Preprints of the
Max Planck Institute for
Research on Collective Goods
Bonn 2011/12

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June 2011

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Quo vadis, Euroland?
European Monetary Union between Crisis and Reform[1]

Martin Hellwig

Abstract

This lecture discusses the 2010 crisis of the European Monetary Union and draws some lessons for reform. Crisis resolution has been difficult because the sovereign debt crisis of countries like Greece and Portugal has come together with real-estate and banking crises in countries like Ireland and Spain and bank vulnerability in countries like Germany and France. Failure to disentangle and resolve the different crises prevents a satisfactory approach to the long-term reform of governance of sovereign borrowing and banking. Any such reform must find a substitute for the discipline that exchange rate mechanisms impose on sovereign borrowers and their lenders when the currency is national. Any mechanism for imposing discipline on sovereign borrowers and their lenders must be designed so that enforcement is credible even in a crisis. Recommendations for reform include (i) an inclusion of sovereign exposure from too-big-to-fail concerns in banking in monitoring of fiscal stance, (ii) independence of bank supervisors from their respective political authorities, and (iii) a strengthening of the powers of the European Supervisory Authorities over the national supervisors.

Key Words: European Monetary Union, sovereign debt crisis, bank supervision

JEL: F33, F 36, F53, G28.

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* Revised text of keynote lecture at the Conference "Life in the Eurozone With or Without Sovereign Default", European University Institute, Florence April 14, 2011. Conference proceedings can be downloaded at http://finance.wharton.upenn.edu/FIC/FICPress.

1. European Monetary Union Before 2008

Developments of the past year have led many to say: We told you so. European Monetary Union was bound to erode the stability culture that the Bundesbank had nourished so that other countries were bound to follow. The temptation to finance budget deficits through the printing press would be overwhelming. And this prediction has now been confirmed. All the safeguards of the Maastricht Treaty and the Stability and Growth Pact have come to naught.

This reaction comes in particular from German economists, many of whom accompanied the formation of European Monetary Union with dire predictions. They forget that the Maastricht Treaty and the protection that European Monetary Union provided to the Bundesbank prevented Mr. Lafontaine, the new Federal Minister of Finance in 1998, from changing the Bundesbank Act so as to make the institution subservient to the Federal Government. They also forget that Mr. Schröder as Federal Chancellor was most prominent in preventing the application of the Stability and Growth Pact in the early 2000's. In other words, erosion of the stability culture of the Bundesbank is also a matter of generation change within Germany. There are reasons to believe that European Monetary Union has slowed this erosion rather than accelerated it.

I have previously commented on these developments in a contribution to the Festschrift for the Centenary of the Swiss National Bank, which was written in 2006 and published in 2007.[2] At the time, I stressed the following points:

- Through the formation of the European Monetary Union, monetary policy has been depoliticized. Whereas the Bundesbank was very much a part of German political debate, the ECB as a supranational institution is removed from national political debate. Moreover, national politicians who rail against the ECB's policies find that there are usually other politicians, from other countries who have different views about these policies – and who insist that the ECB is as much, or as little, beholden to them as to the railing plaintiff.

- Depoliticization does not imply an end to frictions and disputes. Disputes about the appropriate intermediate targets of monetary policy or about the tradeoff between a reliance on rules and discretion arise naturally, and the central banking community is the more likely to cultivate these conflicts, the less it feels threatened by politicians and governments. In the case of European Monetary Union there are ample grounds for such "professional" disputes because the pursuit of price stability in an area with multiple non-integrated market systems presents a difficult new challenge. Moreover, it might take time, for the institution and the surrounding media, to get used to the much decreased importance of the exchange rate.

