The European Arm of the International Financial Crisis

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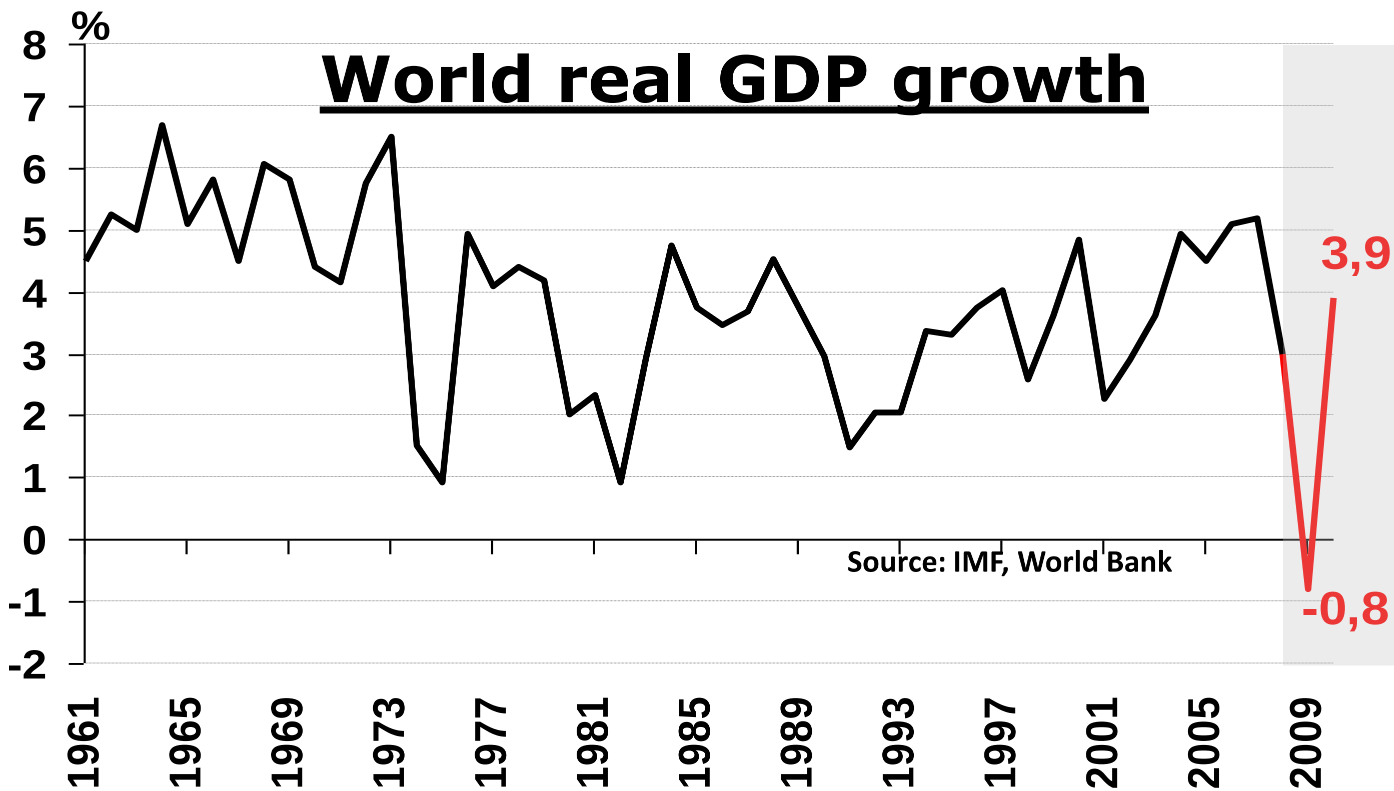
Table of Contents

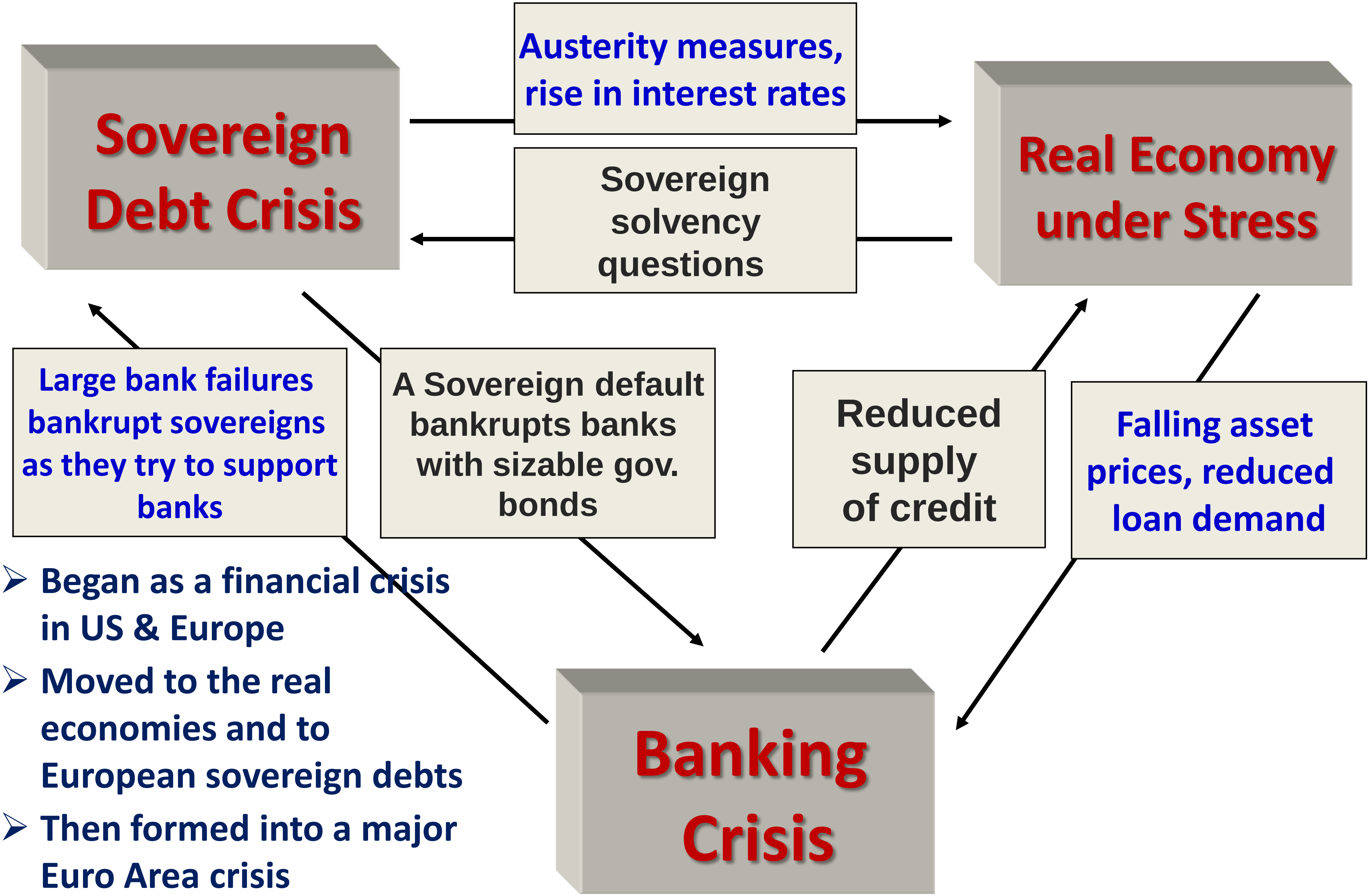
Introduction: The worldwide Great Recession

