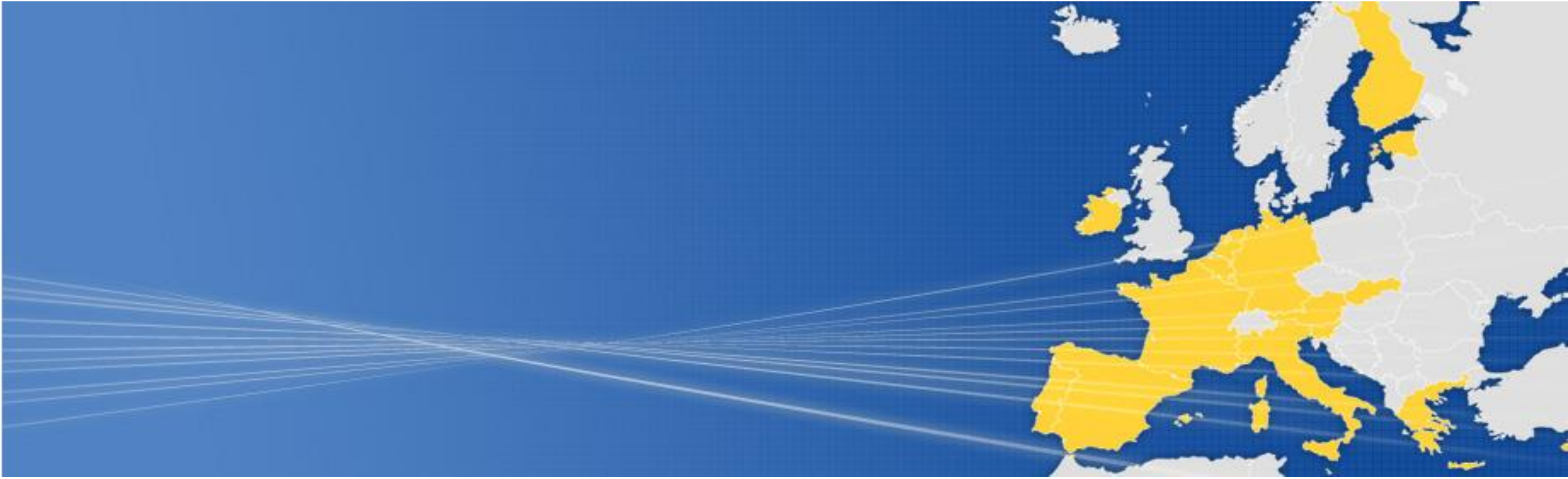

How Europe is Overcoming the Euro Crisis?

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3 March 2014

European Stability Mechanism

Eight reasons for the sovereign debt crisis

1. Member States did not fully accept the political constraints of being in EMU
2. Transition to permanent lower interest rates
3. Economic surveillance too narrow
4. Methodological problems with calculating structural fiscal balances
5. Insufficient control of data by Eurostat
6. Financial market supervision still mainly national
7. No crisis resolution mechanism
8. Biggest financial crisis in 80 years

Europe reacts to the euro crisis at national and EU level

A comprehensive strategy

- Comprehensive reforms at national level
- Improved economic policy coordination in the euro area
- Preparing the system for the future: reinforcing the banking system
- Financial backstops (EFSF and ESM)
- Focus now on growth

EFSF/ESM programme countries are the reform champions

- **Greece, Ireland, Portugal and Spain** are in top 5 of 34 **OECD countries** with regard to implementation of **structural reforms. Policy areas concerned**:
  - **Labour productivity** (e.g. product market regulation, human capital)
  - **Labour utilisation** (e.g. labour market regulation, social welfare system, active labour market policies)

Ranking in OECD report
1. **Greece**
2. **Ireland**
3. Estonia
4. **Portugal**
5. **Spain**

"Euro area countries under financial assistance programmes are among the OECD countries whose responsiveness [to the OECD's structural reform recommendations] *was highest and also where it most increased compared with previous period."*

