

Crisis Cycle - Challenges, Evolution and Future of the Euro

by John H. Cochrane, Luis Garicano, and Klaus Masuch

“Whatever it takes”

- Mario Draghi

“Because it is France”

- Jean-Claude Juncker

“We are not here to close spreads”

- Christine Lagarde

CRISIS CYCLE



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- Currency union without fiscal union is possible and sensible, but must solve the fiscal free rider problem.
- The euro was set up well to contain this problem, but (naturally) with a few lacunae.
- A series of crises erupted; emergency actions broke the constraints.
- Member states and EU institutions **did not** (i) **reform between crises** to (ii) address **moral hazard incentives**, making further intervention more likely.
- **Problems have now built up**, such that the ad hoc system that emerged from crisis interventions is in danger of a serious and chaotic failure.
- Reform is possible, and economically straightforward. One last chance!
- Disclaimers: 1) Euro fans! 2) Economics not law. 3) No morality play. Not really criticism of crisis decisions.

Founding: Monetary union, **no fiscal union**. Monetary-fiscal separation:

1. Independent ECB. Limited mandate, “price stability” (and only that, not employment, not bank regulation / financial stability).
2. No monetary financing of sovereign debts.
3. Debt and deficit limits for member states.
4. “No bail out” (cross-country, fiscal) for public debt.

1999-2007: **ECB Monetary policy** (strategy, operational framework, decisions, communication) contributed to, and enhanced the founding philosophy

- ECB created new money via loans to banks against high quality collateral; did not buy any sovereign debts.
- ECB communication made clear that it would not support member states.
- Successful interest rate target, single mandate, low inflation.

A currency union without fiscal union must countenance sovereign default, like corporates, at least as a fall-back last-resort option. Treaty was silent.

- **No** sovereign “bankruptcy” (restructuring) procedure.
- Gray area? **No** crisis resolution, help with conditionality, “European IMF.”
- **No** regulatory (or private) risk weights on sovereign debt. Counts as liquidity buffer. → Banks hold large, concentrated portfolios. Hostages. Default/restructuring brings down banks.
- **No** banking union, common banking regulation, supervision, deposit insurance. National regulation, lender of last resort, regulation.

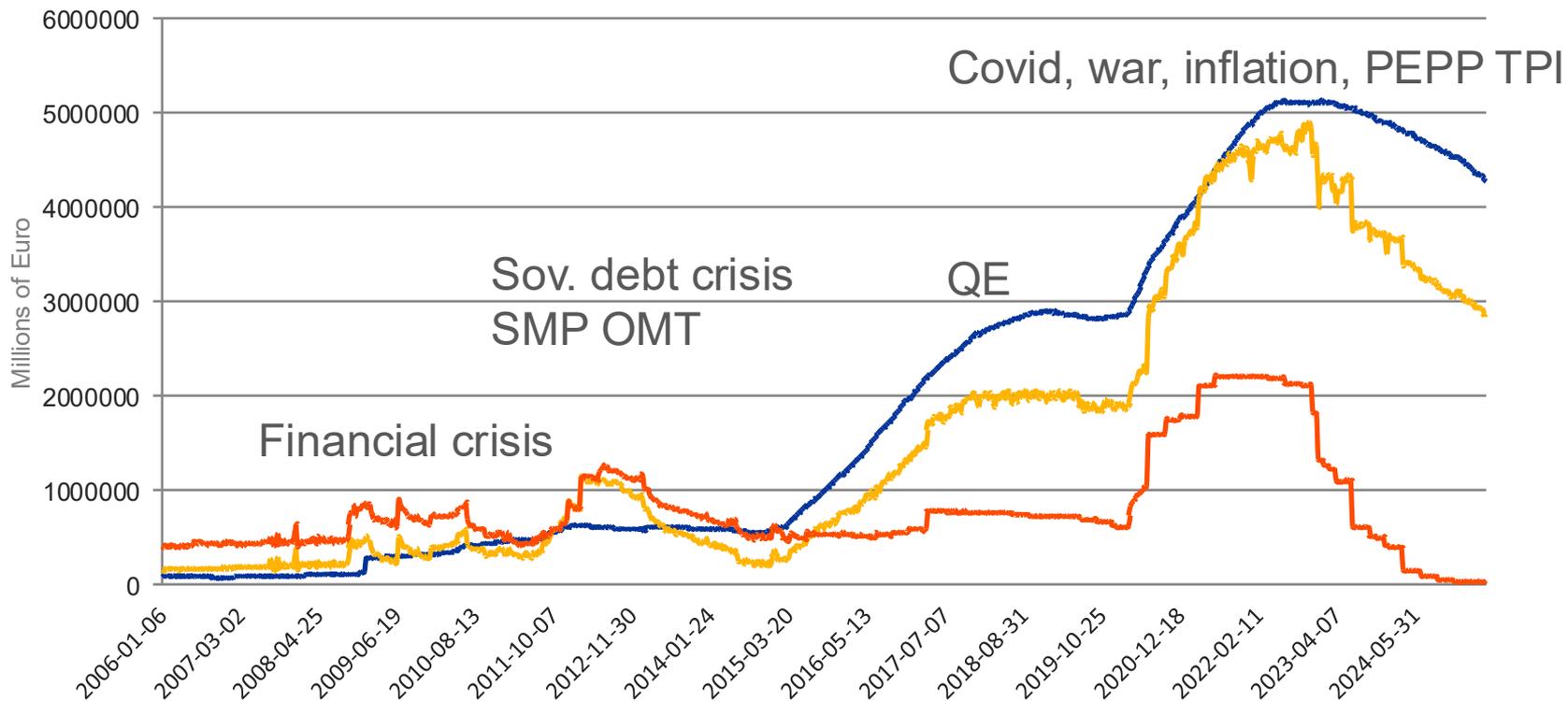
Natural. Sovereign default? “Let’s not talk of such unpleasant things. Everyone will behave. We’ll figure that out later if we have to.” Institutions evolve with experience.

