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The Euro Crisis: What We Should Learn

HIGHLIGHTS

● The European Monetary Union places numerous controls on governments, and it was hoped that this would function to prevent a crisis. However, there is no "fire brigade," i.e., a mechanism which would enable the euro member countries to act when a crisis actually occurs.

● The problem in southern Europe is that there is an extremely high level of correlation between banking stress indicators and sovereign stress indicators. Banks in southern Europe have an enormous home bias, and have invested heavily in securities issued by their own sovereigns. This forms a negative feedback loop. The banking union will make it possible to break this cycle.

● The EU seeks to ensure balance-of-payments that are close to balance everywhere in the euro area. For this purpose, governments could agree to use industrial policy tools in order to rebuild the trade goods sector. This would be a solution that might be politically palatable but would be economically less efficient, and which would provoke the question of the wisdom of maintaining the monetary union.

1. WHAT HAVE WE LEARNED FROME THE CRISIS IN EUROPE?

(1) THE PROBLEM OF ASYMMETRY

ITOH: Today I would like to ask you for your expert opinions concerning the reasons behind the numerous events which have taken place in Europe, and the current status of the crisis in Europe. I would also like to know what you see as the remedies for the situation, or the policy directions to be taken.

Let us start with the question of the main reasons for the crisis in Europe. Some economists focus on the problems of the unification of currencies, or the lack of adjustability of exchange rates, while other commentators focus on the mismanagement of public finance systems.

Taking up the problem of the unification of currencies, we know that there was some kind of convergence between countries following the European monetary integration. But commentators in the US and Japan pointed out that fixing the exchange rate in itself produced a source of divergence.

PISANI-FERRY: There was a famous debate at the time of the establishment of the euro between Jeffrey Frankel and Andrew Rose on one side and Paul Krugman on the other. Krugman argued that currency unification would ultimately increase, rather than ease, specialization and asymmetry. I think that Krugman was proved right in this debate; differences in the intra-euro area were accentuated, real exchange rate misalignments were aggravated, the trade goods sector shrank in the south and grew in the north, current account imbalances widened, and net foreign

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asset positions were reinforced.

We have to recognize that there was significant asymmetry in the euro area between specific countries, for example between Germany and Spain, in terms of initial conditions and systems. This asymmetry was diminished by convergence under the fixed exchange rate system, but this reduction of asymmetries was shallow, and behind it we still had structural differences that were underestimated.

And those initial conditions created many problems. You have to remember that in l998, the year before the euro was established, Germany had a huge current account deficit and embarked on a program of cost reduction, wage compression, and so on. At the same time, the southern European countries benefited from a drop in long-term interest rates because of the fast convergence to the euro, and that triggered a domestic demand boom. Even with the restrictive fiscal policy which was implemented by Spain, for example, it generated booming private demand. So this asymmetry was there from the very beginning.

There were also some systemic deficiencies. If you read the Maastricht Treaty, it basically states that every problem that can be thought of comes from the government side; there is a tremendous faith in market rationality, an assumption that we could maintain a stable common currency based solely on budgetary discipline. That is, it assumes that if member countries control the sources of stability from the government side, the system will be stable. Therefore the potential for instability to be created by the private side was massively underestimated. And so we had massive capital inflow to southern Europe. Now, we have a sudden cessation of capital flow, and no private capital is flowing into Southern Europe.

WOLFF: I might talk a little bit more about the systemic side. Before the euro was founded, there was a lot of skepticism regarding the idea that the monetary union could function without fiscal and political union, but once the euro was there, this opinion was no longer heard so much. People were essentially saying that if we maintained the fiscal discipline of the Stability and Growth Pact, we would have a stable system. What this view misses is what we might call a 'fire brigade' aspect in the crisis. We have a system in which there are numerous controls on governments, and we hope that this will prevent a fire, but we do not have any mechanism in place to enable us to act when there is a fire. We need someone to act and make decisions in a crisis, to close down banks, to recapitalize banks, to bail out governments and the like. Although there were serious discussions on how far we should go before the establishment of the monetary union, a political decision was made not to do any more than just establish the monetary union.

(2) Difficulty in Adjustment by Means of Wage-Price Mechanism

ITOH: You have already mentioned a number of important issues. When there are differences in productivity growth between two countries, theoretically there must be some kind of adjustment of the exchange rate to adjust wages. But this doesn't happen under a fixed exchange rate system.

