Monetary and banking challenges in the euro area: Towards a resolution?

Dinner address by Athanasios Orphanides at the Swiss National Bank research conference on *Policy Challenges and Developments in Monetary Economics*

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It is an honor to be invited to address this year's SNB research conference on policy challenges and developments in monetary economics. I am thankful to the organizers for this privilege and to the Chairman of the Swiss National Bank, Thomas Jordan, for his kind introduction. Over the past five years the crisis has pushed monetary policy into unconventional territory in many economies around the world, presenting numerous novel challenges and inspiring exciting new research in monetary economics, such as the work presented at this conference. My focus this evening will be on a particular challenge we currently observe in Europe, in a sense in all the countries around Switzerland. As the epicenter of the global crisis we have been experiencing since 2007 has moved into the euro area almost three years ago, and the euro area is caught in a storm, Switzerland has become a refuge of monetary stability in the region.

In the euro area we observe a unique period in monetary history, with uncommon new challenges. We experience the growing pains of a monetary union in its teenage years faced with an existential crisis. But this is not an ordinary monetary union. The euro area is key for deepening economic and political ties in the European Union. Over the past several months, the euro area has gone through episodes that have raised the prospect of its disintegration, with global contagion implications. How this crisis is resolved has potentially immense implications for the global monetary system.

The crisis did not start in Europe. The beginnings can be traced to the United States in the summer of 2007. The global recession and financial crisis that followed the collapse of Lehman in September 2008 and engulfed virtually all developed economies also proved painful to Europe. In the euro area, however, the recession and banking crisis also brought to plain light weaknesses relating to the institutional framework of the euro. This is what has been behind the phase in the crisis that we are experiencing today.

What has gone wrong? The euro area is an economic and monetary union that is unique on many respects. The ECB and more broadly the eurosystem enforce a single monetary policy and provide a lender of last resort in the common currency to the banking system for the union as a whole. But this is not sufficient for a monetary union to function properly. At least some minimal policy coordination and control is also needed on fiscal policy. And in light of the economic integration of the economies of the member states, the protection of the integrated financial sector is essential to avoid contagion. One way to achieve these objectives would be with a complete political union. However, this solution was ruled out in the creation of the European Union. Rather, the idea for the European Union was to form a single economy, an integrated financial system, in the euro area a single currency and single monetary policy, but still leave sovereign states handle their own fiscal affairs and retain all risks with fiscal implications, including the protection of the financial system in each member state.

On the fiscal side, it was attempted to achieve the necessary minimal coordination by requiring member states to respect strict limits on their debts and deficits. This was the objective of the Stability and Growth Pact. Tight control of fiscal policy in each individual member state was meant to ensure that individual member states would not face fiscal imbalances. Further, no crisis management mechanism was set up at the beginning. One interpretation is that the strict fiscal rules and the absence of any crisis management mechanism would be sufficient to avoid any country getting into trouble while the creation of a crisis management mechanism would generate moral hazard.

The global recession and financial crisis revealed flaws in this arrangement. The fiscal framework was lacking and could not be enforced. The rules were not respected, and some states, Greece being the prime example, violated the rules to such an extent that debt sustainability questions were raised following the recession of 2009. But another flaw that was uncovered as a result of the global banking crisis was that the financial integration framework was fragile. In an effort to promote the common market, EU directives and regulations promoted a single unified banking sector before the crisis. Banks based in one member state could easily operate everywhere in the Union, take deposits, take risks in lending. But supervision, deposit protection, resolution, all remained nationally based. The crisis showed that this nationally-based banking system embedded in a monetary union was internally inconsistent and prone to instability. More that anything else, over the two years this element has been at the center of the negative feedback loop between sovereigns, banks and real economies in euro area member states. The resulting adverse dynamics have been a source of trouble in the euro area in particular because the lender of last resort to the banking system is the ECB while no similar euro area resolution authority exists.