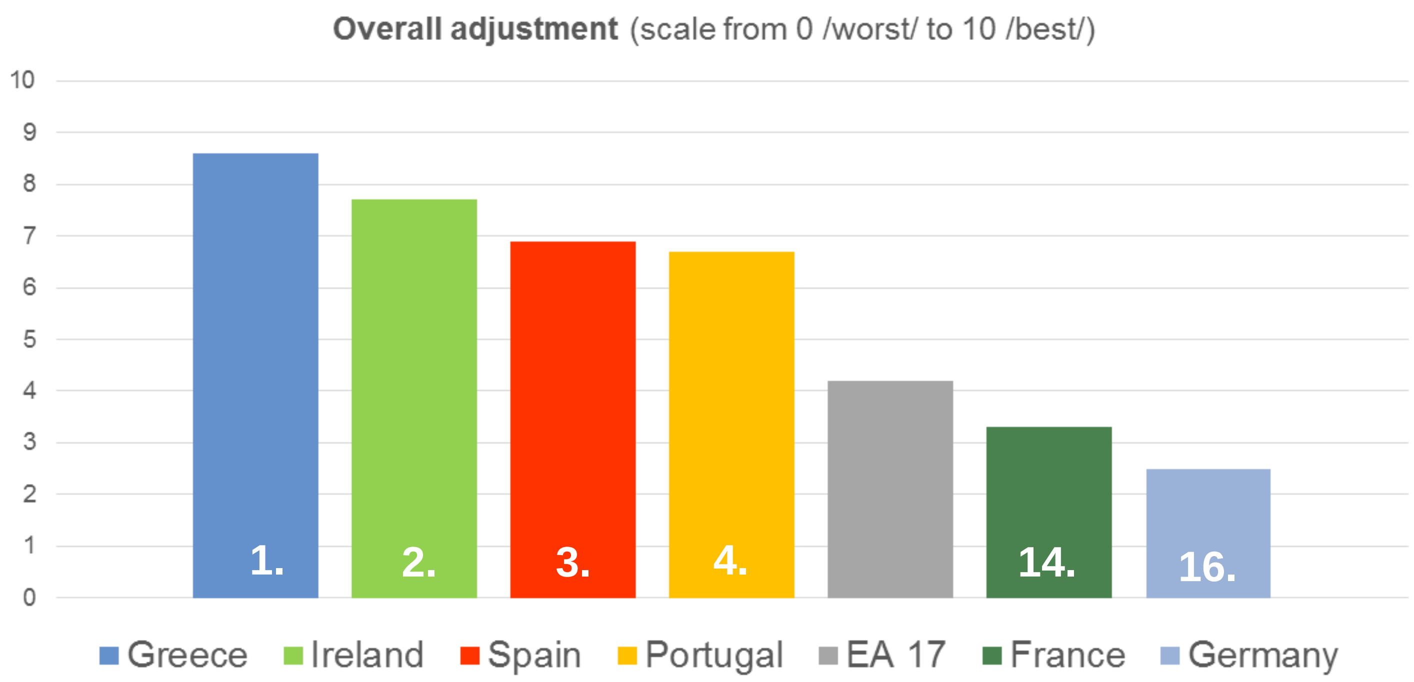
- Going for Growth 2013 (OECD Report)

Source: OECD report *Going for Growth 2013*
Ranking takes into account responsiveness to OECD recommendations on structural reforms in key policy areas

European Stability Mechanism

EFSF/ESM programme countries are the reform champions (2)

- **Greece, Ireland, Spain and Portugal** ranked highest in overall measure of 4 key medium-term adjustment criteria:
  - Rise in exports
  - Reduction of fiscal deficit
  - Changes in unit labour costs
  - Progress in structural reforms



Source: "Adjustment Progress Indicator" in *2013 Euro Plus Monitor* published by the Lisbon Council

