Notre Europe
Thinking a united Europe
Penser l'unité européenne

Policy Brief
No.36
June 2012

Debt Crisis and Banking Crisis: Are We Heading Towards European Guarantees?


Sofia Fernandes

Sofia Fernandes is Research Fellow in economic and social affairs at *Notre Europe*.

Introduction

The difficulties that the eurozone has been facing since 2010 have made it quite clear that the eurozone suffers from a structural weakness caused by the interdependence of the banking and sovereign debt crises. There exists a vicious circle between these two crises, both because the banks hold in their portfolios a considerable share of bonds issued by their respective governments and because states shoulder sole responsibility for bailing out their national banks. Thus, when states are in difficulty their banks are too (Greece), and conversely, banking system problems undermine national public finances (Ireland, Spain).

In order to re-establish financial stability in the eurozone and to prevent any further crises, the EMU countries must find solutions to each of these two crises and break the link between them. To this end, member states must adopt a roadmap leading to the implementation of a fiscal and banking union within the eurozone. At the heart of these two steps forward we come up against a single question: Are member states ready to accept greater solidarity within the group, which would translate into a sharing of the risk linked to public indebtment – through the issuance of common bonds – and of the risk linked to the banking industry – through the creation of a European fund for the resolution of banking crises? While some countries, including France, seem to be prepared to move forward down this path, others, such as Germany, insist on up-front offsets for such progress, in particular a strengthening of the European authorities' powers of fiscal and banking surveillance. However, this crisis is so acute that it appears to cast doubt on the possibility of moving forward in stages in the dialectic between responsibility and solidarity by strengthening the former before agreeing to boost the latter. In order to emerge from the crisis, the member states need to move forward on both levels simultaneously.

This Policy Brief sets out to debate the terms on which these steps forward can be made in the short and medium-to-long term. Thus the first part deals with the issues involved in debt mutualisation by presenting the proposal of the German Council of Economic Experts for the establishment of a "European Debt Redemption Fund" (ERF) as a compromise between the solidarity required to negotiate a way out of the crisis, and a commitment to fiscal discipline. This initiative would mark the first step towards the creation of eurobonds designed to protect member states against a common risk, namely that of a self-fulfilling solvency crisis.

The second part of this paper considers the European banking system's weaknesses, which should be addressed by a banking union. While it is not possible to directly recapitalise national banks with the tools currently available, the goal of sharing the risks linked to the banking industry must become part and parcel of the roadmap leading towards a banking union in order to break the link between banking crisis and sovereign debt crisis.

1. Towards debt mutualisation: re-establishing financial stability and strengthening the EMU

In order to overcome the current difficulties and to protect member states from market attacks, numerous voices have been raised since the start of the crisis in favour of a mutualisation of national public debts through the issuance of eurobonds benefitting from the joint and several guarantee of the eurozone member states. This mutualisation of the debt implies a transfer of risk between strong EMU countries, largely spared from the market turmoil, and weak EMU countries which are currently at the eye of the storm. However Germany does not plan to guarantee any other member state's debt as long as each country is allowed to conduct its fiscal policy in a fully independent manner. In Germany's view, the creation of eurobonds constitutes the final stage of the establishment of a political and fiscal union, not its starting point.

Yet these two positions are not impossible to reconcile. While it is true that issuing common bonds would eliminate the financial markets' "disciplinary" role – which would reduce the incentives to pursue fiscal discipline – the establishment of a form of mutualisation of the debt can be accompanied by a strengthening of fiscal surveillance, and it may prove to be an incentive for member states to consolidate their public finances.

