Banking Union to save Monetary Union

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Part I: The present: Monetary Union without Banking Union An unstable combination

Fundamental issue behind euro crisis

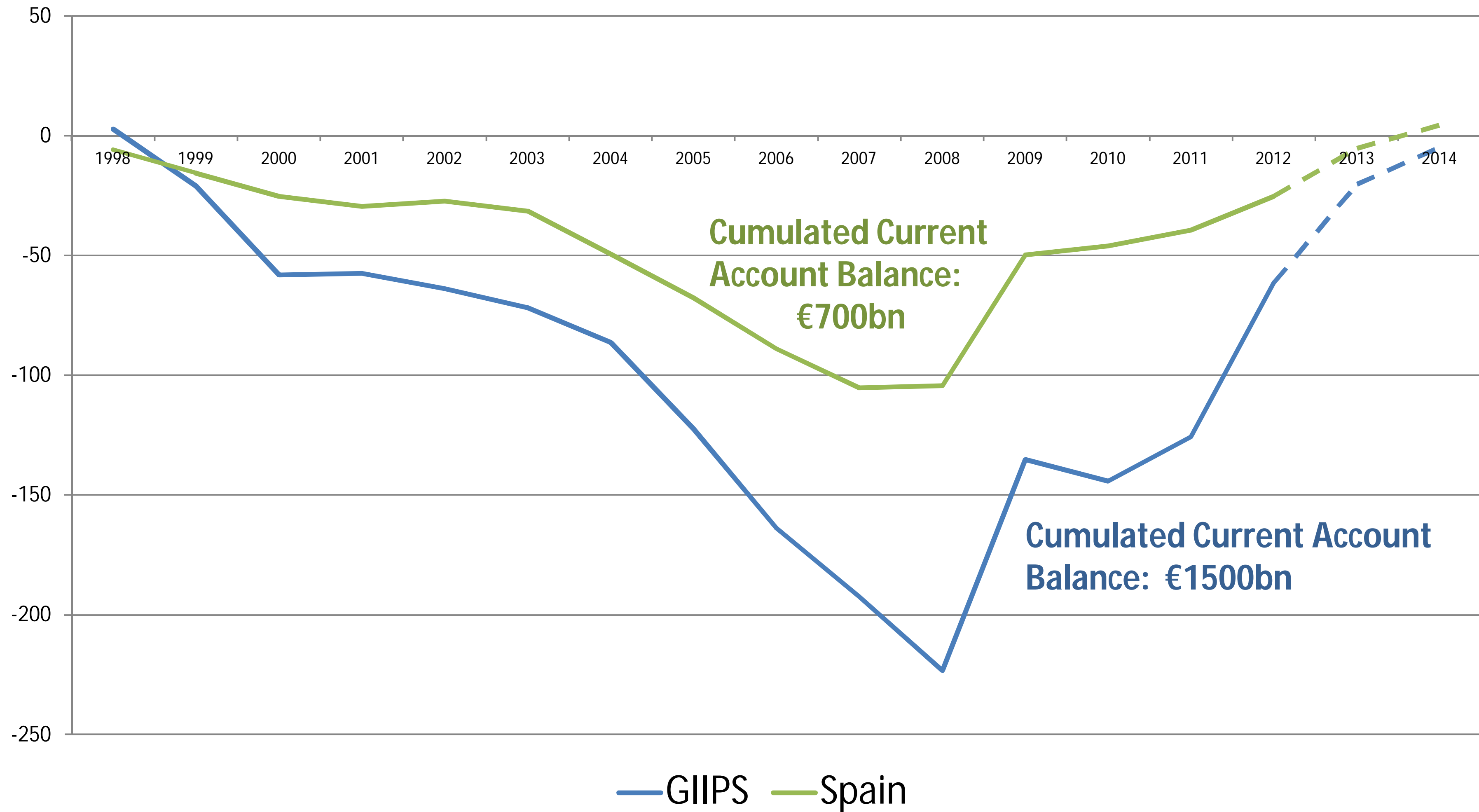
- Excess savings in Northern Europe (and deficit in South - East).
- Most savings arise at banks, so must be invested in euro.
- During boom savings circulate freely in EA.
- Euro crisis: Southern assets become 'toxic'.
- ECB (+ESM) intervene to keep South alive.
- Will ECB (need to) be there forever?

