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TESTIMONY ON THE EUROPEAN DEBT AND FINANCIAL CRISIS

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problems and banking problems, resulting in gradual contagion to m
and more asset classes. The banking and sovereign crises are com
crisis of the European Union institutions.
- Successful crisis resolution will need to include at least four comp
European level, in addition to steps to be taken by individual co
federalism' banking federalism' a profound overhaul of EU/euro-a
and short-term arrangements that chart a path towards the com
previous three points.
- These requirements for crisis resolution cannot be met unless politi
change sharply in their favour, which leaves the United States and t
nomy exposed to the risk of financial contagion. However, only th
themselves can solve their current predicament.

TESTIMONY ON THE EUROPEAN DEBT AND FINANCIAL CRISIS

NICOLAS VÉRON, SEPTEMBER 2011

bridged this gap with policy initiatives that go beyond a narrow reading of their mandate, but they could do so only to a limited extent that has not been sufficient to stop the contagion.

- Fourth, a successful crisis resolution will need to include at least four components at the European level, in addition to steps to be taken

Europeans themselves can solve their current predicament.

These remarks should not be taken as unduly pessimistic. In the US public debate, one frequently hears the euro area described as an inherently unsustainable experiment, and European nations as incapable of reform. Such dark depictions of the European situation are unhelpful and misleading. European monetary union is certainly an experiment, but it is not doomed to fail: euro-area countries have shown and are showing an extraordinary degree of political commitment to perpetuate their currency union. They have already taken very significant institutional steps towards more centralised economic and financial management since the beginning of the crisis, and are gradually accepting the need for further steps, even though the process is not as swift as external observers might wish. Most euro-area periphery countries have taken very serious and painful initiatives to reform and place themselves back on a sustainable economic track. And elections in many European countries since the start of the crisis have shown that the vast majority of senior creditors were made whole in almost all cases of individual bank problems, and so were junior creditors in the vast majority of cases.

In the spring of 2009, the US Supervisory Capital Assessment Program (commonly known as 'stress tests') identified ten of the country's 19 largest financial institutions as undercapitalised, and the subsequent wave of capital strengthening helped investors regain trust in the institutions at the core of the US financial system, even as smaller banks continued to fail in large numbers in 2009 and 2010. In the EU, no similar process of triage and recapitalisation was conducted in time to restore confidence. A first round of European stress tests in September 2009 had negligible market impact as only aggregate numbers, not bank-by-bank results, were published. A second round of stress tests led to the publication of bank-by-bank results for 91 financial institutions across the EU in July 2010, but the disclosures lacked specificity and comparability, and some institutions that had passed the tests, such as Allied Irish Banks, were exposed as severely undercapitalised shortly afterwards. A third round of stress tests led to better disclosures in July 2011, but identified only limited recapitalisation needs.

The European reluctance to accept bank failures and banking sector restructuring can be traced to various factors. To start with, banks are comparatively much larger in Europe than they are in America, compared with the size of national economies and even after the consolidation that the crisis has induced on the US side. According to the Bank for International Settlements, in 2009, the aggregated assets of the top three banks represented 406 percent of GDP in the Netherlands, 336 percent in the UK, 334 percent in Sweden, 250 percent in France, 189 percent in Spain, 121 percent in Italy, and 118 percent in Germany, compared with 92 percent in Japan and 'only' 43 percent in the US. This is due to a combination of two main factors. First, banks generally play a larger role of financial Settl the ongoing restructuring of the Spanish banking sector might eventually result in a change in attitudes there. The same factors help explain why national policymaking communities are often in collective denial of the moral hazard created by the too-big-to-fail problem, as well as in denial of the conflicts of interest that are potentially embedded in the universal bank model which combines retail banking, investment banking, plus in many cases asset management, insurance activities, and proprietary investment within diversified financial conglomerates. In many continental European countries, supervisory authorities harbour a culture that favours keeping sensitive information tight between themselves and the supervised entities, and are thus inclined to resist calls for public disclosures about financial risks and exposures, as was illustrated by controversies around the successive rounds of European stress tests.

