NATIXIS

FLASH ECONOMICS
ECONOMIC RESEARCH

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# The euro-zone crisis may last 20 years

***We should not believe that the euro-zone crisis will be solved rapidly.***

***All the following conditions must be met before the euro zone can pull out of the crisis:***

- ***the private sector must be sufficiently deleveraged in the countries where it is over-indebted (Spain, Greece, Ireland, Netherlands), especially after the fall in real estate prices;***
- ***the economies must have created jobs to replace those lost due to deindustrialisation and the bursting of the real estate bubble (France, Italy, Spain, Greece, Ireland, Portugal);***
- ***the fiscal deficits must have been reduced despite the weakness of activity;***
- ***the countries that have a structural external deficit must have wiped it out (reindustrialisation, improvement in competitiveness, decline in demand), or federalism must have been implemented.***

**ECONOMIC RESEARCH**
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***All this will take a very long time, which means there is a risk of major and long-lasting economic, financial, social and political instability, hence also one of depressed financial asset prices and high volatility in the financial markets for a long time to come.***

**The financial markets sometimes believe that the euro-zone crisis will be solved rapidly**

**The rather limited progress towards resolving the euro-zone crisis** (ECB's VLTRO from end-2011; European summit in June 2012 with decisions concerning banking supervision and recapitalisation, the implementation of the ESM) **has admittedly led to a major, but temporary improvement financial markets (Charts 1A** and **B)**.

**Chart 1A**
**Euro zone: Stock market index and credit spreads**

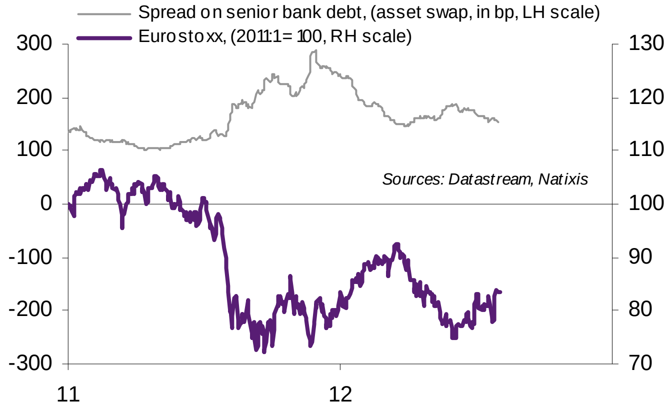
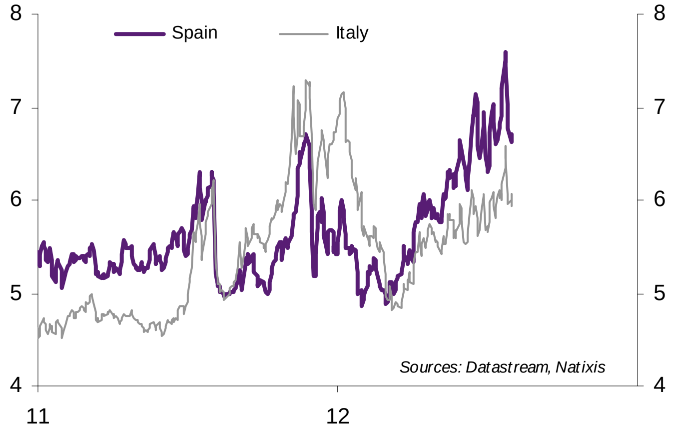



**Chart 1B**
**Interest rate on 10-year government bonds**




**But the financial markets should understand that the euro-zone crisis will be very long, given the developments that are needed to end it:**

- rebalancing of the balance sheets of private economic agents;
- restoration of full employment;
- reduction in fiscal deficits;
- correction of external deficits, or federalism.

**The long-term developments required to end the euro-zone crisis**

## 1. Rebalancing of balance sheets

In the euro zone as a whole, and especially in some countries (Spain, Greece, Ireland, Netherlands), **an imbalance has appeared in the balance sheets of private economic agents between liabilities** (due to a very high private-sector debt ratio, **Chart 2A**) **and assets** (due to the bursting of the real estate bubble and the fall in real estate prices, **Chart 2B**).