- 10 years ago, in Sept. 2008, the Lehman episode caught everyone by surprise: Economists, central bankers, regulators, rating agencies



- It led to a collapse in int/al trade and …
- … the biggest world-wide recession since the 1930s
- The international financial crisis, which had started in August 2007, stopped in 2009 thanks to heavy US intervention
- <u>USA faced two legs of the crisis</u>: Financial & Real Economy
- <u>Europe faced three legs</u>: : Financial, Real Economy, Sovereign

The three legs of a crisis



- Began as a financial crisis in US & Europe
- Moved to the real economies and to European sovereign debts
- Then formed into a major Euro Area crisis

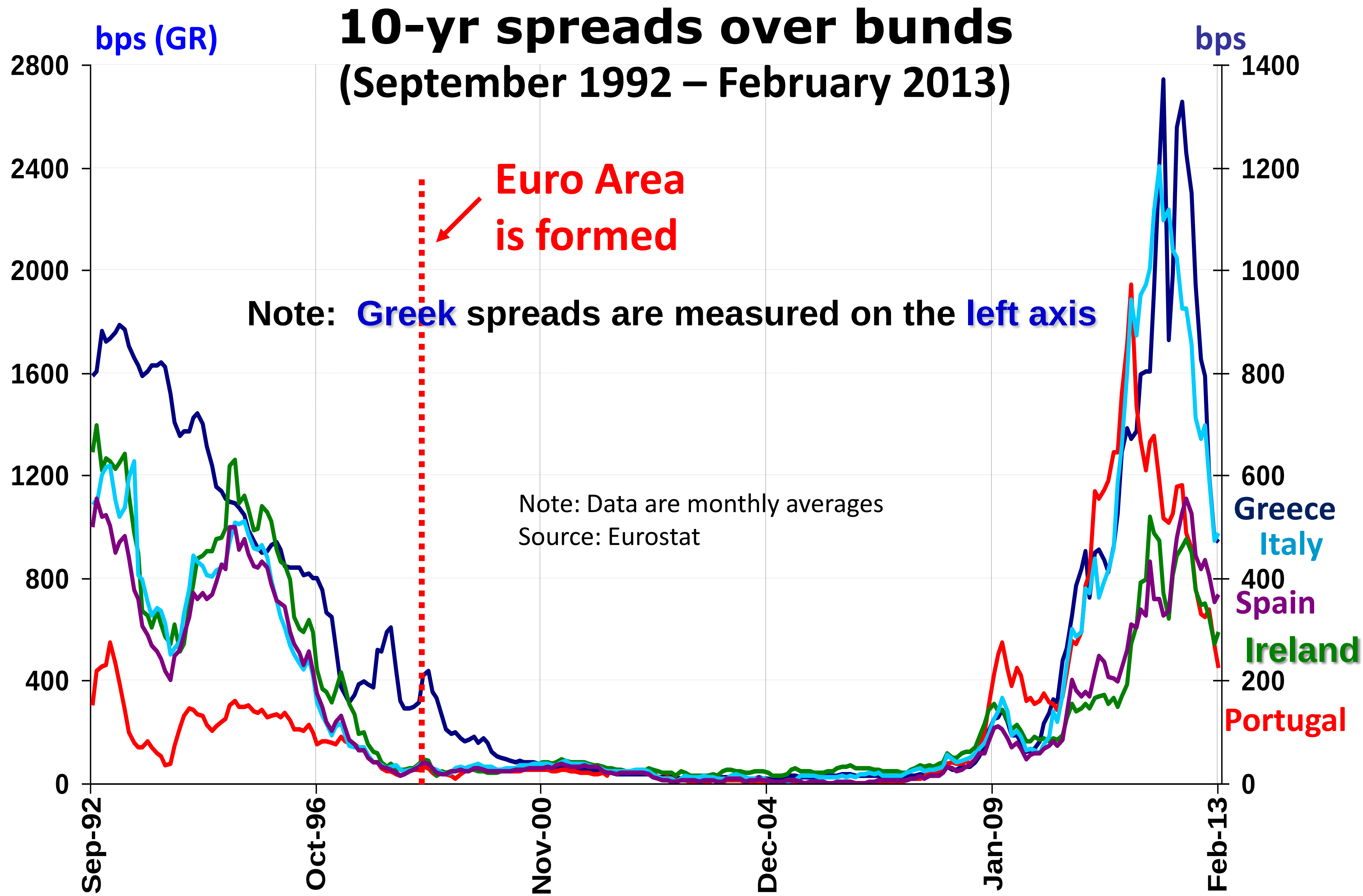
Source: Shambaugh, BPEA (2012)

Europe faces two consecutive crises

Diagram shows the cost of buying insurance for holding a bond issued by a European bank