Flow versus stock imbalances

- Flow problem: diminishing as current account deficits in South are falling.
- => flow problem soon secondary.
- Stock problem persistent: existing stock of Northern claims on South must be rolled over continuously (depending on maturity).
- Stock is large (sum of past flows 1 500 billion euro) – with Spain about 50 % of total.

GIIPS: Current account balance (in bn EUR)

CEPS



Intra-EA barriers to cross border flows (and rollovers!)

(National) Supervisors:

1. In North: push banks to reduce risk and exposure to South – both branches and subsidiaries.
2. Ratings downgrades make cross border lending more costly under Basle rules (increase capital requirements when capital very expensive).

(Incentives similar in South: so Southern supervisors also push banks to keep/increase exposure to national borrowers.)

Consequences of Intra-EA barriers to cross border flows

Sudden stop:

1. In South credit crunch and high risk premia
2. In North: liquidity glut (negative interest rates, credit more available).

=> Economy contracts in South, keeps up in North

Euro area financial markets pre crisis
HEBRIDES
Aberdeen
Glasgow
Edinburgh
UNITED KINGDOM
Belfast
Isle of Man (U.K.)
Irish Sea
Leeds
Manchester
Liverpool
Cardiff
London
English Channel
Jersey (U.K.)
North Sea
Stavanger
Skagerrak
Amsterdam
Rotterdam
Brussels
Paris
Strasbo
Nantes
FRANCE
Bordeaux
Toulouse
Marseille
MONACO
Bilbao
Andorra la Vella
ANDORRA
Barcelona
Balearic Sea
BALEARIC ISLANDS
Corsica
Sardinia
Cagliari
Ligurian Sea
Genoa
Turin
Geneva
Bern
SWITZ.
Zürich
Vaduz
Stuttgart
Bremen
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Prague
Poznań
POLAND
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Warsaw
Gdańsk
