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Edited by Miroslav Beblavý, David Cobham and L'udovít Ódor
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1 Introduction

*Miroslav Beblavý, David Cobham and L'udovít Ódor**

This volume brings together the papers and panel contributions presented at the conference on 'The Euro Area and the Financial Crisis', held in Bratislava from 6 to 8 September 2010. The conference was hosted by the National Bank of Slovakia and jointly organised by the National Bank of Slovakia, Heriot–Watt University in Edinburgh and Comenius University in Bratislava. The event was characterised by intensive discussions between central bankers, academics and policy-makers from all over Europe, which contributed directly and indirectly to the authors' revisions of their papers. The basic question was: What are the implications of the financial crisis and the great recession for the future of the euro area?

The book begins in Chapter 2 with the keynote contribution by Governor Athanasios Orphanides on the issues surrounding financial stability in Europe. Part I addresses the experience of the crisis. Thorvardur Ólafsson and Thórarinn Pétursson try in Chapter 3 to identify the factors that caused the depth and duration of the crisis to be larger in different countries. Philip Lane in Chapter 4 focuses on the Irish case. Angel Gavilán, Pablo Hernández de Cos, Juan F. Jimeno and Juan A. Rojas in Chapter 5 examine the Spanish case. Aurelijus Dabušinskas and Martti Randveer in Chapter 6 consider the varying experiences of the Baltic countries. Part II considers the issue of accession to the euro area by countries in Central, Eastern and Southeastern Europe (CESEE). Biswajit Banerjee, Damjan Kozamernik and L'udovít Ódor in Chapter 7 analyse the different strategies for entry to the euro used by Slovakia and Slovenia. Miroslav Beblavý in Chapter 8 investigates whether euro entry was associated with significant rises in prices (especially for non-tradable goods and services) in Slovakia. And in the first panel contributions Governor Ewald Nowotny in Chapter 9 and Zdeněk Tůma, together with

* We would like to express our thanks to the discussants and all the other participants in the conference, and to Martin Šuster of the National Bank of Slovakia, for their contributions to the conference and to the book.

David Vávra, discuss in Chapter 10 whether and how CESEE countries should accede to the euro.[1] Part III looks at the future of the euro area. Francesco Giavazzi and Luigi Spaventa in Chapter 11 argue that much more attention needs to be paid to current account deficits within the European Monetary Union (EMU). Daniele Franco and Stefania Zotteri in Chapter 12 consider the role that national fiscal rules could play in avoiding future problems. Thomas F. Huertas in Chapter 13 discusses mechanisms for 'bail-in' as an alternative to future bail-outs of financial institutions. Laurent Clerc and Benoît Mojon in Chapter 14 review the conduct of monetary policy in the euro area since the inception of the euro and the challenges that the Eurosystem has faced since the financial crisis. Boris Cournède and Diego Moccero in Chapter 15 assess the contribution that a price-level (as opposed to an inflation) target could make to the operation and performance of monetary policy. This is followed by contributions by Wendy Carlin, Vítor Gaspar, Stefan Gerlach and Jacques Mélitz to the second panel (Chapters 16–19), on how to restore confidence in the euro project.

Despite the different backgrounds of the contributors, there was a significant measure of convergence, and five important observations emerge. The first is the need to reshape and strengthen EU governance. Governor Orphanides made it clear in Chapter 2 that alongside the important topic of better prudential regulation and supervision attention should be paid to governance issues, notably crisis resolution. The financial crisis found the member states and their financial frameworks largely unprepared, which led to chaotic resolution mechanisms and huge costs for taxpayers. Orphanides calls for a unified EU resolution mechanism based on three principles: limited moral hazard, fair burden-sharing and cost-effectiveness.

