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# TESTIMONY ON THE EUROPEAN DEBT AND FINANCIAL CRISIS

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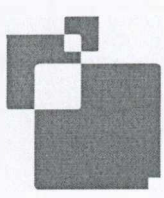
## Highlights

- Europe's banking system has been in a state of systemic fragility since 2007-08. The current phase is marked by a sequence of interactions between sovereign problems and banking problems, resulting in gradual contagion to more countries and more asset classes. The banking and sovereign crises are compounded by a crisis of the European Union institutions.
- Successful crisis resolution will need to include at least four components at the European level, in addition to steps to be taken by individual countries: fiscal federalism; banking federalism; a profound overhaul of EU/euro-area institutions; and short-term arrangements that chart a path towards the completion of the previous three points.
- These requirements for crisis resolution cannot be met unless political conditions change sharply in their favour, which leaves the United States and the global economy exposed to the risk of financial contagion. However, only the Europeans themselves can solve their current predicament.

This Policy Contribution reproduces the written statement prepared by the author for the hearing on *The European debt and financial crisis: origins, options and implications for the US and global economy* at the Subcommittee on Security and International Trade and Finance of the US Senate Committee on Banking, Housing, and Urban Affairs, on 22 September 2011. Nicolas Véron (n.veron@bruegel.org) is a Senior Fellow at Bruegel and a Visiting Fellow at the Peterson Institute for International Economics.

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# TESTIMONY ON THE EUROPEAN DEBT AND FINANCIAL CRISIS

NICOLAS VÉRON, SEPTEMBER 2011

THE EUROPEAN CRISIS is entering a critical phase because policy initiatives undertaken so far have not prevented systemic contagion. I will concentrate my remarks on the role of Europe's banking system in the crisis, the steps needed at the European level for the crisis to be resolved, and the short-term outlook. The key points of my statement are the following:

- First, Europe's banking system has been in a continuous stage of systemic fragility since 2007-08, in contrast with the United States where banking crisis resolution was swifter and was essentially completed in 2009. The inability of European policymakers to resolve their banking crisis so far can be explained by deeply-embedded features of their respective countries' financial systems and political economy structures.
- Second, the current phase, which is often described as a sovereign debt crisis, is really a sequence of interactions between sovereign problems and banking problems. Had western Europe's banks been in a better shape a year and a half ago, the policy approach to the Greek debt crisis would have been entirely different, possibly allowing for a much earlier sovereign debt restructuring. So the situation is best described as twin sovereign and banking crises that mutually feed each other. The result of this interaction is a gradual contagion to more countries and more asset classes.
- Third, the crisis has exposed a major deficit of executive decision-making capability in the EU and euro-area institutional framework, which helps to explain the insufficient policy response. It can thus be said that the banking and sovereign crises are compounded by a crisis of the EU institutions themselves. Specialised European bodies, primarily the European Central Bank (ECB), have partly 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 by individual countries: (a) fiscal federalism, ie mechanisms that ensure that fiscal policies in the euro area are partly centralised with shared backing across countries so as to meet the requirements of monetary union; (b) banking federalism, ie a framework for banking policy at the European level that credibly supports the vision of a single European market for financial services; (c) an overhaul of EU / euro-area institutions that would enable fiscal and banking federalism to be sustainable, by allowing centralised executive decision-making to the extent necessary and by guaranteeing democratic accountability; and (d) short-term arrangements that chart a path towards the completion of the previous three points, which is bound to take some time. These should involve expanded instruments to intervene in the banking sector and to provide interim funding to struggling euro-area governments, taking into account the possibility of insolvent member states having to undergo debt restructuring.
- Fifth, these requirements for crisis resolution cannot be met unless political conditions change sharply in their favour. This leaves the US exposed to a risk of financial contagion, which it can partly mitigate with adequate contingency planning and proportionate precautionary measures. The US can and should also continue to play a constructive role by providing advice to its European partners, and thus helping them rise to the momentous challenges they face. However, only the



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 citizens resist the temptation of populism and are willing to embrace the needed adjustment policies.

I believe that the integrity of the euro area will be defended in this crisis and that the EU will eventually emerge with a stronger, more resilient economic and financial policy framework. But the road will be very bumpy, and Europeans will pay a high economic price for the inadequacies of their collective decision-making processes.

