Don’t let the euro-area crisis go east

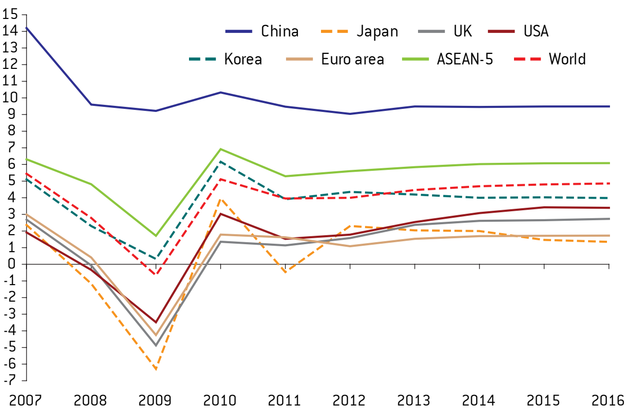
Agnès Bénassy-Quéré (CEPII, Paris), He Fan (IWEP/CASS, Beijing), Masahiro Kawai (ADBI, Tokyo), Tae Joon Kim (Korea Institute of Finance, Seoul), Yung-Chul Park (Korea University, Seoul), Jean Pisani-Ferry (Bruegel, Brussels), David Vines (Oxford University), Yu Yongding (IWEP, Chinese Academy of Social Sciences, Beijing)[1]

Asia-Europe Economic Forum Paper, January 2012

From one crisis to another

During the 2007-09 financial crisis, the euro area quickly suffered an impact through the financial channel. The key reasons were that European banks were deeply exposed to US distressed assets and they were also heavily leveraged. Asian banks had fortunately avoided European excesses. However Asia was brutally hit after the Lehman Brothers collapse by the sudden fall in global trade and the reversal in capital flows. On the whole, Asia suffered severely from the global financial crisis: from 2007 to 2009, the GDP growth rate fell by 8.6 percentage points (pp) in Japan, 5 pp in China, 4.8 pp in Korea and 4.6 pp in ASEAN-5 (Figure 1).

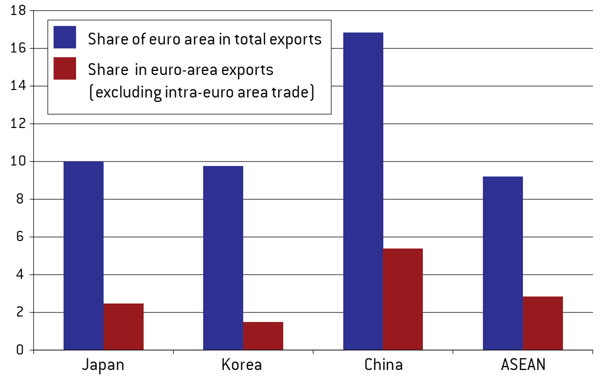
Figure 1: GDP growth (in percent), 2007-2016*



Source: IMF, World Economic Outlook, Sept 2011. * IMF staff forecasts from 2011 to 2016.

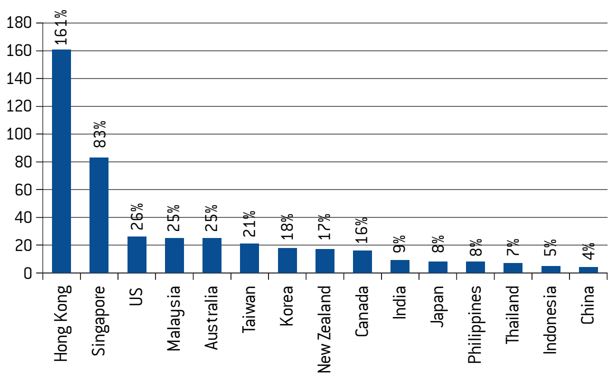
The euro-area crisis presents a new risk for Asian economies, for different reasons. First, the euro area represents between 9 and 17 percent of Asian exports of goods (see Figure 2). A fall in euro-area demand will be especially painful for China, which has a growth model that still relies heavily on foreign demand in the west. Second, as evidenced by the International Monetary Fund spillover report on the euro area[2], the crisis may to a great extent spread to emerging countries through various financial channels. Although Asian banks can be considered relatively strong (as they do not hold much of troubled European periphery’s government securities), they may suffer from domino effects, eg through large European banks. Only 5 percent of European banks’ total foreign claims is allocated to the Asia-Pacific region. However, these claims amount to a huge percentage of GDP in two key Asian financial centres, Hong Kong (161 percent of GDP) and Singapore (83 percent of GDP, see Figure 3). If European banks were to start massive withdrawals of funds, the consequences could be sizable. The biggest risk on the financial side is therefore associated with bank deleveraging and indeed – given the worsening conditions in the European interbank market – European banks in Asia have already started selling assets in order to send back cash to their headquarters. In fact, the euro-area crisis already affected emerging markets in the autumn of 2011, with capital leaving these markets and being re-allocated from equity towards bond markets[3].

