Ομιλία Mr. Martin Hellwig

MPI Gemeinschaftsgüter

Martin Hellwig

Banks, Governments, and Monetary Union in the Crisis

Athens, May 2014

A look at history: Weimar

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

A look at history: Weimar

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

The „euro“ crisis in its fourth year

- Europe is preparing for banking union
- Worries about asset quality review and stress tests
- Banking systems have not yet recovered – no cleanup
- Government finances have not yet recovered, despite improved access to markets
- Popular unrest in the periphery countries
- ... and in the north
- Low growth

Where do we come from?

- The No-Bailout clause of the Maastricht Treaty and the SGP seemed to provide for proper governance of fiscal policy
- The Treaty also pledged the ECB to abstention from government finance
- Banking regulation was governed by the principle that solvency problems were for the sovereign, liquidity problems of individual institutions for national central banks, liquidity problems of the system for the ECB to handle

Where do we come from ?

- April/May 2010: Greece has a liquidity problem, no market access
- October 2010: Deauville: Private Sector Involvement, not now, from 2013
- November 2010: PSI only in cases of insolvency, not in cases of illiquidity
- March 2011/July 2012: PSI now, but only 20%
- October 2011/March 2012: PSI now, over 50%
- When will there be the next haircut?

What has been missing?

- Strategic thinking
- Comprehensive Assessment of situation
  - Risks and exposures
  - Ability to pay
- Assessment of Alternatives without Illusions
  - On institution design
  - On sustainability of rules and sanctions
  - On liquidity versus solvency
  - On the effects of what is being done

Why were the principles broken?

- Crisis was more than the system could handle
- Not a currency crisis!
- BUT
- A traditional sovereign debt crisis in Greece, Portugal, and perhaps Italy,
- A traditional real-estate and banking crisis, in Ireland and Spain,
- And a latent banking crisis in Germany and France where the mess of 2008 had not been cleaned up

Sovereign Debt Crises and Banking Crises

- Sovereigns that don‵t make ends meet.
  - ... ask/coerce banks into funding them
  - ... cause bank insolvency from haircuts – Argentina, Greece
- Rescuing banks that are indebted in „foreign" currency can overtax the power of the sovereign
  - ... and cause sovereign a debt crisis (Iceland, Ireland, Spain)
  - ... which may cause the sovereign to lean on healthier banks....

What has gone wrong?

- Lack of market integration
- Lack of market discipline
- Lack of fiscal discipline
- Lack of effective supervision

Lack of integration

- Separate goods markets
- Different inflation rates
- Equal nominal interest rates
- Different real interest rates
- As drivers of imbalances and bubbles

Lack of market discipline and supervision

- No exchange rate discipline (exchange rate as an indicator of current developments, brake on foreign borrowing)
- No consciousness of risk on the side of creditors (zero risk weights as a basis for asking for bailouts)
- What discipline in a regime where the supervisor represents funding and political interests of the state? ... and is influenced by pressures from local and national elites?

Lack of Fiscal discipline

- Illusions about enforcement (SGP, Agent General)
- Lack of political legitimacy
- Differences in fiscal traditions
  - Financial Repression, monetary funding of government in G-I-S-P
- Differences in traditions as to what is the role of the state
  - Industrial policy, services publiques in France
- Why should the fiscal pact work better?

Lack of effective regulation: The politics of banking

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

Examples

- Dexia and government funding
- Landesbanken and governments
- Commerzbank/Dresdner Bank and the desire for a national champion
- The Swiss merger
- The French merger
- Italy pre 1990
- Spain and the cajas

Lack of effective Supervision

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

French and German Banks

- Poorly capitalized 2 – 4 % of total assets
- Excess capacity, low margins
- No cleanup in 2008/2009, rescue of everybody (except WestLB)
- Significant exposure to..... toxic assets, sovereign debt, cross-border bank debt, shipping loans...
- Sales of Greek debt to .... Cypriot banks

Problems today

- Excessive Indebtedness: Greece, Spanish Cajas and Provinces, Banks; the problem is not dealt with by „devaluation“, external or internal
- Weak banks, weak lending, weak economies, low growth
- The Japanese temptation - „only a liquidity problem“ – the challenge for asset quality review and the SSM
- Lack of viable institutions and lack of liability (Maastricht, SGP, Bank Bailouts) – SSM as a solution?

Why is there no progress?

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

Why is there no progress?

- Lack of a workable supranational discourse
  - Conflicts of creditors and debtors,
  - Clashes of personalities
  - Conflict Commission – Member States
  - Turf wars
- Lack of legitimacy
  - Elites versus public
  - Legal Tricks -
  - Banking Union as an example: Art 127 (6), Art. 114?
  - „Brussels“

An example

- Treatment of sovereign debt in banking regulation
- Sovereign carve-out in large exposure and equity regulation
- „Sovereign debt is riskless“
- „If it is not riskless, banking regulation is unsuitable for reducing the risk“
- „ESM will do the job“
- „If not, we must have eurobonds“
- ... or the ECB will bail us out

„..only a liquidity problem"

- Interest rates are high because markets see a problem
- „The problem is only serious because interest rates are so high. If markets believe that ...."
- Sachsen LB 2007, Dexia, HRE 2008, Greece 2010: „only a problem of market access"
- Dexia, HRE would be insolvent without state aid
- Hausmann 2012: Greece does not have what it takes to be as rich as Greeks are: The problem is one of consumption and a standard of living out of line with productivity

... and we can rely on the ECB

- Moral hazard from ECB availability: The Greenspan put
- Many politicians have learnt that inspite of Maastricht they can get access to the printing press if they borrow from banks and the banks get into difficulties
- Strength of the ECB is a weakness
- Monetary Policy can smooth over the crisis but cannot deal with its root causes

On the ECB

- German Paradox: The ECB is independent but it must not do anything different from the Bundesbank, especially not anything we dislike
- Legalisms: Prohibition of direct lending to governments versus license to do open market policy
- Price stability as an objective – viability of the monetary and financial system not?
- Karlsruhe Court decision is based on poor economics but must be taken seriously – the rivalry of the courts can be dangerous

On the ECB 2

- However the central bank introduces money into the economy, it produces windfalls
  - Banks as borrowers
  - Issuers of securities
- LTROs
  - Inflationary?
  - Saving insolvent banks?
- Central bank versus interbank markets as providers of liquidity

Example: LTROs

- Summer 2011: Prospect of Greek haircut suggests many European banks may become insolvent (Dexia did)
- Funding broke away
- Stock markets went into decline
- Announcement of recapitalization exercise generated more pressure on markets, significant deleveraging by banks (November)
- LTRO indicated ECB readiness to ensure bank funding (what about solvency problems?)

