a single policy instrument.

**Fiscal austerity may be improving the current account at the expense of rising unemployment**

In the current context, we can see that fiscal austerity may be improving the current account – external balance – at the expense of rising unemployment – the internal balance. This is illustrated in the following diagram (see Figure 3), in which external balance is measured on the vertical axis, and internal balance is shown on the horizontal axis. A fiscal tightening, such as we are seeing in peripheral Eurozone countries, leads to lower demand, and therefore a movement towards current account surplus (upwards), but also towards lower growth and higher unemployment (to the left). Membership of the EMU means that these economies do not have independent monetary or exchange rates with which to restore internal balance. Prior to the EMU, currency depreciation would have enabled them to increase competitiveness and boost growth at the same time as improving their current account position (moving up and to the right on Figure 3).

Fig 3 Reconciling the internal and external balances




Source: ING

**The EMU's architects hoped that supply-side reforms would substitute for the loss of independent exchange rates**

The architects of the EMU were well aware of this problem. Their hope was that members of the monetary union would substitute for the loss of independent exchange rates and monetary policy by applying supply-side reforms. Thus, poorer, deficit economies would catch up with their richer brethren through sustained liberalisation and supply-side improvements. In the event, as we now know, the economic convergence in income that actually occurred in the first ten years of the EMU was due less to supply-side changes in the poorer peripheral economies than to a surge in spending based on cheap credit. Indeed, this ill-fated boom concealed a dramatic divergence in terms of competitiveness.

**The EU recognises other macroeconomic imbalances and competitiveness also need to be addressed**

While attention has been focused on reducing the budget deficits of the Eurozone's periphery, the EU has recognised that other macroeconomic imbalances and competitiveness also need to be addressed. Last year, agreement was reached on commission proposals for a Macroeconomic Imbalance Procedure (MIP), which involves monitoring a range of variables including current account imbalances, competitiveness, unemployment, and private sector indebtedness (see Appendix). A new Excessive Imbalance Procedure (EIP) includes fines for Eurozone member states that fail to follow up on recommendations.

**The new Excessive Imbalance Procedure (EIP) looks problematic**

There are several problems with the proposed EIP:

1) Since members of the EMU do not have the option of exchange rate adjustment, restoring the competitiveness gap is likely to be a long slog. This is especially so given the European Central Bank's objective of holding inflation below or close to 2%. As a result, peripheral economies may have to undergo many years of very low inflation, if not deflation, or else find ways of substantially improving their productivity relative to core countries.

**It has an in-built bias towards forcing the adjustment on the deficit countries**

2) It has an in-built bias towards forcing the adjustment on the deficit countries, given the fact that the current account balance triggering the start of an EIP is an asymmetric band around zero. It remains doubtful that surplus countries will be forced to take any action. In other words, deficit countries are being invited to emulate Germany.

**It is doubtful whether its system of fines can work**

3) It is doubtful whether the system of fines for countries failing to comply with EU recommendations will be successful. It is hard to imagine that fines would actually be imposed on countries that are already under-performing, and perhaps already receiving bail-outs to help address their fiscal and banking problems.

In any case, the EIP begs the question of what policies need to be adopted to address the problems of competitiveness and economic imbalances. In the next section, we examine the three basic dimensions of economic policy that would address both these problems and the objective of achieving fiscal sustainability.

## Roads to survival – The three dimensions

**Fiscal austerity alone will not ensure the survival of the EMU**

Fiscal austerity alone will not ensure the survival of the EMU. So, what to do? There are a number of policy options, some of which are mutually exclusive, others not. Later, we will describe a number of scenarios that set out a variety of policy permutations and their consequences. In this section, we describe the policy options on three basic dimensions:

**Reform – Structural, or supply-side reform**

1) **Reform** – Structural, or supply-side reform could stimulate economic growth. Since this is seen as complementary to the prescription of fiscal austerity, this is the road favoured by Germany and other core countries.

**Reflation – Loosening macroeconomic policy to boost demand**

2) **Reflation** – The thrust of macroeconomic policy could be loosened to boost demand. So far, any easing has had to come from the monetary side, but France has joined some of the peripheral economies in arguing that the pace of fiscal consolidation should be slowed, if not temporarily reversed.

**Redistribution – Boost the periphery with resource transfers from the core**

3) **Redistribution** – The burden on the periphery could be relieved by resource transfers from the core. In fact, there have already been some covert or contingent transfers through cheap ECB funding or bail-out loans, but longer-term common "Euro" bonds or explicit fiscal transfers could be part of the road to survival although the political barriers to these steps are currently huge.

Next, we examine the policies involved and their potential impact.

## Reform – Supply-side miracles

**German policy-makers argue that austerity vs growth is a false dichotomy**

The recent backlash against fiscal austerity has been widely characterised as a debate between "austerity vs growth". But who is against growth? The answer from German policy-makers is that austerity vs growth is a false dichotomy, and that fiscal austerity is not necessarily harmful to growth. Aside from the importance of retaining the confidence of bond markets (see below), the German prescription is supply-side reform.

**Market liberalisation or activist intervention can lead to long-term benefits**

Structural reforms, it is argued, allow fiscal austerity to be coupled with growth. Indeed, the idea that market liberalisation or activist intervention can lead to long-term benefits to growth commands widespread support among economists, the European Commission and international bodies such as the OECD and IMF. But the crucial phrase here is 'long term': the short-term effects are more controversial. At best, the effects on economic activity in the short term are likely to be only mildly positive; at worst, they could have significantly negative effects.

**Over a ten-year period, GDP could be raised by over 15% in the periphery**

Research from the OECD on product and labour market reform suggests the potential impact would be particularly large in the Eurozone's peripheral economies. Over a ten-year period, it suggests that GDP could be raised by over 15% in Greece, and by almost as much in Italy, Spain and Portugal. At the other end of the spectrum, the Netherlands, being much closer to international best practice, would enjoy more modest gains of c.5%.

**However, the short-run effects are more unpredictable…**

However, the OECD concedes that "studies do a better job at estimating the long-run effects of structural reforms than the dynamics towards this steady state"; in other words, the short-run effects are more unpredictable. Indeed, in current circumstances, with unemployment high and the corporate sector reluctant to invest, the necessary resource reallocation that supply-side reform is intended to trigger is unlikely to happen smoothly. Some reforms, such as wage cuts or the lowering or time limiting of unemployment benefits, necessarily involve a loss of disposable income that is likely to lead to feed through quickly into lower consumption. The hoped-for pick-up in employment and business investment might take rather longer to come through.

**…and could be negative**

The net result is that output and employment is likely to fall in the immediate aftermath of such reforms, unless there is some offsetting loosening in fiscal or monetary policy. The German labour market reforms in the mid-2000s are a good illustration of the delayed positive impact on the economy. While the adjustment needs were much smaller than currently in the peripheral countries, it took around three years before the reforms showed positive results.

**To the Austrian school, short-term output losses are part of the process of "creative destruction"**

To the Austrian school of economists, short-term output losses from reforms are part of the process of "creative destruction". More radical 'Austrian' prescriptions would go much further, arguing for drastic downscaling of the size of government (with savings from spending cuts being used to finance tax cuts) with a view to shifting resources to more productive uses in the private sector.

**However, the destruction may be more immediate, provoking howls of protest**

However, the fact that the destruction is more immediate than the creation tends to provoke howls of protest from those directly affected. This presents a serious political constraint on reform. Politicians having to deal with the backlash from the vested interests stand to lose in the reform process. Indeed, the resistance to economic reforms that are being debated and implemented in the Eurozone's periphery is one reason why incumbent governments have been falling or being voted out, and technocrats installed as leaders in Greece and Italy.

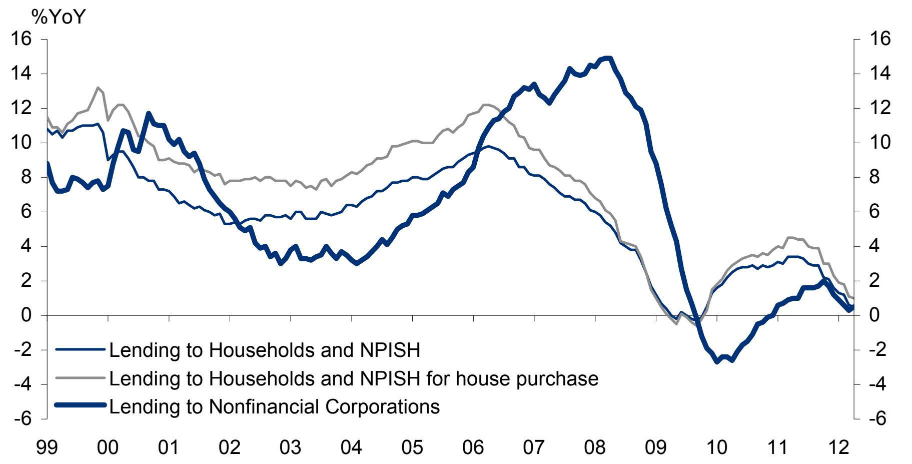
**The crisis is prompting major reforms designed to make the financial sector safer**

Another crucial focus of reform is in the financial sector. Since the financial crisis began in 2007, policy-makers have been working on increasing the robustness of the financial sector. This has largely taken the form of tougher regulations on banks, in particular by requiring them to increase their capital buffers and reduce their risk profiles. The new Basel III bank regulatory standards will not be fully implemented until 2019.

**Policy-makers concede that tougher regulation may harm economic growth**

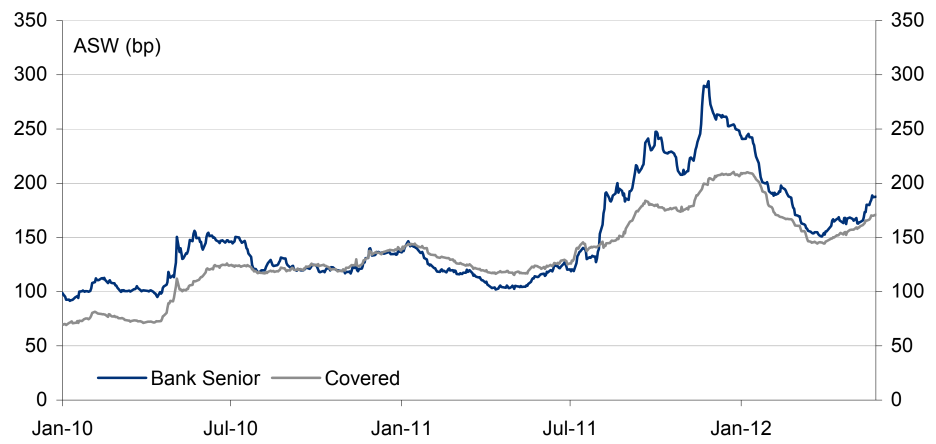
Policy-makers have recognised that tougher regulation may have some negative effects on economic growth, reflecting increased lending spreads as banks pass on an increase in their funding costs. However, they argue that: (a) the effect will be modest; the OECD, for example, suggested a GDP loss of c.0.1% pa; and (b) this is a 'price worth paying' for the avoidance of future shocks from the banking system.

