PANEL DISCUSSION I

EMU 2.0: Building a Durable Monetary Union in the Eurozone

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Summary

There is increasing acceptance that the Eurozone, as constructed in the 1990s, lacks key features of a complete monetary union and that design weaknesses have exacerbated the intensity and persistence of the financial crisis in Eurozone members. There is less agreement however on what the missing parts are and on what can be done to insert them into the living organism of the single currency. There are two distinct challenges. The immediate task is to accelerate emergence from the current crisis of insolvent sovereign states, failed and undercapitalised banks and weak economic performance. The ultimate objective, however, must be to re-design the currency union so as to minimise the risk of renewed crises in future. Confusion on the source of the euro crisis, particularly the relative contribution of fiscal and monetary factors, has inhibited the search for solutions.

This paper examines the fiscal explanation for the eruption of the euro crisis and finds it wanting. Pre-crisis fiscal deficits were generally not very large and were not concentrated in countries that got into difficulties later on. Instead, chronic fiscal deficits suddenly appeared when private-sector bubbles burst and tax revenues plunged in certain countries. Fiscal deficits substituted for private-sector deficits that already existed.

There has recently been greater acceptance that fiscal problems were not the main source of the euro crisis but this message must be reinforced if the crisis is to be addressed. Germany's Deputy Minister of Finance, Jörg Asmussen, was the country's "point man" on the euro crisis before he joined the Board of the ECB in 2012, and he probably represented mainstream European opinion in November 2011 when he declared that "There is no euro crisis, it's a government debt crisis. The euro is stable."[1]

The next section discusses the emergence of private-sector deficits that were the root cause of the problem. They were largely financed by borrowing from other euro-zone countries and an overall external euro-zone balance concealed them until 2008. These imbalances were largely driven by the banking system, with money growth in deficit countries far outpacing the average for the zone.

The third section presents a very simple—and very obvious—trilemma that must be addressed in a currency union. Countries cannot have an arrangement that has free capital flows, a monetary policy that is dedicated to inflation targeting only, and complete isolation from financial problems in other members.

In trying to preserve each of these elements, the euro zone has chosen a blanket bailout regime for banks, creating a problem of moral hazard that could once again set large and unsustainable private capital flows in motion. Membership of a poorly-designed euro zone exposes states to dangers that they would not otherwise face. Banking systems in member states can grow beyond the ability of the local sovereign to bail them out and attempts at local bailouts for banks have undermined sovereign borrowing capacity in several countries.

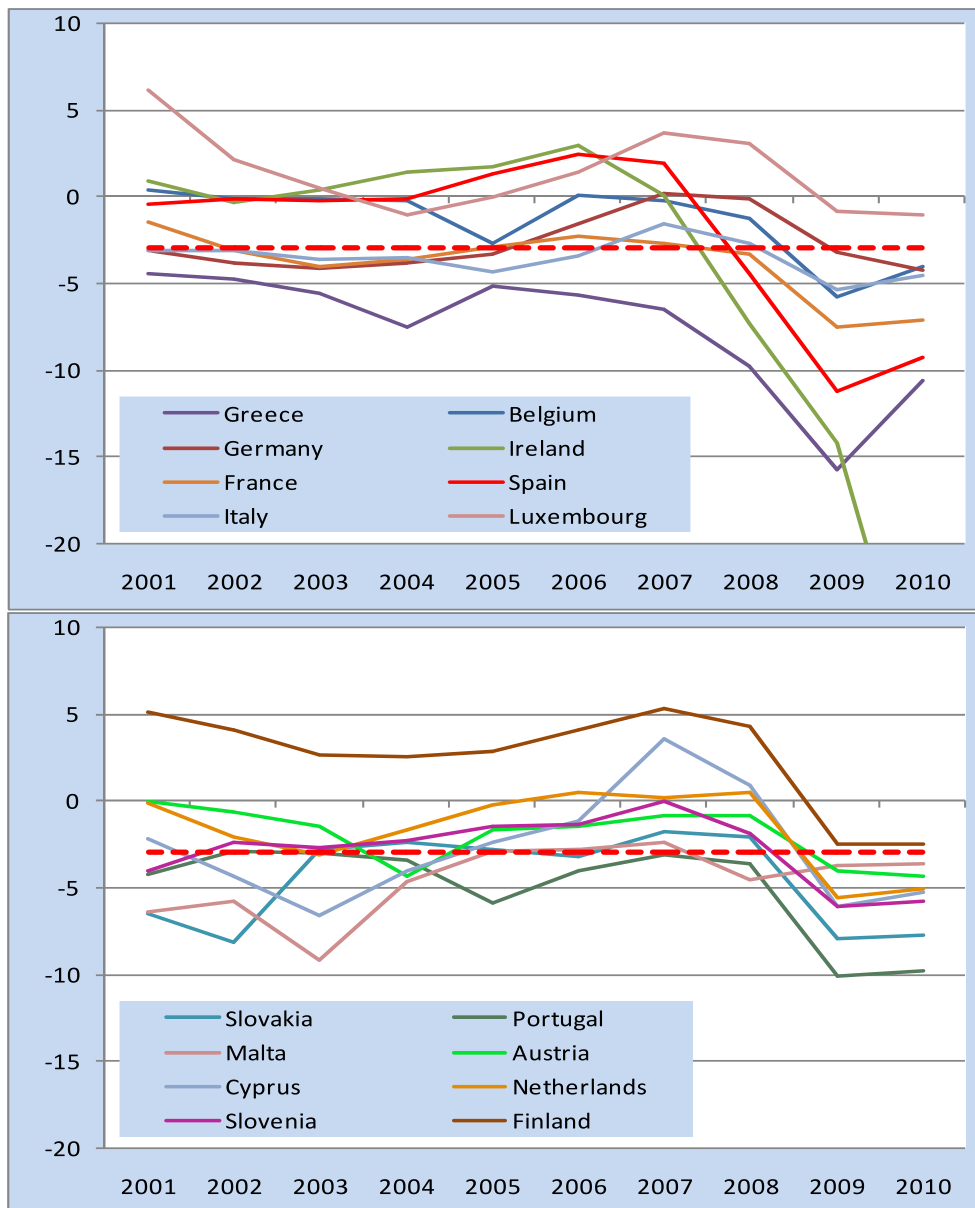
The conclusion is that the sovereign debt crisis will persist unless a joint supervisory and resolution regime for banks accompanies a return to market discipline in the European banking industry.