Now we have to evolve.

Eurosystem – consolidated balance sheet (Jan. 2006 – June 2024)

- **Bond holdings** (Securities of euro area residents denominated in euro)
- **Bank deposits / reserves** (Liabilities to euro area credit institutions related to MPOs denominated in euro)
- **ECB loans to banks** (Lending to euro area credit institutions related to MPOs denominated in euro)

Euro
Millions
Eurosystem,
Euro area,
Weekly data



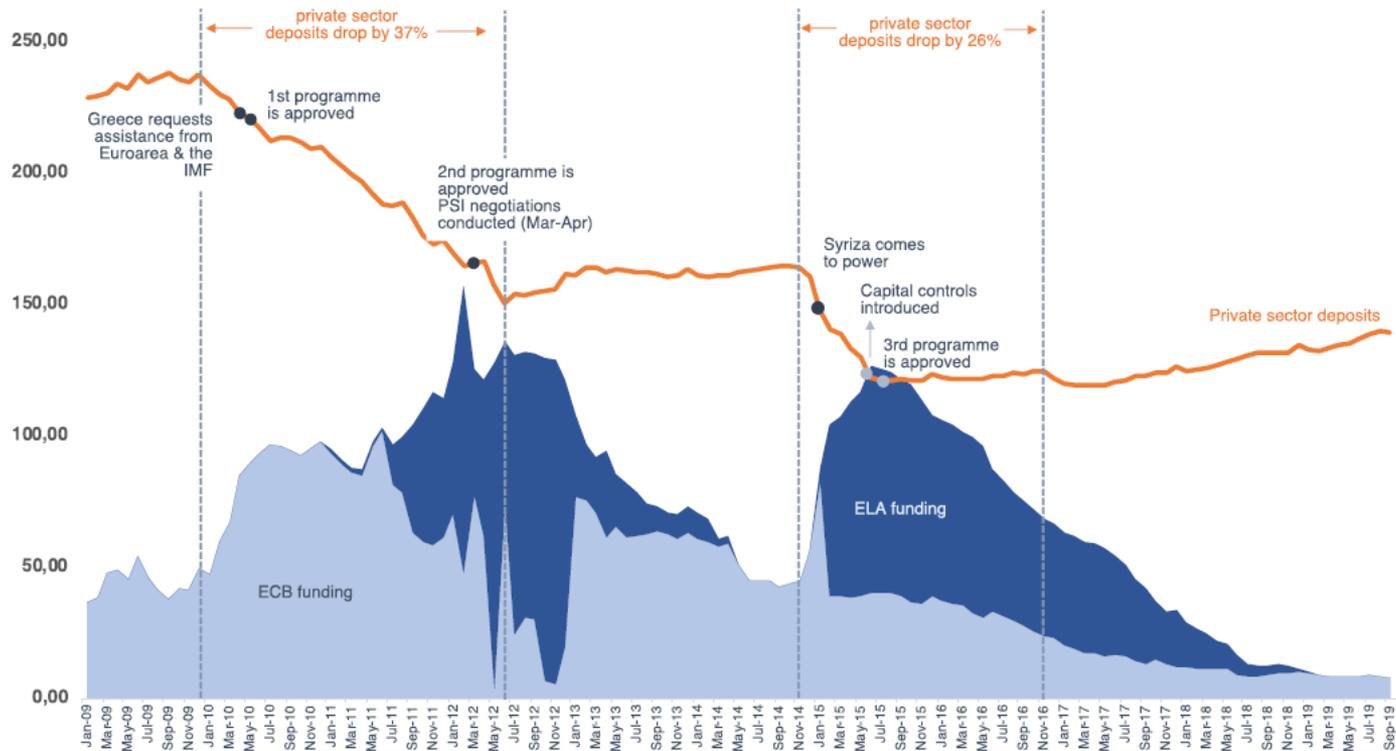
Source:
ECB

- 2003-2004. France and Germany break debt and deficit rules.
- Then, financial crisis, sovereign debt crisis, low-inflation QE, covid, war, energy.
- ECB buys larger and larger quantities of sovereign debt, with fewer and fewer restrictions, props up asset prices, subsidizes banks.
- Temporary help with conditionality develops after Greece, but then abandoned.
- Banking reform to *break “vicious circle between banks and sovereigns”* (EU Council, 2012) never happens, banks still hold large concentrated public debts.
- ECB now holds large portfolio, and is widely expected to stop any sovereign spread from rising.
- Countries do not see market incentives to borrow less, spend wisely, implement growth-oriented microeconomic reform.

- Mostly loans to banks against much looser collateral.
- Same rate for all banks, collateral. Funds risky investment. (The point)
- 2007 “fine tuning operations” €95 b
- Fall 2008. Much looser collateral, full allotment, €1Tr.
- Banks buy sovereign, 0 risk weight.
- Periphery banks hold own sovereign debt, €781b 2008-2013.

- Portugal, Ireland, Spain, Italy, Cyprus
- “Imbalances.” Low rates? Debt? Benefit of precommitment. (& expected ECB.) Alas consumed not invested.
- Ireland 2008. Banks 500% of GDP. Govt guarantees, €440b. National LOLR?
- Greece. Fall 2009: Rollover crisis. Bailout, exit? Capital flight. ECB lends to Greek banks €83b by April 2010. Banks buy €22b more government debt!
- May 2010 €110b loan with adjustment program; SMP ECB buys sovereign debts. Letters to ministers.
- Restructuring (at last) March 2012. ~ €50b repaid in full. ECB made whole.
- 2012, Italy spreads widen. July 26 “Whatever it takes.” OMT with ESM conditionality.
- 2015 Again after Syriza victory. Bank outflow, financed by ECB emergency lending. (ECB to Bank of Greece Target 2, Bank of Greece emergency lending) 2015-2018 ESM loans with adjustment program; loan forgiveness.

