TREASURY EXECUTIVE MINUTE

Minute No.

25 November 2011

Deputy Prime Minister and Treasurer

cc: Assistant Treasurer and Minister for Financial Services and Superannuation
Parliamentary Secretary to the Treasurer

THE EUROPEAN DEBT CRISIS

Timing: At your convenience

Recommendation/Issue: That you note this briefing.		
Noted	Signature:	/ ./2012

KEY POINTS

- The debt crisis that has gradually enveloped Europe over the past two years continues to deepen, with commentators increasingly concerned about a further escalation. In addition, there is a continued lack of consensus amongst European Leaders and supranational institutions about how the crisis can be stemmed once and for all.

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- More broadly, there continues to be significant divergence in approach amongst European Leaders, who have failed to reach common ground on key issues including the role of the European Central Bank (ECB), the potential for a closer fiscal union and stronger governance arrangements which include automatic sanctions.

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- Given the level of uncertainty and ambiguity characterising the current environment, it is impossible to say with any certainty how the crisis will play out over coming weeks and months.

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- Europe's sovereign debt crisis is also weighing on the outlook for the UK.
  - The Bank of England this month significantly revised down its growth forecasts for 2012 in light of the UK's exposure to the European debt crisis and noted that a further escalation of the crisis could deal a significant blow to the UK's economic recovery.
  - The Chancellor will deliver the Autumn Statement (MYEFO equivalent) to the House of Commons on 29 November, where updated UK economic and fiscal forecasts from the independent Office of Budget Responsibility will also be announced.

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ADDITIONAL INFORMATION

Macro developments

- As 2011 draws to a close, downside risks to the macroeconomic environment in Europe have further crystallised. European Commission forecasts released on 10 November 2011 suggest that GDP in the EU is expected to stagnate well into 2012. Growth for 2012 is now forecast at about 0.5 per cent (down from the original forecast of 1.5 per cent). By 2013, a return to growth of about 1.5 per cent is expected – reflecting the protracted nature of the recovery.
  - The Commission noted that a sharp deterioration in confidence had impacted on investment and consumption, weakening global growth had held back exports, and the urgent need for fiscal consolidation had weighed on domestic demand.
  - Rapid improvements are not expected in the labour markets, with unemployment forecast to remain at the current level of around 9.5 per cent.
  - Inflation is forecast to fall back below 2 per cent over the coming quarters.
- In view of the weak GDP growth, the Commission considered that the risk of a double-dip recession in Europe is real, with the main downside risks stemming from sovereign debt worries, the financial sector and a slowdown in world trade.
  - While the Commission does not expect a recession in its baseline scenario, given the high likelihood of protracted period of stagnation and the unusually high uncertainty around key policy decisions, a deep and prolonged recession complemented by continued market turmoil could not be excluded.

Moving backwards?

- It is now a familiar story that Europe has been consistently behind the curve in managing the debt crisis. Policymakers have been slow to respond to developments; with efforts to contain the crisis consistently falling short of expectations. This has led to an almost constant review of crisis management arrangements, with additional measures routinely necessary to address deficiencies in the policy response.

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– There are also doubts about whether private sector investors would be attracted to invest in co-investment funds.

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Recent issuances have been delayed due to a lack of investor appetite and EFSF bonds are trading at spreads resembling peripheral debt.

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The role of the ECB

- There is a clear and growing chorus of opinion that the ECB will need to be a key player in responding to the crisis. Although the German Government, the Bundesbank and the ECB all continue to strongly resist open ended bond purchases to stabilise markets, contacts are increasingly of the view that if stress in the system becomes too great, opposition will wane and the ECB will significantly step up its securities markets program.
- While contacts have said that the ECB's balance sheet can support such action there are differing views about whether there are legal impediments to doing so. The ECB has consistently argued that safeguarding the monetary transmission mechanism has underpinned its intervention in bond markets. While some contacts suggest that an open ended bond buying could still be supported on this ground, others suggest that it would be more difficult to maintain and would in fact be difficult to view it any other way than the direct financing of sovereigns.

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- Another argument against a significantly scaled up bond buying program goes to the core of the ECB's mandate: monetary stability. To date, the ECB has sought to sterilise the impact of the liquidity it creates through its bond purchases. There are concerns that neutralisation will become increasingly difficult if there is a significant step up in the size of the ECB's bond buying program

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Break up or further integration

- The future of the European project remains highly uncertain and the crisis has crystallised concerns held by some commentators at the time that the Euro was first adopted: that in its current form, the Euro area is an imperfect union. As a result, debate continues about whether the European debt crisis will lead to a breakup of the Eurozone or whether deeper integration will be the ultimate outcome.

- Overall, the common view is that Europe is unlikely to continue to continue in its current form and the potential for closer integration and member exit are both real options. The options are not seen as mutually exclusive

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Fiscal union

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- While there has been substantial debate on all of these proposals over the past 12 months (and the Commission this week released a consultation paper examining the rationale, pre-conditions and possible options of financing public debt through Stability Bonds) there has been no consensus on any of these issues.

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Impacts on the UK

- The UK has not been immune from the events unfolding in Europe. The Bank of England Governor, Sir Mervyn King, released the latest Inflation Report on 16 November, presenting a sobering picture on the outlook for the UK economy.

- Against the backdrop of a worsening outlook for global growth, intensifying strains in Euro area sovereigns and banks, and a significant deterioration in confidence, the Bank significantly cut its growth forecasts for 2012 from 2.2 per cent to 0.9 per cent. The Bank notes that the outlook for growth is unusually certain, reflecting in particular the exposure of the UK economy to developments in the Euro area.

– The Governor said that the ongoing, and escalating, debt crisis in Europe is his key concern. While a credible and effective policy response to the sovereign debt crisis would diminish the uncertainty for the UK, the Bank expects a prolonged period of subdued growth which will in turn impact on the UK's recovery. Although the Bank's forecasts have included the impact of the sovereign debt crisis to the extent that they are already reflected in bank funding costs, asset prices and confidence, it has not factored in an extreme outcome associated with developments in the euro area – that is, the outlook could be worse depending on how the crisis unfolds from here.

– Chancellor Osborne will deliver the Autumn Statement (MYEFO equivalent) to the House of Commons on 29 November, where updated UK economic and fiscal forecasts from the independent Office of Budget Responsibility will also be announced. This will no doubt provide an opportunity for the Chancellor to outline the Government's view on the impact of the sovereign debt crisis.