OMT

- Summer of 2012: Banks in periphery countries, especially weak banks, lend to governments but not to firms
- Recession is deepened by a lack of funding for nonfinancial firms
- OMT as an attempt to address problems in the „transmission mechanism"?
- Asymmetry of OMT due to fragmentation?

Monetary Policy and Government Budgets

- Central banks ordinarily earn profits
- ....because they earn returns on assets
- ....because their „debt" is not really debt but only a balance sheet entry
- Central bank profits are transferred to the government – anything the central bank does has fiscal implications
- Karlsruhe: This should require parliament to have a say
- Central bank independence – antidemocratic?
- Imposed in Germany by the allies in 1924, 1951

Banking Union to the Rescue?

- Without a cleanup of the banking system, there is a risk of a Japan-type experience
- A cleanup is not to be expected under national competence
- ECB will permanently act as a source of funding
- Back to the regime of Italy in the seventies and eighties?
- Banks as a source of funding
- - a cause for low growth

Ingredients of banking union

- Supervision
  - How effective can the SSM be with 16+ different national laws implementing EU directives?
  - Can the SSM get rid of zombies?
- Resolution
  - Do governments want to give up the power to determine which banks are there and which are not?
  - Is a viable resolution regime feasible? The Lehman legacy is still with us
- Deposit Insurance
  - Who will be bailed out and who will pay?

German attitude

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

A deeper problem

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

However,...

- Power over banks is part of sovereign power
- Will member states be willing to give that up?
- Or will they use other means to impose financial repression?
- The mayor of Leukerbad...
- and the President of the French Republic

- Except: Without a REAL banking union, the monetary union will likely fall apart
- ... and the event can be very ugly

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Eurobank

Discussion of Martin Hellwig's :

"Banks, Governments, and Monetary Union in the Crisis"

&

The special case of Greek Banks

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Professor of Finance & Economics, Un. of Piraeus

Athens, May 06, 2014

Sponsored by IOBE at Athens Music Hall

Brief Review of Hellwig presentation

- Martin Hellwig begins with Weimar Republic and then presents the history of the 4-yr EMU crisis, the different conflicts and the main actors involved: Banks, Governments and the ECB
- He asks: *"What went wrong*? " In his view, ∃ four fundamental failures in EMU:
  i. Lack of Market integration
  ii. Lack of Marker discipline
  iii. Lack of Fiscal discipline
  iv. Lack of effective Financial Supervision
- **I would add that EMU was a political project, which perhaps came too soon. The use of a common currency was imposed on yet not an Optimum Currency Area (OCA). This was always the American view, which perceived EMU as a competitor to the $ area**
- **There was a belief among politicians that market forces would lead to an endogenous adjustment towards an OCA.**

Brief Review (continued)

- Then Martin asks: "*Why there is no progress in addressing the failures?*" He brings political and other reasons:
  i. Conflicts within countries between political parties, banks, etc.
  ii. Lack of analysis and populism
  iii. Lack of workable supranational discourse (e.g. creditors ↔ debtors)
  iv. Lack of legitimacy (elites ↔ public, legal tricks, etc.)
- **I would add there was a fundamental conflict between two objectives:**
  i. **Fixing a new stronger architecture for EMU <u>without</u> further fiscal integration, that is, <u>mimicking an OCA</u> without the need of transfers**
  ii. **Resolving the crisis with drastic measures, which would, however, increase moral hazard and undermine objective (i)**
- **Creditor nations preferred objective (i) and caused the crisis to prolong. Deauville, or the innocuous bank stress tests of November 2011 are prime examples**

