

Special Report

Euro area: Reform or retreat



Highlights

- Since the global financial crisis, the question of whether the euro will survive has periodically arisen. Greece's third bailout demonstrated a strong political commitment to the euro, but also revealed deep tensions. EMU is still far from being an optimal currency area, and cannot stand still if future crises are to be avoided.
- Through the turbulence of recent years, the region has taken major steps to strengthen institutions and governance. But it is not enough to 'do what it takes' in the heat of a crisis. More reforms are needed, to labour and product markets, and to the business environment.
- Policy makers need to accelerate risk-sharing: a common deposit insurance fund, capital markets union and a European unemployment insurance scheme would smooth the impact of future shocks.
- The question is whether Europe is up for it. Leaders should take note of consistently solid popular support for the euro, now close to 70%. With fiscal adjustments largely completed and monetary policy finally gaining traction, now is the time for integration and reform.

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Introduction



Euro-area integration – Work in progress

Summary

“Europe will be forged in crises”

The founding father of the EU, Jean Monnet, said in his memoirs in 1976 that “Europe will be forged in crises, and will be the sum of the solutions adopted for those crises”.

Since the global financial crisis (GFC), the question of whether the euro will survive has come to the fore on several occasions. The euro area came to the closest point of losing a member in July when bailout negotiations with Greece went down to the wire. Our aim with this report is to analyse this question from a long-term perspective.

The single currency remains an unfinished project

The report looks at the theory behind European integration, and assesses what has been done to make the euro-area currency union more ‘optimal’. The euro’s current challenges exist largely because the single currency remains an unfinished project, and we believe it has to evolve in order to survive. We outline the most important steps that have to be taken to avoid a break-up in the future.

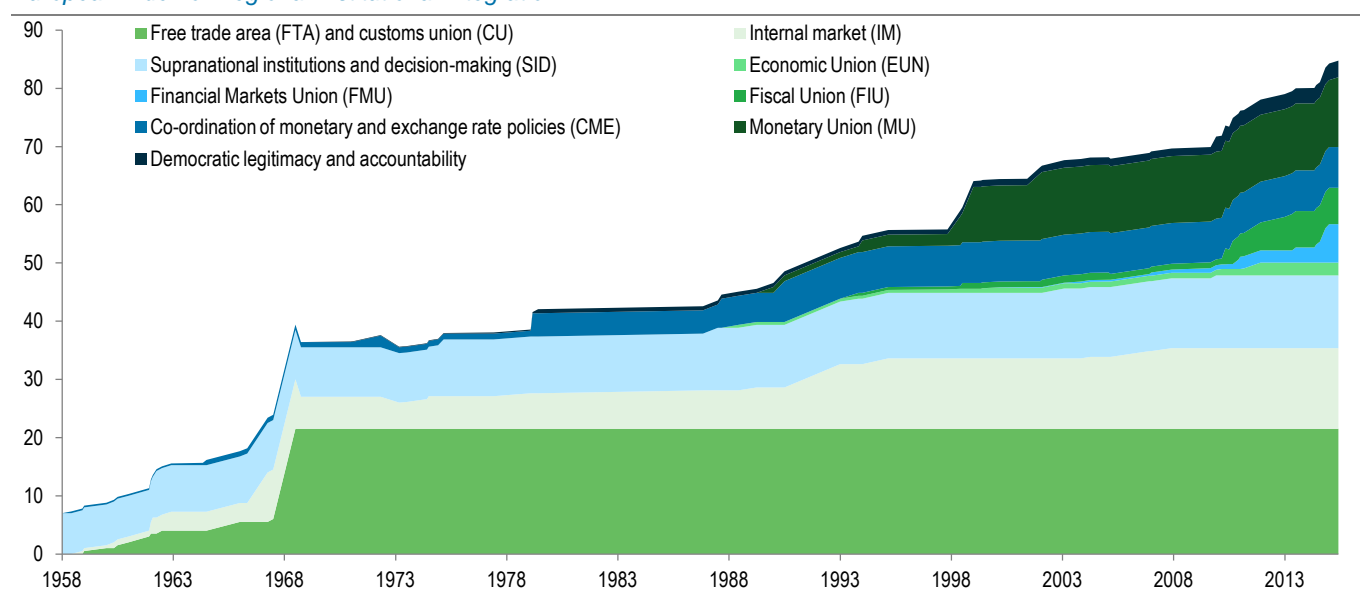
The euro will survive as long as the political will to preserve it is intact

In our view, the euro will survive as long as the political will to preserve the union remains. Political opposition to the single currency is increasingly evident in the euro area’s core as well as its periphery, and popular support for the euro usually falls during a recession. We believe, therefore, that policy makers urgently need to address the structural impediments that keep growth low and fast-track institutional reforms to improve risk-sharing across the region.

The most pressing steps in the short term are to complete the banking union, fast-track reform of labour markets and the business environment, and ‘put the Grexit genie back in the bottle’. Long-term, the ‘forged in crises’ approach to integration may not be sufficient to ensure the survival of the European project. A more proactive integration model is needed, in our view, aiming ultimately at a euro-area fiscal authority with a dedicated budget.

Figure 1: Integration has gone into overdrive since the GFC

European Index of Regional Institutional Integration



Source: Dorrucci, E, D Ioannou, F P Mongelli, and A Terzi (2015), “The Four Unions “PIE” on the Monetary Union “CHERRY”: A New Index of European Institutional Integration”, ECB Occasional Paper No. 160 (February), Standard Chartered Research

The euro crisis was a wake-up call for policy makers

Introduction

The euro crisis was a wake-up call for euro-area policy makers, revealing institutional deficiencies in the structure of the European Monetary Union (EMU). The creation of the single currency was, from the beginning, primarily a project driven more by political motivation than economic grounds. Many economists had pointed out before the creation of the euro that even the original EMU members could not be regarded as forming an optimal currency area. European leaders believed that by adopting the euro, member states would be forced to subsequently move towards more economic and political integration. They believed that an agreed set of convergence criteria would be enough to ward off the negative consequences of irrevocably fixing exchange rates.

Euro-area economies have underperformed the US

But euro-area economies have failed to converge since the introduction of the euro, raising questions about the value of tying policy-making to a single-currency regime, particularly since the negative consequences have been very much in evidence in recent years. Since the onset of the GFC, core euro-area economies have underperformed the US, while peripheral economies have yet to recover their pre-GFC level of GDP. The consequence has been a growing disillusionment with euro-area institutions. The crisis has given institution-building an added impetus, and much has been done to achieve a more solid framework for the single-currency area. But radical and anti-euro political parties have become more popular, even though support for the euro remains steadfast in most countries.

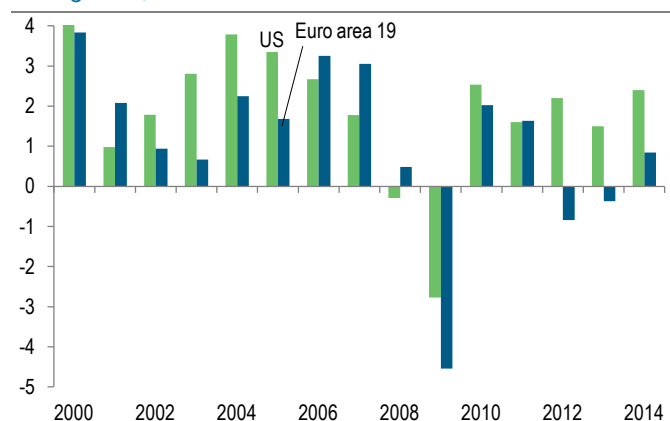
Convergence has been held back by structural rigidities and weak institutions

We argue that convergence in the past has been held back by structural rigidities and weak institutions, although there has been substantial progress in tackling both. The region's underperformance in recent years was down to a policy squeeze and the shock of the first Greek crisis. Now, governments are no longer tightening policy to cut fiscal deficits, and credit is growing again after a prolonged period of bank deleveraging as institutions cleaned up their balance sheets.

The backdrop: unsustainable growth

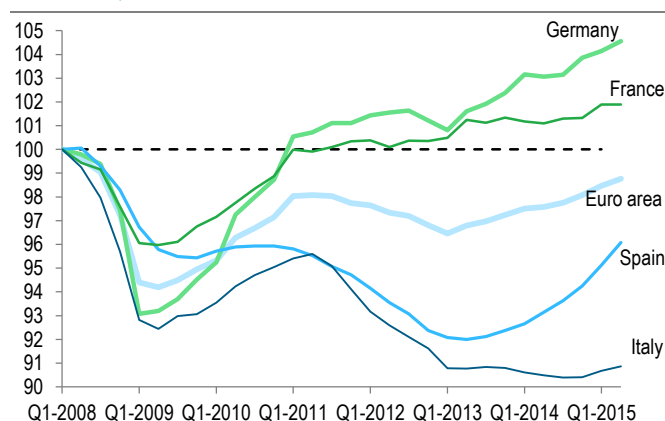
Ahead of the GFC, the euro-area periphery experienced strong capital inflows (and widening current account deficits). Ideally, these flows would have supported the periphery's convergence with wealthier countries by raising productivity growth and incomes. Inefficient markets (including those with a high degree of employment protection and inflexible wages, and industries sheltered from competition) resulted in a misallocation of capital and failed to provide the environment for sustainable

Figure 2: The US has generally outpaced the euro area
GDP growth, %



Source: OECD, Standard Chartered Research

Figure 3: Diverging economies in the euro area
Real GDP, rebased to Q1-2008



Source: Eurostat, Standard Chartered Research



growth. Macro-prudential tools were too weakly applied (if at all), resulting in a credit boom and bust in several countries. When the crisis hit, the flows halted and the adjustment process was painful.

Positive economic and institutional developments in recent years

Most countries have corrected imbalances

Most countries have corrected their current account (C/A) imbalances, initially through domestic recession (dampening import demand), but also by improving competitiveness. Fiscal deficits have been reduced through prolonged austerity. Employment prospects have improved and unemployment has fallen to its lowest level in three-and-a-half years. However, the unemployment rate remains too high – more than twice that of the US – and it is important that the declining trend continues. Europe is particularly poor at finding work for its young and older workers – the employment-to-population ratio for the 25-54 age group is better than in the US, but employment rates are much lower for under-25s and older workers, suggesting that further labour market reforms are needed.

Productivity, which determines long-run GDP growth prospects, remains weak, rising just 1.5% between 2000 and 2014 compared with 10.9% in the US. This is partly due to weaker investment in the euro area than in the US. With credit and confidence returning to the region, the investment climate has become more favourable and reforms are likely to deliver stronger returns. Recent institutional developments will also improve the environment for investment. The banking union is finally supporting better transmission of monetary policy: credit markets are less fragmented, and demand and supply of bank loans to the private sector is accelerating.

The question of whether debt write-downs will be required across the euro area has been asked numerous times. It remains a contentious point, but not one that we believe is a deal-breaker for further integration.

We think Greece is a special case in requiring debt restructuring

After the deal for the third Greek bailout the question of debt restructuring became less of a taboo. That said, some member states remain reluctant to acknowledge that Greek debt needs restructuring, even after clear advice to that effect from the IMF. This suggests that the euro area is still far from the burden-sharing mindset that would be required for debt restructuring on a grander scale.

Our view is that Greece is a special case that can be managed within the existing rules and framework of EMU; we do not believe that debt write-downs are required across the euro area as a necessary condition for the euro to survive.

High public debt was not a cause of the crisis, but significantly limited the response through fiscal policy

The cause of the euro crisis of 2010-12 was not high public debt, but rather the unfinished framework of the currency union, with weak institutions, which led to imbalances developing and then reversing suddenly.

The euro crisis did, however, reveal the vulnerabilities that come with high public debt, mainly reduced scope to respond to an economic downturn with fiscal policy and the need for tight control of budget deficits. Therefore we believe that as long as the euro area remains on a sustainable growth path and strengthens the powers of institutions to supervise deficits, further crises can be avoided.

The euro has close to 70% support

The dilemma: shoring up popular support while tightening integration

The euro is consistently viewed favourably, with close to seven in 10 respondents supporting the euro when polled in May 2015 (Eurobarometer's most recent half-yearly poll). Support has never dipped below 60%, and has been on an improving trend for the past two years. But the region cannot stand still. In particular, further risk-sharing is needed to avoid the stress of shocks, and this will require further integration, and developing a capital markets union and some form of fiscal union.

Moves to tighten integration reduce popular support for the euro

The problem is that major moves to tighten integration have in the past reduced popular support for the EU and euro, and reform programmes have often led to voters rejecting governments that implement them. We believe that the unemployment level is particularly important in determining support for the European project and euro-area institutions, and that governments need to prioritise the removal of barriers in product and labour markets to hasten employment creation – even if the benefits take time to emerge.

An imperfect OCA has led to diverging economies and destabilising imbalances

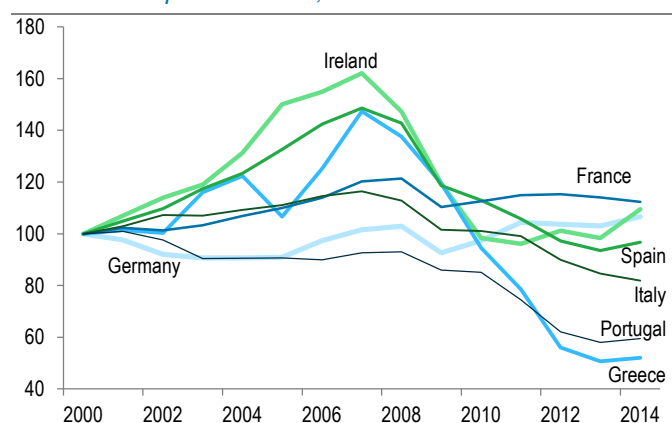
Our report: optimal currency areas – from theory to practice

Our report kicks off with the theory behind an optimal currency area (OCA, Chapter 1) to identify the gaps in the euro area. The consequences of an imperfect OCA have been diverging economies and the rise of destabilising imbalances. On our OCA scorecard, the region averages 3/5 (Figure 9), with the absence of a risk-sharing system the main drawback. Labour mobility is high in physical terms (free movement of labour is enshrined in the EU treaties, and the Schengen accord bans border checks among the 26 signatories). But in practical terms, features such as language, culture and lack of recognition of professional qualifications act as barriers. Business cycles are broadly synchronised, but poorer countries have been much more vulnerable to shocks than the richer core.

We look at reforms in labour and product markets, and the 'ease of doing business'

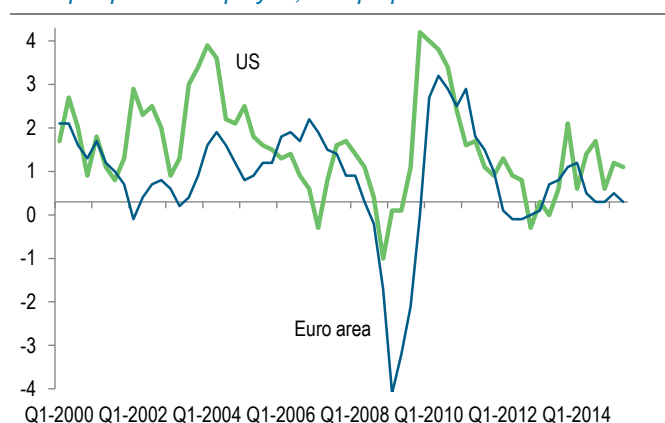
How can the euro area develop more of the characteristics of an OCA and reap the benefits of being a single currency area? In Chapter 2, we take a closer look at how far structural reforms can boost growth and what has been achieved in terms of labour market reforms, improving product market regulation and the 'ease of doing business' in the euro area. The absence of sufficient risk-sharing between member states is a major limitation of the euro area. We look at how structural reforms to financial markets can help the region's long-term growth potential, and discuss how far a fiscal union can be achieved.

Figure 4: EMU saw a peripheral investment boom and bust
Gross fixed capital formation, 2000=100



Source: AMECO, Standard Chartered Research

Figure 5: Euro-area productivity underperforms the US
GDP per person employed, % 4q/4q



Source: OECD, Standard Chartered Research

Labour market reforms have increased in recent years, lowering the scope and level of labour taxes and social security contributions, and easing wage-setting regulations. There is room for further action: employment protection remains significantly higher than in the UK and US. That said, labour market reforms deliver benefits to growth only over the long term, according to the IMF.

The full benefits of reform are only felt after several years

Studies suggest that product market reforms are more important for productivity and growth, and can enhance the impact of subsequent labour market reforms. The full benefits are felt only after several years but could be substantial. The IMF estimates that product market reforms could raise GDP in peripheral countries by 10% in the long run. This chapter shows that product market regulations have been eased more in the periphery (albeit from a high starting point) than in the core, with some peripheral countries (Italy and Portugal) in line with, or better than, the core. Countries have been slow to implement the EU Services Directive, and this is reflected in higher price mark-ups for services than for tradable goods.

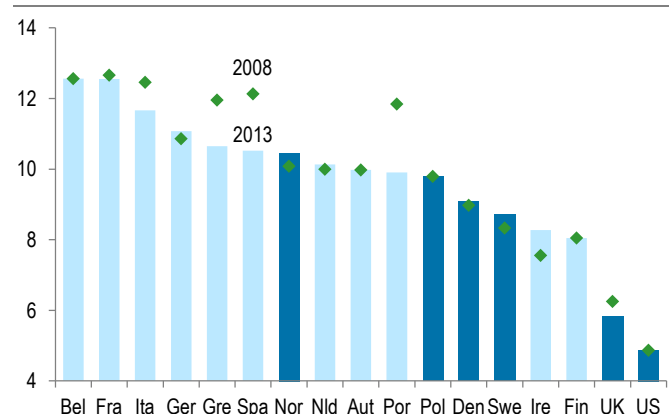
The World Bank's 'Ease of Doing Business' report indicates some important shortcomings, particularly in enforcing contracts. However, by cutting complex and costly regulatory processes and improving legal institutions, southern European countries have been improving at a faster pace than other euro-area countries.

Now is the appropriate time to undertake structural reforms, in our view, since the fiscal squeeze is largely over and monetary policy is accommodative. The problem is that it often takes a crisis before Europe takes significant action.

Banking union has been a game-changer

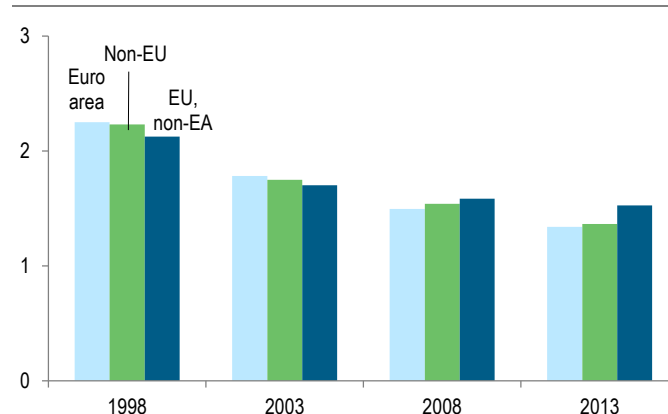
We then discuss the measures taken to improve financial integration and highlight the steps that are most urgently needed. Banking union has been a game-changer, improving market confidence in banks and limiting the sovereign-bank negative feedback loop that greatly exacerbated and prolonged the crisis. In the future, the banking union should lead to pan-European banks diversified enough to be able to withstand country-specific shocks without requiring taxpayer-funded bailouts. Completing the banking union with a common deposit insurance fund would be a major positive step, albeit politically difficult.

Figure 6: Employment protection higher in euro area
Strength of employment protection legislation, 2013 vs 2008*



* Combined scores of OECD employment protection legislation indicators – lower is less protection ; Source: OECD, Standard Chartered Research

Figure 7: Euro area has eased product market regulation
Diffusion index 1998-2013



Source: OECD, Standard Chartered Research

Deeper, more integrated capital markets would boost financing options and increase resilience to shocks

Banking union provides only part of the answer: capital markets union aims at boosting market-based financing, which still accounts for just one-fifth of lending, compared with some 70% in the US. Deeper, more integrated capital markets would make the euro area much more resilient to shocks, improve the transmission of monetary policy and encourage long-term investment in infrastructure projects underfunded by governments. An ambitious capital markets union could boost euro-area growth by improving the matching of savings and investment. It could also play an important role in improving risk-sharing in the region, especially given the questions over how far risk-sharing through fiscal transfers can become a reality.

Fiscal union is politically challenging

Fiscal union is regarded as the ultimate concluding step towards European integration, albeit politically challenging, as it involves ceding even more sovereignty from the national level to the euro-area level. As such, it is likely to go hand in hand with greater political union. The recent 'Five Presidents' report envisages a euro-area-wide fiscal stabilisation mechanism in time, with the European Stability Mechanism (ESM) continuing to deal with crisis management. The next stage of integration will require treaty-level change, enshrining convergence criteria in law. We believe that a new institution, acting as a counterpart to the European Central Bank (ECB) but responsible for fiscal policy, should be a top medium-term priority.

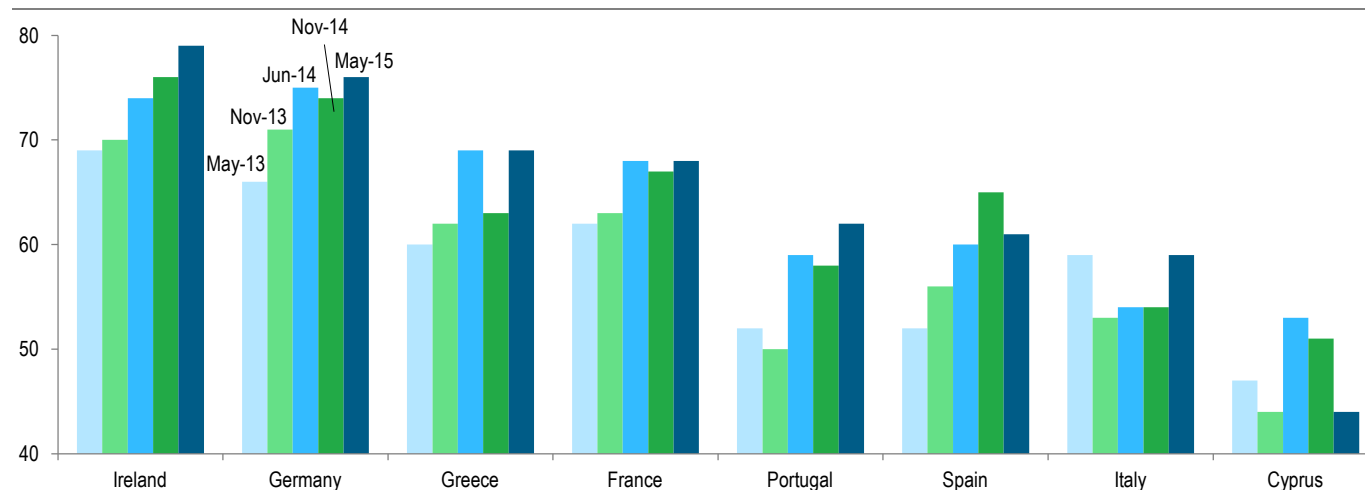
Our final chapter addresses the role of politics. The euro remains a political project, in our view. Politics, rather than economics, will ultimately determine the outlook for the single currency – though prolonged economic underperformance could sow the seeds of a potential break-up. The experience of the 1930s suggests that a fixed-currency regime will not survive in the face of deep recession, high unemployment and severe economic hardship – and that such an environment can be an incubator for extremism.

The euro could be vulnerable in countries with weak growth and where reform is in the early stages

We take a look at the radical and anti-euro political parties that have become more prominent in the euro area since the crisis. Despite the worst recession in recent memory (worse in many cases than in the 1930s), and extreme stresses in relations between euro-area governments and institutions, no country has yet left the euro – although Greece has come close on several occasions and Cypriots are, on balance, against the euro. Countries are particularly vulnerable when growth has been weak

Figure 8: Support for the euro varies between countries and over time

Support for the euro, %



Source: Eurobarometer, Standard Chartered Research



and unemployment high for a prolonged period, and where reform is still in the early stages (as the benefits will take time to be felt).

In Europe today, the migrant crisis is an additional factor that may increase the popularity of inward-looking policies or parties supporting the nation-state at the expense of the broader community.

Among the major economies, Italy stands out as having had the weakest support for the euro over the past two years, albeit still above 50%. For Italy's reformist government, it may be a race against time to kickstart growth before voters turn to more radical options. Portugal has historically had low growth, and euro support was in the balance in 2013, but has since risen sharply. Politics is pro-euro and reformist. France, where two-thirds are in favour of the euro, is also accelerating reforms in the shadow of rising nationalist support ahead of the 2017 presidential election. Euro-area policy makers will be aware that while the single currency could withstand a Grexit, it would be unlikely to survive the exit of Italy or France.



1. Optimal currency areas – Theory and practice



What makes an optimal currency area?

Mundell: factor mobility

Currency union: “hardly ...within the realm of political feasibility”

Robert Mundell first wrote about what constituted an ‘optimum currency area’ (OCA) in 1961 (American Economic Review). In asking “What is the appropriate domain of a currency area?” he wrote that “It might seem at first that the question is purely academic since it hardly appears within the realm of political feasibility that national currencies would ever be abandoned in favor of any other arrangement.”

“... a currency domain is partly an expression of national sovereignty”

He proposed that if a region has factor mobility within, and factor immobility between other regions, then it should have a separate currency. The key is labour mobility – free movement of labour, a lack of cultural and institutional barriers (language and customs, for example) and pension arrangements. With high labour mobility, adjustment to asymmetric shocks that hurt employment can come through workers moving from areas where demand has fallen to where it has risen, thus helping to moderate changes in wages and unemployment. There are clear practical impediments to cross-border labour mobility within the euro area, including language and culture. These hurdles are evident when comparing the euro area with other currency unions.

Mundell also points out, however, that “a region is an economic unit while a currency domain is partly an expression of national sovereignty. Except in areas where national sovereignty is being given up, it is not feasible to suggest that currencies should be reorganized; the validity of the argument for flexible exchange rates therefore hinges on the closeness with which nations correspond to regions. The argument works best if each nation (and currency) has internal factor mobility and external factor immobility. But if labor and capital are insufficiently mobile within a country then flexibility of the external price of the national currency cannot be expected to perform the stabilization function attributed to it, and one could expect varying rates of unemployment or inflation in the different regions.”

Meade and Scitovsky: different views on Europe

For Mundell, an OCA could be characterised as having internal-factor mobility and external-factor immobility

In turn, Mundell refers to James Meade (1957) and Tibor Scitovsky (1958), who held different views about whether Western Europe could be considered an OCA: Meade argued that the conditions for a common currency in Western Europe did not exist, in particular because of the lack of labour mobility; whereas in contrast, Scitovsky favoured a single currency area in Western Europe, believing that it would induce a greater degree of capital mobility, although he was of the view that steps would need to be taken to make labour more mobile and facilitate supranational employment policies. The two differed over the precise degree of factor mobility required to delineate a region. In Mundell's view, an OCA was a region defined in terms of internal-factor mobility and external-factor immobility.

Capital mobility, price and wage flexibility and fiscal integration

Fiscal integration can help deal with asymmetric shocks

In addition to labour mobility, other criteria for a successful currency union include capital mobility, price and wage flexibility – and where this is imperfect, a redistributive fiscal transfer mechanism. Peter Kenen argued that fiscal integration – a large ‘federal’ component to spending at the regional or local level – can help in dealing with asymmetric shocks.



Euro-area countries trade heavily with each other

Intra-regional trade, co-ordinated business cycles

A high degree of intra-regional trade and similar business cycles are thought to be key to successful currency unions. Euro-area countries trade heavily with each other (intra-European trade is greater than international trade), and most recent empirical analysis of the 'euro effect' suggest that the single currency has increased trade significantly within the region, compared to trade between non-euro countries.

In the 1980s, when the key steps towards the creation of the euro were taken, there were two schools of thought. The first – more prevalent in Germany – was that only economies with similar characteristics should be allowed into the euro; the euro area would thus be a more selective, close-knit union comprising Germany and its neighbours such as the Netherlands, Belgium and Austria. The second school – more prevalent in France – was that EMU should be as inclusive as possible, expecting that the euro would lead to further integration down the road. The euro would force countries to resolve their structural issues.

Benefits and costs of a currency union

Benefits: lower transaction costs, greater competition

The most basic benefit of a currency union is that it eliminates the transaction costs of switching between different currencies. Before the euro came into being, the European Commission estimated the direct benefit for Europe at nearly 0.5% of GDP every year (EU Commission, 1990).

A currency union facilitates the flow of information on relative prices

There are benefits in addition to reduced transaction costs – a single currency boosts competition by facilitating the flow of information about relative prices. A single currency can boost investment by reducing uncertainty about currency movements and giving businesses access to deeper, more liquid financial markets. Eliminating currency risk within the area reduces uncertainty over future prices for firms and consumers, and can help to improve mobility of labour and capital (i.e., building the OCA). Trade has risen as a result of the single currency, with the impact calculated to be a boost of 5-15%, according to Baldwin (2006), or even higher at 8-23%, according to Rose (2009).

