



## **RESCUING THE EURO**

**Fernando Fernández Méndez de Andés, IE Business School**





## HOW WE GOT HERE

There are lessons that are best not forgotten. And we Europeans, carried away by our presumed exceptional status, have been doing this for years now. At the time of the Argentine crisis (I know this is an example we don't like bringing up) there was fervent debate among economists over the possibility of keeping to a fixed exchange rate system indefinitely (not just over whether it is a good idea, as that is another issue altogether). The conclusion, which can be summarised in an article by Stanley Fischer<sup>1</sup>, who was then deputy director at the IMF, was to go back to the theory of optimal currency areas<sup>2</sup> then formulated like a corner solution. Countries could choose to fix exchange rates irreversibly only if this was done in parallel with organising an integrated economic area, and if irreversible progress was made in meeting the four basic conditions for a common currency, namely labour mobility, trade integration, flexible prices and salaries, and a single stability fund. In short, if there was a single political authority which could reconcile the role of issuer of currency – as lender of last resort – with that of issuer of sovereign debt – the Treasury. Otherwise, variable exchange rates were the only alternative, with flotation being done more or less cleanly<sup>3</sup>, which brings us back to how to manage exchange rate autonomy, and the possibility of a euro break-up if the European Monetary Union is left as a multilateral fixed exchange rate system. A break-up would clearly be an undesirable event, which would have catastrophic consequences, in my opinion, though it is an event that is increasingly less unlikely and towards which some decisions and, above all, indecisions, seem to be irresponsibly leading to. This is why

<sup>1</sup> Stanley Fisher (2001), "Exchange Rate Regimes: Is the Bipolar View Correct?" *Journal of Economic Perspectives*. Spring 2001, Volume 15, Number 2, 3-24.

<sup>2</sup> Initially formulated by Mundell in 1961 and later developed by MacKinnon (1966) and Kennen (1966).

<sup>3</sup> This issue is rearing its head again in the light of the financial crisis and many economists are warning to the possibility of a dirty exchange rate flotation, even to the point of maintaining that it could be possible to simultaneously combine capital account freedom, a fixed but revisable exchange rate and independent monetary policy. See Rakesh Mohan's refutation of the "Impossible Trinity" from *In the Wake of the Crisis*, edited by Blanchard, Romer, Spence and Stiglitz, International Monetary Fund, MIT Press, Cambridge, Mass, 2012. I still think this is a fleeting illusion though, characteristic of the Chinese chimera, when that country, given its size, is not exactly a price-taker.

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we should be very clear from the start: the break-up of the euro would be a political and economic disaster; the end of the European dream and the rise of populist nationalism, the return of protectionism and widespread impoverishment<sup>4</sup>. There are no miraculous devaluations and less so in a region that trades heavily within itself such as Europe. We Europeans are so determined to rewrite history that we have forgotten the very reasons that gave rise to the Monetary Union, it would seem that this was merely a whim of a few enlightened bureaucrats, or benign dictators in economic parlance.

The fact is that we Europeans continue to ignore basic economics lessons, and the euro crisis keeps on rolling. The much feared double-dip recession is not just already a reality, one of the rare occasions on which it has happened historically: it also threatens to become a second Great Depression. And this will not be for want of warnings. The European Monetary Union came into being in the midst of scepticism, if not outright hostility from the academic profession. There were many amongst us who, always prone to fanciful conspiracy theories to conceal their own ignorance, invoked American apprehension at the birth of a new currency and a new empire that aspired to rival the dollar and deprive it of its leading role worldwide. But paranoia is a poor economic adviser. The more enlightened among Europeans themselves knew that we were setting in motion a process that would lead ineluctably to a strengthening of the European Political Union. Romano Prodi, then chairman of the European Commission, could not have said it more clearly at the time, although nobody chose to heed him: "I am sure the euro will oblige

<sup>4</sup> For a rigorous description of its economic consequences see Eduardo Levy in Fernando Fernández (2012), "The crisis in Europe: a sovereign debt problem or a euro crisis?", *Papers by the Fundación de Estudios Económicos* No. 44, p. 279-289.



us to introduce a new set of economic policy instruments. It is politically impossible to propose that now. But some day there will be a crisis and new instruments will be created”<sup>5</sup>. That is why the British stayed out. For that reason and because the United Kingdom is perhaps the only European country where there was a genuine academic and political debate on what the European Monetary Union ultimately means. They knew that the euro would inexorably lead toward a more integrated Europe and they were not prepared to forgo their sovereignty, proud and melancholic as they are at the same time about their Empire and their special relationship with the United States. But the new Europe must be built on intelligence and realism, not through adventurous forays of voluntarism.

The euro is dead. Long live the euro! There is no doubt that today the time has come that defines the future. We Europeans have lived in complacency for too many years. In part this has been justified because the euro has actually given us ten years of spectacular economic growth, financial and price stability, and even better social and regional cohesion in Europe. But it has also revealed our ignorance, because it was well known that stabilising the exchange rate always has the same effect everywhere, namely a strong initial expansion as the devaluation and inflation premium is reduced, leading to a surge in investment as a result of the phenomenal improvement in financial conditions<sup>6</sup>. An improvement which is only transitory and can become reversible if the additional funding is not used to boost the country’s productive and export capacity; if the growth period is not accompanied by structural reforms that enhance external competitiveness. Because increased availability of international financing necessarily raises a country’s level of external borrowing. This is even truer in a Monetary Union which, like the EMU, is intended to be irreversible, which therefore means that external funding is available in our own currency. External vulnerability that makes the country come to de-

<sup>5</sup> Romano Prodi, address to the European Parliament, December 2001.

<sup>6</sup> So well-known in fact, that it has been part of economic policy consensus since at least the eighties. See Kiguel, Miguel A, “The business cycle associated with Exchange-Rate-Based Stabilizations”, *World Bank Economic Review*, vol. 6 (May 1992), p. 279-305.



pend on the risk appetite of investors or, in the European case, their confidence in the sustainability of the common currency structure. Sustainability which is inversely correlated to institutional complexity, to the inability to take and implement decisions, to the doubts entertained in creditor countries, to the political reluctance and difficulties when it comes to understanding what a Monetary Union really means, what it entails and what makes it irreversible.