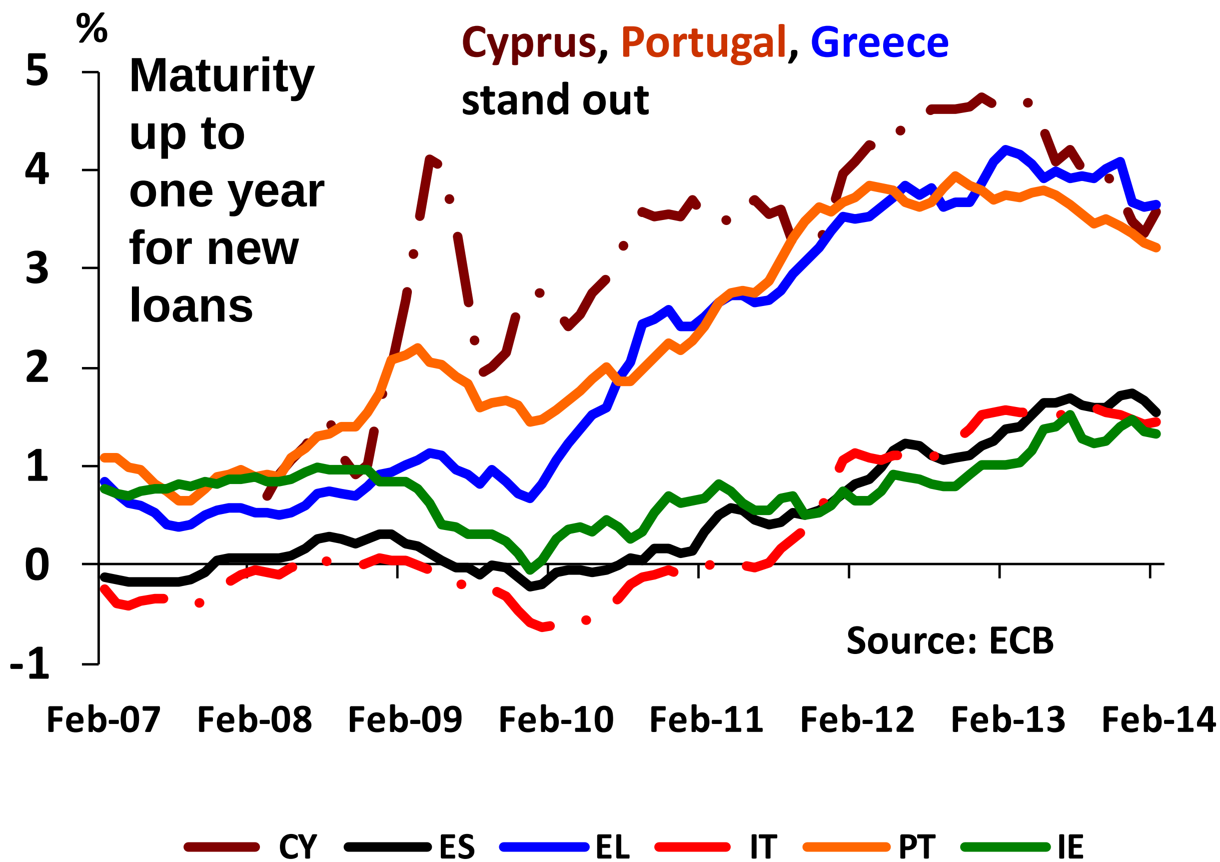
Brief Review (continued)

- In Martin's view, the ECB proved to be the only effective backstop to the crisis, e.g. LTROs, OMT
  - **Of course, the ECB went trough its own learning curve. In the beginning it religiously followed its inflation objective and tried to fortress its independence by espousing aggressive fiscal contraction plans or aggressive deleveraging plans for banks.**
  - **Gradually it realized there was real danger of instability of the EMU financial system and now it has stretched its mandate in order to accommodate the EMU escape from the crisis**
- Martin argues there is now a moral hazard problem, a Greenspan put in EMU, as politicians have learned to lean on their domestic banks, which in turn would unload their problems on to the ECB
  - **Temptation for Greek politicians to ignore the severe liquidity crisis in Greece and the heavy dependence on the ECB, and lean on the recapitalized banks in order to lend fresh money or to even save favorite voters from trouble**

Brief Review (continued)

- More on ECB: Martin discusses the problem of <u>fragmentation</u> of monetary policy today. **This is serious.**
  - The spreads discourage lending in the Periphery
  - Not only a reflection of different risk premia.
  - Some Greek companies abandoned their headquarters in Greece to be able to borrow at cheaper rates
  - The ECB is hinting it could intervene in securitization markets for bank loans in the Periphery, yet BASEL III penalizes their formation

Lending rates to NFCs (spreads over German rates)



Brief Review (continued)

- Hellwig: "*Without a REAL banking Union, the monetary union will likely fall apart … and the event can be very ugly*" **I completely agree**
- Yet, he expresses reservations on the feasibility of the project, arguing for each pillar of the Banking Union:
  i. Supervision: ECB has an incentive to do the AQR and stress tests correctly and start supervision with a clean slate. Yet, He questions the effectiveness of future ECB supervision within 18+ national laws
  ii. Resolution: He doubts national government would abandon their power to determine which banks to resolve
  iii. Deposit Insurance: Who will be bailed out and who will pay?
- And finally he comes to my own earlier comment: The <u>deeper problem is funding </u>for resolution and deposit insurance

Now, a few words on Greek banks

I. Size of Banking in Greece is small compared to Europe

II. The multiple crises affected financial intermediation as the financing of bank balance sheets became difficult

III. Major bank restructuring in 2012-13 has led to fewer well-capitalized banks, which now face challenges in the management of Liquidity and NPLs