Figure 9: Euro area – A sub-optimal currency area

Characteristics of an optimal currency area (OCA)	Score	Euro-area scores
Labour mobility and wage flexibility	3/5	Legally, the euro area has full labour mobility. However, practical factors such as language and cultural differences are still a significant obstacle. Labour rigidities remain, and reforms over the years have created new barriers to labour market flexibility while also reducing some barriers. Differences in labour markets are most evident between the north and south.
Capital mobility/ financial integration	3/5	Despite some convergence, each member has a different set of financial regulations, and corporate and bankruptcy laws. These hinder capital mobility. Banking union and capital markets union are steps in the right direction, in our view.
Product market	3/5	Product markets are governed by different laws in each member state. The plans for a digital union and energy union aim to make the European market more uniform in those two key markets.
Centralised risk-sharing system	1/5	A centralised risk-sharing system is absent in the euro area, unlike in federal unions such as the US and UK. The need for fiscal transfers arose acutely after the European debt crisis. Bailouts through the EFSF and ESM have been, effectively, a fiscal transfer.
Synchronisation of business cycles	4/5	Euro-area members have mostly synchronised their business cycles. That said, the experience since the GFC showed that significant divergences can emerge.

Source: Standard Chartered Research

Improves mobility of labour and capital by removing exchange rate risk

Meanwhile, the flow of technology and ideas should also improve. Countries with a history of high inflation and currency devaluation benefit from the credibility afforded to other countries, enjoying lower borrowing costs than they would face by 'going it alone'. Where currency unions encourage closer integration, efficiency can improve across the whole region, according to De Grauwe and Mongeli (2005).

Alesina and Barro (2002) observed that small countries with a history of high inflation and close (in a variety of ways) to a large and monetarily stable country stood to gain the most from giving up their own currency. In their view, "as the number of countries increases, their average size decreases and the volume of international transactions rises. As a result, more and more countries will find it profitable to give up their independent currency."

Cost: loss of independent monetary policy

The loss of monetary policy autonomy can be significant if not counterbalanced by more effective fiscal policy

The offset to these benefits is that fixed exchange rates entail the loss of independent monetary policies and exchange rate flexibility. Mundell stressed that the degree of factor mobility and price flexibility are key in this trade-off. If wages and prices can adjust very quickly, the adjustment to shocks can occur via movements in prices and wages, minimising the cost of loss of exchange rate flexibility. In practice, wages and prices are sticky even in flexible economies. For several euro-area economies, the euro debt crisis showed that inflexible labour markets result in high unemployment when demand shrinks, with wages slow to adjust while oligopolistic and other market-distorting practices hold prices high even in the face of collapsing demand.

Being part of a currency union can amplify fiscal deterioration in the event of a shock that disrupts output, if wages and prices fail to adjust (to restore competitiveness in the tradables sector) and/or if a country is tied to a set of fiscal targets. The risks and consequences of financial instability can end up being worse in a currency union than they otherwise would be, especially if fiscal dynamics call into question a country's membership of the union, and/or risk contagion in other countries in the union. This can result in self-fulfilling 'runs' on bank and sovereign debt, as happened during the euro crisis of 2011-12 before ECB President Draghi restored confidence in a backstop through the announcement of Outright Monetary Transactions (OMTs).

Outside a single currency area, the adjustment can be more rapid through the exchange rate. For example, during the crisis, Iceland achieved a 25% decline in wages relative to euro-area core countries in a short space of time through a devaluation of the krona. By contrast, while wages have fallen sharply in Greece since the start of the crisis, prices have remained sticky and competitiveness gains have been poor.

Figure 10: Benefits of a currency union

- Lower transaction costs
- Increases transparency of prices and, therefore, competition
- Removes FX risk, increasing capital and labour mobility
- Raises credibility of monetary policy, lowering borrowing costs

Source: Standard Chartered Research

Figure 11: Costs of a currency union

- Loss of independent monetary policy
- Some loss of independent fiscal policy
- Loss of exchange rate devaluation option

Source: Standard Chartered Research



How to achieve a successful monetary union

Countries do not need to be 'similar'

Dissimilar regions can share a currency as long as there are sufficient alternative risk-sharing channels

The advantages of a single currency come at a potentially high cost. The success of a currency area depends on whether the advantages mitigate the costs of losing an independent monetary policy. A successful currency area generally promotes the alignment of economic cycles, and supports price and financial stability within the currency area.

Strong trade links synchronise the business cycles of the trade-partner regions

While a degree of similarity might be thought of as important (as it makes it less likely that one country suffers from an asymmetric shock), in practice this is not necessarily the case. Bank of England (BoE) Governor Carney pointed out that the Canadian monetary union works well despite having substantially larger industrial variation than even the US (Carney, 2013). Meanwhile, the industrial structures of the core and periphery of the euro area are more similar than those of Canada or the US.

Openness and integration within a currency union are important, enhancing the benefits of a shared currency, but also diminishing the cost of losing exchange rate flexibility. If one part of the union imports a large share of what it consumes from other parts, changes in demand will be quickly transmitted, helping to align economic cycles. Rose (2009, and with Franklin in 1998) showed that countries with closer trade links tend to have more synchronised business cycles, an effect that Rose noted was happening across the euro area.

Capital mobility can also help with the adjustment to a shock, and if capital in one area or country is owned elsewhere in the union, the impact of the shock is spread and diluted. Borrowing in cross-union credit markets or integrated banking systems allows one part of a union to smooth out temporary falls in income. However, if the funds provided by one part of a union to another can be withdrawn easily, these outflows can end up undermining financial and economic stability across the union.

The costs of a sub-optimal currency area

Europe's recent downturn was worse than in the 1930s for many countries

In the eight years since the onset of the GFC, many euro-area countries have experienced a worse downturn than they did during the gold standard period in the 1930s (for a discussion of the gold standard, see Chapter 3). The crisis revealed that the euro-area economies did not have either sufficient labour mobility or fiscal integration to adjust to and withstand an outside shock. Euro-area leaders had believed that countries would embark on labour market reforms to ensure adequate flexibility in the event of an economic downturn. In addition, by adopting sound fiscal policies (formalised through the 1997 Stability and Growth Pact) the risk of policy-driven shocks would be limited.

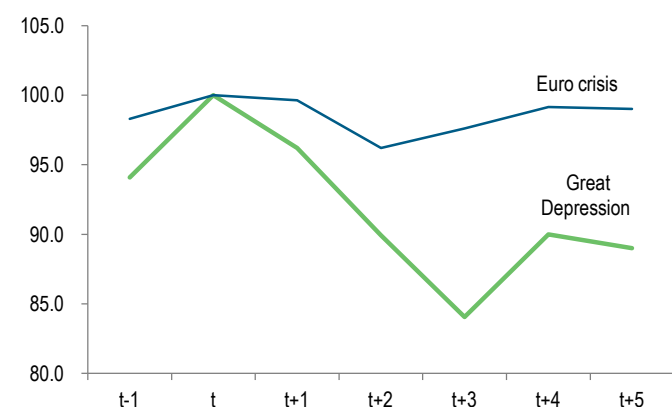
Part of the problem was that the introduction of the euro had created the belief that risks were mutualised despite the explicit 'no bail-out' clause in the Maastricht Treaty, and then the Lisbon Treaty. Sizeable capital flows from the euro-area core – predominantly Germany, although the Netherlands was also a source – to the periphery drove an economic and asset boom in the periphery. Large C/A deficits and inflation rates and unit labour costs significantly higher than in the core ensued. Following the crisis, private capital flows from the core to the periphery halted.

Under a single currency, internal devaluation via falling prices and wages is the way to restore competitiveness, but this has been relatively slow, despite deep recessions in some countries, partly due to inadequate labour and product market reform.

The lack of banking union was damaging

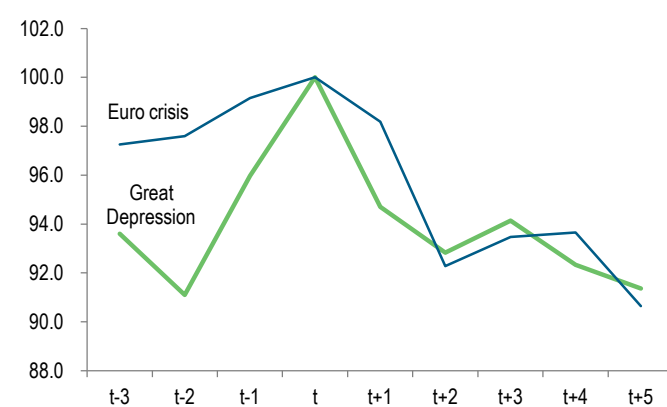
In economist Paul Krugman's view (2012), a currency area should have high integration of bank guarantees and a system of lender of last resort provisions for governments, as well as the traditional Mundell criterion of high labour mobility and the Kenen criterion of fiscal integration. The lack of a banking union contributed to some damaging developments in the euro area during the crisis. While US bank deposits are guaranteed at the federal level, individual euro-area member states were responsible for bank bailouts. This resulted in the bank-sovereign loop, whereby worries about the cost of bank bailouts for the sovereign put more pressure on the value of already-devalued sovereign bonds, further straining the balance sheets of banks that held the debt. Bank bailouts also caused a large increase in some deficits, including in Ireland, where debt/GDP jumped by 40pts.

Figure 12: France: euro crisis vs Great Depression
GDP 100=peak pre-euro crisis and pre-Great Depression



Source: Maddison project, AMECO, Standard Chartered Research

Figure 13: Italy: euro crisis vs Great Depression
GDP 100=peak pre-euro crisis and pre-Great Depression



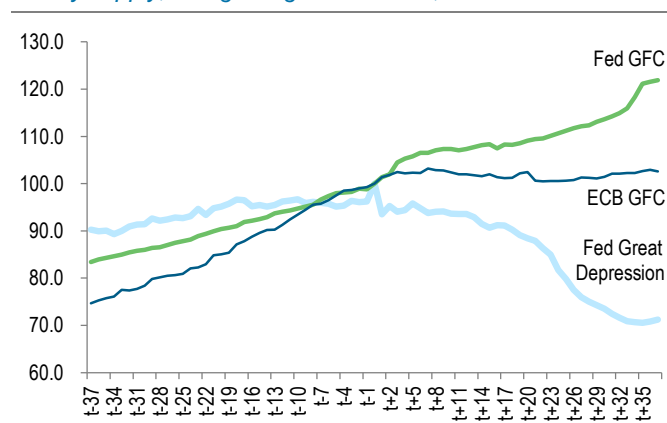
Source: Maddison project, AMECO, Standard Chartered Research

Figure 14: Netherlands: euro crisis vs Great Depression
GDP 100=peak pre-euro crisis and pre-Great Depression



Source: Maddison project, AMECO, Standard Chartered Research

Figure 15: Fed and ECB both avoided the mistakes of the Great Depression
Money supply, t=beginning of recession, indexed to 100 at t



Source: Fed, ECB, Standard Chartered Research



Why have a monetary union?

Why, given the experience of the gold standard some 60 years earlier, as well as other examples of failed currency unions, did European countries consider fixing their exchange rates and then irrevocably adopting a single currency? The EMU evolved as an essential element of the single market, to enhance the economies of scale that emerged from a region of harmonised rules. Peripheral countries recognised that periodic devaluations were a poor substitute for genuine and durable competitiveness. For decades after the Second World War until the introduction of the euro, Italy, Spain and other weak countries were using the exchange rate as the main tool to maintain their competitiveness, especially against Germany (Figure 17). This was done mainly through persistently higher inflation differentials before the first Exchange Rate Mechanism (ERM) (Figure 16), but sometimes also through official devaluation.

In addition, successive French presidents pushed for fixed exchange rates within a monetary union, as they appeared to find dependence on German monetary policy intolerable. The concern was most passionately stated by President Francois Mitterrand in a September 1989 conversation with British Prime Minister Margaret Thatcher: “Without a common currency, we are all, us and you, already at the will of the Germans. When they raise their interest rates, we are obliged to follow them, and you who are not even in the monetary system, you do the same thing! Thus, the only way to have a right to have a say, is to establish a European Central Bank where we can decide on things together,” Guigou (2000).

Imbalances in an imperfect monetary union

Creating the euro and living with the consequences

Members who are in trouble today usually had been using the exchange rate to maintain their competitiveness prior to joining

Under the European ERM formed in 1979, participating currencies could move only within a fixed band of 2.25% around the European Currency Unit (ECU), apart from Italy, Spain, Portugal and the UK which operated under a 6% band. But there were periodic devaluations. From 1979 to 1999 when the ERM participants’ exchange rate was fixed, the Italian lira depreciated about 80% and the Spanish peseta depreciated about 86% versus the ECU.

Since the introduction of the euro, the serial inflationists have had to learn to live without the exchange rate as the option to regain competitiveness. What this means is that either their economies must raise productivity to that of the euro-area average, or go through the process of internal devaluation.

Lack of convergence and divergence in some areas

The euro-area crisis resulted from imbalances that had built up since the introduction of the euro, and for which – unlike sovereigns with fiscal unions – there is no automatic correction mechanism. These imbalances included diverging unit labour costs, a significant increase in C/A deficits in some countries versus C/A surpluses in other countries, and sizeable budget deficits.

Unit labour costs diverged to unsustainable levels

With a free floating national currency, if unit labour costs (ULCs) in the local currency increased, market forces would cause the exchange rate to adjust (the currency would depreciate) to restore competitiveness. After the introduction of the euro, the exchange rate was fixed between trading partners, meaning that ULCs had to adjust. However, rigidities prevented wages and productivity from adjusting fast enough to prevent a long period of no growth or low growth.

ULC divergence was significant in causing loss of competitiveness

German ULCs decreased in the early 2000s following the Hartz reforms of 2002 as the German government worked with labour unions to restrain wage growth, to regain competitiveness. At the same time, German manufacturing productivity increased, and also benefited from cheap input from Eastern European countries.

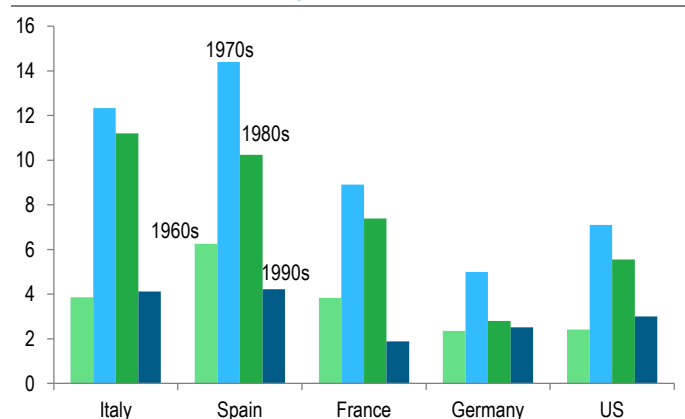
The 'dual' labour market prevalent in some European countries creates significant distortions

In contrast, southern European countries allowed their ULCs to increase. Italy and Spain were traditionally more used to indexing wages, which meant they had persistently higher inflation rates and depreciating currencies prior to joining the euro. In addition, governments and private borrowers of these countries expected the cheap borrowing after the introduction of the euro to last permanently and did not take measures to raise productivity.

Since the crisis, Spain has made substantial progress in lowering its ULCs through a combination of higher productivity and lower nominal wages (Figures 28 and 29).

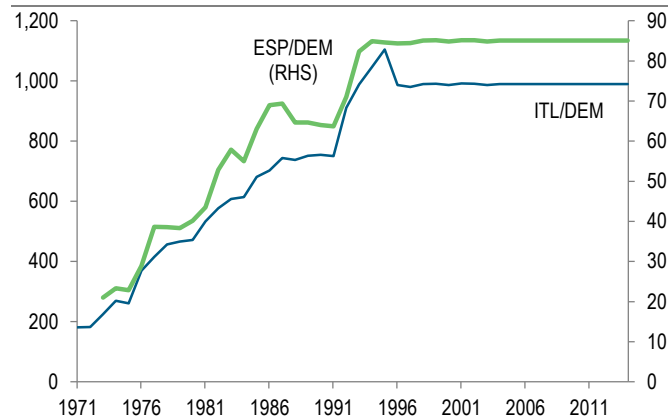
The loss of competitiveness is also visible by looking at the real effective exchange rate (REER), which is the nominal exchange rate adjusted for the local inflation rate. Southern European members' REERs rose much faster during 2000-08 than European 'core' members' (Figure 26).

Figure 16: Italy, Spain had chronically higher inflation...
CPI inflation decade average, %



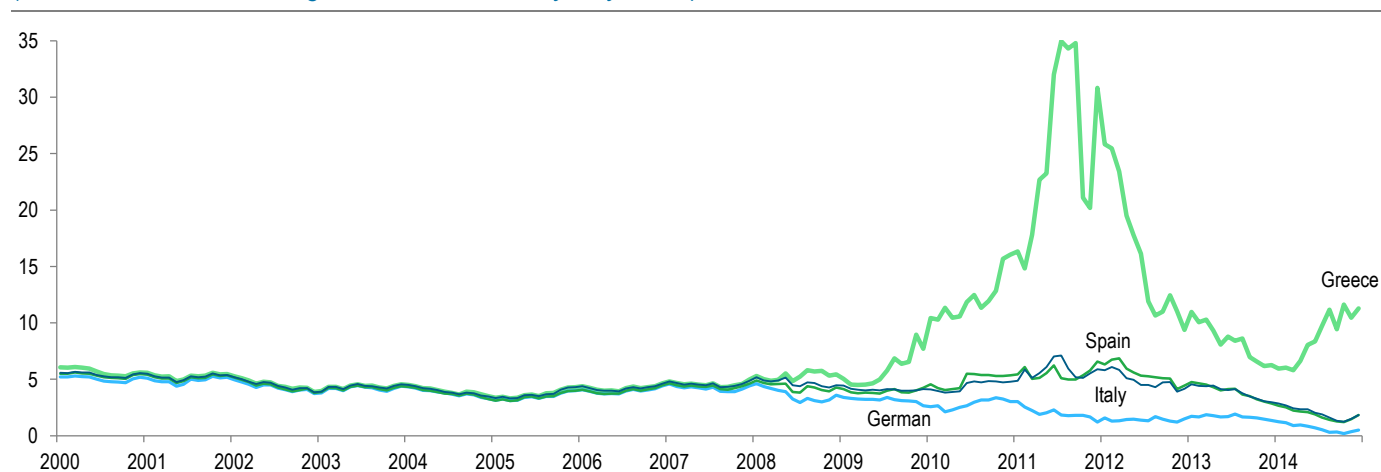
Source: World Bank, Standard Chartered Research

Figure 17: ... which led to persistent depreciation of the lira and peseta against the Deutsche mark



Source: Bloomberg, Standard Chartered Research

Figure 18: Just a year before the GFC, Greek government bonds yielded a few basis points above German Bunds
(German Bunds and Greek government bonds, 10-year yield, %)



Source: Bloomberg, Standard Chartered Research

Inflexible labour markets in the southern Mediterranean countries made internal devaluation harder to achieve. 'Dual' labour markets operate in Italy and Spain, where temporary employment with low or no benefits and no job security is in stark contrast with permanent jobs with higher job security. Because permanent contract workers are largely insulated from shocks, temporary workers are hit hard in recessions.

Since 2010, Greece has been through one of the toughest exercises of internal devaluation in modern financial history. However, while nominal wages fell by around 30% between 2010 and 2014, prices peaked in 2012 and have since decreased by just about 5%. Two reasons commonly cited by the Greek government and highlighted by technocrats at Greece's official creditors are the dominance of Greek oligopolies and the regulation of certain product markets, which prevent prices from adjusting quickly.

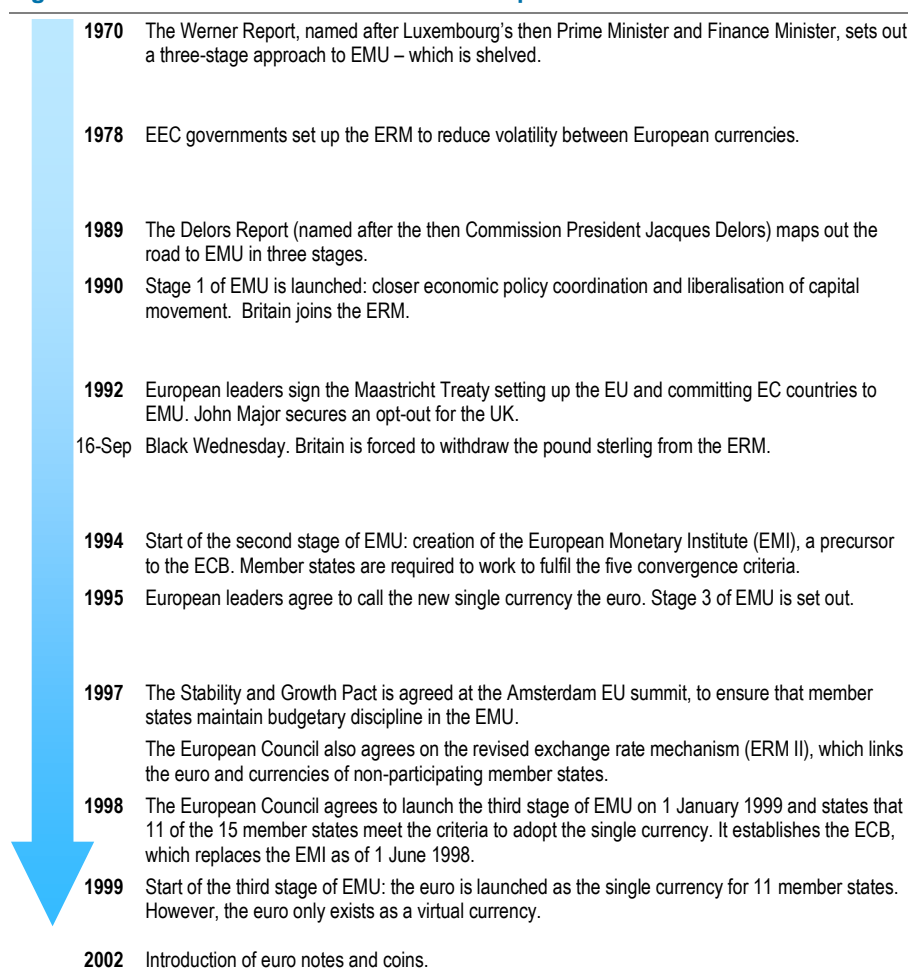
Italy, Spain and others in the periphery are therefore under pressure to restructure their economies if they want to achieve the flexibility to make euro membership work.

Current account imbalances revealed underlying problems

C/A imbalances were ignored

C/A deficits of countries in the periphery widened after the introduction of the euro while those of core countries, especially Germany, moved further into larger surpluses (Figure 31). C/A imbalances within the euro area were, to a certain extent, regarded as an accounting feature only.

Figure 19: Timeline of the euro area's development



Source: European Commission, Standard Chartered Research

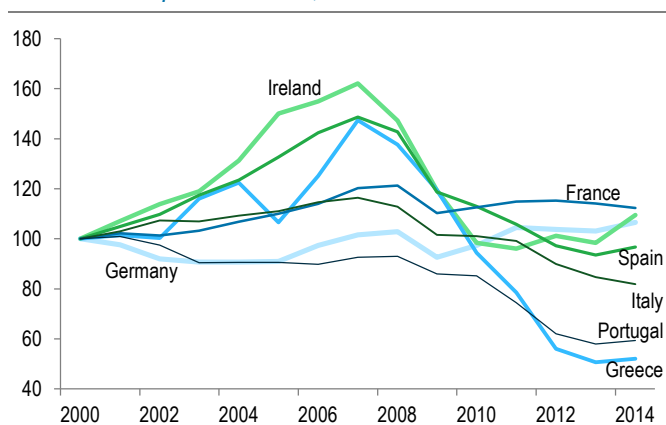
Unlike budget deficits and debt, there was no limit to C/A imbalances in the Maastricht criteria. Financial markets were supposed to correct these imbalances by transferring capital across the euro area to where it had the highest return. This would result in 'good' C/A deficits as capital flowed to countries where investment returns were higher, raising growth rates. In the run-up to the GFC, this is exactly what happened. However, as it turned out, funds flowing from the core euro area to the periphery were not allocated to productive purposes. In Ireland and Spain, for instance, the funds fuelled unsustainable property booms. A significant portion of the capital flows was also used to increase consumption instead of investment – especially in Greece, but also in other crisis-hit countries to an extent.

As of today, the high-deficit countries have managed to shrink their C/A deficits. However, they did so not by adjusting against core members, but against the rest of the world (Figure 31). The euro-area C/A has, as a result, moved from being roughly balanced to a EUR 300bn (3% of GDP) surplus in five years. At the beginning of the crisis, the adjustment was mostly due to demand compression: lower imports due to lower domestic demand and, to a lesser extent, to higher exports. However, improvements in competitiveness have since led to a remarkable pick-up in export performance in the periphery, while domestic demand has started to recover in many countries, driving imports higher.

The macroeconomic imbalances procedure (Figures 32 and 33) aims at identifying imbalances in current accounts, government finances and other parts of the economy, and the risks associated with those imbalances. The European Commission sets out action points for governments with a view to avoiding a return to the distortions of the pre-crisis era.

Figure 20: Euro introduction was followed by an investment boom in periphery countries...

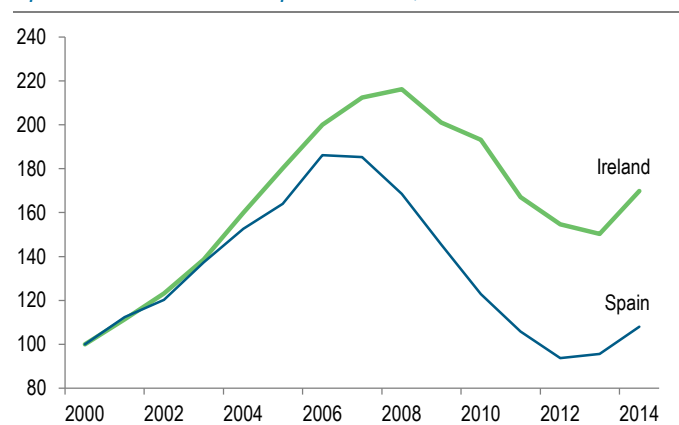
Gross fixed capital formation, 2000=100



Source: AMECO, Standard Chartered Research

Figure 21: ... which led to unsustainable property booms instead of productivity improvements

Spain and Ireland house price indices, 2000=100



Source: ECB, Standard Chartered Research

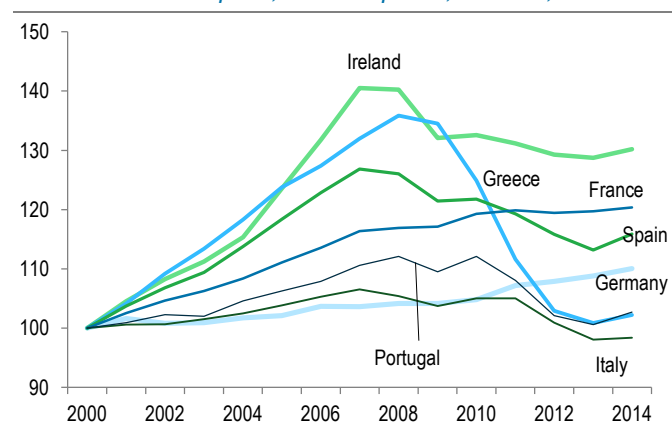
Budgetary positions worsened

The assumption of risk-free sovereign debt led to unsustainable budget deficits

Deteriorating budgetary positions also contributed to the euro-area crisis. Even though the Stability and Growth Pact was supposed to bind countries to limit their debt/GDP ratios to 60% and deficits to 3%, the rule was flouted even by core countries such as Germany and France. This was an example of how rules without enforcement power lack credibility. Moreover, the notion that no sovereign could default on its debt led the market to significantly misprice European sovereign debt. In 2006, Greek 10Y government bond yields were trading at a spread of just 30bps above German Bunds. This led governments to believe that interest rates would be permanently lower, driving an unsustainable expansion in spending. There were few market sanctions for raising spending and maintaining large deficits.

