The Financial Crises of the 21st Century

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Options for the Euro Area

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Abstract

The current Euro crisis is mainly the result of in-adequate institutional design in the Euro area, impeding adequate policy responses. It is a problem of design faults in the structure of political rather than of economic governance. An adequate mechanism design providing credible rules for Euro-area governance requires a political union with European banking supervision and European fiscal policy. The crisis confirms the insight of economic theory that a common currency cannot work properly without a central fiscal counterpart.

There are only two realistic options available: Either a break up of the Euro area with resort to national particularism or a decisive move towards stronger integration – a political union with a transfer of fiscal power to a central European government with democratic legitimacy to enforce rules and implement sanctions. A transfer of national sovereignty to the European level is essential to ensure the functioning of the Euro project.

1. Introduction

The current Euro crisis is mainly the result of in-adequate institutional design in the Euro area, impeding adequate policy responses. It is a problem of design faults in the structure of political rather than of economic governance. An adequate mechanism design providing credible rules for Euro-area governance requires a political union with European banking supervision and European fiscal policy. The crisis vindicates impressively the insight of economic theory that a common currency cannot work properly without a central fiscal counterpart.[1]

Since history can't be run in reverse, there are only two realistic options available: Either (1) the break up of the Euro Area with resort to national particularism or (2) a decisive move towards stronger integration – a political union with a transfer of fiscal power to a central European government with democratic legitimacy to enforce rules and implement sanctions. A transfer of national sovereignty to the European level is essential to ensure the functioning of the Euro project. It needs to allow for smoothing of asymmetric shocks, to enforce rules and to provide a political counter-balance for strongly integrated financial markets. Such a transfer needs not be substantial in order to create an effective fiscal union (see Marzinotto et al. 2011; Bordo et al. 2011).

In contrast, it would be a dangerous illusion to trust that a return to the governance structure before the crisis might be a workable option. The idea to go back to pre-crisis mode by tightening rules in a *minimal fiscal Europe* will not work: The minimum inter-governmental fiscal coordination without transfer of power to a central agency has utterly failed. Stricter adherence to the Maastricht Treaty, the Stability and Growth pact or a fiscal compact would not have prevented the current crisis. Neither is a strategy of muddling through a workable option, hoping that ECB operations with conditionality might work as a substitute for missing shock absorbers and enforcement power. Central bank interventions can only provide a temporary bridge towards deeper political integration in Europe. Without effective reform, conflicting interests among participating countries are prone to create more severe crises in the future and to endanger the monetary dominance of the central bank against fiscal counterparts.

2. Policy response to deleveraging and the sudden reversal of credit flows

Since the outbreak of the financial crisis in 2007, the economic performance in the Euro area, in particular in the periphery countries, has been characterised by a disturbing trend: Even five years after the start of the crisis, unemployment rates are at worrying levels in many parts of the Euro area and still rising (see figure 1). Whereas unemployment has declined in Germany throughout the crisis, it is still increasing in most other regions within the Euro area. In Greece and Spain, the rates are now even higher than those prevailing in the United States and Germany five years after the Great Depression has started in the year 1929. In contrast, in the US and other developed countries unemployment has peaked in 2009 and is declining since then.

The stark contrast in performance can only partly be due to underlying differences in economic fundamentals. After all, economic development in the build-up period before the crisis exhibited trends strikingly similar both in the Euro periphery countries and in the United States. Just like parts of the United States, periphery countries had been characterised by deficit spending, huge inflows of private capital, real estate bubbles triggered by rapidly expanded credit and high leverage. A period of rapid financial deregulation allowed all these regions to run persistent current account deficits, attracting substantial capital inflows. For a long time, expectations of high productivity growth and improved competitiveness created a virtuous, self-reinforcing circle, with bond spreads steadily declining.

[1] In an interview with Der Spiegel (Wir sind vorbereitet, 21.09.1998), Otmar Issing, at that time just appointed as ECB chief economist, pointed out: "*Historically, the Euro Area is a unique experiment. The normal rule is: one country, one currency. … My preference was always: Political union and later or parallel to that a currency union as supplement. Now it is the other way round. I am sure that the Euro area will uncover deficits in the area of political integration in many respects. Policy has to react.*"

