Sovereign crisis & banking in EMU

Gikas A. Hardouvelis*

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- ✶ **Professor, Department of Banking & Financial Management, UNIPI**
- ✶ **Ex Director of the Economic Office of the Greek PM, 11/2011-5/2012**

Sovereign crisis & banking in EMU

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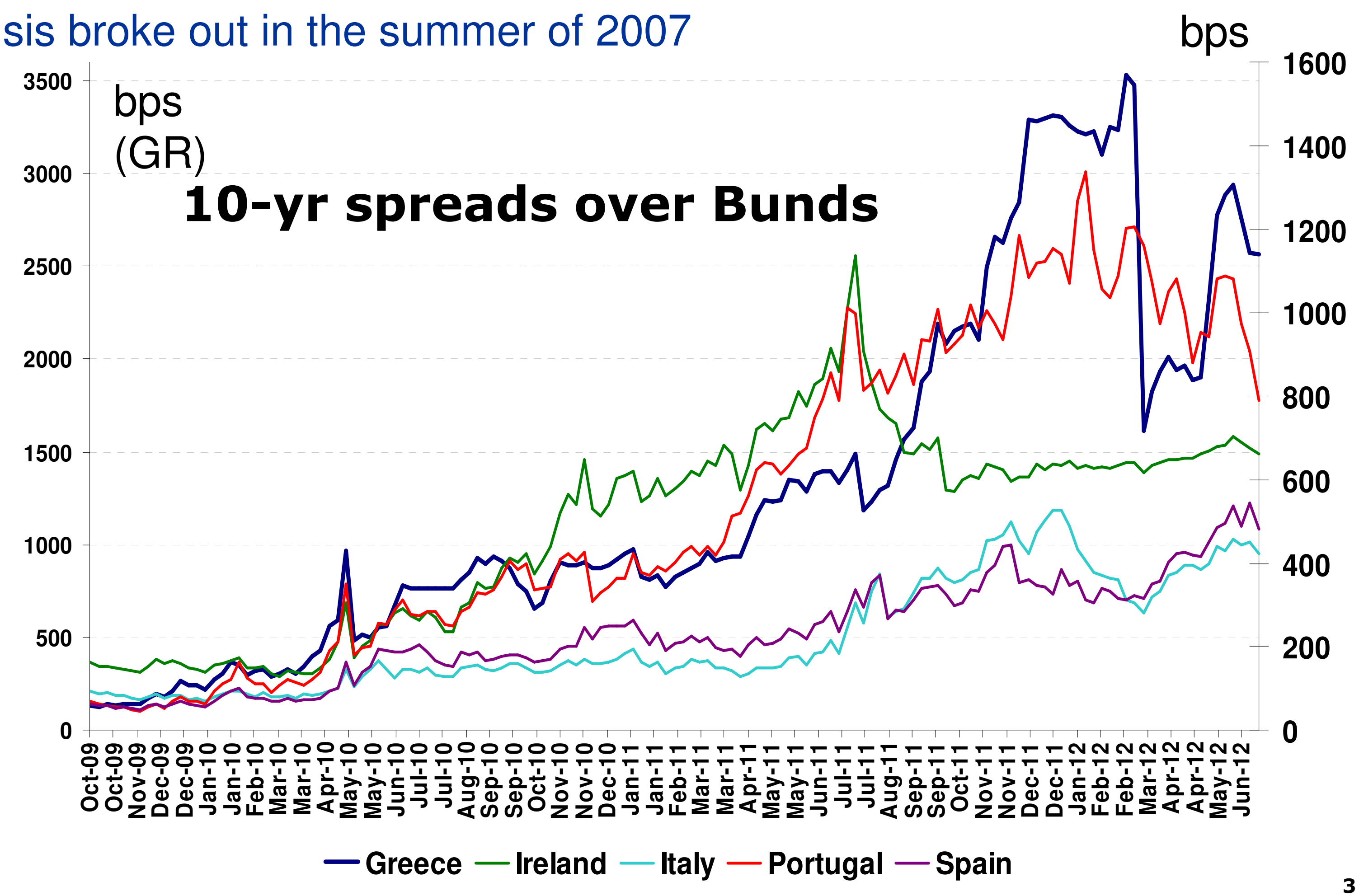
I. The international financial crisis led to the Greek & Euro Area sovereign crisis

✓ Leverage, private & public, was overstretched during the period up to 2007, when liquidity was abundant, interest rates and inflation were low, while real output growth was high ("great moderation period") with a real estate bubble developing in many countries

✓ The financial crisis broke out in the summer of 2007

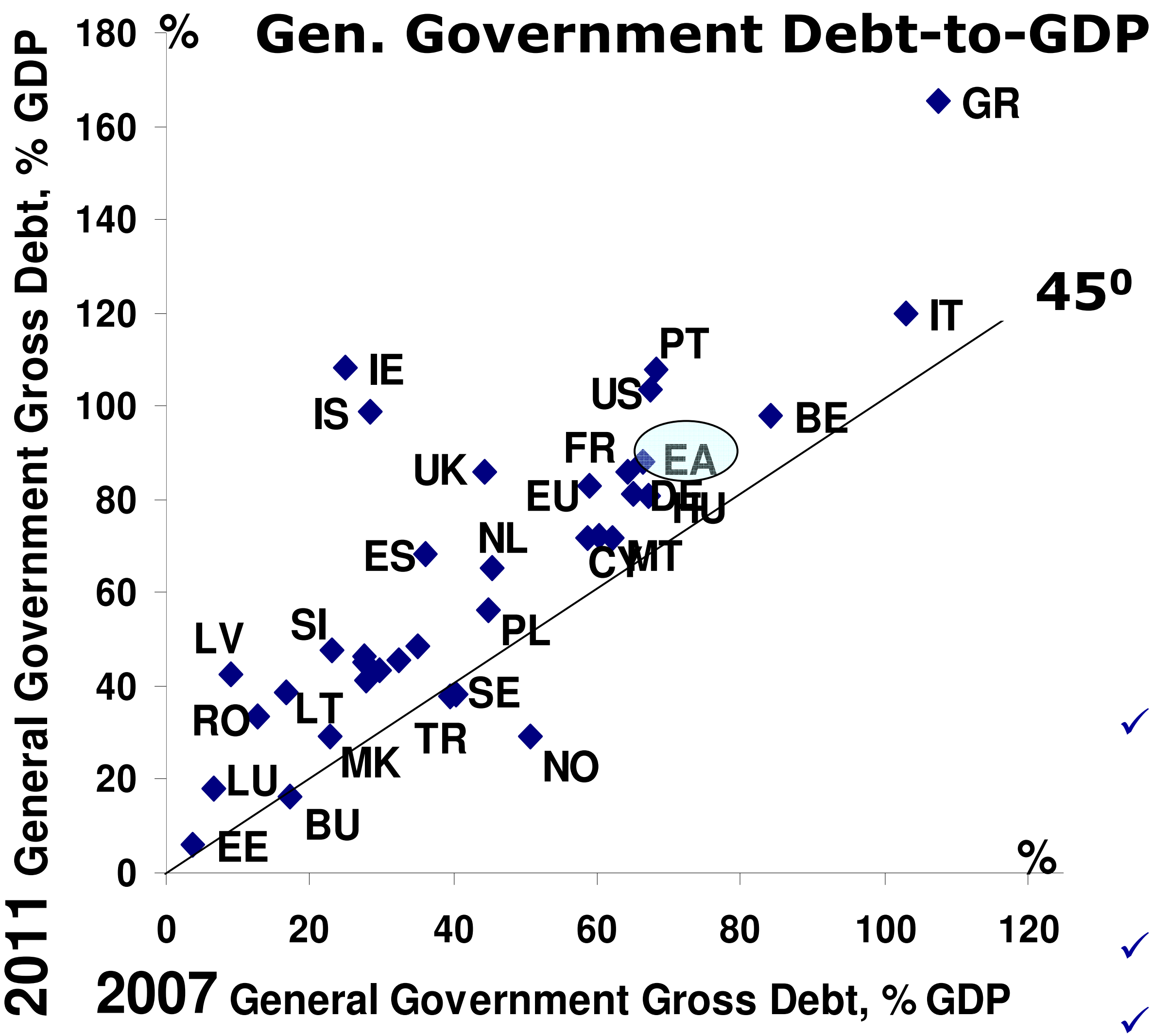
✓ The sub-sequent world wide recession at the end of 2008 exposed country vulnerabilities particularly in Europe