Figure 22: Euro introduction also led to unsustainable consumption booms

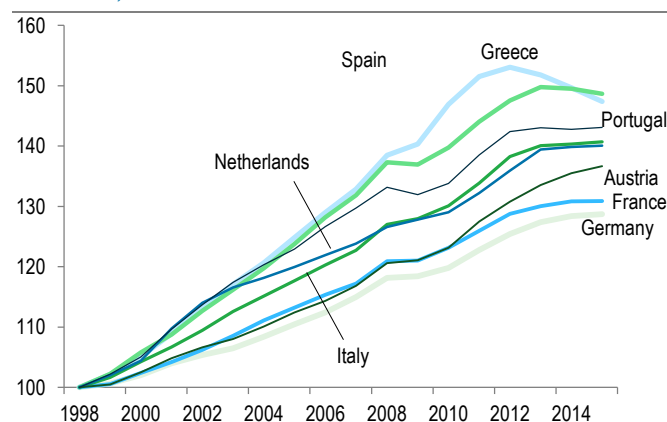
Household consumption, constant prices, rebased, 2000=100



Source: AMECO, Standard Chartered Research

Figure 23: Inflation was the key for loss of competitiveness

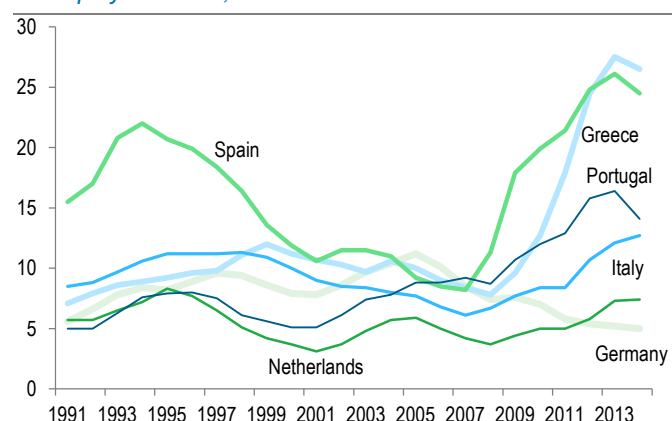
CPI index, 1998=100



Source: AMECO, Standard Chartered Research

Figure 24: The labour market is highly fragmented

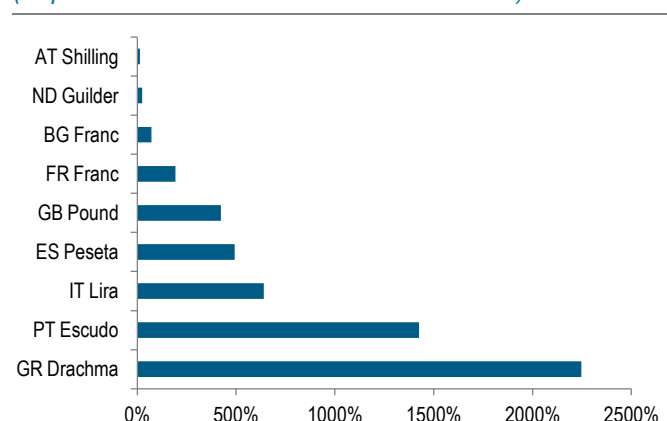
Unemployment rate, %



Source: AMECO, Standard Chartered Research

Figure 25: Chronic devaluations ahead of the euro

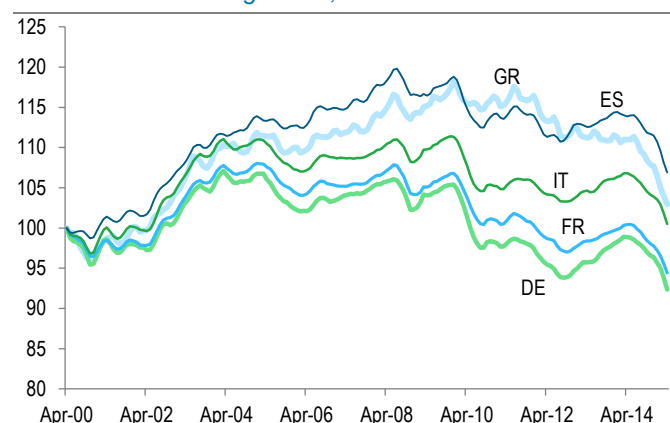
(Depreciation vs the Deutsche mark 1960-1995)



Source: Bundesbank, Standard Chartered Research

Figure 26: Competitiveness diverged under EMU

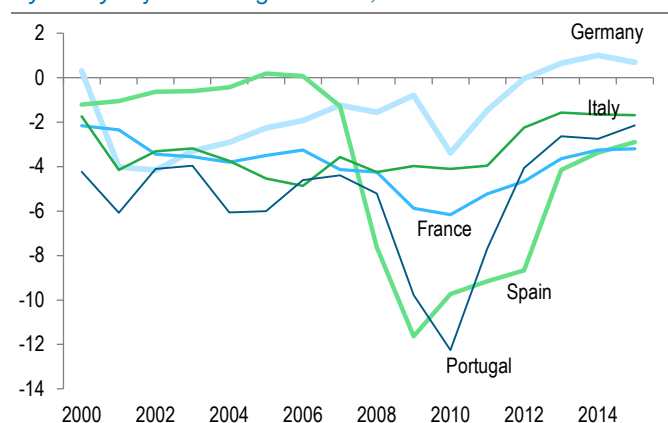
Real effective exchange rates, 2000=100



Source: BIS, Standard Chartered Research

Figure 27: Budget deficits were unsustainable

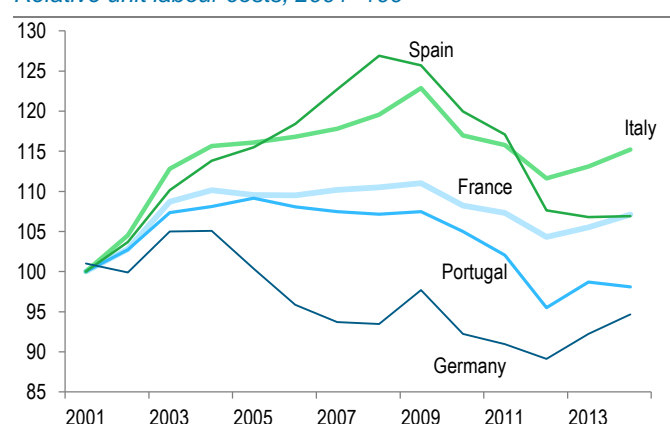
Cyclically adjusted budget deficits, % of GDP



Source: AMECO, Standard Chartered Research

Figure 28: Labour costs accelerated in Spain and Italy

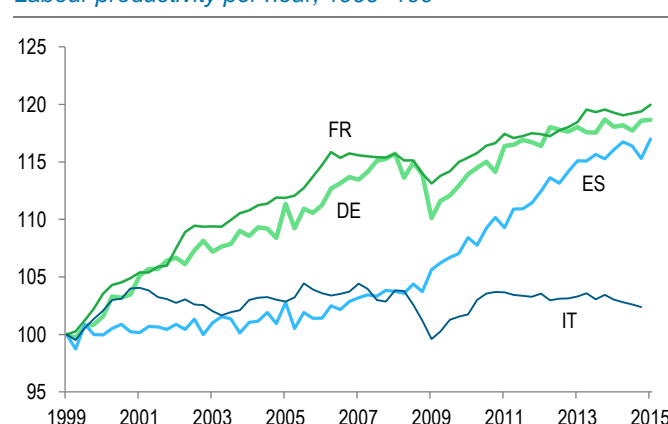
Relative unit labour costs, 2001=100



Source: OECD, Standard Chartered Research

Figure 29: Italy requires productivity improvements

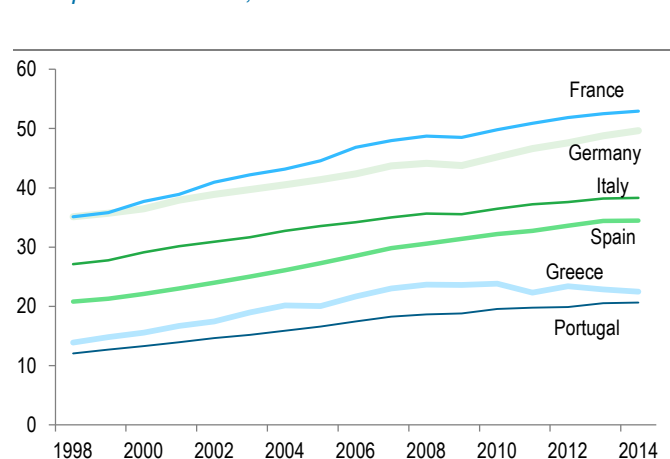
Labour productivity per hour, 1999=100



Source: ECB, Standard Chartered Research

Figure 30: Major competitiveness imbalances persist

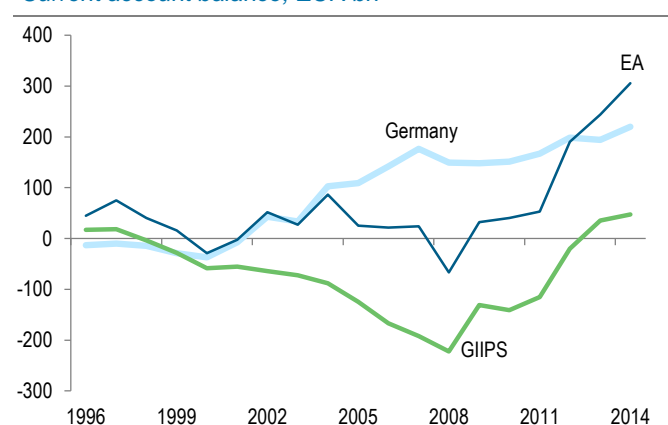
GDP per hour worked, EUR



Source: AMECO, Standard Chartered Research

Figure 31: Current account imbalances shifted from within EA to the rest of the world

Current account balance, EUR bn



Source: AMECO, Standard Chartered Research

Extracts from the macroeconomic imbalances procedure

Figure 32: The macroeconomic imbalances procedure: identifying imbalances

Imbalances, risks and action points for the main euro-area countries

Country	Comment
Germany	High C/A surplus. Risks have increased in light of the persistence of insufficient private and public investment, which represents a drag on growth and contributes to the very high C/A surplus (we believe this still deserves close attention). The need for action to reduce the risk of adverse effects on the German economy, and – given its size – of a negative spillover to the economic and monetary union, is particularly important.
France	In a context of low growth and low inflation, poor corporate profitability and the insufficient policy response so far, risks stemming from the deterioration in both cost- and non-cost competitiveness and high (and rising) French indebtedness – in particular, public debt – have significantly increased. The European Commission reopened the excessive deficit procedure for France in May 2015 due to above-target budget deficits. Consequently, the government prepared a list of adjustments to bring the structural budget in line with the Commission's targets by 2018.
Italy	In a context of protracted weak growth and persistently low productivity, risks stemming from the very high level of public debt and poor cost and non-cost competitiveness have significantly increased. The need for action to reduce the risk of adverse effects on the Italian economy and, given its size, of a negative spillover to economic and monetary union, is particularly important.
Spain	Spain exited the financial assistance programme for the recapitalisation of financial institutions in 2014 and is currently subject to post-programme surveillance and European Semester surveillance. Despite some improvement in the C/A rebalancing, risks related to the high levels of private- and public-sector indebtedness, and the highly negative net international investment position, continue to warrant close attention in a context of very high unemployment. The need for action to reduce the risk of adverse effects on the Spanish economy and, given its size, of a negative spillover to the economic and monetary union, is particularly important. Spain has remained in an excessive deficit procedure since 2009 and is seen as successfully bringing budget deficits in line with the European Commission's targets.

Source: European Commission report on the prevention and correction of macro-economic imbalances, Standard Chartered Research

Figure 33: Macroeconomic imbalances procedure

The European Commission's latest assessment

Severity score	Country	2014	2015
1	No imbalances	-	-
2	Imbalances that require monitoring and policy action	Belgium, Bulgaria, Germany, Netherlands, Finland, Sweden, UK	Belgium, Bulgaria, Romania, Finland, Sweden, UK
3	Imbalances that require monitoring and decisive policy action	Hungary	Hungary, Germany
4	Imbalances that require specific monitoring and decisive policy action	Ireland, Spain, France	Ireland, Spain, Slovenia
5	Excessive imbalances that require specific monitoring and decisive policy action	Croatia, Italy, Slovenia	Bulgaria, France, Croatia, Italy, Portugal
6	Excessive imbalances that require decisive policy action and the activation of the Excessive Imbalance Procedure	-	-

Source: European Commission, Standard Chartered Research



2. Reforming the euro area



Reforming the euro area – The record so far

Policies and institutions have a strong bearing on economic performance. The Lisbon Strategy launched in 2000 reflected a need for reform, and since the GFC euro-area policy makers have been active in creating institutions and tools to support the single currency (Figure 34). However, euro-area productivity and employment growth has tended to lag that of the US, especially since the GFC.

Productivity growth needs to improve and unemployment must fall if political support for the euro is to remain steadfast

More needs to be done to improve economic efficiency and reform institutions if productivity growth, which will determine long-run GDP growth prospects, is to improve. Unemployment also needs to fall if political support for the euro is to remain steadfast. In recent years, governments have taken drastic action to reduce fiscal deficits and the resulting shortfall in demand has cut imports, reducing or eliminating external deficits. However, governments have also been more active in reducing market rigidities and improving economic efficiency to drive competitiveness gains.

There have also been some positive institutional developments. Banking union is finally supporting better transmission of monetary policy: interest rates are falling and lending rates for the non-financial corporate sector are now at historical lows. Credit markets are less fragmented, and demand and supply of bank loans to the private sector is accelerating.

Meanwhile, we believe the focus of risk-sharing should be on completing the banking union and implementing the capital markets union. Euro-area institutions have been strengthened to deliver a framework to avoid the extreme imbalances that developed ahead of the crisis and steer countries towards structural and governance reforms.

However, we see limited fiscal transfers at the disposal of the euro-area institutions. Risk-sharing through full fiscal integration looks to be a step too far for most euro-area voters and governments, though the region's bailout mechanism – the ESM – could be the foundation for a euro-area Treasury.

Figure 34: Integration overdrive

Institutions/tools created since the crisis

The region now has a plethora of tools to protect and support the currency union

Institution	Description
European Stability Mechanism (ESM)	Permanent mechanism to assist countries in financial difficulty
European System of Financial Supervisors (ESFS)	Institutions to improve the cooperation of national regulators of banks, pensions and capital markets
These include:	European Systemic Risk Board (ESRB)
	European Banking Authority (EBA)
	European Insurance and Occupational Pensions Authority (EIOPA)
	European Securities and Markets Authority (ESMA)
Macroeconomic imbalances procedure	Designed to provide an early warning system of imbalances within the euro area, such as unsustainable C/A deficits or surpluses and housing bubbles.
Banking Union	To break the 'bank-sovereign' negative feedback loop, to reduce fragmentation of the banking system and to improve confidence in banks.
Fiscal Compact	A stricter version of the Stability and Growth Pact. Members must enshrine legally a mechanism that corrects fiscal imbalances or face fines by the European Commission.
Europlus pact	Plan that requires euro-area members to make concrete commitments to a list of political reforms intended to improve their countries' fiscal strength and competitiveness. The non-binding nature of its recommendations has so far meant that it has had little real impact.

Source: European Commission, Standard Chartered Research

The impact of reform on growth

Structural reforms can improve an economy's long-term capacity to grow by driving more efficient use of resources and raising productivity. The problem is that the results can take years to materialise, and the measures be unpopular in the interim.

Reforms could raise GDP by 2.5-6.5% after 10 years

Models differ over the extent of the impact of reform on economic growth. The European Commission's paper, 'The growth impact of structural reforms', December 2013, looked at structural indicators of labour and product markets and assumed a gradual closure of the gap relative to best-performance. The conclusion was that gains in output and employment could be large if countries even halved the gap versus the three best EU performers. GDP could be raised by 1.5-4% after five years and by 2.5-6.5% after 10 years, with the impact on Greece's GDP even larger (at 6% and 14% after five and 10 years, respectively).

The ECB's analysis suggests that service-sector reforms, combined with labour market reforms, can raise GDP by 3-4% after five years (ECB Economic Bulletin Issue 2, 2015). Furthermore, countries that have implemented reforms have tended to show better underlying export performance (stronger exports driven by improved price and non-price competitiveness).

A study by the IMF, 'Assessing the gains from structural reforms for jobs and growth', 2014, concludes that structural reforms in the euro area can increase GDP markedly, particularly in the peripheral countries, although they may take time to have an effect. After five years of product and labour market reforms, output could be 4.1% higher in the periphery than without such reforms, and higher still if the entire euro area reforms at the same time. The largest gains come from product market reforms, while labour market reforms have a positive but modest impact on GDP growth, according to the IMF study.

Labour market reforms

Following the 2008 crisis, there was a rise in unemployment across the euro area, but also an increase in the degree of divergence of unemployment rates

Figure 35: Structural reforms can boost growth

Impact of product market, labour and tax reforms, % deviation from baseline*

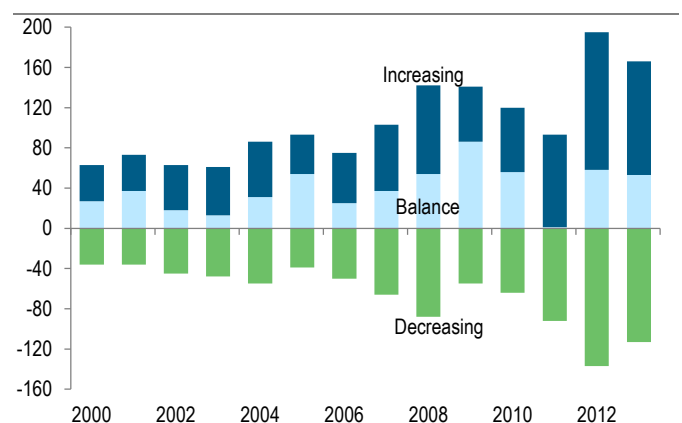
Impact on	Year 1	Year 2	Year 5	Long run
Core when only core reforms				
GDP	0.8	1.6	3.4	10.2
Employment	0.9	1.6	1.8	3.0
Core: entire euro-area reforms				
GDP	1.1	2.1	3.7	10.6
Employment	1.4	2.4	2.0	3.0
Periphery: only periphery reforms				
GDP	0.7	1.5	4.1	13.6
Employment	0.7	1.4	2.3	4.2
Periphery: entire euro area reforms				
GDP	1.4	2.7	4.8	15.4
Employment	1.7	2.9	2.6	4.2

*The IMF model increases the ratio of Active Labour Market Policies (ALMP) spending per unemployed to GDP per capita relative to the average within a set of countries with high ALMP spending; proxies lower unemployment insurance through cutting government spending and raising the labour supply; and lowers employment protection insurance to the three lowest in the OECD.

Source: IMF, Standard Chartered Research

Figure 36: Euro-area reforms

LABREF labour market reforms



A reform is said to have an 'increasing' (resp., 'decreasing') direction whenever the enacted measure raises (resp. lowers) the scope and level of corresponding taxes or monetary benefits or the stringency of corresponding regulations

Source: European Commission LABREF database, Standard Chartered Research

The near-term impact of labour market reforms is low; benefits to growth come over the long term

(unemployment had, in any event, differed widely between countries for many years), well above what was explained by differences in GDP growth.

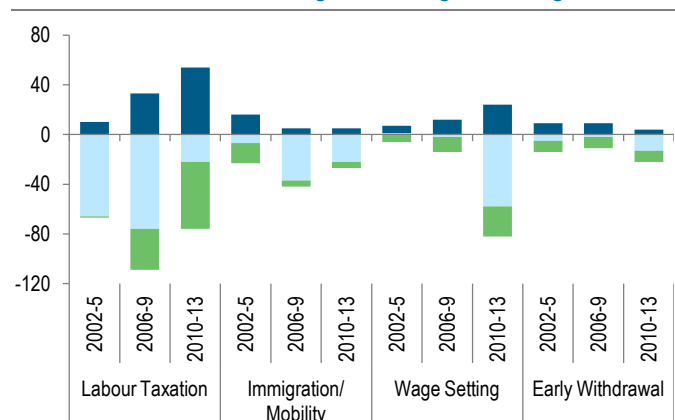
Labour market reforms aim at cutting structural unemployment by lowering the cost of adjusting the workforce, making it easier to reallocate labour, and by raising productivity. That said, the IMF suggests that the near-term impact of labour reforms is low, with the benefit to growth only becoming apparent in the long term. In the case of the peripheral countries, labour market reforms are only a quarter as effective as product market reforms in boosting growth. The impact increases when the entire region reforms because of spillover effects.

Reform activity has tended to accelerate in recent years in response to the GFC and then the euro crisis, as countries tried to rebalance their economies, especially those that had accumulated large C/A deficits.

The charts below (from the European Commission's LABREF database on labour market and welfare policy measures) show that the largest number of reforms happened in 2010-13, particularly relating to labour taxation and wage setting. On balance, there were more reforms lowering the scope and level of labour taxes and social security contributions than raising them, and easing rather than tightening wage-setting regulations.

Figure 37: Comparing reforms, three different periods

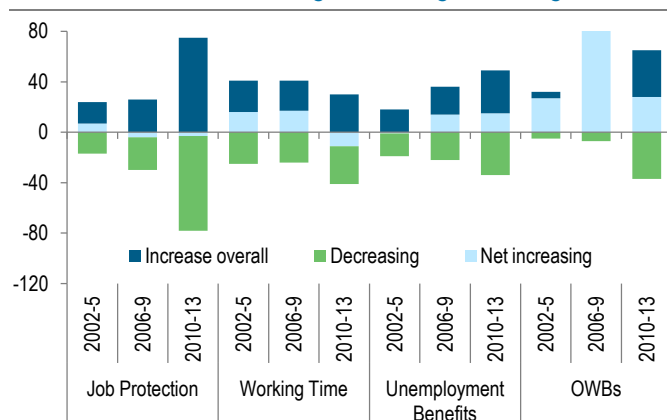
Number of reforms increasing/decreasing market rigidities



Source: LABREF database, Standard Chartered Research

Figure 38: Comparing reforms, three different periods

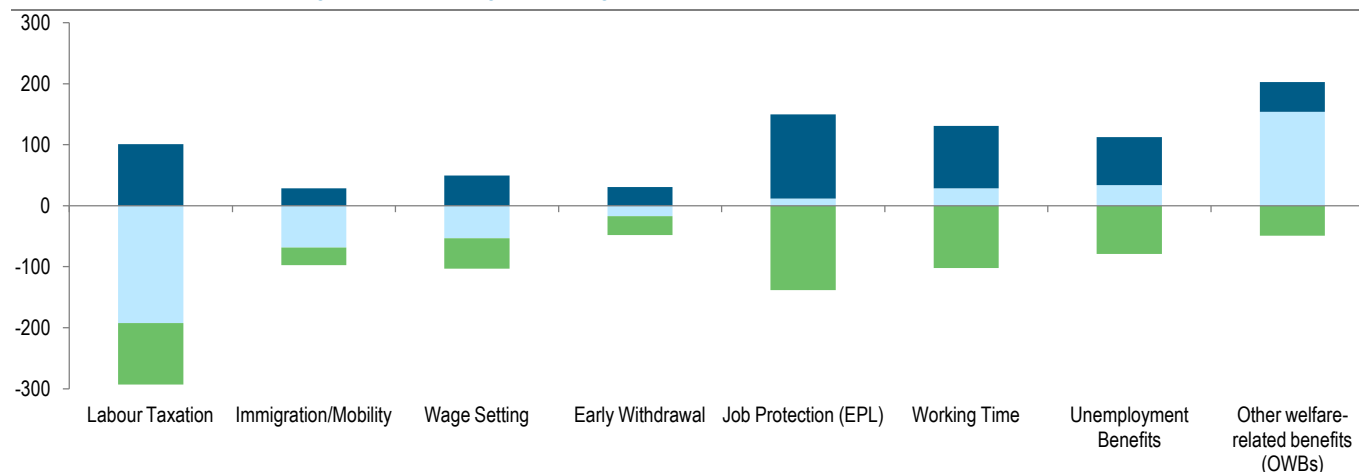
Number of reforms increasing/decreasing market rigidities



Source: LABREF database, Standard Chartered Research

Figure 39: Euro-area labour reforms by category 2000-13

Number of reforms increasing and decreasing market rigidities



Source: LABREF database, Standard Chartered Research

Changes to legislation have aimed at decentralising the wage-setting system

Changes to legislation have aimed at decentralising the wage-setting system and aligning wages with the economic environment (e.g., France, Italy, Portugal, Spain), helped to restore competitiveness and cut the divergence in unit labour costs.

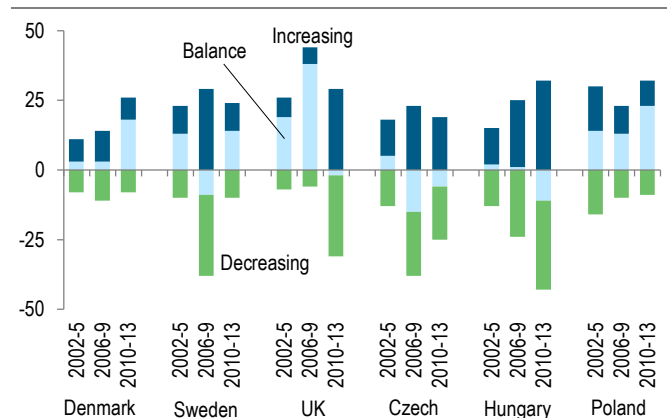
Laws governing immigration/mobility (immigration policies and measures to allow labour market integration of immigrants and internal mobility), early withdrawal (early retirement and disability schemes) and working time (working hours and part-time work, family-related working-time organisation and sabbatical and other special leave schemes) were reduced in scope, on balance, in 2010-13.

By contrast, unemployment and other welfare-related benefits (including short-time working schemes, in-work and family-related benefits as well as social assistance and sickness schemes) increased, on balance, possibly reflecting the need to support higher numbers of unemployed after the onset of the crisis.

In several countries, employment protection regimes were reformed, with a view to encouraging job creation, while tackling the divide between those on temporary and permanent contracts (including in Portugal, Estonia, Netherlands, France, Italy, Greece, Slovenia and Slovakia). OECD employment protection indicators show that between 2008 and 2013 in the euro area, only Ireland increased the strictness of laws on dismissals. In Portugal, employment protection fell sharply (albeit from a high starting point) and Greece, Spain and Italy also loosened employment protection.

Figure 40: EU countries outside the euro

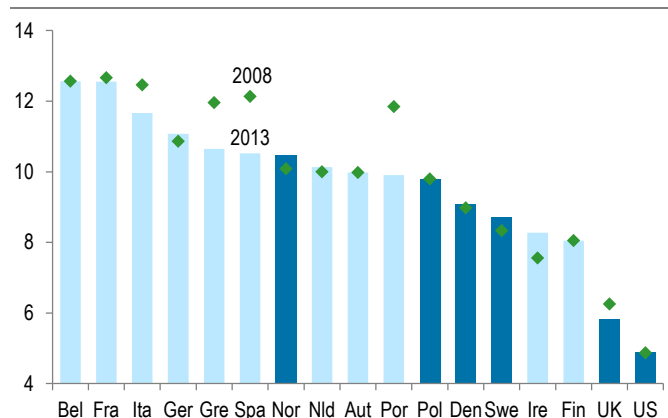
Number of reforms increasing/decreasing market rigidities



Source: LABREF database, Standard Chartered Research

Figure 41: Employment protection is high in euro area

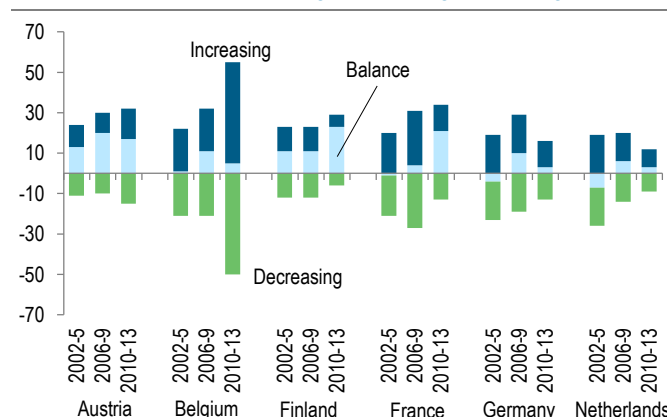
Strength of employment protection legislation 2013 vs 2008*



* Combined scores of OECD employment protection legislation indicators – lower is less protection; Source: OECD, Standard Chartered Research

Figure 42: Comparing countries, three different periods

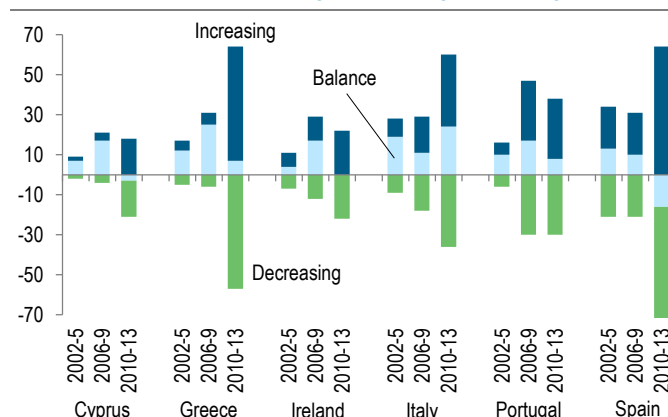
Number of reforms increasing/decreasing market rigidities



Source: LABREF database, Standard Chartered Research

Figure 43: Comparing countries, three different periods

Number of reforms increasing/decreasing market rigidities



Source: LABREF database, Standard Chartered Research

Reform has been greater in the euro area than in other EU countries

Product market reform

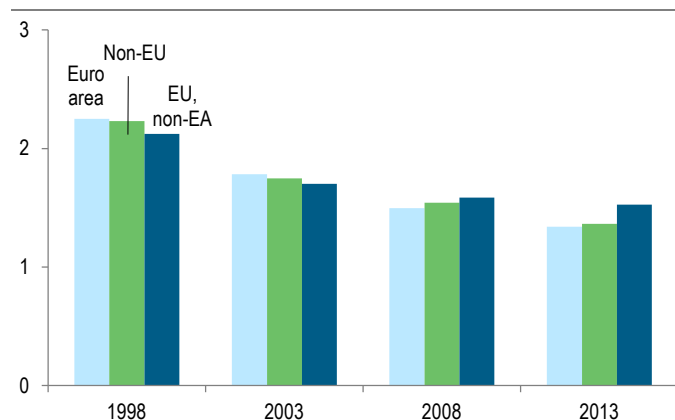
Since 1998, there has been notable progress in reforming product markets, with countries pursuing market liberalisation and deregulation. The euro area has improved faster than other European Union (EU) countries, and peripheral euro-area countries have made good progress, albeit from a relatively high degree of regulation to start with. That said, countries have been slow to implement the EU Services Directive, and this is reflected in higher price mark-ups for services than for tradable goods. The IMF notes the scope for product market reforms to boost GDP by cutting anti-competitive regulation, lowering barriers to entry and raising competition.

