Financial Integration in Europe: Lessons from Ireland?

Max Watson

I. Introduction

It is a great pleasure to join you at the National University of Ireland, Galway, and to help mark the launch of your Economics Graduates Network. This is a suitable occasion to look to the future, and to explore some forward-looking lessons from Ireland’s crisis. My focus will be on financial integration in Europe – exploring why it has not lived up to expectations and asking what might be the features and implications of a future steady state.

Financial integration in Europe, and especially in the euro area, accelerated promisingly from the late 1990s onwards. This was seen as helping to revitalise growth in the EU core and to support real convergence in the periphery, including through the privatisation of Eastern European banks to euro area owners. Within the euro area, based on US experience, it offered a prospect of cross-border risk-sharing and consumption-smoothing – valuable elements in a monetary union with no central fiscal transfer mechanisms and with limited labour mobility.

Subsequently, however, financial integration through private markets stalled, and it has now gone into reverse. With hindsight, there are questions how consistently it contributed to sustainable growth. In some cases, cross-border flows seem to have been destabilising – feeding real estate bubbles, or high levels of private and public consumption, and then undergoing ‘sudden stops’, and potentially acting as channels of contagion. These issues concern some cases not only the euro area periphery but also in the Baltics and Balkans.

In an effort to understand this story better, I will first explore the macrofinancial drivers of intra-EU capital flows, and then discuss the political-economic backdrop to this experience. I will go on to ask what policies may be needed in a new ‘steady state’, and whether the evolving architecture of the euro area will get us to, and sustain, that steady state. The case of Ireland, which in some respects is not quite ‘typical’, sheds invaluable light on these issues.

II. Macrofinancial drivers of capital flows

It is important to explore what drove intra-European flows and the associated imbalances during the pre-crisis period, and why the experience of financial integration varied so much across countries. This will help identify what risks may be inherent in the EU and euro area systems, and also the scope to guard against such risks through policies at the national level.

One can divide the policy-related drivers of capital flows into six sets of framework factors: global push influences; global trade shocks; real and, respectively, nominal convergence

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plays; euro area monetary conditions; and national fiscal and prudential policies. Each of these played some contributing role in the emergence of financial stress in the euro area.

- **Global ‘push’ influences**: There was a long period of easy conditions in global markets up to 2007, often termed a ‘wall of liquidity’ and ‘search for yield’. In parallel, international supervisory approaches relied heavily on the assessment systems of banks and rating agencies. Some countries – including the US, the UK and Ireland – went further in embracing ‘light touch’ regulation and supervision. This amounted to a lax financial setting, characterised by a generalised mispricing of risk; and it was punctured by the global reverberations of the Lehman Bros failure.

- **Global trade shocks**: Changes in competitiveness and trade flows vis-a-vis China, Eastern Europe, and oil exporters had a differential impact on euro area members, as did the matching patterns of capital flows. Germany’s exports benefited, while those of the periphery suffered, in part due to euro appreciation. Capital flows from outside the area went mainly to core countries, which then recycled these to finance deficits in the periphery.³ Separately, the depressive effect on prices of globalisation may have given policy-makers a false sense of security about longer-run cyclical dynamics.

- **A real convergence play**: High returns during catching-up trigger inflows, particularly where regime changes enhance credibility, and in the presence of exchange rate pegs. It is hard to keep interest rates at levels required for macro-economic balance.⁴ EU Accession attracted such inflows through fundamentals and credibility effects.⁵ These concerns have recently led the IMF to support macroprudential tools, including capital controls; but in EU and Accession economies, capital controls were anathema. On the deficit country side, the convergence outlook triggered rising income expectations: capital inflows supported a rise in consumption in anticipation of high future earnings.

- **Currency convergence**: With euro adoption, exchange risk ended: real interest rates fell, and access to funding expanded. Perceptions of a euro destiny were also powerful: in Eastern Europe, euroised lending took place at low interest rates, and there was a funding shock as concerns about exchange risk were lulled by prospects of euro convergence and of medium-term appreciation due to productivity gains.

- **Euro area monetary conditions**: The ECB’s monetary policy was close to a Taylor-rule approach. Notwithstanding its ‘two pillars’, it seems that the acceleration and slowing of broad money over the past decade did not serve as an advance trigger for policy, although inflation performance would have left scope for this.⁶ Area-wide policy naturally did not match the cyclical position of booming members: some loss of competitiveness was needed to bring them back in line with area cyclical position.

