Japan-China-Korea (A3) Conference
Monetary and Financial Cooperation in the Region

Handout

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May 24, 2012

RIETI, Tokyo

Lessons of the euro crisis for East Asia

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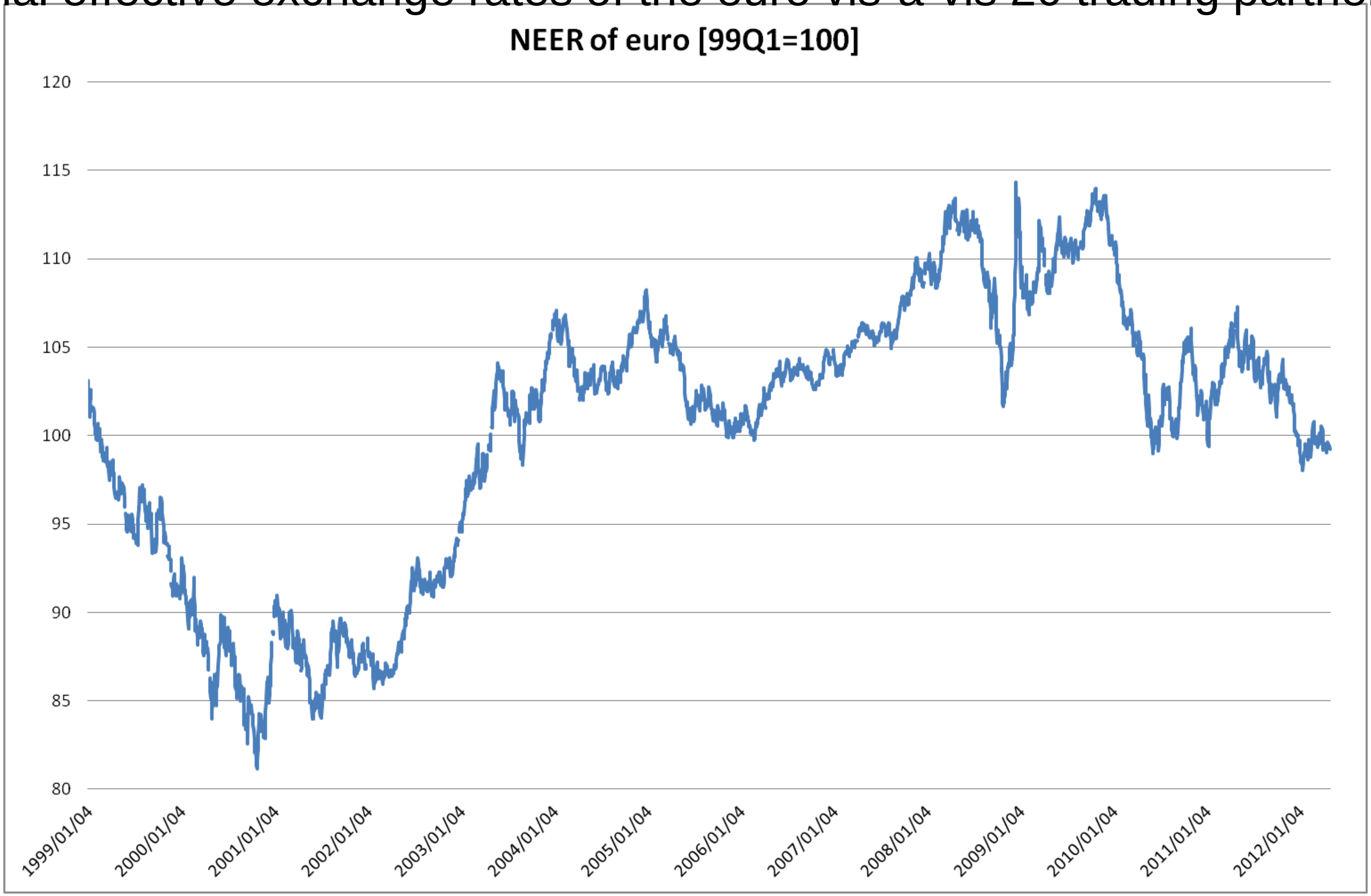
Turbulance of the euro

exchange rates of the euro in terms of the USD and the JPY

Data：ECB

Turbulance of the euro

nominal effective exchange rates of the euro vis-a-vis 20 trading partners



Data：ECB

From the global imbalance to the global financial crisis

- United States

The current account deficits caused by (1) fiscal deficits and (2) housing investments in the first half of 2000s.

