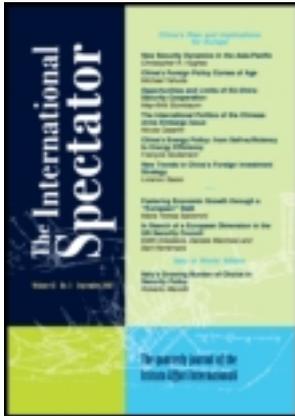


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Policy Lessons from the Eurozone Crisis

Chiara Angeloni, Silvia Merler and Guntram B. Wolff

The current European crisis has shed light on several weaknesses and the institutional incompleteness characterizing the euro area. The manifestation of Europe's fragility was preceded by a large build-up of debt in the private sector, associated with national current account divergences and the deterioration of competitiveness particularly of the euro periphery countries. With the economic situation deteriorating, private sector debt became less credible, contaminating banks' balance sheets and placing a heavy burden on governments. A sovereign-bank vicious circle emerged: on the one hand, with banking risk translating into higher sovereign risk because of the governments' guarantor role and, on the other hand, with the deterioration of government's creditworthiness affecting the banking systems through banks' sovereign bond holdings. In principle, this negative feedback can be stopped by breaking one of the channels of transmission. A banking union at the European level is proposed as one solution.

Keywords: European sovereign crisis, banking union, macroeconomic imbalances

The euro area faces a severe crisis. Indeed, the outcome of the crisis of the euro area will have repercussions far beyond Europe. Therefore, the aim of this article – after a review of some of the developments in the run-up to the crisis – is to discuss the central fragility of the euro area in some detail and put forward the policy option of a banking union to mitigate this fragility.

The crisis has clearly exposed the failure of the Maastricht architecture for Economic and Monetary Union (EMU). Central to this failure is the lack of executive decision-making or the absence of a political union. In fact, as a senior policymaker outside of Brussels told one of the authors of this article, it was “almost reckless to form a common currency without an appropriate political union”. By way of example, banking resolution and supervision remain largely national, and forbearance on bank resolution has become one of the key features of

Chiara Angeloni is Research Assistant at Bruegel, Email: chiara.angeloni@bruegel.org; *Silvia Merler* is Research Assistant at Bruegel, Email: silvia.merler@bruegel.org; *Guntram B. Wolff* is Deputy Director of Bruegel. Email: guntram.wolff@bruegel.org

this crisis.¹ It is becoming increasingly clear that the failure to integrate banking policies is at the core of the crisis. In fact, common monetary policy operates in the euro area, in particular via banks, and banks are closely connected to the national central banks' liquidity policies. The large build-up of debt in the private sector via the banking system was largely unchecked in the run-up to the crisis. The integrated financial system allowed Spain, Portugal and Greece to borrow very significant sums, amounting to more than 80 percent of GDP, outside the country.²

Capital inflows went hand in hand with significant losses in price competitiveness. Repaying external debt, while being obliged to reduce prices to regain competitiveness and to export more, is difficult.³ European banking authority stress tests failed to restore trust in the euro area's banking system as the solutions presented to address the debt overhang remained unconvincing to markets. In addition, the build-up of negative feedback loops from increasingly fragile sovereigns to increasingly fragile banking systems laid bare the eurozone's systemic fragility.

The remainder of this article is therefore organised as follows. The next section briefly reviews pre-crisis developments. This is followed by a detailed description of the sovereign-banking vicious circle that is a common feature of the crisis. The third section illustrates a possible way of breaking the loop – a European banking union – and the last section presents some conclusions.

Pre-crisis developments

The focus of the current euro crisis seems to be the sustainability of public finances. To reassure markets in this respect, eurozone countries are increasingly relying on the implementation of consolidation measures. Standard equations of public debt dynamics show indeed that if the interest rate on the debt exceeds the nominal growth rate of GDP, then stabilisation of the debt-to-GDP ratio requires that the country must run a sufficiently large primary (that is, non-interest) budget surplus. Based on this analysis, fiscal consolidation to reduce primary budget deficits is part of the prescription for EMU countries with sovereign debt difficulties. The increase in public debt experienced by countries like Ireland, Greece, Spain and Portugal during the financial crisis is certainly one important issue that needs to be addressed and corrected, but it is by no means the only one.

In fact, in the ten years preceding the outbreak of the crisis, the dynamic of public debt remained more or less stable in all eurozone countries (Figure 1).

¹ESRB, *Forbearance, Resolution and Deposit Insurance*.

²Ahearne and Wolff, *The Debt Challenge in Europe*.

³In fact, historical lessons show that even the external interest burden can become difficult to shoulder. John Maynard Keynes wrote extensively on the problem of external debt payments at a different time and in a different context, but his lessons remain valid today.