[1] As quoted in The Economist (2011).

1. Fiscal and external imbalances

As is well known, the Stability and Growth Pact sets limits on government deficits and debt that are intended to guard against fiscal imbalances in member states, so avoiding pressure for ECB intervention and bail-outs. Annual deficits are limited to 3 percent of GDP and debt should not exceed 60 percent. Violations can theoretically lead to censure but have more often been tolerated, resulting in a series of adaptive rule changes and forbearance, without any resort to sanctions.

Chart 1: Budget Balances for 16 Euro-zone Countries, 2001-2010 (in percent of GDP).

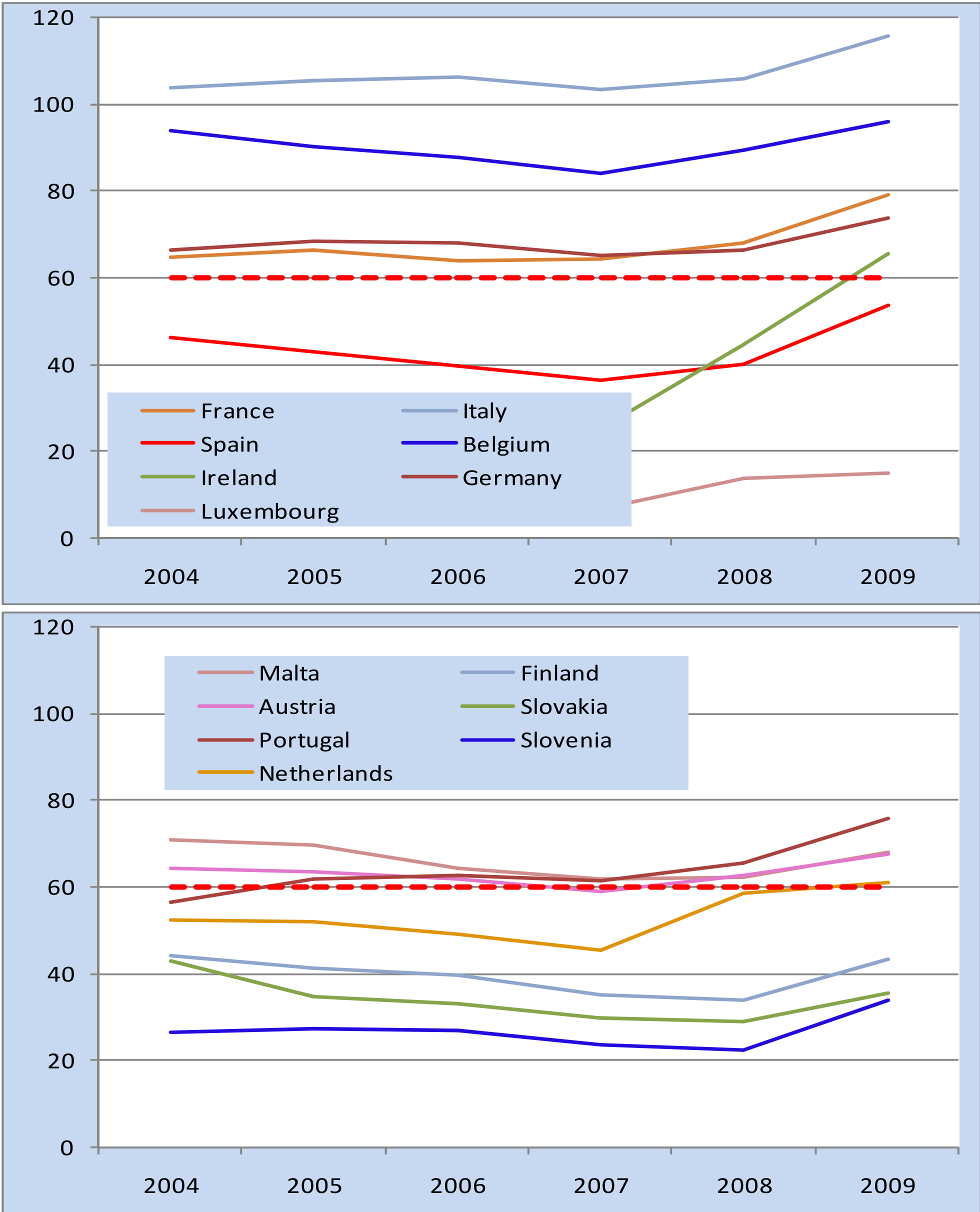


Source: Eurostat.

