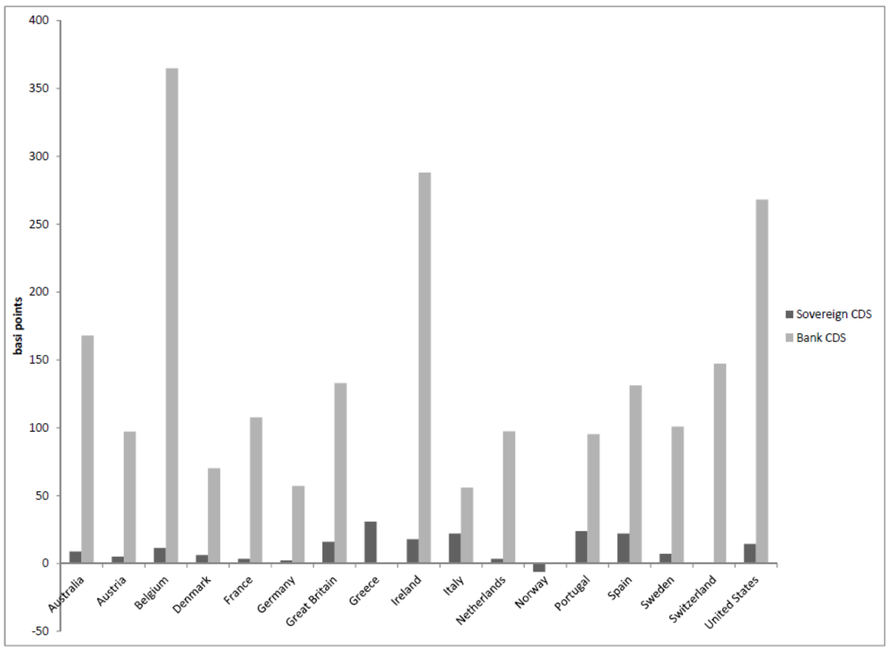
Can the Euro Survive?