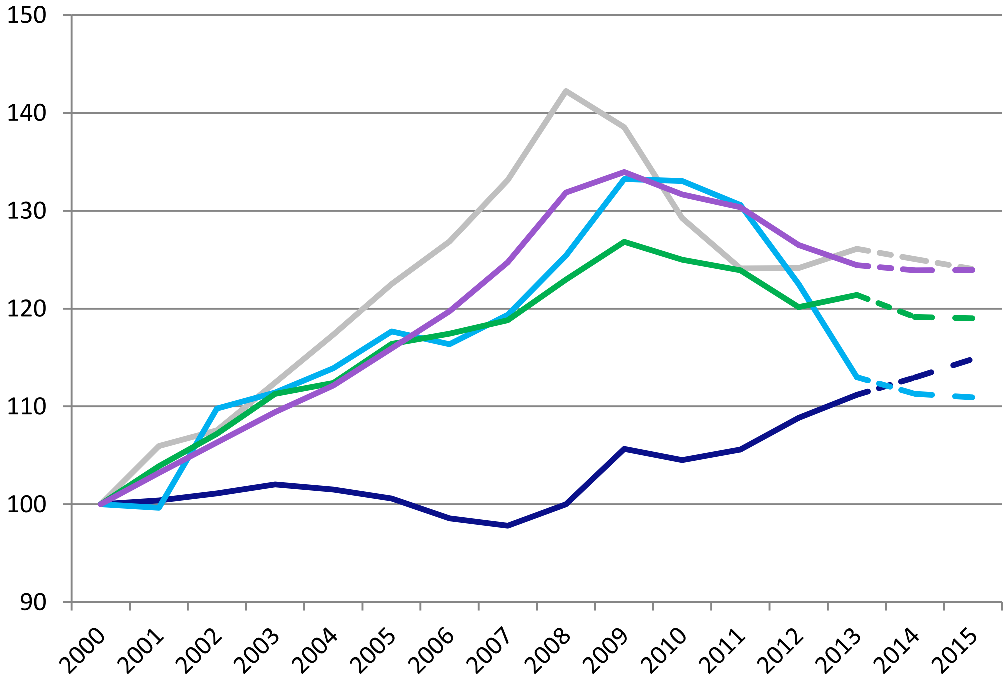
The ranking comprised 17 euro area countries + UK, Poland and Sweden

European Stability Mechanism

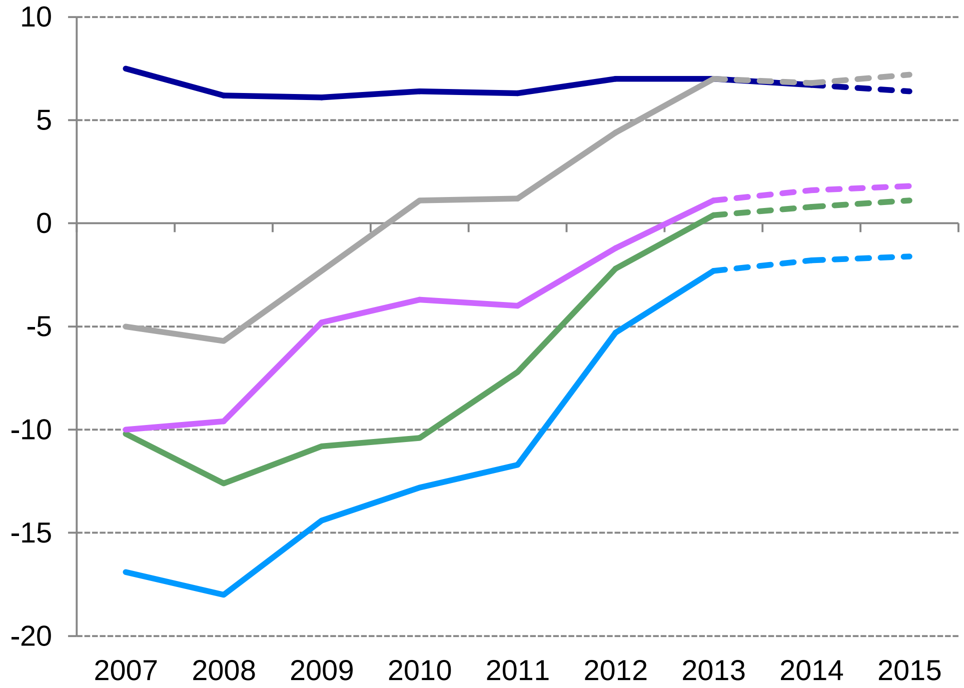
The strategy is delivering results - competitiveness