Figure 2: the Euro-Asia trade link: share in total goods trade of euro area or Asian exports, in percent



Source: CEPII-CHELEM (http://www.cepii.fr/anglaisgraph/bdd/chelem.htm).

Figure 3: the Euro-Asia banking link: share of European banks' foreign claim in Asian countries' GDP



Source: Haizou Huang (2011).

A link between finance and trade – and another potentially important channel of impact – is trade financing. Asian economies rely heavily on trade financing for growth and European banks are major players in this field, as they provide most of dollar-denominated trade financing in Asia. The ongoing deleveraging by Asia-based European banks could induce them to cut also their financing of trade. Finally, in this period of extreme uncertainty, pessimism and the loss of confidence could worsen the global and regional outlooks and make the impact through the trade and financial channels even more severe by complementing it with high volatility on the financial markets.

On the whole, against the background of weak US demand, spillovers from the euro area to Asia could be substantial, and it could be considerably more difficult for Asia to repeat the fiscal and credit expansion of 2009 and achieve the post-Lehman V-shaped recovery.

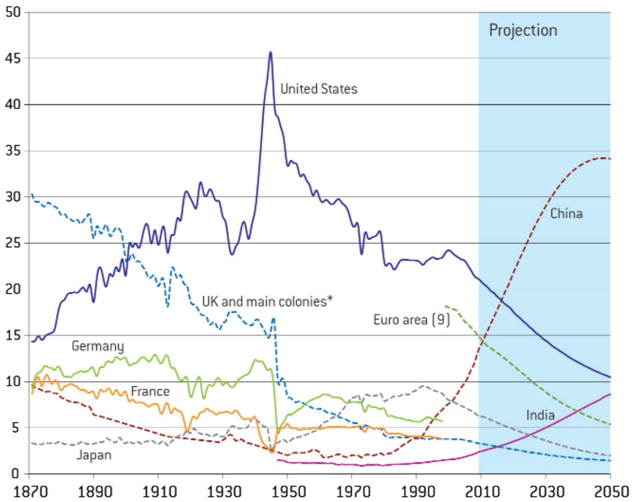
Asia has a specific stake in the survival of the euro

The economic impact of spillovers is not the only reason why Asia has a stake in the Eurozone crisis and why it could be interested in assuming a more active role in finding a solution.

First of all, the euro can provide a good alternative for Asian countries to diversify their large foreign exchange reserve holdings away from the US dollar. Diversification is becoming a relevant issue for Asian countries, increasingly concerned that the US might in the long run need to significantly devalue the dollar, in order to improve its competitive position and resume growth. Moreover, there is concern that the US might give in to the temptation of running high inflation, letting the dollar depreciate further and benefitting from the debt-reducing effects of higher inflation and currency depreciation. This would harm Asian countries (particularly China, that can boast as much as US$ 3,200 billion in total reserves, most of which are invested in dollar-denominated assets) and diversification would constitute a form of insurance against this scenario. With this respect, the euro is a natural alternative to the dollar for the positions it has achieved as an international currency. But for diversification to take place, Europe must necessarily manage to convince Asian countries that the euro is also a *safe* alternative[4].

