Banking Union and Fiscal Union in Europe:

Outlook and implications for global partners

Haizhou Huang

21 January 2013

2013 macro policy mix

- Euro area: continuing fiscal consolidation and easy monetary policy under banking union and fiscal union

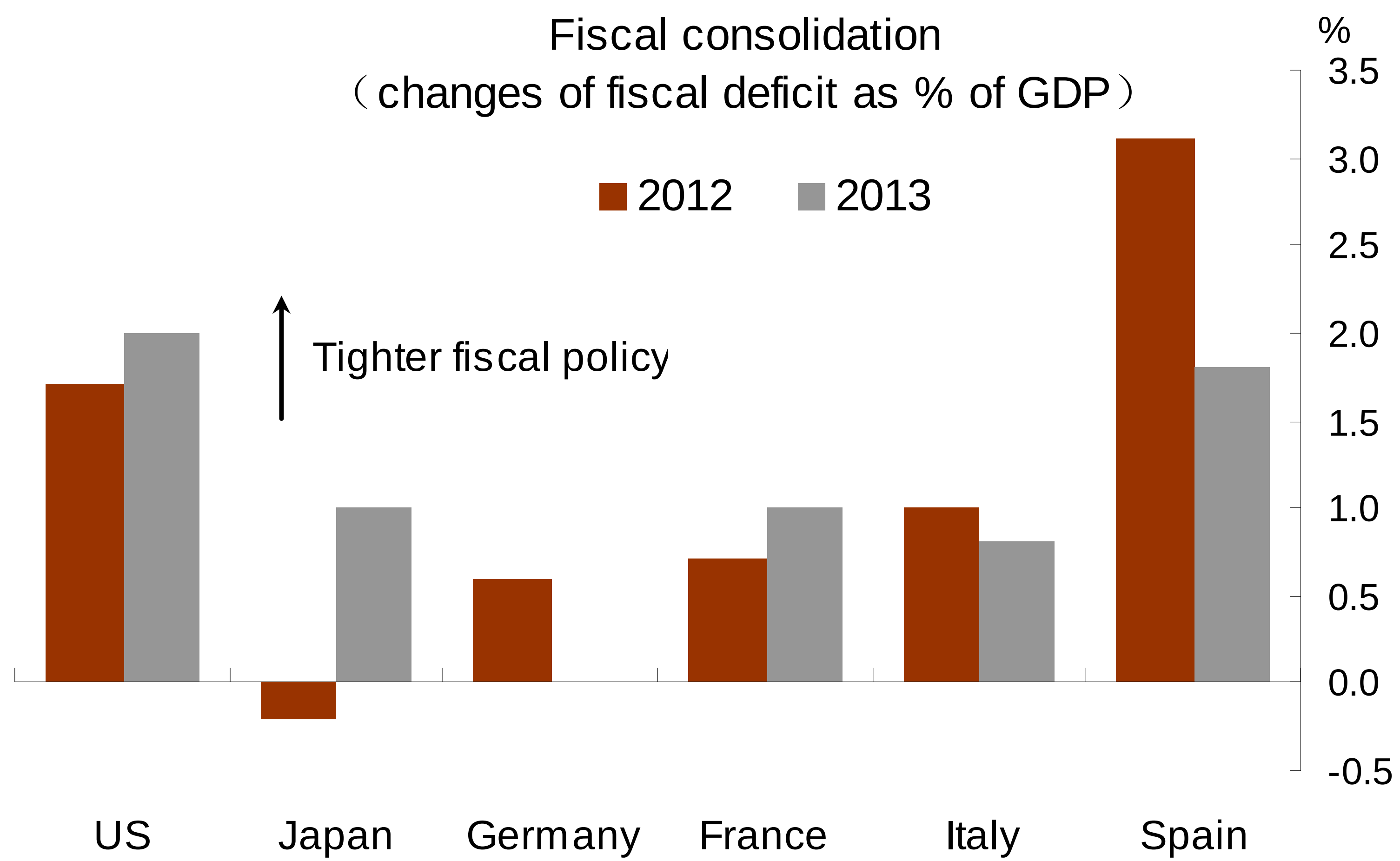
- US: crossing fiscal cliff and continuing easy monetary policy

