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Europe and Germany's new coalition need a plan to restore European financial integration

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German lending to its neighbors is a key determinant of growth in the euro area. Since the 2008 financial crisis, those flows have changed radically, with less investment going into the eurozone "periphery" and more leaving the euro area altogether. Despite a boom in supranational financial institutions, policymakers have yet to address the root cause of the capital flight: the persistence of policy uncertainty in cross-border financial markets. This paper proposes three unorthodox policy solutions.

– To re-attract investment into the eurozone, policymakers need to alter markets' perceptions of debt sustainability. 2022 offers a unique opportunity for reform.

– The new German government has a strong political interest in averting any situation in which supranational support to other eurozone countries would become necessary again.

– Financial stability in the eurozone depends on controlling the spread of interest rates for sovereign debt. As quantitative easing (QE) is central to this goal, the European Central Bank should focus primarily on interest rates for tightening monetary policy.

– Germany should propose EU legislation to bring sovereign risk analysis in banks in line with regulator expectations. Moreover, it should help establish an EU debt management office.

INTRODUCTION

The flow of investments from Germany to its eurozone neighbors is a major determinant of growth in the currency union. They correspond to almost 75 percent of the value of the total German economy in 2021. And given their size, where they flow to is a key force influencing the political economy of Europe.

Hence it is of interest that, after the global financial crisis (GFC), Germany's investment began flowing out of the euro area in historical volumes. Indeed, the hole that the departure of German investment has left in the eurozone's GDP is comparable in size to the EU Recovery and Resilience Facility (RRF).

Reversing this trend should be top-of-mind for policymakers. Yet policy solutions appear exhausted. Even after a heady decade of creating supranational institutions in the financial sector, disintegrative trends persist. If not a lack of supranational integration, what has caused German "capital flight" out of the euro area, and what can policymakers do to reverse it?

The question is all the more urgent given that a once-in-a-generation political window for bold reforms is now opening: The euro area's largest economies share a common goal in recovering robustly from the COVID-19 shock; the euro area's fiscal rules, having been suspended during the pandemic, are legitimately coming under debate; and the Russian invasion of Ukraine has inspired a constructive and ambitious new wave of solidarity among Europe's elites.

I argue that the main cause is the persistence of fundamental uncertainty about the stability of the interest rates at which eurozone governments borrow. That uncertainty has its roots in successive crises which have undermined the markets' confidence in the sustainability of the euro area governments' debt. To re-attract investment into the common currency, policymakers need to radically alter markets' perceptions of debt sustainability in the eurozone.

THE DATA – DECLINING GERMAN BANK LENDING TO THE EURO AREA

Germany's Financial Account

To set the scene, it is worth revisiting why and how money actually flows out of Germany and how these flows are accounted for in the nation's overall balance of payments, which includes exports and imports.

Germany's export surplus with the world has been steadily high, if marginally declining, since the 1990s. This surplus is dominated by the exports of goods and attributable to imports by the eurozone, the United States, and the rest of the world in that order.

The proceeds of these exports are mostly spent on consumption by households or on investment by firms. What is left is then deposited into bank accounts, pension, and insurance funds, and (for companies and high-net-worth individuals) investment funds. These institutions reinvest the money outside of Germany: by granting bank loans in the case of banks or by purchasing stocks and bonds.

For this flow of money heading out of Germany, the data show two strong geographic trends (Figures 1-5):[1] First, there is a precipitous decline in cross-border lending from Germany to the so-called eurozone periphery (Greece, Portugal, Cyprus, Italy, Ireland, and Spain). For instance, the total shortfall of cross-border bank lending from Germany to Italy following the financial crisis amounts to over EUR 60 billion – that is roughly equivalent to the total that Italy received in grants from the European Recovery and Resilience Facility (RRF).

