Benoît Cœuré: Risk-sharing in EMU – before, during and after the crisis

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the inaugural conference "European crisis: historical parallels and economic lessons" of the Julis-Rabinowitz Center for Public Policy and Finance, Princeton University, Princeton, 20 April 2012.

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Ladies and gentlemen,

I am honoured to be able to speak at the inaugural conference of the Julis-Rabinowitz Centre for Public Policy and Finance.

In my remarks today, I wish to reinterpret the crisis in the euro area by speaking about mechanisms to share economic risks within Economic and Monetary Union (EMU).

I will first describe risk-sharing in EMU before the global financial crisis of 2007–08. The architects of the euro expected Monetary Union to foster flexibility of national economies and convergence between them, and emphasised the need for economic policy to accompany and accelerate this process. Furthermore, they stressed that national public debt levels needed to be moderate on average, so that fiscal policy could be used to smooth out the effects of adverse economic shocks. They also believed that most of the pre-EMU shocks to national economies were the result of monetary and exchange rate policy decisions, and they expected them to be less pronounced once Monetary Union was in place.

I will argue that the outcome was very different from that foreseen by the architects of the euro. In the first years of EMU, market-based risk-sharing mechanisms developed surprisingly quickly – perhaps too quickly – while policy did too little to induce flexibility or convergence and national fiscal institutions malfunctioned.

I will then speak about the effects on risk-sharing of the global financial crisis of 2007–08 and the ensuing European sovereign debt crisis that began in 2010.

The two crises impaired the market-based risk-sharing mechanisms in EMU. Since flexibility or convergence had not been achieved to the necessary extent, and national fiscal policy had limited ability to provide self-insurance, the two crises left the euro area with insufficient risk-sharing arrangements. The actions of the European Central Bank (ECB) and other public institutions, acting within their respective domains and according to their mandates, had the effect of temporarily filling this void.

In the last part of my remarks, I will argue that, for EMU to be put on a sound and durable footing, market-based risk-sharing mechanisms must be restored and strengthened. Furthermore, the need for policy-makers to foster flexibility and convergence and for national fiscal policy to act responsibly must be taken seriously. The development of new pan-European institutions is also desirable, but as a complement to – not as a substitute for – policy action at the national level.

Risk-sharing in the euro area before the crisis

The architects of the euro were well aware of the theory of optimum currency areas. Based on their knowledge of this theory and on empirical evidence, they expected firms and households in euro area countries to respond much less flexibly to economic shocks than, for instance, firms and households in individual states in the US union. Comparatively less developed financial markets, more rigid labour markets, low mobility of labour across

participating economies, and the absence of a federal system of taxes and transfers similar to that in the United States were well-known features of the newly created Monetary Union.

Since financial markets were relatively less developed and labour markets relatively more rigid, most professional economists expected market-based risk-sharing mechanisms to play a limited role in EMU, at least initially. To cope with this situation, the European governments bound themselves in the Treaty on European Union to foster the flexibility and convergence of their economies and to cooperate on economic policy. Furthermore, the nations adopting the common currency agreed to fiscal rules. The reasoning was that if an EMU member country had a moderate level of public debt in the steady state and an adverse economic shock occurred, the government of that country would be in a position to smooth taxes and spending over time. The national deficit would go up and down with the business cycle, but debt would fluctuate around this moderate steady-state level. History has taught us that successful monetary unions usually come together with a fiscal union.[1] This is illustrated by the history of the United States. Nevertheless, the view held in Europe at the time of the creation of the euro was that national fiscal rules could substitute for a fiscal union, provided they were strong enough.

What did we actually see in the first years of EMU, before the outbreak of the global financial crisis? The policy commitments were not kept. Policy-makers made little effort to foster flexibility or convergence.