- Asia

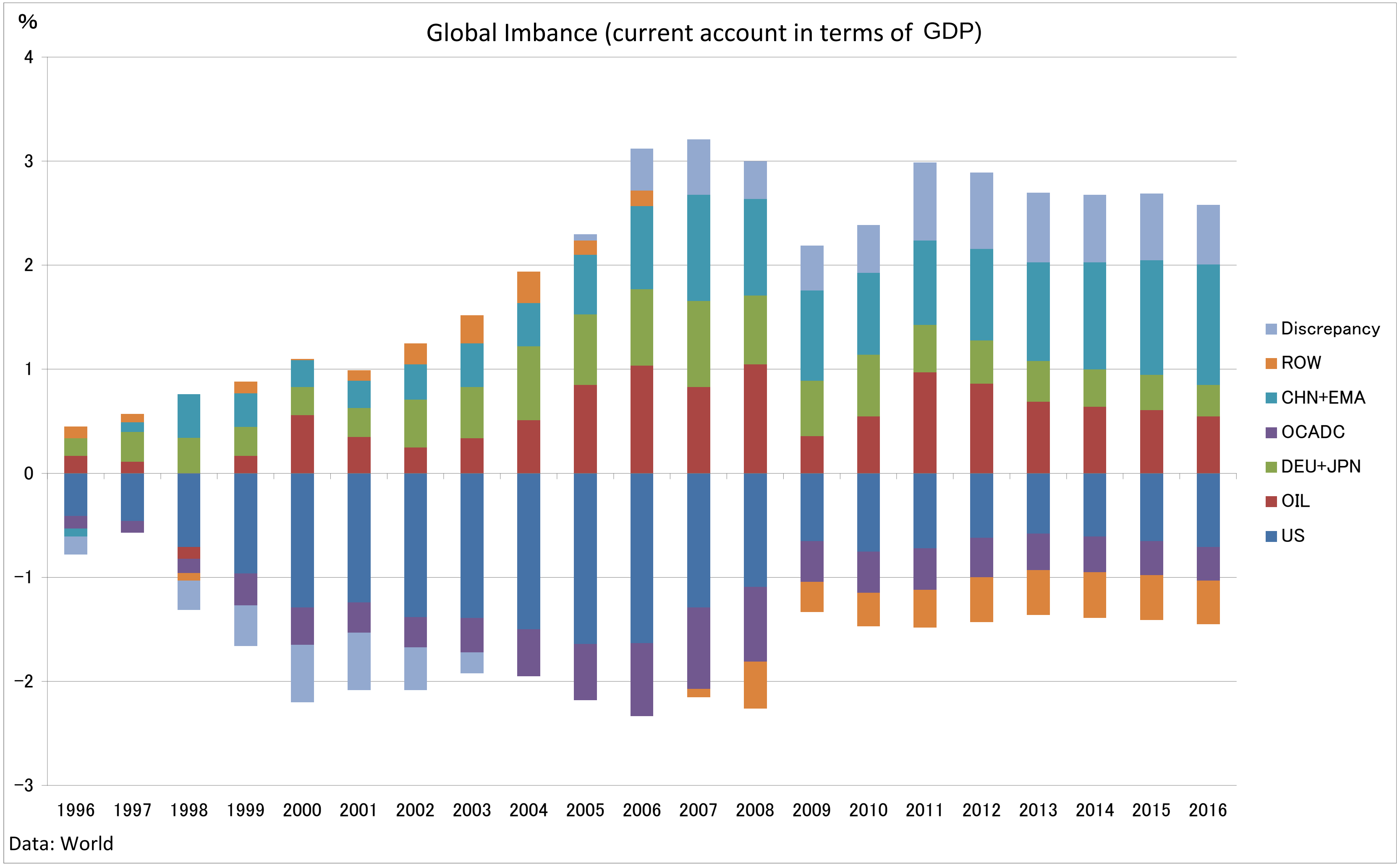
Saving glut => US government bonds to support financially the US fiscal deficits

- Oil exporting countries

oil price surge => increases in oil money => European financial institutions => Housing in the US (subprime mortgage backed securities)

=> Housing bubble bursts in the US damaged balance sheets of European financial institutions as well as US ones. At the same time, they had contagion effects on UK, Ireland, and Spain.

