



TOWARDS A MORE INTEGRATED AND STABLE EUROPE?

National Bank of Poland

by

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Key points

1. Background: global credit boom and excess leverage.
2. EMU system not designed to handle state insolvency: bank public finance nexus.
3. Potential for self filling 'speculative attacks' or rather 'runs'.
4. => need institution to deal with sudden stops.

Key points I: lessons from history

Global credit boom led to excess leverage (debt/income) on both sides of Atlantic.

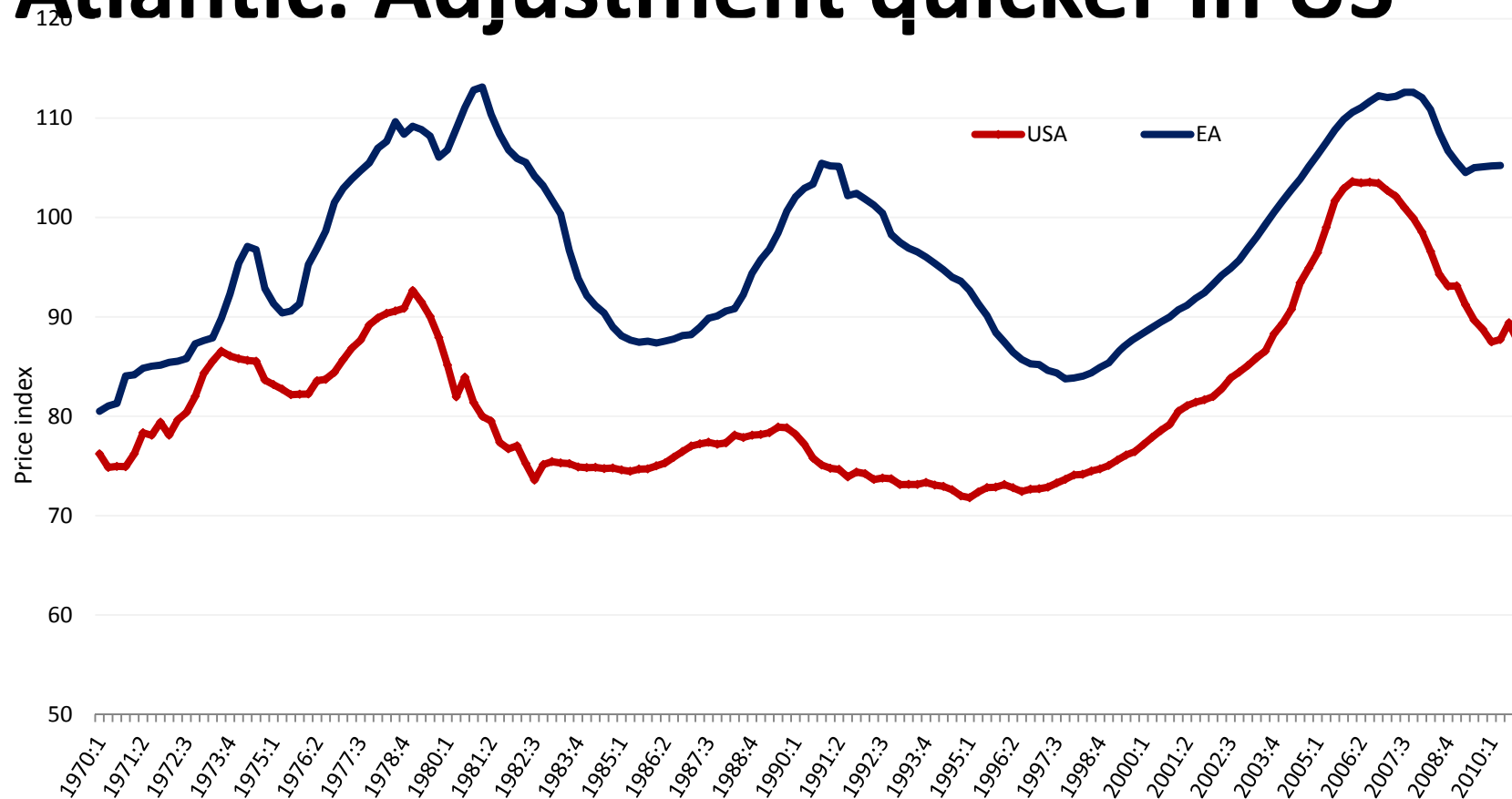
Leverage higher in euro area and concentrated on banks (compared to US).

Experience shows that 'deleveraging' takes time and induces long periods of low growth.

=> Little hope problem can be fixed quickly.

Sovereign defaults come in waves, after end of credit boom => better be prepared.

Real estate boom on both sides of Atlantic. Adjustment quicker in US



House prices: price-to-rent ratios. Source: OECD, March 2011. and authors' computations. Note: Euro area index is defined as the weighted average (by GDP) of Belgium, Germany, France, Italy, Spain, Finland, Ireland, Netherlands and Greece.

