Seminar on “The Limits of Surveillance and Financial Market Failure: Lessons from the Euro-Area Crisis”
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Remarks made at Session 4

More Effective Management of the Euro-Area
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On two separate occasions the question of how to manage the Eurozone has generated intense debate. The issue was addressed a first time by the Delors Committee and when its recommendations were implemented in the context of the Maastricht Treaty. The second time the issue took centre stage was in the wake of the Euro crisis after 2009.

The deliberations of the Delors Committee were based on two principal considerations. First, the Committee refrained from commenting on the desirability of EMU; instead, it confined itself to outlining the conditions under which an EMU could be viable. Second, it accepted from the outset a scenario where for reasons of political reality the responsibility for economic (i.e. non-monetary) policy would remain in the hands of the national authorities.

The continuation of decentralized economic policies in conjunction with a single monetary policy was considered to be possible in a macroeconomic framework of closely supervised, coordinated non-monetary policies in combination with binding rules for budgetary policies. Such rules were seen to be necessary because of limited confidence in smoothly operating market signals, but also because they would serve as safeguards against failures in voluntary coordination of policies. And the decision to abolish exchange rates had itself eliminated key market signals from forex and bond markets.

The blueprint presented by the Delors Committee was adopted with some amendments in the Maastricht Treaty. Rules were complemented by quantitative criteria; at the same time their application was left to interpretation and discretion.

The framework laid down in the Maastricht Treaty seemed to work well after the start of MU in 1999. Notwithstanding some unfavourable developments, such as the explosion of oil prices, the ECB succeeded in maintaining price stability as measured by the harmonized index of consumer prices. Countries at the periphery, such as Spain and Ireland, which in the discussions in the Delors Committee were seen to be particularly vulnerable to competitive pressures, experienced an unexpected upswing in economic activity and were able to strengthen significantly their fiscal position.

During the initial years discussions on how to manage the Eurozone centered mainly on the Stability and Growth Pact. After having been violated by two major countries without triggering corrective action, the Pact was reformed in 2005 to be applied more flexibly, without strengthening it. Still, on the whole, managing the Eurozone was not a prominent issue.

On closer inspection there were, however, developments, which should have been recognized as early warning signals that not everything was going well. For example, while the average rate of inflation in the Eurozone measured 2% p.a. between 1999 and 2006, it masked significant divergences. Whereas consumer prices rose by 1.6% p.a. in Germany and Finland, the corresponding figures for Spain, Greece and Ireland were 3.3 to 3.6%. The price level in these three countries thus increased cumulatively two and a half times in comparison with Germany and Finland. These developments did not go unnoticed. The ECB observed that consumer price changes tend to correlate closely with unit labour costs and translate into real exchange rate changes and shifts in competitive positions. Nonetheless, as it was not clear whether these developments were partly the result of the Balassa-Samualson effect or, more generally, a desirable adjustment towards more balanced competitive positions, the discussion did not lead to action. Although seeds for future trouble were thus sown long before the crisis erupted and while large current account imbalances emerged, it was still business as usual in the Eurozone.

The stage for change was set by the global financial crisis of 2007. The bailout of financial institutions making huge losses on their subprime mortgage portfolio and the recession of 2008/9 with sharp declines in GDP gave rise to a massive deterioration in budgetary positions. Markets began to focus on the possibility of sovereign default, which in turn would backlash on financial institutions with sizeable sovereign debt holdings. In this situation news of Greece's unsustainable fiscal position sufficed to trigger a widespread withdrawal of market financing. At that point it did not matter much whether excessive debt resulted directly from profligate fiscal policies or indirectly from nonperforming loans to the private sector. Market finance dried up and typically the process was sudden, abrupt and disruptive.

Lax fiscal policy did play a role. However, the fundamental cause of the crisis must be traced to private sector credit flows. As the move to the single currency reduced risk premia and lowered interest rates in countries with previously high interest rates, it sparked credit demand in a number of countries, in particular for consumption and property spending, with ample financing provided from national banks and through cross border flows. As the credit boom was unevenly distributed within the Eurozone it generated marked divergences in GDP growth, inflation and unit labour costs. The concomitant shifts in competitiveness together with income effects gave rise to massive external imbalances.

These developments created a situation in which the single monetary policy was by and large appropriate for the Eurozone as a whole, but inappropriate for economic conditions in individual countries: it was too loose in countries with rapid growth and too tight where growth was sluggish. In fact, this situation was not different from Mundell's classic model of demand shifts between two countries, where he demonstrated that a single currency would be desirable only, if flexible prices and movements of labour generated the necessary adjustment in order to return to a sustainable equilibrium. There is little evidence that such automatic adjustment mechanisms play a role within the Eurozone. On the contrary, imbalances have increased over time, dashing the hopes of those who had argued that the single currency would set in motion an endogenous process of convergence.

With hindsight the failure of the Maastricht governance framework to prevent the crisis can be attributed to three factors:

1. The rules of the Maastricht Treaty were compromised and binding benchmarks and norms were not observed.
2. Early warning signals in the form of divergent cyclical and competitive positions were largely ignored.
3. There was a lack of awareness of the consequences of the built-up of sizeable current account imbalances within the Eurozone, financed by private debt.