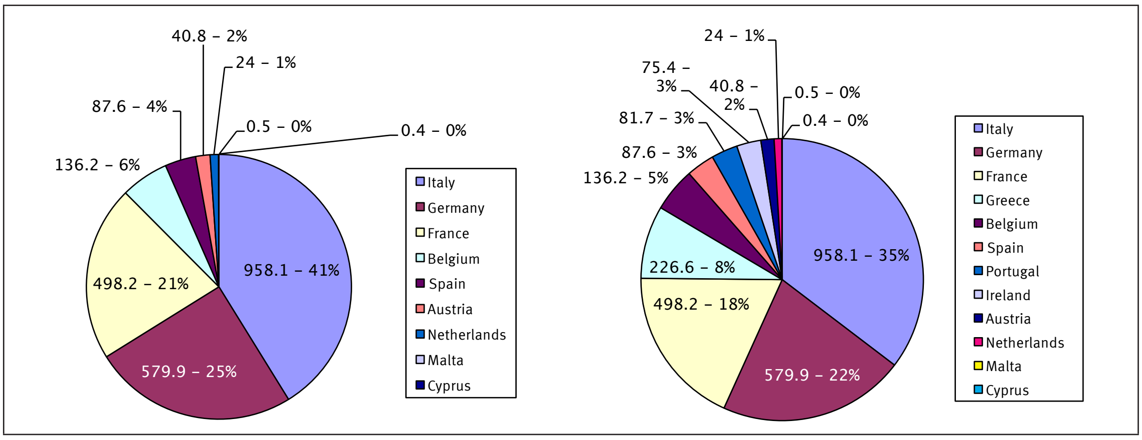
The proposal put forward by the German Council of Economic Experts (GCEE) for the creation of a "European Debt Redemption Fund" meets this requirement. The proposal provides for a form of debt mutualisation that is limited in both time and volume, which would make it possible to re-establish financial stability in the eurozone on the one hand, and to guarantee that member states commit to a process designed to redeem their excessive debt on the other (1.1).

The adoption of this solution, however, should not rule out the creation of eurobonds in the medium-to-longer term in order to strengthen the eurozone. Debt mutualisation is a response to the urgency of the crisis today, but once the eurozone has regained its financial stability and implemented a fiscal union, euro bonds will make it possible to remedy the structural fragility of the eurozone member states – their vulnerability to self-fulfilling solvency crises – and to strengthen the euro's international role thanks to the creation of a vast European bond market (1.2).

1.1. The European Debt Redemption Fund: a way out of the crisis

The GCEE submitted a proposal in late 2011 for the establishment of a "European Debt Redemption Fund"[1] making it possible to reconcile joint and several liability in eurozone members' funding with a road map for the reduction of public debt which exceeds the debt ratio of 60% of GDP over the next 25 years[2].

Graphs 1 and 2 - Maximum ERF volume on the basis of existing debt over 60% of GDP at end 2011 (2325.7 billion euro without the countries benefiting from aid programmes, and 2709.4 with those countries*)



Source: Notre Europe. Data: German Council of Economic Experts, Eurostat for the public debt of countries benefitting from financial assistance.

* Countries that are currently running a structural adjustment programme would join the ERF only after the successful conclusion of the respective adjustment programme; countries whose public debt is lower than 60% of GDP would not take part in the ERF, the countries in question being Finland, Luxembourg, Slovakia, Slovenia and Estonia.

1. German Coucil of Economic Experts, "Assume responsability for Europe", *Annual report 2011-2012*, 9 November 2011.
2. Setting up an ERF would require a phase involving the transfer of excessive national public debt to the ERF (maximum term of 5 years, and variable according to the amount to be transferred from each country) during which countries' funding needs up to a sum equivalent to their excessive debt would be covered by bonds issued by the ERF. This debt would be cancelled by member states' payments into the ERF over a period of 20 to 25 years.

The adoption of the ERF would allow those member states currently under market pressure to borrow at lower interest rates, which would cut their debt-servicing costs. Those member states currently under financial assistance could join the fund at the end of their programme, which would save them from having to return to the markets in the short term.

