



MAX-PLANCK-GESELLSCHAFT

MPI Gemeinschaftsgüter  
Martin Hellwig



# Governments, Banks, and the ECB in the “Euro Crisis”

Athens, November 2013

# A look at history: Weimar



- The myth of the reparations burden (Schuker 1988)
- Lack of identification of the elites with the state
- Lacking acceptance of impoverishment by war
- Fiscal irresponsibility: the civil service pay „reform“ of 1928
- Powerlessness of the Agent General under the Dawes Plan
- How can a dysfunctional polity be reformed?

# A look at history: Weimar



- Monetary policy provided government funding from 1914 to 1923, directly, or indirectly, through discounting bill of banks
- „Great banks“ assumed that they could always rediscount bills with the Reichsbank – poor liquidity positions
- 1931: Reichsbank tried to stave off the crisis by lending to insolvent Danat and Dresdner
- 1931: When they hit the 40% boundary for coverage of the currency, banks had to be closed
- Economic disaster followed.. and political disaster

# The Multiplicity of Crises



- Not a currency crisis! A combination of
- 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 banks are poorly capitalized and the mess of 2008 has never been cleaned up

# Sovereign Debt Crises and Banking Crises



- Sovereigns that don't make ends meet.
  - ... ask/coerce banks into funding them
  - ... cause bank insolvency from haircuts – Argentina, Greece
- Rescuing banks that are indebted in „foreign“ currency can overtax the power of the sovereign
  - ... and cause sovereign a debt crisis (Iceland, Ireland)
  - ... Which may cause the sovereign to lean on healthier banks....

# Politics of banking



- „Banks are where the money is“
- Use of banking regulation to obtain funding
- Sovereign carve out in banking regulation
- Long tradition of financial repression pre 1990
- Government funding – resurgence since 2008
- Real estate funding – concerns about voters and about local elites
- Industrial policy concerns – national champions

# Why the creditor bailout in 2010?



- German and French banks were significantly exposed
- Poorly capitalized, Excess capacity
- No cleanup in 2008/2009, rescue of everybody (except WestLB)
- Significant exposure to..... toxic assets, sovereign debt, cross-border bank debt, shipping loans...
- Sales of Greek debt to .... Cypriot banks

# Problems today



- Excessive Indebtedness – Governments, banks, households
- Lack of viable institutions and liability (Maastricht, SGP, Bank Bailouts)
- The Japanese temptation - „only a liquidity problem“
- Mix of politics – banking – banking supervision
- No willingness to downsize the industry
- „Banks are where the money is“ versus „banks are where the risk is“



# Why is there no progress?



- Lack of workable national discourse
  - Elimination of parliaments from discussion
  - Conflicts of agendas, within governments, between governments and opposition, between government, banks, the public, between the federal government and the Länder (Landesbanken)
- Illusions and populisms, lack of analysis
  - What are the problems? What are feasible strategies? What are the tradeoffs?
  - Example: should Greece leave the euro? ... What does that mean? .... A banking crisis, breakdown of the payments system, breakdown of...?

# Why is there no progress?



- Lack of a workable supranational discourse
  - Conflicts of creditors and debtors,
  - Clashes of personalities
  - Conflict Commission – Member States
  - Turf wars
- Lack of legitimacy
  - Elites versus public
  - Legal Tricks -
  - Banking Union as an example: Art 127 (6)

# Where are we going?



- Indebtedness of states, banks, private households is very high
- Regaining „competitiveness“ increases real burden of the debt
- Some cut of debt will be necessary
- Through resolution?
- Through monetization? Much easier: The ECB is weak because it is so strong!
- .... With or without institutional reform?

# ECB and moral hazard



- Moral hazard from ECB availability: The Greenspan put
- Many politicians have learnt that inspite of Maastricht they can get access to the printing press if they borrow from banks and th ebanks get into difficulties
- Strength of the ECB is a weakness
- Conditionality? Banking union?

# On the ECB



- German Paradox: The ECB is independent but it must not do anything different from the Bundesbank, especially not anything we dislike
- Legalisms: Prohibition of direct lending to governments versus license to do open market policy.
- Price stability as an objective – viability of the monetary and financial system not?

# On the ECB 2



- However the central bank introduces money into the economy, it produces windfalls
  - Banks
  - Issuers of securities
- LTROs
  - Inflationary?
  - Saving insolvent banks?
- Costs of intervention? Not only inflation!
- Central bank versus interbank markets as providers of liquidity

# What do we want?



- Overcome the crisis
- Establish a sustainable regime

## What went wrong?

- Lack of fiscal discipline
  - Maastricht? SGP? New pact?
- Lack of Market discipline
  - PSI?
- Lack of effective supervision
  - Supervision as a tool for making banks cough up money

# Fiscal discipline by imposition?



- Lack of political legitimacy
- Illusions about enforcement (SGP, Agent General)
- 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



# Lack of market discipline



- No exchange rate discipline (exchange rate as an indicator of current developments, brake on foreign borrowing)
- No consciousness of risk on the side of creditors (zero risk weights as a basis for asking for bailouts)
- Separate goods markets, differences in inflation rates and real interest rates as a main driver of imbalances – low real rates in the periphery enabled high growth in the early 2000s – and the buildup of risks

# Lack of Supervision



- Buildup of risks was not checked
- Zero risk weight rule for sovereign exposures
- Dangerous business practices (shadow banking activities) were allowed
- Forbearance („extend and pretend“) was and is tolerated
- Insufficient downsizing of the industry
- ... all in the name of national interests, sovereign funding, political and economic elites, competitiveness of „our“ banks
- ... and the desire to avoid a credit crunch

# The Japanese Risk



- Japan 1992: Denial – Deferral – Intransparency
- No cleanup of banks' books
- Continues operations of Zombies
- Continued lending to bad borrowers
- Too little lending to new firms
- 20 years of stagnation/depression
- Contrast: Sweden 1992

# Banking Union as a solution?



In principle yes, but ....

- „In the case of directives, the ECB will apply the national laws implementing the directives“
- Supervision without resolution?
- Asset quality review?
- Which banks (if any) will be closed
- And what about all the other tools of power by which national governments can impose on „their“ banks?

# German attitude



- Control of risks for ESM , ECB
- ... But also for own competence in banking supervision?
- ... And the competence of Spanish authorities in dealing with the cajas?
- The wonderful consistency of insisting that ECB must check on the real estate valuations in the books of the cajas, but not on the ship valuations in the books of HSH Nordbank

# A deeper problem



- Recovery and resolution require funding
- Contributions to deposit insurance and/ or restructuring funds
- ... Take too much time to build up
- ... Are insufficient in a crisis (US S&L's: \$123 bn. from taxpayers, \$ 29 bn. from industry)
- ... Need to bail in bank creditors
- ... Need for a fiscal backstop
- ESM insufficient

# A deeper problem



- Ultimately, support for banking system needs a recourse to taxation
- A European finance minister?
- A European tax base?
- In whose hands will this lie?
- What role for parliamentary participation in decision making?
- Is there enough time to develop a European polity that would provide for the requisite legitimacy?