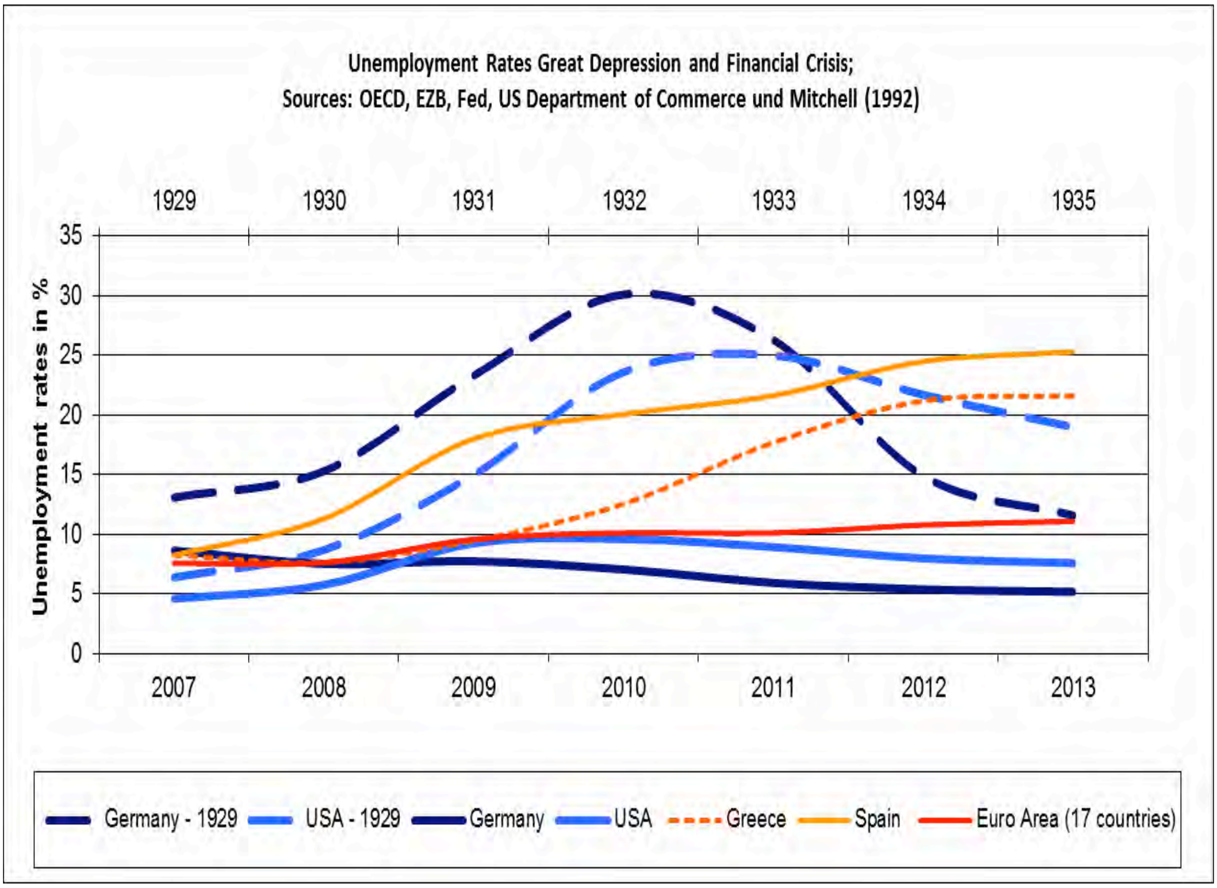

Figure 1 Unemployment Rates: Great Depression and Financial Crisis

But when the financial crisis started, a sudden reversal of credit flows forced a rapid deleveraging process in the private sector. Since real adjustment requires sufficient time, a sudden stop of credit flows threatens to turn the virtuous circle into a vicious downward spiral. The period of the Great Depression provides a scary example of this process. As documented extensively (see Taylor 2012), deleveraging after global financial crises leads to protracted credit contractions with painful recessions. The flight to safety with abrupt reversal of capital flows induces deflationary pressure, triggering destructive implosion of production capacity unless the adjustment process is smoothed by aggressive policy measures. The fall in output due to deleveraging in the private sector needs to be mitigated by unconventional monetary policy and/or temporary substitution of private by public demand. Having studied that lesson, a vigorous response both of monetary and fiscal policy helped to ease this adjustment process in the United States in the current crisis. This response helped to prevent a general depression after the contraction in private credit following the bankruptcy of Lehman Brothers.

The ECB was one of the first central banks providing massive liquidity support in August 2007. In the Euro area, however, policy response to the deleveraging process after the bursting of the bubble has been handicapped by inadequate institutional governance design. In the absence of a central fiscal counterpart, ambiguity prevails about the extent to which the central bank is willing and able to engage in unconventional policy subject to implicit fiscal risks. This ambiguity limits the effectiveness of such operations, raising doubts about the sustainability of the Euro area.

With monetary policy in the Euro area being centralised, adjustment of regional imbalances cannot be smoothed by flexible exchange rates. Without fiscal union, the burden of the macro economic adjustment fell asymmetrically on the countries with current account deficit. In a low inflation environment, such a process of deleveraging is likely to trigger debt and deflation spirals. In the absence of smoothing transfers from the core countries, such a process can lead to a vicious circle with a long period of protracted stagnation in the periphery, threatening the prosperity both of debtor and creditor countries.

3: Core problem: Divergences in the Euro area

In the period before the outbreak of the financial crisis, most Euro area countries now in trouble have been characterised by high growth rates and declining public debt to GDP ratios. Since the start of the Euro, the periphery countries experienced a strong boom, crashing in 2008/2009 and stagnating since then (figure 2).

