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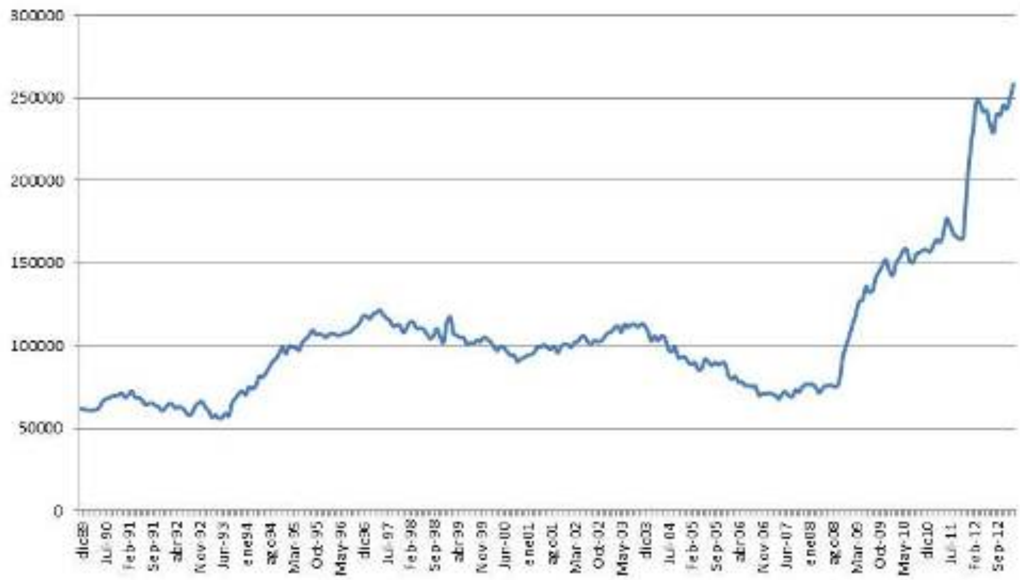
The European Central Bank
Banking union on the cheap will fail

May 16th 2013, 16:33 by Luis Garicano | London School of Economics

A recent Free exchange column (http://www.economist.com/news/finance-and-economics/21577060-european-central-bank-has-lost-control-interest-rates-spain-and) discusses the European Central Bank's troubles in providing support to peripheral economies (summary here (http://www.economist.com/blogs/freeexchange/2013/05/european-central-bank)). We are inviting experts in the field to comment on the piece and related research. Michael McMahon, a macroeconomist at the University of Warwick commented here (http://www.economist.com/blogs/freeexchange/2013/05/european-central-bank-0) . Gilles Moec, co-head of European economic research at Deutsche Bank, added thoughts here (http://www.economist.com/blogs/freeexchange/2013/05/european-central-bank-1) . Next up is Luis Garicano, professor of economics at the London School of Economics.

SINCE the start of the crisis, the link between banks and their sovereigns has only been strengthening with dire consequences for the periphery’s economies. To focus on Spain, in October 2008, the Spanish financial system had €78 billion of Spanish government bonds. By February 2013, these holdings had increased to €259 billion: almost 30% of GDP, according to Bank of Spain data (see Figure 1).

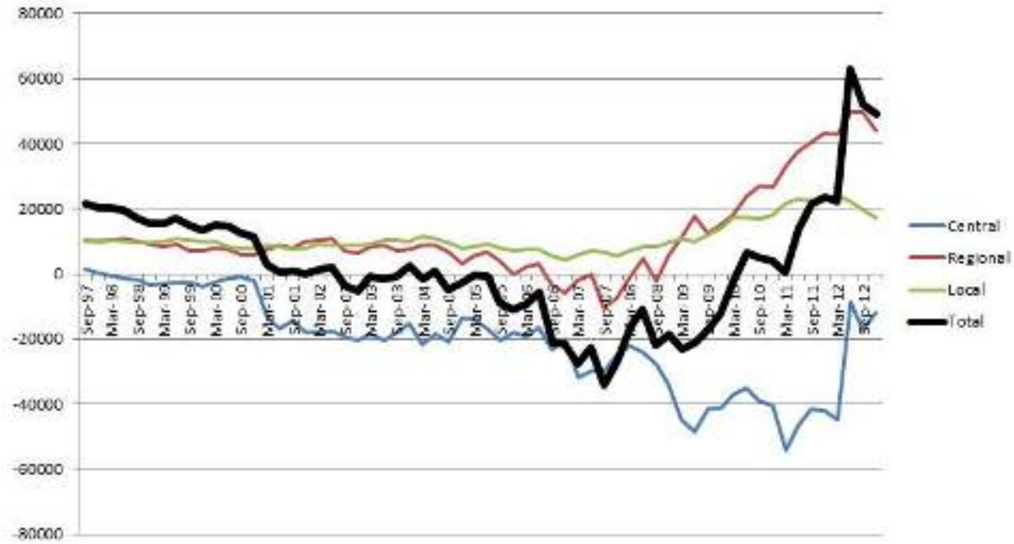
Figure 1. Bank holdings of public debt, Spain
(Current Euros, Dec 89-Feb 13)



Source: Bank of Spain. OTHER MONETARY FINANCIAL INSTITUTIONS 8.5 Assets. Domestic
B) Aggregated balance sheet according to the euro area returns Debt securities: general government
http://www.bde.es/webbde/es/estadis/infoest/a0805e.pdf.