- China: implementing expansionary fiscal and prudent monetary policies

Euro area & US: fiscal consolidation and easy monetary policy

	Short-term cycle	Long-term cycle
	– Weak aggregate demand – High unemployment	**High government debt** - Developed countries' government debt as a percentage of GDP has risen to 110% in 2012, well above the 90% warning level -Bank deleveraging
Policy implication	Easy monetary policy	Fiscal consolidation, easy monetary policy

US & euro area countries focus on fiscal consolidation



Sources：European Commission, Eurostat, CBO, IMF, CICC Research Note：The changes in fiscal deficit/GDP ratios are used to measure the stringency of fiscal tightening. For instance, the fiscal deficit in US took -8.7%/-7.0% of GDP in 2011/2012, so the fiscal tightening of 2012 is calculated as 1.7% of GDP。

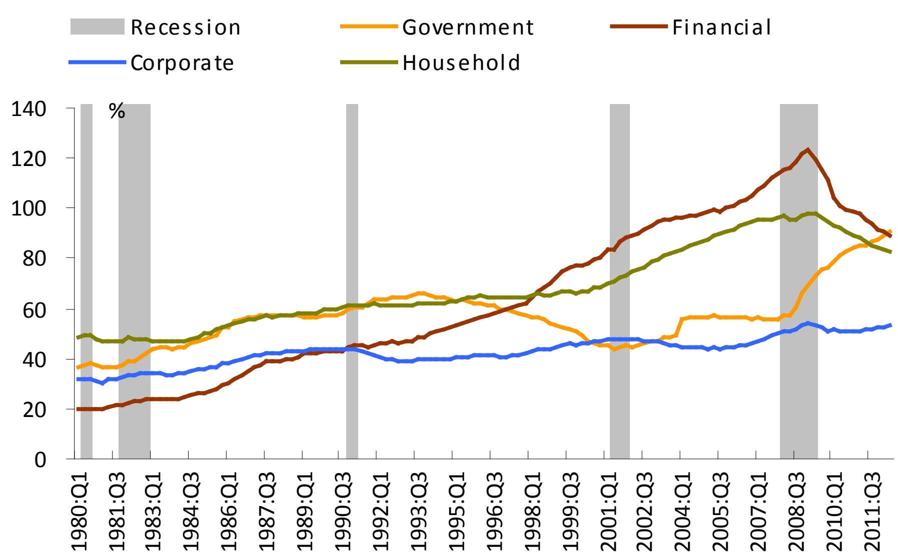
Euro area & US stick to ultra easy monetary policy

- Slow recovery of the US labor market means QE3 is likely to run throughout 2013
- The Fed may increase the scale of QE3 after Operation Twist expires at end-2012 to ease the impact of fiscal tightening in early 2013
- It is still quite likely that Spain will request aid from the EU, and the ECB will start purchasing government bonds