Fig 4 Eurozone bank lending growth (% YoY)




Source: Ecowin

Fig 5 Eurozone bank funding costs (asset swap spreads)




Source: Bloomberg

**The damage may be greater than has so far been suggested in official circles**

However, there are a number of reasons why the damage to economic growth from tighter bank regulation has already been, and will continue to be, greater than has so far been suggested in official circles:

**Bank funding has been under huge pressure**

1) Bank funding has been under huge pressure: markets are not waiting for full implementation of the new regulations, and are holding banks to higher standards than the current regulatory minima. Moreover, there is still huge uncertainty about how onerous bank regulation will finally be. This has a corrosive effect on investor interest in banks.

2) Fears for bank solvency, particularly in the Eurozone's periphery, have been heightened by the fact that the new regulations are encouraging banks and insurers to increase their holdings of government debt. This is not only because of their low-risk weightings, but also because of the new liquidity coverage ratio (LCR), which will require banks to hold more liquid assets. In the LCR proposal, sovereign debt is one of the few qualifying assets to satisfy the LCR.

**Regulations are reinforcing the links between banks and their sovereigns**

Meanwhile, the unresolved sovereign debt crisis has meant that banks and their sovereigns have been strongly interlinked. No wonder then that the ECB has had to step up its unconventional measures to help banks' funding. Ironically, this has contributed to tightening these interlinkages, as peripheral banks have reinvested some of the LTRO money in their domestic sovereign bond market.

**The volume of bank lending as well as its cost has been harmed**

3) The impact of regulation has clearly not just been on the cost of funds and loans. The volume of bank lending has been weak or, in the case of the periphery, declining over the past two years. While this is partly due to weak demand for loans, the anecdotal evidence from banks suggests that they have partly been addressing the need to increase their capital adequacy ratios by curbing lending. This is especially true in peripheral markets, where access to finance was mentioned as one of the most pressing problems by SMEs, according to a recent ECB survey[1]. The economic models that have been used to assess the macroeconomic impact of regulatory change have essentially ignored these volume effects.

**Disintermediation may help, but also raises questions about systemic stability**

4) The weakness in bank lending has partly been offset by a surge in corporate bond issuance. However, this process of disintermediation raises the question of whether tougher bank regulation will actually increase the stability of the financial system as a whole. While the increased robustness of regulated deposit-taking banks is welcome,

[1] See http://www.ecb.int/pub/pdf/other/accesstofinancesmallmediumsizedenterprises201204en.pdf chart 15 on page 14.

the transference of risk to more lightly regulated non-banks and capital markets could lead to increased, rather than reduced, volatility in asset prices. This is crucial, because asset price shocks are typically the catalysts of financial crises.

**Reform in peripheral economies has had a pro-cyclical effect, exacerbating their recent weakness**

Overall, we would argue that the regulatory drive in the banking sector, like the initial steps towards labour market reform in peripheral economies, has had a pro-cyclical effect, exacerbating the recent weakness in the Eurozone economy. While reform may yield longer-term benefits for growth, it has so far reinforced rather than relieved the contractionary effects of fiscal austerity.

## Reflation – Is austerity now 'too big to succeed'?

**German policy-makers argue slackening in the austerity effort would be severely punished in bond markets**

Policy-makers in Germany have been at the forefront of those arguing that fiscal austerity is not necessarily harmful to growth. This is partly based on the view that any slackening in the austerity effort on the part of peripheral governments would be punished severely by bond markets. Thus, the argument goes, markets would take fright at higher budget deficits, driving up bond yields sharply and thereby harming economic growth.

**However, the planned austerity may have become 'too big to succeed'**

However, with increasing downward pressure on growth in peripheral economies and the attendant political damage, the supposedly positive effects of fiscal austerity on financial market confidence have been called into severe doubt. The required austerity to meet mandated budget deficit targets has become unrealistically large. In effect, the proposed cuts may have become 'too big to succeed'.

**Short-term fiscal multipliers: the impact on output may now be higher**

The recent experience of Eurozone bailout programmes has shown that heavy front-loading of restrictive fiscal packages can have heavy consequences on growth. In the paradigmatic Greek case, international lenders – including the IMF – have systematically overestimated the capacity of the real economy to weather the shock of the adjustment. Overestimation of growth prospects has inevitably revived the debate on both the appropriate policy mix (spending cuts vs revenue increases) and the appropriate pace of fiscal consolidation that should characterise a post-crisis "second-generation" package.

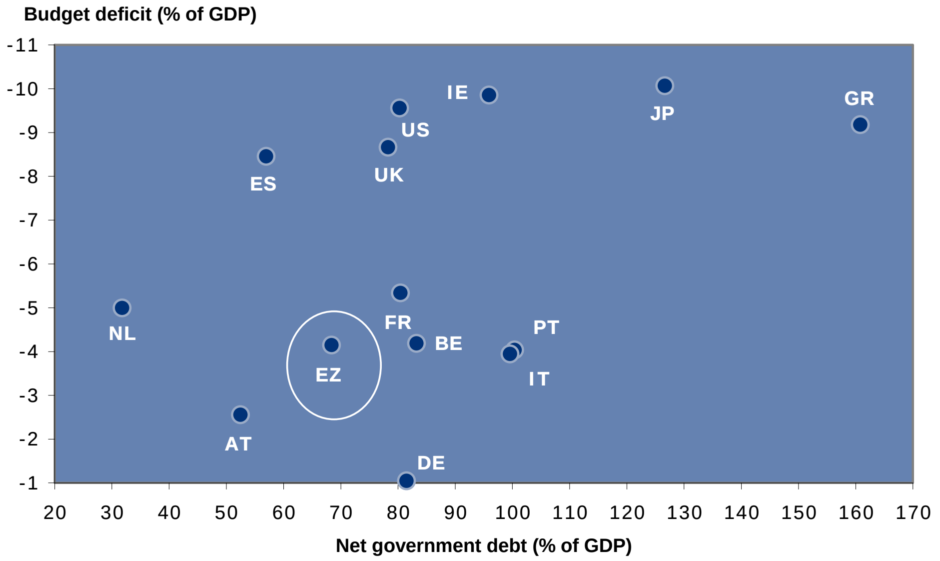
The IMF has recently returned to the issue in its latest *Fiscal Monitor* (April 2012). In discussing the latest results of IMF internal, mostly unpublished research, the IMF acknowledges that the negative impact of fiscal tightening on economic growth might be amplified by some features of the current economic environment, including a negative output gap (pro-cyclical fiscal consolidation), the debt/GDP ratio level and the current monetary policy stance (see Figure 6). According to the IMF, fiscal multipliers can now be expected to be higher than previous studies suggested.

Our own calculations (using the Oxford Economics Global Model) resulted in similar multipliers: a 1% fiscal stimulus in core EU countries (Germany, the Netherlands, France and Finland) translated into 0.6-0.75ppt of additional GDP growth in these countries, and 0.3ppt of additional GDP growth in the Eurozone as a whole.

Fabienne Fortanier
Paolo Pizzoli

Moreover, the fiscal austerity has not been confined to peripheral economies. Even the core countries have been tightening fiscal policy. This has typically been justified by the desire to retain bond market confidence and to 'set an example' to peripheral economies. But the net effect is that the fiscal stance of the Eurozone as a whole is tougher than it would have been had it been set by a central fiscal authority; after all, the Eurozone as a whole is running lower deficits and has lower debts than the US, Japan or the UK (see Figure 6).

Fig 6 Net public debt and budget deficits as % of GDP




Source: IMF, Eurostat

**Credible commitments to longer-term cuts might prompt markets to tolerate less rapid deficit reductions in the short term**

While there is universal agreement on the need for Eurozone governments to reduce their debt-to-GDP ratios over the long term, there is less agreement on the necessary pace. Critics of the current strategy would argue that there is scope to slow, or even in some cases temporarily reverse, the fiscal consolidation. Provided that credible commitments to longer-term budgetary savings are made, focused on structural reforms such as pension or healthcare reforms, the markets may be prepared to tolerate less rapid deficit reductions in the short term. Moreover, market confidence could perhaps be sustained by exploiting this room for manoeuvre to prioritise near-term steps to boost long-term growth – and hence fiscal sustainability – via public investment and tax cuts targeted at reducing the cost of labour and investment. However, given the Eurozone's poor track record on fiscal consolidation, the commitment for long-term austerity will have to be very strong. Signing and implementing the fiscal compact could be such a strong commitment.

**Core Eurozone countries, notably Germany, have more room for manoeuvre…**

The core Eurozone countries, notably Germany, have more room for manoeuvre in slackening off on the pace of fiscal tightening. While they still have work to do get below the treaty-mandated ceiling of 60% on their public debt-to-GDP ratios, it is hard to imagine that the markets would take fright at a temporary easing in their consolidation plans. Indeed, courtesy of 'flight to safety' flows, they have a great opportunity to borrow at record low interest rates. German two-year government yields have fallen to below zero, and ten-year yields to less than 1.30%. This is an ironic fiscal dividend from the Euro crisis that so far has not been exploited.

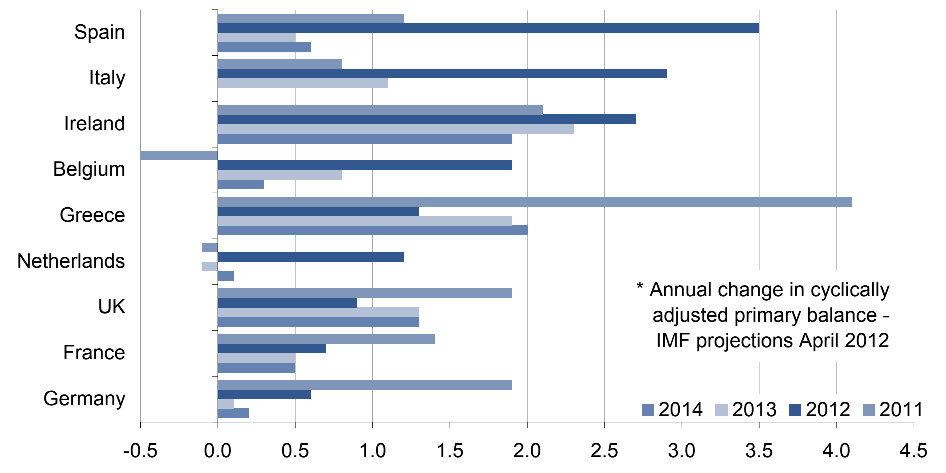
**…although this might widen their growth advantage over the periphery further**

Of course, a fiscal loosening confined to core countries would further widen their growth advantage over the periphery, but there would be some spill-over benefits to the latter from the resulting boost to demand in core countries. However, this would probably require tailor-made stimulus, because so far, peripheral countries have not benefitted from stronger German growth. On the contrary, growth rates of German imports from peripheral countries have clearly lagged behind those from core countries.

