György Szapáry:

The Great Financial Crisis revealed the weaknesses of the Maastricht-community

The Great Financial Crisis brought to the fore problems of the Maastricht-community which are still besetting the euro area. To trace the origin of the problems one must go back to the creation of the common currency. Prior to adopting the euro, inflation and interest rates were significantly higher in Ireland and the Mediterranean countries (PIIGS) than in the other countries which entered the monetary union. As the PIIGS were preparing to join the monetary union, their interest rates dropped to the level required by the Maastricht criteria, which stipulates that the 10-year interest rate cannot exceed by more than 2 percentage points the average of such rates in the three countries of the Europeans Union with the lowest inflation rate. That drop in interest rates triggered a boom in credit expansion mostly to households, partly financed by capital inflows from other euro area members. Inflation and wages rose in the PIIGS and, since adjusting the exchange rate was not an option in a monetary union, competitiveness weakened in those countries and with imports boosted by the rapid credit growth, large current account deficits emerged. For a long time, the view prevailed that in a monetary union the possibility of a balance of payments crisis is all but ruled out. Markets espoused that view and interest rate spreads were practically non-existent within the monetary union prior to the crisis. Nor was there enough attention paid to the looming dangers of the accumulation of non-performing loans in the banking system. In the environment of the pre-crisis booming economy, prudence was somehow lost.

Following the collapse of Lehman Brothers in the United States in September 2008, panic spread, capital started to flee from eurozone countries with large current account deficits and the interest rate spreads skyrocketed in the PIIGS. Suddenly these countries could not finance their balance of payments deficits from the market and had to turn to the IMF and the EU for help. Simultaneously, both in the US and Europe, major financial institutions were confronted with large amounts of non-performing loans in their portfolio. Governments had to bail out many banks which lead to sharp increases in fiscal deficits and government debt. A general trend of deleveraging ensued: banks reduced credit to lower the loan to deposit ratios, governments lowered their budget deficits to limit the rise in debt and household consumption shrunk because of high unemployment. A general mood of uncertainty took hold in the eurozone dampening investment and holding back growth.

In the aftermath of the crisis, the EU took many reform steps. One of the most important was the establishment of the European Stability Mechanism which provided financial support for countries with payment difficulties. Other steps include the strengthening of bank supervision and the launching of the Banking Union. To complete the latter, a unified deposit insurance scheme and a common resolution fund would need to be created. Another weakness of the monetary union is that there does not exist a common budget large enough to use countercyclical fiscal policy for the eurozone as a whole. With the level of public debt significantly higher in many euro area countries than before the crisis, the fiscal space to stimulate growth has been limited, even the fiscal stabilizers have not been allowed to perform their anticyclical role in a number of countries.

The legacy of the crisis is heavy: higher public debt, rising income and wealth inequality and low investment that holds back technology change. The higher financial integration within the euro area did not bring about better cross-country risk sharing and greater ability to deal with asymmetric shocks. The euro area has been running a surplus of between 2% and 3% of GDP over the last six years, but this saving is invested outside of the monetary union while the union is lagging growth and unemployment is still high in several member countries. The debate is between countries pushing for risk sharing and those advocating risk reduction. Without a greater degree of risk sharing, the eurozone is set to encounter crises.