

European Monetary Union: Lessons from the Debt Crisis

Summary of the 40th Economics Conference
of the Oesterreichische Nationalbank

Ernest Gnan,
Esther Segalla¹

Sovereign debt crises have far-reaching consequences and usually go hand in hand with (or can be traced to) banking and – in many cases – currency crises. Therefore, managing and resolving sovereign debt crises pose extraordinary challenges to economic policymakers. Decisive action and reforms have been taken over the past two years to tackle the current European debt crisis. However, given their numerous transmission channels, these measures have been the subject of intense debate among decision-makers, experts, the media and the general public. There are differences in the analysis of the underlying problems, the recommendations of appropriate economic policy responses and in the lessons that should be learned. The 40th Economics Conference of the Oesterreichische Nationalbank (OeNB) from May 10 to 11, 2012, in Vienna brought together renowned national and international experts and practitioners from politics and the economy as well as finance and academia to address these issues from various angles, discussing and identifying possible short- and longer-term solutions with all their advantages and disadvantages.

Recent developments in international bond markets indicated that the euro area's problems cannot be considered to be solved, *OeNB Governor Ewald Nowotny* said in his opening remarks. Several euro area countries are currently facing credibility problems, which are associated with high risk premiums. In such an environment, very high debt levels, caused in part by the consequences of the recession, call for significant fiscal consolidation programs. The resulting social and political instability and weakened economic growth trigger uncertainty among international creditors, reducing the positive effects of consolidation. One lesson of the most recent consolidation effort should be that consolidation programs must be seen in the context of growth prospects, *Nowotny* said. In particular, policymakers must take account of the effects of fiscal consolidation measures over time: In the short run, they have a growth-dampening effect. This makes it necessary to take recourse to exter-

nal policy intervention. Consequently, the help of the European and international community of states appears to be indispensable. At the same time, it is important to create suitable incentives for the countries concerned to implement the necessary comprehensive structural economic reforms. These countries must choose the best possible reform path to ensure that the reforms are in fact politically sustainable and to prevent any renewed negative impact on market confidence.

Decision making in the EU to cope with the crisis has frequently been criticized as being a drawn-out and unwieldy process. One should not forget, however, that the euro area countries and the EU Member States are sovereign democracies, *Nowotny* emphasized. Reforms and assistance programs must be accepted and supported by national parliaments and citizens in both debtor and creditor countries. In addition, critics often fail to recognize that the EU has already taken far-

¹ *Oesterreichische Nationalbank, Economic Analysis Division, ernest.gnan@oenb.at, and Economic Studies Division, esther.segalla@oenb.at.*

reaching steps both to address the crisis and to reform the economic policy framework. In fact, European policy-makers' response to the crisis has greatly advanced European integration. The current problems resulting from the crisis are difficult to resolve, but at the same time they have an enormous potential to let Europe emerge from the crisis with renewed economic and political strength.

In his opening address, *Werner Faymann, Federal Chancellor of Austria*, reasoned that providing solidarity while maintaining financial discipline are the economic policy challenges in the euro area. Past policy efforts (e.g. bank packages, economic stimulus packages, financial market stabilization, fiscal packages, and debt brakes) have been crucial elements in safeguarding the future of the EU, but there is also the need to incorporate social balance and fairness into those concepts. There exists a firm commitment toward the promotion of employment, growth and competitiveness, which creates the necessity to invest in education and training, research and development, innovation and green technologies, infrastructure networks, and health care. To be able to make these investments, governments must ensure that their interest burden does not rise too sharply; therefore, fiscal discipline is of utmost importance, considering that the euro area countries already spend close to EUR 300 billion every year on interest on government debt. A promising initiative to mobilize funding for infrastructure projects is the Europe 2020 Project Bond, with the European Investment Bank (EIB) providing credit enhancement to support private investment in target industries such as transport, energy and broadband. Faymann suggested that if all Member States jointly increased the EIB's capital base by a total of EUR

10 billion, an additional EUR 60 billion in loans would be available for project funding, possibly triggering an investment stimulus of EUR 180 billion. Initiatives like the project bonds are based on two pillars: fiscal discipline on the one hand and the development of new sources of income on the other hand. An example for the latter is the introduction of a financial transaction tax, which helps transfer funds from the financial markets to the real economy. Regarding the drastic increase in youth unemployment, Faymann cautioned against the imminent risk of a lost generation in Europe and pledged for a joint agenda for economists and politicians to find ways how to solve the crisis.