The GCEE expects 10-year interest rates for ERF bonds to hover around the 2.5 to 3% mark. It points out that even if current market uncertainty could lead to higher interest rates, these rates are unlikely to rise any higher than the European Financial Stability Facility's borrowing rate (which stood at approximately 3.3% in January 2012).

Nevertheless, an interest rate at that level would still lead to a rise in borrowing costs for those EMU member states that are currently benefitting from exceptionally low interest rates – thanks, in part, to the public debt crisis – such as Germany and The Netherlands (among the countries taking part in the ERF). Yet these countries might accept the cost of such solidarity for two basic reasons. On the one hand, because they will have their partners' pledge to redeem their debt, in addition to which, the creation of the ERF is accompanied by a strong conditionality designed to ensure fiscal discipline and the honoring of commitments entered into (*Box 1*); and on the other hand, because this partial debt mutualisation would make it possible to reduce or even to eliminate the need for costly support and bail-out measures for member states temporarily debarred from borrowing on the financial markets.

Box 1 – The European Debt Redemption Pact

The creation of the ERF is accompanied by a redemption pact based on the following terms:

1. **Member states must adopt a budget consolidation strategy and a structural reform agenda;**
2. **Debt up to 60% of GDP must be restricted through the adoption of a golden rule limiting structural deficit to 0.5% of GDP (in compliance with the Fiscal Compact rule);**
3. **The cancellation of each country's excessive debt will be ensured by special fiscal measures designed to generate revenue earmarked for paying the debt, such revenue being directly paid into the ERF without passing through national budgets;**
4. **Each country must guarantee the debt that it transfers to the fund through a 20% deposit in the shape of international (gold and currency) reserves, for use as collateral in the event of default on payment. The joint and several liability of member states only applies after the use of the collateral.**

The main difficulty with this proposal is that it requires member states to have a substantial primary budget surplus if they are to cancel their excessive debt, and this surplus depends on the country's growth prospects. The GCEE reckons that Italy, the country which would transfer the most substantial debt, would need to chalk up a primary surplus worth 4.2% of GDP over 25 years[3], assuming a nominal GDP growth of 3% of GDP per year and a 4% interest rate for the ERF debt, and a 5% interest rate for national bonds. Weak growth would call the debt reduction scenario into question. What this means is that the proposal needs to be accompanied by a growth strategy at the European level, a necessary precondition (albeit insufficient *per se*) to ensure a boost to growth in the eurozone.

Despite this difficulty, it is worth pointing out that, without the ERF and the drop in borrowing costs that it would occasion for the EMU's vulnerable member states, the debt reduction effort would be even more burdensome. In addition, it needs to be stressed that the debt reduction path suggested in this proposal corresponds to the condition laid down in the revised Stability and Growth Pact (and which is also included in the Fiscal Compact), which stipulates that any debt over 60% of GDP must be reduced at an average rate of one twentieth per year[4].

The GCEE's proposal has attracted the support of numerous national and European players, in particular that of the European Parliament (EP). The EP's Economic and Monetary Affairs Committee has built it into its report on the proposal for a Regulation on common provisions for monitoring and assessing draft budgetary plans and ensuringthe correction of excessive deficits in the eurozone. This regulation is part of the Two-Pack, a legislative package that will complete the reinforcement of fiscal surveillance in the euro-

3. In its Spring 2012 economic forecast, the European Commission expects Italy to show a primary budget surplus of 3.4% of GDP in 2012 and of 4.5% of GDP in 2013.

4. Article 4 in the Treaty on Stability, Coordination and Governance states that: "When the ratio of a Contracting Party's general government debt to gross domestic product exceeds the 60% reference value... that Contracting Party shall reduce it at an average rate of one twentieth per year as a benchmark".

zone that began with the Six-Pack and the Fiscal Compact. It provides, in particular, for the *ex ante* supervision of national budgets by the European institutions. This increased supervision at the European level is a virtually compulsory offset if any progress in solidarity is to be made within the eurozone.

