# The Eurozone Crisis and Emerging Market Balance of Payments Crises

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# Diagnosis

What ails the Eurozone is neither a lack of ECB monetary expansion nor the multiple equilibria syndrome.

The Eurozone suffers the tragedy-of-thecommons.

#### EZ crisis combines two types of emerging market crises: OLD slow-moving crises and NEW fast-moving crises

OLD crises caused by a tragedy-of-the-commons

- High fiscal deficits & high real wage & Current account deficits
- More government debt

NEW-crises caused by a lending boom:

- systemic risk-taking  $\rightarrow$  fragile banks & Large Capital inflows
- Current account deficits
- Bailouts → more government debt



## GIIPS

- Capital inflows reversed starting in 2008
- Central bank credit expansion of more than 1000%



Central Bank's loans to credit institutions [bn. €]

#### There is a tragedy of the commons in the Eurozone

> To borrow from a NCB, a bank must be:

- Solvent
- Have eligible collateral

Countries, not the ECB, have

> Supervisory power to decide whether a bank is solvent

> Determine the quality of collateral

Very, very few banks have been closed down in the EZ since 2007.
> Zombie banks?

#### Why was there no fall in reserves?

- Target2 imbalances (up to November 2011)
- LTRO (December 2011 and February 2012)
- ELAs
- ESFS/ The Next: ESM



Source: Institute of Empirical Economic Research -Universität Osnabrück

# Solution?

The medicine for the NEW (1990s) crises is massive liquidity injection

The medicine for the OLD (1970s-80s) crises is Structural Reform

But the Eurozone crisis is a combination of both

- > CONUNDRUM:
- →Liquidity injections to stem banking panics reduce the incentives for reform.
- →Aggravate imbalances
- $\rightarrow$  The eventual crisis is deeper

### Slow Adjustment and NCB credit



### Conundrum

Stylized fact

Structural reforms typically occur in the wake of economic crises

Tornell, 1999, "Reform From Within"

Structural Reform increases long-run growth, but

- Reduces the *rents* of powerful groups
- Powerful groups have the power to block reform

Crisis has the magic power to dissolve the collusion of powerful groups and their opposition to reform.

>Can EU, ECB impose reforms on GIIPS?

### How big is a big enough rescue?





### **Policy implications**

Europe needs a vision of a USA-type financial system, meaning:

- A federal reserve bank system NCBs are just subsidiaries
- Single supervisory authority *for all* banks
- An FDIC for small deposits
- No direct recapitalization (don't insure all the liabilities of the banks)
- A no-bailout clause among countries' public debts (liquidity loans yes, solvency loans no)
- A reform of voting rights at the ECB (voting according to capital share)
- A subsidiarity principle (=no joint liability)

Both the central banks and public rescue fonds should protect tax-payers.

Future Alternative Scenarios

- 1. Reform and convergence
- 2. The EZ breaks apart
  - back to 1980s-style stabilization cycles

3. EZ stays together but no reformWill inflation increase significantly?Will the Euro depreciate severely? Can it stop at eurusd=1?

Lets analyze the experience of Germany in the 1920s



Basis of all curves: 1913 = 1



#### Germany Oct 1918 – July 1919



# Slow Adjustment: Greece



Source: International Financial Statistics, IMF





Germany 1919 - 1923

### December 8, 2011 press release of the ECB.

- To reduce the reserve ratio, which is currently 2%, to 1% as of the reserve maintenance period starting on 18 January 2012. As a consequence of the full allotment policy applied in the ECB's main refinancing operations and the way banks are using this option, the system of reserve requirements is not needed to the same extent as under normal circumstances to steer money market conditions.
- To increase collateral availability by (i) reducing the rating threshold for certain asset-backed securities (ABS) and (ii) allowing national central banks (NCBs), as a temporary solution, to accept as collateral additional performing credit claims (i.e. bank loans) that satisfy specific eligibility criteria. These two measures will take effect as soon as the relevant legal acts have been published.

# Mario Draghi Q&A July 5, 2012

 What we could do and what we have done with respect to this is broaden the eligibility rules of collateral so as to attract the greatest number of banks, including those banks of a small/medium size which we believe are closest to the SMEs. But we have also done another thing, recently, at the last Governing Council meeting. We broadened the collateral eligibility so that banks can actually use the assets they create in lending to the real economy as collateral in borrowing from the ECB. So they are not only using government bonds, they are now also using credit claims and asset-backed securities of a lower rating, which means that for the banks in a sense it is now very useful to lend to the real economy because that way they also generate collateral that they can use for funding themselves. And we want to do this to keep the risk for the ECB balance sheet – and I have said this many times – very, very low.

### Euro Area Summit June 29, 2012

- The Commission will present Proposals on the basis of Article 127(6) for a single supervisory mechanism shortly. We ask the Council to consider these Proposals as a matter of urgency by the end of 2012.
- When an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could, following a regular decision, have the possibility to recapitalize banks directly.

## The balance sheet of a Central bank

Assets	Liabilities
Gold	Bills in circulation
Private Securities owned by central bank	Deposits from private credit institutions
Public securities owned by central bank	Loans from Euro-system
Other Assets	Other liabitlies
Loans to Euro-system	Capital

### Evolution of the Eurosystem Monetary Base:

- Phase 1. 2008-2011
  - GIIPS NCBs increase credit to domestic banks
  - Other NCBs (e.g. Bundesbank) reduce credit to domestic banks
  - Aggregate Monetary Base remains on trend
- Phase 2. 2012-
  - Bundesbank hits the limit: its stock of domestic assets is practically zero .
  - GIIPS NCBs still need to extend credit to domestic institutions
  - > Aggregate Monetary Base starts to increase above trend
- Phase 3.
  - ???



#### **Monetary Base of Eurozone**