The European Monetary Union has in fact been broken up for a long time, save in the world of public capital flows. The private financial system has ceased to operate functionally. Euro Area monetary flows have renationalised and cross-border funding has disappeared or become a rarity<sup>7</sup>. The interbank market is non-existent, European banks have used long-term financing received from the European Central Bank, the so-called LTRO, exclusively to fund their national Treasury, in the case of the peripheral countries with government deficit problems, or to hoard it again in the ECB to ensure they meet liquidity ratios in the case of the central countries. As had already happened in the countries under a rescue programme by the Troika, non-domestic European banks used the windfall official liquidity to sell off their bond holdings and exit the troubled countries. This is logical, almost mandatory, for any responsible manager, but it is a textbook example of a collective action problem generated by a tumbling Monetary Union. Above all, because this behaviour was not just the rational response from bank managers to a possible “credit event”, but was instead induced, prompted and even precipitated by their own domestic regulators. In a Monetary Union with as many regulators as there are countries, not only does country risk not vanish nor necessarily lessen; instead it can even be amplified by the protective action of each sovereign regulator towards its own national banks. Cutting to the chase, the fundamental, statutory concern of the Bundesbank is not to save the euro but to safeguard the stability of its financial system and the solvency of German banking institutions. And this persuades the national

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<sup>7</sup> German banks cut their exposure to countries on the periphery by €55 billion in the first half of this year, back to levels seen in 2005. *Financial Times*, 29 July 2012.

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central bank to ask its banks to leave Greece or to sell off Spanish debt. It is rational behaviour from a national standpoint but suicidal from the point of view of a Monetary Union. 'Take the money and run' seems to have been the message from national regulators. Europe has a serious problem of incompatible incentives.

In such circumstances the only real source of liquidity for the system in the peripheral countries is the ECB, because its major issuers have not been able to go to the private market since midway through last year, including even the most solvent corporates and with the abstraction of certain windows of opportunities opened by decisive European decisions that later failed to materialize. Thus the debtor position of, for example, the Bank of Spain, relative to the Bundesbank in the Euro system, the so-called Target 2, just keeps growing and growing, and is unanimously interpreted as an indicator of vulnerability in a vicious circle of lack of confidence in the single currency<sup>8</sup>. Nobody in the United States is bothered by the debtor position of the Federal Reserve of New York vis-à-vis its counterpart in Kansas, nor is anyone in Spain concerned about Galicia's creditor position regarding Catalonia. But they are in Germany, the Netherlands, or Finland as regards Spain or Italy, and they make suicidal statements to each other about the need to make provisions against such exposure<sup>9</sup>; in the same way as domestic regulators

<sup>8</sup> In gross terms, total funding of Spanish financial institutions through the ECB reached €402.185 billion in July, which was up by 10.2%. In July Spanish banks accounted for 32.5% of total funding through the Eurosystem, thus tripling the relative weight of Spain's financial system or its GDP in the Euro Area.

<sup>9</sup> Hans Werner Sinn, one of the five German wise men who are members of the Chancellor's Committee of Experts, has sparked debate in Germany for publicly asking the Bundesbank to compel the other national central banks in the Eurosystem to make provisions against this debtor position. Complete regulatory nonsense which only reflects his personal conviction that the euro has failed and that the German central bank would do well to start recognising the associated losses. See Sinn and Wollmershaeuser, *Target Loans, Current Account Balances and Capital Flows: The ECB's Rescue Facility*, NBER WP No. 17626, November 2011.



advise or urge their banks to scale down their positions in the countries on the periphery in a kind of self-fulfilling prophecy of collective madness.

If Europeans themselves seem not to trust the single currency, how are the Americans or the Asians going to? Once again, true to the form observed with previous exchange rate crises, it is the nationals themselves, this time the Europeans, who are the first to withdraw their money from the countries on the periphery and the banks there, regardless of whether they are solvent or liquid. When the Central Bank of Switzerland found itself forced to step in to prevent the Swiss Franc appreciating as a refuge currency, nobody in Europe wanted to draw a parallel with the Central Bank of Uruguay during the Argentine crisis. Such a comparison was taken as an insult. Too much pride and not enough rigour; too much self-importance and not enough decisiveness. The IMF warns emphatically<sup>10</sup>: “The adverse bank-sovereign feedback loops at the heart of the crisis have intensified”, “depositor confidence is increasingly fragile”, “drastic decline in interbank activity”. The conclusion is evident; financial conditions are speeding up the actual crisis. But it does not have to be like this. This paper seeks to examine and describe what can be done and how, continuing the thread of several pieces on the same subject which already sketched the broad outlines of the solution<sup>11</sup>.

## HOW TO PREVENT THE EURO GOING UNDER

All European leaders insist that they are working tirelessly to avoid a break-up of the Monetary Union. There is no European Summit, no ECOFIN meeting, and no session of the ECB’s Governing Council that concludes without some turgid statement about doing everything possible and more to save the single currency. Yet the fact

<sup>10</sup> IMF, *Euro Area Policies, 2012 Article IV Consultation*, July 2012. Available on the website as IMF Country Report 12/181.

<sup>11</sup> See Fernández and Navarrete (2009), *The Reform of the International Financial System*, and (2011), “A Euro with a Future, a European deposit guarantee mechanism and banking resolution for the single European currency”, *FAES Papers*, No. 158.



is that the euro appears to suffer from Penelope's shroud syndrome. Each step forward that is promised is refuted by the facts or followed up by some official statement which plays it down and makes it contingent upon meeting a whole set of new conditions which are spun out over time. The latest example, actually from August even though all the leaders were on holiday, is the Draghi Plan, whereby the ECB is poised to buy up the debt of the struggling countries on the periphery, even perhaps to hold a certain unofficial spread level, as long as (i) they ask for this publicly, and (ii) they submit to strict macroeconomic conditions in an as yet undefined procedure. A Plan which is highly reminiscent of the IMF's Contingent and Flexible Credit programmes<sup>12</sup> and which has given rise to a whole raft of expectations and a substantial improvement in these same spreads. But the Bundesbank has waded in and considers it irresponsible and an unnecessary risk. And the German political authorities are wavering in silence as to whether to toe the line out of respect for the ECB's independence or to show an understanding of the Bundesbank's stance against it in response to pressures from the electorate there.