The mismatch in authority relating to banking created and continues to create severe problems. In the case of Ireland, the banking crisis in late 2008 created large demands for the resolution and restructuring of the banking system. Although the cost of a collapse would have created severe contagion for the euro area as a whole, Ireland alone was called to incur all of the cost of cleaning up. Despite having a very good fiscal position before the crisis, Ireland was essentially forced to take up the implicit liabilities associated with supporting its banking sector that generated concerns about the sustainability of its debt going forward. By saving the banks, Ireland internalized the broader damage that their collapse would have spread to the banking system throughout Europe, but had to incur the cost on its own.

The institutional framework of the euro area was incomplete and did not have a crisis response mechanism in place to handle such developments. Bold political leadership was necessary to control the problem effectively. Unfortunately, the political response not only proved inadequate but it made the problem worse.

To understand the inadequacy of the policy response recall how small the initial shocks were for the euro area a whole in both cases mentioned above, Greece and Ireland. The problem was that the shocks were very large for the country involved in isolation. In terms of GDP, Greece and Ireland each account for only about 2 percent of the euro area. For the euro area as a whole, the shock uncovered in Greece due to fiscal imbalances and the shock to Ireland due to the banking collapse could be easily contained if euro area governments were willing to tackle them collectively.

A European solution from the very beginning would have avoided the consequences we experienced over the past two years. But to do this properly would have required some degree of mutual help that was not envisioned in the original construction. Concern about the moral hazard such a solution could have created for the future made this unpalatable. In the event, the policy response by European governments magnified the cost instead of resolving the problem. In the process, trust among governments of the member states and their people has been lost, perhaps one of the more damaging casualties for the European project.

In the face of the crisis, European leaders decided to provide loans to countries faced with shocks that brought their debt dynamics into question. But they also decided to magnify the credit risk in sovereign paper as a means to avoid the future moral hazard, with catastrophic consequences.

The most critical error was committed nearly two years ago. In October 2010, following first a meeting in Deauville between the leaders of France and Germany and then confirmed in a European Union Summit in Brussels, governments decided to introduce the concept of private sector involvement (PSI) in euro area debt. An investor buying euro area sovereign debt should no longer assume the debt would be repaid in full. Rather, any investor would have to worry that if the country faced the prospect of high debt and needed a loan during an adjustment period, then a haircut on the debt should be expected, even if there was no issue regarding the sustainability of the debt.

The error was compounded in 2011 with the selective haircut on Greek debt following European Summit decisions on July 21 and October 26. By creating the precedent that a member of the euro area would be forced to impose a selective haircut on the private holders of its debt reinforced to investors how the PSI concept could be applied in any other member of the euro area. The damage resulting from these decisions on euro area sovereign markets was extensive.

Introducing in this manner the prospect of default in euro area sovereign markets was bad enough but the situation got even worse. The treatment of Greece, particularly in light of adjustment program that was seen as too harsh, raised questions about the prospect that Greece perhaps should leave the euro. This made things worse for a number of other member states as it introduced the idea that perhaps entry into the euro area is not irreversible, as it was meant to be. Bringing the irreversibility of joining the euro area into question added convertibility risk into the mix. The mishandling of the crisis introduced currency risk on top of sovereign risk in the equation. Since the proposition of leaving the euro is to allow for a devaluation, thereby easing immediate pressures of economic adjustments, this possibility created destabilizing incentives for private depositors to maintain deposits in accounts in euro in member states under pressure. Left unchecked, these destabilizing dynamics can become self-fulfilling. This instability will threaten the existence of the euro area as long as doubts regarding the irreversibility of the euro persist.

To understand the extend of this risk, one only has to compare the evolution of the financing costs for Germany and France, the two largest economies in the euro area, to those of Italy and Spain, the next two largest. Over the past few months the financing costs for the governments of Italy and Spain were at times several percentage points higher than those in Germany and France. On some occasions, the difference was so dramatic that it appeared unsustainable, had it continued. Most recently, ECB announcements have compressed these spreads somewhat, but substantial differences remain.