While the EP's approach embraces the bulk of the measures proposed by the GCEE, there is one crucial difference. While the GCEE sees the ERF as an alternative to the creation of eurobonds, its goal being a return to exclusively national responsibility for debt issuance after the cancellation of excessive debt, the EP sees it as the first stage in a roadmap leading to the creation of the eurobonds.

1.2. A roadmap towards the creation of eurobonds

While in the short term member states need to thrash out a solution to allow them to address the emergency, in the longer term their priority is to prevent the return of similar crises and to prepare the EMU to face such crises should the need arise. To this end, member states need to remedy the shortcomings in the EMU that the crisis has revealed. One of those shortcomings is the vulnerability of eurozone countries to self-fulfilling solvency crises.

In effect, EMU member states issue debt in a currency over which they do not have full control. This implies that a liquidity crisis in these countries – if strong enough – can force the government to make default. Investors know this fact and act in consequence: when an EMU country experiences budget difficulties, they over-react by raising the risk attached to the bonds of this country. This in turn increases the interest rates of the country's bonds, aggravating the problems of liquidity. The result is a "self fulfilling solvency crisis": the country becomes insolvent because investors fear insolvency[5].

The adoption of a eurobond system would make it possible to address this risk, which is shared by all eurozone countries. In effect, in a scenario in which national debts are below 60 percent and all EMU countries conduct responsible fiscal policies, eurobonds would not work as a mechanism of non-reciprocal solidarity (implying a transfer of risk from "weak" to "strong" EMU countries), but rather as an insurance arrangement covering all EMU countries from a common risk[6].

Just as debt mutualisation in the short term must be accompanied by strong conditionality in order to guarantee member states' responsibility, so in the longer-term scenario eurobonds must also constitute an incentive to fiscal discipline. There exists a range of options for achieving this. One might imagine a system in which an EMU country infringing the fiscal rules or not following the Commission's recommendations on fiscal discipline would have to pay an additional "penalty" fee to refinance their debt through common bonds. A partial financing of national public debt through eurobonds (i.e. the famous blue bond/red bond proposal by Delpla and von Weizsäcker[7]) would be also a way to secure that eurobonds do not disincentive fiscal discipline. As member states would have lower interest rates for their common bonds and higher ones for their national bonds, they would be induced to limit their national issuances.

Lastly, a eurobond system within the eurozone would offer the possibility of a large and highly liquid market, which would translate into low credit risk and liquidity premiums. In addition, the larger issuance volumes and more liquid secondary markets implied by the issuance of eurobonds would strengthen the position of the euro as an international reserve currency[8].

5. De Grauwe, Paul, "The governance of a fragile Eurozone", *CEPS working document*, No. 346, May 2011.
6. Fernandes, Sofia and Rubio, Eulalia, "Solidarity within the Eurozone: how much, what for, for how long?", *Notre Europe Policy Paper*, No. 51, February 2012.
7. Delpla, Jacques and von Weizsäcker, Jakob, "The Blue Bond Proposal", *Bruegel Policy Brief*, No. 3, May 2010.
8. European Commission, *Green Paper on the Feasibility of the Introduction of Stability Bonds*, COM (2011) 818 final, November 2011.

2. A banking union to address the weaknesses of the eurozone's financial system

The global financial crisis and the European public debt crisis have highlighted two major weaknesses in the eurozone's financial system.

First of all, there is the dichotomy between strong financial integration within the eurozone and a supervision system that still rests with the national authorities. Before the crisis, certain countries developed excessive private imbalances which were neither detected nor corrected, due largely to the existence of a fragmented banking supervision system in the EMU.

In addition, the crisis has also highlighted a feature of the eurozone that makes it especially vulnerable, namely the close connection between banking and sovereign debt crises. There is a vicious circle between these crises because the banks in the eurozone hold considerable quantities of sovereign bonds issued by their respective governments and because the member states hold sole responsibility for bailing out the banks headquartered on their territory. Thus the sovereign debt and bank problems mutually exacerbate one another[9].