In the longer run, Asia's stake in the survival of the euro is also connected to the value of having a multipolar international monetary system. As suggested by Figure 4, the shares of the US and Europe in the global economy are likely to decline over the long-term. Conversely, China will grow fast and could surpass the US in around 2035. In the coming two or three decades, the distribution of economic power is likely to be more balanced than at any point over the last century, which calls for an international monetary system able to match such a multipolar real economy. Although significant steps have been taken in China to internationalise the renminbi, it will take time until the renminbi can cover the various functions of an international currency[5]. In the meantime, the euro may remain the only credible complement to the dollar, provided the problems of political cohesion are resolved within the euro area[6].

Figure 4: Percentage share of selected countries in world GDP, 1870 – 2050 (2005 exchange rates and prices)



Source: Angeloni *et al* (2011).

A third reason why the survival of the euro is important for Asia is related to the interest Asia itself has in the issue of regional cooperation. Even though some flaws in its original construction have become evident, the euro area represents the most advanced experiment in regional cooperation. The idea of Asian monetary integration is a long-lived one[7] and is justified by the increasing economic and financial interdependence among Asian countries. Asia (ASEAN+3) will be the largest economic bloc by the second half of the 2010s, with strong intra-zone integration in terms of supply chains. Hence the rationale for some form of macroeconomic policy coordination. The crisis of the euro-area model has implications for how Asian countries will think about their own integration.

Europe should first and foremost rely on its own strengths

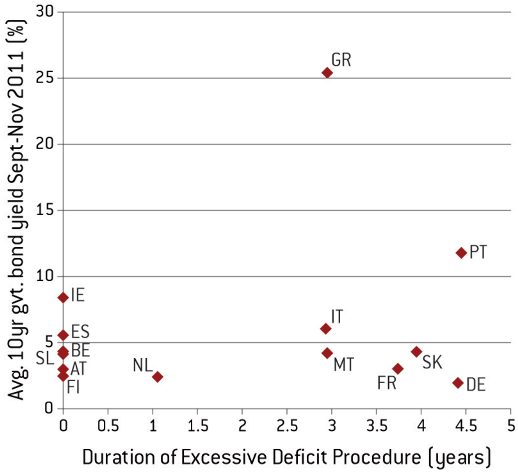
The discussion in the previous sections suggests that Asia has a considerable interest in the survival of the euro and the rapid macroeconomic recovery of the euro-area's members. But Asian countries have repeatedly made clear that the first step in the solution has to come from Europe itself. In September 2011, Wen Jiabao called on European countries to "put their house in order" before asking China for a bailout[8], and there is a generalised perception in China that a credible effort from the European side is an indispensable prerequisite for Asian countries to help.

In terms of fundamentals, the aggregate euro-area situation (abstracting from differences across countries) is assessed as being better than the US situation by international organisations such as the IMF (IMF, 2011[9]): in 2010, the debt-to-GDP ratio in the euro area was 85 percent against 94 percent in the US, and the international investment position is also stronger in the euro area. The issue is therefore one of governance: through governance reform, Europe will contribute to improving Asia's international economic environment and economic outlook. In turn, Asia would likely be willing to help strengthen Europe's response.

So, what can Europe do to save itself? As a first step, Europeans should understand if the problem is simply one of enforcement or rather one of substance. During the first decade of the euro, much emphasis was placed on the fact that playing by the fiscal rules enshrined in the EU treaty was both necessary and sufficient for the success of monetary union. Also the most recent developments have been along this line: on 9 December 2011 the Heads of State or Government of the euro area and other EU countries agreed on the principle of a new treaty that will commit them to introducing at national level a new fiscal rule binding general government deficit below 0.5 percent of GDP in structural terms. They also agreed on activating automatically a sanction procedure for countries in breach of the 3 percent of GDP ceiling for budgetary deficits, unless there is a qualified majority of euro-area states to oppose them[10].