Global imbalance



Data: IMF, *World Economic Outlook*

From the global financial crisis to worldwide fiscal account worsening

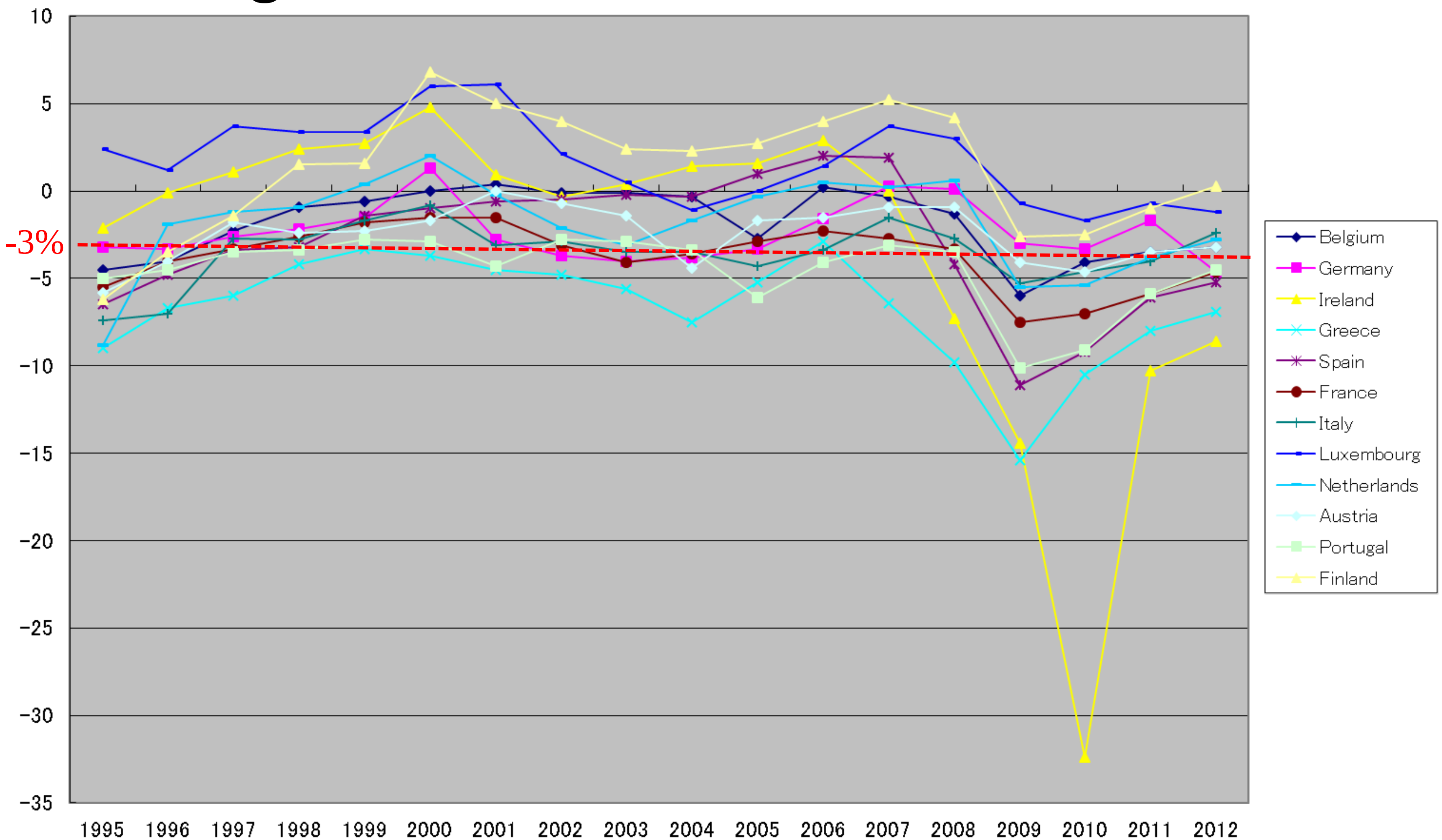
- The global financial crisis had two effects:

(1) It damaged balance sheets of financial institutions => governments had to make capital injection to them. (5 billion euro (2% of GDP) in Greece)

(2) It brought about worldwide recession. => G20 made international coordination in fiscal stimulus against the worldwide recession.