**Chart 2A**
**Household + corporate debt (as % of GDP)**

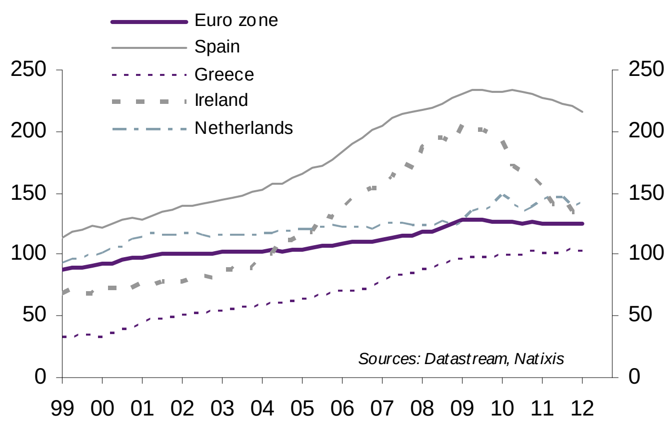
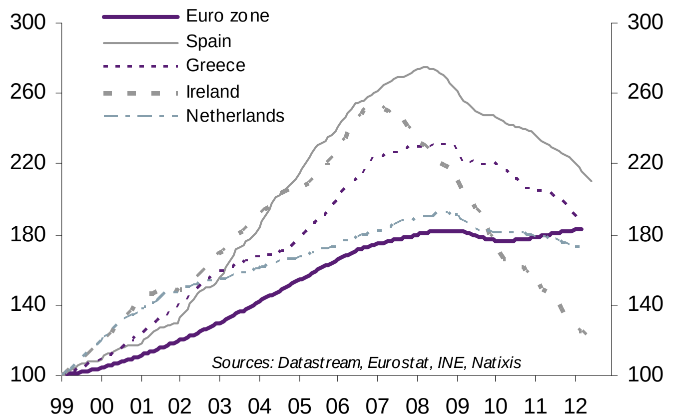



**Chart 2B**
**Real estate prices (1999:1 = 100)**



**As long as this balance sheet mismatch lasts**:

- **the private sector has to deleverage (Chart 3A)**, and therefore reduce its spending **(Chart 3B), leading to sluggish growth;**

- **private borrowers' solvency will be poor (Chart 3C)**, which means that there is no end in sight for the **banks' problems**.

