A EURO WITH A FUTURE
A European Deposit Insurance and Banking Resolution Scheme for the Single Currency

Fernando Fernández Méndez de Andés, IE Business School
Fernando Navarrete Rojas, Director, Economy and Public Policies, FAES

1 Fernando Fernández and Fernando Navarrete are co-authors of the FAES report *The Reform of the International Financial System*, published in 2009.
The institutional architecture of the Maastricht Treaty sought to avoid at all costs the bankruptcy scenario of a member country, but the design and implementation flaws that have riddled the brief history of the euro have inescapably doomed us to it. Greece seems condemned to default, the debt volume is simply unbearable and the fiscal adjustment necessary to deliver a sufficient primary surplus is unattainable. In this scenario, the predefined road map of the Economic and Monetary Union becomes rather useless. Europe is rushing into the unknown and this uncertainty is hampering financial markets, threatening to plunge Europe - and also the rest of the world, let us not deceive ourselves - into a second wave of recession and banking crises. The Greek crisis is a historic event; not so much in terms of the size of its debt or its economy - barely 2% of the euro area’s GDP - as in terms of its meaning as a maturity test of the European project. Because it will surely become the precedent which will guide the actions of European economic policies in this journey to unchartered territory that has just begun.

The question is threefold: what can we do?, what must we do?, can we do what we must do? We certainly can continue delaying the Greek agony several more months by granting it more official financing and turning a blind eye to the unavoidable breaches it will commit. Today, this seems to be the official proposal, but it will not solve the problems. It could even be counterproductive if such additional financing serves to fuel the paralysing delusion that the default of the Greek public sector can be avoided. This is not possible and we know it. But the truth is, given the current shortcomings in the functioning of the euro zone, we must buy time to prevent a disorderly default of the Greek public sector from jeopardising the project of the single currency. This would pull down behind it the whole political architecture we have been building for Europe since the 1950s to guarantee a common future of peace and prosperity. Therefore, the priority of European leaders must be defining and implementing, in the shortest possible time, a new road map for the future of the euro zone. A sure road that envisages the possible emergence of seemingly insurmountable obstacles, such as a country’s eventual default. A
“The priority of European leaders must be defining and implementing, in the shortest possible time, a new road map for the future of the euro zone”

road that enables the Economic and Monetary Union to emerge in a stronger position, as an area promoting economic stability, that knows how to address the failures of its members –preventing their collapse from dragging others with them, and capable of providing second opportunities to those deserving them.

We should begin by assuming reality with all its consequences. The reality is that national banking markets ceased to exist as such in the euro zone many years ago to become an integrated single banking market instead, with deep interrelationships that go far beyond national borders. This was assumed by the private sector a long time ago. Also by financial markets, that’s why they relentlessly punish all European banks. Politicians are the only ones left to assume this and clearly explain it to their constituents. In a single European banking market, is it really sensible to place on the different national Treasuries the responsibility of individually addressing banking crisis and insuring deposits in each country?

It would be wise to begin by acknowledging that the public pillar is what fails in the European financial integration. There is private financial integration but the public safety net is fragmented making it weak and, therefore, lacking credibility. We have, on the one hand, a cluster of European authorities responsible of financial supervision and regulation without executive capacities to prevent and face the costs of a banking crisis and, on the other hand, national Treasuries reluctant to act and poorly prepared when it comes to paying, as was clearly demonstrated with the Irish crisis. It is now time to assume that banking problems anywhere in the euro zone are a problem affecting all Europeans without exception, because in the end we are all stricken by them. With this change of attitude and its subsequent change in policies, we should be able to transform national systemic banking cri-
sis, which drag with them entire countries when they explode, into local financial crisis; costly but manageable for European taxpayers.

Establishing a true European Deposit Insurance and Banking Resolution Scheme capable of intervening and restructuring banks in all euro countries would serve to prevent and solve any future crises better. But it is, above all, a necessary precondition to enable an orderly default in Greece, stopping any “de facto” expulsion of this country from the single currency after a sovereign default. Avoiding the expulsion of a member country is not only important for its citizens, but for all Europeans as well, due to the risk of a contagion effect sweeping away the economy and the project of the European Monetary Union. The irreversibility clause for members of the Economic and Monetary Union is neither a luxury nor a gratuitous concession; it is a necessary condition for its own effectiveness. If a country could be expelled or could opt-out of the euro, how could markets be stopped from bidding that such a country wouldn’t be the last? How could debt spreads be lowered to reasonable levels so as to make the European project viable? Which country, which company, could finance itself indefinitely at 300 basis points over its competitors, with whom it shares currency?

