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Working Paper

Improving the Eurosystem for old and new members

UCD Centre for Economic Research Working Paper Series, No. WP12/03

Provided in Cooperation with:

UCD School of Economics, University College Dublin (UCD)

Suggested Citation: McCarthy, Colm (2012) : Improving the Eurosystem for old and new members, UCD Centre for Economic Research Working Paper Series, No. WP12/03, University College Dublin, UCD School of Economics, Dublin

This Version is available at:

<https://hdl.handle.net/10419/72247>

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UCD CENTRE FOR ECONOMIC RESEARCH

WORKING PAPER SERIES

2012

Improving the Eurosystem for Old and New Members

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WP12/03

January 2012

**UCD SCHOOL OF ECONOMICS
UNIVERSITY COLLEGE DUBLIN
BELFIELD DUBLIN 4**

Improving the Eurosystem for Old and New Members

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Ante Čičin Šain Lecture, Croatian National Bank, Zagreb, September 22, 2011¹

JEL: E58, F31, F33, F36

¹ Thanks to Gary O'Callaghan and Tomislav Presečan for helpful comments.

1. Croatia is an Obvious Euro-Candidate

Croatia appears to be an obvious candidate for membership in the common currency. Most of the money and credit stock is already denominated in foreign currency, mainly in Euro, most foreign trade is within the Eurozone, most of the banking system is in foreign ownership and no great advantages appear to be on offer from exchange rate flexibility. People think and plan in Euros.

But the experience of some smaller Eurozone members contains cautionary lessons for Croatia. The financial crisis has shown up serious flaws in the design of the common currency as well as glaring inadequacies in the policy response. Croatia's experience in managing a financial system substantially dollarized (with Euros) also sheds light on the problems already encountered by peripheral Eurozone members, such as the difficulties in controlling domestic credit expansion. The high penetration of Euros in a country with a reasonably stable currency of its own is also a foretaste of the problems a Eurozone member would encounter were it to depart the common currency or be ejected.

2. Design Weaknesses in the Eurosystem

Paul de Grauwe (2011) has argued that states participating in the Euro have placed themselves in a position where the risk of sovereign default is heightened, and it is salutary to note that, should Greece default on its sovereign debt as seems increasingly inevitable, this will be the first such sovereign default in Europe since the 1950s. Several other countries are at risk of sovereign default to varying degrees as evidenced by yield spreads in the bond market and prices for credit default swaps. The reason is that these countries can no longer create money to meet sovereign obligations in their own currency and have placed themselves in the traditional position of Latin American countries unable to borrow except in dollars.

The Eurosystem was designed without a lender of last resort to governments, whose exposure to sovereign default risks was concealed in the years up to 2008 in the great credit-fuelled convergence play in Eurozone bond markets. Risk premia on peripheral debt were almost eliminated. After the shock of 2008 the supply curve of sovereign credit is no longer elastic once debt ratios reach somewhere around 80% or 90% of GDP, and certainly not for countries which are no longer able to finance themselves, even temporarily, through monetary expansion. The ECB has paradoxically been a more reluctant lender of last resort to banks in the countries with the weakest sovereigns. These are by definition the countries with the least ability to fiscally support their banking systems.

The European Central Bank has chosen consistently to discriminate between categories of creditors of the distressed Eurozone members, favouring bank creditors over sovereign creditors. Allied to the Merkel/Sarkozy Deauville declaration of October 2010, envisaging explicit provision for sovereign defaults post-2013, these policies have cut the legs from under the most vulnerable sovereign bond markets. The result has been crisis intervention by the ECB to purchase Italian debt in the secondary market for fear of a collapse in Europe's largest sovereign debt market.

It is clear that the Greek crisis was fiscal in origin with inadequate budgetary control, falsified statistics and off-balance manoeuvres designed by Wall St. investment banks. Portugal too was lax in failing to address deficits and debt. But the problems in Ireland in particular, and also in Spain, were different. Ireland ran, on average, a fiscal surplus over the period from 1999 to 2007 and had, at end-2007, one of the lowest debt-to-GDP ratios in the EU. Both Spain and Ireland experienced monumental credit-fuelled construction bubbles and the transfer of banking debts onto the state balance sheet exacerbated the fiscal crisis in both countries. Robust policy architecture for a common currency area must be capable of responding to monetary as well as fiscal excesses, and must be able to distinguish accurately between the two.

3. What Happened in Ireland

In a single capital market loose monetary conditions can wash up on anyone's shore, and there can be no presumption that the national central bank (the local branch office of the Eurosystem) will recognise what is happening or be able to respond effectively. What happened in Ireland should be of particular interest to Croatia, a small country contemplating the abolition of its own currency and entry to the Eurozone.