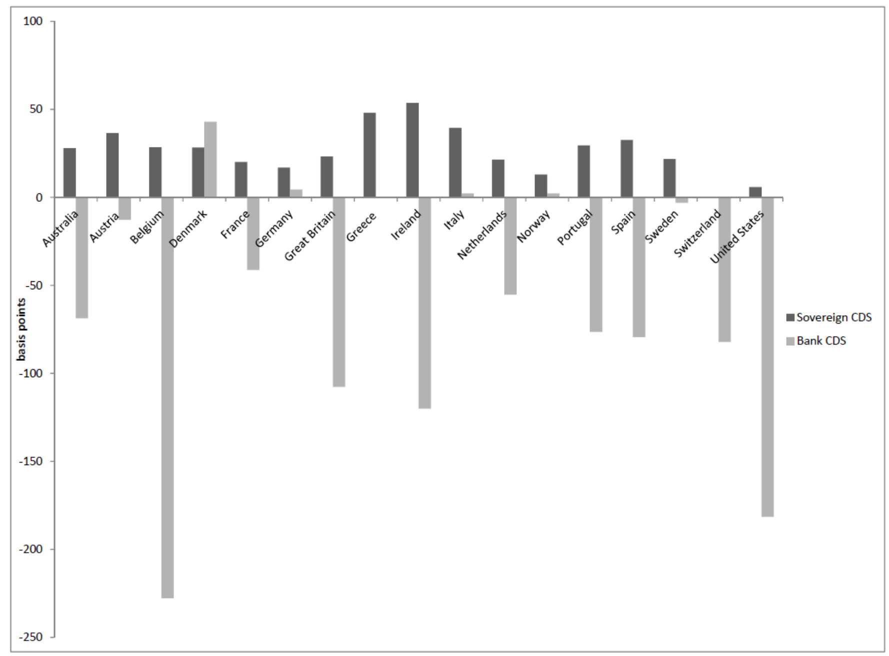
Zvi Eckstein

IDC, Herzelya, 27.3.2012

Sovereign Risk and Banking risk

Banking sector vs. Sovereign CDS: Before/After Lehman





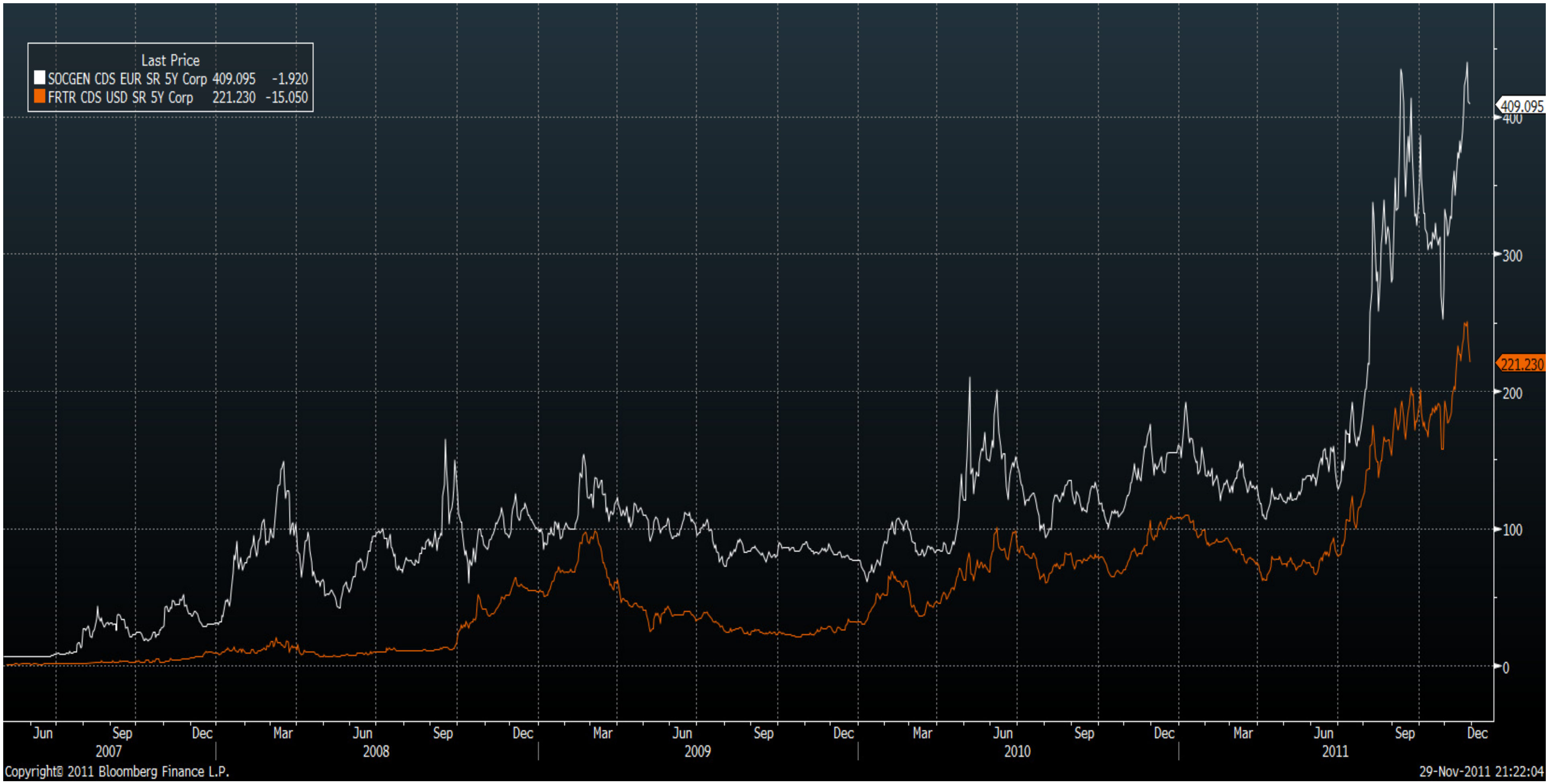
Change in CDS before bailout (before Lehman)
Jan 07 – Sep 08

Change in CDS during bailout (after Lehman)
Sep 08 – Oct 08

Acharya-Drechsler-Schnabl (2011)