Reforms that lower mark-ups and increase competition reduce the cost of goods and services for consumers. Liberalisation of professional services and the judicial system can bring broad economic benefits. The EU Commission's calculations suggest that reducing the Product Market Regulation (PMR) indicator of the OECD by 1 point (on a scale of 0-6) increases the creation of new companies in the relevant sectors by 0.8ppt; this in turn corresponds to a 5.4ppt reduction in the profit rate.

The IMF analysis estimated that product market reforms could raise GDP by 2.4% in the periphery after five years (by 10% in the long run) and by 1.3% in core euro-area countries (5.7% in the long run).

Figure 44: Product market regulation, by region

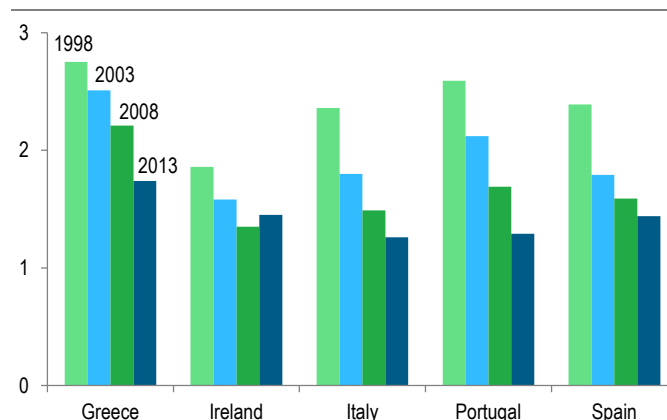
Diffusion index, 1998-2013



Source: OECD, Standard Chartered Research

Figure 45: Product market regulation, periphery

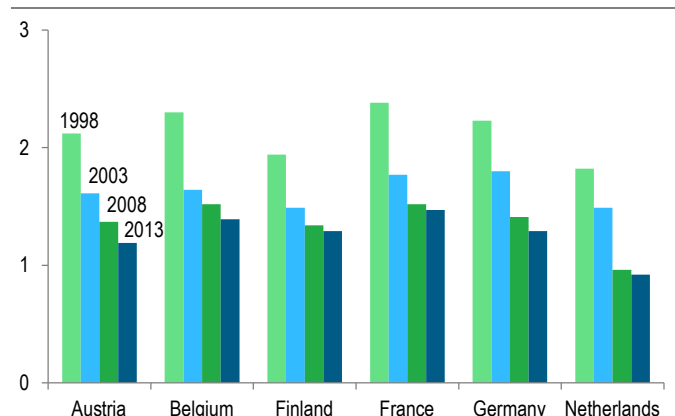
Diffusion index, 1998-2013



Source: OECD, Standard Chartered Research

Figure 46: Product market regulation, core

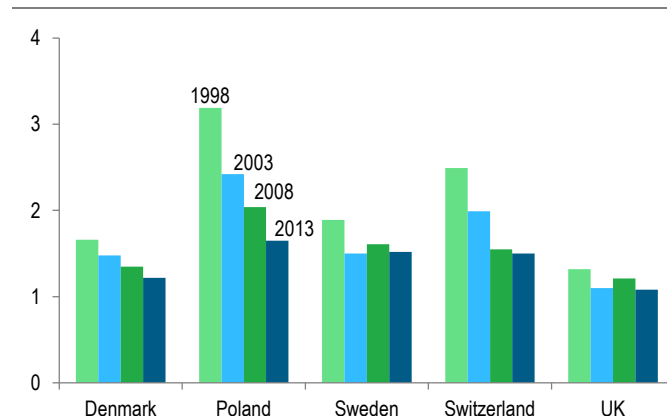
Diffusion index, 1998-2013



Scale from 0 to 6, where higher numbers are associated with increased restrictiveness
Source: OECD, Standard Chartered Research

Figure 47: Product market regulation, non-euro-area

Diffusion index, 1998-2013



Source: OECD, Standard Chartered Research

EODB measures the 'nuts and bolts' of an economy

Ease of doing business

The World Bank's annual Ease of Doing Business (EODB) report monitors what it calls the "nuts and bolts" that hold the economy together, including "the laws that determine how easily a business can be started and closed, the efficiency with which contracts are enforced, the rules of administration pertaining to a variety of activities – such as getting permits for electricity and doing the paperwork for exports and imports". If these and other aspects of the economy are not working properly, economic progress can be slow, and fiscal and monetary policies may be less effective.

It is important to remember that 'doing business' is based on what an economy's laws and regulations require and, as such, may not reflect how well regulations are implemented. For example, 'paying taxes' looks at tax rates and how many hours are spent on tax returns, rather than how successful tax collection is.

The headline 'ease of doing business' ranking aggregates 10 indicators (equally weighted) measuring how easy it is to start a business, deal with construction permits, get electricity, register property, obtain credit, pay taxes, trade across borders, enforce contracts and resolve insolvency, as well as the strength of protection for minority investors. Each of these component indicators is an amalgam of several basic measures (each given the same weight).

The 'distance to frontier' scores benchmark economies according to regulatory best practice

We focus on the 'distance to frontier' scores, which benchmark economies according to regulatory best practice, showing how close or far a country is from the best performance on each indicator. This avoids the problem of ranking, which could mark down a country by comparison with others, even if its performance has improved.

The Doing Business data is comparable for this year and the previous year, but changes in methodology (adding new indicators) mean that there is no comparable headline 'distance to frontier' reading over the past decade. We therefore focus on just one indicator to make inter-temporal comparisons – that is, the ease of starting a business.

Figure 48: Ease of doing business

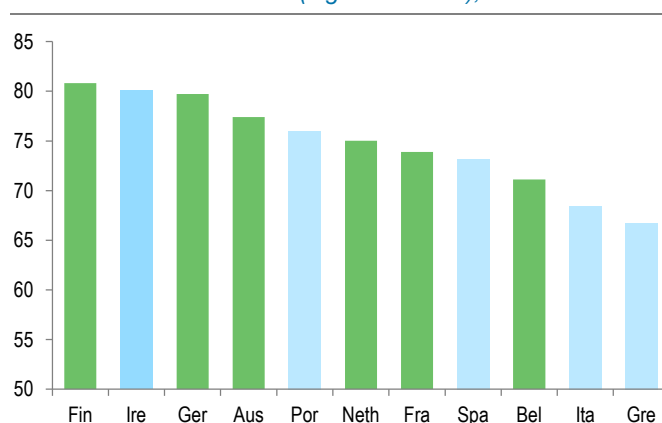
Euro area and selected OECD countries' ranking, 2015

Economy	Ranking	Economy	Ranking
Denmark	4	Netherlands	27
Norway	6	Japan	29
US	7	France	31
UK	8	Poland	32
Finland	9	Spain	33
Sweden	11	Slovakia	37
Ireland	13	Belgium	42
Germany	14	Czech Rep.	44
Estonia	17	Slovenia	51
Switzerland	20	Hungary	54
Austria	21	Italy	56
Latvia	23	Luxembourg	59
Lithuania	24	Greece	61
Portugal	25	Cyprus	64

Source: World Bank, Standard Chartered Research

Figure 49: EODB – Comparing euro-area countries

EODB distance to frontier (higher is better), 2015*



*How far on average an economy is at a point in time from the best performance achieved by any economy on each Doing Business indicator since 2005, or the third year in which data for the indicator was collected. The measure is normalised to range between 0 and 100, with 100 representing the frontier. Source: World Bank, Standard Chartered Research

There have been huge improvements in the ease of starting a business in the past 10 years

Figures 50, 51 and 53 show that there has been substantial improvement in the ease of starting a business in the past 10 years. This category measures the procedures, time, costs and paid-in minimum capital to start a limited liability company.

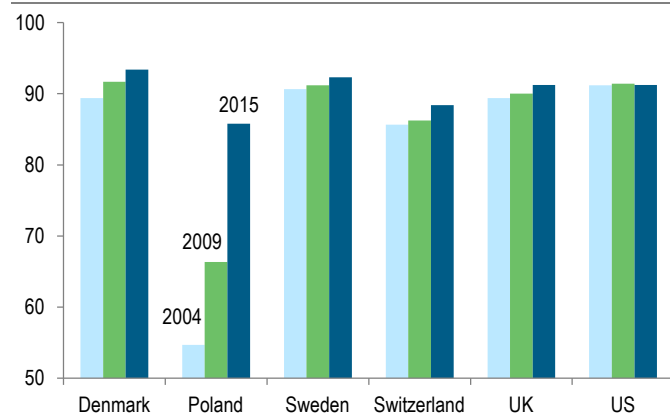
Greece, Portugal and Spain have taken important steps to improve in this area. Portugal is ranked 10th and Ireland 19th in starting a business – Ireland had already lowered barriers to starting a business 10 years ago.

Among the core countries, Germany and Austria score surprisingly low on 'Starting a business', due to a higher number of procedures and longer time (two to three weeks) needed to set up a business.

The cost is higher than for other countries and paid-in minimum capital (both as a percentage of income per capita) is also higher for Germany.

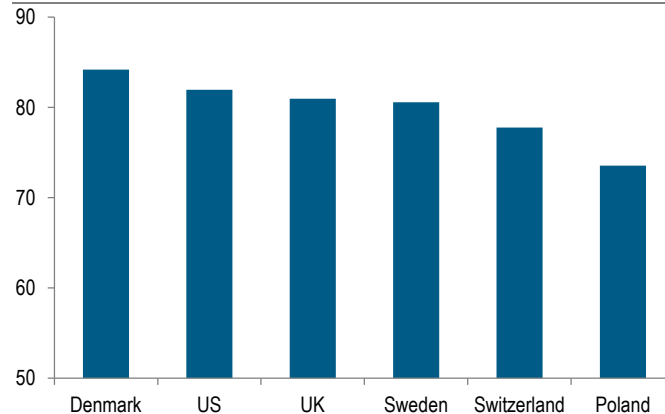
By comparison, some important European non-euro-area countries started from a strong position and have barely changed over the past decade, while the major central European countries lag behind but have improved over the years.

Figure 50: Comparing countries, three different periods
EODB starting a business: distance to frontier: non-euro-area



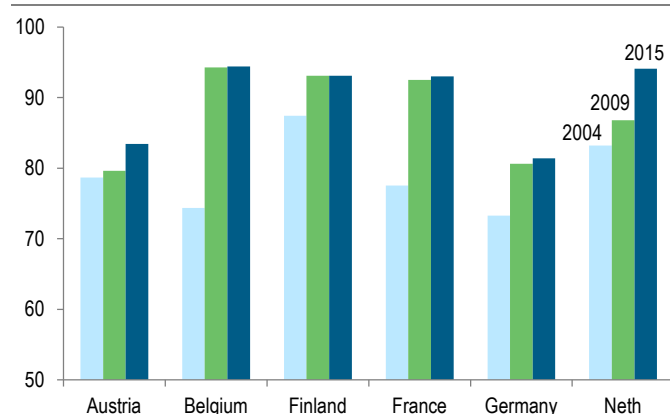
Source: Bloomberg, Standard Chartered Research

Figure 51: EODB – Comparing non-euro area countries
EODB distance to frontier, 2015



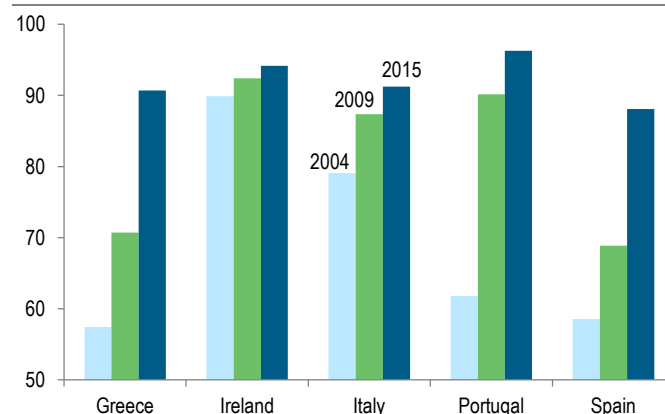
Source: Bloomberg, Standard Chartered Research

Figure 52: Comparing countries, three different periods
EODB starting a business: distance to frontier: euro-area core



Source: LABREF database, Standard Chartered Research

Figure 53: Comparing countries, three different periods
EODB starting a business: distance to frontier; periphery



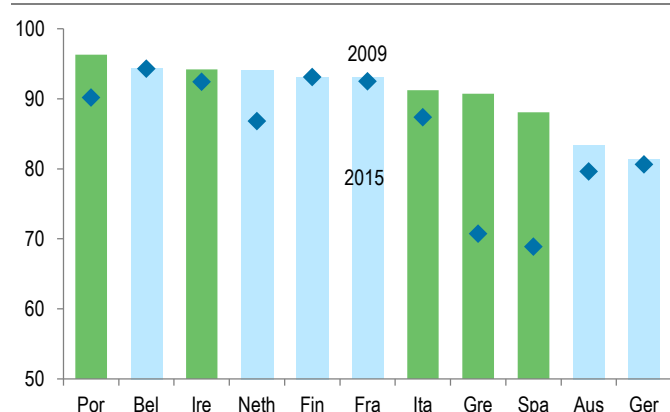
Source: LABREF database, Standard Chartered Research

EODB looks at six regulatory measures and four legal institutional measures

Ease of doing business – Detailed reports

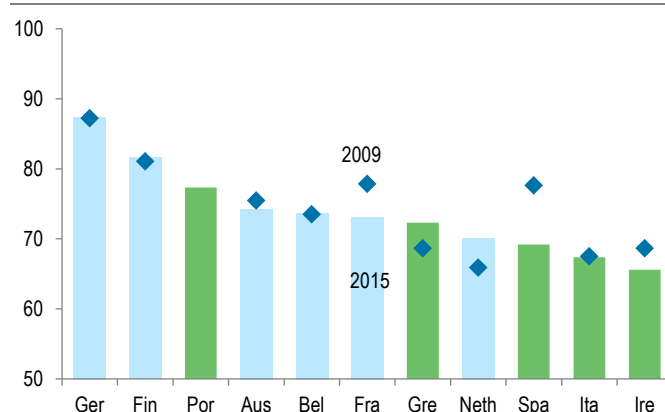
Ease of doing business looks at six measures of complexity and cost of regulatory processes and four measures of the strength of legal institutions (as well as labour market regulation – flexibility in employment regulation, benefits for workers and labour dispute resolution). We have differentiated between six ‘core’ countries (Germany, France, the Netherlands, Austria, Belgium and Finland) and five ‘peripheral’ countries (Italy, Spain, Portugal, Ireland and Greece).

Figure 54: EODB – Starting a business
EODB distance to frontier, 2015 and 2009



Source: World Bank Ease of Doing Business, Standard Chartered Research

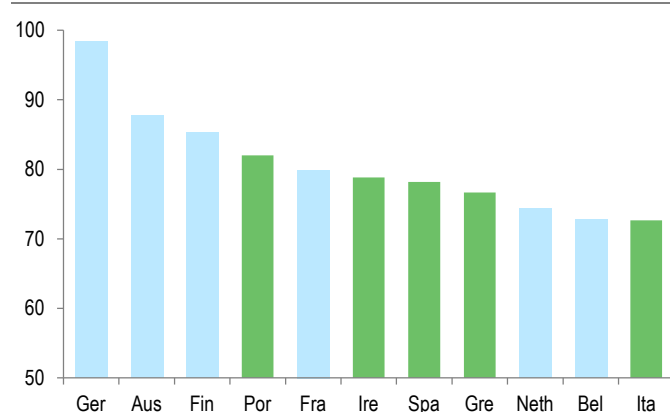
Figure 55: EODB – Dealing with construction permits
EODB distance to frontier, 2015 and 2009



Source: World Bank Ease of Doing Business, Standard Chartered Research

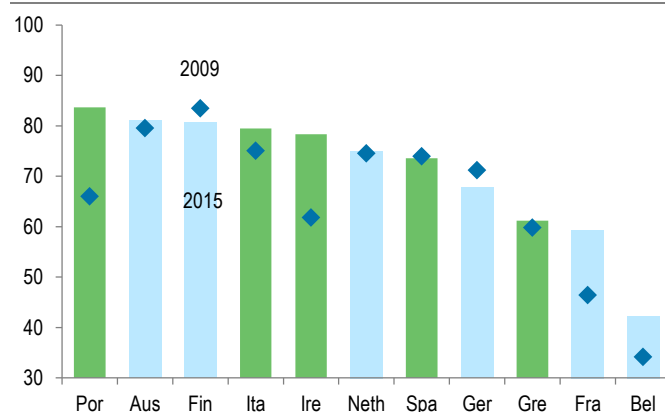
Under some categories, including ‘dealing with construction permits’, ‘getting electricity’ and ‘trading across borders’, ‘enforcing contracts’ and ‘resolving insolvency’, Italy, Greece and Spain fall behind the core countries. Portugal and Ireland perform well generally (reflected in their high overall EODB ranks). Dealing with construction permits measures the number of procedures, time and cost to complete all formalities to build a warehouse. In Italy and Spain, it takes more than twice as long to get a construction permit as in Germany (in Spain and Ireland that time rose between 2009 and 2015), while in Ireland the cost is higher than elsewhere. ‘Getting electricity’ and ‘registering property’ measure the number of procedures, time and cost to, respectively, get connected to the electrical grid and transfer a property. In Italy, it takes four times as long and it is five times as expensive to get electricity as in Germany. Registering a property is lengthy and costly in Belgium; in Greece it requires 10 procedures, versus just one in Portugal.

Figure 56: EODB – Getting electricity
EODB distance to frontier, 2015



Source: World Bank Ease of Doing Business, Standard Chartered Research

Figure 57: EODB – Registering property
EODB distance to frontier, 2015 and 2009

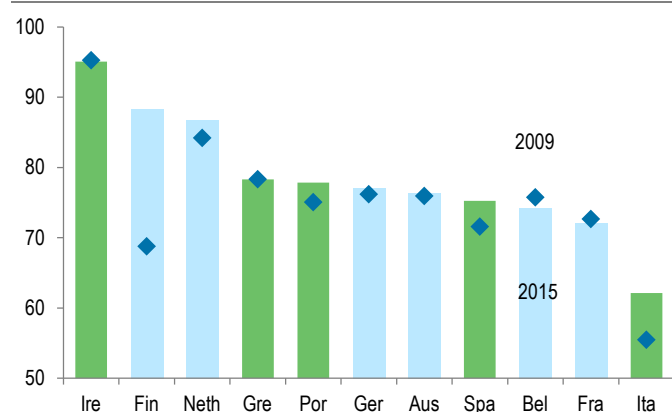


Source: World Bank Ease of Doing Business, Standard Chartered Research

'Paying taxes' assesses the payments, time and total tax rate for a firm to comply with all tax regulations. The total tax rate in best-performing Ireland was 25.9% in 2014, compared with 65.4% in Italy. In 'trading across borders', the number of documents, time and cost to export and import by seaport is measured.

Figure 58: EODB – Paying taxes

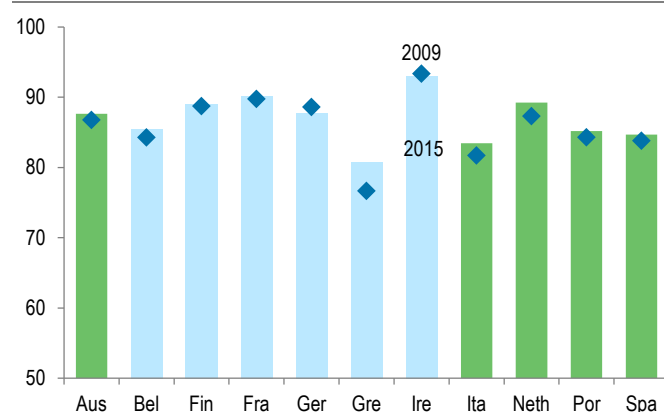
EODB distance to frontier, 2015 and 2009



Source: World Bank Ease of Doing Business, Standard Chartered Research

Figure 59: EODB – Trading across borders

EODB distance to frontier, 2015 and 2009

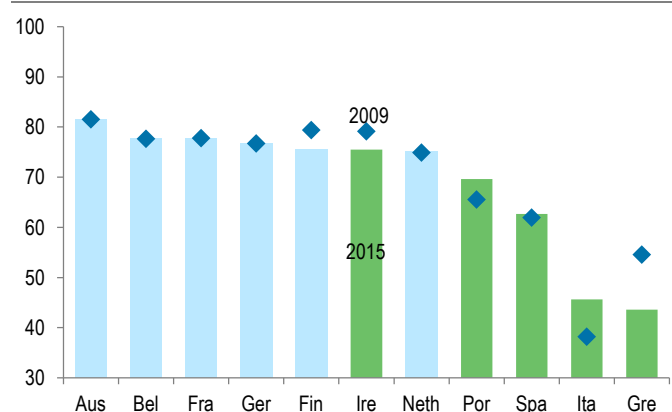


Source: World Bank Ease of Doing Business, Standard Chartered Research

With the exception of Ireland, the peripheral countries score poorly in this category. In 2014, it took at least twice as long to export from Portugal, Italy and Greece as from Germany and Ireland, and it was more costly to import into and export from Spain than Germany and Ireland. In the regulatory categories, peripheral countries perform relatively poorly in enforcing contracts and resolving insolvency. Judicial reform can also contribute to smoother working of the economy, with benefits to GDP growth. Reforms were undertaken in Greece, Portugal, Italy and Spain during the euro crisis to improve contract enforcing by reducing the length of civil trials. But the EODB 2015 report shows that the time taken to resolve a commercial dispute is 1,580 days in Greece (up from 900 days in 2009) and 1,185 days in Italy, respectively four and three times as long as in Germany and France, and involves more procedures. Finland and Ireland have also seen a lengthening of the time taken to resolve a dispute since 2009. Greece also performs poorly in terms of the time, cost, outcome and recovery rate for a commercial insolvency, taking 3.5 years to resolve (under six months in Ireland).

Figure 60: EODB – Enforcing contracts

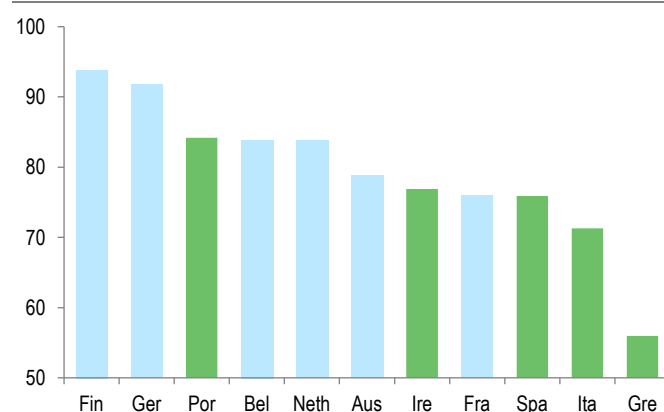
EODB distance to frontier, 2015 and 2009



Source: World Bank Ease of Doing Business, Standard Chartered Research

Figure 61: EODB – Resolving insolvency

EODB distance to frontier, 2015



Source: World Bank Ease of Doing Business, Standard Chartered Research

In the final two regulatory categories – ‘getting credit’ and ‘protecting minority investors’ – the distance to frontier scores are relatively low for all euro-area countries. ‘Getting credit’ measures the degree to which collateral and bankruptcy laws protect the rights of borrowers and lenders and assesses credit information systems. Italy and Portugal score low on the strength of legal rights; depth of credit information is low in Belgium. Across the board, legal protection fell between 2009 and 2015, according to the ‘strength of legal rights’ index in the ‘getting credit’ category, although changes to the methodology might account for some of the deterioration.

‘Protecting minority investors’ measures minority shareholders’ rights in related-party transactions and in corporate governance. Ireland scores well compared with the Netherlands, where the extent of disclosure, the extent of director liabilities, ease of shareholder suits and the extent of conflict of interest regulations are lower, as are measures of corporate transparency and the strength of minority-investor protection.

Improvements in southern European countries

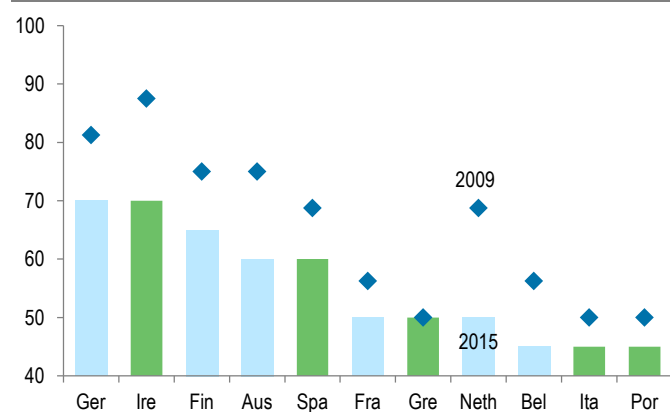
Southern European countries have accelerated reform

Greece, Italy, Portugal and Spain accelerated reforms in the aftermath of the GFC. By cutting complex and costly regulatory processes and improving legal institutions, southern European countries are improving at a faster pace than the rest of the euro area, albeit at a starting point further from the ‘regulatory frontier’ than others.

The 2015 EODB report notes that in 2013-14, Greece reformed in three EODB areas of business regulation, making starting a business easier by lowering the cost of registration. The property transfer tax was reduced and the requirement for a municipal tax clearance certificate was eliminated. Enforcing contracts was made easier by introducing an electronic filing system for court users.

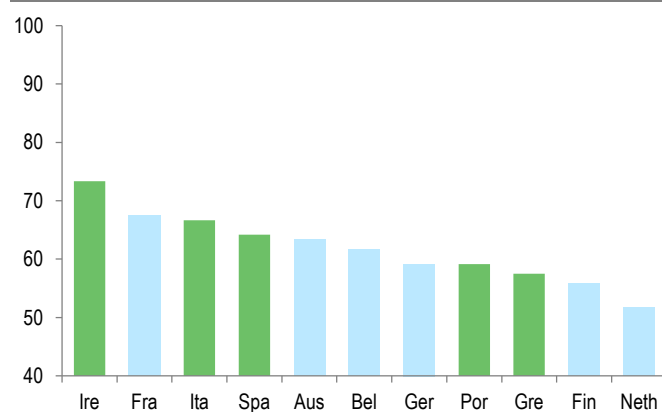
Italy and Spain also made starting a business easier. Italy lowered the minimum capital requirement, while Spain simplified business registration and cut the corporate income tax rate. Portugal cut its corporate income tax rate and introduced a lower corporate tax rate for qualifying SMEs. It also made enforcing contracts easier by reducing court backlogs, streamlining court procedures, enhancing the role of judges and accelerating the resolution of civil and commercial disputes. Spain introduced new rules for out-of-court restructuring as well as provisions applicable to pre-packaged reorganisations.

Figure 62: EODB – Getting credit
EODB distance to frontier, 2015 and 2009



Source: World Bank Ease of Doing Business, Standard Chartered Research

Figure 63: EODB – Protecting minority investors
EODB distance to frontier, 2015



Source: World Bank Ease of Doing Business, Standard Chartered Research

Banking union – A game-changer?

Introduction

Full banking union consists of a single supervisor, resolution mechanism and fund, and a common deposit guarantee

The decision to create a banking union was a key moment during the worst point of the euro-area debt crisis. It served both to end immediate doubts about the future of the euro area and make the euro area more resilient in the long run.

During the crisis, doubts over governments' ability to stand behind their banks resulted in deposit outflows, widening bank-funding spreads and increasing the fragmentation of the euro-area banking sector. Lending costs rose sharply in the periphery, impairing the monetary policy transmission mechanism.

Banking union is a key development for the long-run success of the euro

Actions to ensure that banks are not reliant on government support came in the wake of the GFC and, in the euro area, were also a response to the contagion that spread among peripheral countries.