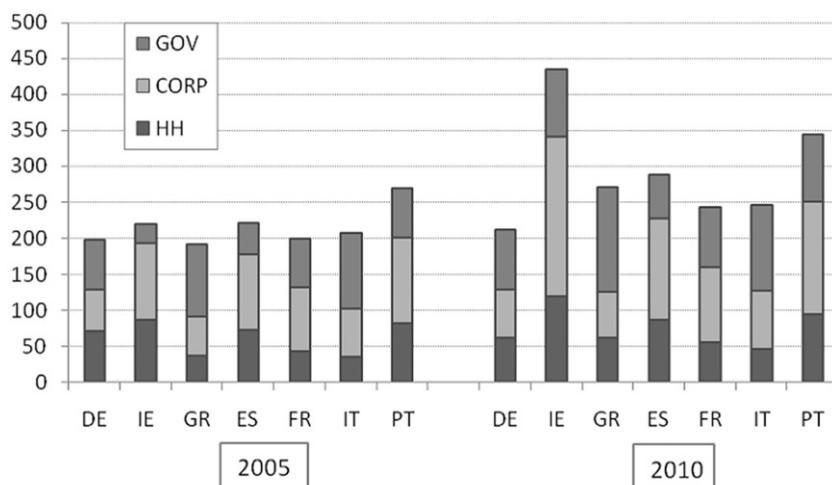


FIGURE 1. Public and private debt in the euro area

Note: Private debt is loans and securities other than shares, taken from Eurostat financial accounts (at market prices). Government debt is at nominal value (Maastricht definition).

Source: Eurostat.

Ireland and Spain in particular entered the crisis with a very low level of public debt (24 percent and 36 percent of GDP, respectively, in 2007), the outcome of a decade of sound public finance management and good growth performance, even though revenues were artificially boosted due to bubbles and the like.

On the other hand, private debt increased considerably after the introduction of the single currency. The main contributor to this increase across countries was the corporate sector, but household indebtedness also rose sharply, especially in Ireland, Spain and Portugal.⁴ The increase in private indebtedness was fuelled by the unprecedentedly low borrowing costs that came with the single currency. The resulting boom became self-reinforcing as higher inflation rates reduced the real borrowing costs even further so that real interest rates became negative in some instances. Borrowing, therefore, increased significantly across all sectors of the economy.

To some extent, the development of current accounts resulting from capital inflows was expected *ex ante* as a result of the currency unification, as the removal of the exchange rate risk would allow capital to flow more freely across borders in an – eventually truly integrated – European financial market. As a result, capital was expected to move ‘downhill’ as predicted by theory, from the richer to the poorer countries that were offering higher rates of return. In this way, the monetary unification was expected to foster income convergence. Blanchard and Giavazzi,

⁴ Ahearne and Wolff, *The Debt Challenge in Europe*; Cecchetti *et al.*, *The Real Effects of Debt*; Gligorov and Landesmann, *The Three Debts*.

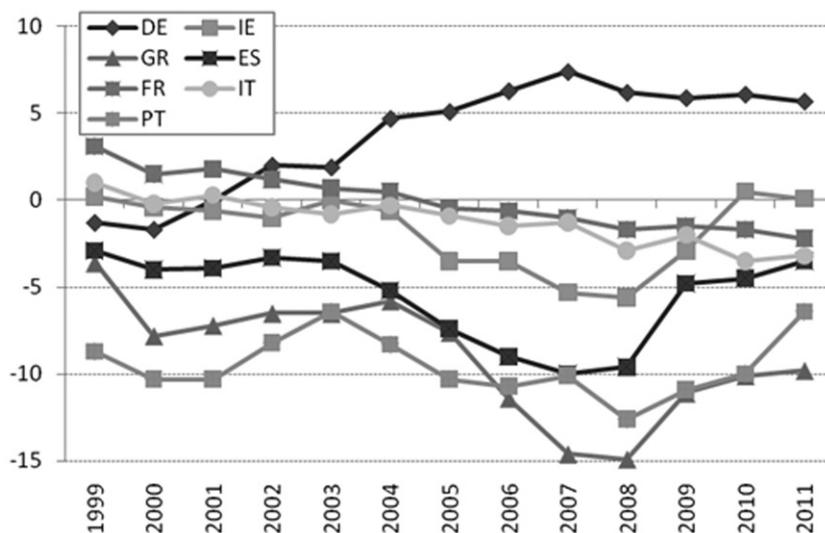


FIGURE 2. Current Accounts

Source: Eurostat.

among others, made this point, when documenting the end of saving/investment correlation in the euro area.⁵ Yet, parts of the income convergence turned out to be illusory as productivity lagged and capital inflows were used for consumption rather than investment.

Mirroring the rise in private indebtedness has been the deterioration in the external position of countries in the euro periphery. Figure 2 shows that Greece, Ireland, Portugal and Spain have run consistent and large current account deficits since early 2000s, which have translated into the build-up of large negative external debt stocks (Figure 3). Studying current account developments, Jaumotte and Sodsriwiboon found that the deficits of Southern countries were too large to be consistent with fundamentals.⁶ They attribute most of this to the saving channel, particularly to the deterioration of private saving, partly linked to financial integration. Waysand *et al.* have looked at bilateral external assets and liabilities of European countries and found a strong financial interdependence between euro area countries and an increase in this interdependence since 2000.⁷

Current account divergence has gone hand in hand with divergences in countries' competitiveness. Figure 4 plots the real effective exchange rates corrected for unit labour costs, normalised in 1999, revealing a trend of divergence in relative competitiveness that lasted for a decade. While cost competitiveness improved markedly in Germany, countries like Greece, Ireland, Spain, Portugal and also

⁵ Blanchard and Giavazzi, *Current Account Deficits*.

⁶ Jaumotte and Sodsriwiboon, *Current Account Imbalances*.

⁷ Waysand *et al.*, *European Financial Linkages*.

