EMU @ 15: Capital Flow Management in Europe – Back Full Circle Again?

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1 Managing capital flows – European views, evolving

Europe's monetary union – common currency – and capital controls do not go together well at all. On the contrary: They ring very much like a *contradictio in adjecto*. Indeed, one could make the case that EMU was ultimately an almost physical corollary of allowing for unfettered cross-border flows of capital within (and beyond) the euro area. But then, controlling cross-border capital flows was very much standard fare in Europe until the end of the 1980s. There were, to be sure, a number of EEC Member States that had taken down barriers earlier. This held especially true for Germany, Austria and the Netherlands. Also, quite obviously, liberalized financial markets had already been a desideratum in the Treaty of Rome 1957, but, importantly, only insofar as they were deemed necessary for a "well-functioning common market" (EEC Treaty, Art. 67).

Consequently, at the time, the EEC Treaty listed numerous reasons for managing intra-EEC financial flows. Short-term transactions, in particular, were judged to be too hot for comfort. They implied binding constraints on domestic credit and liquidity policy which were appreciated as an indispensable instrument of national policymaking. Only in the mid-1980s did perceptions change. Deeper financial integration became an objective (also against the backdrop of financial as well as technological innovations entailing that controls could only go so far.) In any case, ever since July 1990, Member States (some with a brief derogation period) were obliged to almost completely relinquish interfering with cross-border financial transactions.

At the time, it was also understood that the leeway for national monetary policy was, as a consequence, rapidly shrinking. In the asymmetrically functioning fixed-rate European Monetary System, autonomy in conducting monetary policy was a vain hope. Tommaso Padoa-Schioppa, one of EMU's main architects, made frequent reference to the unholy trinity. In this respect, "one (financial) market" spelled "one money" by virtue of the inconsistency triangle between fixed exchange rates, autonomous national monetary policy and liberalized intra-European flows of funds.

It is from this angle that the common currency to be launched a decade later could be understood as a *ruse de l'histoire.* Today, after some European sovereigns have experienced a "sudden stop" in the wake of the crisis, it is somehow ironic that in order to reestablish the conditions for a well-functioning common currency, cross-border financial markets have to be reestablished. And some of the means to do so – instruments of macroprudential policy – are closely akin to the cross-border management of capital flows.

Thus, the Great (or North Atlantic) Financial Crisis (GFC) with its European particularity of fragile sovereign debt in some places has brought the story back full circle. At times, Europe's monetary union resembled a badly functioning fixed-exchange rate system, with monetary conditions split along national lines. And ever since the GFC, most of the efforts of the ECB as well as of European regulators were directed at reinvigorating cross-regional finance in EMU, at repairing the monetary transmission mechanism. A substantially reduced level of cross-border flows as well as cross-border exposures translating into significant spreads between prices of sovereign bonds and their direct local derivatives (cost and availability of local credit) were seen as a problem, as an issue of public policy.

In these brief remarks, I will first sketch why unimpeded capital flows were understood as unequivocally beneficial in the European case. This evaluation was put into practice and almost mechanically (at least in a European understanding) led to the common currency. That is why, second, renationalization and the fragmentation of financial markets, a major consequence of the GFC, were deemed to be so detrimental. Reversing those trends – in effect, reversing or reorienting capital flows – became a major objective. In particular, ECB policies can be effectively understood along these lines. More specifically, the ECB's balance sheet – its structure as well as its size – pays testimony to this point. Third, two policy responses have been developed to engineer or control cross-border flows: (a) the Single Supervisory Mechanism (supra-nationalized enforcement of common regulatory rules) and (b) macroprudential tools that, in effect, regionalize monetary policy implementation. They bring back views on capital flow management with an eye on underwriting financial stability.

2 EMU: Capital flowing downhill, finally

Shortly after the introduction of the common currency, Olivier Blanchard and Francesco Giavazzi spelled out, in an important article, arguments as they flowed naturally from the canonical model: By necessity, Economic and Monetary Union entailed substantial current account deficits in the poorest economies. And those were good deficits that supported the catching-up or convergence process. As those flows were backed by investments that were evaluated as productive ex ante, "financial markets showed no signs of worry" (Blanchard and Giavazzi, 2002), at least not contemporaneously.

In fact, allowing for this reallocation of capital was a major purpose of Europe's financial and monetary redesign: Surplus funds should be deployed toward their most attractive opportunities. Hence, this suggested a decorrelation between national saving and investment ratios, i.e. an "unpuzzling" of the Feldstein-Horioka puzzle.

2.1 Precrisis consensus

Free trade in assets (which, of course, also means liabilities) was judged – as it was with tangible widgets – to be generally beneficial, implying that scarce resources were optimally allocateds (i.e. that capital flowed downhill). Concurrently, the unimpeded cross-border flow of goods required a commensurate amount of finance to grease the wheeling and dealing which pushed out the production possibility frontier.