The second trend is the uptick of money flowing out of the euro area to Asia and the United States. This change is visible both directly in bilateral accounts and indirectly as portfolio flows within the eurozone to regional financial centers such as France and Luxembourg. These member states house the euro area fund industry and clearing houses, acting as gateways into the global bond and equity markets. Hence the increase in Germany's exposures to them suggests, in part at least, the accumulation of third country exposures.

This trend is corroborated by strong growth in portfolio investment heading toward the United States and Asia relative to investment within the euro area,

1 See the Bundesbank's geographical breakdown of Germany's financial account, here: https://www.bundesbank.de/dynamic/action/en/statistics/time-series-databases/time-series-databases/759784/759784?listId=www_s201_aw1d4_2b (Bundesbank, 2022)

FIGURE – 1
Since the financial crisis, German bank lending to the euro area has been declining consistently relative to investment in equities and bonds
(cumulative and net, in EUR billion)

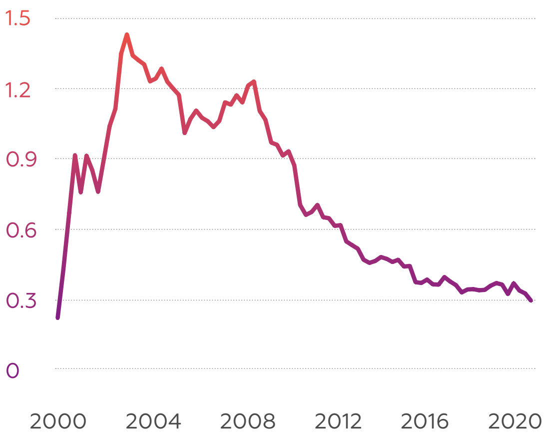


FIGURE – 2
Within this trend, bank lending to Italy has declined consistently relative to bank lending to the rest of the euro area (cumulative and net, in EUR billion)

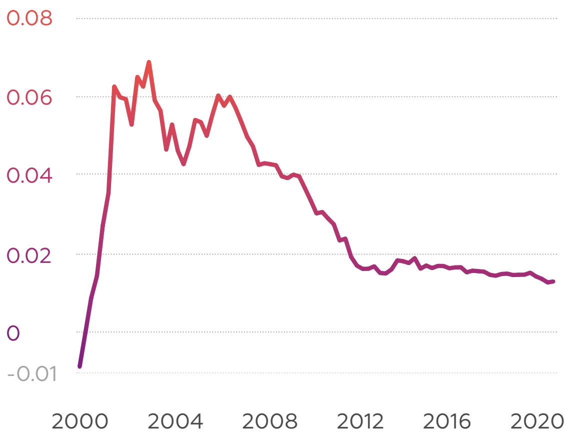


FIGURE – 3
Bank lending to the euro area periphery moreover has stagnated compared to equity and bond investment flowing to the United States and Asia
(cumulative and net, in EUR billion)

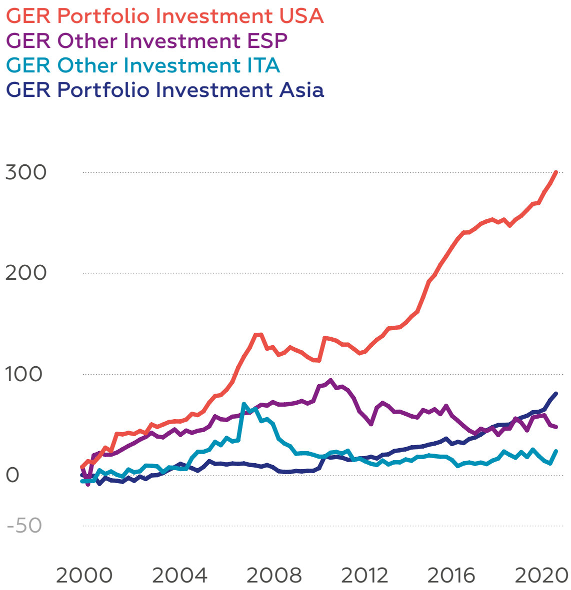
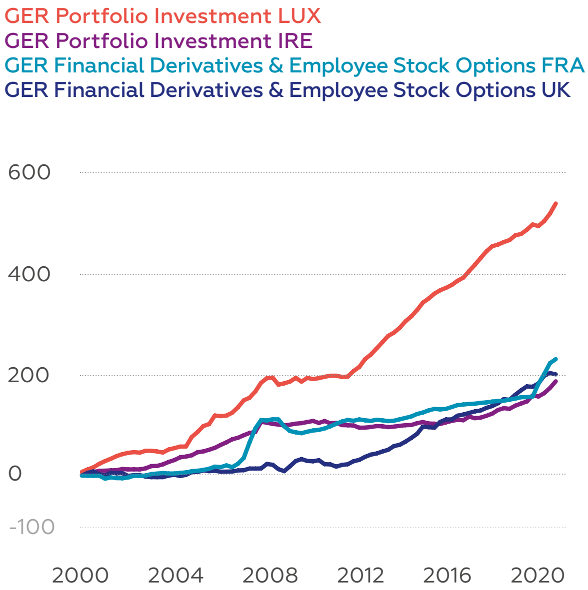