Greek Bank Funding



Greece. 2010: Loans to banks. ELA=T2. SMP “malfunction” “transmission” IMF. Many creditors walk. “Contagion” “Grexit”. 2012 “whatever it takes” OMT. ESM 2015

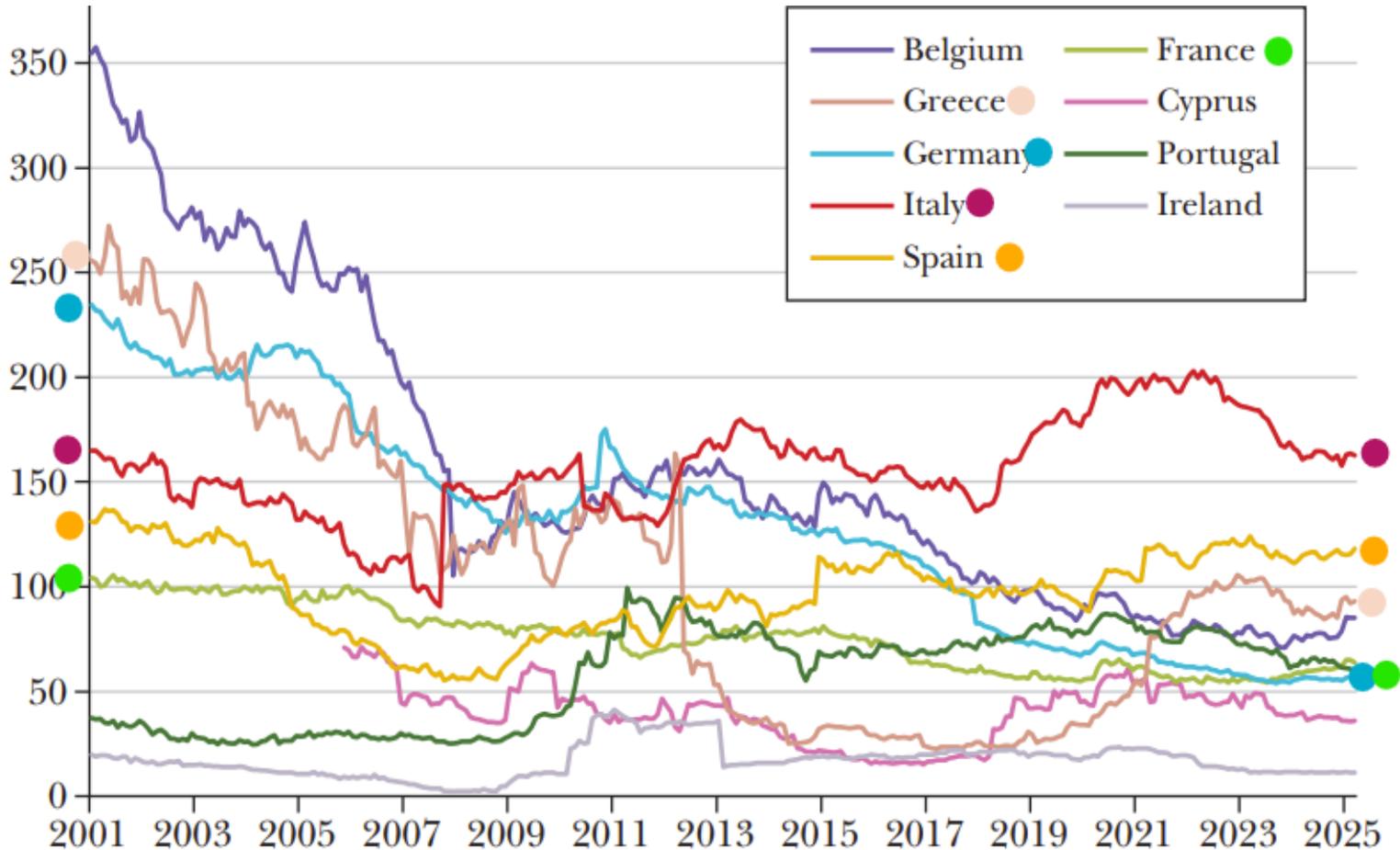
Bank Exposure to the Respective Domestic Government in some EA Countries, 2001–2025

In % of Equity Capital

Source:

Zsolt Darvas & Lennard Welslau & Jeromin Zettelmeyer, 2025. "Sovereign Debt and Fiscal Integration in the European Union," *Journal of Economic Perspectives*, American Economic Association, vol. 39(4), pages 49-74, Fall.

ECB Balance Sheet Items (BSI) database. Note: Both government securities holdings and loans to the government are considered. For data availability reasons, the chart uses equity capital rather than the more commonly used Tier 1 capital. Except for Germany, Tier 1 capital is lower than equity capital. Tier 1 capital refers to a bank's highest-quality capital, including common stock, retained earnings, and other disclosed reserves. It is defined in Article 25 of Regulation (EU) No. 575/2013, available at <https://eur-lex.europa.eu/eli/reg/2013/575/oj/eng>.



- Effort at institutional reform. ESM, SSM, OMT, bank union. Largely abandoned.
- QE. PSPP. APP. Capital key. Lending to banks to buy sovereign debt.
- Target 2 build up.
- Covid, war. PEPP, TPI. No restrictions. March 2020 “Not here to close spreads.” France?
- “Transmission Protection Instrument.” July 2022, No ESM, capital key limits, ECB alone decides. ECB judges policy, negotiates conditions? “Fragmented” “Dysfunctional” spreads.

