

# Global Financial Systems

## Chapter 22

### Economic Challenges Facing Europe

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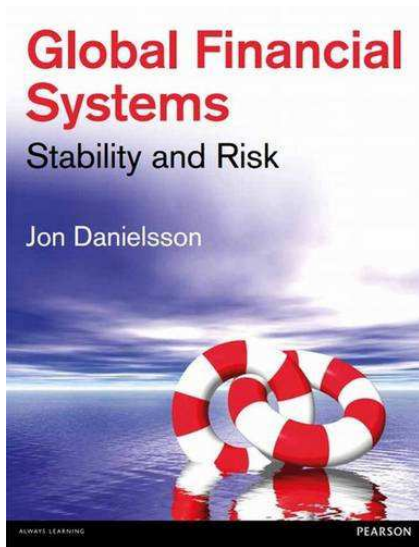
To accompany

*Global Financial Systems: Stability and Risk*

<http://www.globalfinancialsystems.org/>

Published by Pearson 2013

## Book and slides



- The tables and graphs are the same as in the book
- See the book for references to original data sources
- Updated versions of the slides can be downloaded from the book web page [www.globalfinancialsystems.org](http://www.globalfinancialsystems.org)

- Version 4.1, November 2016
- These slides use content from Chapter 22 “Economic Challenges Facing Europe” published on–line

# EU: which way to go?

# Fiscal & transfer union

## United States of Europe?

- Common taxes and intra-state re-distribution (much more than now)
- Centralization of key-decision making
- Eurobonds
- The successful countries may end up sending money to the poorest indefinitely
- Key obstacle: political

# Breaking up

- Reversion to national currencies
- Even split of the European Union
- Separation of non-crisis and crisis countries
- More efficient & tailored solutions to problems in crisis countries possible
- Potentially new common market & currency by smaller set of countries
- Favored by euroskeptic parties but politically very unlikely

# Muddling through

- Prevailing approach taken by EU authorities
- Circumvent most difficult questions and deal with small decisions towards European integration
- Most likely scenario

# BREXIT



# Background

- UK member of EU and its predecessors since 1973
- Wanted to join much earlier, blocked by French president Charles de Gaulle
- Worried that the UK was incompatible with the objectives of the Union

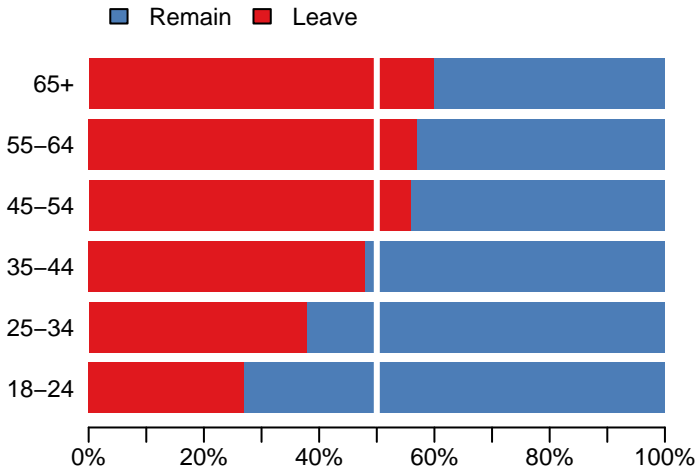
# Article 50

- Sets rules for an EU exit
- Part of the Lisbon Treaty of 2007
- Never used by a nation before
- Sets exit deadline of 2 years after notification of the European Council of a country's intention to leave the EU

# Demographics

- The remainders were stronger in Scotland and Northern Ireland
- Leavers in England and Wales
- London strong support for remain

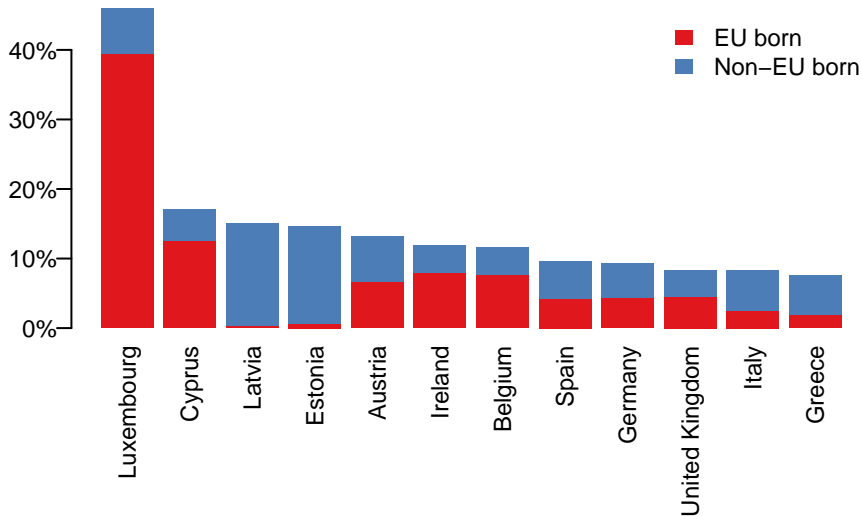
# Voting behavior - by age



# Immigration

- One of EUs four freedoms is the free movement of labor
- The common market implemented from the 1990s
- Any citizen of a European country can move to any other country without any restrictions, find work and benefit from public services
- Motivated by
  - Displacement of people around WWII
  - Europeans are the same people in a common market
  - Economic reasons