Kaliningrad
RUSSIA
Bornholm
Baltic Sea
Öland
Gotland
Riga
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ESTONIA
ALAND ISLANDS
LITHUANIA
Vilnius
Vitsyebsk
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Minsk
BELARUS
Hrodna
Homyel'
Brest
Rivne
L'viv
Chernivtsi
Kraków
Vistula
Brno
SLOVAKIA
Bratislava
Vienna
Budapest
HUNGARY
Cluj-Napoca
ROMANIA
Ljubljana
Zagreb
SLOVENIA
CROATIA
BOSNIA AND HERZEGOVINA
Belgrade
SERBIA
Sarajevo
MONTENEGRO
Podgorica
Tirana
ALB.
Skopje
MACEDONIA
Sofia
Adriatic Sea
VATICAN CITY
Naples
Tyrrhenian Sea
Ionian
Danube
Rhine
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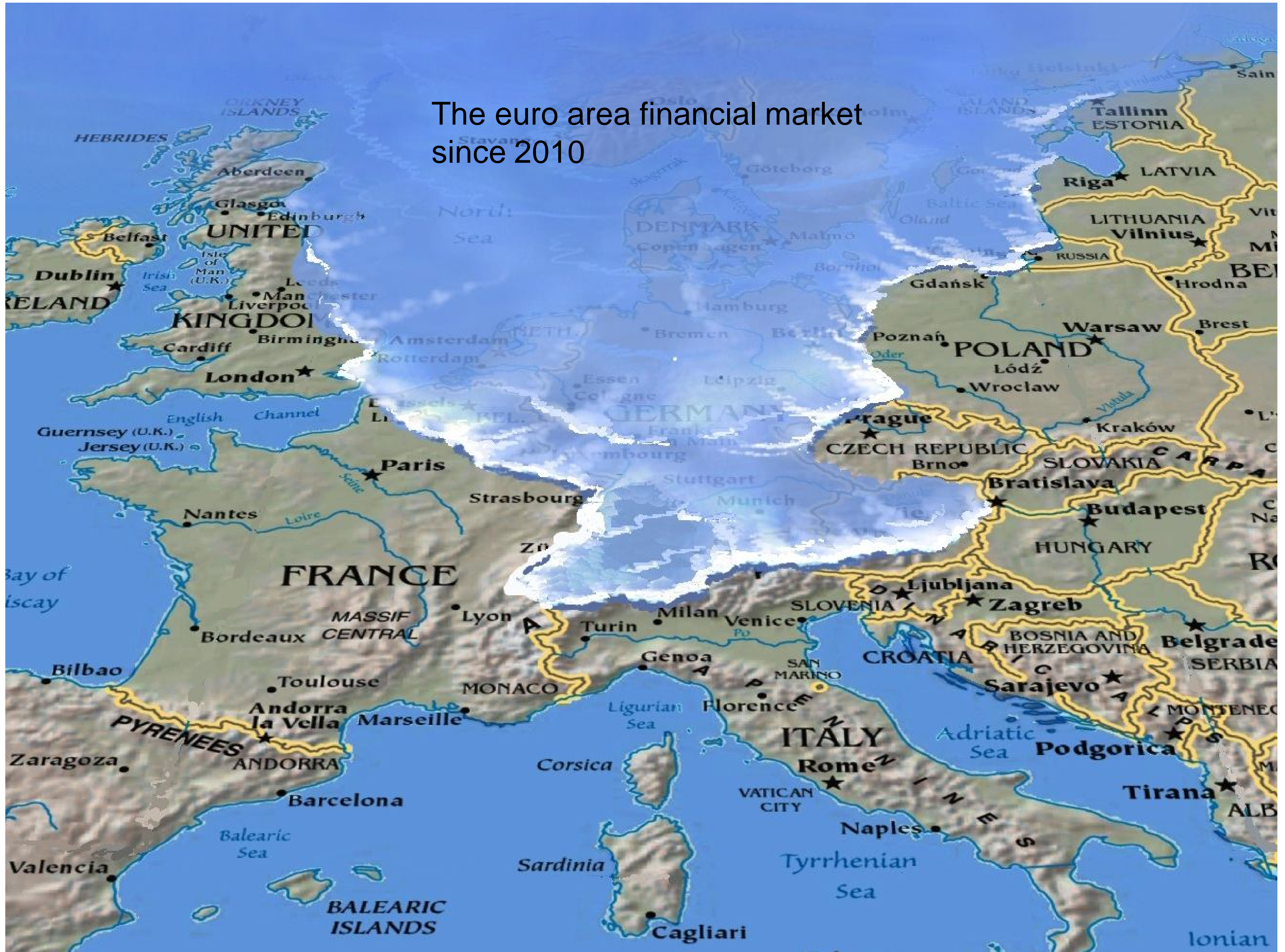
The euro area financial market
since 2010
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Glasgow
Edinburgh
UNITED
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Dublin
Irish Sea
Isle of Man (U.K.)
Liverpool
Cardiff
Birmingham
London
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Guernsey (U.K.)
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Nantes
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Bilbao
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Andorra la Vella
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PYRENEES
MONACO
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Zaragoza
Barcelona
Balearic Sea
Valencia
BALEARIC ISLANDS
Corsica
Sardinia
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Ligurian Sea
Turin
Milan
Genoa
Venice
SAN MARINO
Florence
ITALY
Rome
VATICAN CITY
Naples
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Adriatic Sea
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Kraków
POLAND
Warsaw
Łódź
Wroclaw
Poznań
Gdańsk
Brest
Hrodna
RUSSIA
LITHUANIA
Vilnius
LATVIA
Riga
Tallinn
ESTONIA

