

Is it possible to get over a banking crisis? Comparative analysis of Ireland and Iceland

By [Céline Antonin](#) and [Christophe Blot](#)

In economics, miracles sometimes prove to be mirages. Iceland and Ireland are witnesses. These two small open economies, paradises of liberalized deregulated finance, harboured growth in the early 2000s, but were hit hard by the financial crisis. The subsequent almost complete nationalization of their financial systems has had a negative impact on the public debt of the two countries. To stem the rising debt and the risk of unsustainability, since 2010 the two governments have implemented fiscal austerity plans, but with a difference: Ireland belongs to the euro zone, while Iceland doesn't. The latest [Note of the OFCE \(no. 25 dated 4 February 2013 \[in French\]\)](#) reviews the recent macroeconomic and financial situation of the two countries to show the extent to which different policy mixes may account for different trajectories for a recovery.

While in Iceland the banking crisis was amplified by a currency crisis, the depreciation of the crown was then a factor in the recovery, so that the country is now growing again. GDP was very volatile: between the third quarter of 2007 and the second quarter of 2011, GDP declined by more than 13%, but has rebounded by 5.7% since. There was less volatility and a shorter recessionary phase in Ireland than in Iceland (8 quarters), and the amplitude of the decline was smaller (-10.7%). However, the recovery is more timid, with GDP growth of only 3.4% since late 2009.

Our analysis leads us to two main conclusions: first, an internal devaluation is less effective than an external devaluation; and second, fiscal consolidation is less costly when it is accompanied by favourable monetary conditions and exchange policy. It is in light of these points that one can redefine the optimal policy mix in the euro zone, as we suggest in more detail in the [iAGS](#) report. An active monetary policy is essential to allow the refinancing of the public debt. The European Central Bank should therefore act as lender of last resort for the member countries. The countries running a surplus need a “reflationary” policy to help reduce their current account imbalances. Fiscal adjustments should be relaxed or even postponed to allow a more rapid return to growth.

Has monetary policy become ineffective?

By [Christophe Blot](#), [Catherine Mathieu](#) and Christine Riffart

This text summarizes the [special study](#) of the October 2012 forecast.

Since the summer of 2007, the central banks of the industrialized countries have intervened regularly to counter the negative impact of the financial crisis on the functioning of the banking and financial system and to help kick-start growth. Initially, key interest rates were lowered considerably, and then maintained at a level close to 0 [\[1\]](#). In a second phase, from the beginning of 2009, the central banks implemented what are called unconventional measures.

While these policies may differ from one central bank to another, they all result in an increase in the size of their balance sheets as well as a change in the composition of their balance sheet assets. However, three years after the economies in the United States, the euro zone and the United Kingdom hit bottom, it is clear that recovery is still a ways off, with unemployment at a high level everywhere. In Europe, a new recession is threatening [\[2\]](#). Does this call into question the effectiveness of monetary policy and of unconventional measures more specifically?

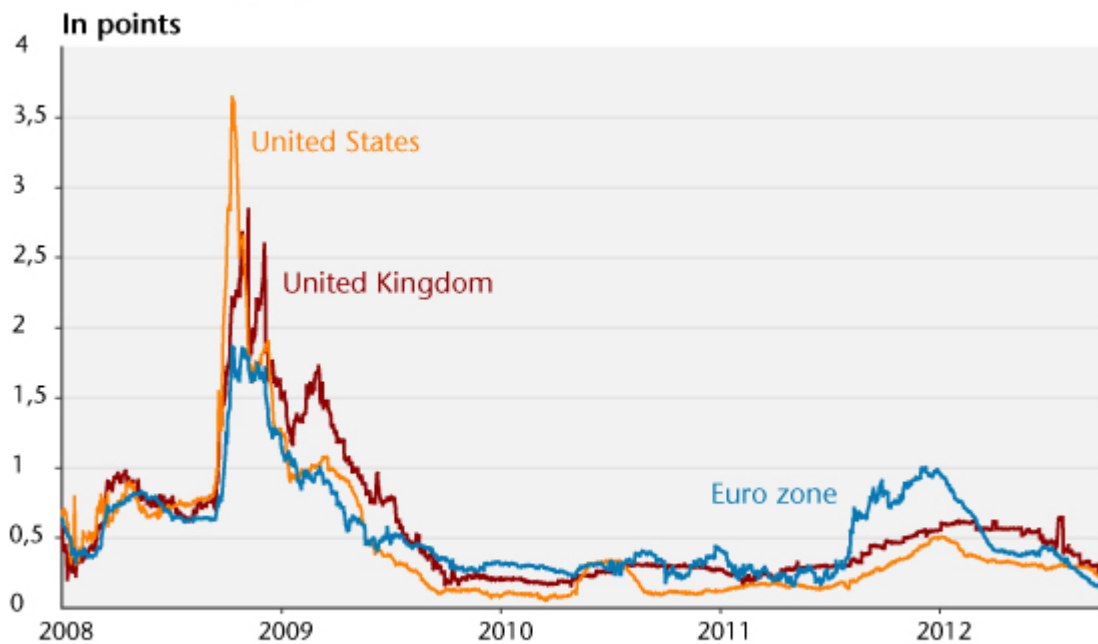
For almost four years, a wealth of research has been conducted on the impact of unconventional monetary policies [\[3\]](#). Cecioni, Ferrero and Sacchi (2011) [\[4\]](#) have presented a review of recent literature on the subject. The majority of these studies focus on the impact of the various measures taken by the central banks on financial variables, in particular on money market rates and bond yields. Given the role of the money market in the transmission of monetary policy, the ability of central banks to ease the pressures that have emerged since the beginning of the financial crisis constitutes a key vector for effective intervention. More recently, this was also one of the reasons motivating the ECB to conduct an exceptional refinancing operation in two stages, with a maturity of 3 years. This intervention has indeed helped to reduce the tensions on the interbank market that had reappeared in late 2011 in the euro zone, and to a lesser extent in the United States and the United Kingdom (see graph). This episode seems to confirm that central bank action can be effective when it is dealing with a liquidity crisis.