Banking crisis and sovereign crisis

The financial crisis spilled over into a sovereign crisis in the euro area in early 2010. A year before, in the first months of 2009, the tense situation of several central and eastern European countries had raised widespread market concerns, but was
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successful international coordination in the form of the so-called Vienna Initiative to maintain liquidity to local banking systems. The euro-area
sovereign crisis started when the governmS2 gsBT/.1(h)1 of
Greece, freshly elected in October 2009, revealed that its predecessor had misled its euro-area
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Similarly, the perceived fragility of continental European banks is the main reason why the Irish government was not allowed to impose losses on holders of senior bonds issued by the country's banks, including the collapsed Anglo Irish Bank, in the discussion of the November 2010 assistance package provided by the IMF and the EFSF, with a strong involvement of the ECB in the negotiation of that package. This condition correspondingly increased the burden of fiscal adjustment for Ireland and remains to this day a matter of controversy in the Irish political environment. Conversely, deterioration of sovereign debt prospects in Greece, Portugal, and Italy has had a knock-on negative effect on their domestic banking systems, given local banks' high levels of home-country sovereign debt exposure, as well as on French banks which hold large portfolios of sovereign debt from the euro-area's periphery countries.

In the latest step to date, a relatively mild debt restructuring scheme euphemistically known as 'private sector involvement' L07.1(e)2(1.2(e)15.2(0(d an)2s)8.(t)18.1(t)28.8(e)0.01 Tc0.32331.2(o)15
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European Commission, with the significant exception of DG COMP, has not been able to make executive decisions that it could impose on individual market participants. Its Directorate-General for the Internal Market and Services has focused on drafting new financial legislation but has devoted limited resources to its core mission of enforcing the integrity of the single market for financial services. Its Directorate-General for Economic and Financial Affairs has provided valuable economic analysis, but so far has not presented a blueprint for crisis management instruments that would bring the situation under control.

The Commission's President, José Manuel Barroso, has been very successful and proactive on one important occasion, when he commissioned a report from a blue-ribbon group led by former French central banker Jacques de Larosière, which resulted in a major overhaul of the EU's supervisory architecture (see below). But in terms of crisis management, the Commission has generally not been able to get ahead of events, partly because of its limited de facto decision-making autonomy vis-à-vis member states (apart from DG COMP, which enjoys special status). This has left much of the action in the hands of the Council, ie the group formed by relevant representatives of the individual member states' governments, who, being accountable as they are to their respective national constituencies, have found it difficult to overcome their differences.

This is better analysed as a failure of institutions than of individual leaders. A different set of political leaders might have done better, but the core problem has been the insufficient political mandate of the Commission (and of the permanent president of the Council since the entry into force of the Lisbon Treaty in January 2010, Herman Van Rompuy), combined with the misalignment between the incentives of individual countries' leaders and the collective European interest. This combination works more or less satisfactorily in ordinary times, but its shortcomings become much more apparent in a crisis environment as it does not allow for effective executive decision-making at the EU level. The 'French-German couple' is occasionally presented as a pragmatic option to bridge the executive leadership gap, but its accountability and legitimacy have been insufficient to provide the required impetus.

In the course of the crisis, individual EU bodies have occasionally found it possible to bridge part of the executive leadership gap. This has been most obviously the case of the ECB, particularly since May 2010 with the Securities Markets Programme of buying sovereign bonds from selected euro-area countries on the secondary markets. However, the extent to which the ECB can go further on this path is not unconstrained, because it is seen by a number of constituents (notably in Germany) as a dangerous intrusion into fiscal policy that is bound to compromise the ECB's independence and its integrity in delivering on its core mission of ensuring price stability. Similarly though less prominently, since 2008 DG COMP has leveraged its authority to examine state aid by individual member states to individual financial institutions to press for more aggressive recapitalisation of the weaker links in Europe's banking system, but its mandate has not allowed it to embark on a system-wide approach.