Transatlantic increase in leverage during boom. After bust US improves, EA not

Euro Area (% GDP)	Total debt	US	Euro area
1999		256	256
2007		334	335
2010		344	381

Source: Federal Reserve, Flow of Funds Z1 (outstanding debt), Eurostat and authors' calculations.
 Note: For the Euro Area debt is computed as sum of loans and securities other than shares, excluding financial derivatives (only loans in the case of HH). This definition broadly corresponds to the definition of the outstanding debt used in the US flow of funds.

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Leverage in EA banking system increases even after bust (contrary to US)

Euro						
Area (% GDP)	Non-financial Corporations	Financial Corporations	General Government	Households	Total economy	
1999	67	66	74	49	256	
2007	93	111	69	62	335	
2010	102	127	87	65	381	
US						
(% GDP)						
1999	63	76	51	67	256	
2007	74	113	51	96	334	
2010	75	101	76	92	344	

Source: Federal Reserve, Flow of Funds Z1 (outstanding debt), Eurostat and authors' calculations

Note: For the Euro Area debt is computed as sum of loans and securities other than shares, excluding financial derivatives (only loans in the case of HH). This definition broadly corresponds to the definition of the outstanding debt used in the US flow of funds.

Key points II: Inconsistency in EMU

EMU system not designed to handle state insolvency.

Regulatory system assumes government bonds are riskless* => banks hold capital on credit to euro governments without exposure limit.

But 'no bail out clause' implicitly assumes that a member could become insolvent.

(*True before EMU for domestic currency bonds when governments could always print enough domestic currency; but no longer true in EMU!)

Key points II continued

Banks and government tied together:

1) Banks hold large amounts of government debt:

Insolvent government = > insolvent banks (Greece, Italy?).

2) Without banks economy goes bust =>

Insolvent banks => government in danger (Ireland, Spain)

Financial system cannot handle state insolvency.

Key points III:

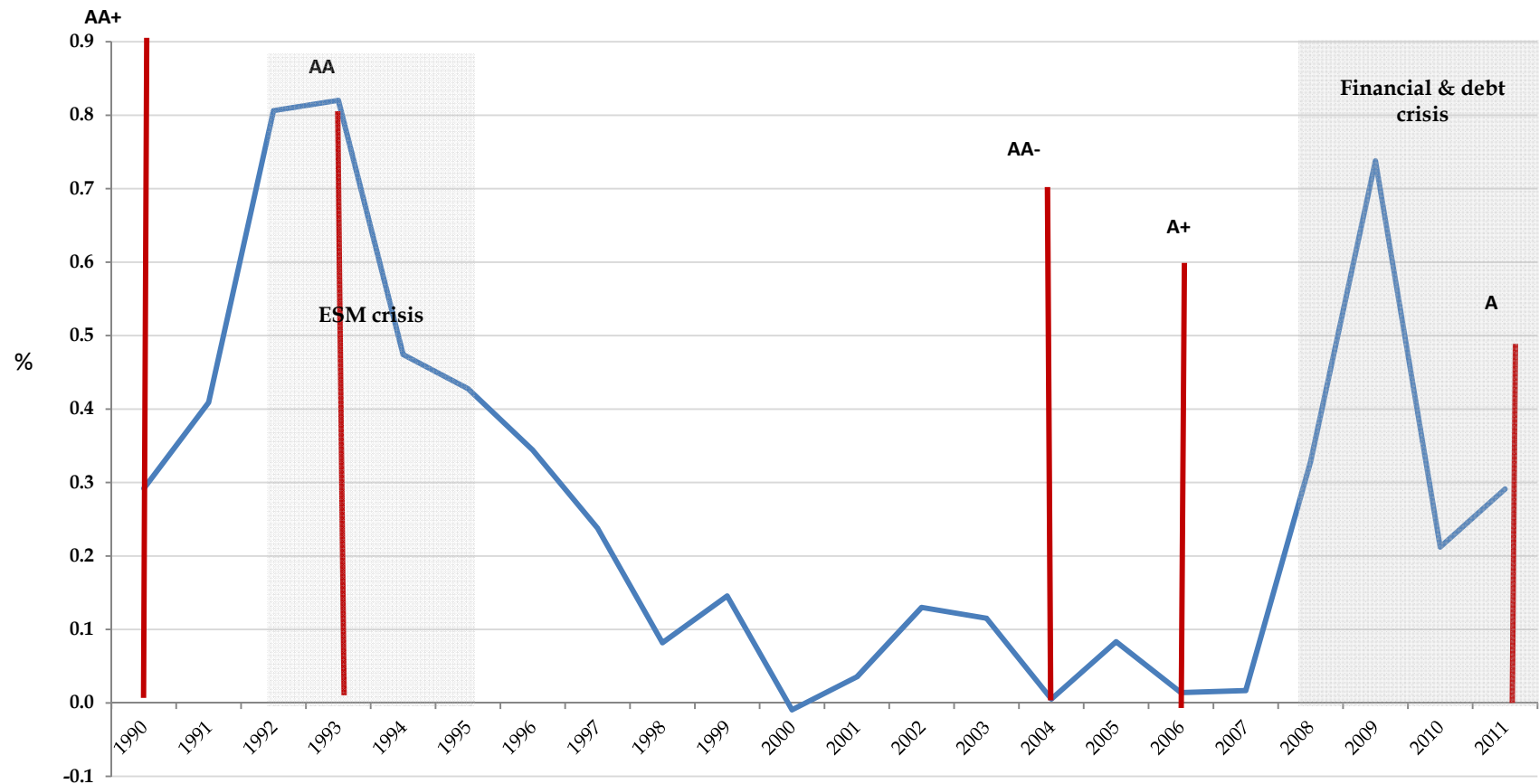
Potential for speculative attacks

At low interest rates Italy is solvent, but at higher interest rates it is not.

Problem not new created EMU to avoid it!

Italy today versus Italy during the 1990s:

Is the pressure bearable? The snowball factor (i-g) in perspective



Key points III:

Potential for speculative attacks

Italy today versus Italy during the 1990s:

Has Italy's 'resistance level' (social/political cohesion) diminished or is it a liquidity problem?

With lira Italy could not have a liquidity problem.

Today yes!

Absence of 'liquidity backstop' lowers value of bonds, creates potential for 'bank run'.

Key points III:

Potential for bank runs

Within euro area 'pain threshold' lower because of impact on financial system?

Key transmission mechanism: inter-bank market as banks lose access economy is affected.

⇒ positive feed back loop, need to intervene to mitigate: credit easing.

But: not all speculative attacks are without reason => who decides?

Conclusion and a proposal

Need European Monetary Fund (EMF) to deal both with liquidity and solvency problems.

EMF/EFSF should have two departments:

1. Adjustment and crisis management
2. Liquidity support

Department 1 needs 'capital' (fiscal resources).

Department 2 needs liquidity: from ECB.

How to finance the EMF (EFSF)?

Department 2 (most urgent now):

Register (or an SPV of the) EFSF or later ESM as bank (MFI) with access to ECB refinancing at normal conditions.

ECB tell EFSF: financial stability in danger?

Finance ministers (=EFSF) put taxpayer at risk:

1. how much to buy?

2. conditionality.

How to finance the EMF (EFSF)?

Parallel with IMF:

IMF is fully financed by ‘money creation’, i.e. by the central banks of member countries providing their own currency.

How to finance the EMF (EFSF) II

Leverage for 'ESM as bank':

ECB takes haircut of less than 5 % => could leverage 'own funds' of ESM up to 20 times.

If 100 billion are earmarked for secondary market purchases total potential intervention volume could be 2 000 billion.

(For comparison: Italy's publicly traded sovereign debt is about 1 500 billion.)

Refinancing the EMF (EFSF) by the ECB: legal issues

Prohibition of ‘monetary financing’: (Art. 123)

“any .. type of credit facility with the European Central Bank in favour of Union institutions,shall be prohibited, ..”

But EIB and KfW are exempted:

“2. Paragraph 1 shall not apply to publicly owned credit institutions which, .. shall be given the same treatment as private credit institutions.”

Refinancing the EMF (EFSF) by the ECB: legal issues

Prohibition of 'monetary financing' has exceptions:

Council Regulation (EC) 3603/93:

“The financing by the ECB of obligations falling upon the public sector vis-à-vis the IMF or resulting from the implementation of the medium-term financial assistance facility shall not be regarded as a credit facility within the meaning of Article 104 of the Treaty.”

Just extend exemption to EFSF/ESM?

No silver bullet

..... but gives us a fighting chance.

Refinancing the EMF (EFSF) by fiscal means: bond insurance

If problem is liquidity run (partial) bond insurance no solution.

'First loss' scheme implies official recognition that Italy is solvency problem.

Not incentive compatible:

In moderate bad scenario: ESM wants to avoid any losses => de facto eurobonds.

In catastrophic scenario: ESM determines size of loss through additional support => if Italy goes bankrupt losses likely to be very large.

Fundamental issue

- With 100-200 billion left in EFSF cannot provide credible fiscal insurance for IT + SP.
- Real problem:
- Sudden stop for all North - South lending.
- Reinforced by (Northern) regulators (e.g. HBV Unicredit case) !
- Given accumulated stocks and 'sticky' flows: unavoidable that ECB becomes 'clearing house' for cross border capital flows.

Long run reforms

- Need robust financial system which can take sovereign insolvency:
- Risk weights for sovereign credit (gradual based on debts/deficits, not only ratings).
- Limit exposure by country!
- EU deposit insurance corporation with risk weighted premia.
- Partial bond insurance via contributions to ESM based on deficits/debts