A purely fiscal solution however would only tackle the problem superficially. Figure 5 compares the average yield on 10-year government bonds over the last three months with the number of years during which countries were under the EU Excessive Deficit Procedure. It suggests that behaviour vis-à-vis the rules of the European fiscal framework is a poor predictor of the difficulties being experienced by euro-area countries[11]. More broadly it suggests that adherence to the euro-area's fiscal rules may not be sufficient to remedy the euro-area's macroeconomic difficulties. There are two reasons why Europe's problems may be much wider than problems that can be fixed purely by fiscal discipline.

Figure 5: Excessive deficit procedures and bond yields in the euro area

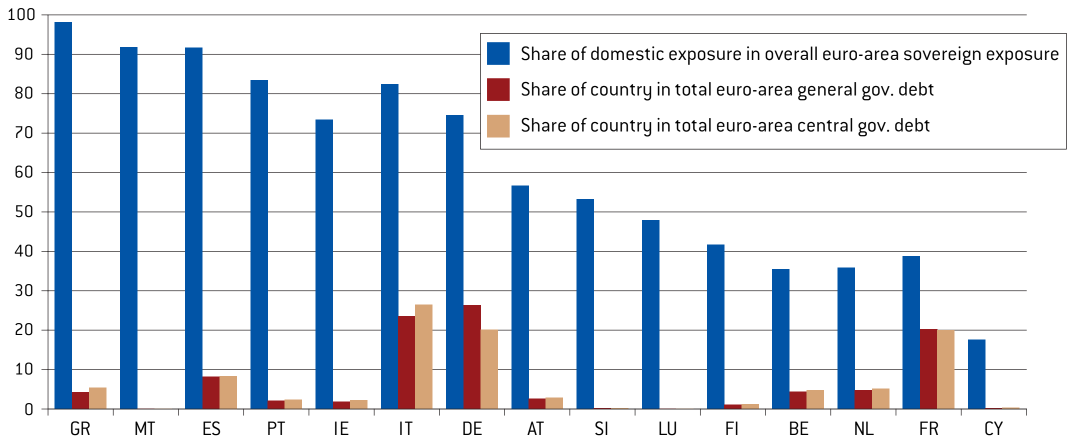


Source: Bruegel.

First, the crisis in the euro area has reached systemic dimensions: it has gone beyond the fiscal problems and has become a crisis of the financial system, and it has gone beyond the 'crisis countries' and is reaching the core. The pressure on sovereign debt markets has spilled over to the banks, threatening the entire financial system. The sovereign-banking vicious cycle comes from the combination of three characteristic features of the euro area that distinguish it from other monetary unions. Banks in the area are very large and still largely national, meaning that each member state is individually responsible for rescuing 'its' banking system. Additionally, banks have a strong home bias, that is, they are largely biased towards 'their' sovereigns in the sovereign bond portfolio (see Figure 6). Furthermore, euro-area governments are individually responsible for the debt they have issued, and co-responsibility is explicitly ruled out by the Treaty. Finally, the European Central Bank is prevented by the Treaty from exercising any form of monetary financing. The coexistence of these different constrains considerably the choice of short-term solutions and makes the euro area extremely fragile, since it prevents one part of the euro-area region from insuring other parts against region-specific shocks. This is something which happens within individual sovereign states, and its absence within the euro area has been extremely important.

Second, the crisis is also one of intra-euro area competitiveness. Since the introduction of the euro, more than ten years ago, the competitive position of the German economy, which entered the euro area in an uncompetitive position, has improved remorselessly, and the position of the peripheral economies (Greece, Portugal, Italy and Spain) has deteriorated remorselessly, to the point where major real exchange-rate misalignments exist within the euro area. The question, then is how to achieve real exchange-rate corrections within the monetary union without triggering a vicious circle of protracted stagnation. As there is no appetite for fiscal stimulus in northern European surplus countries, the only macroeconomic instrument available to foster growth will be supportive monetary policy, implying a weak euro. The euro area may therefore have in the coming years a preference for external depreciation. Still, the adjustment of peripheral countries is a major challenge and the risk will remain for several years that some countries finally find no other choice than to leave the monetary union and devalue substantially. As a result, currency risk has been added to sovereign risk; this additional risk greatly complicates the financial-system crisis.