**Chart 3A**
**Loans to the private sector* (Y/Y as %)**

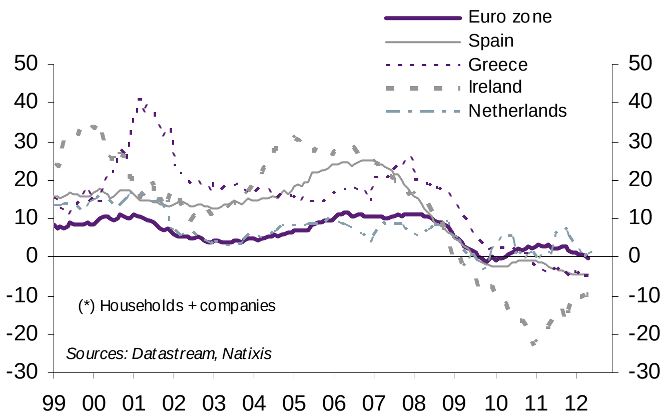



**Chart 3B**
**Domestic demand (in volume terms, Y/Y as %)**

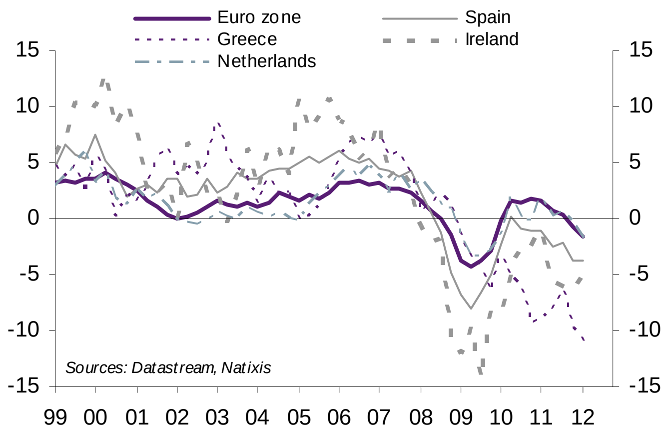
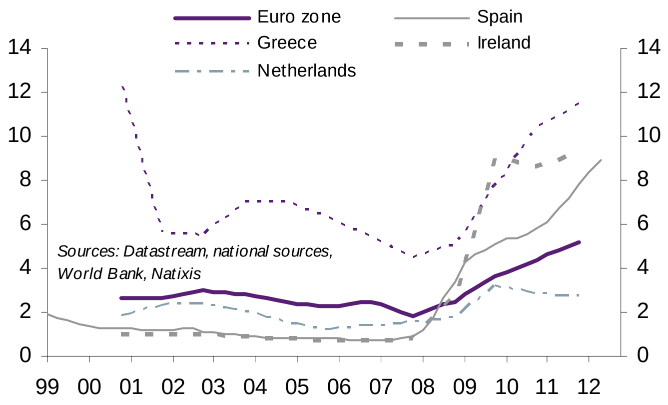



**Chart 3C**
**Non-performing loans (as % of total loans)**




## 2. Restoration of full employment

The 2009 crisis, in the aftermath of the Lehman bankruptcy, led to **heavy factory job losses** due to the fall in global trade; then the bursting of the real estate bubble triggered a **decline in construction employment**.

All in all, many countries (France, Italy, Spain, Greece, Ireland, Portugal) currently have a **very pronounced shortfall in employment (Charts 4A, B** and **C)**, and therefore a **very high level of unemployment (Chart 5)**.

