Hyman P Minsky Conference
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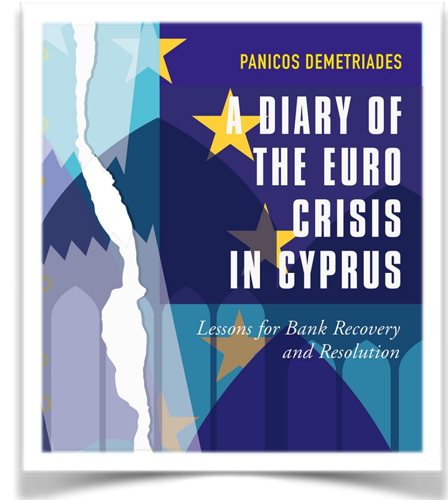
Session on Outlook for reform of the euro system



Central bank independence and the future of the euro

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Outlook for reform

- Much of the discussion has focussed on gaps in the euro's architecture
    - A European Deposit Insurance Scheme (EDIS) to complete the banking union - Germany demanding risk reduction (including reducing NPLs) before agreeing to Commission proposals
    - Disagreements between France and Germany centering around risk sharing vs risk reduction have meant that moves towards more risk sharing have stalled
    - Franco-German economists proposal aims to break the deadlock by recommending measures to both reduce risk and improve risk sharing
- Little discussion on whether the current architecture is working, instead Eurozone is congratulating itself for getting through the crisis with the euro intact

The euro has survived the crisis…but at what cost?

- Major setbacks to central bank independence (CBI)
  - Since 2014, four Eurosytem central bank governors have resigned or were removed from office (Cyprus, Slovenia, Latvia, Slovakia)
  - Others have come under political pressure to resign (e.g. Greece, Portugal)
  - Appointments of cronies and unqualified sympathisers on central bank boards
- Money laundering scandals have embarassed the ECB (Latvia, Estonia, Malta, Cyprus) and have exposed new financial stability risks (e.g. bank run on ABLV)
  - They have exposed the incompleteness of the first pillar of the banking union - banking supervision - as supervision of AML/CFT remains in the hands of NCBs and unclear sharing of responsibilities over ELA between ECB and NCBs
- ECB has struggled with its own legitimacy having taken on more powers and engaged in non-standard measures: has it violated its own independence (?)

Why has CBI been eroded?

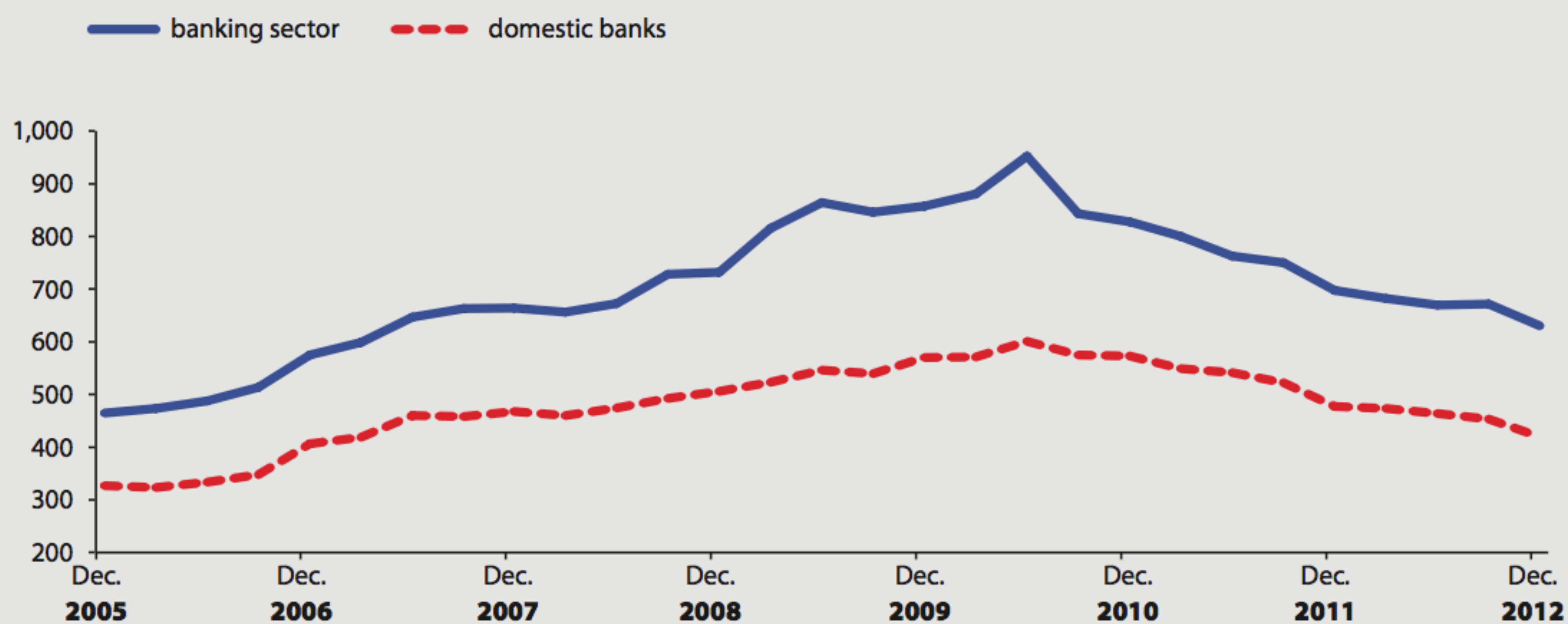
- In Cyprus and Slovenia: cleaning up failing banks, bailing-in bondholders and uninsured depositors
  - In both Cyprus and Slovenia central banks have both supervision and resolution responsibilities (this is the case in 10 euro area countries)
  - Latvia: money laundering and corruption allegations, involving Russian money and influence, following FINCEN sanctions on ABLV
- Germany: legal challenges and attacks on ECB for OMT and APP
- Greece, Slovakia, Slovenia, Cyprus and (now) Italy: governments forcing board members out and appointing sympathisers on boards
- Common theme - rise of “populist” governments, Commission failures to uphold the Treaties (e.g. rule of law in periphery) and narrow interpretation of independence by the ECB. Lack of clarity on ELA responsibilities