Figure 6: Gross exposures of European banks to sovereign risks, by country (in percent, 2011)



Source: Pisani-Ferry (2012).

The ECB has actively played a leading role in dealing with the emergency, using a wide range of 'non-standard' monetary policy instruments: first, it has actively engaged in providing liquidity to the banking system by both expanding the list of collateral accepted for lending to banks and by introducing special refinancing operations with long maturity to cope with the liquidity shortage on the interbank market; second, it has intervened actively in the secondary market buying distressed government bonds in the context of the Securities Markets Programme (SMP). But the ECB has no primary financial stability mandate that would justify an 'aggressive' intervention to prevent turmoil on the bond markets, and it also lacks the appropriate governance structure of a kind which would support the pursuit of such a mandate. The monetary policy decisions are taken by the Governing Council according to the rule of 'one governor, one vote'. But the distribution of losses incurred by the ECB on its balance sheet are distributed differently: each member state will bear a share of the loss that is computed according to the same member state's contribution to ECB capital (so some member states risk being under-represented in bond-purchase decisions in comparison to the potential losses they could bear). Therefore the ECB has evidently been uncomfortable with this situation.

Furthermore the deal struck on 9 December 2011 maintains a 'constructive ambiguity' over the relationship between the European Financial Stability Facility (EFSF) and the ECB. What has been improved – on the occasion of the latest deal – is the 'firepower', ie the amount of financial resources put on the table to tackle the crisis. The Heads of State or Government have decided to anticipate the entry into force of the European Stability Mechanism (endowed with €500 billion) to 2012 and there was a commitment to mobilise €150-200 billion of European resources that will be provided to the IMF in the form of bilateral loans. It remains to be seen whether emerging countries are willing to supplement this effort, while the United States so far has not displayed excessive enthusiasm for the idea.

Asia can contribute to the solution

At the current juncture, the *politics* of providing help to Europe is very difficult in Asia, partly due to the poor record of Europeans during the Asian financial crisis. Asian countries remember well the reluctance of Europe to provide help: a regional solution through the creation of an Asian Monetary Fund was rejected by the US and the Europeans, no bilateral assistance was agreed for Asian countries at the end of the 1990s (except for limited amounts to Korea) and the contribution given by the Europeans was almost entirely limited to supporting the approval of IMF programmes.

Symmetrically, the response of Asian countries to Europe's courting of them has been to date quite cautious, due also to domestic political constraints. Any help to Europe – a rich region – from Asia – a poorer one – will need to be carefully designed in order to minimise the misperception risk. Public opinion in China has already started to be concerned with a bailout that is perceived as being risky and of questionable effectiveness, not to mention the equity dimension (Yu Yongding, 2011). As a result of the prevailing uncertainty in Europe, the emphasis has been put on a multilateral framework for aid (through the IMF) rather than on a direct Europe-Asia partnership (through direct investment in the EFSF). The idea of boosting the IMF's resources in order to cope with the euro-area crisis was initially opposed by the Europeans themselves, as the Bundesbank rejected using foreign-exchange reserves to this end. But this objection has now been overcome, and IMF involvement has become possible. That involvement is probably the best way to reassure possible Asian contributors about the safety of their investment.