- Threats to the ECB's independence might be expected to come from the European Commission. The European Commission has a history of ambition to enlarge its own turf. This ambition has mostly worked against Member State prerogatives, but there was every reason to ex-

2 M. Hellwig, Switzerland and Euroland: European Monetary Union, Monetary Stability and Financial Stability, in: The Swiss National Bank 1907 – 2007, Zürich 2007, 741 – 780.

pect it to work against the ECB as well. In fact, in the discussion about the Constitution for the European Union, the President of the ECB had already found it necessary to protest against a suggestion, which he understood to have come from the Commission, that would have "simplified" the procedure changing some of the strategically important articles of the Statute of the European System of Central Banks and the European Central Bank.

- Lack of credibility of the "Stability and Growth Pact" was identified as a problem. It therefore seemed likely that, at some point over the medium run, we would come across a problem like the one that Greece has posed over the last year. For this eventuality, in 2006/7, I predicted that the European Union would move forward as it had in past crises, with a mixture of muddling through and changes in governance. I warned that, in such a context, the ECB's independence might be at stake. If a Treaty revision introducing a mechanism to deal with the fiscal crisis of a Member State government were to stipulate that, in such a crisis, the ECB should contribute to reducing damage and frictions and if this stipulation was part of a larger package, then the requirement that changes to the Treaty must be ratified by parliaments in all Member States would not be worth much as a safeguard for the ECB's independence.

- Finally, I argued that there is an unnatural tension in a system with a supranational authority for monetary policy and national authority in banking supervision. While appreciating that bail-outs of insolvent banks belonged in the domain of national finance ministers, I suggested that mechanisms of co-ordination and assignments of tasks for the national authorities and the central bank as a lender of the last resort were not sufficiently well specified. The information that transpired about the various memoranda of understanding on the matter did not inspire much confidence.

2. Why Is the Current Crisis so Difficult to Handle?

With hindsight, it is clear that my analysis in 2006/7 was too sanguine. Whereas I expected the coming fiscal crisis of a Member State to be dealt with pragmatically, without too much ado, the Greek sovereign debt crisis has now been with us for over a year and the European Union is still far from finding a way out and from establishing workable governance mechanisms for the future. Moreover, we are not just dealing with the Greek sovereign debt crisis, but with crises in other countries as well.

The main reason why it has been so difficult to come to terms with these problems is that we are not just dealing with one crisis, but with three crises at the same time. We have, first, the kind of fiscal crisis that we see in countries like Greece and Portugal. We have, next, the kind of banking crisis that we see in countries like Ireland or Spain, where local banks have gone on lending sprees and nourished real-estate bubbles and, when the bubbles burst, their solvency was impaired. We have, finally, the kind of latent banking crisis that we see in countries like Germany or France where banks with very fragile balance sheets have large exposures to sovereign debt from Southern Europe and/or to bank debt from Ireland and Spain. These three crises are entangled with each other, and it is difficult to disentangle them.

The difficulties came into evidence after the Deauville meeting of Merkel and Sarkozy when they announced that, in the future, under the successor to the EFSF, any support of sovereign debtors would require a bail-in of creditor banks. Merkel and Sarkozy thought that they were just talking about the future, a regime that was to be imposed after 2013. But they forgot that, as of now, there are outstanding bonds that will mature in 2020. Would such bonds benefit from a grandfathering clause? Or would the bondholders be subjected to the bail-in requirement after 2013? Just raising the question creates unrest for today's financial markets – and for the German and French banks that may be holding such bonds. And what about debt that will be maturing in 2012? This debt will have to be refinanced, perhaps by issuing new debt with a maturity extending beyond 2013. Conditions under which this debt can be issued in 2012 will depend on prospects for how this debt will be treated after 2013. These conditions in turn affect how today's holders of debt maturing in 2012 assess the prospects of actually receiving their dues. These considerations show that it is difficult to even talk about proper governance post-2013 while we must be afraid that the effects of such talk will disturb today's markets and deepen the triple crisis that we have.

