Ágnes Csermely: Who pays the ferryman? The story of the euro area from recession to political crisis to the revision of the institutional structure*, [1]

The debt crisis has brought to the surface key weaknesses in the institutional structure of the EU. The public securities markets of the individual countries have turned out to be potentially just as vulnerable to speculative attacks as fixed exchange rates. It has emerged as an unmanageable problem that, while governments themselves are struggling with the sustainability of debt, banks operating on the integrated money and capital markets are also relying on the national governments for a bailout. The difficulties of potential recovery are aggravated by the fact that the strict fiscal policy serving as the institutional foundation of the euro area needs to be restored at a time when the private economy is also in the process of deleveraging, while monetary policy is unable to boost growth through further interest rate cuts. Calming down the escalating crisis would have required rapid crisis management measures. However, the measures adopted as a result of compromises between economic rationality and political reality proved inefficient for a long time. The institutional vacuum gave rise to the emergence of self-generated negative spirals. It has now become obvious that the institutional framework of the monetary union needs to be reconsidered, including increased risk sharing between member states, and that an increasing number of fiscal and control functions need to be elevated to the Community level. The emerging institutional structure, which still lacks full political support, is seen as a longer-term strategic goal.

THE BASIC CONCEPT OF THE EURO AREA: MONETARY UNION WITHOUT A FISCAL UNION

Before the introduction of the single currency, the countries of the euro area operated an exchange rate regime that was pegged to the German mark (ERM, ERM-II). That period was characterised by frequent currency crises and, consequently, several participating currencies were repeatedly devalued due to market forces. With the liberalisation of the movement of capital, such speculative attacks became increasingly common and more expensive. As the increasing vulnerability of fixed exchange rate systems became apparent in other parts of the world as well, economic thinking began to reconsider the costs and the benefits of strictly managed exchange rates. By the early 1990s, "corner solutions", i.e. the irreversible fixing of the exchange rate and free floating, had become the exchange rate systems preferred by the economic profession.

In keeping with the ever-closer economic integration, member states of the European Union decided in favour of adopting a single currency. The fact that, during the previous decades, the Bundesbank had been the only central bank to pursue an independent monetary policy, was certainly conducive to making that decision. At the same time, there was no political support for centralisation or even harmonisation of fiscal policies. Therefore, it was intended that the stability of the institutional structure would be guaranteed by the budgetary discipline of the individual countries. That idea fell in with the economic thinking of the early 1990s as, at that time, the credibility of the fixed exchange rate was mostly undermined by the lack of budgetary discipline.

Accordingly, the Maastricht Treaty included a number of institutional guarantees in order to ensure fiscal discipline by the member states. First, a law was adopted banning member states or the ECB from providing a "bail out", i.e. monetary financing, to another member state. The fiscal policy of member states was monitored through the joint discussion of convergence and stability programmes whereas an excessive deficit procedure was initiated against countries that did not comply with fiscal discipline.

* The views expressed in this article are those of the author(s) and do not necessarily reflect the offical view ot the Magyar Nemzeti Bank.
[1] Based on the presentation delivered at the 20th Convention of the Hungarian Economic Association in Eger, on 28 September 2012.

MOST PERIPHERAL COUNTRIES GOT INTO TROUBLE FOR REASONS OTHER THAN A LACK OF FISCAL DISCIPLINE

While cracks in the architecture of the euro area had already appeared before the crisis, including half of the member states being subjected to the EDP at times, fiscal discipline continued to exert its influence. With the exception of Greece, the troubled countries managed to meet the fiscal criteria. At the beginning of the crisis, Spain and Ireland had the lowest public debts. While Italy and Portugal had higher levels of debt, their budget deficits had been reduced to acceptable levels and thus were not being subjected to an excessive deficit procedure when the crisis erupted.

In smaller countries, the rapidly increasing debt of the private sector represented the fundamental problem. Following their accession to the euro area, significant amounts of capital began to move into these countries. The resulting low interest rates, coupled with the "europhoric" income expectations linked to their accession to the euro area, encouraged the rapid increase of the indebtedness of the private sector. Both a credit bubble and a real estate bubble was generated, increasing the vulnerability of the banking system. The rapid growth of foreign indebtedness did not trigger a policy response as, according to the prevailing opinion, debts between countries within the monetary union did not matter.