✓ Sovereign spreads widened in the EMU Periphery



I. The financial crisis led to increased indebtness by governments ...

✓ Markets focus on the sustainability of government debt



Source: EU

2011 GG Debt (€ bn)	
Portugal	184.3
Ireland	169.3
Italy	1,897.2
Spain	735.0
Greece	355.6
Belgium	361.7
Germany	2,088.5
France	1,717.3
UK	1,547.5

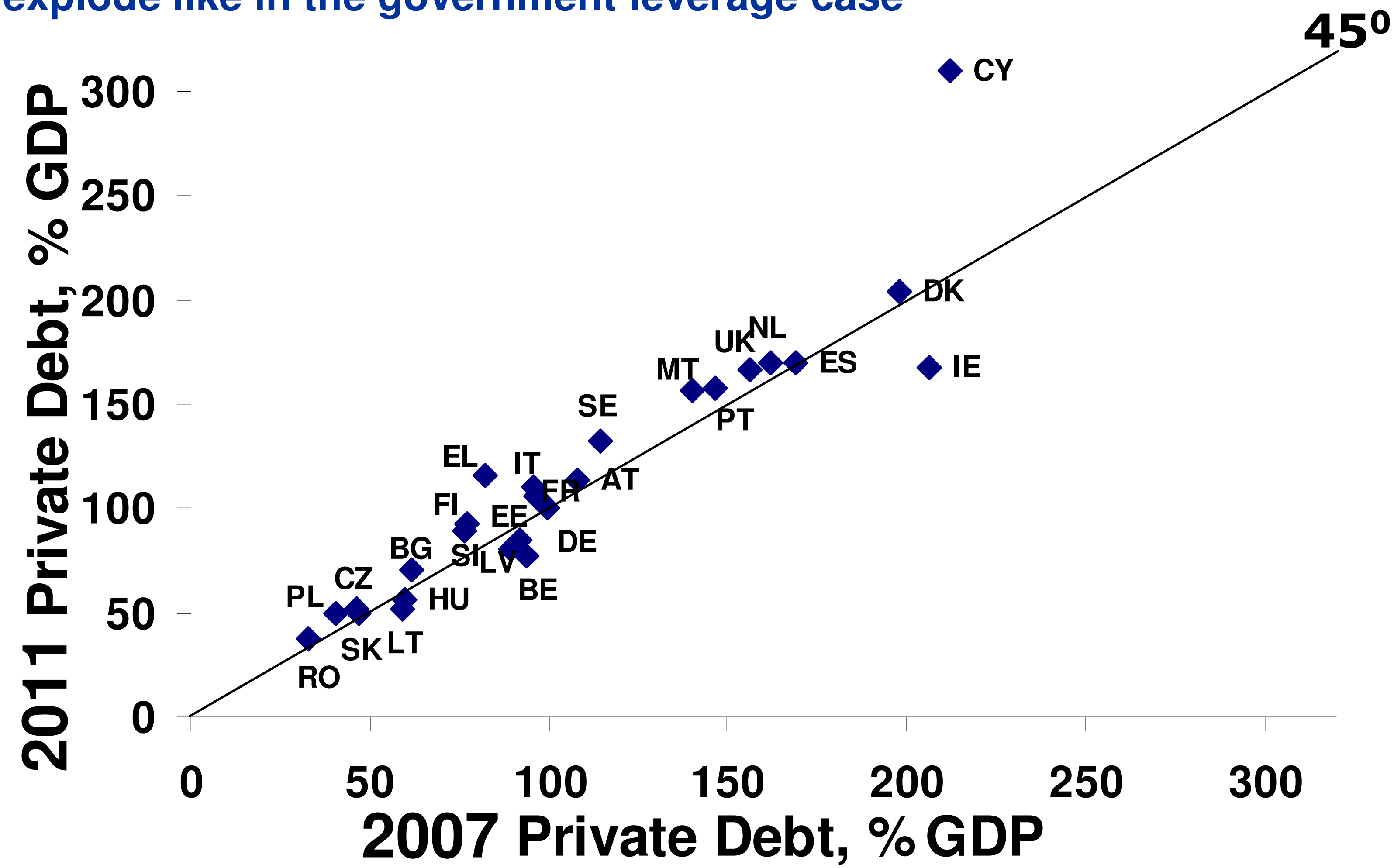
✓ Debt Deterioration everywhere from 2007 to 2011, exceptions being Bulgaria, Turkey, Sweden and Norway.

✓ Largest deterioration in Ireland

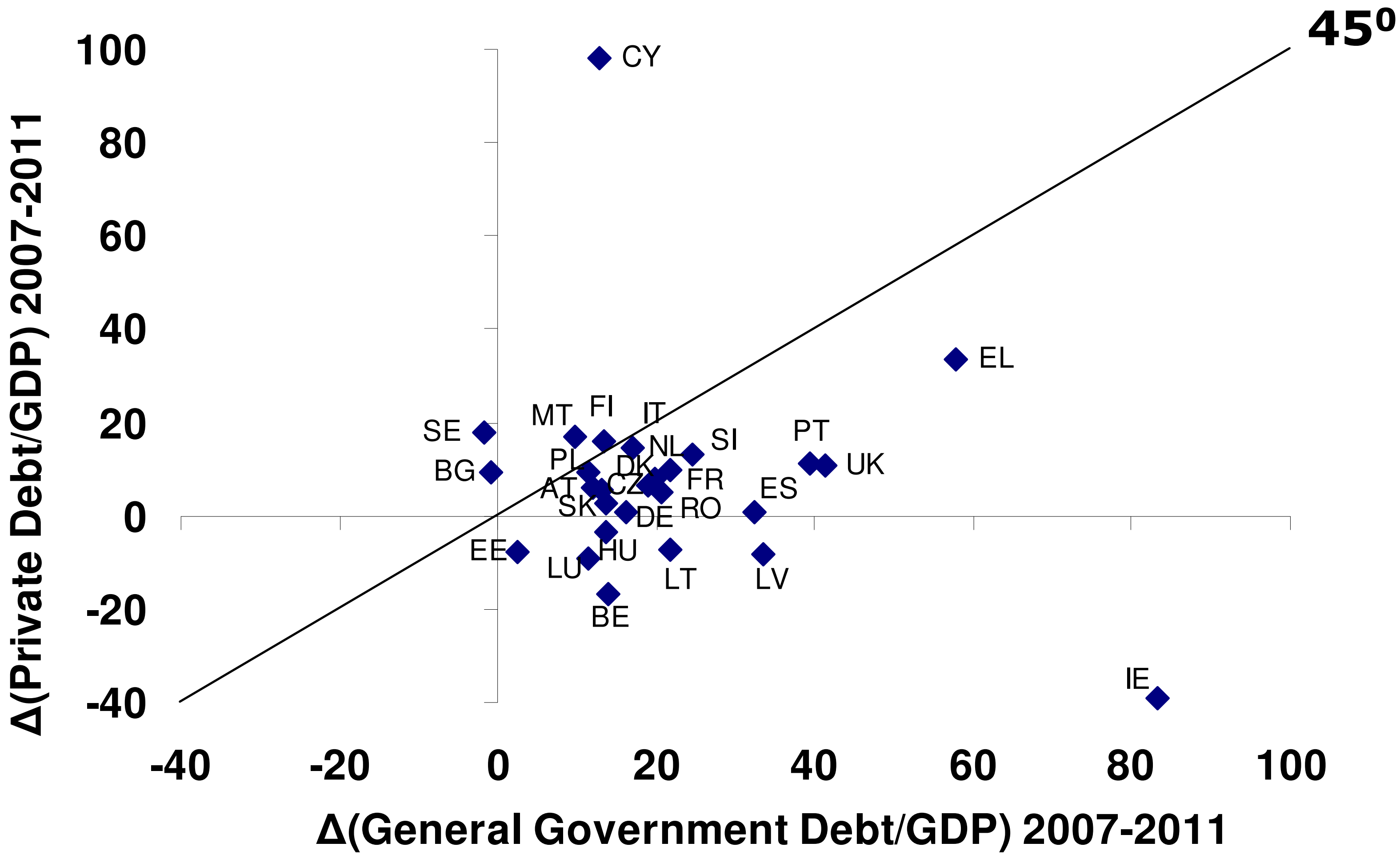
✓ EA showed smaller deterioration than US or UK

