J.P.Morgan

Europe Economic Research
28 May 2013

The Euro area adjustment: about halfway there

- The narrative of crisis management in the Euro area has two dimensions: first, designing new institutions for the next steady state (EMU-2); and second, dealing with the national legacy problems, some of which were there at EMU's launch and some of which arose during the first decade of the monetary union's life.
- It is critical to understand that Germany's approach—and Germany is largely determining how the crisis is being managed—is that national legacy problems have to be sorted out at the national level before further steps of integration—which involve meaningful amounts of risk and burden sharing—can be taken.
- This creates the image of a set of journeys of national level adjustment. Some of these journeys are simply unwinding imbalances that built in the first decade of EMU, while some will take countries to completely new destinations. The key question is: where are we in these journeys of adjustment. In this report, we examine the journeys in terms of sovereign deleveraging, competitiveness adjustments, household deleveraging, bank deleveraging, structural reform, and national level political reform.
- In some areas, quite a lot of progress has been made. In other areas, the adjustment has barely begun. Putting it all together, we would argue that these national level adjustments are about halfway done on average.
- This approach to crisis management has had a huge impact on the macro economy, depressing overall performance and widening the degree of dispersion. At first blush, to say that we are only halfway along these journeys seems very depressing: the region could not tolerate another three years like the last three. But, ongoing adjustment does not mean ongoing recession. What matters is how the various headwinds buffeting the real economy change. Our judgment is that the headwinds will fade even though adjustments will be ongoing.
- We anticipate that the region will return to growth. But, without a much more aggressive central bank, growth will remain lackluster and the region will remain vulnerable to shocks. A 1%-1.5% growth trajectory is probably the best the region can hope for.
- At some point, the narrative of crisis management will change, and the new institutions for the next steady state will be rolled out. There are two ways this could happen: first, if the journeys of national level adjustment are well advanced; or second, if irresistible political and social pressure builds in the periphery.
- Both of these are some way off. Thus, the region is likely to continue with the current narrative of crisis management for a while longer. In our view, discussions around the institution building for the next steady state will continue in parallel, but a meaningful shift to regional risk and burden sharing is unlikely to happen soon.

Economic and Policy Research

David Mackie
(44-20) 7134-8325
david.mackie@jpmorgan.com

Malcolm Barr
(44-20) 7134-8326
malcolm.barr@jpmorgan.com

Marco Protopapa
(44-20) 7742 -7644
marco.protopapa@jpmorgan.com

Alex White
(44-20) 7134-5298
alexander.s.white@jpmorgan.com

Greg Fuzesi
(44-20) 7134-8310
greg.x.fuzesi@jpmorgan.com

Raphael Brun-Aguerre
(44-20) 7134-8308
raphael.x.brun-aguerre@jpmorgan.com

JPMorgan Chase Bank N.A, London Branch

See page 9 for analyst certification and important disclosures.

Malcolm Barr
(44-20) 7134-8326
malcolm.barr@jpmorgan.com

David Mackie
(44-20) 7134-8325
david.mackie@jpmorgan.com

Contents

The narrative of crisis management 2
The idea of a journey 3
The journey of sovereign deleveraging 4
The journey of competitiveness adjustments 5
The journey of household deleveraging 6
The journey of bank deleveraging 7
The journey of structural reform 9
The journey of national political reform 12
The macro consequences of crisis management 13

The narrative of crisis management

Crisis management in the Euro area has evolved over the past three years, as the crisis itself has evolved. But, throughout, a key underlying theme has always been present: that the national legacy problems would have to be dealt with at the national level before the region would embark on further steps of integration which would involve significant risk/burden sharing.

Many thought that the Cyprus bailout represented a sea change in the way the crisis was being managed. But, this was not true, in our view. Prior to Cyprus, Euro area sovereigns entering EU/IMF programs had to bear the burden of sovereign deleveraging, bank recapitalization and structural reform, themselves. This pattern continued with the Cyprus bailout, but with the extension that when the respective sovereign's shoulders were not broad enough to bear the burden of recapitalizing its banks, bank creditors would be bailed in. The Cyprus bailout simply reinforced the message that national legacy problems would be dealt with at the national level.

Germany has always taken an inter-temporal perspective with regard to crisis management. It has been concerned that the more that burdens are shared ex ante, the less likely it is that appropriate adjustments will be made ex post. However, in order for Germany to ensure that its preferred approach to crisis management is followed, sufficient liquidity firewalls have to be in place to manage the financial market stress. Initially, this stress was dealt with by building fiscally-based liquidity hospitals for sovereigns (EFSF/ESM), alongside ECB liquidity support for banks. This approach became problematic as financial market stress moved to Spain and Italy in 2011, countries that are too big to be accommodated in the traditional kind of fiscally-based liquidity hospital. The OMT can be viewed as a solution to this problem. By stepping into the role of being the lender of last resort to sovereigns, the ECB removed the capacity constraint to ensure that sovereigns can always be funded. The OMT has allowed Germany to continue with its preferred approach to crisis management.

In the early days of the crisis, it was thought that these national legacy problems were largely economic: over-levered sovereigns, banks and households, internal real exchange rate misalignments, and structural rigidities. But, over time it has become clear that there are also national legacy problems of a political nature. The constitutions and political settlements in the southern periphery, put in place in the aftermath of the fall of fascism, have a number of features which appear to be unsuited to further integration in the region. When German politicians and policymakers talk of a decade-long process of adjustment, they likely have in mind the need for both economic and political reform.

The nature of crisis management has had a huge impact on the macro landscape. A greater bearing of the burden at the national level has weighed on regional growth and has generated a significant degree of intra-regional dispersion. It has also increased political tensions in the region. A critical question is whether the macro economy can improve even if the narrative of crisis management remains unchanged. We think that it can, but only to a limited extent.

Many would argue that the burden of dealing with legacy problems cannot be fully borne at the national level, and that, at some point, crisis management will need to

Malcolm Barr
(44-20) 7134-8326
malcolm.barr@jpmorgan.com

David Mackie
(44-20) 7134-8325
david.mackie@jpmorgan.com

change. This may be true. But, it is worth highlighting that there are some grey areas which are likely to be exploited increasingly over time, which will ease the path of adjustment: elongated fiscal journeys and the restructuring of official liabilities. As the crisis has unfolded, policymakers have increasingly focused on structural budget developments and have allowed the impact of automatic stabilizers to be fully reflected in headline budget numbers. Slower progress toward the ultimate structural fiscal objectives is also likely as time passes. Meanwhile, a restructuring of official liabilities will deliver debt relief and will ease the burden of debt servicing. This has already taken place for Greece, Ireland, and Portugal. More should be expected for these countries and also for Spain and Cyprus.

