European crisis and its implications for global inflation dynamics

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It is a pleasure to participate at this conference on "Globalisation and inflation dynamics in Asia and the Pacific", and I appreciate the opportunity to share some thoughts with you about the implications of the ongoing European crisis for global inflation dynamics.

Let me begin with a few words on the broader topic of the conference. Over the long term, inflation is always and everywhere a monetary phenomenon. But over shorter horizons, inflation dynamics are driven by the interaction of an economy's productive capacity with demand, and the influence of macroeconomic policy on both.

Globalisation has influenced the inflation process through a number of channels. First, by allowing the gains from trade to show with greater force, it has facilitated more efficient production on a worldwide scale, which could be seen as a positive supply shock to each economy benefiting from it. This was an important factor that provided a benign backdrop for monetary policy during long stretches over the past 20 years. Against this backdrop, central banks around the world consolidated disinflation gains that brought us to an environment of relative price stability worldwide.

Second, globalisation may have influenced the response of inflation to any difference between domestic demand and domestic potential supply. The global balance between demand and supply becomes a greater force in determining inflation dynamics in an economy with greater links to the rest of the world. By linking the economies around the world more closely, globalisation has facilitated a potentially more forceful transmission of shocks from one part of the world to others.

Which brings us to our specific topic for this evening, the implications of the ongoing European crisis for global inflation dynamics.

The key word, I believe, is uncertainty. When looked at as a single economy, the euro area, the collection of the 17 economies that have adopted the euro, is the second largest economy in the world, with the US still being the largest. At the moment, the euro area is at the centre of a financial crisis with global dimensions. The risk of disintegration is not negligible, with global contagion effects that are as difficult to assess as what we experienced only a few years ago with the collapse of Lehman. But the situation is far more dangerous as the starting conditions are more precarious. The repair from the global recession of 2009 is far from completed, indeed balance sheets are weak. In many economies, there is much less fiscal space to deal with additional weakness. In this setting, we can envision three different scenarios in Europe with vastly different implications for global inflation.

A catastrophic scenario in Europe, a full blown crisis in the euro area, could impart deflationary pressures to the global economy. We have recently been through such a close call, following the collapse of Lehman. A vast monetary policy expansion at a global level averted the worst in 2008–09. But monetary policy at the moment is still overextended. In many economies, policy rates are near zero and we are operating in unconventional territory where the effectiveness of additional easing is much more uncertain. So the risk that

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monetary policy may be less effective in containing the deflation concerns is higher than it was three years ago.

A muddling-through scenario in Europe, where the current environment of instability remains but with just sufficient action on the part of governments to avert deterioration, should be neutral on the expected inflation developments around the world. But such a scenario would come with continued high risks, perhaps increasing risks of trouble. Even with the best intentions of avoiding one, an accident can occur due to a miscalculation.

A good scenario in Europe is one that restores the euro area to a sustainably stable path. This would certainly be welcome. But in that case, central banks around the world should be ready to face an inflationary dynamic. With global liquidity currently at exceptionally high levels, restoring confidence and solid growth in Europe could quickly move the global economy to a phase of excess credit growth and exuberance, feeding into inflation.

So the implications of the European crisis for global inflation depend crucially on how it evolves in Europe, that is, how it is handled going forward. To assess the likelihood of the different scenarios, it may be instructive to review how we got to the current stage of the crisis and some of the options ahead regarding its resolution.

The ongoing global crisis did not start in Europe. The beginnings can be traced to the United States, where, starting in the summer of 2007, we saw the first serious cracks in financial markets. The crisis had still not reached the euro area in a major way until after the collapse of Lehman in September 2008. The global recession and financial crisis that engulfed virtually all developed countries at the end of 2008 and 2009 also proved painful to Europe. But unlike most of the rest of the world, in the euro area the recession also brought to light weaknesses in the construction of the euro that thrust the crisis into a new phase, the one we are still experiencing today.

The euro area is an economic and monetary union. A monetary union enforces monetary policy coordination and a common lender of last resort to the banking system for the union as a whole. For a monetary union to function properly, however, additional coordination and cooperation are necessary. Some minimal policy coordination and control are needed on fiscal policy. The protection of the integrated financial sector is also necessary. One way to achieve these is with a complete political union, a solution that was ruled out in the construction of the European Union. Rather, the idea for the European Union was to form a single economy, an integrated financial system, in the euro area a single currency and single monetary policy, but still leave sovereign states to handle their own fiscal affairs and retain all risks with fiscal implications. The European Union treaty prohibits member states from assuming the debts of other member states and prohibits monetary financing by any central bank in all member states.