- **National fiscal and prudential policies**: For economies in the euro area or its gravity pull, this easy monetary and financial setting arguably needed balancing by strict fiscal and macroprudential policies. However, in many cases the opposite was the case. Fiscal positions were weaker than perceived, since they were flattered by

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⁴ ‘Capital Flows: Master or Servant’, L. Lipschitz, T. Lane and A. Mourmouras (IMF WP/02/11Rev)
⁵ ‘Growth in the Central and Eastern European Countries of the EU’, S. Schadler et al (IMF O.P., 2007)
transient boom revenues and pro-cyclical output gap estimates. In Ireland, the IMF overestimated the structural budget balance by 7% of GDP, and in Spain by 3%, in 2006. Supervision in Ireland and Spain was deeply flawed; and in Eastern Europe, home-host co-ordination basically failed in the macrofinancial domain.

For converging euro area and euroised economies, these shocks were mutually-reinforcing. They fostered credit growth, expansion of the nontraded goods sector, and rising current account deficits. In all circumstances, this would have triggered a financial boom. A key question is what turned such cycles into crises that in some cases more than tripled the public debt. Experience in Ireland helps to nail this down, because Ireland was not quite typical. Ireland was not a ‘catching-up’ case. Its high cross-border claims indicate that ‘threshold effects’ of incomplete integration were not an issue. Its exports were competitive on euro entry. Three elements were critical: very easy monetary and financial conditions; very weak prudential policies; and a fiscal policy that seemed strong, but was mismeasured.

For the future, several of the macrofinancial drivers cited above can be seen as exceptional. Within the euro area, however, the interaction of area-wide monetary conditions (which at times will not match the cyclical position of the economy) with national fiscal and prudential policies will be a permanent challenge. Germany, for example, may be entering a period when euro area policy rates will be low relative to the national cyclical position. Moreover, asymmetric shocks will continue to strike members, albeit different from those of the past decade. And in this considerably less-than-optimal monetary area, symmetric shocks will continue to cause different economic trajectories in the various member states.

III. Political-economic roots of the crisis

If the above factors clarify the ‘how’ of the crisis, it is also important to explore the ‘why’. At the epicentre were badly aligned incentives and severe errors in risk assessment in banks. But the macrofinancial context for this risk-taking reflected wider ideological, political and institutional problems also, which lay behind the drivers identified above. Understanding these is important because they may represent continuing obstacles to pre-emptive policies. At each level, a key element was the ‘capture’ of policies by a range of interests and influences. This involved not just the industry capture of regulation; political self-interest; or corruption. It also involved ideological capture, influencing a wide range of policies:

- Global conditions reflected political and ideological priorities in major economies. China’s strategy was driven in part by concerns to maximise autonomy after the Asian crisis. The United States embraced and exported an ideology of efficient markets and rational expectations, and also used housing credit policy to address distributional concerns. The efficient markets ideology fostered over-reliance by regulators on rating agencies, banks risk models, and ‘light touch’ supervision, in the belief that risks were well-managed and hedged, even though innovation made the system more opaque. It had macroeconomic policy ramifications also: with private markets viewed as efficient and self-stabilising, it seemed defensible to neglect private imbalances and stick to a narrow interpretation of inflation targeting and fiscal rules. Such political and ideological factors together led to a lax macrofinancial setting at the global level.

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In the euro area, there were also political and ideological factors at play. Politics blocked cross-border supervision and resolution. Sovereign risks, partly for political reasons, were not differentiated by supervisors or central bankers, and this imparted dangerous signals. Politics or ideology played a role in announcing prematurely the death of the national balance of payments when monetary union was incomplete, dampening concern about intra-euro imbalances. (Eurostat even stopped collecting balance of payments data on euro area members.) And regarding the EU and euro area periphery, a climate of faith in private markets also diminished concern about imbalances: open-capital-account convergence was seen as a self-stabilising affair.