The crisis also showed that one of the pillars of the monetary union – the 'no bail-out' principle – was more wishful thinking than credible threat for financial institutions and member states. Several participants argue that this problem needed to be fixed, but there is no clear consensus on how to do this. Huertas (Chapter 13) argues that EU countries cannot continue to support large financial institutions, and advocates 'bail-in' rather than bail-out: he explores the creation of buffers at systemically important financial institutions in the form of subordinated debt which in case of emergency would be automatically converted into capital. This would place the primary burden not on taxpayers but on the creditors of financial institutions. Mélitz in his panel contribution (Chapter 19)

[1] Dr Tůma was unable to attend the conference but kindly submitted his views shortly afterwards.

argues there is no need for no bail-out rules in EMU. Instead, as with the states of the US, a national government could simply be allowed to default, while policy should be limited to the construction and operation of EMU-wide prudential rules for banks backed up by ECB powers to act as lender of last resort. Gerlach in his panel contribution (Chapter 18) takes the failure of no bail-out rules as given and proposes a mechanism that credibly promises a rescue, but at unattractive terms. Such a mechanism would replace the temporary European Financial Stability Facility (EFSF) and would contain significant automatic write-downs (of 20–30 per cent) and strict conditionality, including pre-approval of budgets.

The second key observation to emerge was a challenge to the models scholars have traditionally used to think about monetary unions, with the most heated debates concentrated on the issue of fiscal policy coordination. Several contributors put much more emphasis than the traditional model on the issue of countries' current account deficits. In particular, Giavazzi and Spaventa (Chapter 11) argue that an important mistake was made in the downgrading of the problem of current account deficits: although monetary union eliminates the threat of currency devaluation, high current account deficits can cause substantial problems if the proceeds of external borrowing are not used for 'productive purposes'. In other words, using external resources to finance investments in non-tradables or domestic consumption can lead to problems in meeting the intertemporal budget constraint. The high level of the former (investment in construction and housing) made economic success fragile in Ireland and Spain, while the latter (borrowing for consumption) resulted in increasing stress in Greece and Portugal.

This general argument, with its emphasis on country-specific conditions, is broadly consistent with the individual country studies by Lane (Chapter 4) and Gavilán *et al.* (Chapter 5). Lane argues that the long Irish expansion actually involved two distinct periods: a 'Celtic Tiger' output boom fuelled by high productivity increases in the second half of the 1990s, and then a property-driven boom period concentrated mainly in the non-tradable sector in the 2000s. He considers the arguments that EMU membership may have contributed to the Irish boom–bust cycle, but emphasises instead the lack of appropriate policies in banking regulation and fiscal stabilisation, and the positive contributions of EMU membership. Gavilán *et al.* use a small open-economy model to discuss the reasons for the emergence of a large current account deficit during the period of strong Spanish growth before the crisis. Their analysis highlights the decline in interest rates due to Spain's participation in EMU, and the demographic changes resulting from the large inflow of immigrants. Given these factors, in their model alternative fiscal policies would have made little difference, while structural reform in labour and product markets would have improved the growth rate but intensified the external deterioration in the short run.

There is also some common ground here in the more general chapter by Ólafsson and Pétursson (Chapter 3), which attempts to explain the cross-country variation in post-crisis experience using a wide variety of pre-crisis explanatory variables. They find that high preceding domestic inflation and macroeconomic imbalances, including large current account deficits, are crucial in determining the incidence and severity of the crisis, while larger banking systems were associated with longer and deeper cuts in consumption and with a higher risk of banking or currency crisis. Exchange rate flexibility tended to make the contraction shorter and shallower, but it also increased the risk of crisis. EMU membership, on the other hand, did not entail the negative effects associated with unilateral exchange rate pegs. In addition, Carlin's panel contribution (Chapter 16) emphasises the issue of relative price levels as between the different countries of the euro area: because nominal exchange rates cannot be adjusted such differentials (which would show up in current account imbalances) have to be reversed and eliminated (not just contained).

