Monetary Union and Financial Stability

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Road map

- Does monetary union (MU) promote or hinder financial stability?
- Did MU create conditions leading to crisis (financial instability)?
- When crisis hit, did MU exacerbate financial instability?
- If not MU, where do the faults lie? role of misguided macroeconomic policies and weak institutions
- What threats to financial stability lie ahead? How to respond?
- What flaws remain in the institutional framework of MU?
- Is it possible to change the narrative that currently blocks progress?
Prolegomena: why MU?

• EU abolished capital controls from July 1990 – that left member states a choice between fixed exchange rates and monetary autonomy
• Stable exchange rates seemed necessary for the Single Market (One Market, One Money)
• So give up monetary autonomy – to a European Central Bank (ECB) and the grand projet proposed in 1970
• Doubtless political motivation too
• But recent economic research suggests that the Global Financial Cycle permits only limited monetary autonomy regardless of the exchange-rate regime – so even more reason to adopt MU
Does MU promote or hinder financial stability?

- MU and financial stability not incompatible - despite the severity of the crisis in the Eurozone, its current stagnation and gloomy prospects
- Maastricht Treaty explicitly states obligation of ECB to ensure financial stability
- But overriding objective of ECB is *price stability* – does price stability ensure financial stability?
- TPS (2004) was cautious: he saw price stability as ‘a crucial contribution to financial stability’ but not a ‘sufficient condition’ – as the crisis demonstrated
Stability may breed instability

- A long calm period may lull investors into taking risks that accumulate and ultimately lead to systemic breakdown
- Maintaining price stability when the economy is very weak may require an extended period of very low interest rates that encourage excessive risk-taking (‘search for yield’) and lead to crisis
So did MU create conditions leading to financial instability?

- MU brought interest-rate convergence → rates too low for some countries, especially those with high rates pre-EMU
- Hence economic boom there, overheating → inflation up → real interest rates down further → more boom
- The fall in interest rates discourages savings, raises investment demand, hence current account deficits
- And MU encouraged capital flows to finance those deficits: from excess savings countries to the others → a ‘capital flows bonanza’ financing leveraged positions in ‘peripheral’ countries
Convergence of Gov. Bond Rates in the EURO Area

No allowance for risk!
Huge capital flows from Germany and France to periphery were bank and portfolio debt, not FDI
Lenders and borrowers

- In the low-rate and ‘risk-on’ environment, German, French, Dutch banks looked for yield: went to riskier assets in ‘periphery’, encouraged by the disappearance of currency risk
- Much of the finance went to leveraged borrowers: households taking big mortgages, banks funding in wholesale markets and lending to real estate development ⇒ housing market booms
- Revealing a key flaw in MU institutional architecture: no unified bank supervisor, national supervisors ignoring international exposures of their banks (Bafin in Germany…)
- And government borrowers benefited too, partly because ECB treated all countries’ bonds as the same: zero risk!
Total gross inflows (% of GDP) into Ireland and the VIX
EU Bank leverage

Source: Miranda-Agrippino and Rey (2014). Based on Bankscope data
Benefits to eliminating capital controls and promoting financial integration – but...

- …need correspondingly integrated financial supervision (and competent, independent supervisors) – of banks, interbank markets, and retail lending
- Integrating securities markets promoted convergence of interest rates – ratings agencies ignored the risks
- And cross-border banks were still treated as national – indeed, often as ‘national champions’ whose ambitions should not be constrained – rather than as Eurozone banks
Where are the ‘usual suspects’?

- Fiscal profligacy? Only Greece
- ‘Asymmetric shocks’ with inadequate adjustment mechanisms? Only insofar as financial shock hit some countries harder than others – and there, labour mobility and automatic tax-transfer mechanisms were irrelevant.
- Inadequate ‘competitiveness’ in crisis countries because their unit labour costs had dramatically risen? Not in this story.

The conventional narrative is simply wrong. But officials have rounded up the supposed perpetrators, and they are suffering. More below.
When crisis hit, did MU exacerbate financial instability? What role for policy mistakes?