Session 1 presided by *OeNB Governor Ewald Nowotny* was dedicated to the role of the ECB in managing the financial crisis. In his keynote address *Peter Praet, Member of the Executive Board of the ECB*, outlined the challenges faced by an economic policy-maker. In 2007 we observed a liquidity crisis in the money market, which quickly turned into a full-blown financial crisis, following the collapse of U.S. investment bank Lehman Brothers in autumn 2008, and finally into a sovereign debt crisis from May 2010 on. Disentangling the mutually reinforcing risk factors at play proves to be a sophisticated challenge for economists and politicians. The ECB's primary objective, maintaining price stability, remains firm, but additional nonstandard measures had to be introduced to address the liquidity and funding constraints in the banking sector.

Active monetary policy must not be viewed as a panacea for tackling the crisis. Monetary policy alone will not be able to address the causes of the crisis. The key question is not only about the price of central bank money but also the extent to which institutional crisis management is needed.

The ECB has been walking a tightrope: On the one hand, maintaining price stability requires substantial and determined action; on the other hand, rapid action can create wrong incentives for some market participants so that structural changes in other areas are being neglected (e.g. restructuring the banking sector). To avoid a bias, monetary policy making should be timely and compatible with market economy principles.

The ECB's nonstandard measures need to be combined with the firm commitment by political decision makers to reforming the institutional architecture of the EU to put fiscal and macroeconomic policies on a stronger footing and to secure the proper functioning of the monetary policy transmission mechanism.

Klaus Regling, Chief Executive Officer, European Financial Stability Facility (EFSF), reflected on the reasons for and the response of Europe to the sovereign debt crisis. In some Member States, fiscal discipline was not observed and macroprudential problems got out of hand. We are currently observing a transition to permanently lower interest rates. The sole focus in crisis management on fiscal issues was too narrow. Moreover, structural fiscal imbalances were badly calculated due to methodological problems, e.g. Spain and Ireland had nominal fiscal surpluses up until 2005–2006. Eurostat was only able to harmonize Member States' figures but had no power to audit. Financial markets were supervised at the national level and no crisis resolution mechanism had been developed at the European level. Europe's reaction to the sovereign debt crisis was organized on multiple levels and can be divided into national, European and emergency financing actions. Action at the national level included restructuring and auster-

ity plans, but also guarantees of strict conditionality. Measures at the European level included the strengthening of the Stability and Growth Pact, the introduction of automatic sanctions to correct excessive deficits and national debt brakes, new procedures to tackle excessive imbalances at the national level (e.g. EIP), more powers for Eurostat and strengthening the supervisory architecture (e.g. by establishing the ESRB). Emergency financing instruments were introduced to recapitalize banks, e.g. the EFSF/ESM. Their capacity of more than EUR 1 trillion for disbursement made the existing firewalls a substantial and sufficient instrument, Regling said, concluding that EMU will function better in the future.

Panel 1, chaired by *OeNB Vice-Governor Wolfgang Duchatczek*, discussed how to manage the financial crisis from a systemic point of view. *Andreas Dombret, Member of the Executive Board, Deutsche Bundesbank*, opened his speech with the allegory of the Gordian knot to demonstrate that there is no easy way out of the crisis. There is a need to tediously disentangle the different parts of the knot, as solving the knot is not the same as cutting it. Likewise, containing the crisis is something different from solving it. Dombret emphasized the differences between the nonsystemic and the systemic components of the crisis and how they can be intertwined. Nonsystemic elements can be treated in isolation, e.g. a single country's debt crisis, which needs to be solved by an adjustment process at the national level. The contagion loops between different sovereigns, the public and financial sector, and between the financial actors and the real economy generate the systemic crisis component. During the crisis we observed national problems turning into systemic ones. What started as a liquidity

problem can easily turn into a solvency problem. Instruments addressing the systemic component of the crisis are effective firewalls, recapitalization measures and the establishment of a well-balanced macroprudential policy framework. The greatest risk to the effectiveness of a firewall arises from the potential simultaneity of payouts. Publicly-assisted recapitalization of the banking system is crucial to avoid excess deleveraging. But neither firewalls nor recapitalization efforts are substitutes for restoring solvency through economic adjustments and structural reforms.