The euro area financial market 2011
Acute liquidity crisis in South
ECB becomes the only conduit
ECB
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Skopje
Sofia

The euro area financial market 2011/12
EFSF and ECB compared

Ultimate stage of crisis: enter capital flight or 'convertibility' risk

- Whatever ECB pumps South returns North as capital flight (so far mainly Greece).
- If extends to other countries: Balance sheet of ECB towards infinity?
- Hence OMT?

ECB
Return flows = capital flight

What to do?

Banking union (BU) plus OMT should reduce barriers to N-S capital flows and eliminate convertibility risk (and thus capital flight).

Does not solve underlying imbalances, but should lead to more normal financing conditions during transition to new real equilibrium.

Part II, the future: Monetary Union plus Banking Union

Banking Union: essential elements and shock absorption capacity

What is a Banking Union?

BU has three elements:

1. Supervision (now agreed in principle, SSM= Single Supervisory Mechanism).
2. Common resolution fund (plus fiscal backstop) agreed in principle once SSM works.
3. Common deposit insurance (or at least reinsurance of national deposit against catastrophic risks). No agreement yet.

Supervision at European level: Can it work?

Yes

- Should be less beholden to special interests as EU level institutions are further from political interests (organized at national level).
- Heterogeneity of economic and political conditions protects ECB/Commission. Example role of DG Comp in Spain and elsewhere.
- Supervisory barriers against intra area cross border flows diminished (?).

After Supervision at European level: A common fiscal back-up

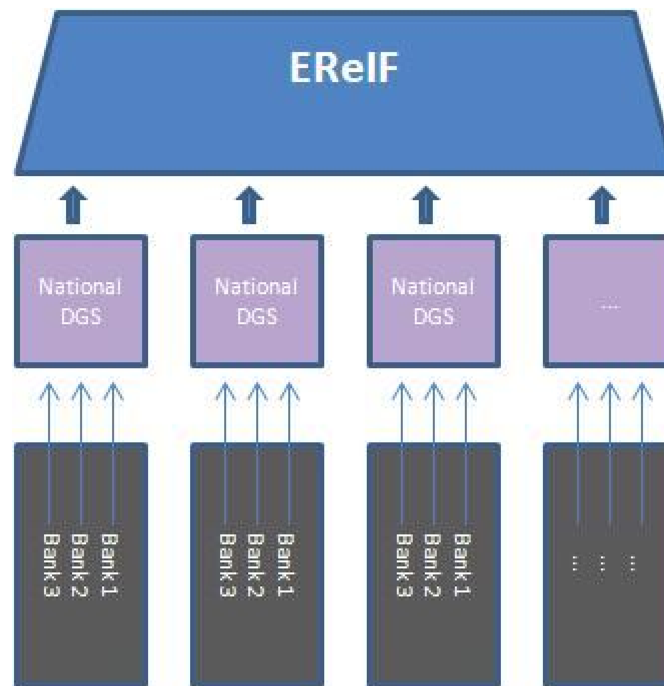
- Key to break feedback loop between sovereign and banks.
- National restructuring funds not enough. Need at least common fund for 're-insurance' against risk that are too large at national level.
- Final back-up by ESM for systemic cases.
- Legacy asset biggest problem for implementation.

After supervision and resolution: European Deposit Reinsurance Fund (EReIF)

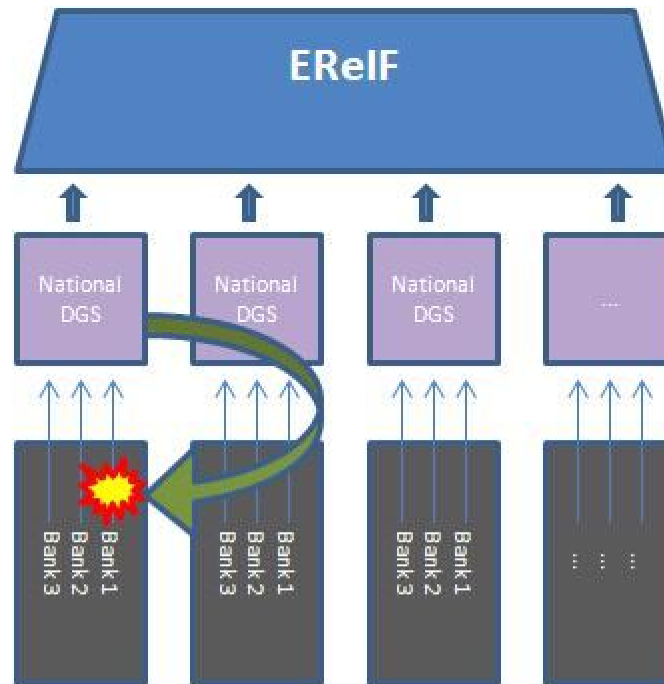
- National DGS can deal with small cases.
- National DGS cannot deal with systemic shocks and sovereign likely to be in trouble as well.

=> Need at least reinsurance with final back-up by ESM for euro area systemic cases.