Why is Cyprus so relevant?

- The Cyprus crisis of 2012-13 demonstrates the imperfections of the euro's financial architecture
- Cyprus joined the EU in 2004 and the euro in 2008 - it liberalised its financial system and became part of the single financial market
- The euphoria that followed sowed the seeds of the crisis
- Risks were under-estimated as per Minsky's financial instability hypothesis
    - Cyprus ruling elite - lawyers, accountants and bankers - actively promoted Cyprus to Russian businessmen looking to "optimise" their affairs
    - Supervision of the banking system (including anti-money laundering) remained lax until risks were already too high
- The SSM was created to address possible capture of national supervisors

CYPRUS: GROWTH OF BANKING SYSTEM

Figure 6: Total consolidated assets of the banking sector as a percentage of GDP



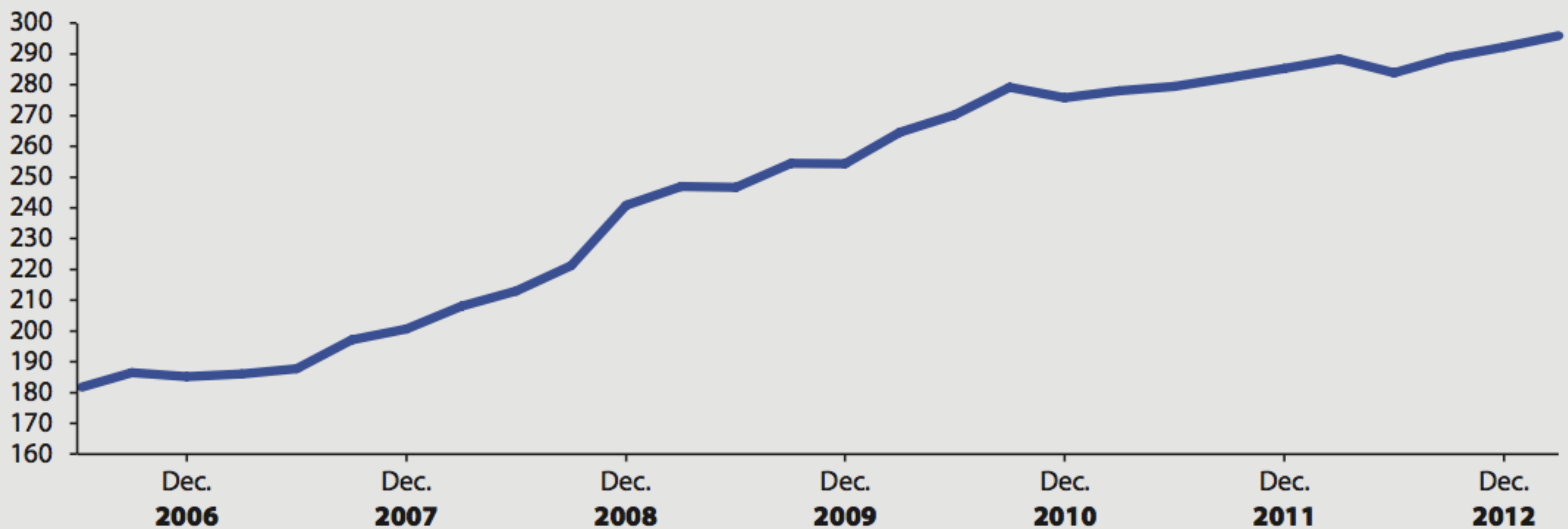
Source: CBC.