**There is some 'wriggle room' in the fiscal compact**

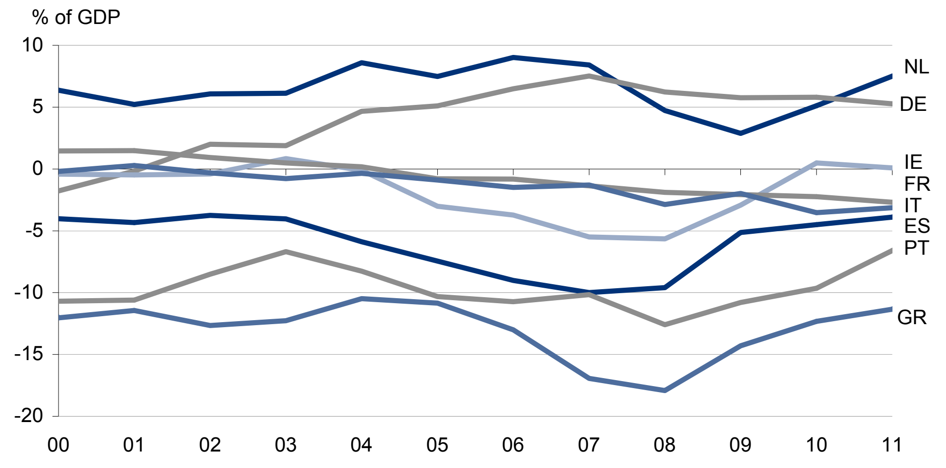
In any case, there is some 'wriggle room' in the fiscal compact to bow to the French-led pressure to give more priority to growth. First, the balanced-budget targets are couched in terms of a limit of 0.5% of the structural budget deficit; in other words, adjusted for cyclical factors, which allows some scope for leniency at times of weak growth. Second, the compact does not specify the length of the transition period to budget deficit targets. Third, deviation is allowed in "exceptional circumstances", such as a deep recession.

Fig 7 Eurozone fiscal tightening




Source: IMF

Fig 8 Current account balances




Source: Ecowin

**Current circumstances *are* 'exceptional'**

It is easy to argue that current circumstances ***are*** exceptional, particularly for peripheral economies. While Greece is locked in an argument over its second bail-out deal, weakness in the Spanish economy surely warrants a slowdown in the pace of its fiscal consolidation. But, as the recession threatens to deepen, this argument is now extending even to core countries such as the Netherlands.

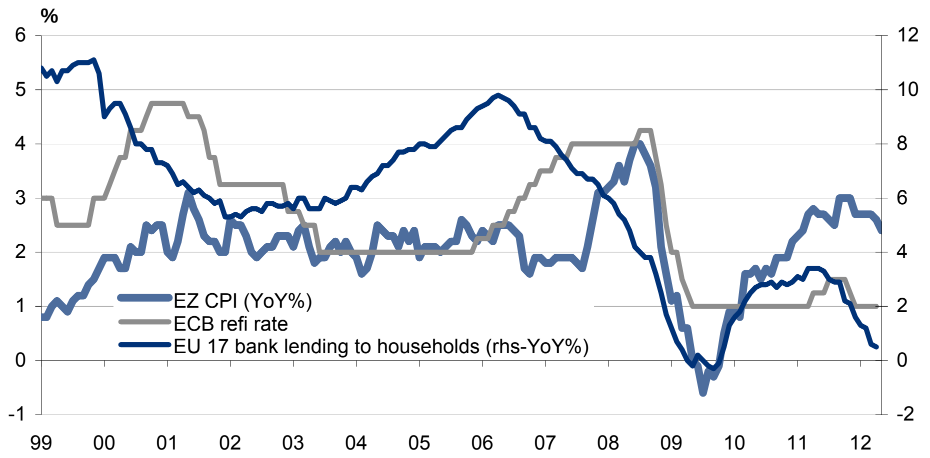
**The *mix* of fiscal measures could also have an important role**

Aside from the overall thrust of fiscal policy, the mix of fiscal measures could also have an important role in enhancing the sustainability of the EMU. Thus, were the easing in the periphery to be focused on cuts in taxes on labour or on stimulating investment, it might provide help in boosting competiveness and growth potential. By contrast, in the interests of rebalancing the Eurozone economy, core countries could stimulate anaemic domestic demand by cutting VAT or other indirect taxes, perhaps especially on products that peripheral economies specialise in. This would also have a politically pleasant, if temporary, side-effect of reducing headline inflation. Boosting public sector wages and public investment might also help the rebalancing process.

**The ECB has reluctantly found itself cast in the role of the fire brigade**

Since fiscal policy has so far been in tightening mode, the ECB has reluctantly found itself cast in the role of the fire brigade of macroeconomic policy. It has been forced to step in not just to put out funding fires for banks and governments, but also to cushion the downturn in economic activity. As a result, it has had to turn a blind eye to its price stability mandate, as headline inflation has run ahead of its 2% target ceiling, prompting muttering of complaints from Germany.

Fig 9 EZ refi rate, CPI, bank lending




Source: Ecowin

**The Bundesbank fears that the boundaries between fiscal and monetary policy have become blurred**

The Bundesbank has loudly voiced its concerns that the boundaries between fiscal and monetary policy have become distinctly blurred since the financial crisis began. By accepting progressively poorer quality collateral for its loans to banks in the periphery and by buying the debt of the troubled sovereigns, it fears that the ECB's balance sheet has been jeopardised. Large-scale defaults or any fracturing of the EMU could wipe out the ECB's capital base, leaving taxpayers, not least in Germany, on the hook.

The ECB has tried to limit its exposure by insisting that the softening of the collateral has been done under the condition that there is no burden sharing; the risk of loss falls entirely on the national central bank (NCB) in question. Nevertheless, this big increase through Emergency Liquidity Assistance (ELA) via the NCB makes the distinction between liquidity and solvency support very thin. Thus, the ECB is losing its grip on its own monetary policy, because NCBs are creating money to keep their domestic banking system afloat (the ECB has still to approve, but if it refuses it effectively pulls the plug on the banking sector of the country concerned).

**The ECB still has some policy options…**

Nevertheless, the insistence of the German government, supported by its core counterparts, to press ahead with the disciplines of the fiscal compact is likely to leave the ECB in its fire brigade role. The menu for further monetary easing includes:

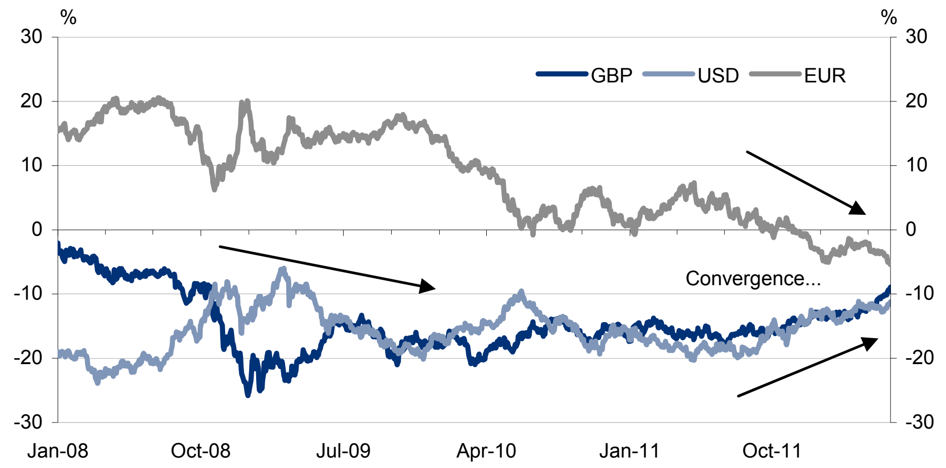
- **Interest rate cuts:** its official policy rate could be cut further from its current 1%, perhaps down as far as 0.25%, which would leave the EONIA rate close to zero.
- **Long-term refinancing operations** (LTRO) to banks. Its three-year "LTRO 2" could be repeated, providing a fresh round of support to distressed banks, and indirectly, sovereigns.

**…but some, like aggressive quantitative easing, would challenge its rulebook and call for political support**

- **Asset purchases**. Its securities markets programme (SMP) could be reactivated, scaled up, and refocused on distressed securities. In other words, the ECB could, in extremis, shift towards aggressive quantitative easing. Such a step would certainly provoke rearguard opposition from its more conservative members, and might require the comfort of politicians having to agree joint and several government guarantees for the risks that this would entail.

- **Signalling and communications**. A more cost-effective option might be to persuade the markets, and thereby massage asset prices, by changing its targets and communications.
  - A convincing commitment to hold peripheral yields below a maximum level, say Spanish and Italian ten-year bond yields at 5%, might mean that its actual purchases would have to be substantially smaller.
  - Modify its price-stability target. Raising the ceiling from close to 2% to say 2.5% or 3% might be less acceptable than to refocus on the – currently lower – core inflation rate. A more radical step, which would need more political cover, would be to adopt a US Federal Reserve-style dual mandate, adding a growth or employment target. Currently, the ECB is only following a growth target as a so-called 'secondary mandate'.

Fig 10 Exchange rates: trade-weighted euro, US dollar and sterling indices 2008-12




Source: Ecowin

**An explicit weak euro policy would probably require the intervention of Eurozone politicians**

- **Euro depreciation** – The ECB has so far studiously stuck to a free-floating strategy towards the euro's exchange rate. Nevertheless, it is clear that the US and UK economies have derived considerable benefit from the depreciation of the dollar and sterling earlier in the financial crisis. Both the Fed and the Bank of England have been reluctant to describe currency depreciation as an explicit policy aim. But the declines in their respective exchange rates, partly as a side-effect of their quantitative easing policies, has provided a welcome boost to economic growth. In the first instance, the ECB is unlikely to make an explicit change in its rhetoric on the exchange rate, but a calculated lack of expression of concern on any further weakness could give the euro further downward momentum. To go further, to an explicit exchange rate policy, would probably require the intervention of Eurozone politicians, since the Maastricht Treaty divided the responsibility on exchange rate policy between the European Council and the ECB in an ambiguous way.

**Monetary easing: QE and euro depreciation could have powerful effects**

Monetary easing can take a variety of forms including, for example, exchange rate depreciation, as well as more unconventional policy measures such as balance sheet policies and unsterilised QE. These can have powerful economic effects. Overall, a full return of credit conditions to pre-crisis levels should result in an improvement in both GDP (0.9ppt pa) and employment (400,000 additional jobs pa) in the first two years, and even larger positive effects in the mid-term. This conclusion can be drawn from looking at our simulations using the Oxford Economics Global Model.

Exchange rate depreciation: exchange rate depreciation contributes directly to economic growth through its positive effects on the current account. The OECD's new global macroeconometric model assumes that a sustained 10% decline in the trade-weighted euro boosts Eurozone GDP by 0.7% after one year and 1.3% after two years. ECB model estimates suggest similar effects (0.9% pa in the first five years), which is more in line with our calculations of 0.85% (assuming constant interest rates). In addition, we find that such increased economic activity is coupled with an increase in employment of more than 350,000 jobs pa in the first years.

Balance sheet policies: since 1 January 2007, the ECB's monetary base has increased by 225%. This currently amounts to c.€1,750bn, or 18.5% of Eurozone GDP. An ECB working paper estimates that the impact on activity of a 10% increase in the monetary base at a given level of the policy rate is similar to the impact of a 25bp decline in the policy rate.

Quantitative easing: up until the end of 2011, the ECB had undertaken c.€225bn of sterilised peripheral bond buying, equivalent to 2.4% of Eurozone GDP. To our knowledge, the ECB has not yet published an evaluation of the consequences of such large-scale QE for Eurozone GDP. However, experiences in the UK (as evaluated in a paper by the Bank of England) indicate that an increase in QE equal to 1% of GDP might raised GDP in the following year by c.0.10-0.15ppt (as total QE of 14% of GDP resulted in 1.5-2% of additional economic growth). Our own calculations (building on the OE Global Model) find effects of around the same size. For example, an increase of €500bn (or 5% of GDP) results in a 0.25bp increase in GDP in the each of the subsequent three years.