**Chart 4A**
**Manufacturing employment (1999:1 = 100)**

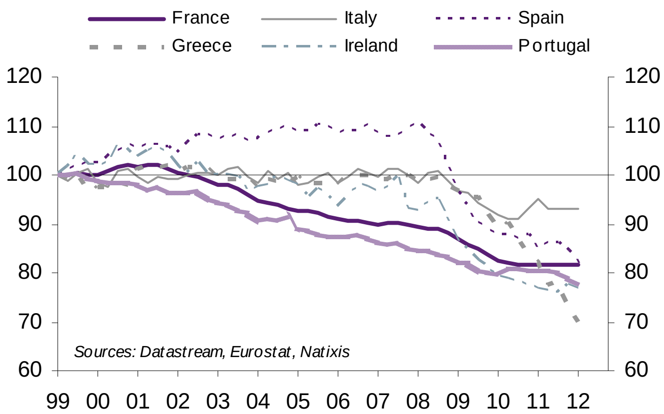



**Chart 4B**
**Employment in construction (1999:1 = 100)**

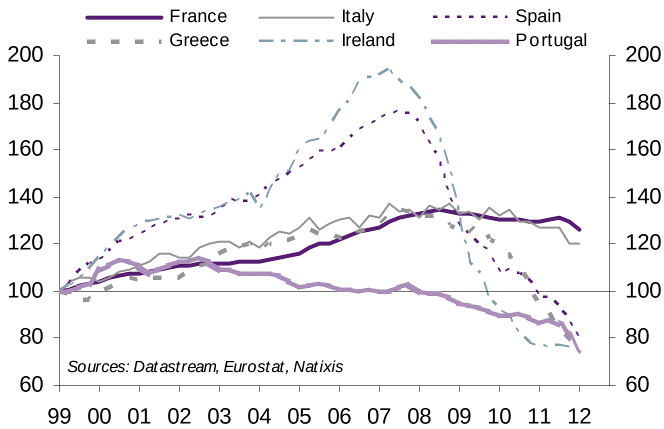



**Chart 4C**
**Total employment (1999:1 = 100)**

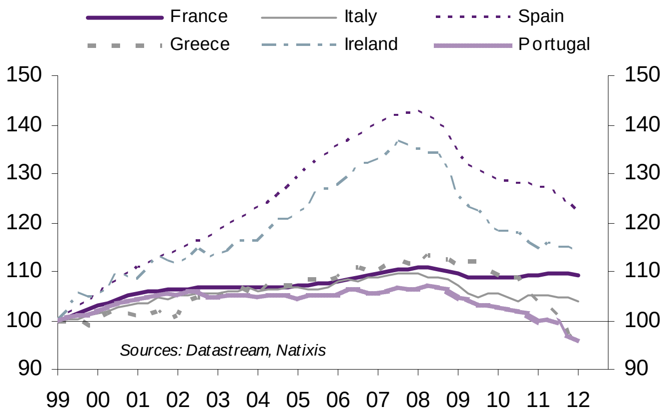
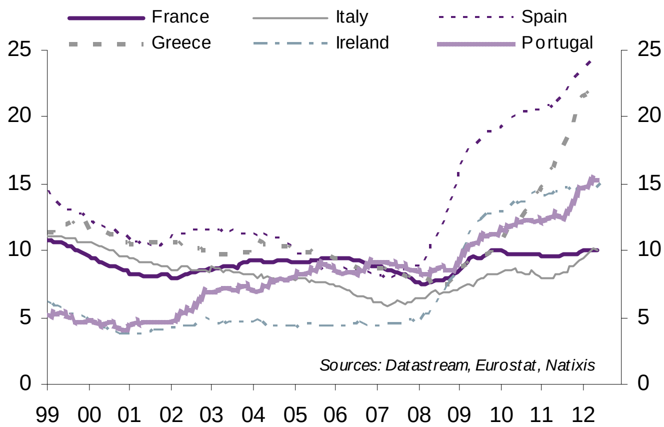



**Chart 5**
**Unemployment rate**




This has generated a **depressive cycle**, since high unemployment leads to a decline in labour's bargaining power and a fall in real wages **(Chart 6)**.

**The crisis will not end before the economies have pulled out of this depressive cycle, i.e. when the job losses have been offset by new jobs. But this process has not yet started**, and would require several measures: attracting new activities to these countries and reindustrialising them. However, this is not happening, as reflected by **the trend in industrial production capacity (Chart 7)**, which is still declining.

**Chart 6**
**Real per capita wage (deflated by the consumer price deflator, Y/Y as %)**

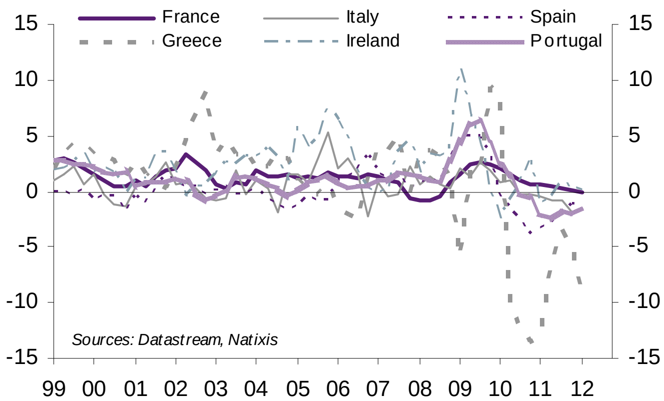
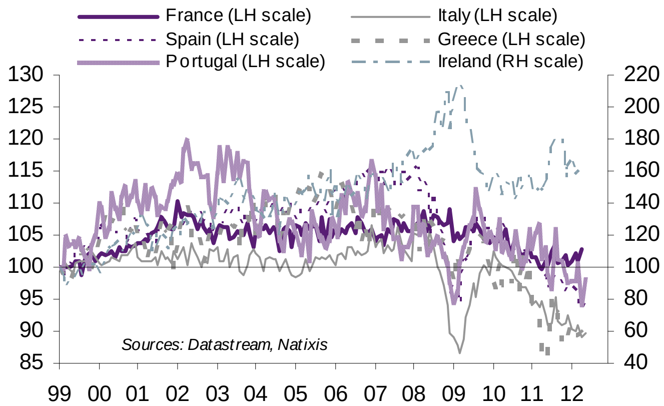



**Chart 7**
**Production capacity in the manufacturing sector (in volume terms, 1999:1 = 100)**



### 3. Elimination of fiscal deficits

The sovereign debt crisis is obviously linked to **excessive fiscal deficits** in many countries **(Chart 8)**.