❑ The second phase is more serious: It threatens the existence of the Euro Area

Euro Area torn by the bond markets



I. A brief history:
  - Three legs of the crisis
  - Two separate phases in its European arm

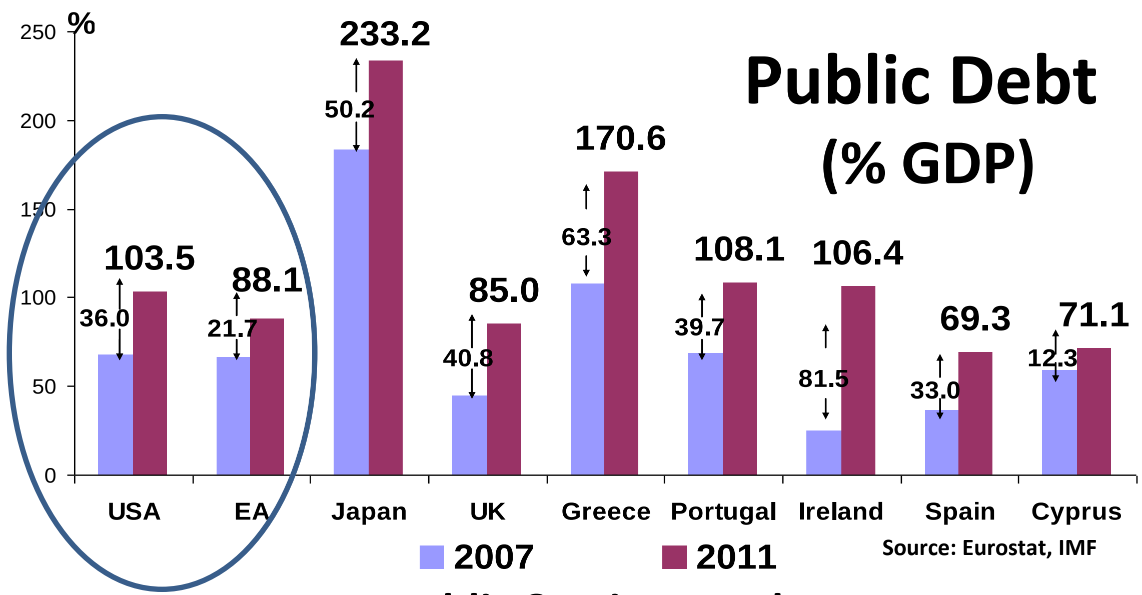
II. Euro Area at threat

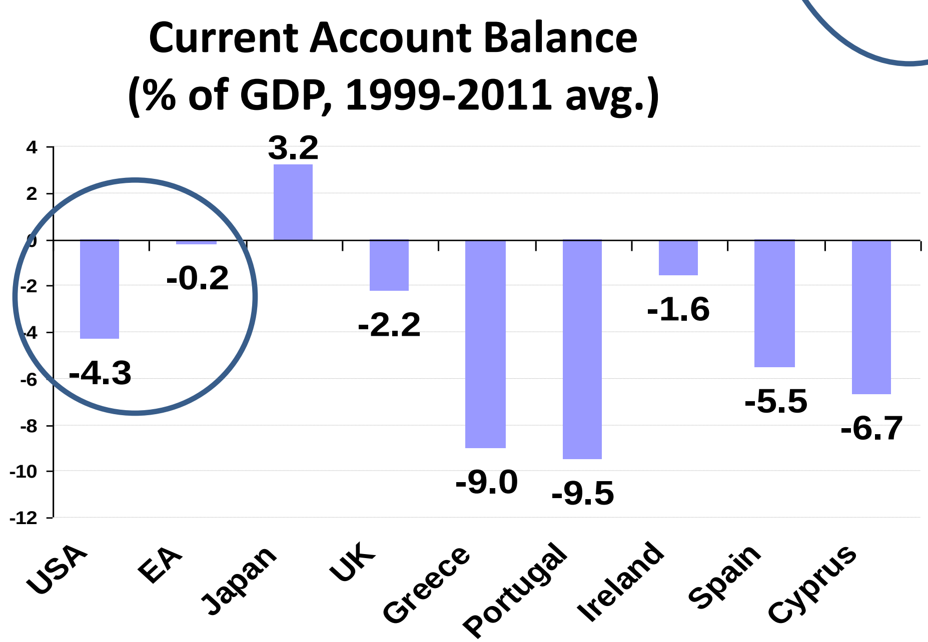
III. Greek troubles
  - Three crisis stages

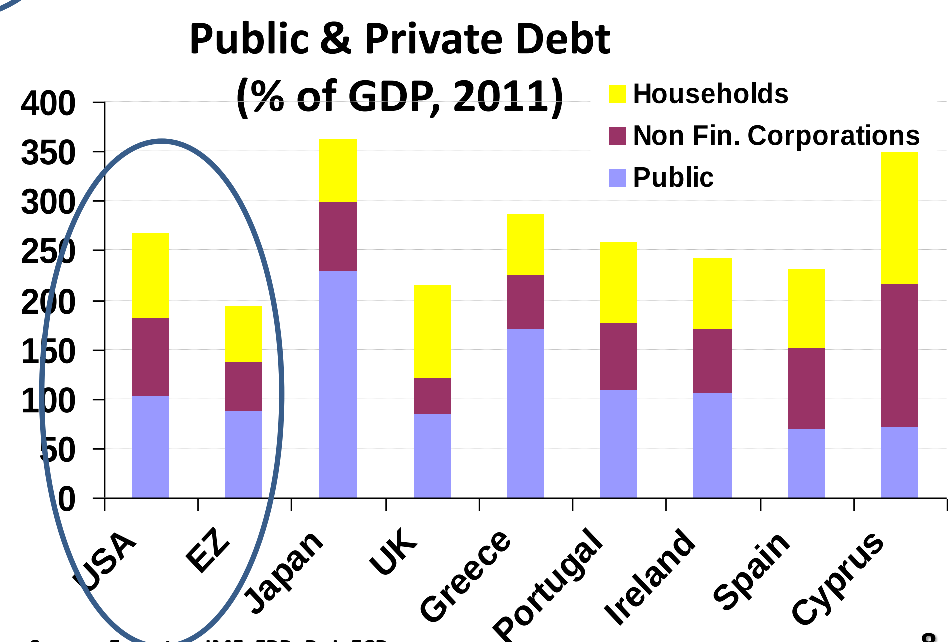
IV. Summary

Why an EMU crisis? Aggregate EMU statistics not necessarily worse than in the US

- **Euro Area in better shape than USA**
  1. Smaller Public Debt/GDP
  2. Same story in Private debt
  3. Balanced current account vs. negative in USA
- **A <u>crisis of cohesion</u> in Euro Area**