Chart 1 plots the relevant budget deficits in 2001-10. Before the financial crisis hit in 2008, Greece had been a serial offender with deficits constantly in the range of 5-6 percent of GDP. The limits were infringed on occasion by Germany, France and Italy and by Portugal. Slovakia, Malta, Cyprus and Slovenia can be seen getting their fiscal houses in order before joining the euro in 2007-09. Many

members experienced difficulties in 2008 but, prior to that, the list of offenders did not include Ireland or Spain and, with the exception of Greece, no country appeared to have chronic problems.

Chart 2: General Government Debt for 14 Euro-zone Countries, 2004-2009 (in percent of GDP).



Source: Eurostat (no official data for Greece or Cyprus).

Chart 2 plots government debt in 2004-09 and it is obvious that many countries infringed the limit before 2008. Exceptions included Spain and Ireland and Portugal was no worse than Germany, France or Austria—lying just above the permitted level of 60 percent. The worst offenders were Belgium and Italy; and Greece also offended badly but there are no official data available.

Overall, then, it is difficult to conclude that fiscal indiscipline was at the root of the euro crisis. With the exception of Greece, the list of offending countries fails to identify those that got into trouble and includes some that have been unscathed—notably, Germany and Austria.

An examination of external imbalances in member countries offers a more credible list of the vulnerable. Chart 3(a) plots current account balances in 2004-10 in percent of GDP. Greece, Portugal, Spain and Ireland all fall into a (yellow) danger zone—if defined as a deficit larger than 3 percent—and Italy sits just above the border. Moreover, the external positions of all of these countries deteriorated significantly in 2005-08 before the crisis brought an abrupt correction. The current account has all of the hallmarks of an accurate predictor of the brewing crisis.

In panels (b) and (c) of Chart 3, the external balance is decomposed into its private and public components. It is obvious from panel (b) that the external imbalances in the problem countries originated in the private sector during 2004-07. The average deterioration was 5.5 percentage points for Greece, Portugal, Spain and Ireland over three years and Italy also went into the red. The stronger countries were stable.

There was far less action in the public sectors in 2004-07 (see panel (c))—as Italy and Portugal showed improvement while Greece languished. But, when the crisis hit in 2007, the composition of the external deficits switched abruptly from the private sector to the public sector as private spending contracted sharply and tax revenues went off a cliff. This initial effect was compounded by bank crises, and higher tax rates failed to recoup revenues while cuts in government spending could not stem the tide.

The only consistent explanation for the euro crisis, then, is that it was nurtured in—and first recognisable—in countries with large external imbalances. These external imbalances emerged from the private sectors of the relevant countries and only migrated to their public sectors after the crisis hit. The fiscal crisis substituted for private- sector imbalances when the crisis hit and the private sector deficits experienced a rapid contraction.

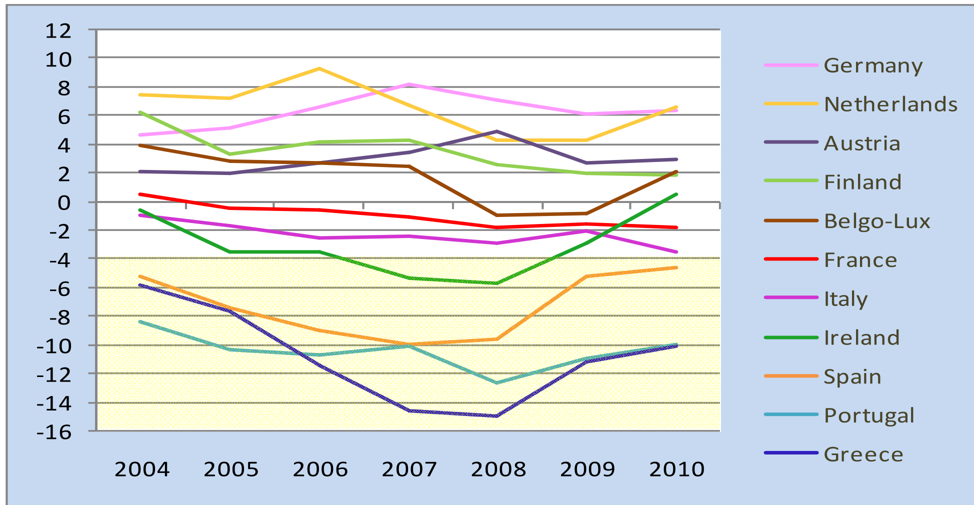
2. Internal and external euro deficits

Looking more closely at current-account balances during Stage III of EMU, the most striking feature is the improvement in Germany's position—especially after 2003. The Netherlands also experienced a significant improvement (Chart 4) while Spain, Italy and France saw deficits emerge. Of the smaller countries, Greece, Portugal and Ireland had the most significant deterioration.