The first of these two fragilities – the shortcomings in the financial supervision system – was addressed in part at the EU level back in 2010 by a reform of banking supervision.

Box 2 – The Reform of European Banking Supervision

In 2011, the EU adopted a new banking supervision architecture including a European Systemic Risk Board (ESRB) and three new European supervision authorities in the financial services industry: the European Bank Authority (EBA) headquartered in London, the European Insurance and Occupational Pensions Authority (EIOPA) headquartered in Frankfurt, and the European Securities and Markets Authority (ESMA) headquartered in Paris.

The ESRB, headquartered in Frankfurt and chaired by the president of the ECB, is tasked with overseeing and analysing the risks that macroeconomic developments and events occurring in the financial system as a whole entail for financial stability ("macroprudential supervision").

The three new European supervisory authorities network and interact with the existing national supervisory authorities to monitor the financial solidity of the financial businesses themselves and to safeguard financial services users ("microprudential supervision"). The national authorities are tasked with daily monitoring, while the European authorities coordinate and, if necessary, arbitrate between the national authorities, and help to harmonise the technical regulations governing the national authorities.

Yet that reform did not allow for the creation of a genuine European supervisor because the new system is based on cooperation among national supervision authorities. This is due first and foremost to the close relationship between bank supervision and the resolution of bank crises; as long as the EU is devoid of the financial tools to support banks in trouble and member states are responsible for shouldering the task, those member states will insist on being allowed to maintain primary responsibility for bank supervision[10].

Where the second weakness revealed by the crisis – the link between bank and sovereign debt crises – is concerned, it quite simply has not been dealt with by the eurozone's decision-makers yet. Two measures would be welcome at the European level to break this vicious circle: the joint issuance of public debt – which would allow the banks to reduce their exposure to the bonds issued by their respective national governments – and a sharing at the European level of the risks linked to the banking industry, which includes responsibility for bailing out banks of systemic importance and/or guaranteeing bank deposits.

It is true that the eurozone heads of state or government agreed in July 2011 to endow the European Financial Stability Facility (EFSF) with the power to provide loans designed to support the banking industry for countries not formally under a financial assistance programme. While that agreement is a step in the right direction, it does not make it possible to completely break the link between the bank risk and the sovereign risk because support for banks has to be channelled through member states. The EFSF's support for banks can therefore be implemented only through a government signing an agreement including the terms on which the money is lent. The European

9. Merler, Silvia and Pisani-Ferry, Jean, "Hazardous tango: sovereign-bank interdependence and financial stability in the euro area", in *Public debt, monetary policy and financial stability - Financial Stability Review*, Banque de France, No. 16, April 2012.

10. Marzinotto, Benedicta; Sapir, André; Wolff, Guntram, "What kind of fiscal union?", *Bruegel policy brief*, No. 2011/06, November 2011.

Stability Mechanism's (ESM) direct recapitalisation of banks was the subject of a hot debate when the mechanism was set up in 2011, and indeed the proposal was rejected. Today the crisis in the Spanish banking system has replaced this issue at the heart of the European debate (2.1), along with the idea, on a broader level, of creating a "banking union" within the eurozone (2.2).

2.1. The case of Spain: the difficulties involved in recapitalising national banks at the European level

While many voices have been raised over the past few months in favour of the direct recapitalisation of Spanish banks by the EFSF/ESM, Germany (with the support of other countries, including Finland and The Netherlands) has firmly opposed such a prospect. A solution of this kind would entail two major problems.

The first is linked to the moral hazard risk. If Europe were to bail out national banks, that would reduce the *ex ante* incentive for governments and national supervision authorities to control their banks properly. Just as it proved impossible with the 2010 reform to set up a genuine European bank supervisory authority because member states were responsible for bailing out their banks, by the same token, it would not be feasible today to ask the European authorities to shoulder the burden of responsibility for bailing out banks unless the member states strengthen bank supervision powers at the European level. The resolution of bank crises and bank supervision are closely connected, and indeed they go hand in hand.