Another critical area of debate concerns the ability of unconventional measures to lower interest rates in the long term and thereby to stimulate activity. This is in fact an important lever for the transmission of monetary policy. The findings on this issue are more mixed. Nevertheless, for the United States, a study by Meaning and Zhu (2012) [\[5\]](#) suggests

that Federal Reserve programs to purchase securities have contributed to lowering the rates on 10-year US Treasury bills: by 60 points for the first “Large-scale asset purchase” program (LSAP1) and by 156 points for LSAP2. As for the euro zone, Peersman [\[6\]](#) (2011) shows that the impact of unconventional measures on activity has in general closely resembled the effect of lowering the key interest rate, and Gianone, Lenza, Pill and Reichlin [\[7\]](#) (2012) suggest that the various measures taken by the ECB since the beginning of the crisis have helped offset the rise in the unemployment rate, although the impact is limited to 0.6 point.

Under these conditions, how is it possible to explain the weakness or outright absence of a recovery? One answer evokes the hypothesis of a liquidity trap [\[8\]](#). Uncertainty is still prevalent, and the financial system is still so fragile that agents are continuing to express a preference for liquidity and safety, which explains their reluctance to undertake risky projects. Thus, even if financing conditions are favourable, monetary policy will not be sufficient to stimulate a business recovery. This hypothesis probably explains the timidity of the recovery in the United States. But in the euro zone and the United Kingdom this hypothesis needs to be supplemented with a second explanation that recognizes the impact of restrictive fiscal policies in holding back recovery. The euro zone countries, like the UK, are pursuing a strategy of fiscal consolidation that is undermining demand. While monetary policy is indeed expansionary, it is not able to offset the downward pressure of fiscal policy on growth.

Graphique. Tensions on the interbank markets*



* The tensions are measured by the spread between the interbank rates (Libor ou Euribor) and the overnight interest rate swap (OIS).

Source : Datastream.

[1] One should not, however, forget the exception of the ECB, which prematurely raised its key interest rate twice in 2011. Since then it has reversed these decisions and lowered the key rate, which has stood at 0.75% since July 2012.

[2] The first estimate of UK GDP for the third quarter of 2012 indicates an upturn in growth following three quarters of decline. However, this rebound is due to unusual circumstances (see [Royaume-Uni: l'enlissement](#)), and activity will decline again in the fourth quarter.

[3] Unconventional monetary policies have already been analyzed repeatedly in the case of the Bank of Japan. The implementation of equivalent measures in the United States, the United Kingdom and the euro zone has contributed to greatly amplifying the interest in these issues.

[4] ["Unconventional monetary policy in theory and in practice"](#), *Banca d'Italia Occasional Papers*, no.102.

[5] ["The impact of Federal Reserve asset purchase programmes:](#)

[another twist](#)", *BIS Quarterly Review*, March, pp. 23-30.

[6] "[Macroeconomic effects of unconventional monetary policy in the euro area](#)", ECB Working Paper no.1397.

[7] "[The ECB and the interbank market](#)", CEPR Discussion Paper no. 8844.

[8] See [OFCE](#) (2010) for an analysis of this hypothesis.

The euro zone: confidence won't be enough

By [Céline Antonin](#), [Christophe Blot](#) and Danielle Schweisguth

This text summarizes the OFCE's October 2012 forecasts for [the economy of the euro zone](#).