The ECB already provides lender of last resort facilities and access to central bank liquidity; additional key features of a banking union include common regulatory supervision, a common resolution mechanism and a cross-border deposit guarantee system.

Since late-2014, the ECB has taken on the role of the common supervisor, albeit with the support of national supervisors. A European Bank Resolution and Recovery Directive has been agreed, with a view that bank losses will be borne by bank shareholders, management and creditors rather than taxpayers. Building a common deposit insurance scheme across sovereign states has proven to be a tougher hurdle, since mutualised deposit guarantee schemes imply a pooling of risk and loss of sovereignty.

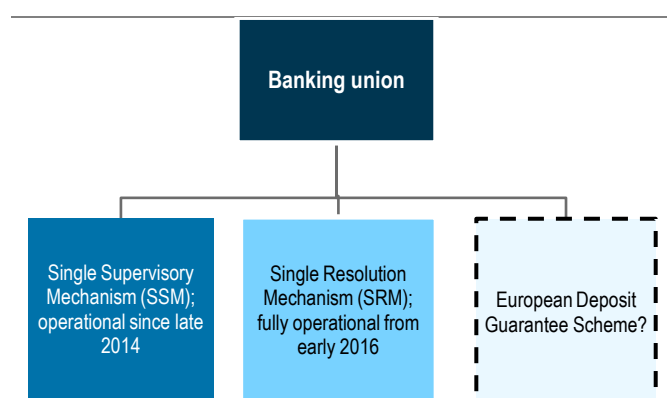
We believe that swift implementation of the current plans to complete the banking union are key in enabling the weak banking sectors of the periphery countries to regain their health and support the real economy.

Why have a banking union?

The bank-sovereign vicious circle was a key ingredient in the propagation of the debt crisis

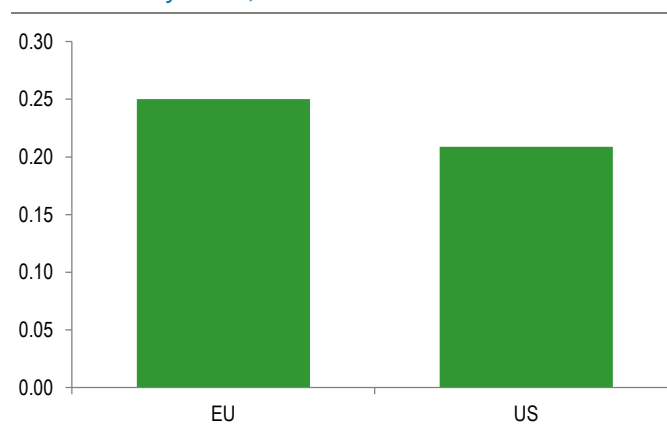
If a full banking union with pan-European banks had been in existence since the introduction of the euro, the euro area's debt crisis would have been much milder. The banking sector was supposed to serve as a risk-sharing mechanism, allocating capital where it is most efficient. However, in the euro-area debt crisis, the banking sector served as an amplifier of contagion instead of a back stop. Cross-border bank lending

Figure 64: The three pillars of the banking union



Source: European Commission, Standard Chartered Research

Figure 65: Relatively more value added by SMEs in the EU
Value added by SMEs, % of GDP



Source: European Commission annual report on SMEs, Standard Chartered Research

halved as major European banks tried to limit their foreign exposure. This exacerbated the vicious circle between sovereigns and banks, which became a key issue in solving the euro-area debt crisis.

The euro debt crisis would have likely been shorter if a banking union had existed

A main characteristic of the currency union is free flow of capital. The inability to maintain this in times of crisis was shown in the cases of Cyprus and Greece. Capital controls were imposed in Cyprus after the bail-in agreement in March 2013 and were gradually lifted in the next two years. The uncertainty following the January 2015 Greek election led to a 'slow-motion' bank run. The decision to hold a referendum on the institutions' proposal on the reforms package forced the ECB to keep emergency liquidity assistance (ELA) to Greek banks unchanged. That meant that the Greek banks were unable to open for three weeks and capital controls were put in place.

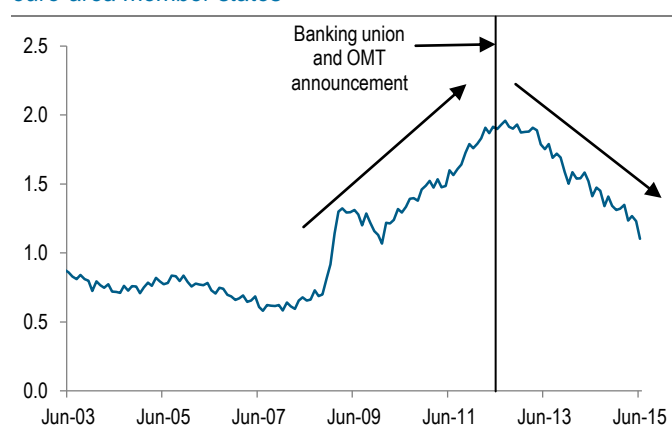
To illustrate the contrast with a true banking union, if a US bank faced severe losses in California, there would be no bank run because US banks operate nationwide, extending loans and taking deposits across the country. This diversification means that losses in one state do not threaten the solvency of the bank.

In addition, the general effects of fiscal distress on the economy damaged banks' asset quality. This was further exacerbated by rating agencies' downgrades of banks' ratings following a downgrade in the sovereign rating. As economic performance worsened, more loans became non-performing.

Banks' holdings of sovereign debt also exposed them to their government's problems (they were required to hold a proportion of their assets in liquid assets, such as sovereign debt). Naturally, banks based in a strong sovereign, such as Germany, were seen as safer than banks based in the periphery. This led to higher funding costs, and therefore higher lending rates, in the periphery, exacerbating the fragmentation of the banking system.

Figure 66: Interest rates diverged in the GFC

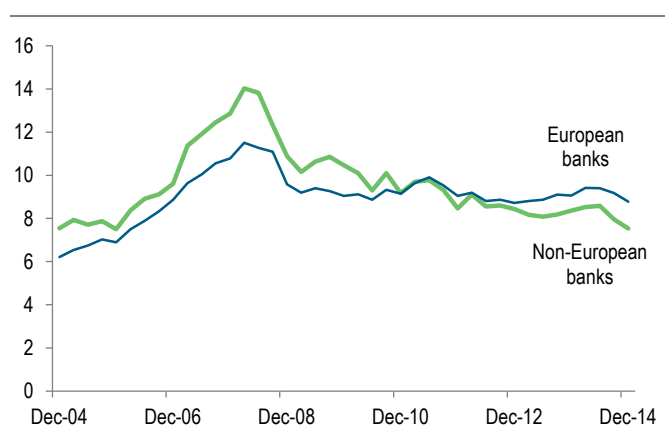
Standard deviation of interest rates on loans to corporations of euro-area member states



Source: ECB, Standard Chartered Research

Figure 67: European banking system remains fragmented

Consolidated foreign claims of reporting banks, USD tn



Source: AMECO, Standard Chartered Research

Full banking union consists of a single supervisor, resolution mechanism and fund, and a common deposit guarantee

Three pillars of the banking union

There are three main elements to banking union (Figure 64):

The first pillar is the single supervisory mechanism (SSM). The ECB took over supervisory responsibility on 4 November 2014 following the comprehensive assessment of banks' balance sheets. Ahead of this, banks had deleveraged significantly and written down non-performing loans to clean up balance sheets. The ECB supervises 123 of the largest banks in the euro area, which together account for more than 85% of the aggregate assets of the euro area's banking system. It has the power to grant and withdraw banking licences to any bank in the euro area.

Reducing the high degree of uncertainty related to the strength of banks' balance sheets was critical in reducing fragmentation across the region. An end to deleveraging and the re-starting of bank lending should help pull the euro area out of recession and back to growth.

The SRM will ensure the smooth resolution of failed banks

The second pillar of the banking union is the Single Resolution Mechanism (SRM). This will give the Single Resolution Board (SRB) the power to resolve failed banking institutions and the ability to impose bail-in conditions. The SRM is in the final stages of being implemented. If all goes according to plan, it will be operational in January 2016. The resolution process will involve imposing losses on senior creditors and uninsured depositors of non-viable banks. The SRB will not fully replace the current national resolution authorities, but will work with them and have the ultimate say. The SRM is still untested, but in the case of Cyprus, where uninsured depositors faced heavy losses, it became clear that the mentality had shifted from bailouts to bail-ins.

The SRF should increase confidence in the banking institutions of smaller countries

The Single Resolution Fund (SRF) is the other part of the second pillar. Its aim is to reduce banking fragmentation by reducing the bank-sovereign channel, where a bank is considered safer if it is based in a strong sovereign because of the implicit guarantees for a taxpayer-funded bailout.

The SRF will be used to cover the costs of bank resolutions, but will not cover deposits. Member states will begin providing finance to the 'mutualised' part of the fund in 2016. The fund is slated to reach EUR 55bn in eight years, or at least 1% of the amount of insured deposits of all banks.

Some have criticised the SRF, arguing that these funds are not enough to cover the cost of future bailouts. Theoretically, just the existence of the SRF should reduce the probability that it will be needed in reality, because it increases confidence in the system, thus avoiding bank runs. However, the existence of the fund may not fully eliminate the expectation that if a major banking crisis recurs, taxpayer funds may be used in an ad-hoc manner to save banks, if it is judged to be in the long-term public interest.

The common deposit guarantee scheme is the third pillar. The first and second pillars should raise confidence in the banking systems of weak member states and limit the contagion to an extent. As long as the deposit guarantee remains with the sovereign, we think there will be doubts about the ability of the sovereign to reimburse covered depositors in case of large-scale bank failures. This is what a common deposit guarantee scheme aims to solve.

The 'Five Presidents' report proposes a European deposit insurance scheme from 2017

The recent report 'Completing Europe's Economic and Monetary Union' by the five presidents of the European Commission, ECB, Eurogroup, European Council and



European Parliament, suggests that a European deposit insurance scheme (EDIS) should be launched no later than 2017.

We think this is a crucial part of the banking union and the best way to ensure that depositors retain confidence in banks even if the sovereign is in trouble. However, it may be difficult to fully break the link between the sovereign and banks if individuals fear that deposits can be converted into a national currency if the country decides to leave the euro. This fear is what drove bank runs in Greece during the reform package/third bailout negotiation phase.

Benefits of a banking union

- 1. Raises confidence in the European banking system:** Knowing that all large European banks are supervised with the same high standards should inspire confidence in the banking system. Higher confidence in the system and the ability to identify problems early should prevent problems from getting too big and prevent failing banks from causing financial instability. The SRF reduces the chances that a banking organisation falls into disorderly default.
- 2. Breaks the bank-sovereign vicious circle:** By making it known in advance that shareholders and junior bond holders will be tapped first to bear losses, the banking union minimises the costs to taxpayers and forces bank investors to diligently check the health of their investments to avoid future bail-ins. This reduces the effect of the implicit guarantee for a government bailout.
- 3. Ends the practice of 'nationalist banking'.** A problem that was known but rarely raised before the announcement of the banking union was that national regulators were 'friendlier' when dealing with home banks. A member of the executive board of the Bundesbank said in a recent speech: "This [the banking union] will prevent domestic supervisors from handling their banks with kid gloves out of national interest." Having a single supervisor sidesteps this issue.
- 4. Identifies cross-border problems:** Cross-border supervision is more complicated, with conflicts usually arising between 'home' regulators and 'foreign' regulators. A single supervisor will be more effective at dealing with these problems.

Developments to monitor

The banking union will keep evolving

As with any project of this scale, the European banking union will likely need many years to achieve its full potential and deliver the positive public benefits it is supposed to, although to the extent that banks have cleaned up their balance sheets in anticipation of the comprehensive assessment, most institutions are already in a stronger position to start lending again. We focus on three key aspects to measure the banking union's success: (1) bank balance sheet repair and lending ability; (2) reversal of the fragmentation of the euro area's financial system; and (3) the transformation of Europe's banking and financial landscape.

Balance-sheet repair and lending ability

Repairing balance sheets remains a challenge for crisis-hit countries

Banks with weak balance sheets cannot lend money to the real economy. Repairing banks' balance sheets is, therefore, an important metric to judge the success of the banking union. Dealing with non-performing loans is key for the banking systems that were hit the hardest – Italy, Spain, Greece and Portugal and Ireland. Countries have taken different approaches to deal with non-performing loans. Some have introduced

Establishing a national 'bad bank' and asset sales to non-bank financial institutions are two ways to clean up bank balance sheets

so-called 'bad banks', pooling non-performing loans together in one institution in order to raise confidence for the rest of the banking sector. Another approach is to sell packages of loans to specialised investors at a discount.

Aggregate lending to non-financial corporations has been negative since mid-2012, reaching a trough at -3.2% y/y in early 2014. The situation has since reversed, turning positive again y/y in mid-2015.

Reversal of fragmentation

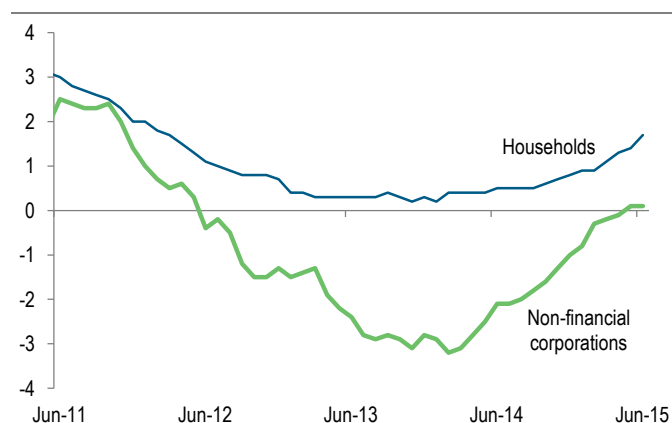
In order to call banking union a success, we need to see a reversal of the past few years of fragmentation of the European banking system and renewed integration. European banks are still shrinking their exposure to other banks in the region. Fragmentation was driven by the realisation that 'banks are global in life, but national in death': if a bank fails, the sovereign where it is based will step in. Therefore having exposure to an Italian bank effectively exposed the investor to Italian sovereign risk.

European banks also exhibit a 'home bias' in their holding of sovereign debt. They hold much more sovereign debt of their home country, even though all have similar regulatory treatment in calculating risk-weighted assets. There are a few reasons for this. First, banks may be under 'moral suasion' from the sovereign to buy its debt. Second, the bank may expect 'friendlier' treatment in case of a bankruptcy (though this was not the outcome for the restructuring of debt under Greece's Private Sector Involvement). Finally, especially for the weaker countries, their sovereign debt return is higher than that of 'core' debt, which enhances their returns. There have been calls to impose limits to concentration risk – for example, a bank would not be able to hold more than a specific portion of its total assets in a single sovereign's debt.

A revision of the risk weighting rules of sovereign debt would be a welcome development

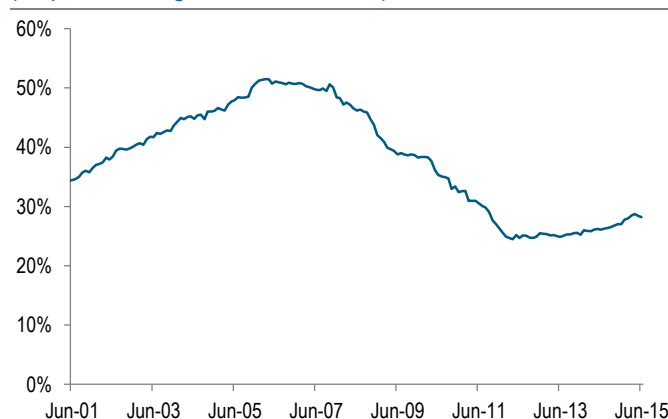
The European Systemic Risk Board recently released a paper arguing that "from a macro-prudential point of view, the current regulatory framework may have led to excessive investment by financial institutions in sovereign debt". It argues for a global "rethink" of risk management practices regarding sovereign debt. Interestingly, since the GFC, countries under stress (Italy, Spain, Portugal, Ireland and Greece), increased their sovereign debt holdings as a ratio of total assets to c.10% from c.4% while non-stressed countries kept the ratio roughly constant.

Figure 68: European banks lending declined during the recession (loans adj. for sales and securitisation, % y/y)



Source: ECB, Standard Chartered Research

Figure 69: Cross-border holdings dropped
Share of MFI cross-border holdings of debt securities (corporate and government issuers)



Source: ECB, Standard Chartered Research

Transformation of the euro area's banking and financial system

The most fundamental change likely to occur in the long run is cross-border banking-system consolidation across the euro area, in our view. The banking union should reduce multinational banks' costs and increase synergies, making a pan-European banking model more attractive than currently (Figures 71 -72).

The emergence of pan-European banks will weaken the bank-sovereign relationship...

The emergence of pan-European banks will be seen as a success of the banking union, providing there are enough of them. Pan-European banks could spread risk across the euro area much more effectively, and be much more resilient to crises. However, the too-big-to-fail (TBTF) issue springs to mind. The Competition Authority of the European Commission and the ECB will work closely to prevent the emergence of any TBTF pan-European bank.

... while preventing the emergence of too-big-to-fail institutions

The benefits of such a development would be substantial – if a country faces an economic shock, a credit crunch would be avoided because banks would be diversified enough in other countries to continue to lend at reasonable rates. For example, in the aftermath of the GFC, the Baltic countries experienced a severe downturn, with GDP dropping around 15% y/y in 2009. However, there was no credit crunch due to the presence of Scandinavian banks, whose exposure to the more stable Scandinavian countries enabled them to continue lending.

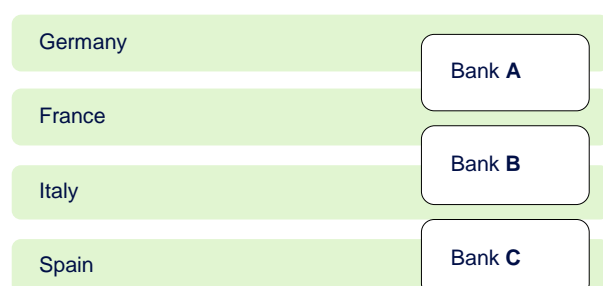
A fully integrated banking system could deliver substantial help in the event of an outside shock. The IMF has shown that economic fluctuations are mostly smoothed through private financial channels, rather than through fiscal risk-sharing (Figure 80).

Depositors should be aware that bank deposits are not fully risk free

A sign of the banking union's success would be depositors' differentiation between banks depending on quality. To date, depositors have had no incentive to put their money in a bank with a sound capital base because of the implicit assumption of bailouts. However, the realisation that uninsured depositors would face losses in the event of a bank failure should make depositors think carefully before choosing their bank. This should also increase banks' incentive to stay well capitalised.

Figure 71: Moving from national banking giants...

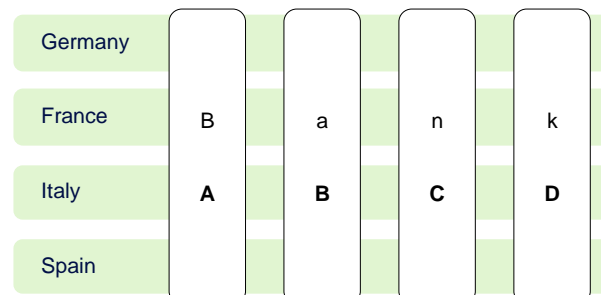
Stylised view of banking system exposure. The current model has banks with large exposure to their home countries



Source: Standard Chartered Research

Figure 72: ... to well-diversified, but not TBTF, banks

Banks have controllable exposure across the entire euro area



Source: Standard Chartered Research

Figure 70: Regulatory treatment of sovereign exposure needs a rethink

Risk weights for sovereigns and central bank exposure in the standardised approach of Basel II

Credit assessment	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-
Risk weight	0	20	50	100	150

Source: ESRB, Standard Chartered Research

Capital markets union – Complement to the banking union

Introduction

Extensive reliance on bank financing was a key factor in the prolonged recession in the euro area

The recent crisis revealed another major weakness of the euro area: its extensive reliance on banking-sector financing. The banking union provides only half the answer to increased financial risk-sharing. About 80% of financing in Europe comes from the banking sector, with the rest coming from capital markets. This is the mirror image of financing in the US, where capital markets are much more developed and account for about 70% of lending. Both equity and debt capital markets in Europe are underdeveloped relative to the US (Figure 75, 78).

So far the European Commission has published a green paper seeking consultation on capital markets union (CMU). The consultation period has ended and it aims to publish an action plan in late 2015. Enhancing high-quality securitisation and the adoption of long-term investment funds (LTIFs) are key developments to expect in the short run.

In our view, ambitious implementation of the CMU is required for the long-run survival of the euro area. Investors should watch this space closely, as it could significantly improve the attractiveness of the EU as an investment destination globally.

What is a CMU, and why is it needed?

Creating deeper and more integrated capital markets in the EU

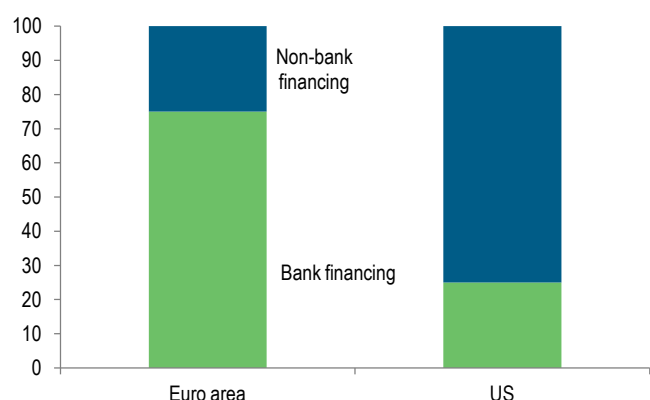
CMU is the term used to describe the European Commission's plan to create deeper and more integrated capital markets in the EU. Unlike the banking union, which is already partly operational, the CMU is still a set of ideas. Capital markets-based financing is essentially any type of non-bank lending, including corporate bonds, securitisation, direct lending by non-banks, peer-to-peer lending and others. As discussed earlier risk-sharing across the euro area is key for the sustainability of the currency union (Figure 80).

CMU could improve the matching of savers and borrowers

A CMU will make the matching of savers and borrowers more efficient and improve private-sector risk-sharing across Europe. This should lead to permanently higher growth through more efficient allocation of capital (and lower funding costs) and smoother business cycles as risks are absorbed more widely across member states.

The key aim of the CMU is to create a single market for capital across the EU, not just the euro area, by removing barriers to cross-border investment within the EU and by creating stronger connections with global capital markets.

Figure 73: Euro area is highly dependent on banks
% of bank financing to total financing*



Source: *estimated by European Commission, Standard Chartered Research

Figure 74: Europe has a much larger banking sector than the US

% of GDP	Banking assets	Bank loans	Bank deposits
EU27	293%	194%	175%
EA	325%	196%	183%
US	89%	67%	59%
Japan	196%	92%	132%

Source: European Banking Federation, Standard Chartered Research

European banks were worse affected by the crisis than US banks

The European debt crisis weighed significantly on the European banking sector and led to banks cutting back lending sharply. This was (and still is, but to a lesser extent) a great concern for the transmission mechanism of monetary policy. If banks' ability to lend is severely impaired, then no matter how loose monetary policy is, banks are unable to boost lending until they repair their balance sheets, which takes time. The annual growth rate of loans to non-financial corporations was negative between Q2-2012 and Q2-2015. This led to the dearth of investment we see in Europe. In mid-2015 fixed investment was still 15% below its pre-GFC levels. Had a strong capital market existed, it would have filled some of the void left by the banks.

More stringent capital requirements mean more financing will be done through non-banks

The regulatory response to the financial crisis has also increased the need for more market-based financing and less bank financing. Basel III regulations require banks to hold more capital, especially more liquid capital, than before. This will likely make bank financing more expensive, especially risky and long-term financing. These changes weigh relatively more on European banks which, due to their business models, have higher leverage ratios than US banks.

A banking union is only a half-answer to the European debt crisis

How will the CMU make the euro area more resilient?

The main channels through which the CMU will likely work are:

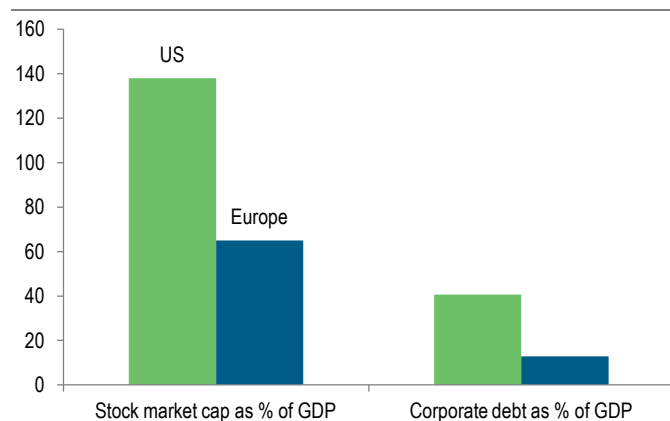
1. By diversifying financing sources

Capital markets can provide an alternative to bank financing for the real economy. This reduces the probability of investment stalling due to insufficient financing after an economic shock. During periods of economic prosperity, market-based financing can be cheaper or more flexible than bank financing. This is possible even at a national level, though for smaller countries the fixed costs associated with setting up capital markets infrastructure are too high to justify their benefits. A Europe-wide CMU would raise the incentives of each member state to build their capital markets infrastructure.

Retail investor participation would significantly increase the pool of capital

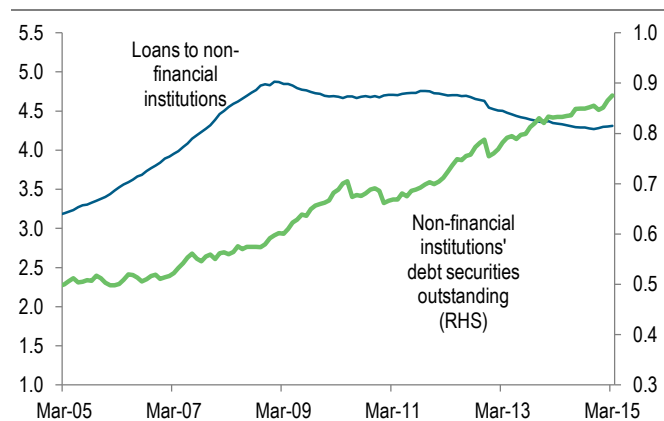
The CMU should increase the supply of savings, which means lower borrowing rates. Euro-area residents have a higher proportion of their savings in bank deposits than in capital markets, in contrast with the US. This is especially the case in countries with less developed capital markets. The CMU could increase retail investors' confidence in capital markets by encouraging savings (e.g., through tax-breaks for small amounts) and through financial education. Moreover, international investors who consider investing in European capital markets would find it more attractive to invest in one country, if the investment was treated similarly to those in other European countries.

Figure 75: European capital markets are underdeveloped
Stock and corporate debt market as % of GDP



Source: European Commission; Standard Chartered Research

Figure 76: Capital markets are becoming more important, but bank loans still dominate financing
EUR tn



Source: ECB, Standard Chartered Research



2. By addressing the lack of cheap financing for specific investment types SME sector

Not all sectors were affected equally by the dearth of financing in the euro area following the GFC. While large corporations with access to capital markets were able to obtain cheap funding and benefited from the ECB's easing policies (Figure 79), SMEs were hit hard. Market-based finance to SMEs is especially problematic due to the nature of these loans: they are less homogeneous than other types of loans (e.g., mortgages) with regard to maturity, legal form, collateral, etc. This makes it difficult to bundle SME loans together in a securitised product.

Structural factors within the European economy, such the high percentage of SMEs, meant that banks essentially represented the only source of financing because they could assess the credit quality of SMEs at a lower cost than non-banks.

SMEs and infrastructure projects face challenges in obtaining finance

The CMU should aim for standardisation of SME loans within and across member states. Better data on SME credit quality would also be helpful for states which have very basic credit score databases and instead rely on 'relationship banking'. This would enable high-quality securitisation of SME loans, seen as key to lowering borrowing rates for SMEs. Loans from multiple jurisdictions could be packaged together, making it easier for SME loans in small countries to be sold to the market. The ECB has emphasised this issue numerous times and has actively supported it by including asset-backed securities (ABS) based on SME loans in its asset purchase programme. The European Commission is considering building an accounting standard for SMEs, a type of simplified version of International Financial Reporting Standards (IFRS) which would be cheaper to follow and would harmonise financial reporting of SMEs across the EU.

Governments seek private-sector help with investment programmes

Infrastructure

Spending constraints and European member states' already high debt levels have reduced governments' willingness and ability to fund large public-sector investment programmes. Therefore, long-term infrastructure projects which would ordinarily be financed by the state need to be primarily financed by the private sector with a contribution from government.

However, investors are reluctant to participate given the idiosyncratic nature of these projects, their very long-term time horizon and regulators' conservative approach. The CMU should aim to harmonise the treatment of infrastructure projects to allow securitised products to emerge, spreading the risk to investors who are comfortable taking long-term risk.