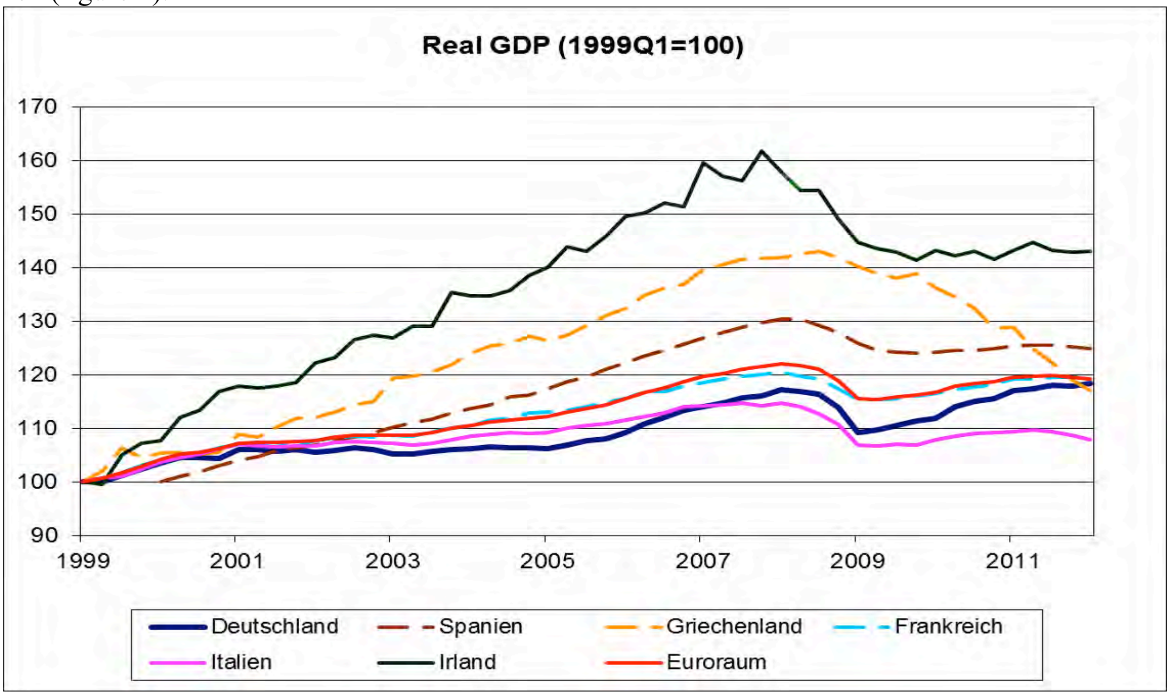

Figure 2 Divergence in growth rates

During the boom period, increased financial integration in the Euro area has encouraged net capital flows from the core to the periphery countries. Whereas current account of the Euro area in total was nearly balanced (see figure 3), total debt exposure including private liabilities increased dramatically in the periphery countries, exposing them to substantial vulnerability in case of a reversal of capital flows. There are strongly contradictory views of the forces driving the persistent current account imbalances in the Euro area.

On the one hand, they may be seen as the result of careless expansion of excessive deficits in the periphery countries, supported by the willingness of creditors to provide loans to periphery governments, betting that No-Bailout clause will be reneged when things go wrong. Additionally, easy credit helped to spur high GDP growth, thus allowing excessive increases in unit labour costs in these countries, resulting in the loss of competitiveness. In that view, excessive government debt is the key villain for the current problems, calling for drastic penalties in order to contain moral hazard. Support of debtor countries by substituting private with official capital flows would encourage moral hazard even further and dampen the urgently needed adjustment.

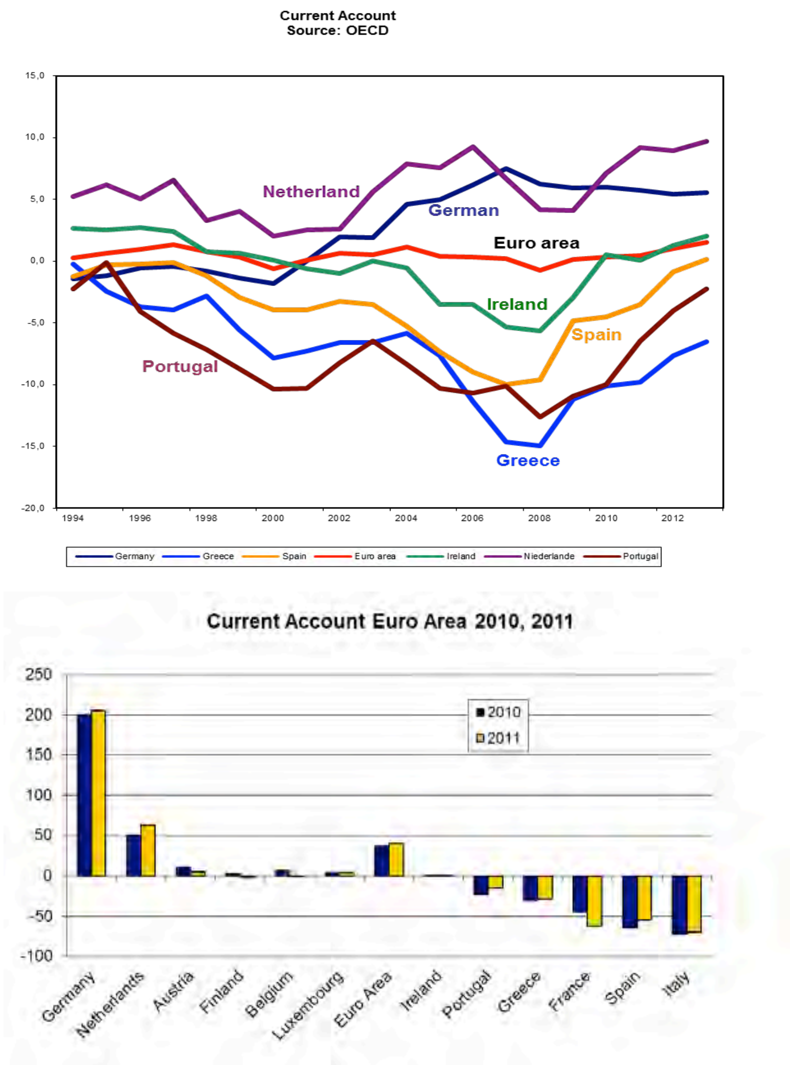

Figure 3 Current account imbalances in the Euro area; Source: OECD Economic Outlook