As with all political in-fighting, given the lack of a clear authority, the European leaders do not refrain from improving their relative political stature by publicly airing their viewpoints and differences of opinion. Such a strategy might seem logical in terms of domestic politics, but it is an economic suicide that threatens to stop the Plan from showing the results hoped for by highlighting the disunity and incoherence of the Euro Area, thus fuelling a lack of confidence in its future. Europe has a political problem, not just an economic one, which is the result of the failure to effectively close the door on the debate on a European Constitution. It is not possible to make any headway in finding a solution to the current economic crisis, which is essentially a crisis of confidence in the European single currency project, without significant progress in building an optimal currency area. And Eu-

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<sup>12</sup> Lines of credit from the International Monetary Fund which were opened in response to the various exchange rate crises and which seek, through a prequalification process, to avoid problems spilling over from one country into another due to the outbreaks of irrational behaviour or temporary hysteria that take hold on financial markets and the stigma associated with using funds from this multilateral body.



rope will not resemble an optimal currency area without making inroads into Political Union, which requires further relinquishment of sovereignty and not just imaginative short-term financial solutions, or exceptional fiscal mechanisms for those that do not toe the line. The Monetary Union does not and cannot stomach the uncertainty associated with repeated appeals to the German Constitutional Court. A new constituent process must be opened which delivers clear rules for everybody concerned<sup>13</sup>. The current situation of inconsistency, of power vacuum, and rules and regulations which change without any recognised rationale or direction, are the paradise of the very speculators who are so harshly censured verbally. Regulatory risk – and the European Monetary Union is the quintessential illustration of this today – is perfect breeding ground for speculation.

### **European Deposit Guarantee Fund**

The constitutional structure of the euro must be culminated with a Banking, Fiscal and Political Union. That is the important task at hand. But there are urgent actions to be taken, vital ones, if we do not want the euro to die in our hands. The pressing issue is to set up a Deposit Guarantee Fund on a pan-European scale and with clear fiscal rules that allows the ECB to act as lender of last resort for the financial system because the cost of its potential recapitalisation will be borne by the incumbent governments on an *ex-ante* agreed procedure. The European Central Bank's worst fear is not inflation, which is neither here now nor forecasted for the coming years, but rather the decrease of its independence as a result of capital losses that leave it at the mercy of the governments of the day. This has always been a nightmare for any responsible central bank.

At this stage of the crisis, a Deposit Guarantee Fund on a Europe-wide scale is the only way the citizens of the European Monetary Union will come to perceive that a euro left on deposit with a bank in Germany is intrinsically the same

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<sup>13</sup> Nicolas Vèron, *The Challenges of Europe's Fourfold Union*, Brueghel Policy Contribution, Brussels, August 2012.



asset as a euro deposited at a bank in Spain, irrespective of the quality of the bank, as was a Deutschmark in Hamburg or Cologne, or a peseta in Seville or Valencia. As long as this is not the case, the outflow of capital from the banking systems of countries considered risky will continue<sup>14</sup>. The drop in deposits deteriorates the liquidity position of financial institutions and makes them more reliant upon wholesale funding just at a time when, as we have already pointed out, this has ceased to exist and is confined to the ECB, which is then interpreted as a symptom of crisis, thus fuelling a vicious cycle.

Financial and sovereign crisis fuel themselves anew through this alleged protection mechanism which, at the heart of a monetary union lacking a common safeguard, a sure backstop, without risk pooling, becomes a destabilising element with incalculable consequences. The free movement of capital, which is inherent to a monetary union, can become incompatible with maintaining financial stability in the absence of a common mechanism guaranteeing bank deposits. Because the essence of a monetary union is that banks should compete with one another without any restrictions, as well as attract deposits from private individuals and companies within the common economic area regardless of the nationality of the account holder or the company. This is precisely one of the Monetary Union's explicit objectives: to boost competition among banking institutions to pare down their commercial margins and deplete their monopoly power to the benefit of banking consumers<sup>15</sup>. But such a goal is counterproductive if: (i) the interbank markets vanish and renationalise; (ii) the national regulatory authorities get in ahead of even the rating agencies, which are so heavily criticised

<sup>14</sup> Bank deposits within the Spanish financial system have fallen off by 5.2% in the twelve months to July this year. In Greece they have plunged by over 30% since the onset of the crisis. Obviously not everything is an outflow of capital in the strict sense, as people draw on their savings to fund consumption when times are hard. Yet the fact is that, despite a 70% reduction in the Spanish deficit on current account, the private sector balance on the financial account has been negative by €316 billion.

<sup>15</sup> The ECB has been complaining for years that the European Monetary Union has been making very slow progress on a retail level. There have been very few cross-border mergers, the costs of transfers between banks in different countries have been excessive and regulations are needed to rein these in, while fees for using cross border cards have been too high and the domestic bias among savers and investors has not been justified.



for their pro-cyclical behaviour, and only concern themselves with their own banks and penalise cross-border positions within the common economic area; (iii) access to ECB liquidity becomes stigmatised and punished by the markets; and (iv) the ECB itself insists on “the first loss“ being absorbed by domestic taxpayers and applies increasing pressure on national central banks to use their national emergency facility, or Emergency Liquidity Assistance (ELA) in European terminology, to provide liquidity for their banks which have been left without collateral discountable in Frankfurt before resorting to help from Europe<sup>16</sup>.

Having arrived at this point, European economists virtually unanimously agree that there are only two options available: either capital controls are re-established for banking transactions between countries, or the deposit guarantee is mutualised. The first possibility means restoring the capacity to shield the national financial system from any flight of capital, which is a must for all regulators, by imposing restrictions on withdrawing cash – a situation popularly referred to as a “*corralito*” and which the British more elegantly term a “bank holiday”. This alternative would inevitably lead to the break-up of the Monetary Union and the more naïve, thinking that this could be temporary, find it a desirable solution until any doubts surrounding the solvency of national banks wear off and financial markets return to normal<sup>17</sup>.