The US economy is almost ready to re-leveraging

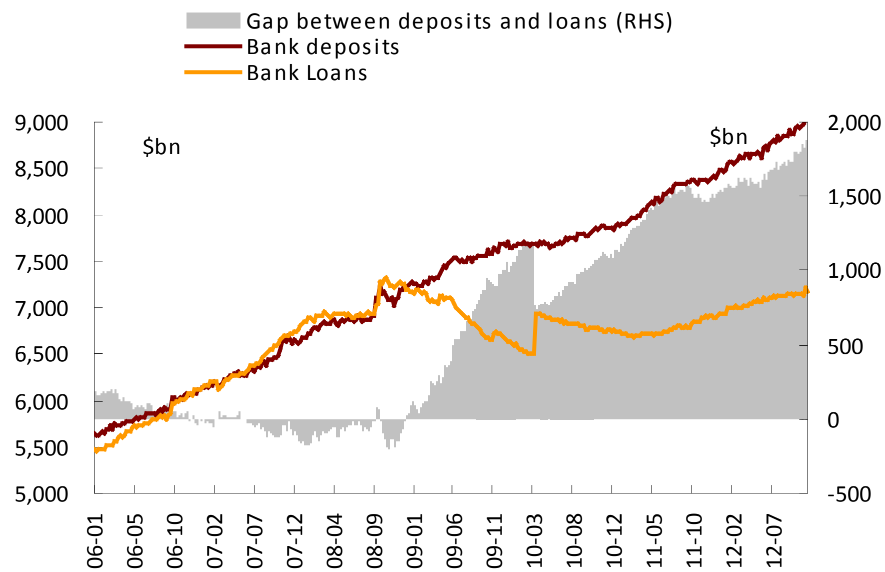
- The US real economy is healthy as the de-leveraging process is almost close to end, and the financial and household sectors have lowered their debt level significantly.
- The corporate sector holds huge amount of cash.

The financial and household sectors have lowered their debt level significantly



Source: Haver Analytics, CICC Research

US bank loans have recovered slowly



Source: Bloomberg, CICC Research

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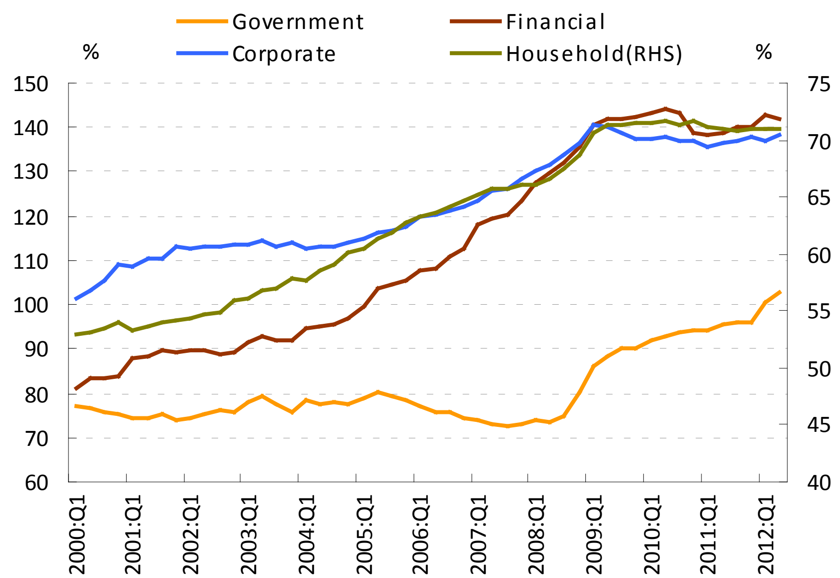
Eurozone needs to de-leverage