Differences between OMT (2012) and TPI (2022)-conditionality

ECB Press release on *Outright Monetary Transactions* **OMT** (Sept 6, 2012):

*“A necessary condition for OMT is strict and effective conditionality attached to an appropriate ... **EFSS/ESM programme.**”*

M. Draghi on **OMT** (Press Conference, Sept. 6, 2012):

*... it is very much up to the **governments** themselves, ... **the European Commission and the IMF to decide on the precise nature of this conditionality.***

C. Lagarde on the *Transmission Protection Instruments* **TPI** (Press Conference, July 21, 2022):

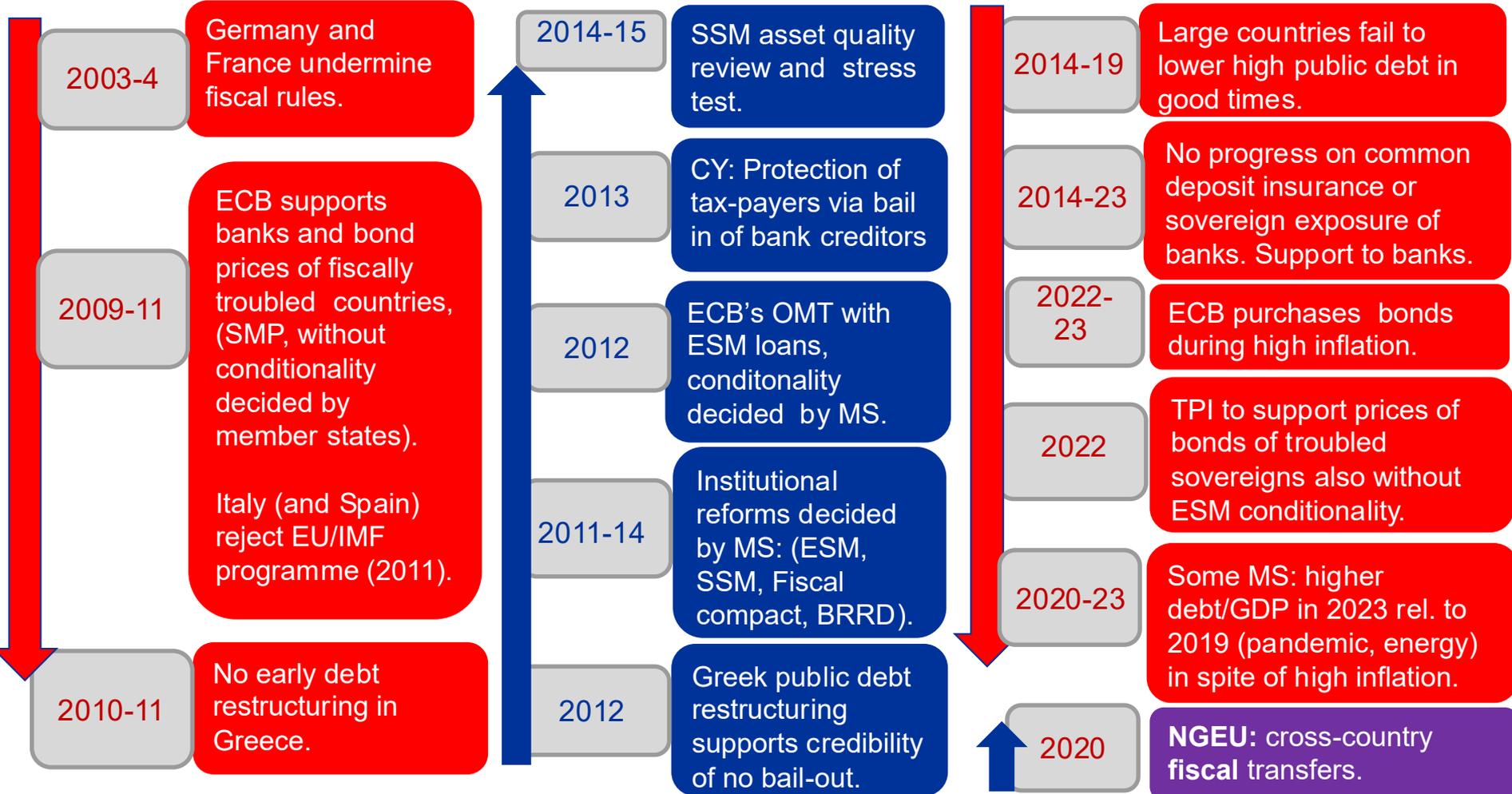
*“ ... all these four categories will be taken into account ... But once again, the **Governing Council decides in sovereignty in respect to eligibility to the TPI....**”*

Overview of ECB programs of country specific bond purchases

	SMP (2010; terminated 2012)	OMT (2012-) not yet activated	PEPP- <i>Flexibility</i> (2020-)	TPI (2022-) not yet activated
Aim	“address the malfunctioning of securities markets ... restore an appropriate monetary policy transmission mechanism. ”	“safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy”	“counter the serious risks to monetary policy transmission mechanism and the outlook ... posed by ...COVID19”	“support the effective transmission of monetary policy ... TPI will ensure that the monetary policy stance is transmitted smoothly across all euro area countries.”
ECB creditor treatment	Ex ante: not specified Ex post: Super Senior	Ex ante: pari passu Ex post: Not yet tested		
Economic (ESM) adjustment program as pre-condition	2010: NO 2011: NO, but confidential ECB letters to Prime Ministers of Italy and Spain)	YES ESM program decided by EA fiscal authorities ; with “ strict and effective conditionality ”	NO “There are no limits to our commitment to the euro. We are determined to use the full potential of our tools, within our mandate.” (C. Lagarde)	NO “decision ... will be in the entire discretion of the Governing Council ... So the four criteria ... will be elements of information ...” (C. Lagarde)*