Banking sector vs. Sovereign CDS: Germany

Banking sector vs. Sovereign CDS: France



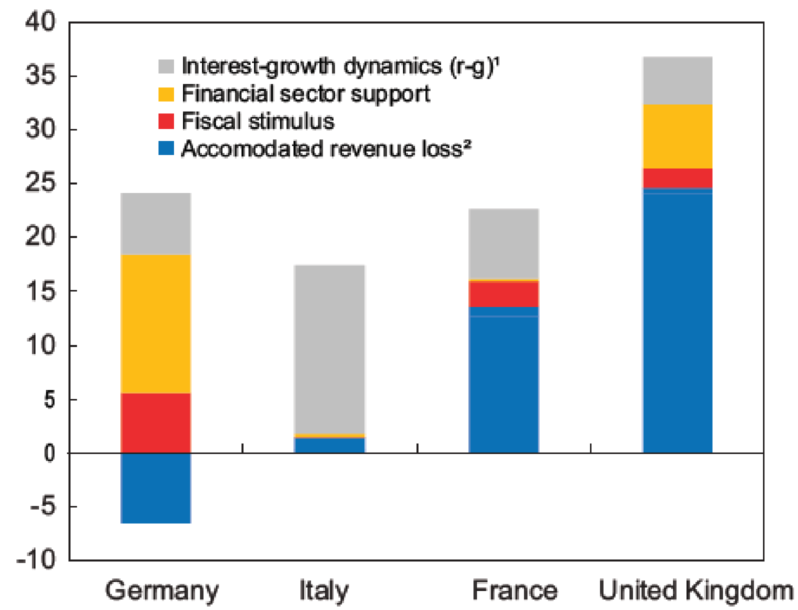
Banking sector vs. Sovereign CDS: Italy

Government deficits and fiscal policy: Debt Crisis

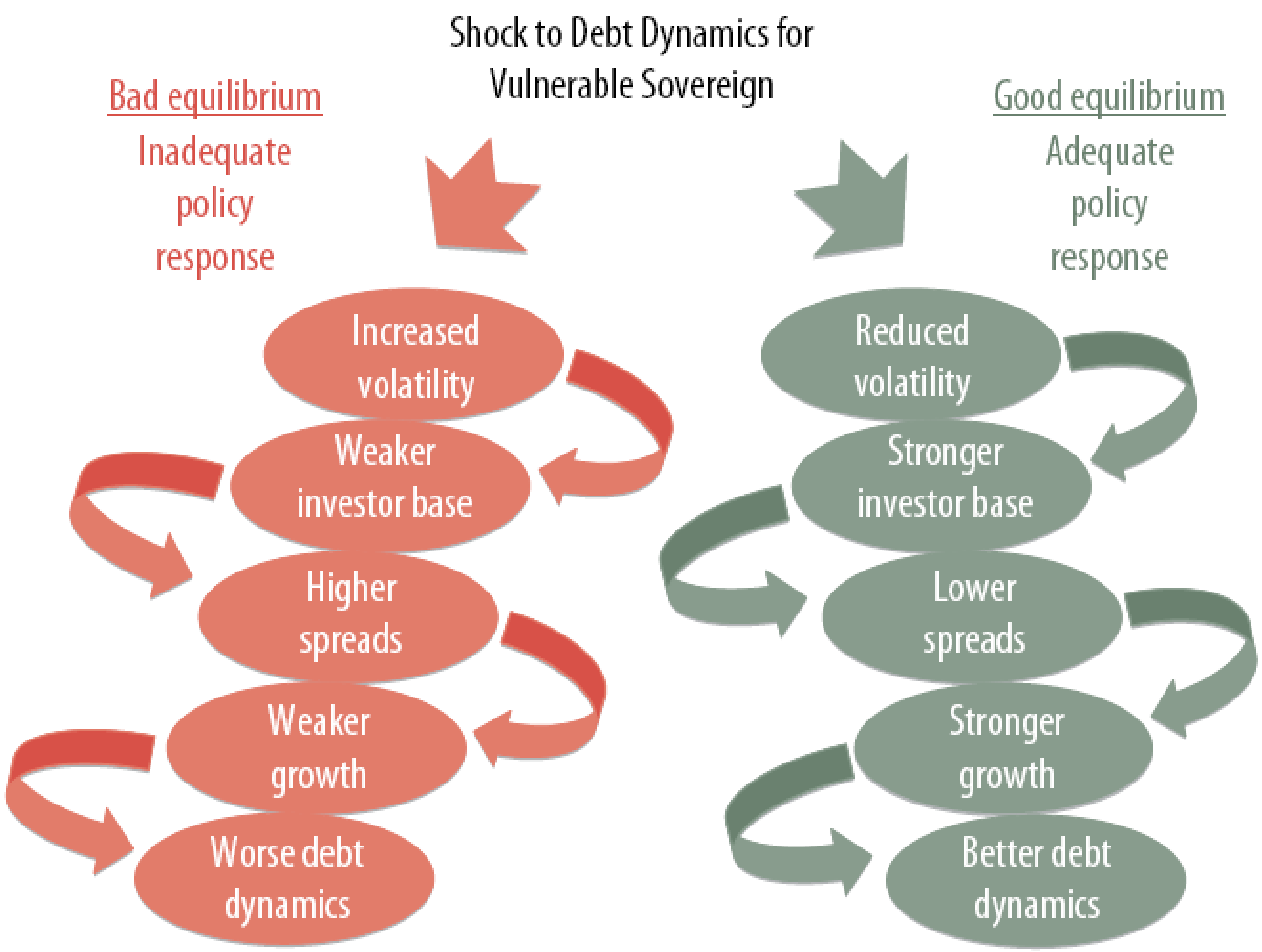
Why do public debt levels increase sharply during crises?

- The stock of debt increases for 3 reasons:
  - **Bailout of the banking sector**
  - **Shortfall in tax revenues**
  - **Increase in interest-growth dynamics**
  - **Fiscal stimulus packages**

Selected European Countries: Drivers of Public Debt Increase, 2007–2011
(Percent of GDP)