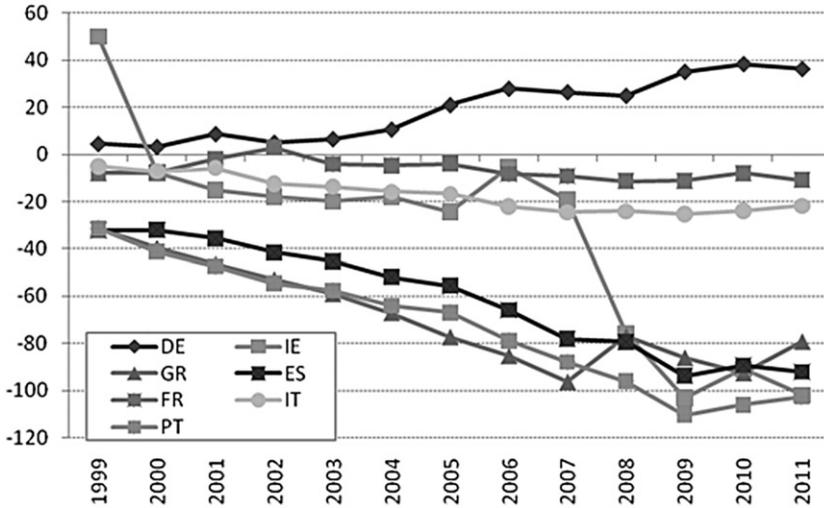


FIGURE 3. International Investment Position (% GDP)

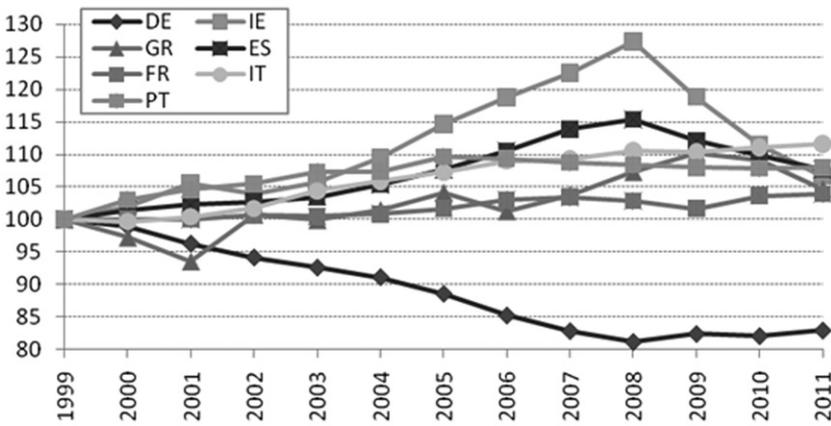


FIGURE 4. Real Effective Exchange Rates (REER)

Source: Eurostat and World Bank.

Italy saw a marked deterioration. That trend has started to be corrected to some extent during the financial crisis but the only two countries that display an adjustment of significant magnitude are Spain and Ireland. Moreover, there has been a disconnect between labour cost correction and the adjustment of producer and consumer prices.⁸

⁸Wolff, *Arithmetics is Absolute*.

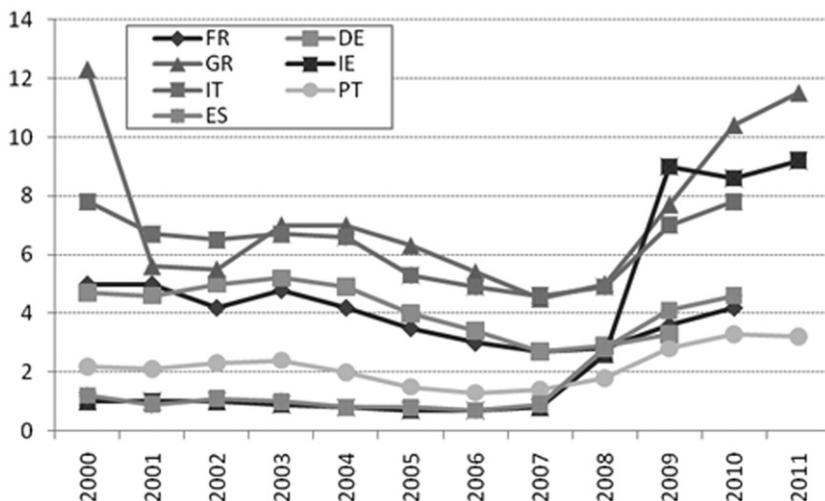


FIGURE 5. Non-performing loans (% total loans)

The loss in price competitiveness has also meant a significant decline in the share of the manufacturing sector in total value added.⁹ The value added share has fallen by as much as 25 percent, highlighting a tendency towards de-industrialisation in the euro area's periphery. At the same time, the non-tradable sector has developed, boosted by the unprecedented inflow of capital from other euro area partners.¹⁰ This has led to housing bubbles (especially in Spain and Ireland), the consequences of which are evident in the large stock of non-performing loans on the balance sheet of national banks (Figure 5).

The redressing of their competitiveness positions can therefore be considered crucial for the longer-term perspectives of peripheral countries but the process will most likely be slow. Aligning competitiveness will also make it more difficult to achieve debt sustainability. In particular, countries now need to reduce their public debt to dissipate doubts about sustainability, but this process now has to take place in a context where the private sector is also highly indebted. As governments implement fiscal consolidation programs, the accompanying increases in taxes and cuts in spending may frustrate the private sector's efforts to reduce the debt overhang. At the same time, the need to regain competitiveness requires relative deflation in the South, but deflation increases the debt burden and puts solvency at risk.¹¹

⁹ Ahearne and Wolff, *The Debt Challenge in Europe*.