*) https://www.ecb.europa.eu/press/press_conference/monetary-policy-statement/2022/html/ecb.is220721~51ef267c68.en.html

Policies and institutional changes during four crises (MS=member states)



ECB balance sheet, excess reserves and balance of payment support for some MS

ECB target2

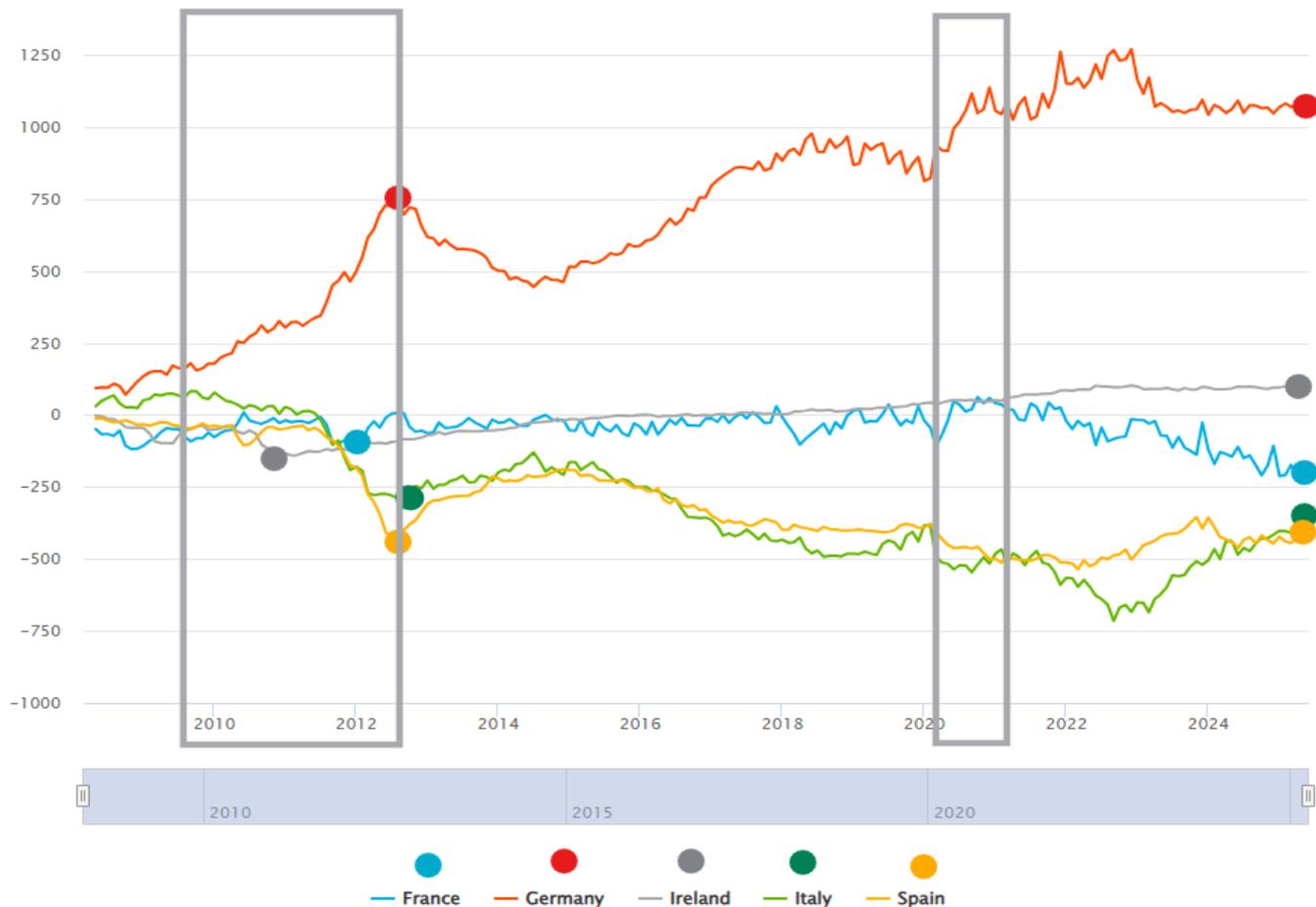
balances:

- Germany
- France
- Italy
- Spain
- Ireland

(EUR billions, 6/2008 -

4/2025;

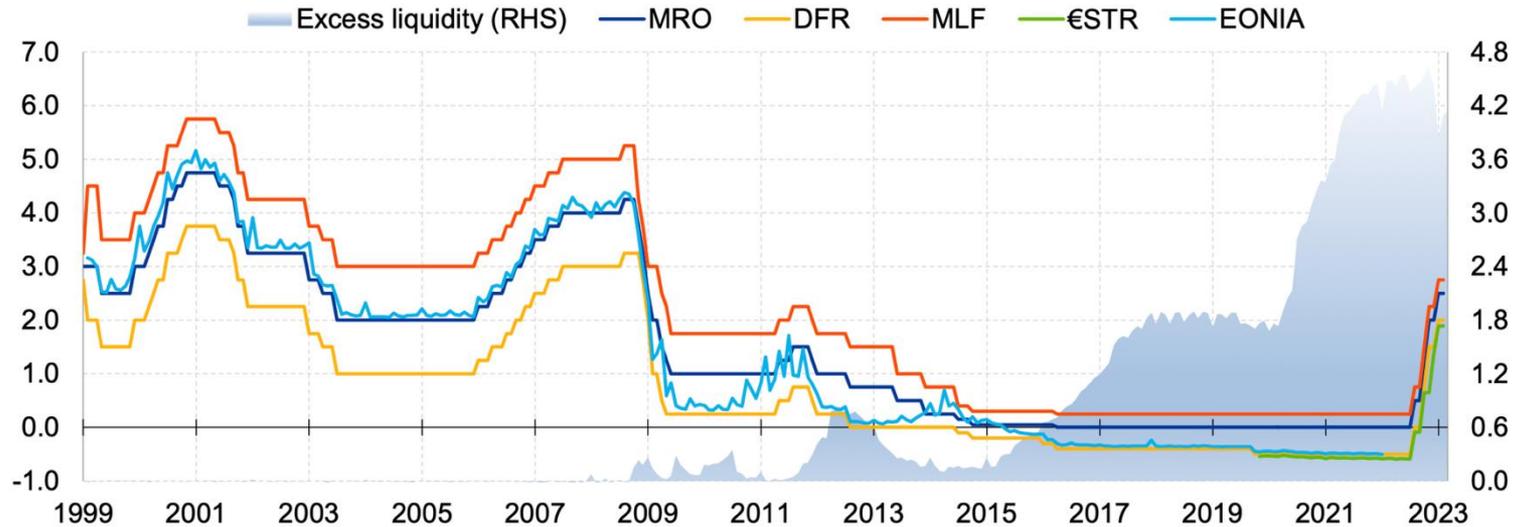
<https://data.ecb.europa.eu/publications/ecbeurosystem-policy-and-exchange-rates/3030621>)



