
Five years of crisis (resolution) – some lessons

Thorsten Beck and José-Luis Peydró

Cass Business School and CEPR; CREI, Universitat Pompeu Fabra-ICREA, CREI, and Barcelona GSE

The past five years have given European countries useful insights on what works in crisis resolution. The lessons should be viewed as forward-looking contributions to the institutional and policy reform agenda in Europe, especially in the Eurozone. The Eurozone is not doomed, it just needs better economic and financial policies.

The past five years have given useful insights on what works and what does not in crisis resolution. Several Eurozone countries went through deep, persistent financial (and economic) crises, caused not only by bad crisis management policies, but mainly by a pre-crisis debt boom.

- Sovereign public over-indebtedness (Greece);
- Real estate private credit bubbles (Ireland and Spain); and
- Current-account imbalances (Portugal, and also in Spain and Ireland, where the credit and real estate price bubbles were in great part financed by foreign liquidity).

More often than not, European policymakers decided not to draw on the extensive crisis resolution experience in and outside of Europe, a decision which has led to substantial number of policy mistakes.

It would be wrong, however, to say that any negative outcome could be explained by policy mistakes. Post-crisis, countries have to go through (often severe) readjustment

periods, often with distributional repercussions. Nevertheless, the experience over the past five years allows lessons to be drawn. While economists pointed out pitfalls beforehand, these lessons definitely benefit from hindsight and should thus not be perceived as knee-jerk ‘told-ya’ reaction.

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Looking beyond fiscal policies

The Maastricht criteria for entering the Eurozone focused on fiscal and monetary policy conditions. As most observers agree, the Maastricht criteria to enter the currency union were too narrowly focused on public sector debt (and were often ignored anyway, including in Germany and France in the early 2000s, and especially bad in the case of Greece).

The Fiscal Compact is a broader approach, but still seems too much focused on fiscal policy. History, and also the Global Crisis starting in 2007-08, suggest that the main determinant of systemic financial crises with strong and persistent negative aggregate effects is a pre-crisis build-up of private leverage. This was the case of Ireland and Spain before the Global Crisis. Such run-ups are normally accompanied by asset price bubbles, especially in real estate. Often this private over-indebtedness ends up on governments’ balance sheets, so that the rise in public debt is more a consequence than a cause of a financial crisis.

- This makes it clear that there have to be better limits on both ex ante build-up of private and public leverage, especially if used for real estate.

Examples include building empty airports in Spain and preparing for the Olympic Games in Greece. Europe suffered from a lack of any limits on build-up of private

leverage prior to the Crisis, and in general from the lack of macroprudential policies that limit systemic risk (Freixas et al. 2015).

- Public and private leverage limits are especially important in good times, when incentives are stronger and more pernicious in the build-up of excessive risk; and
- The limits have to be softer in bad times when some relaxation may help economic recovery, as fiscal multipliers are greater in crisis times and issuing equity in crisis times is more costly for private agents.

Convergence in a currency union, therefore, cannot be purely on fiscal grounds; however, it cannot even be on current-account grounds alone, though credit booms were mainly financed with foreign debt, which implied strong internal Eurozone imbalances.

Importantly, convergence also has to happen on the institutional level. Devaluation of a currency allows a strong internal coordination mechanism to reduce overall local prices in a country with respect to foreign products and services, which was the typical way for periphery Eurozone countries to get out of economic recessions in the past.

- Rigid external prices in a currency union should imply substantially more flexible internal prices and flexible labour, service, and product markets that allow adjustment to external shocks.

In fact, a key argument in favour of peripheral countries to adopt the euro was that the only way to go out of a crisis would be with a more flexible, competitive economy through structural reforms.

Sadly, the substantial lower risk premia – and thus lower costs of borrowing – that came with the euro implied strong booms but too little economic reforms in the periphery countries. The case of Greece has especially shown the need for such flexible markets (the same in e.g. Spain, but here the labour market has been partly liberalised after the onset of the Crisis). Greece went into the Crisis with rigid internal price structures and no option to adjust external prices, which ultimately exacerbated the impact of fiscal retrenchment beyond that predicted by normal-times fiscal multipliers.