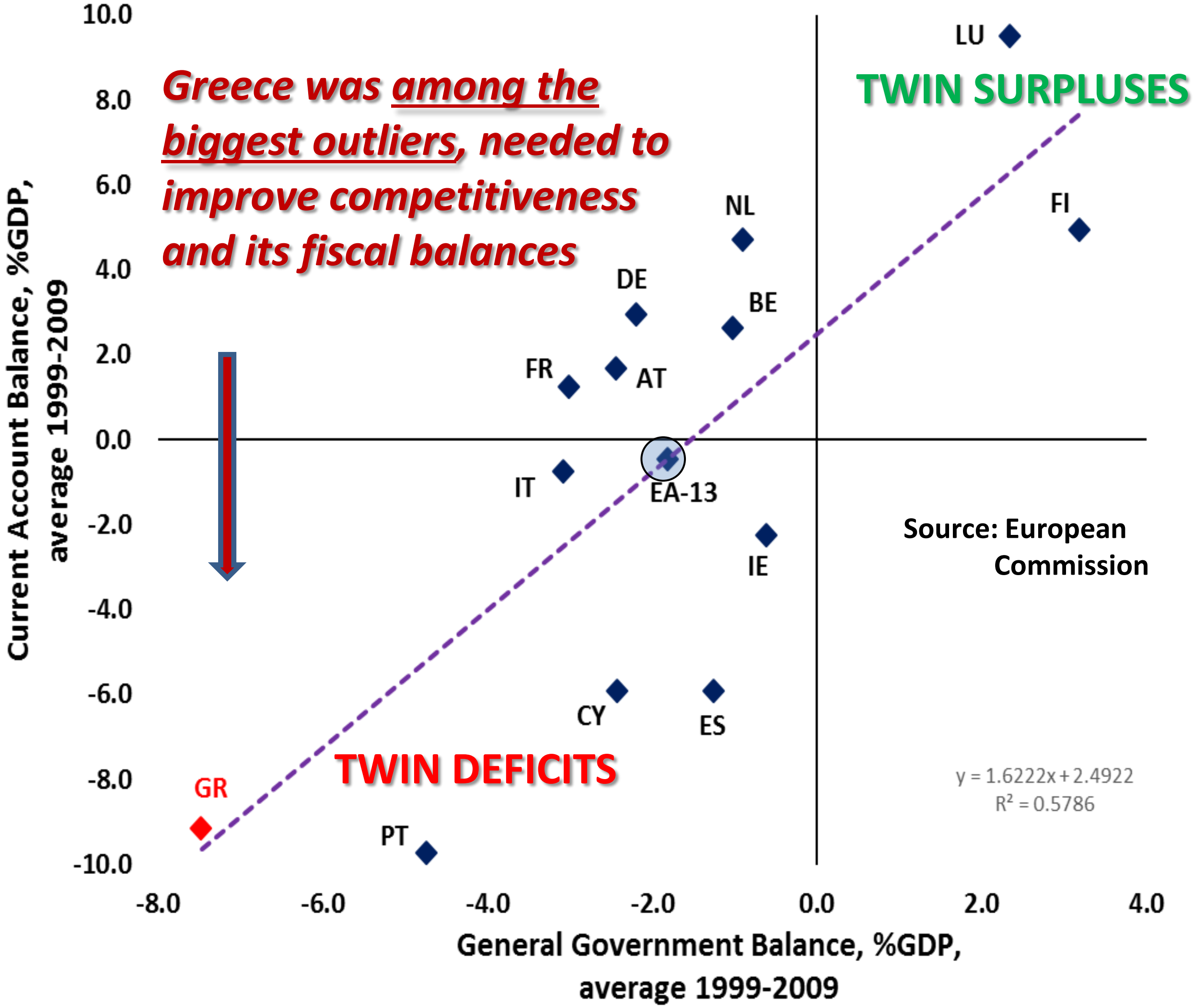
Source: Eurostat, IMF

Source: Eurostat, IMF, FRB, BoJ, ECB

Answer: Serious imbalances within EMU

- Post-EMU, a competitive North and an uncompetitive South emerged
- Politicians interpreted the EMU crisis as a fiscal crisis only
- There was no auto-matic mechanism to correct the imbalances as before 1999
- The South borrowed cheaply and Banks of the North were happy to expand: Everyone happy
- Markets did not price-in those imbalances

Average annual external and fiscal balance in EA-12 (plus Cyprus) before the Greek/EMU crisis hit in early 2010



Why EMU? A historical background

- EMU was a political project created by the Maastricht Treaty quickly after the fall of the Berlin Wall, initiated by the French, who viewed EMU as the first step toward the political integration in Europe, with Optimum Currency Area (OCA) considerations expected to be fulfilled endogenously over time
- OCA requires:
  1) Highly interconnected external trade sectors with free cross-country mobility of financial capital, labor, and products & services
  2) Adequate degree of uniformity across domestic economic structures and policies
     a. Common economic policy criteria, synchronization in fiscal policies
     b. Similarity in the structure of the real economy ,e.g. price and labor market flexibility, pension system rules, competitiveness rules, uniform degree of state intervention in the private sector, etc
     c. Common bank regulation and supervision
  3) Existence of a fiscal mechanism to smoothen the effects of asymmetric shocks, e.g. on the terms of trade, on size of foreign demand, on asynchronous domestic business cycle developments

The Greek crisis exposed EMU faults

- During the international crisis 2007-2009 many financial rescue decisions were taken within the G-20 forum ➔ the crisis did not raise concern about the stability of the Euro Area
- It was the Greek crisis which raised awareness of the EA faults as it caught Euro Area unprepared
  - Europeans rushed to rescue Greece in May 2010, abandoning the no bail-out principle; created the EFSF. Some argue it was their bank exposures to a Greek default that pushed them.
  - I think it was the fear of an EMU break up. GREXIT became a possibility and was priced in the bond markets. The BIG FEAR: What if a large country were to leave EMU immediately after once the precedent was established?
  - Yet at Deauville in October 2010 Merkel-Sarkozy wavered back, afraid of moral hazard and fiscally irresponsible copy-cat countries, hence claiming bail-ins, not bail-outs, would be the rule in the future
- Since the Greek crisis, European politicians continue to be torn between crisis mitigation and crisis prevention, trying to design a better architecture

A moral hazard rationale dominated the response to the Greek crisis

- Crisis brought to the surface **two needs**, not necessarily complementary:
  1) Need for actions to contain the crisis
  2) Need for reform, for a better long-run framework, which would ensure long-term stability of the euro and prevent a future crisis
- Academics agree: **Solve the crisis first** and then worry about the long-run architecture and the adverse incentive problems
- European politicians chose **a mid-way path**, hence tackling the crisis on a piecemeal basis, always running "behind the curve" of events
  - When the crisis hit Greece, the country seemed too small to impact the rest of EMU → Moral hazard reasons and austerity prescriptions dominated the discussions
  - Politicians also catered to their domestic constituencies and the domestic populist press, which painted the Greeks as lazy and corrupt, who are taking their money. They confused the EMU imbalances with moral arguments about the Greeks. They never took decisive actions, and were thus continuously "behind the curve" in their responses

New Institutions are created in EMU

- **Emergency safety net:**

  1) **ESM** (European Stability Mechanism, a continuation of EFSF) was activated in Sept 2012, modeled after the IMF, namely provides funds to Euro Area members under an MoU vetted by the Troika

  2) **OMT** (Outright Monetary Transactions) announced in July 2012, after the decision on the Banking Union and before the Mario Draghi's speech on "whatever it takes." Never utilized thus far. Monetary backstop. ECB can purchase unlimited amounts of member state's government bonds when under an ESM program and yields are under stress.

- **Banking Union** decision in June 2012 (see next page). Yet bank supervision more lax relative to the US, as capital rules on large banks are softer, allowing internal models to reduce the required capital.
- **Stricter fiscal rules** in the Stability and Growth Pact. An alphabet soup of pacts. Creation of independent national Fiscal Councils. Early submission to EC of annual budgets. Targets on the cyclically adjusted fiscal balance. Voting procedure on sanctions.
- Yet, <u>no transfer mechanisms initiated or envisaged</u>

Banking Union in Europe

- SSM since November 2014, looks over ≈128 large banks, first stress tests 10/2014
- SRM since 1/1/2016, it will have €55bn when fully funded, would first bail-in uninsured lenders up to a % of bank assets

Banking Union

Art. 127(6) TFEU: "The Council, ..., may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions ..."