In fact, private sector overheating caused fiscal indicators to appear in a better light, as revenues from a growing rate of employment, property taxes and extra profits continued to improve the budgetary position for years. Therefore, authorities in both Brussels and the member states were unprepared for the speed at which these revenues disappeared following the outset of the crisis and the extent of the subsequent deterioration in the governments' financial positions. The loss of temporary revenues generated by the overheated economy and deep recession resulted in a rapid increase in public debts. The unmanageability of the situation was, however, greatly aggravated by the escalation of the problems emerging in the banking sector. On the one hand, this generated a direct fiscal cost, while indirectly (due to the steadily declining economic output as a result of the credit crunch), it also marred the perception of the sustainability of public debt.

THE INSTITUTIONAL PROBLEMS OF THE EURO AREA CONTRIBUTED TO THE DEEPENING OF THE CRISIS

Numerous earlier debt crises[2] documented in economic history typically resulted in a more serious and longer-lasting economic slump compared to exchange rate crises. The extent of the current debt crisis is outstanding even by these standards, as many developed countries are simultaneously affected globally, and consequently these countries which are forced to cut their domestic demand are unable to recover from the recession by increasing their exports.

The protracted nature of the debt crisis has partly been due to the fact that, at such times, the efficiency of traditional economic policy instruments is extremely low, as decision-makers tend to focus more on downsizing debt rather than on maximising profits. Due to the vicious circles emerging in the debt crisis, the recovery of economic growth becomes extremely difficult. The interactions between the financial sector and actors of the real economy contribute to the emergence of a downward spiral. The behaviour of the private sector tends to be mostly affected by the increasingly unfavourable income expectations, growing interest costs and a loss in the value of real estate and holdings of securities, resulting in a substantial decline of the propensity to consume, along with a reduction in employment and the deferral of investments. The activity of the banking system is impacted by the deteriorating quality of portfolios, the loss of the value of collateral, the increasing cost of borrowing and the tightening of external financing conditions, which results in a reduction in the general availability of loans. Through the so-called financial accelerator effect, all of these also have repercussions for the balance sheets of non-banking actors. The lending shortage has a restraining effect on production, contributing to the slump in the economy, the deterioration in the perception of risk, the decline of asset prices and the rise of interest expenses. All of this makes the outlook of economic agents even gloomier, which in turn increases the adaptation pressure.

In the countries caught up in the vicious circle of the debt crisis, both governments and central banks play a key role in stabilising the situation. However, deploying the traditional instruments of stabilisation is not the most important step to facilitate recovery from the crisis.

[2] IMF (2009), *World Economic Outlook*, April, Chapter 2.

Monetary policy

The monetary policy of countries in a debt crisis responds to the substantial decline of growth and the increase of deflation risks by reducing interest rates. This, however, has a small impact on household credit demand and thus on consumption, as the primary goal is to reduce debt. Similarly, low interest rates will not provide a strong enough incentive for investors, due to the uncertainties in the market. As the impact is low, central banks tend to use their maximum latitude in order to improve monetary conditions. In this type of crisis, however, the most important task of central banks is to remove the obstacles to the functioning of the financial system. To that end, they help resolve the scarcity of bank financing through new instruments to improve liquidity and attempt to restore operation of the frozen segments of capital markets as soon as possible, resorting to a wide array of unconventional measures.

During the initial period following the onset of the crisis, the monetary policy pursued by the ECB was similar to that of the central banks of other developed countries. It reduced key interest rates, in several steps, to virtually zero, created new liquidity-generating opportunities for banks and launched an asset purchase programme in order to restore the functioning of frozen money markets. However, as the crisis spread to European sovereigns, the limitations of the institutional arrangement emerged. While during the period prior to the crisis, the public securities issued by member states of varying degree of indebtedness had, from an investor point of view, been very close substitutes of each other, from 2009, these sub-markets which play a key role in the transmission of monetary policy started to become increasingly segmented. Similarly, it could be assumed that risk avoidance due to doubts concerning the future of the euro area as well as speculation were playing a part in the shaping of the extreme pricing. Despite the key importance of public securities markets in the preservation of the functionality of the financial system, the ECB, bound by the ban on monetary financing, was unable to play an active role in the stabilisation of these markets.