While the adjustment programmes involving private and public deleveraging in several other periphery countries were painful but relatively successful, the programme in Greece failed, which can thus be (partly) explained by deep structural rigidities. This lack of reforms could be due to the deep links between the Greek political elite (PASOK and ND) and the economic elite, which has benefitted enormously from corrupt and inefficient government structures. Similarly, the clientelistic nature of Greek politics (jobs and/or economic rents for electoral support) prevented the previous government from implementing reforms that would ultimately undermine this system.¹

Restructuring – done correctly

Since debt is in general not state-contingent, it results in too much ex-post liquidation and insufficient risk sharing across borrowers and lenders, and has some moral hazard problems such as debt overhang and risk shifting. These problems are even worse in the Eurozone countries as debt is written in euros, which is not controlled by the local governments and central banks (opposite to e.g. the US and the UK), and is especially short-term (and thus very fragile) to weak borrowers, as e.g. banks or the periphery sovereigns.

Ex post restructuring is thus necessary in some circumstances to reduce the huge ex post-crisis costs, and this is even more necessary in the Eurozone, given the lack of other adjustment risk-sharing mechanisms such as fiscal union and loss of monetary sovereignty. Going into the Crisis, Europe had few, if any, restructuring mechanisms in place. Europe has made progress in establishing resolution mechanisms for banks, including stronger capital requirements and bail-in rules, as well the beginning of a banking union to cut the links between weak banks and weak sovereigns. These reforms come in the wake of mistakes done during the Crisis, such as guaranteeing too many bank liabilities with taxpayers' money (e.g. in Ireland, Spain or Greece).

¹ An illustrative example is the problems faced in Greece by Andreas Georgiou, the technocrat in charged with running the Greek statistics office who showed the real public fiscal deficit that Greece truly had. See <http://www.wsj.com/articles/deficit-drama-greek-authorities-step-up-probe-against-statistics-chief-1427060060>.

There has been little restructuring, on the other hand, in the household sector. In the US with most states with non-recourse mortgage loans and bankruptcy procedures for households, the deleveraging process has been much faster via defaults and the restart in growth therefore relatively quicker by alleviating debt problems. This part has been missed in Europe, though there have been improvements, as for example in Ireland during this Crisis (or in Sweden in the 1990s). For non-financial firms, restructuring has always been easier, but it has even improved further in the Crisis, e.g. in Spain (even allowing some new fresh money to have some priority over existing senior debt or giving second opportunities to entrepreneurs with too much debt). A right balance between too much debt overhang and zombie lending to inefficient firms and banks has, of course, to be struck.

- The only aspect that has not been touched at all is a framework for insolvency for countries, and this is urgently needed.

Similarly as for households, enterprises and banks, restructuring of sovereign debt requires an adequate framework, especially in a currency union.

The repeated adjustment in Greece's debt burden after 2010 and 2012 has increased uncertainty, especially given the ad-hoc nature of these adjustments. The lack of such framework and the attitude 'we do not do sovereign insolvency in Europe' in 2009/10 has delayed the urgently needed adjustment of the Greek debt burden. Even the 'private sector involvement', i.e. bail-in of private debtholders in 2012 proved to be insufficient. In the US, public default occurs and 'life continues', as it happened with Detroit, Orange County, and very recently with the problems in Puerto Rico.

Given that there is not going to be a fiscal union in the Eurozone soon, financial integration is one way of obtaining higher risk sharing within the Eurozone. Financial integration has been mainly through debt, and debt (as we have explained) which cannot be easily restructured. Thus:

- More debt restructuring in general and favouring more equity-based type of finan-

cial instruments (over debt) would allow for substantial higher risk sharing within the Eurozone, thus limiting partially the problems associated with a lack of fiscal union within a monetary union.