Daniele Nouy

Single Supervisory Mechanism (SSM)

- ECB as central prudential supervisor of credit institutions in the Euro area
- Separation of prudential supervision from monetary policy
- Based on SSM Regulation and on SSM Framework Regulation
- In effect since 4 November 2014

Elke König

Single Resolution Mechanism (SRM)

- Single Resolution Board (SRB) as central European resolution authority for the Banking Union
- Single Resolution Fund replacing national resolution funds
- Based on SRM Regulation
- Applies to credit institutions covered by SSM from 1 January 2016

European Deposit Insurance Scheme

- Proposal by EU Commission to be published before the end of 2015
- Handling of larger shocks and increasing depositor confidence
- Level playing field for all credit institutions under Banking Union
- Based on "reinsurance approach”

Single Rulebook: CRD IV/CRR, BRRD, DGSD

Euro Area reform has stalled: Why?

- As the European economy rebounded, reform pressure subsided:
  - Not much is done since the Single Resolution Mechanism of July 2014, which is part of the Banking Union, and was initiated in the midst of the crisis in 2012
- Two sides to the debate (crisis mitigation vs. prevention):
  - (A) France, Italy and the European South worry about crisis mitigation; they support additional mechanisms of risk-sharing and stabilization, stronger governance
  - (B) Germany, Netherlands, and others worry about moral hazard and crisis prevention; they oppose additional risk sharing, and instead propose tougher enforcement of fiscal rules, market discipline

Euro Area reform: Yes, it can continue

- The IMF came out in Feb 2018 with a proposal for a tighter fiscal union
- In Jan 2018, a dozen French & German CEPR economists offer ideas on a number of financial, fiscal and institutional reforms that would **improve both crisis prevention and crisis mitigation**, i.e. both market discipline (→ lower moral hazard) and risk sharing (→ mitigate a crisis) in the Euro Area:
  1) **Break the Bank-Sovereign doom loop via sovereign bond concentration charges for banks and a common deposit insurance**
  2) **Switch to fiscal targets based on simple expenditure rules & finance possible planned deviations from those targets with junior debt**
  3) **Make the "no-bailout" clause time-consistent by designing orderly debt restructurings through legal and economic means**
  4) **Create a Euro Area fund to absorb large economic disruptions, with contributions proportional to its possible use**
  5) **Create a synthetic Euro Area safe asset (like a CDO)**
  6) **Reform the Euro Area institutional architecture by separating the watchdogs from the political decision makers**

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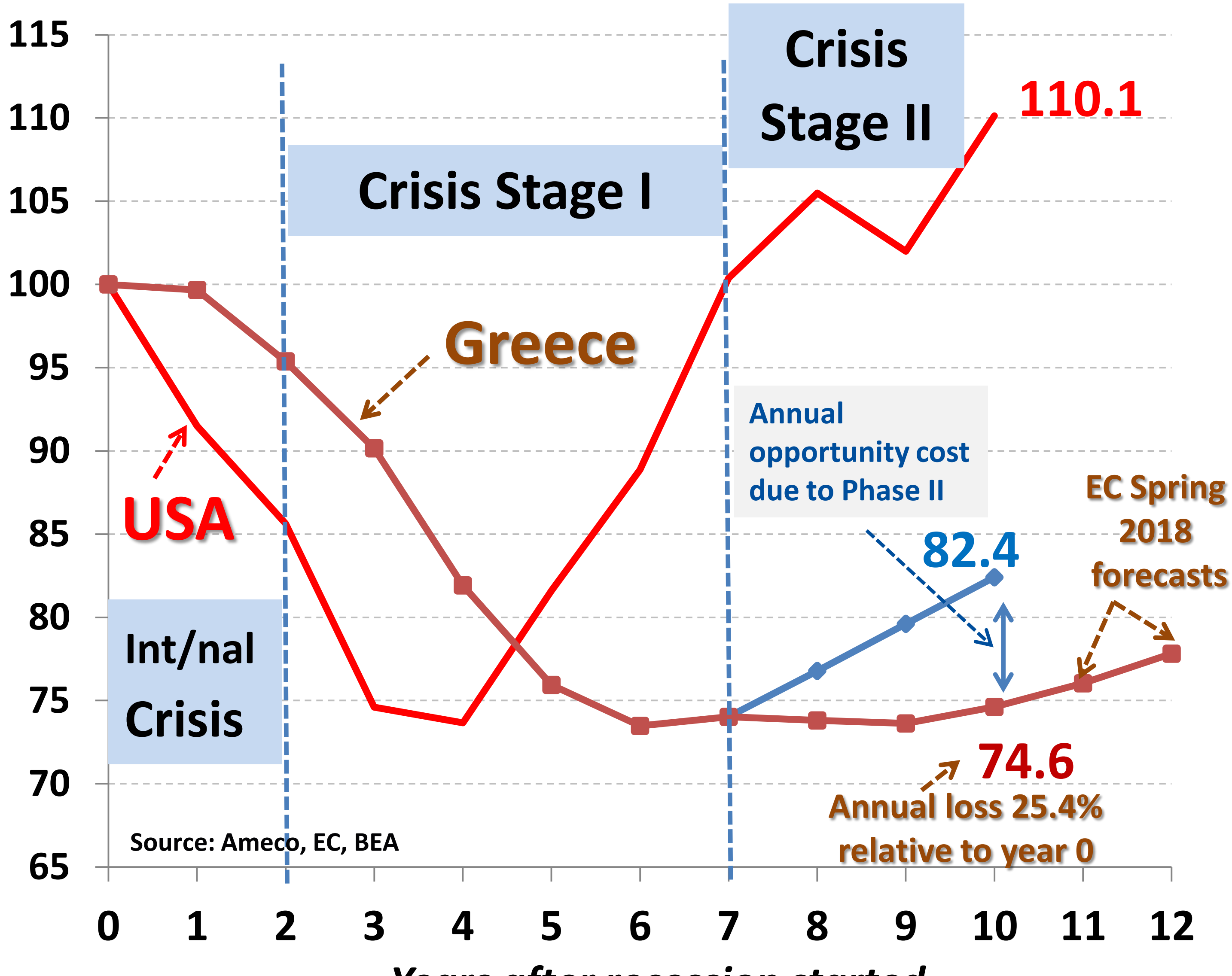
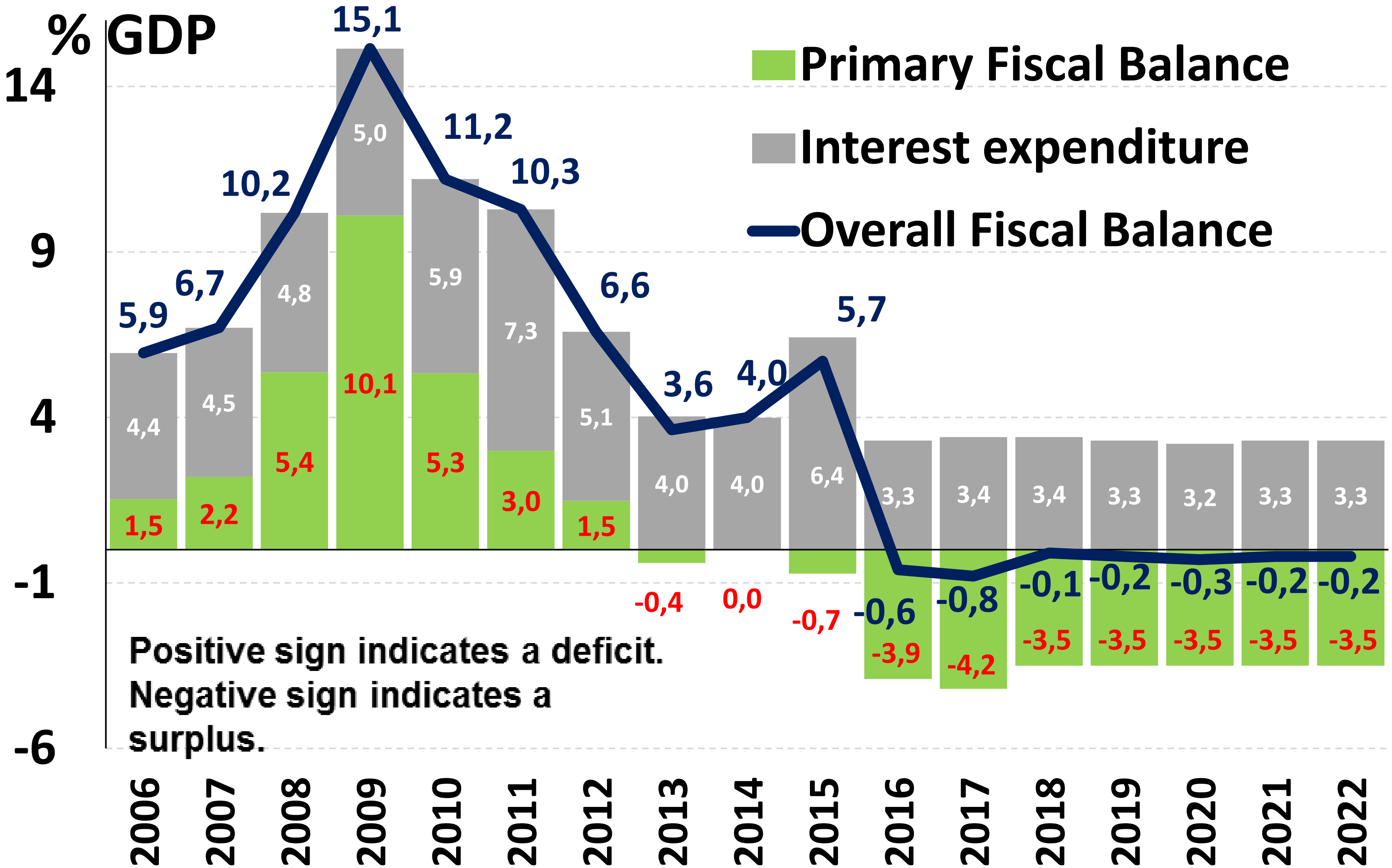
Two stages prolong the Greek crisis:
Economic imbalances drive the first – Politics the second