*Martin van Vliet*
*Fabienne Fortanier*

**Gaining acceptance for more radical monetary measures may be easier than for explicit fiscal transfers**

- The box above summarises the potential impact of some monetary easing options. While there is little scope to cut interest rates further from current levels, there is still considerable scope to ease monetary policy further. The recent acceptance by the German government and the Bundesbank that Germany may have to play a role in Eurozone rebalancing by tolerating inflation above 2%, so long as the Eurozone as a whole keeps inflation below that level, is a symbolic shift that could lead to more. Aggressive quantitative easing and tolerance, even encouragement of euro depreciation would certainly require the ECB to be given more political cover. This may not be easy, but as we note above, it might be easier than gaining acceptance for explicit fiscal transfers. However, the fact that Germany, as the Eurozone's export powerhouse, might have most to gain from a depreciating euro, could ultimately make it more sympathetic to such transfers.

## Redistribution – Choose your poison

**The notion of a 'transfer union' is currently politically toxic…**

The notion of the EMU turning into a 'transfer union', whereby richer members support poorer members, is currently politically toxic. Core country taxpayers are angry at the idea of having to bail-out the indebted periphery. But German politicians still profess to

**…but German policy-makers still see fiscal union as the ultimate destination**

support the EMU architects' ultimate goal of political and fiscal union. Indeed, history suggests that these are crucial to the survival of monetary union. However, faced with a sceptical public, German politicians have therefore had to go about this the hard way, by insisting on fiscal discipline as a pre-condition for any moves towards fiscal transfers or union. Despite this, trying to place the burden of adjustment solely on debtors has clearly run into trouble. The recognition is slowly dawning that creditors will have to share more of the pain. The only question is how the resource transfers will occur.

**Still, there have already been transfers, albeit involuntary, covert and contingent…**

Since tax-payers in core countries are reluctant to pick up the tab, explicit transfers are patently some way off. Nevertheless, there have already been transfers, but they have been involuntary, covert and contingent. For policy-makers, it is a case of 'choose your poison'. Here is the menu:

**More defaults would effectively be involuntary resource transfers from creditors**

1) **More defaults**, whether orderly or disorderly, continued weakness in growth and asset prices (notably of real estate) threatens more losses for creditors. Such defaults are effectively involuntary resource transfers from creditors to debtors. In the case of Greece, private sector holders of government debt have already swallowed big losses, so further restructuring, which now seems inevitable whether or not it stays inside the EMU, will necessarily involve losses for official creditors and hence non-Greek taxpayers.

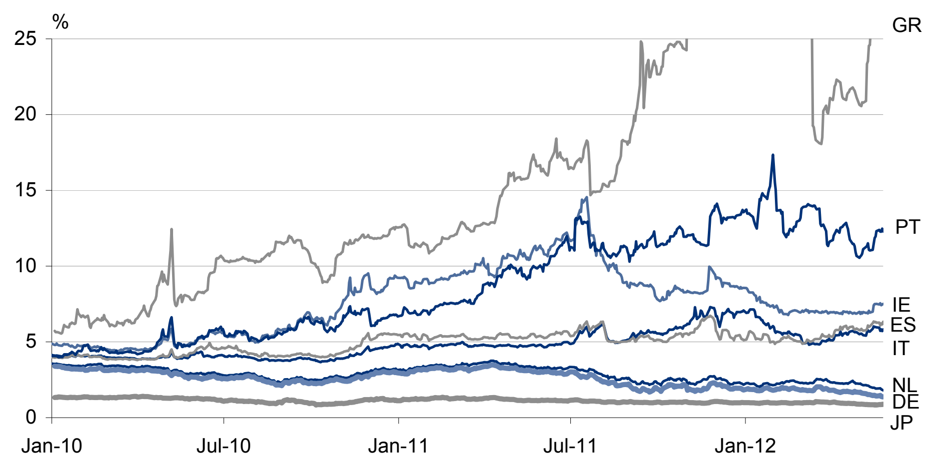
**More concessionary loans involve implicit transfers and contingent liabilities…**

2) **More concessionary loans**, involving implicit transfers in the form of below-market interest rates on loans and contingent liabilities in the event of further defaults or restructuring. The general expectation is that the 'firewall' of the European Stability Mechanism (ESM) is likely to have to be expanded from its current €500bn if it is to cover the potential problems of Spain or Italy.

**…as would more ECB liquidity infusions and asset purchases**

3) **More ECB liquidity infusions and asset purchases**, which would involve more implicit transfers by holding down the funding costs of distressed banks and sovereigns, largely in the periphery. The justification is that this may give the recipients breathing space to prevent a liquidity problem from turning into a solvency problem. However, this entails risk: such support represents a further contingent transfer were these borrowers subsequently to fail. Moreover, another problem, as highlighted by 'LTRO 2', is the risk that subsidised funding of peripheral countries' banks tightens the link with their host sovereign as the banks load up on government bonds.

Fig 11 Eurozone government bond spreads




Source: Ecowin

**Banking union: mutualising bank risk might involve actual transfers to recapitalise banks…**

4) **Banking union**, whereby mutualisation of bank risk would bolster the banking system and break the link between bank and sovereign solvency. This might involve both

…and contingent transfers in the form of guarantees…

…but they could dramatically increase confidence in the system

actual and contingent resource transfers. Actual transfers might be required to finance the recapitalisation of troubled banks in Spain or other parts of the periphery. Beyond this, moves towards banking union might involve contingent transfers in the form of guarantees. ECB executive board member Peter Praet recently said there was “no escaping a banking union” including “a single euro area authority responsible for the supervision and resolution of large and complex cross-border banks.” Eurozone-wide deposit guarantee and resolution funds could be financed by bank levies in the first instance, but ultimately these would have to be back-stopped by Eurozone governments. Inevitably, this would transfer more risk from the periphery to the core, but this would provide a dramatic boost to confidence in the health of the banking sector by severing its vulnerability to weak peripheral government finances.

Funding union would mutualise risk on the government issuance…

…leading to sharply lower spreads…

5) **Funding union,** involving mutualisation of risk on the issuance of common bonds (sometimes called Eurobonds or E-bonds). By pooling their credit risk, the effect would be to sharply reduce the cost of borrowing for the Eurozone’s less creditworthy borrowers, at the expense of the rest. Small wonder then that Chancellor Merkel, supported by the leaders of other triple AAA-rated countries such as the Netherlands, are against this. But President Hollande has come out strongly in favour, saying “For Mrs Merkel, Eurobonds are the end of point of a process of integration. For me, they are the starting point.”

…and reduce the weighted average cost of borrowing for the Eurozone as a whole…

…provided fiscal discipline was enforced

In principle, common bonds could be a ‘positive sum game’, reducing the weighted average cost of borrowing for the Eurozone as a whole. It would be a powerful symbol of mutual commitment, and were it to replace all national issuance, would create a massive, liquid, market of over €8tn. However, a second concern of Germany and its allies is moral hazard, since purely mutualising debt in this way would remove the incentive for individual countries to curb their borrowing that comes from the market discipline threat of higher bond yields. This moral hazard risk might push the yields on common bonds up, perhaps more than outweighing the yield reduction stemming from their liquidity. On top of this, Chancellor Merkel has argued that the creation of common bonds would require the arduous renegotiation of EU treaties (proponents of the idea not surprisingly dispute this).

Advocates have addressed German worries with limited, temporary or conditional schemes

Advocates of common bonds have attempted to address the core countries with a variety of schemes that have been more limited in scale, accompanied by heavy conditionality or which are temporary in nature. However, an essential pre-condition for a permanent programme will clearly be moves towards fiscal union, enshrining fiscal discipline into law. Whether the ratification of the fiscal compact signed last year will be enough to satisfy Germany is a moot point.

The EU budget could evolve into a larger system of fiscal transfers, ultimately to a fully-fledged federal fiscal union

6) **From transfer union to fiscal union**, whereby the existing EU budget would evolve into a larger system of fiscal transfers ultimately through to a fully-fledged federal fiscal union with a central authority with discretionary spending, taxing and borrowing powers. Fiscal resources would be shifted from richer members to poorer members on a much larger scale than is presently the case. The EU budget currently amounts to c.1% of EU GDP, and because even core Eurozone countries receive some funds from it, the net transfers that result from it are the equivalent of a mere one-fifth of this. Not surprisingly, this has little impact on economic convergence in the Eurozone. Again, although the German political elite may talk airily of fiscal and political union as being the ultimate goal of European integration, this has not translated into selling their voters the merits of fiscal transfers.

This would require major changes in fiscal and political powers

It is clear that any distribution of income or tax revenue would require major political changes. Core countries would demand changes in fiscal and political powers to ensure robust governance of government finances in the periphery. This would imply a challenging loss of sovereignty for the latter. This could be done within an intergovernmental framework, but it would be more viable if a commitment to cede sovereignty was secured beforehand. In fact, these changes would require new EU treaties and popular support in referenda, which would not be easy to secure.

**A federal fiscal union could be an altogether tougher sell**

A federal fiscal union with a Eurozone fiscal authority with its own spending, taxing and borrowing powers would be an altogether tougher sell. In effect, this would be the 'United States of Europe' (or, more precisely, 'United States of Eurozone'), in other words, political union. The implied shift in political power to the centre would probably, although not necessarily, go along with bigger fiscal transfers than envisaged in a decentralised transfer union.

**The economic impact would be enhanced by a strong governance framework…**

The governance framework around fiscal transfers would also have a major bearing on their economic impact. In principle, such transfers would provide a major boost to growth in the periphery and narrow the gap in incomes across the Eurozone. This is partly because peripheral economies are smaller. Thus, a transfer of the equivalent of 1% of core countries GDP would add 1.9% to growth in peripheral economies, or 3.9% if Italy were excluded, all else being equal (see Box below). However, as so often, all else would probably not be equal. It is hard to imagine that such transfers would be accomplished seamlessly, not least because the transfers would reduce the incentives on peripheral economies to keep up the pace of fiscal consolidation and reform.

**…since the track record of transfers in Europe is not encouraging**

Indeed, the empirical evidence on the track record of transfers in Europe is not encouraging. While income disparities tend to be reduced, one ECB working paper talks of transfers having resulted in 'immiserising convergence', where growth falls as a result of transfers and convergence results only from growth in the receiving regions having fallen by less than in the paying regions. Thus, the impact of transfers would depend heavily on limiting waste and disincentives.

**The impact of fiscal transfers**

Another often suggested way forward for the Eurozone to restore growth could be a transfer union. Through direct fiscal transfers from economically-stronger countries to weaker ones, a transfer union generally aims at both increasing and converging economic growth rates in all countries involved in the transfer. However, although historical and empirical evidence indicates that fiscal transfers may have positive effects in stabilising incomes and, consequently, in tackling social inequality, there is limited empirical evidence that they also result in stronger economic growth.

In practice, there are two main options to fund fiscal transfers from core to periphery countries. First, transfers can be offset by fiscal tightening in the core, resulting in negative labour market effects, and subsequently subdued growth and relatively higher debt ratios. Second, core countries may opt not to offset the transfer by fiscal tightening, in which case they would not suffer output losses, but would experience even higher debt ratios.