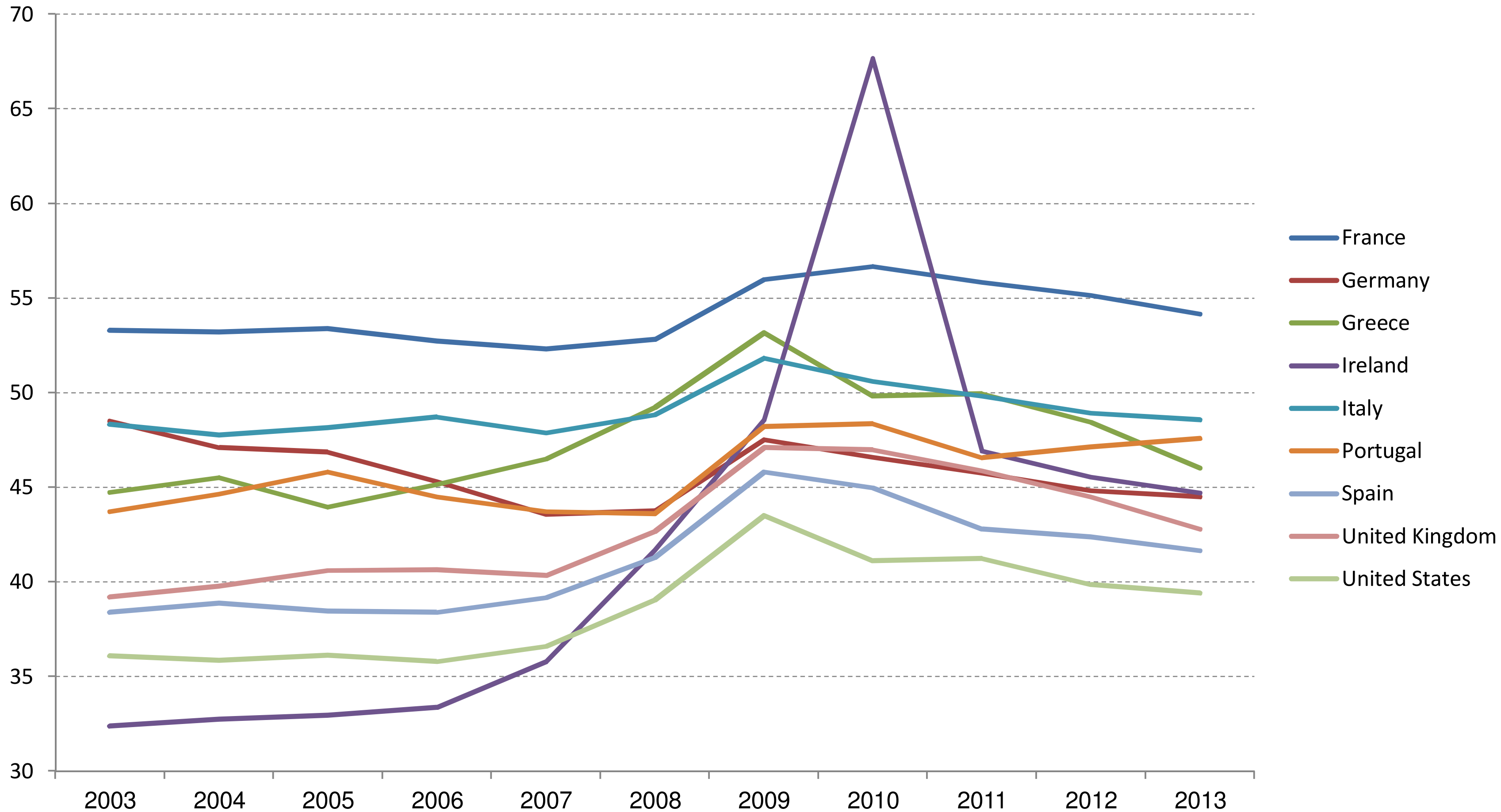


IMF's Regional Economic Outlook - Europe - Oct 2011



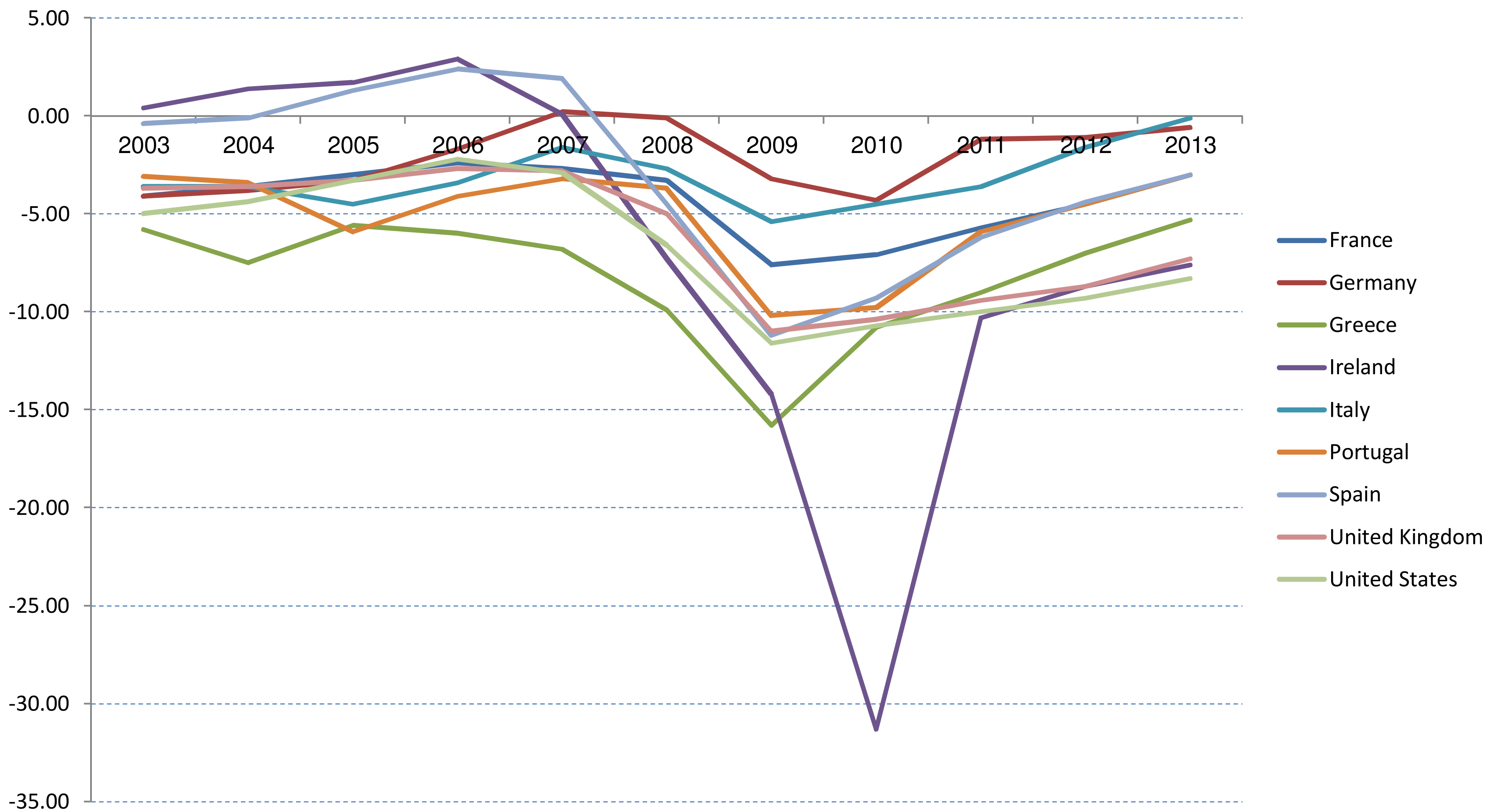
GFSR – IMF Sep 2011