The governments would like to eliminate these fiscal deficits, which will be **required to permanently drive down long-term interest rates (Chart 9), but in 2012 we can see a very worrying development: the fiscal deficits are not shrinking;** on the contrary, they are increasing **(Charts 10A** to **F)** because of the sluggish activity **(Charts 11A** and **B)**.

**Chart 8**
**Fiscal deficit (as % of GDP)**

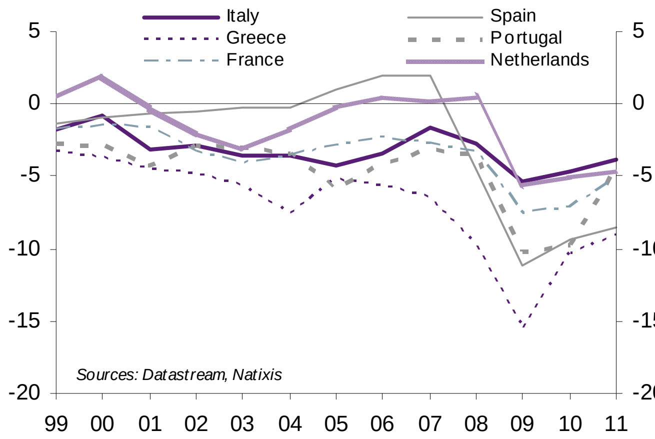



**Chart 9**
**Interest rate on 10-year government bonds (as %)**

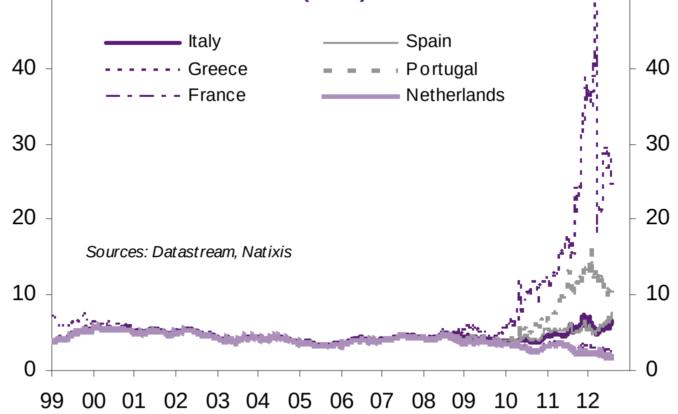



**Chart 10A**
**Italy: Cumulative fiscal deficit (in EUR bn)**

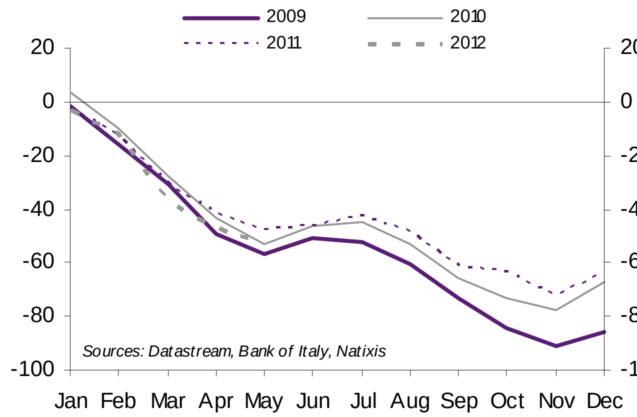