On the fiscal side, the minimal coordination that was adopted rested on member states respecting strict limits on debts and deficits. This was the objective of the Stability and Growth Pact. Tight control of fiscal policy in each individual member state would ensure that no member state would run into trouble with its fiscal finances. In order to avoid any moral hazard issues, no crisis management mechanism was set up at the beginning. It was assumed that the strict fiscal rules and the absence of any crisis management mechanism would be sufficient to avoid any country getting into trouble.

The global recession and financial crisis revealed two flaws in this construction. First, the crisis revealed that the fiscal framework was lacking. It was not respected by all member states and could not be properly enforced. In the case of Greece, towards the end of 2009 it became clear that the country was running fiscal deficits that had been and were projected to stay too large, raising questions of debt sustainability.

Second, the crisis revealed that the financial integration construction was fragile. Before the crisis, EU directives and regulations promoted a single unified banking sector. Banks based in one member state could easily operate everywhere in the Union, take deposits, take risks in lending. But supervision, deposit protection, resolution, all remained nationally based. The crisis showed that this nationally-based banking system embedded in a monetary union was not robust to large shocks. Paraphrasing Mervyn King, large banks were European in life but local in death. More than anything else, in the euro area this element has been at the centre of the negative feedback loop between sovereigns, banks and real economies in member states. This has been a source of trouble in the euro area in particular because the lender of last resort to the banking system is a European institution – the central bank of the euro area, that is the ECB – while no similar euro area resolution authority exists.

The resulting mismatch has created and continues to create severe problems. In the case of Ireland, the banking crisis in late 2008 created large demands for the resolution and restructuring of the banking system. Although the cost of a collapse would have created severe contagion for the euro area as a whole, the member state was called to incur all of the cost of cleaning up. Despite having a very good fiscal position before the crisis, Ireland was forced to take up the implicit liabilities associated with supporting its banking sector that generated concerns about the sustainability of its debt going forward.

The euro area construction was incomplete and did not have a crisis response mechanism in place to handle such developments. Bold political leadership was necessary to control the problem effectively. Unfortunately, the political response proved inadequate and added to the problem rather than alleviating it.

Let me be clear. In both cases mentioned above, Greece and Ireland, the initial shocks were very small for the euro area as a whole but very large for the country in isolation. A European solution from the very beginning could have easily contained the consequences of these shocks. In the event, the policy response magnified the cost and transmitted it also to other economies in the euro area, and the world. By the end of 2010, both countries had to resort to the IMF and their euro area partners for assistance.

In terms of GDP, Greece and Ireland make up around 2% of the euro area. For the euro area as a whole, the shock uncovered in Greece due to fiscal imbalances and the shock to Ireland due to the banking collapse could be contained if euro area governments were willing to tackle them collectively. But to do this properly would have required some degree of coinsurance, mutual help. The problem with this was concern about the moral hazard such a solution could have created for the future. For some governments in the euro area, this was anathema.

Perhaps the most important casualty of the crisis in Europe is that of trust among governments of the member states and their people.

In the face of the crisis, European leaders decided to provide loans to countries faced with shocks that brought their debt dynamics into question. But they also decided to rule out the mutual help framework that could have ensured stability in each state going forward. Rather, European governments decided to magnify the credit risk in sovereign paper as a means to avoid the future moral hazard.

In October 2010, following first a meeting in Deauville between the leaders of France and Germany and then confirmed in a European Union Summit in Brussels, a fatal error was committed by the governments. They decided to introduce the concept of private sector involvement (PSI) in euro area debt. The idea was that an investor buying euro area sovereign debt should no longer assume he would be repaid in full. Rather, any investor would have to worry that if the country faced the prospect of high debt, then a haircut on the debt would be implied, even if there was no issue regarding the sustainability of the debt.

In 2011, with decisions on 21 July and 26 October, European leaders went further and forced a selective haircut on Greek debt. By creating the precedent that a member of the euro area would be forced to impose a haircut on the holders of its debt, they reinforced to investors how the PSI concept would be applied in any other member of the euro area.

Introducing the prospect of sovereign default was bad enough, but it got worse. As a consequence of the forced and highly selective default of Greek debt, combined with an adjustment programme that was seen as too harsh on the Greek population, questions about the prospect of Greece leaving the euro started appearing. It did not help that some analysts and academics were arguing that Greece would be better off if it unilaterally left the euro area. Whether Greece should remain in the euro or not was arguably the main question faced by voters in yesterday's election in Greece. Of course, what is a prospect for one member state could later be a possibility for another. The irreversibility of joining the euro area was brought into question.