- Phase II costs annually 7.8 ppts or €18bn
- Was unnecessary
- Real GDP at 100 in 1929 for USA 2007 for Greece
- After 10 years, USA at 110.1 in 1939, but Greece at 74.6 in 2017
- Forecast as of Fall 2014: Greece at 82.4 in 2017



Fiscal imbalances are corrected by 2014

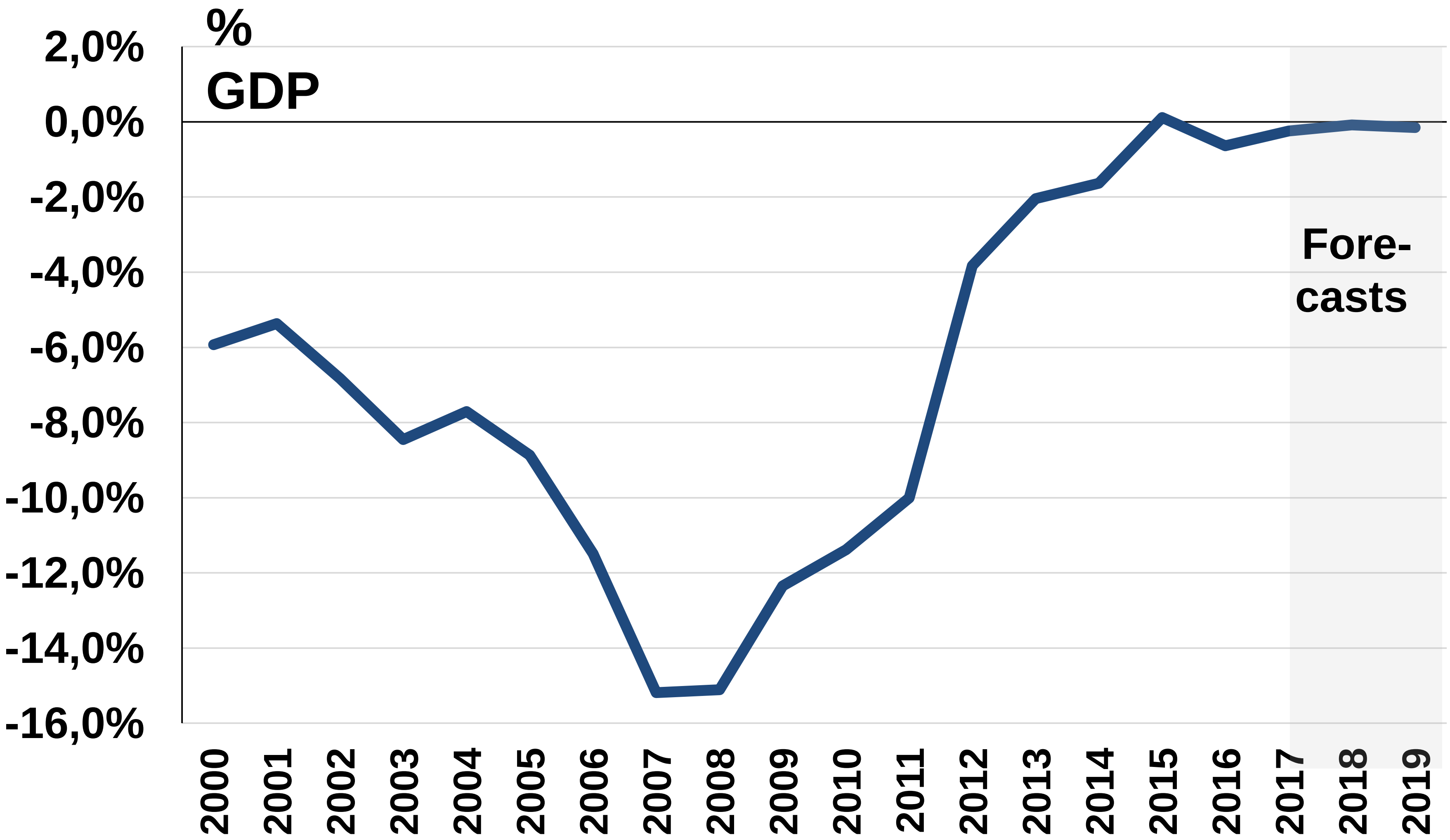
- Peek imbalance in 2009 (primary deficit at -10.1% of GDP)
- By 2013 the primary balance was at a surplus of 0.4% of GDP



