The main lessons to be drawn from the European financial crisis

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What are the main lessons to be drawn from the European financial crisis? This column argues that the Eurozone really is at a major cross-roads. Without a common fiscal policy, and without adequate institutions for aggregate demand management, European leaders have to constantly alter the rules. Currency risk will be the major concern of financial markets, much more than in the past, due to how Europe has dealt with the Greek crisis.

What are the main lessons to be drawn from the European financial crisis? Any debate on how to make the Eurozone more resilient ought to start with this question.

Two things stand out:

1. There is a trilemma – emphasised by Obstfeld (2013) amongst others – that, namely, given the size of global finance, the Eurozone cannot have full financial integration, financial stability and no common fiscal policy;
2. The Eurozone does not have adequate institutions and tools for aggregate demand management.

A trilemma?

Financial integration exposes the weaker member states to the risk of sudden stops, namely of sudden withdrawal of international financial flows. This risk can be diminished by surveillance and avoiding the accumulation of excessive imbalances. But it will never disappear, particularly in the event of systemic financial crisis.

If a sudden stop occurs, the sovereign most likely will lack the fiscal resources to cope with it. The size of the financial sector has grown just too large. At the end of 2007, bank assets were several multiples of GDP in most Eurozone countries (over five times in the Netherlands, about four in Italy, about three and a half in France). Unlike a typical emerging country hit by a sudden stop, Eurozone members cannot devalue their currencies to cope with the crisis. Yet, as became crystal clear in Greece – but also in other countries of southern Europe – currency risk is a major concern for market participants.

During a sudden stop, the bank-sovereign loop that we have seen at work during the crisis becomes inevitable. The home bias of bank portfolios aggravates the loop. But in the presence of currency risk, even a bank with well-diversified assets would not be able to withstand the flight to safety of its depositors. And the sovereign would typically not be in a position to help, given that it can neither devalue nor print money.

On the contrary, in countries with high public debt the sovereign itself could be the primary source of fragility, and its exposure to debt runs could activate the bank-sovereign loop. Any country with a large public debt, and with no access to monetary financing, could be subject to a run on its debt, even if it was solvent in the long run. In other words, liquidity crises triggered by lack of confidence could push into insolvency not only banks, but also sovereigns with high public debts and no access to the printing press.

- This trilemma implies that, in order to preserve financial integration and avoid future crisis, we need adequate common fiscal resources to cope with both systemic banking crisis and sovereign debt runs.

The European Stability Mechanism and the Single Supervisory Mechanism are steps in the right direction, but they are not enough. A full banking union will not be achieved until we have a system of common deposit insurance and adequate common resources for bank resolution and recapitalisation. And the European Stability Mechanism cannot cope with a sovereign debt run, because its resources are insufficient and its decision-making procedure too constrained by national vetoes.

The need to accelerate the completion of the banking union is widely acknowledged in the official debates. A significant fraction of the latest Four Presidents' report is devoted to this issue (although the envisaged time frame is still too long).

The question of how to make the Eurozone resilient to the risk of sovereign debt runs is not on the table. On the contrary, to make quantitative easing acceptable, the ECB had to rule out loss sharing between national central banks on purchases of government debt. As confirmed by the Greek crisis, restructuring of public debt held by official creditors is impossible inside the Eurozone, implying that sovereign debt risk and currency risk are intertwined. In this, the Eurozone resembles a currency board with a special voting rule, rather than a full monetary union (see Buiter 2015).

The reason why the trilemma is so hard to solve is clear. The initial asymmetries in public debt and financial fragilities between countries are so large that some nations fear that public risk sharing would amount to ex-ante redistribution. But this reasoning is wrong.

First, banking and debt crisis often result from lack of confidence (multiple equilibria). If so, guarantees (like common deposit insurance, or the existence of a lender of last resort) are sufficient to prevent illiquidity from morphing into insolvency. In this case, no transfer between countries is required to get rid of the bad equilibria, and everyone is better off.