The rest of this statement expands on these points and provides additional background.

#### Europe's banking crisis

Europe has been in a continuous state of systemic banking fragility since August 2007. This puts it in contrast with the US where the phase of

systemic banking crisis ended in 2009, even though the broader economic crisis has proved difficult to address and casts a shadow on America's long-term fiscal outlook. One indication of Europe's prolonged state of fragility is that the ECB's extraordinary liquidity support to euro-area banks (in the ECB's parlance, fixed-rate full allotment in refinancing operations), introduced in October 2008, remains in place to this day. By contrast, the closest comparable programme on the US side, the Federal Reserve's Term Auction Facility, was gradually phased out and expired in March 2010. Similarly, in October 2008 the European Commission's Directorate-General for Competition Policy (DG COMP) made its enforcement practices on the control of state aid to the banking sector more flexible on the basis of Article 87.3b of the European Community Treaty, which allows for aid "to remedy a serious disturbance in the economy of a member state". This adaptation of competition policy to crisis times has been continuously in place since then, and European Commissioner for Competition Policy Joaquin Almunia recently announced that it would remain so until early 2012 at least.

In comparison with the US, the European banking sector has until now gone only through modest restructuring as a consequence of the crisis, particularly in the euro area. Among major European financial institutions, only Halifax Bank of Scotland (HBOS) in the United Kingdom and Fortis in the Benelux countries were dismantled or forcibly merged into competitors at the height of the crisis, in comparison to Countrywide Financial, Bear Stearns, Lehman Brothers, American International Group, Washington Mutual, Wachovia and Merrill Lynch which were merged or restructured in the United States. Moreover, the US bank receivership process administered by the Federal Deposit Insurance Corporation meant that a significant number of small-and medium-sized banks (and some large ones, such as Washington Mutual) were allowed to fail. In Europe, where most countries did not have an orderly resolution process for depository institutions in 2008-09,

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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 intermediation in Europe than in the US, where non-bank financial intermediaries and capital markets provide a larger share of total capital and credit. And second, many European banks have aggressively expanded internationally, thus

increasing the scope of activities that, to the extent that these banks aren't allowed to fail, are implicitly supported by taxpayers in the home country. On average, the largest European banks have 57 percent of their activity outside of their home country (in the rest of Europe and in the rest of the world in about equal proportions), while the average ratio is only 22 percent among a comparable sample of the largest US banks.

Moreover, there is a high degree of interdependence between banking systems and policymaking systems in most western European countries. This interdependence also exists in the US, and its specific forms vary widely from one country to another. In Germany, many locally elected officials sit on the boards of local public banks, an activity from which they typically derive a significant part of their personal income; publicly-owned banks at regional (*Land*) and sub-regional levels are often used as tools for local economic-development policy. In Spain, a similar situation used to exist with the local savings banks (*Cajas*), even though this is now changing as many *Cajas* are being merged and restructured under compulsion from the central government. In Italy, non-profit foundations with strong links with local political establishments are key shareholders in most prominent financial institutions. In France, the regional component is perhaps less strong but at the national level, financial policymakers and bank executives tend to come from the same small pool of senior civil servants, and it is common practice for the former to switch to a high-level bank position at mid-career. In all these countries and elsewhere in Europe, this interdependence is a significant factor in the national political economy.

Moreover, the protection granted by national governments to their 'home' banks does not have to be a function of cozy links between public and private-sector elites, as there is also a strong component of economic nationalism at play. In most euro-area countries, banks are frequently seen as national or local 'champions' whose prosperity is presumed to be broadly aligned with the national interest – even where this presumption does not rest on specific, compelling evidence. Resistance to cross-border bank takeovers remains deeply entrenched particularly in France, Italy and Spain but also in parts of northern Europe – even though

*'In many European countries, supervisory authorities harbour a culture of keeping sensitive information tight between themselves and the supervised entities, and thus are inclined to resist calls for public disclosures about financial risks and exposures.'*