Source: IMF, ESM, MTFS 2019-2022

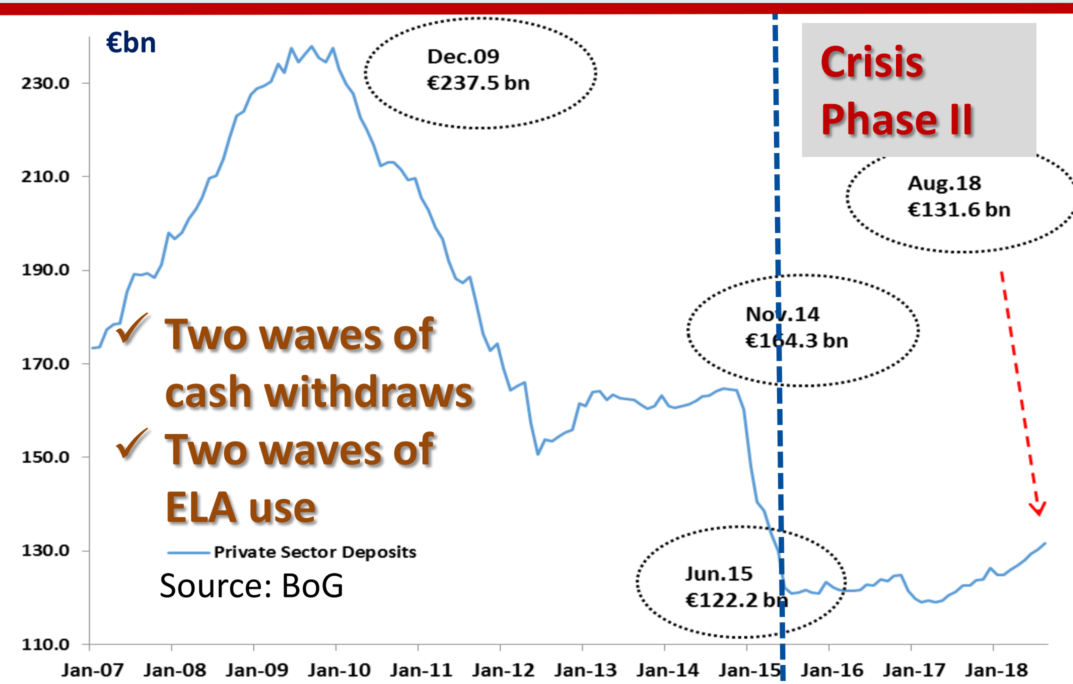
Current Account was also balanced

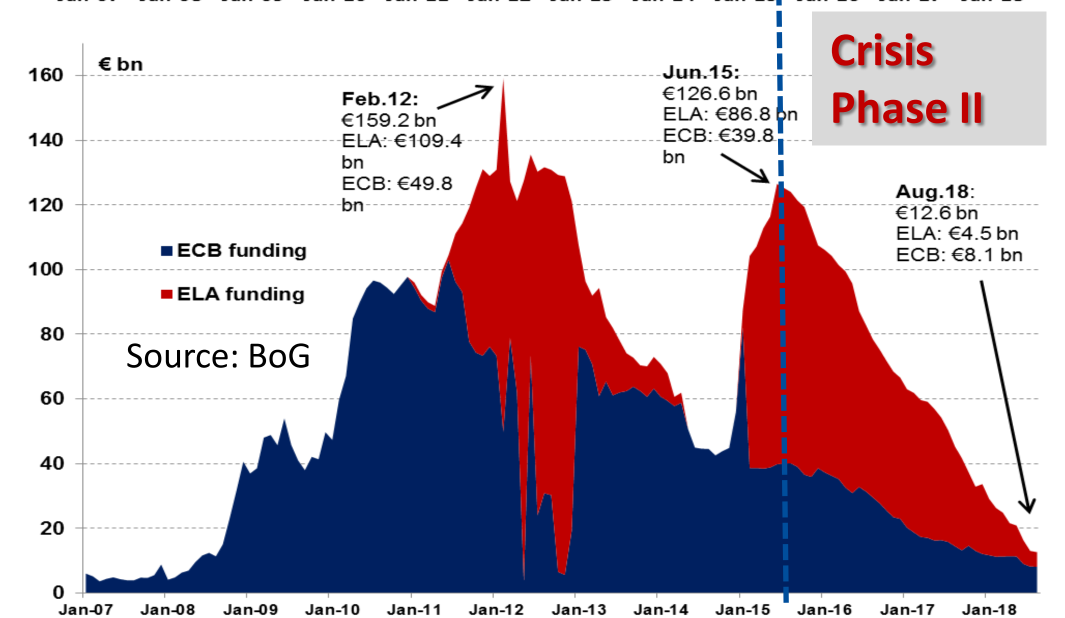
- Peak imbalance in 2007-2008
- Complete correction by 2015



A second wave of deposit withdrawals

- During the international crisis deposits were rising
- Two waves of cash withdrawals since 2010
- The second comes with stage II of the Greek crisis
- Dependency on the Eurosystem climaxed in 2011-12 and again in 2015