European rankings by assets/GDP

Number	Bank	Bank assets/GDP
1	Bank of Cyprus Group	211.1%
2	Cyprus Popular Bank Group	189.7%
3	ING Bank	176.7%
4	Nordes Bank Finland Group	152.5%
5	Rabobank	128.4%
6	Dexia	111.6%
7	Bank of Valetta	110.2%
8	Banque et Caisse d'Epargne de l'Etal	101.4%
9	HSBC Malta	100.3%
	National Bank of Greece	67.9%
	Eurobank	57.0%
	Alpha Bank	36.2%
	Piraeus Bank	26.3%

CYPRUS' EFFORTS FOR A MINSKY MOMENT

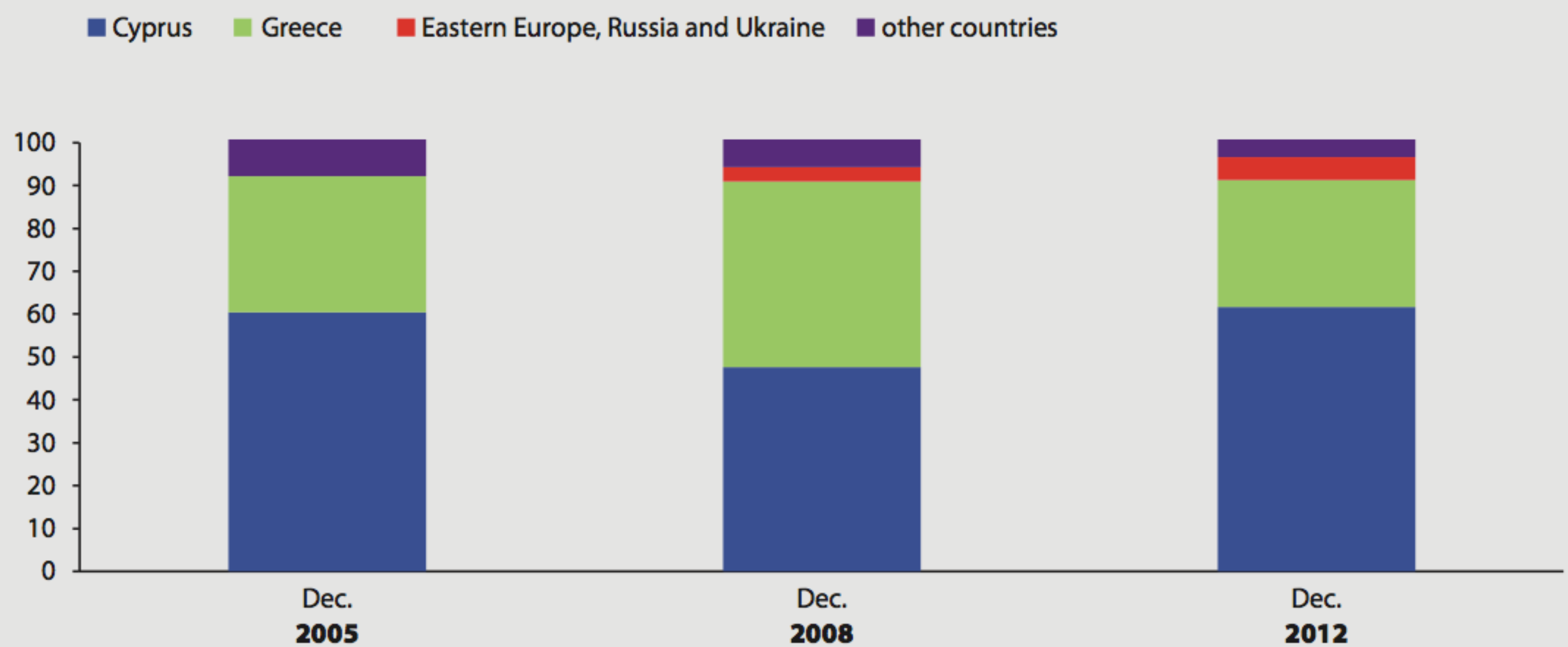
Figure 7: Bank credit to the private sector as a % of GDP