- Divergences within EMU are declining
- Competitiveness is improving in all Member countries having requested EFSF/ESM financial assistance

Nominal unit labour costs, whole economy (2008=100)



Current Account Balance (as % of GDP)



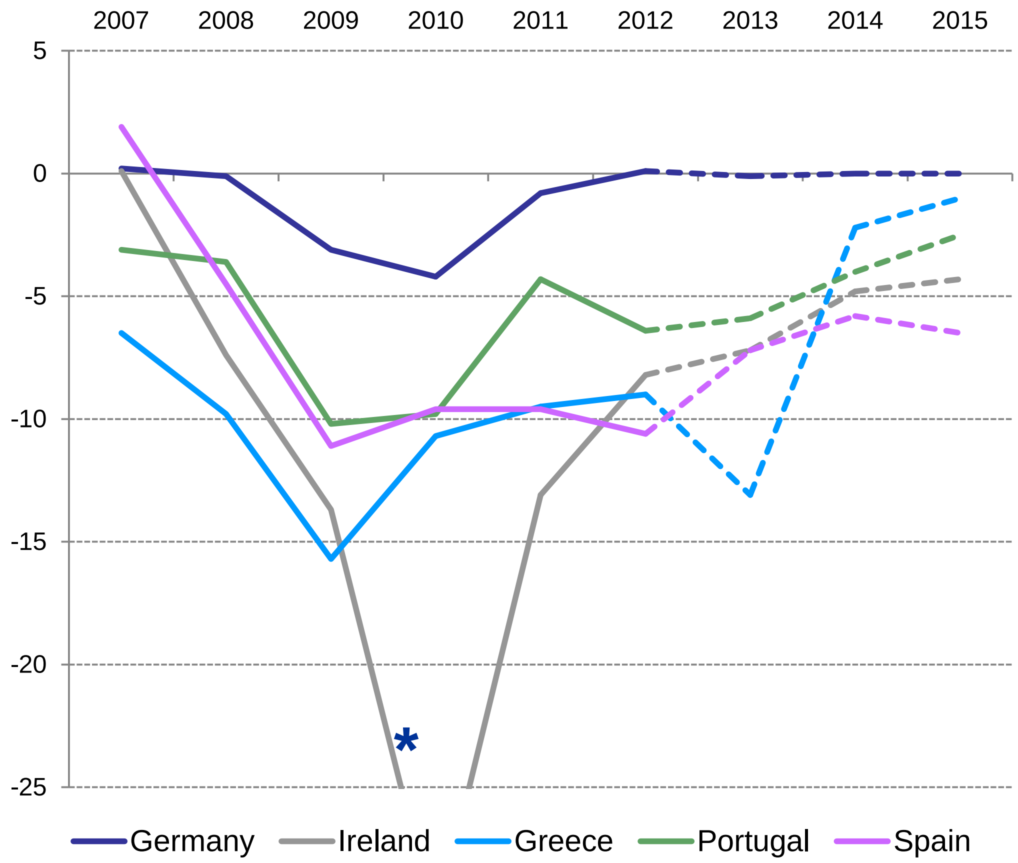
Germany Ireland Greece