Additionally, their direct lending to all the government levels, which was a negative €22 billion in 2008 (government deposits where larger than loans), was €49 billion by February 2013 (see Figure 2).

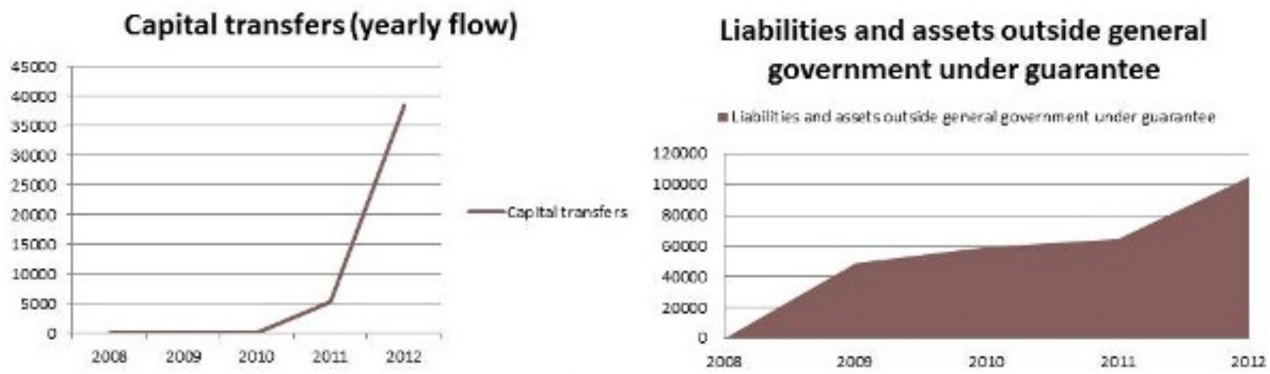
Figure 2. Net bank lending to governments
(Loans- Deposits, Current Euros, Dec 97-Feb 13)



Source: Bank of Spain, Own calculation. 8. OTHER MONETARY FINANCIAL INSTITUTIONS 8.25 Loans to/deposits held by general government C) Breakdown of assets and liabilities from/with other MFIs, by sub-sector
http://www.bde.es/webbde/es/estadis/infoest/a0825e.pdf

The loop is also strengthening in the other direction. The hidden losses in the banking system are starting to materialise, with €37 billion injected this year by the Spanish state, apart from a still ongoing stock of slightly over €100 billion of state-guaranteed bank debt by the end of 2012 (see Figure 3).

Figure 3. Bank failures and Government Solvency



Source: Eurostat, Supplementary tables for the financial crisis Spain: 10/4/2013

European leaders are aware of the damaging loop, and committed themselves at the June 2012 Euro Summit to “break the vicious circle between banks and sovereigns”. Specifically, they promised that, “When an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could, following a regular decision, have the possibility to recapitalise banks directly.”

Regrettably, this good purpose was fast “clarified”. A senior EU official told the *Wall Street Journal* only a few days after the summit (on July 6):

> I need to make clear what the ESM can do: the ESM is able–if one were to decide ever on such an instrument–to take an equity share in a bank. But only against full guarantee by the sovereign concerned … Does it still remain the risk of the sovereign or [does it go to] the ESM? It remains the risk of the sovereign.

Later, the Dutch, Finnish, and German finance ministers, on a summit on September 29 stated that, “the ESM can take direct responsibility of problems that occur under the new supervision, but legacy assets should be under the responsibility of national authorities…".

Mr Wolfgang Schaeuble has been fast backpedalling on hopes for a banking union and turning it into a banking union “on the cheap”. At the recent Dublin summit, he said banking union "only makes sense…if we also have rules for restructuring and resolving banks. But if we want European institutions for that, we will need a treaty change.“ Other rules cheapening the banking union include no deposit insurance, and no resolution authority for the ECB without (certainly hard to envision and long in coming) treaty changes. In fact, the only decision that has been made is the one that ostensibly involves no cost, the new Single Supervisory Mechanism to start in March.