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 subsequently stabilised thanks to energetic efforts of economic reform and budget tightening, most remarkably in the Baltic countries, and to 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 government of Greece, freshly elected in October 2009, revealed that its predecessor had misled its euro-area neighbours and the public about the true state of the country's public finances. The ensuing deterioration of Greece's access to capital markets led it to seek help from fellow euro-area countries and the International Monetary Fund (IMF), resulting in the May 2010 announcement of a first conditional assistance package of €110 billion, quickly followed by the decision to set up a European Financial Stabilisation Facility (EFSF)

with €440 billion in financial firepower to intervene in similar situations. Simultaneously, the ECB initiated a 'Securities Markets Programme' under which it buys sovereign debt of troubled countries in secondary markets. Subsequently, the EFSF and IMF jointly agreed to provide conditional assistance packages to Ireland (November 2010) and Portugal (April 2011), and in July 2011, further assistance to Greece was decided by the euro-area heads of state and government.

The interdependence between sovereign credit and banking systems has been a running theme of this sequence of events. Euro-area sovereign debt assets are held in large amounts by euro-area banks, with a significant bias for the bonds of the country in which the bank is headquartered but also significant cross-border exposures to other euro-area countries' sovereign debt. This is partly due to policy choices before the crisis which in retrospect appear questionable, particularly the risk-weighting at zero of euro-area sovereign bonds in regulatory capital calculations, the long standing acceptance of such bonds with no haircut by the ECB as collateral in its liquidity policies, and possible instances of moral suasion by home-country public authorities that resulted in large holdings of the home country's sovereign debt. In early 2010, the concern about the possible financial stability consequences for banks in France, Germany and other countries of having to book losses in the event of a Greek debt restructuring was a significant motivation for the decision to provide financial assistance to Athens. Even though it is impossible to know counterfactuals, had the western European banking sector been less fragile at that time, it is very possible that a different course would have been taken involving Greek debt restructuring as early as 2010, and everything afterwards would have developed very differently. Put bluntly, the moral hazard created by the Greek package is largely a consequence of the failure or unwillingness of European policymakers to resolve the European banking crisis in 2009.



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' (PSI) was made a condition for the new assistance package to Greece whose outline was announced on 21 July 2011, largely because of domestic political factors in countries including Germany and the Netherlands. However, the continued banking fragility led leaders to go for a 'voluntary' form of PSI that would only entail moderate impairment of the affected assets. This arguably results in the worst of both worlds for Greece and the euro area: a further deterioration of Greece creditworthiness (PSI being considered 'selective default' by the main credit rating agencies) and contagion to other euro-area countries, in spite of solemn declarations that the Greek case is unique and would not be used as a template for other country situations; and simultaneously, a reduction of the Greek debt burden that is too limited to significantly improve its debt dynamics.

The interconnectedness between the banking and the sovereign crises helps to explain the lack of consensus about the current capital strength of

Europe's banks. The official position of EU authorities and all euro-area governments remains that, with the possible exception of Greece, euro-area countries are not going to default on their sovereign obligations. Under this assumption, the current depressed market prices of periphery countries' debt need not be reflected on the balance sheets of banks with large held-to-maturity portfolios of such debt, and the European banking sector would appear adequately capitalised as a whole. If, however, market signals are taken at face value, or simply if a prudential approach is applied that compels banks with high exposures to periphery sovereigns to hold sizeable additional capital buffers, the average level of capital strength appears seriously insufficient. Thus, the solvency assessment of Europe's banks crucially depends on the view one has of the seriousness of the sovereign crisis. The rapidity of contagion, which extended to Italy in July and to French banks in August, suggests a conservative attitude is warranted, as the IMF is also arguing in its latest Global Financial Stability Report.

#### A crisis of EU institutions

This sequence of events highlights that European policymakers missed an important opportunity when they neglected to address their banking sector's fragility decisively when market conditions were relatively favourable in 2009, especially after the success of the US Supervisory Capital Assessment Program. This failure is not for lack of good advice: the IMF, among others, had emphasised this challenge in its policy recommendations to European leaders. Had this advice been taken, and had Greek debt been adequately restructured in the first half of 2010, we would probably not have a major systemic crisis in Europe.