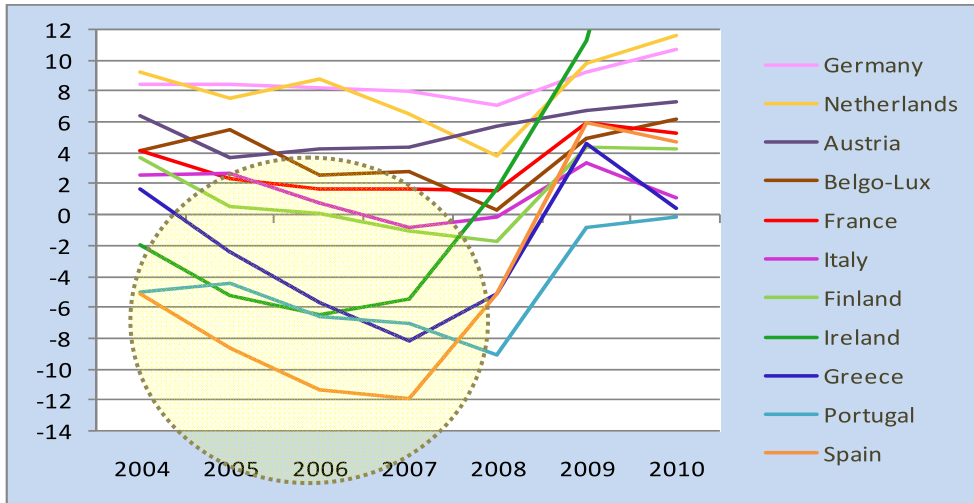
Even while these surpluses and deficits developed, the overall current-account balance for the eurozone was remarkably stable. It mostly fluctuated in a region of plus/minus €10 billion (about 0.1 percent of euro-zone GDP), with a small surplus emerging in the mid 2000s (Chart 5).

Chart 3: Selected Euro-Zone Countries, 2004-10 (in percent of GDP)