I. … but private bank debt did not increase as much

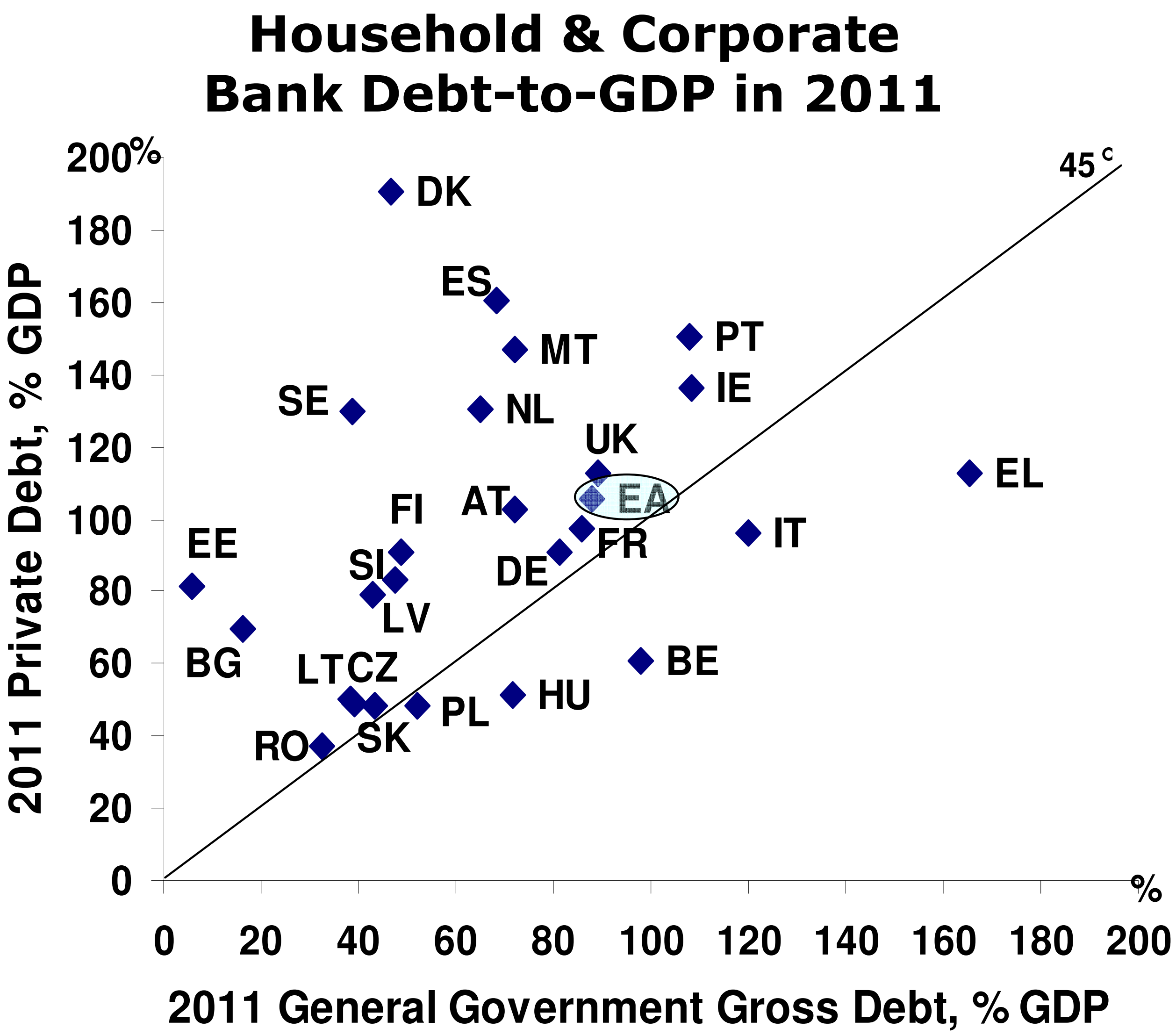
- ✓ Private banks responded immediately and restrained lending
- ✓ Thus despite the stagnation of nominal GDP, the ratios did not explode like in the government leverage case



I. Indeed, the change in private bank debt was smaller than the change in public debt



I. Yet today's private bank debt is still larger than public debt in most countries



- ✓ EA Private debt higher than Public debt in 2011
- ✓ Most countries above the 45-degree line: Higher private than public debt
- ✓ Exceptions in the EA are Belgium, Italy & Greece, where Private debt is smaller than Public Debt