Fiscal policy's scope for action

Fiscal policy also plays an important part in the stabilisation of the debt crisis. The most helpful forms of fiscal loosening are ones intended to directly generate demand in the economy (e.g. vehicle scrapping schemes, employment programmes or investment in infrastructure). Another government task of primary importance is the speedy restoration of the lending ability of the banking system, since lending is needed to enable the allocation of resources and growth to resume. In earlier debt crises which were successfully managed, the priorities of economic policy have always included the cleaning of the balance sheets of the banking system (e.g. Sweden 1992–1993, USA 2007–2009). On the other hand, it took a long time to restore growth in countries where economic policy turned a blind eye to the bad loans that had accumulated on banks' balance sheets (e.g. Japan's "lost decade" following the crisis of 1992).

Similarly to monetary policy, fiscal stabilisation in Europe can be divided into two periods. In the first phase of the crisis, when the centre of the crisis was still in the US, the European Union announced the launch of a coordinated fiscal stimulus package. The European Economic Recovery Plan allowed a quick yet temporary fiscal relief in each country considered to be free of concerns about fiscal sustainability. This internationally coordinated programme was successful. In 2009, it was expected that growth would resume in both the US and Europe. However, as the first results of stabilisation became apparent, the fiscal policies of the US and Europe started to follow different paths. While fiscal incentives continued in the US, the EU opted for the gradual elimination of excessive deficits. In 2011 and 2012 budgets were severely tightened in most countries. This could partly be due to the fact that the Greek debt crisis had openly questioned the institutional foundations of the euro area and increasing speculation was surfacing in connection with a possible disintegration of the euro area. Therefore, various European economic policy-makers came to the conclusion that, in the current situation, the most important task was to restore the most important institutional foundation of the euro area, i.e. the fiscal discipline of the member states as soon as possible. Rapid fiscal consolidation also appeared to be the appropriate remedy against the contagious effects of the debt crisis.

The change in direction in European fiscal policy gave rise to a serious debate both within the euro area and on international fora. Core European countries with a favourable risk rating were criticised[3] for having reversed fiscal policy too fast, removing the only support for growth and thus helping Europe slump back into recession. Since growth in peripheral countries can only be based on exports, the countries which previously provided the lending for the run-up of excessive debts should now increase their internal demand in order to encourage the economic adaptation of the peripheral countries.

[3] IMF (2012), *World Economic Outlook*, April, Chapter 2.

An even more serious controversy took shape in connection with the fiscal policy to be pursued by the member states in trouble. While the European mainstream considered that a multi-annual programme of reforms and dynamic fiscal consolidation would be necessary, the delayed start of economic growth raised increasing doubts concerning the appropriateness of quick fiscal consolidation. The chief argument of the advocates of increasing fiscal latitude[4] was that these countries were in a special situation where the fiscal multiplier was substantially higher than usual[5] and therefore austerity would set back growth to such an extent that the targeted budget deficit could not be achieved due to the melting of tax bases and the extra expenditure as a result of the decline in employment. In an extreme situation, austerity can become self-destructive, i.e. regardless of the measures taken, the decline in growth and its adverse effect on market returns will result in the perception of fiscal sustainability not improving at all.

A slower rate of fiscal consolidation is only viable if someone is willing to finance it at an acceptable rate of interest. Advocates of rapid fiscal consolidation argue that the key to resolving the situation is the speedy restoration of trust on the market, which can only be achieved by attaining a sustainable budgetary position as early as possible. As long as that is not achieved, high interest premiums and the continuing decline of asset prices will only aggravate the balance sheet position of the private sector. According to this school of thought, a slowdown in consolidation leads to long-term recession.

The intertwined fates of states and banks

Finally, as far as the management of the problems of the banking system is concerned, the approach taken by European countries was again different from that of the US. In the United States, a substantial cleaning of portfolios and the recapitalisation of major banks by the federal government started in 2009. While a similar wave of recapitalisation took place in Europe in 2009, the systemic audit of the portfolios is still to be carried out. Moreover, the European authorities left much greater scope for banks to improve their capital position through balance sheet adjustment, i.e. downsizing their assets.