In decisions taken after May 2010, and until now, European leaders have often appeared to be behind the curve, and to react to the crisis's previous stage rather than to the current one. The

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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 macro-

prudential 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, *"With the present status of integration, the European Union does, even upon the entry into force of the Treaty of Lisbon, not yet attain a shape that corresponds to the level of legitimisation of a democracy constituted as a state. (...) Neither as regards its composition nor its position in the European competence structure is the European Parliament sufficiently prepared to take representative and assignable majority decisions as uniform decisions on political direction. Measured against requirements placed on democracy in states, its election does not take due account of equality, and it is not competent to take authoritative decisions on political direction in the context of the supranational balancing of interest between the states. It therefore cannot support a*

*parliamentary government and organise itself with regard to party politics in the system of government and opposition in such a way that a decision on political direction taken by the European electorate could have a politically decisive effect".* This 'structural democratic deficit' (also in the words of the Court) is a fundamental impediment to building up an effective executive capability at the EU level.

### Conditions for crisis resolution

The design flaws of the euro area, including the lack of a federal fiscal and banking policy framework and the democratic deficit of EU institutions, had been well identified by analysts at the time the Maastricht Treaty was signed in 1991. However, this did not prevent the euro from being introduced in 1999 and from having what can fairly be described as a highly successful first decade, ostensibly disproving its doubters' warnings. Similarly, the same shortcomings need not be fatal now if individual member states succeed in bringing their sovereign finances, their banking systems and their economies back on a sustainable track. However, the unfavourable global economic environment and loss of investor confidence during the sequence of events so far make it unlikely that the crisis can be overcome without meaningful progress in addressing fundamental weaknesses in the European institutional framework.

Structural reforms that favour entrepreneurship and enhance the economy's growth potential, fiscal adjustment, and bank restructuring are required at the level of individual member states. They are an indispensable dimension of any successful crisis resolution. They vary from one country to another and their elaboration would require detail beyond the scope of this testimony. At the European level, the necessary steps can be (rather simplistically) summarised into four components: (a) a consistent federal euro-area framework for fiscal policy (fiscal federalism); (b) a consistent federal euro area / EU framework for banking policy (banking federalism); (c) a general overhaul of the EU's political institutions that would upgrade their executive decision-making capability; and (d) adequate short-term crisis management arrangements to bridge the time gap



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<sup>1</sup>. 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 on Banking (or Vickers Commission) in the United Kingdom. Member states provide the guarantee for deposits, even though the modalities are harmonised under EU legislation, and only the member states have the fiscal capacity to intervene with equity or capital-like instruments in a crisis situation (even though liquidity policy in the euro area is mainly conducted by the ECB, and the ECB also has a say over additional liquidity assistance that may be provided by the euro-area's national central banks beyond its own operations).

A European banking policy framework would imply the consistent formulation and implementation of

1. Jacques Delpla and Jakob von Weizsäcker (2010) 'The Blue Bond proposal', *Policy Brief* 2010/03, Bruegel.

regulatory, supervisory, resolution, deposit guarantee, and competition policies with regard to the banking industry throughout the EU. Compared with the present situation, this would entail at least four steps:

- The EBA should be granted supervisory authority over all credit institutions in the EU, which it would exercise either directly [specifically, over the central operations of banks with a pan-European scope] or indirectly [by delegating it back to national agencies, over banks that are only active in one country, or over local operations of pan-European banks];
- The EBA's own governance should be overhauled so as to ensure its decision-making is better aligned with the European public interest [the current decision framework involves single-majority voting by representatives of the 27 EU member states, which can lead to massively skewed outcomes because of the disproportionate influence of smaller countries];
- The EFSF should provide an explicit guarantee of national deposit guarantee schemes in all countries in the euro area, in order to prevent bank runs in the event of national sovereign-debt difficulties;
- Existing processes that allow member states to block cross-border acquisitions of 'their' banks should be dismantled or brought under the control of European authorities.

The combination of these measures would have the effect of 'decoupling' the banks from their national governments, putting an end to the single major impediment to the formation of a genuine European banking system, as opposed to a collection of national ones, as an indispensable complement to monetary unification. These proposals are broadly similar to the ones outlined by the IMF's then managing director Dominique Strauss-Kahn in a speech in Brussels on 19 March 2010<sup>2</sup>.