Whether this proves to be enough for the national level adjustments to continue until they are completed remains to be seen. Critical will be the behavior of the ECB. In recent months, the ECB has been willing to tolerate more economic weakness and a lower inflation outlook, and more persistent problems with the transmission mechanism around the periphery. To the extent that the ECB's response is only limited, the journeys will be correspondingly harder. A more dramatic response from the ECB would make the journeys of adjustment much easier.

The idea of a journey

The requirement that national legacy problems are dealt with at the national level creates the image of a journey. Some of these journeys are about unwinding problems that built in the first decade of EMU, while others are about countries reaching completely new destinations. With this image in mind, the obvious question is "where are we in these journeys?" In the coming sections we examine this question for sovereigns, banks, households, real exchange rates, structural reform, and national political reform. For each of these we have in mind the idea of a journey from the worst point of recent years to some final destination. We then consider how much of the journey has been completed. The clear message is that considerable progress has been made. But, it is also evident that there is still a lot more to do.

- Sovereign deleveraging—about halfway there.
- Real exchange rate adjustment—almost there for a number of countries.
- Household deleveraging in Spain—about a quarter of the way there in stock terms, but almost there in flow terms.
- Bank deleveraging—hard to say due to heterogeneity across countries and banks, but large banks have made a lot of progress.
- Structural reform—hard to say but progress is being made.
- Political reform—hardly even begun.

Taking everything together, we would argue that on average the region is about halfway there in terms of the journeys of national level adjustment.

Malcolm Barr
(44-20) 7134-8326
malcolm.barr@jpmorgan.com

David Mackie
(44-20) 7134-8325
david.mackie@jpmorgan.com

The journey of sovereign deleveraging

It is reasonably easy to specify the journey for sovereigns because the fiscal compact lays out two medium-term fiscal objectives. For countries with a debt to GDP ratio of more than 60%, the requirement is that they establish a primary surplus that moves their debt stock down to 60% of GDP over twenty years. Otherwise, the fiscal objective is that the structural position should not be any greater than a deficit of 0.5%.

The adjacent table gauges how far countries are in this journey by considering the progress made since the most extreme deficit readings of recent years. Germany, Luxembourg, and Estonia are the only countries in the region that meet both fiscal objectives. Of the peripheral countries, Italy is furthest ahead in the journey, with 75% completed. Other peripheral countries, including France, have generally completed less than half of the journey. These calculations may exaggerate the amount of progress regarding the debt objective, due to the simplifying assumption that average borrowing costs will equal nominal growth rates over time. While this is a reasonable assumption for sovereigns issuing domestic debt with their own central bank, it is not clear whether this will apply to peripheral economies in the Euro area. To the extent that average borrowing costs exceed nominal growth, the required primary surpluses will be larger. But, on the other hand, these calculations do not take into account the likelihood of further official debt restructuring for program countries. Official debt restructuring obviously makes meeting the debt objective easier, at least in a net present value sense, and it also makes meeting the structural deficit objective easier by reducing debt servicing payments.

This analysis suggests that, if we exclude Germany, Luxembourg, Estonia, along with Austria and Finland who have almost fulfilled the conditions of the fiscal compact, the rest of the region has completed about half of the fiscal journey. However, this does not mean that growth in the next few years will be as weak as it has been in the past few years. Aside from the role of financial stress in creating

Fiscal journeys in the medium term

% of GDP

	Structural balance to get to -0.5% of GDP			Primary balance to get debt to 60% of GDP		
	2012	Distance still to travel	% of journey completed	2012	Distance still to travel	% of journey completed
Germany	0.3	0.0	100	2.6	0.0	100
France	-3.6	3.1	45	-2.3	4.1	41
Italy	-1.4	0.9	76	2.5	1.1	75
Spain	-5.5	5.0	38	-4.5	6.3	44
Netherlands	-2.6	2.1	42	-2.2	3.0	29
Belgium	-3.0	2.5	26	-0.5	2.6	35
Austria	-1.5	1.0	64	0.1	0.6	76
Greece	-1.0	0.5	97	-1.0	6.8	58
Finland	-0.7	0.2	0	-0.8	0.7	47
Ireland	-7.4	6.9	26	-3.9	7.1	44
Portugal	-4.2	3.7	55	-1.4	4.6	56

Structural balances for 2012 are from the European Commission spring 2013 forecast. The objective is that the structural position should be no greater than -0.5% of GDP. The objective for the primary balance is based on achieving a debt to GDP ratio of 60% over a twenty year period, assuming that borrowing costs are equal to nominal growth. These calculations use peak debt levels from the European Commission spring 2013 forecast. Primary positions for 2012 exclude one-offs worth 4% of GDP in Greece, 3.2% of GDP in Spain and 0.6% of GDP in Portugal. Source: European Commission and J.P. Morgan

Malcolm Barr
(44-20) 7134-8326
malcolm.barr@jpmorgan.com

David Mackie
(44-20) 7134-8325
david.mackie@jpmorgan.com

macro weakness, the pace of fiscal adjustment is likely to slow as the region shifts its attention to generating growth and reducing unemployment. But, it does mean that fiscal austerity is likely to be a feature of the macro landscape in the Euro area for a very extended period.

The journey of competitiveness adjustments

We have specified the journey for competitiveness adjustments by assuming that internal real exchange rates within the region need to return to the levels that prevailed at EMU's launch. Essentially, this means that the appreciations seen in the first decade of EMU's existence need to be fully unwound. It is possible that this objective is not ambitious enough; that is, that real exchange rates were misaligned at the start of EMU. But, it provides a reasonable metric as a starting point.

The table below gauges how far countries are in this journey by considering the progress made since the most extreme misalignments of recent years. With the exception of Italy, where no progress at all looks to have been made, there have been significant real exchange rate depreciations around the rest of the periphery, with countries having completed 70%-100% of the necessary journey.

The demand weakness that has helped to depress real exchange rates has also helped to narrow current account imbalances. Here we specify the journey in terms of achieving a current account balance. On this basis, significant progress has been made across the periphery. However, it is possible that this objective is not ambitious enough: that some of these countries need to generate current account surpluses in order to unwind the significant build-up of external liabilities that occurred during the period of large current account deficits.

One caveat to this analysis is that these real exchange rate realignments and current account improvements have only happened due to extreme demand weakness, and that further adjustment is needed to ensure that these improvements are maintained when recovery occurs.