After more than two years of crisis in the euro zone, this time the meeting of the European Council, held on 18 and 19 October, had nothing of the atmosphere of yet another last-chance summit. Even though discussions on the future banking union [\[1\]](#) were a source of tension between France and Germany, there was no sword of Damocles hanging over the heads of the European heads of state. However, it would be premature to assume that the crisis is coming to an end. It is sufficient to recall that the GDP of the euro zone has still not regained its pre-crisis level, and in fact declined again by 0.2% in the second quarter of 2012. This decline is forecast to continue, as we expect GDP to fall by 0.5% in 2012 and by 0.1%

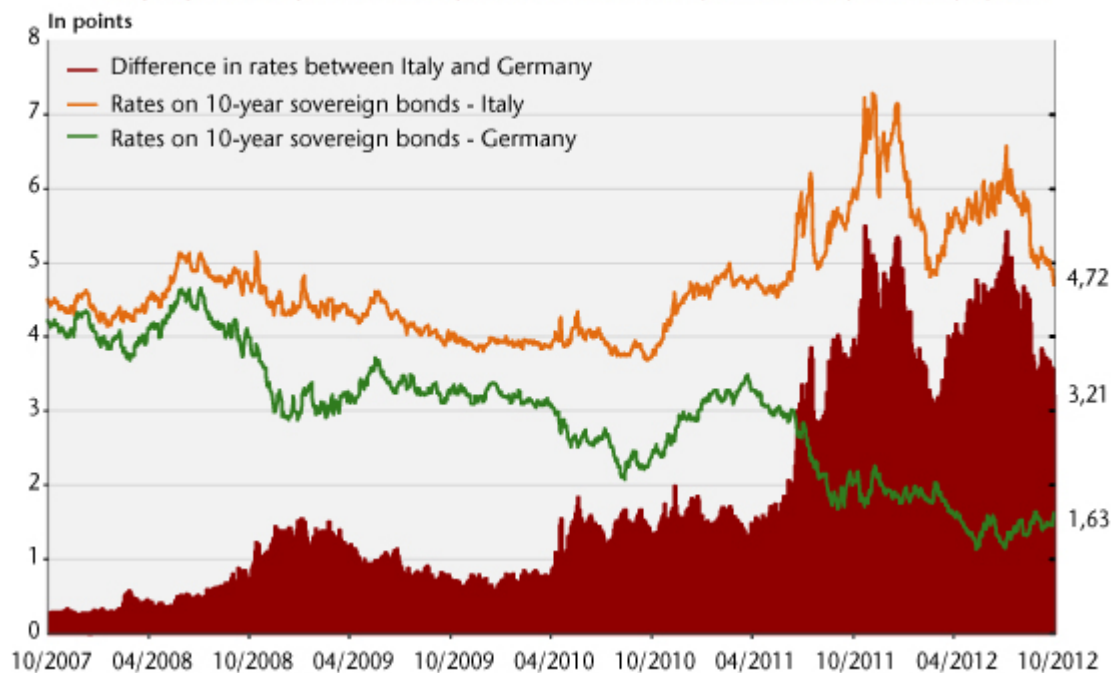
in 2013. Consequently, the unemployment rate in the euro zone, which has already surpassed its previous historical record from April 1997, will rise further, reaching 12.1% by end 2013. What then are the reasons for the lull? Can the euro zone quickly resume its growth and hope to finally put an end to the social crisis?

Since the end of 2011, Europe has adopted a new treaty (the Treaty on stability, coordination and governance, the TSCG) which is being ratified in the 25 signatory countries. The new law is specifically intended to strengthen both budgetary discipline – through the adoption of national golden rules – and solidarity through the creation of the European Stability Mechanism (ESM), in so far as the use of the ESM is conditional on ratification of the TSCG. On 6 September, the ECB unveiled the basic points of its new conditional purchase of sovereign debt ([see here](#)), which is aimed at reducing the interest rates of countries subject to the ESM. Thus, the risk premium, as measured by the difference between the Italian and Spanish sovereign interest rates and the German rate, after peaking on 24 July 2012, decreased respectively by 2.2 and 2.5 points (Figures 1 and 2). This is of course still far from normal, but this lull is nevertheless welcome and it shows that the spectre of a breakup of the euro zone has receded.