Following the markets' reactions to the Deauville announcement, EU finance ministers tried to quiet the markets by saying that bail-ins would only be required when a debtor were to have a solvency problem. For support with liquidity problems, no bail-in would be required. To me, this is another example where concern about the current mess precludes a sensible discussion of future governance. From a debtor's perspective, the problem is always just a liquidity problem. And the private creditor will agree if that helps him avoid a bail-in. If you think about the substance of the matter, you will notice that, for sovereign debt, the concept of insolvency as an objective inability to pay is not an operational concept. To assess a sovereign debtor's ability to pay, one would have to deal with questions like: What is the debtor country government's ability to get the country's elites to pay taxes? What is the debtor country government's ability to get a political consensus for selling assets? What is the debtor country government's ability to restrict public-sector salaries? These questions have played a key role in sovereign debt crises, in Weimar Germany as well as the Latin American countries in the eighties, in Greece and, to some extent, even in the United States today. Because these questions go to the core of what makes a national polity and society, I see no scope for providing "objective" standards for dealing with them. By relying on the non-operational distinction between insolvency and illiquidity, the finance ministers lay the foundations for bad governance in the future.

If we were able to clean up the current crises right away, we might be able to have a clean slate for discussion governance after 2013. Unfortunately, this is not very likely. To some extent, this is a matter of technical and legal problems. More importantly, there is no political will to clean things up right away. On this point, Germany bears much responsibility. From the very beginning of its intervention in the financial crisis, in October 2008, the German government has been bent on preventing transparency about the costs of intervention by shifting risks into the future.

In October 2008 and the following months, support was mainly provided in the form of guarantees. As we all know, guarantees do not cost anything, and they do not have to be put on the budget. The "bad bank" law in 2009 allowed banks to place dubious assets with the government. The government takes current write-offs (or not) on these assets, and a reckoning with the banks is deferred for twenty years. The support package for Greece and the EFSF have the great advantage that you do not have to tell the taxpayers that you are bailing out banks again. The advantage is all the greater if you can say that you are just dealing with a liquidity problem and no taxpayer money will be lost. I am afraid that, as long as there is no change in attitude concerning the costs and benefits of transparency, we will not be able to clean up the system, and discussions about governance after 2013 will be contaminated by all three of the crises that we have right now.

In this context, it is not helpful that so much of the political discussion last year has been formulated in terms of solidarity and in terms of a currency crisis. There has been a lot of discussion of the sort that if it was not for Greece or Spain, German exports would not be doing as well as they are. Therefore, Germany should feel an obligation to support the peripheral countries with their debt problems. The story can also be told in another way: If it had not been for European Monetary Union, the interest rate premia for the peripheral countries' sovereign debts would probably have remained where they were prior to 1995, which, except for Greece, is twice as much as what they have become after the crisis – and a large multiple of what they were before 2007! And Germany would have had a higher real investment and higher real growth in the first half of the decade. This part of the story should presumably be part of the solidarity equation as well.[3]

More importantly, talking about these matters in terms of solidarity creates significant political risk. Solidarity is a big word which means different things to different people. For a government to use taxpayer money in the name of solidarity, there must be some acceptance of this solidarity among the electorate. In this respect, there are significant differences across countries, even for solidarity within the country itself. Outside of certain political and intellectual elites, there is as yet little acceptance of any general notion of cross-border solidarity within the European Union. Public political discussion in the European Union mostly takes place along national lines. Within the different national discourse communities, notions of solidarity towards other nations tend to be seen with suspicion. The European Union is seen as a mechanism that siphons off money from national uses. The turbulence of last year's discussions has very much reinforced these suspicions. We may deplore the populism that we see in these debates, but we should not underestimate the risk of an uncontrollable political backlash – in all affected member states. In this respect, the open disrespect for existing law that has been shown by many participants has been very harmful. So has been the lack of transparency about who is being supported, public employees in Greece taking early retirement or German and French banks avoiding significant write-offs.

3 H.-W. Sinn, Rescuing Europe, CESifo Forum 11, Special Issue, August 2010, W. Franz, C. Fuest, M. Hellwig and H.-W. Sinn, A Euro Rescue Plan, CESifo Forum 11, No. 2, 2010, pp. 101–104.