Government expenditures (%GDP)



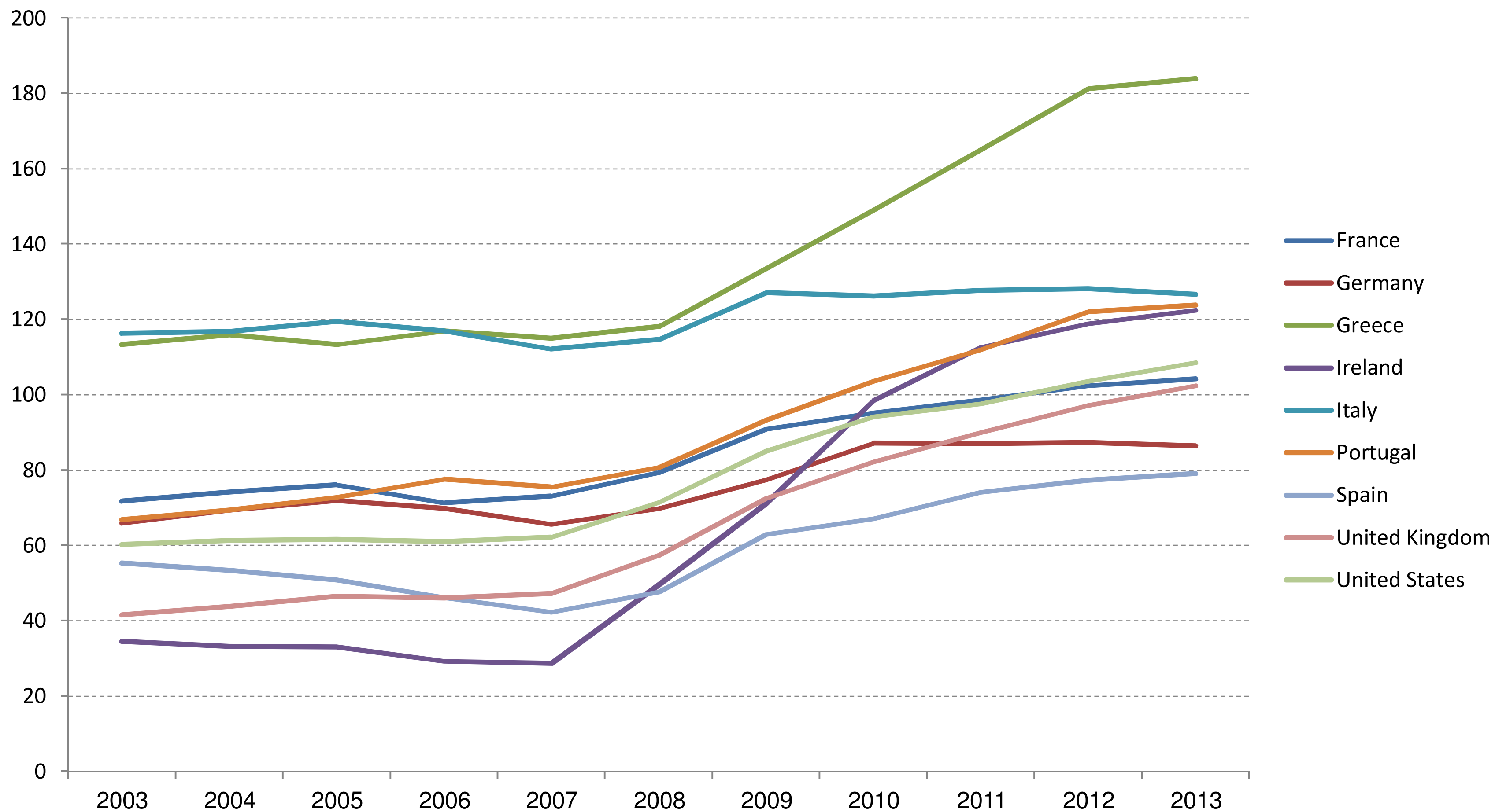
OECD Statistical database

General deficit (% of GDP)



[OECD Economic Outlook - Oct 2011]