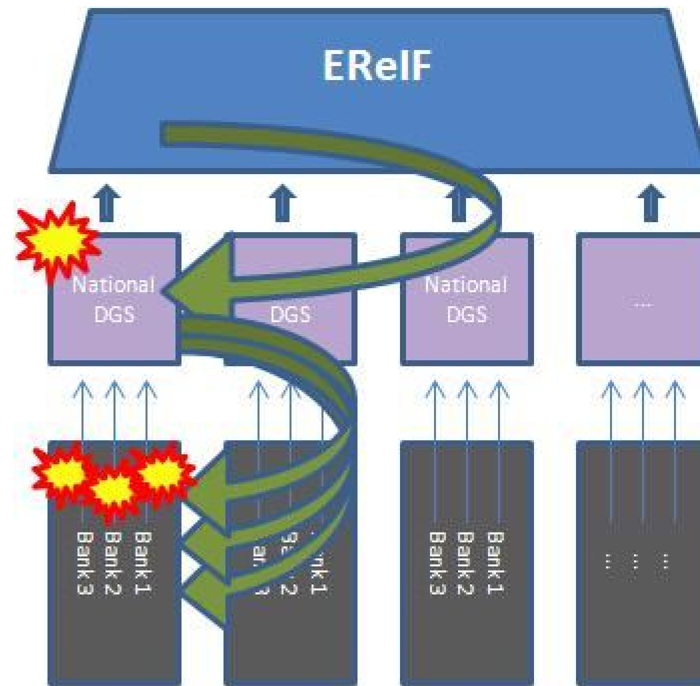
The EReIF in tranquil times: local banks pay premia to the national DGS, which pays part to EReIF



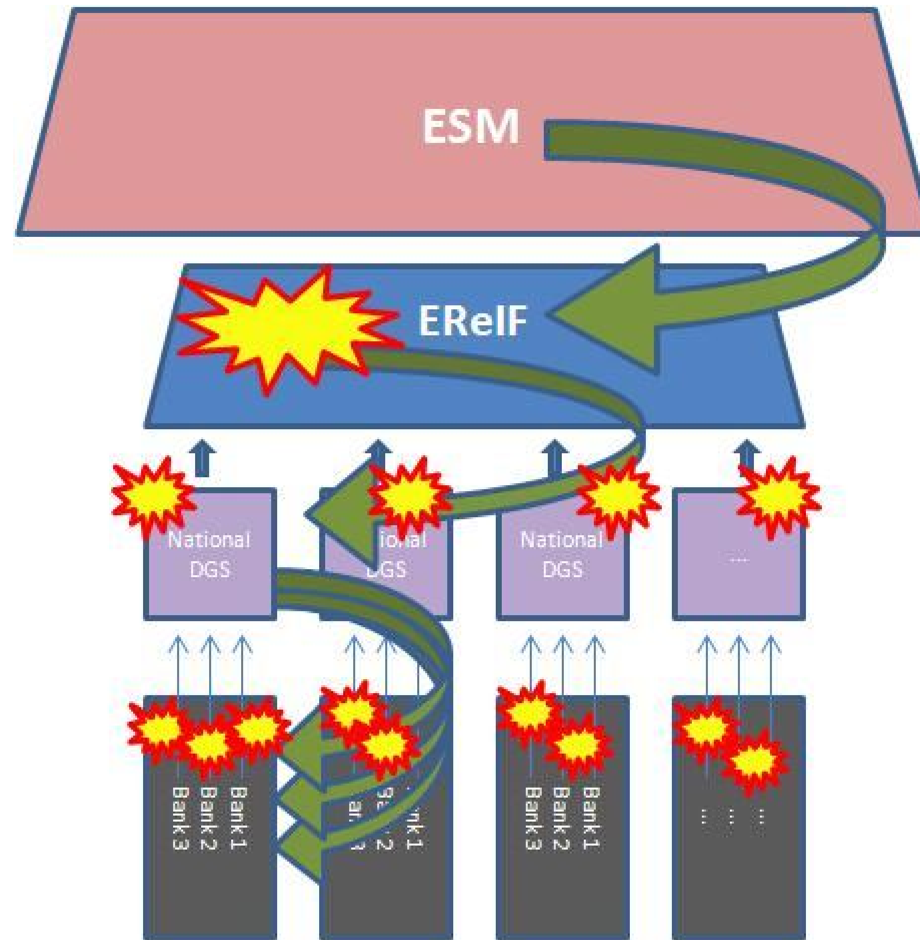
Small shock absorbed by national DGS (no need for reinsurance)



Large shock (systemic at national level) requires pay out by EReIF



Euro area wide shock requires intervention by ESM (possibly ECB)



Shock absorbing benefits of a Banking Union

States of US enjoy one huge advantage over Eurozone MS:
A well-functioning ***Banking Union***

- Freddie Mac, Fannie Mae and the Federal Deposit Insurance Corporation spread state risks and losses (GSEs through securitization).
- Bank failures during crisis prime example:

Nevada versus Ireland, Spain versus Florida?