The discussion has also not been helped by euro-skeptical journalists and populist politicians interpreting the crisis as a currency crisis. The crisis is not a crisis of the euro and its internal or external stability. The internal purchasing power of the euro has not been affected. The external purchasing power of the euro has declined somewhat in the spring of 2010, but the devaluation vis à vis the dollar was hardly more than a correction of an excessive revaluation in the years 2002 – 2009, excessive that is, relative to differences in inflation rates. Journalists and politicians like to tell stories about such exchange rate movements, but there is no story to be told. Movements like the ones we have seen have been a recurrent phenomenon since the reintroduction of flexible exchange rates in the seventies, and for most of them we do not have any explanations. (I also would not wish to refer to the subsequent revaluation of the euro vis à vis the dollar as an indication that the crisis had been overcome.)

As for the governance of the euro, I appreciate that, over the past year, there has been a lot of controversy about the behavior of the ECB. However, I do not see this development as running counter to the depoliticization and professionalization of the debate about monetary policy that I had observed in previous years. The discussions that we have had about ECB policy during the last year and a half have mostly not been about issues of independence of the central bank or about the responsibilities of the ECB for the overall economy. These discussions have been narrowly focused on how the ECB should deal with the crisis. Leaving aside the legal question of whether the ECB's decisions and policies are compatible with the Treaty, I believe that most of those discussions can be interpreted as instances of reasonable professional dissent in central banking. Thus, I do not see the ECB as having been captured by President Sarkozy or any other head of government or head of state.

There is a lot of criticism against the ECB buying up all sorts of things, including strange assets, toxic assets, etc. I have no idea what the quality of these instruments are but I have been thinking that, if the losses are there anyway, they have to be borne by someone and, if the banks that invested in these instruments are unable to bear them, then using seigniorage to cover these losses may not be the worst idea. I do, however, fear that if political systems or financial systems get used to the ECB solving their problems, then using seigniorage to underwrite losses on poor investments will end up being a very bad idea indeed. This is precisely why I believe that we need to think about what an appropriate and credible governance system for the period after 2013 would be.

3. Underlying Problems That Must Be Addressed

The preceding remarks indicate why the current crisis is so serious and why it is so difficult to get out of it. I now turn to the issues that we need to think about when we ask what would be a good system of governance for the future. In so doing, I will make believe that the problem of transition out of the current crisis can be ignored and proceed as if we could start with a clean slate.

If we think about what actually went wrong over the last decade, we must be concerned about the implications of the lack of an exchange rate mechanism for capital flows and for governance in the euro area. In providing a fairly sanguine assessment of European Monetary Union in 2006, I very much underestimated this problem.

We have a common currency, but not a common price system. Markets are not integrated to such an extent that regional and national price movements are as highly correlated as they would be in a single sovereign region or country. Year by year, the variance of inflation rates across the different member states of Euroland is much higher than the variance of inflation rates across American states, Swiss cantons, or German Länder. If exchange rates were flexible, these differences in inflation rates would by and large be reflected in exchange rate movements. Anticipation of exchange rate movements would force nominal interest rates to be different in different countries.

In a currency union, however, the exchange rate is fixed, and there is no reason why borrowers in different countries whose credit risks are similar should be charged different nominal interest rates. When nominal interest rates are the same, however, differences in inflation rates induce differences in real interest rates. In countries with higher inflation rates, real interest rates are lower, and, ceteris paribus, investment demand will be higher. Higher investment in turn boosts aggregate demand, which contributes to rising prices. Some of the capital flows that we have seen in the years before the crisis reflected these differences – in inflation rates, real interest rates and investment demand – and reinforced them. Thus funds flowed from countries like Germany, where inflation was much below the average and therefore real rates were higher, to banks – and ultimately real-estate investors in countries like Ireland and Spain where inflation rates were higher and real interest rates accordingly low. For public debtors in the peripheral countries, there also was the temptation to borrow more as entry into the European Monetary Union had eliminated the high risk premia that they had had to pay in the past.[4]

I am not concerned about these capital flows per se. As a consequence of monetary union, some such capital flows were to be expected – and were fully intended. Previous interest rate differentials had been very high and had contributed to preventing capital from flowing to destinations where it would be most productive. After all, these interest rate differentials contained not just the premia for expected differences in inflation rates or expected exchange rate movements, but also the premia for the associated exchange rate risks. Eliminating these impediments to the flow of capital would contribute to raising welfare in countries receiving these flows and putting them to productive use as well as providing returns for investors in countries with surplus savings.

