Europe: A Pause in the Crisis? Part II

Nicolas Véron outlines the many difficulties and obstacles inhibiting Europe's commitment to achieve a banking union.

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Steve Weisman: This is Steve Weisman with Nicolas Véron at the Peterson Institute for International Economics, for the second part of our conversation on the situation in Europe at the end of the summer, focusing on the progress that Nicolas has been monitoring toward a possible European Banking Union.

Has anything happened over the latter half of the summer that has made you more or less hopeful that Europe will achieve its goal in this regard?

Nicolas Véron: Actually at their summit at the end of June, the leaders of the euro zone have made a decision, which is to ask the European Commission to make proposals, as is usually the case in that sort of process. It's a proactive process. Technically, the next step has to be the proposals that will be delivered by the European Commission, specifically the Commissioner for the Internal Markets, which is in charge of financial supervision and regulation on how to engineer this banking union, and this proposal is expected before the middle of September. So it's within two or three weeks from now.

Not much has leaked from what the commission's proposals would be. There have been some leaks, but there is no draft proposal around, and so at this point we are left to speculate on what will be considered, let alone what will be eventually decided on, what will be the initial steps of this so-called Banking Union and really the expression, 'banking Union' refers to several things. It refers to a long-term vision of an integrated framework in Europe for banking policy which should, at least in principle, include all key elements, namely supervision, resolution, and deposit insurance in particular.

But it also refers to something more immediate, which is what will the European Union, and specifically the euro zone, do with the banking system, which is to a large extent in a difficult situation right now as the next steps of euro zone crisis management. So there is a long-term dimension. There is a short-term dimension, as many leaders including the president of the European Central Bank, Mario Draghi, have insisted it's important to keep both directions in mind. They shouldn't engage in short-term crisis management without long-term vision, but conversely there is a temptation often in Europe to focus on the long-term vision, and forget that the house is burning right now, and something has to be done quickly and this also applies to banking union.

So Banking Union is not just a question of long-term architecture, it's also a question of short-term crisis management. And the way the leaders have framed it in their June 29th statement is to say, "We want to put in place a single supervisor mechanism for the euro zone or beyond, and once we have this in place, we want the European Stability Mechanism, which is a bailout fund, which is not yet in place but hopefully will be in place in the next few weeks or months, to be able to intervene directly in individual countries' banking systems, perhaps starting with Spain and Ireland, in terms of individual bank recapitalization." What is meant by recapitalization remains a bit of a work in progress too.

Steve Weisman: Let's talk about that. Recapitalization could also entail consolidation or basic changes in ownership?

Nicolas Véron: I think it should. One lesson of the crisis is that debt is a different thing from equity. You can lend to banks, but you don't resolve their fundamental situation, even when the lending is on fairly preferential terms or subordinated lending or even hybrid instruments. So at some point, I think if they want to make progress or strides toward resolutions in the banking system for the euro zone, they will have to consider equity intervention, equity injections. And when I talk about equity I really talk about voting common equity, and not some more fancy instruments that are less loss absorbing and more like debt, what the people in markets typically called funny equity, or hybrid instruments subordinated, etcetera.

Steve Weisman: Where would they get this equity?

Nicolas Véron: The money is in the ESM [European Stability Mechanism]. Of course it's a limited pot of money, which is one of the parameters of the current equation, but I think more important is the question of what will be the processes for intervention? What will be the responsibilities that the European Stability Mechanism will take? And how will all this be decided? And here we are in a complete fog right now because this is politically very significant.

We are talking about the euro zone level making decisions to close banks or to nationalize banks—I mean taking public ownership, but the public ownership at the European level, which is frankly without precedent. So we're talking potentially about fairly large banks, which play a very important role in individual member states' economies.

Steve Weisman: But isn't it an admission that let's say Spain can't do it on its own?

Nicolas Véron: Absolutely, and this admission has been done already with the decision of the government of Spain to appeal to the European Financial Stabilization Facility or EFSF to recapitalize its banks, but in a natural framework. So there are different degrees to this Europeanization of the crisis resolution approach, but it would be a step further of course to have. The current system is basically the EFSF lends to Spain so that Spain recapitalizes banks and takes ownerships in some of them.

Here we're talking about something different, which is the ESM would completely bypass the member states and take direct ownership or recapitalize directly. And how this works in terms of accountability and responsibility, of different banks, and assessing their situations of their balance sheet, and their viability prospects and all that, remains very much to be seen. Of course it is to be linked with the other big questions that we've talked initially, which is the long-term architecture. What is this new single European supervisor or supervisor mechanism?

What's the relationship with the ECB, because the Italians said in their leader statements that this will be basically hosted by the ECB, but there are many ways to do this and how credible would it be? Can it really be a game changer in the crisis and can it be effective in reaching what the leaders have explicitly stated as their aim, which is to break the negative feedback loop between bank credit and solvent credit, which has been very harmful in the recent phases of the crisis. Or will it be a sort of a halfway house and other wishy washy European decisions that tries to strike a compromise, but doesn't really convince investors that progress has been made? And so far the indications are mixed.

There are reports of European member states considering something which would grant supervisors the authority to close banks, which I think is absolutely indispensable if we want this mechanism to be credible. But this can mean many different things, and then you have to look at the legal fine print because closing banks is a nonlegal expression which can cover different processes, which don't mean the same thing in practice. And also it has been reported that this was controversial. So we are not yet at the point of decision on this.

Another big question is whether this will cover all banks in the euro zone or only the largest ones. And this is a big question both financially and politically because many local banks, like in the U.S. with community banks or credit unions, have very strong local political connections. But they're also, particularly in the case of Spain, also in some other places, proven to be a potential factor of systemic instability because Spain's problem has been more with the smaller local banks, which all made the same mistakes, like the Savings and Loans in the U.S. in the '80s, than the big banks, which are comparatively sounder or at least appear so at this point.

Steve Weisman: Right.

Nicolas Véron: That's one very hot issue in Germany, because in Germany, the local banks are mostly the savings banks. And cooperative banks are very embedded in the political system. So they're a big voice in this debate. Now that Spain has all of these problems, the German situation really doesn't have an equivalent in other countries. So maybe there will be a German exception here, it would seem. And many other questions, the most important, really revolve around this question of resolution and deposit insurance, which may need the use of public money. This raises the question of the relationship between banking union and fiscal union because if there is a European level framework for bank resolution and deposit insurance that somehow requires European fiscal capability to be credible, this immediately begs the question, "What do we have in terms of European fiscal capability?" And at this point we have the EFSF. We have the ESM. These bailout funds are very limited in size and therefore cannot provide the credibility that would be needed for sustainable bank resolution and deposit insurance.

So basically, it is impossible in practice, even though some politicians or policy makers would like it, to isolate the banking union debate from the broader debates about fiscal union, and even political union. Actually, it's impossible to reference them in a way -- they have to be a package. So that doesn't mean it's the same discussion. It doesn't mean there are the same decisions. But there has to be a parallel consideration of banking union, fiscal union, and political union, as actually we discussed in a previous one of these chats.

Steve Weisman: In these chats and in your testimony and recent speeches, which are on our website. Thank you, Nicolas, for bringing us up to date.

Nicolas Véron: Thank you too, Steve.