PISANI-FERRY: We knew the adjustment mechanism was a weak point in the euro system. A very few state governments in the euro area put systems in place to monitor competitiveness and to find ways to increase the flexibility of wages and prices to ensure that the asymmetries among countries would not continue to build up. The Finnish government engaged in some consideration on the issue, but nothing was done in most countries. There was an implicit belief that if you could control your fiscal deficit, the rest would be OK. This belief made wages, prices, credit all massively underestimated.

ITOH: Do you think that after the European countries overcome the present urgent problems, you will be able to find a way in which even countries like Greece and Spain can adjust for structural changes without using exchange rate adjustment?

WOLFF: If we look at what has been happening in the last couple of years, we have had severe recessions in a number of countries. What we saw was that depending on the way the respective labor market functions, this has led to a decrease in wages.

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However, the decrease is only the start of a wage adjustment process.

ITOH: I think there are two types of economic thinking; one type believes in the functioning of the market, that eventually the price mechanism will function effectively and adjustment will occur. The other may be a resurgence of the Keynesian type of idea, for example with George Akerlof and Robert Shiller. I think an increasing number of people have this type of idea and are more pessimistic about the wage-price mechanism.

PISANI-FERRY: I am not of the flexible price school. The reality is that there is more wage flexibility and less price flexibility than many people would have thought. There is more wage adjustment, largely due to government policies, for example reducing the minimum wage. There have been a lot of troubles with labor market reforms, but they are showing results, and they are delivering. On the price front, however, that is not the case at this stage.

WOLFF: Under globalization, you need to have lower export prices in order to regain your external competitiveness, but the low degree of competition within Europe due to our protective competition policy makes adequate price changes difficult. The link between wages and prices is not fully re-established.

Then there is also the aspect of capital costs. In southern Europe in particular, the financing of capital has become more expensive. If wages are adjusted but capital becomes more expensive, then it might be more difficult to make overall prices adjust downward.

ITOH: This reminds me of discussion concerning the so-called optimal inflation rate. When the inflation rate is around zero, it becomes very difficult to make adjustment towards the down side. When you have an inflation rate at a certain level, you can have much more flexible adjustment amongst sectors.

PISANI-FERRY: We also have a problem with deflation. Those countries in southern Europe basically have two significant problems at the same time, a problem with competitiveness and the exchange rate, and they now have an additional problem with indebtedness; public indebtedness and private indebtedness. So there is a contradiction between these two problems. The more you deflate to restore competitiveness, the more you worsen your debt dynamics.

(3) Instability of Intra-Regional Capital Flows

PISANI-FERRY: As has already been mentioned, we used to have massive capital inflow to southern Europe, and now we have a sudden, complete stop of capital flow, and are facing massive capital outflow. Previously, the risk was massively underestimated, and now there is a risk of total risk aversion.

This is a result of financial fragmentation in Europe. The banks in southern Europe have largely lost access to the interbank market. This resulted from the problem of the banks' exposure to sovereign debt. Essentially, the banks have been substituting non-risks, and so banks have bought more and more government paper. So we have created additional fragility.

ITOH: It must be a very difficult situation politically. When the banking sector has bad loans to the private sector, bankruptcy procedures can be initiated as a simple way to reshuffle assets and debts. When it comes to lending to the government sector, you cannot just initiate bankruptcy procedures.

PISANI-FERRY: Spanish banks were more protected by holdings of the sovereign bonds three years ago than they are now. Now with the effect of the crisis, Spanish domestic banks are more exposed in their holdings of Spanish government debt.

ITOH: So banking sector problems are becoming complicated.

PISANI-FERRY: The financial fragmentation in Europe caused a lack of intra-regional capital flows within the euro area and especially disturbed capital inflows into southern Europe. And it also affected private actors. For example, suppose that you run company Z in Europe, in country X, for example in Germany, and the same company in country Y, like in Italy. You don't get the same access to credit between X and Y, even though the companies themselves are the same, with the same customers and locating within Euro area, because each company was only funded by a domestic bank. One gets credit at a much higher interest rate than the other one.