Rescue – do it once and right or lose traction/momentum

On the rescue programmes for very weak countries, substantial reductions in public debt should have been traded with true structural reforms that improve GDP and the competitive environment of the local economy. Greece could have done many, as the above example of the independent statistical institution shows us, or as Papaianou et al. (2015) explain carefully, and not the mistakes on contractive fiscal policy given the strong fiscal multiplier in crisis times.

- It is important that such structural reforms are ‘owned’ by the local government, the political class, and the population of a country.

Greece has clearly shown that if this is not the case, it won’t work. We predict that doubling down, as currently being done by going step by step (as Ms. Merkel likes to do without looking ahead) has in great part brought us into this bad situation and will not solve the problem.

Compromises have saved the day and lost the year! To quote just one example, the Greek liquidity support of 2010 and debt restructuring 2012, partly motivated by the desire to protect banks in Germany and France, where a large share of private debt was swapped for public debt, has resulted in a rise in political tensions between Greece and its creditors over the past years. It has ultimately resulted in a rise of nationalism and populism across the Eurozone, both in periphery countries (most notably Greece), but also in the creditor countries, such as Finland and Germany.

The human factor counts

The human factor counts; trust is crucial. Trading a reduction of debt for future deep structural reforms, including institutional framework, requires trust, and trust has been lost on both sides. If one cannot trust that the Greeks have a properly functioning statistics office, can outsiders trust them on deep structural reforms over time after an initial large debt reduction?

Economists often like to view policymakers as rational players, deciding purely on the basis of numbers and arguments. The experience with Yanis Varoufakis, Greek finance minister for the first half of 2015, has shown that this is not necessarily the case. Tensions were rising very openly in the Eurozone. The very different style of the new Greek finance minister might very well have contributed to the agreement in early July between Greece and its creditors, even though numbers and arguments had not really changed. Of course, even after the Greek referendum, the other countries have to sell the third Greek bailout to the local voters, and these voters also need to trust that their governments look after their interests. One missing solution that is not on the table is substantial debt relief as substantial reforms are taken over time, which may be incentive-compatible for both sides.

A central bank is a political player – no matter what the Treaty tells you

The ECB has been crucial in the Crisis. Draghi's statement to do 'whatever it takes' (and the related OMT) was crucial in calming markets during the Eurozone public debt crisis of summer 2012 and avoiding self-fulfilling runs. In this context, the Eurozone also provided public liquidity to banks when European cross-border interbank markets failed.

- A central bank can never be a purely technical institution – politics is always involved (unlike what some German economists and politicians like to think).

The role of the ECB in the recent stand-off between Greece and its creditors, most prominently the other 18 Eurozone countries, has clearly shown that. Beyond being a creditor to the Greek government – a rather unfortunate role – at which point does the ECB decide as the lender of last resort to not extend liquidity support to Greek banks further or even withdraw it? Given multiple equilibria, and the associated large economic and political costs, if the (ex-post) wrong decision is taken, this is clearly not a purely technical decision.

More generally, most economists agree by now that financial stability should also be a concern of the ECB, in addition to price stability. While the inflation target paradigm of the pre-2008 period was based on a clear separation between (micro-prudential) financial stability and monetary stability, the Crisis has taught us that such a separation is not feasible.

Central banks' primary objective in history has been financial stability, while price stability is a more recent focus. Most times, both objectives reinforce each other, but not always. Moreover, with free capital mobility and without a full banking union (including deposit insurance), once citizens think that their country could potentially leave the Eurozone, it is optimal – and hence self-fulfilling – to run on the banks, thereby completely destabilising a bank-dominated economy.

Importantly, however, the ECB's role is not substitutive of the periphery economies reforming their economies, notably Greece but also the others, and the creditor countries allowing some sovereign debt restructuring and more expansive fiscal policies.

Concluding remarks

The Eurozone is not doomed; it just needs better economic and financial policies. The experience with the mistakes in crisis resolution over the past five years can serve as critical input into the necessary institutional reform in the Eurozone.

References

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