¹⁰ Ruscher and Wolff, *External Rebalancing*.

¹¹ Merler and Pisani-Ferry, *Hazardous Tango*.

The European sovereign debt crisis and the sovereign-banks loop

The European sovereign crisis has brought to light a characteristic weakness of the eurozone countries that was previously ignored: the strong link between sovereigns and banks. The reason for the interconnectedness between financial and sovereign sector risk is manifold.¹² On the one hand, European member states are individually responsible for the rescue of their national banking system: this is particularly true in the absence of a banking resolution authority and framework at the European level. The consequence of this is that the risk of rescuing domestic banks translates into the risk of tremendous fiscal deterioration for the governments, particularly in the case of banking systems that are very large, as is the case in eurozone countries. Mody shows that the rescue of (globally or locally) important banks in 2008–09 was the trigger of a regime shift in the dynamics of euro area countries' sovereign spreads,¹³ which became more correlated with the prospects of the financial sector. Similarly Acharya *et al.* show that announcements of bailouts in Western Europe coincided with a 'shift' in credit risk from banks onto sovereign, with both banks and sovereign credit default swaps (CDS, contracts that provide insurance against the risk of the default of a counterparty, be it sovereign or bank) increasing in the post-bailout period and co-moving.¹⁴ On the other hand, banks hold considerable amounts of government debt securities of the country in which they are located. A decline in a government's creditworthiness then translates into an immediate negative impact on the value of its banks' assets. Alter and Schüller have found that before government intervention the credit risk spills from banks to sovereign, whereas after intervention the contagion tends to go the other way, pointing to the role of the sovereign's balance sheet deterioration.¹⁵ More importantly still, the location of banks links them intimately with the economic performance of the country and the government through their normal credit-giving activities, as well as their possibility of raising funding on the market. For example, country risk coming from an over-indebted corporate sector will then translate into worse government as well as bank performance.¹⁶

These drivers mutually reinforce the negative interdependence between sovereign and banking risk. Figure 6 gives an idea of how strong this link is, by showing the co-movement between banks and sovereigns' CDS. The higher the price of CDS underwritten on the debt issued by a sovereign, the higher the probability markets attach to that sovereign defaulting on its debt. Figure 6 shows that CDS on sovereigns and CDS on banks have been strongly correlated over 2011 in the

¹² BIS, *Impact of Sovereign Credit Risk*; Gerlach *et al.*, *Banking and Sovereign Risk*; Merler and Pisani-Ferry, *Hazardous Tango*.

¹³ Mody, *From Bear Stearns to Anglo Irish*.

¹⁴ Acharya *et al.*, *A Pyrrhic Victory?*

¹⁵ Alter and Schüller, *Credit Spread Interdependencies*.

¹⁶ Angeloni and Wolff, *Are Banks Affected?*

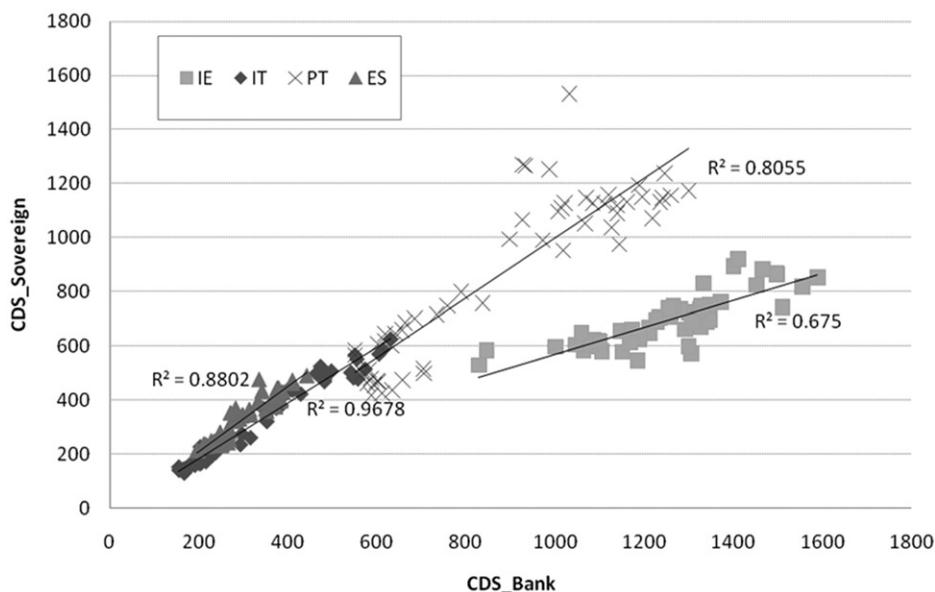


FIGURE 6. Correlation between sovereign and banking credit default swap
Note: Weekly averages from January 2011 to February 2012. Banking CDS by country are calculated as weighted averages of CDS of the individual banks considered for each country. The graph for Greece is not displayed since it is characterised by a hyperbolic pattern.
Source: Angeloni and Wolff, *Are Banks Affected?*, with data from Datastream and Macrobond.

peripheral countries of the eurozone. This means that, for investors, the risk of sovereign and the risk of banks are far from being independent.