Second, suppose that the financial crisis is triggered by insolvency, not just by illiquidity. Here transfers between countries would be required. But in principle, risk sharing is feasible also between very different partners. To be fair, the terms of the ex-ante agreement have to take into account asymmetries in risk.

There is no reason why this principle cannot also be adapted to the problem at hand, for instance by linking the cost of the common deposit insurance, or of other common precautionary funds, to the aggregate financial fragility of each country, so that residents of riskier countries would have to pay a higher ‘fee’ in normal times.

Aggregate demand mismanagement

The second main lesson is that lack of aggregate demand aggravated and prolonged the financial crisis in southern Europe. When hit by a sudden stop, domestic fiscal policy has no option but to become more restrictive, and a credit squeeze cannot be avoided as domestic banks are forced to deleverage. To avoid a deep and prolonged recession, active aggregate demand management at the level of the Eurozone as a whole is required. But this did not happen.

Monetary policy did not respond fast and aggressively enough, and it even tightened prematurely. Eventually the ECB did all the right things, with extensive bank lending and quantitative easing. But these actions came too late in the crisis, when the real economies in Southern Europe had already suffered huge losses. Just imagine how much easier it would have been to handle the sudden stops in southern Europe, if the statement, ‘whatever it takes’, had come at the beginning of the crisis.

Even if monetary policy had reacted more promptly, however, the zero bound on interest rates imposes limits on what monetary policy alone can achieve. As is now well-understood, coordinated monetary and fiscal expansion is needed in these extreme circumstances (see Giavazzi and Tabellini 2014). Yet the Eurozone has no common fiscal policy, and the countries in northern Europe were and are running large current account surpluses, subtracting additional aggregate demand from the rest of the Eurozone.

This aggregate demand mismanagement was not just the result of human error. It reflects the institutional design of the Eurozone. The lexicographic mandate on price stability delayed the ECB response. The ECB waited until the Eurozone as a whole was in deflation before reacting adequately. And the lack of institutionalised risk sharing implies that the burden of adjustment to a sudden stop falls exclusively on the debtor countries, with no enforceable obligation by the creditors to expand their fiscal policy in order to sustain aggregate demand in the Eurozone as a whole.

Difficulties in fixing the problems

These institutional features that led to this mismanagement ought to be corrected by changing the mandate of the ECB, by removing the constraints on monetary financing in order to facilitate a coordinated monetary and fiscal expansion, and by endowing the Eurozone with the possibility of issuing and servicing its own debt. But these issues are still taboo in official circles, and the Four Presidents' report does not even mention them.

Why this reluctance to acknowledge that the institutional foundations of the Eurozone impair aggregate demand management during systemic crisis? The answer probably goes beyond asymmetric risk and the fear of redistribution.

There is also the idea that moral hazard is a serious issue, that if countries started from a balanced budget then they could cope with their own resources when hit by idiosyncratic shocks, and that extreme economic pain is needed to induce adjustment in the weaker countries. But this idea has no solid foundation, for both economic and political reasons.

In 2007, Spain was running a budget surplus of over 2% of GDP. Given the extent of current financial integration, a sudden stop cannot be assimilated to an idiosyncratic demand shock that can be met with national fiscal policy alone. Moreover, if average inflation in the Eurozone was 3%, rather than a negative number, relative wage adjustment and the removal of the debt overhang in southern Europe would be much easier. Finally, as vividly illustrated by Greece, extreme economic hardship weakens the support for pro-Europe political parties, making adjustment less likely, not more likely.

Concluding remarks

The Eurozone is at a cross-roads. Having serious contemplated the exit of Greece from the Eurozone, European leaders altered the rules of the game, even if Grexit did not occur so far. From now on, currency risk will be a major concern of financial markets, much more than in the past. The Eurozone is correctly perceived to resemble a currency board, more than a full monetary union. In these circumstances, economic convergence between the core and the periphery will take a very long time, if it happens at all.

Waiting until convergence has been achieved before addressing the fault lines is too risky. Not just because a new financial crisis could erupt, but also because of the rise of populist anti-euro parties. Ctizens of Europe will turn to these parties, if they see that the political establishment is unable to address the challenges ahead.

References

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