=> Fiscal accounts of euro zone states as well as the United States and Japan worsened.

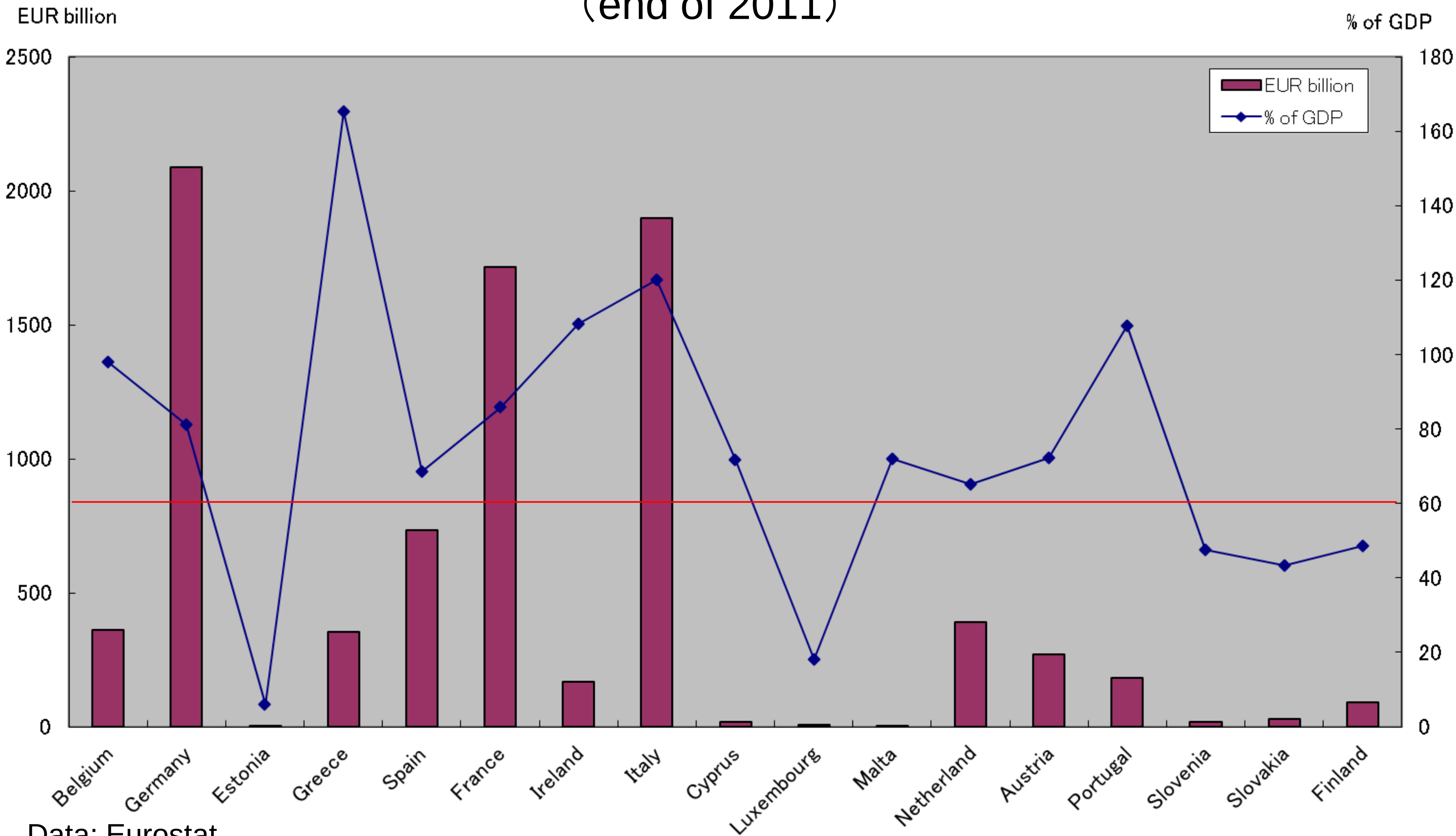
Worsening fiscal deficits in euro zone states



