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The Potential Role of Development Banks in Solving the European Monetary Union Crisis

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Abstract

The present crisis in the Eurozone is much more than a sovereign debt crisis. The Eurozone's southern periphery experienced strong capital inflows in the first decade of its membership in the currency union. However, these states, despite importing a large amount of foreign capital, did not sufficiently increase their export capacities in order to repay the foreign loans. Since the introduction of the euro, the economic production in Europe's peripheral countries has been excessively focused on domestic demand (non-tradable goods and services). Therefore solving economic problems in the Eurozone requires a structural shift in the peripheral states. Relying solely on austerity, as we have observed during the last two years, is not a sufficient way in which to defuse the crisis. It only concentrates on cutting the budget spending by neglecting the structural problems. In the first part of that paper we analyze the mechanism, which led to a buildup of imbalances in the European Monetary Union and its impact on the structure of production in the southern periphery. In the second part we argue that, due to problems in the private financial sector, the southern states should establish or assign new tasks for existing development banks to facilitate the change in their development model. In this connection we refer to the example of a German development bank - Kreditanstalt für Wiederaufbau - which played an important role in the reconstruction of the German economy after the Second World War. This paper, which focuses on theoretical analysis, is addressed not only to all those interested in solving the Eurozone economic problems, but also

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to economists and politicians dealing with development and structural policy in non-EU countries.

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Introduction

The current crisis in the euro area is commonly associated with the sovereign debt crisis in the southern states of the EMU (Portugal, Greece, and Spain) as well as in Ireland. However, the public debt in relation to GDP rose, since the inception of the euro, only slightly in Portugal and Greece. In Spain and Ireland it was even significantly reduced. The public debt-to-GDP ratio in the afore-mentioned countries began to skyrocket first in the aftermath of the crisis (see figure 1).

In the literature another interpretation of the crisis in the EMU becomes more popular. The main problem of the Eurozone is seen in the divergent economic development in the "south" (Greece, Spain, Portugal, Italy) and "north" (among others: Germany, Holland, Luxemburg) of the EMU (see for instance: Chen et al., 2012; Sinn et al., 2012). This divergence manifests itself in two areas: first, the southern countries have been losing continually international competitiveness by experiencing at the same time a decade of strong domestic-demand led growth since the mid 1990s. Second, the decrease in competitiveness in connection with high current account deficits led to a buildup of strong negative external net positions in the southern EMU-states.

In this paper we first analyze the mechanism, which led to the imbalance between north and south countries and show up its consequences for the structure of economic production in the southern periphery. In the following section we provide an analysis of the monetary background for growing divergence in the EMU and derive two conclusions for further research. First, one of the reasons for cumulating imbalances in the EMU was the credit policy of the financial institutions in the southern countries. Second, the crisis led to strong distortions in the banking sector and the capital allocation in the southern economies has not been working properly since then. In the fourth section we study the case of the German development bank - Kreditanstalt für Wiederaufbau (KfW). We show how KfW improved the credit access for those companies, which were excluded by the banking sector directly after the Second World War. In a further section, based on the example of KfW, we analyze how development banks in the southern states could contribute to the necessary structural change and thus to a reduction in the imbalances in the EMU. In the sixth section we summarize the results of this paper.

The following countries are commonly treated as the crisis states: Italy, Spain, Ireland, Portugal and Greece. In this paper we focus only to Portugal, Spain and Greece. They will be defined as “southern states”, “southern periphery” or “PSG”. These countries, while acknowledging the differences between them, have experienced strong capital inflows from abroad and, also due to this, have seriously lost their international competitiveness since the inception of the euro. Ireland’s economic difficulties are mainly related to malinvestment by a strongly outsized banking sector. Italy, by contrast, has been losing its competitiveness steadily since the beginning of the 1990s but the international capital flows were not so relevant for economic development as in the case of the PSG. Its external imbalance as the share of GDP is much more modest than in the southern states (Chen et al., 2012, p. 4).

The countries, which went the opposite way in the EMU and have noted current account surpluses over a longer time and have been financing the southern periphery, are especially Germany, Austria, Holland, Luxemburg and France. They will be defined as “core countries” or “north states.” However, France’s current account has been mostly slightly negative since 2006, and its economic development, especially in the last few years, actually reminds one more of the economic development in the southern periphery. Nevertheless, since the inception of the euro, France has been one of the major “financiers” of the PSG-countries.