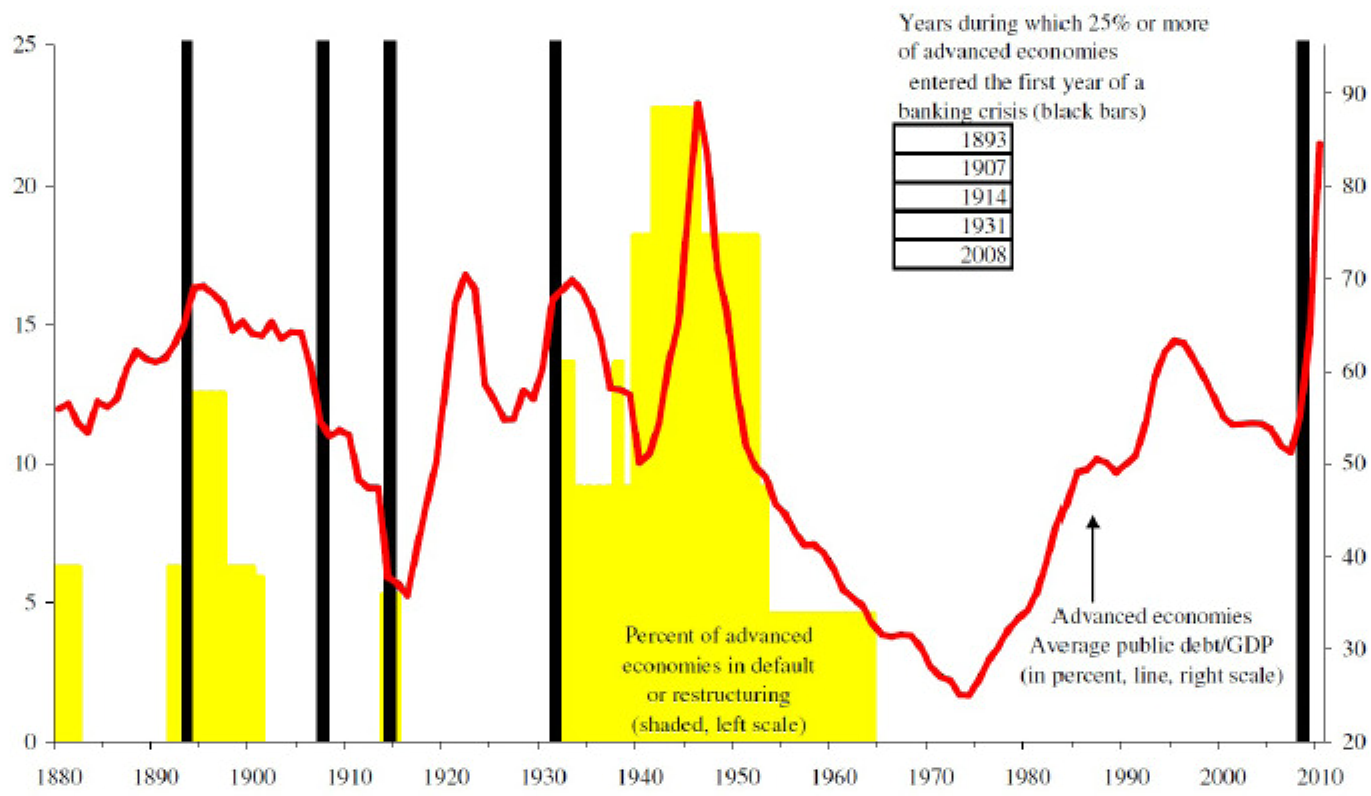
Gross Government debt (% GDP)