2. WHAT ARE EFFECTIVE POLICY RESPONSES TO THE CRISIS?

(1) THE ROLE OF THE ECB

ITOH: Many people are worried that there would be huge contagion effect if a member county, such as Greece, withdrew from the euro. What is the most effective policy to stop this contagion? Do you think ECB can be a useful and effective institution to address the problem?

PISANI-FERRY: The ECB has said that solvency is not its business. Its business is to control a convertibility risk. In order to control it, the Bank mentioned about their bond-buying plan for the eurozone and is going to intervene on the short end of the yield curve by purchasing sovereign bonds with a maturity of up to three years in the secondary market.

ITOH: Olivier Blanchard, the chief economist for the IMF, stated that more intervention in individual markets like the CP market was needed when the interbank market got into trouble and disintegrated, becoming unable to provide a spreading effect to the entire market. If you apply a similar argument to Europe, more active intervention will be needed, not only in the macro monetary environment as a whole, but also on the level of individual countries.

PISANI-FERRY: The ECB is going to do it, but only with limits. There was a specific discussion on the ability of the ECB to act as a lender of last resort to the banking system, especially in view of its price stability focus and the absence of an explicit financial stability mandate. The worries expressed in the literature proved to be excessive. In 2007 the ECB did not hesitate long before providing wholesale liquidity to the banking system.

WOLFF: The central function of a central bank is to counter fear. Fear drives the entire economies of different countries into a bad equilibrium. You need institutions that have no fear, that intervene and address the fear in the financial market.

The ECB is currently the only institution that has the ability to fearlessly start acting on the problem. But the ECB also has a problem; it was not founded on the model that the institution becomes the lender of last resort for governments and addresses the factors inducing fear. The Bank's political backing is also not as strong as it would like. We need to achieve greater political consensus amongst the governments to make the ECB take these actions.

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(2) THE BANKING UNION: HOPES AND PROBLEMS

ITOH: Do you think the ECB is the only way for each individual government to produce results? Can you think of any other effective government policies to deal with the crisis?

PISANI-FERRY: We are now reaching the limits of the measures that have been put in place. Even if the market measures are viable, and also the things that have been done in the short term to address fear, we are close to the limit. That is the rationale behind the establishment of the 'banking union.' Governments are the only ones responsible for bailing out the banking system. And the banking system depends on the guarantee of sovereignty, and holds vast amounts of national bonds. The problem in southern Europe is that we have seen an extremely high level of correlation between banks' stress indicators and sovereigns' stress indicators. The banks in southern Europe invested extremely heavily in the securities issued by their own sovereigns. This is an enormous home bias. And so this is also a terrible feedback loop.

The banking union, basically, is the way to cut this link. You give the banking union the responsibility not only for supervision but also for resolution, deposit insurance and ultimately the provision of a fiscal backstop at the European level. So it is federalization of banking policy. The principle was agreed in June, but that was in very general terms.

The questions now are whether the governments are really going to implement the plan and how far they are prepared to go. The focus now is whether they are speaking of the first 25 banks – which will not solve the problem – or speaking of 6,000, banks in the EU area.

The other proposal is a mutual insurance model or mutualization of debt – Eurobonds. States could issue debts based on guarantees from other European Union countries.

ITOH: In Japan, we have a great deal of experience of bank loan problems, and it is not a simple matter. Merely controlling bank behavior is not sufficient. It is a very complicated situation even in one country, and involves a great deal of political maneuvering. It would surely be even more complex when more than one country is involved, and as such a very difficult thing to organize.

WOLFF: A report of the Advisory Scientific Committee under the European Systemic Risk Board said that they fear Europe is actually on the same route as Japan in 'the lost decade' due to the failure in terms of debt restructuring, not engaging with debt forbearance, and not acting quickly. There is a negative feedback loop. The only way to break this negative link is to have a strong and decisive resolution authority. And in Europe, we don't have a European resolution authority. With national resolution authorities, there are different incentives to impose some losses with some of their European partners. In the European context, it is very complex because we have so many different countries that have different interests in this matter.

3. What are the remaining challenges?

(1) Lack of an effective mechanism for adjusting intra-regional imbalance

ITOH: As we have already discussed, there was some kind of convergence or agglomeration mechanism in unified Europe because there are more economic activities in the prosperous area. And the 'peripheral' area lacked any kind of mechanism for growth because they didn't have any agglomeration of economic activities. If you had a flexible exchange rate system as an adjustment mechanism, devaluation of the currencies of peripheral countries would provide some source of economic stimulation. But when the exchange rates are unified as they are in the euro area, this type of system will not work.