The third component of crisis resolution is the upgrading of EU institutions, to enable them to support the federal frameworks for fiscal policy and banking policy in a politically sustainable manner. Essentially, this means bridging the current democratic deficit to a sufficient extent that

executive decisions can be legitimately taken in these policy areas at the European level and not only at the national one. This cannot be achieved without significant changes in the EU treaties. One aspect has to be the correction of the design flaws identified by Germany's Federal Constitutional Court in its above-quoted 2009 ruling, namely the redefinition of the European Parliament's electoral constituencies in order to ensure equal representation of EU citizens, and enhanced oversight powers for the European Parliament over the executive and budget functions of EU institutions. Whether these measures would be sufficient to close the democratic gap is debatable, and would obviously warrant further public deliberation.

One additional layer of complexity is the tension between the euro-area perimeter and that of the EU as a whole. At this point, the euro area comprises 17 of the EU's 27 member states, the outliers being the UK, Sweden, Denmark, and seven central and eastern European countries [Bulgaria, Czech Republic, Hungary, Latvia, Lithuania, Poland, and Romania]. Some of these countries may move towards joining the euro area assuming that the current phase of turmoil is overcome, but this does not seem to be a likely prospect for the United Kingdom, and perhaps others. How the EU institutional framework can cohabit with what UK Chancellor of the Exchequer George Osborne has memorably termed "the remorseless logic of monetary union that leads from a single currency to greater fiscal integration" among euro-area countries remains an open question. This is particularly true in the area of banking policy, which is currently set at the EU rather than euro-area level, a fact that is reflected in the location of the European Banking Authority in London. This tension may become increasingly prominent in the years ahead.

Finally, the fourth necessary component of crisis resolution is to manage the transition from now to the completion of a federal fiscal and banking policy framework under reformed EU institutions, which, even under extreme assumptions, is bound to take an extended period of time, measured in years rather than months, to achieve. By definition, these transition arrangements represent a more short-term concern that needs to be addressed within the existing Treaty

2. Available at <http://www.imf.org/external/np/speeches/2010/031910.htm> [accessed 22 September 2011].

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'<sup>3</sup>. 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

agency of a leveraged EFSF that would be granted access to ECB liquidity. This appears to be what was recommended by US Treasury Secretary Timothy Geithner in his conversations with his European colleagues last week. It is also the short-term solution that emerged from a collective simulation exercise jointly hosted by the Peterson Institute and Bruegel last week, on which my colleagues Guntram Wolff at Bruegel and Ted Truman at the Peterson Institute have reported on the two organisation's respective websites<sup>4</sup>. Our simulation suggests that this could be compatible with the ECB's mandate under the existing Treaty and that it could have a material impact in addressing market contagion.

#### Short-term outlook and policy options for the US

Spelling out these conditions for crisis resolutions underlines the Herculean political challenges of their implementation. Treaty changes that involve multiple referendums and also likely amendments to national constitutions, including in Germany; the shift of core areas of sovereignty from the national to the EU level; the definition of a *modus vivendi* with non-euro area members within EU institutions whose functioning would become dominated by euro area-only processes; and, inevitably, the public acknowledgement of major policy failures in the treatment of the crisis so far.

At this point, it appears very difficult to identify a reliable path from here to there, and the short-term outlook is not the most encouraging. Things are likely to get worse in Europe before they can get better. In the current circumstances too many European citizens, and too many of their leaders, remain in denial of their collective predicament, which prevents necessary initiatives from being undertaken. This means that contagion may spread further in the very short term.

This, however, remains a crisis for the Europeans to resolve. Europe's international partners can help, but cannot take their place to fix the situation. The euro area as a whole is not in a state

*'The short-term outlook in Europe is not encouraging. Things are likely to get worse before they can get better. Too many European citizens, and too many of their leaders, remain in denial of their collective predicament, which prevents necessary initiatives from being undertaken.'*

3. Adam Posen and Nicolas Véron (2009) 'A solution for Europe's banking problem', *Policy Brief* 2009/03, Bruegel.

4. Conference on *Resolving the European debt crisis*, 13-14 September 2011, summary available at <http://www.bruegel.org/publications/publication-detail/publication/606-resolving-the-european-debt-crisis/> (accessed 22 September 2011).



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<sup>5</sup>. 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) *Why we should listen to Tim Geithner*, available at <http://www.bruegel.org/publications/publication-detail/publication/608-why-we-should-listen-to-tim-geithner/> [accessed 22 September 2011].