Statement for the

Senate Committee on Banking, Housing and Urban Affairs
Subcommittee on Security and International Trade and Finance

Hearing on

THE EUROPEAN DEBT AND FINANCIAL CRISIS: ORIGINS, OPTIONS AND IMPLICATIONS FOR THE US AND GLOBAL ECONOMY

Joachim Fels, Morgan Stanley

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Introduction and Summary

1. The origins of the euro area's twin sovereign debt and banking crisis include (i) a weak institutional framework with one money but many nations; (ii) an oversized and undercapitalized banking sector with high exposure to sovereign debt; and (iii) diverging growth and competitiveness trends between euro member countries, leading to large current account imbalances and a build-up of debt in the deficit countries. The crisis was exacerbated over the past eighteen months by a slow and inadequate response to the Greek and the banking sector problems, and more recently by the decision to involve the private sector in the latest Greek bail-out package. A lasting solution of the crisis requires bold reforms of the euro area's institutional framework, including (i) a big step towards closer fiscal union between member states with a (partial) loss of fiscal sovereignty to avoid moral hazard, (ii) large-scale recapitalization and restructuring of the banking sector, and (iii) a central bank able and willing to serve as a lender of last resort to member states in order to prevent self-fulfilling 'runs' on otherwise solvent sovereigns. Major political and legal obstacles to such reforms imply that a quick resolution of the

crisis is unlikely. A deepening crisis potentially involving a default by one or several members states and, as a worst case, a break-up of the euro would have severe adverse consequences for the US and global financial sector and economy.

The Origins of the Crisis

2.   There are three key factors at the root of the current sovereign debt and banking sector crisis in the euro area. First, a unique institutional framework combining a single monetary policy conducted by a central bank constrained by a narrow inflation mandate with decentralized fiscal policy and decentralized banking supervision in the 17 member states. Second, an oversized, undercapitalized and fragmented banking sector highly dependent on wholesale funding. Third, divergent trends in growth and price competitiveness between member states' economies, which led to large current imbalances within the union and a build-up of debt in the deficit countries.

3.   The most important of these three factors is the euro area's peculiar institutional framework. One distinctive feature of this framework is that while monetary policy is centralized, individual member states have retained their fiscal sovereignty. To prevent countries from running excessive fiscal deficits, the Stability and Growth Pact (SGP), an inter-governmental agreement that accompanied the move to a single currency, set limits for individual countries' debts and deficits and envisaged fiscal sanctions for fiscal sinners. However, the SGP lacked teeth because the imposition of sanctions always required a qualified majority vote by all finance ministers ('sinners watching over sinners'), and because the criteria were watered down further in 2003, when the two

largest countries, Germany and France, missed the fiscal criteria and coalesced to change the goal posts. Moreover, the Treaty regulating monetary union contains a ‘no bail-out’ clause, stating that no member country can be forced to stand in for the debts of other members. At the same time, the Treaty lacks a mechanism for orderly sovereign debt restructurings and it does not provide for a mechanism to exit the euro area. In fact, while a country may chose to exit the euro, there is no provision for excluding a non-compliant member state. In summary, the euro area’s institutional framework has neither been able to prevent irresponsible fiscal behaviour, nor does it provide a mechanism for an orderly resolution once a fiscal position has become unsustainable – either in the form of fiscal transfers or an orderly insolvency.

4. To make matters worse, another distinctive feature of the euro area’s institutional framework is that the European Central Bank is constitutionally banned from financing governments directly, be it through direct loans or purchases of government bonds at auction. This provision was enshrined in the Treaty establishing monetary union to enhance the ECB’s credibility as an inflation fighter – the Treaty states price stability as the ECB’s primary mandate – and, in particular, to placate Germany’s fears of financing governments through the printing press, which are rooted in the experience with hyperinflation in the Weimar Republic of the 1920s and the experience of financing two wars through the printing press. However, an important consequence of this provision is that governments no longer have a lender of last resort to turn to in case creditors refuse to fund them at reasonable interest rates. Without access to the printing press in extreme circumstances, there is a risk of self-fulfilling ‘runs’ on otherwise solvent governments.