Another perspective on the competitiveness adjustment can be gained by looking at exports. Looking at how exports have evolved since before the crisis, Spain really stands out. The impressive performance of Spanish exports doesn't simply reflect the

Progress made with competitive adjustments

	RUWC mfg 4Q12	% of journey completed	RULC whole economy 4Q12	% of journey completed	Current account 2012	% of journey completed	Exports % change since 1Q07
	2005=100		2005=100		% of GDP		
France	102.3	100	103.4	0	-1.8	0	4.7
Italy	109.2	4	103.8	0	-0.5	86	-1.6
Spain	92.4	74	95.0	86	-0.9	91	13.1
Portugal	90.4	100	91.4	99	-1.9	85	8.5
Ireland	81.3	100	87.1	100	5.0	100	10.0
Greece	94.8	92	87.1	100	-5.3	65	n.a

For the current account, the percent of the journey completed refers to balancing the current account position. For competitiveness, the percent of the journey completed is to restore competitiveness back into line with where it was at the start of EMU. Competitiveness refers to relative unit wage costs in manufacturing and relative unit labour costs in the whole economy, both relative to the rest of the Euro area. For reference, German exports have increased 16.9% since the start of 2007. Source: J.P. Morgan, national statistics offices, and European Commission

Malcolm Barr
(44-20) 7134-8326
malcolm.barr@jpmorgan.com

David Mackie
(44-20) 7134-8325
david.mackie@jpmorgan.com

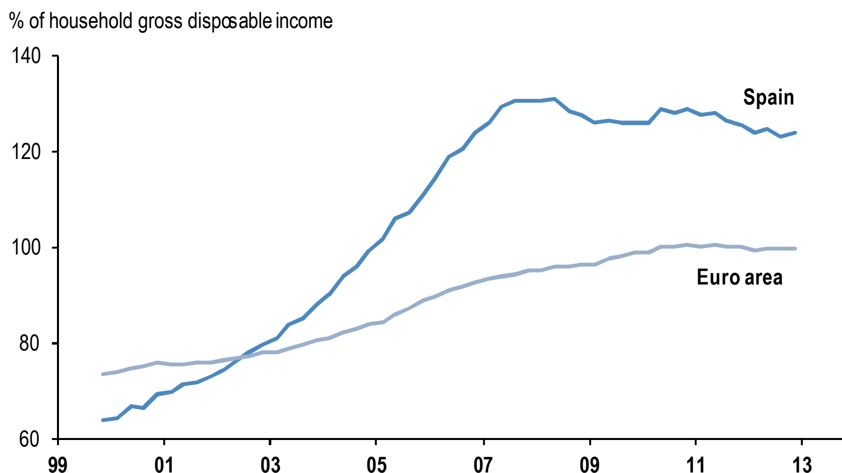
real exchange rate improvement. In addition, it reflects the adaptability of Spanish firms who have responded to the collapse in domestic demand by shifting their output toward foreign markets. That Spain has been able to do this to a much greater extent than other countries suggests a greater degree of underlying flexibility.

The journey of household deleveraging

The pressure on households to delever is not uniform across the Euro area. It is concentrated in specific countries such as Spain and Ireland. In Spain for example, in 2002, household debt as a share of household disposable income was the same as the Euro area as a whole, at around 77%. At the peak in 2007, household debt in Spain had risen to 131% of income, while in the Euro area as a whole it had risen to only 95%. Since then, Spanish household debt has declined to 124% of income while the area wide average has moved up to 100%.

Specifying a journey for household deleveraging is difficult because there is no clear way to define the equilibrium level of leverage. Given that the Euro area as a whole has experienced neither a housing boom nor a massive expansion of household debt, it seems reasonable to specify the journey in terms of Spanish households moving their debt to income ratio back into line with the regional average. This would involve a further decline to around 100%. If we specify the objective in this way, Spanish households have only completed around 25% of the journey in terms of the stock adjustment.

But, in terms of the impact of household deleveraging on economic growth, it is more appropriate to consider the level of the household sector's financial surplus. If we consider the journey for Spanish households in the same way that we do for sovereigns, that is, what financial surplus is required to put debt on a downward trajectory, then households have made much more progress. Last year, the Spanish household sector's financial surplus was 1.3% of gross disposable income. Some simple simulations show that a financial surplus of around 1.5% would reduce debt to 100% of income after a decade. This suggests that, while household deleveraging



Malcolm Barr
(44-20) 7134-8326
malcolm.barr@jpmorgan.com

David Mackie
(44-20) 7134-8325
david.mackie@jpmorgan.com

is likely to remain a feature of the Spanish macro landscape for the foreseeable future, the flow adjustment required by Spanish households from here is fairly modest. Moreover, it is likely to be easier in the coming years for households to maintain a financial surplus. Since 2009, households, nonfinancial corporates, banks, and the government have all been trying to delever together. The move by nonfinancial corporates has been particularly striking; a shift in the sector's financial position from a deficit of 10.9% of GDP in 2008 to a surplus of 3.5% of GDP currently. This simultaneous attempt to delever depressed incomes, which was compounded by additional financial market stress. The macro environment is unlikely to be as difficult as this in the coming years, so households should find it slightly easier to continue to make progress with deleveraging.

The journey of bank deleveraging

Specifying a journey for banks and gauging where we are in that journey is very challenging. We can use regulatory objectives for capital ratios, leverage ratios, and loan to deposit ratios. As far as capital is concerned, large banks are required to achieve a ratio of core tier 1 capital to risk-weighted assets of 9% (a minimum core tier 1 of 4.5%, a capital conservation buffer of 2.5%, and a SIFI buffer of 2%). In our calculations we assume a 10% objective because banks want to exceed the minimum required. Global regulators have tended to settle on maximum leverage ratios (defined as total assets divided by capital and reserves) of 25-33. CRD IV, which lays out the framework for the EU, leans towards a limit at the upper end of that range but without imposing a firm requirement. In our analysis, we assume a desired leverage ratio of 33. There are no firm requirements for loan to deposit ratios, but regulators seem to be encouraging banks to move towards a level of 100%-120%.

The ECB's aggregate data provide one perspective on the adjustment thus far. It is not possible to use these data to create a capital ratio, because the ECB does not provide a measure of risk-weighted assets. But, these data can be used to look at leverage and loan to deposit ratios. At the level of the region as a whole, leverage has fallen markedly in recent years, from a peak of 18.6 in 2008 to 14 currently. Across an average of northern Euro area countries, the leverage ratio has fallen by

Total assets divided by capital and reserves

	Pre-crisis max	Latest	Change
Austria	14.6	9.9	-4.8
Belgium	29.4	18.5	-10.9
France	19.1	16.7	-2.4
Finland	17.3	22.3	5.0
Germany	21.9	19.3	-2.6
Netherlands	24.9	21.0	-3.9
Average	21.2	18.0	-3.3
Italy	14.7	11.0	-3.7
Spain	16.0	8.8	-7.1
Average	15.3	9.9	-5.4
Portugal	13.2	10.9	-2.4
Greece	16.4	8.8	-7.6
Ireland	24.3	8.5	-15.9
Average	18.0	9.4	-8.6

Source: ECB

Ratio of household and corporate loans to deposits (%)

	Pre-crisis max	Latest	Change
Austria	108.0	99.9	-8.1
Belgium	87.9	58.7	-29.3
France	143.7	125.0	-18.7
Finland	165.6	166.1	0.5
Germany	135.8	105.1	-30.7
Netherlands	155.1	135.8	-19.4
Average	132.7	115.1	-17.6
Italy	170.3	134.9	-35.4
Spain	215.7	160.0	-55.8
Average	193.0	147.4	-45.6
Portugal	171.9	151.8	-20.1
Greece	95.9	138.7	42.8
Ireland	255.2	163.2	-91.9
Average	174.3	151.2	-23.1

Source: ECB

Malcolm Barr
(44-20) 7134-8326
malcolm.barr@jpmorgan.com

David Mackie
(44-20) 7134-8325
david.mackie@jpmorgan.com

just over 3 points from its pre-crisis peak. In Italy and Spain, the adjustment in overall leverage has been larger, while in Ireland and Greece it has been even greater. In general, the aggregate data reported by the ECB suggest that banks comfortably meet the required leverage ratios.