As mentioned, a high-level group led by Jacques de Larosière was formed in late 2008 at the initiative of the European Commission's President, and in February 2009 this group recommended the creation of three European Supervisory Authorities to help oversee Europe's financial sector from a pan-European perspective – respectively, the European Banking Authority (EBA) based in London, the European Securities and Markets Authority (ESMA) based in Paris, and the European Insurance and Occupational Pensions Authority (EIOPA) based in Frankfurt. These supervisory authorities were complemented by the creation of a European Systemic Risk Board (ESRB) to coordinate macroprudential policy. The corresponding EU legislation was (by EU standards) swiftly approved and the new institutions officially started operations on 1 January 2011. Even though it is still early to form a judgement, the EBA has had a material impact in making the disclosures accompanying the July 2011 stress tests markedly more reliable than had been the case in the previous round a year earlier. Thus, it can be hoped that these new agencies can bridge part of the leadership gap in the future as they gather institutional strength. However, as with the ECB and DG COMP, their mandate is limited and cannot be overextended to matters that entail major dimensions of political legitimacy and accountability.

The European Parliament has been gaining competencies in successive revisions of the European treaties, and is now an important player in shaping legislation. However, its oversight powers on the EU institutions, especially the Council, remain restricted in comparison to most national parliaments. Moreover, the European Parliament, unlike lower houses in democratic regimes, is not elected on the basis of electoral constituencies of about-equal demographic weight, as smaller EU member states elect more Members of the European Parliament (MEPs) than larger ones in proportion to their population. These shortcomings have led Germany's Federal Constitutional Court, in a landmark ruling in June 2009, to find the EU institutions not democratic enough to be granted powers in key areas of sovereignty, including fiscal policy.

In the words of the Court, [illegible]

between the present turmoil and an ultimate crisis resolution that would include the previous three components.

The first component, fiscal federalism, already exists in Europe in indirect forms, including the borrowing capacity of the European Commission and the European Investment Bank (which are however tightly limited) and the collateral policy of the ECB, which allows it to take risks with an ultimate guarantee from member states. A further tentative step was taken in the direction of building a euro-area fiscal federation with the creation of the EFSF, even though its design is strictly intergovernmental, and the decision to provide loans to struggling euro-area countries at below-market rates. However, none of this prevents the possibility of fiscal or economic mismanagement or financial shocks in individual member states putting the stability of the entire monetary union at risk, as is now the case.

A vivid debate in Europe centres on the possible practical form of such fiscal federalism. One much-discussed proposal, by my Bruegel colleagues Jacques Delpla and Jakob von Weizsäcker, would have euro area members pool debt issuance up to 60 percent of their respective GDP in the form of euro area-wide 'blue bonds', and meet any additional funding needs through higher-yielding 'red bonds' that would instill market discipline at the level of individual countries[1]. Another option, typically referred to as 'Eurobonds', would be to federalise all sovereign borrowing in the euro area under a joint and several guarantee from all euro-area countries. A more limited approach, first suggested by Daniel Gros at the Centre for European Policy Studies and Thomas Mayer at Deutsche Bank, would be to allow the EFSF to leverage its current resources and vastly expand its lending capacity by allowing it to borrow from the ECB. All these proposals imply new mechanisms to discipline the economic policy behaviour of individual member states and mitigate the moral hazard inherent in any pooled borrowing scheme.

In a landmark speech in Aachen on 2 June 2011, ECB President Jean-Claude Trichet outlined what he sees as the necessary next steps: in a first step, "in the medium term", giving the European Council, on the basis of a proposal by the European Commission and in liaison with the ECB, the right to veto national economic policy decisions that may be harmful to euro area stability; and in a second step, "in the historical long term", establishing a European 'ministry of finance' that would exert ongoing surveillance of both fiscal policies and competitiveness policies, that could take over direct responsibility for economic policy in failing countries, and that would also exert responsibilities in financial sector policy and external representation. Even though he did not specify how this intrusive authority could be legitimised from a political standpoint, this vision emphasises the need for executive decision making capacity at the core of the future fiscal federal framework, as not all future policy challenges can be captured in a set of ex-ante rules and automatic sanctions, no matter how well designed.