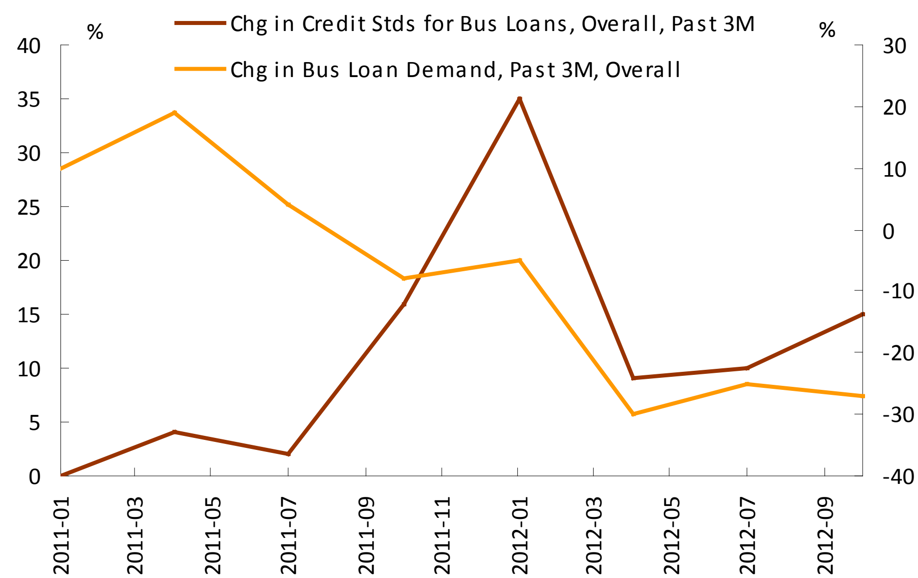
- Except the government, the balance sheets of other sectors have not had noticeable improvements, therefore Eurozone will have to go through a serious and painful process of de-leveraging.
- If Eurozone does not strike to improve its competitiveness, it is likely to become the next Japan as it will experience the same kind of hardship.

Economic sectors have not lowered debt level



Source: Haver Analytics, CICC Research

The demand and supply of bank loans declined



Source: Haver Analytics, CICC Research

