Lessons from the 2011 Euro Area Panic

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Not just a remake of the 2007-09 crisis

- Some strikingly **common** features:
  - Systemic risk arising from "small, peripheral market":
    - subprime loans for 2007-09 crisis
    - Greece, Ireland for the 2011 Euro panic
  - Gradual, extensive cross-market, cross-country contagion:
    - across fixed-income markets (ABS, interbank, etc.) in 2008
    - across sovereign debt markets in 2011
  - Surge in demand for liquidity and banks' increasing reliance on Central Bank liquidity provision:
    - Fed in 2008-09
    - ECB in 2011
- One all-important **difference**: the **"fiscal-bank solvency nexus"**

The fiscal-bank nexus in the Euro panic

- In some cases (Ireland, Spain) bank solvency problems lead to fiscal solvency issues:
  - recapitalization of Irish banks
  - prospective recapitalization of Spanish Cajas
- In other countries (Greece, Italy, Belgium) with long-run public debt accumulation and slow growth, fiscal solvency issues threaten bank stability:
  - domestic <u>and</u> foreign banks own public debt of troubled countries → their value drops proportionately to their exposure
  - domestic government's explicit guarantees (deposit insurance) and implicit guarantees (recapitalization in case of distress) become less credible → value of <u>domestic</u> banks drops further, their access to funding dries up

The fiscal-bank nexus (2)

- "**People are shorting banks as a way of shorting sovereign debt**. What we are really seeing is the markets deciding they don't like the fiscal position in Europe. The best way to get leverage and express that opinion is through shorting the banking system, because they know that the governments have to bail out the banks" (Tom Vosa, head of markets economics, Europe at National Australia Bank).
- "**People are shorting these stocks and pushing them down because of fear about the broader macro issues**. Yesterday really felt like the latter part of 2008, where you were seeing the crisis moving from one bank to another. The one thing that **could be dangerous** is **if it becomes a self-fulfilling prophecy**." (Chris Wheeler, analyst at Mediobanca).

From "Cause of French Banks' Fall Not Rating Fears: Analyst", by Catherine Boyle, 11 August 2011, CNBC.

Multiple equilibria?

- Simultaneous run on governments and banks: in both cases, beliefs of insolvency may raise funding costs and become self-fulfilling:
  - A persistent yield differential above 400 bp threatens the long-run sustainability of public debt in otherwise solvent countries.
  - The selloff also threatens thinly capitalized European banks, forces up their lending rates, weaken their deposit base and impairs their lending ability.
- Role for ECB intervention as lender of last resort:
  - Security Market Program (SMP) allows banks to refinance themselves by selling public debt to ECB
  - De Grauwe: importance of LLR to prevent panic-driven search for liquidity from becoming a self-fulfilling solvency crisis, i.e. eliminate the bad equilibrium

Liquidity provision: two possible targets

- A. Act as a "circuit breaker" when momentum trades are destabilizing
  - Limited approach: it only seeks to limit the rate of change over a given window, with no view of the longer-term trend
  - Similar to the view of the major central banks about currency interventions
  - Probably the current ECB view of the appropriate scope for its SMP
- B. Pursue a "target ceiling" for each yield spread
  - Determine that spread for a given country should be no more than X (based on some fundamentals model) → intervene to keep the spread within that bound
- Task A is naturally suited to a fast-moving institution such as the ECB and poses no concerns for the money supply
- Task B could in principle be entrusted to one of three institutions:
  - ECB
  - EFSF (European Financial Stability Fund) or ESM (its successor)
  - Eurobond issuance program

Which institution should stabilize spreads?

- EFSF would need a very large fund (Buiter: 3 trillion €):
  - with Italy, Spain and even France under attack, it could only rely on Germany for true firepower
  - another problem with EFSF: born to withstand "small local crises" (e.g., Greece), it is unsuited to fight widespread ones and may actually become a vehicle of contagion: Italy, Spain and France lending to Greece…
- Eurobonds, with fees charged to sovereign issuers replacing target spreads:
  - similar problems as EFSF
- ECB would not suffer from this limitation (no limit to its ability to create liquidity) but would need to decide on form of intervention:
  - sterilized: ECB soaks up liquidity by issuing bonds, mandating extra reserve requirements or attracting deposits from creditor banks
  - non-sterilized: variant on quantitative easing, with the difference that it would leave the ECB with the credit risk of few troubled sovereigns

Line between solvency and liquidity?

- More serious issue: difficult to discriminate between liquidity (multiple equilibria) and solvency problems → danger that ECB liquidity provision would exacerbate moral hazard problems:
  - to provide liquidity to Greek, Irish and Portuguese banks, the ECB balance sheet has already absorbed public debt with potential solvency problems
  - sovereigns may effectively fund themselves from the ECB through their troubled banks, i.e. use the fiscal-bank solvency nexus *strategically*
  - if solvency is an issue, the ECB is not equipped to bargain complex conditionality programs with sovereigns nor to restructure banks
- Dealing with solvency issues of (i) governments and (ii) banks is outside the mandate of the ECB; yet, dealing with these issues – and with their "nexus" – is vital for the survival of the Euro
- Essential and urgent to complete the Euro Area (EA) architecture with well-designed institutions to address solvency issues and **break the bank-fiscal solvency nexus** at the root of current crisis

A possible blueprint for the future

- EA-level entity in charge of EA-wide bank deposit insurance and distressed bank recapitalization and closure policy
- EA-level entity in charge of restructuring troubled sovereign debt and lending to sovereign issuers at risk-adjusted rates
  - Must be able to borrow from the ECB to overcome “limited firepower” problem. Key issue: which rules are to govern such borrowing?
  - Its loans must condition not only on fiscal policies but on growth-enhancing policies (liberalizations, institutional improvements, etc.)
- ECB left in charge of direct market interventions in case of liquidity crisis
- **Key point: incomplete and unbalanced EA institutional architecture exposes it to speculative attacks** – these will not stop unless this structural fault is remedied

Some advertising!

- The Euro-nomics Group (M. Brunnermeier, L. Garicano, P. Lane, R. Reis, T. Santos, D. Vayanos, S. Van Nieuwerburgh and myself) is preparing a book on these issues
- We are also setting up a web site:

  www.euro-nomics.com

  to post preliminary work, op-eds, etc.
- Stay tuned for more!