The two-way bank-sovereign feedback loop is a special feature of the euro area.¹⁷ The product of specific weaknesses in its architecture, it renders the euro area countries particularly fragile and prone to the threat of self-fulfilling debt crises. Therefore it is indispensable to understand where the loop comes from and to envision a way to break out of it.

From banks to sovereign – liabilities

The main channel of contagion from banks to sovereign is the explicit and implicit government guarantees for the banks in their jurisdictions. On the one hand, governments allow banks to issue government-guaranteed bonds, an instrument that can reassure investors in case banks face difficulties in accessing credit in the interbank market. Yet, government guarantees of banks are likely to become liabilities for the government if the banking system gets into trouble. On the other hand, when banks (especially the largest ones) are under pressure, the market expectations that governments will eventually bail out those institutions that are considered ‘too

¹⁷ De Grauwe, *Governance of a Fragile Eurozone*; Pisani-Ferry, *The Euro Crisis*.

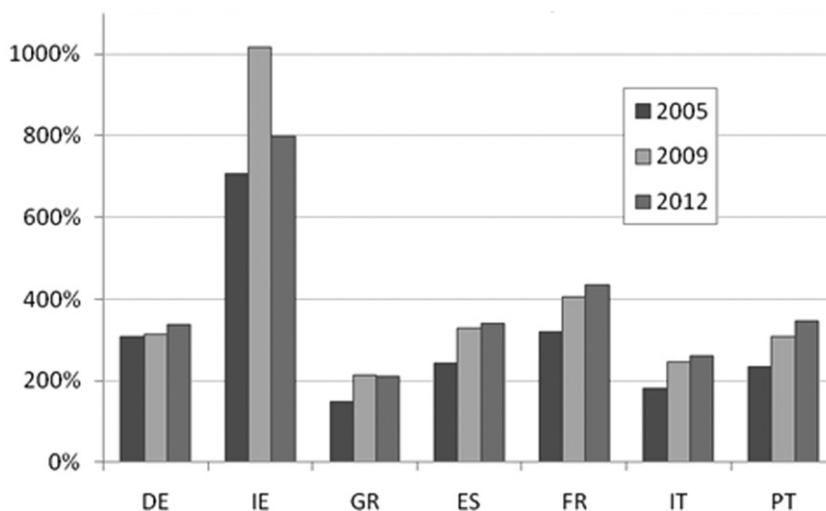


FIGURE 7. Total assets of domestic banks over GDP, select euro area countries
 Source: ECB and Eurostat.

big to fail' increase the doubts about the sovereign's creditworthiness and the perception of risk.¹⁸

In the euro area, due to the lack of an integrated and unified resolution regime, each member state is responsible for its domestic banking system, with the cost of bank capitalisation and rescue packages remaining with the individual countries. In addition, the effects of the increased likelihood of bank rescue on a sovereign's public finance position and its creditworthiness depend both on the size of the domestic banking sector and on the level of resources at the disposal of the respective government. These two parameters are highly country specific with the consequence that, in periods of market stress and uncertainty, governments are affected in different ways. Figure 7 shows the size of the domestic banking systems of some of the euro area countries, and compares the domestic banks' total assets with respect to national GDP at different points in time. The graph shows that the overall size of the banking systems differs significantly in the various member states, but that the magnitude remains of a comparable order.

From sovereign to banks – assets

Inversely, a deterioration in the creditworthiness of a sovereign has an impact on the banking system. Most of the literature recognizes four main channels of risk transmission from governments to banks:¹⁹

¹⁸ Gerlach *et al.*, *Banking and Sovereign Risk*; Merler and Pisani-Ferry, *Macroeconomics of North and South*.

¹⁹ BIS, *Impact of Sovereign Credit Risk*.

1. The value of banks' holdings of sovereign debt decreases as the higher riskiness of the sovereign diminishes the value of the bonds.
2. Government bonds are used by banks as collateral, both on the interbank markets in normal times and for central bank emergency lending in troubled times; thus their reduced price affects banks' ability to raise funds.
3. Sovereign downgrades normally translate into lower ratings for banks located in the downgraded country.
4. Increased sovereign risk negatively affects the value of the implicit/explicit government guarantees to banks, with a perceived higher bank risk in the financial markets.²⁰

The spillover effect from sovereign risk to bank risk is particularly strong for euro area banks because they hold huge amounts of government bonds.²¹ On top of that, banks in the euro area are characterised by a home bias in the composition of their government debt portfolios: domestic banks tend to hold high proportions of bonds issued by their own sovereigns, with the consequence that stress on the sovereign bonds market can very easily spill over onto the national banking system. Even if it is likely that this bias has decreased with the introduction of the euro, which rendered cross-border investment easier and safer, the pattern still persists and, interestingly, has contributed to reinforcing the sovereign-domestic bank loop in the euro area.

Macroeconomic channels and vicious circles

The highly fragile dependency between banks and sovereigns has a severely negative effect on the functioning of domestic economies. Indeed, governments are responsible for the redistribution of resources among their citizens and represent an important share of the aggregate demand of each economy, whereas the banking systems guarantee an efficient reallocation of funds within the economy. Thus, the sovereigns and the banking sectors can be seen as the polar triggers of the broader vicious circle characterizing the euro area.