However, governance mechanisms for these capital flows were insufficient. Capital flows to banks in Ireland and Spain took too little account of the dangers inherent in the Wicksellian dynamics of real interest rates, investment and housing price appreciation generating a bubble. In

4 On this argument, see again Sinn (fn. 2) and Franz et al. (fn. 2).

Greece and Portugal, there was too little concern about fiscal sustainability. In both contexts, there was a lack of discipline, on the side of lenders as well as borrowers.

This lack of discipline was to some extent due to the lack of an exchange mechanism. For a country that has its own currency, the exchange rate typically provides a disciplining mechanism. This mechanism may work because it goes against the country's pride to see the exchange rate devalued, and therefore policies that destroy the international competitiveness of important industries may come to be questioned when the loss of competitiveness affects the exchange rate. Or it may work because lenders distrust the country government's ability to finance its activities without using the printing press and therefore refuse to lend in the country's currency, a constellation which Eichengreen and Hausmann have called original sin.[5]

Many argue that, if only Greece or Portugal had been able to borrow in their own currency, they could now devalue their currencies and they would be fine again. Arguments get the matter backwards. If these countries still had had their own currencies, they would not have been able to borrow in their own currencies in the first place, at least not to the same extent and at the conditions that they actually got. Given the constraints on domestic-currency borrowing, they might have borrowed in foreign currencies, but, as they did so, they would have had to consider the risks inherent in such borrowing. With significant foreign-currency-denominated loans outstanding, they would have to consider that a devaluation of the currency would not only restore the international competitiveness of some industries but also inflate the value of their foreign-currency-denominated debt in terms of the home currency. The experiences that Latin American countries have gathered over the past three decades with different exchange rate policies provide ample warnings. None of them has been able to eliminate the consequences of original sin, the inability to borrow freely in one's own currency and the risks inherent in foreign-currency borrowing.

In Euroland, the disciplining mechanisms that are based on exchange rate movements and exchange rate risks are missing. On the one hand, as mentioned, this reduces frictions and enhances efficiency in cross-border capital flows. On the other hand, it increases the temptation for sovereign borrowers and their lenders to neglect fiscal sustainability.

Fiscal sustainability, fiscal discipline and a respect for (intertemporal) government budget constraints are important because each member state government is in principle independent and sovereign in its own fiscal policy. This independence is the only way to accommodate the very different attitudes towards fiscal policy and, more fundamentally, towards the role of the state that we have in different countries. For instance, the UK has a very strong market orientation in economic policy, the French government a very strong desire for state control over the economy. (Germany is somewhere in between, in principle very market oriented but in the details sometimes quite interventionist.) These differences induce difference in the extent to which economic

5 B. Eichengreen and R. Hausmann, Exchange Rates and Financial Fragility, in: Federal Reserve Bank of Kansas City, New Challenges for Monetary Policy, Kansas City 1999, 329 – 368.

fluctuations put the government at risk. It would be difficult to put the implied fiscal policies under a common set of principles.

Differences in attitudes towards the role of the state also concern the question how much society, and in particular the social and economic elites, are willing to pay for the state. In the case of Greece, as in Latin America three decades ago or Weimar Germany in the twenties, we are not just talking about an external transfer problem; we are also talking about an internal transfer problem due to the unwillingness of significant parts of society to contribute to government finance.[6] In this context, of course, we also must take account of the expensive monuments that statesmen like to build to themselves, Olympic Games and the facilities that they require, or certain kinds of industrial policy, industrial policy as a disguise for social transfers or industrial policy as a realization of economically unviable technical dreams like the Concorde.