Meanwhile, the ECB aggregate data also suggest that significant progress has been made in rotating toward more stable sources of funding, but the picture is more mixed than for leverage. Among northern Euro area countries, excluding Finland, ratios of loans to deposits have fallen markedly. But, the aggregate data for France and the Netherlands remain above the 100%-120% range that regulators have gravitated toward as the norm. Reductions in ratios of loans to deposits elsewhere in the region have been more dramatic, with the exception of Greece which has suffered substantial deposit flight. But, even after marked declines from their post-crisis peaks, ratios of loans to deposits remain well above 120% in Italy, Spain, Portugal, and Ireland. For some of these countries, the picture is a bit misleading due to the popularity of bonds sold to retail customers. These are not included in the loan to deposit ratio, but we think they should be.

Another window on the adjustment is provided by looking at a sample of the larger Euro area banks. Here we consider data reported by 36 of the largest banking groups in the region. Together, their assets are almost 60% of total banking assets in the Euro area. The messages on overall bank leverage and changes in the funding mix are similar to those that emerge from the ECB's aggregate data. The fall in leverage in the sample has taken the median bank down to a leverage ratio of 18 times capital, below current regulatory thresholds. Leverage has fallen more rapidly among the banks with higher overall leverage, bringing the third quartile of the distribution

Balance sheet change among 36 largest Euro area banks

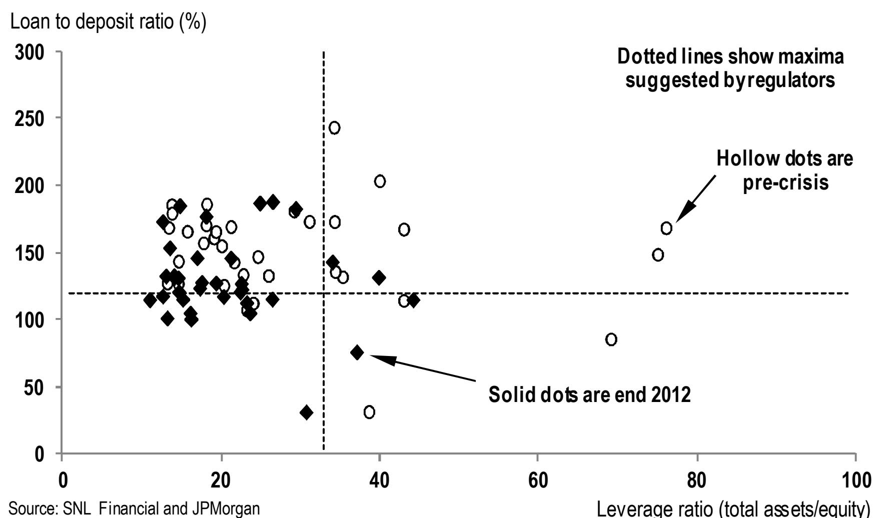
	Pre-crisis	Latest	Change	% Journey
Leverage (Total assets/Equity)				
Median	23.1	18.0	-5.1	100
Third quartile	35.2	24.7	-10.5	100
Loans to deposit ratio				
Median	157.0	126.7	-30.3	82
Third quartile	172.9	145.7	-27.2	51
Core Tier 1 capital ratio				
Median	5.9	11.2	5.3	100
Third quartile	5.3	10.4	5.1	100
Italian and Spanish banks only (11 banks)				
Leverage (Total assets/Equity)				
Median	18.1	14.6	-3.5	100
Third quartile	21.1	17.4	-3.7	100
Loans to deposit ratio				
Median	168.5	132.4	-36.1	74
Third quartile	180.8	172.8	-8.0	13
Core Tier 1 capital ratio				
Median	5.5	10.4	4.9	100
Third quartile	5.2	10.1	4.9	100

Source: SNL Financial and J.P. Morgan calculations. % Journey refers to adjustment from pre-crisis extreme to leverage ratio of 33, loan to deposit ratio of 120%, and capital ratio of 10%.

Malcolm Barr
(44-20) 7134-8326
malcolm.barr@jpmorgan.com

David Mackie
(44-20) 7134-8325
david.mackie@jpmorgan.com

Post crisis adjustment by large Euro area banks



Source: SNL Financial and JPMorgan

towards levels regulators will be comfortable with. But, progress in reducing loan to deposit ratios is less well advanced, with the third quartile of the distribution showing a ratio well above regulatory guidance. Progress on the ratio of capital to risk weighted assets, however, is more positive, with both the median bank in the sample and the third quartile now above the 10% ratio.

Despite a commonly held view that bank deleveraging still has a long way to go, our analysis suggests a significant amount of progress has been made. Indeed, in our bottom-up analysis, the median large bank in the region has completed the journey to acceptable leverage and capital ratios, and has almost completed the journey for the loan to deposit ratio. There are two key challenges to this rather optimistic view. One challenge comes from the valuation of assets. To the extent that assets have not been priced appropriately, these metrics will exaggerate the extent to which progress has been made. The second challenge comes from the various ways that the Euro area banking system is segmented, between large and small banks and between core and peripheral banks. This makes it very difficult to paint a single picture for the journey of Euro area bank deleveraging.

The journey of structural reform

Specifying a journey for structural reform is very difficult. The structural state of the economy has to be measured; what needs to change has to be identified; the extent of the necessary change needs to be calibrated; and we need to be able to assess where we are in real time.