Federico Sturzenegger, President of Banco Ciudad de Buenos Aires, observed that the approaches to resolving the Greek government debt crisis resemble a replica of a 1980s package and have been promoted regardless of the discussion, during the past decade, of mechanisms to strengthen the sovereign debt market (e.g. the Strategic Debt Restructuring Mechanism, collective action clauses, Calvo's minimum price scheme, the Global Stabilization Mechanism, regional hubs and Precautionary/Flexible Contingent Lines). Drawing on lessons from the Argentinian case, the fixed exchange rate regimes and the high exposure of the financial sector to sovereign risk are the main similarities between Argentina and the European countries. With respect to dissimilarities, Argentina had a simultaneous liquidity and solvency crisis, whereas in Europe only a few countries are suffering under a solvency crisis, and liquidity, on the other hand, should not be an issue. In Europe the ECB can provide liquidity, whereas Argentina was not able to provide liquidity in U.S. dollars. The size of the financial sector is substantially larger in Europe and therefore the interconnectedness of sovereign debt restructuring with the

health of the financial sector is more critical. In order to isolate the financial sector from exposure to sovereign debt risk, Argentina took a series of different measures. Banks were only allowed to have assets applied to sovereign debt within a particular range of caps, loans were pledged against tax collections and lending to the public sector had to be authorized jointly by the central bank and the ministry of finance. Argentina temporarily reduced capital and liquidity requirements to avoid credit contraction. The above measures were combined with the obligation of banks not to distribute dividends. Furthermore, Sturzenegger stressed that debt restructuring should be implemented through maturity extension at relatively low interest rates to avoid forcing substantial losses on the financial sector in the short run.

Panel 2 moderated by *Martin Summer, Head of Division (OeNB)*, presented arguments on how private creditors should be involved in debt restructuring. *Thorsten Beck, Professor at the University of Tilburg*, started the discussion by asserting that the current crisis is a child of the 2008–09 recession and the failure to address deficiencies in the euro area's institutional structure. In particular, it made obvious the financial trilemma of the impossibility to maintain financial stability with European banks doing business across borders but regulation remaining a national responsibility. While we observe a lot of benefits from healthy cross-border banking through the diversification of domestic banks, there are also increased risks from higher volatility in capital flows and contagion. It is crucial to develop a European-level framework together, including a strong resolution authority, to overcome home-country biases in regulation. Furthermore monetary and financial stability should no longer be

treated as separate goals. Rather, a new framework for macro stability needs to incorporate macroprudential regulation which takes into account asset price developments as part of monetary policy in addition to microprudential regulation. The close link between sovereign debt and banks holding large shares of domestic bonds requires that asset concentration ratios take such a home bias into account. Another important issue is the establishment of insolvency procedures for sovereign debtors at the EU level. Beck highlighted the importance of untying the banking and sovereign debt crisis by introducing a new safe asset based on a mutual fund structure containing euro area countries' government debt (e.g. in proportion to their GDP). This fund can then issue tradable securities whose payoffs are the joint payoffs of the bonds in its portfolio. An introduction of such a new asset needs to go hand in hand with institutional reforms, including recapitalizing and restructuring the banking sector. This would guarantee the regulatory underpinning necessary for maintaining a stable and efficient financial system.

Loriana Pelizzon, Professor at the University Ca'Foscari Venice, addressed the empirical challenges of measuring contagion effects, and how different propagation works after a negative shock appears. A simple correlation between two variables does not quantify contagion effects as an outcome of propagation if crisis times are associated with higher volatility. Comparing credit default swaps for different European countries using quantile regressions, she concluded that the propagation of shocks has been remarkably stable and the risk spillover among the countries is not affected by the size of the shock. But this analysis does not tell the complete story as cross-sector banks

only embody one component of a quite complex financial world. Other actors such as hedge funds, brokers, dealers, and insurance companies have also become increasingly interconnected, thus increasing the level of systemic risk in the whole financial industry. Pelizzon concluded providing specific policy recommendations, e.g. that banks should be recapitalized with multi-period payments and a strict no-dividend payout imposition.