Figure 77: The CMU will likely evolve through a series of small steps rather than a single large step

Near-term goals	Long-term goals
Take-up of European Long-Term Investment Funds (ELTIFs)	Reduce costs of setting up and marketing investment funds
Encourage high-quality securitisation	Further develop venture capital and private equity financing
Improve credit information on SMEs	Legal reform: company, solvency, tax, securities law harmonisation
Develop private placement markets	Simplified accounting standard for SMEs
Review current prospectus regime (investment disclosure requirements)	

Source: Standard Chartered Research

CMU would improve the monetary policy transmission mechanism by reducing fragmentation

The introduction of European Long-term Investment Funds (ELTIFs) is a positive step in this direction. ELTIFs are designed to increase the amount of non-bank finance available for companies investing in the EU real economy. They will enable single funds to raise finance across the EU, which is not possible currently. The definition of infrastructure investment needs clarification and investor education on how ELTIFs can be an efficient vehicle for long-term investments is necessary. Insurance-sector regulations, such as those introduced by the Solvency II directive will likely be adjusted to make investments in ELTIFs attractive for insurance asset managers. The European Commission estimated in 2013 that c.EUR 1.5-2.0tn would be needed to finance infrastructure projects up to 2020; ELTIFs are expected to contribute a significant amount of this target.

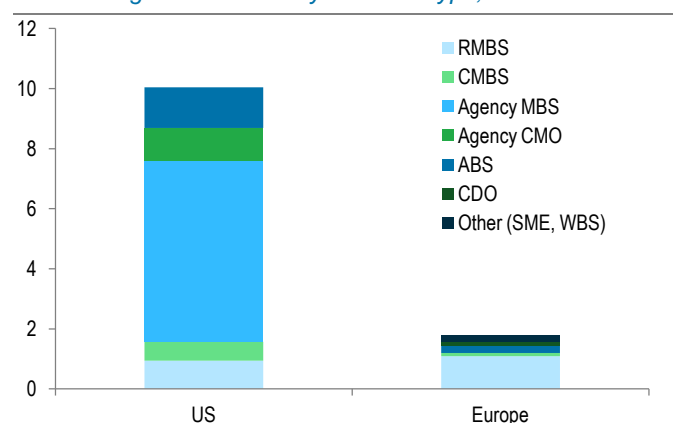
3. **By reducing fragmentation; increasing risk-sharing between countries; improving the transmission mechanism of monetary policy**

The CMU can complement banking union efforts to reduce the fragmentation of the financial system. An ambitious CMU should strengthen cross-border capital flows from their current low level and broaden their appeal to different market participants, reducing fragmentation. A well-functioning CMU would significantly improve the transmission of monetary policy, allowing the ECB to operate more effectively.

The CMU could minimise the 'home bias' effect

Currently, the banking sector accounts for most cross-border transactions, mainly via wholesale bank lending. The CMU would help other investors such as pension funds, insurance companies and retail investors to reduce their home bias by increasing their investments in other European countries.

Figure 78: US outstanding securitisation dwarfs European
Outstanding securitisation by collateral type, USD tn



Source: SIFMA, Standard Chartered Research

Figure 79: Large corporates were less impacted by the credit crunch
(Bloomberg investment grade index yield, %)



Source: Bloomberg, Standard Chartered Research



Reforms likely to come 'early' (2016-18)

European officials have signalled that they aim to implement reforms as soon as possible in order to build momentum and send a signal to the market that CMU is happening. According to a speech by Jonathan Hill, EU Commissioner for Financial Services, Financial Stability and Capital Markets Union in mid-2015, the early priorities focus on (1) promoting high-quality securitisation and finalising the definition of infrastructure investment to accelerate the take-up of ELTIFs; and (2) the European Commission's Prospectus Directive, which aims to provide investors with consistent and clear information on potential investments across the EU.

More ambitious reforms, such as insolvency and securities law harmonisation across the EU would need legislative proposals by the European Commission and adoption by national parliaments, which will be a lengthy process. Developing a more dynamic private equity and venture capital culture is also likely to take several years.

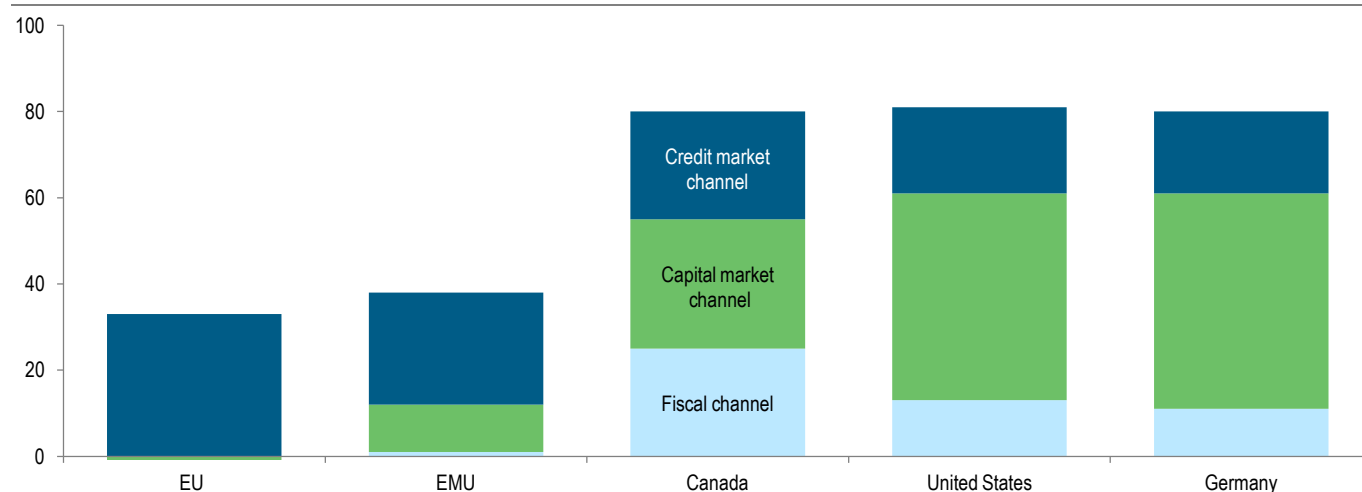
Macro-prudential policy toolbox needs to be strengthened

The CMU will give rise to new financial stability risks. If risks are mispriced over a long period, bubbles can be created more easily in a CMU, as capital pools are deeper and capital moves faster. Monetary policy is a blunt instrument. Therefore, the European authorities must ensure that the appropriate institution, probably the ECB, has a policy toolkit capable of targeting a specific risk in the financial system without having to resort to monetary policy. For example, the Bank of England's Financial Policy Committee changed mortgage lending criteria in 2014 to cool down the property market without having to hike interest rates prematurely. In addition, a European version of the Securities and Exchange Commission (SEC) would likely be needed to support a unified European capital market.

CMU would have to be accompanied by more stringent macro-prudential regulation by the ECB or a new regulator

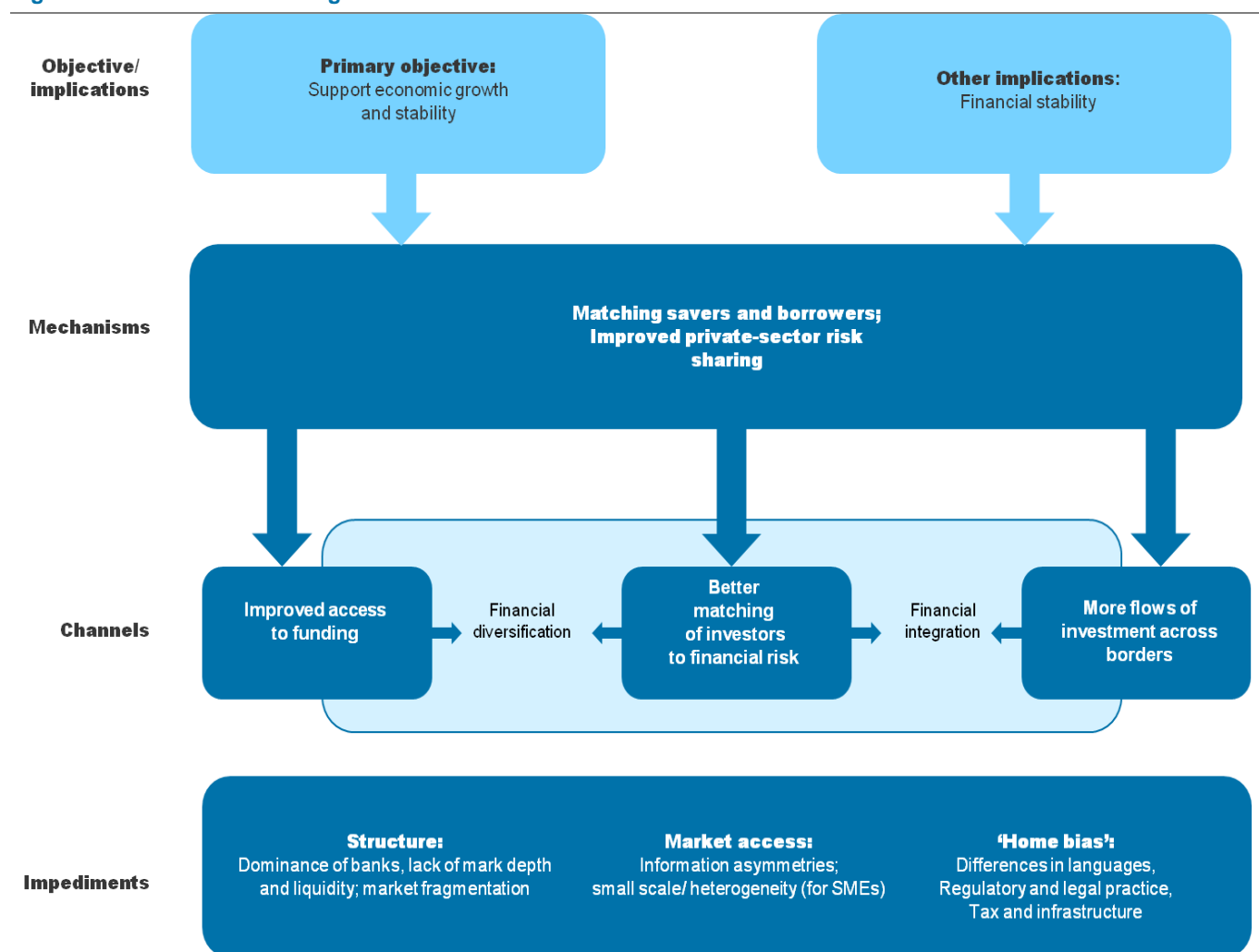
Figure 80: Capital markets account for a higher proportion of risk-sharing than fiscal transfers

% of shock smoothed by different channels



Source: IMF (2013) toward a fiscal union for the euro area, Standard Chartered Research

Figure 81: The channels through which the CMU would work



Source: Bank of England Financial Stability Paper 33: A European Capital Markets Union, Standard Chartered Research



Fiscal union and the limitations of risk-sharing

Deeper integration – the only way forward?

Germany supports closer fiscal integration

Germany has long been vocal on the need for greater fiscal union within EMU. Comments from former Greek Finance Minister Varoufakis paint a Machiavellian portrait of German Finance Minister Schaeuble as being intent on forcing Greece out of EMU to frighten other governments into agreeing to transfer fiscal powers to Brussels. This is an extreme view, but it encapsulates Germany's position that fiscal union is the only way to guarantee the future of the monetary union.

The threat of Grexit sharpened the focus on the need for deeper integration

The very real threat of Grexit has sharpened the focus on the need for deeper integration, with Italian Finance Minister Pier Carlo Padoan arguing that to take away the risk of euro exit and break-up, there needs to be deeper fiscal and political convergence. Italy reiterates German calls for a common euro-area budget and a common unemployment insurance scheme on the fiscal side, while on the political side, it sees the need for an elected euro-area parliament (alongside the current European Parliament) and a European finance minister. Key will be to balance moral hazard with risk-sharing.

It is important to remember that fiscal union is not a 'be all and end all' – the US single currency operated for a long time before federal income tax was introduced and federal tax receipts were relatively low even by the 1930s. In states within the US and Germany, risk-sharing is largely through credit and capital markets, rather than fiscal transfers.

How could a fiscal union begin to take shape?

Fiscal union is politically the most challenging integration step

A fiscal union would be the most credible sign that the euro area has the political will to stay together for the long run. Fiscal union is politically the most complicated aspect of the integration process because it involves ceding even more sovereignty from the national level to the euro-area level. It is very unlikely that Europe will move towards a fiscal union without a control mechanism for fiscal policy at the European level. This could take the form of a veto on national fiscal policy from a European body, most likely the European Parliament.

A euro-area finance ministry: Under fiscal union a euro-area finance minister would manage fiscal resources at a federal level and would have a veto over national budgets if there were a threat to fiscal sustainability.

A common unemployment insurance scheme could be a first step towards fiscal union

Common unemployment insurance: Pier Carlo Padoan, Italy's finance minister, suggested introducing a common European unemployment insurance scheme as the first step towards genuine fiscal union. This would be a limited version of fiscal risk-sharing without the need for treaty change, which is a lengthy process. An unemployment insurance fund would be pre-funded, mostly through employers' contributions. It should be designed in a way that prevents permanent fiscal transfers between member states. In the scenario of an asymmetric shock (a recession that impacts only one or some of the member states) it would act as an automatic stabiliser to soften the negative effect. After the recent European debt crisis some countries' unemployment rates surged (Greece, Spain) while others were at record lows (Germany, Austria). Unemployment insurance expenditure is a very cyclical component of government spending; therefore if it were funded centrally it could act as a cushion in the event of a substantial shock to the public finances of the most severely affected members.

'Euro bonds' would be a major step towards fiscal union, but so far remain a distant prospect

'Euro bonds': The issuance of debt securities backed by the euro area as a whole would be a major step towards further integration; however, this remains a distant prospect for now. Germany has been especially reluctant even to discuss such a possibility. Several steps will likely be required before the euro area reaches the point where all members feel comfortable about the idea of 'euro bonds'.

By considering only the recent past, it is easy to conclude – mistakenly, in our view – that financially strong countries such as Germany would lose out from such an arrangement. Comparing French and German growth rates since 1960, we observe that France had higher growth rates than Germany in 33 of the 55 years, including 10 consecutive years from 1995 to 2005. That said, fiscal transfers should be designed to smooth business cycles, not equalise incomes across member states. For example, countries with lower GDP per capita should be expected to grow faster; it does not mean that they should contribute more to the common budget.

A fiscal union would work to smooth the 'asymmetric shocks' (shocks that affect each country in a different way) between members. This would not be purely a zero-sum exercise as fiscal expenditure is more effective in recessions.

Federations use fiscal transfers extensively to smooth the effect of shocks on regions

Fiscal integration can help to smooth the effects of shocks that affect only part of the currency area. Fiscal spending by centralised fiscal authorities in nation states can be as high as 40-50% of GDP: even in the lowest-spending and most decentralised economies, central government spending is in double digits as a share of GDP (11% in Switzerland in 2010 and 16% Germany). Automatic fiscal stabilisers kick in when one part of the union slows, as tax revenues fall and welfare spending increases.

In the UK there is evidence that around one-fifth of the variation in regional personal income relative to the national average is stabilised by central government transfers. The degree of stabilisation in France and the US is similar, with a slightly lower figure for Canada.

Fiscal tools can help mitigate the loss of exchange-rate flexibility. However, in a currency union, fiscal stress can end up being amplified in individual countries; at the extreme, problems can spill over into other countries. The problem of 'moral hazard' indicates a need for tight fiscal rules – unfortunately the euro-area experience shows that credible sanctions for breaking those rules are hard to develop (deadlines for meeting targets have been pushed back). At the same time, fiscal rules prevent policy from being a shock absorber.

Figure 82: Even the weakest federations have a higher central government spending than EU or euro area

	General government expenditure, % of GDP	Central government expenditure, % of GDP
Australia	36	26
Canada	44	17
Switzerland	34	11
Germany	48	16
Belgium	53	30
UK	50	46
US	43	26

Source: Bank of England, Carney (January 2015) Fortune favours the bold, Standard Chartered Research

Euro-area fiscal rules have become increasingly complicated, but are improving

The IMF (May 2015) notes the complexity of the EU's fiscal framework following several iterations since the 1997 Stability and Growth Pact (SGP): 2005 reforms to the SGP, the 2011 Six Pack, the 2012 Fiscal Compact, and the 2013 Two Pack.

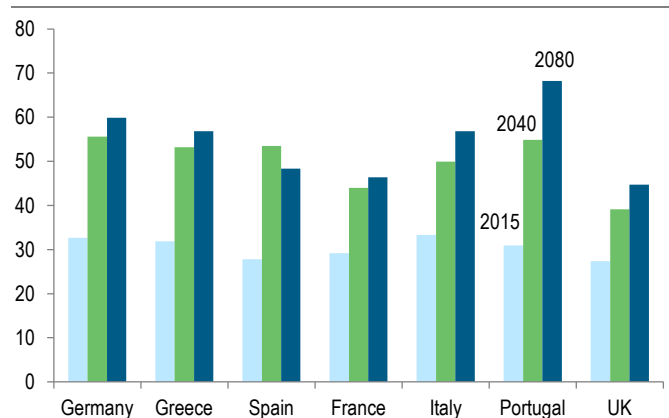
- The SGP included three EU-wide rules: limits of 3% of GDP for the overall fiscal deficit and 60% of GDP for public debt, and a requirement for medium-term budget positions to be “close to balance or in surplus”
- The 2005 reform of the SGP aimed at making the rules more flexible by introducing country-specific medium-term objectives set in structural terms
- The Six Pack reform in 2011 was designed to improve enforcement
- The Fiscal Compact and Two Pack reforms of 2012 and 2013 reinforced monitoring and surveillance in the euro area and required signatories to anchor EU rules at a national level, to ensure convergence towards their medium-term objectives
- In 2015, the SGP was made more flexible to encourage investment and structural reforms, and to allow for the economic cycle. But the revised guidance added another layer of complexity – for example, the appropriate fiscal adjustment will be defined using a matrix with five categories of economic conditions.

More stringent enforcement is needed to keep member states' fiscal policy in order

Compliance has been poor, due to unintended violations of the rules, the exploitation of loopholes and weak enforcement. The euro area as a whole has missed the debt target every year since 1999. Most countries met the 3% fiscal deficit target during the pre-crisis period (1999-2007) and post-2012, though both Greece and Portugal have failed in most years since they joined the euro area.

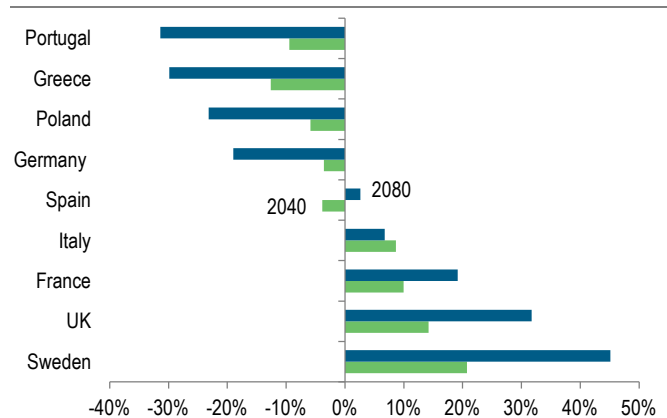
Changes in underlying economic fundamentals mean that there may be inconsistencies in the deficit and debt targets, given likely lower potential GDP growth in the region. A 3% deficit will only be consistent with a 60%-of-GDP debt target if nominal GDP growth is slightly more than 5%; since the crisis, anticipated medium-term nominal growth potential has been revised closer to 3% pa. This implies debt ballooning to 100% of GDP from a starting point of 60%. In practice, it has been difficult to identify a level beyond which fiscal sustainability fails. In addition, public debt is affected by many factors that are unrelated to budget deficits (for example, fiscal contingent liabilities).

Figure 83: Ageing population will be a challenge
Old-age dependency ratios, %



Source: Eurostat; projections are from main scenario, Standard Chartered Research

Figure 84: Projected population changes vary significantly
Change compared with the 2015 level



Source: Eurostat; projections are from main scenario, Standard Chartered Research

The IMF suggests a simpler, more robust fiscal framework: a two-pillar approach, with a single fiscal anchor (public debt-to-GDP) and a single operational target (an expenditure growth rule, limiting expenditure growth to the economy's potential growth rate, possibly with an explicit debt-correction mechanism) linked to the anchor. Successful implementation of the framework would require more automatic monitoring and swifter constraints once rules are breached, with a more credible sanctions procedure. The IMF warns that treaty change may be needed.

The 'Five Presidents' report

The Five Presidents report contains comprehensive proposals for the future of European integration

The European Commission published a report titled 'Completing Europe's Economic and Monetary Union' in June 2015, outlining European leaders' thoughts on the future of European integration. European Commission President, Jean-Claude Juncker, led the compilation of the report, in close co-operation with the four other presidents of the EU Council, Eurogroup, ECB and European Parliament.

The report builds on the assumption that the EU is moving towards an "ever closer union". Economic, financial, fiscal and political union are all still on the table. Imbalances within the euro area receive significant attention, and the report advocates a new way of dealing with this problem. The proposal to establish a "euro-area stabilisation function" is also significant.

The report splits the way for further integration into two stages: 2015-17 and 2017-25. Stage 1 should essentially continue the current process of structural reforms and integration as far as possible under the current treaty. Substantial progress should be made in terms of 'Financial Union' (banking and capital markets unions) and some progress towards 'Fiscal Union'.

The report mentions four pillars upon which the convergence process should rest:

- i. A new **euro-area system of competitiveness authorities** to monitor the evolution of unit labour costs and make sure divergences do not occur. These authorities should be accountable to member governments but have operational independence.
- ii. **Stronger implementation of the macroeconomic imbalances procedure** to prevent and correct imbalances before they grow too large.
- iii. **A stronger focus on employment and social performance** to promote fair and well-functioning labour markets and social safety nets.
- iv. **Stronger co-ordination of economic policies** to enable the euro area to deal with European problems in a unified way rather than each state acting independently.

Stage 2 is more ambitious as it deals with formalising the convergence process by enshrining convergence criteria in law. This will be a prolonged process, likely requiring treaty change, and involving approval via referenda in some member states. The report says this formalisation would be a condition for a euro-area-wide "shock absorption mechanism" (fiscal stabilisation function). Details of how the stabilisation function would work will be studied further by an expert group. The report outlines four guiding principles: the mechanism should not create permanent fiscal transfers; it should not undermine incentives for sound fiscal policy or to address structural weaknesses; it should be consistent with the existing EU fiscal

framework; and it should not be an instrument for crisis management since that is the role of the ESM.

The report finally outlines the key next steps regarding the reform of political institutions, arguing for greater co-operation between the European Parliament and national parliaments and for formalising the Eurogroup. Member states were asked to contribute by sending ‘issue papers’ to the European Commission with their vision for “completing and strengthening the EMU”. These vary, reflecting each member’s current appetite for further integration.

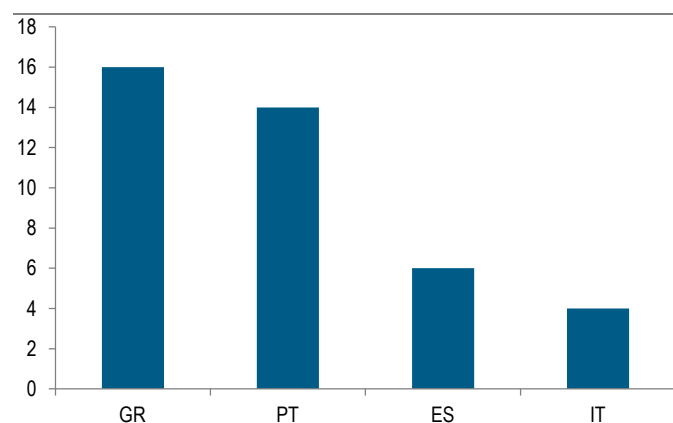
Members responses show that those hit hardest by the crisis are more vocal in calling for more reforms. Italy, Spain and Portugal want substantial further integration. The Italian paper calls both for a “more ambitious policy mix” to restart growth – including structural reforms – and a stronger institutional framework. At the same time it calls for more “national ownership” of the policies, which is a tricky issue, as we have seen in the case of Greece.

The contribution from Spain suggests moving ahead with fiscal and political union by transferring sovereignty to the European level. Spain also advocates ongoing structural reforms to eliminate rigidities within the euro area.

The Portuguese proposal argues that politics must move up to the European level; a situation whereby national politics attempt to solve European problems is not sustainable. EU integration can proceed at a different pace for different members. Not all EU members have signed the Schengen agreement and non-euro-area members can join the banking union if they wish; other types of unions (fiscal, political) could proceed in the same fashion. Each member would decide if and when it is ready to join. But in an extreme scenario the EU could become an ‘à la carte’ union with many layers.

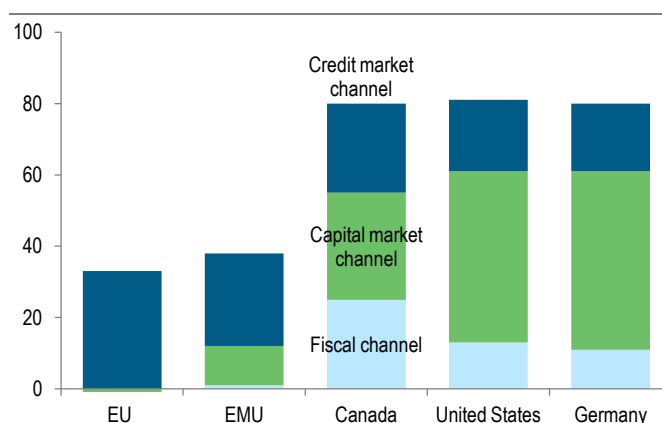
The joint proposal from France and Germany was more modest, essentially not calling for any significant reforms in the near future.

Figure 85: Fiscal union does not mean permanent transfers
Number of years the country had the highest European growth rate since 1960



Source: AMECO, Standard Chartered Research

Figure 86: Euro area lacks a fiscal channel for risk-sharing
% of shock smoothed by different channels



Source: IMF (2013) toward a fiscal union for the euro area, Standard Chartered Research



3. What are the political risks of a euro-area break-up?



European integration versus nation-state sovereignty

In 'The globalisation paradox', Harvard Professor Dani Rodrik outlines a 'trilemma' that the world faces. Only two of the following three options are possible at the same time: hyper-globalisation; nation states; democratic politics.

Rodrik's trilemma helps to analyse the trade-offs in the European integration process

Hyper-globalisation means making the world economy flatter. This is achieved by maximising the free movement of labour across borders and harmonising regulations related to goods and services at a global level. The concept of the nation state means that nations retain their sovereignty in setting domestic policy (as is the case currently). Democratic politics means that the decision-making power remains in the hands of elected officials.

The established system is based largely on democratic politics at the nation state level with loose global integration based on the Bretton Woods compromise. Nations retained enough autonomy to maintain a balance between the demands of their citizens and the requirements of globalisation.

Euro-area integration can be thought of as a localised version of globalisation

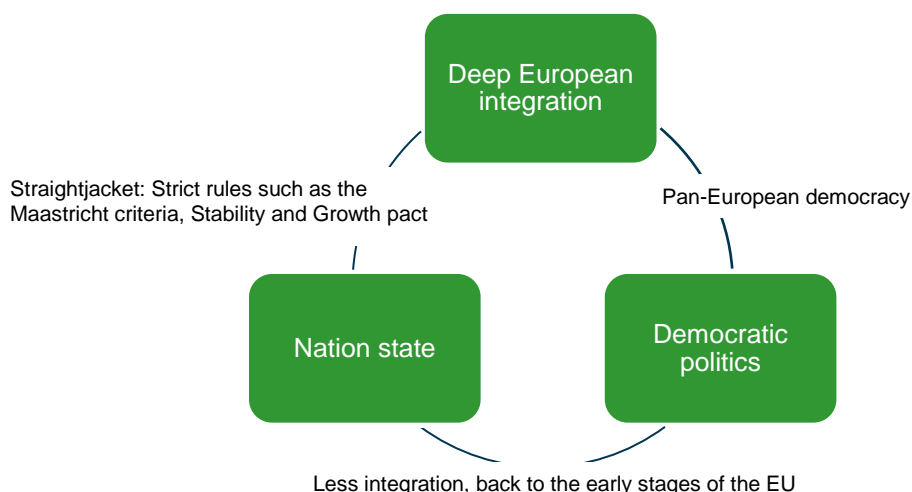
As the world moves towards more globalisation, there is a greater need for institutions to co-ordinate agreements on regulations at a global level. One example of such an institution is the World Trade Organization (WTO) which aims to reduce trade barriers and ensure fair trading practices. Such institutions take some national-level powers away from the nation state in return for more integration. If a country wants to be a member of the WTO and enjoy the benefits it must also follow its rules.