The integration of markets for goods and services between euro area countries did continue, though essentially independently of any policy measures and as a result of previously taken commitments, such as the Single European Act, and to some extent as an endogenous consequence of Monetary Union. Trade flows within the euro area have increased and their nature has changed, with a lot more trade at the intensive margin and export price compression.[2]

However, labour markets remained rigid in essentially all member countries. Labour within individual euro area countries has traditionally been significantly less mobile than labour in this country. Economic research shows that in the United States, in the year after a regional labour demand shock, labour mobility accounts for about one-half of the increase in regional employment resulting from that shock. In the European Union, before the crisis, it would take three times as much time – three years – for labour mobility to account for a similar proportion of the rise in regional employment after a shock. Instead, most of the reaction to shocks came through changes in participation rates.[3] Almost everywhere, the adoption of the euro was followed by at best incremental reform steps. Dual labour markets developed, with a significant fraction of employment growth due to temporary, and thus fragile, jobs.[4]

Perhaps most importantly, many countries had entered EMU with high levels of public debt and did little or nothing to reduce it. For instance, France had a public debt-to-GDP ratio of 57% in the year 2000 and 64% in 2006. Germany had a public debt-to-GDP ratio of 60% in

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[1] See Bordo, M., "The Euro needs a Fiscal Union: Some Lessons from History", Shadow Open Market Committee, October 2010.

[2] See Fontagné, L., Mayer, T. and Ottaviano G., "Of Markets, Products and Prices: The Effects of the Euro on European Firms", *Intereconomics: Review of European Economic Policy*, 44 (3), 2009, pp. 149–158.

[3] Strikingly, this finding held within individual European countries. This empirical regularity could not therefore be explained by factors such as language or unwillingness to move to another country. See Decressin, J. and Fatas, A., "Regional labour market dynamics in Europe", *European Economic Review*, 39(9), 1995, pp. 1627–1655. The contribution of labour mobility to adjustment may have improved in the 1990s and now be closer to that observed in the United States. See L'Angevin, C., "Labor Market Adjustment Dynamics and Labor Mobility Within the Euro Area", *DGTPE Working Paper*, 2007–6.

[4] See Arpaia, A. and Mourre, G., "Institutions and performance in European labour markets: Taking a fresh look at evidence", *European Economy – Economic Papers*, No 391, Directorate General Economic and Monetary Affairs, European Commission, 2009.

2000 and 68% in 2006. The analogous numbers for Italy were 108% and 106%, and for Greece 103% and 106%. The Stability and Growth Pact was devised in 1998 to make sure that national budgets were kept close to balance or in surplus, thus regaining their ability to deliver insurance against macroeconomic shocks. It did not work.

While progress was at best slow when it came to labour flexibility and national fiscal policy, market-based risk-sharing mechanisms developed surprisingly quickly. Integration of financial markets proceeded at a rapid pace, allowing firms and households in Europe to reap the benefits of lower and more uniform financing costs.

The ECB developed its own set of indicators, both price and quantity indicators, in order to monitor the progress of financial integration in the euro area.[5] In some market segments, integration was immediate and complete; in others it was more gradual. Euro area money markets achieved the fastest and most complete integration. The cross-country standard deviation of unsecured lending rates decreased essentially to zero immediately after the introduction of the euro. While somewhat more fragmented, equity markets showed significant signs of integration as well, especially after the application of the Financial Services Action Plan. For example, the share of equity issued by euro area residents and held by residents of other euro area countries more than doubled between 1997 and 2006, to 29%.[6]

Perhaps the most striking sign of market-based risk-sharing in the first years of EMU was the simple fact that the current account deficits and surpluses of euro area countries widened significantly. Furthermore, the large current account deficits were financed internally, within the euro area. In the years between the launch of EMU and the global financial crisis, Greece saw its current account deficit rise from about 7% to 15% of GDP; Spain from about 3% to 12%; Ireland from zero to about 7%; and Portugal from about 3% to 5% of GDP. These deficits were financed in the market, largely by investors from a single country: Germany. Germany, which entered EMU with a roughly balanced current account, saw its current account surplus climb to about 8% of GDP by 2007.

One can say that in the first years of EMU, the Feldstein-Horioka puzzle within the Union quickly disappeared. This development had a straightforward explanation in economic theory: less wealthy euro area countries had better growth prospects and offered a higher return on investment. In this environment, greater financial integration allowed a decrease in saving and an increase in investment in less wealthy euro area countries.[7]