The Consequences of the Growing Divergence in the EMU (Real Economy Level)

As mentioned in the introduction, the southern EMU countries had high current account deficits since the inception of the euro, which led to a buildup of strong negative external net positions in these states. Usually, the main factor, which influences the current account, is the balance of trade.

At least since the debate about German reparations after the First World War, it was accepted, that a country (whole economy) exports capital only when it has a positive balance of trade (Cassel, 1926, p. 63); and conversely in the case of capital imports. In order to avoid crisis in connection with international capital flows (on the real economy level) the whole process must proceed in the following way: in the first phase the economy with a higher scarcity of capital (higher real interest rates) runs import surpluses. In the second phase, the economy with lower scarcity of capital has a positive balance of trade, which can be interpreted as a retransfer of former borrowed capital. Only when international capital flows follow this pattern could they be beneficial for involved countries. Foreign capital enables additional investments or consumption in the capital importing economy. The retransfer of the former exported capital includes usually interest rates, which are equivalent with additional income in the capital exporting country (Lechner, 1988, p. 376 et seq., similar by Metsel, 1999, p. 92 et seq.).

The southern EMU-states, since it was known they would join the euro, have started to run import surpluses. A substantial part of the additional import was made possible by the export surpluses of the core countries in the currency union (especially from Germany). This capital flow between north and south in the Eurozone was economically justified. In the southern states capital scarcity was larger. But, contrary to what many economists presumed, the real convergence, in order to enable the PSG-states to reduce high deficits on the balance of trade, has not occurred automatically. In the first decade of their membership in the currency union, the southern states used import surpluses to boost their consumption directly or indirectly - for additional investment in the non-tradable sector. Their export capabilities had hardly increased (see figures 2-4).

This overconsumption has also influenced the structure of production in the peripheral countries. Widening consumption was on the one hand feasible due to import surpluses, but on the other hand also national companies have responded to the growing internal demand and reoriented their output on it. Additional factors, which played an important role for the structure of production in the southern periphery, as pointed by Chen et al. are: the nominal appreciation of the euro vis-à-vis the rest of the world, real appreciation in southern vis-à-vis northern economies, the rise of China and a deeper integration of Central and Eastern European countries with the rest of Europe or rising oil prices (Chen et al., 2012). It is well demonstrated in the comparison of GDP growth with the balance of trade data that economic development was driven by the non-tradable sector. The economies of the PSG were actually performing quite well in the first decade in the Eurozone, but their export capacities were stagnating.

As finally the economic crisis erupted, the sources, which fueled the growth, were erased. The domestic demand fell sharply due to austerity, diminishing consumption and the lack of the foreign financing. This could be also an explanation, why the current depression in the PSG is so deep. The consequence of the divergent economic development in the EMU is the, already mentioned, strong imbalance between south and north. The northern states have orientated their economies on foreign demand, and built up export surpluses, which partly flowed to the southern periphery. The opposite happened in the PSG, where producers lost competitiveness on international markets or reoriented their production on domestic demand. These countries are now unable to transfer the foreign capital that had been borrowed. The reduction of the imbalances in the currency union requires thus on one hand a reorientation on domestic demand or on new foreign markets in the northern countries – and this seems to be the easier part – but also allowing to build up import surpluses vis-à-vis the southern countries (retransfer of the borrowed capital). On the other hand – and this is more difficult – the southern countries have to switch from the consumption-led to a more export-led economic model.

The Monetary Dynamics behind the Crisis of the EMU

The rebalancing of the EMU is a multi-level task and requires measures in different areas. Identifying the main problem of the southern countries in the area of weak export performance leads one to naturally rethink, in the first place, the devaluation option. But this particular aspect will not be discussed any further in this paper. We focus here, instead, on the possible contribution of financial infrastructure to any necessary structural change. But first we study in this section how banking industry facilitates the rise of consumption in the non-tradable sector and shows up the consequences of their credit policy for financial intermediation since the outbreak of the crisis.

In a monetary economy the credit market determines mainly the aggregate production and demand for the labor force (Hankel, 1989, p. 186). Two factors were crucial for the development of credit markets in the PSG: easy monetary policy by national central banks (before the introduction of the euro) and then by the European Central Bank and capital flows from the core countries. These easy monetary conditions led to an extraordinary credit boom in the southern periphery. According to Brzoza-Brzezina, who analyzed the case of Greece, Ireland and Portugal, strong lending booms in these countries, with an annual growth of credit rates of 20-30%, began 3 - 4 years before adoption of the euro (Brzoza-Brzezina, 2005). This trend was continued in the EMU. What is not surprising, is that the rise in overall credit was connected with a massive increase of lending to households, especially housing loans. For example, in the period 2000 – 2009 the total credit to domestic households rose in Greece from 17.0 bn. to 119.6 bn. € (respectively 12,5% and 51,6% in relation to GDP). The amount of housing loans increased in that period from 11.3 bn. to 80.6 bn. € (Anthanassiou, 2007, p. 164). Therefore we can state, that a strong impulse for the reorientation of the production process on domestic demand originated from the credit market.