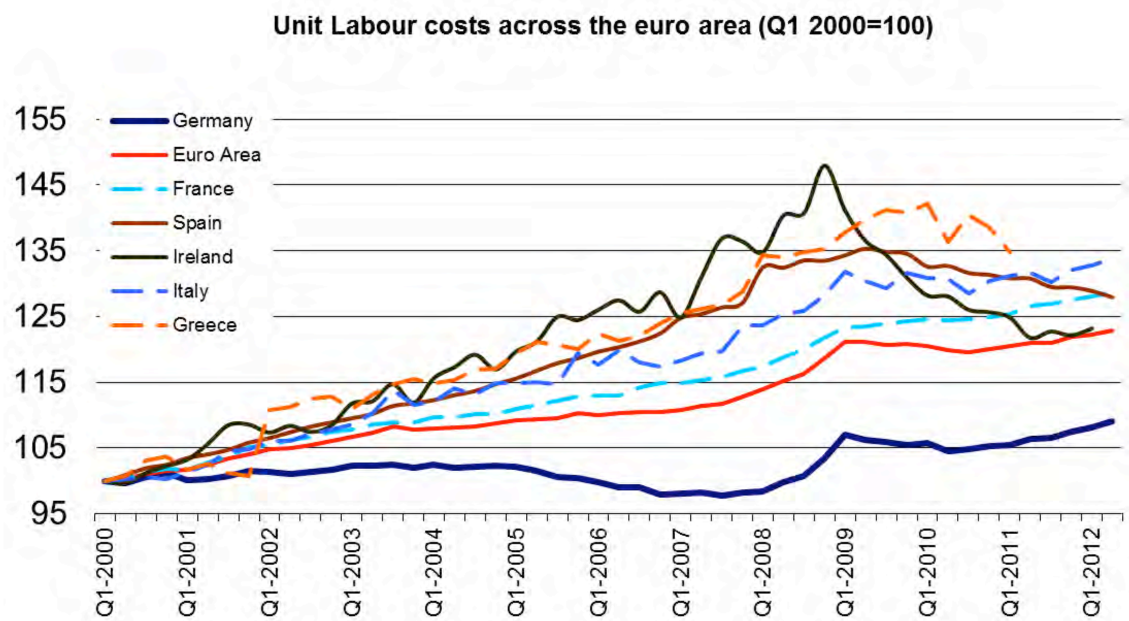

Figure 4 Divergence in unit labour costs in the Euro area; Source: OECD

On the other hand, the massive capital flows to periphery countries can be viewed as the rational investment choice of creditors betting on high growth and expected convergence of periphery countries, following standard neoclassical economic theory. Trusting that stable European governance institutions will speed up the catch-up process of poorer countries both in Southern and Eastern Europe, capital investment in these areas seemed to be an individually rational prudent strategy. Seen from that perspective, the strong rise in unit labour cost (compare figure 4) initially has been the result of high productivity growth, as predicted by the Balassa Samuelson effect. But just as in many other episodes of financial liberalisation such as Latin America in the 70s and East Asia in the 90s, unregulated short term capital flows, driven by short term investors created negative aggregate externalities, leading to boom and bust cycles. In that view, the reason for building up imbalances has been a market failure, encouraging inefficient credit booms and real estate bubbles, creating fragility due to the risk of sudden reversals. Since rapid deleveraging risks the destruction even of productive investments, support to smooth the adjustment process would be in the interest of both debtors and creditors. Fights about how to share the burden of adjustment, however, result in costly delays.

It is hard to test empirically which of these contradicting views is the correct one. Obviously, usually there are multiple causes at work, and each country has its own pecularities and specific problems. In Greece, for instance, excessive government debt and public spending have definitely been the key driving factors. But in most other periphery countries the substantial bulk of capital flows evidently went into the private sector, fuelling an unsustainable credit boom, in particular in the real estate sector. In Spain and Ireland, the debt to GDP ratios of gross government debt declined impressively to record lows until 2007 (see figure 5). Before the crisis, these countries were considered to be the poster boys of fiscal virtue. As measured by the Maastricht criteria, until 2007 they seemed to set a paradigm of virtue with debt to GDP ratios declining at steady speed to close to 40% (Spain) or even below 30% (in the case of Ireland). At the same time, however, banks balance sheets and private credit expanded at an unprecedented rate. Not surprisingly, when private banks on the verge of bankruptcy had to be rescued during the financial crisis, private debt suddenly turned into public debt, with a dramatic turn in debt to GDP ratios shooting up to over 120% in the case of Ireland.

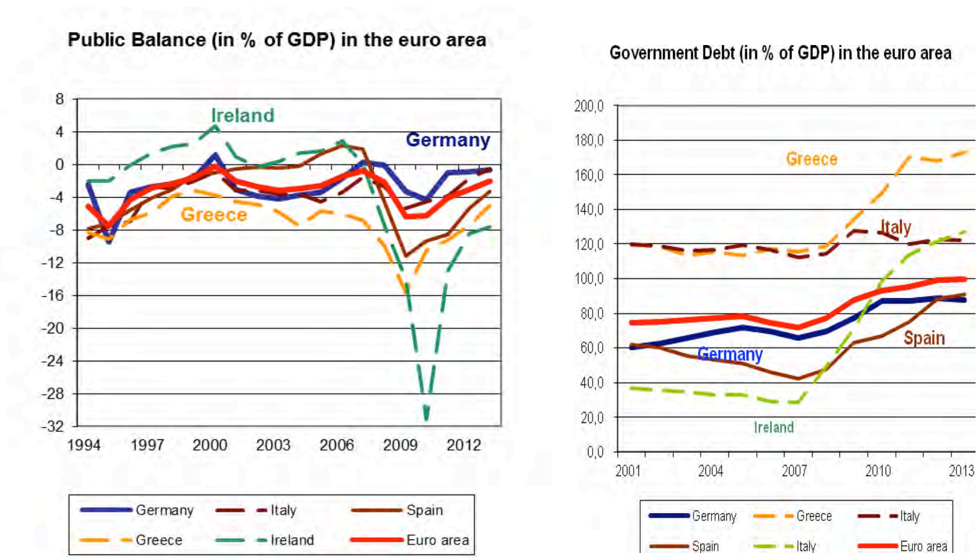

Figure 5 Public Debt in the Euro area OECD; IMF

This development illustrates fundamental weaknesses of the governance structure in the Euro area. The Maastricht criteria, focussing purely on public debt, simply ignored the build up of private imbalances (creating hidden public liabilities). Even worse, the criteria did not allow for cyclical fluctuations in deficit rates, just at a time when fiscal policy was urgently needed as stabilizer of regional shocks, since monetary policy can no longer play that role in a currency area. Boom countries like Spain and Ireland should have had an even much tighter fiscal policy than implemented so as to dampen the build-up of imbalances in the private sector. At the same time, deficit criteria should have been relaxed for weak countries like France and Germany. Violating the deficit criterion during recession in 2003 did not prevent Germany from becoming a safe heaven in the financial crisis. Transfers from strong (periphery) to weak (core) regions in that period would have dampened imbalances, preventing the build up of fragilities in the whole Euro area.

