



MAX-PLANCK-GESELLSCHAFT

MPI for Research on Collective Goods
Martin Hellwig



A Treasury for the European Banking Union?

Madrid, May 2017

The „euro“ crisis seven years on



- Banking union in its third year
- Banking systems have not yet recovered
- Worries about asset quality are still there
- Nonperforming loans are a major problem
- Bank lending remains weak, economic recovery is weak
- Government finances have not yet recovered
- Populism has barely been contained – for the moment

What can be done?



- One possible answer: Nothing – Nonfinancial entities (firms, households) are highly indebted and recovery will only come when their balance sheets have been repaired.
- Another answer: Reduce the scale of the banking system, close down some banks, recapitalize others so that the banks again become profitable/well capitalized and can use restructuring/insolvency mechanisms to reduce leverage in the nonfinancial sector.
- A third answer: Socialize losses from NPLs, e.g. through an EU wide (or national) bad bank.

Assessment



- „Nothing“ is politically destructive.
- Recapitalization and/or socialization of losses require injections of money, presumably public money.
 - In conflict with principles of BRRD
 - What if the government itself has problems
- Closing down banks requires political will and that may be lacking
 - Industrial policy concerns
 - Political connections of bank owners/creditors
 - Fear of backlash from bail-in.

„Europeanize the Problem!“



- Knee-jerk reaction, just like Rumsfeld and Cheney „knew“ that Iraq was behind 9/11.
- What can Europeanization achieve?
- Funding – more than redistribution?
- Deposit Insurance – more than redistribution?
Would DI have dispelled the bank run in Greece, where people were worried that claims denominated in € would be redenominated?
- Bad Bank – more than redistribution? Towards creditors and across member states?

A Step back: The creation of banking union



- Banking union was agreed in response to Spain's demand for ESM support to restructuring of Spanish banks.
- Germany: But then we must make sure that supervision does not remain in national hands (Germany was somewhat surprised when this turned out to apply to German banks as well!)
- ECB: We want to have a say in supervision in order to avoid our monetary policy being blackmailed by national policies towards banks.
- „Break the bank-sovereign nexus“

Beware of illusions

– Going even further back



- The No-Bailout clause of the Maastricht Treaty and the SGP seemed to provide for proper governance of fiscal policy
- The Treaty also pledged the ECB to abstention from government finance
- Banking regulation was governed by the principle that solvency problems were for the sovereign, liquidity problems of individual institutions for national central banks, liquidity problems of the system for the ECB to handle

Why were the principles broken?



- Crisis was more than the political system of the EU could handle
- A traditional sovereign debt crisis in Greece, Portugal, and perhaps Italy,
- A traditional real-estate and banking crisis, in Ireland and Spain,
- And a latent banking crisis in Germany and France where the mess of 2008 had not been cleaned up

What had gone wrong?



- **Lack of Market integration:** Different goods markets, different inflation rates, equal nominal and different real interest rates
- **Lack of Market discipline:** No exchange rate discipline, no risk consciousness of creditors
- **Lack of fiscal discipline:** No political legitimacy, no effective enforcement
- **Lack of effective supervision:** Government funding concerns, industrial policy concerns, politics of real estate funding

Fiscal union to the rescue?



- Illusions about enforcement, despite contrary experiences (SGP, Agent General in Weimar)
- Lack of political legitimacy
- Differences in fiscal traditions
 - Financial Repression, monetary funding of government in G-I-S-P
- Differences in traditions as to what is the role of the state
 - Industrial policy, services publiques in France

What would a European finance minister do?



- Funding? Requires an EU competence for funding, which in turn requires a major transfer of competences (But: remember the ECSC industry levy)
- Budgeting? Allocation and administration of funds? What would be different from the current setup? New supranational tasks (security)?
- Control, say in national fiscal policies? How legitimate would that be? Workable federalism is not about upper levels having a say in lower levels' decisions, but about each level doing its own job in funding and implementation.

Back to banking union



- Supervision
 - How effective can it be with 16+ different national laws implementing EU directives?
 - Asset quality review without viable resolution procedures?
- Recovery and Resolution
 - Governments do not want to give up the power to determine which banks are there and which are not?
- Deposit Insurance
 - Who will be bailed out and who will pay?
- Backstops? A Treasury?

„Banking union has nothing to do with public finance!“



- „Taxpayers have nothing to do with banks!“
- BRRD: Bail-in of „all“ creditors
- except for....
- But we have MREL!
- And precautionary recapitalizations! In national competence – see MPS
- Subject to state aid control – see MPS
- Contradiction in terms?
- Problematic governance, problematic banking policy

Illusions about bank resolution



- Institutions with systemically important operations in multiple jurisdictions remain too important to fail – SPE is politically unacceptable; one may also doubt whether it would be viable.
- BRRD contains no provisions about liquidity in a recovery and resolution procedure. Is this the task of the central bank? When there are doubts about solvency?
- BRRD contains no provisions for the case where bail-in-able funds are insufficient.
- Need for a fiscal backstop! A Treasury with the power to borrow and to impose levies?

National or EU/euro area?



- National fiscal backstops/national precautionary recapitalizations raise questions about viability:
 - Sufficiency of funding
 - Distortions through politics: kicking the can down the road, maintaining national champions, safeguarding preferred classes of creditors
- State aid control necessary, but very well suited to dealing with these problems
- Supranational fiscal backstops raise questions of moral hazard concerning financial repression, taxation and economic policies

A treasury for the banking union?



- How about a facility providing a funding backstop to the SRM?
- With the power to issue its own debt, with debt service funded by either an industry levy or a surcharge on VAT.
- E.g. along the lines of the ECSC arrangements in the past.
- With the means to provide recapitalizations as well as residual loss absorption.
- Subject to a modified form of state aid control.
- With a ban on recapitalizations by national governments.

Banking union and the ECB



- Cleanups are lagging under national competence
- ECB as a source of funding for banks
- And (indirectly) governments
- Back to the regime of southern Europe in the seventies and eighties?
- Banks and the central bank as a source of government funding
- - and financial repression as a cause of low growth

Banking union and the ECB

- the other side of the ledger



- Ireland 2010, Greece 2015 – the ECB as an agent of the creditors?
- Threatening to destroy the functioning of member state monetary and payments systems?
- In a single state, such behaviour is forestalled by the threat of revoking independence, in the monetary union, this threat is moot.
- To eliminate abuse of central bank power over banking systems, one needs some political counterweight: Court, Commission, Treasury? With political legitimacy provided by parliament

The deeper problem



- Banks have power over money, and money is a source of power. Traditionally treated as a part of sovereign power
- Will member states be willing to give this up? Or will they use other means to impose financial repression?
- In monetary union, there is a tug of power over banks between the ECB and member states.
- Any mechanism that weakens member states and strengthens the ECB reduces one mechanism of blackmail and increases the potential for another one

The deeper problem ctd.



- One vision would be a fully fledged, democratically legitimized treasury at the EU/EMU level with power to fund and undertake interventions (recapitalizations etc.) and the ability to provide a check on power abuses of the ECB. This would presumably go along with the development of EU/EMU wide banks.
- BUT: Can we imagine Monsieur le Président de la République Française being placed in the position of the mayor of Leukerbad vis à vis the banks?