The second option is immediate implementation of a bank deposit guarantee system on a Europe-wide scale to act as collective cover for the savings of Euro-

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<sup>16</sup> This summer we have witnessed how a Spanish banking institution, Banco de Valencia, had to turn to the ELA mechanism after delays to the start of a recapitalisation and restructure plan for the Spanish banking sector that had been agreed with Europe.

<sup>17</sup> The amount of proposals for a temporary suspension of the Monetary Union that are beginning to emerge in political (not just German) and even academic circles is surprising. In my opinion it means failing to grasp anything about what money is in a fiat money system, which by definition is based exclusively on the people’s confidence. If such trust is damaged, recovery is slow and painful, and the loss of monetary policy autonomy runs very deep, as is testified by the efforts lasting for a matter of decades that have to be made by those countries that, due to their background of persistently high inflation, have witnessed their financial systems being dollarized, – this being understood in its technical sense, where a substantial portion of the loans and deposits of private individuals is transacted in a foreign currency.



peans and as a mutualised arrangement for their bank deposits. This is an alternative that inexorably leads to surrendering financial and fiscal sovereignty to as yet undefined European authorities and would mark the starting signal for a genuine Banking Union. A European Deposit Guarantee Fund could take a whole variety of forms and several key decisions have to be taken, three of which are in my opinion fundamental: coverage, funding and legal form. The coverage in all the countries in the Euro Area would have to be the same from the start, which is no small matter as there are different national traditions and laws. The most reasonable solution would be to begin with a European coverage limited to €100,000 per banking institution and account holder, which the Commission itself was advocating at the dawn of the financial crisis. Lesser amounts, which might be justified from a political economy standpoint, do not provide a solution for the underlying problem, which is none other than to avert a legal flight of capital within the single currency area. Permitting a second national tranche above this level of coverage might appear politically reasonable and compatible with the principle of subsidiarity, but it would entail the same problem. There is no precedent of long-lasting monetary unions which have functioned using competing deposit guarantee systems.

A more delicate question is how to fund it. Within the Monetary Union, prefunded systems currently coexist with others that are not, systems which impose a levy on financial institutions in proportion to the volume of funds guaranteed alongside others that are essentially a public contingent guarantee. A prefunded system with a levy on deposit institutions is clearly the better option; a flat rate for all countries and funds guaranteed that would have to be carefully gauged, as it is evident that it involves making bank funding more expensive precisely at a time when this is not exactly very abundant. Setting this will always be a discretionary decision based on forecasts of what impact it would have on the prices of banking products and the size of the figure expected to be raised. But one should eschew voluntarism, as it will never be enough to stop a systemic crisis ending up costing the taxpayer. This is why setting up a European deposit guarantee system is a quasi-fiscal decision, because it involves the explicit mutualisation of bank de-



posits in Europe and European taxpayers being willing and committed to maintaining the nominal value of bank deposits as a fallback position in any crisis situation, whether idiosyncratic or systemic, domestic or pan-European.

No less a problem is the changeover period, because irrespective of the level of coverage and the tax rate applied with the setting up of the European system, the various different countries would arrive in very different circumstances. Both because of the accumulated amount in their pre-existing national fund and the degree of stress in their banking systems, and therefore the likelihood that some of their financial institutions will soon use the collective guarantee. The European architecture, and specifically the banking union, is plagued with such legacy problems, the solution to which requires a blend of imagination and solidarity in burden-sharing<sup>18</sup>. If they are not sorted out properly, the future banking union will be irrelevant; if we wait for the banking systems in the countries on the periphery to fail and for their financial institutions to go into liquidation before it gets underway, there will not be much of a European identity left to preserve. The European Deposit Guarantee Fund must be on hand to resolve this banking crisis, which Spain is suffering today, as agreed by the Council in June. The coverage by the Fund for 2012 can be established now and each financial institution's contribution calculated. The National Treasuries of the various different countries would be responsible for advancing the contribution of those of its banks that are struggling. The Spanish Treasury could use a portion of its €100 billion bank support package to avoid the bank-sovereign debt loop, a sum which could be recovered through the turnaround of the institutions temporarily under public supervision and their subsequent sell-off.

There are also institutional aspects concerning the European Deposit Guarantee Fund which should be agreed as swiftly as possible. It should be an institution that

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<sup>18</sup> See *Breaking the Deadlock: a Path Out of the Crisis*, Inet Council on the Euro Zone Crisis, July 2012, which stresses that a certain level of burden-sharing is not just necessary but fair to the extent that the current imbalances are, to a not inconsiderable degree, due to the perverse set of incentives in place.

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is legally and operationally independent from the European banking regulator, the restructuring authority and also the supervisor. It would work closely with them all but its objective is different and limited: guaranteeing bank deposits and responding to withdrawals of these in the event of a banking crisis. It is not, nor should be, an institution whose brief is to step in when banks have problems, or to manage banks in difficulties; it should simply be a guarantee fund financed by the membership fees of banking institutions and which responds to undesirable but potential events. One further problem is whether one should include all the countries in the European Union or only those from the Euro Area. As this is ultimately a quasi-fiscal decision, it does not seem to make much sense, and it could be counterproductive to extend such a deposit guarantee to all Member States of the European Union. Because without it, and I say this again, a euro deposit in a German bank will be different from the same deposit in that very same currency in a bank in Spain. This implies that they are not the same asset, nor the same currency, which is precisely what was sought to be avoided through the Monetary Union's irreversibility, or "no exit", rule. Meanwhile it is evident that a deposit in sterling in a bank in London is quite another thing, a different kind of financial asset.