Nowhere is this integration trend more evident than in Europe. If we replace hyper-globalisation with 'Europeanisation' we can see that Europe is the region with the highest level of integration of independent nations. Member states have ceded some their decision-making powers from the national to the European level.

Depending on the context, some see this as a loss of sovereignty. Others, such as ECB President Draghi, say that the member states are "sharing sovereignty". States' electorates democratically decided to make this arrangement for the common good

Figure 87: More integration means less national sovereignty

Rodrik's trilemma: countries can choose two of the three directions



when the states decided to join the EU and subsequently the euro area. The key question is what happens when the electorate changes its mind when it sees that its state is not benefiting as much as it expected from joining?

The trilemma is evident in the tensions between Greece and its European partners. Alexis Tsipras, the Greek prime minister, has repeatedly insisted that he has a democratic mandate to ease austerity imposed on Greece, yet Greece's limited autonomy means that in practice austerity will continue if Greece wishes to remain in the euro.

Pan-European problems versus local politics is a major obstacle to further European integration

In the efforts to revive the euro-area economy, several independent bodies including the ECB and the IMF have asked for countries with 'fiscal space' to use it to increase demand in the economy. However, there is no mechanism to persuade German policy makers to make policy according to the needs of the euro area as a whole rather than just the needs of Germany. As such we have outcomes which may be optimal for the political realities in each member state, but are far from optimal at the euro-area level.

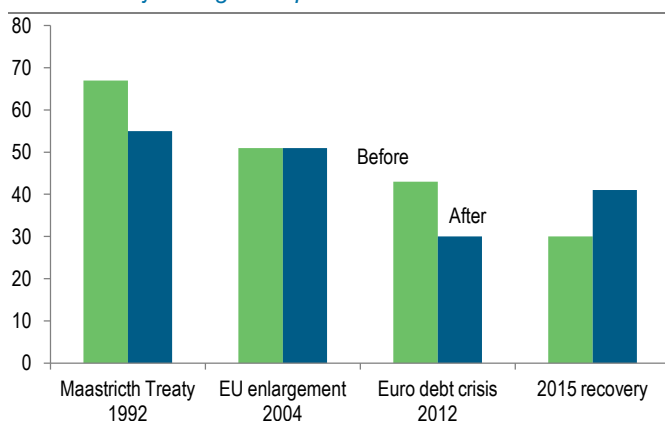
Some Europeans are already having second thoughts about European integration, ranging from the UK's decision to hold a referendum on whether to remain in the EU to the recent suggestion by the Spanish government that a core group should proceed with fiscal and political union.

Each crisis will likely be followed by further integration

The process of European integration is a long-term project, with support for it likely to fluctuate with business cycles. If the member states choose more integration they should focus on shifting democracy up to the European level, for example by giving more powers to the European Parliament.

Figure 88: Has public opinion towards the EU reached a floor?

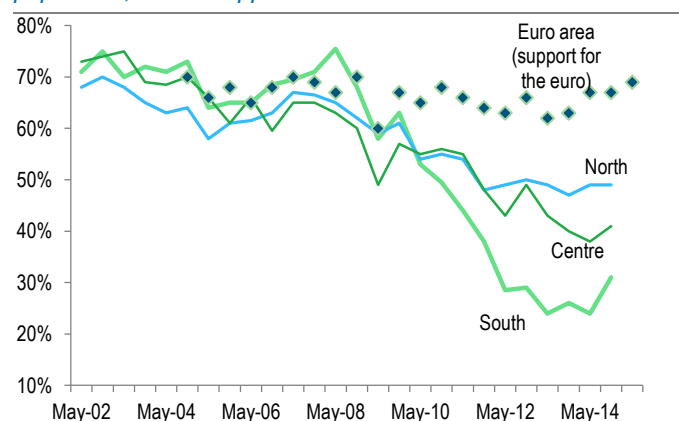
*% of respondents who have a positive view of the EU before and after major integration phases**



Source: Eurobarometer, Standard Chartered Research *based on two slightly different questions as the first series was discontinued in 2011

Figure 89: Trust in European institutions has fallen in the south since the crisis, but trust in euro holds up

% of respondents who trust EU institutions, weighted by population, and % support for the euro



Source: Eurobarometer, Bruegel, Standard Chartered Research

Revisiting the gold standard

The gold standard has some interesting parallels with EMU

If history is any guide then the euro area will most likely not last. The closest historical example of a range of countries fixing their exchange rates is the gold standard period before the Second World War. Under the gold standard, participating economies effectively had a fixed exchange rate but there was no supranational institution to co-ordinate the central banks. The euro is more than a fixed exchange rate system as it is backed by the ECB, a supranational central bank.

The gold standard has many useful parallels with the euro

Like the gold standard period, the only way for countries to regain competitiveness in the short run under the euro is through internal devaluation, which can be a long and painful process. Similar to the period after the Great Depression, countries which had major banking crises after the GFC were worse affected than others, or than if they had not been in a single currency.

Political will is the key difference between the gold standard and the euro

The major difference between the gold-standard member countries and the euro area is the political will to maintain the currency union, until now at least. Unlike the large economies in the 1930s, the euro area has achieved a much greater level of integration so far; however, it is still far from what we could call an 'optimum currency area' as discussed in Chapter 1.

Similar factors motivated the adoption of the gold standard and the creation of the euro

Why did countries adopt the gold standard?

The gold standard was first adopted by a large group of countries in the late 19th century and led to the so-called 'first period of globalisation'. Countries enjoyed the advantage of no exchange rate uncertainty and sought long-term price stability, following painful experiences with hyperinflation and extreme exchange rate volatility. The Western elite regarded the gold standard as a mechanism that protected orthodox policy-making from populist politics. It enabled investors to invest and trade across countries free from exchange rate fluctuations.

But under a fixed exchange rate system economies had to give up independent monetary policy. The goal of monetary policy was no longer a domestic goal of stable inflation and low unemployment but rather it was to ensure that the currency maintained its parity against gold and to maintain the free flow of capital. With free gold convertibility and the absence of capital controls, interest rates had to be very high if the markets perceived government finances to be weak, in order to avoid capital outflows, and adjustments to competitiveness came through internal devaluation. When the gold standard was originally conceived, welfare states barely

Figure 90: Dates of changes in the gold standard policies and economic recovery

	Return to 1929 income level	Devaluation
Austria	1939	1931
Belgium	1939	1935
Finland	1934	1931
France	1939	1936
Germany	1935	Exchange controls, effectively devaluing in 1931
Italy	1938	1936
Sweden	1934	1931
Netherlands	1949	1936
Switzerland	1946	1936
UK	1934	1931
US	1940	1933

Source: Bernanke and James (1991) Maddison Project 2013, Standard Chartered Research

existed. This meant that governments did not have the role of crisis back-stop they have today by engaging in counter-cyclical fiscal policy; this made the issue of public debt less important. Most countries had to briefly abandon the gold standard during the First World War in order to finance the war using fiat currency, but subsequently re-adopted it in the mid-1920s. To that extent, it was not irreversible. Concerns over Grexit relate in part to the fear that once a country leaves the euro the notion of irreversibility is destroyed.

The UK gave up on the gold standard after six years

Countries adopted deflationary policies when they should have done the opposite

The UK was the first country to break free from the gold standard in 1931, just six years after adopting it following the First World War. At the beginning of the Great Depression in 1929, the strong consensus among the global ruling elite, heads of governments and central banks was to preserve the gold standard at all costs. Policy was implemented to this end instead of boosting employment. In the mid-1920s, UK Prime Minister Baldwin said that “All the workers of this country have got to take reductions in wages to help put industry on its feet.”

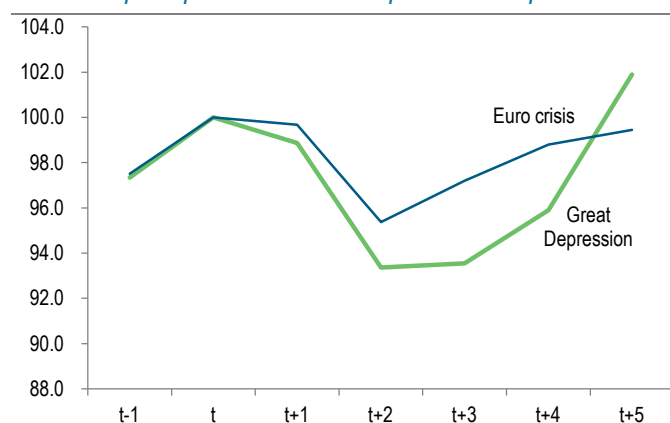
“Nobody told us we could do that!”

But the gold standard led to countries adopting deflationary policies during the Great Depression, when they should have been doing the opposite. Monetary policy was tightened in 1931 when the UK attempted to maintain the value of the pound (GBP). The policy stance was exacerbated by the Treasury’s response, which sought to balance the budget by cutting public spending and welfare payments to shore up confidence in the GBP. When this failed to restore investor confidence, and amid growing popular protests, the UK abandoned the gold standard and the GBP devalued by 25%. This move came as a shock: Tom Johnson, a parliamentary secretary for Scotland famously exclaimed “Nobody told us we could do that!”, while Jackson Reynolds, president of the First National Bank of New York said “It was like the end of the world”.

Studies suggest that the Bank of France exacerbated the Great Depression by not increasing money supply at the same time as other central banks were obliged to shrink money supply due to gold outflows. The French share of world gold reserves rose to 27% in 1932 from 7% in 1926. Such studies suggest that France’s policies directly accounted for about one-third of the deflation that the countries on the gold standard experienced during the Great Depression. The Bank of France sterilised gold inflows to prevent monetary expansion.

Figure 91: UK – euro crisis vs Great Depression

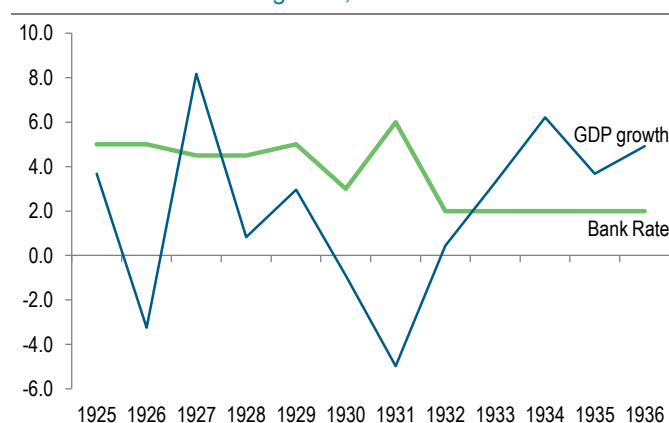
GDP 100=peak pre-euro crisis and pre-Great Depression



Source: Maddison project, AMECO, Standard Chartered Research

Figure 92: BoE hiked in recession to defend gold standard

Bank rate and real GDP growth, %



Source: Bank of England, Standard Chartered Research

Therefore the global monetary base contracted, exacerbating the Great Depression.

Growth improved following departure from the gold standard

Comparing the group of countries which abandoned the gold standard early with those who stayed longer, we observe that on balance the former group recovered more quickly (Figure 90). By leaving the gold standard, countries regained monetary policy autonomy and could set interest rates which were appropriate for their domestic economy. The collapse of the gold standard triggered 'currency wars' and policies dubbed 'beggar thy neighbour' by some observers. However, they managed to increase inflation globally, which was part of the solution to the Great Depression.

Lessons from the break-up of the gold standard

Lesson 1: Member governments and central banks must co-ordinate

The institutional structure is key in the smooth functioning of the markets

The first lesson is that institutions at the time were too weak to be able to cope with globalisation. Global markets are not created in a vacuum. Institutions have to be in place to manage the process of globalisation as complex trade and investment agreements are required to ensure that markets run smoothly. Moreover, the gold standard was a fixed exchange rate system among several nations, each of which maintained its own central bank. Central banks had to co-operate closely for the system to function smoothly; for example, by extending loans to each other in times of stress. However, in order to do that they would have to be sure that the counterparty bank would remain in the gold standard at all costs.

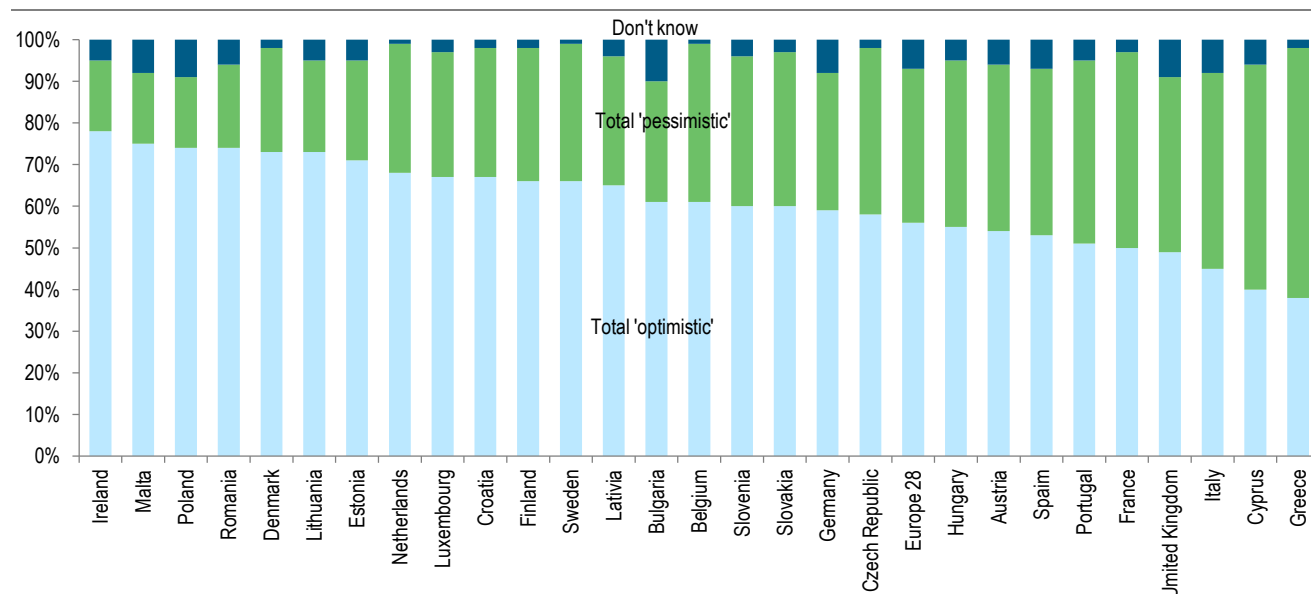
Lesson 2: Domestic politics - 1, globalisation - 0

As long as politics remain in the national-domestic domain, rules imposed from outside will be strongly resisted

The second lesson is that when grand visions of globalisation, favoured by the elite, ran counter to domestic politics, the latter won. The gold standard was maintained due to a world view favoured at the time by policy makers as a way of promoting global trade and investment. But the politics remained local, meaning that the average voter did not share the same world view: at a time of particular stress national sovereignty won out over globalisation.

Figure 93: Sentiment in Ireland is in stark contrast with Greece (both went through a bailout programme)

'Would you say that you are very optimistic, fairly optimistic, fairly pessimistic or very pessimistic about the future of the EU?'



Source: Eurobarometer 82 - 2014, Standard Chartered Research

The current state of politics

The euro was built on political will, and its survival depends on it

If political leaders cannot change course, voters may change leaders

Early in the Great Depression it was unthinkable for policy makers – the heads of government and central banks of the then-largest economies – to even consider abandoning the gold standard. The economic reality, however, manifested itself through social unrest.

The risk is that unless the euro area can generate sustainable growth and lower unemployment, social unrest may lead to election outcomes that put anti-euro politicians in power. Dissatisfaction with the 'European project' does not just affect poorer, high-unemployment countries; it is also evident in wealthier, low-unemployment countries that believe they are shouldering an unfair burden.

The problem is that the structural reform and closer integration that is needed to move the euro area onto a stronger growth path alienates voters, pushing them into the arms of radical parties. For some voters, Europe's migrant crisis has sharpened the national versus global debate, highlighting domestic economic shortcomings and encouraging nationalist sentiment.

The road to political union

Euro-area integration will require states to cede more sovereignty

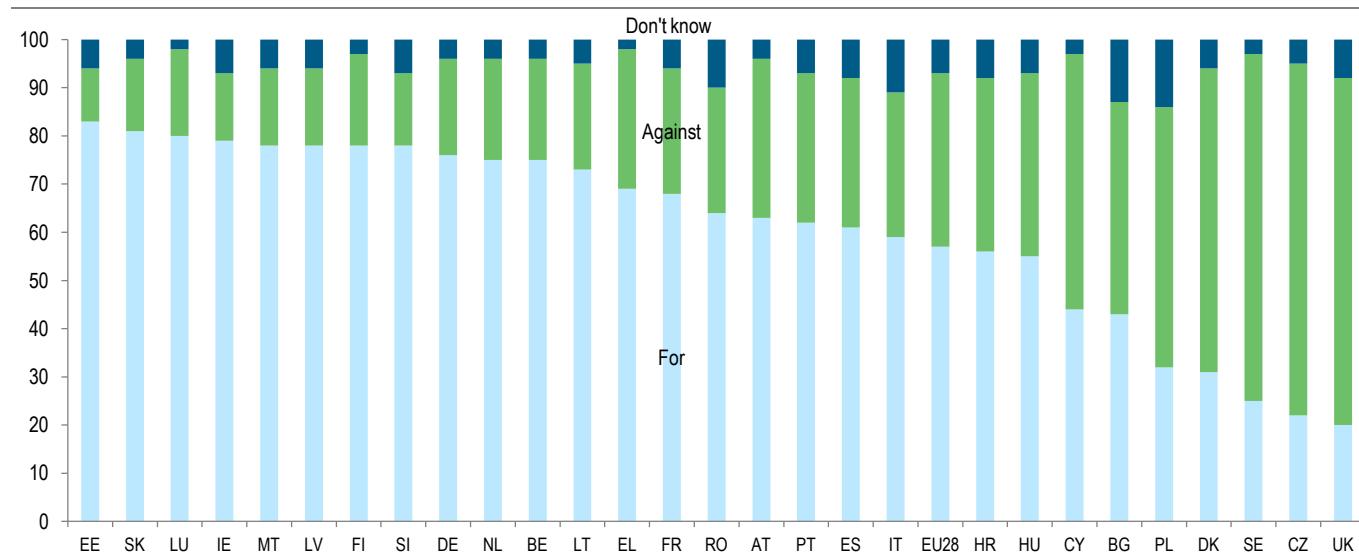
According to the trilemma posed by Rodrik, if the integration of the euro area is to continue, nation states will inevitably have to cede even more of their sovereignty. This will likely see greater powers for the European Parliament. French President Francois Hollande recently proposed a separate euro-area parliament, rather than an EU parliament, to manage the affairs of the common currency area independently of EU-wide affairs. The design of common political institutions with real decision-making power, unlike the European Parliament whose decision-making power is limited, will likely be a long and complex process. For example, smaller countries would aim to increase their voice at the euro-area level, while larger countries would try to allocate decision-making power according to population.

Europe has seen the rise of extremist parties since the GFC

Since the GFC, various types of anti-establishment parties have emerged as formidable players in European politics. The political space has changed radically

Figure 94: Countries who have not adopted the euro have a negative view; mixed sentiment in periphery

What is your opinion of the euro?



Source: Eurobarometer 83 - 2015, Standard Chartered Research

and many countries are moving closer to multi-party coalition governments and away from a two-party system. Momentum for these parties peaked around mid-2014, during the European Parliament elections and following the euro area's double-dip recession. In many cases their popularity has subsequently waned, but several are in a position to influence government, challenge the leadership of the country (in the case of Marine le Pen) or, as with Syriza in Greece, to form a government.

Significant differences exist between these groups, ranging from anti-euro but pro-EU, such as the Alternative for Germany, to fully anti-EU, like France's National Front. They can be characterised as 'soft' versus 'hard' Eurosceptics. Below we list the current parties that have an anti-EU/anti-euro stance in the largest European economies.

Germany

Alternative for Germany (AfD)

Germany has the least to fear from extremist politics, so far

Compared with the other major European countries, Germany has the lowest anti-establishment sentiment. German politics have been virtually unchanged in the past 10 years. The Christian-Democrat coalition (CDU and CSU) has polled 40-45% of the vote and the Social Democratic Party (SPD) around 25%. The Greens and the Left party, neither of which are anti-establishment, receive about 7-10% each.

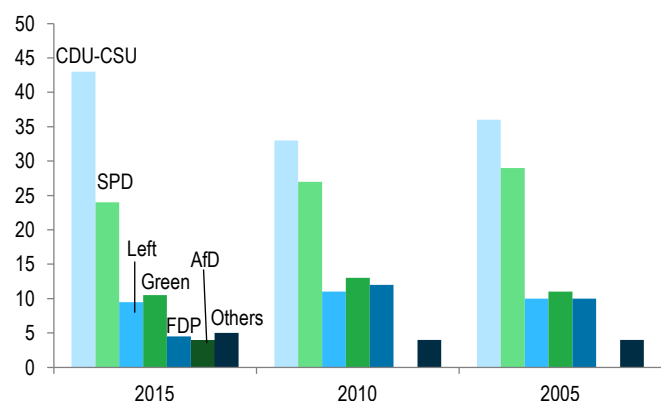
The main anti-euro party in Germany is the Alternative for Germany (AfD), founded in 2013. It can be described as moderately right wing. Its manifesto states that the euro area has proven to be unsuitable while southern European countries are sinking into poverty under the competitive pressure of the euro.

The AfD's position is more nuanced than that of other anti-establishment parties: it is anti-euro but not anti-EU. It calls for an end to bailout policies. It also calls for either the creation of a smaller currency union with countries that are more homogeneous or the re-introduction of national currencies.

The AfD won 4.7% of the votes in the 2013 federal election, missing the 5% barrier to enter the Bundestag. In the 2014 European elections, the AfD came in fifth place in Germany, with 7.1% of the national vote, securing seven seats in the European Parliament. It was accepted into the European Conservatives and Reformists (ECR) group in the European Parliament (the same group as the UK Conservatives). In May 2015 disagreements among AfD leaders over the party's position on several issues led to an internal crisis.

Figure 95: German politics are relatively stable

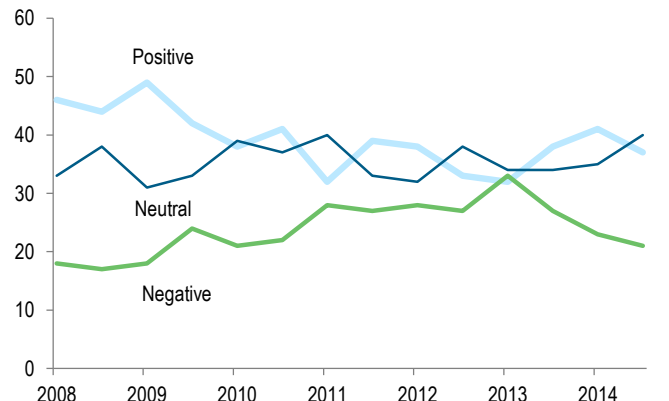
Voting intention poll averages, %



Source: Der Spiegel, Standard Chartered Research

Figure 96: EU's image in France has improved since 2013

Eurobarometer surveys, %



Answers to the question: "In general, does the EU conjure up for you a very positive, fairly positive, neutral, fairly negative or very negative image?" Source: Eurobarometer, Standard Chartered Research

The AfD could gain more support if the German public becomes tired of successive bailouts of weaker European countries. The current government is mindful of this risk and maintained a tough stance in negotiations with Greece; though in the end parliament agreed a third Greek bailout despite rebellion within Chancellor Merkel's party.

France

A prolonged period of low growth may increase nationalist parties' popularity in France

Unemployment in France stood at 10.3% in Q2-2015, up slightly from 10.2% in Q2-2014. While there are signs that growth is picking up, the economic situation remains fragile as the current socialist government tries to push through structural reforms, including to the labour market.

The National Front (FN) is France's main anti-euro/anti-EU party. Founded 1972, its main ideology is based on sovereignty principles and 'French preference', a concept which puts French interests above non-French. FN is considered a 'hard' Eurosceptic party. Since 2011, the party's leader, Marine Le Pen, has pursued a strategy of 'normalisation', attempting to move the FN away from its image as an extremist party in the hope that this will change the perception of the FN as a mere challenger to a party fit to govern.

This strategy has proved successful, with the FN's popularity rising sharply in recent elections. It won several municipalities in the 2014 municipal elections; it finished top in the 2014 European Parliament elections, with 25% of the votes which translated to 23 seats. In the current European Parliament, the FN did not manage to form a group at first, but in June 2015, it and the Netherlands' Freedom Party (PVV) along with Members of the European Parliament (MEPs) from various parties formed a new group: Europe of Nations and Freedom (ENF). The Freedom Party of Austria (FPO), Italy's Northern League (LN) and Belgian Vlaams Belang declared their intention to join too. FN did not do as well as expected in the 2015 regional elections, failing to secure a single region.

An FN administration would be a threat to the future of the euro area

France's next presidential election is in 2017. Polls show that Marine Le Pen would lead the first round of the election with about 30% of votes. However, polls on the run-off round (which includes the top two candidates from the first round) show Le Pen losing to most other candidates by 5-10%. Ongoing high unemployment and weak growth would favour the FN at the polls: an FN president or government would send shockwaves across the EU and would be a threat to the future of the euro area.

Italy

Italy has endured prolonged economic stagnation and high unemployment, bringing political challenges to its euro membership. Italy has the weakest level of support for the euro (59%) of the major euro-area countries, albeit up from its post-GFC low of 53%.

Italy's anti-establishment parties receive a high share of the vote, but they are unlikely to be able to form a coalition

Three political parties in Italy have at some point advocated that Italy should consider exiting the euro area: the Five Star Movement, Lega Nord and Forza Italia. Together, they have about 50% of the vote. However, to date their differences have prevented them from forming a Eurosceptic coalition. If Lega Nord and Forza Italia managed to form a coalition there would be an increased likelihood of an Italian exit from the euro.

Given that in Greece parties on the left and far-right managed to form a coalition based on their common anti-establishment identity, a coalition between the Five Star Movement and/or Lega Nord and Forza Italia cannot be ruled out entirely. The risk is

that without a recovery in growth dissatisfaction increases and seemingly unlikely political pairings form.

The pro-euro Democratic Party (PD) is currently in government after gaining the largest share in the 2013 general election. The next general election will be held in 2018, or before if the current administration decides to seek a new mandate sooner.

Five Star Movement (M5S)

M5S has a Eurosceptic element and would hold a referendum on Italy's membership of the euro

Five Star Movement (M5S) is currently the largest opposition party in Italy. It was founded in 2009 by Beppe Grillo, a popular activist, comedian and blogger and Giaroberto Casaleggio, a web strategist. It cannot be categorised as either left wing or right wing, but the movement has a 'hard' Eurosceptic element. In the European Parliament, it joined the Europe of Freedom and Direct Democracy group (EFD) which includes UKIP and the Sweden Democrats (both hard Eurosceptics).

Beppe Grillo announced in late 2014 that he would collect signatures to hold a referendum on Italy's membership of the euro, with M5S campaigning for euro exit. Though such a referendum is not currently allowed by the Italian Constitution, it would be a strong sign of dissatisfaction with the single currency. M5S is also against euro-area austerity policies, though it is also in favour of the introduction of 'euro bonds'; it also advocates debt relief for southern Europe on the scale granted to Germany after the Second World War.

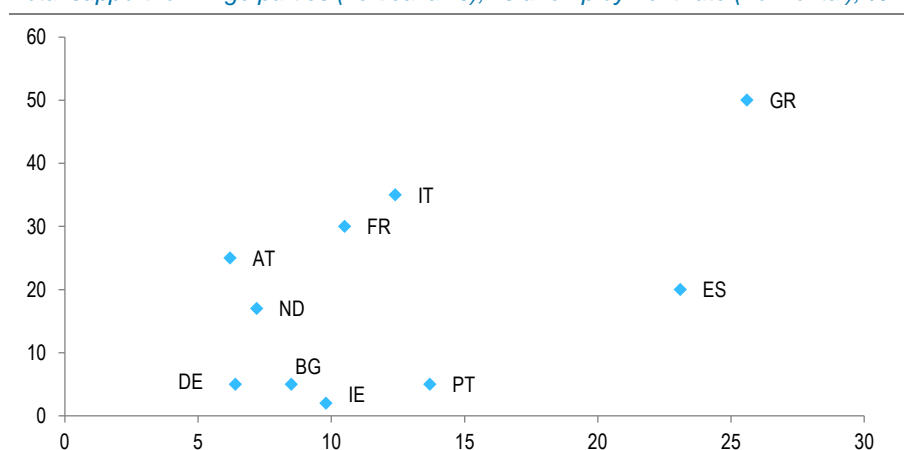
According to recent polls M5S still has the second-highest share of the vote in Italy, at c.20%. This percentage has held steady for the past two years, though it is slightly lower than the 25% achieved in the general election. Since the election, the party has lost a number of key members. Late in 2014, M5S experienced internal conflict amid supporters' dissatisfaction. Grillo later announced that he would broaden the party's leadership to a committee of five or more individuals.