FIGURE – 4
Finally, equity and bond investments to the United States and Asia can be seen to flow through the euro area's fund industries in Luxembourg and Ireland
(cumulative and net, in EUR billion)



Source: Bundesbank, Author's Calculations and in particular into its periphery states (figure 5). At the same time, there appears to be increasing demand for derivatives in Paris and London. These are the principal European financial centers that investors turn to if they wish to hedge the risks of holding foreign currency.

The fact that the money is going elsewhere is problematic in particular because of the real demand for investment left unfulfilled in the euro area. Low growth rates, depreciating infrastructure, declining investment in education and job training, and declining productivity – not least in Germany – all point to a latent need for investment in the euro area (Summers & Furman, 2020).

THE CAUSES – UNCERTAINTY AND CRISIS

A Mistaken Belief in Supranational Institutions

If demand for investment in the eurozone exists, why do German flows disappear overseas, and how can this be reversed? One consensus view over the past decade has been that the solution lies in creating supranational institutions. They restore cross-border lending by establishing common rules (e.g., Bénassy-Quéré & Markus, 2019, and Veron, 2015).

In fact, the institutional achievements of the so-called "Banking Union" have been formidable. They include the Single Supervisory Mechanism (SSM), the powerful supervisor of systemic EU banks; volumes of secondary legislation implemented by the European Banking Authority (EBA) which have harmonized rules across the bloc; and the largely untried, but financially viable, Single Resolution Board (SRB) devoted to resolving systemic banks upon bankruptcy.[2]

So, given the institutional strength of the Banking Union, why has investment not remained in the euro area? In practice, supranational supervisory institutions are not necessarily engines of growth. On the contrary, a robust body of literature shows that tough supervision moderates risk-taking, and more supervisory institutions do not correspond to closer financial integration (Blanchard & Summers, 2019). Intuitively, supervision should mitigate excessive growth by setting limits on risky investments.

The Global Financial Crisis

If not institutional integration, what drives financial integration, and what can policymakers do to reinvigorate it? This is, in fact, one of the main macroeconomic problems that the euro's founders sought to solve with the Maastricht Treaty in 1991.[3] The principle they proposed as a solution remains valid today: the elimination of uncertainty in interest rate markets to facilitate investment in the single market.

To explain how interest rate uncertainty impacts cross-border lending, it is worth revisiting the three crises in which these forms of financial market panic resurfaced in the eurozone: the global financial crisis (GFC) in 2008, the eurozone crisis in 2013, and the coronavirus shock in 2020.

As discussed, the prelude to the impact of the GFC in Europe was a period of robust financial integration. Monetary union at the turn of the century removed foreign exchange risk and depressed interest rates in the eurozone periphery. As this group grew rapidly in the tailwind of monetary union, it imported equipment and goods from more developed manufacturing nations like Germany, running current account deficits as Germany accumulated a surplus.