- **Bad**: financial integration amplified disturbances created by higher perceived risks in dealing with counterparties.
- **Good**: reversal of ‘capital flow bonanzas’ was met by Emergency Liquidity Assistance and Target2 payments system, so MU design was good here.
- But housing markets hit, bank portfolios impaired.
- With banks overleveraged, their solvency was quickly tested.
- The authorities chose bailouts over bailins: losses were met by taxpayers in host countries, not lenders and taxpayers in lending countries – Ireland paid, not Germany.
• Households were (and are) overleveraged too: their growing financial difficulties hit consumption demand
• Household incomes down → tax revenues down, while unemployment up → social expenditures up: so budget deficits rose and further contributed to government debt
• Again, nothing here about diverging competitiveness.
• But capital inflows had led to rise in prices of non-traded sector, especially housing, and diversion of resources into that sector, with long-run damage: this is a low-productivity sector that creates little human capital.
Household leverage stubbornly high

![Household Debt to Income Ratio by Country](image)
Bad policies

- Should have used aggressive monetary and fiscal stimulus while fixing banks and requiring creditors to take much of the burden from their bad loans
- But monetary stimulus too little, too late – ECB not fulfilling its mandate of inflation ‘below but close to 2%’
- ‘Rigour’ partly motivated by moral hazard considerations – the belief that only sustained pressure on governments will bring reforms
- Fiscal austerity – counterproductive, because resulting contraction raised debt burden nevertheless
They are not doing their job – as defined by themselves!

The Maastricht Treaty states that the task of the European Central Bank is stable prices, and the Council of the Bank has itself defined price stability as a rate of inflation below but close to 2%
Gross debt-to-GDP ratios

Source: AMECO (European Commission)
Gross debt-to-GDP ratios

Source: AMECO (European Commission)
Austerity isn’t working

Source: DeGrauwe and Ji (2013a)
• Bank ‘stress tests’ (first round) totally inadequate
• Bailins excluded – no ‘private sector involvement’ in dealing with bad debts
• Emphasis on ‘restoring competitiveness’ through wage cuts (‘internal devaluation’)
• Meanwhile, the authorities promoted financial disintegration and reassertion of national borders
- ringfencing liquidity
- implicit pressure on domestic banks to shift their government bond portfolios towards domestic bonds, with strong incentives (‘the greatest carry trade ever’ – borrow from ECB at 1%, buy Italian bonds yielding 7%)
And initially, there were *no* eurozone institutions to deal with...

- too-big-to-fail banks
- too-big-to-fail countries (and until 2012 *all* were deemed TBTF)
- government debt overhang and debt restructuring

The result: weak recovery, then double dip, now stagnation
Current ‘recovery’ especially weak in historical perspective

Graph I.4: Comparison of past and current recoveries - GDP, euro area

Note: Past recoveries included are those from the mid-1970s, early-1980s and early-1990s.

Source: European Commission, European Economic Forecast, November 2014
Unemployment is a huge concern

The ‘periphery’ countries look even worse, and the ‘debt overhang’ is a major obstacle to recovery.
So did MU contribute to financial instability and crisis?

- Not directly, but some factors made crisis worse
- Openness to capital flows and financial integration created conditions for crisis
- ECB in principle responsible for systemic risk and ‘macroprudential’ policies to deal with it, but no executive powers, and national authorities ignored macropru
- Bank-sovereign nexus: problems of banks hit sovereigns, but banks hold a lot of domestic government bonds – exacerbated by credit default swap (CDS) markets
- Markets took fright at rising government debts: who would bail out governments that couldn’t roll over their debts by printing money?
What threats to financial stability in MU now and how to respond?

• Greatest threat is political reaction to continued austerity and stagnation
• Some favour exit for countries suffering from such pressures
• But a ‘well-prepared orderly exit’ is an oxymoron – any preparations would bring chaotic market conditions and capital flight
• Exit would have devastating effects on balance sheets and contracts
• Contagion through capital flight from any country thought at risk of exit
• And exit would destroy MU by making it into a fixed exchange rate regime that could survive only with capital controls
Must maintain ECB as credible lender of last resort (LLR) to governments

- Draghi’s ‘whatever it takes’ and OMT programme
- Moral hazard $\rightarrow$ conditionality (consistent with Bagehot)
- Must be willing to permit government debt restructuring if debt burden is unsustainable (Greece May 2010 was a major error)
- But could ECB let a large country default? – effects on banks in home country and elsewhere – are some countries too big to fail?
- And can or should the ECB enforce deeply political conditions? – return to this below
Need powerful eurozone-level microprudential supervision and macroprudential authority