A problem with the existing setup is that it may generate unstable dynamics for the banking system in a member state perceived to be weak and these perceptions may be self-fulfilling. As a thought experiment, suppose someone were concerned that a further deterioration of the recession might cause additional pressure in a member state perceived to be weak. Under the existing setup, if banks in this state required future temporary support from the government as a result of the additional deterioration, this support would be the responsibility of the government already facing pressure. Private depositors could become concerned that with some small probability the member state in question might be engulfed in a debate about whether it should leave the euro in the future. This, in turn, would generate an incentive to shift some deposits to banks in other member states that are perceived to be stronger.

This thought experiment illustrates how the destabilizing dynamic that has shifted demand for sovereign debt from the states perceived to be weak to those perceived to be stronger inside the euro area is also creating incentives for deposits to flee from the states perceived to be weak. To resolve this instability requires fundamental changes in the institutional framework of the euro area. Bold political action by euro area governments is needed. Ideas under discussion offer the prospects for a lasting solution. But not all solutions are equal. From an institutional design perspective, some may be superior to others for the long-run. Let me briefly mention some of the pertinent considerations for two possible paths.

One path is to move towards a more complete political and fiscal union and find ways to reverse some of the divergence in spreads in the cost of financing of different governments. In this regard, some ideas essentially involve some form of mutualization of risks associated with government borrowing by the member states. Different variants of mutualization are suggested: Some are direct, involving the creation of eurobonds that allow governments to use the credibility of other governments to reduce their financing costs. Others are indirect, for example the ideas that involve the ECB engaging in potentially unlimited and unconditional purchases of the debt of the member states that need support. Surely, if these ideas were pursued, the immediate pressures on the weakest sovereign markets would be relieved. But the drawbacks for the long run can be immense. Without a mechanism to control future spending by sovereign governments, these solutions could create more severe tensions in the long run. Without a stronger political union that limits significantly the sovereignty of state governments to control their future spending decisions, solutions of the crisis that involve mutualization of risks associated with the issuance of sovereign debt would be detrimental to the European project over the long run.

Another path is to continue to exclude mutual support on the governments but limit the damage and contagion arising when a sovereign is under stress. To achieve this, it is essential to move towards a more integrated financial sector in the euro area, a banking union. A key objective would be to break the loop between sovereigns and banks in states perceived to be weak. The rationale can be supported by recalling that the euro area is not simply a monetary union, it is meant to be a single, integrated market with a common currency. In such a common market, a bank based in a member state and its customers must not be penalized simply because the bank's head office happens to be in a state perceived to be weak. All businesses and households should face the same responsibilities and same opportunities in banking, regardless of their location within the euro area. In the euro area, this does not hold at the moment. Over the past two years, the banking industry has become segmented along national lines and heterogeneity has increased dramatically, threatening the functioning of the currency union and the common market. To reverse this dynamic, a truly European solution is necessary for bank stability, resolution and deposit insurance.

Frameworks in other federations could serve as examples. The United States and Switzerland are examples of federal states where federal institutions are responsible for banking, delinking the finances of a particular state from the real economy.

The need for further integration along these lines has been recognized by European authorities and some progress made. This week, on Wednesday, the European Commission proposed a new framework for a single supervisory mechanism (SSM) for banks in the euro area. The proposal, under discussion in today's informal ecofin meeting among EU finance ministers and central bankers, would give new supervisory powers to the ECB aiming to unify bank supervision.

This proposal represents considerable progress compared to current arrangements. However, an important element, perhaps the most crucial for containing the crisis at this juncture, is missing from the proposal advanced by the European Commission on Wednesday. The issue is the risk depositors may believe they face by maintaining deposits in a bank in a member state if that member state faces fiscal problems and the incentives this perception creates for a deposit flight. Even if unfounded, perceptions of such a risk can be self-fulfilling. To resolve this problem, we need a federal institution offering deposit insurance to all depositors in the single currency. Without such federal deposit insurance, the destabilising dynamic between banks and states remains.

Consider the example of the United States. The FDIC, a federal institution guarantees bank deposits in all states and thus a depositor need not worry about the safety of his/her deposits depending on the finances of the state where his/her bank is headquartered. In the United States, fiscal problems in a particular state do not threaten the banking sector and the real economy, as they do in the euro area. The euro area needs an institution similar to the FDIC. The same institution that is responsible for insuring depositors, working together with the ECB in its new supervisory authority, should also have broad early intervention and resolution authority for the euro area as a whole. It is essential to deepen the common market by pool together the management of the banking sector in the euro area.