In all these issues, political legitimacy is derived from national political discourse. EU interference is resented and cannot be taken too far. Therefore, it is all the more important for participants in national discourse to be aware of the fact that the government is subject to a budget constraint, and that the presumed benefits of certain policies and certain monuments must be compared to their costs. In this respect, the elimination of a disciplining mechanism for government borrowing is very problematic.

The Stability and Growth Pact should have provided for such a mechanism, but in the early 2000's, Germany and France prevented its application because their governments considered the Pact to be an infringement of their sovereignty. This experience carried a more general lesson, namely, arrangements for imposing fiscal discipline will not work if the parties whose job it is to enforce them are not interested in doing so. This was true of the Council with the Stability and Growth Pact. It was also true of the Commission with the No-Bail-Out Clause of the Maastricht Treaty. In last year's crisis, the Commission had nothing to gain by fulfilling its official role as a guardian of the Treaty. In contrast, it had a prospect of significantly enlarging its own turf by working towards a new regime that would provide for inter-state bail-out in the European Union. Given these experiences, I find it remarkable that negotiations about future governance have completely neglected the problem of credibility.[7] Ever since Deauville, we have been en route towards a Stability and Growth Pact 2, which is going to have the same governance problems as its predecessor.

Current discussion focuses on "competitiveness". As far as I can tell, this is a weasel word that makes believe that EU institutions are addressing the issues when, in fact, the meaning of the word is not clear. In the present context, it might be deemed to concern the problem that higher-

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6 On the internal transfer problem in Latin America in the eighties, see H. Reisen and A. v. Trotsenburg, Developing Country Debt: The Budgetary and Transfer Problem, Development Center Studies, OECD 1988, on Weimar Germany, see H. James, The German Slump: Politics and Economics 1924 – 1936, Oxford University Press, Oxford, 1986, and S. Schuker, American "Reparations" to Germany, 1919 – 33: Implications for the Third-World Debt Crisis, Princeton Studies in International Finance No. 61, 1988, International Finance Section, Princeton University, Princeton, N.J. 1988.

7 This point is already raised in Franz et al. (fn. 2).

than-average wage and price inflation in a member state erodes the ability of firms in that state to compete in domestic, EU and world markets. This problem is associated with the kind of Wicksellian dynamics that I mentioned above, where differences in inflation rates induce differences in real rate of interest, which then drive capital flows. This being said, I fail to see what policy interventions would be called for and what policy instruments would be used to deal with such developments. (Remember that wage setting mechanisms are quite different in different countries.) Nor do I see how EU institutions would induce member state governments to actually intervene. I therefore suspect that word itself is a device used to hide the fundamental dissent between different member states as to what the economic coordination mechanism should be that the Council is presumably looking for.

Coming from a background in microeconomics and competition policy, I feel very uneasy about the word "competitiveness" because it has been abused so much. When a politician uses the word "competitiveness", he usually means that he wants his country's "champions" to conquer the world. For this purpose, he does not mind subsidizing them with taxpayer money or giving them a monopoly position at home as a generous source of finance. Having observed Mr. Sarkozy in his previous incarnation as Minister of Finance at the time of the Sanofi-Aventis merger, I know that this is his mode of thinking. I am therefore concerned that a governance arrangement focused on "competitiveness", which makes sense in some macro settings where you are talking about wages being set semi-exogenously through collective bargaining or through the government providing a benchmark, may end up being intermingled with particular notions about microeconomics and competition policy, in an attempt to get the rest of the European Union to adopt a form of industrial policy which, for France, has been very costly, one of those monuments that politicians like to build for themselves.[8]

So far, I have only talked about the problem of fiscal discipline on the side of the borrower. What about the lenders? The Wicksellian dynamics to which I pointed were driven by differences in real rates of interest that are induced by differences in inflations rates when nominal rates of interest are the same. But, why should nominal rates be the same? Why should we take it for granted that interest rates on Greek government bonds ought to be (almost) the same as interest rates on German government bonds? If fiscal sustainability in the different countries is different, nominal interest rates should be different. Yet, prior to the crisis, differences in nominal interest rates for different member state governments were negligible. Were there no reasons to believe that default risks differed? In my 2007 paper, I observed that the failure of financial institutions and financial markets to take account of the fact that different sovereign borrowers had different fiscal capacities represented an anomaly.