One can conclude that in the same way as the banking sector contributed to the swap to domestic demand-led growth, financial institutions could theoretically help to conduct, via an appropriate credit policy, the structural change in the southern periphery. But the events in connection with the crisis have affected the financial sector in two different ways. First, the capital flows from core countries reversed – an important source of credit action financing is no longer available. Second, the crisis swapped dynamically into the real economy influencing incomes and asset prices. This led to a systematic crisis in the banking sector. The actual percentage of non-performing loans, for example, in the Greek banking sector amounts to 24% (see figure

5). The deposits from companies and households in the Greek banks were reduced by almost 50% in the years 2009 – 2012 (see figure 6). The capital intermediation in the southern periphery has come to a standstill. In each of the countries considered in this paper, where we can observe a strong credit contraction. It lacks therefore the external financing for the necessary structural shift.

The Role of the German Development Bank (KfW) in the "German Economic Miracle"

Directly after the Second World War, Germany descended into economic chaos. First, the monetary reform from 1948, which stopped galloping inflation, established a basis for a new economic beginning. However, the banking sector was far from working optimally. An important role in the first decade after the war in improving capital intermediation in the economy was played by the German development bank – Kreditanstalt für Wiederaufbau (KfW) (Wallich, 1955, p. 168).

The main task of the KfW was to enable access to credit for those companies, which were seen by the banks as being too risky. One of the KfW-features, which crucially contributed to its success, was the establishing of the German development bank as a refinancing instance. The KfW usedthe existing banking apparatus, which meant that capital intermediation took place in an indirect way. This enhanced the effectiveness of the resource allocation. KfW gave direct credit only when an investment project, which was seen as being macroeconomically important, had no access to external financing via the regular banking sector (Hankel, 1961, p. 152 et seq.).

The philosophy of KfW and its role in the German economy shows up very well as an example in export financing. Since the end of the 1950s, German companies have become continually more export oriented. But the banks were not willing to provide export credits for German companies in an adequate amount. The KfW recognized this negative development in the banking sector, which blocked the plans of expansion of German enterprises and started to refinance export credits abundantly. According to Hankel, it was recognizable, how these refinancing operations by the KfW influenced the structure of production in the German economy (Hankel, 1961, p. 110 et seq.).

The Need for Development Banks in Southern Periphery

As mentioned in section III, the banking sector in the peripheral countries is dysfunctional. Many financial institutions have been or will be recapitalized with public funds. There is a significant amount of non-performing loans and toxic assets in their balance sheets. Since 2010, the PSG has noted a sharp credit contraction. A proper capital intermediation in this financial environment is impossible.

In order to enhance the functioning of the financial sector, the southern periphery has to conduct a deep restructuration and recapitalization of the banking institutions. However, even if this process succeeds, it is doubtful, whether the banks will be willing to finance the structural change in the PSG in an adequate scale. It can be rather expected, that financial institutions would be shunning such a risk for quite a longer period of time. Therefore, it is advisable for southern countries to establish or to assign new tasks for existing development banks.

How should the development banks work in the southern periphery? In the first place, it is desirable that these institutions will enhance financing in the desired sectors of the economy in an indirect way. KfW was successfully operating in the first place as a refinancing bank. After the outbreak of the crisis many countries were enhancing the financing of small and medium enterprises, which, especially during the havoc on financial markets, have a strongly limited access to bank credit (see for that: McKinnon, 1977) by using different Credit Guarantee Schemes (CGSs) (OECD, 2013). The indirect intermediation has two crucial advantages: first, using existing banking apparatus reduces costs and improves the efficiency of capital intermediation. Second, these institutions must actually be as independent as central banks. They should be free from any political influence and from any pressure from different lobby groups. The establishing of a development bank as a refinancing or guarantee institution is the first step in ensuring its independence. In the case of the EMU's southern periphery it is desirable, that these development banks will be additionally supervised by EU institutions. At least, many of the northern countries, in the first line with Germany, which strongly influence proceedings in the EU, are the main creditors of the southern states. It lies, above all, in their interest to ensure a successful structural change in the PSG.