**Chart 10B**
**Spain: Cumulative fiscal deficit (in EUR bn)**

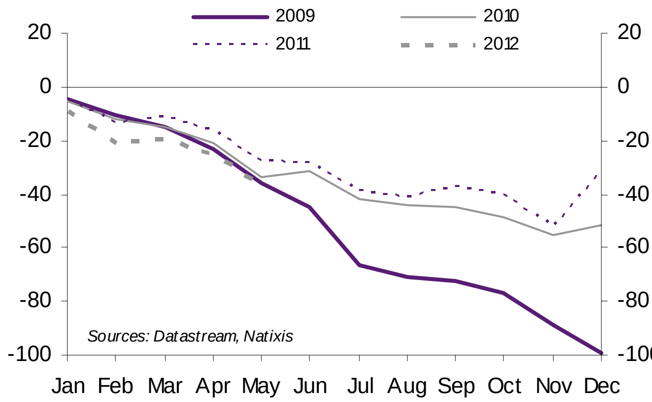



**Chart 10C**
**Greece: Cumulative fiscal deficit (in EUR bn)**

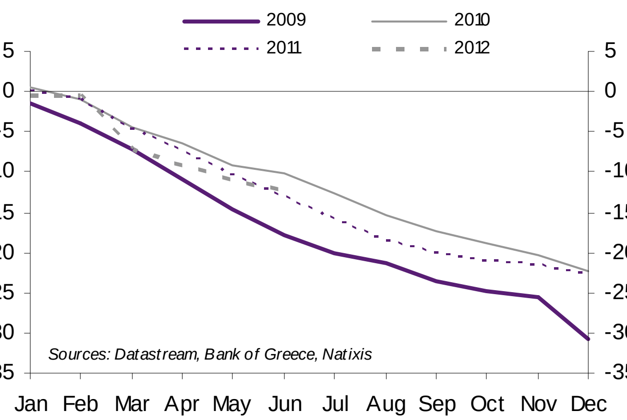



**Chart 10D**
**Portugal: Cumulative fiscal deficit (in EUR bn)**

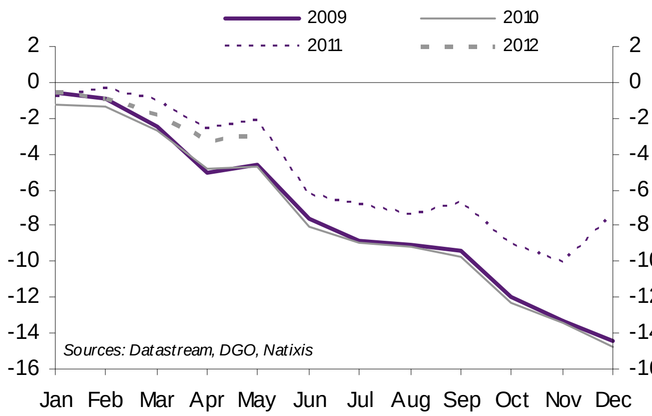


Chart 10E
France: Cumulative fiscal deficit (in EUR bn)

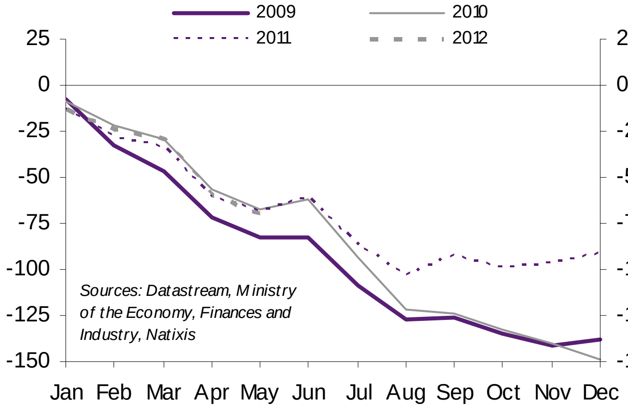



Chart 10F
Netherlands: Cumulative fiscal deficit (in EUR bn)

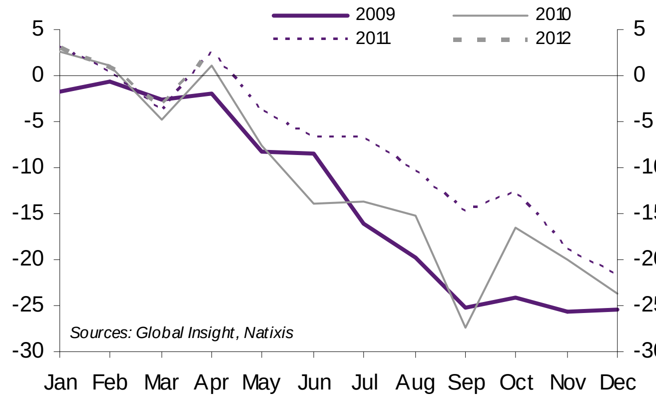



Chart 11A
Real GDP growth (Y/Y as %)