A Deposit Guarantee Fund is the first and most pressing step towards building a European Banking Union. So pressing that while it is not yet effective, any flirtatiousness with a Greek exit from the euro is an act of utter irresponsibility threatening to set off an uncontrollable European banking stampede which would entail the catastrophic end of the Monetary Union. Yet, it is not the only step needed. A sustainable banking union requires a single mechanism for banking regulation, supervision, and resolution. This poses a major institutional problem for those countries that have opted out, above all for the United King-



dom, or are not yet in, and a complex legal problem for the European Union. But as the euro crisis has shown, and as we already knew yet preferred to ignore, you cannot have a single central bank without a single regulator, supervisor and resolution authority. To keep regulatory arbitrage to a minimum it would be good to coordinate and move towards the harmonisation of international banking regulation, as the Financial Stability Board is doing, and even more in the European Union. Likewise, it would be good to coordinate tax legislation so as to avoid tax havens, but this is a political objective on a different scale and level of urgency.

### **Bank supervision, intervention and resolution**

There is a lot of political debate over what type of supervision is needed in the European Banking Union<sup>19</sup>. Above all because the Commission's original documents seemed to suggest that a decentralised two-tier system would suffice where the major European banks, the so-called systemic banks, to use current terminology, would be supervised by a European authority whereas the others would continue to be under their national supervisor, but subject to common guidelines<sup>20</sup>. This is a mistake, as the Commission has finally come to realize in its proposal and the large German banks have acknowledged, whose association has just requested a single supervisor for all European banks<sup>21</sup>. In a crisis all banks are systemic, as Northern Rock or Caja Castilla La Mancha showed. A separate issue is whether the single supervisor should be the ECB or the EBA, that is, should the same monetary authority be entrusted with monetary policy or not. There are pros and cons in both models and the international evidence is divided in this matter. But a clear,

<sup>19</sup> See, for example, *Europe's Catch 22 Moment: How Realistic are Proposals for a Banking and Fiscal Union?* Briefing Note, Open Institute, Brussels, June 2012.

<sup>20</sup> This is the gist of the proposal presented by the Commission to the Council in June and its insistence on the single rule book as sufficient to harmonise banking supervision in Europe. See Herman Van Rompuy, *Towards a Genuine Economic and Monetary Union*, Report by the President of the European Council, Brussels, 26 June 2012, or the tough position taken in public by the German Finance Minister in opposition to a single supervisor for all the European banks.

<sup>21</sup> See *Financial Times*, 22 August 2012.



definitive and unambiguous decision should be taken<sup>22</sup>. Lack of legal certainty and institutional squabbles are the recipe for lack of confidence.

There is a broad consensus among economists that the European Banking Union also needs a single banking resolution and settlement system for the Euro Area. The reasons behind this are plain and boil down to three: avoiding the policy of national champions in defence of one's own banks; allowing evenly-matched and balanced competition on a level playing field, free of national, regulatory or accounting assistance or simply regulatory forbearance and supervisory leniency; and guaranteeing the functioning of a common currency financial market even in conditions of banking or sovereign stress, so that the vicious circle between a banking and a sovereign crisis is broken. It is obvious that if it is to be credible, the single mechanism means a certain mutualisation of the banking debt because the resulting fiscal cost, whatever it may be, will have to be borne collectively, shoulder to shoulder, by all the taxpayers in the Euro Area to the extent of their participation in the capital of the Resolution Fund, which should be the same as their participation in the capital of the ECB.

Everything suggests that the resolution mechanism should include a stage-by-stage approach<sup>23</sup>. **First**, an early intervention system before the problems affect the banking institution's solvency, conditioning the management of banks to this situation before liquidity or capital adequacy problems emerge<sup>24</sup>. Such conditions would affect the distribution of profits, the overall remuneration of executives and directors, even going so far as to embrace their forcible dismissal, and the possi-

<sup>22</sup> The Commission in its proposal has opted for a mixed solution: the ECB will be the Resolution Authority but in a separate Executive Board.

<sup>23</sup> This is what the Royal Decree Law on restructure and resolution of lending institutions does, for example (RDL 24 dated 31 August 2012); it was passed by the Spanish government to satisfy the financial conditions established in the MoU (Memorandum of Understanding) on the recapitalisation of the Spanish banking system and which has been unanimously interpreted as a foretaste of European legislation of this kind.

<sup>24</sup> This kind of approach was defended in the *FAES Report*, Fernández and Navarrete (2009) in which it was examined in some depth.



ble conversion of certain types of debt into equity with loss-absorbing capacity. Such an early intervention mechanism means increasing the degree of discretion with which central banks act, which demands an enhancement of their legitimacy, though also the legal protection of their managers. **Secondly**, a traditional method of stepping in when capital requirements are not met, where the intervened institution is temporarily under the administration of the Resolution Fund, with the objective of restoring it to solvency and bringing it back to the market as soon as possible. This second aspect is the outline generally under consideration in most current legislative systems and for which Europe-wide harmonisation should not prove overly complex. **And a third** mechanism of liquidation for institutions that are not viable in the likely and reasonably realistic macroeconomic and financial scenarios. The purpose of this procedure can only be to keep taxpayers' costs to a minimum, which prevents the usual bankruptcy procedure for non-financial companies from being applied and lends itself to creating some kind of bridging bank system, in other words, banking institutions where the liquidator dumps the valuable assets in the hope that the market does not punish them too much given expectations of their immediate sell-off.

### **A limited Fiscal Union**

The European Banking Union leads inexorably to a Transfer Union, to a Fiscal Union. Denying the evidence is not sound policy and nor is using too many euphemisms. Men of State lead public opinion, they are not guided by it. A banking union means pooling banking risk, banking institutions and customers. Imagining that in a systemic crisis the financial sector alone will manage to foot the bill for restructuring it is denying reality. Increasing their dues, the part which the sector itself has to cover, as they pursue measures under consideration such as raising capital ratios or setting up reserve funds, is a sound policy. But it will always fall short when it comes to facing up to the huge cost of a systemic banking crisis<sup>25</sup>. This cost can be cov-

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<sup>25</sup> This cost is estimated to be around 15% of GDP in the now classic book by Reinhart and Rogoff (2009), *This Time is Different, Eight Centuries of Financial Folly*, Princeton University Press.



ered up over time in several ways, the most usual being financial repression, central bank losses or inflation, but at the end of the day, it will have to be met by the taxpayer, by the Union taxpayer. The burden-sharing in a banking crisis after the event, as is happening in this European crisis, is obviously not an optimal situation, neither economically nor politically, and can lead to undesirable and explosive outcomes, such as the break-up of the single currency area itself. This is why it is vital to relaunch the Monetary Union with fiscal rules that are clear, precise, straightforward and workable, with no margin of political discretion. Only this will make it credible and sustainable beyond the voluntarism and populist rhetoric of subjecting the market to political dictates.