At the national level, political factors were key. In boom cases, politicians feasted on transient tax revenues, ignoring warnings.9 In Spain, large banks were well supervised, but there was a politically fatal division of caja supervision between the central bank and the regions. In Ireland, free market ideology coincided with a genuine concern about weak competition in banking. More broadly, the climate of opinion in Ireland was, to say the least, not supportive of intrusive supervision.10

Thus, while nothing can detract from the responsibility of banks, the euro area crisis cases had a macrofinancial backdrop deeply rooted in political-economic factors at the national, as well as the global and regional, level. This conjunction can also be seen in the distorted pattern of allocation that was allowed to develop in some other advanced economies – such as Iceland, the United Kingdom and the United States. By contrast, such a nexus was avoided in Canada, Sweden and Turkey, where past crises left coalitions of support for sound finance.

If one turns to the literature on ‘regulatory capture’, it seems that macroprudential and fiscal policies – mainstays of crisis prevention – may belong to a category quite vulnerable to capture. Their benefits are diffuse, while their costs fall on sectors with strong lobbying power (banks and housing).11 The loss of fiscal revenues from a boom also entails political ‘costs’. There will be no success in preventing crises if the build-up of tensions is ignored as a result of industry capture or political expediency, and is not met with ‘open dissent’.12

If indeed obstacles to pre-emptive polices may be deep-rooted, then it is crucial to make a clear analytical case and build a policy consensus on indicators that will call for action. Credit growth and asset prices are frequently cited. However, experience indicates that external imbalances – in the EU, but also within the euro area – were a key element in the risk nexus. To understand better the nature of a steady state in the euro area, and how policies can safeguard it, we need to explore the risks associated with such imbalances.

IV. Financial integration and current account imbalances

Most analyses of European financial integration before the crisis focused on conditions in government bond markets and wholesale money markets.13 Cross-border asset ownership was

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9 ‘Asset Booms & Tax Receipts: the Case of Spain’, C. Martinez-Mongay et al. (EC Economic Paper 293, 2007)
10 For a nuanced comment, see ‘The Irish Banking Crisis’ (2010), Report by Governor Patrick Honohan, ¶ 1.33.
also seen to expand, as did cross-border bank ties – with a majority of banks in Eastern Europe owned by euro area banks. The financing of imbalances was facilitated.14

What attracted less attention was the nature of the rising external imbalances – in particular the composition, sector destination, and instrumentation of flows. Here, experience differed substantially across countries in the euro area and EU peripheries. In several cases where financial stresses later developed, flows were dominated by bank lending and portfolio capital (especially the purchase of debt instruments), rather than direct investment. Moreover, such flows were associated with an expansion of consumption and residential investment, and in some cases also public sector deficits. Such a pattern can be observed in several countries of the euro area periphery, including Greece, Ireland (in the 2000s), Portugal and Spain.

A similar pattern of flows was also evident in some Baltic and Balkan economies, but not all of Eastern Europe. The ‘problem cases’ were small, open, financially underdeveloped, at an early stage of catching-up, with poor business environments, and with exchange rates linked to the euro (often reflecting past instability). These factors encouraged euroised lending, often channelled to the non-traded goods sector. By contrast, the Czech Republic, Poland and Slovakia did not share most of these characteristics, and they experienced a balanced pattern of capital inflows – more oriented towards investment in export-oriented industries.

Debt-based flows to the non-traded goods sector did not achieve risk-sharing, and involved more vulnerability than FDI flows to the traded goods sector. For the deficit economy, the stream of payments was contractually set. For the surplus economy, claims were concentrated in financial portfolios, which are a possible contagion channel. Flows to the non-traded goods sector were not associated in the near term with a higher capacity to service debt.

Large loan flows to the nontraded goods sector can be an equilibrium phenomenon in the long run. However, the euro area flows that took place to governments and banks raise questions about implicit guarantees. There were also failures in evaluating sovereign risks and real estate exposure. In Eastern Europe the role of foreign currency lending suggests some distortions in risk assessment, although the behaviour of foreign ‘mother’ banks in the crisis was more stabilising than for cross-border loans (aided by the Vienna Initiative), suggesting that incentives were better aligned, including the risk of recapitalisation costs.15

At all events, over the medium term heavy and unbalanced inflows proved macrofinancially unsafe. Vulnerability rose in the form of external liabilities and domestic balance sheet risks. Moreover, in countries without exchange rate flexibility, and where wages were downwardly rigid, future adjustment posed risks of a protracted recession. There was thus a heightened risk that shocks could result in severe adjustment costs. Abstracting from debates about misallocation, ‘speed limits’ and prudent macrofinancial risk limits were clearly exceeded.