Similarly, macro-prudential counter-cyclical measures helping to dampen excessive credit growth have been neglected during the times when imbalances were building up. Whereas the Maastricht criteria were sceptical about the ability of financial markets as disciplinary device in the case of public debt, financial integration unambiguously relied on the notion of efficient private capital flows, despite strong warnings in the Delors Report (1989) about volatility of such capital flows:

Experience suggests that market perceptions do not necessarily provide strong and compelling signals and that access to a large capital market may for some time even facilitate the financing of economic imbalances. Rather than leading to a gradual adaptation of borrowing costs, market views about the creditworthiness of official borrowers tend to change abruptly and result in the closure of access to market financing. The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive. Hence countries would have to accept that sharing a common market and a single currency area imposed policy constraints (Delors Report 1989, S. 20).

4. Design faults in the Euro area governance structure

In the absence of a central fiscal agent, in times of crises a vicious circle arises: The toxic mix between national sovereign debt and bank debt threatens to reinforce a fire sale mechanism. Banks hold "local" government bonds as supposedly "risk free" assets. When doubts about government solvency set in, the market value of bank assets shrinks. Banks need to build up their equity position. Since raising new equity during a crisis is extremely costly, this usually triggers a deleveraging process, inducing a credit contraction. Doubts about bank solvency lead to bank runs. The need to recapitalize the banking system weakens government solvency, with adverse effects on bank capital, reinforcing the vicious circle. Breaking this vicious circle requires temporary support. But temporary support may aggravate the link between sovereign debt and banks balance sheets. On the other hand, lack of support may blow up the system.

In contrast, debt crises in individual states in the United States do not endanger the stability of their financial system for two essential reasons: First, supplementary support from central fiscal institutions and from non-local financial institutions provides automatic stabilizers. A decline in economic activity in a particular state relative to the rest of the United States induces changes in taxes and transfers (such as unemployment benefits and other transfer programs) that offset about 40 cents of that decline, providing substantial fiscal stimulus (Feldstein 2011). Remarkably, labor mobility across the US is much higher than across the Euro area, reducing the need for fiscal transfers within a monetary union when exposed to asymmetric shocks.

Second, well functioning financial markets rely on the availability of safe assets – assets used as collateral since they will not default in nominal terms. In all sound monetary arrangements, nominal government bonds of the central fiscal authority play this role. The Fed as central bank does not use debt instruments of individual states for monetary policy operations, and so financial institutions do not hold local (state) debt for that purpose. Local debt is subject to default risk, despite balanced budget requirements. Instead, US treasuries issued by the central government play this role in the United States. Being denominated in the own currency and backed by federal tax revenues, nominal default can always be avoided, providing a liquid market for safe assets. [2] The Fed traditionally uses short term T Bills as standard instrument for conventional monetary policy; for non-conventional policy mainly long-term government securities but also Agency Mortgage-Backed Securities (issued by government-sponsored enterprises) are used.

The absence of centrally issued or sponsored bonds complicates monetary policy operations in the Euro area enormously. As long as the ECB accepts bonds issued by specific Euro area member states as collateral, market prices for these bonds will be influenced by its own actions. Whenever the ECB decides discretionary about the size of haircuts imposed on bonds of specific states, the border between monetary and fiscal policy is blurred. Relying on market prices for determining haircuts is no help either, since these market prices crucially depend on expectations about ECB actions, introducing

[2] The argument the ECB should follow the Fed example and refrain from using bonds of individual states as collateral is misleading. As long as there does not exist an equivalent to default free federal bonds in the Euro area, unconventional monetary policy operations are bound to interfere with regional fiscal policy. Constructing "safe assets" is a crucial step for separating fiscal and monetary operations (see also Brunnermeier et. al. 2011).

the risk of self-fulfilling multiple equilibria. So the disciplinary role of prices for state government bonds is bound to be distorted.

The Euro was created as a "depoliticised currency." Monetary policy was delegated to an independent central bank with a clear mandate to maintain price stability. By purpose, the Euro was founded with a central bank but no unified fiscal authority - based on the idea that an institutional design with a strong independent central bank will help to ensure a regime of monetary dominance, making it immune against fiscal pressure. The answer to the question about what would happen when the need for fiscal and monetary co-ordination might arise was left ambiguous – hoping that without defining explicit rules for sharing fiscal risks, the need to share such risks would never materialize. Instead, a „minimal fiscal *inter-governmental* Europe" was meant to provide sufficient safe guards without transfer of power, relying on tight rules such as binding no-bailout clauses.

This view turned out to be naïve: As pointed out by many economists[3] already at the start of the Euro project, a common currency cannot work properly without a central fiscal counterpart. All central bank operations are inherently exposed to some fiscal risk, even though these risks may be minimal (compare Sims 2012). This issue is of particular concern when there is a need for unconventional monetary policy measures.[4] Effectiveness of such measures is bound to be limited in the absence of the standard tool for such operations - the purchase of long-term government securities,[5] issued by a central agency.

In order to enforce monetary dominance (so as to be able to implement long run price stability), a central bank needs to be safe-guarded against balance sheet risks. Such a fiscal backing - ensuring recapitalization from the fiscal authorities when needed - is a crucial condition to make sure that losses will not be covered by the printing press. According to the democratic principle "No taxation without representation" the decision to provide fiscal backing needs to be taken by a democratically elected government. So when the Bank of England decided to engage in quantitative easing in 2011, the British fiscal authorities explicitly guaranteed that any losses will be covered by the Treasury: *"In January this year, the Chancellor authorised the Bank to create a new fund for the purpose of buying assets from the private sector. Any profits on the Asset Purchase Facility are passed to Her Majesty's Treasury, while any losses are also indemnified by the Exchequer."* (Bean 2009)

In the end, fiscal risks have to be borne by the tax payer. But the responsibility for potential risks of ECB interventions is ambiguous. In the Euro area, the lack of an adequate fiscal counterpart being able to take similar decisions lies at the core of the current problems. Currently, there exists no central institution in Europe with democratic legitimacy to bear the implicit fiscal risks of monetary operation such as lender of last resort activities and at the same time being able to impose penalties and enforce sanctions against violations. The current governance design poses a collective action problem which impedes efficiency gains from such risk sharing, possibly creating huge negative externalities.[6]

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[3] For example, Prati and Schinasi (1998) argued that the Euro area system with national central banks as lender of last resort cannot work if pan-European banks run into trouble.