This surplus was saved largely in German banks, which then lent it to Germany's neighbors (Lane, 2010). Counterparties in the rapidly developing periphery states tended to be better capitalized and less exposed to the US subprime market than their German equivalents (Schoenmaker & Peek, 2014). Prima facie, Germany accumulated foreign exposures offering respectable returns on risk.

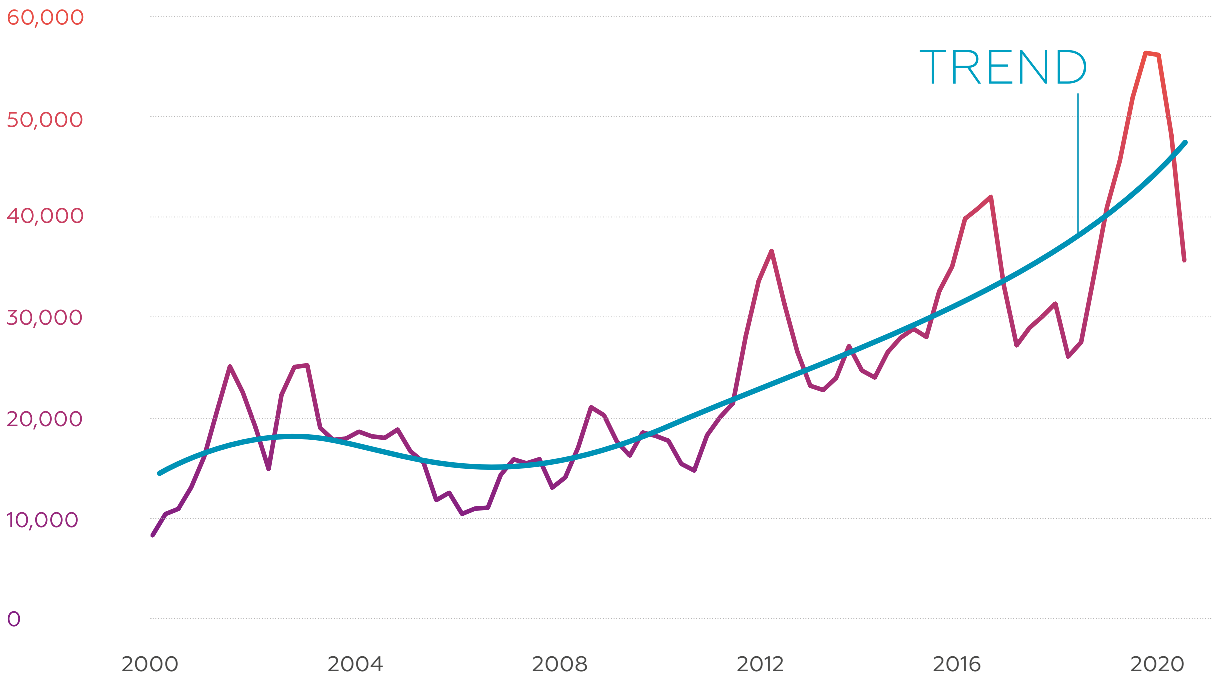
The fall of Lehman Brothers in 2008 changed this. Markets questioned the ability of the governments of some periphery states to bail out key sectors of their economy which had been caught up in the generalized macroeconomic downturn. It is important to note that widespread fears did not emerge about the solvency of a eurozone sovereign until almost a year and a half after the crisis begin in the United States.

2 Is there an equivalent to the EBA and SSM in the EU's other high profile workstreams, like climate change and digital regulation? To qualify, this institution would have several executive bureaucracies numbering several thousand employees each with supranational power over, and making regular interventions in, every aspect of systemic C02 emitters and tech firms, from employee compensation to risk appetite.