A transfer equivalent to 1% of core countries' GDP equals 1.9% growth in peripheral economies, or 3.9% if Italy were excluded, all else being equal and assuming that these transfers translate entirely into growth. However, due to import leakages, for example, the effect may be smaller in the periphery and core countries could benefit as well. Indeed, our estimates using the Oxford Economics Global Model indicate that a 1% fiscal transfer via fiscal loosening improves economic growth in both the core (+0.25ppt) and the periphery (between 1.5-2.0ppt). Moreover, employment is positively affected, particularly in the periphery: a 1% fiscal transfer may decrease the unemployment rate by c.0.7ppt pa in the first two years after the transfer starts. This would for example result in additional 100,000 jobs pa in Spain.

*Carsten Brzeski*
*Philippe Ledent*
*Fabienne Fortanier*

## Greece – More than 'a little local difficulty'

**Strong support for anti-bail-out parties has put a Greek exit firmly on the agenda**

Recent events have clearly put the survival of the EMU in its current form under imminent threat. In particular, strong support for anti-bail-out parties in the Greek elections on 6 May has put the possibility of a Greek exit firmly on the agenda. Although polls show Greek voters to still be strongly in favour of staying in the EMU, the official message from Eurozone politicians is that this will depend on a government emerging from the new elections on 17 June that is prepared to deliver on the bail-out.

**The heightened risk of further exits may force rapid progress on EMU-supportive policy options**

In our report, *A Greek cliff-hanger* (25 May), we explore the implications of a possible Greek exit if a post-election compromise is not found. The essential point is that while Greece accounts for only 2% of Eurozone GDP, this would not be merely 'a little local difficulty'. Aside from direct losses from Greek defaults and depreciation that would ensue, the collateral damage from the heightened risk of further exits would force rapid progress on the EMU-supportive policy options discussed earlier. The immediate fire-fighting in the financial markets would again fall to the ECB. But with the rubicon of exit having been crossed, the Eurozone's political elite would surely have to take stronger action to ensure its survival.

**This may apply even if compromise enables Greece to stay in the EMU**

However, even if compromise enables Greece to stay in the EMU, which remains our base-case scenario, this 'near-death' experience is likely to accelerate the pace of policy change. Angela Merkel is prone to talk of the process of European integration being a marathon: the Greek saga could turn it into a sprint. In the next section, we outline a series of scenarios that examine the possible alternative roads to survival.

## Six scenarios for survival

**It is unlikely that policy change will be confined to just one of the three dimensions**

It is unlikely that policy changes within the Eurozone will be confined to just one of the three dimensions described earlier. Indeed, we expect movement along each of the reform, reflation and redistribution dimensions. In some cases, the movements may counteract one another. For example, austerity focused on the periphery or reflation focused on the core would redistribute growth away from the periphery rather than towards it. But, in others, the policy shifts would be mutually supportive. Thus, moves towards banking union or common bonds would not only be redistributive, but also reflationary.

**The scale and the timing of the policy changes are clearly debateable…**

**…and some are unprecedented, making assessment tricky**

In order to assess the potential impact of these policy changes, we describe here a number of scenarios. These are stylised combinations based on the above dimensions. The scale and the timing of the policy changes are clearly debateable. On this score, it should be borne in mind that we could progress from one scenario to another, depending on how the economic and political environment evolves. As we noted earlier, the calibration of some of these policy shifts, some of which, like common bonds, would be unprecedented, is necessarily tricky. Indeed, since some of the options might worsen the economic and political climate in the short term, there is liable to be an element of trial and error in policy-making over the next few years. Nevertheless, we hope these scenarios will help to shed some light on the gloom surrounding the outlook for the Eurozone.

**We describe six scenarios**

Below, we describe the following scenarios:

1) ***Austeria*** – Emphasis on the fiscal compact (asymmetric austerity) and structural reform ("creative destruction"). This is an extension of the austere prescription that Germany and its core allies have been advocating.

2) ***Draghia* (banking union)** – Combining further loosening of monetary policy with swift recapitalisation of banks, Eurozone-wide deposit guarantees, supervision and resolution schemes.

3) ***Bondia* (funding union)** – Adding a fast-track progression towards the common issuance of Eurobonds.

4a) ***Europhilia* (from transfer union to fiscal union)** – Adding explicit fiscal transfers from the core to the periphery, accompanied by adherence to fiscal ceilings and structural reforms.

4b) ***Switzerland* (small federal government transfer union)** – A federal version of 4a in which the public sector is reduced in size and decentralised.

4c) ***America* – (looser fiscal policy and transfer union)** – This is essentially a variant of 4a, combining a smaller public sector (lower spending and taxes) – and hence economic liberalisation – with a more activist fiscal policy.

5) ***Inflationia* (*Outer Draghia?*)** – Involving radical monetary easing – aggressive quantitative easing and euro depreciation (see point no.2). This could encounter resistance from trading partners and prompt a protectionist backlash.

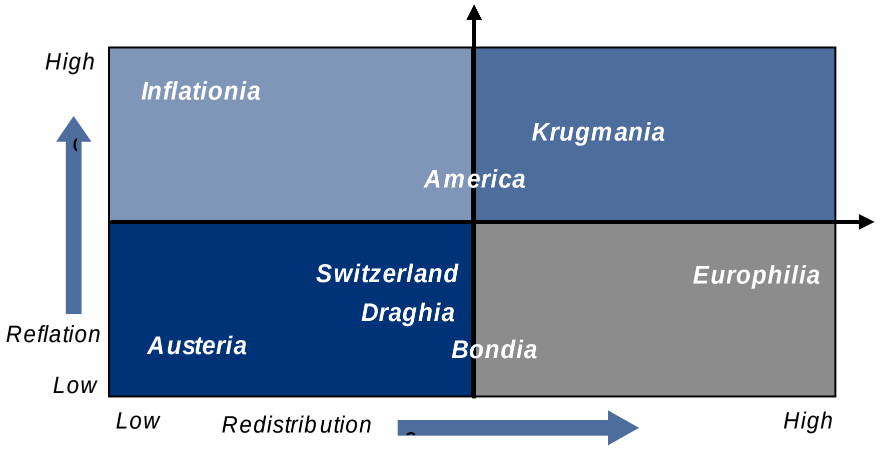
6) ***Krugmania*[2]** – A more aggressive version of America, fiscal stimulus focused on public investment, bigger government, more relaxed attitude to inflation in the short run, combined with credible commitments to long-term fiscal consolidation.

In order to put these scenarios into context, the diagram below maps them on the reflation dimension (vertical axis) and the redistribution dimension (horizontal axis). Thus,

[2] This scenario is named after Professor Paul Krugman, a staunch and high-profile advocate of Keynesian solutions, to what he terms the 'depression' in the US and Europe.

scenario 1, *Austeria*, involves little by way either of reflation or redistribution, at least initially, and therefore lies in the bottom left-hand quadrant[3]. By contrast, *Krugmania* would involve substantial doses of both, placing it in the top right-hand quadrant.

Fig 12 EMU survival scenarios – Combining reflation and redistribution




Source: ING

**Over time, we could progress from one scenario to another**

As noted above, over time one could imagine progressing from one scenario to another. Since explicit fiscal transfers are perhaps the most politically challenging option, it could take years to arrive at the *Europhilia* scenario, having first travelled through *Draghia* and then *Bondia*. However, in our assessments below, we assume for analytical purposes that each scenario's policy mix is adopted as swiftly as quickly as possible.

1) **Austeria**

**An intensification of the current strategy of austerity and structural reform…**

**…points to further economic weakness and divergence…**

This scenario combines tough implementation of fiscal austerity and structural reform. The burden of adjustment falls heavily on the periphery. In effect, this is not so much a continuation, but an intensification of the strategy pursued so far. In the short term, the combination of asymmetric austerity and "creative destruction" leads both to weaker economic activity and increased divergence in economic growth between the core and the periphery. 'Internal devaluation' based on lower wage inflation might improve the debtors' current account balance and thereby reduce external indebtedness, but at the expense of higher unemployment 'internal balance'.

**…and defaults…**

**…imposing losses on private and official creditors…**

On this basis, it is hard to escape the conclusion that this would put peripheral economies on the path towards default, raising the question of the willingness of core countries to countenance increasing the 'firewall' of bail-out funding. The presumption of a hard-line stance in this scenario implies default and restructuring would be likely for Greece and Portugal over a one- to two-year horizon, and perhaps ultimately Spain. This in turn would cause losses for private and official holders of peripheral debt. In effect, this represents an involuntary transfer of resources.

**In the longer term, debt relief and the benefits of structural reform might spark a revival**

Further out, the combination of debt relief and the accumulating benefits of structural reform might give some scope for a revival in peripheral economies. Since the combination of weak growth and defaults would drive the euro substantially lower, there might also be a boost to net exports for the Eurozone as whole in the longer term. However, the dogged pursuit of fiscal austerity across the Eurozone would like mean that growth would be generally subdued, implying that the path to fiscal sustainability and bond yield convergence would be a long one. Indeed, it is hard to escape the conclusion

[3] Although, as we will argue below, the consequence of Austeria could be further defaults, which entail redistributive effects, these are essentially unintended and involuntary. In effect, the redistribution on the scale in the diagram could be regarded as voluntary or intentional redistribution such as that arising from common bond issuance or fiscal transfers.

that is doubtful whether this scenario would lead to a politically or economically sustainable situation in the longer term.

2) **Draghia (banking union)**

In this scenario, fiscal austerity is cushioned by further loosening of monetary policy and efforts to improve the health of the banks. Recapitalisation of troubled banks is coupled with a determined drive towards 'banking union' involving Eurozone-wide deposit guarantees, supervision and resolution schemes[4].

**Bank recapitalisation and risk mutualisation coupled with looser monetary policy…**

**…would transform confidence in the banking system**

This might be seen as a logical extension of scenario one, in that the ECB has already been holding the system together with its expanding collection of unconventional measures. The likelihood of defaults in *Austeria* might indeed prompt further measures, in particular to support the banks – perhaps using ESM funds – to bail-out or facilitate the resolution/consolidation of banks. Moving to a Eurozone-wide deposit guarantee and bank resolution schemes would dramatically improve depositor and investor confidence in the health of banks. This would reduce their funding costs, reducing lending rates and improve credit availability.

**Fully-fledged QE and euro weakness would have to overcome internal resistance in the ECB**

Cuts in interest rates and a move to extend of the ECB's securities markets programme (SMP) into fully-fledged quantitative easing, and attendant weakness in the euro, would also feature in this scenario. This would have to overcome internal resistance in the ECB, not least from the Bundesbank, about inflation and moral hazard, but it might be easier to gain agreement on greater monetary ease than the politically-challenging need to agree on more bail-out funds. That said, unless these actions were to be taken quickly and aggressively, the need to agree on funding bank recapitalisation might make the latter necessary anyway.

**Economic growth would benefit from cheaper and more plentiful credit and a weaker euro**

Compared with *Austeria*, *Draghia* would result in stronger economic growth, courtesy of the combination of cheaper and more plentiful credit along with a weaker euro. Government bond spreads would likely narrow somewhat as a consequence, but the headwind of fiscal austerity would still be holding back growth and doubts about fiscal sustainability of the periphery, while less intense than in *Austeria*, would linger.