4 See Christopher Sims, Press Conference, October 2011, Princeton "*The euro was founded with a central bank but no unified fiscal authority. That raised questions about what would happen when the need for fiscal and monetary co-ordination arose. The euro zone nations will have to work out a way to share fiscal burdens and connect fiscal authorities to the ECB. … The notion that things will get settled in the euro only if some weak countries leave is unrealistic*."

[5] Long-term government securities are the standard tool for such policies in well designed monetary systems like the United States or Great Britain. See also the following quote Milton Friedman made at a keynote address to the Bank of Canada 2000, when discussing the policy of the Bank of Japan: *"Monetary growth has been too low. Now, the Bank of Japan's argument is, "Oh well, we've got the interest rate down to zero; what more can we do?" It's very simple. They can buy long-term government securities, and they can keep buying them and providing high-powered money until the high powered money starts getting the economy in an expansion. What Japan needs is a more expansive domestic monetary policy."*

[6] Mervyn King characterized this problem in a press conference at the Bank of England on 16.11.2011 aptly: "*Ultimately it is a question of real resources. Central banks don't have real resources; they create money. To the extent that governments feel that they have to take the burden of transferring real resources from one country to another in order to sustain a current account deficit for a period, that is a decision that can be taken only by governments…. But the whole issue is: Do they wish to make transfers within the euro area or not? And that is not something which a central bank can decide for itself. That is something which only the governments of the euro area can come to a conclusion on. And that is the big challenge which they face."*

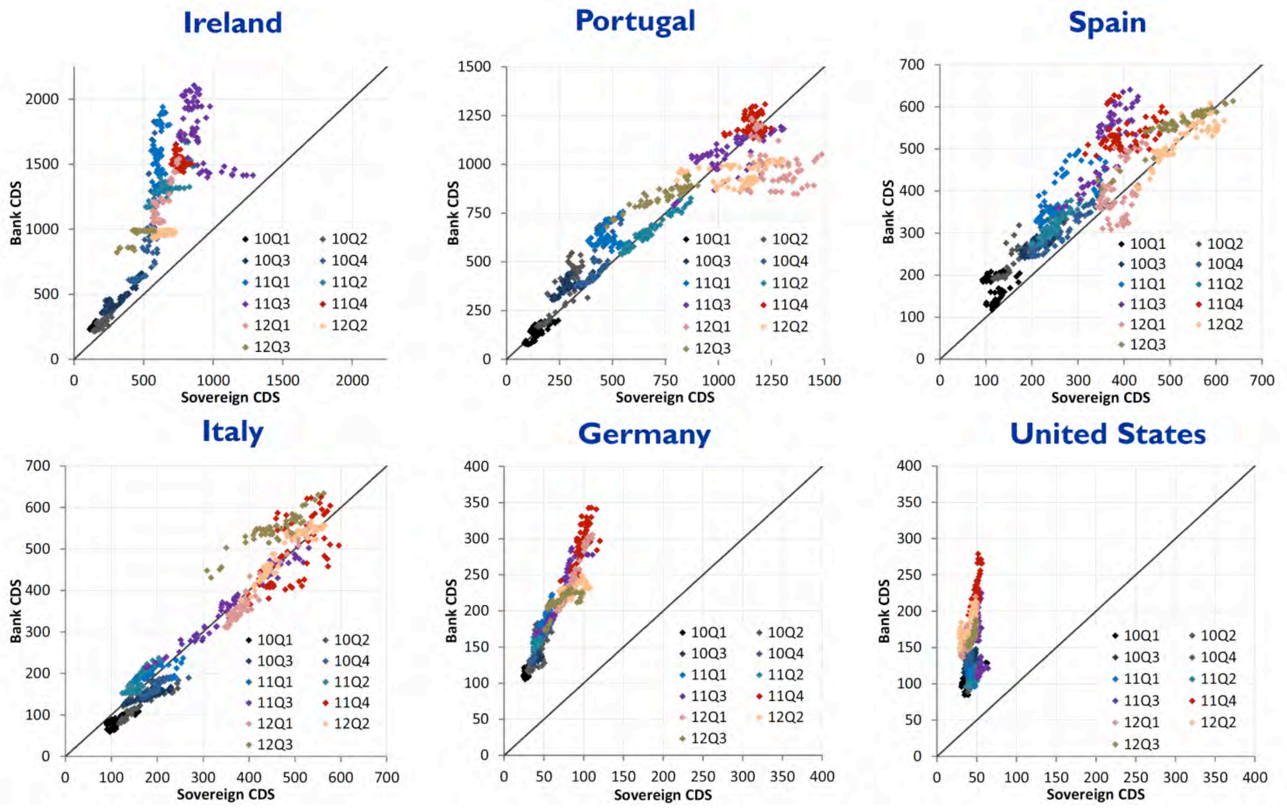


Figure 6 correlations between credit default swaps for bank bonds and sovereigns
Source: Cœuré (2012)

The ambiguity about how to share the burden of implicit fiscal risks across Euro area members impedes the efficiency of the central bank operations stabilising the financial system. By relaxing collateral requirements and via massive Target2 operations the ECB tries to stabilize the financial sector in the periphery in order to break the vicious circle arising from the strong link between the yield levels of national sovereign and bank bonds (see Illing et. al. 2012). As shown in Figure 6, credit default swaps for bank bonds and sovereigns have been highly correlated in the periphery countries since beginning of 2010. Despite massive rechanneling of funds via the Target2 system (figure 7) aiming to stem the capital flight, the flow of bank deposits (both customer and interbank deposits) from periphery to core countries has steadily increased at least until June 2012 (figure 8a, 8b).