Experience has shown that the Eurozone is not an optimal currency area. Imbalances are not automatically adjusted away and coherence will therefore have to be assured through other means. What are the options?

Some recommendations call for "more Europe" i.e. a fundamental reorganization of the Maastricht framework, either by introducing an institutionalized system of financial transfers along the lines of the German Finanzausgleich or, even more far-reaching, a move to a "single fiscal policy". Both proposals are in essence political and require a transfer of national sovereignty, transforming the supra-national structure of the Eurozone into that of a federal state. A system of financial transfer would presuppose a high degree of tax harmonization and a single fiscal policy would imply that national governments and parliaments abandon their most cherished responsibility for taxation and spending. The principle of “no taxation without representation” would thus require a fundamental restructuring of democracy within Europe. Leaving aside the question of whether in a federal Europe policies would indeed ensure greater stability – after all, there are many examples of long-lived imbalances within nation states – for the foreseeable future there is no readiness among member states to take a step in this direction.

As long as (non-monetary) policy decisions are left in the hands of national authorities, there is little choice but to continue to manage the Eurozone on the basis of voluntary coordination within the framework of mutual surveillance. A more effective management can therefore only mean a more effective process of surveillance. As the crisis has demonstrated this would necessitate improvements in three areas:

First, monitoring and limiting public sector indebtedness must be complemented by a careful analysis of private sector debt accumulation and the corresponding financing flows.

Second, more attention must be given to heeding the information drawn from price and wage indicators

Third and most importantly, more emphasis must be placed on prompting early corrective action.

How could such improvements be achieved? There are two approaches through which the process of surveillance could be made more effective.

A first one would be to refine further the methods of coordinating policies through benchmarks and guidelines and to strengthen incentives to encourage their observance and implementation through a more elaborate menu of carrots and sticks. For instance, sanctions could be complemented with rewards for good behaviour. However, for both technical and political reasons there remains doubt as to whether this approach would engender significantly more positive results than in the past. First of all, coordination is a technically difficult process. Participants' views tend to differ about the assessment and interpretation of financial and economic data. Forecasts of future developments are subject to considerable uncertainties. There may also be disagreements about the desirable policy objectives and the underlying model of how to attain these objectives. And these difficulties are exacerbated in a monetary union where the key variable for coordinating policies - the exchange rate - is lacking.

Second, it is questionable whether the policy failures of the past were the result of a lack of information and inadequate monitoring. All relevant data were amply available but the authorities seemed hesitant to make use of them or were unwilling or unable to respond in a decisive and timely manner. Surveillance relying on peer pressures and the threat of administrative sanctions fall too easily victim to political bargaining or recommendations are ignored because they are considered politically inopportune. There is indeed a danger that well-intended improvements in the surveillance process may end up in an increasingly bureaucratic exercise of more committees, more meetings and more papers, without much practical effect.

The aim must be to induce countries to act out of self-interest in recognition of emerging serious financial constraints. In a system of fixed exchange rates these take the form of unsustainable reserve losses; in a single currency area the constraints are ultimately felt in rising costs for budget financing and debt roll-over.

A second alternative to strengthen the surveillance process would be to accord a more significant role to such market signals at an early stage. To this end surveillance should be conducted with the grain of the market; i.e., rather than relying essentially on peer pressure and sanctions more emphasis should be given to market discipline as a means of prompting member countries to adopt the necessary corrective measures.

Market pressures emanate from the financial sector. The problem is that financial markets exhibit herd instincts and react abruptly and the withdrawal of market finance tends to compound liquidity problems usually arising in crisis situations. Yet, it is hard to believe that financial institutions with large research facilities and risk control departments are not able to interpret correctly the available data. The aim must therefore be to encourage financial institutions to price risks properly.

Market behaviour is not independent of the regulatory framework within which financial institutions operate. The operation of the intra-euro-area payment system means that intra- central bank finance in effect replaces private flows. In addition, regulatory provisions such as zero-weighting of sovereign debt or equal treatment of sovereign debt as collateral for borrowing from the ECB are likely to have moulded mistaken views on risk. Fast and ready assessments of “too big to fail” may have tempted banks to gamble in expectation of a bailout. The key to more rational and reliable market signals and discipline is that those who take risks must be aware that they will also have to bear the consequences of their decisions. Recent revisions in the regulatory framework aimed at stricter and uniformly applied supervision within Europe in combination with macro-prudential intervention at an early stage should help to sharpen risk awareness and affect accordingly market behaviour. However, for market signals to become an effective means of enforcing policy changes, two additional preconditions would need to be fulfilled: (1) the banking system, after its health has been restored, should not count on public sector support in crisis situations and (2) the ECB should refrain from intervening in particular securities markets with a view to influencing interest rates. Interest rates on bonds of different countries must be allowed to differ. In other words, when the current crisis has been overcome the no-bail out rule must be made credible.

Nonetheless, better surveillance together with market discipline forms no silver bullet to guarantee a more stable development within the Eurozone. What is needed is the political will to act quickly and decisively – not only out of self-interest of the member countries but also out of interest in maintaining the Euro as the common currency.

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