The slow consolidation of the banking system may be due to several factors. First, while banking activities have spread across national borders, there was no unified surveillance of their activities or a European institution with an overall view of their relations and the potential contamination channels. Concerns about potential rippling effects also delayed the write-off of losses. Second, since the cleaning of bank portfolios is typically carried out with substantial state commitments, governments in a weakened budgetary position were reluctant to take on added burdens. The example of Ireland in particular, where the nationalisation of failed banks was followed by an extremely fast increase of public debt, put governments on guard.

The situation, however, continued to deteriorate due to the postponement of bank consolidation. If the quality of a bank's portfolio deteriorated, investors immediately responded by downgrading the risk rating of the country where the bank's headquarters were based since, if the bank goes bankrupt, the state will ultimately have to cover the depositors' money. Since the balance sheet totals of numerous banks were very high compared to the size of national budgets, investors also downgraded their perception of fiscal sustainability. That also had repercussions on the perception of banks as they had a large amount of public securities in their possession. A vicious circle was thus generated, resulting in an ever-worsening investor perception of banks and governments. The resulting uncertainty slowed down the performance of the economy by curbing lending by banks and the ensuing extremely high costs of financing. The recession in turn added to the problems of both the banking system and public finance.

The state has no lender of last resort

Finally, as an additional aspect of institutional problems, mention must be made of the absence of the lender of last resort function to the state. The crisis has revealed that, if liquidity problems occur, member state governments are unable to obtain funds as central banks are prohibited from providing monetary financing to governments. That leaves the states concerned in a situation similar to having a debt denominated in a foreign currency. Paul de Grauwe[6] illustrates the problem through a comparison of the economies of Spain and the UK. Despite the similar fundamentals of the two countries, there is a significant difference in yields on the public securities market. This may be related with the market perception whereby if a government had liquidity problems, the Bank of England would be both able and willing to provide temporary

[4] Gros, D. and R. Maurer (2012), "Can Austerity Be Defeating?", *Intereconomics,* 3.

[5] Under normal circumstances, monetary policy is capable of compensating the impact of fiscal austerity, while economic operators aim to smooth their consumption; such compensatory mechanisms do not work in the current situation.

[6] De Grauwe, Paul (2011), "Managing a fragile Eurozone", *Vox.Eu blog.*

financing assistance, whereas the same is considered unlikely as far as the ECB is concerned.[7] Should such a difference in behaviour really exist, it may increase the risk of sovereign default in euro area countries under a worst-case scenario. Therefore, apart from a crisis-driven market behaviour that has tended to test potential economic policy responses to extreme scenarios, the questions about the lender of last resort function may have been an additional factor feeding speculation on the public securities markets of peripheral countries. The exposure of the public securities markets of member countries to speculative attacks is certainly considered a serious systemic risk. Temporary liquidity problem could escalate into a solvency crisis as sustainability indicators decline, due to the prevailing interest rates and poor economic performance.

ECONOMIC POLICY RESPONSES

The euro area was caught unprepared for the spread of the European sovereign debt crisis. Since the monetary union, based on fiscal self-control, lacked institutions for crisis management, the necessary measures could not be adopted before the conclusion of a negotiation procedure between the member states. By nature, this decision-making mechanism is significantly slower than that of the United States, for example, where the federal government and the Fed were fully empowered to adopt decisions on emergency measures, including immediate liquidity injections financed by the central budget. The delay in the adoption of crisis management measures, public discussion on contrary opinions and interests and the uncertainty surrounding the ultimate decision contributed substantially to the escalation and the spread of the crisis to several countries within the region.

The institutional reforms carried out during the crisis fall into two categories. The first group includes measures designed to prevent the emergence of potential crisis situations in the future, while the second group includes the institutions of crisis management. Since the measures in the second category also involve direct financial transfers and commitments to future liabilities, progress in that field has been slower. A future risk-sharing framework is still work in progress.

Preventive measures

To prevent the emergence of potential crises in the future, the institutions to enforce fiscal discipline have been reinforced in various phases and through several legislative packages (six-pack, two-pack and the Fiscal Compact). The extent of the adjustment expected of the member states in order to eliminate the excessive deficit and excessive debt procedure has thus been more accurately defined. Failure to adjust leads to financial sanctions. Moreover, the changing of the rules of procedure has made it substantially more difficult for member countries to sabotage the enforcement of the rules of fiscal discipline through political compromises.