However, a Fiscal Union does not imply tax harmonisation but simply avoiding and internalising the externalities, both positive and negative, which occur within the Union itself due to the legitimate use made by the various countries of their untransferred sovereignty. In a strict sense, Fiscal Union requires three things: rules on fiscal performance, decision mechanisms in the event of not adhering to them, and an Administration to implement them. Despite its apparently conflictive nature, setting rules on budgetary outcomes is technically the easiest part. Simple pre-arranged rules on deficit, debt and nominal expenditure would suffice. The rest can and should remain the competence of national governments and a legitimate way to compete strategically with their national blend of public and private assets in an area with freedom of movement for capital and workers.

The latest European trend, quite unsurprisingly based on the work of the IMF under the academic leadership of Blanchard, is to move towards structural deficit rules that take into account the cyclical behaviour of economies<sup>26</sup> and permit fiscal policy to be used beyond automatic stabilisers. I am aware it is conventional

<sup>26</sup> The new European fiscal rules known as *Fiscal Compact* or *Euro Pact Plus* clearly represent a slide towards cyclically-adjusted deficit targets, which are also what the latest IMF report on the Euro Area proposes: *Euro Area Policies, Article IV Consultation*, July 2012, IMF Country Report No.12/181.

**"The European crisis is a crisis of maturity of the Monetary Union which it will not be possible to emerge from without a reform of the Euro Area's Founding Treaties and the confronting of the thorny implicit issues of sovereignty"**

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wisdom, but I consider it to be a frequent and manifest error, an example of a lack of awareness of the basic principles of political economy and the bureaucratic taste for enlightened “arbitrism”. It was exactly this political philosophy which killed off the Stability and Growth Pact in 2003 after violations of it by France and Germany. There will always be good economists, and better politicians, willing to justify any deficit for a good cause. Complex rules, which are hard and not straightforward to interpret, only mean there is more elbow room for political negotiation and eroding European legitimacy; because there is no doubt that they unleash discriminatory tensions among the different countries and accusations of unequal treatment. We are already seeing this. Yet the fact is that there are also purely technical reasons that advise against cyclical rules. Put in no uncertain terms, global potential investors, who are ultimately destined to finance these deficits, might not endorse these same cycles. What needs to be financed is the current deficit, not the cyclically adjusted one, and this could prove too much for the willingness to help and the risk appetite of investors: tell Spain or Portugal about it! If they are being consistent, those in favour of cyclical rules ought to be defending rising levels of government debt in the various European countries and certainly the immediate introduction of eurozone-backed Eurobonds. The former implies not realising that one of the persistent effects of globalisation is the end of European exceptionalism and with it the end of the emerging investors’ appetite for European government debt, given the high current borrowing levels in terms of GDP, which in Europe are three times those of the latter countries. The second point, namely creating Eurobonds as soon as possible, despite being without doubt an attractive proposition technically, as this would be the way to seamlessly top off the constitutional architecture of the new euro, comes up against self-evident political problems. It seems that insisting on this point at this juncture, is a little like putting the



cart before the horses. Let us have common, simple and enforceable fiscal rules first, and we will talk about risk pooling of sovereigns later.

Whatever the case, the fiscal rules would have to be in place beforehand and imply automatically surrendering sovereignty. If they are to be credible, given Europe's track record with the Stability Pact, the rules call for a decision mechanism with the least possible degree of political intervention. The solution adopted by the European Union, using the procedure of automatic application by the Commission save for a reverse decision by the Council passed by a qualified majority, is a shrewd and ingenious legal device that might just work. Because this is really about handing over the capacity for effective decision-making, about rendering the last word and therefore fiscal sovereignty, to a supranational authority for issues concerning deficits, debt and how government expenditure grows, rather than what it is spent on. Failure to comply would automatically involve outside intervention by the supranational authority. However, this is a highly important decision, which raises at least two immediate problems, to which we shall only make a passing reference here because they are more of a legal and constitutional nature than an economic one. The first one is technical and institutional. The decision-making authority should ultimately be precisely defined: do we Europeans want a supranational authority (the Commission) or an international one (the Council)? The middle way, which is the current one, involving a sort of joint decision which the European Parliament lately wants to become a part of, only increases the potential for blocking and institutional paralysis<sup>27</sup>. The second problem is directly political. Once the institution which is to govern the euro in fiscal matters has been chosen, how do we endow it with democratic legitimacy throughout the entire Union? Which leads us, as was said at the beginning of this paper, to the conclusion that the European crisis is ultimately a political crisis, a crisis of maturity of

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<sup>27</sup> We should bear in mind that there is no national monetary union which functions with a double decision by the legislative and the executive in economic and tax matters. The nearest thing to this is perhaps the fiscal cliff which the United States seems to be heading towards due to the power struggle between the President and Congress as regards authorising debt limits.



the Monetary Union. A crisis which it will not be possible to emerge from without a reform of the Euro Area's Founding Treaties and the confronting of the thorny implicit issues of sovereignty. Putting this matter on the table is the present, poisoned yet inevitable, which the German Constitutional Court may soon grant us.

I would not wish to end this section on saving the euro without mentioning, albeit briefly, certain common fallacies regarding the political debate which, either due to simplification by vested interests, complete ignorance or bad faith, give public opinion the impression that we are faced with a crisis that could be sorted out with one stroke of the pen if only those in charge wanted to. Such putative ways out are the most dangerous because, rather like the ailing man who keeps searching for a doctor until he finds one that prescribes him what he wants, European societies, and no doubt Spanish society, are reluctant to come to terms with the fact that this is the end of an era and overcoming the crisis calls for profound institutional and political change, as well as regards individual behaviour. Societies and civilisations, like living beings, grow, reproduce and die off.