Being deprived of a true European safety net, means that an eventual default by Greece would immediately make the banking system in that country insolvent. Furthermore, if the ECB were to cease offering liquidity against the collateral of a public debt in default, in compliance with its statutory obligation, the Greek banking system would be, on top of that, completely illiquid. In any case, a massive bank run and the collapse of the Greek financial system would be impossible to avoid. This would paralyse the economy thus forcing the country to issue some means of
“If a country could be expelled or could opt-out of the euro, how could markets be stopped from bidding that such a country wouldn’t be the last?”

payment (maybe “spartacones”, resembling the 2001 Argentinean “patacones”). It is therefore vital to prevent the public default from volatilising savings in Greece. In order to do this, the default should be immediately followed by the massive intervention of the local financial system by a European Deposit Insurance and Banking Resolution Scheme for its subsequent tender, with complete transparency, to international financial institutions capable of assuming the security of the deposits, and with access to the ECB’s liquidity.

The Greek default will entail a cost for all taxpayers in the euro zone through the ECB’s recapitalisation. The ECB has been Greece’s sole source of liquidity for nearly two years and will therefore absorb a large part of the cost of the default. There is already a protocol in force for the distribution of benefits and losses of the ECB. It is envisaged in its own Statutes. Let us, therefore, adapt these already existing criteria regarding the distribution of the common burdens\(^2\) to the functioning of a new European Deposit Insurance and Banking Resolution Scheme which needs to be created urgently. Under no circumstance would this involve setting up new European institutions or changing Treaties, but rather putting together, providing contents and resolutely acting with what already exists: the European Central Bank, European Systemic Risk Board, European Banking Authority, and the European Financial Stability Facility (EFSF). Basically, it would change the current notion of the EFSF from a supplier of liquidity to sovereigns to transform it in a com-

\(^2\) Even if the distribution criteria has the virtue of its immediate applicability, which is essential in the current situation, future eventual improvements of the system should develop a distribution criteria allowing the internalisation of each country’s banking institutions contribution to systemic risk in the euro area, in accordance with the recommendations of the FAES report *The Reform of the International Financial System.*
mon fund for the purpose of restructuring the banking system. As such, all participating countries would share the costs of creating an effective and credible scheme for deposit insurance and banking resolution in Europe.

Only if Europe advances its euro defence line, from the reduced stronghold of current mechanisms of mutual government aid, toward the open camp of banking resolution, will it be possible to attain the financial harmonisation started by the euro and attack the core of the contagion problem. Needless to say, extending the European common banking safety net to all countries will demand significant relinquishments. The most obvious one, relinquishing sovereignty regarding decisions on banking supervision, intervention, and crisis management; but also the necessity of a closer and more effective fiscal coordination that stops the repetition of irresponsible behaviour of national fiscal authorities.

A European-wide banking safety net does not solve all the design problems of the euro. It is not a panacea enabling countries to forget all about their obligations regarding fiscal adjustment and structural reform. Relocation of activities and employment will continue taking place in those countries which lose international confidence and credit or which are unable of keeping international competitiveness. Increasing fiscal coordination will continue being necessary to avoid negative externalities, but to begin with, it would suffice with a thorough and methodical application of the mechanisms of fiscal discipline already approved and commonly known as the European Semester.

The solution to the debt crisis in the euro area demands determined, specific and urgent political actions beyond the usual rhetoric, and far away from an ill-de-
fined political and fiscal integration which is unattainable today, and who knows if it would be democratically desirable. Facing together the challenge of solving banking crises is undoubtedly politically complicated, but possible. Much more possible and effective in the short term than creating a single European Treasury. And it would also serve to distribute the burdens of a potential restructuring and shake-out of the banking system in Greece, Germany, France or Spain. It would be dire news if countries with a higher bank exposure to Greek sovereign risk should once again act of their own accord and try to clean-up the impact on its ailing banking system by themselves. Germany and France should see that this is the perfect time to receive the contributions from the rest of European members, but for this to happen they must abandon the idea of steering by themselves the restructuring of their financial systems and be willing to cooperate in the future on the resolution of banking problems in the whole euro area. Ultimately, those who will benefit the most in the long term from a credible European Deposit Insurance and Banking Resolution Scheme are savers and taxpayers from capital-exporting countries. There won’t be many more opportunities to get on the right track.

“It would be dire news if countries with a higher bank exposure to Greek sovereign risk should once again act of their own accord”