The banking union alone cannot bring recovery

by Christian Odendahl

The banking union, two years after its inception, is still a work in progress. In another financial crisis, it is debatable whether a truly European approach would prevail over a partly national response; and the process of decoupling banks from the solvency of their governments is far from complete. Overall, however, the banking union is a significant step. The blame for the faltering recovery in the eurozone should be directed elsewhere.

There are three objectives for the banking union. The first is to break the vicious loop between banks and sovereigns. If banks get into trouble in the future, taxpayers should be spared as much as possible. Likewise, banks should properly diversify their assets across the eurozone (and beyond), rather than load up on their home government's bonds and thereby risk being dragged down if the state's solvency is in doubt.

With the Single Resolution Mechanism (SRM) and the Bank Recovery and Resolution Directive (BRRD) agreed, the resolution of a bank in trouble will have to rely to a much larger extent than before on bail-ins of equity- and bond-holders. A common resolution fund, building up to €55 billion over eight years, is supposed to help in cases where public money is needed.

The problem is that policy-makers have overdone the bail-in and underfunded the resolution fund. In times of crisis, a wall of money to arrest panic can be more useful than a sudden bail-in. The reason is that market panic over the value of bank bonds, even if unjustified, can destabilise the whole system. The ECB's OMT programme, which arrested bond market panic in 2012, is a good example of what a wall can do. This is not to say that taxpayers should bail out investors. A large resolution fund just ensures that panic does not destabilise the banking system, which would lead to even larger costs for taxpayers, and banks in trouble could be resolved in an orderly manner to the extent that is possible. With the current setup, national ad hoc measure might prevail in a systemic crisis.

Progress on diversifying the banks' holdings of domestic sovereign debt has been slow, because policy-makers are worried that a sell-off by domestic banks would push up government funding costs. The ECB's current asset quality review (AQR), however, will test the resilience of banks to falling prices of government bonds, which is a good start. The ECB should use this opportunity to toughen regulation on sovereign bond holdings, too.

The second reason to have a banking union is to prevent future crises through better regulation. National regulators in pre-crisis years often turned a blind eye to the build-up of risk in their financial system, especially the debt financing of asset bubbles. They tend not to consider risks at the eurozone level, and face political pressure not to rein in their banks. The ECB in theory has different incentives: it takes eurozone-level risk into account; it is charged with 'cleaning up' the economy after financial crises; and it has no interest in promoting national champions. The ECB's current actions and self-confidence suggest that it will be a better regulator in practice, too.

The final aim is to draw a key lesson from the Japanese experience of the 1990s – if rather late in the day. Instead of realising losses and cleaning out their loan books, Japanese banks rolled over loans to barely solvent 'zombie' companies, preserving the illusion of health for both, and blocking the supply of credit to more productive firms, which is necessary for a sustained recovery.

The eurozone has finally started to force banks to face the music: the ECB is conducting the AQR of the largest banks' books; in conjunction with the European Banking Authority, it will subsequently stress test their balance sheets; and it will require those that fail to raise capital. Banks now have an incentive to restructure bad assets so that new credit can help support recovery. Judging by the reaction of banks, some of which have realised losses and raised capital on financial markets, it is working. However, the problem remains that the economic assumptions underlying the stress tests could turn out to be too optimistic. For example, inflation is currently lower than in the 'adverse scenario' used in the stress tests. The ECB should correct its assumptions and toughen the stress tests.

Firms in, say, Italy still pay more for their funding than their German peers. In part this is because the banking union is still incomplete – in some parts set to remain so – and balance sheet clean-ups take time. Another reason could be the economic prospects for many firms in struggling economies, especially small ones: domestic demand is weak and export growth requires time, stronger world demand and a weaker currency. Boosting economic demand is the job of fiscal and monetary authorities. They should relax fiscal targets while the recovery is still weak, and ensure that monetary policy is sufficiently forward-looking and aggressive to raise inflation back to target. The ECB and European policy-makers are, belatedly, playing their part on banking; now they need to adopt the right macroeconomic policies, too.

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CER in the press

Financial Times
24th July 2014
As Lord Kerr explained in an article on Wednesday for the **CER**, the practical issues about the euro, free movement of people and opt-outs are actually relatively simple. "The EU will adamantly refuse to mediate between London and Edinburgh," he said.

The Telegraph
17th July 2014
Mr Ian Bond said China is unlikely to rescue the Kremlin as the West pulls back. "They drove a very hard bargain on the gas pipeline deal [with Gazprom] and they are not going to roll over Russian debt at low interest rates out of friendship for Putin," he said.

Financial Times
9th July 2014
John Springford [of] the **CER** said he disagreed with accusations by some UK commentators that the euro area's policy on clearing houses amounted to regulatory protectionism aimed at winning business from London.

Bloomberg Businessweek
24th June 2014
"The signing of the OMV-Gazprom deal is part of Russia's attempt to drive a wedge in the EU's response to the Ukraine crisis," said Rem Korteweg of the **CER**.

Financial Times
12th June 2014
This week, the **CER** produced a report on the economic consequences of leaving the EU. Its conclusion is stark: all conceivable halfway houses would deliver the lack of influence that comes from being outside the EU with the lack of independence from being inside it. "In" or "out" is the choice: of the two, the first would be vastly better.

Spiegel
5th June 2014
In the 'FAZ' the Brit Charles Grant writes: "There is no mention of Spitzenkandidaten in the treaties, but rather that the European Council should take the parliament election results into account." That is the nature of a revolution: it writes its own laws.

Wall Street Journal
3rd June 2014
"The lower inflation is, the harder it is for Spain or Italy to get on top of their debt burdens", said Simon Tilford, deputy director of the **CER**.