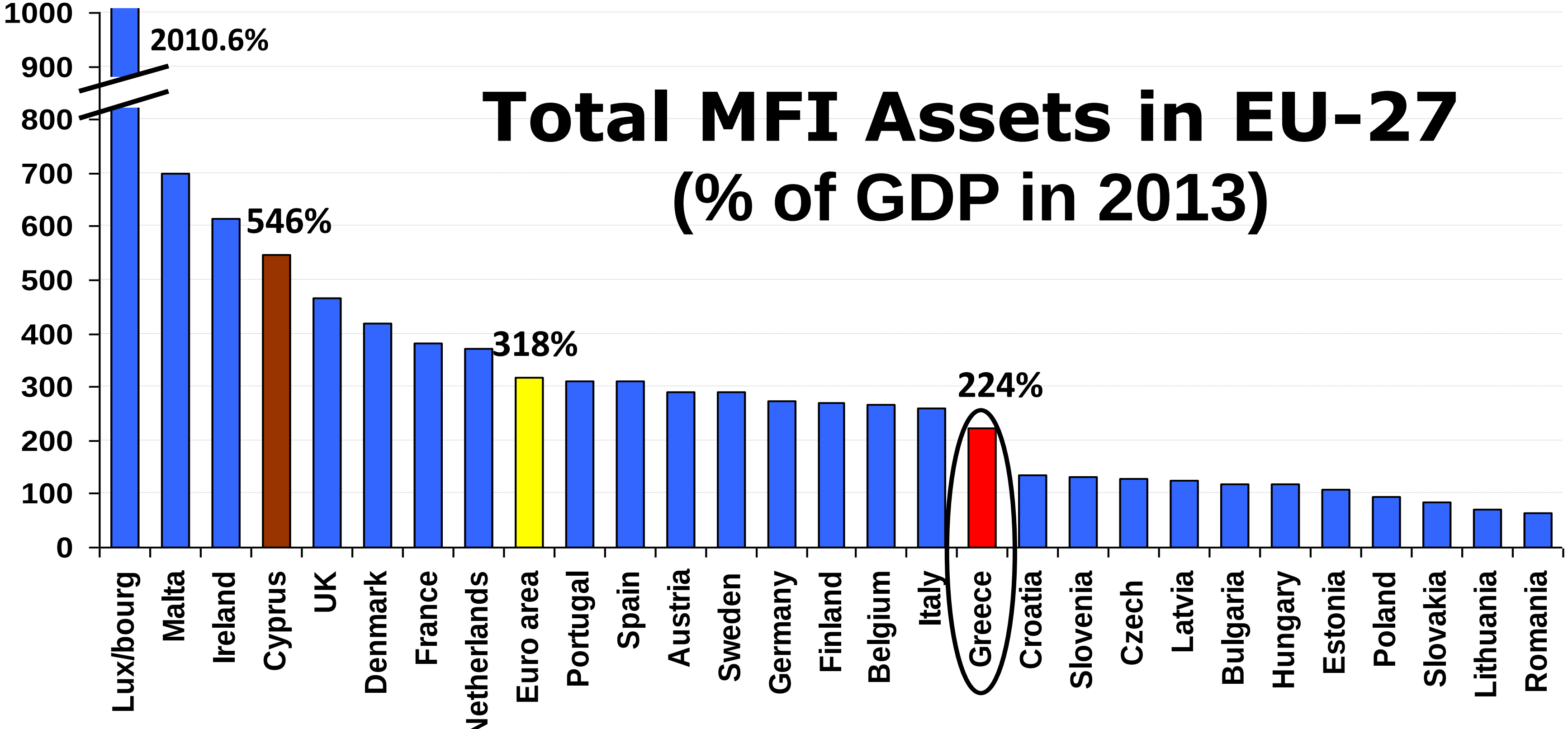
Bank size varies across the Globe & across EU countries, remains small in Greece

Eurobank

- ✓ Banks are more important in Europe
- ✓ Greek banking has room to expand

EU, USA & Japan- banking sector (2013)

	EU	USA	Japan
Total Assets (€ tr.)	€ 42.5	10.4	7.2
Total Assets (% GDP)	325%	85%	213%



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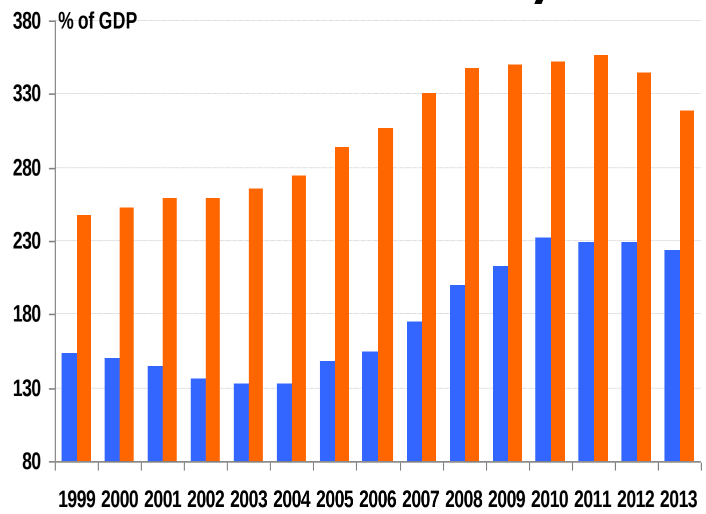
Source: ECB, European Commission