The first misconception places all responsibility at the door of the European Central Bank. The ECB could fix everything tomorrow if it really wanted to. False: the ECB can only flood the market with liquidity, which would end up having consequences in the medium term on inflation, and let us not fool ourselves into thinking that it is going to be any different this time. Yet even if we were prepared to assume a certain level of inflation risk, which in Europe would always be small and less than in the United States for well-known reasons, the fact is that the money and banking multiplier does not work: the banks do not trust each other, and less still among the various countries within the Euro Area, and the money does not filter through into the non-financial private sector. The banks do little more than corner liquidity and return it to the central bank, which continues to pay interest on its standing deposit facility and will have to do this even more to sterilise bond market interventions. And they will not do so as long as doubts remain over (i) whether the various countries will remain in the euro,



(ii) the capital adequacy of certain banking institutions and the ability of their respective governments to bail them out, and (iii) the solvency of the sovereign issuer itself and the chances of filing for administration. In short, the ECB cannot avoid a country being expelled from the euro along with the implications this would have for its financial system. This decision is up to governments, its own and those of its other European partners. The ECB can hasten its expulsion and has already shown that it has no intention of doing this by lowering collateral requirements as far as needed and providing unlimited short term liquidity for Greece, but a central bank cannot act like a country's Treasury without destroying itself and the credibility of the single currency in the process.

The second fallacy, that this crisis will only be overcome through growth, is a complex ideological line of argument which curiously associates adherents of economic orthodoxy with austerity<sup>28</sup>. As though this was imposed of their own volition by warped minds and quasi social criminals, and was not actually a result of our earlier excesses, made by irresponsible and spendthrift governments who failed to understand, or simply did not want to, what our membership of the European Monetary Union meant. There is no historical precedent of a debt crisis, of a crude, systematic and sustained binge of government and private borrowing, and that is without a shadow of doubt what it was, which has been remedied without a greater or lesser contraction of GDP. And this European crisis neither is, nor will be, any exception. Trying to combat a debt crisis with more debt seems paradoxical, yet this is essentially what Neo-Keynesians propose. However much they attempt to have this debt shouldered by somebody else – either Germany or the IMF –; or have it paid through taxing the rich more heavily, as though this had no impact at all on growth; or seek to water it down over time using the kind of wizardry which is all too reminiscent of the financial engineering techniques used in the private financial sector and which actually led to the current crisis. Moreover, in the case of Eu-

<sup>28</sup> The weekly homilies by Krugman in the *New York Times*, or the repeated, though more aggressive, memos from Stiglitz, are the best example of this school of thought, which believes, like certain well-known Spanish political leaders, that if money is not available, you just create it and that is that.

**"The future of the Spanish economy, the success of its adjustment process and the appropriate correction of its imbalances, will have a notable effect on the chances of survival of the common currency project"**

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rope there are idiosyncratic circumstances which have already been discussed: Europe does not save enough and is no longer an attractive area for foreign portfolio investment, or at least major new competitors have emerged. The real growth policy which Europe needs is to free up its markets from useless and counter-productive restrictions, to reduce the transaction costs of doing business in Europe, so as to restore its drawing power and dynamism, and not to increase public expenditure or implement more infrastructure projects which have yet to show a cost-benefit return in a zone which already has a more than ample provision of government investment.

Finally there are those who still think that imaginative technical and financial solutions exist that would help us avoid reality. One such magical construct, which has sprung up everywhere, is the separation of the legacy problem regarding debt and the future model, so that it does not repeat itself. It is interesting from an analytical point of view but irrelevant in the context of the euro, for technical and political reasons. Technically the euro's problem is that the Monetary Union is a persistent and permanent gamble where trickery is off limits and any decision sets a precedent, however much those in charge tell you otherwise<sup>29</sup>. Briefly, by sorting out the legacy problem, or failing to do so, one is settling, aggravating or putting off the legal and institutional configuration of the new Euro Area. In practice, it is already too late to continue analysing the problem, "paralysis through

<sup>29</sup> Owing to that very persistent nature, the Greek bailout came so late and the decision was so complex with respect to imposing a haircut on creditors. And for that very reason it is proving so difficult to get to specifics as regards the support for the Spanish financial system, because all those involved know that a precedent is being set which will determine the future of the European Banking Union on mutualisation of deposit risk, the involvement of creditors in the cost of the bailout, and the banking resolution mechanisms.



analysis". Investors have lost confidence in the European project and will not recover it just with ingenious financial solutions. At most they will give us a bit of time, even though this might be less and less every time, judging by the aftermath of the latest bailouts, including the Spanish bank facility. Investors have cottoned on to the problem and want definitive solutions to what they perceive as a constitutional problem, because, to be brutally frank, if Spain and Italy have funded themselves with foreign currency, then they are bankrupt.

## **HOW TO STOP THE EURO DRAGGING DOWN SPAIN OR VICE-VERSA**

Even though the aim of this paper is not to conduct a specific analysis of the Spanish economy, it would be incomplete if we did not make at least a few references to the current situation, immersed in the midst of a process of specifying the terms of the financial support. The future of the euro does not hinge on us, or at least not just us. But it is evident that the future of the Spanish economy, the success of its adjustment process, appropriate correction of its imbalances, and getting it right in defining European strategies, will have a notable effect on the chances of survival of the common currency project. And in any case, the Spanish economy will be better placed for whatever comes around if it sorts out its problems successfully and if it adopts a resolute policy of adjustment and competitiveness.

It is well known that when the Partido Popular came to power, the Spanish economy had three serious problems pending which gave rise to an extraordinary credibility deficit. Despite the repeated promises made by the previous incumbents, even in the wake of the November elections, the fact is that the government accounts were totally out of control and the 6% government deficit target for 2011 actually turned out to be 8.9% of GDP, virtually without any improvement on the previous year and showing a structural deficit of 7.6%, according to the IMF<sup>30</sup>. This state of disarray also revealed a State structure which was unsustainable

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<sup>30</sup> See *Spain, 2012 Article IV Consultation*, IMF Country Report No.12/202



and inefficient. Likewise, and also deeply mired in the same syndrome of denial left over from the previous administration, the banking system faced grave solvency problems in a substantial part of it and the repeated attempts to play down, conceal or put off these problems had meant that both saints and sinners alike had to pay for them. Spanish financial institutions, regardless of their quality, had been practically blackballed from international markets. It was an established fact that the financial reforms known as FROB I and II had been totally unsuccessful. Finally, the economy was on the way to a double dip recession with a jobless rate approaching 25% of the labour force. The employment reforms, timid and embarrassingly unworthy of the task, had not managed to turn around the situation. The former Spanish government, lacking clear ideas, the victim of continual mind-changing, and having unilaterally granted the right of veto to trade union organisations, evidenced the fact that the Spanish labour market was overwhelmed and without any hope of recovery in sight.