Lega Nord

Lega Nord (Northern League, LN) was founded in 1989. It is considered a conservative/right-wing party and can be categorised as a 'hard' Eurosceptic party. Its original aim was to achieve autonomy for northern Italy through the federalisation of the country. However, the party recently re-orientated its goals to capture a larger share of the vote: it talks less about regional autonomy and more about anti-euro and anti-immigration issues. In the 2013 election it received 4.1% of the votes, about half of what it achieved in the previous general election.

Figure 97: Support for fringe parties is loosely correlated with unemployment

Total support for fringe parties (vertical axis), vs unemployment rate (horizontal), %



Source: Bloomberg, various polls, Standard Chartered Research

In power, the LN would review all the founding EU treaties

Since taking over as party leader, Matteo Salvini (a journalist) has hardened the party's stance, becoming more anti-euro/anti-EU. After the European Parliament elections LN tried to form a nationalist party group with France's FN, but this failed since they could not garner the necessary numbers of MEPs. Salvini has said that if his party came to power he would "review all the founding EU treaties". LN is working to find an alternative to the euro: a parallel currency, a two-speed euro or the return to the lira. During the Greek debt-crisis negotiations, Salvini stated that "a unilateral Italian exit from the euro would be a mess" and "instead, we are evaluating different solutions". He also added that the Maastricht Treaty's 3% budget deficit limit is "killing" the region of Lombardy which is running a surplus.

LN could extend its influence in the future. Polls conducted in 2015 show that it would get the third-largest share of the vote, around 14%; higher than Forza Italia.

Forza Italia

Forza Italia (FI) is the successor to People of Freedom (PdL) party. It was revived in 2013 after it had merged with other right-wing parties in 2009. It is headed by Silvio Berlusconi, who served four terms as prime minister. FI is generally a centre-right, Christian democratic party but with more liberal characteristics than its predecessor. It is considered more mainstream than both LN and M5S.

FI is part of the European People's Party (EPP) group in the European Parliament, considered the mainstream right-of-centre group. PdL was traditionally a pro-Europe party; FI, however, has moved closer to euro scepticism. In late 2014, Berlusconi joined the other two main opposition parties, M5S and LN, in advocating that Italy should exit the euro area, or at least renegotiate all euro governance rules. Polls suggest its support has declined to below 15%, making it Italy's fourth-largest party.

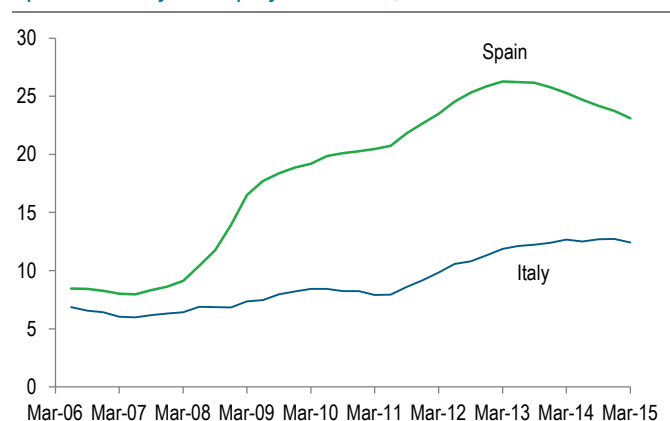
Spain

Spain is undergoing a strong cyclical recovery and will likely be one of the fastest-growing member states in 2015. After the euro-area debt crisis, Spain's unemployment rate exceeded 25%; it has subsequently fallen to 22%.

Podemos is becoming a serious threat to the traditional parties in Spanish politics

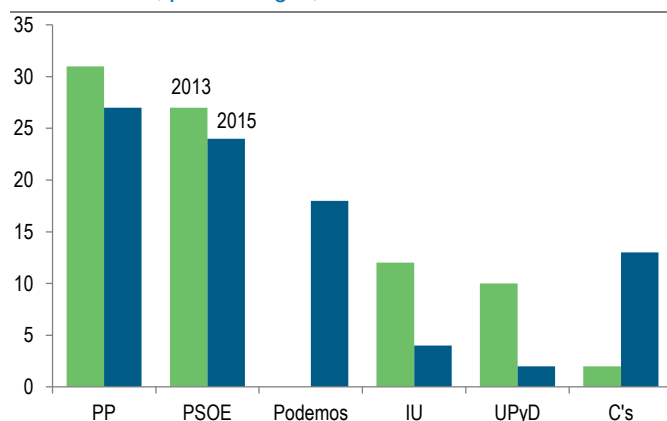
Podemos (literal translation: 'we can') is the main anti-establishment party in Spain.. It was founded in 2014 and has quickly become the third-largest party based on membership. Its roots are traced in the 'Indignados' (the outraged) movement in

Figure 98: Unemployment rates remain elevated
Spain and Italy unemployment rates, %



Source: Eurostat, Standard Chartered Research

Figure 99: Political newcomers are a serious force in Spain
Vote intention, poll averages, %



Source: Various polls, Standard Chartered Research



Spain during the protests against austerity policies in 2011-12. Podemos' founder, Pablo Iglesias, is political science academic and an MEP. Podemos' rapid rise reflects popular unease about the policies pursued by the traditional parties. Spain has been ruled by either the right-wing/conservative People's Party (PP) or the centre-left Socialist Workers' Party (PSOE) since the end of the dictatorship in the late 1970s.

In November 2014, Podemos published an extensive document titled 'An economic project for the people' outlining its agenda. Podemos calls the euro a 'mouse trap' (Reference 7) claiming it is impossible to pursue policies that satisfy the national interest within the existing framework. It does not, however, argue for Spain to exit the euro. Instead it seeks reform of the euro area:

"It is fundamental that the Spanish government promotes and achieves as soon as possible strategic agreements with (the governments) of other European countries to change the current conditions of governance of the euro."

The document lists changes that it would pursue in government: make the EU's Stability and Growth Pact more flexible, add 'full employment' to the ECB's policy targets; make the ECB accountable to the European Parliament and others. Podemos has expressed solidarity with Greece's Syriza, but has lost support as a result of the troubles associated with Syriza in government. In Q4-2014 and Q1-2015 Podemos was the frontrunner in opinion polls, gaining as much as 30% of the vote. But support has since fallen below 20%.

The Netherlands

Extremist parties have increased their popularity since the crisis, but their influence remains limited

The Dutch economy is growing slightly faster than the euro-area average and unemployment is a modest c.7%. Despite this, voter resentment over northern euro-area countries' support for the south has led to the rise of anti-EU sentiment. In the Greek bailout negotiations, the Netherlands was one of the states least supportive of Greece.

The two main anti-EU parties in the Netherlands are the Party for Freedom (PVV) and the Socialist Party (SP). Both won 15 seats at the last election with around 10% of the vote each and both are polling around 21% for the next election; this suggests that anti-euro sentiment may become a stronger feature of the next Dutch parliament. The ideological differences between the two make a coalition extremely unlikely (although not impossible, particularly given the Dutch tradition of cross-spectrum coalition governments).

Party for Freedom

The Party for Freedom (PVV) was founded by Geert Wilders in 2006, combining economic liberalism with a conservative stance on immigration and culture. The PVV holds hard anti-euro views, advocating full withdrawal from the EU and a return to the Dutch guilder. The party argues that the EU has compromised Dutch sovereignty and is too costly. Wilders has claimed that the EU should, at most, be an economic union with free trade agreements.

Party support peaked around 2009-10: it won four European Parliament seats in 2009 and 24 seats (the third-highest) in the election to the House of Representatives in 2010. However, in the 2012 election its share of the vote dropped to 10.1% from 15.5% and it lost nine seats, but remained the third-largest party. Since then, three more MPs have left the party. In the 2014 European Parliament elections, the party retained all its seats



despite its share of the vote dropping by 3%, finishing joint second. Within the European Parliament the PVV is part of the Europe of Nations and Freedom group.

The next Dutch general election will be held no later than March 2017 – assuming the government completes its term, which has not happened since 2002. Opinion polls indicate that support for the PVV has risen: it is polling at c.20-22%.

Socialist Party

Founded in 1971, the Socialist Party (SP) is a left-wing social democratic party. Its first members of parliament were elected in 1994. The party is critical of globalisation, particularly European integration, describing it as an unnecessary 'super state'. It does not propose an exit from the euro but believes that the EU should only intervene when countries themselves are unable to act. It is critical of the EU's free market policies.

The SP has had 15 seats in the House of Representatives since 2010, and in the 2012 election gained 9.7% of the vote. It has two MEPs in the European Parliament (having won 9.6% of the vote in 2014), who sit in the European United Left/Nordic Green Left (EUL/NGL) group alongside the Finns Party.

The party has rarely achieved over 10% of the vote. According to opinion polls its main rival, the incumbent Labour Party (PvdA), has lost almost 15% of its support since the 2012 election. The SP, by contrast, has almost doubled its support, polling around 20% in mid-2015. While it is unlikely to take office, it could make significant gains at the next election.

The prolonged recession has led to a rise in Euroscepticism in Finland

Greece

Greek politics have experienced the greatest shift within Europe since the GFC and will likely remain volatile for some years. The traditional two-party system of centre right and centre left, long dominated by New Democracy on the right and PASOK (Pan-Hellenic Socialist Movement) on the left, has been replaced by a highly fragmented political scene with several parties in the parliament. On 20 September Greece's sixth election in eight years is due to take place. Although there are more parties on the left of the political spectrum, deep divisions reduce their influence.

Syriza

Syriza (the acronym translates as 'Coalition of radical left') was founded as a coalition of leftwing parties in 2004 and Alexis Tsipras (prime minister in 2015) became its president in 2007. Syriza emerged as the big winner from the political turmoil following the Greek crisis, ousting PASOK from its long-standing position as the main contender against New Democracy. Its support surged from 5% in 2009 to 36% in 2015 when it won the election and formed a government. After the agreement on the third bailout in summer 2015, numerous Syriza MPs deserted the party, most of whom joined the Popular Unity party. Syriza is part of the EUL/NGL group in the European Parliament.

Communist Party of Greece (KKE)

KKE was founded in 1918, influenced by Marxism-Leninism. It has a very stable support base of around 4-6%. It is one of the hardest-Eurosceptic parties in Europe, advocating an exit from the euro and the EU. It has never participated in a coalition government, believing in an 'all or nothing' approach rather than compromise. As such, it is unlikely to be influential in the future. KKE is a non-inscrit party in the European Parliament (i.e., it does not sit within one of the recognised political groups in the parliament).



Popular Unity

Popular Unity was founded in 2015 by Panagiotis Lafazanis, formerly of the Left Platform (the extreme left-wing part of Syriza). The party openly advocates Grexit. Polls before the September 2015 elections showed it enjoyed around 4% support. Similar to KKE, Popular Unity is unlikely to be able to find coalition partners, therefore its influence may be limited.

Golden Dawn

Golden Dawn was founded in 1985 by Nikolaos Michaloliakos, its current leader. It is on the far-right of the political spectrum. It emphasises policies related to immigration and foreign policy; its economic policy is vague. It first entered parliament in the 2012 elections with 7% of the vote on the back of immigration concerns. Its support has held up well since then. Golden Dawn is unlikely to be influential as none of the other political parties would be willing to form a coalition with it. It is a non-inscript party in the European Parliament.

Portugal's politics remained remarkably stable following the bailout

Portugal

Portugal received its first of three EU bailout packages in 2011 and exited the programme in 2014. Since then economic growth has recovered, and stood at 1.5% y/y in Q2-2015. Unemployment remains high at 13.7%, with youth unemployment above 30%.

Public support for the euro sank to 50% in November 2013, but has since recovered to 62%, ahead of Spain and Italy. Unlike other countries, anti-euro sentiment is mainly espoused by left-wing parties. This has not translated into electoral success for Eurosceptic parties.

Portuguese Communist Party

The Portuguese Communist Party (PCP) contests elections as part of the Democratic Unitarian Coalition (CDU). The CDU is broadly Eurosceptic as it is opposed to the euro, the free market and austerity; nonetheless the coalition supports European political integration.

In the 2011 general election the CDU won 16 seats (7.9% of the vote), 14 of which are held by PCP members. The coalition gained 11.1% of the vote in the 2013 local elections and 12.7% in the European Parliament elections, winning three seats. The MEPs sit in the European United Left/Nordic Green Left group.

The next Portuguese general election will be held in October 2015 and the CDU is polling an average of 8.5%; it looks unlikely to form part of the government.

Euroscepticism is rising, with strong support for the FPO

Austria

As of June 2015, Austria has one of the lowest unemployment rates in Europe, at 5.5-6%. Yet Eurosceptics gained almost 30% of the votes in Austria's 2013 general election. The Freedom Party of Austria won 21% while Team Stronach won 6% and the Alliance for the Future of Austria fell just short of the 4% threshold necessary to enter parliament. The next elections will take place no later than October 2018.

Freedom Party of Austria

Austria's biggest anti-euro party is the Freedom Party of Austria (FPO), founded in 1956. It is a right-wing party which promotes Austrian national identity. It has historically been strongly anti-establishment, and in recent years this has taken the form of anti-euro sentiment. The FPO would like Austria to leave the EU.



The FPO's popularity declined in the early 2000s, but it regained support following the appointment of Heinz-Christian Strache as chairman in 2005. Under Strache, the FPO's policies have moved further right, becoming more openly anti-immigration and anti-EU.

The FPO won 21% of the vote in the 2013 general election, gaining 40 seats and becoming the third-largest party in the National Council (total seats in the national council: 183; the top two parties have 57 and 47, respectively). Neither of the leading parties, the Social Democrats and the People's Party, considered forming a government with the FPO, and instead formed another 'grand coalition'.

In the 2014 European Parliament elections, the FPO doubled its seats to four with 20% of the vote. Its MEPs are in the newly formed (as of 16 June 2015) Europe of Nations and Freedom group in the European Parliament, a far-right Eurosceptic group. Opinion polls since summer 2015 show the FPO in the lead, with support in the high-20% area.

Alliance for the Future of Austria

The Alliance for the Future of Austria (BZO) was founded in 2005 as a splinter group of the Freedom Party of Austria. It advocates a referendum on the Lisbon Treaty and Austria's withdrawal from the euro. BZO won 10% of the vote in the 2008 general election and enjoyed strong support around 2008-10. However, in the 2013 election it failed to reach the 4% threshold to gain seats in parliament. In the 2014 European Parliament elections the party's share of the vote fell to a mere 0.5% and it won no seats. Polls indicate that it is unlikely to gain major support in future.

Team Stronach

Team Stronach was founded in 2012 by businessman Frank Stronach. It is considered a rightwing Eurosceptic party. In the 2013 legislative elections it received 5.7% of the votes giving it 11 seats. In 2015, two MPs defected to the Austrian People's Party, the mainstream rightwing party in the governing coalition. Team Stronach has suggested that Austria should exit from the euro and return to the schilling, while also saying that a parallel currency would be a possibility. The party did not contest in the 2014 European Parliament elections. In mid-2015 its support weakened substantially to less than 4%.

Belgium

Belgium, as de facto capital of the EU, is one of the least Eurosceptic states

Belgium, as the de facto capital of the EU and home of a number of EU institutions and NATO, displays less anti-euro sentiment than many other euro-area countries. 69% of Belgians consider themselves EU citizens and only 22% have a negative view of the EU, according to Eurobarometer surveys. Belgium's GDP growth has remained at around 0.3% q/q since 2013; unemployment is similarly stable at c.8.5%.

New Flemish Alliance

Belgium's ruling party is the New Flemish Alliance (N-VA), a Flemish nationalist party founded in 2001. In recent years it has become slightly more critical of the EU, arguing that there should be less interference in national politics. It describes itself as 'Eurorealist' and is a member of the European Conservatives and Reformists (ECR) group in the European Parliament. Nonetheless, the party does not advocate anything beyond mild reform and wishes to remain in the euro and EU.



Vlaams Belang

Vlaams Belang (VB) is a nationalist Eurosceptic party that advocates independence for Flanders and tighter immigration laws. The party's policies are less extreme than those of its predecessor, Vlaams Blok, which was forced to disband in 2004 after being judged as unlawfully discriminatory. VB is critical of EU bureaucracy, arguing that national sovereignty should prevail and states should be able to control their own borders. VB MEPs are members of the far-right Eurosceptic Europe of Nations and Freedom group in the European Parliament.

In the 2014 Belgian elections to the Chamber of Representatives, VB won 3.7% of the vote. The party won three seats, down nine from its previous representation. The party won only one of 21 Belgian seats in the European Parliament in 2014, with 4.3% of the vote, and party support appears to be waning. Support for VB in the Dutch-speaking region can perhaps be attributed more to its advocating of Flemish nationalism than its views on the EU.

Republic of Ireland

Like Portugal, Irish politics have remained largely stable since the bailout

Ireland's European relations were tested in the Irish bailout in 2010. The government successfully underwent the programme and in 2015 Ireland is expected to be one of the fastest-growing euro-area members. Its unemployment rate has fallen steadily to below 10% from highs of around 15% in 2011.

The impact of positive economic growth has been reflected in Irish public opinion. Eurobarometer reports that 70% of Irish people consider themselves EU citizens, well above the EU average of 63%. Furthermore, only 16% of Irish people have a negative view of the EU; the comparable EU average stands at 22%.

Sinn Fein

Sinn Fein took its current form in 1970 after a split within the party. It is broadly a democratic socialist party with the goal of a united Ireland independent of the United Kingdom. Gerry Adams has been the party's leader since 1983.

Sinn Fein has a 'soft' Eurosceptic view of the EU. It urged a 'No' vote in the 2008 referendum on the Lisbon Treaty and seeks an EU with greater devolved power and national sovereignty. It is also opposed to EU-mandated austerity measures which it argues have restricted Ireland's economic growth. In the European Parliament, Sinn Fein is part of the European United Left/Nordic Green Left (EUL/NGL) group.

In the 2011 general elections Sinn Fein won 14 of the 166 seats in the Dail Eireann, the lower house of the Irish Parliament, with around 10% of the vote (10 more seats than in 2007). The party is the fourth-largest in the Republic of Ireland. In 2014 it won three seats in the European Parliament.

Ireland's next parliamentary election will take place before April 2016. As of mid-2015 Sinn Fein was polling around 21% of the vote, 7ppt behind the leading Fine Gael. However, since mid-2014 the two parties have been extremely close in the polls, with Sinn Fein leading at some points. If this trend continues it may significantly increase Sinn Fein's representation as Ireland operates a proportional voting system, possibly making Sinn Fein the second-largest party. Given positive Irish opinion of the EU, Sinn Fein's support probably does not primarily stem from its stance on the EU but rather its broader policy.

Finland's prolonged recession has led to a rise in Euroscepticism

Finland

Prolonged stagnation and low growth in Finland has increased support for non-mainstream parties. Its leading Eurosceptic party, the Finns Party, is now in government as part of a three-party coalition. Nevertheless, support for the euro is among the highest in the region, at 78% in May 2015.

The Finns Party

The Finns Party was founded as the True Finns in 1995 by Timo Soini, who remains the party leader. Despite having socially conservative policies, the party is fiscally centre-left and criticises austerity. The party's main platform is Finnish cultural unity and national recognition.

The Finns oppose bailouts, but voted in favour of Greece's deal

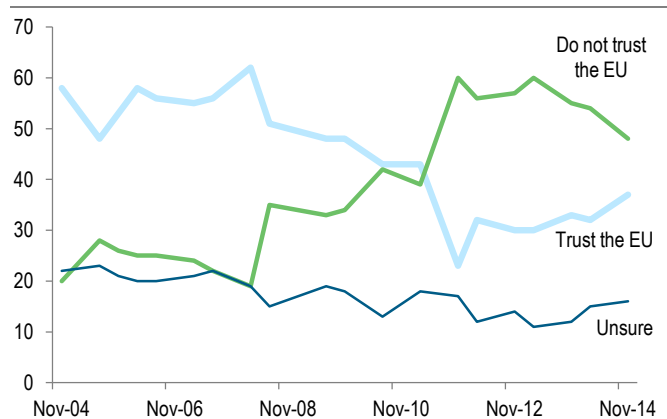
It takes a 'soft' Eurosceptic view of the EU, arguing that EU bureaucracy and membership costs restrict Finland. The Finns Party seeks reform of the EU and a renegotiation of the terms of Finnish membership, as well as an end to bailouts. The party's website states that "it is NOT the function of the EU to rescue the financial disasters of the investment bankers". Furthermore, it believes that the euro is a flawed project that needs a fresh solution. The Finns Party aims to return much sovereign power to Finland without necessarily leaving the EU. That said, the party voted unanimously in favour of Greece's third bailout, with its leaders arguing that they were powerless to stop the deal going ahead.

The party is the second-most popular in Finland, winning 38 seats in the national parliamentary election in May 2015 with 17.7% of the vote. While this represented a decline of one seat versus the previous election, the relative success of the Finns Party was bolstered by the losses of the National Coalition Party, which lost seven seats. The Finns Party now forms part of a coalition alongside the Centre Party and the National Coalition Party and has four cabinet ministers. The next election will not be held until 2019 so it will play a crucial role in Finnish politics for some time.

In the European Parliament the party's two MEPs are part of the European Conservatives and Reformists (ECR) group. Its rise can perhaps be attributed to Finnish concerns over economic security and dissatisfaction with the existing political system, which is seen as elitist. If these concerns are not addressed they may increase and Finns might gain further support.

Figure 100: Irish regain trust in EU after economy improves

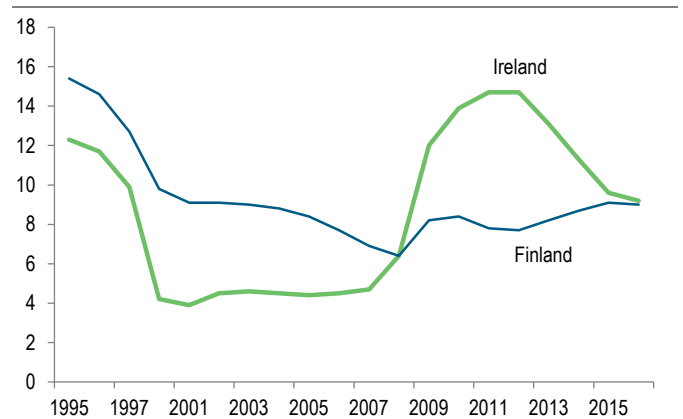
Answer to question 'Do you trust the EU?'



Source: Eurobarometer, Standard Chartered Research

Figure 101: Ireland's high unemployment did not produce extremist parties; Finland's situation is more uneasy

Unemployment rate, %



Source: AMECO, Standard Chartered Research

Euro enlargement

Since 2009 four countries have adopted the euro, though support from others is lukewarm at best

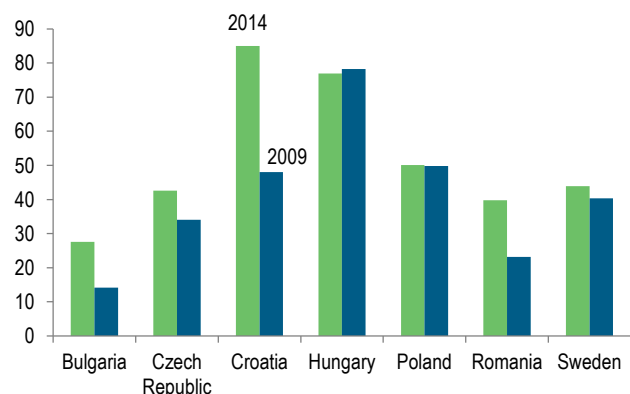
In the midst of the euro-area challenges, a fact often overlooked is that the euro area is getting bigger. Since 2009, four countries have adopted the euro: Slovakia, Estonia, Latvia and Lithuania, bringing the total number of euro-area member states to 19. The enlargement of the euro area is a sign that despite its flaws, the currency union remains more attractive for some countries than the alternative.

In theory, by 2020, all but five members of the EU are due to have joined the euro, with just Poland, Bulgaria, the UK, Denmark and Sweden staying outside. On current fundamentals the new joiners look likely to be less cause for concern than the existing weak euro-area economies. These countries have lower debt/GDP ratios than the euro-area average (Figure 102).

Officially, all EU members except the UK and Denmark (which have opt-outs) are obliged to join the euro area. If this happened, euro-area GDP would increase by about 20%. But among the countries that remain outside EMU, support for the euro is lukewarm at best, and in some countries opposition is high, suggesting that euro enlargement is likely to be on hold for the time being.

Figure 102: Most euro candidates have debt below 60%

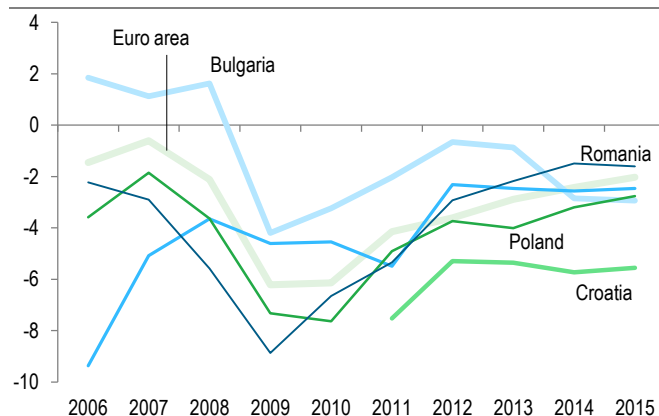
Debt to GDP ratio, %



Source: AMECO, Standard Chartered Research

Figure 103: Budget deficits are converging

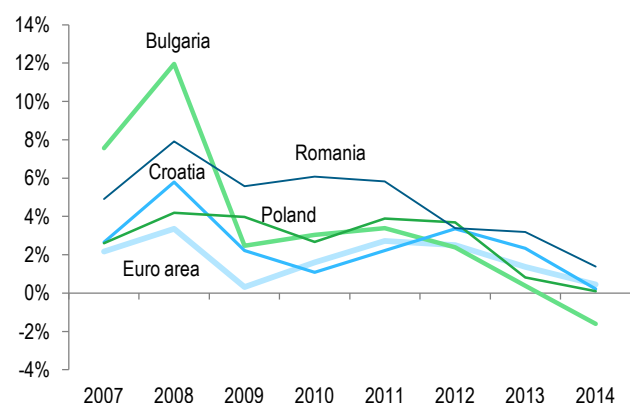
Government balance, % GDP



Source: AMECO, Standard Chartered Research

Figure 104: Inflation is converging among candidates

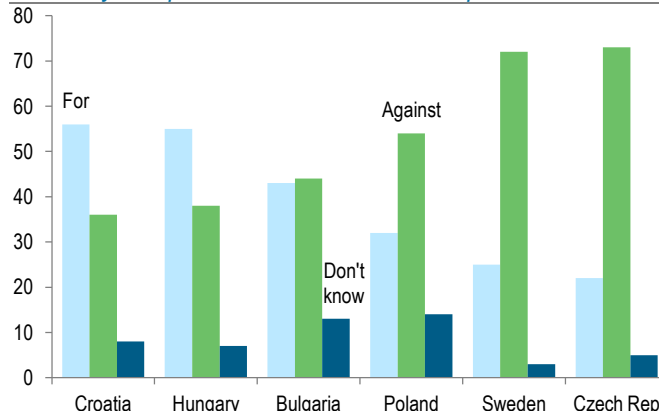
CPI, % y/y



Source: AMECO, Standard Chartered Research

Figure 105: Support for the euro is lukewarm, at best

'What is your opinion of the euro?' % of responses



Source: Eurobarometer, Standard Chartered Research

Conclusion

The threshold for euro exit is very high, even though fears of a break-up will likely return periodically

The euro has had a turbulent time since its creation almost 17 years ago. Will the single currency exist for another 17 years? We think it will, and in a more optimal set-up than currently. Fears of break-up will remain and resurface each time the region faces challenges. To the extent that euro-area institutions can evolve and integration can become closer, the impact of outside shocks should diminish.

Politics remain the major uncertainty, but the short history of the euro tells us that the exit threshold for a single member is very high: Greece faced three weeks of forced bank closures and the Greek government had to make a U-turn after acknowledging what was at stake; Cyprus faced a significant bail-in of depositors' wealth and still chose to stay in the euro. Among creditor countries, Eurosceptic parties have not been a significant challenge, even in government: the Finns Party, part of Finland's governing coalition, voted for Greece's third bailout.

Political will is the necessary condition for the continuation of the euro area. Many observers, especially from outside the euro area, have underestimated the amount of political and popular backing for the euro. For now, we do not see sufficiently strong political forces that could lead to a euro-area break-up; support for the euro has risen again since the euro-area recession and backing for anti-euro parties has, on the whole, fallen.

Policy makers must take advantage of economic recovery to move the region ahead

But the region is still not strong enough to manage another shock, either economic or geopolitical, and support for the euro could be tested by the need to move to closer integration, if voters do not see positive benefits from euro-area membership. Policy makers must urgently take advantage of the recovery phase of the euro-area economy to implement structural reforms, complete banking union and accelerate the move to a capital markets union. In time, and under the right conditions, a move to fiscal union should begin.

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