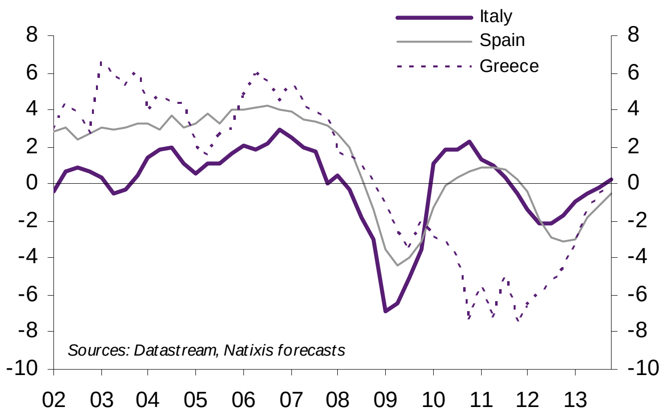
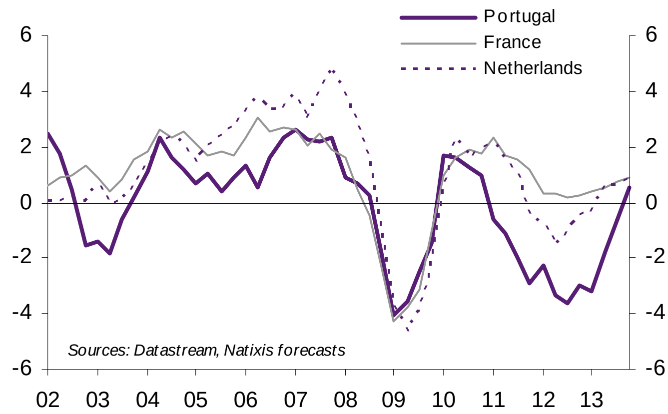



Chart 11B
Real GDP growth (Y/Y as %)




## 4. If there is no federalism, the structural external deficits must disappear

**Some countries** (Spain, Greece, Portugal, France) **have structural external deficits (Chart 12A)** because of the **small size of their exporting sectors**, especially in industry **(Charts 12B** and **C)**.

Chart 12A
Current-account balance (as % of GDP)

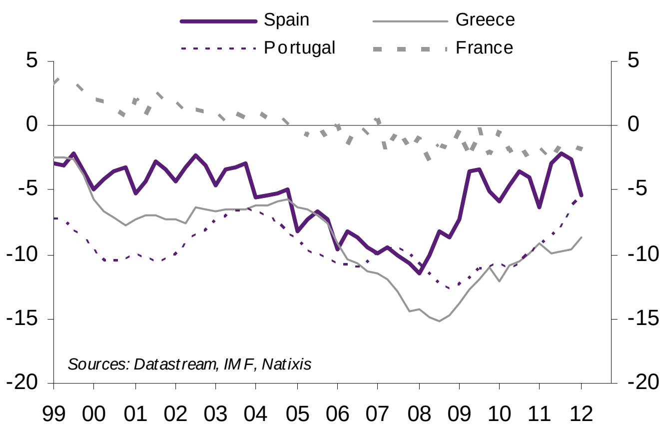



Chart 12B
Manufacturing employment (as % of total)