Also, all the attendant financial benefits were uncontroversial: consumption could be smoothed over time. For example, nations with ageing populations might accumulate nest eggs (i.e. net foreign asset positions). Moreover, given potentially substantial income volatility, in particular in highly specialized regions, the current account could provide for a welcome insurance mechanism, helping to cushion region-specific shocks. Finally, open financial markets allowed for spreading (and reduction) of risks, and, in the same vein, for exposure to otherwise unavailable opportunities.

Admittedly, costs were also acknowledged. History had too often demonstrated that banking and exchange rate crises were very much a real possibility, also in advanced economies (Kindleberger, 1978). Such crises spelled considerable volatility (in quantities and prices). And, as they occurred, they left as a rule lasting scars that surfaced in large and protracted output gaps (Reinhart and Rogoff, 2009).

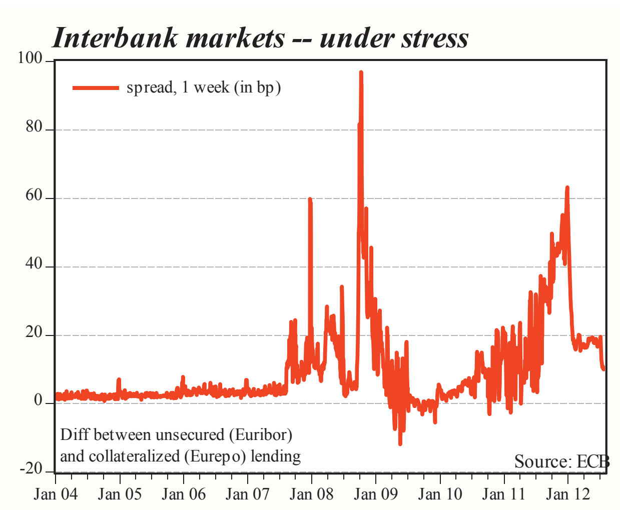
But, given that regulatory and supervisory environments in Europe were evaluated as robust, these were scenarios Europeans could safely disregard. Therefore, the consensus held that controlling capital flows was generally detrimental.

2.2 …shaken by events

Now, the financial crisis, lingering since the summer of 2007 and morphing into the GFC over the next 12 months, shook this belief at its core. Reality had shown that even in Europe, terrible things, both financial and economic, could happen.

Interbank money markets, which were most deeply integrated of all, showed increasing signs of fractures. Spreads between unsecured and collateralized interbank funds widened to unprecedented levels (see graph 1). It became standard to speak of dysfunctional markets. This widening of spreads mirrored (1) an increased counterparty risk as well as (2) fundamental uncertainty about (funding) liquidity needs of banks (access to funds in case of need). Two diagnoses were pondered: This is a case of (1) asymmetric information, or (2) a run of banks on themselves (in wholesale markets) (Kotz, 2008). The diagnoses implied two policy options: (1) let the market sort it out, or (2) provide liquidity in the form of outside money to stop the run. After the (wholesale) run on the bank Northern Rock, the first diagnosis and its policy implications were simply discarded.

Graph 1



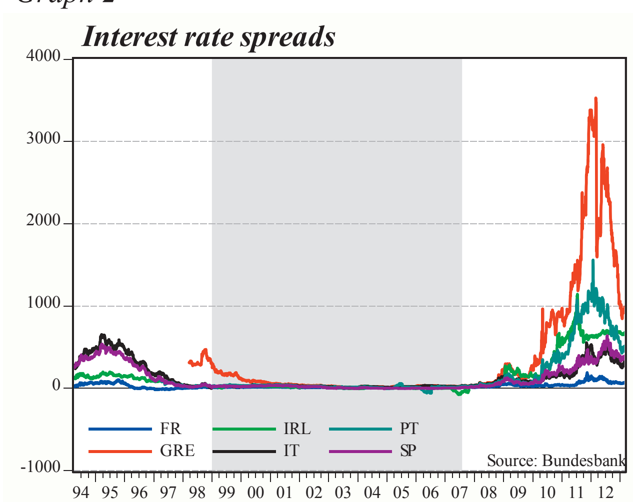
When markets fail to deliver, a public policy issue arises. In this case, the ECB came to rescue, lending its balance sheet to substitute for the private sector's unwillingness to extend credit, in particular to the troubled EMU periphery – as wholesale banks had done amply before. All the classical symptoms of a "sudden stop," as so often experienced elsewhere, were in evidence, though without the typical consequences, courtesy of the ECB. Basically, all the ECB's measures invented and implemented under the heading of "enhanced credit support" filled these gaps in the chain of substitution. But one can of course ask oneself whether those were market failures – or to which degree they were – or whether spreads were, indeed, appropriately reflecting underlying structural problems. In other words: Did fragile member states face a liquidity crisis or had they fallen prone to solvency problems?