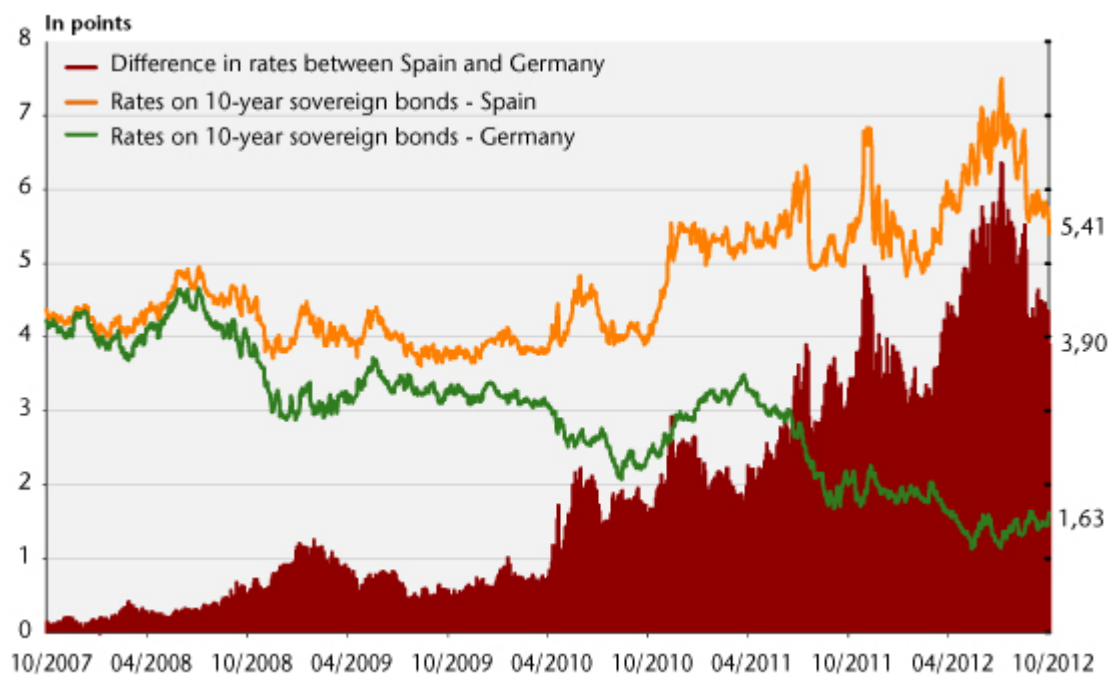
Could this new wave of optimism be a precursor to an upturn in the economy of the euro zone? The answer to this question is, unfortunately, negative. The fiscal policies of countries in the zone are still highly restrictive, a situation that has even intensified in 2012, pushing Italy and Spain back into recession and deepening the recession that was already hitting Portugal and Greece. For the euro zone as a whole, the fiscal stimulus will come to 1.7 percent of GDP in 2012 (table). The series of votes on national budgets confirms this strategy of a forced reduction of budget deficits for 2013, with the overall fiscal consolidation for the euro zone as a whole coming to 1.3%. There will be significant differences between

the countries, since in Germany the fiscal stimulus will barely be negative (-0.2 point) while in Spain, Italy and Greece it will be more than -2 GDP points. However, the recessionary impact of this synchronized fiscal consolidation will be even greater given that the euro zone countries are still at the bottom of the economic cycle. In these conditions, the targets for budget deficit reduction will not be met, which will inevitably raise the question of the appropriateness of further budget cuts. More and more Member States thus risk being caught in a vicious circle where low growth calls for further fiscal adjustments that in turn deepen the economic and social crisis. It is essential that any decision about improving the governance of the European Union or the transmission of monetary policy restores confidence and creates the conditions for a return to growth. But this will be insufficient to escape the recession and should not obscure the impact of the fiscal strategy.

Graphique 1. Long-term sovereign interest rates in Italy and the Italy-Germany Spread



Graphique 2. Long-term sovereign interest rates in Spain and the Spain-Germany Spread



Source : Datastream.

Tableau. Fiscal stimulus in the euro zone countries

In GDP points

	2009	2010	2011	2012	2013
Germany	0,7	1,5	-0,9	-0,5	-0,2
Austria	0,4	0,6	-1,6	-0,1	-0,9
Belgium	1,9	-0,3	-0,1	-1,1	-0,8
Spain	3,8	-2,5	-1,1	-3,4	-2,4
Finland	0,4	1,5	-1,6	-0,4	-1,3
France	2,3	-0,5	-2,9	-1,6	-1,8
Greece	3,2	-8,0	-5,3	-5,0	-3,9
Ireland	2,2	-4,4	-1,5	-2,4	-1,8
Italy	0,8	-0,4	-1,2	-3,2	-2,1
Netherlands	4,0	-1,1	-0,2	-1,0	-1,2
Portugal	5,0	-0,7	-3,7	-3,7	-1,8
Euro zone 11*	1,8	-0,3	-1,3	-1,7	-1,3

* Excluding Cyprus, Luxembourg, Malta, Slovakia, Slovenia and Estonia.

Note : The fiscal stimulus is measured by the opposite of the variation in the cyclically adjusted primary balance, that is, excluding interest charges and exceptional revenue: it approximates the discretionary budget policy.

Sources : OFCE calculations and forecasts, October 2012.

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[1] See [here](#) for an analysis of the importance of the proposed banking union and the questions it raises.