Portugal Spain

Source: Eurostat,
EC European Economic Forecast - Winter 2014

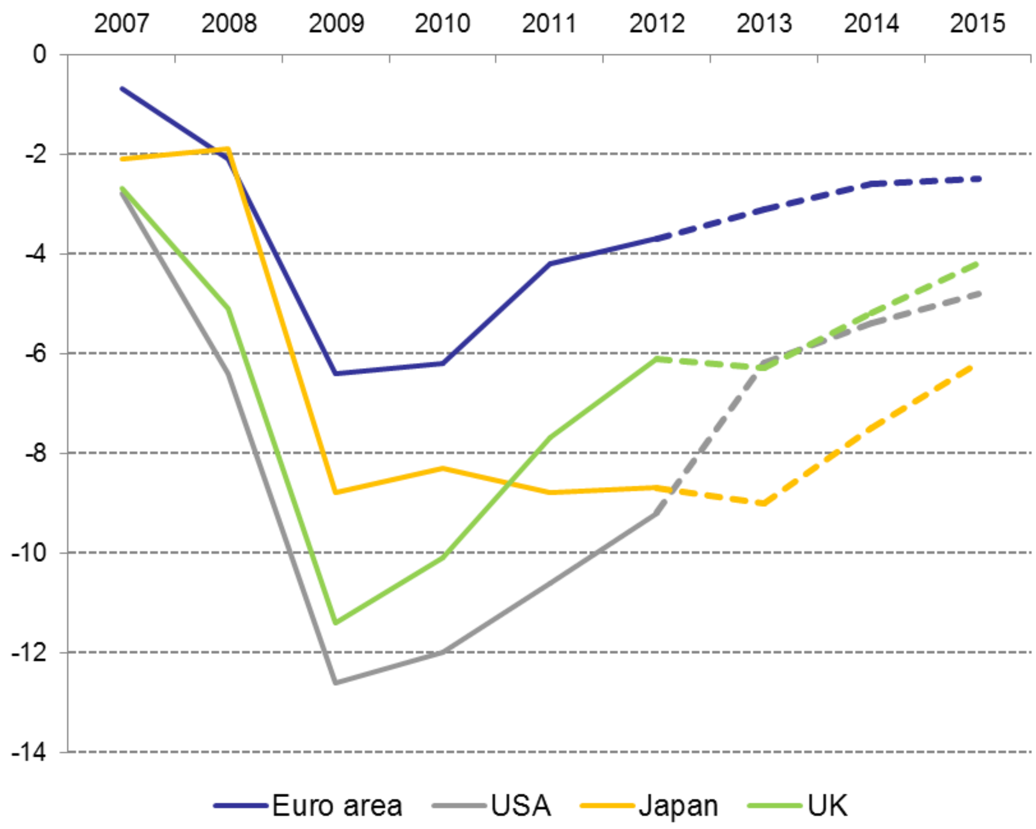
European Stability Mechanism

The strategy is delivering results - fiscal

Fiscal balance, euro area Member States
(as % of GDP)



Fiscal balance, Euro area vs USA and Japan
(as % of GDP)