Target 2: unintentional fiscal policy

ECB key policy rates, overnight market rates and excess liquidity

(RHS: EUR trillion; LHS: percentage)



Source: ECB.

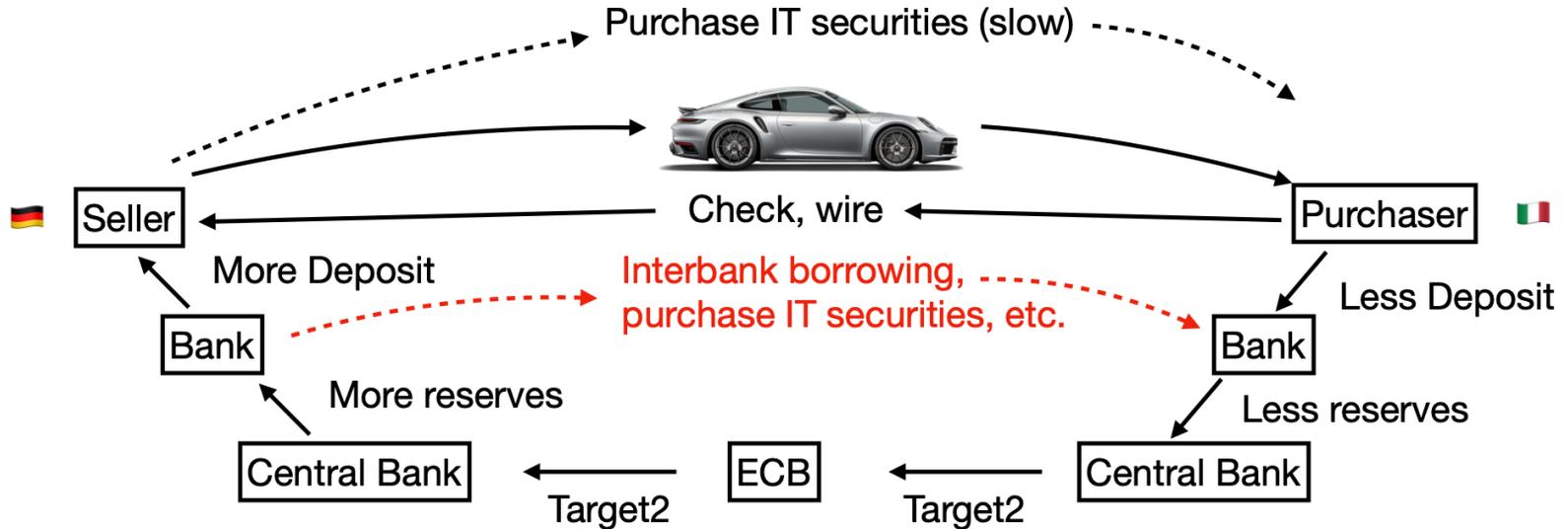
Note: Three key ECB policy rates form the policy rate corridor: Main Refinancing Operation (MRO) rate, Marginal Lending Facility (MLF) rate and Deposit Facility Rate (DFR).

Source: Isabel Schnabel, https://www.bis.org/review/r230302p_slides.pdf

Target 2 and trade deficit financing.

Capital and current account balance. How?

Was: private securities. Now: Target 2



Was: IT bank needs new reserves fast, less deposits. DE bank wants to get rid of reserves fast. Interbank loan or securities capital account.

Is: Neither bank cares. Risk free rate Target 2 sits there until DE depositors move.