The anomaly can now be explained. Market participants gamed the system, and they seem to have been right. Of course I am just speculating here about what bankers thought in 2001, 2002, and so on. They might just have been dumb and not appreciated that the different member states

8 For a comprehensive discussion, see Monopolkommission, Wettbewerbspolitik im Schatten „Nationaler Champions", XV. Hauptgutachten 2002/2003, Nomos-Verlag 2005, pp. 21 – 28; English translation of an abbreviated version pp. 575 – 585.

differed in their ability to pay their debts. But they might also have been very clever and anticipated that the Maastricht rules were not going to withstand the pressure of a crisis. If this is what they thought, they were right, at least so far. They may yet be proved to have been wrong if the debts they hold will be subjected to haircuts after all. However, the very weakness of the banks in the wake of the subprime-mortgage crisis provides a strong reason why governments have shied away from such haircuts.

If we want the lenders to take a part in imposing discipline on borrowers, we need to have bail-ins in the future. On this point, however, we should not deceive ourselves. There has been a lot of talk, but as yet no scheme that I would consider to be credible. If a new treaty this year or next year stipulates bail-ins of creditors in future debt crises, I expect that, if by 2020, we have another debt crisis and the solvency of banks is at risk, the bail-in clauses that are agreed now will be found to be just as good as the sanctions mechanism of the Stability and Growth Pact or the no-bail-out clause of the Maastricht Treaty. Moreover, the banks will know this, and, given the experience we have just had, they will be confident about their ability to "convince" the European Union and its member states that the application of bail-in clauses in a crisis is likely to have dire consequences.

4. Some Recommendations

In thinking about future governance, we must above all worry about the credibility of the regime we install. There is no foolproof recipe for doing so, but some improvements over the current regime – and current plans should be possible. Most importantly, we should begin to think about banks, their behavior and their governance, as part of the problem of Euroland governance. Until now, discussions about banking systems and discussions about Euroland governance have been treated as if they were completely unrelated. I consider this separation of the two sets of issues to be a big mistake. We need to integrate the discussions of the governance of the banking system with the discussion about how to reform the Euro system. In the following, I formulate a few recommendations in this direction.

Recommendation 1: Whatever governance mechanism is set up to discipline fiscal policy should be sensitive to information about the country's banking system.

This recommendation is based on the observation that fiscal problems in Ireland and Spain have not arisen from unsound fiscal policies but from unsound banking practices, in combination with a too-big-to-fail or a too-political-to-fail approach of the government. By the terms of the Stability and Growth Pact, Ireland and Spain were doing wonderfully even as the risks were building up. The problems that caused the Irish situation to blow up and that are still causing significant pressure for Spain never even appeared on the radar screen of the Stability and Growth Pact. Given that banking systems can be too political to fail and given that bank bail-outs may overtax the national taxpayers, institutions observing fiscal sustainability should have an eye for banking developments and the fiscal risks they imply. In my opinion, this matter is not being given enough attention.

Recommendation 2: Make bank supervisors independent.

Traditionally, banking supervision has been treated as a national prerogative, usually in the domain of the finance minister. In the past, I have supported this arrangements on the grounds that, with too-big-to-fail policies, ultimately, the risks of poor banking supervision are borne by the taxpayer. If we look at the actual record, however, for how banking supervision has done under the authority of finance ministers, I find that there is a good case to be made for independence. In the years prior to the crisis, governments have been more concerned about not throwing sands into the wheels of "their" banks than about protection of taxpayers from the fallout of the risks that these banks assumed. This has been the case in Ireland, where the government and the supervisors did not want to damage the ability of Irish banks to get funds from abroad. This has also been the case in Germany where the government and the supervisors did not want to interfere with the ability of the Landesbanken and of the real-estate-finance institutions to earn money abroad. In both cases, taxpayers were not served well by government use of authority over banking supervision. The rationale for this authority is thereby undermined.