Source: EU, IMF, ECB, Federal Reserve, NBS

II

I. Rising leverage & the Euro Area sovereign crisis

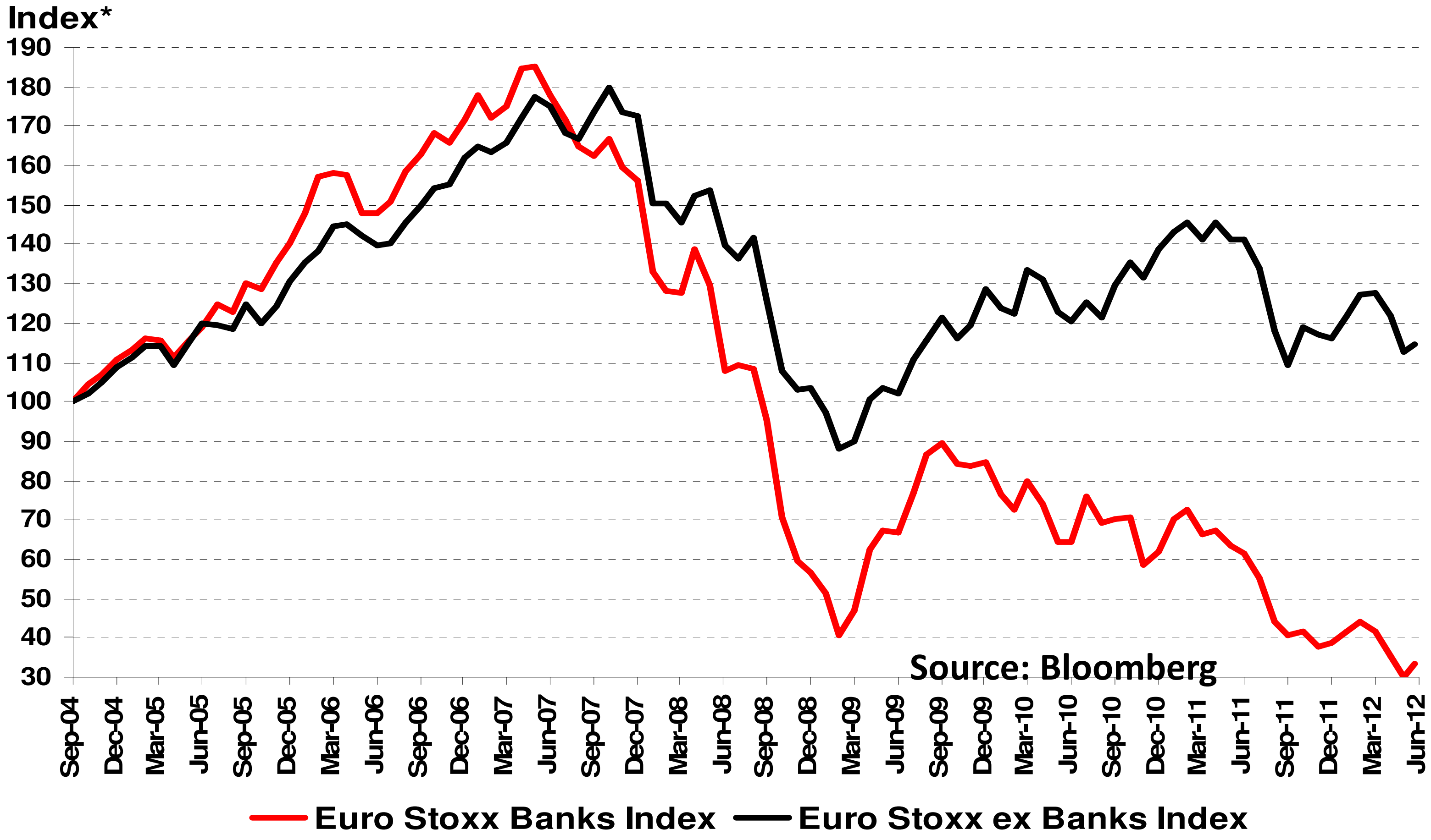
II. Pressure on Banks

III. Can the Euro Area be saved?

IV. Conclusion

II. The crisis was more damaging to banks

- ✓ **European bank stocks were hit harder than the rest of public companies since banking is more sensitive to crises or recessions**

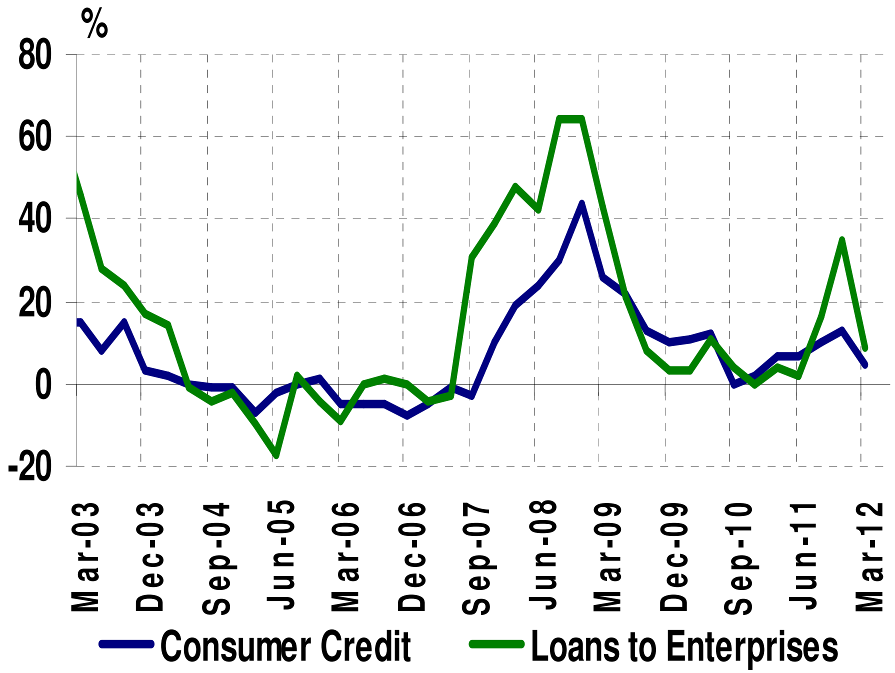


Note: September 30, 2004=100, end-of month data

II. There is pro-cyclicality in banking

Euro Area

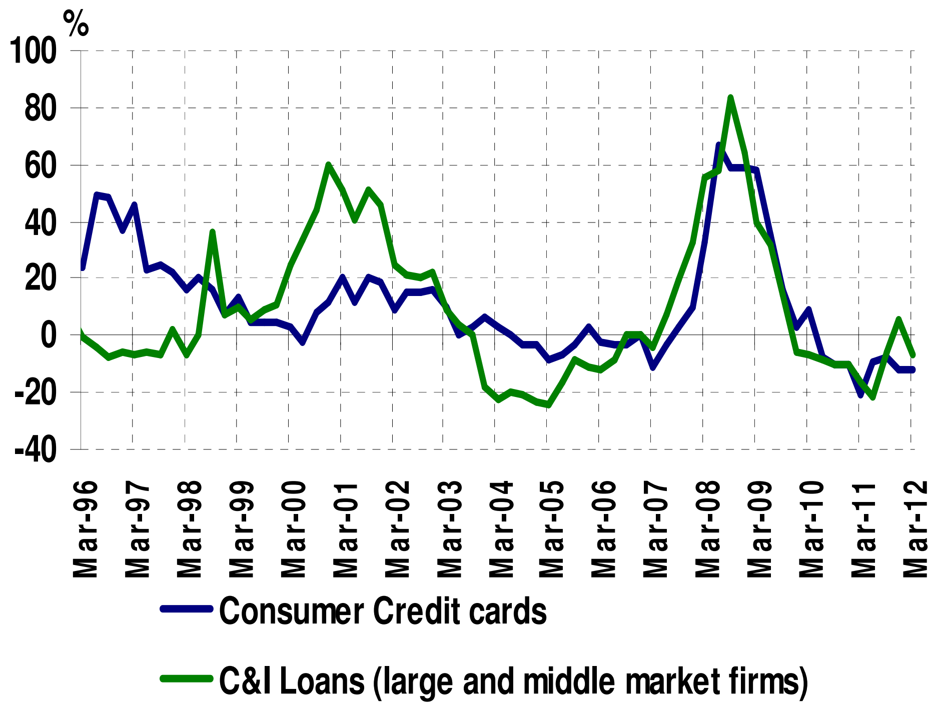
Net percentage of banks reporting a tightening of credit standards