The countries with large current account deficits boomed. All countries with large current account deficits except for Portugal experienced a signification improvement in real GDP. Between 2001 and 2007, real GDP increased by 35% in Ireland, 30% in Greece and 25% in Spain. By comparison, in the same period Germany grew by 10%. Increasingly, there were signs that high GDP growth rates were not accompanied by comparable developments in productivity. Current account deficits were exacerbated by excessive expectations of future revenues, encouraged by a benign global environment. As the boom continued, a gap in relative prices opened. Between 1998 and 2007, unit labour costs in Greece, Ireland, Portugal and Spain increased by 10% or more. In the same period, unit labour costs actually fell in Germany, and by more than 10%. The magnitude of that gap in relative prices as well as the size of the current account deficits could have – and perhaps should have – been interpreted as warnings. Accordingly, lending between euro area countries probably reflected insufficient risk management by financial institutions rather than genuine opportunities. This

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[5] The full set of these indicators can be found in the ECB's annual report entitled "Financial integration in Europe".

[6] See "Financial integration in Europe", ECB, April 2008.

[7] See Blanchard, O. and Giavazzi, F., "Current account deficits in the euro area: The end of the Feldstein-Horioka puzzle?", *Brookings Papers on Economic Activity*, 33(2), 2002, pp. 147–210.

should have been apparent from the extent to which long-term cross-national investments were funded by short-term liabilities. To the extent that this was the case, hidden liabilities developed even in countries in which official fiscal statistics appeared reassuring. As such liabilities originated in the private sector, it was not properly understood that they would eventually migrate to government balance sheets when they assumed systemic importance.

To sum up, here is a snapshot of risk-sharing mechanisms in EMU on the eve of the global economic crisis: financial markets which had developed surprisingly quickly – perhaps too quickly, in the light of the large transnational capital flows within EMU; insufficient surveillance by governments of current account imbalances and insufficient risk management by market participants; and, at the same time, little policy effort to achieve flexibility, convergence or fiscal responsibility owing to a benign global environment, and perhaps to the erroneous belief that Monetary Union would in itself engineer convergence. The mix of mobile capital, rigid labour and fiscal underperformance left the euro area vulnerable to a sudden malfunctioning of financial markets. Fickle capital could flow out of deficit countries at short notice, leaving them unprepared for adjustment.

EMU seemed on the way to becoming an endogenous optimum currency area, and insufficient attention was paid to the possibility that markets could become segmented along national borders. Such fault lines should have been evident.

Crisis

When the global financial crisis of 2007–08 hit the European financial system, the market-based risk-sharing mechanisms in EMU were impaired. The newly developed euro area-wide interbank market, in particular the unsecured interbank market, first froze and, when it recovered, it became fragmented along national lines. A deterioration also occurred in the secured market segment, usually more resilient to market stress. Today, yields on money market instruments, and even more on sovereign bonds, have diverged across euro area countries. Cross-border bond holdings by banks have been partially unwound, and pan-European banking groups are tempted to allocate liquidity into national pools. In equity markets, the impact of the financial crisis on cross-border integration seems to have been more limited, but overall, much of the pre-2007 progress in terms of financial integration risks being erased.[8]

Since flexibility and convergence had not been achieved to the necessary extent and national fiscal policy had limited ability to provide insurance, the euro area was left with insufficient risk-sharing arrangements. The actions of the ECB and other public institutions – some of them newly created – within their respective domains and according to their mandates, had the effect of temporarily filling this void.

Official assistance packages – backed by the European Financial Stability Facility (EFSF) and the International Monetary Fund – have provided elements of ex post cross-country risk-sharing to Greece, Ireland and Portugal, which had been cut off from international markets. Other policy steps have been taken towards restoring trust in financial markets and the soundness of banks. I am thinking of, for example, the capital exercise of the European Banking Authority (EBA) and injections of public capital into banks in some euro area countries.

Meanwhile, the actions of the ECB and of the euro area national central banks – the Eurosystem – aimed to ensure the uniform transmission of the single monetary policy and a smooth functioning of euro area payment systems – in effect substituting for the

[8] On the impact of the crisis, see “Financial integration in Europe”, ECB, April 2012.

malfunctioning euro area interbank market. Let me describe briefly the policy measures of the ECB in response to the crisis.

The ECB cut the policy interest rates to unprecedentedly low levels and chose to match fully the increase in the banks' demand for reserves, in order to support economic activity, prevent deflationary pressures and ensure a uniform transmission of the single monetary policy. We also lengthened the maturity at which we provide reserves to banks by launching two three-year longer-term refinancing operations (LTROs). Let me explain why. In the autumn of 2011, market-based funding was becoming scarcer for banks in the euro area. The LTROs have been critical, we think, in preventing funding issues from igniting a disorderly deleveraging process which could have led to a significant curtailment of banks' lending to households and firms, and posed a downside risk for price stability.