V. The role of national policies in the euro area

In a euro area featuring full political and fiscal union, with common financial and labour market institutions, the national balance of payments would dissolve. For now, however, the

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14 ‘Current account deficits in the euro area: the end of the Feldstein-Horioka puzzle?’ O. Blanchard and F. Giavazzi (Brookings Papers on Economic Activity, 2007)
15 For a discussion, see ‘Recovery and Reform’ (EBRD Transition Report 2010); and ‘Financial Integration and Growth – Is Emerging Europe Different?’, C. Friedrich, I. Schnabel and J. Zettelmeyer (EBRD WP 123, 2010)
area is probably moving towards limited and policy-conditional fiscal and banking unions. If so, the national balance of payment remains a relevant context, and national policies will need to preserve stability in terms of private sector imbalances as well the public finances.

This suggests calibrating fiscal and macroprudential policies with an eye on external current account and NIIP trends, as one would – say – in an economy with a hard peg and good external support networks. Indeed, in practice, the current account trajectories of Ireland, Portugal and Spain (and their primary fiscal balances) seem set on a path consistent with prudent long-run norms. And such concerns are certainly compatible with recent EU policy initiatives such as the Fiscal Compact and Macroeconomic Imbalances Procedure.

But for the future it may be necessary to be more activist over the cycle in using national policies to dampen swings in the private sector. Here, one must be specific about the goals of preventative action. This cannot be to avoid ‘distortive’ booms; early on, it is hard to tell booms that are bubbles from booms driven by productivity shocks. Nor can it be to prevent any loss of competitiveness; under monetary union, this is a natural adjustment mechanism during asymmetric booms; and it can also be a productivity-driven equilibrium process.

A viable real-time goal is to dampen booms that are triggering macrofinancial vulnerabilities, reflecting imperfections in capital and labour markets. The symptoms would include (1) a deteriorating current account deficit and NIIP, driven by credit expansion that is dependent on portfolio and short-term banking flows; (2) a loss in competitiveness in conditions where wages are downwardly rigid and the exchange rate is fixed, implying the risk of heavy adjustment costs; and (3) rising unhedged balance sheet exposures.

To that extent, deviations from trend in coincident indicators such as credit growth, asset prices, and the current account deficit tell one something about vulnerability. These are indeed the kinds of indicators used in the Macroeconomic Imbalances Procedure. However, they need to be augmented by data on balance sheet exposures and labour market flexibility, giving a measure of the potential economic cost of shocks; and also by an analysis of the composition of current account imbalances and their financing. Moreover, under monetary union, if policy interest rates are below Taylor rule levels for the national economy, then credit conditions may be unduly easy and allocation may suffer. This is an a priori case for fiscal and macroprudential tightening, partially offsetting the pro-cyclical monetary impulse.

This suggests that national policy frameworks need further enhancement. First, it is crucial, as booms (and busts) get underway, to be realistic about the output gap and the fiscal stance. Country-specific analysis is needed, supplementing standardised EU and IMF cross-country measures, which proved deceptive during recent booms. Avoiding errors that exacerbate booms and busts is a key goal. But in addition, it seems that fiscal frameworks must allow for discretionary action to moderate credit booms and address large external imbalances.

One needs, also, a transparent approach to the timing and scale of macroprudential measures, with advance agreement on relevant triggers. This is a difficult area, and much more technical work is needed. Realistic estimates are also needed of the impact of both sets of pre-emptive measures, in an open capital account setting – both during a destabilising boom and during the subsequent adjustment period. This impact may be modest. So acting promptly on both fronts offers the best chance of dampening destabilising fluctuations. Where the institutional setting works, wage policy of some form may make a crucial contribution to managing the cyclical path of the economy – especially in the adjustment phase.
In all these respects, transparency, simplicity, and accountability are key; and decision-making bodies need independence. These factors provide bulwarks against policy capture. This is an important set of issues today. The current period of prolonged low interest rates is one in which the seeds may be sown for future financial imbalances, notably in ‘surplus’ countries. We need to be clearer when and how such trends should be addressed by national policies rather than by premature increases in policy rates for the euro area as a whole.