# Fraction of immigrants in population



# Leave arguments

- *Less immigration* [main issue]
- EU is excessively regulated
- EU is moribund
- Don't want to be ruled by EU courts
- Contributions to EU budget outweigh monetary benefits
- Desire to orient Britain away from EU and towards the world

# Remain arguments

- Devastating economic consequences
- Free movement of people and free trading (customs union) across the EU
- UK is more powerful within an alliance of 28 member states
- High skilled immigrant workers fuel growth



# Economic arguments were with remain

- Many large countries and international organizations warned against brexit
- Also key institutions in UK (like Bank of England and Treasury)
- Almost all credible economic experts
- Strong attacks on economic specialists and the various institutions:

*“I think people in this country have had enough of experts.”*

*— Michael Grove, Secretary of State for Justice*

# Key issues

- Customs union
- Or free trade
- Financial passports

# Exit options

1. Membership in all but name
2. EEA/Swiss model
3. Turkish model
4. Canadian model
5. Default WTO
6. Hard Brexit

# Consequences for Europe

- UK strongest member of liberal bloc
- EU without Britain: more regulations & a more protectionism

# Political consequences

- Punish Britain to dissuade others?
- *Merkels*: want fair exit agreement to keep Britain as an ally
- *Junckers*: want to use Brexit to promote a more federal Europe

# Crisis country Italy

# Italy

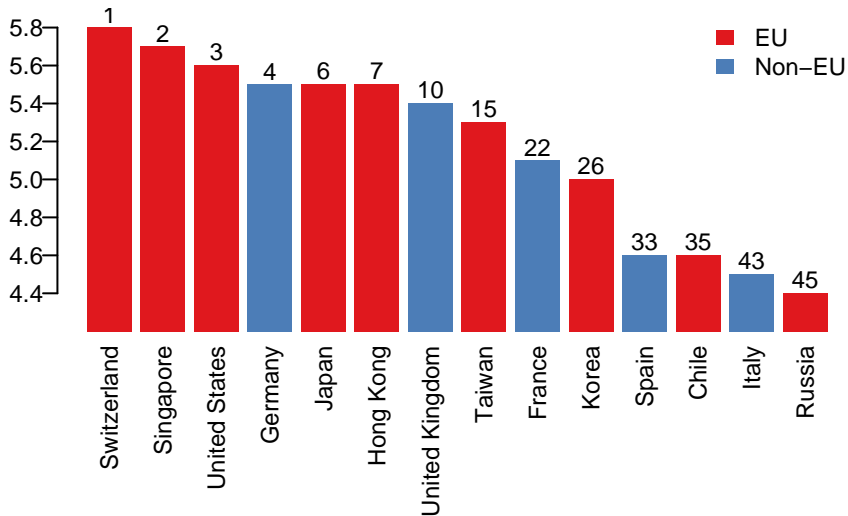
- Founding member of EU
- Its Fifth-largest economy

# Current situation

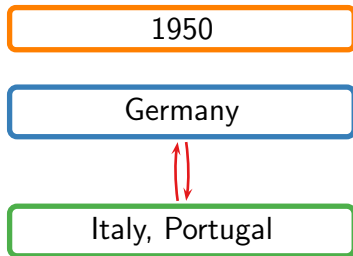
- Little or no growth for many years
- Very low adult employment
- Debt to GDP ratio is 135% and growing
- Declining productivity since 1990s
- Fragile banking system



# Global Competitiveness Index (WEF)



# Squeeze



# Squeeze



# Fundamental problems

- Historically used devaluations to retain competitiveness and avoid reforms
- Euro membership prevented evaluations but enabled the sovereign to borrow cheaply
- No structural adjustments
- Accumulation of debt instead of expenditure matching
- Over-regulation — difficult business environment
- Restricted labor market
- Fleeing investors

# Italian banks

- Main problem: non-performing loans (NPLs)
- Make up €360bn of the banks' assets (roughly 18%)
- In France only 5%, in UK only 1.5% of total bank assets
- Current capital figures include deferred tax assets
  - Seen as unreliable
  - Not accepted as equity under Basel III once the rules are fully implemented (by 2019)

# Small and politicized banking system

- A large number of small local banks
- Over banking (very costly)
- Strong co-dependant relationship between local community and banks
- Close relationship between politicians and bankers
- Difficult to restructure and close banks

# Banca Monte dei Paschi

- Italy's oldest and third largest bank
- Had €46.9bn NPLs in 2015 — ECB asked them to reduce it to €14.9bn by 2018
- This increased uncertainty about the bank's solvency
- Share price dropped by more than 24% since June 2016

# Political issues

- EU law: Bondholders need to take losses (automatic bail-in) before a bailout by the state
- Problems:
  1. Damage to Renzi's political reputation: autumn 2016 referendum
  2. Bail-in damages market confidence further
  3. Public discontent & further rise of nationalism