Data: Eurostat

Government debts of euro zone states

（end of 2011）



Data: Eurostat

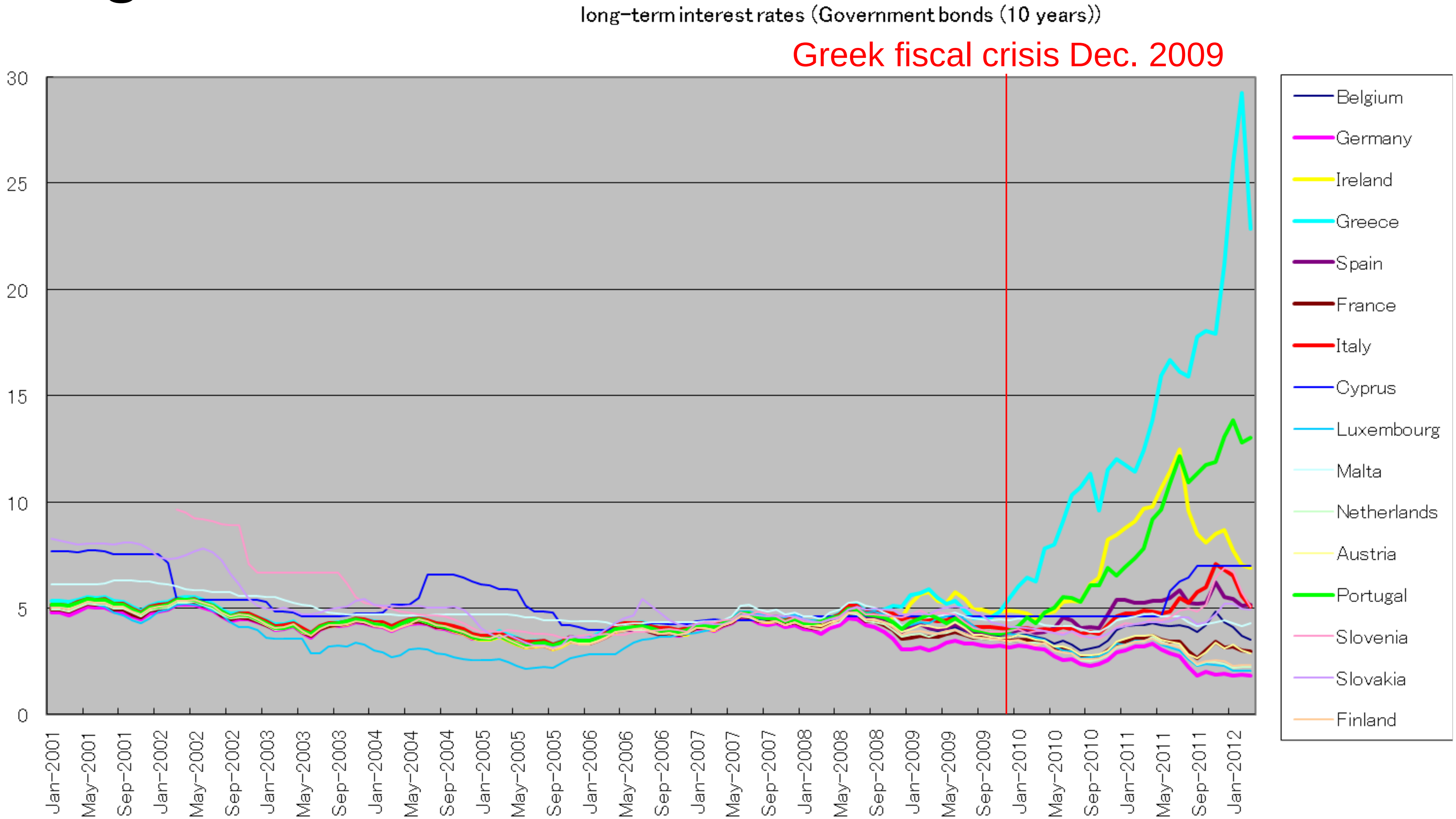
The Greek fiscal crisis as a trigger of European fiscal crisis

- In October 2009, a change of government brought to light grave deficiencies in the compilation of fiscal statistics. (fiscal deficits: 3.7% =>12.7%=>13.6% in 2009, government debts: 99.6% => 115.1% in 2009)

=> The fiscal credibility or confidence of Greece was lost.