VI. Crisis management and resolution

Recent crisis management in Ireland has been in many ways a ‘model’; but is it a viable model for other countries? There are obvious lessons in Ireland’s clear and robust approach to implementing its fiscal and financial programme. But there are three features that qualify the idea that it could be a model. First, Ireland has shown, historically, much greater downward flexibility in labour costs than other crisis economies. Second, Ireland entered the boom with a good business environment, high skills, and a record of export-led growth. This is an unusually favourable basis for rebalancing the economy now. Third, less favourably, the failure to address bank problems early led to a situation in which huge liabilities were transferred to the public sector. One can debate aspects of that decision; but what is beyond dispute is the failure of national, EU, and IMF surveillance in the years that preceded it.

There is another sense in which the Irish experience should not encourage complacency. The European tools available to address its difficulties fell short of what is needed. There was no cross-border support directly for banks, or innovative approaches in the form of, say, tail risk insurance. There was a prohibition on restructuring banks’ bonded debt, even where a bank had essentially failed. This exacerbated a feedback loop between bank and sovereign weakness. The current initiatives on banking union seem set to address these issues for the future, though it is unclear how far they will cover legacy assets. The economics of this legacy asset issue need to be based on the prudent valuation of all balance sheet items at the time of an equity injection, which is more important than the provenance of specific assets.

At the euro area level, the instruments envisioned at the June 2012 Summit should deliver results over time. However, full implementation of those decisions is vital – and they have not gone unchallenged. With this proviso, conditional budget-based support via the ESM, monetary support from the ECB, progress towards banking union, and a global back-stop in the IMF, should gradually end the crisis. A major concern is that episodes of volatility could be ‘needed’ to prod the political process along. It also remains hazardous to base the architecture of crisis resolution on a narrow pillar of fiscal resources – but the tax base of surplus countries is not immense, and political patience in these countries is running short.

In this setting, political leadership remains key. Growth in debtor countries will resume only gradually, while the direct and indirect claims of creditor countries will continue to mount for a while. This implies a continuing strong emphasis on policy actions at the national level to restore market and political confidence, and reduce risk premia. Under all circumstances, it will take a number of years to transition to a steady state – especially in financial integration.

What about the challenge of safeguarding that steady state? Here stronger macrofinancial analysis and prescription is needed at the centre, as well as at the national level, especially as

the elements of a banking union are put in place. The ESRB, however, is not emerging as the kind of body needed to catalyse pre-emptive action. The first round of the Macroeconomic Imbalances Procedures, meanwhile, seems to have pulled its punches in both surplus and deficit cases. The new emphasis on the ECB’s macroprudential role, in the context of banking union, is more promising. But the ECB would need a strong central capacity for analysis, and this would need to take into account the role of national fiscal policy in the macrofinancial setting. We saw in Ireland five years ago how the IMF, relying in part on local financial stability analysis, concluded that a soft landing to the boom was safely assured.

VII. Concluding remarks

In this lecture, I have tried to highlight where financial integration in Europe went wrong. I have painted the picture of a euro area framework that required, and will continue to require, strong fiscal and prudential policies at the national level. Booming economies in the euro and its gravity pull faced a ‘perfect storm’ of factors that were mutually-reinforcing; but the future will pose challenges that are comparable in type, if probably not in cumulative scale.

I have suggested that we are now, with some backsliding, moving towards policy frameworks at the euro area level that will allow a gradual transition to a future steady state. But given the nature of this steady state – a limited and conditional fiscal and banking union, and distinctive national labour market conditions – pre-emptive national policies will be crucial in realising the benefits of soundly-based financial integration.

When it comes to preventing future crises, the political-economy concerns that I have expressed apply not just in Europe but also, for example, in the United States and China. Yet the counterfactual is clear. Unless we can contain financial cycles within reasonable bounds, we are condemned to see a further ratcheting up of the public debt, and a future of financial repression. That would be hugely costly. It would foster corruption; stifle growth; and make a return to higher and volatile inflation rates almost inevitable. Ultimately, in an innovative environment, it would also prove to be porous and would break down – sowing new crises.

In other words, starting from today’s public debt levels, the stakes are high. There is a need to strive untiringly for a deeper political consensus that will move financial integration – in Europe and globally – to a new steady state, and will address future financial cycles with well-adapted tools.

November 2012

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