OECD Economic Outlook - Oct 2011

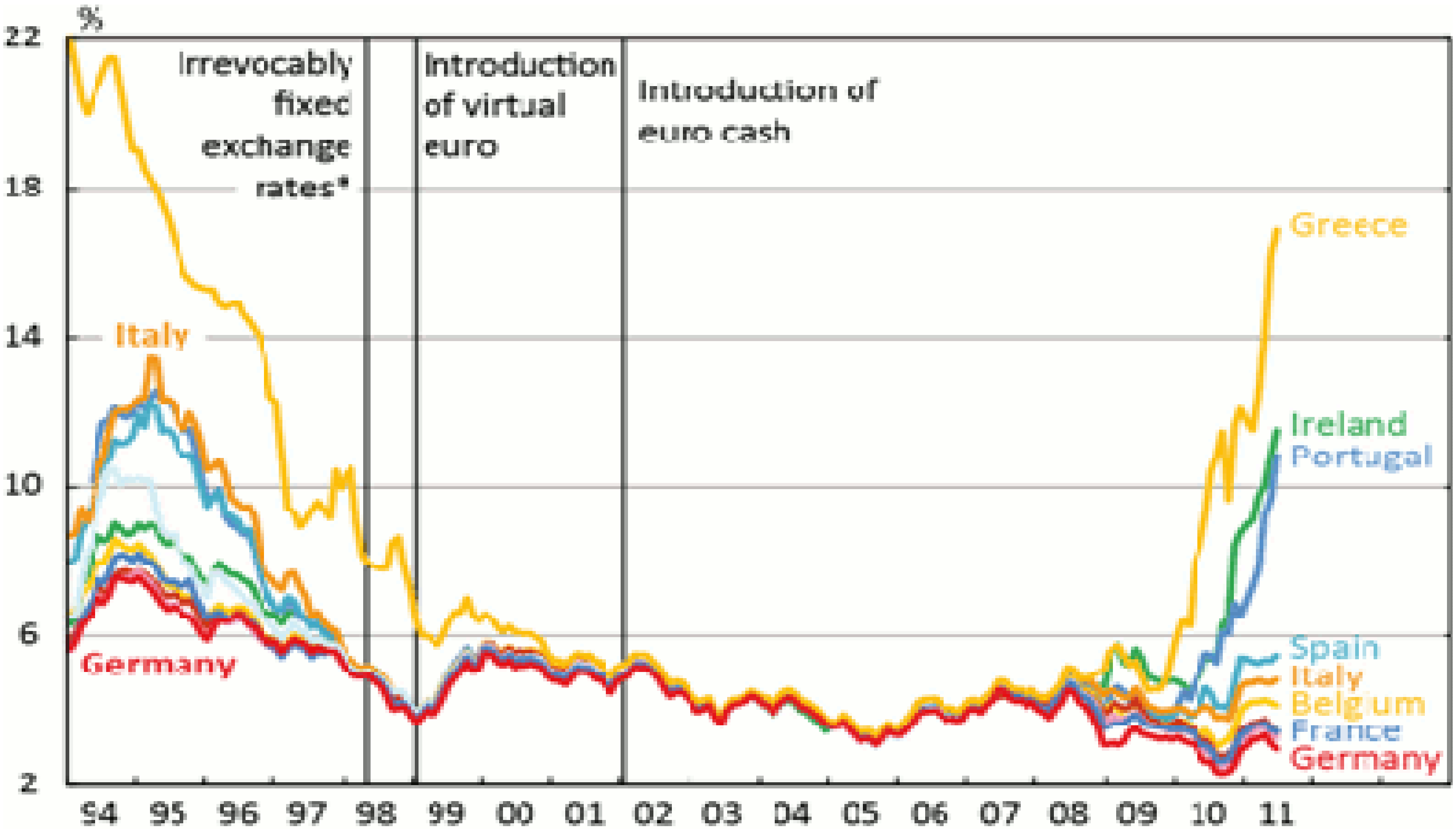
Debt Crisis

Reinhart and Rogoff (2009):Sovereign defaults in developed countries are not uncommon