Secondly, while the loans that the EFSF grants to member states are subject to strong conditionality and to regular follow-up to ensure that the commitments entered into are honoured, in the case of direct aid to banks, the question of *ex post* supervision would arise. As EFSF Director Klaus Regling said: "If I were asked to give money directly to banks, I would have to manage those banks… and we are simply not set up for that."[11].

So even though such a measure would be welcome in order to prevent an increase in the national public debt, it seems fairly unfeasible under current circumstances. The solution thrashed out for Spain – aid granted to the government but subject to conditionality restricted solely to the banking industry – seems to be the compromise possible. Yet endowing the EMU in the medium to longer term with a fund for resolving bank crises must be countenanced, and this in the context of the establishment of a banking union.

2.2. Towards a banking union built on three pillars

As Mario Draghi has stressed, a banking union must rest on three pillars: a greater centralisation of banking supervision, a European mechanism for resolving bank crises, and a common deposit guarantee fund.

The pillar that attracts the greatest support is the one that envisages a strengthening of banking supervision at the European level. Hardly surprisingly, Angela Merkel has displayed a certain amenability to moving forward in that direction, albeit while laying the emphasis on the supervision of systemic bank groups[12]. Her position on a banking union is thus consistent with her position on a fiscal union: in the dialectic between responsibility and solidarity, it is necessary to strengthen the former – which in this case translates into greater supervisory powers for the European authorities – before strengthening the latter.

Thus, following the strengthening of European banking supervision, it would be feasible to share the risks linked to the banking system in order to break this detrimental relationship between the sovereign debt and banking crises.

The second pillar in this banking union that seems to attract favourable comments is the creation of a European deposit guarantee fund, which would replace national bank deposit guarantee systems. The creation of this fund would be facilitated by the partial harmonisation of public guarantees through the EU (we should remember that the member states agreed in 2008 that bank deposits in the EU would be guaranteed to the tune of 100,000 euro per customer and per bank as of 2011). Guaranteeing bank deposits at the EMU level would have the benefit of preventing a bank run in the event of a national sovereign debt crisis and it would help to break the link between the sovereign debt crisis and the banking crisis.

Even if several figures, including the chairman of the European Central Bank, have recently come out in favour of such a move, we should remember that the European Commission submitted a proposal for a directive on the recovery and resolution of bank failures on 6 June (*Box 3*), and that that proposal does not provide for the creation of such a fund, simply providing at this stage for potential interaction among national banking resolution funds (which may include national deposit guarantee funds).

11. Klaus Regling cited in Reuters, "Direct bank recapitalisation by eurozone funds unlikely", 26 April 2012.

12. In a short communiqué issued before her meeting with the president of the European Commission on 4 June, the chancellor said: "We (…) are going to be discussing how to place banks of systemic importance under the supervision of a specific European supervising authority".

Box 3 – Proposal for a directive "establishing a framework for the recovery and resolution of credit institutions and investment firms" submitted by the European Commission on 6 June 2012

The aim of this legislative initiative from the European Commission is to offer national supervisors a "toolbox" of instruments for use as far upstream as possible so that bank failures need end as infrequently as possible in a bail-out funded by the taxpayer. The process is divided into three stages.

In times of normality, banks have to develop living bills describing the measures they would take in the event of a deterioration in their financial health.

As soon as a bank becomes unable to meet its own funding requirements, the authorities can force it to implement its living bill with a list of measures accompanied by a timetable. They may also appoint a special administrator.