As mentioned above, the economic process in the southern periphery has been strongly focused on domestic demand. A sharp decrease of domestic demand in the aftermath of the crisis, has led in turn to a skyrocketing of the unemployment rate. Coping with these two aspects is crucial for the economic healing of the southern periphery, but also for rebalancing the EMU. Therefore, development banks in the southern countries should focus on providing refinancing or guaranties for credits for these investment projects, which improve the export capabilities by demanding at the same time an over proportional additional labor force.

Concluding Remarks

The main reason behind the economic problems in the Eurozone is the divergent development in the core states and southern periphery. The core (north) countries, since the introduction of the euro, have orientated their economies on foreign demand, and strengthened competitiveness and built up significant export surpluses. In contrast, the southern states went through a phase of consumption led growth accompanied by strong import inflows. Despite importing a large amount of foreign capital, they did not sufficiently increase their export capacities and note the currently substantial negative external net positions.

The rebalancing of the EMU requires above all, on the site of the southern periphery states, the reorientation of the structure of production on foreign demand. To accomplish the structural shift several reforms on different areas are needed. In this paper we analyzed the potential role of financial infrastructure by the redirecting of the economic process.

In section three of that paper we showed how the financial sector in southern periphery is dysfunctional and that under current conditions capital intermediation is not working properly. In the following part we analyzed the experience of the German development bank – Kreditanstalt für Wiederaufbau (KfW). We stated that the KfW has been successfully influencing the credit policy of financial institutions by offering credit refinancing in these areas, which were seen as macro-economically significant.

In the same way as the KfW in Germany, development banks in the southern periphery could have an effect on the lending policy of Greek, Spanish or Portuguese financial institutions. Whereas the crisis in the south of the EMU was connected with a sharp decrease of domestic demand, what in turn led to a strong increase of the unemployment rate, the development banks should provide refinancing or guaranties for credits for those investment projects, which contribute to export growth and demand additionally over proportional extra labor force. Furthermore, it is advisable to establish development banks just as refinancing or guarantee banks, because this could reinforce the desired independence of these institutions.

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Figures

Figure 1 by author (data OECD), Figure 2-6 by kind permission of "www.querschusse.de"

Figure 1. Debt to GDP-ratio in Greece, Portugal, Spain and Ireland (in percentage terms)

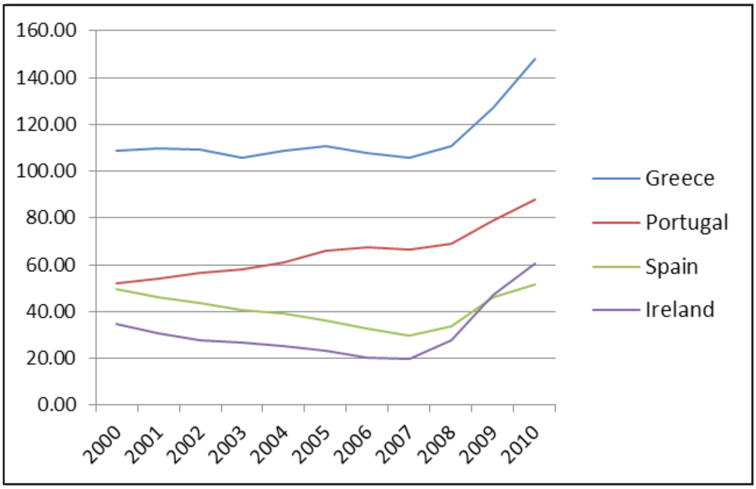

Figure 2. Unadjusted export (red line)/import (blue line) in Greece

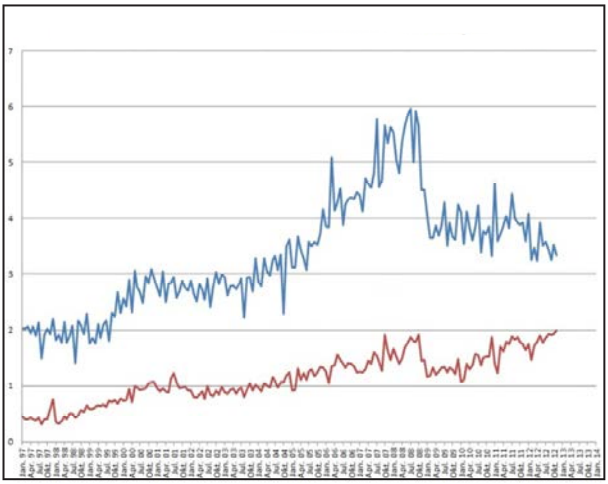

Figure 3. Unadjusted export (red line)/import (blue line) in Spain in bn. of €; (in real terms)