At times, we have undertaken direct intervention in selected financial markets. We have intervened only on a temporary and limited basis in clearly dysfunctional markets judged as being of critical importance for the transmission of the ECB's monetary policy.

The extent of the financial tension and the downward pressure on economic activity has varied across the euro area countries. Typically, banks that have experienced funding strains are operating in countries that ran large current account deficits in the pre-crisis era. The direct purpose of the ECB's intervention has been to ensure that each bank – irrespective of its location in a particular euro area country – has sufficient reserves to deal with the possibility that creditors may refuse to roll over loans to that bank. Concretely, in some cases the reserves borrowed by distressed banks have been transferred to the creditors of those banks, often banks in the main current-account-surplus country in the euro area, Germany. The ECB has acted, on a temporary basis, as a substitute for decentralised markets within the euro area.[9]

As a by-product of these developments, so-called TARGET2 imbalances have emerged. You will recall that TARGET2 is a recording, clearing and settlement system operated by the ECB. National central banks in the euro area – members of the Eurosystem – can build up claims vis-à-vis TARGET2 over time. TARGET2 is only a mirror of the underlying economic and financial imbalances: with a properly functioning interbank market, no claim would appear in TARGET2, and the underlying economic situation would be exactly the same. Constraining the flow of funds through TARGET2 would address a symptom of the crisis without tackling its causes. It would hamper the freedom of capital movements as well as the smooth operation of payment systems, which is a basic task of the Eurosystem as mandated by its Statute.

The current situation is not a viable risk-sharing arrangement for the long run. Today, risk-sharing between euro area countries occurs to a considerable extent through public institutions and only to a limited extent through markets. This has constituted an optimal response to a temporary malfunctioning of markets. However, financial integration remains key to the efficiency and competitiveness of the European economy. The EU is a market-based economy and markets must play the primary role in allocating economic resources across EMU countries, sending price signals and monitoring the associated risks under adequate supervision.

Risk-sharing in the euro area after the crisis

Let me discuss now what I see as the challenges ahead of us: how to restore and strengthen market-based risk-sharing mechanisms between euro area countries, and how to make euro area countries more resilient to adverse economic shocks in the future.

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[9] See also Merler, S. and Pisani-Ferry, J., "Sudden Stops in the Euro Area", *Bruegel Policy Contribution*, 2012/06.

I would like to break this discussion down into four areas.

First, the rest of the euro area – or the rest of the European Union – should continue to support the adjustment process of euro area countries that had to address an unsustainable fiscal deficit or current account deficit – provided that there is adequate conditionality and monitoring. Currently, the rest of the euro area is accompanying – via the EFSF – the fiscal adjustment in Greece, Ireland and Portugal. Indeed, the rest of the world is supporting it through the IMF. The establishment of the European Stability Mechanism makes permanent the possibility of external support to a euro area member country in need. Ex ante monitoring and peer pressure are even more critical. The new excessive imbalance procedure prepared by the European Commission should be applied forcefully to identify an imbalance early on and seek a common solution with the euro area country in question.

Second, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union – known as the Fiscal Compact – must be promptly ratified and applied consistently. Consistent application of its provisions – in particular, the balanced budget rule – will restore market confidence and the ability of national fiscal policy to smooth out the effects of adverse economic shocks. Note that the rules laid down in the Fiscal Compact concern the structural budget deficit, not the cyclical component of the budget. The intention is not to tie the hands of national fiscal policy-makers. Instead, the idea is to define clear and enforceable goals for fiscal policy in the long run, while leaving room for fiscal policy to react to negative shocks at business cycle frequency. This is surely a sound prescription for fiscal responsibility.

Third, Europe needs to restore and strengthen its risk-sharing via financial markets and financial institutions. As was outlined in the Delors Report, EMU was created as the indispensable complement to the Single Market.[10] It is ironic that the outcome of this crisis is EMU with, de facto, little cross-country capital mobility. However, we cannot simply return to the kind of financial integration we had in the pre-crisis era. I have argued on other occasions that European policy-makers ought to adopt a "Financial Compact" as a complement to Monetary Union and to the Fiscal Compact, and pursue the creation – or re-creation – of a true pan-European market for capital. Repairing the single market for capital is a collective endeavour in which the ECB has a role to play, in coordination with the European Commission and the European Supervisory Authorities.