If the first two stages fail to redress the situation, the bank in question will be restructured. Four main tools are offered in the context of this restructuring process:

- the disposal of activities;
- the creation of a bridging tool ("*bridge bank*") grouping together a bank's healthy assets and basic functions prior to selling them off to another financial player, while the other part of the bank containing its questionable assets is liquidated in the context of bankruptcy proceedings;
- the separation of assets ("*bad bank*"), which makes it possible to transfer the questionable assets to a management structure and to clean up the bank's balance sheets;
- an internal "bail-in" which makes it possible to recapitalise a bank by watering down its shares.

In addition, all member states must set up a national bank resolution fund, which may be combined with existing deposit guarantee funds. Banks are going to have to feed these resolution funds over the next ten years, so that by 2024 they should account for 1% of all deposits covered in the EU, in other words some 100 billion euro. National funds can make mutual loan agreements for use in times of crisis.

Lastly, the third pillar concerns the creation of a European mechanism for the resolution of banking crises. While the Commission's 6 June proposal defends the creation of national bank resolution funds financed by the private sector, the most ambitious proposals for risk sharing linked to the banking industry argue that such a fund should be set up at the eurozone level. Despite private sector funding, this fund should benefit from public funds both during the phase involving the creation of the fund's private capital and subsequently, in the event of a severe banking crisis. Such a fund cannot therefore be implemented from one day to the next. Thus it is not a response to the present crisis, but rather a medium-term goal aiming to boost the EMU's ability to resolve bank crises and to help to break the vicious circle pegging bank crises to sovereign debt crises.

www.notre-europe.eu / info@notre-europe.eu
19 rue de Milan – 75009 Paris – France
Tel: +33 (0)1 44 58 97 97 / Fax: +33 (0)1 44 58 97 99

Conclusion

Over two years have now elapsed since the start of the public debt crisis, yet financial stability still has not been re-established within the eurozone. Its current difficulties also highlight the need to go further and to move towards the establishment of a fiscal and banking union at the EMU level. These steps must allow us to end up with common guarantees in funding for member states and in support for the banking industry in response to the two major weaknesses in the EMU that the crisis has revealed: member states' vulnerability to self-fulfilling solvency crises, and strong interdependence between the banking crisis and the sovereign debt crisis. Two issues need to be addressed in order to achieve this. On the one hand, this increased solidarity among member states must be accompanied by stronger fiscal and banking supervision on the part of the European authorities. And on the other hand, it is necessary to distinguish the short-term issues from the medium-term issues because, before all else, member states must come up with responses to today's difficulties and re-establish financial stability in the eurozone.

To this end, the implementation of a debt mutualisation system capable of simultaneously ensuring stronger fiscal discipline (to complement the measures already adopted in the context of the Six-Pack and of the Fiscal Compact) and lower public indebtment needs to be countenanced. The GCEE's proposal to create an European Debt Redemption Fund meets these requirements and so it must be taken into consideration. However, this response to the emergency situation must only be seen as the first step in a roadmap leading to the establishment of a permanent eurobond system in the medium to long term. This would make it possible to protect all eurozone members against a shared risk – the one of suffering self-fulfilling solvency crises – while at the same time also strengthening the euro's international role thanks to the creation of a vast European bond market.

The EMU currently responds to the banking industry's difficulties in the same way as it responds to member states' liquidity issues. In other words, when a member state is no longer able to provide its banking system with the necessary support, it has to turn to Europe for financial aid, and that aid is granted in return for increased supervision on the part of the European authorities. While such a solution makes it possible to respond to immediate difficulties, it does not allow either a strengthening of the European financial system or, above all, a break in the vicious circle binding the banking and sovereign debt crises. Thus, in the medium term, member states have to consider adopting tools designed to share out the risk linked to the banking industry; in particular, they should consider setting up a European deposit guarantee fund and a European banking crises resolution fund. But as an offset for these steps, member states are going to have to accept the implementation of a fully-fledged European banking supervisory system.

With the support of the European Commission
Europe for Citizens Programme

design: *Notre Europe*
ISSN 2105 7885