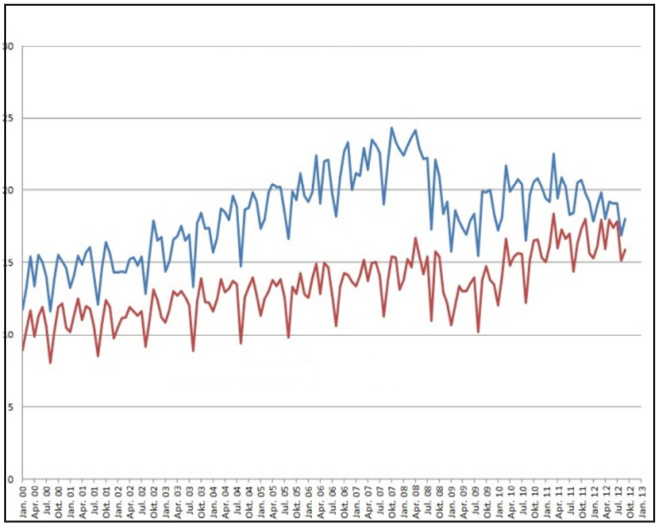

Figure 4. Unadjusted export (red line)/import (blue line) in Portugal in bn. of €;

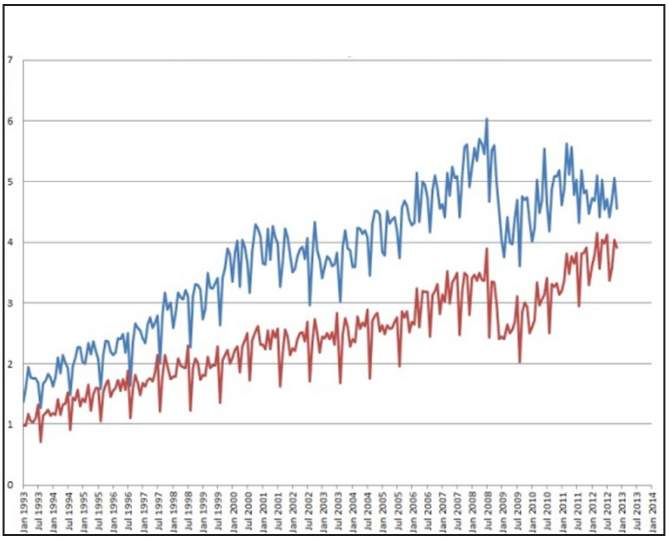

Figure 5. Non Performing Loans (NPLs) in percentage terms in Greece

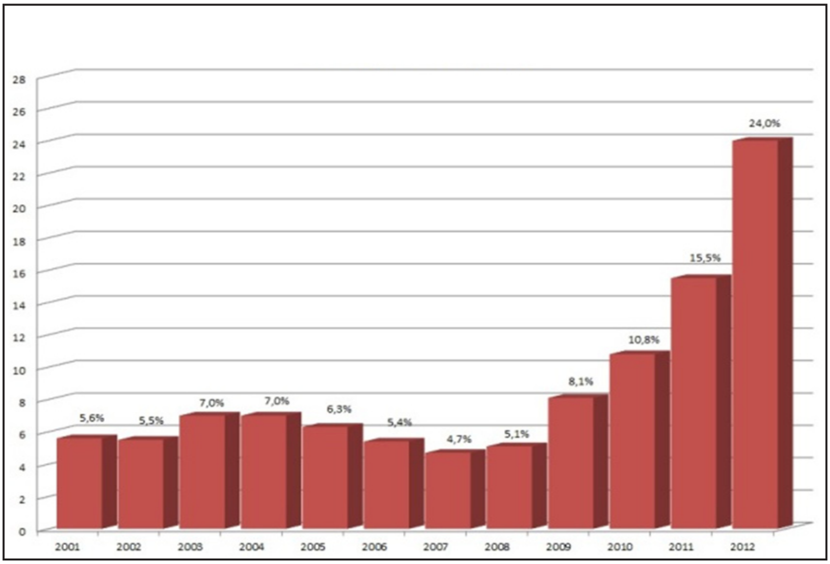

Figure 6. Deposits of households and corporate sector by Greek financial institutions