Growth in Greek banking during the EMU years: nothing extraordinary

Eurobank

Total assets/GDP

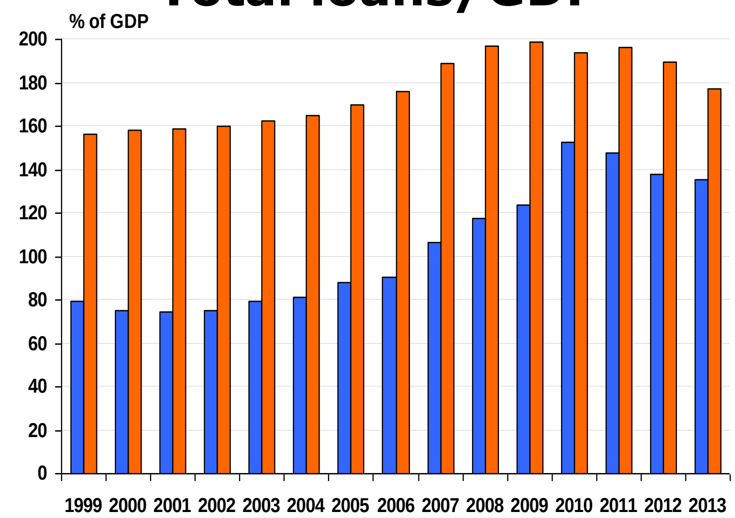


Source: ECB, Eurostat

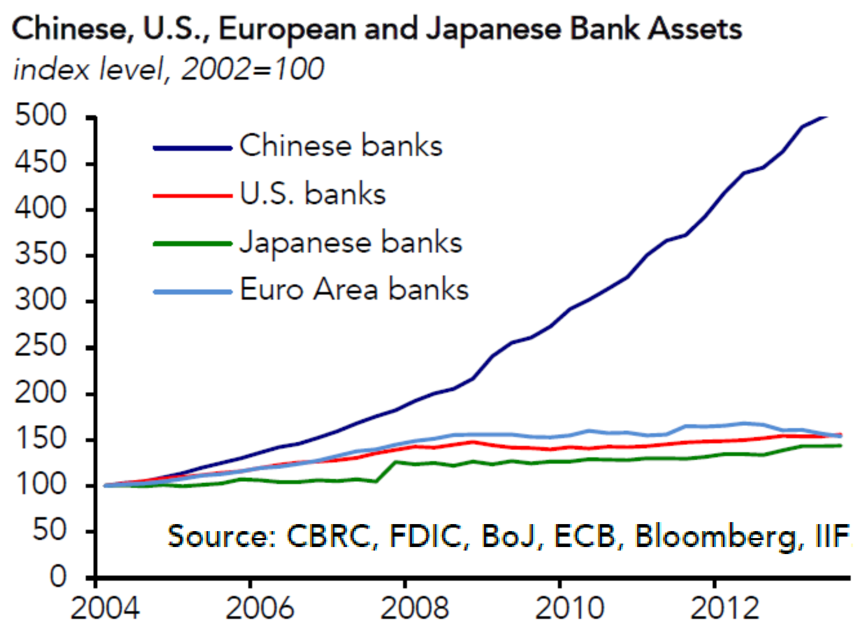
Euro Area

Greece

Total loans/GDP



- ✓ **Bank asset size in Greece smaller than in EA throughout history**
- ✓ **Asset size grew faster than nominal GDP after 2004, stabilized after 2010**
- ✓ **Compared to Assets, Greek Lending as % GDP closer to EA avg**
- ✓ **Chinese huge banking growth !**



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The four systemic Greek banks today, fully capitalized, face new challenges

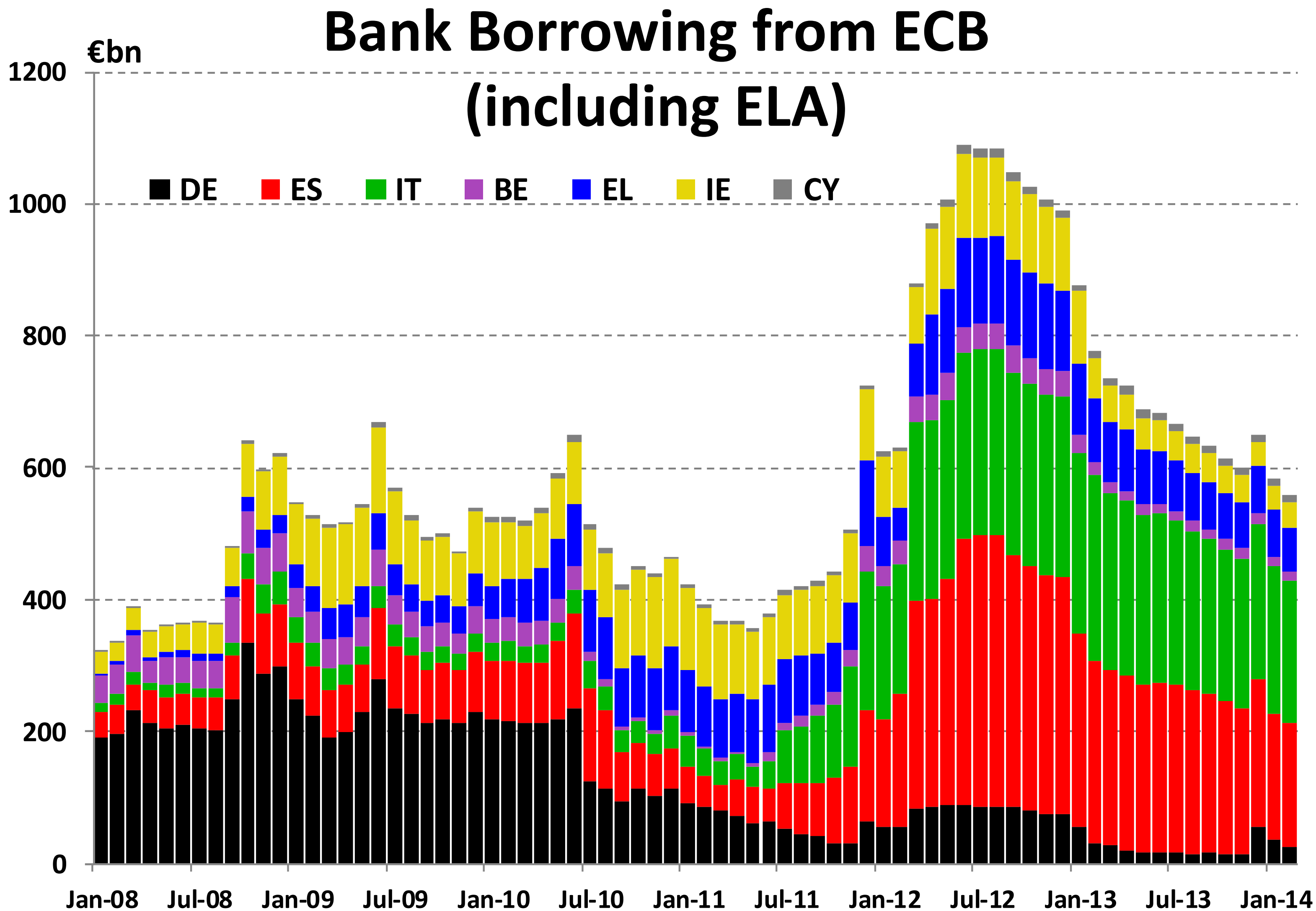
Eurobank

- ✓ Four systemic banks hold 90% of assets and loans
- ✓ Liquidity remains a challenge as long as deposits do not return to the system, the wholesale market remains expensive, forcing banks to the ECB
- ✓ Banks create special divisions to handle NPLs, which continue to rise but at lower rates
- ✓ Loan restructurings can help export-oriented companies and contribute to growth

31.12. 2013	Group Assets €bn.	Group Net Loans €bn.	Group Deposits €bn.	Group Loans / Deposits	Employees World-wide	Capital Adequacy Ratio today
NBG	110.9	61.3	62.9	98%	36,306	15.7%
Piraeus	92.0	60.4	54.3	111%	22,509	15.6%
Eurobank	77.6	45.6	41.5	110%	20,053	19.0%
ALPHA	73.7	51.7	42.5	122%	16,934	16.6%