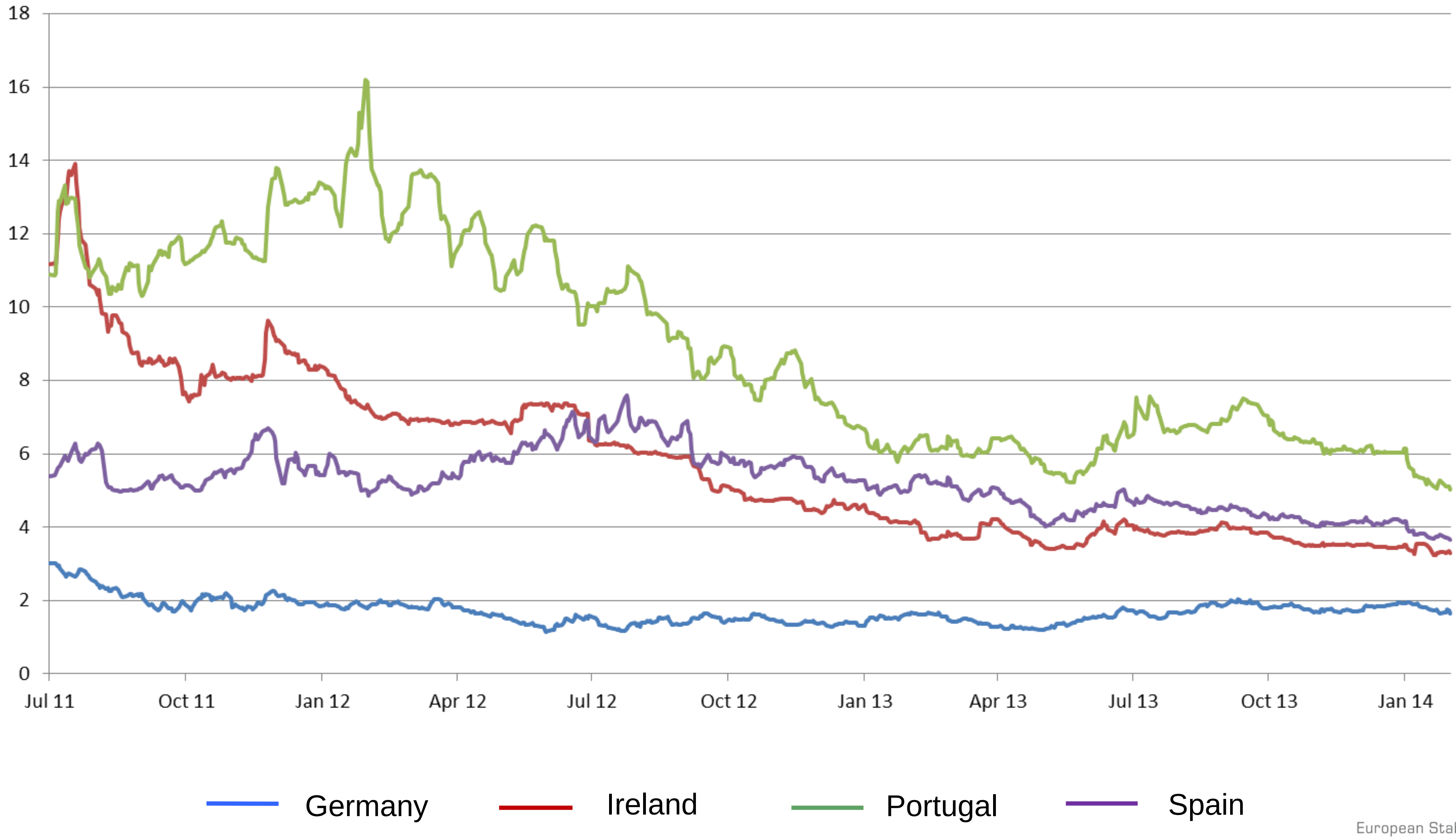


Source: European Commission, European Economic Forecast – Winter 2014

* Actual figure for Ireland in 2010: -30.6%

The strategy is convincing the market . . .

10-year government bond yields



Source: Bloomberg

European Stability Mechanism

… allowing countries to once again borrow at sustainable rates …

Ireland

- Successfully regained market access with the issue of a 10-year bond in January 2014
- Interest rates have fallen (for 10y bond) from 15.1% in July 2011 to 3.1% at end of February 2014

Portugal

- Successfully returned to markets with the issue of a 10-year bond in May 2013
- Interest rates have fallen (for 10y bond) from 16.6% in Jan. 2012 to 4.8% at end of February 2014

Spain

- Maintained access to long-term capital markets
- Remained a regular long-term borrower
- Interest rates have fallen (for 10y bond) from 7.6% in July 2012 to 3.5% at end of February 2014