The third observation concerns fiscal policy. Bringing the problem of current account deficits to the forefront does not mean that fiscal policy problems are less relevant than before. On the contrary, several contributors highlighted the need to strengthen the Stability and Growth Pact (SGP) and increase the effectiveness of national fiscal frameworks. Gaspar in his panel contribution (Chapter 17), who also highlights the challenges posed by demographic trends in the EU, argues that both market discipline (operating through interest rate differentials) and the SGP have failed to ensure appropriate behaviour by national fiscal authorities. Major adjustments in the governance of the euro area are therefore called for; these will include higher financial penalties and stronger conditionality on financial support to countries in difficulty. Gerlach in his panel contribution (Chapter 18) stresses the importance of incorporating more automaticity in the SGP and replacing the existing inadequate market discipline by incentives for governments to act with restraint: he calls for a mechanism of graduated sanctions. Franco and Zotteri (Chapter 12) discuss the fiscal policy reforms which have been introduced or are under consideration in different EU countries, with particular reference to current and ongoing German and French reforms and to fiscal rules. Such national reforms need to be complementary to any changes at the EU or euro area level, but they can contribute to fiscal discipline and facilitate stabilisation. However, they need to be supported by public opinion. Carlin in her panel contribution (Chapter 16) suggests a further task for fiscal policy: she proposes the use of fiscal policy not just to stabilise the price level but to ensure optimal relative prices *vis-à-vis* the rest of the monetary union.

The fourth observation is that the crisis has uncovered some of the weaknesses of the conventional monetary policy framework. Policymakers on both sides of the Atlantic found themselves in a difficult situation after hitting the effective lower bound for nominal interest rates. They had to chart unknown waters using non-standard monetary policy measures, including quantitative and credit easing. Some of the contributors tried to identify gaps in the conduct of monetary policy and analysed the costs and benefits of changes in the standard flexible inflation targeting (IT) regime. Clerc and Mojon (Chapter 14) investigate whether the build-up of financial fragility was a consequence of monetary policy and whether it would be worth incorporating financial stability issues into the conduct of such policy. Although their modelling suggests that higher interest rates in the run-up to the crisis would have had relatively small effects on house prices, they suggest that the ECB should widen its monitoring of asset prices as well as money and credit and should stand ready to take decisions based on that monitoring even when consumer prices seem securely stable. They also discuss the potential conflict between the ECB's price stability target and its liquidity management operations intended to ensure financial stability. Cournède and Moccero (Chapter 15) ask whether there is a case for price-level targeting (PLT) instead of inflation targeting. If bygones are not bygones the risk of hitting a zero lower bound is reduced. Moreover, when an economy is near that bound PLT is preferable to, for example, raising the inflation target. There is a growing body of literature that finds some other aspects of PLT appealing, including lower volatility of inflation and hence nominal policy rates, lower inflation risk premia in long-term rates and higher capital accumulation. On the other hand moving to PLT is not without costs. The main concerns are that there is little practical experience of PLT, there are question marks over the transition from inflation targeting (credibility issues) and agents might not be sufficiently forward-looking.

The final observation is that there is no optimal one-size-fits-all euro adoption strategy and much depends on the set-up of the foreign capital inflow-based catching-up growth model. Banerjee, Kozamernik and Ódor (Chapter 7) compare the successful paths by which Slovakia and Slovenia joined the euro area. The starting positions of these two countries were very distinct and there were also substantial differences in the conduct of monetary policy before euro adoption. While Slovenia preferred stable exchange rates and more administrative control over the process, Slovakia allowed for significant exchange rate appreciation and deep structural reforms which resulted in a high productivity growth differential *vis-à-vis* the euro area. This also confirms the importance of investments in productive uses if one relies on external financing. Dabušinskas and Randveer (Chapter 6) compare the impact of the financial crisis on the Baltic countries, which were hit particularly hard. They had experienced a prolonged boom period but then suffered falls of one-fifth in consumption. According to Dabušinskas and Randveer the high cyclical volatility of these countries can be explained mainly by the strong procyclical developments in the financial sector. Foreign capital inflows via the financial sector were significantly higher in the Baltic countries than in most other new EU member states. In addition, the choice of exchange rate regime (currency board or fixed exchange rate regime) could have created overconfidence.