3) **Bondia (funding union)**

**Fast-track progression towards common issuance…**

*Bondia* adds a fast-track progression towards the common issuance of Eurobonds to moves towards banking union. Provided markets were given an early commitment to move in this direction (officials are already hoping to secure agreement on a 'roadmap'), this would relieve the pressure on the ECB to step in to support embattled peripheral sovereigns with its SMP or outright quantitative easing.

**…although given German reservations, it initially would not be on a permanent basis**

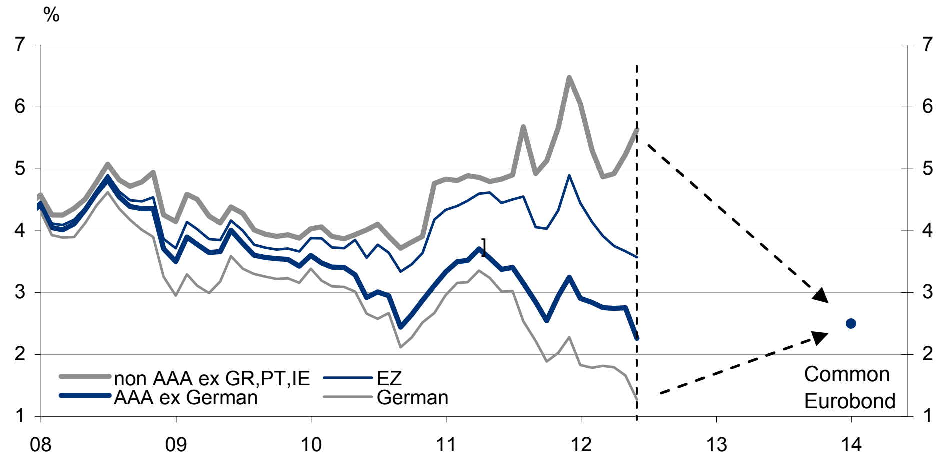
**A redemption fund might be a first step…**

**…with agreements on discipline being a pre-condition**

Given the reservations of Germany and core countries, we assume that common issuance would not immediately be on a permanent basis. This might be dangled as a carrot as the ultimate destination, but even an interim scheme would have dramatic effects on bond market sentiment. We assume that a variant of the German redemption fund proposal for debt above the 60% debt/GDP level would be most appealing to the politicians of the core. It has the merit of being temporary, drawing a line under past ill-discipline, and maintaining incentives for good behaviour on future domestic issuance. A precondition for this would be ratification of the fiscal compact, which would further enhance market confidence in the durability of the scheme. The assumption of joint and several liability would necessarily involve a degree of political solidarity that would facilitate other moves towards integration, such as an eventual move to an explicit transfer union.

[4] We contemplated calling this scenario 'Bankia', but we decided to avoid any confusion with the name of a troubled Spanish bank

Fig 13 Eurozone government bonds: from divergence to convergence?
ten-year bond yields




Source: Bloomberg

**Dramatic convergence of borrowing costs would be a boost to the periphery…**

**…perhaps forestalling the pressure for QE**

Compared with *Draghia*, *Bondia* would imply a much more dramatic convergence of government bond yields and, by extension, bank funding costs. This would give a substantial boost to activity in the periphery. However, this would, at least partially, be at the expense of core countries' growth, since they would see some increase in their funding costs. Moreover, since common issuance might eliminate the need for the aggressive monetary easing assumed in *Draghia*, the net benefit to growth in the short term might be relatively modest.

4) **Europhilia (from transfer union to fiscal union)**

**Positive reception to other Europhile policies might create rapid momentum towards fiscal union**

Since *Bondia* already presumes a substantial shift in mutual political commitment, the next step, towards fiscal transfers, might not be too far behind. We noted earlier that the current political climate in core countries, at least excluding France, is hostile to the notion of a 'transfer union', but a positive reception to other Europhile policy options in *Draghia* and *Bondia* might create surprisingly rapid momentum in this direction. Realistically, treaty changes would be required to set up a comprehensive system of transfers, which would likely take more than a year. However, in the meantime, an emergency package, say focused on investment projects, might provide a means of accelerating the resource transfer to the periphery.

**Robust governance might limit the disincentives to fiscal discipline**

**We assume core countries would borrow to finance the transfers, resulting in a net fiscal stimulus**

In the *Europhilia* scenario, the presumption is that a robust system of fiscal governance is agreed as a pre-condition for the implementation of more substantial fiscal transfers. This would limit the resulting disincentives to fiscal discipline and thereby improve the effectiveness of transfers in boosting economic growth and convergence of the periphery. Our assumption is that the transfers to the periphery would involve a net fiscal stimulus, whereby the core countries do not finance the transfers by domestic fiscal tightening, but rather additional borrowing. The rationale is that higher taxes and/or spending cuts in the core countries would harm their economic growth and jeopardise popular support for 'solidarity'. Additional core country borrowing would likely only have a modest adverse effect on their credit worthiness, especially given the fact that the transfers would reduce the risk of future bail-outs to the periphery.

***Europhilia* would transform market perceptions…**

**…boosting asset prices and the euro**

In any case, the assumed transformation of Eurozone politics in the *Europhilia* scenario would transform market perceptions. It would be seen as more sustainable than a mere funding union, and focus the markets' attention on the fiscal and economic health of the Eurozone as a whole. This would further reduce the credit risk on the new common bonds and boost asset prices and the euro's exchange rate. To the extent that rising confidence would serve to lift the Eurozone economy's growth prospects, this would tend to lead to an ex post rise in bond yields.

**Successful implementation of a transfer union might create the political momentum to move to federal fiscal union**

In the longer term, successful implementation of a transfer union might create the political momentum to move to federal fiscal union with a Eurozone fiscal authority with its own spending, taxing and borrowing powers. In effect, this would be the 'United States of Europe' (or, more precisely, 'United States of Eurozone'); in other words, political union. The implied shift in political power to the centre would probably, although not necessarily, go along with bigger fiscal transfers than envisaged in a decentralised transfer union.

**A '*Switzerland'* variant might involve a smaller federal government and a lesser degree of centralisation**

One variant of the *Europhilia* scenario might be an evolution to a 'Switzerland' scenario with a small federal government involving a low degree of centralisation (high degree of state autonomy) and a convincing no bail-out regime. In other words, there would be limited joint liability for states' debts. This would do relatively little to address imbalances, and might require more aggressive structural reform to achieve sustainability. More liberalisation and lower taxes could be the recipe.

**An 'America' variant might involve looser, more activist fiscal and monetary policies**

Another variant might be an 'America' scenario, again with smaller government, more economic liberalisation, but combined with looser and more activist fiscal and monetary policies. However, it is harder to imagine the political shifts that would be required to achieve such a radical transformation in the Eurozone's economic and political model.

5) **Inflationia**

**Aggressive monetary easing would imply a defeat of Bundesbank-style monetary conservatism**

*Inflationia* might be thought of as '*Outer Draghia*', a scenario that involves a much more radical monetary easing. This would comprise of both aggressive quantitative easing and euro depreciation. This necessarily implies a defeat of Bundesbank-style monetary conservatism. *Inflationia* also assumes a backlash against fiscal austerity, providing a further boost to economic activity and inflation as fiscal consolidation is put on the back-burner.

**This is an 'inflate away the problem' story**

However, while budget cuts would be foregone, the uplift to growth and inflation would lead to a sharp reduction in the denominator of the Eurozone's debt-to-GDP ratios. This is an 'inflate the problem away' story. An alternative, market-led route into this scenario might be a sudden and dramatic loss of investor confidence in Eurozone and its policy-making, prompting a collapse in the euro.

**Core countries might be better placed to capitalise on a weaker euro**

Since core countries might be better placed to capitalise on a weaker euro, it could raise the risk of increasing intra-Eurozone imbalances. Nevertheless, growth in the periphery would still be stronger than in previous scenarios. Moreover, robust growth in the core might provide the political support and economic resources for bigger fiscal transfers to the periphery.

**A sharp euro depreciation could encounter resistance from trading partners…**

**…either through competitive easing or, worse, protectionism**

A sharp euro depreciation could encounter resistance from trading partners, although the outcome would depend on what form the resistance took. It could be that it would trigger competitive monetary easing by the Eurozone's trading partners. While this would limit the euro's depreciation, it would boost external demand, so the net effect on Eurozone growth would still be positive. A more negative response might come from protectionism and/or the flight of capital, which in turn might raise funding costs. This could have very negative effects for economic and financial stability.

**But they might be surprisingly tolerant, seeing it as 'a price worth paying'**

However, to the extent that this strategy revived the Eurozone's growth and did not impair its fiscal sustainability, trading partners might be surprisingly tolerant of euro depreciation, seeing it as 'a price worth paying' to avoid defaults and break-up. In particular, since Europe is progressively becoming a less important trading partner to the US, the US might be relatively relaxed about this so long as the dollar's appreciation was confined to the euro, or better still, offset by a depreciation against Asian currencies.

6) **Krugmania**

**Keynesian fiscal stimulus focused on public investment with long-term commitments to fiscal consolidation…**

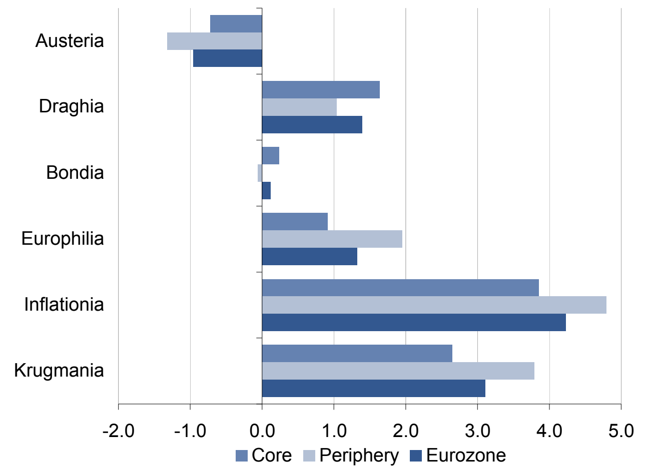
*Krugmania* is another reflationary scenario, with the emphasis more on fiscal stimulus. A sharp deterioration in the Eurozone economy in the near term might be the catalyst for a much stronger backlash against fiscal austerity. A Keynesian prescription of a fiscal stimulus focused on public investment is combined with credible commitments to long-term fiscal consolidation. Amid a generalised relaxation of fiscal policy across the Eurozone, initially led by core countries, a *Krugmania* scenario also allows for a greater element of solidarity and redistribution to the periphery, financed by additional borrowing by core countries.

**…might be combined with modest quantitative easing and tolerance of euro depreciation**

The ECB adopts a more relaxed attitude to inflation in the short run, and lends further to support activity through quantitative easing and tolerance of euro depreciation, albeit on a more modest scale than the *Inflationia* scenario. Despite quantitative easing, *Krugmania* leads to higher bond yields in the face of a rewriting, if not abandonment, of the fiscal compact and an upturn in economic activity and inflation. Upward pressure on bond yields might be limited by the longer-term fiscal consolidation plan and the downward pressure on debt-to-GDP ratios from stronger nominal GDP growth.