Broadly speaking, there are three ways to directly assess the health of an economy from a structural perspective. The first is to look at outcome-based indicators like participation rates and long-term unemployment to gauge how rigidities may be impeding the functioning of the economy. The second is to look at quantitative indicators of the legal structure of an economy, such as those produced by the Fraser Institute, the World Bank, and the OECD. And the third is to look at survey-based

Malcolm Barr
(44-20) 7134-8326
malcolm.barr@jpmorgan.com

David Mackie
(44-20) 7134-8325
david.mackie@jpmorgan.com

Average rankings across various indicators

	Ranking
Netherlands	2.8
Ireland	3.1
Finland	3.2
Germany	4.5
Austria	4.9
Belgium	6.4
Spain	7.4
France	7.7
Portugal	7.9
Italy	8.0
Greece	10.1

Source: Eurostat, OECD, Fraser Institute, World Bank, WEF and J.P. Morgan

This table shows the average ranking across Euro area countries across the following indicators: female participation rate (age 15-64); male participation rate (age 55-64); Fraser Institute labor market regulation; Fraser Institute business regulation; World Bank overall ease of doing business; OECD Employment Protection Legislation; OECD Product Market Regulation; World Economic Forum labor market efficiency; World Economic Forum goods market efficiency.

measures of business people's perceptions of how easy it is to work in an economy, such as the one produced by the World Economic Forum.

An immediate difficulty is that these different indicators do not necessarily paint the same picture. Perhaps this is not surprising since economies are very complicated systems. There is also the issue of what the legal statutes say (as described by the Fraser Institute, the World Bank, and the OECD) and how these statutes are interpreted by the bureaucracy and judiciary (as suggested by the World Economic Forum). One way to try and summarize all this information is to create an average of the rankings across all the indicators. This is what is done in the table above.

Looking across a broad range of indicators, the Netherlands comes out as the Euro area economy in the best structural shape, closely followed by Ireland and Finland. At the bottom of the range lie Portugal, Italy, and Greece. Germany is in the top half while France is in the bottom half. This comparison doesn't specify exactly what needs to be done. Instead it simply shows which countries need to do the most. Given the complexity of labor and product market institutions, structural reform has to be tailored to particular situations.

Nor does this comparison tell us where we are in real time. A number of these indicators are lagging reality, sometimes by a couple of years. For example, the 2012 Fraser Institute report covers data for 2010. The OECD data are even more out of

Predicted effect of Italian 2012 structural reforms

Indicator

	2008 actual	Latest	2013 predicted	R^2 of regression
OECD				
Average	1.90		1.65	
EPL	2.38		2.08	
PMR	1.32		1.22	
Fraser Institute				
Overall	6.87	6.73	6.83	0.66
Labor	6.34	6.48	7.08	0.74
Business	5.39	5.59	5.66	0.15

For the OECD data, a higher reading indicates less flexibility. For the Fraser Institute, a higher reading indicators more flexibility. Source: OECD, Fraser Institute and J.P. Morgan

Impact of Italian 2012 reforms on rankings

Rank

	Latest actual	Predicted for 2013
OECD (20 countries)		
Employment protection legislation	14	11
Product market regulation	15	11
Fraser Institute (144 countries)		
Overall economic freedom	83	79
Labor market regulation	72	56
Business regulation	100	95

This table uses the estimated impact of the product and labor market reforms on the ranking Italy in these various surveys, assuming no changes in any other countries.
Source: OECD, Fraser Institute and J.P. Morgan

Malcolm Barr
(44-20) 7134-8326
malcolm.barr@jpmorgan.com

David Mackie
(44-20) 7134-8325
david.mackie@jpmorgan.com

date: they cover 2008. Gauging where we are in real time is a huge challenge due to the complexity of many reforms. We have conducted an exercise trying to answer this question specifically for Italy.

During 2012, the Monti government introduced broad-based product market reforms covering energy, transport, and professional services. The aim of the reforms was to reduce tariffs and increase flexibility. It also introduced labor market reforms to reduce dismissal costs, promote apprenticeships, decentralize wage settlements, and liberalize employment placement services.

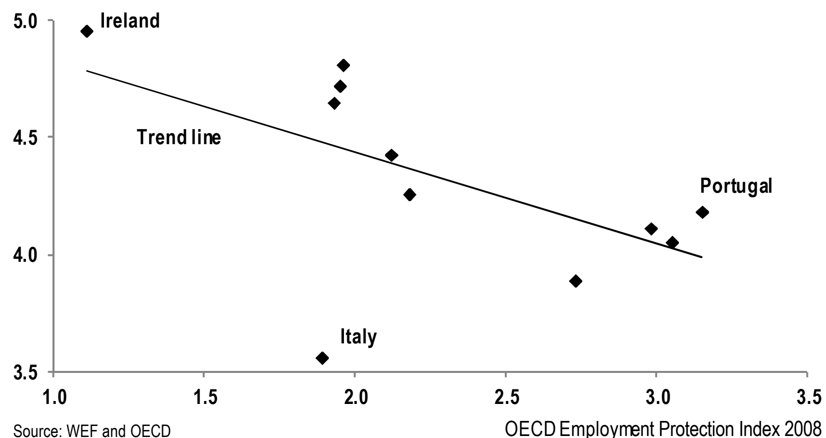
Estimating how these reforms will impact the various measures of structure mentioned earlier is not easy. One way to do this is to use the Italian Treasury's estimates of how the reforms have impacted the OECD measures of labor and product market structure. According to the Italian Treasury, the 2012 labor market reforms have reduced the OECD employment protection legislation index by 0.3pt, while the 2012 product market reforms have reduced the OECD product market regulation index by 0.1pt (lower readings on these indicators indicate less restrictive labor and product markets).

We can use these estimates, along with some bivariate regressions, to estimate how the 2012 reforms will have impacted the Fraser Institute indices, which are also measures of legal structure. We are not able to do this for the World Bank Doing Business survey due to a lack of sufficient data. The table on the previous page provides predictions for how these indicators will move from the latest readings (before the reforms) to 2013 readings (after the reforms). Not surprisingly, all of these indicators show that the 2012 reforms have improved the structure of the Italian economy.

In terms of gauging the extent of the improvement, we can calculate where Italy would rank in these surveys after the 2012 reforms, assuming that nothing has changed in any other country. This is also shown on the previous page. Thus, for example, Italy's ranking in the Fraser Institute indicator of labor market regulation would improve from 72 to 56. If we compare the estimated index value for 2013 with

Labor market indicators

WEF labor market efficiency 2008

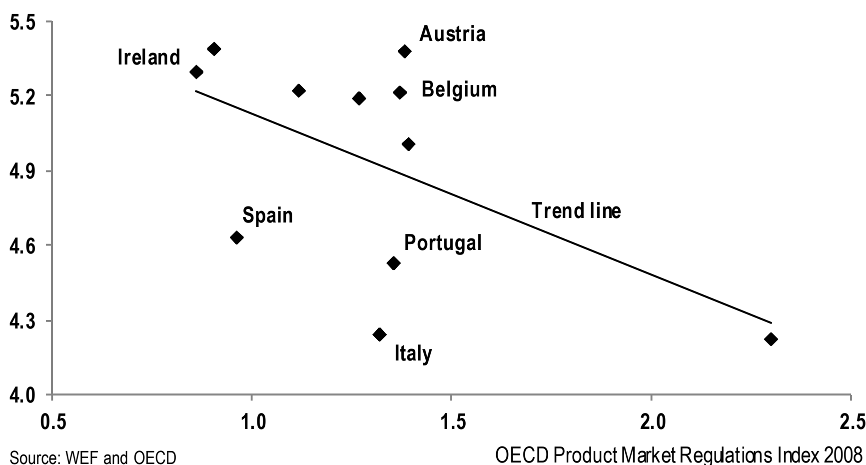


Source: WEF and OECD

Malcolm Barr
(44-20) 7134-8326
malcolm.barr@jpmorgan.com

David Mackie
(44-20) 7134-8325
david.mackie@jpmorgan.com

Goods market indicators



Source: WEF and OECD

the best in the region (which is Ireland), then it would suggest that Italy has made a reasonable step toward best practice in the region.