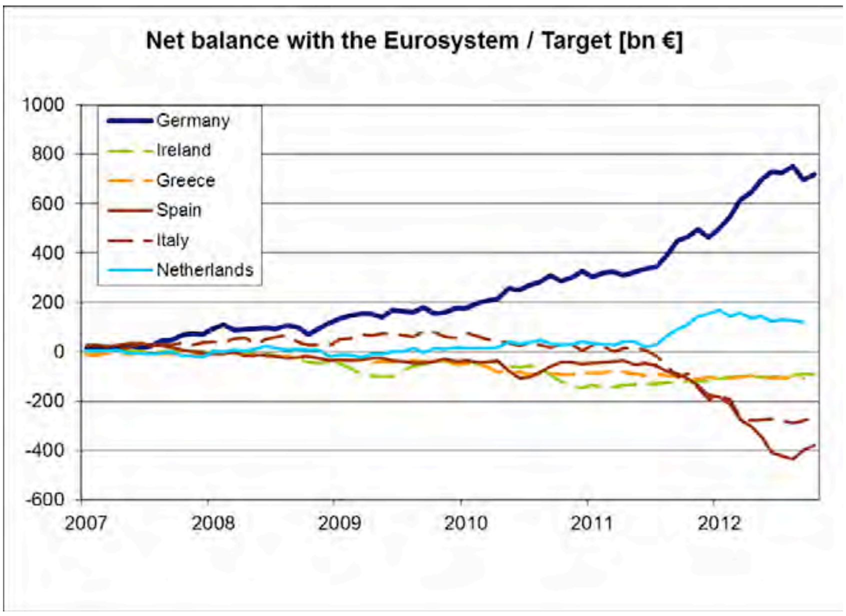
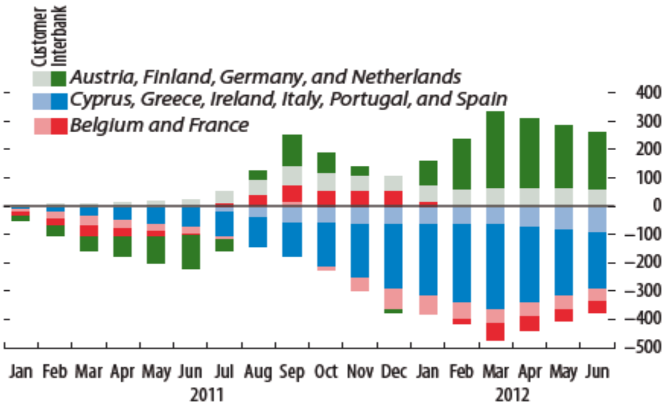


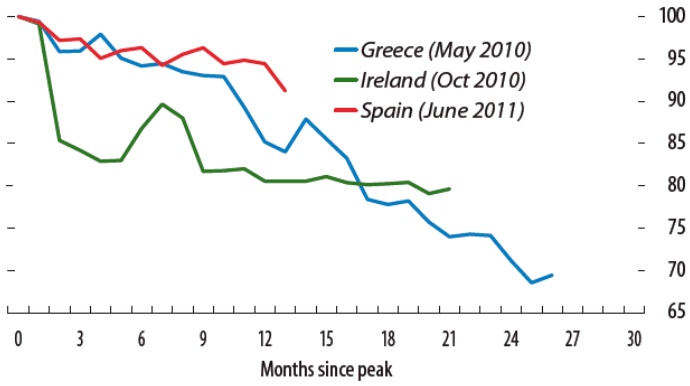
Figure 7 Target Net Balance with the Euro System
Source: Frank Westermann, Osnabrück, http://www.eurocrisismonitor.com/

Figure 2.7. Bank Deposit Flows in the Euro Area
(In billions of euros, cumulative change since December 2010)



Sources: Haver Analytics; and IMF staff estimates.

Figure 2.8. Bank Customer Deposit Trends
(Index: Peak = 100)



Sources: Haver Analytics; and IMF staff estimates.

Figure 8: Flow of bank deposits from periphery to core countries,
Source: IMF Global Financial Stability Report October 2012, p 29f.

In the absence of well defined sharing rules, the fight to prevent a credit crunch in the periphery countries risks to be ineffective. Due to the failure of the interbank market as a result of ongoing distrust among banks prevented, lending activities in the periphery countries are declining despite the massive support from the European central bank. There is a stark contrast between the expansion of the monetary base (the increase in central bank money) and both money supply (M1, M2, M3) and credit for the real economy. As shown in figure 9, money supply and credit have been shrinking in periphery countries in the Euro area at an alarming rate.

