FINANCE AT CENTER STAGE

Some Lessons of the Euro Crisis

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April 2014
Introduction

• The crisis that followed the events of August 2007 have shown conventional macroeconomic models were ill equipped to capture the key role of financial markets:
  • as a source of shocks
  • in the transmission of shocks and policies

• At the same time, financial regulation missed macro aspect.

• These are also lessons of the euro zone crisis, which grew directly out of the 2007-2009 global crisis.

• Financial markets must be at center stage in any discussion of the future of EMU.
Growth of Global Banking

• Financial markets expanded worldwide after 1990s.

• Especially true given the low interest rates and liquidity boom of 2000s; global trend toward deregulation.

• Banking expanded most markedly in Europe.

• International financial integration made it easy for banks to get big, even in small countries.

• In many, banking assets far surpassed GDP.
<table>
<thead>
<tr>
<th>Bank</th>
<th>Home country</th>
<th>Bank assets</th>
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</thead>
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<tr>
<td>Erste Group Bank</td>
<td>Austria</td>
<td>0.68</td>
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<tr>
<td>Dexia</td>
<td>Belgium</td>
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<td>BNP Paribas</td>
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<td>Deutsche Bank</td>
<td>Germany</td>
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<td>Bank of Ireland</td>
<td>Ireland</td>
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Bank and Sovereign Solvency Now Closely Linked

• Sovereign debt markets are subject to multiple equilibria; but analogous liquidity risk characterizes financial institutions.

• Financial system depends on sovereign’s fiscal health in at least two distinct ways (the first less discussed than the second):
  • sovereign backstops financial system, but cannot maintain confidence in banks if it has insufficient fiscal space – “too big to save” problem (modeled by Acharya, Drechsler, Schnabl, “Pyrrhic Victory,” 2011)
  • system holds sovereign national debt (absent a euro zone bond) but euro sovereigns cannot print money, as stressed by De Grauwe (2012)

• And sovereign’s health depends on its support of banks.
  • range of vulnerability to multiplicity is therefore larger
  • expectations can trigger “doom loop,” a.k.a “lethal embrace” and “vicious circle,” which becomes more severe as growth slows, heightening bank/fiscal weakness (cf. Brunnermeier et al. 2011; Mody and Sandri 2012)
Trilemma for Members of Currency Unions with Big Banking Systems

One cannot enjoy all three at same time:

1. Financial integration with partner countries.
2. Fiscal independence.

This is the financial/fiscal trilemma. Indeed, fiscal independence implies segmentation, impaired stability. With own currency, add price stability: quadrilemma.
Capital Flows in the Euro Zone

• Three salient features of the euro’s first decade:
  • Bigger current account deficits of poorer countries.
  • Much bigger intra-euro area flows and positions.
  • Sovereign yield convergence.

• Authors such as Blanchard and Giavazzi (*BPEA*, 2002) identified an appropriate “downhill flow of capital” in Europe, absent elsewhere in the world, and promoting real convergence.

• Others praised creation of a bigger unified financial market, allowing reductions in home bias, greater liquidity, cross-border bank M&A.

• Two potential issues:
  • Current accounts driven by demand and housing investment.
  • Portfolio diversion and risk concentration, pricing distortions.
10-year Spreads against Bund (basis points)
Domestic Credit to Private Sector

Percent of GDP

Greece
Ireland
Italy
Portugal
Spain
Germany
Residential Real Estate Price Behavior
Real Exchange Rates in the Euro (relative CPIs)
Real Interest Compared to Germany

![Graph showing real interest rates compared to Germany from 1995 to 2012 for Greece, Ireland, Italy, Portugal, and Spain.](image)
Peripherals’ Current Account Imbalances
(percent of GDP)
Banks Shifted Foreign Lending toward GIIPS

The chart shows the percent of total foreign claims allocated to GIIPS for Austria, Belgium, Germany, France, and the Netherlands from 1999-Q4 to 2011-Q4. The graph indicates a significant shift in foreign lending towards GIIPS, particularly noticeable in the later years of the period.
Causes and Consequences

- ECB applied equal collateral haircuts to all sovereigns regardless of credit rating or fiscal fundamentals (as stressed by Buiter and Sibert in 2005).
- Quasi-automatic financing through ECB standing facility.
- Bailout expectations? Buiter and Sibert argued not, but their case appears quaintly naive in retrospect.
- Zero risk weights for sovereign euro area debt (still in CRD IV).