This analysis suggests that the 2012 reforms represent progress, but there is more to do. However, importantly for Italy, improving the structural performance of the economy is not just about reforming laws. It is also about changing the bureaucracy and the judicial system. This is evident from looking at the relationship between quantitative measures of structure, such as the OECD measures of employment protection legislation and product market regulations, and the perceptions of business people. According to the OECD, Italy is not too far from the Euro area average. But, the WEF indices show that business perceptions of working in Italian goods and labor markets are much poorer. This suggests that the problem is as much about how the laws are interpreted by the bureaucracy and the judiciary, as it is about the laws themselves.

The journey of national political reform

At the start of the crisis, it was generally assumed that the national legacy problems were economic in nature. But, as the crisis has evolved, it has become apparent that there are deep seated political problems in the periphery, which, in our view, need to change if EMU is going to function properly in the long run.

The political systems in the periphery were established in the aftermath of dictatorship, and were defined by that experience. Constitutions tend to show a strong socialist influence, reflecting the political strength that left wing parties gained after the defeat of fascism. Political systems around the periphery typically display several of the following features: weak executives; weak central states relative to regions; constitutional protection of labor rights; consensus building systems which foster political clientalism; and the right to protest if unwelcome changes are made to the political status quo. The shortcomings of this political legacy have been revealed by the crisis. Countries around the periphery have only been partially successful in producing fiscal and economic reform agendas, with governments constrained by

Malcolm Barr
(44-20) 7134-8326
malcolm.barr@jpmorgan.com

David Mackie
(44-20) 7134-8325
david.mackie@jpmorgan.com

constitutions (Portugal), powerful regions (Spain), and the rise of populist parties (Italy and Greece).

There is a growing recognition of the extent of this problem, both in the core and in the periphery. Change is beginning to take place. Spain took steps to address some of the contradictions of the post-Franco settlement with last year's legislation enabling closer fiscal oversight of the regions. But, outside Spain little has happened thus far. The key test in the coming year will be in Italy, where the new government clearly has an opportunity to engage in meaningful political reform. But, in terms of the idea of a journey, the process of political reform has barely begun.

The macro consequences of crisis management

It is not possible to develop a macro story for the Euro area without having a narrative of crisis management. The narrative that we have laid out—national legacy problems have to be dealt with at the national level before further steps of integration involving risk/burden sharing are taken—has had a huge impact on the macro economy, creating weakness overall and significant divergence.

An optimistic assessment would say that the region is only halfway along the journey of dealing with these legacy problems. At first blush, this would seem to be very depressing. In macro terms, the region would not be able to cope with another three years like the last three. But, ongoing adjustment does not mean ongoing recession. The key issue for growth is how the headwinds emanating from the adjustment are fading.

In order to forecast economic growth in the region, we use a simple framework that starts from the region's growth potential and then gauges the impact of various forces that can be reasonably well identified (the monetary policy stance, fiscal policy, the exchange rate, global growth, and the terms of trade). This leaves an unexplained residual for the whole exercise to add up. This residual reflects the combined impact of financial conditions, deleveraging, and sentiment.

This framework helps to explain the move back into recession at the end of 2011. Although fiscal policy became a bigger drag, the additional effect was not that large. None of the other drivers of growth turned negative enough to explain the large deterioration in growth momentum, so we are left to conclude that the primary cause of the return to recession was the tightening of financial conditions that began in the middle of 2011. Presumably, the decline in household and business sentiment was also driven by the dramatic increase in financial stress.

Turning to this year, a number of headwinds are fading: fiscal austerity, the terms of trade, and the global backdrop. A key judgment that has to be made is the size of the residual headwind. Our forecast anticipates no change relative to last year. This seems a very conservative assumption. Wholesale borrowing costs have declined dramatically since last year. Even at the retail level, borrowing costs are lower. Banks are still tightening lending standards but not as severely as at the start of last year. Our view here is that a cyclical recovery in activity will trigger an improvement in credit flows, rather than the other way round.

Malcolm Barr
(44-20) 7134-8326
malcolm.barr@jpmorgan.com

David Mackie
(44-20) 7134-8325
david.mackie@jpmorgan.com

Even though we anticipate an exit from recession, the still substantial journey of adjustment suggests that growth is likely to remain lackluster for an extended period. This is unlikely to change unless either the region moves more quickly to area-wide burden sharing (with a banking union the most advanced in terms of negotiations) or the ECB becomes a lot more aggressive.

The path to a banking union is very unclear at the moment. Many are pushing for rapid agreements on resolution, recapitalization, and deposit guarantees to quickly follow the agreement on the single supervisory mechanism. But, in line with its approach to crisis management, Germany is seeking to slow the process down, using the argument that treaty change is required to put fiscal risk sharing and burden sharing on a sound legal basis. More clarity will come in June, after the Eurogroup meeting which will agree on the ESM bank recapitalization instrument and the EU leaders' summit which will discuss the broader journey to further integration.

For now, the ECB is inclined to move very cautiously, reflecting a pessimistic view of the supply side of the economy and concern about moral hazard. A sense of what could be achieved by the central bank if it were minded to be more aggressive is illustrated in the chart on the following page which shows the relationship between domestic demand growth in the past three years and fiscal austerity. Core Euro area countries are pretty close to the line that represents a fiscal multiplier of 1.0. Those countries which have experienced greater financial/banking stress, Italy, Spain, Portugal, and the Netherlands, have seen demand perform more poorly than would have been expected on the basis of fiscal policy alone. This illustrates both the direct effects of financial stress on banks and the indirect effects of financial stress as it lifts the size of the fiscal multiplier. In contrast, both the US and the UK have seen more demand growth than would have been expected on the basis of fiscal policy alone. Not all of that can be put down to differences in monetary policy; there have also been differences in bank recapitalization and currency movements. But, this simple analysis suggests that the ECB could have a significant effect on demand growth even in a deleveraging environment, if it were prepared to be aggressive.