To this end, let me put forward a few ideas. Meeting the capital adequacy targets set by the EBA's capital exercise should be a priority. This process will strengthen banks, which will not only facilitate an appropriate provision of credit to the economy, but will also reduce counterparty risk and thereby help restart interbank transactions. In addition, the liquidity coverage ratio foreseen under the Basel III agreement must be implemented in such a way that it is not an obstacle to restarting interbank credit, in particular in its cross-national dimension. It is also vital to break the feedback loop between bank and sovereign credit which lies at the very heart of the current crisis.[11] I therefore believe that the Financial Compact should include a harmonised regime for bank resolution and, further ahead, a single European agency responsible for deposit insurance and for winding down failed banks.

Fourth, European policy-makers need to take seriously the notion that it is up to them to foster the flexibility of labour market institutions, the mobility of labour between regions and euro area countries, and the integration of European markets for goods and services. Much progress remains to be made in order for Europeans to live in a truly Single Market. Policy

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[10] "Report on economic and monetary union in the European Community" (the Delors Report), Committee for the Study of Economic and Monetary Union, Jacques Delors, Chairman, April 1989.

[11] This mechanism was foreseen by Eichengreen and Wyplosz. See Eichengreen, B. and Wyplosz, C., "The Stability Pact: More than a Minor Nuisance", *Economic Policy*, 13, 1998, pp. 65–104.

initiatives to raise the economic growth potential in the aftermath of this crisis will be welcome. It is crucial that their promoters take the perspective of the Single Market, as opposed to the perspective of national economies.

You have probably noticed that my discussion of how to recreate risk-sharing mechanisms in the euro area made little mention of the ECB. This is because the single monetary policy can at best support the required reform steps. Our best contribution will be to provide liquidity to banks so long as they are financially sound and have high-quality collateral, to ensure a smooth functioning of the payment system and, above all, to continue to deliver price stability.

Conclusion

Let me conclude.

When one thinks about the crisis in the euro area in terms of mechanisms to share economic risks within EMU, the following observations emerge.

The years between the creation of the euro and the global financial crisis saw an unexpectedly rapid development of market-based risk-sharing mechanisms in EMU. However, current account imbalances were not monitored adequately by governments, and risks taken by financial market participants were insufficiently understood. Those years also saw, contrary to the provisions of the Treaty on European Union, little action by policy-makers to induce flexibility and convergence or to correct public finances. History will tell whether this was due to a benign global environment, to excessive faith in the endogenous effects of monetary union, or to badly designed institutions. The euro area became vulnerable to a breakdown of financial markets.

Policy interventions temporarily provided risk-sharing arrangements for Europe, but ultimately, market-based risk-sharing mechanisms must be restored and strengthened. Furthermore, the need for policy-makers to induce flexibility and convergence and for national fiscal policy to act responsibly must be taken seriously. New pan-European institutions can be an important complement to – without being a substitute for – policy actions at the national level.

I would like to end by quoting James Ingram's conclusion of his visionary study of European monetary integration, published 39 years ago by this University:

"It is obvious that the necessity for perfect confidence in the permanent fixity of exchange rate in monetary integration, as defined in this essay, ultimately confronts the reality of national sovereignty, which implies the right and power of a nation to change its mind. Europe has so far resolved the potential conflict between sovereignty and federalism through negotiation and compromise. Such resolution may become increasingly difficult as integration becomes closer. Without some signs of political unification, it may be particularly difficult to convince the capital markets that exchange rates are irrevocably fixed."[12]

Negotiation and compromise have indeed become more difficult as integration has become closer. But the EU is a union of democracies and it should be more trustful of the power of democracy to produce the solutions that will address the deep causes of the crisis. Signs of political unification are needed more than ever to combat European fragmentation, withstand the temptation to raise national barriers, and take collective action to deliver stability and growth.

Thank you for your attention.

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[12] Ingram, J.C., "The Case for European Monetary Integration", *Essays in International Finance*, 98, Princeton University, 1973.