It became clear in the Summer of 2008 that the Irish banks were in serious trouble. The national authorities had failed to appreciate the risks to system solvency consequent on a credit-fuelled property bubble financed through bank foreign borrowing in the Euro bond and money markets. After the Lehman collapse there was a run on corporate and wholesale deposits and the government responded in late September by guaranteeing virtually all of the liabilities of the Irish banking system, a figure approaching 300% of GNP.

A state-run asset management agency was established to purchase distressed assets from the banks at what was expected to be a limited discount. These measures appear to have been based on the presumption that the Irish banks were illiquid rather than insolvent or that if insolvent, the capital deficiencies would turn out to be manageable. This was a massive and costly miscalculation. Virtually all of the banks were bust, several having lost large multiples of their equity capital. Larger-than-expected discounts from the asset management agency helped to crystallise these losses. Shareholders were wiped out but bank bondholders have been paid, even in banks bust many times over, despite the resultant insolvency of the state itself. If the costs of bailing out bank bondholders had been zero, or kept at modest levels, most observers think that Ireland would have avoided an EU/IMF rescue given the low starting debt/GDP ratio. In this sense, the Irish crisis is a banking crisis and was not prevented by adherence to the Stability and Growth Pact parameters. Reviews of the origins of the Irish banking and fiscal crises can be found in Kelly (2009) and McCarthy (2009).

As the true extent of Irish bank insolvencies emerged through 2009 and 2010, the ECB continued to insist that bank bondholders should be paid at state expense, even to the point where the Irish government had to withdraw from the bond market in September 2010. There followed a succession of undisciplined public utterances from ECB officials and governing council members threatening a discontinuation of liquidity support to European banks. The result was a silent run on the most vulnerable, the Irish banks, and the government felt impelled to resort, in November 2010, to an EU/IMF rescue, see O'Callaghan (2011), who argues that the ECB exacerbated the run on the Irish banks.

ECB discrimination between categories of creditors is most clearly illustrated in the case of Anglo Irish Bank, the third-largest domestic bank when the crisis broke and responsible, on its own, for about half the total losses in the banking crash.

At the end of September 2008, Anglo Irish Bank had €4.1 billion in book capital. It was the first to run out of liquidity and sought government support shortly after the Lehmans collapse. Bank managements and the then Financial Regulator maintained that Anglo and the other Irish banks were adequately capitalised and that their problem was just a temporary shortage of liquidity, hence the government decision to guarantee virtually all of the liabilities of the banking system, Anglo included.

In the 27 months up to the end of 2010, Anglo alone booked €34.4 billion in loan losses, amounting to almost half of all the loans it had made. The losses in Anglo equal 8.4 times its book capital. To be clear, this bank has blown all of its capital not once but eight-and-a-half times. Bank busts on this scale have rarely happened anywhere in the world.

Anglo has since been wound down by the government. The bank has been turned into a resolution company which does not lend, does not accept deposits and is devoted solely to collecting whatever it can from those borrowers still on its books. It is also pursuing former executives over insider lending and will be gone altogether as soon as these tasks are accomplished. There are police inquiries under way into false accounting, share support schemes and other possible abuses. However most Anglo bondholders have already been paid and the remaining bondholders live on, including holders of senior unsecured bonds which do not enjoy any formal guarantee from the Irish government. At the insistence of the European Central Bank, these unsecured, unguaranteed bondholders in a bank which is in resolution are still to be paid over €3 billion, in full and with no haircut.

The Irish government was bullied into this commitment last November by the European Central Bank during the negotiations leading up to the EU/IMF rescue. The ECB threatened to withhold liquidity from the Irish banking system. and the government must have believed the threat. The sole beneficiaries of this ECB policy are the bondholders in this defunct bank, and the same generosity is being extended to unsecured, unguaranteed bondholders in other banks which are either defunct or would be were it not for government guarantees and capital injections. So far as I know, it is unprecedented for bondholders in defunct banks to be paid by a country already in an IMF programme. As a bonus Irish politicians are treated to regular lectures from EU and ECB officials about their generosity to Ireland.

The losers from this ECB policy are, most obviously, the Irish taxpayers, but it should be clear that the holders of sovereign bonds are being treated badly too. Forcing a government struggling to meet its sovereign obligations to pay billions of Euro to people to whom it does not owe any money weakens that government's capacity to meet its own sovereign obligations.

The ECB has never offered any coherent explanation for this policy. There appears to be some notion that paying off holders of bonds in dead banks at the expense of taxpayers and sovereign bondholders will assist confidence in the European banking system. The policy is a remarkably inefficient way to help under-capitalised banks, if that is the intention, since the bonds being re-paid are held by hedge funds, pension funds, life

assurance companies and numerous other mark-to-market investors, as well as by banks. Instead, the policy of protecting bank bondholders first at the expense of distressed sovereigns has helped to create a new short-circuit from shattered sovereign bond markets back into bank balance sheets and persists in the pretence that Europe does not have a banking crisis. Competing creditors, particularly risk-averse traditional holders of European sovereign debt such as pension funds, have been significant losers and have exited the peripheral bond markets in large numbers.