3 To appreciate why interest rate uncertainty was a central problem of Maastricht, consider the fate of Mitterrand's 1981 government. It was elected on a campaign promise for fiscal expansion, at the same time as the German government balanced its budget and maintained a "hawkish" interest rate. France's import-dependent economy responded to increased government spending by increasing its imports from Germany. In turn, a weakened Franc, rising import costs, increasing inflation, and consequent market speculation on the currency, forced the central bank to raise interest rates. This curbed growth and undermined the original objectives of expansionary fiscal policy. Governments across the European Economic Community hoped to overcome such pitfalls of interdependence, and the market volatility they created, by pooling their interest rates and exchange rates into the euro.

FIGURE 5 – RISING POLICY UNCERTAINTY IN EUROPE

The “World Uncertainty Index” is calculated by estimating the total number of words indicating uncertainty in Economist Intelligence Unit (EUI) country reports, normalized by the total number words in the report, and then multiplied by 1000.



Source: The World Uncertainty Index

The trigger for their emergence were revelations of an extreme, and to some extent covered up, surge in Greece’s fiscal debt burden after the GFC in 2009. Initial reaction to this news in the eurozone was muted as Greece’s debt burden made up less than five percent of the euro area’s overall.

Yet in the autumn of 2009, a new coalition government in Berlin reversed statements by the previous Finance Minister Peer Steinbrück who had implicitly supported the bailout of defaulting euro area member states. The new government, under the auspices of Finance Minister Wolfgang Schäuble, adopted a more stringent interpretation of Article 125 of the Treaty on the Functioning of the European Union, to the effect that Germany would not support the bail-out of a defaulting member state government.

The Eurozone Crisis and the Doom-Loop

This policy reversal let the cat of uncertainty out of the political bag, because it raised the prospect of a break-up of the eurozone, beginning with Greece but spreading to any member state that could not continue to pay interest on its debt (figure 5). As a result, other highly indebted governments also saw the price of their bonds collapse, mirrored by a corresponding surge in interest rates. This in turn raised the probability of their default as more and more state revenue had to be allocated to interest payments.

This mattered because banks in highly indebted countries, acting as counterparties to German banks’ foreign lending, held large amounts of their governments’ sovereign debt. Moreover, sovereign bond interest rates are used as the baseline, or “risk-free,” interest rate against which many other interest rates in the economy (from mortgages to industrial loans) are priced.

As Greek, Italian, Cypriot, Spanish, and Portuguese sovereign debt went down in value, local banks lost their strong capital positions, despite much lower exposures to the US property market at the source of the crisis than German banks (Lane, 2013). Periphery governments struggled to raise the funds needed to support their banks, which in turn further undermined their credit on the market. This earned the label "doom-loop." At this stage, exposed German lenders were also hard hit.

The removal of a fiscal backstop previously deemed implicit by markets caused interest rate spreads to widen uncontrollably between highly indebted (i.e. periphery countries) and less indebted member states (like Germany), until the European Central Bank (ECB) clarified that it was willing to provide a backstop to bond markets in the form of Outright Market Transactions (OMT).[4] However, the "doom-loop" phenomenon imposed two subtle, but fundamental, changes for the currency union.

First, the interest rates at which different euro area governments borrow were shown to be fundamentally unstable in the absence of central bank intervention. Second, the possibility of renewed foreign exchange volatility due to a euro area member crashing out of the common currency was shown to be a genuine risk and was only mitigated by extraordinary monetary policy.

The Coronavirus Crisis: Living with Uncertainty

The onset of the COVID-19 pandemic in 2020 produced a similar but more limited resurgence of collective uncertainty, in particular in relation to interest rates. The episode is instructive because of how explicitly it reveals the discreet effect of interest rate uncertainty on financial integration in the eurozone.