Source: CBC.

Cyprus' gamble for resurrection (Greece)

Figure 5: Asset allocation of the three Cypriot banking groups by country
(%)



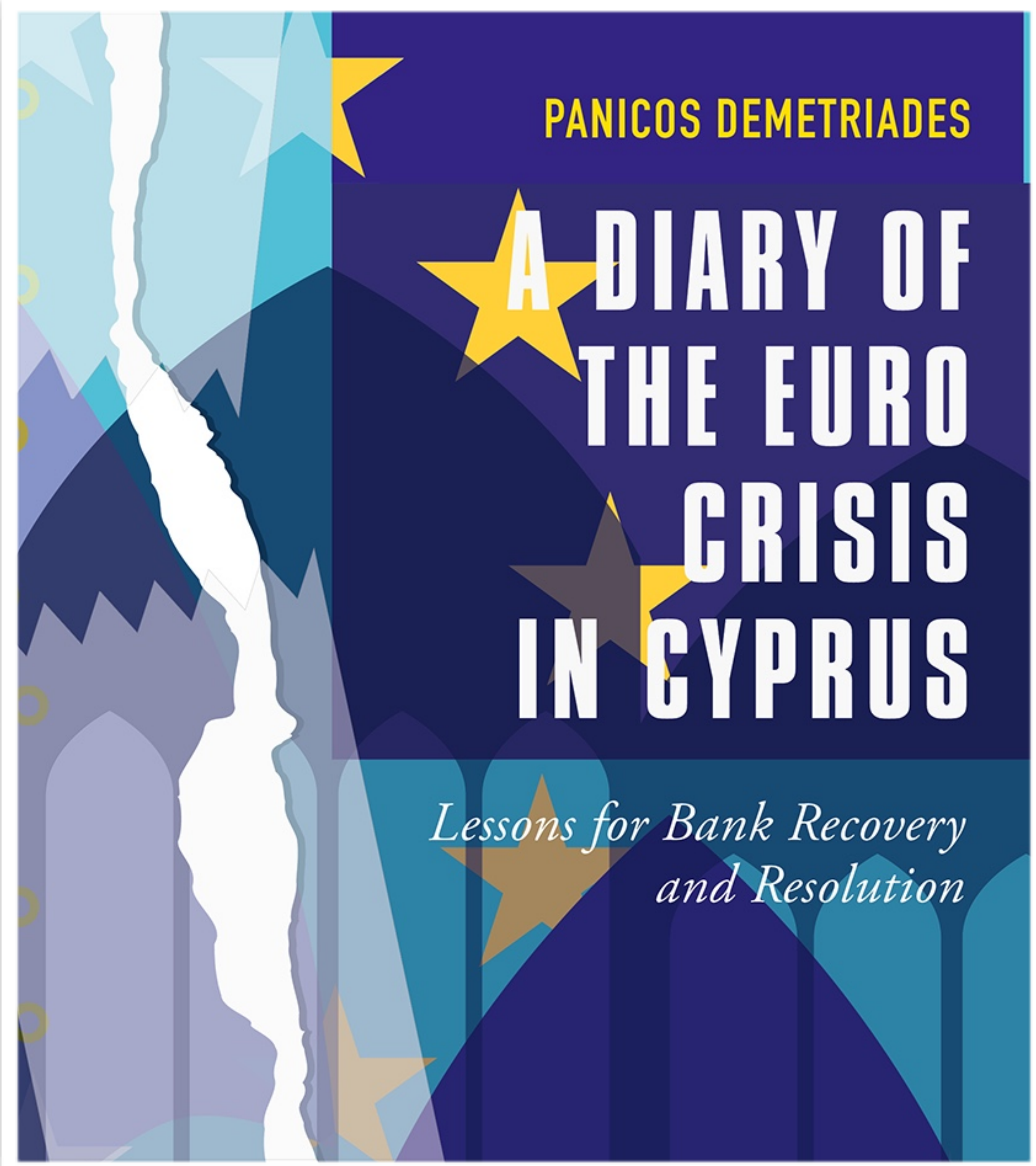
Source: CBC.