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Comparison Spain & Florida

Key statistics:

	Spain	Florida
Population (in million, 2011)	46.1	19.1
Nominal GDP (in € billion, 2011)	1063	542
Change in nominal GDP (2007-2011)	1.0%	-0.9%
Unemployment rate (2011)	21.7%	10.5%
Change in unemployment rate (2007-2011)	13.4pp	6.5pp

Florida: an example of the US banking union in action

- 2008-12: FDIC closed 65 banks headquartered in FL
  - Losses incurred by FDIC of roughly $14 billion.
- Federal loss sharing through Fannie Mae & Freddie Mac of $19 billion since 2008 (losses concentrated in Florida, borne by federal government).
- Total direct 'loss absorption' : about 33 billion, 6 % of GSP.
- Not counted: Large banks operating nationwide have 50 % + market share. Private sector losses on average twice sum of FDIC and GSEs. Loss absorption by 'foreign banks' probably another 6 % of GDP
- => Total loss absorption (ex post) much higher!

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Comparison Ireland & Nevada

Key statistics:

	Ireland	Nevada
Population (in million, 2011)	2.7	4.5
Nominal GDP (in € billion, 2011)	156	94
Change in nominal GDP (2007-2011)	-17.6%	-3.6%
Average net migration rate since 'bust' (2008) as percent of total population	0.32%	0.09%
Unemployment rate (2011)	13.5%	14.4%
Change in unemployment rate (2007-2011)	9.8pp	8.8pp

Nevada's Advantage (over Ireland)

- 2008-09: FDIC closed 11 banks headquartered in NV
  - Assets of over $40 billion =30% NV GSP
  - Losses incurred by FDIC of roughly $4 billion

- Federal loss sharing through Fannie Mae & Freddie Mac of $8 billion since 2008 (losses concentrated in Nevada, borne by federal government).
- Total direct 'loss absorption' : about 12 billion, 10 % of GSP.

- Not counted: High market share of out-of-state banks in NEV, also, partially in Ireland (HSBC, etc.) = Market banking union.

- => Total loss protection much higher; 20 % of GSP?

Foreign owned banks: a substitute for BU?

- Spain/Ireland did not have protection from a Banking Union.
- But market integration can mimic shock absorbing properties of BU: Foreign owned banks can absorb losses (and supervisors allow them to maintain exposure).
- Examples:
- In Baltics foreign banks had 80 - 90 % market share, absorbed most losses.
- (Exception Latvia where only significant local bank almost pushed the government into insolvency).
- Ireland: large UK banks also absorbed some losses.

Foreign owned banks: a substitute for BU?

- Foreign owned banks must be strong enough to carry losses.
- Magnitudes?
- Estonia about 5 % of GDP in loan write downs by Swedish banks.
- In US large banks have over 50 % market share and absorbed over 440 billion in writ downs (twice as much as FDIC + GSEs – not surprising as GSEs covered only 'conforming', i.e. low risk mortgages.
- => More shock-absorbing capacity from foreign owned banks than could ever be provided by any 'fiscal capacity' for EA?

But for small countries only?

Cross border risk sharing: US versus euro area

- In US most risky part (sub prime) were securitized and sold to capital market (a lot to gullible Europeans). Large US banks retained remaining risk.
- In Euro area cross border investment is usually in most secure or short term spectrum: interbank deposits (implicit ECB guarantee) and covered bonds (which have guarantee by banks and thus transfer little risk).
- Hybrid forms of capital mostly sold locally.
- => Existing form of financial market integration in euro area does not provide shock absorber.

Banking versus Monetary Union
Loss sharing and liquidity provision

		BANKING UNION	
		NO	YES
MONETARY UNION	NO	**ICELAND** : no liquidity, no loss sharing => adjustment brutal, default only way out if shock major	**BALTICS:** protection against losses via foreign owned banks, but no central bank liquidity => adjustment brutal, but mitigated by lower legacy losses.
	YES	**EURO AREA (Spain, Ireland)**: No loss sharing but central bank liquidity provision => adjustment delayed but eventually harder	**US e.g; NEVADA :** substantial protection against losses => adjustment market led but much easier given lower legacy losses

- Conclusion:

1. Banking union more important than monetary union?
2. Key ‘shock absorber’ for monetary union is banking union.