Euro area — Two-speed recovery:
Germany the leader, Spain/Italy the laggards

Euro Area GDP growth rate, %					
	2009	2010	2011	2012E	2013E
Euro Area	-4.4	2.0	1.4	-0.3	0.3
Germany	-5.1	4.2	3.0	1.0	1.0
France	-3.1	1.7	1.7	0.2	0.4
Italy	-5.5	1.8	0.4	-2.0	-0.5
Spain	-3.7	-0.3	0.4	-1.3	-1.2

Sources：Eurostat, CICC Research

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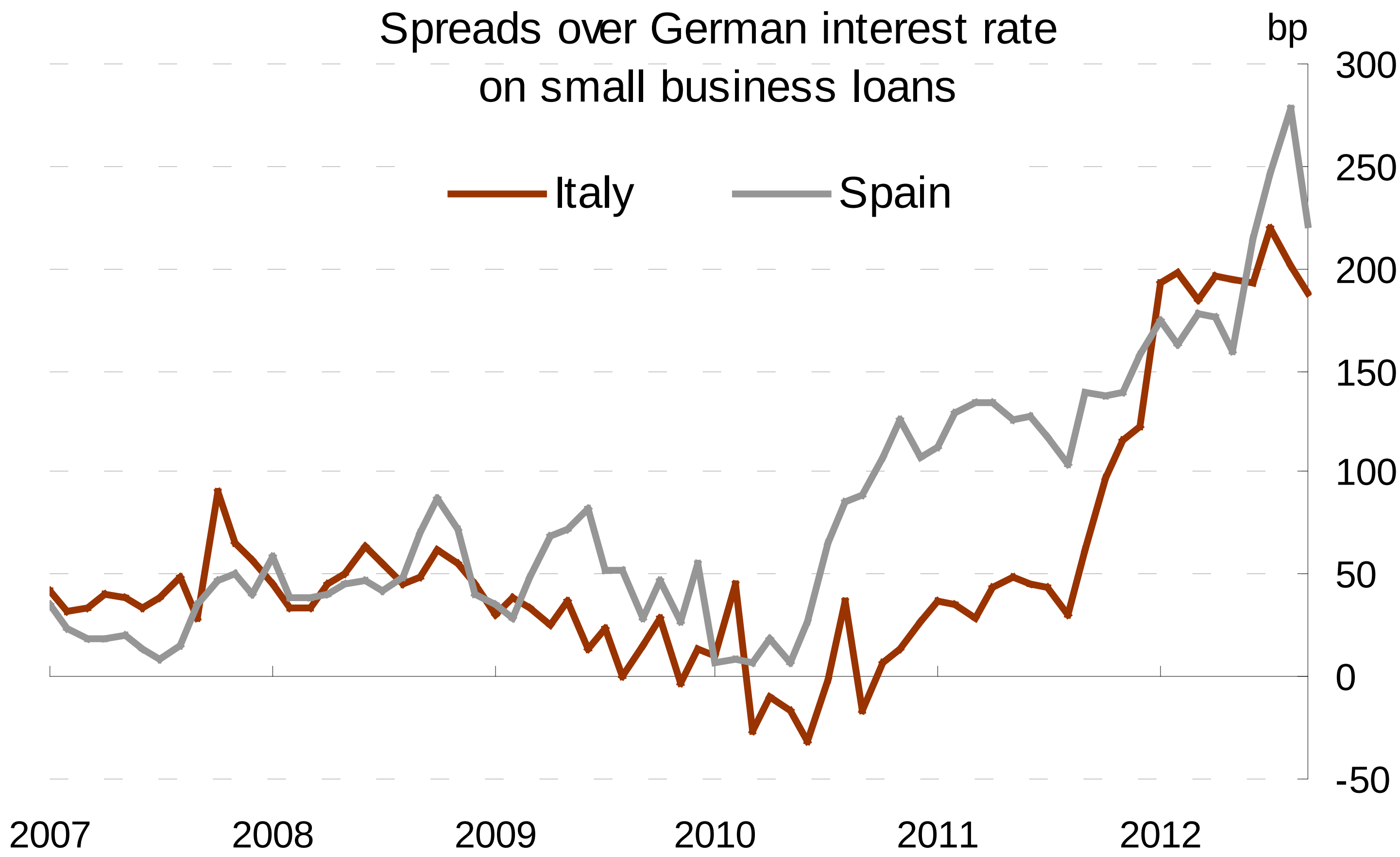
Breakdown in monetary transmission means Spanish and Italian firms pay higher interest rates than their core counterparts