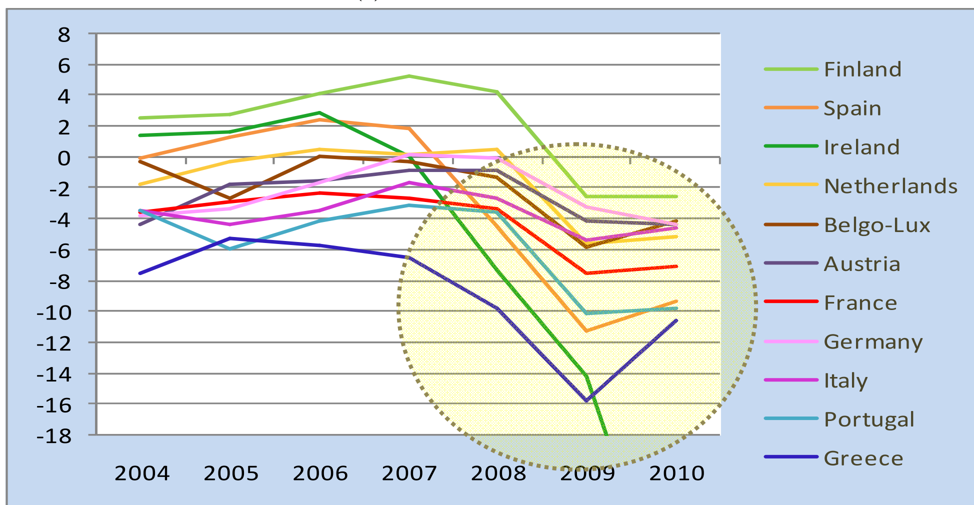
(a) Current (External) Account



(b) Private Sector Balance

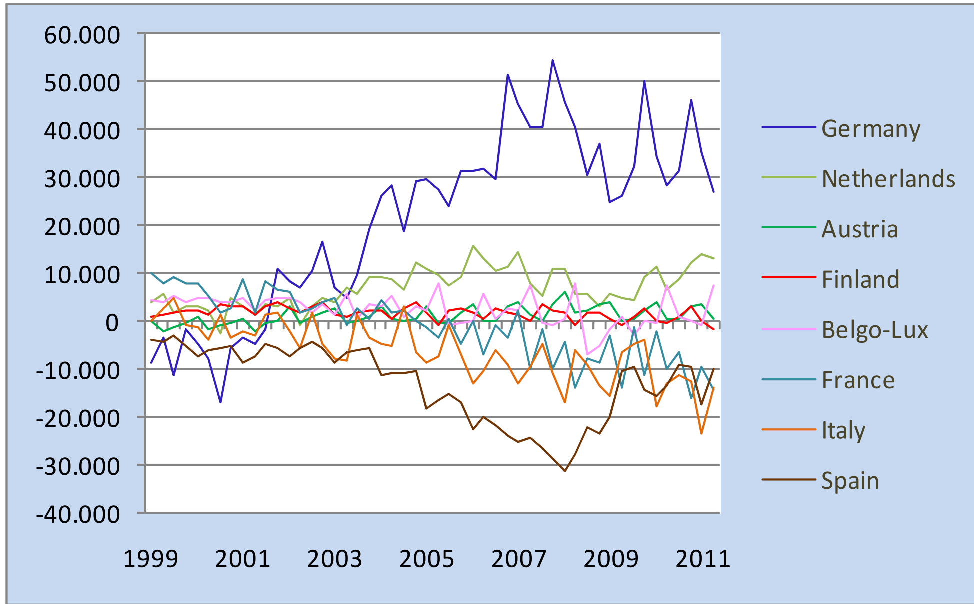


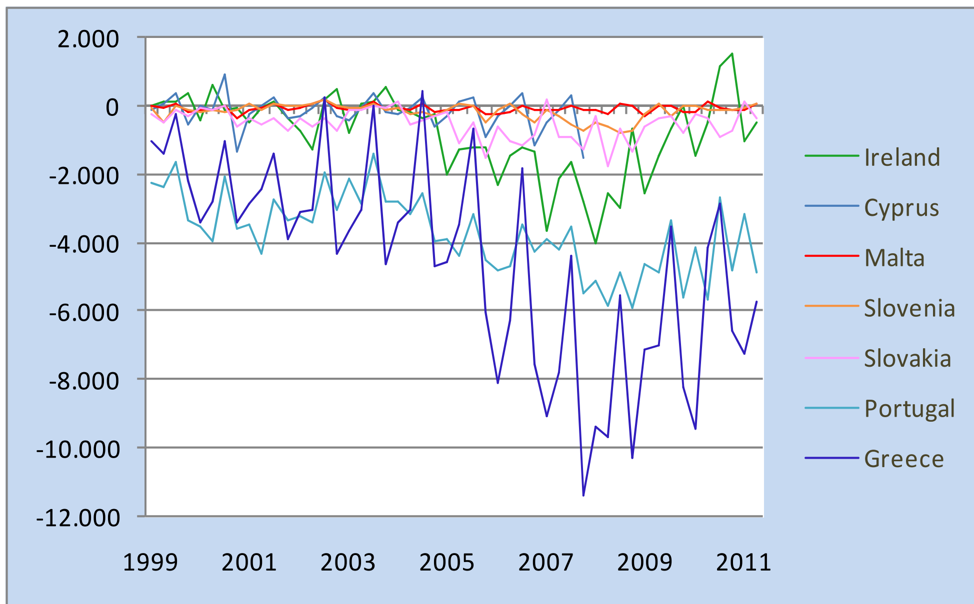
(c) Public Sector Balance



Sources: Eurostat and ECB

Chart 4: Current Account Balances in the Euro Area, 1999-2011 (quarterly, in euro millions).