Improved economic policy coordination in the euro area

- Euro governments adopted **more comprehensive and binding rules** for national economic policies
  - **Stability and Growth Pact** has stricter rules on deficit and debt
  - **Less room for political interference** by national governments
  - **Balanced budget rules** are introduced in national legal systems
  - **European Semester**: yearly cycle of economic policy coordination
  - Stronger emphasis on **avoiding macroeconomic imbalances**
  - New focus: **avoid "spillovers"** of bad economic policy from one euro country to another

Reinforcing the banking system

- The EU established **three new European supervisory authorities: EBA, EIOPA and ESMA.** The new **ESRB** early warning system for identifying and monitoring macro-prudential risks is functioning

- Europe is pushing ahead with **financial market reforms**
  - "Basel III" (CRDIV/CRR) to be progressively implemented starting in 2014
  - Huge capital increase for banks – Core Tier 1 capital ratios are now 9% or more
  - Approx. €450 billion raised by EU banks since 2008

- Regulatory framework at national level to be harmonized: **CRDIV/CRR, BRRD, DGSD.** The CRDIV/CRR will be implemented this year. Agreement with the European Parliament on BRRD, DGSD was achieved in December 2013.

Towards Banking Union

- **Single Supervisory Mechanism** (SSM) for euro area banks will be operational in November 2014
- **Bank Recovery and Resolution Directive** (BRRD) will create a uniform framework for bank recovery at national level
- Proposal for **Single Resolution Mechanism** (SRM) with **Single Resolution Fund** (SRF) agreed by European Council in December 2013; currently under negotiation with European Parliament
- **ESM Direct Recapitalisation Instrument** will be operational once SSM enters into force and euro area MS unanimously approve
- Harmonisation of **national deposit guarantee frameworks** (amended directive to be adopted)

EFSF and ESM: mission and scope of activity

Mission : to safeguard financial stability in Europe by providing financial assistance to euro area Member States

Instruments

- ***Loans***
- ***Primary Market Purchases***
- ***Secondary Market Purchases***
- ***Precautionary Programme***
- ***Bank recapitalisations through loans to governments***

All assistance is linked to appropriate conditionality

EFSF and ESM finance their activity by issuing bonds or other debt instruments

The ESM's governing bodies

Board of Governors

- The ESM's highest decision-making body, comprising euro area finance ministers
- Latvia's representative will be finance minister Andris Vilks
- Most important decisions require unanimity, e.g. providing financial assistance to an ESM Member
- Current Chairman of ESM BoG is Jeroen Dijsselbloem, who is also President of the Eurogroup

Board of Directors

- Responsible for specific tasks mandated in ESM Treaty or delegated by the Board of Governors
- The Board of Directors decides e.g. whether tranches of financial assistance may be disbursed to beneficiary country
- Each member of ESM Board of Governors appoints one Director

EFSF/ESM lending and assistance

- **Support for five countries (EFSF: Ireland, Portugal, Greece; ESM: Spain and Cyprus)**
  - Combined lending capacity: €700 bn
  - Committed amount to the five countries: €238.6 bn
  - Disbursed so far: €222 bn
  - Macroeconomic adjustment programmes for Ireland, Portugal, Greece and Cyprus
  - EFSF may no longer engage in new financial assistance programmes (as of 1 July 2013)
  - Ireland and Spain have exited their financial assistance programmes

- **Potential concerted ESM – ECB intervention (Outright Monetary Transactions/OMT)**
- ESM programme provides conditionality
- The ECB could engage in secondary market purchases.