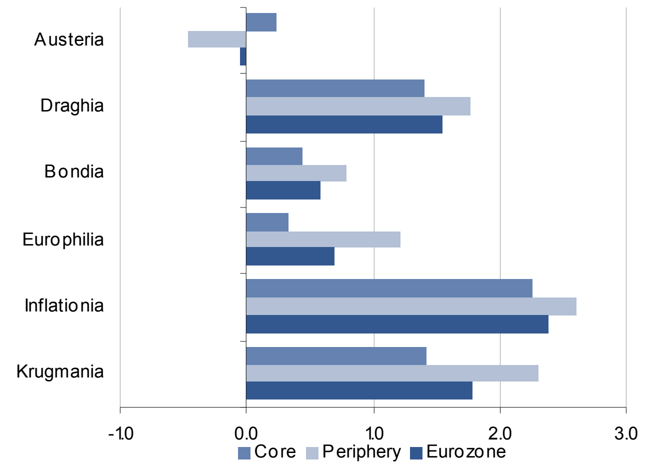
In Figures 14 and 15, we summarise our initial simulations of the impact of the six scenarios on GDP and employment in the second year after implemention, and in comparison with our base-case forecast. Thus, *Austeria* leads to a drop in output of c.1% compared with our base-case forecast, implying that recession is extended into 2013. The other scenarios generally leave output and employment higher than in our base-case. *Bondia* provides less of a boost than *Draghia*, because we assume that unlike *Draghia*, *Bondia* does not use QE. *Draghia* would lift Eurozone GDP growth to a respectable 2¼% in 2013F. The most extreme reflationary scenarios of *Krugmania* and *Inflationia* have much more dramatic effects, adding as much as 4% to growth.

Fig 14 GDP growth in various scenarios (% chg from base, year two)




Source: ING estimates

Fig 15 Employment rate in various scenarios (% chg from base, year two)




Source: ING estimates

We will go into more detail about our simulations in a future report. However, the following table (see Figure 16) provides a flavour of the directional consequences on a two- and five-year view. An important implication is that it is doubtful whether *Austeria* is a viable route to survival for the EMU given that it depends heavily on debt restructuring to achieve fiscal sustainability. All of the scenarios offer a more assured route to sustainability, which in the long-term implies bond yield convergence and higher core bond yields. Short-term euro weakness is an importance catalyst for economic recovery, which might then lead to some euro recovery, except in the *Inflationia* scenario.

Fig 16 Scenario impact scoreboard

| | | | Bond yields | | |
|---|---|---|---|---|---|
| Scenario | Output | €/$ | Core | Periphery | Spreads |
| *Greek exit* | ↓↓→↓ | ↓↓→↓ | ↓ →● | ↑ →● | ↑↑→● |
| *Austeria* | ↓↓→↓↓ | ↓ →↓ | ↓↓→↓↓ | ↑ →↑ | ↑↑→↑↑ |
| *Draghia* | ↑ →↑ | ↓ →↑ | ● →↑ | ↓ →↓↓ | ↓ →↓↓ |
| *Bondia* | ● →↑↑ | ● →↑ | ↑ →↑↑ | ↓↓→↓↓ | ↓↓→↓↓ |
| *Europhilia* | ↑ →↑↑ | ↑ →↑ | ↑ →↑ | ↓ →↓↓ | ↓↓→↓↓ |
| *Inflationia* | ↑↑→↑↑ | ↓↓→↓↓ | ↑ →↑↑ | ↑ →↑↑ | ● →↑ |
| *Krugmania* | ↑↑→↑↑ | ↓↓→↓ | ↑ →↑ | ↑ →↑ | ● →● |

Source: ING

Note: Arrows show direction of impact in years 1-2 -> years 3-5 (●=no change)

# Conclusion

In this report, we set out three dimensions – reform, reflation and redistribution – along which a road to the EMU's survival might be built. Although along the way we note the political constraints facing the various policy options, we avoid ruling anything out, focusing instead on the possible economic and financial market consequences. A number of important conclusions emerge from this exercise:

**Roads to survival do exist**

1) There are a range of policy options, whether in isolation or, more likely, in combination, that could transform the outlook. Roads to survival do exist. Whether the political and economic environment will allow them to be travelled is less clear.

**Fiscal austerity alone is not enough**

2) Fiscal austerity alone is not enough. Recent fiscal targets have become 'too big to succeed': our *Austeria* scenario is one that leads to more defaults. Indeed, at least a partial back-tracking on fiscal consolidation is under way. The core countries have more room to manoeuvre to ease up to boost growth, but whether they choose to exploit it, either domestically or via transfers in the periphery, is again more a political than an economic question. There is little sign of acceptance of an outright reflationary approach as set out in our *Krugmania* scenario.

**Monetary policy options could be even more powerful**

3) Monetary policy options could be even more powerful, extending beyond interest rate cuts to QE and euro depreciation. The ECB would need political support to overcome reservations in core countries to go in the direction of our *Draghia* or *Inflationia* scenarios. Given the arduous process of achieving agreement on fiscal transfers, monetary easing is likely to remain the first line of defence for the EMU, in our view.

**A banking union or funding union could weaken the link between bank and sovereign solvency**

4) Moves towards banking union and funding union, as in our *Draghia* and *Bondia* scenarios, could weaken the link between bank and sovereign solvency. They would dramatically reduce the cost and increase the availability of credit. The mutualisation of risk would be a redistributive policy, benefiting the periphery disproportionately, but it would also be a 'positive sum game' that would reflate the Eurozone as a whole. Although borrowing costs for core governments might rise slightly as safe haven flows reversed, they would share in the 'survival dividend' of rising asset prices and stronger economic growth.

**Fiscal discipline is not merely a political pre-condition, it is also important to maximising economic benefit**

5) Core country demands for fiscal discipline are not merely a political pre-condition, they are also important for maximising the economic benefit of these and more ambitious redistributive policy moves in the direction of our *Europhilia* scenario. Financial markets want to see a convincing road to fiscal consolidation, and the effectiveness of fiscal transfers will require robust governance.

**Whether or not Greece leaves the EMU, the pace of policy change will accelerate**

Ultimately, politics will determine whether, and how quickly, we migrate away from the recurrent crises of *Austeria* to the dream of *Europhilia*. The current popular resistance to fiscal transfers will probably take time to crack, leaving policy-makers no option but to deploy more covert and contingent approaches to address the funding problems of banks and sovereigns in the periphery. Sadly, it may be that deepening recession and financial shocks may be required to accelerate the process. However, that could be the silver lining in the clouds currently hanging over Greece. Whether it leaves the EMU, with all the calamitous effects that we have described before, or remains in, the pace of policy change in the Eurozone is bound to accelerate. Indeed, whether this is along a road to survival remains to be seen.

# Appendix: Macroeconomic Imbalance Procedure

The MIP is a surveillance mechanism that aims to prevent and correct macroeconomic imbalances within the EU. It relies on an alert system that uses a scoreboard of indicators and in-depth country studies, strict rules in the form of a new Excessive Imbalance Procedure (EIP) and enforcement in the form of financial sanctions for euro area Member States which do not follow up on recommendations.

## Preventing and correcting macroeconomic imbalances

Over the past decade, the EU has registered serious gaps in competitiveness and major macroeconomic imbalances. A new surveillance and enforcement mechanism has been set up to identify and correct such issues much earlier: the Macroeconomic Imbalance Procedure (MIP), based on Article 121.6 of the Treaty. It will rely on the following main elements:

An early warning system: an alert system is established based on a scoreboard consisting of a set of ten indicators covering the major sources of macroeconomic imbalances. For each indicator, alert thresholds have been set to detect potential imbalances. The scoreboard and the thresholds are not applied mechanically and the scoreboard will be complemented by an economic reading. The composition of the scoreboard indicators may evolve over time. The aim of the scoreboard is to trigger in-depth studies which will do deep dive analyses to determine whether the potential imbalances identified in the early-warning system are benign or problematic. The Commission can organise missions, with the ECB if appropriate. The in-depth reviews shall be made public.

Preventive and corrective action: The new procedure allows the Commission and the Council to adopt preventive recommendations under article 121.2 of the Treaty at an early stage before the imbalances become large. There is also a corrective arm in more serious cases, and an excessive imbalance procedure (EIP) can be opened for a Member State. In cases of serious imbalances, the Member State concerned will have to submit a corrective action plan with a clear roadmap and deadlines for implementing corrective action. Surveillance will be stepped up by the Commission on the basis of regular progress reports submitted by the Member State concerned.

Rigorous enforcement: A new enforcement regime is established for euro area countries. The corrective arm consists of a two-step approach:

- An interest-bearing deposit can be imposed after one failure to comply with the recommended corrective action.
- After a second compliance failure, this interest-bearing deposit can be converted into a fine (up to 0.1% of GDP).
- Sanctions can also be imposed for failing twice to submit a sufficient corrective action plan.

The decision-making process in the new regulations is streamlined by prescribing the use of reverse qualified majority voting to take all the relevant decisions leading up to sanctions. This semi-automatic decision-making procedure makes it very difficult for Member States to form a blocking majority.

**Key Documents**

1) COM(2012) 68 final: Alert Mechanism Report 2012 [128 KB]: the economic reading of the scoreboard and recommendations for in-depth reviews
2) Statistical Annex of the Alert Mechanism Report [4 MB]: data on scoreboard and additional indicators
3) Relevant legislation: the MIP is part of the 'six-pack' of legislative acts that strengthen the surveillance of economic fiscal policies.
4) Scoreboard data platform: Interactive database for the indicators of the scoreboard and additional 'reading' indicators.

**Background documents**

- Occasional Paper 92/2012: Scoreboard for the surveillance of macroeconomic imbalances: technical explanations on the scoreboard.
- Staff working paper: Scoreboard for the surveillance of macroeconomic imbalances: envisaged initial design [59 KB] (8 Nov 2011).

*Source:http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/index_en.htm*

## Scoreboard for the Surveillance of Macroeconomic Imbalances

The scoreboard consists of the following ten indicators with indicative thresholds: 10

- three-year backward moving average of the current account balance in percent of GDP, with a threshold of +6% and - 4%;
- net international investment position in percent of GDP, with a threshold of -35%;
- five-year percentage change of export market shares measured in values, with a threshold of -6%;
- three-year percentage change in nominal unit labour cost, with thresholds of +9% for euro-area countries and +12% for non-euro-area countries, respectively;
- three-year percentage change of the real effective exchange rates based on HICP/CPI deflators, relative to 35 other industrial countries, with thresholds of -/+5% for euro-area countries and -/+11% for non-euro-area countries, respectively;
- private sector debt in percent of GDP with a threshold of 160%;
- private sector credit flow in percent of GDP with a threshold of 15%;
- year-on-year changes in the house price index relative to a Eurostat consumption deflator, with a threshold of 6%;
- general government sector debt in percent of GDP with a threshold of 60%;
- three-year backward moving average of the unemployment rate, with a threshold of 10%.