Timeline of crisis

- Dec 2011: EBA stress tests reveal capital shortfalls
- **3rd May 2012: Change of central bank governor**
- 6th May 2012: Laiki requests state aid followed by BOCY in June
- June 2012: Government applies for financial assistance
- November 2012: Troika agreement with Christofias' (outgoing) government
- December 2012: Eurogroup decides to wait for presidential elections in Feb 2013
- 16 March 2013: First Eurogroup agreement involving deposit levy
- 19 March 2013: Cypriot parliament turns down deposit levy
- 21 March 2013: ECB announces ELA decision for Cypriot banking system
- 25 March 2013: Final agreement between Eurogroup and new Cyprus Government involving bail-in of bondholders and uninsured depositors

The Cyprus crisis in a nutshell

- In 2013 Cyprus came close to becoming the first country to leave the euro. Its crisis was the result of unchecked capital inflows and under-estimation of risk, facilitated by a lax regulatory framework and politically connected law firms
- Bail-in protected public finances but had several unintended economic and political consequences, including erosion of central bank independence through legal changes to CB governance



Scope of central bank independence in the euro area

- The ECB interprets its own independence narrowly– as protecting its monetary function in its pursuit of its primary objective of price stability (Mersch, 2017).
- Mersch explains that such a narrow definition enhances the central bank's legitimacy, as independence places a central bank outside the normal process of democratic and political accountability
  - A clear and narrow mandate makes it easier for citizens to monitor its performance
- Moreover, only central bank Governors and members of the Governing Council of the ECB have personal independence safeguards
- For Single Supervisory Board only ECB appointed members have their personal independence protected
- ECB has been reluctant to protect NCBs facing political attacks for resolution or supervision actions

CBI setbacks in the euro area - do they matter?

- Answer is YES, here's a more recent example from Cyprus
    - Public inquiry into recent failure of coop bank revealed that CBC was trying to delay early intervention measures by SSM in 2017 to protect the gov't before the 2018 election
    - The coop bank had been bailed out with public money in 2013 (and ran by gov't since)
    - Cyprus government now scapegoating SSM for coop bank failure (alleging SSM was constantly shifting regulatory goal posts)
    - The fiscal cost: 20% of GDP as first instalment, second instalment could be up to 30% of GDP (€6 billion NPLs shifted to taxpayer)

Small countries matter

- Europe is as strong as its weakest link - small countries are systemic
    - Political money launderers will target small countries with elites that are susceptible to corruption and can lean on regulators
        - Once dirty money enters, it is a threat to the integrity of the single financial market, and could become a threat to democracy
- Erosion of central bank independence facilitates the capture of regulators by corrupt elites
- Erosion of central bank independence is contagious, may start from small peripheral countries but, if not tackled effectively, it could eventually reach the core (e.g. Italy now being a prime example)

Political money laundering

- In Europe, notwithstanding the creation of the SSM, the supervision of Anti-Money Laundering (AML) remains a national responsibility
- In small countries with large banking systems regulators can be inadequately resourced, captured by special interest groups or subjected to political pressures to turn a blind eye
    - Paul Manafort's trial highlighted how dirty money flowed from Ukraine to shell companies in Cyprus via a politically connected law firm
    - In 2018, EBA identified serious failings (breaches of EU law) in the supervision of Pilatus Bank by Malta's Financial Intelligence Analysis Unit
- A wave of recent scandals, including ABLV (Latvia) and Danske (Estonia), indicates that EU is as strong as the weakest link and that democracy itself is under threat

Six recommendations

My new book Central Bank Independence and the Future of the Euro (Agenda Publishing, 2019 forthcoming) recommends

1. Strengthening the governance of eurosystem central banks by introducing uniform fit and proper criteria for central bank boards
2. Creating a pan-European regulator for AML/CFT
3. Europeanising the provision of emergency liquidity assistance (ELA)
4. Separating out the SSM from the ECB legally or strengthen the protection of bank supervisors' independence
5. Removing resolution responsibilities from Eurosystem central banks
6. Increasing the presence and visibility of the ECB in euro area member states