Source: ECB, The Euro Area Bank Lending Survey

USA

Net percentage of banks reporting a tightening of credit standards

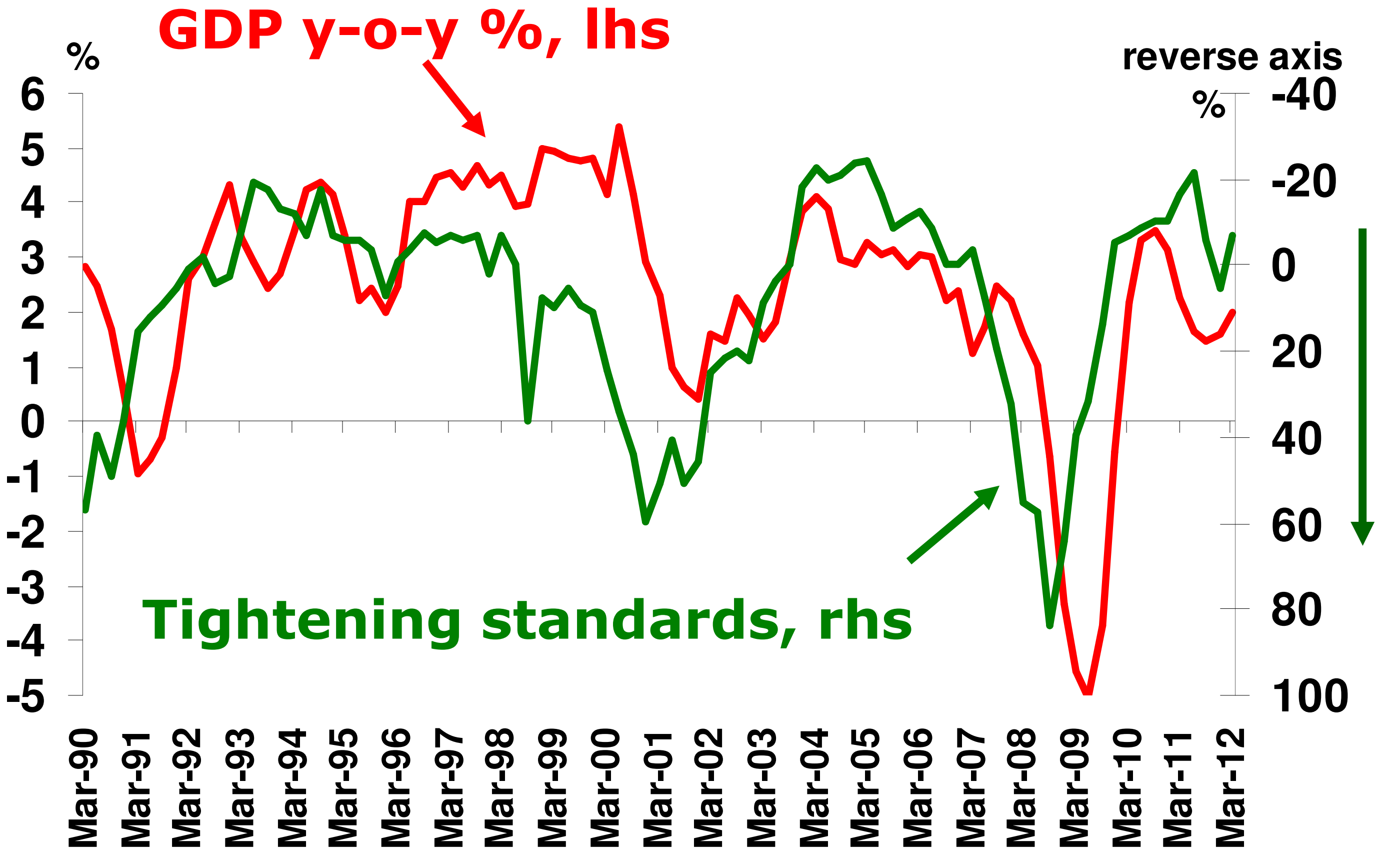


Source: Federal Reserve, The Senior Loan Officer Opinion Survey on Bank Lending Practices

✓ *In the EA, the results of the April 2012 bank lending survey indicate that the net tightening of credit standards for loans to firms dropped markedly in Q1 2012. In the US, banks are loosening credit standards for loans to consumers and firms.*

II. Procyclicality vividly seen in US bank degree of tightening of credit standards across cycle

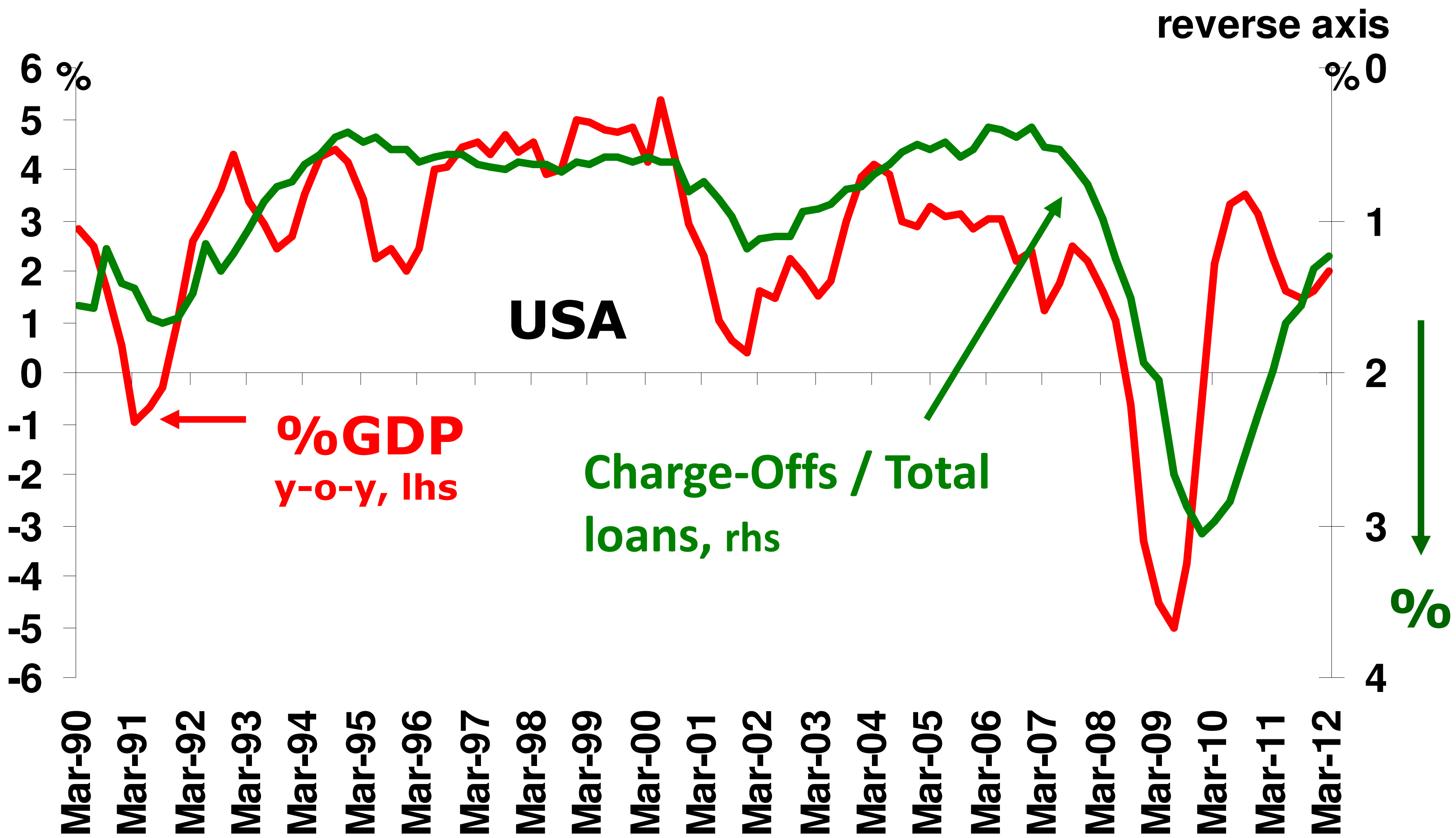
✓ "What is known as **procyclicality** is the fact that over time, the **dynamics of the financial system and of the real economy reinforce each other**, increasing the amplitude of booms and busts and undermining stability of both the financial sector and the real economy." (BIS (2009))



USA, data for real GDP growth (lhs) and the net percentage of banks reporting a tightening of credit standards in Consumer & Industrial loans to large & medium sized firms (rhs, reverse scale)

Source: ECOWIN, Federal Reserve, The Senior Loan Officer Opinion Survey on Bank Lending Practices, April 2010

II. Charge-Offs vary countercyclically

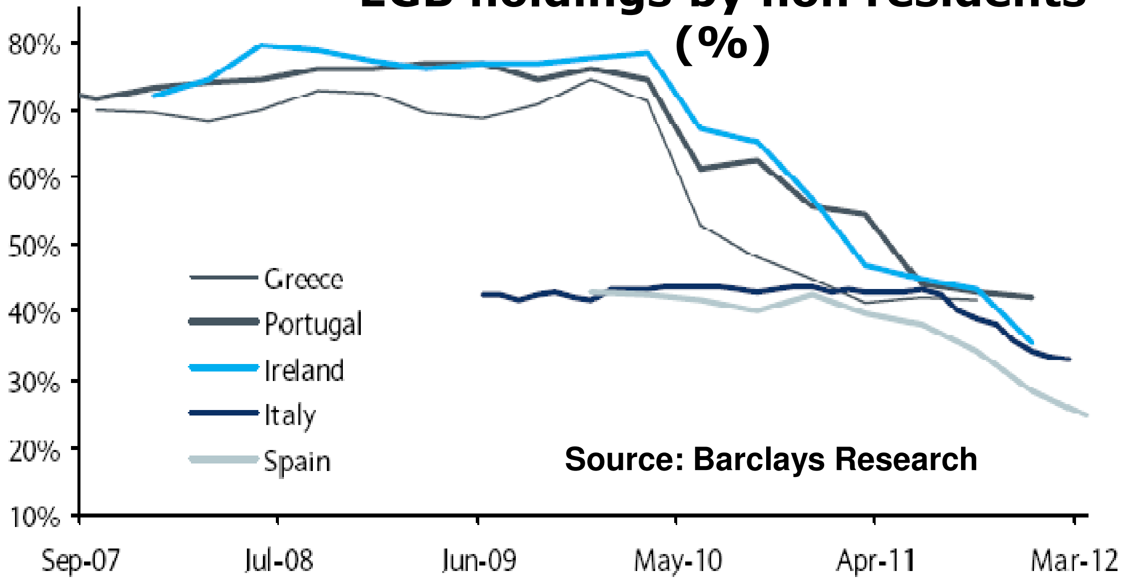


Source: ECOWIN, Federal Reserve

II. Sovereign & banking crises in a vicious cycle

- ✓ Banks are pressured by deleveraging of the private sector
- ✓ Regulators became stricter on capital requirements
- ✓ Banks in the Periphery are also pressured by the leverage of the public sector as they hold government bonds that became toxic