*Source: http://ec.europa.eu/economy_finance/publications/occasional_paper/2012/pdf/ocp92_en.pdf*

# Research analyst contacts

| Developed Markets | | Title | Telephone | Email |
|---|---|---|---|---|
| London | Mark Cliffe | Global Head of Financial Markets Research | +44 20 7767 6283 | mark.cliffe@uk.ing.com |
| | Rob Carnell | Chief International Economist | +44 20 7767 6909 | rob.carnell@uk.ing.com |
| | James Knightley | Senior Economist, UK, US $ Bloc | +44 20 7767 6614 | james.knightley@uk.ing.com |
| | Chris Turner | Head of Foreign Exchange Strategy | +44 20 7767 1610 | christopher.turner@uk.ing.com |
| | Tom Levinson | Foreign Exchange Strategist | +44 20 7767 8057 | tom.levinson@uk.ing.com |
| Amsterdam | Maarten Leen | Head of Macro & Consumer Economics | +31 20 563 4406 | maarten.leen@ing.nl |
| | Martin van Vliet | Senior Economist, Eurozone | +31 20 563 9528 | martin.van.vliet@ing.nl |
| | Teunis Brosens | Senior Economist, US | +31 20 563 6167 | teunis.brosens@ing.nl |
| | Dimitry Fleming | Senior Economist, Netherlands | +31 20 563 9497 | dimitry.fleming@ing.nl |
| | Fabienne Fortanier | Senior Economist, Eurozone | +31 20 576 9450 | fabienne.fortanier@ing.nl |
| | Padhraic Garvey | Global Head of Developed Markets Debt Strategy | +31 20 563 8955 | padhraic.garvey@ingbank.com |
| | Jeroen van den Broek | Head of Developed Markets Credit Strategy | +31 20 563 8959 | jeroen.van.den.broek@ingbank.com |
| | Maureen Schuller | Senior Credit Strategist | +31 20 563 8941 | maureen.schuller@ingbank.com |
| | Alessandro Giansanti | Senior Rates Strategist | +31 20 563 8801 | alessandro.giansanti@ingbank.com |
| | Job Veenendaal | Quantitative Strategist | +31 20 563 8956 | job.veenendaal@ingbank.com |
| | Roelof-Jan van den Akker | Technical Analyst | +31 20 563 8178 | roelof-jan.van.den.akker@ingbank.com |
| | Mark Harmer | Head of Developed Markets Credit Research | +31 20 563 8964 | mark.harmer@ingbank.com |
| | Max Castle | Credit Analyst | +31 20 563 8815 | max.castle@ingbank.com |
| | Malin Hedman | Credit Analyst | +31 20 563 8962 | malin.hedman@ingbank.com |
| Brussels | Peter Vanden Houte | Chief Economist, Belgium, Eurozone | +32 2 547 8009 | peter.vandenhoute@ing.be |
| | Carsten Brzeski | Senior Economist, Germany, Eurozone | +32 2 547 8652 | carsten.brzeski@ing.be |
| | Manuel Maleki | Senior Economist, France | +32 2 547 3995 | manuel.maleki@ing.be |
| | Julien Manceaux | Economist, Belgium, Switzerland | +32 2 547 3350 | julien.manceaux@ing.be |
| | Philippe Ledent | Economist, Belgium | +32 2 547 3161 | philippe.ledent@ing.be |
| Milan | Paolo Pizzoli | Senior Economist, EMU, Italy, Greece | +39 02 89629 3630 | paolo.pizzoli@ing.it |

| Emerging Markets | | Title | Telephone | Email |
|---|---|---|---|---|
| New York | H David Spegel | Global Head of Emerging Markets Strategy | +1 646 424 6464 | david.spegel@americas.ing.com |
| | Gustavo Rangel | Chief Economist, Brazil, Argentina, Chile, Peru | +1 646 424 6465 | gustavo.rangel@americas.ing.com |
| London | Simon Quijano-Evans | Head of Research & Chief Economist, EMEA | +44 20 7767 5310 | simon.quijano@uk.ing.com |
| Bulgaria | Elena Ganeva | Economist, Bulgaria, Croatia | +359 2 917 6720 | elena.ganeva@ingbank.com |
| Czech Rep | Vojtech Benda | Senior Economist, Czech Republic | +420 2 5747 4432 | vojtech.benda@ing.cz |
| Hungary | David Nemeth | Senior Economist, Hungary | +36 1 255 5581 | nemeth.david@ing.hu |
| India | Upasna Bhardwaj | Economist, India | +91 22 3309 5718 | upasna.bhardwaj@ingvysyabank.com |
| Mexico | Debora Luna | Economist, Mexico | +52 55 5258 2095 | debora.luna@americas.ing.com |
| | Ezequiel Garcia | Economist, Mexico | +52 55 5258 2064 | ezequiel.garcia@americas.ing.com |
| Philippines | Joey Cuyegkeng | Economist, Philippines | +632 479 8855 | joey.cuyegkeng@asia.ing.com |
| Poland | Mateusz Szczurek | Chief Economist, CEE | +48 22 820 4698 | mateusz.szczurek@ingbank.pl |
| | Rafal Benecki | Chief Economist, Poland | +48 22 820 4696 | rafal.benecki@ingbank.pl |
| | Grzegorz Ogonek | Economist, Poland | +48 22 820 4608 | grzegorz.ogonek@ingbank.pl |
| Romania | Vlad Muscalu | Economist, Romania | +40 21 209 1393 | vlad.muscalu@ing.ro |
| Russia | Dmitry Polevoy | Economist, Russia & Kazakhstan | +7 495 771 7994 | dmitry.polevoy@ingbank.com |
| | Egor Fedorov | Senior Credit Analyst | +7 495 755 5480 | egor.fedorov@ingbank.com |
| Singapore | Tim Condon | Head of Research & Chief Economist, Asia | +65 6232 6020 | tim.condon@asia.ing.com |
| | Prakash Sakpal | Economist, Asia | +65 6232 6181 | prakash.sakpal@asia.ing.com |
| Slovakia | Eduard Hagara | Senior Economist, Slovakia | +421 2 5934 6392 | eduard.hagara@ing.sk |
| Turkey | Sengül Dağdeviren | Head of Research & Chief Economist, Turkey | +90 212 329 0752 | sengul.dagdeviren@ingbank.com.tr |
| | Muhammet Mercan | Senior Economist, Turkey | +90 212 329 0751 | muhammet.mercan@ingbank.com.tr |
| | Ömer Zeybek | Economist, Turkey | +90 212 329 0753 | omer.zeybek@ingbank.com.tr |
| Ukraine | Alexander Pecherytsyn | Head of Research, Ukraine | +38 044 230 3017 | alexander.pecherytsyn@ingbank.com |
| | Halyna Antonenko | Financial Markets Research Analyst | +38 044 590 3584 | halyna.antonenko@ingbank.com |

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## ANALYST CERTIFICATION

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| | | | | |
|---|---|---|---|---|
| **AMSTERDAM** Tel: 31 20 563 9111 | **BRUSSELS** Tel: 32 2 547 2111 | **LONDON** Tel: 44 20 7767 1000 | **NEW YORK** Tel: 1 646 424 6000 | **SINGAPORE** Tel: 65 6535 3688 |
| **Bratislava** Tel: 421 2 5934 6111 | **Geneva** Tel: 41 22 593 8050 | **Manila** Tel: 63 2 479 8888 | **Prague** Tel: 420 257 474 111 | **Taipei** Tel: 886 2 8729 7600 |
| **Bucharest** Tel: 40 21 222 1600 | **Hong Kong** Tel: 852 2848 8488 | **Mexico City** Tel: 52 55 5258 2000 | **Sao Paulo** Tel: 55 11 4504 6000 | **Tokyo** Tel: 81 3 3217 0301 |
| **Budapest** Tel: 36 1 235 8800 | **Istanbul** Tel: 90 212 329 0752 | **Milan** Tel: 39 02 89629 3610 | **Seoul** Tel: 82 2 317 1800 | **Warsaw** Tel: 48 22 820 5018 |
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| **Dublin** Tel: 353 1 638 4000 | **Madrid** Tel: 34 91 789 8880 | **Paris** Tel: 33 1 56 39 32 84 | **Sofia** Tel: 359 2 917 6400 | |

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| | |
|---|---|
| **Amsterdam** | ING Bank N.V., Foppingadreef 7, Amsterdam, Netherlands, 1102BD. *Netherlands Authority for the Financial Markets* |
| **Bratislava** | ING Bank N.V., pobocka zahranicnej banky, Jesenskeho 4/C, 811 02 Bratislava, Slovak Republic. *National Bank of Slovakia* |
| **Brussels** | ING Belgium S.A./N.V., Avenue Marnix 24, Brussels, Belgium, B-1000. *Financial Services and Market Authority (FSMA)* |
| **Bucharest** | ING Bank N.V. Amsterdam - Bucharest Branch, 48 Lancu de Hunedoara Bd., 011745, Bucharest 1, Romania. *Romanian National Securities and Exchange Commission, Romanian National Bank* |
| **Budapest** | ING Bank N.V. Hungary Branch, Dozsa Gyorgy ut 84\B, H - 1068 Budapest, Hungary. *Hungarian Financial Supervisory Authority* |
| **Istanbul** | ING Bank A.S., ING Bank Headquarters, Resitpasa Mahallesi Eski Buyukdere Cad. No: 8, 34467 Sariyer, Istanbul , Turkey. *Capital Markets Board* |
| **Kiev** | ING Bank Ukraine JSC, 30-a, Spaska Street, Kiev, Ukraine, 04070. *Ukrainian Securities and Stock Commission* |
| **London** | ING Bank N.V. London Branch, 60 London Wall, London EC2M 5TQ, United Kingdom. *Authorised by the Dutch Central Bank* |
| **Manila** | ING Bank N.V., Manila Branch, 20/F Tower One, Ayala Triangle, Ayala Avenue, 1226 Makati City, Philippines. *Philippine Securities and Exchange Commission* |
| **Mexico City** | ING Grupo Financiero (México) SA de CV, Bosque de Alisos 45-B, Piso 4, Bosques de las Lomas, 05120, Mexico City, Mexico. *Comision Nacional Bancaria y de Valores* |
| **Milan** | ING Bank N.V. Milano, Via Paleocapa, 5, Milano, Italy, 20121. *Commissione Nazionale per le Società e la Borsa* |
| **Moscow** | ING BANK (EURASIA) ZAO, 36, Krasnoproletarskaya ulitsa, 127473 Moscow, Russia. *Federal Financial Markets Service* |
| **Mumbai** | ING Vysya Bank Limited, Plot C-12, Block-G, 7th Floor, Bandra Kurla Complex, Bandra (E), Mumbai - 400 051, India. *Securities and Exchange Board of India* |
| **New York** | ING Financial Markets LLC, 1325 Avenue of the Americas, New York, United States,10019. *Securities and Exchange Commission* |
| **Prague** | ING Bank N.V. Prague Branch, Plzenska 345/5, 150 00 Prague 5, Czech Republic. *Czech National Bank* |
| **Singapore** | ING Bank N.V. Singapore Branch, 19/F Republic Plaza, 9 Raffles Place, #19-02, Singapore, 048619. *Monetary Authority of Singapore* |
| **Sofia** | ING Bank N.V. Sofia Branch, 49B Bulgaria Blvd, Sofia 1404 Bulgaria. *Financial Supervision Commission* |
| **Warsaw** | ING Bank Slaski S.A, Plac Trzech Krzyzy, 10/14, Warsaw, Poland, 00-499. *Polish Financial Supervision Authority* |

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