Sources：ECB, CICC Research; Note: Loan amount <1 million Euro, Maturity 1~5 yrs

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China: expansionary fiscal and prudent monetary policies

	Short-term cycle	Long-term supply	Monetary/credit cycle
	Aggregate demand growth slowed - Impact of policy tightening earlier - Slower private sector investment - Export slowdown - Business destocking	**Falling potential growth rate** - Fading demographic dividend - Declining dependence on foreign trade - Real estate crowding out the real economy	**Inherent monetary/credit tightening pressure** - Business deleveraging - Households rebalancing assets between domestic and foreign currencies - Banks less willing to lend - But property bubble remains
Policy implication	Expansionary fiscal policy	Structural reform	Risks of monetary policy being too tight or too loose

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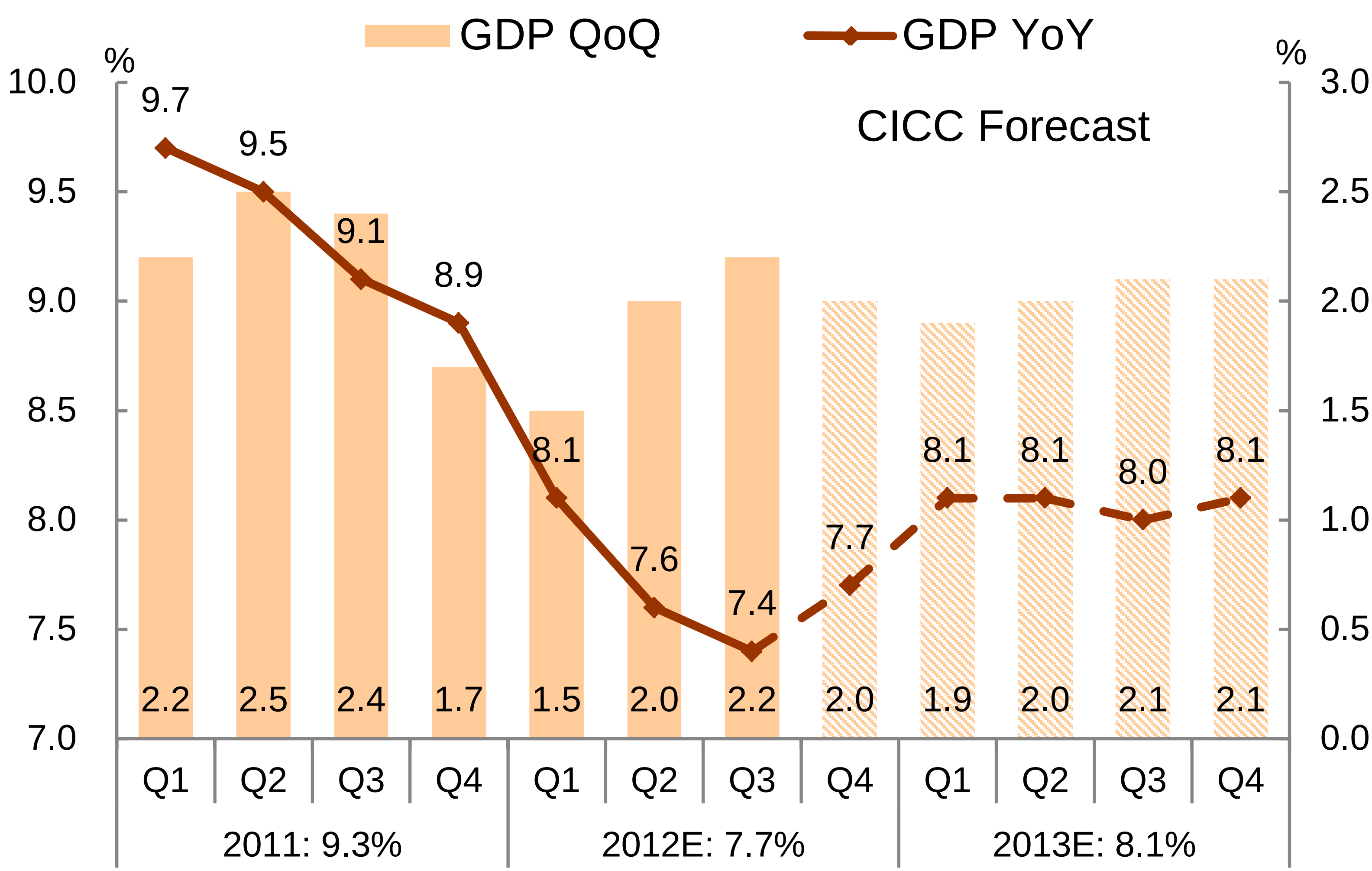
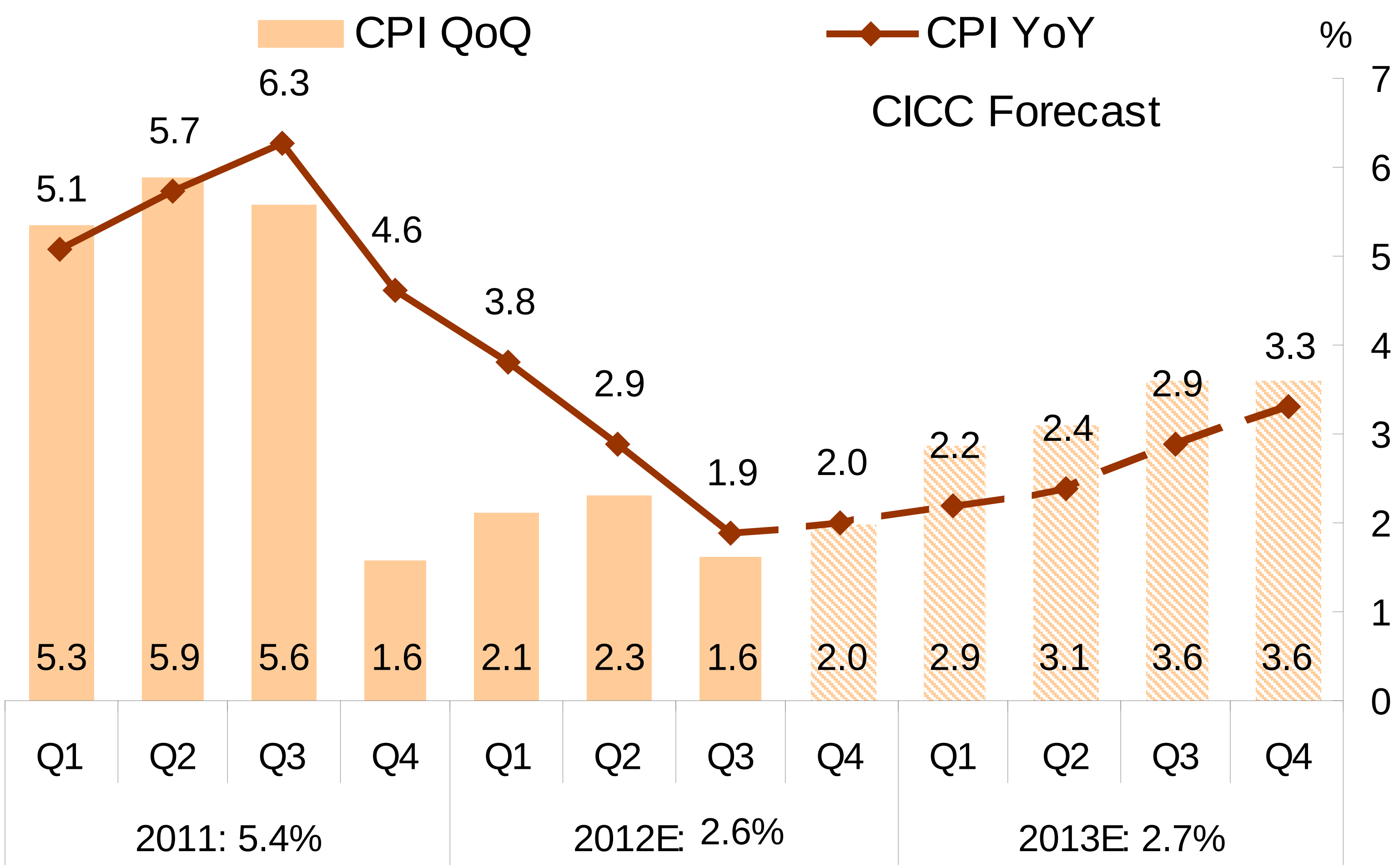
China: growth will recover modestly