True, access to the printing press, if overused, can be inflationary. But investors typically fear default more than inflation, which is usually much slower to materialize and less disruptive for the financial system than a default. The lack of access to the central bank as a lender of last resort helps to explain why investors treat countries with high debt in the euro area as 'credits' and thus differently from countries with similarly high debt levels (Japan, UK, US) who, in principle, have access to their central bank and are thus 'true sovereigns'.

Exacerbating Factors

5. While the three key factors above – a weak institutional framework, an oversized and undercapitalized banking system, and growing imbalances within and between euro area member countries – have been at the root of the crisis, it was exacerbated by a slow and inadequate policy response ever since the Greek problems became apparent in late 2009. Delaying the initial aid package for Greece until May of last year helped spark contagion into Portugal and Ireland. Making the rescue fund (the European Financial Stability Facility EFSF) a temporary institution scheduled to expire in 2013 fuelled fears that default would become likely after the fund's expiration. Including the principle of private sector participation in post-2013 bail-outs into the blueprint for the post-2013 permanent rescue fund (the European Stability Mechanism ESM) confirmed those fears. Failure to force banks to recapitalize faster and more aggressively undermined both investor confidence in the financial system and companies' and private households' access to bank credit. Moreover, by breaking an earlier promise and involving private investors in the latest Greek bail-out package decided on 21 July 2011 through a 'voluntary' debt

exchange, euro area governments sparked the latest round of contagion into the Spanish and Italian bond markets as the promise that 'Greece is an exception' was not deemed credible. In all these cases, domestic political considerations in the face of widespread public opposition to further bail-outs especially in Germany, the Netherlands and Finland, prevented bolder and more timely steps. Rather than blaming governments in these countries for delayed or misguided decisions at the European level as many commentators do, we view this outcome as the logical consequence of what we identified as the most important underlying cause of the crisis – the euro area's inadequate institutional economic governance framework.

Options to Resolve the Crisis

6. A lasting solution of the crisis requires bold reforms of the euro area's institutional framework – fiscal and monetary – as well as banking sector recapitalization and restructuring. Fiscal reform should include two elements. First, a fiscal transfer mechanism or insurance scheme that provides a backstop for governments unable to fund in the market at reasonable interest rates. Second, a (partial) transfer of member states' fiscal sovereignty to a European authority to avoid irresponsible fiscal behaviour.

7. Second, to prevent self-fulfilling runs on otherwise solvent sovereigns, the euro area needs a central bank able and willing to serve as a lender of last resort to member states in exceptional circumstances. To some extent, the ECB has assumed this role in the current crisis by buying government bonds of Greece, Portugal, Ireland and, more recently, Spain and Italy in the secondary market. However, the amounts purchased have

been relatively small and the ECB is constitutionally barred from buying bonds directly at auction.

8. Third, to break the negative feedback loop between the sovereign crisis and the banking sector crisis, banking regulators should push for a large-scale recapitalization program including both private sector and EFSF involvement.

9. There are major legal and political obstacles to bold and far-reaching reforms of the euro area's fiscal and monetary framework. These reforms would require a change in the Treaty of Europe, which would have to be ratified in all national parliaments and would, in several countries require popular votes. Past experience with Treaty changes suggests that this could take several years. Yet, without such reforms, the euro area's sovereign debt crisis is unlikely to be solved. As a consequence, it is safe to assume that the crisis will continue in the foreseeable future and probably deepen further.

Implications for the US and Global Financial Sector and Economy

10. A deepening crisis potentially involving a default by one or several members states and, as a worst case, a break-up of the euro would have severe adverse consequences for the US and global financial sector and economy. First, higher funding costs for the public and private sector, fiscal austerity measures and banking sector stress suggest that the euro area economy will broadly stagnate in the foreseeable future, with many Southern member countries including Italy and Spain experiencing a renewed recession. Thus, European import demand looks set to slow, which will dampen US and other

regions’ export growth. Second, a deepening European crisis is likely to push the euro exchange rate lower versus the dollar and other currencies, which will also hurt US and other exports to Europe. Third, while US banks, in general, are viewed as stronger in terms of capital, liquidity and asset quality than their European peers, the European crisis has contributed, alongside global growth concerns, to higher funding stress and a higher cost of capital in the US and elsewhere.