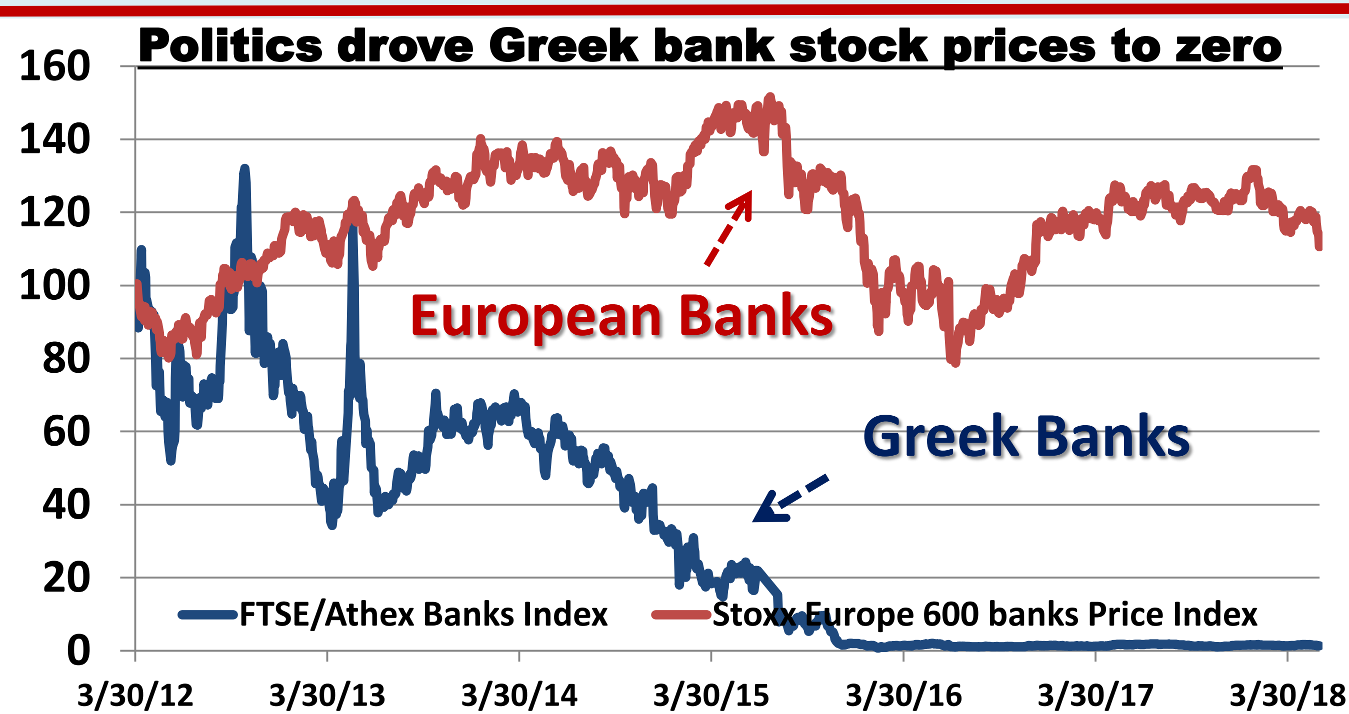


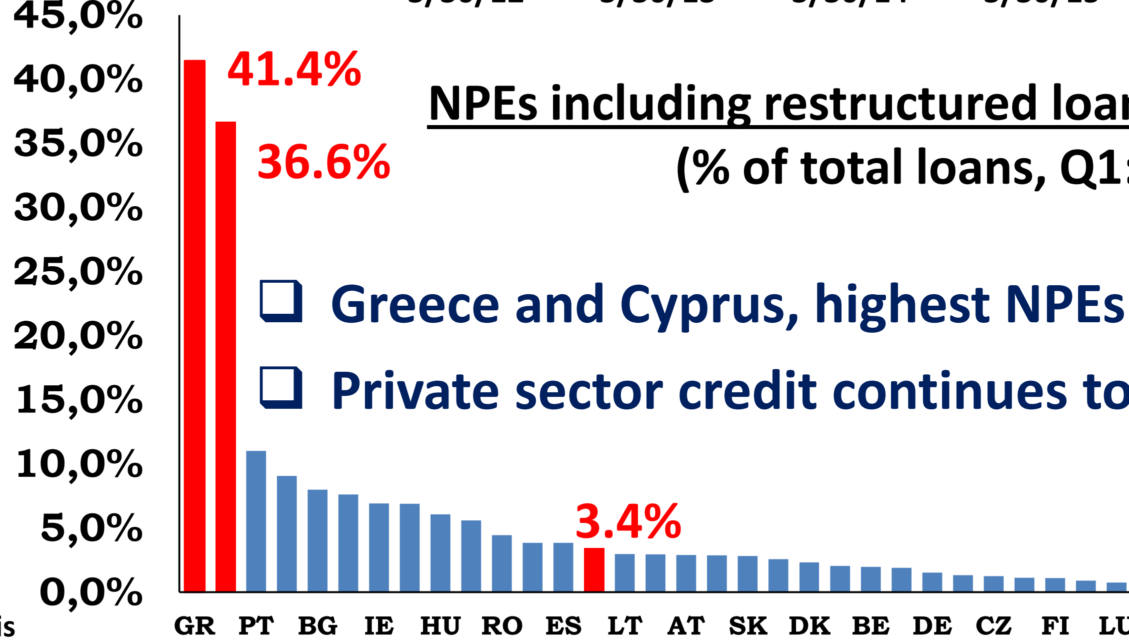


Greek banks face difficulties

BANK INDICES = 100 at 30/3/2012

- Bank stocks reached zero value for a second time in November 2015
- Earlier, they had gone to zero in Feb 2012 due to the default: PSI (Private Sector Involvement)





NPEs including restructured loans, EBA definition
(% of total loans, Q1:2018)

- Greece and Cyprus, highest NPEs in Europe
- Private sector credit continues to contract

Will Greece continue as a Euro Area member 10 years ahead?

- **Only if "revolutionary fantasies" like the 2015 one are not repeated – *this is probably the case***
- **Only if Greece continues to reform (*questionable*) and remains fiscally prudent (*possible*)**
- **And if banks manage to reduce their NPEs relatively quickly (*possible*, they have to bring them below 10% to be part of the Banking Union)**
- **Yet <u>stagnation is harder to overcome today</u> thanks to the 3-year delay due to the wild 2015 policies and the subsequent over-taxing policies, which brought <u>pessimism</u> and lack of investment drive**
- **European "enhanced" supervision for the foreseeable future**

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A summary view from the stock market

- ❑ Feb 2018: European financial stocks at 80% of Sept 2004 vs US financial stocks at 147%
- ❑ Yet European non-financials at 280% in Feb 2018
- ❑ Greek banks at zero at the end of 2011

Concluding remarks

- 10 years after Lehman we observe a different economic and financial landscape
- EMU faced all three legs of the financial crisis plus went through a double crisis, the second due to its own imbalances, which were triggered by the Greek crisis
- Financial regulators appear to be stricter in the US relative to Europe
- Challenging times ahead for Europe the moment cyclical recovery is over or the moment ECB begins restricting monetary policy
- Yet, EMU will not dissolve as easily as some colleagues of ours tend to think. Its architecture is changing and more is to come
- Greece can tag along as long as it reforms and keeps fiscal prudency, but has lost valuable time and GDP/income, thanks to an unnecessary and politically driven recession since 2015 that prolonged the crisis, brought capital controls, pessimism and lack of investment. The job for a quick long-term recovery is harder now than it was in 2014.

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THANK YOU FOR YOUR ATTENTION!

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