The second component of eventual crisis resolution, banking federalism, also exists in embryonic form in the EU, with a largely though not completely harmonised banking regulatory framework in the form of EU financial legislation, and the recently created EBA which was endowed with limited supervisory and crisis management competencies. Even so, however, most supervisory and resolution authority still rests with member states, and so does a still significant amount of rule making that affects financial institutions, on conduct of business and consumer protection but also on prudential aspects as is illustrated by the current debate about the recommendations of the Independent Commission T*-0.sd iIN17.1(e)22(b)34.223.9(h)A whic1z.8(an ls)8.5.2(n)17.1(s
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regulatory, supervisory, resolution, deposit guarantee, and competition policies with regard framework. Here too, in addition to action at the level of individual member states, the twin issues of banking crisis and sovereign crisis need to be addressed.

A central role could be played by an instrument to be created on an explicitly temporary basis, analogous to the Resolution Trust Corporation (RTC) that brought about the resolution of the US savings and loan crisis in 1989-90. More than two years ago, in June 2009, Bruegel and the Peterson Institute published an analysis in which Adam Posen, now on the Monetary Policy Committee of the Bank of England, and I suggested a blueprint for such a European RTC, or as we termed it with reference to a German precedent a 'European Banking Treuhand'[3]. The role of this ad-hoc entity would be to catalyse and steer the necessary restructuring and cross-border consolidation of Europe's banking sector, by identifying which institutions are undercapitalised on a consistent basis across national borders, by taking over and restructuring those that cannot find enough capital from arm's-length sources, and by managing the corresponding assets and reselling them when market conditions allow. In the context of the sovereign crisis, this trust corporation could play an additional stabilising role by ensuring the orderly functioning of the banking system in countries which undergo a sovereign debt restructuring. To fulfil its role, it would require enabling legislation passed in emergency by all relevant member states.

With a proper framework in place to manage banking emergencies on a consistent, system-wide basis, the euro area could envisage energetic debt restructuring in member states that cannot meet their obligations, which I believe to be the case for Greece alone at this point. This would send shockwaves through the system but would also contribute to a reduction of uncertainty. It would need to be backed by enhanced liquidity assistance to other member states. The most likely option for this in the short term is expanded intervention by the ECB, possibly through the of financial distress. Its aggregate debt and deficit metrics compare favourably to the US, UK or Japan.

The IMF has played a very constructive role since the beginning of the crisis. Beyond the financial assistance it has provided to Greece, Ireland and Portugal, it has brought invaluable experience and technical input to the discussion among Europeans. The US government, together with other non-European countries, has provided pointed advice at critical moments. But none of these external partners of Europe can unlock the key bottlenecks in the current phase, which are primarily political in nature.

Financial contagion to the US from further deterioration in the euro area cannot be ruled out. In spite of the recent downgrading by Standard and Poor's, US sovereign debt retains safe haven status and I do not expect this to change in the short term, including in the case that things would take a sharp negative turn in Europe. However, because of multiple financial interdependencies across the Atlantic, deterioration in Europe could have financial impact in the US. These transatlantic contagion risks can be mitigated to an extent by appropriate contingency planning and enhanced dialogue between financial supervisory authorities in the US, on the one hand, and the US arms of European financial firms, as well as US financial firms with financial exposure to Europe, on the other hand. Under the current circumstances, the US should not overreact and financially ring-fence itself from the rest of the world to an extent that would compromise global financial integration from which the US is one of the key beneficiaries. Thus, precautionary measures are warranted but should remain proportionate. This seems to be the current mindset of US financial authorities.

The Federal Reserve is also participating, together with others of the world's prominent central banks, in a network of currency swaps with the ECB that facilitates the access of euro-area banks to liquidity in dollars and other non-euro currencies. The benefits of this initiative in terms of financial stability, at the global level and also from the strict domestic point of view of the US, appear to vastly exceed the risks involved to the Federal Reserve.

The US, the IMF and others global partners have an important role to play by providing advice and what John Maynard Keynes called ruthless truth-telling to their European partners. Many Europeans still find it difficult to acknowledge the extreme seriousness of the current conditions in the euro area. Expressing concern in constructive but frank terms can help, as Secretary Geithner apparently did in a mid-September visit to Poland[5]. But, once again, only the Europeans themselves can meaningfully address their current, dangerous situation.

5. For further information and an analysis of this see Guntram B. Wolff (2011) [illegible], available at http://www.bruegel.org/publications/publication-detail/publication/608-why-we-should-listen-to-tim-geithner/ (accessed 22 September 2011).