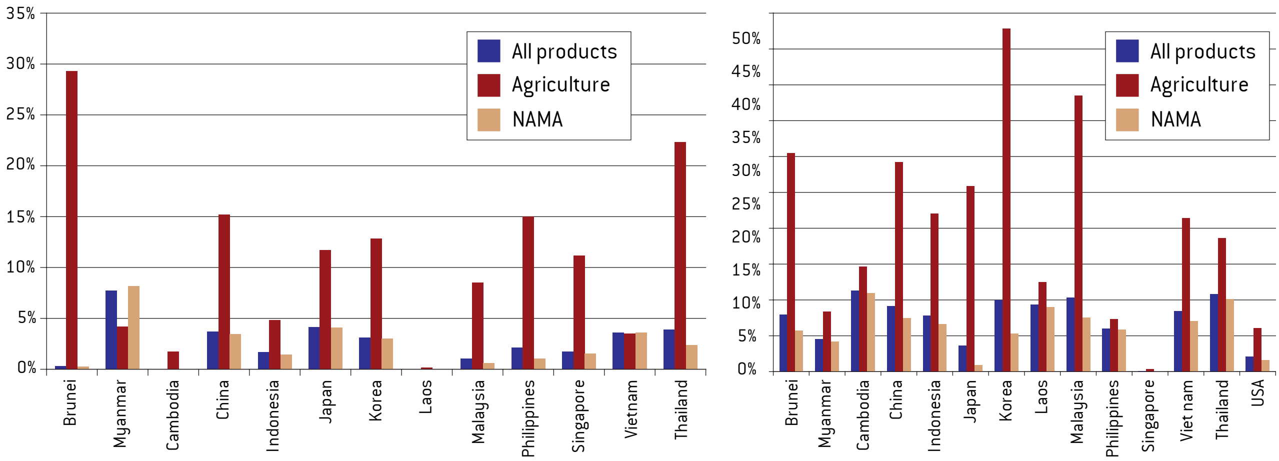
There are three reasons for this stance. First, the IMF's expertise will guarantee the minimum degree of risk-management required by Asian countries to put their resources on the table. Second, the IMF is becoming more independent from EU institutions in dealing with the euro-area crisis (in the case of Italy, the IMF exercises surveillance alone rather than as part of the Troika), which from the point of view of Asia should be further reassuring. Third, and most fundamentally, IMF involvement is likely to force European policymakers to take seriously enough the macroeconomic and systemic risks identified above. It is no surprise that in November China rebuffed the approach of Europeans, who were suggesting that China buy EFSF bonds. That rebuff happened because China was being offered the bonds of an institution the very credibility of which was at stake. By contrast, investment by China (and by Asia more generally) in IMF financing for Europe will lead to a very different outcome. It will bring IMF conditionality into play, and will thus provide a guarantee of IMF oversight over the mix of macroeconomic and financial policies being adopted in Europe. And since the IMF is a preferred creditor, it will offer a further guarantee of any money that Asia invests.

Another investment option could be for Asian banks to buy European banks with a global reach and become major players in trade financing, reducing their level of dependence and insuring themselves against the risk of sudden stops in trade financing due to foreign banks deleveraging. But this option could be difficult to implement in practice, as there are non-negligible differences between Asian and European banking culture, and a more realistic solution could be for Asian banks to buy assets released by the European banks in the process of deleveraging.

In view of the increasing role of Asia in the world economy, there is a rationale for Asians to contribute to the stabilisation of the global environment. It is however clear that regardless of the form of this aid, Asian countries cannot be asked to step in without something in exchange. Given that the most appropriate vehicle for channelling Asian support seems to be the IMF, then the issue of IMF governance will inevitably need to be revisited sooner or later. Were they to rescue the core of Europe, Asian countries would have a motive to demand enhanced representation and voting rights in the IMF. As well as possible quota changes, the reshuffle could imply moving to a single euro-area representative on the IMF board. Such a move has been long contemplated but has not happened. The cooperation between Asia and Europe could also be made more explicit by linking the Asian regional fund (whenever the current Chiang Mai Initiative evolves into a true monetary fund) to the ESM, making region-to-region swaps of resources possible.

However there is a further global macroeconomic issue, which suggests that an additional form of assistance by Asia may be necessary. It would be a mistake to restrict any Asian support to the euro area to the financial support discussed above. It would be consistent with the fact that, as shown by Figure 2, the euro area is more a market than a supplier for Asian countries; hence there is an interest in maintaining the solvency of a big customer. However euro-area governments' efforts to put their houses in order may well be impeded by the collapse of European growth, even if financial collapse within Europe and the euro area is averted. In a period of strong fiscal adjustment, growth in Europe is unlikely to come from domestic sources. Thus, foreign demand will be a key contribution to any successful process of euro-area adjustment. This involves faster rebalancing of growth in China, but also further opening up of Asian markets. Figure 7 shows how several Asian countries lag behind in terms of tariff cuts (although the picture has been somewhat changed by the signature of a bilateral trade agreement between Korea and the EU in 2008). Services markets, as well as public procurement markets are also concerned by the necessity to open up to foreign supplies.