Source: Bank announcements in February-March 2014
* Data as of 30.09.2013

Due to the crisis, ECB dependence has changed nationalities

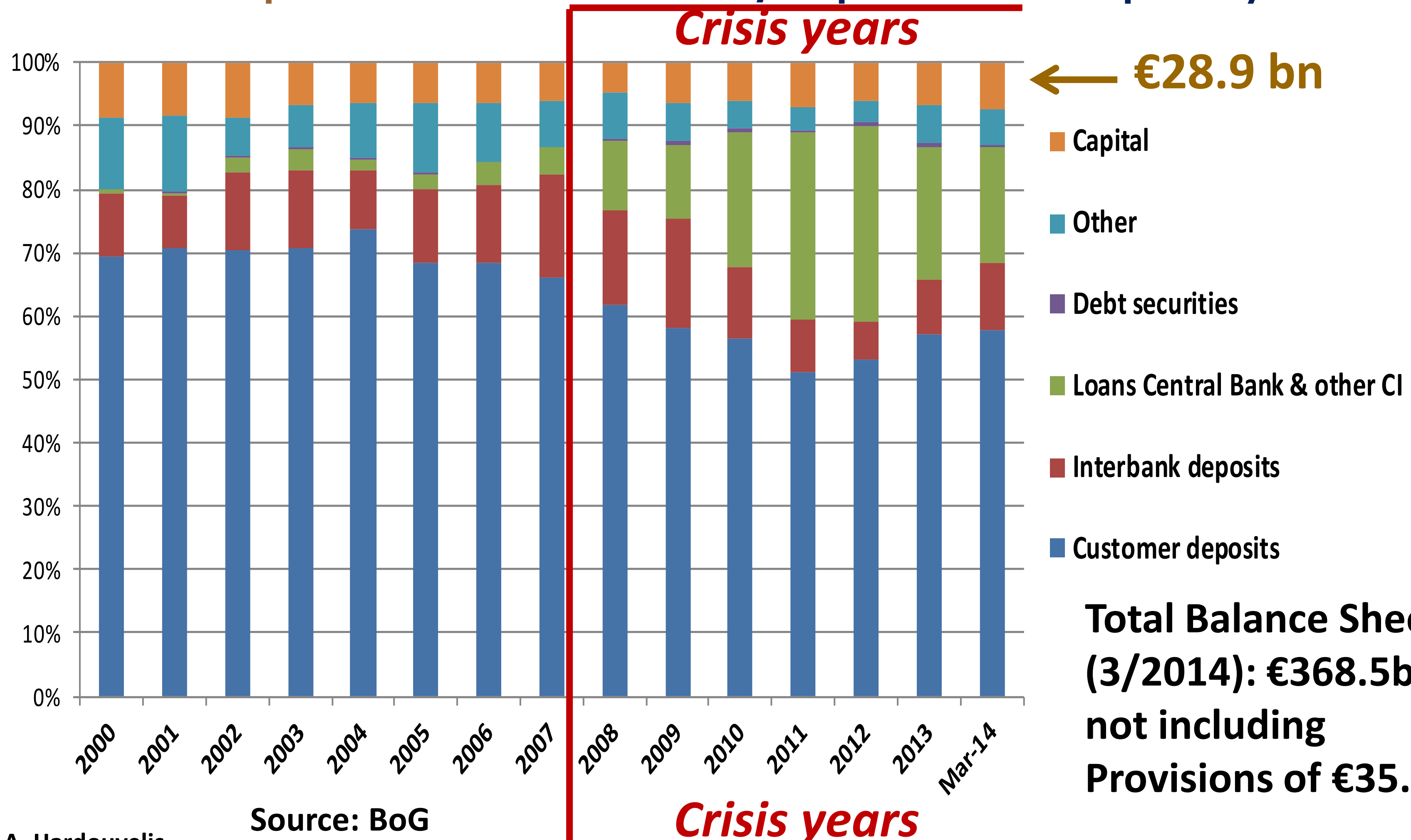


Source: Bloomberg

Financing of banks' balance sheets over the years in Greece

Eurobank

- ✓ Share of deposits falls after 2004, but more so after 2007
- ✓ Eurosystem funding increasingly important after 2007
- ✓ Share of Capital declines until 2008, improves subsequently



