Journal of Macroeconomics 39 (2014) 250–259

Contents lists available at ScienceDirect

Journal of Macroeconomics

journal homepage: www.elsevier.com/locate/jmacro

The European Crisis and the Role of the Financial System

Vítor Constâncio

European Central Bank, Kaiserstrasse 29, 60311 Frankfurt am Main, Germany

ARTICLE INFO

Article history:
Available online 19 September 2013

JEL classification:
H63
E52
F36
G01

Keywords:
European crisis
Banking Union
Fiscal and macroeconomic imbalances

ABSTRACT

The paper aims to provide a deep rationale for Banking Union in the euro area. It shows that the banking sectors of core and peripheral countries were responsible for financing the credit boom that created the imbalances and vulnerabilities that later were at the centre of the crisis. The increase of debt ratios in the periphery until 2007 was more significant for the private sector than for the public sector. The crisis has been as much a banking crisis as a sovereign debt crisis and to avoid similar future risks a European Supervisor and a Resolution Authority are essential.

1. Introduction

There are, of course, several narratives and interpretations about the way the crisis unfolded in the euro area. For some, it is mostly a story of unsound fiscal policies and excessive sovereign debt; for others, it is principally a story of competitiveness losses engineered by uncontrolled unit labour costs; and for others still, it is essentially a traditional balance of payments crisis in a "fully fixed" exchange rate regime. In more recent years, the narrative of seeing it as a banking crisis has gained attention, combining it with the sovereign debt crisis to create a story of "two debt overhangs".

Naturally, there is a grain of truth in all these narratives, as is to be expected given the complexity and interplay of factors within a major international crisis.

However, more than trying to discuss a cogent overall interpretation of the euro area crisis, I would like to explore two perspectives:

- First, what were the root causes and key initial drivers of the crisis?
- Second, what role did the international financial crisis, originating in the US, play in triggering the European crisis?

The first question is important to identify the possible shortcomings in the design of monetary union that need to be corrected to avoid future crises. It is my contention that the initial driver of the crisis was located in the financial sector, particularly banks which intermediated large capital flows towards the periphery, creating imbalances that became unsustainable when a sudden stop occurred following the international crisis and the abrupt revision of price of risk that it entailed.

The second question is useful to consider whether the construction of monetary union would have been sufficient to ensure a gradual correction of vulnerabilities and avoid a crisis, if a major international shock had not occurred. One can

E-mail address: vitor.constancio@ecb.europa.eu

0164-0704/$ - see front matter © 2013 Elsevier Inc. All rights reserved.
http://dx.doi.org/10.1016/j.jmacro.2013.08.009

speculate that, left alone, the euro area may have been able to gradually overcome its own vulnerabilities through a process of inter-regional rebalancing. But we can never be certain about that. Fortunately, this question is less consequential than the first one.

2. The root causes of the crisis

2.1. The prevailing crisis narrative

Beginning with the first perspective, the oldest narrative of the crisis, progressively corrected by academics but still popular with some segments of public opinion, goes more or less like this: There was essentially nothing wrong with the initial design of EMU, and the crisis resulted mostly from the fact that several peripheral countries did not respect that design – in particular the fiscal rules of the Stability and Growth Pact – which generated the sovereign debt crisis. This is the "it was mostly fiscal" narrative, which can be easily connected to two of the others: fiscal indiscipline led to economic overheating, wage and price increases implied loss of competitiveness, and this then led to the balance of payment crises.

Although this is an internally coherent narrative, it is not correct, especially as a main driver of the crisis.

First, there is no strong correlation between whether a Member State respected or not the Stability and Growth Pact before the crisis, and the yields being demanded by financial markets today. For instance, Germany and France did not respect the Pact in 2003–4; Spain and Ireland respected it more or less fully until 2007.

Second, there was no uniform increase in overall government debt during the first years of the common currency in the countries that are now under sovereign stress.

In fact, in a number of those it declined, and in some of them it declined substantially. For instance, from 1999 to 2007, public debt in Spain declined from 62.4% of GDP to 36.3% of GDP. In Ireland, over the same period, public debt fell from 47.0% of GDP to 25.0% of GDP. While at relatively high levels, public debt also went down in Italy (from 113.0% of GDP to 103.3% of GDP) and increased only slightly in Greece. However, in the latter two cases, debt levels were still indeed far above the 60% stipulated in the Stability and Growth Pact (see Table 1).

2.2. Bringing the banking sector back in

I submit that, to have a more accurate narrative for the causes of the crisis, we have to look beyond fiscal policies alone: imbalances originated mostly from rising private sector expenditures, which were in turn financed by the banking sectors of the lending and borrowing countries.

As the above table shows, contrary to public debt levels, the overall level of private debt increased in the first seven years of the EMU by 27%. The increase was especially pronounced in Greece (217%), Ireland (101%), Spain (75.2%), and Portugal (49%), all of which are countries that have been under severe pressure during the recent crisis (Constâncio, 2012). The steep rise in public debt, on the other hand, began only after the financial crisis. Over the course of four years, public debt levels increased by a magnitude of five in Ireland and by a magnitude of three in Spain.

Seen from this perspective, the rapid increase in public debt levels followed from collapsing tax revenues and from social expenditures, which increased during the recession after the automatic stabilisers were triggered. Dangerous feedback effects between local banking systems and sovereigns which emerged after the start of the financial crisis also served to weaken the fiscal accounts.

Where did the financing come from for the explosion of private debt? A particular aspect of the process of financial integration in Europe after the introduction of the euro was a major increase in cross-border bank activity. Exposures of banks from non-stressed countries to stressed countries more than quintupled between the introduction of the euro and the beginning of the financial crisis (see Fig. 1).

While this explosion of financial inflows was unevenly distributed among periphery countries, it affected all of them, and containing its effects proved extremely challenging (see Fig. 2).

I have first-hand experience of the difficulties that periphery countries faced. The European rules on free movement of capital, the objective to create a level-playing field for different banking sectors, and the belief in the efficiency of supposed

Table 1
Growth of public and private debt ratios to GDP.

	Public sector debt ratio (% of GDP)			Private sector debt ratio (variation in %)
	1999	2007	Δ 99-07 in %	Δ 99-07 in %
Euro Area	71.7	66.4	−7.4	26.8
Greece	94.9	107.2	13	217.5
Italy	113.0	103.3	−8.6	71.2
Spain	62.4	36.3	−41.8	75.2
Portugal	51.4	68.4	33.0	48.9
Ireland	47.0	25.0	−46.8	101.0