The incoming government made a clear and correct diagnosis from the outset, but it seems, nine months later, that the scale of the inheritance it had received and the seriousness of the challenges to be dealt with were decisive in the delays in getting the right response underway, which gave rise to a degree of confusion among the domestic and international messages. It would have been a miracle if the government had not been undermined by the postponement of certain decisions and the unpopularity of others, which were economically necessary, such as the VAT rise or the 7% cuts in the salaries of public employees. Nonetheless it still has enough political capital and time in office to press ahead with the still necessary reforms, however painful they may be, which will allow us to return to the path of growth and prosperity. That is what it is working on.

The Organic Law on Budget Stability and Financial Sustainability contains the necessary elements to restore confidence in the accounts of the various arms of the Spanish government, and recover the principles of transparency, solidarity, authority and loyalty to the Constitution. It does not place any restric-



tions on the autonomy of local and regional governments but, as with the EU's New Growth Pact, it seeks to cut out the externalities which short-sighted or irresponsible behaviour on the part of some of them imply for Spanish citizens as a whole. If any local or regional government thinks, contrary to all the evidence regarding the financing of institutions on a sub-national level, that it can challenge the Spanish State's budgetary limits, it should try issuing bonds without a guarantee. If what it aims to do is contest the current legal framework for regional funding so it can make off with a larger share of the pie, it should state this clearly and do it legally, looking for the required votes, but it should stop playing the victim when the current system was made in its own image and likeness. Meanwhile, the government is fully legitimised to apply the full force of the law. Were this to be otherwise, this would seriously harm the credibility of the Kingdom of Spain and our chances of remaining in Europe.

The Memorandum of Understanding on Financial Sector Policy Conditionality<sup>31</sup> between the European Union and the Kingdom of Spain, and Royal Decree Law (RDL) 24/2012, as mentioned earlier, put an end to the long-held fictional belief that the problems of the Spanish financial sector were insignificant and could be managed unaided. One hundred billion euros, or almost 10% of Spain's GDP, is no trivial figure, especially if it is added to the sum of nearly 120 billion euros which the sector has already used in its own recapitalisation. The criticism received can be well summed up by the former governor of the Bank of Spain's appearance in parliament. He basically turned up to call for an extension of silence and the charitable regulatory approach until happier days arrive. The policy whereby one's dirty linen is best washed at home is clearly incompatible with both the Monetary Union (although it may well be true that

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<sup>31</sup> Approved and finally signed at the European Council on 20 July 2012, together with the relevant annexes, the *Terms of Reference for Fund Staff Monitoring in the Context of European Financial Assistance for Bank Recapitalization*, and the *Master Financial Assistance Facility Agreement* between the EFSF (the European Financial Stability Facility), the FROB and the Kingdom of Spain.



other countries with a savings surplus might have engaged in it) and the free movement of information and capital that ought to be the rule in a single currency area with aspirations of credibility and durability. If any criticism can be levelled, it is the tardiness in applying this and the absence of a common standard on the part of the European authorities, represented by a galaxy of institutions that do not always agree with each other. Muddling the European message is not a good approach to restoring confidence to a Spanish financial system that needs regulatory stability as much as it does capital.

The February and June reforms represent a sea-change in how the Spanish job market works and this has been acknowledged by the European Commission and the IMF. The reforms standardise employment relations in Spain and mark the end of exceptionality by reducing unequal treatment and the cost of dismissal. They represent a cautious change of regime, which strives for internal flexibility and to restrict union intermediation by decree through facilitating opt-out clauses. Other additional reforms are needed so that those already implemented, in particular those affecting unemployment benefits, can become fully effective and bring us closer to a so-called single labour contract. Turning Spain into a competitive, dynamic and flexible economy is the best contribution we can make towards a sustainable euro. This requires not just scaling down the general government apparatus to make it sustainable in a budgetary sense, but also, and above all, making it somewhat less omnipresent and insatiable in a regulatory sense, and thus more efficient.

It is now true to say that the Spanish economy has been placed under European administration, and this is also more or less explicitly the case for all those countries having problems accessing private capital markets, which nowadays means practically all of them except Germany and one or two smaller neighbours. Words are important in politics but we must not let ourselves be confused. Surrendering fiscal and financial sovereignty is desirable, furthermore it is a necessary condition for Europe to overcome the euro crisis, and a



foreseeable consequence of both crowning the design of the Euro Area to make it sustainable and our wish to remain in it. Things have always gone well for Spain when it has opened up to Europe, particularly when Europe defined itself as an area open to the world rather than a fortress-Europe. Budgetary stability, monetary orthodoxy, structural reforms and privatisations are policies which Spain started to import from Europe in the eighties. Once again, they remain the policies best-suited to Spain. It is up to the current Spanish government to apply them with ambition and resolve. Yet it is also up to European leaders to define a common institutional framework for all Europeans, rather than a special state of emergency for those countries where Europe has had to step in. This is why the European Monetary Union needs to found itself again, to change its founding treaties, because no democratic country will tolerate a protectorate. Constitutional changes that will involve the inevitable mutualisation of bank and sovereign debt in exchange for mechanisms of fiscal control at source. A possible and necessary agreement which the financial markets require without delay. The raw materials have already been provided in the successive decisions by European Councils since 2009. Now all that is needed is to bring them together in a consistent and systematic fashion and commit publicly and solemnly to applying them according to a pre-announced timetable. The alternative could very well be our “winter of discontent”.



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