Total Balance Sheet (3/2014): €368.5bn, not including Provisions of €35.5bn

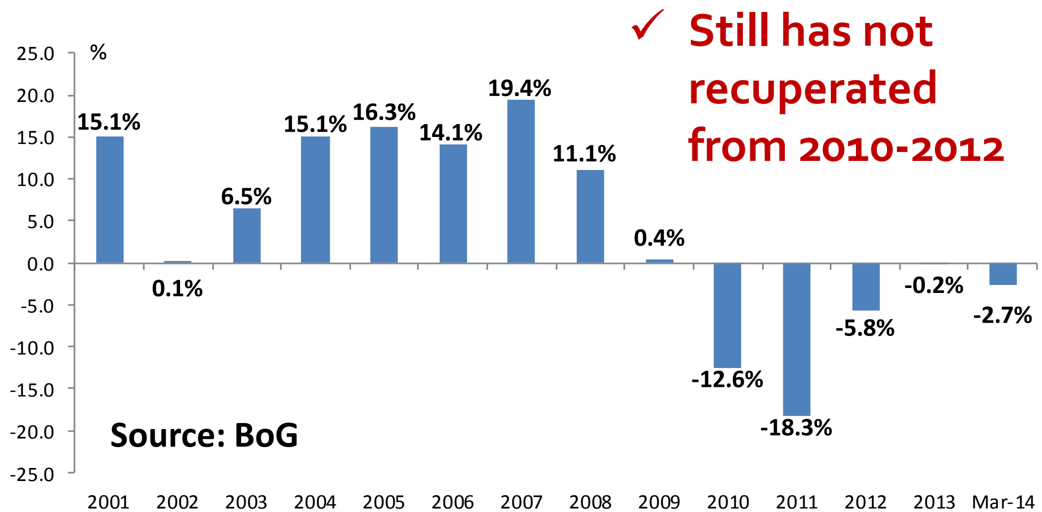
Source: BoG

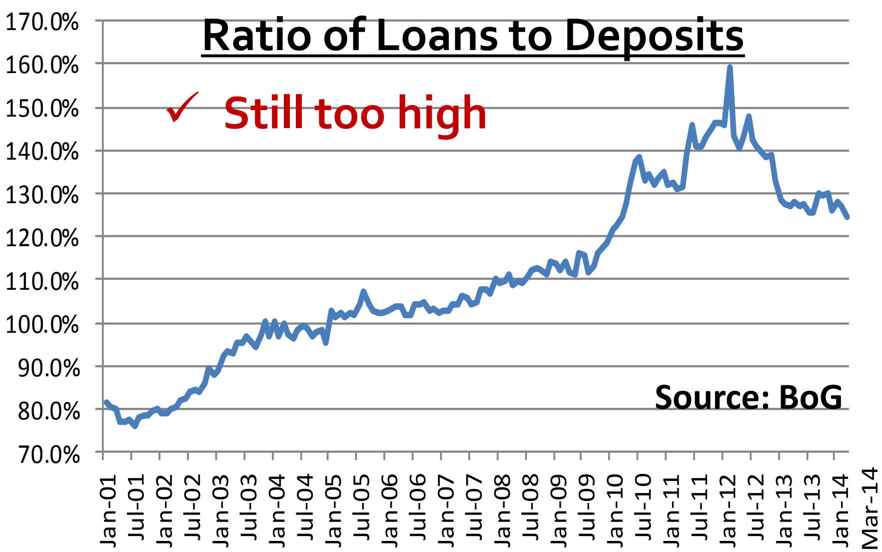
Crisis makes the financing of bank balance sheets increasingly more difficult

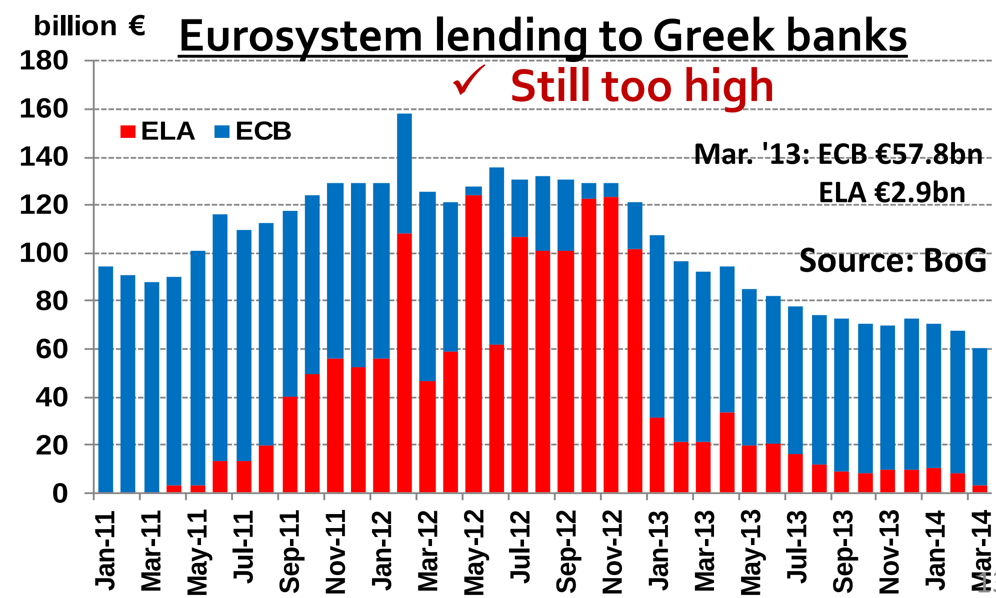
Eurobank

- ✓ Deposit ⇩ from late 2009 to June 2012 elections ⇨
  - Increase in dependence on the Eurosystem
  - ELA more expensive, has shrunk
  - Increase in ratio of loans to deposits with improvement only after 2012H2