Underlying these failures is the deeper problem that politicians and governments tend to look at banks as a source of funds rather than a source of risks. When this attitude prevails, they are more concerned about getting the banks to fund close to the politicians' hearts than about getting them to avoid risks that might be costly to the taxpayers. Whereas, in theory, supervision under the authority of the finance minister reflects the potential involvement of taxpayers in bailing banks out, in practice, it may provide the basis for a symbiosis of governments and banks, where banks provide funds for certain activities and governments protect the banks from excessive competition. Before the deregulation of the seventies and eighties, there were many regulations that explicitly called for bank funding of specified activities, with highly adverse effects on the risks to which banks were exposed, while government guarantees as well as restrictions on competition in banking provided the banks with rents. Examples are geographic restrictions on mortgage lending (Texas), very high minimum reserve requirements (Portugal), requirements to invest in government bonds (Sweden). The symbiosis thrived on the lack of transparency about the costs of political intervention and the lack of transparency about the risks to which banks were exposed.

Even after the financial crisis, the underlying attitude is still there. Discussions about Basel III were dominated by banks claiming that sharper regulation would induce a credit crunch, as if a lack of funding possibilities had been a key characteristic of the past decade. The German government was most concerned about preserving the status of public-sector banks in Germany, among them the main culprits in the crisis, with estimated costs to the taxpayer in the range of 50 bn. to 150 bn. EUR. Given the observation that, in practice, governments are not much concerned with risk from their banks and that prudential supervision is often blunted or even abused for political purposes, the theoretical case for putting banking supervision under the authority of the government seem practically irrelevant.

Recommendation 3: Strengthen the competences of European supervisory institutions and of European networks of national supervisors.

I have two reasons for this recommendation. First, the Irish experience shows that banking supervision at the national level can have significant repercussions for other member states of the European Union. Charles Goodhart's saying, "Banks are international in life, but national in death", does not quite fit the Irish experience.[9] In Euroland today, the costs of bank bail-outs are not just borne by the national taxpayer but by taxpayers all over. This suggests that national banking supervision should be subject to some co-ordination and control at the supranational level.

Second, I believe that the problem of regulatory capture is reduced if we have a network of bank supervisors acting in co-ordination but with some degree of independence. Something like this has been observed in competition policy for network industries such as telecommunications or electricity. Here, the workings of the European networks of national regulators have reduced the amount of capture by comparison to what we had before, largely, I believe, because each regulator could point to regulators in other countries as benchmarks. Just as importantly, the desire to be accepted by one's peers at the European level has affected the motivation of sector-specific regulators.

A final point: I would not wish to have banking regulation integrated into the central banks. In the crisis, it did not make much of a difference whether a country's supervisory authority was integrated with the central bank or not. This suggests that this question is of little consequence for the performance of banking supervision. However, the American experience shows that, if banking supervision and monetary policy are under the same roof, the integrity of monetary policy can be compromised by concerns about financial institutions. Such a development can lead to bad monetary policy. It can also become a source of moral hazard as the financial industry develops a sense that, if they get into trouble, the central bank will bail them out. There should be transparency in the sense that supervisors should know where monetary policy is going and the central bank should know what the state of the financial system is, but the different functions should not be under the responsibility of the same institution.

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9 C.A.E. Goodhart, "Procyclicality and financial regulation," Banco de España, *Estabilidad Financiera* 16 (2009), p. 16. Goodhart puts the formulation in quotation marks, perhaps in deference to Mervyn King's "global banks are global in life but nation in death", for which, unfortunately, I have not found a reference.

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