Source: CEIC, CICC Research

China: inflation will pick up slightly



Source: CEIC, CICC Research

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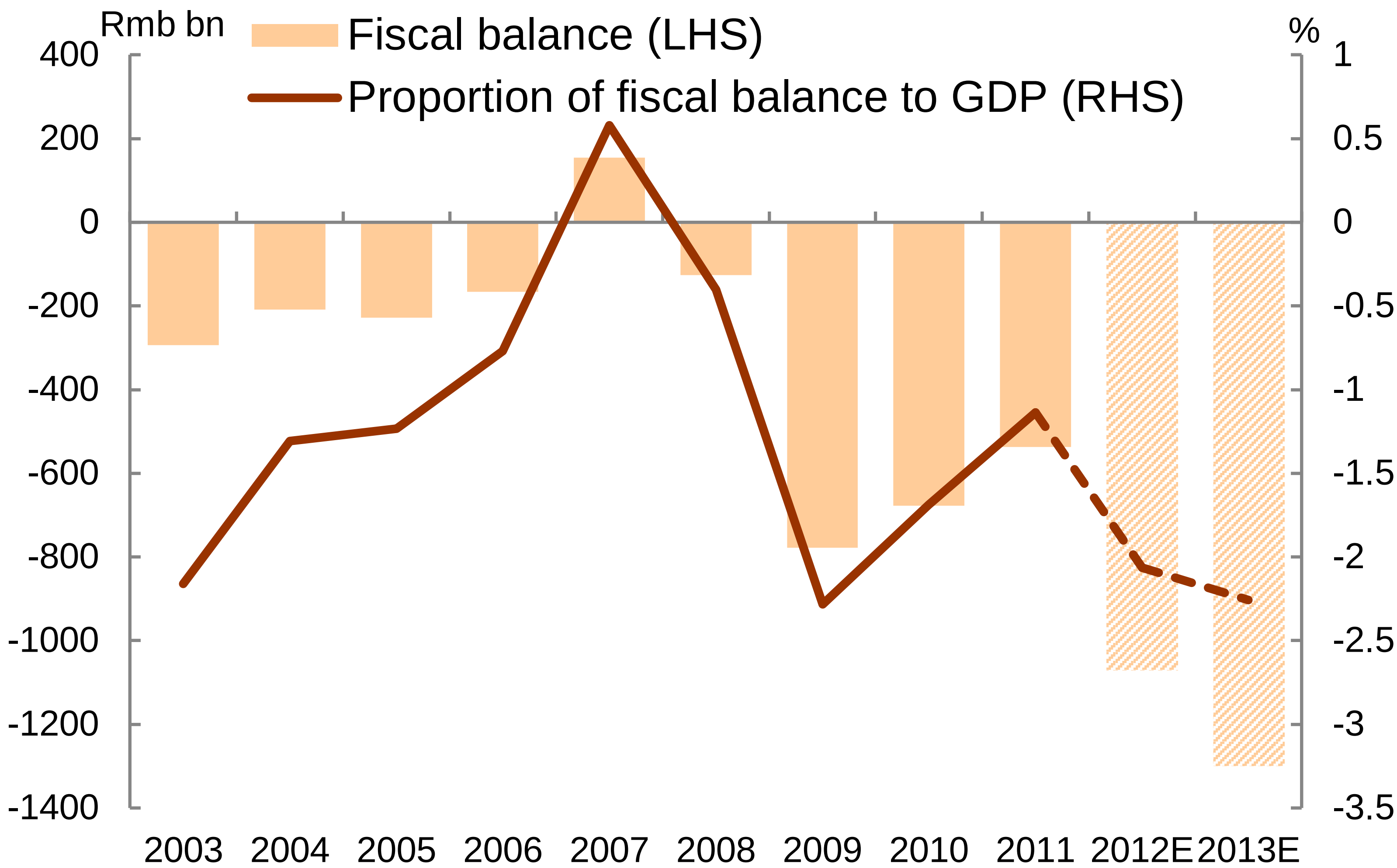
China's expansionary fiscal policy

- Fiscal expansion will continue in 2013 with a greater deficit than in 2012
- Structural tax cuts: replacement of business tax with VAT will be implemented nationwide
- Property tax trial will be expanded
- Infrastructure investment will grow at a faster pace

China: fiscal deficit will expand



Source: CEIC, CICC Research

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China: prudent monetary policy

- M2 growth will be 14%, new bank lending Rmb9trn
- Two RRR cuts, one IR cut
  - Inflation is not a constraint
  - Overall financing costs are relatively high
  - Fiscal expansion has crowding-out effect on private sector financing conditions
- Property bubble hampers monetary easing
- QE3 may reduce the extent of monetary easing in China

Effectiveness of macro policies

- High fiscal multiplier, low money multiplier
  - China's fiscal spending will mobilize other investment funds
  - Developed world is deleveraging and interest rates are near zero
- China: expansionary fiscal and prudent monetary policies
  - Able to boost growth more effectively in short-term
  - But structure will worsen with the government sector crowding out the private sector
- Euro area & US: fiscal consolidation and easy monetary policy
  - Weak recovery momentum in short-term

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