Implications:

- Banks had more incentive to hold sovereign debt.
- All countries faced rates of most creditworthy sovereigns.
- Helped drive aggregate demand, reinforcing global trends.
- In peripherals, real appreciation and delayed structural reform.
The Maastricht Treaty’s Maginot Line

• Monetary policy geared to low, stable inflation via central bank independence and treaty remit to preserve “price stability.”
• Fiscal policy constrained by EDP (as implemented through SGP).
• Treaty’s no-bailout clause; ECB statute on monetary financing.
• National discretion over structural reform – reform promoted by inflexibility of exchange rate?
• National discretion (and fiscal responsibility) for deposit insurance, supervision, regulation, resolution; LLR role of ECB left vague (Begg et al. CEPR report, 1991; Vives 1992).
• See Obstfeld (1997) paper.
• To have gone further in the treaty would have raised intractable issues of fiscal union, democratic deficit.
• These defenses were easily circumvented.
The Case for Fiscal Rules

• In 1990s no one foresaw that banking troubles themselves could cause sovereign weakness, *even in seemingly fiscally prudent euro countries*, or that the inability of weakened sovereigns credibly to protect banks would segment financial markets along national lines.

• The possibility for banking itself to undermine the sovereign had been seen in Latin America, Asia, where dollarized debts made depreciation problematic (Díaz-Alejandro on Chile, 1985).

• “Too big to save,” coupled with cross-border contagion, undermines the argument that stand-alone national fiscal policies can work (the financial/fiscal trilemma).

• Suggests a *new argument for fiscal rules*: a profligate government undermines the credibility of its own financial backstop powers, opening the door to market segmentation and contagious instability.
Financial Reform to Break Doom Loop

Remedying the defects in the financial-market structure of the original blueprint. Ideally:

• Unified comprehensive regulatory structure (SSM).

• Universal deposit insurance scheme.

• Universal resolution regime (SRM).
Financial Reform State of Play

• Imperfect SSM is being implemented (by November 2014).
• Push-back on euro area wide deposit insurance with joint funding. But it is needed to break the doom loop at national level, addressing financial/fiscal trilemma.
• On SRM: the case for taking resolution decisions out of national hands is super-strong:
  • National policymakers may exercise excessive forbearance in declaring home banks insolvent.
  • They may devote insufficient resources to reorganizing insolvent banks when much of the benefit of rescue accrues abroad.
  • ECB oversight though SSM cannot be effective unless there is a credible end-game for financial institutions, including big ones.
  • But end-game threat is not credible, and does not weaken the doom loop, unless there is sufficient joint funding for resolution.
April 2014 European Parliament on SRM

- Functions to begin 2016.
- Single resolution fund financed by ex ante & ex post bank levies.
- National contributions with “progressive mutualisation over an 8-year transitional phase.”
- Transitional bridge financing from ESM or national sources?
- National budgetary processes required before “extraordinary public support” from any member state.
- Resolution and supervision for banks to be “at same level.”
- Single resolution board of five full-time members (including executive director) plus national resolution representatives; will have “broad powers in cases of bank resolution.”
Private Creditor Bail-In

• Under new common EU R & R framework, shareholders will lose and unsecured, uninsured creditors will face haircuts – as they should.

• Benefits of creditor involvement include:
  • Reduced moral hazard.
  • Reduced taxpayer subsidy and therefore an attenuated doom loop.
  • Reduced subsidy to leverage – leading banks to hold more capital/assets.
  • Reduced subsidy to bank size.

• Higher funding costs for banks move us closer to social optimum!
• Similarly, euro area sovereign debts are now issued with CACs, leading to similar advantages if bank strength makes sovereign default is credible.
• Disadvantages are possibly greater volatility and reduced liquidity in sovereign and bank funding markets.
• For former, need continuity of ESM and possibly OMT.
• For latter, need continuing strong ECB last-resort lending presence.
• Convertibility-risk genie is now out of the bottle.
More Fiscal Centralization *Is* Needed – How Much?

1. Will bank fees be enough, even supplemented by ex post levies? Not likely. Only a sufficiently large “bazooka” can be a credible enough stabilizing force for EMU financial markets, given bank size, and reverse market segmentation.

2. Variable national insurance contributions for access to banking union (beyond bank fees) can reduce policy moral hazard as well as partially offset asymmetric exogenous shocks.

3. But SRM fund can be far less than full fiscal union, which seems unlikely any time soon. Role for GDP-linked debt (Obstfeld-Peri, Borensztein-Mauro, Drèze)?

4. As fiscal mutualization rises, bigger *democratic* deficits?