Deeds speak at least as loudly as words. And policy interventions revealed the dominating diagnosis: Markets did not work properly. Markets were appraised as functionally inefficient. More specifically, they did not correctly reflect fundamental values.[1] And they did not do so because liquidity – market as well as funding liquidity – was in very limited supply. This had an impact on access to as well as the costs of funds, in particular for SMEs – and the impact differed very much throughout EMU.

3 Renationalization of Europe's financial markets

While from a regulatory angle, capital was as free as it ever had been since the beginning of the Great Financial Crisis, it did not want to flow anymore, at least not to certain parts of Europe. Jurisdictional (and supervisory) borders became important again. European financial markets fragmented. And they disintegrated for endogenous reasons in response to incentives and expectations, not as a consequence of regulatory restrictions. Consequently, with interest rate spreads as wide as they were, the law of one price apparently did not hold. Or did it? Did markets now appropriately tell the difference between default probabilities? After almost eradicating any spreads for some seven years (see Graph 2), had markets come to reason, finally? If so, where was the policy issue? Should nature be left to run its course (diagnosis 1 and policy proposition 1)?

Graph 2



[1] Tobin, 1994. Tobin differentiated between four dimensions of efficiency: information arbitrage, fundamental valuation, full insurance and functional efficiency. Functionally inefficient markets do not allow for proper allocation of funds to most useful purposes as well as a cost-effective pooling and pricing of risk. Ben Friedman (2010) in addition stresses that one should also account for the costs at which those functions are discharged, that is, whether private rewards measure up to social productivity.

The deeper questions were about the appropriateness of current account deficits, which mirrored the underlying savings and investment behavior of private agents and public authorities, and, inextricably linked thereto , these agents' way of funding (mainly via banks). If those savings and investment balances implied untenable intertemporal trajectories, they had to be corrected. And, clearly, some current account deficits did not reflect good choices, at least not ex post. The deficits simply had to be cut back and the resulting net external liabilities brought in line, honoring solvency (intertemporal budget) constraints.

3.1 Current accounts (and their accumulation over time) matter, in EMU also

Ever since the early 2000s, concurrently with the introduction of the common monetary policy, balances arose in Europe. They arose between what was later dubbed "North" and "South." They were also persistent. And, over time, they added up to ever larger regional net debt positions. Most remarkably, in the South, they were mainly the result of a fall in private net savings, not fiscal imbalances (Holinski et al., 2012).[2]

Savings behavior in the South might have been a response to low real interest rates, which were lower in the South as a result of almost identical nominal rates and of higher inflation. They might also have been related to financial market liberalization, with a larger gamut of instruments at households' disposal. In any case, much of the capital flowing downhill ended up in not particularly productive ventures, especially buoying a real estate boom.

3.2 …as do their enablers: banks

Some push factors might also have been involved – banks in the North were possibly not only passive providers of credit for expenditures, which, as time went by, have proved to be far off track. And – this is important – it was banks in particular that underwrote this process. We will come back to that.

But that was not at all a common reading at the time. Indeed, current account balances, the difference between national savings and capital expenditures, were understood as having as great an impact as in the U.S., i.e. none. They were regional. Hence they did not matter. Also: They were read as reflecting differences in opportunities between providers of funds in the North and catching-up investors in the South. These balances did not deserve the prefix "im-." Instead, they mirrored

[2] Holinski et al. (2012) define the North (Austria, Finland, Germany and the Netherlands) and the South (Greece, Ireland, Portugal, Spain) by way of cluster analysis, leaving some countries (France, Italy) in an in-between category.

the interaction of private decision-makers with ex ante attractive options. Hence, they were good (Blanchard and Milesi-Ferretti, 2009), meaning that ultimately, those obligations would largely be honored.

Conventional wisdom strongly suggested that it would be pretentious for civil servants to second-guess those enlightened decisions.

4 Re-establishing Europe's monetary and financial union

But, with EMU resembling a confederation rather than a nation state (Sargent, 2012), jurisdictions (plural!) matter. They matter in particular because of banks. Most of the intra-European capital flows had been intermediated by banks. Those banks were largely funded in wholesale interbank markets, which are particularly vulnerable to herding and sudden directional changes of flows. This vulnerability also meant that it was important to acknowledge gross flows, not only their net as they show up in current accounts.

Only with the benefit of hindsight, EMU was understood to have a design flaw. A genuine union, as the new diagnosis holds since the summer of 2012, needs more macro (think of all the two-, six- and other pacts) as well as financial surveillance.