Euro area growth breakdown
%q/q, saar

	2011	2012	2013E	Change 2012/2011	Change 2013E/2012
Growth potential	1.3	1.3	1.3	0.0	0.0
Conventional monetary policy	1.2	1.6	1.6	0.4	0.0
Fiscal policy	-1.0	-1.7	-0.9	-0.7	0.8
Exchange rate	0.0	0.4	-0.4	0.4	-0.8
Global growth	-0.1	-0.2	0.0	-0.1	0.2
Terms of trade	-0.3	-0.2	0.2	0.1	0.4
Inventory	-0.2	-0.4	0.0	-0.2	0.4
Residual - Financial conditions/ sentiment/deleveraging/NPLs	-0.3	-1.7	-1.7	-1.4	0.0
Actual GDP	0.6	-0.9	0.1	-1.5	1.0

GDP is q/q saar. Monetary policy is the gap between a normal nominal interest rate of 3.25% and the actual overnight interest rate multiplied by 0.5. Fiscal policy is the European Commission's assessment of the change in the cyclically adjusted primary position adjusted for one-offs. The fiscal multiplier is assumed to be 1.0.The exchange rate effect is the average quarter on quarter change in the nominal broad trade weighted exchange rate multiplied by 4 and then multiplied by minus 0.10. A small additional drag has been added to the currency effect this year to take account of the yen weakness. Global growth effect is global GDP quarterly annualized minus potential (3.1) multiplied by 0.2. The terms of trade effect is headline CPI (ex taxes) %oya minus 2% multiplied by 0.6. Taxes are excluded from inflation to avoid double counting with the fiscal policy impact. The financial conditions/sentiment component is the residual in the past. Source: EC, National statistics offices and JP Morgan

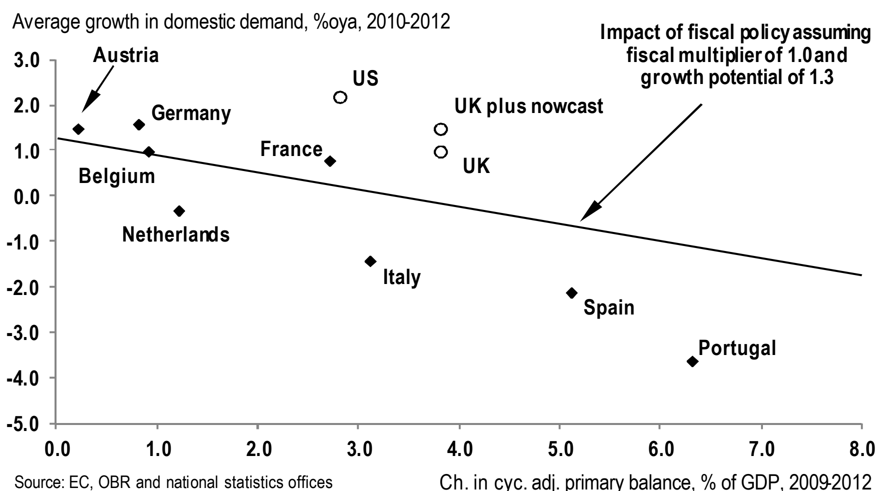
Currently, our forecast does not assume any additional measures from the ECB. Nevertheless, growth is expected to pick up gradually to around 1%-1.5% annualized and remain close to that pace for the foreseeable future. This would be enough to stabilize Euro area unemployment, but not enough to bring it back down. Moreover, even when growth resumes, the region is likely to remain sensitive to shocks.

A crucial final question is what will prompt Germany to agree to a new narrative—essentially greater risk/burden sharing at the regional level. In our view, there are two ways this could happen: first, when significant progress has been achieved in the national adjustments; or second, if there is an irresistible build-up of political and social pressure around the periphery.

Most likely, these journeys at the national level don't need to be completed in full in order to achieve further steps toward integration, especially the creation of a banking union. That is likely to develop over the coming years, even if the national-level journeys are still ongoing. But, for Germany to be comfortable, more progress needs to be made than we have seen thus far, in our view. But, some further steps of integration—such as a fiscal union which could support Eurobonds—would likely require even more progress, especially in terms of national level political reform. In our view, it is unlikely that Germany would agree to Eurobonds without a significant change in political constitutions around the periphery.

The other trigger of a shift to a new narrative would be if social dislocation in the Euro area were judged to have passed some form of tipping point. At present this appears unlikely, but it is possible that reform fatigue could lead to i) the collapse of several reform minded governments in the European south, ii) a collapse in support for the Euro or the EU, iii) an outright electoral victory for radical anti-European parties somewhere in the region, or iv) the effective ungovernability of some Member States once social costs (particularly unemployment) pass a particular level. None of these developments look likely at the present time. But, the longer-term picture (beyond the next 18 months) is hard to predict, and a more pronounced backlash to the current approach to crisis management cannot be excluded.

Change in cyclically adjusted primary balance and average demand growth 2009-2012



Source: EC, OBR and national statistics offices

Malcolm Barr
(44-20) 7134-8326
malcolm.barr@jpmorgan.com

David Mackie
(44-20) 7134-8325
david.mackie@jpmorgan.com

Recent J.P. Morgan Global Issues

Beyond "whatever it takes": ECB policy challenges in the year ahead, Mackie, Barr, Fuzesi, Feb 2013
More growth, less fear: 2013 global economic outlook, Kasman, Hensley, Lupton, Jan 2013
The time is always now: introducing J.P. Morgan's global nowcaster, Lupton, Hensley, Kasman, Brun-Aguerre, September 2012
Moving towards a much larger ECB balance sheet, Mackie, Wadhwa, Normand, July 2012
Global impact of the Euro area crisis, Kasman, Hensley, Lupton, June 2012
Global manufacturing puts in overtime as other sectors dawdle, Kasman, Hensley, Lupton, May 2012
The Euro area's painful path to Eurobonds, David Mackie, Malcolm Barr, Nicola Mai, February 2012
Global economic outlook 2012: let's get cyclical, Bruce Kasman, Joseph Lupton, David Hensley, Jan 2012
Japan well on its way to becoming a capital importer, Masaaki Kanno, January 2012
Nowhere to hide: EM decelerating alongside US and Euro area, Joseph Lupton, David Hensley, Luis Oganes October 2011
Wagging the dog: powerful swings in EM inflation spill over to DM, J. Lupton, D. Hensley, July 2011
Global repercussions from the Japanese earthquake, Joseph Lupton, David Hensley, March 2011
A way out of the EMU fiscal crisis, Joseph Lupton, David Mackie, December 2010
Stuck in a low inflation rut, Joseph Lupton, David Hensley, October 2010
Government debt sustainability in the age of fiscal activism, Joseph Lupton, David Hensley, June 2010
Central bank exits and FX performance, Joseph Lupton, Gabriel De Kock, December 2009
JGB challenge: exploding public debt amid falling domestic saving, Masaaki Kanno, Masamichi Adachi, Reiko Tokukatsu, Hitomi Kimura, October 2009
Manufacturing bounce to launch global recovery, David Hensley, Joseph Lupton, July 2009
Slack attack: low utilization rates, disinflation, global policy response, Joseph Lupton, David Hensley, May 2009
Bouncing toward malaise: a roadmap for the coming US expansion, Bruce Kasman, Michael Feroli, Robert Mellman, Nikolaos Panigirtzoglou, May 2009