EGB holdings by non residents (%)

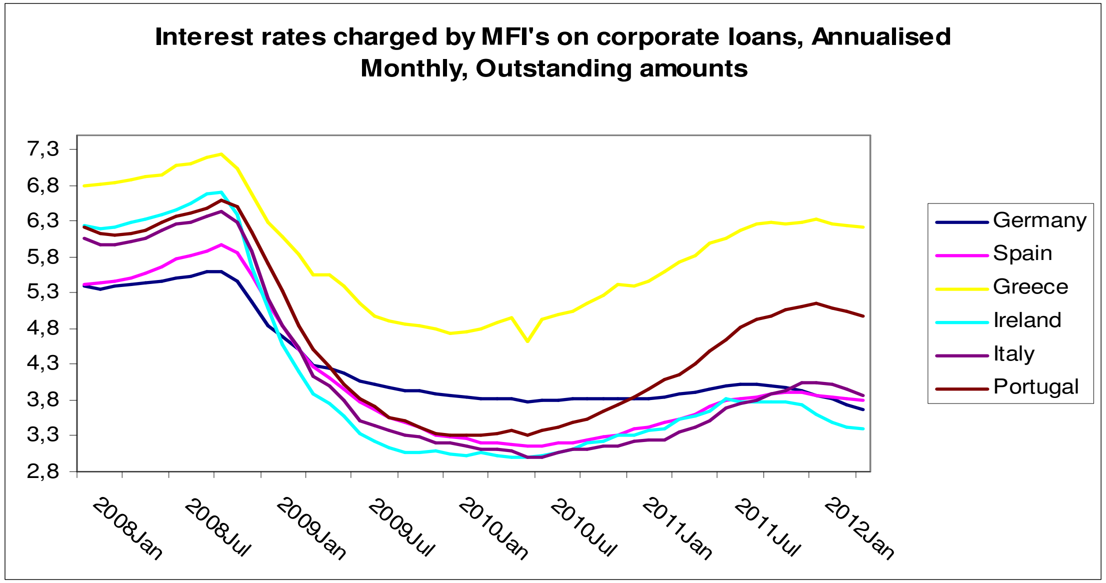


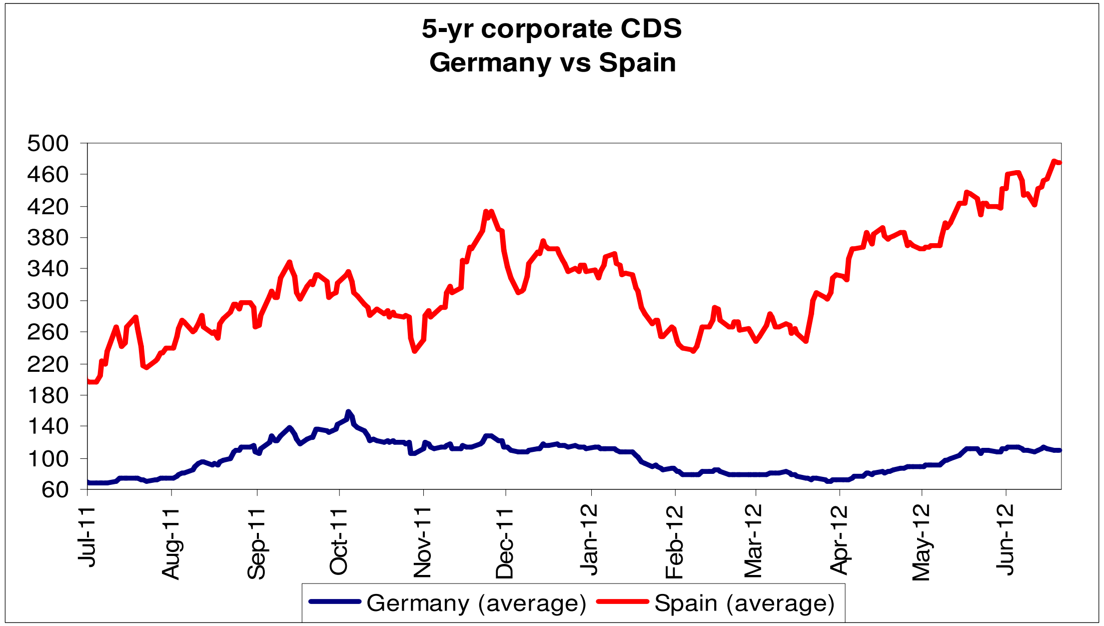
Source: Barclays Research

- ✓ Counties with high debt are unable to borrow at low rates from the international market, hence they lean on their domestic banks to absorb their borrowing needs
  - ❖ Domestic banks become overexposed to domestic sovereign debt, which in earlier times was considered safe but today carries the probability of becoming toxic.
  - ❖ Thus a **vicious cycle develops**, in which sovereign crisis becomes a banking crisis (Greece is a prime example), which feeds back to a worse country crisis, a prolonged recession, rising NPLs, etc.

II. Euro Area is taken apart by cash leaving the starved South and migrating to the North

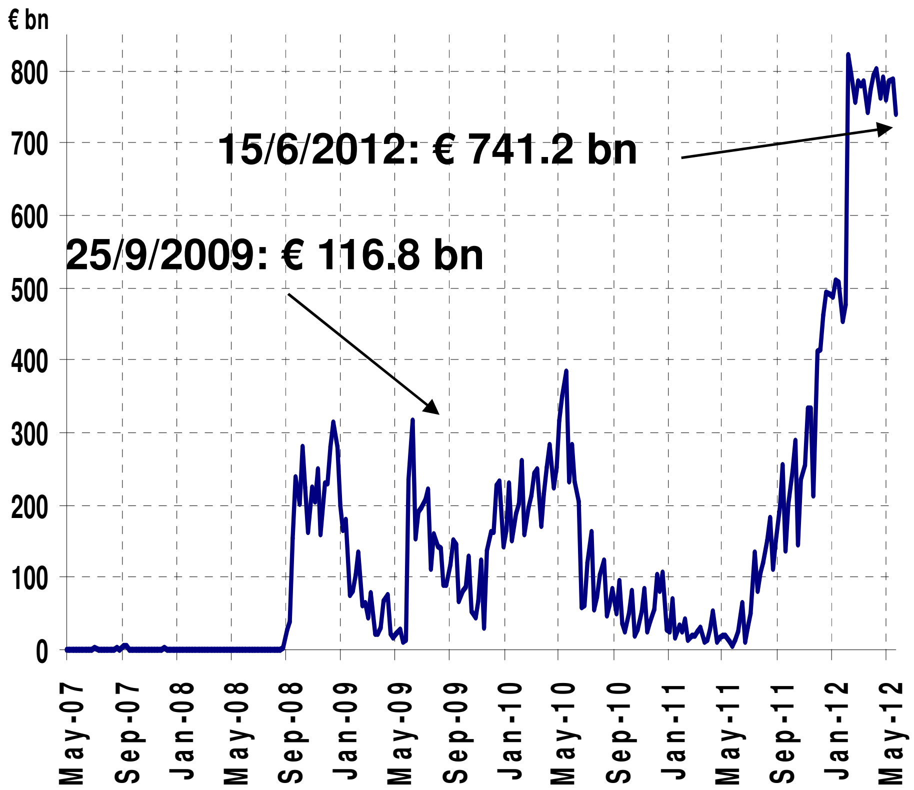
- ✓ **Cash is moving to the North and/or leaving Europe all together as it seeks security**
- ✓ **The North is enjoying its own euphoria of low cost financing, both in the public sector and the private sector**
- ✓ **This disparity hardens politics as Northerners fail to understand the plight of the South**