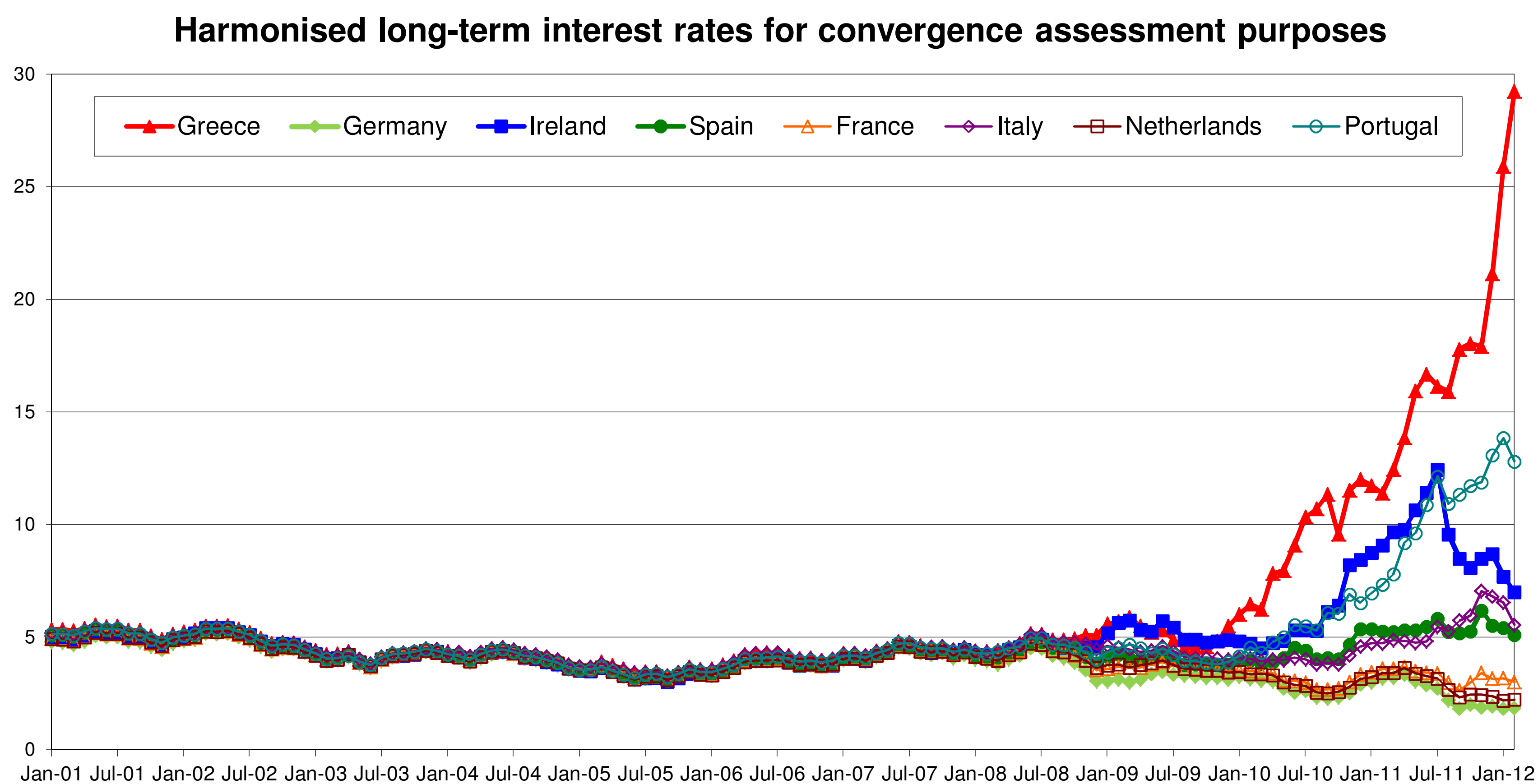


European Debt Crisis

European 10 year Bonds rates

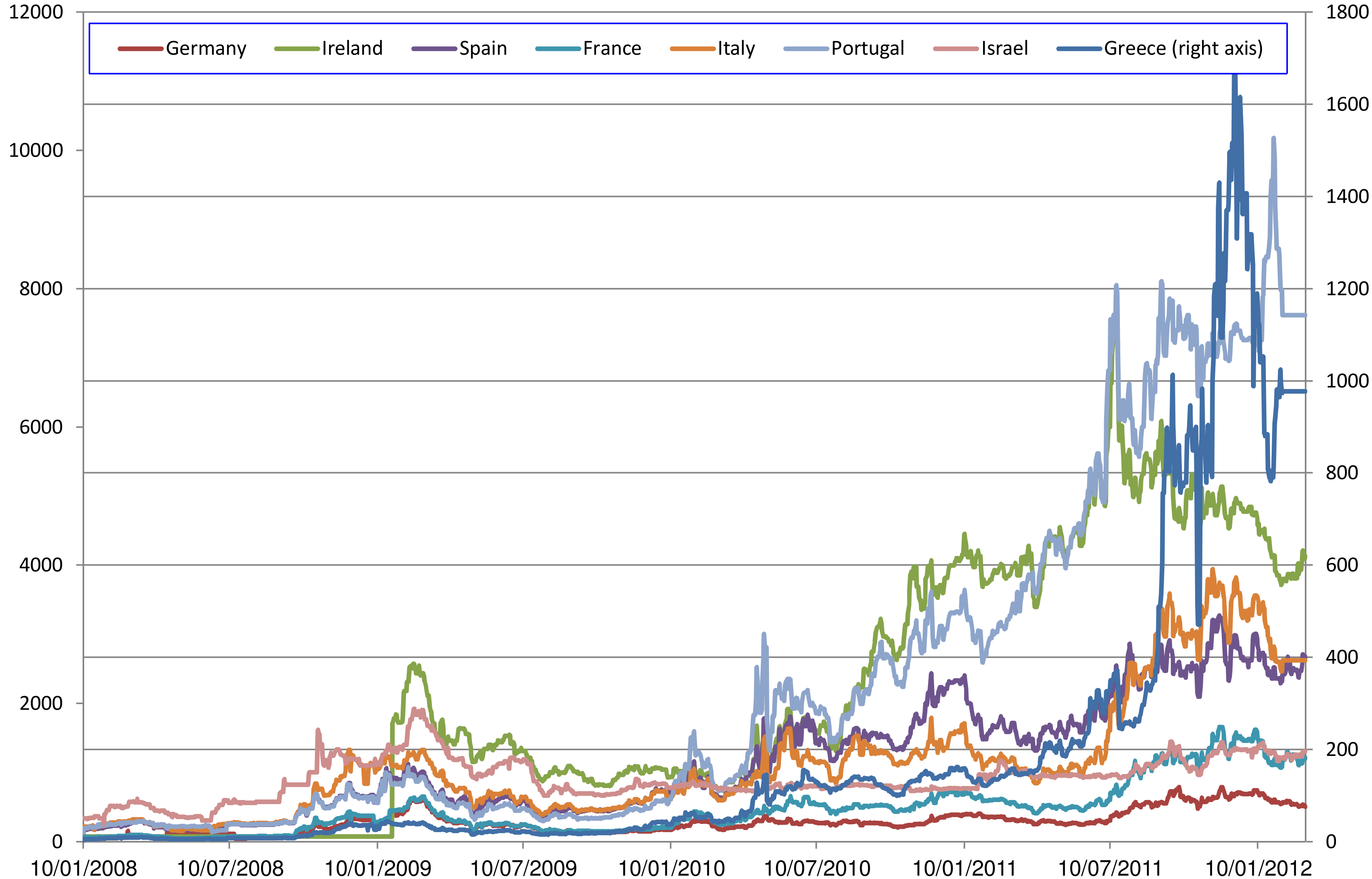


European 10 year bonds



Percentages per annum; period averages; secondary market yields of government bonds with maturities of close to ten years; denominated in

CDS


Germany
Ireland
Spain
France
Italy
Portugal
Israel
Greece (right axis)
12000
10000
8000
6000
4000
2000
0
1800
1600
1400
1200
1000
800
600
400
200
0
10/01/2008
10/07/2008
10/01/2009
10/07/2009
10/01/2010
10/07/2010
10/01/2011
10/07/2011
10/01/2012

European Crisis: What is the solution?

- Decisive actions taken now:

- Budget rules follow tightly
- Labor Market reforms
- Pension reforms
- ECB could be “market maker of last resort” (FED)
- ECB should coordinate systemic risk191919
- Stabilize the banks by separating them from sovereign debt potential default