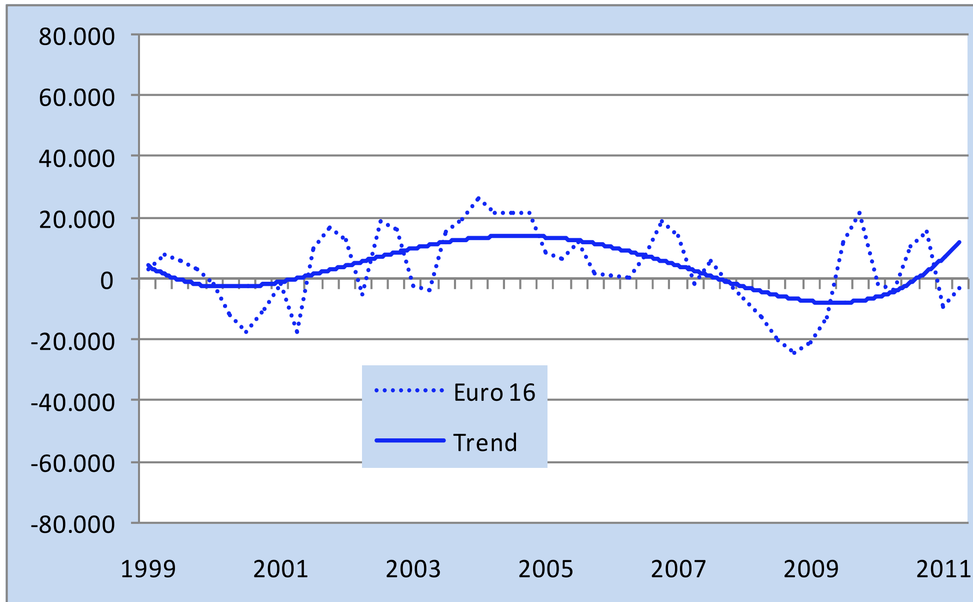




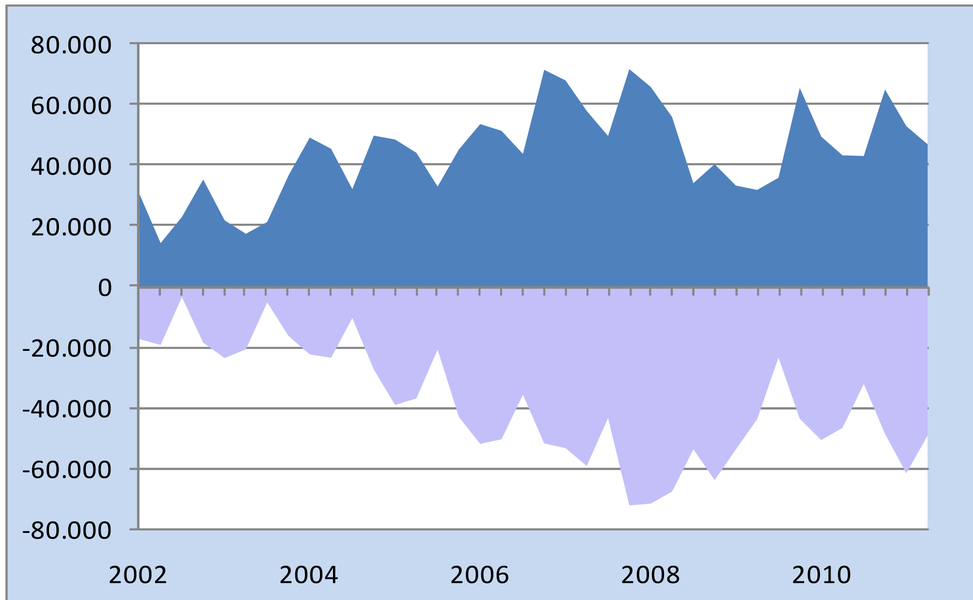
Source: Eurostat.

Chart 5: Current Account Balance of the Euro Area (quarterly, in euro millions).

(a) Overall Balance, 1999-2011



(b) Disaggregated Balance, 2002-11



Source: Eurostat.

So the major imbalances in the euro area were internal to the zone as a whole and deficits in some countries were mostly reflected in surpluses in others. Panel (b) of Chart 5 plots the current account surpluses in Germany, the Netherlands, Austria, Finland, Belgium and Luxembourg against the deficits of the other ten members (with France switching from the surplus to the deficit group in 2005). By mid 2008, the internal imbalance in the euro area was running at about €65 billion per quarter—approaching 3 percent of quarterly euro-area GDP—and the associated internal debt climbed by €900 billion (or 10 percent of annual euro-zone GDP) in the five years from 2004 to 2008. However, for the

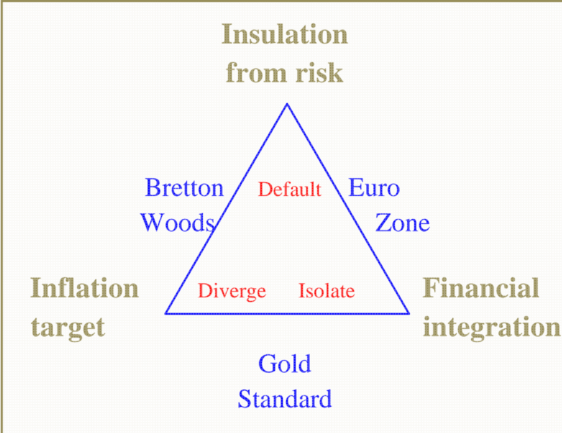
main debtor countries, this accumulated credit represented a more substantial 25 percent of their combined GDP. The burden of adjustment would ultimately fall on the indebted nations only.

3. Policy trilemma

Consider a fixed currency arrangement where two or more countries either share a common currency or fix the exchange rates between their currencies according to some mutually agreed intervention mechanism. A currency could be shared even it were issued by one of the countries for use by the group and there would, in any event, need to be an understanding on the arrangements for issuance. (The CFA franc region, for example, has two issuing authorities). For a currency association with fixed exchange rates, the agreement on the intervention mechanism could include a promise of mutual support in the event that one member of the group experienced (temporary) difficulties in maintaining its peg. (The pre-1999 European exchange rate mechanism, for example, established pre-agreed intervention limits and loan arrangements).

Any fixed currency arrangement, so defined, is faced with a trilemma (Mankiw (2010) identifies a similar problem) concerning: (a) the degree of financial integration between members; (b) the level of insulation from financial risk in partner countries; and (c) the ability to use monetary policy to target inflation and not have that sole objective potentially undermined by a need to avoid financial instability. The associated countries have to choose between three combinations of two elements each—but cannot adopt all three at the same time:

Trilemma of a Currency Association



(i) If the currency union wants to insulate member states from financial risks in other member states and, at the same time, maintain a strict inflation target, it had best place limits on financial integration from the outset. Otherwise—if there are extensive financial links between states and there is a financial shock to one member—the monetary authority may have to intervene in order to prevent the financial shock from spreading. (The monetary authority might need to abandon its inflation target and increase its lending to the banks of the affected state).