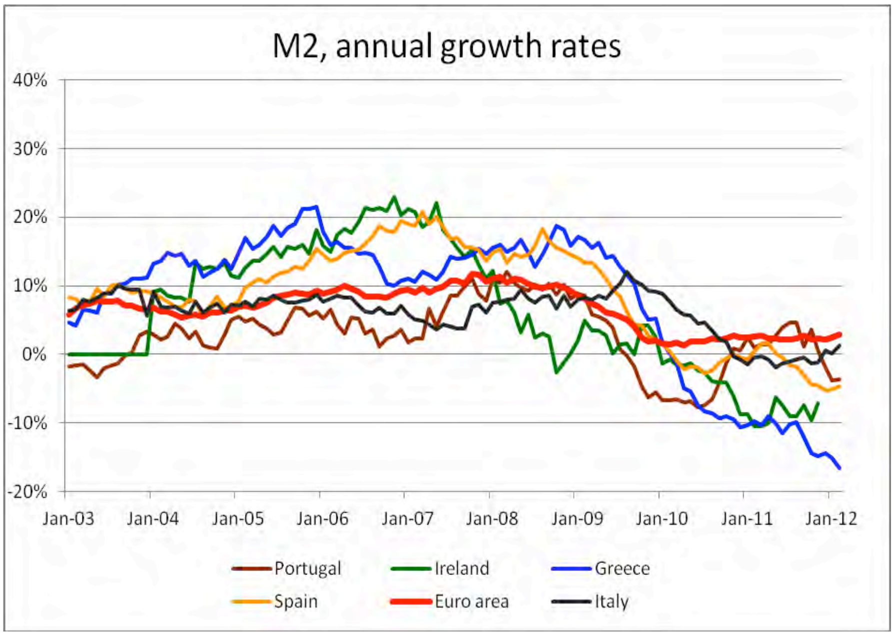


Figure 9a National contributions to M3 growth
Source: National central banks, Euro area

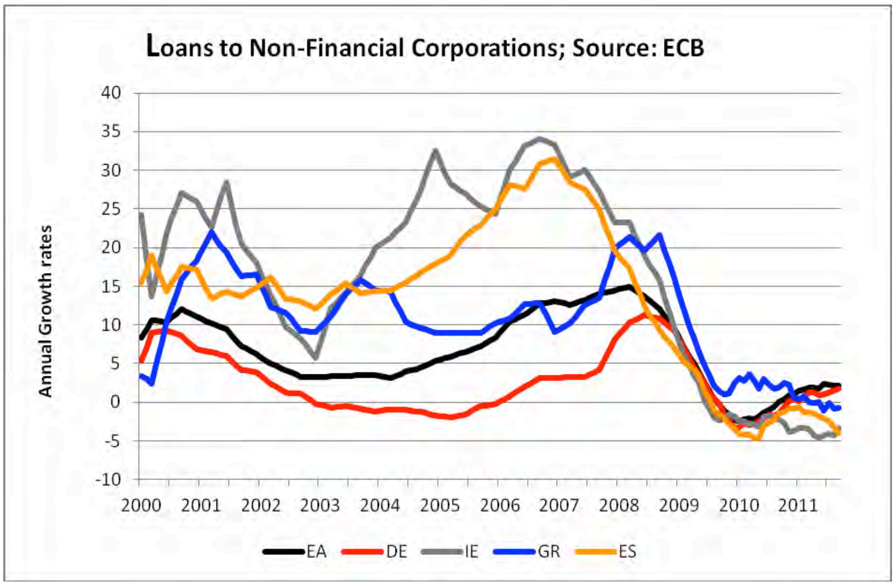


Figure 9b Growth of loans to non-financial corporations; Source: ECB

The sovereign debt crisis in Greece and the crisis in the banking system as in Ireland and Spain exposed these countries to the risk of asset price deflation and deleveraging. This created the risk of a break-up of the Euro area, threatening the viability of the currency union. Responding to the resulting pressure, German Chancellor Angela Merkel repeatedly stressed „If the Euro fails, then Europe will fail.“ European politicians hinted at various occasions that they will do “whatever it takes” to save the euro.

But the lack of formal agreements specifying what this statement implies reinforced doubts about the irreversibility of the euro, resulting in the fragmentation of the banking system and a partly renationalisation of Euro area banks’ funding markets. Given the inter-governmental structure in the Euro area, fights about how to distribute potential losses pose the risk of an inefficient non-cooperative outcome, making the materialisation of such risks even more likely. In the absence of instruments helping to prevent a meltdown of financial markets in periphery countries, the likelihood that losses actually materialize may increase substantially, with the risk of a breakdown of financial markets even in core countries due to contagion effects.

5. The ECB as substitute for the missing central fiscal authority

The crucial flaw in the design of the Euro area – the lack of a central fiscal counterpart in charge to make explicit choices about what implicit fiscal risks of monetary policy actions should be taken is the key reason for the dismal performance of the Euro area compared to other regions such as the United States (as illustrated in figure 1). In order to prevent the break-up of the Euro area, the ECB had to act as a substitute for the missing central fiscal authority. By relaxing collateral requirements for periphery country banks and by fighting capital flight from the periphery with re-channeling of funds via massive Target2 operations the ECB tries to stabilize the financial sector in that area. Such operations lie on the border between liquidity provision and fiscal policy, stretching the official mandate.

Up to now, these measures have not been successful. High spreads between periphery and core countries signal that capital markets are worried about the risk of a break-up of the Euro area. In response to that "convertibility risk" the ECB has recently announced the introduction of Outright Monetary Transactions (OMTs) – possibly unlimited interventions in secondary markets for sovereign bonds in the euro area, aiming to repair the transmission channel and so eliminate the "convertibility risk." These transactions are meant to be made only subject to strict and effective conditionality. According to the ECB, they will be withdrawn when governments do not adhere to the conditions imposed by the EFSF/ESM.

It may seem a sound idea to provide support for adjustment conditional on reforms being implemented. Yet that is not the task of the central bank, but of a democratic elected government. OMT measures risk blurring the distinction between monetary and fiscal policy even further. Apart from the problem of dynamic consistency, the tendency to rely on continued support from ECB lending risks to dampen incentives for serious governance reform in Europe and so help to reinforce the flawed design (the vicious circle between government and bank debt). ECB operations with conditionality cannot work as a substitute for missing shock absorbers and enforcement power. Central bank interventions can only provide a temporary bridge towards deeper political integration in Europe. Without effective reform, conflicting interests among participating countries are prone to create more severe crises in the future and to endanger the monetary dominance of the central bank against fiscal counterparts. If we do not want to risk the break up of the Euro area, the Euro crisis needs to be used as a chance to redesign governance rules in Europe with a decisive move towards stronger integration and a transfer of national sovereignty.

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