In Japan, we have a very similar problem between the northern region and the center of the country. There is a very significant budgetary transfer mechanism from the center to the periphery. But given that it is a single country, the movement of people among the regions is more active than in the EU, and the adjustment mechanism can readily function.

PISANI-FERRY: Yes, the adjustment of imbalance by the movement of labor is not easy in Europe. Of course, people might move between countries because Germany has full employment and the southern European countries, like Spain, have a high level of unemployment. But we would need much more portability across highly diversified economies; there are issues of language, of the portability of pensions or of skills, and so forth. This raises the issue of creating a more federal system in Europe to ensure such portability.

Another mode of adjustment would be something we learned from the current balance-of-payments crisis in southern Europe. The Maastricht Treaty eliminated the possibility of providing balance-of-payments assistance to EU member countries, because it was thought that there would no longer be any concern regarding the balance-of- payments of any of the countries within the euro area. The member countries were thought of as regions within a country. And we now want to ensure balance-of-payments that are close to be balanced everywhere in the euro area, with as much employment as possible. Governments could agree to use industrial policy tools in order to rebuild the trade goods sector to ensure balanced balances-of- payments, but this must be a distortionary policy. The question is if it is compatible with the single market. It would be a solution that might be politically palatable but economically less efficient, and that would provoke the question of the wisdom of maintaining the monetary union. These discussions are not yet in the public domain.

(2) A fiscal adjustment mechanism and national interest

ITOH: Before the introduction of the euro, Germany had its own philosophy and strategy of macro- and micro-economic policies, and the other countries had difficulties in adjusting their economic policies to the fixed exchange rate. But the introduction of the monetary union required Germany to move away from its original position, from its own mode of monetary policy, toward a more European one. But nowadays there is still controversy regarding the German side, among people in the arena of monetary policy and people involved in the European Central Bank.

WOLFF: Even though the system was officially symmetrical across the whole of Europe, and the central banks and their network were supposed to mutually take care of the stabilization of the exchange rate, the Bundesbank was the *de facto* core and acted as some form of 'anchor' for the exchange rate system. But the Bundesbank seemed to disregard its *de facto* obligation to supervise the exchange rate with other central banks. The economic situation in Germany warranted a different kind of policy mix than the rest of Europe, and that may be one explanation why the Bundesbank took a different stance from the other central banks.

The situation now is difficult. The president of the Bundesbank has a national mandate, yet as a member of the governing council, he should act for the interests of the euro zone as a whole. He needs to strike a very delicate balance there, and the key for him is not to fall on one side of the mood amongst German voters.

ITOH: If you look at German politics from outside, Ms. Merkel, the German Chancellor, appears to be having more and more difficulty with regard to European policy because German voters seem to be opposed to increasing commitment to the European issues rather than focusing on the German issues.

PISANI-FERRY: There is no political representation of European interests in the system. The EU has a weak central government, and we have a parliament which has no power to raise taxes. Voters don't think that the members of the European Parliament have any legitimacy.

ITOH: Historically speaking, there have been repeated efforts to create a European budgetary system. Perhaps this crisis represents a major opportunity for a 'big push' towards that.

PISANI-FERRY: It would be very difficult to argue that. For the last fifteen years, each time there has been a treaty revision, the power of the parliament has increased. And they hoped that it would gain legitimacy. But each time we have given more power to the European Parliament, it has resulted in a reduced participation rate in the election. Political debates take place exclusively between the political factions in the parliament. Voters don't know anything about the political debates in the European Parliament.

ITOH: Without having that kind of overall fiscal scheme, is it still possible for you to have a fiscal adjustment mechanism to support the monetary union?

PISANI-FERRY: That is the debate we are currently having. There are basically two views: one is the federal model and the other view is a mutual insurance model. The logical implication of a mutual insurance model is to go for Eurobonds. Basically, you don't have common public goods, and you don't have spending items, but you are creating a network of arrangements across the participating countries by means of which national parliaments can cooperate and make common decisions. It is a horizontal structure without a center. It doesn't exist and there is no model for it, but in a way, that is the route we have taken.

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