Sadly, Mr Schaeuble has it exactly backwards. The key to restart growth and ensure the survival of the euro process is to recognise that "mistakes were made" by all in the design of the euro, and that these mistakes have had very severe consequences for a number of countries (the debtors) which are now spreading to the rest. In other words, sharing of legacy debts is fair, and, provided the institutions are firmly put in place to avoid future credit bubbles, growth enhancing.

We can again turn to Spain for evidence that the deterioration of the aggregate sovereign finance balance sheet is at the root of the current contraction. In spite of the improved credit access by the state caused by lax monetary policies and the OMT threat by Mario Draghi, credit conditions are tight, and families and business are still struggling.

Spain has been applying the German recipe to the letter. First, before the SSM is constituted, it has been trying to clean up its own mess with the funds of the state. In the current round, the subordinated liability exercises raised €12.7 billion and the state injected €37 billion for nationalised Cajas (in Q4 2012), plus €1.8 billion (Q1 2013) for surviving ones, for a total of around 5% of GDP. The 3 to 1 ratio public to private participation is similar to the SNS Reaal recap using the new Dutch intervention act, which invested €3.7 billion from the Dutch state, and subordinated debt for €1 billion. Spain moreover set up a bad bank whereby the weaker Cajas and banks transferred a gross total of over €100 billion, for a net asset value of €50.78 billion (transfer finished March 2013) in assets. Senior creditors have benefited from all existing (SLE) bail in exercises. Regrettably the liability exercise again left out senior creditors, which are in fact the ones who have the best monitoring ability (thus able to provide good incentives to countries) and loss absorption capacity

But the bank recap combined with Draghi's magic words is not improving credit access. True, the OMT means the state is financing itself at much better rates, with cheaper and better credit to banks and a halving of risk premia. But the Bank Lending Survey from the Bank of Spain for January shows that 22% of banks have tightened their lending to large companies, and 10% to SMEs and families for both house purchase and for consumption. The most recent data show that lending to corporates is falling by about 6% per year and this fall with will continue or accelerate this year. Aggregate figures show a huge rise in credit to general government and a brutal drop in credit to businesses and households. But of course, credit drops could be, regardless of surveys, caused by lack of demand, rather than excessive supply restrictions.

Evidence of the causal link between supply restrictions and growth in Spain is provided by a recent trio of papers. In a recent AER publication (http://research.barcelonagse.eu/tmp/working_papers/628.pdf) , Jiménez, Ongena, Peydró and Saurina show that weaker banks deny more loans, even when the loans compared are identical (which allows them to identify the supply, rather than demand channel) and that business cannot in general substitute for the weak bank by going to another bank. Also, in a recent (April 2013) working paper, Bentolila, Jansen, Jiménez and Ruano show that businesses whose credit proceeded from weak financial entities that were later subject to intervention (the old "Cajas") reduced employment by an additional 3.5 to 5 percentage points relative to those whose credit proceeded from strong ones. Finally, in work with my colleague (http://cep.lse.ac.uk/pubs/download/dp1188.pdf) at the London School of Economics Claudia Steinwender, we show that Spanish-owned companies reduce employment substantially more (6%), and investment by much more (by 19%) than the Spanish operations of foreign companies, pointing also to the key role played by investment.

In sum, the Spanish state owns more bank risk, the banks own more of the public-sector debts, credit is being restricted, and growth is suffering. The low cost banking union being proposed, which loads the cost of the clean up on the individual member states will not cut through these problems. Several of the key Schaeubleian nostrums must be rejected:

– Legacy debt cannot possibly be absorbed by individual states. The euro-zone countries must recognise they signed up to a flawed euro area and that we are today where we are, at least in part, as a result of these flaws. The two key objectives being pursued—minimising taxpayer and EMS involvement as well as ensuring an adequate credit supply—are in contradiction. Maintaining the supply of credit across the euro zone must be the priority.

– As Cyprus shows, member states cannot individually guarantee deposits, and common deposit insurance (right now completely off the table) must be part of union

– Some instrument for joint lending (a form of Eurobonds) that may allow the gradual easing of the link between banks and sovereigns is necessary. I have proposed, with a group of European economists, the ESBies, a solution based on securitisation that avoids joint liability. This solution generates a large liquidity premium shared by all, redirects flight-to-safety flows from across national borders to across tranches.

– A banking union needs strong centralised resolution powers within the supervisor. As the Cajas debacle showed: local authorities are too close to management and do not internalise the cost to the system of wobbly banks. Moreover, the ESM must have the ability to directly inject funds into banks, at market prices, and also lend to local deposit insurance schemes, but sharing cost requires centralised decision making.

– A deposit guarantee scheme is needed to break the link between sovereigns and banks. Its cost, with a credible resolution framework able to impose losses on creditors and uninsured depositors, does not have to be excessive.

After the German elections, Europe has a short window of opportunity to rescue the euro project. It is the moment for Germany to accept what it signed for in joining the Euro or exit.