The banking industry should bear the costs of this insurance, separated from the finances of the member states. This could be done by imposing the appropriate deposit insurance premium on deposits across the euro area. An FDIC-type authority with taxing power on deposits in the euro area as a whole would be able to finance bank resolution, and do so efficiently working together with the ECB in its new supervisory authority.

Moving towards a banking union, as just described, would largely insulate the real economy in a member state from pressures facing the sovereign and minimize the risk posed by the possibility of a default by a member state. Although progress can be reported in this direction, the pace so far has been disappointing. The question is whether euro area governments have the political will to make the necessary progress. The absence of a solid proposal to create a European agency for deposit insurance is not encouraging.

With its bold actions in recent months, the ECB has bought some more time for governments. But the central bank with its monetary policy operations cannot solve on a permanent basis what is fundamentally a political problem. European governments cannot assume that muddling through is sustainable for too long. Last week, the ECB once again took bold action providing relief to the system by introducing Outright Monetary Transactions (OMT). This program envisions secondary market purchases of sovereign bonds of selected member state. Doing so can certainly alleviate the immediate funding pressure that is faced by some member states. Already, the announcement of the program has been hailed as contributing to stability, even before any purchases took place. It is essential to recognize, nonetheless, that the OMT cannot on its own provide the basis for lasting stability.

Concerns have already been expressed regarding outright purchases of the government debt of selected states. Even though the objective of purchases of debt of selected member states may be to ensure the proper functioning of the single monetary policy in the euro area, an appropriate goal for the ECB, such purchases, by necessity, also provide temporary monetary financing support to those member states.

This may be an unavoidable temporary side effect, but it cannot persist indefinitely. To be sure, the risk, under the circumstances, is not the classical risk of monetary financing for the euro area as a whole and should not be confused with such a risk. Classical monetary financing would be the attempt to finance euro area public expenditures as a whole through inflation. This is not the case. When looked at from the perspective of the euro area as a whole, the ECB is taking care to stay true to its mandate of pursuing and defending price stability in the euro area as a whole. That said, outright purchases of debt of selected member states could be seen as supporting the reduction of financing costs of some member states at the possible expense of an increase of financing costs of other member states. This has direct distributional effects on public finances among member states that the ECB is ill suited to undertake. The political legitimacy for such decisions should be with euro area governments and euro area political institutions alone. It is the governments themselves that should control the extent to which fiscal resources are transferred to a state under pressure and the extent to which mutual insurance on the cost of financing is engineered. The ECB, as the central bank of the euro area could facilitate the implementation of these political decisions, within its mandate.

The ECB decision to requite conditionality with direct involvement of governments, as a necessary condition for activating its OMT program mitigates these concerns. It is important that, as the ECB announced, activation of the OMT requires that a member state meet the conditions for the possibility of EFSF/ESM primary market purchases of its debt. Since EFSF/ESM primary market purchases must be agreed by the governments, the OMT program could be seen as complementing the implementation of financing help agreed by the governments.

This conditionality is critical for the ECB to avoid the risk that its actions be misinterpreted as shifting relative fiscal resources from some member states to others. The ECB has stated that the aim of OMT is to safeguard an appropriate monetary policy transmission and the singleness of the monetary policy in the euro area. The risk of misinterpretation cannot be mitigated completely, however. If the OMT program is activated for selected member states for a long time, it could become a vehicle for permanent relative support for the financing of some member states. To avoid this risk completely, the ESM should eventually undertake all purchases of state debt, and the ECB should return to the traditional role of providing the liquidity that may be necessary to implement ESM decisions, within its mandate.

To conclude, we live through historic moments in monetary history. In the euro area, we experience unique monetary and banking challenges. The crisis has expanded our horizons for the instruments of central banks and more broadly for their role in maintaining stability. For the euro area, my hope and wish is that the transition from its teenage years into adulthood will be less turbulent than has been so far.