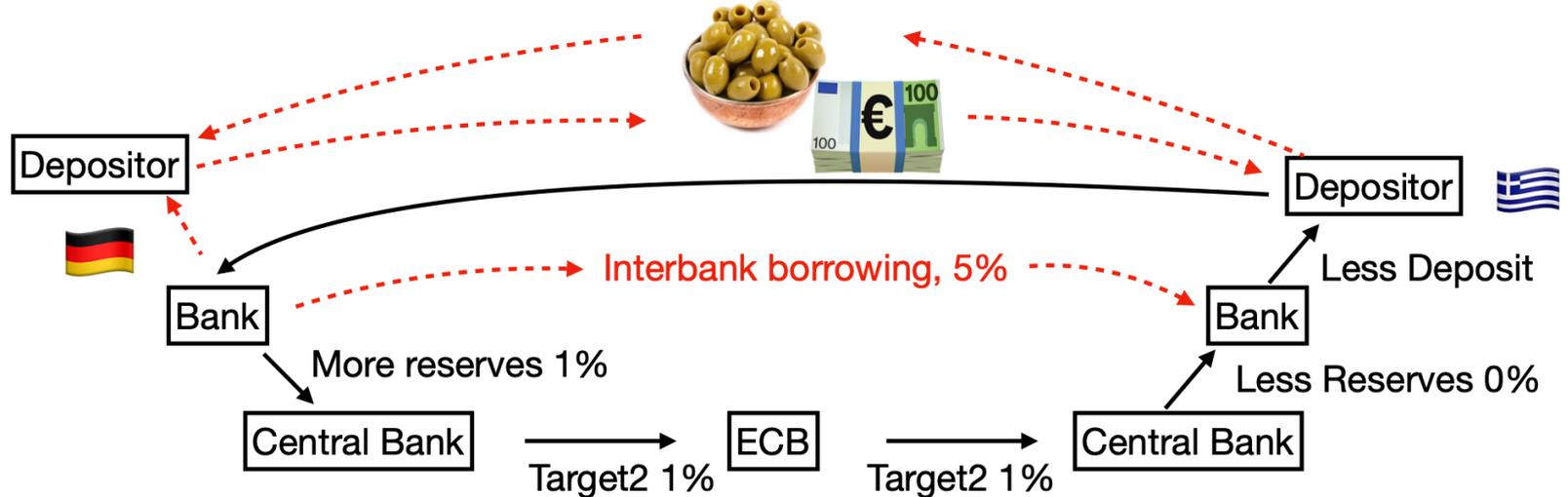
(Authors: Financing capital flight is similar, qualitatively more important)

Target 2: unintentional fiscal policy

Capital Flight

Was: interbank borrowing, risky assets, real adjustment. Now: Target 2

Trade, purchase risky securities (slow)



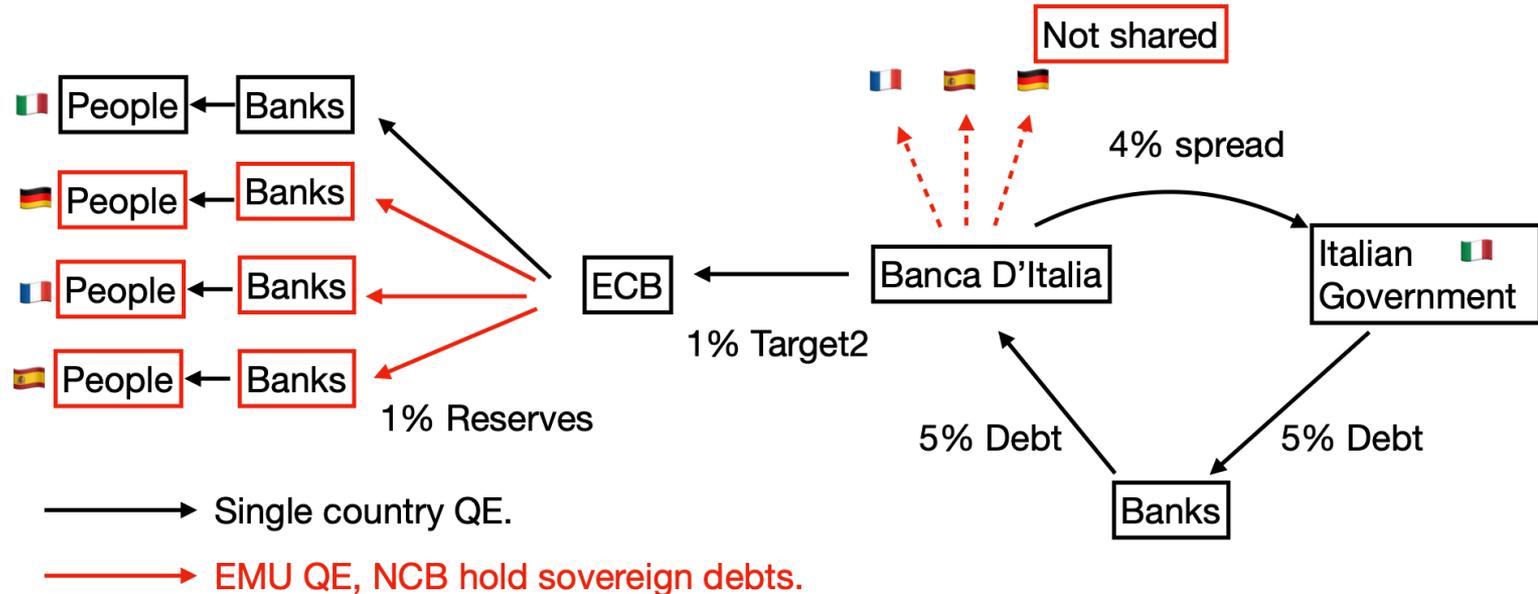
Was: GR bank needs reserves fast, less deposits. DE bank wants to get rid of reserves fast. Interbank loan. Slow reverse capital after price decline, rate rise, or real adjustment.

Is: Neither bank cares. Risk free rate Target 2 sits there and *finances capital flight*.

Target 2: unintentional fiscal policy

QE: Bought by national central banks. Lets risky governments borrow at risk free rate, euro area taxpayers subsidize.

(Also ECB lending on collateral goes to IT0)



“between 2014 and 2023, Germany paid a cross-border transfer of 11% of GDP to other counties, while Italy and Spain received across-border subsidy of 5.9% and 7.2% of their GDP” Chen, Jiang, Lemobroni & Lustig

The euro started as a common currency without fiscal union. It has, unwittingly, become a fiscal transfer scheme. The ECB will be unable to resist monetizing debts.

Backdrop: Stagnant growth, large sovereign debts, unsustainable welfare states, defense needs.