- The lost confidence shifted from an equilibrium (a government bond bubble equilibrium) to another (a fiscal crisis equilibrium) in the context of multiple equilibria which include a fundamental equilibrium as well as the two.（Reinhart and Rogoff, "*This time is different.*"）

Long-term interest rates of euro zone states



Data: ECB

Contagion of the Greek fiscal crisis to other euro zone states

- Some factors caused contagion of the Greek fiscal crisis to other euro zone states.

(1) Similarity among Greece and other South European countries in terms of fiscal deficits and government debts in the situation where they had no fiscal disciplines because the Stability and Growth Pact has not been well worked.

(2) Any fiscal transfers or financial rescues are prohibited except for natural disasters under the Lisbon Treaty in order to prevent moral hazard. It takes time in order that the EU member states should amend the Lisbon Treaty to establish an ESM that will give financial assistance to a crisis country.

(3) Debt reduction for Greece was procrastinated, which aggravated the Greek fiscal crisis and increased possibility of contagion to other euro zone states.

Measures to solve the euro crisis

(1) To implement fiscal consolidation (⇔fiscal austerity) as well as to establish fiscal discipline in order to restore fiscal confidence of the crisis countries.

=> Escape from the fiscal crisis equilibrium among the multiple equilibria.

(2) To restructure debts (including debt reduction) for the severest crisis country

=> Reduce its debt burdens to decrease sovereign risk.

(3) To establish safety net for financial institutions (EFSF, ESM, and ECB's buying the government bonds)

=> Reduce adverse effects of the debt reduction on financial sector and, in turn, development from fiscal crisis to financial crisis.

Important causes of occurring and aggravating the crisis

- Greece has kept fiscal aspects (fiscal deficit and government debts) exceeding their Maastricht convergence criteria because surveillance over fiscal criteria under the Stability and Growth Pact has not been well worked in establishing fiscal discipline, which has fostered such moral hazard as to ignore fiscal consolidation.
- The Lisbon Treaty prohibits fiscal transfers except for natural disasters. As a result, the EU member states needed discussion regarding financial rescue to Greece and could not make prompt response to it. It has taken some time to establish the ESM and it was necessary to establish the EFSF instead of the ESM for the moment.

Lessons for East Asia

- Crisis prevention:

  Surveillance over exchange rates and fiscal balances as well as macroeconomic situation and soundness of financial sector. It is important to monitor not only capital outflows but also surge in capital inflows.

⇒ ASEAN+3 Macroeconomic Research Office (AMRO)

- Crisis management:

  It is absolutely necessary that governments should make prompt decision and give quick responses to crisis. The initial responses to crisis is important. For the purpose, the CMIM should be more flexible in terms of creating a precautionary credit line and increasing the IMF de-linked portion of currency swap arrangements.

Strengthening Regional Financial Cooperation in East Asia (1)

- Manila ASEAN+3 Finance Ministers and Central Bank Governors' Meeting on May 3, 2012 agreed as follows:

1. Strengthening Crisis Resolution Mechanism (CRM): "CMIM Stability Facility (CMIM-SF)"

(1) To double the total size of the CMIM from US$120bn to US$240bn.

(2) To increase the IMF de-linked portion to 30% in 2012 with a view to increasing it to 40% in2014.

(3) To lengthen the maturity and supporting period.

Strengthening Regional Financial Cooperation in East Asia (2)

2. Introducing Crisis Prevention Function (CPF): “CMIM Precautionary Line (CMIM-PL).

(1) To allow Executive Level Decision Making Body to flexibly apply the 5 qualification criteria as ex-ante qualification and ex-post conditionality.

(i) External position and market access

(ii) Fiscal policy

(iii) Monetary policy

(iv) Financial sector soundness and supervision

(v) Data adequacy

(2) To introduce the commitment fee of 0.15% to CMIM-PL.

Conclusion

- Lessons from the euro crisis tell us as follows:

(1) Surveillance (over fiscal aspects in the euro crisis) is necessary to prevent crisis.

(2) Prompt responses to crisis are necessary to manage crisis. Otherwise, the crisis would be aggravated and make contagion to other countries in the region.

- Governments in East Asia should strengthen regional financial cooperation as follows:

(1) To strengthen AMRO's role as an independent regional surveillance unit.

(2) To make surveillance over intra-regional exchange rates by using AMU and AMU Deviation Indicators.

(3) To increase IMF-delinked portion to allow the monetary authorities in the region to give quick response to crisis.