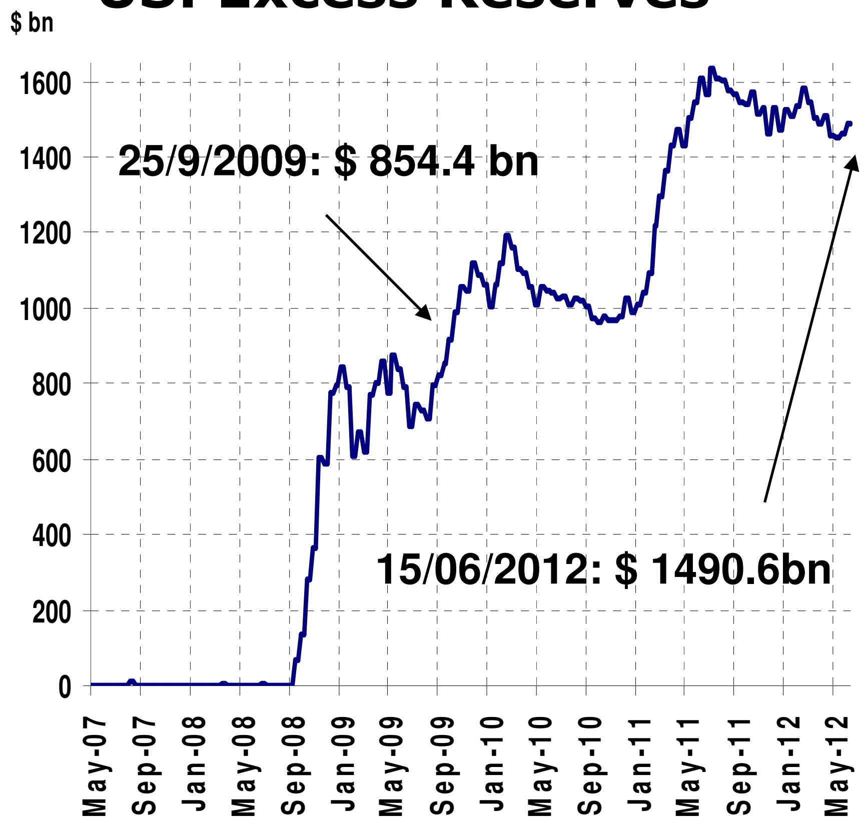


II. Overall, cash is being hoarded, yet liquidity is a major constraint

Euro Area: Deposit Facility



US: Excess Reserves



Source: Federal Reserve, ECB

✓ **We cannot claim the crisis is over unless the inter-bank market returns to normality**

III

I. Rising leverage & the Euro Area sovereign crisis

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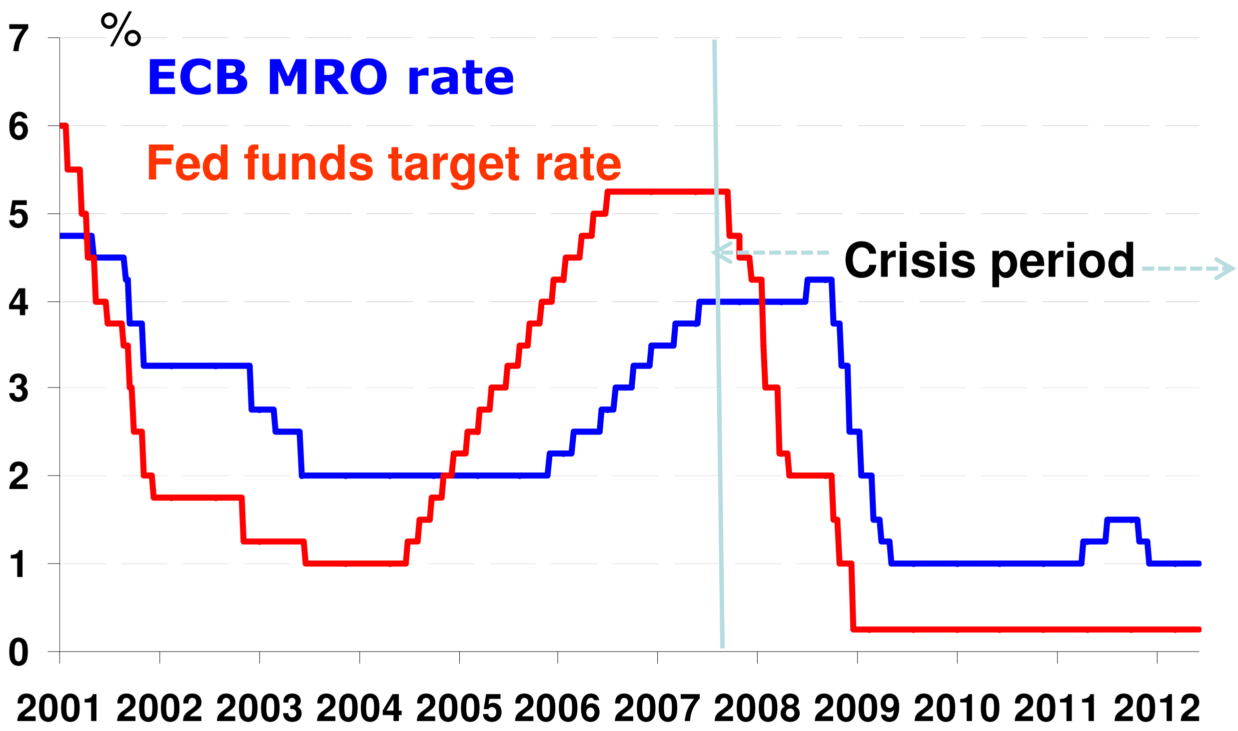
III. Europeans in disarray are fixing an architecture with a 15-year lag

- ✓ EMU was formed not because it was an Optimum Currency Area but because it served the political aim of eventual political union
- ✓ It faces its first major test, yet dissolution is not an option: Implies huge costs in financing, in trade, in politics and the average European living standards
- ✓ The crisis revealed <u>two needs</u>, <u>not necessarily complementary</u>:
  1) **Need for actions to contain the crisis**
  2) **Need for a better long-run framework, which would ensure long-term stability of the euro**
- ✓ Euro Area reversed the policy sequencing, focused on redesigning its framework first and ignored the need to contain the crisis
  - ❖ **The new design,** which comes ex-post with a 15-year lag, **tends to inhibit actions that add to moral hazard** but could counter the crisis
  - ❖ Example is the insistence on having the private sector participate in the losses; or the ECB's priority in the Greek PSI
- ✓ Given the mushrooming crisis, some sort of **banking and fiscal union** is unavoidable today
- ✓ Yet, the politics is short-sighted and varies across Europe, hence EMU may dissolve before politicians are able to act decisively