Since the lack of budgetary discipline was not the sole or the primary factor contributing to the emergence of the current crisis, a new institution, the excessive imbalance procedure was developed to monitor the emergence of macroeconomic imbalances and to coordinate economic policy responses. It allows the Commission to continuously monitor the balance and indebtedness indicators of the member states and, if it concludes that financial imbalances are accumulating, it will put forth suggestions for the required financial adjustment. The European Semester establishes the institutional framework that enables the Commission to express, at an early stage of the budgetary process, its opinion on the structural and stabilisation measures, and economic policymaking. Finally, new European bodies have also been set up with a view to monitoring the lending trends that play a crucial role in the emergence of financial imbalances. The tasks of the European Banking Authority (EBA) include the coordination of surveillance activities, the assessment of the processes of the banking system from a microprudential point of view and the formulation of recommendations, while the European Systemic Risk Board (ESRB) was given the task of carrying out macroprudential analyses. At the outset of the crisis, however, these institutions did not exist and even if they had existed, they would not necessarily have had an opportunity to exert a significant influence on the situation as these new bodies hardly have any actual power to adopt decisions. The opportunity to intervene in and the responsibility of managing the problems of the banking system have been left at the national level.

Crisis management measures to control the debt crisis

The debt crisis can be brought under control if, as a result of the appearance of a lender of last resort of sufficiently high fire-power, market participants attribute very low probability to the occurrence of sovereign default, which would result in the inability of the state to finance its maturing government bonds. At the outbreak of the crisis, however, the function of the lender of last resort to the state had not been institutionalised within the euro area.

[7] In both countries, monetary financing is banned by the Maastricht Treaty.

Moreover, the no bail-out clause and the prohibition of monetary financing also prevented the emergence of a possible solution. The most severe obstacles, however, were of a political nature. Since, at the time of the establishment of the European Union, such an eventuality was not included among the rules of the game, taxpayers within the EU are very unwilling to grant financial support to other countries. While political support for smaller transfers was obtained, it became increasingly difficult with the escalation of the crisis, as the possible grand total became increasingly difficult to assess.

The establishment of the European System of Financial Supervision (EFSF) was the first in a series of emergency measures. Under the EFSF, rather than EU member states providing direct lending, they contributed to the establishment of a crisis management fund to provide financial assistance to member states facing liquidity problems subject to strict macroeconomic conditions. Later on, in an attempt to set up a permanent institution, member states decided to establish the European Stability Mechanism (ESM), which is capable of involving money market funds to finance consolidation programmes under the guarantees granted by the member states. In 2010, the ECB also announced its Securities Market Programme (SMP), under which it purchased government bonds at the value of €217 billion. The interventions by the ECB were designed to restore the proper transmission of monetary policy, i.e. to enable low interest rates on the public securities markets of troubled member states. Since, however, the volume of the intervention was not significant, it was unable to achieve a substantial reduction of risk premia. Later on, at the turn of 2011 and 2012, the ECB also employed indirect means to help restore the public securities markets of peripheral countries. Under the LTRO (Long Term Refinancing Operation) programme, it made available multi-annual credit lines to banks. These were primarily used by commercial banks in troubled countries partly for purchasing public securities issued by their respective countries.

Despite the measures adopted in order to manage the crisis, these interventions lacked sufficient fire-power to prevent the spread of the crisis. On the contrary, the escalation of the crisis was accompanied by market hysteria concerning the potential sufficiency of the available funds. These solutions also failed to address the problem arising from the joint assessment of the position of banks and governments. In fact, it is possible that the LTRO, despite providing effective relief to the liquidity crisis in the banking sector, made the problem of related risks even worse. A number of suggestions have been put forward on the possible means to increase the magnitude of Community-level interventions on the public security markets in addition to the commitments of the member states through contributing to the EFSF and the initial capital of the ESM. None of these suggestions have, however, been given the required political support as both the simple and the complex schemes were implicitly based on the sharing of costs on a Community level. The fact that it was apparent which countries would be the payers and the beneficiaries in the short term was not the only obstacle that prevented the broad political support of these schemes. Another factor playing an important role in the protracted negotiations has been that such a risk-sharing mechanism goes far beyond the framework of cooperation envisaged by the Maastricht Treaty.