4. Fixing the Continuing Eurozone Crisis

At some stage policymakers will have to accept a Greek default, stand behind those sovereigns which can be saved and admit to their electorates that banks have to be re-capitalised, by the national fiscal authorities or by European institutions if necessary. It is an open secret that this has been the IMF position ever since the initial Greek crisis in April-May 2010. The extend-and-pretend policy of the EU Commission's DG Ecofin and the European Central Bank has bought time, at enormous cost, which has not been used productively.

It is reasonable to identify the Greek crisis as fiscal in nature and there are several countries, Portugal and Ireland included, which need to restore fiscal balance as quickly as possible. But the pretence that there is no banking crisis and that fiscal retrenchment in a few Eurozone members will rescue the single currency has been an expensive failure.

A Greek sovereign default now looks inevitable. Greek ejection from the Eurozone, through the withdrawal of liquidity support to the Greek banking system, would be a penal response from the ECB and I fervently hope they do not contemplate such action. As Willem Buiter (2011) has argued recently, it would make little sense for Greece to choose Eurozone exit: the economy would remain dollarised (with Euros), capital controls would not work, there would be little inflation tax revenue from a currency nobody wished to hold and every prospect of financial disorder and economic dislocation. The Eurozone is like the Eagles' song Hotel California: You can check out anytime you like, But you can never leave.

5. Designing a Eurozone Attractive to New 'Peripheral' Members

The greatest risk to small countries joining the currency union under prevailing structures and policies is the heightened risk of sovereign default, stemming from attempts to avert a banking crisis. The bursting of a credit and construction bubble will worsen the budget deficit dramatically and the additional fiscal costs of bank rescue can make the overall debt burden too large to handle. This is essentially the story for Ireland, and a large part of the story for Spain. The risk of excessive deficits and debt of the kind witnessed in Greece may however have passed. Fiscally irresponsible Eurozone governments will not emerge again for a long time, because the sovereign bond markets will not finance them.

The ECB has chosen to teach a lesson (basically, the lesson that they do not care very much) to sovereign debt-holders. The lesson to bank creditors is that they will be looked after, at the expense, if needs be, of taxpayers and sovereign creditors. This means that the risk of a credit bubble consequent on Euro entry has not been removed, although the risk of irresponsible budgetary policy is much reduced, since current policy is that only bank bondholders, and not lenders to sovereigns, should be exposed to moral hazard. Only limited consolation can be taken from foreign ownership of banks. As Kraft and Galac (2011) argue, the instruments available to control credit expansion are compromised in the absence of effective capital controls, and foreign-owned banks cannot be forced, under current arrangements, to stand behind bust affiliates in another member state. While it should be acknowledged that, for example, British banks stood behind bust units in Ireland and various European banks took their losses in Eastern Europe and the Baltics, they were in receipt of direct and indirect official support as they did so. There can be no guarantee that a government in the future might not be forced to bail out local units of foreign banks in order to protect depositors after a banking bust. It is probably quite a good idea for a small country to let someone else own the banks, but they can always liquidate and leave.

The best protection for a small sovereign would be a centralised system of deposit insurance, bank supervision and bank resolution. In a fully functioning currency union, such as the dollar area, these functions are centralised. If a bank headquartered in North Carolina, as some very large banks happen to be, goes bust, the Governor of North Carolina is not expected to pick up the pieces using only the tax base and sovereign credit of North Carolina. If this were the US system, state governors would refuse to allow banks to be based in their states. Or decline to join the dollar area when invited.

The responsibility which has been centralised in the Eurozone since 1999 has been the conduct of credit and monetary policy, with an independent central bank and an inflation target which has been taken seriously. The result has been the mother of all banking crises which remains unresolved. The response to the banking crisis has induced an avoidable sovereign debt debacle which now extends to about half of the Eurozone sovereign bond market. It could have been confined to Greece, or possibly to Greece and Portugal, if the scale of the banking crisis had been admitted from the beginning. The political response to date has consisted, especially in creditor countries in Northern

Europe, of pressures for a centralisation of fiscal policy and an intensified European oversight of state budgets.

The failure of the Stability and Growth Pact, first breached by France and Germany, not by Ireland and Spain, has resulted in demands for a stronger fiscal pact with additional sanctions. It is extraordinary how often the failure of a policy leads to demands that the failed policy be intensified. What Europe needs, and what Croatia should expect, is a European Central Bank which is empowered to take responsibility for financial stability in the single capital market. This means centralised bank supervision and resolution, centralised deposit insurance and an end to moral hazard and the implicit subsidisation of capital for banks. It does not need fiscal union, for which there is no democratic consent: fiscal discipline for the foreseeable future can safely be entrusted to the bond market vigilantes, who have thankfully risen from their slumber.

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