The weakness of the sovereign side, represented by higher government yields, deteriorates the value of bank assets. This in turn translates into bank solvency and liquidity concerns, increasing the financial strains on banks. The impaired soundness of the banking sector can have a negative effect on credit growth, which results in weaker economic growth and consequently lower tax collection. Both lower tax collection and weaker growth constitute risks for the sustainability of public finances. On the other hand, problems in the banking sector increase the likelihood that banks will have to be rescued by the governments and this risk translates into higher costs of financing for governments. In an attempt to reassure the markets,

²⁰ *Ibid.*

²¹ Merler and Pisani-Ferry, *Who's Afraid of Sovereign Bonds?*

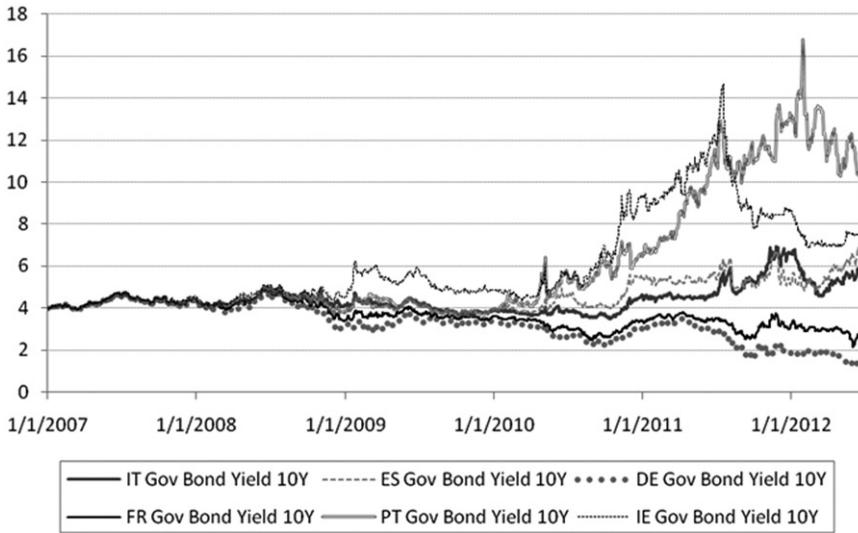


FIGURE 8. Divergences of government bond yields over time

Note: Daily bond yields normalized to 4 in January 2007.

Source: Datastream.

governments rely increasingly on harsh austerity measures, which add to the burden on the real economy. Weaker economic activity also increases the probability that loans on the assets side of bank balance sheets will not be repaid, fuelling the vicious circle even more. As a consequence of this feedback loop, countries in the euro area are no longer treated by investors as equals, and have a rather differentiated risk attached to them.

This two-way vicious circle is responsible for having worsened the fragile conditions of the European economy in general and for having exacerbated differences across countries.

The first evident consequence of the euro area vicious circle is the huge divergence in the cost of borrowing faced by the governments: as Figure 8 shows, yields of government bonds started to diverge considerably during 2010, reaching a peak at the end of 2011.

There is already evidence that the sovereign banking nexus has translated into negative effects for the real economy. Financial integration – perhaps one of the most important achievements of the single currency – is gradually giving way to fragmentation in financial markets which are increasingly retrenching within national borders.²² Banks are not particularly willing to lend to the real economy in a situation of heightened risk and this is happening not only in the periphery but also in the stronger member states. Companies and private agents are facing

²² ECB, *Corporate Indebtedness in the Euro Area*.

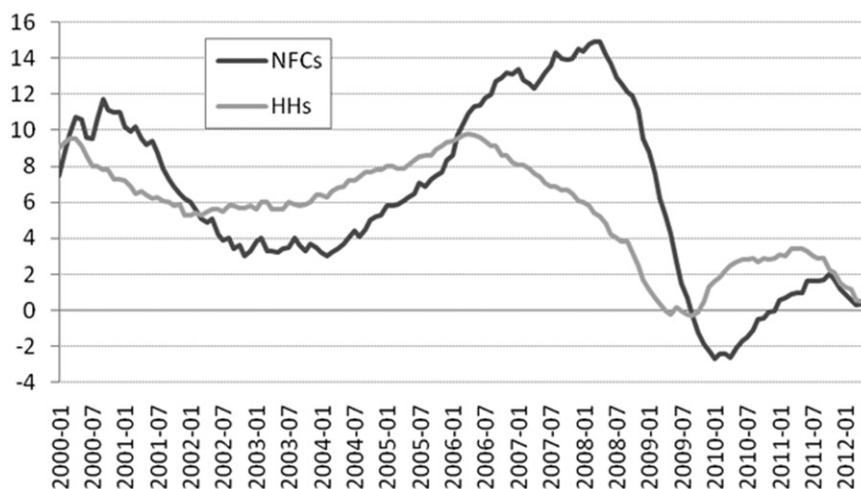


FIGURE 9. Bank loans to households and non-financial corporations in the euro area
Source: ECB

somewhat different conditions for borrowing money from banks, depending on their location, even though the European Central Bank (ECB) with its liquidity policy is dampening the effect of sovereign spreads on bank credit rates.

Credit dynamics, as measured by bank loan growth rates to non-financial corporations and households, have declined. Figure 9 shows the annual growth rates for the monetary financial institutions' (MFIs) loans to households and non-financial corporations since 2000. After the huge fall in concomitance with the 2008 Lehman bankruptcy, loan growth in the euro area as a whole remained subdued. In addition, as Figure 10 reveals, there exists a substantial heterogeneity in patterns across euro area countries. After the steep decline experienced by both southern and northern euro area countries until mid-2010, credit growth then recovered in northern euro area countries while it remained negative in southern countries.