A breakthrough in the suppression of market speculations concerning the appearance of a lender of last resort was achieved in summer 2012. On the one hand, the legal concerns about the operation of the ESM were resolved and even the contributions by the member states were increased. Yet, even more importantly, the ECB announced its OMT (Outright Monetary Transaction) programme. Under the latter, the ECB is willing to purchase an unlimited amount of public securities issued by countries under an ESM programme, provided that these countries meet the criteria set by the programme. While only verbal intervention has occurred so far , the possibility of unlimited intervention resulted in a significant decline in returns on the public securities markets of the countries concerned, despite the fact that participation in the programme has been subject to stricter conditions than was first thought by the markets. Unfortunately, this has not brought an end to the debt crisis. It remains to be seen whether the countries in need of financial assistance will be able (and willing) to push through the required strict fiscal consolidation programmes under the deteriorating economic conditions and increasing social tensions or whether they will arrive at a point where leaving the monetary union has smaller costs.

Separating the risks of banks and governments

A crucial aspect in the escalation of the crisis was that the risks of banks and sovereigns have been linked and have mutually reinforced each other, due to banks operating on a multinational basis, whilst the bank bail-out functions have been delegated to the level of the member states. Prior to the crisis, no institutional solution had been established for bank surveillance beyond the member state level or for the sharing, between the countries concerned, of the costs of the management of the banking crisis. If, as a consequence of the crisis, the banking system to be established in the future requires an accord between the activities of banks and the magnitude of crisis management capacities, there are two possible alternatives for the development of the euro area. Either banks must return to the confines of the individual member states or, if the benefits of the increased efficiency of a single monetary market are to be preserved, the institutions of Community-level bank bail-out instruments and Community-level deposit insurance must be established. As a condition precedent for the increased sharing of the inherent risks of the banking system, however, both prevention and bank surveillance must also be raised to the Community level in order to eliminate the problem of free riders. That new institutional setup has been outlined by the proposal for a banking union.

The banking union would be based on four pillars. The first pillar is the common regulatory framework, i.e. the "single rulebook" of prudential rules. Supervision and prevention would be transferred to a central surveillance body headed by the ECB. While essentially functioning as a microprudential authority, according to the current ideas it would also have macroprudential powers. On the longer run, the safe operation of a collectively supervised banking system could potentially be supported by a joint bail-out fund, which would be established mainly with contributions of the banking sector, but which would, ultimately, have access to the financial instruments of the ESM. On the other hand, potential sharing of the current costs of the consolidation of banks has no political support. Finally, there have been negotiations on the potential establishment of a deposit insurance fund, to be financed by the contributions of banks. Such an institution, however, would also be unable to exert effective influence on the behaviour of the depositors, unless it is backed by Community-level funding. For the time being, greater progress has been achieved as far as the establishment of common surveillance is concerned, while no political consensus has yet been outlined in terms of the framework of the common sharing of risks.

Quo vadis, Eurozone?

The crisis has demonstrated that the concept of a "monetary union without a fiscal union" which serves as the institutional basis of the euro area is ineffective in dealing with situations that endanger financial stability and, therefore, a crisis management framework at the level of the monetary union is required. As a condition precedent for sharing financial stability risks, however, joint institutions must also be established to prevent the accumulation of risk. This situation requires various aspects of the treaty between the member states to be reconsidered. Various functions currently within the competence of the individual member states should be centralised and a substantial risk-sharing should be established between the European countries. That would represent a different quality of the framework of cooperation, which can only be achieved through a reinforced political mandate rather than a series of minor technical steps of institutional reform. Since the summer of 2012, various European leaders have disclosed their ideas concerning the future of the euro area, all of which were based on the establishment of a restricted fiscal federation legitimated by a political union. While due to political reasons these ideas are very unlikely to be achieved in the short term, the vision of the future of the euro area may play an important role by encouraging the union to choose solutions pointing toward a deepening integration during the management of the crisis.