- MU with financial integration in world with Global Financial Cycle requires MU-wide authorities:
  - many banks have cross-border activities
  - the payments system is at eurozone level
  - money and credit in MU are indivisible – not national
- We now have the Single Supervisory Mechanism (SSM) for micropru and the European Systemic Risk Board (ESRB) for macropru
- But macropru policies may have to distinguish across countries – and this makes macropru irredeemably political
Healing a fragile banking system

• SSM just completed a ‘comprehensive assessment’, reviewing asset quality and ‘stress tests’
• A fairly good start, although some found it a whitewash – not for Italy, perhaps for Germany?
• Tough followup required: recapitalise some, wind up others, encourage mergers (with caution!), repeat assessment soon with more demanding standards
• Mitigate bank-sovereign nexus: reduce home government bond components of bank portfolios – SSM is said to contemplate forcing transfers of as much as € 1 trillion – and limit negative aspects of CDS markets
• Deal with ‘overbanking’ – some shift from bank to market finance: the ‘capital markets union’
Bank vs. market-centred financial systems
percent of total debt financing of corporate sector

Source: ECB, Federal Reserve
EUROPEAN CENTRAL BANK
Eurozone capital markets are underdeveloped
Banking Union

• SSM for micropru
• Single Resolution Mechanism (SRM) to deal with weak banks – but no cross-border burden sharing, indeed totally inadequate funding, so can’t act as ‘backstop’ if many or large banks fail tests
• Many would say a common deposit insurance system is necessary in MU – not obvious
Dealing with sovereign debt overhangs

• Some countries will never pay off debts
• ‘Extend and pretend’ is not the way out – debt overhangs have negative effects on incentives, investment, growth
• Only a few options: raising growth rates above interest rates, running primary fiscal surpluses, inflating debt away, debt mutualisation, and debt restructuring (default)
• Need orderly restructuring – some form of debt relief
• A comprehensive proposal will be forthcoming from a CEPR group that will meet here a week from today
What flaws remain in the institutional framework?

• Financial stability overly dependent on ECB: it runs monetary policy, SSM, ESRB, payments system, while other institutions are weak
  
  • Powerful, independent, not properly accountable
    - quarterly appearances before non-expert MEPs with limited staff
    - Executive Board appointed by deals in European Council – when EP voted against one, they were ignored
    - ECB Council members perceived as representatives of their home countries (perhaps also by themselves)
    - but not really ‘representative’: 1 woman among 24
  
  • Much of its authority is based on Treaty – yet it lacks perceived legitimacy: who elected Draghi?
And who trusts him (aside from me)?

Question: For each of [the following European institutions], please tell me if you tend to trust it or tend not to trust it? [...] The European Central Bank (Tend to trust, Tend not to trust). We compute the share of respondents who answer “Tend to trust”
Sample: Denmark, France, Germany, Ireland, Italy, Portugal, Spain
The narrative that blocks progress and may destroy the euro

- Germany is captive of myths (and some others buy them too – Finland, Austria, …):
  - debtor country profligacy
  - misinterpretation of 1920s and 30s
  - belief that we already have a ‘transfer union’
  - laziness of ‘southerners’, their ‘uncompetitiveness’, new ‘evidence’ that they are ‘much richer than Germans’
  - unshakeable belief in bad macroeconomics, including fundamental asymmetry between debtor and creditor countries: only debtors need adjust, while creditors can continue to run big surpluses

- Public never told that their banks have been badly managed, badly supervised, and should share burden of bad loans
This narrative dominates the media (just as the anti-immigration stories dominate the British media, with complete disregard for the evidence)

• Not clear that it’s possible to change it – a necessary but perhaps not sufficient condition is serious political leadership, in very short supply
• A further, deeper crisis or a long, grinding period of stagnation or contraction might just force change
• But MU might break down before then, as the politics of several of our countries turn very nasty
• Still, we must try in our own domains to bring evidence and analysis forward – MU is such an extraordinary achievement, with so many positive consequences, that it deserves the effort
“[T]he road toward the single currency looks like a chain reaction in which each step resolved a preexisting contradiction and generated a new one that in turn required a further step forward.”
Tommaso Padoa Schioppa, 2004 (quoted by Guiso, Sapienza, Zingales, 2014)

The next step: deeper political integration?