Annual change in Deposits & Repos



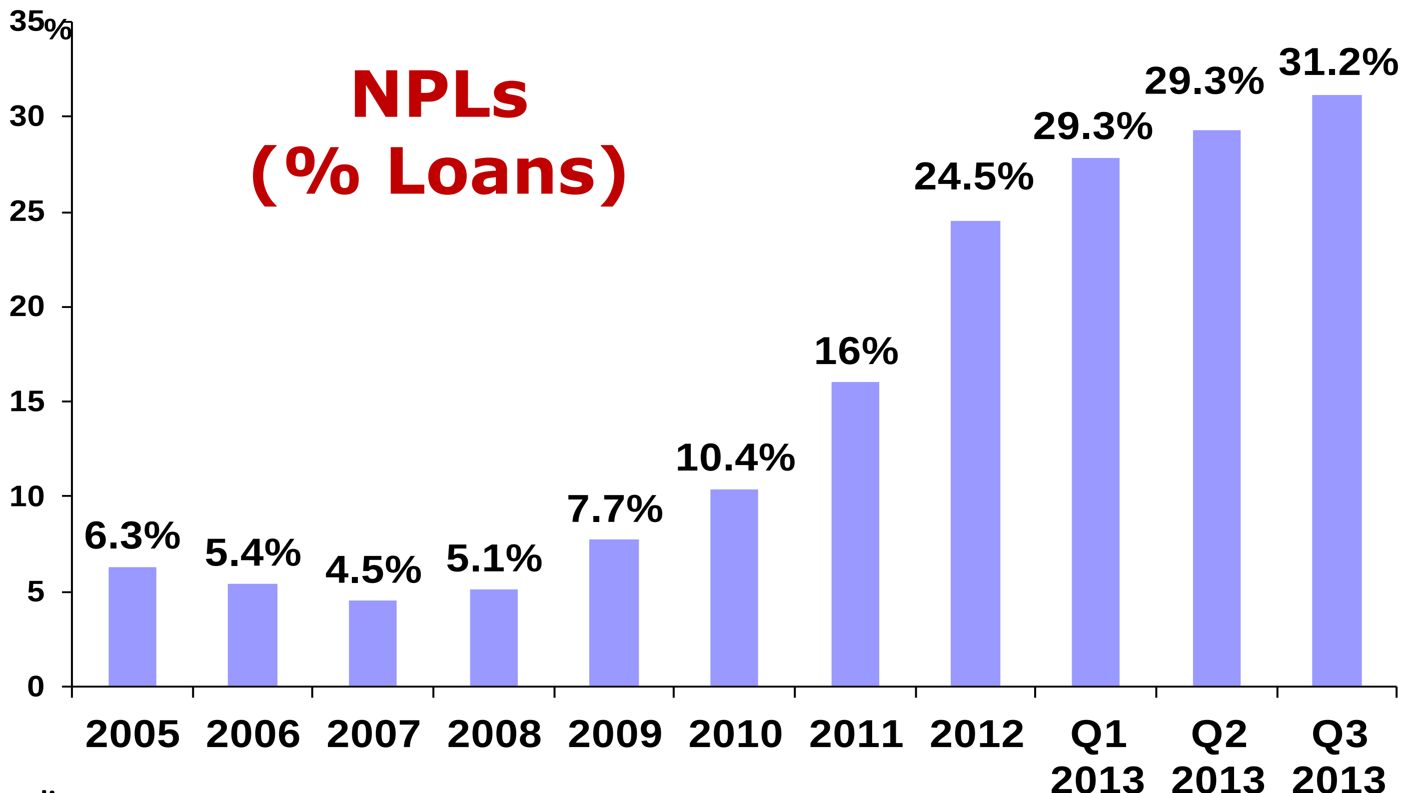




The second challenge: Non-Performing Loans

Eurobank

- Continuous loan restructurings contain the rise in NPLs, which are expected to stabilize in 2015
- New internal units in banks specialize in problematic loans, plus a new export-oriented growth model can be achieved for the Country as emphasis is placed on financing tradable sectors



Source: BoG

Despite the Greek crisis, financial intermediation continues

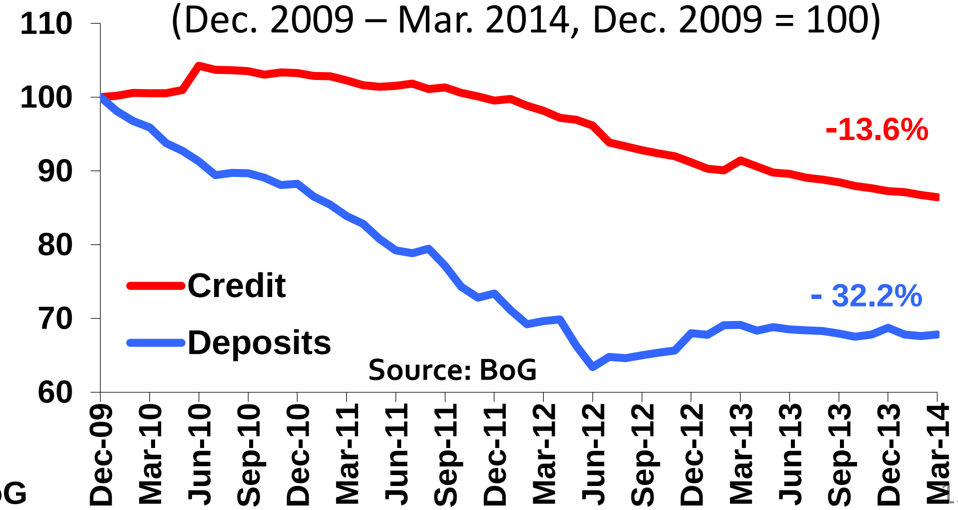
- Despite the challenges of
  - Capital,
  - Liquidity,
  - and NPLs,

  since the beginning of the EMU crisis, the drop in lending to the private sector is smaller than the drop in deposits
- On March 6, 2014 the results of the second BoG stress tests were announced
  - Need for additional €6.4bn of new capital to cover needs up to the end of 2016
  - Subsequently, Piraeus Bank raised €1.75bn , Alpha €1.2bn, and Eurobank €2.9bn , while NBG is currently raising €2.5bn

Domestic Private Sector

(€ bn)	Credit	Deposits		Credit	Deposits
2008	249.3	227.6	Mar. 2013	227.0	164.1
2009	249.3	237.5	Jun. 2013	223.4	162.7
2010	257.5	209.6	Sep. 2013	220.6	161.4
2011	248.2	174.2	Oct. 2013	219.3	160.4
2012	227.3	161.5	Nov. 2013	218.6	161.0
			Dec. 2013	217.5	163.3
			Feb. 2014	216.2	160.5
Source: BoG			Mar. 2014	215.5	161.1

Domestic Private Sector Deposits & Loans
(Dec. 2009 – Mar. 2014, Dec. 2009 = 100)



Source: BoG

Summary

- Martin Hellwig provides a fresh look and a sharp analysis of the EMU crisis, which is not completely over yet
- He is to be applauded for his objective point of view, his concerns and predictions
- The EMU crisis affected Greek banks originally through the PSI+, now through the challenge of NPLs
- Despite the recent enthusiastic recapitalizations through the private sector, liquidity remains an open issue as borrowing from the ECB supports close to 1/3 of total lending to the private sector
  - Hence, Greece may escape from a new MoU, but unless citizens regain their trust in the domestic institutions and deposits flow back into the banking system, the country will remain dependent on the ECB for a while

Athens, May 06, 2014,
Discussion on the presentation by Martin Hellwig:
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at Athens Music Hall

Thank you for your attention

www.eurobank.gr/ research

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