The post-war Bretton Woods system was based on closely-linked currencies with inflation targets but the member states were, nonetheless, largely isolated from financial shocks in other members. This was because the system had extensive capital controls. And capital liberalisation in the 1970s was partly to blame for the demise of the system.

(ii) If the currency association decides to promote financial integration and to preserve an inflation target, it will have to abandon any promise to isolate members from contagion. The association will inevitably run the risk of contagion from a financial shock in one member—in particular if the affected state is unable to contain it. This risk increases with the promotion of financial integration (and the prevalence of asymmetric shocks between states).

    Under the ante-bellum gold standard, financial integration between members increased greatly but the system was subject to frequent banking crises that affected other members.

(iii) If the currency association wants to promote financial integration and, at the same time, isolate other members from localised shocks, it must face the possibility that the monetary authority will have to intervene in order to prevent the shocks from spreading. This will, of course, eventually undermine a monetary policy that is dedicated to an inflation target.

    The euro zone from the advent of the financial crisis has tried to forestall financial contagion from shocks on the periphery by intermediating banks through the ECB. As a result, the ECB has seen its balance sheet more than double in size (and it now stands at 30 percent of euro-zone GDP)

The euro zone has yet to address this inconsistency in policy goals. The United States, in contrast, decided to address problems of financial instability at a federal level and the potential costs of bank resolution have been mutualised. It is in this sense that the United States is a complete monetary union—it is both a currency and financial association. The ECB has tried to place the main responsibility for financial containment on the taxpayers and sovereign bondholders of afflicted states. However, this has not been a sufficient backstop and the ECB has had to lend large amounts to afflicted banks.

By not recognising this trilemma, the monetary policy of the euro zone is confused and unclear. But, more importantly, the haphazard response to the trilemma has created a very dangerous situation—the refusal to allow banks to haircut bondholders, in an attempt to contain financial contagion, has institutionalised moral hazard for bank lenders who have no disincentive to lend heavily into small and weakly-supervised local banking markets.

4. Market discipline on banks

These fundamental weaknesses in the banking system architecture will inhibit the maintenance of financial stability assuming it can be restored, aside entirely from issues which have engaged commentators inside and outside Europe, including the absence of fiscal transfers, limited labour mobility and other growth-inhibiting structural weaknesses (see for example Shambaugh (2012)). Aside entirely from fiscal transfers, and accepting that labour mobility will remain limited, there are weaknesses in Eurozone banking policy which have contributed to the severity of the current crisis, inhibited its management and which will threaten further crises if the system survives.

The currency union is not also a banking union. Responsibility for bank supervision and bank resolution are matters for member states, despite free capital mobility and freedom of establishment for banks.

While the various European treaties, including Maastricht, are silent on how to deal with bank or sovereign debt crises, the Eurozone now has a *de facto* resolution regime for sovereign debt and a quite different one for bank debt. The regime for sovereign debt, as evidenced in the experience of Greek bondholders up to and including the recent re-structuring, involves conditional liquidity provision to distressed sovereigns by official lenders, but only up to a point. Once that point has been reached, the official lenders get paid in full, including any secondary market purchases made by the European Central Bank. Private holders of sovereign bonds get haircut, in the Greek precedent by very substantial amounts. Sovereign debt in the Eurozone has been juniorised retrospectively.

Meanwhile no unsecured senior bondholder in a Eurozone bank has taken a loss, even holders of bonds issued by banks which have collapsed and been closed down. This resolution regime for banks is remarkably creditor-friendly in contrast to the regime now in place for sovereigns. Sovereigns already in official lending programmes have been required to pay holders of unsecured bank bonds, to the detriment of their prospects of re-entry to the sovereign bond market[2]. Not surprisingly, sovereign ratings have suffered and traditional holders of sovereign bonds have exited the market. There is thus a moral hazard regime for banks and their creditors, but not for sovereigns. Outside the Eurozone but inside the European Union, senior unsecured bank bondholders have experienced haircuts, notably in Denmark. Had Denmark chosen to join the Euro rather than merely fix the exchange rate against it, Denmark's sovereign debt would today be higher and its sovereign rating lower. Its borrowing costs would have risen and its budget deficit would be larger. Holders of Danish sovereign bonds know that Denmark enjoys monetary autonomy, and do not fear contingent liabilities for bank rescues. Despite fiscal imbalance, the failure of several smaller banks and severe losses for some of the larger banks, Denmark's 2024 bond has recently been yielding 1.50% in the secondary market, trading better than the corresponding German benchmark at times. This is Denmark's reward for avoiding Eurozone membership.

The reinstatement of market discipline for banks is a prerequisite if financial stability is to be restored. The three 'pillars' of bank regulation enshrined in the Basle framework are capital adequacy, effective supervision and market discipline. Market discipline requires that lenders to banks face some prospect of loss. This need not encompass every class of lender to banks (small depositors could be protected, for example), but a significant category of bank creditors must be exposed to loss or there is no market discipline. Moreover Rochet (2008) has demonstrated that supervision and market discipline are *complements*: the absence of market discipline renders the supervisory task too difficult. He argues that bank supervisors will be deprived of market signals about the relative credit-worthiness of banks, and will be less able to resist political pressures for forbearance in the interest of bank creditors, unless there is market discipline.

