THE EURO AND FINANCIAL CRISES

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Can a financial crisis similar to the Asian one erupt in Europe? Our immediate answer is negative. These disturbing financial upheavals occur in “emerging” markets not in the bastions of stability that are found in Europe. The conditions that led to the financial crises in Asia are just not present in Europe.

The question of whether financial crises of the Asian kind can happen in Europe should not be brushed aside too lightly, however. From the Asian financial debacle we have learned the following about the conditions that can lead to financial instability. First, capital markets are liberalised creating the potential for vast international movements of financial assets. Second, countries keep their exchange rates pegged creating the perception that there is little risk involved moving funds from one market to the other. Third, the monetary regime (including the system of regulatory control) is not adapted to the new regime of liberal capital markets. These three factors have been present in one way or the other in the financial crises in Asia, but also in Latin America during the 1970s and 1980s. Of course, they do not always lead to disaster. There are also examples of countries that have avoided financial disturbances despite the fact that they went through the same process of liberalisation. Nevertheless it is fair to conclude that these three factors substantially increase the probability of major crises.

So, are these factors to be found in today’s Europe? Obviously not. But Europe is soon going to move into EMU creating a totally different financial environment. It can be argued that the factors that create the conditions for financial disturbances may very well emerge in the future EMU.

EMU is certainly going to dramatically increase the degree of capital mobility within the euro area. Today, it is still the case that European capital markets are relatively closed. Financial institutions and insurance companies in Germany, France, Italy, etc. hold an overwhelming share of their total portfolio (often more than 90%) in domestic assets. The complete elimination of foreign exchange risk following the introduction of the euro and the disappearance of regulatory constraints on the holdings of “foreign” euro assets will change all that, leading financial institutions to dramatically increase their holdings of “foreign” euro-assets. The result will be to open up financial markets in Europe in a more profound way than in the 1980s when most European countries eliminated their systems of capital controls. The size of the funds that will be freely moving within the euro area will make a quantum jump.

Against the background of this dramatic liberalisation of Europe's financial markets there is the fact that the regulatory and institutional environment will not be adapted. Prudential control will still be done at the national level. This will handicap the regulators in assessing the risk of the institutions under their jurisdiction. In addition, financial institutions in each country of the euro area will, at least initially, overwhelmingly be national. The German financial markets will be dominated by German financial institutions, the French markets by French institutions, etc. Thus, institutionally the financial markets will still have a substantial domestic segmentation. This will make it difficult to efficiently spread the risk of asymmetric economic shocks, i.e. economic shocks occurring in one country and not in others.

The conditions that could lead to financial disturbances will, therefore, be present in the future euro area, at least during its initial phase when institutions have not yet adapted to the new environment. This, of course, does not mean that crises must inevitably occur. In order to gauge the risk of such occurrence let us analyse a particular scenario.

Suppose a country, which we arbitrarily call Spain, experiences a boom which is stronger than in the rest of the euro-area. As a result of the boom, output and prices grow faster in Spain than in the other euro-countries. This also leads to a real estate boom and a general asset inflation in Spain. Since the ECB looks at euro-wide data, it cannot do anything to restrain the booming conditions in Spain. In fact the existence of a monetary union is likely to intensify the asset inflation in Spain. Unhindered by exchange risk vast amounts of capital are attracted from the rest of the euro-area. Spanish banks that still dominate the Spanish markets, are pulled into the game and increase their lending. They are driven by the high rates of return produced by ever increasing Spanish asset prices, and by the fact that in a monetary union, they can borrow funds at the same interest rate as banks in Germany, France etc. After the boom comes the bust. Asset prices collapse, creating a crisis in the Spanish banking system.

Too far fetched to be realistic? The US monetary union provides many examples of such local booms and busts followed by financial crises that lead to large scale bail-out operations. Scenarios of local booms and bust, as the one just described, will almost certainly happen in the future euro-area. The essential ingredient triggering such crises is the existence of regional differences in rates of return on assets coupled with the fact that in a monetary union banks can borrow at the same interest rates.

These future euro financial crises, however, will in one crucial aspect be different from the financial crises recently experienced in Asia. They will not lead to speculative crises in the foreign exchange markets. Thus, if Spain is confronted by a banking crises this will not spill over into the Spanish foreign exchange market because there will be no such market. One source of further destabilisation of the markets will, therefore, be absent.

The founders of EMU have taken extraordinary measures to reduce the risk of debt default by governments. Maastricht convergence criteria and a stability pact have been introduced to guard EMU from the risk of excessive government debt accumulation. The Asian financial debacle teaches us that excessive debt accumulation by the private sector can be equally, of not more, risky. This has escaped the attention of the founders of EMU, concerned as they were by the dangers of too much government debt. In the meantime the EMU-clock is ticking, while he institutions that should guard EMU from financial and banking crises have still to be put into place.