- ➔ **Problem 1: Incentives. For bondholders, banks, governments; incentive for system reform.**
- ➔ **Problem 2: What happens in the next, bigger, crisis?**

Minimalist proposals that do not require a treaty change:

- **Monetary without fiscal union.** Orderly default/restructuring must be possible.
- Enhanced EFI/ESM to provide fiscal support with conditionality.
- Remove the bank/sovereign doom loop. Sovereign debt is risky! Must be in hands that can bear risk, withstand default.
 - Banking union.
 - Risk weights, diversified portfolios.
 - Money funds.
- The ECB buys a portfolio if anything. With EU guarantee? Or Eurobonds.
- No more low quality collateral, subsidizing banks, sovereign debt via T2

Thanks!

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- ECB programs of **purchases of sovereign bonds of individual (fiscally/financially) stressed euro countries**
- **ECB and (risk of) sovereign default**

2010: **Greece: No debt restructuring** in spite of very large solvency risks

2010-12: **SMP: Securities Market Program**

2012: **Greek sovereign debt restructuring**

2012: **OMT: Outright Monetary Transactions (OMT; “whatever it takes”)**

2020: **Flexibility* of PEPP: Pandemic Emergency Purchase Program**

2022: **TPI: Transmission Protection Instrument**

*) “For the purchases of public sector securities, the benchmark allocation across jurisdictions will continue to be the capital key of the national central banks. At the same time, purchases under the new PEPP will be conducted in a **flexible manner**. This allows for **fluctuations in the distribution of purchase flows over time**, across asset classes and **among jurisdictions**.”

https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318_1~3949d6f266.en.html

*“The TPI will be an addition to our toolkit and can be activated to counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the euro area. ... secondary market purchases of securities issued in jurisdictions experiencing **a deterioration in financing conditions not warranted by country-specific fundamentals** The scale of TPI purchases would depend on the severity of the risks facing monetary policy transmission. **Purchases are not restricted ex ante.**”*

ECB Press Release, The Transmission Protection Instrument, 21 July, 2022.

<https://www.ecb.europa.eu/press/pr/date/2022/html/ecb.pr220721~973e6e7273.en.html>

Aims of APP, in particular PSPP:

M. Draghi, Jan 2015: “.. to counter [that] ... First, inflation dynamics have continued to be weaker than expected. ... [with] the sharp fall in oil prices ... the potential for second-round effects ... has increased and could adversely affect medium-term price developments. Second, ... the prevailing degree of monetary accommodation was insufficient to adequately address heightened risks of too prolonged a period of low inflation.”

“... we will buy government debt up to the percentage that will allow a proper market price formation. Therefore, we have two limits. The first one is an **issuer limit, which is 33%**, and another one is an **issue limit, which is 25%**. ... The 25% limit, by the way, is the one foreseen in order **not** to be a blocking minority in the collective action clause assemblies, basically, bond holders' assemblies, and it's the basis for us to be able to say, there is going to be pari passu. ...

each monetary policy operation always has some fiscal implication [that] are dealt with easily within a one-country framework, between the central bank and the treasury. But in the euro area, there is no European treasury, and **each national treasury gives an implicit or explicit indemnity to its own central bank, but not the euro system as a whole.** https://www.ecb.europa.eu/press/press_conference/monetary-policy-statement/2015/html/is150122.en.html

Aims of APP, in particular PSPP:

“Originally, in the early times, there were two lists of collateral, one risk-shared, the risk of which was shared, the so-called Tier 1, and one where the risk was not shared, and that’s Tier 2. The additional credit claims decision we took about, I think two years ago, was on a no-risk-sharing basis. ...

Is **risk-sharing** or no risk-sharing a fundamental decision as far as the effectiveness of this decision is concerned? We believe that it might have some effects, but they are not relevant. Let me give you an example where actually it is fundamental; OMT. In **OMT full risk-sharing is fundamental** for the effectiveness of that monetary policy measure and you understand why; because it’s selective, it addresses specific countries, the countries are under stress, the debt sustainability is an issue and there are tail risks that could make things precipitate for certain individual countries. In that case, risk-sharing is fundamental for the effectiveness of monetary policy ...

We are in a multi-country setup, so the issue of potential fiscal transfers coming from our monetary policy decision is there. ‘...https://www.ecb.europa.eu/press/press_conference/monetary-policy-statement/2015/html/is150122.en.html

Aims of APP, in particular PSPP:

“The ECB has taken a further, very expansionary measure today, but it’s now up to the governments to implement these **structural reforms**, and the more they do, the more effective will be our monetary policy. That’s absolutely essential, as well as the fiscal consolidation side. So structural reforms is one thing, **budget and fiscal consolidation** is a different issue. It’s very important to have in place a so-called **growth-friendly fiscal consolidation** for confidence strengthening. This combined with a monetary policy which is very expansionary, which has been and is even more so after our decisions today, is actually the optimal combination. But for this now, we need the actions by the governments, and we need the action also by the **Commission**, both in its **overseeing role of fiscal policies** and in its implementing the investment plan, which was launched by the President of the Commission, which was certainly welcome at the time, now has to be implemented with speed. Speed is of the essence.....

it would be a big mistake if countries were to consider that the presence of this programme might be an incentive to fiscal expansion. They would undermine the confidence, so it’s not directed to monetary financing at all.

[Question: there is a debate in the academic community whether the central bank can in the case of a hypothetical **default** actually, or could run with a negative capital. Could you tell us your views on this issue in the euro area context?]

Draghi: ... Now, what happens if, it can be two things. First of all, if we have an event, the first thing that would be drawn upon would be the buffers of the national central bank. By and large, most central banks have adequate buffers, **so nothing will happen.**

https://www.ecb.europa.eu/press/press_conference/monetary-policy-statement/2015/html/is150122.en.html