All this illustrates that the catching-up model based on foreign financing is not without risks and the policy options need to be selected with care. The crisis brought mixed feelings about the attractiveness of euro area membership for new member states. On the one hand – as Ólafsson and Pétursson showed in Chapter 3 – euro area membership served as a shelter against the excessive volatility of financial markets. On the other hand, the problems in Greece illustrate that membership of the elite club is not a panacea and if the internal problems of the union are not solved the future of the euro is uncertain. This brings additional arguments for opponents of euro adoption in many new member states and lowers the motivation to meet the Maastricht criteria in the near future. Tůma and Vávra in their panel contribution (Chapter 10) argue that 'the provision of long-term nominal stability is the only tangible economic benefit of the euro project'. This may be enough to justify adoption by the fixed exchange rate economies of Southeastern Europe, but not enough for the independent monetary policy countries of Central and Eastern Europe (though these countries may have sufficient political reasons for joining the euro). On the other hand, Nowotny in his panel contribution (Chapter 9) argues that the euro will remain an attractive option for potential entrants, but he emphasises that participation implies a commitment to structural reforms which will enable the economy to function without recourse to competitiveness-improving devaluations.

On one of the more specific issues of euro adoption, Beblavý (Chapter 8) provides an analysis of whether in the Slovakian case there were faster or exceptional price rises associated with the introduction of euro notes and coin (of the kind typical of popular beliefs about the euro in many existing member countries). The answer turns out to be 'no', in the sense that Slovakian entry to the euro occurred at a time of actual and perceived disinflation. However, there is some evidence of faster inflation in certain non-tradables around the time of entry. More generally, Beblavý emphasises that countries are likely to experience euro adoption in quite different ways, which implies that Slovakia's experience here cannot be generalised.

In the four months between the conference itself and the submission of this book to Cambridge University Press, the European Union, the ECB and the euro area countries have taken – often after much debate – a number of measures to strengthen the coordination and credibility of monetary, fiscal and financial policies, in a process which is still continuing. We have not attempted to cover these innovations here, and most of the chapters were finalised in October or November 2010 (the only exception is Lane's Chapter 4 on Ireland which takes the story up to the end of December). At this stage it is clear that some important issues remain unresolved. Moreover, as conference participants broadly agreed, while better policies can reduce the probability or magnitude of future crises, it will not be possible to completely prevent them. We believe that the way in which events and policy changes work out will be consistent with the analyses and propositions put forward in this book. But there will, of course, be plenty of scope for further critical work in this area.

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2 Towards a new architecture for financial stability in Europe

Athanasios Orphanides

As crises often do, the global financial crisis we have been experiencing has highlighted key policy challenges that were insufficiently attended to in the past and has focused minds on needed improvements. In Europe, the crisis has exposed fault lines in governance and deficiencies in the architecture of the financial supervisory and regulatory framework. The need for more effective micro- and macro-prudential regulation and supervision, but also for better coordination between the two as well as among regulators, has been underlined. The crisis has confirmed that central banks can play an important role in safeguarding financial stability, but also demonstrated that a mandate to maintain price stability is not sufficient to ensure financial stability, strengthening the case that central banks need to be armed with the appropriate policy tools to enhance their contribution to financial stability.

The crisis has prompted critical thinking about the EU economic and financial policy frameworks and the need for a new supervisory architecture. The severe economic cost suffered as a result of the crisis, and the acknowledgement of the need to limit the likelihood of future costly occurrences, has provided an important opportunity for the development of an improved financial stability framework for Europe and highlighted the urgency of the need for a comprehensive crisis management regime. Not that this was not understood earlier. The lack of harmonisation in the European legal and supervisory framework and its potential cost in managing crises were known. Nevertheless, perhaps due to the complications and political sensitivities involved in addressing crisis management, and perhaps owing to other policy priorities, undue reliance was arguably given to the role of crisis prevention, avoiding prickly issues such as how potential losses associated with the efficient resolution of a cross-border financial institution were allocated.