Analysts' Compensation: The research analysts responsible for the preparation of this report receive compensation based upon various factors, including the quality and accuracy of research, client feedback, competitive factors, and overall firm revenues. Principal Trading: JPMorgan and/or its affiliates normally make a market and trade as principal in fixed income securities discussed in this report. Legal Entities: J.P. Morgan is the global brand name for J.P. Morgan Securities LLC (JPMS) and its non-US affiliates worldwide. J.P. Morgan Cazenove is a brand name for equity research produced by J.P. Morgan Securities plc; J.P. Morgan Equities South Africa Proprietary Limited; JPMorgan Chase Bank, N.A., Dubai Branch; and J.P. Morgan Bank International LLC. J.P.Morgan Securities Inc. is a member of NYSE and SIPC. JPMorgan Chase Bank, N.A. is a member of FDIC and is authorized and regulated in the UK by the Financial Services Authority. J.P. Morgan Futures Inc., is a member of the NFA. J.P. Morgan Securities plc (JPMS plc) is a member of the London Stock Exchange and is authorized and regulated by the Financial Services Authority. J.P. Morgan Equities South Africa Proprietary Limited is a member of the Johannesburg Securities Exchange and is regulated by the Financial Services Board. J.P. Morgan Securities (Asia Pacific) Limited (CE number AAJ321) is regulated by the Hong Kong Monetary Authority. JPMorgan Chase Bank, N.A., Singapore branch and J.P. Morgan Securities Singapore Private Limited are regulated by the Monetary Authority of Singapore. JPMorgan Securities Japan Co., Ltd. is regulated by the Financial Services Agency in Japan. J.P. Morgan Australia Limited (JPMAL) (ABN 52 002 888 011/AFS Licence No: 238188) is regulated by ASIC and J.P. Morgan Securities Australia Limited (JPMSAL) (ABN 61 003 245 234/AFS Licence No: 238066) is regulated by ASIC and is a Market, Clearing and Settlement Participant of ASX Limited and CHI-X. J.P.Morgan Saudi Arabia Ltd. is authorized by the Capital Market Authority of the Kingdom of Saudi Arabia (CMA), licence number 35-07079. General: Information has been obtained from sources believed to be reliable but JPMorgan does not warrant its completeness or accuracy except with respect to disclosures relative to JPMS and/or its affiliates and the analyst's involvement with the issuer. Opinions and estimates constitute our judgment at the date of this material and are subject to change without notice. Past performance is not indicative of future results. The investments and strategies discussed may not be suitable for all investors; if you have any doubts you should consult your investment advisor. The investments discussed may fluctuate in price or value. Changes in rates of exchange may have an adverse effect on the value of investments. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. JPMorgan and/or its affiliates and employees may act as placement agent, advisor or lender with respect to securities or issuers referenced in this report.. Clients should contact analysts at and execute transactions through a JPMorgan entity in their home jurisdiction unless governing law permits otherwise. This report should not be distributed to others or replicated in any form without prior consent of JPMorgan. U.K. and European Economic Area (EEA): Investment research issued by JPMS plc has been prepared in accordance with JPMS plc's Policies for Managing Conflicts of Interest in Connection with Investment Research. This report has been issued in the U.K. only to persons of a kind described in Article 19 (5), 38, 47 and 49 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 (all such persons being referred to as "relevant persons"). This document must not be acted on or relied on by persons who are not relevant. Any investment or investment activity to which this document relates is only available to relevant persons and will be engaged in only with these persons. In other EEA countries, the report has been issued to persons regarded as professional investors (or equivalent) in their home jurisdiction. Japan: There is a risk that a loss may occur due to a change in the price of the shares in the case of share trading, and that a loss may occur due to the exchange rate in the case of foreign share trading. In the case of share trading, JPMorgan Securities Japan Co., Ltd., will be receiving a brokerage fee and consumption tax (shouhizei) calculated by multiplying the executed price by the commission rate which was individually agreed between JPMorgan Securities Japan Co., Ltd., and the customer in advance. Financial Instruments Firms: JPMorgan Securities Japan Co., Ltd., Kanto Local Finance Bureau (kinsho) No. 82 Participating Association / Japan Securities Dealers Association, The Financial Futures Association of Japan, Type II Financial Instruments Firms Association and Japan Investment Advisers Association. Australia: This material is issued and distributed by JPMSAL in Australia to "wholesale clients" only. This material does not take into account the specific investment objectives, financial situation or particular needs of the recipient. The recipient of this material must not distribute it to any third party or outside Australia without the prior written consent of JPMSAL. For the purposes of this paragraph the term "wholesale client" has the meaning given in section 761G of the Corporations Act 2001. New Zealand: This material is issued and distributed by JPMSAL in New Zealand only to persons whose principal business is the investment of money or who, in the course of and for the purposes of their business, habitually invest money. JPMSAL does not issue or distribute this material to members of "the public" as determined in accordance with section 3 of the Securities Act 1978. The recipient of this material must not distribute it to any third party or outside New Zealand without the prior written consent of JPMSAL. Canada: The information contained herein is not, and under no circumstances is to be construed as, a prospectus, an advertisement, a public offering, an offer to sell securities described herein, or solicitation of an offer to buy securities described herein, in Canada or any province or territory thereof. Any offer or sale of the securities described herein in Canada will be made only under an exemption from the requirements to file a prospectus with the relevant Canadian securities regulators and only by a dealer properly registered under applicable securities laws or, alternatively, pursuant to an exemption from the dealer registration requirement in the relevant province or territory of Canada in which such offer or sale is made. The information contained herein is under no circumstances to be construed as investment advice in any province or territory of Canada and is not tailored to the needs of the recipient. To the extent that the information contained herein references securities of an issuer incorporated, formed or created under the laws of Canada or a province or territory of Canada, any trades in such securities must be conducted through a dealer registered in Canada. No securities commission or similar regulatory authority in Canada has reviewed or in any way passed judgment upon these materials, the information contained herein or the merits of the securities described herein, and any representation to the contrary is an offense. Korea: This report may have been edited or contributed to from time to time by affiliates of J.P. Morgan Securities (Far East) Ltd, Seoul branch. Brazil: Ombudsman J.P. Morgan: 0800-7700847 / ouvidoria.jp.morgan@jpmorgan.com. Revised May 4, 2013. Copyright 2013 JPMorgan Chase Co. All rights reserved. Additional information available upon request.