Latvia's contribution to ESM paid-in capital

- All ESM Members subscribe to the **ESM's capital stock** (currently €700 billion), which comprises:
  - Paid-in capital (€80 billion)
  - Committed callable capital (€620 billion)
- The **contribution key** is based on the country's share in the total population and GDP of the euro area
- According to this key, **Latvia's share would be 0.40%,** i.e. €2.82 billion (including €324.4 million in paid-in capital)
- Latvia will benefit from a **temporary correction** (i.e. reduction) to its capital contribution key - this applies to new ESM members whose GDP per capita is less than 75% of the EU average
- Latvia's share during the correction period (until 2026) is **reduced to 0.27%** with a capital subscription of €1.93 billion, which includes **€221.2 million in paid-in capital**
- The paid-in capital will be paid by Latvia in **five annual instalments** of €44.24 million

Latvia was a pioneer in its adjustment strategy

- Latvia chose a path of **fiscal consolidation, structural reforms and nominal income cuts** (internal devaluation) rather than abandoning its peg to the euro
- Thanks to these efforts and financial assistance from the EU and international lenders, Latvia's **economic recovery has been remarkable**
- As a result of the adjustment, **Latvia's competitiveness improved** which sparked a rapid increase in exports
- Latvia has been the **fastest-growing economy** in the EU since 2012
- Latvia's strategy has become a successful example of **macroeconomic adjustment**, followed by EFSF/ESM programme countries

“Clean exit” from financial assistance programmes by Ireland and Spain

Ireland

- EFSF financial assistance programme **concluded on 8 December 2013**
- Ireland received a total of €67.5 bn in loans from international lenders; **€17.7 bn from the EFSF**
- Thanks to international support and a macroeconomic adjustment programme, Ireland’s **GDP is expanding** and **unemployment has been declining** for 9 consecutive months
- Ireland’s banking sector has undergone **significant correction** (downsizing, recapitalisation and deleveraging)

Spain

- ESM financial assistance programme (loan to Spanish government for bank recapitalisation) **concluded on 31 December 2013**
- Spain received **€41.3 bn** in loans (debt securities) from the ESM
- Thanks to ESM assistance, **banks have strengthened their capital, improved access to private funding and regained soundness**
- Successful bank restructuring has paved the way for Spain’s **real economy to rebound**

Measures to boost growth in EU

- Progress in resolving the euro crisis **removes important uncertainties for investors, consumers, banks and financial markets**
- **EFSF/ESM programmes include long list of structural reforms**
- **Coordinated action at national and EU level for Growth and Jobs**
  - Member States take action to achieve specific competitiveness goals
  - Member States coordinate policies to pursue growth-friendly fiscal consolidation and to restore lending to the economy
  - European "Marshall Plan" against youth unemployment
- **European Investment Bank (EIB)**
  - 90% of its lending supports sustainable growth and job creation
  - €10bn capital increase, which will raise lending capacity by €60 bn
  - EU-EIB Project Bond Initiative

Latest euro area growth figures are encouraging

- **GDP growth positive** in Q2 - Q4 2013 after 6 quarters of economic contraction
- **Industrial production** in euro area grew 1.8% in October 2013, the fastest pace in over 3 years
- **Business activity** and **consumer confidence indicators** in euro area rose significantly in final months of 2013
- European Commission forecast for growth in euro area: **1.2% in 2014 and 1.8% in 2015**
- **Latvia's** GDP growth is projected to be above 4% in 2013 and 2014, the highest in the EU

Source: Eurostat, European Commission

Conclusions: The euro crisis is not over yet . . .

. . . **but the end is in sight:**

- The euro area has moved **out of recession**
- Borrowing countries are reducing fiscal deficits and eliminating current account deficits as **competitiveness is restored**
- **Interest rate differences** between Northern and Southern Europe have been **cut by more than half**
- **Unemployment has stopped rising**, industrial production is growing and confidence indicators are up

Conclusions: Certain risks to economic recovery are still present

- Borrowing countries need to continue their **difficult adjustment**
- Some of them need continued **financial support**
- **Financial markets** in Europe are **fragmented**
- Potential growth in Europe will be **limited**

Yet we should keep in mind that . . .

- History shows that crises generally trigger **positive changes**
- This is also true in Europe: monetary union **will emerge stronger** when the crisis is over