The GFC in its European manifestation has shown that jurisdictional limits do matter. When supervision, the implementation of common rules, is done differently and in particular when, in case of problems, the capacities to respond are different in different regions, then markets freeze – disintegrate – for plausible reasons. Dealing with this at the root hence has to address Europe's incompleteness. This implied more of a union in terms of implementation of banking politics, but it also called for a response to local financial stability issues, such as bubbles in asset prices.

4.1 SSM: On the way toward a common banking policy

The second lesson – the first, namely responding to the GFC, having led to the creation of European supervisory authorities along the de Larosière blueprint – was thus the creation of a Single Supervisory Mechanism in the wake of the European sovereign-bank crisis. This strongly suggested the centralization of supervisory functions, a denationalization of rule enforcement. Given the strong and searched-for cross-border integration of banking, in particular wholesale banking, previous approaches at managing the attendant externalities had proven flawed.

As concerns cross-regional flows, the SSM will mean that ringfencing or subsidiarization within the SSM's perimeter, i.e. its enforcement reach, will be impossible for national supervisors. National authorities have a clear reporting line and they will follow the same set of procedures ("The Manual"). After a while, the general supervisory philosophy will hold for all of the euro area's 6,000 credit institutions.

This Europeanization of banking policies is work in progress, in particular with regard to the two further pillars or legs of the three-legged stool of banking union: dealing with troubled banks and underwriting retail deposits. But the restructuring and resolution regime now in place compares very favorably with the ad hoc attempts at handling challenged banks with a cross-border dimension. Also, while there is still much to be done, the trust in deposit insurance schemes should be buttressed with the new regime.

4.2 Regional diversity calls for macro-prudential

Monetary policy in Europe is mainly transmitted via bank balance sheets. And those balance sheets are procyclical, in particular balance sheets funded with bought deposits or non-core liabilities (Bruno and Shin, 2012). Moreover, regional heterogeneity in banking structures by necessity implies differential impacts (Kotz, 2001). In addition, regional – non-area wide – bubbles in asset prices are to be expected in a monetary union with member states or regions as diverse as those in Europe.

Macroprudential policies thus are mainly about controlling procyclical bank lending policies (Bruno and Shin, 2012). Given the euro area's diversity, there is inevitably a regional dimension to such controls. Macroprudential policy thus amounts to adapting – in fact, regionalizing – monetary policy. In our second-best world, we are also forced to accept that monetary policy does include financial stability.

From a European perspective, macroprudential policy thus inexorably has a regional capital flow management dimension. This implies redistributive issues (a quasi-fiscal policy characteristic) and all the attendant legitimacy questions. Therefore, exercising macroprudential policy is difficult indeed. But Europe does not have the luxury to simply disregard the issue.

5 En guise de conclusion…

Europe's monetary and financial union was and still is incomplete. Therefore, it was and still is vulnerable, though currently much less so. But for an inconveniently long period, EMU appeared to be barely capable of surviving; not breaking up only because of lifeline support from the ECB (all the full allotment programs, Covered Bond Purchasing Programs, LTROs, OMT policies, and so forth).

That was an untenable situation. It is why EMU's institutions have to be adapted in order to become a viable, productive framework. Breaking up would have come at potentially (almost) prohibitive costs. Therefore, Europe's policy makers came reluctantly to the conclusion: Dis-integration was a market failure. Relaunching cross-border flows became the first and foremost policy priority. Missing markets were in particular substituted for by the ECB, more precisely, its balance sheet. The interbank settlement system (TARGET2) provided a backstop to absorb the sudden flow reversal. Reestablishing these flows – reintegrating markets – also meant, according to this reading, fostering efficient allocation and economic growth.

At its launch, Europe's monetary union was characterized by a rather distinct setup: Monetary policy was supra-nationalized, financial markets were almost completely open – but banking politics (supervision, restructuring, retail deposit insurance) remained largely nationalized. This would have been fine in a first-best world. But on our planet, the setup has been found wanting (Brunnermeier et al., 2012).

The alignment between the perimeters of pertinent policy domains – mainly through coordination – was too weak. Jurisdictional borders also define the limits or framing of policymaking. As soon as relevant externalities occur, as they do by force of arrangement in monetary unions, coordination problems become an issue. And Europe is learning its lessons. These include accepting the formidably demanding task of facing up to regional financial stability issues (in other words, capital flow management or macroprudential policy). On my book, Europe is going in the right direction. Not far enough, yet. There is, for reasons of legitimacy (not touched upon in these broad-brush remarks) as well as incentive compatibility, more need of an alignment of perimeters between decision competencies and ultimate accountability. Of course, alternative options – reallocating financial regulatory responsibilities to the national level – are conceivable. But, as the crisis has amply demonstrated, these options do not work well at all with a monetary union.

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