The ECB's price-based indicator for financial integration (which measures the correlation and equivalent of asset prices across the currency) fell steeply with the onset of financial panic in February and March 2020. In an episode not dissimilar to the German government's 2009 U-turn on eurozone sovereign defaults, ECB President Christine Lagarde triggered a spike of panic selling of periphery government bond yields by suggesting it was not the ECB's job to buy them. The price of those bonds, and the ECB's financial integration barometer, bottomed out only after the ECB's chief economist clarified its willingness to buy sufficient quantities of the instruments being rapidly sold off by markets (Hartmann, et al., 2021).

The implication for participants in the euro area's financial markets[5] is that the ECB's commitment to bond purchases represents a "single point of failure." It alone stops the reappearance of the contagion effects seen during the eurozone crisis. Moreover, any increase in policy uncertainty about the ECB's commitment has a non-linear macroeconomic effect. Despite the existence of the European Stability Mechanism (ESM) – the EU bailout facility formed with an endowment that rivals the IMF's – spreads surged in the absence of clear signaling around the backstop from the ECB (Orphanides, 2021).

In the absence of ECB intervention, the price of indebted member states' sovereign debt would have plunged and their interest rates soared. Markets would have had every reason to expect illiquidity to lead to insolvency in the most vulnerable debt markets. They would also be correct to assume severe macroeconomic outcomes, as ballooning interest payment would have crippled the ability of such member states to provide fiscal support as their economies locked down. The euro cost of the downturn would likely have far exceeded the EUR 1.85 trillion the ECB spent to prevent it, which itself was roughly three times larger than the late-arriving EU Recovery and Resilience Facility.

POLICY OPTIONS – THREE WAYS TO CREATE CERTAINTY

The strong relationship between government interest rate uncertainty and financial disintegration means that policies bolstering financial integration must first focus on establishing lasting certainty in markets dealing in government bonds issued by eurozone countries.

Given that bond markets operate on a long-time spectrum, with bonds that have a maturity of thirty years, creating lasting facts on the ground means establishing policies and institutions that span the short to long terms. In the current political landscape, I suggest three steps that are within the reach of current German and EU leadership.

4 For a seminal analysis of policy communications during the Sovereign Debt Crisis, see Jones, 2015.

5 Since the GFC, this "tail-risk" of interest and exchange rate uncertainty in the Eurozone has been factored into every lender's credit risk model in the form of a heightened probability of government defaults. Since lending across borders and buying of foreign subsidiaries usually involves increased exposure to the national government of the counterparty, it is constrained so long as that government is allocated even a moderate probability of default.

Opt for Rate Hikes Before QE Tapering

First, as a transition in the short-term, the Bundesbank should support the ECB reversing the normal order of its monetary policy. The ECB's current forward guidance stipulates that new asset purchases should be reduced ("tapering") before interest rates are raised. The rationale for this sequencing is that the assets (stock markets, corporate bond markets, etc.) targeted by QE tend to improve faster after a crisis than interest rates in the real economy (e.g., mortgages, direct bank lending, etc.)

Asset purchases need to be treated differently in the euro area than in other jurisdictions.

Yet in the euro area, as I have argued at length, central bank asset purchases have an indispensable function: They stabilize the interest rates at which governments borrow in such a way as to reduce the negative consequences of volatility and uncertainty in interest rates across borders.[6] Consequently, asset purchases need to be treated differently in the euro area than in other jurisdictions where central banks have an array of other tools to manage the high asset prices stemming from quantitative easing.[7]

Set a Common Standard for Sovereign Risk Assessment

Second and in the medium term, the new coalition in Berlin should propose national and secondary European legislation updating the standard Basel III and IV capital planning methodology for sovereign exposures held by system euro area banks.[8] These banks should bring their internal assessments of sovereign debt in the eurozone in line with the assessments conducted by independent EU agencies, including the ECB and the ESM, in two areas: the risk-weighting of sovereign exposures and the assessment of euro area sovereign probability of default (PD) in internal credit risk models and scenario analysis.