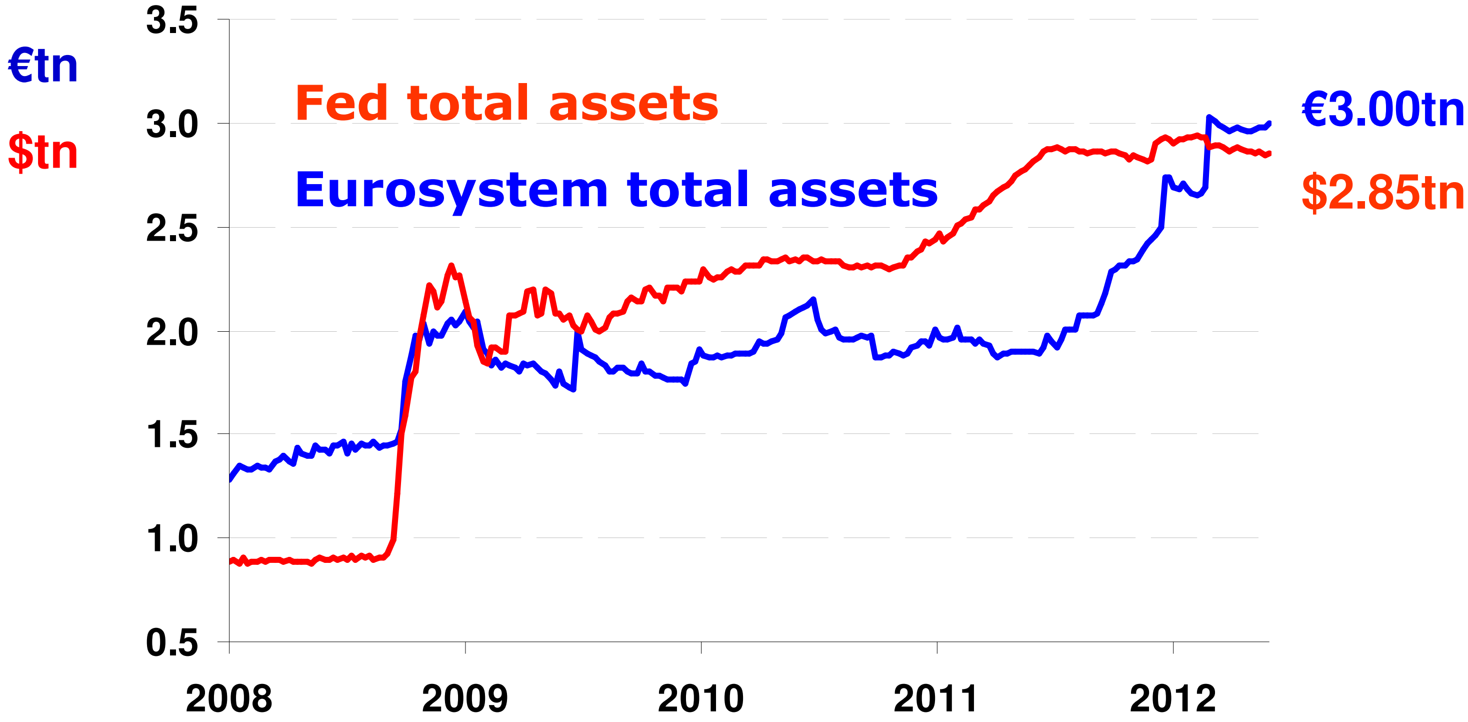
III. Can the ECB help avert the collapse?

- ✓ ECB is sluggish to respond, as evidenced by a comparative analysis with the Fed in managing the overnight rate
- ✓ Partly this is due to its single focus on price stability

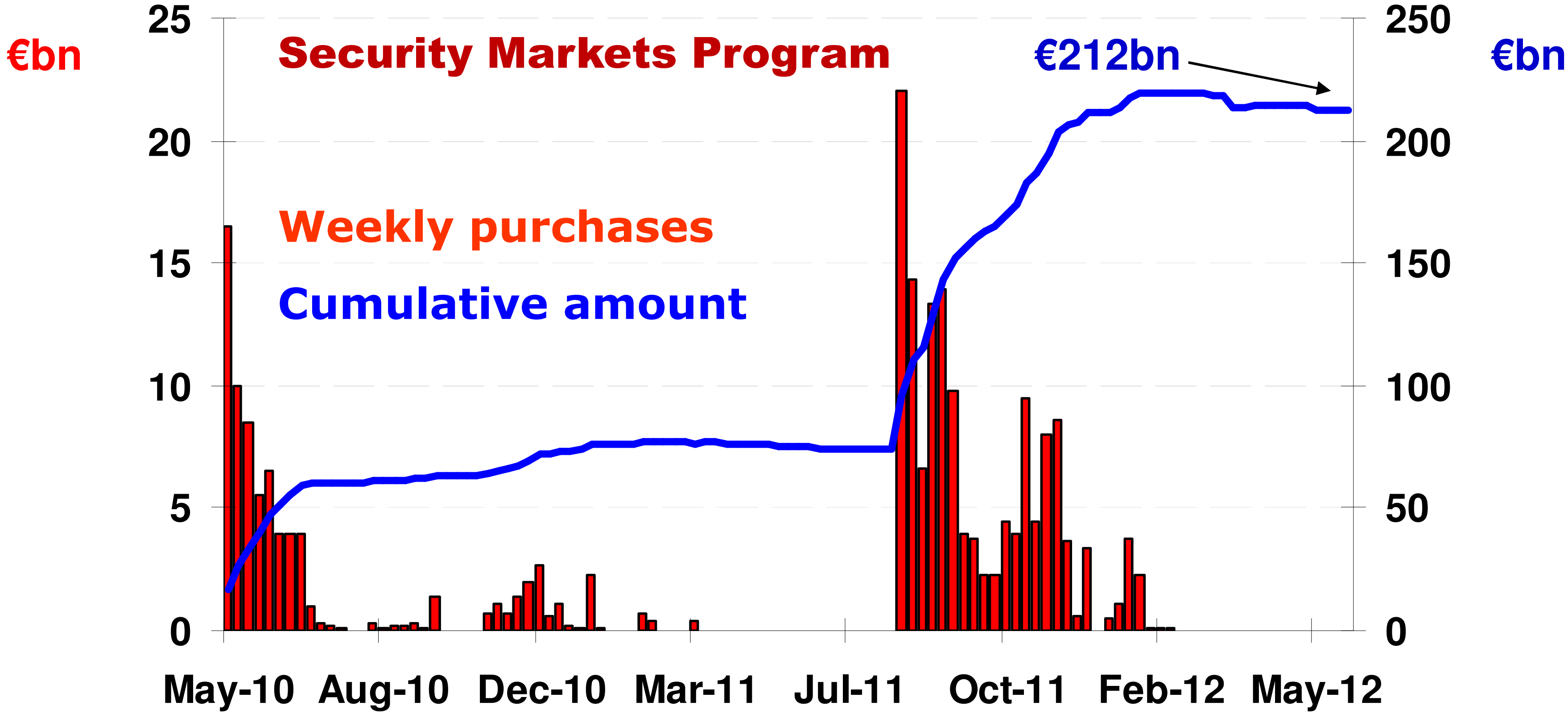


III. Quantitative Easing came late in the crisis

- ✓ The ECB has the power to provide ample liquidity and avoid the size constraints, which even a European Deposit Insurance system cannot surpass
- ✓ The Fed was more aggressive early on in using Quantitative Easing, yet the ECB also expanded aggressively in the second half of 2011 after the Italian crisis revealed a great danger to the Euro Area



III. Is a Euro Area "Operation Twist" possible?



- ✓ The so-called ECB's "nuclear option" or SMP began in May 2010
- ✓ <u>Markets could stop their pressure on the Periphery if</u> the ECB were to buy bonds of the Periphery and sell equal value bonds of the Center
  - ❖ This operation twist would be a special case of the SMP program
  - ❖ Yet, watch out for the subordination status of private bondholders following the Greek PSI and possible strange price effects

IV.

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IV. Final remarks

- ✓ The international crisis led to a sovereign crisis in EMU as it exposed major weaknesses, including the large size of government debt and lack of competitiveness in some of the countries
- ✓ The sovereign crisis mushroomed because Europeans were always behind the curve in their response: An originally tiny Greek problem was left to grow for the valid reasons of moral hazard and long-run discipline
- ✓ Yet the policy sequencing was wrong, as the economists' dictum was not followed: "*Solve the crisis first, then worry about moral hazard*"
- ✓ Today, fiscal discipline without a closer fiscal union are hard to coexist
- ✓ The sovereign crisis has turned into a banking crisis in the European Periphery, although in many countries the banking excesses preceded the sovereign crisis
- ✓ Liquidity is being transferred from the Periphery to the Centre, where countries enjoy low borrowing rates and are living their own euphoria
- ✓ The ECB is an institution that could play a more active role in averting an EMU collapse but it has to follow the aggressive mode of the Federal Reserve