Session 2 was moderated by *Ernest Gnan, Head of Division (OeNB)*, and dealt with the question of how to contain systemic risk and debt restructuring. *Albrecht Ritschl, Professor at the London School of Economics*, offered a historical perspective on the European debt crisis by provokingly asking the question whether Germany owes debt to Greece. While the answer to this question is no, the thought experiment remains valid, he claimed. After World War II, Germany was one of the world's largest debtors, with foreign debt amounting to approximately 90% of Germany's 1938 GDP. Germany's economic recovery is attributable to large-scale debt relief and a shift of the bill to the allies. The London Debt Agreement in 1953 was negotiated between Germany on the one part and most other Western countries, including Greece, on the other part and postponed the clearing of debt and occupation costs to a future German unification. The settlement of debt and costs never took place. According to Ritschl, the lessons to be learnt from history are, first, that clearing mechanisms are abused. During World War II Germany appropriated large amounts of funds, while TARGET2 has now released large funds from Germany. He stressed that when we observe a freeze in the capital market, it matters indeed where the money was issued. Another lesson is that in

order to prevent debt default we need to micro-manage debtors' fiscal and interest rate policies. The third lesson is that technocratic governments lack democratic legitimacy and ultimately lead to debt default and domestic political turmoil. Ritschl therefore advocated drastic debt forgiveness for Greece to allow its economic recovery.

Jakob von Weizsäcker, Head of Department at the Thuringian State Ministry for Economics, elaborated on the relevance of euro bonds, based on three arguments. First, the current crisis architecture may not be sufficient to stand a severe stress test scenario; second, euro bonds are a signal of firm commitment to the euro project; and, third, euro bonds are a safe asset. The blue bond proposal distinguishes between blue bonds and red debt to achieve two seemingly opposite objectives (higher and lower yields) at the same time. The idea is to split debt into a senior (blue) part, which covers debt issued up to 60% of GDP as a threshold, and a junior (red) part, consisting of Member States additional debt above the blue part's 60% threshold. Blue bonds would be repaid prior to red bonds. This would result in differing risk assessments, and, therefore, different interest rates. The proposal rests on several integral pillars, such as joint and several liabilities for the blue bonds, orderly default procedures and collective action clauses for red debt, strengthening of fiscal discipline due to more expensive public-sector borrowing at the margin and the introduction of a European debt agency to counter governments' incentives to service red debt first. For the transition phase, von Weizsäcker proposed to create a debt redemption scheme and to allow a sufficiently big haircut now.

After dinner, participants were invited to an evening discussion with

Maria Fekter, Federal Minister of Finance of Austria. OeNB Governor Ewald Nowotny praised the good cooperation between the Ministry of Finance and the OeNB with regard to banking supervision. Fekter explained that the crisis is being tackled with a four-step programme: first, help for the countries in need (e.g. with bilateral loans and credit, EFSF, ESM), second, a reform of institutional frameworks (e.g. by introducing debt brakes), third, monitoring the implementation of the necessary measures (e.g. through the Troika) and, fourth, sanctions or an increase in help if necessary. With respect to Austria, Fekter pointed out that the federal government had agreed with the governors of the nine Austrian federal provinces to achieve a zero deficit by 2016. Austria remains in a strong position, with a 2.6% deficit, the lowest unemployment rate in Europe, and above average economic growth. Nevertheless, the reduction of the public debt level (currently at 72% of GDP) requires strict fiscal consolidation. In order to cut debt and foster economic growth at the European level, a legal framework needs to be developed that comprises fiscal consolidation, debt brakes, and fiscal discipline in all countries. The biggest expenditure burden in Austria remains the pension system. With the current average actual retirement age at 58, the goal is to keep workers longer in employment, which would both reduce costs and benefit economic growth. Fekter called for moderate policies between Keynesian state interventionism and Hayekian reliance on free markets. Issuing new public debt is not a solution; rather, there should be a mix of market incentives, innovative power and state regulation. Fekter wished for a more dynamic path in economic development and intergenerational fairness to secure prosperity.

Session 3 in the morning of the second conference day was chaired by *Peter Mooslechner, Director of the OeNB's Economic Analysis and Research Department*. *Joshua Aizenman, University of California, Santa Cruz and National Bureau of Economic Research*, discussed the question of how to strike a balance between short-term stabilization and forward-looking reform by analyzing first the development of currency unions and then financial sector regulation. While early reforms are in general desirable, in practice, they are often postponed and a crisis is needed to actually implement them. The completion of Economic and Monetary Union (EMU) was driven by exaggerated forced optimism about the endogeneity of optimal currency areas. However, creating institutions with the aim of overcoming fiscal short-sightedness apparently requires painful learning. Convergence to an “ever closer union” is not assured. The celebrations of the 10th anniversary of EMU in 2008 were premature. The asymmetric shocks hitting Europe in 2008–09 (peripheral euro area countries vs. Germany) awakened the financial market to the incompleteness of the EMU project. The euro has been the outcome of Europe's history over the past 200 years rather than the optimal currency area logic. Economic integration may have overshoot the people's (and the political) willingness to integrate. Likewise, the U.S. dollar is the outcome of 200 years of painful learning, including a civil war, the defaults of eight states, and the Great Depression. By comparison, the euro area is still in its infancy, experiencing its first painful maturing crisis. Put differently, the euro is a “half pregnancy.” The crisis has forced the euro area to move fast on the learning curve. For EMU to succeed, the EU center must be granted more negotiating power