Effective bank supervision and high capital ratios have long been seen as *substitutes*: see Merton (1978). In the absence of market discipline, supervision is unlikely to be effective and capital adequacy ratios would need to be high in order to compensate. Those who resist higher capital ratios ought logically to favour the restoration of market discipline, through ending the no-bank-bondholder-left-behind regime which currently operates in the Eurozone.

Thus it is not sufficient to argue, as ECB executive council members have been doing (for example Coure (2012)) that the Eurozone needs a centralised system of bank supervision and resolution. The

[2] In Ireland, subsequent to entry to an IMF programme, the sovereign was required by the ECB to pay 100% to holders of unguaranteed bonds issued by two banks already in resolution, having lost between eight and ten times their capital.

bank resolution system must in addition be one which restores a minimum of market discipline, since supervision will not otherwise be effective. The restoration of market discipline in turn requires that the bank resolution regime must be financed in substantial degree through the bailing-in of bank creditors when banks get into trouble. Banks would be required to deploy balance sheets including significant liabilities exposed to loss, in addition to common equity and on a clear *ex ante* basis.

Schemes proposed recently which would see centralised Eurozone funds, such as the new ESM facility, used to re-capitalise banks do not pass this test, nor does pre-funding of a European resolution authority through levies on the financial sector. These schemes would ease pressures on individual sovereigns but would retain the central weakness of current policy. Moral hazard remains under these public bail-out schemes for bank creditors, but with the costs falling on a different set of taxpayers and undermining the credit-worthiness of a different set of sovereigns.

Ending moral hazard would bring the resolution arrangements for bank bondholders into line with those already implemented for sovereign bondholders in the case of Greece, and now presumed by the markets to apply to sovereign Eurozone bonds generally, as evidenced by secondary market price behaviour. The proposal would make centralised supervision easier and would reduce the risk of another Eurozone banking crisis through removing the moral hazard that has been created in bank financing. It would also help in undoing the entanglement of distressed banks with distressed sovereigns, the source of destructive negative feedback loops and financial dis-integration.

5. Concluding remarks on capital flows and sovereign exposure

A feature of the current crisis is the disparate experience of the sovereigns now undergoing distress. Only in the case of Greece did the problem originate unambiguously over the years prior to 2008 in unsuitable budgetary policy. In both Spain and Ireland, the bursting of credit-fuelled property bubbles played a central role. In a currency union, these are regional banking bubbles, a recurring phenomenon in the United States in recent decades. With free capital flows and freedom of establishment for banks, these regional bubbles (and associated current account deficits) may be impossible to prevent, see Kraft and Galac (2011).

But the United States is a complete monetary union in the sense that bank supervision and resolution are centralised and significant categories of bank creditors have been exposed to loss. In the Eurozone these regional bubbles resulted in distress for the sovereigns concerned in the absence of bank resolution, despite the sovereigns' compliance in earlier years with budget deficit and debt limits. Economies with low official debt ratios face exaggerated vulnerability under the moral hazard regime: lenders to banks presumed to enjoy the protection of a state with a low debt ratio may perceive greater fiscal headroom and hence a diminished incentive to monitor bank credit-worthiness[3]. Countries already in the moral hazard regime and required to get their debt ratios down face a perverse incentive: if they are too successful, they will be adversely selected by lenders to their banking systems. It has been argued that EU countries already in the Eurozone face heightened risks of sovereign default (de Grauwe (2011)); while non-members face weak incentives to enter the system (McCarthy (2012)).

[3] In 2007, the gross debt ratios in Spain and Ireland were 36% and 25%, amongst the lowest in the Eurozone, compared to 65% in Germany.

The principal policy response in re-designing the Eurozone architecture has been the fiscal compact, reinforcing the provisions of the stability and growth pact and designed to inhibit budgetary excess in future years. Only in Greece might these new arrangements have made a difference had they been in place from the beginning. In countries already in official lending programmes and those facing that prospect, the new treaty can be characterised as prohibiting an abuse of access to sovereign bond markets which these countries no longer enjoy. With market discipline for sovereigns restored for the foreseeable future, this emphasis on fiscal rules is excessive.

Finally the surplus countries, notably Germany, necessarily acquired financial claims on the private sector (banks) of deficit countries prior to the crisis. The insistence that bank creditors suffer no losses is an attempt to insist that countries running a payments surplus be enabled to acquire financial claims without credit risk, something not possible outside the gold standard and settlement in bullion. In any event, since the losses have actually occurred, they can only be transferred and not eliminated. The protection of bank creditors in surplus countries transfers losses to taxpayers in deficit countries and to sovereign bondholders, including sovereign bondholders in surplus countries. If no lender in a surplus country is to suffer loss, this requires settlement in goods, that is, no payments surplus. A functioning monetary union (outside the gold standard) which facilitates payments imbalances cannot simultaneously offer zero risk to bank creditors and protection from banking crises.

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