How to break the sovereign-banks loop: a European banking union

The previous sections explained how the interdependence between sovereigns and banks has fuelled the vicious circle in the euro area that ultimately represents the main cause of the current economic crisis. On the one hand, the deterioration of sovereign creditworthiness impacts banking risk, for example, through the reduced value of the government securities held in the banks' assets portfolios. On the other hand, the cost of bank rescue that governments have implicitly or explicitly guaranteed to shoulder is proportional to the liability of the banks' balance sheets.

The way to exit from this vicious circle is to break or at least attenuate the links between sovereigns and banks. Logically, a two-way feedback loop can be

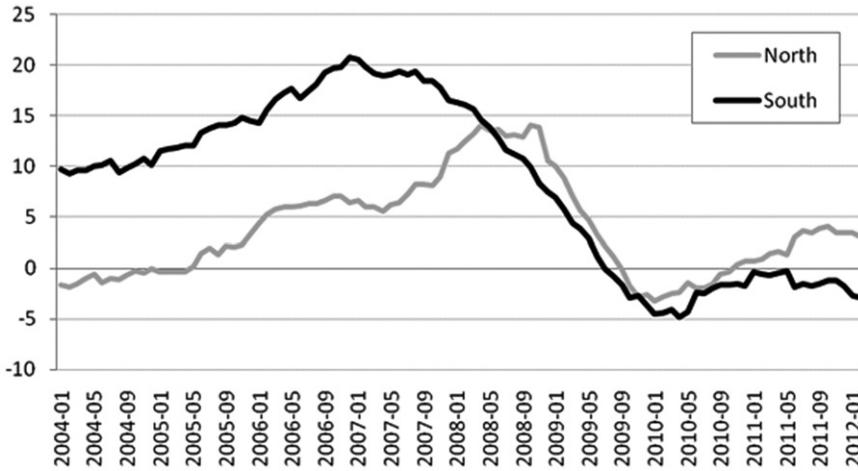


FIGURE 10. Different developments of loans to non-financial corporations between North and South

Source: Pisani-Ferry and Wolff, *Propping up Europe?*, with ECB data.

interrupted either by cutting the link from banks to sovereigns or by cutting the link from sovereigns to banks. Due to the numerous channels of this linkage, however, it may not be that easy to design a mechanism to address all channels. The creation of a banking union would be an option that would reduce the impact of banking problems on the sovereign. It would thus be a crucial step in tackling the negative feedback loop between banks and sovereign.

Establishing a banking union requires the creation and development of four fundamental pillars: banking regulations, supervision, resolution and a deposit guarantee scheme (DGS). Currently, the banking framework in the euro area is in many respects still not fully harmonised and responsibilities are mainly borne at the national level. Indeed, banking regulations and to some extent supervision are harmonized at the European level, as are the standards for national deposit guarantee schemes. However, the national dimension is still predominant in supervision in particular. In addition, and most importantly, banking crisis management and resolution remain national, with the consequences for the banks-sovereign loop explained previously.

A first move towards a banking union was undertaken by the eurozone summit on 28–29 June 2012. The summit decided to create common supervision and allow for direct capital injections into banks through the European Stability Mechanism (ESM). This was an important step towards breaking the negative feedback loop and will therefore contribute to the stability of the euro area. Two issues on the road to a banking union will prove particularly contentious: the organisation of common financial supervision, which is an explicit part of the summit agreement, and the creation of a resolution authority, which is not really covered in the summit statement.

Organising common supervision is not an easy task. Clearly, the European Banking Authority (EBA) and the European Systemic Risk Board (ESRB),²³ part of the new European System of Financial Supervisors (ESFS)²⁴ established in keeping with the recommendations of the De Larosière report of 25 February 2009, are supposed to mitigate the shortcomings in financial supervision revealed by the financial crisis, but it remains unclear how effective they can be, as the stress tests failed to uncover the real problem cases. Moreover, in its most recent decisions, the Council did not specify which banks would be covered and what kind of relationship there would be between the national and the common supervisor. Should national supervision be discontinued? Should national supervisory authorities be placed under the administrative control of the new European supervisor?

To be most effective, a system covering a large set of banks is desirable. The crisis has revealed that problems often arise in small to medium-sized banks, but that these problems are nevertheless too large to be handled by national fiscal and administrative authorities alone without causing contagion. Moreover, restricting the banking union only to large banks would lead to significant distortions in the banking system and would imply unequal coverage across countries. However, this would involve a radical transformation of the European supervisory landscape in which national supervisors would lose their status and become agents of the common European supervisor. This restriction would also involve major changes in the respective national legislations underpinning supervision.

Alternatively, a narrower solution would consist of European supervisory power being limited to large banks only. The national supervisors could then either keep their supervisory powers over these banks so that supervision would be dual, or their supervisory authority would be restricted to smaller banks. While this option may be easier to implement in practical and political terms, it should be borne in mind that only a broad solution will be effective in overcoming the negative feedback between banks and sovereigns. It is therefore of central importance that the ECB, the European Commission, the presidents of the European Council and the Eurogroup make a concerted effort to achieve a solution that changes the supervisory landscape in a meaningful way.

Another issue on the road to a banking union that will prove particularly contentious is the creation of a resolution authority, but the 28–29 June summit's conclusions are surprisingly silent on the matter. While there is political agreement to allow for direct capital injections into banks by the ESM, nothing is said about how this can be achieved and who should take the necessary decisions. Indeed, a bank resolution authority involves significant choices about the distribution of

²³ Wolff and Merler, "Fledgling Referee of Systemic Risk", provide an overview of the ESRB.