relative to the Member States. To monitor the fiscal scope of Member States, the EU fiscal rules should relate public debt and deficit to the tax base, which would be preferable to the currently used deficit- and debt-to-GDP ratios; the ratios to the tax base can also explain risk premiums on sovereign debt more reliably. EMU reforms must be implemented while memories of the crisis are still fresh.

The pendulum of financial regulation tends to swing between under-regulation in good times and over-regulation following a crisis (the paradox of regulation). It is one of the inherent problems of regulation that its success in avoiding crises is imperceptible, whereas its costs and the financial sector's interests spark opposition to regulation. Conversely, over-regulation after a crisis generates a larger cost of stagnation, which is often insufficiently taken account of in the political discourse. Central banks and financial regulators should be more independent of the financial industry they oversee and regulate. Financial regulation must be centralized to be able to adequately address systemic risks and avoid regulatory arbitrage. Global regulatory minimum standards reduce the risk of regulatory arbitrage and increase the costs of deregulation. The challenge is to create a regulatory system immune to the paradox of regulation.

The ways out of the crisis were the topic of the concluding panel discussion chaired by *Peter Mooslechner (OeNB)*. *Sylvie Goulard, Member of the European Parliament*, and *Professor Wilhelm Kohler, Universität Tübingen*, explored who should provide assistance to what extent and in what way. Goulard emphasized that Europe had enacted comprehensive reforms over the past few years. The Greek crisis could have been predictable. The EU needs a strong center, a

democratic body committed to transparency. In contrast to the European Parliament, which works in an open and transparent way, the European Council meets almost like a private club and takes decisions that usually lack control and – sometimes – objectivity. Rules alone are not enough for a Union-wide economic and structural policy. There is a broader scope to competition and location. Also, what people usually criticize as “bureaucracy” is not the EU’s problem. Rather, the lack of political union must be addressed. In other words, the interests of the EU must take priority over national interests. At the moment, the north-south divide is one of the greatest threats to Europe. Taking up Aizenman’s metaphor of the “euro baby”, Goulard said that the baby had been born and will be living, and Europe will take all the necessary measures. The EU and the euro need the full and sincere support of politicians. Stereotyping and bashing partners (“lazy”, “rigid”, etc.) is harmful and does not help resolve problems.

Professor Wilhelm Kohler, Universität Tübingen, pointed out that misguided fiscal policies in combination with mispricing of risks by the financial markets had caused the sovereign debt crisis. Next to excessive private sector borrowing, fiscal imbalances have given rise to massive external imbalances, which now have to be resolved by external or internal devaluation (with or without deflation). Increasing productivity fast is a crucial element in responding to the crisis. At the same time Kohler warned that growth alone would not suffice to alleviate imbalances. The monetary policy stance is already very expansionary, higher inflation is no viable solution to the debt

crisis. The question as to whether the central bank should act as lender of last resort in government bond markets must be given due consideration. Country bailouts by other countries can buy time for reforms and fiscal consolidation and avoid adverse imbalances but bear the risk of moral hazard. As regards the pace of fiscal consolidation, going too fast could lead to a recession/debt trap, a double dividend through non-Keynesian expectation effects of expansive consolidation is theoretically possible, but in practice unlikely. Still it is unavoidable to bring public finances back on a sustainable track. Whether the TARGET2 liabilities caused by current account deficits and/or capital flight are a problem depends on whether the euro area is a genuine currency union or a mere fixed exchange rate system.

Finally, in the course of the Economics Conference, *OeNB President Claus Roidl* and *OeNB Governor Ewald Nowotny* introduced the winner of this year’s *Klaus Liebscher Award*. *Harald Oberhofer, Universität Salzburg*, received the prize for his scientifically rigorous and highly policy-relevant study entitled “Firm Growth, European Industry Dynamics and Domestic Business Cycles,” which was selected from a large number of excellent submissions. In his paper, the author conducts a systematic empirical analysis of the links between national and European business cycles, focusing on the question of how this interaction affects European industrial enterprises. The data show that despite substantial progress in European integration, national business cycles have a larger impact on firm growth than pan-European developments.