Figure 7: Ad-valorem tariff equivalents of bilateral protection (in percent, year 2007)



Source: CEPII-MacMap-hs6 (http://www.cepii.fr/anglaisgraph/bdd/macmap.htm).

Conclusion: the need for an institutional framework

In conclusion, there are many reasons why Asia and Europe could and should cooperate to fix the euro area. Unfortunately one obstacle to cooperation is the lack of a proper institutional framework to host a regular dialogue between Asia and Europe. The ASEM (Asia-Europe Meeting) – an informal process of cooperation and dialogue between Europe and Asia established in 1996 – has not been active enough, and bilateral discussions lack the scope and reach needed to be effective. The AEEF, bringing together experts from both the continents, could play a role in bridging the gap and in providing a high-level contribution to the discussions that must take place.

References

Angeloni, Ignazio, Agnès Bénassy-Quéré, Benjamin Carton, Zsolt Darvas, Christophe Destais, Jean Pisani-Ferry, André Sapir and Shahin Vallée (2011) *Global currencies for tomorrow: a European perspective*, Blueprint 13, Bruegel

Haizou Huang (2011) 'Euro-area crisis and its impacts on EMs and China', presentation at AEEF, Seoul, 9 December

Pisani-Ferry, Jean (2012) 'The euro crisis and the new impossible trinity', *Policy Contribution* 2012/01, Bruegel.

Yu Yongding (2011) 'Beijing will not ride to Eurozone rescue', *Financial Times*, 31 October

Notes:

1 Agnès Bénassy-Quéré (Paris School of Economics (University Paris 1) and CEPII, Paris), He Fan (IWEP/CASS, Beijing), Masahiro Kawai (ADBI, Tokyo), Tae Joon Kim (Korea Institute of Finance, Seoul), Yung-Chul Park (Korea University, Seoul), Jean Pisani-Ferry (Bruegel, Brussels), Yu Yongding (IWEP, Chinese Academy of Social Sciences, Beijing). The authors are grateful to Silvia Merler (Bruegel) for her contribution to the preparation of this paper. This paper draws on discussions held on the occasion of the Asia-Europe Economic Forum in Seoul, 9 December 2011.

2 International Monetary Fund (2011) 'Euro-area policies: spillover report for the 2011 Article IV Consultation and selected issues', *Country Report* No. 11/185

3 See Haizhou Huang, 'Euro-area crisis and its impact on EMs and China', AEEF presentation, Seoul, 2011. The Korean case is especially telling. Between August and November 2011, the Korean stock market saw net sales while the bond market remained more stable. Although outflows to Europe can to a great extent be offset by inflows from US and other Asian countries, this cannot be taken for granted were the euro-area crisis to grow global. See Kwang-Yeoul Yoo, AEEF presentation, Seoul, 2011.

4 See Yu Yongding (2011).

5 See Yu Yongding (2011, preliminary version) 'The internationalisation of the RMB'; and Shahin Vallée, 'The internationalisation path of the RMB', Bruegel working paper, forthcoming.

6 Angeloni *et al* (2011).

7 Japan was particularly active in this field, proposing the idea of an Asian monetary fund already in 1997 (see Masahiro Kawai, 'Asian monetary integration: a Japanese perspective', AEEF presentation, Seoul, 2011.

8 See Jamil Anderlini and Lifen Zhang (2011) 'Wen sets preconditions to help Europe', *Financial Times*, 14 September.

9 See IMF Fiscal Monitor, September 2011.

10 See European Council (2011) 'Statement by the euro-area heads of state or government', 9 December.

11 Within the framework of this treaty-based procedure, countries deemed in Excessive Deficit are instructed to reduce their deficit within a certain time frame. They are expected to be sanctioned in case of no-compliance, ultimately in the form of fines.