²⁴ The ESFS consists of the European Systemic Risk Board (ESRB) and three European Supervisory Authorities (ESA).

costs between shareholders, creditors, uninsured depositors, taxpayers, and/or surviving banks, as well as about ownership and competition in the sector as a whole.

One possible way of organising bank resolution would be to require national authorities to act once the European supervisor detects a significant capital shortfall in a bank. The European supervisor's decision would be legally binding on the national authorities to find a solution. As long as national fiscal resources are sufficient, the national authorities would be fully in charge of making the decisions on the restructuring and the burden-sharing. However, they would have to keep the European supervisor fully informed and they would obviously have to comply with state aid rules to avoid competitive distortions.

If national tax resources were too limited and ESM funds had to be directly channelled into banks through equity injections, national resolution powers would have to be significantly reduced. In Greece, in particular, the difficulty in retaining resolution power at the national level while finance is supplied from abroad has become particularly apparent. In fact, the restructuring process may be protracted and banks may be kept alive on emergency liquidity assistance despite their negative capital. It is thus advisable to render direct capital injections into banks conditional on the passing of national emergency legislation empowering the European level with resolution authority.

An even more radical option would be to give the actual resolution authority for all banks to the European level upfront. The European authority would be empowered to take the decisions on the distribution of costs and the re-organisation of banks in Europe. It is clear that the more far reaching the transfer of authority to the European level, the more pressing the issue of the political and democratic legitimacy of the decision-making process becomes. A model whereby the essential decisions on resolution are taken by national authorities requires only limited further enhancement of legitimacy at the European level. If resolution authority is fully moved to the European level, however, Europe would have to agree on a new way of legitimising such decisions. This would require a significant step towards more political integration.

Ultimately, resolution and supervision authority should be organised at the European level and should cover as many banks as possible. Only broad coverage will allow an effective banking union to be established in which the capacity to absorb shocks will also be moved to the European level. In other words, only broad European coverage will make it possible to break the vicious circle between banks and sovereigns that so strongly characterises the current crisis. In order to achieve quick and effective decisions on resolution, more resolution authority would have to be moved to the European level. Such a solution would require clear rules, on the model of state aid rules, to avoid bank resolution leading to major competitiveness distortions in the banking environment. The task set by Europe's leaders is daunting. Europe will have to act fast and avoid getting trapped in minimalist solutions.

Conclusions

This article presents an overview of developments prevailing in the euro area both before and during the crisis, highlighting the importance of the negative feedback between banks and sovereigns and the resulting deep economic consequences for the entire area.

Figures from the pre-crisis period point to a series of worrisome developments, especially in the private and external sectors, that were to a large extent ignored. Private debt of both households and non-financial corporations increased sharply as of 2000, fuelled by the unprecedented low level of interest rates due to the introduction of a single currency. The divergences in countries' competitiveness – which went hand in hand with the divergences in current account positions within the area – resulted in an increase in the periphery in the size of the non-tradable sector relative to the tradable sector, with detrimental effects on growth and sustainability.

The financial crisis led to a significant and rapid increase in the level of public debt across the euro area, but especially in the periphery countries, even though many of them had sound public finances before the outbreak of the crisis. At the same time, divergences in price competitiveness did not correct due to downward rigidities. As a consequence, the strong fall in domestic demand often resulted in strong increases in unemployment. The financial crisis also revealed, especially in the case of Ireland, that the cost of rescuing over-leveraged banking sectors (by relying on individual countries' own means) can have dramatic effects on public finances, thereby triggering the dangerous sovereign-banks loop.

Sovereign states in the euro area have tried to react to the negative feedback loop mainly by reducing fiscal deficits, but this solution has not proved as effective as was hoped. Indeed, additional fiscal consolidation has impacted the (already) weak growth prospects of countries with a heavy debt burden, thus partially offsetting consolidation efforts. As a matter of fact, international investors have not always reduced interest rates when consolidations have taken place. At the same time, structural reform agendas have frequently not been implemented so that the underlying structural divergences have not been corrected, shedding further doubt on the viability of the common currency and on public finances. In turn, doubts about fiscal sustainability reduce the creditworthiness of governments, and the resulting higher interest rates further undermine fiscal sustainability.

Moreover, doubts about sovereigns' creditworthiness have translated into weaknesses in the banking systems, which are highly affected by increased sovereign risk because of the huge amounts of government debt on banks' balance sheets. The fall in the value of government debt thus undermines the financial stability of the banking sectors, which in turn impacts the creditworthiness of governments. The main macroeconomic consequences of this chain reaction have been fewer bank loans to the real economy and weakened growth prospects for all countries.

This vicious circle could be stopped by breaking one of its channels of transmission. The impact of banks' liabilities on sovereigns could be stopped, to some extent, by the creation of a banking union at the European level. This would involve setting up regulations, supervision, and resolution authorities at the European level, as well as a system of deposit re-insurance. It would comprise banks in the euro area and perhaps beyond. Ideally, as many banks as possible would be covered by the common banking union, as restricting it to larger banks would undermine the effectiveness of the banking union and lead to significant distortions in competitiveness.

It will probably take time for such a new architecture for the European financial landscape to be put in place. Yet, never before has there been a greater need for action.

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