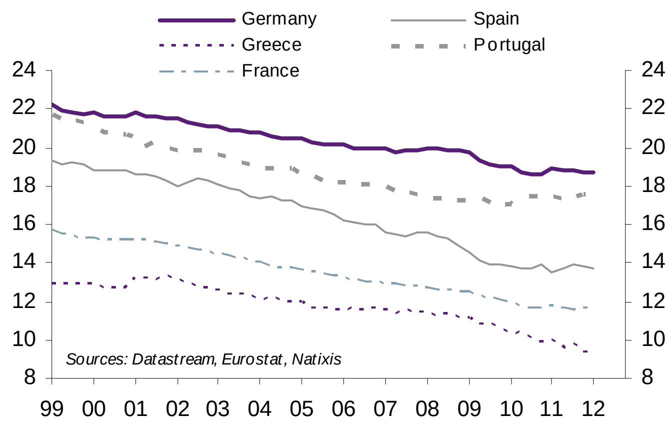
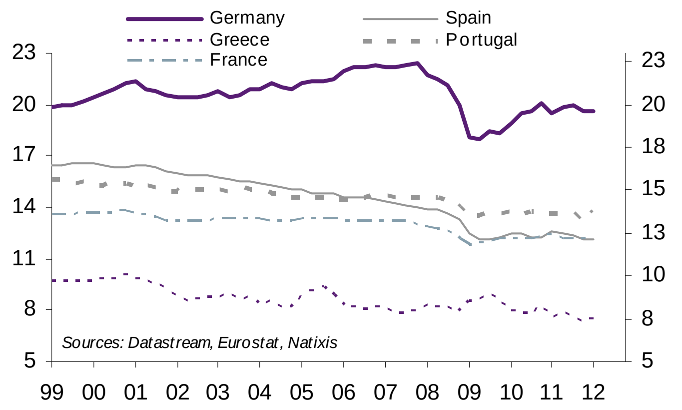


Chart 12C
Value added in the manufacturing sector
(in volume terms, as % of GDP)




**This situation is not sustainable**, since these countries are accumulating a continuously growing external debt, and will **end up becoming insolvent**.

There are then only **two solutions, both of which take a very long time**:

- **federalism**, i.e. the implementation of transfers from surplus countries to deficit countries; this organisation of the euro zone (a "transfer union") is currently being rejected;

- **reindustrialisation of countries with a deficit**.

**Conclusion: We should not expect a rapid end to the crisis in the euro zone**

**The euro-zone crisis will not end before:**

- the private sector is sufficiently deleveraged;
- the economies have created new jobs to replace those lost in industry and construction;
- the fiscal deficits have been sharply reduced;
- in the absence of federalism, the external deficits are eliminated.

All this will take a very long time (20 years?).
**The economic, financial, social and political uncertainty will therefore be pronounced in the euro zone for a long time to come. For the financial markets, this points to a depressed level of prices due to the high risk level, and high volatility (Charts 13A** and **B).**

Chart 13A
Euro zone: Stock market index and bank CDS

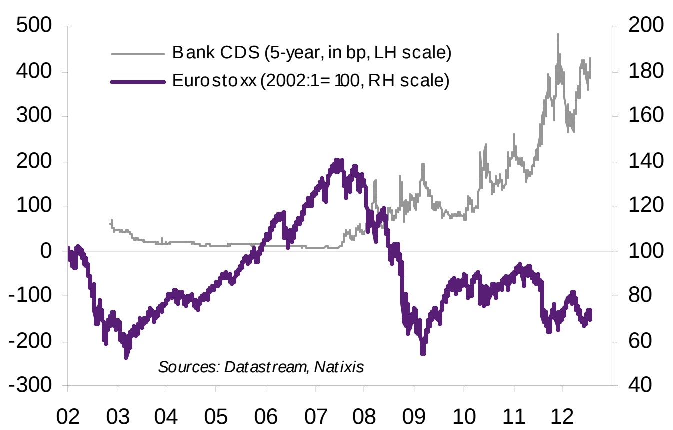
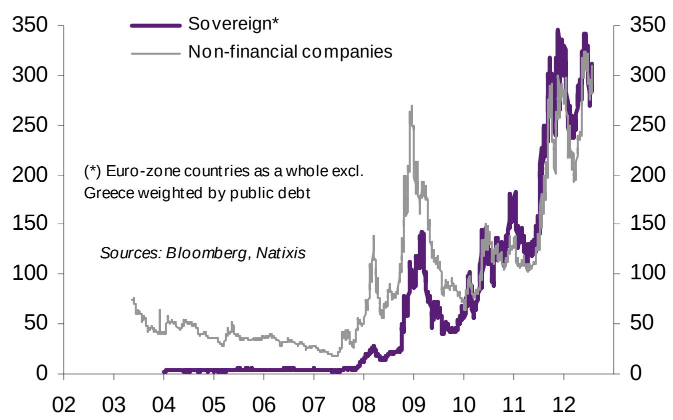



Chart 13B
Euro zone: CDS (5-year, in bp)



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