In the European context the financial crisis has illustrated not only the deficiencies of the current EU cross-border arrangements, but also that a fragmented approach towards crisis management and resolution is insufficient to deal with these shortcomings. I take for granted the desirability of further integration of our economy across member states, and further enhancement and cross-border development of the financial industry in Europe. This is imperative to raise efficiency and more fully exploit the benefits of a common market, even more so in the euro area, where member states have tied their fortunes together more closely by adopting the common European currency. The economic benefits of integration are unquestionable, but realising the great potential presented by our union also makes it necessary to place greater emphasis on comprehensive EU-wide solutions towards enhancing financial stability in Europe.

Against this background, I would like to thank Narodna Banka Slovenska (the National Bank of Slovakia) for the invitation to address this conference on 'The Euro Area and the Financial Crisis'. I focus on a few issues related to the question of how the financial supervision architecture in Europe could be strengthened in order to secure financial stability. Namely, I discuss elements of micro- and macro-prudential policy tools for enhancing regulation and supervision, and also the development of a crisis management framework in Europe. I also present some pertinent thoughts on governance. Before proceeding, however, I should note that the views I express are my own and do not necessarily reflect those of my colleagues on the Governing Council of the European Central Bank (ECB).

Financial stability is a multifaceted concept. It involves the stability of the whole financial system, comprising financial institutions, financial intermediaries and financial markets. The latest international financial crisis has been associated with a serious weakening and, in some cases, failure of financial institutions, together with stress in credit markets and in the funding of financial institutions. These inflicted heavy costs on real economies and their taxpayers in many countries, including in the EU.

In light of the cost to the real economy associated with financial instability as well as the threat to public finances, the desirability of policies that reduce the occurrence of future crises as well as policies that contain the damaging effects of actual crises is clearly evident. This entails two main elements: first, prudential regulation and supervision policies and, second, a crisis management and resolution framework. The two elements are interrelated because the effectiveness of prudential supervision crucially depends on the incentives of financial institutions and thus on the likely costs incurred by the management and other stakeholders of a financial institution in case it needs to be resolved during a crisis.

This is the notion that endgames matter.[1] For cross-border institutions, EU governance issues may need to take a central role.

As already mentioned, the crisis has highlighted weaknesses in prudential regulation and supervision. It has demonstrated a general underappreciation of systemic risks in micro-prudential supervision and highlighted the need for a more system-wide macro-prudential approach towards supervisory oversight to ensure overall stability in the financial system. But what further prudential tools should be developed, or how should existing tools be enhanced? A number of sometimes competing proposals have been put forward by policy-makers, regulators, academics and the financial services industry to be included in preventive policies.[2] These proposals entail specific prudential policy instruments aimed at mitigating the build-up of systemic risk. Systemic risk – that is, the risk of serious disruption in the provision of financial services to the economy – arises from linkages both within the financial system and through its interaction with the real economy across the cycle. Macro-prudential policies are needed to address the cyclical aspect of systemic risk, noting that in 'good times' financial imbalances tend to build up as leverage increases and financial institutions become overexposed to risks, ultimately raising the probability of triggering system-wide instability. Prudential tools can be used to counter an excessive build-up of these risks in the financial system as a whole.

Higher prudential requirements regarding capital and liquidity would enhance the resilience of credit institutions to shocks and adverse market developments. A leading role in the construction of a harmonised global framework for the achievement of this objective rests with the Basel Committee on Banking Supervision (BCBS). In December 2009, the BCBS approved for consultation a package of proposals to strengthen global capital and liquidity regulations (Basel Committee on Banking Supervision, 2009b). These proposals are aimed at raising the quality, consistency and transparency of bank capital (predominance of common equity, phasing out of hybrid Tier 1 and abolishing Tier 3); introducing a simple capital-to-asset ratio (leverage ratio); introducing measures to promote the build-up of capital buffers in good times (countercyclical capital buffers); restrictions on dissipating capital when buffers are depleted (capital conservation measures); and strengthening the risk coverage of the capital framework (by increasing capital requirements for counterparty credit risk arising from derivatives, repos and securities financing activities).

[1] This is discussed in detail in Claessens, Herring and Schoenmaker (2010).
[2] See, e.g., International Monetary Fund (2010a).