This phase of the management (or rather, mismanagement) of the crisis by European governments introduced currency risk into the mix on top of sovereign risk. The idea of leaving the euro, for Greece or anyone else, is to allow for a devaluation that might ease the immediate pressures of economic adjustments. You can imagine the incentives this created for private depositors to maintain deposits in accounts in euros in Greece.

In a short two years, the crisis response to a small problem by euro area governments introduced credit risk in sovereigns and currency risk in deposits in member states perceived as weak, threatening the whole construction of the euro area.

At the moment, the system is extremely unstable. It is essential to understand this to comprehend the global risks of something going wrong and the adverse scenarios it could create. Let's focus on Italy and Spain, the third and fourth largest economies in the euro area. At the moment, because of the credit risk embedded in euro area sovereigns, the financing costs for the governments of these countries are a few percentage points higher than some other countries in the euro area, including Germany and France, the largest two. Such differences cannot be sustained for long.

Suppose someone is concerned that the deterioration of the recession might cause additional losses in the banking sector in the countries perceived to be weak. In the current setup, if banks in these countries require future support from their governments, the responsibility falls squarely with these governments.

In this setting, would it be unreasonable for private depositors to be concerned that with some small probability these countries too might be engulfed in a debate about whether they should leave the euro in the future? Would it then be unreasonable for businesses and households to wonder whether it may make sense to have euro accounts with any extra euro deposits held as savings in banks in member states that are perceived as stronger?

The same destabilising dynamic that has shifted demand for sovereign debt from the weak to the strong states inside the euro area is creating incentives for deposits to flee from the states perceived to be weak to the states perceived to be stronger. A worsening of the crisis should not come as a surprise unless some fundamental aspect of the design of the euro is changed. How things evolve depends on whether European governments move towards adopting a solution that removes the destabilising forces inherent in the euro construction or choose to limp along, risking a collapse on the way.

Solutions do exist, if the political will can be found to adopt them: Let me briefly mention two possible solutions, both with different pros and cons. One solution is moving towards a more complete political and fiscal union – find a mechanism to reduce the credit spreads introduced by the earlier decisions. Ideas like eurobonds with mutualisation of risks associated with government borrowing are on the table. If adopted, these ideas can diffuse the immediate pressures. But without a mechanism to control spending by sovereign governments, these solutions could create more severe tensions in the long run. Without a stronger political union, one that reduced the sovereignty of state governments to control their spending decisions, this may not be feasible to design properly.

Another solution is to move towards a more integrated financial sector – a banking union. The idea here would be to break the loop between sovereigns and banks so that even if a sovereign is considered weak, banks based in that country and the real economy are not unduly penalised for this. Banks must not be penalised depending on where their head office happens to be, which is currently the case. We must delink banks from sovereigns. As in other areas, we need to work backwards to solve this problem. Banks, their customers and their shareholders must face the same responsibilities and same opportunities everywhere in the union – at least in the common currency area.

In the euro area, at the moment, we observe that the sovereign crisis has increased the heterogeneity of the member states, has increased the segmentation in banking and is threatening the functioning of the currency union and the common market. To reverse this dynamic, Europe needs a truly European solution on bank stability, resolution and deposit insurance. There are frameworks elsewhere that could serve as examples. In the United States, for example, the supervisory environment and operation of the FDIC implies that depositors need not worry about the safety of their deposits depending on the finances of the state where their bank is headquartered. And resolution is the responsibility of this federal institution.

We need to work towards establishment of an FDIC-style entity for Europe. That entity could offer insurance to depositors and also have broad early intervention and resolution authority on cross-national European banks. At least for the euro area, where we share a common currency and, consequently, a common lender of last resort for the banking system, I believe that this is essential to pool together the management of the banking sector to deepen the common market. When this is achieved we will have insulated the real economy from troubles that a sovereign may run into.

Many practical elements need to be worked out. For example, how should a pan-European resolution mechanism be funded? An FDIC insurance fee, common across all banks, could provide the seeds of a resolution fund that could be used for early intervention and resolution. The main issue is to create the political will to make progress in this domain.

In the aftermath of yesterday's elections in Greece, where with their vote the Greek people reaffirmed their determination to stay in the euro area, one may feel that the immediate tensions about a possible breakup of the euro have diminished. But the result merely reduced the risk of an immediate collapse. The European summit at the end of the month offers another opportunity to make progress.

Time is running out for Europe. Limping along may buy more time but is not a solution. A muddling-through scenario in Europe may seem well intended and may avoid the worst for a while, but in no way reduces the risk of an accidental meltdown.

Returning to the rest of the world I will emphasise just one word. In the current environment, the key word on the implications of the European crisis for global inflation dynamics is uncertainty.