There are different ways to implement this policy objective. One approach would be to permit banks to adopt sovereign ratings and PDs weighted by a euro area sovereign rating/PD, in the case of direct exposures to euro area sovereigns. Another would be to permit them to assume baseline projections and ratings for euro area sovereign debt provided by the ESM and/or ECB, rather than rating agencies. In both cases, the result should improve the risk weighting of the sovereign debt of euro area member states while taking into account the reality of its fully guaranteed and partially sub-sovereign status.

Though seemingly narrow technical measures, either step would put a floor of stability beneath the assessment that euro area banks make of sovereign bonds, making explicit the implicit guarantee of central bank intervention in government bond markets that has come under question with each fresh crisis since 2008. In doing so, they would provide banks with the regulatory cover needed for long-term cross-border planning to unfold in line with stated supervisory goals. At the same time, they would set a minimum legal standard for the risk analysis of euro area sovereign exposures in line with those goals, which can play a countercyclical role in regulating the financial sector's overall sovereign risk appetite.

Launch a Debt Management Office

Third, as the EU Stability and Growth Pact (SGP) will be renegotiated over the course of 2022, Germany's governing coaliton should embrace the development of a long-term euro area debt management office. This would be an institution that independently manages (buys and sells) euro area government debt. A Franco-Italian sketch for such an institution has already been proposed in the context of SGP reform negotiations. The draft proposal envisages a European Debt Agency (EDA) that assumes part of the euro area debt purchased by the ECB through its asset programs and manages it overtime.

6 This objective is considered to be part of the ECB's legal mandate to ensure price stability. This is because in in a situation in which government borrowing rates spiral out of the ECB's control, the effect of ECB interest rates on price levels is undermined (in technical parlance, the "transmission mechanism" of interest rates is impaired). The ECB is legally bound to avoid this outcome.

7 Such as raising reserve requirement ratios (the amount of money banks are required to store in the central bank), changing their interest rate tiering (the "tiered" multiple interest rates at which different banks can borrow and/or keep deposits at the central bank), and calibrating the lending facility open for banks facing liquidity difficulty (the so-called Targeted Long-Term Refinancing Operations).

8 See Basel Committee on Banking Supervision, 2017, for an overview of existing rules.

The proposal would spin off the team that currently fulfils this function at the ECB, render it intergovernmental rather than supranational, and subject it to predetermined debt management rules. To buy the debt, the EDA would issue its own bonds, which like the ESM's would trade with the highest rating. As revenue, it would receive annual contributions from member states.[9]

The Franco-Italian sketch presented by Giavazzi and Weymuller offers a simple initial rubric, which a coalition counterproposal should shape and galvanize. For instance, the non-paper leaves open the governance structure of the EDA and conditionality attached to inclusion in its program. Robust conditionality and a suitably political and intergovernmental governance would be key to legitimizing such an innovation in Germany.

Indeed, with an intergovernmental governance framework, a pre-set mandate, and conditionality principles focused on productive investment, an EDA-style institution would be a means for Germany to exert a greater control over the sustainability of euro area sovereign debt.

CONCLUSIONS

Germany's new leaders have a unique opportunity to make progress on these fronts with favorable partners on the European stage and in the macroeconomic honeymoon of the Recovery and Resolution Fund (RRF). But that honeymoon will not last. A decade of reallocated German private sector cross-border lending outside of the euro area has contributed to lowering growth rates in capital-hungry periphery states.

Without action, Germany's international investment position will eventually burn through domestic political capital, as low growth continues to undermine debt sustainability in periphery member states and increases the pressure for further supranational support. Moreover, as the governing coalition is divided over supranational risk sharing (with a split between the Greens and the FDP in particular), it has an overriding political incentive to reduce the need for it from the outset.

Consequently, the Bundesbank should support the ECB front-loading rate hikes and maintaining control of spreads via maintained asset-purchase programs; the new German coalition should propose secondary legislation on the European level to bring sovereign risk analysis in banks in line with regulator expectations; and it should help establish a permanent EU debt management office.

9 See Weymuller, et al., 2021, for the details for this proposal.

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