

The SSM and the euro

& Bird & Bird

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The future of banking regulation and supervision in the EU

ECB & Mocomila

Frankfurt, November 15, 2013

EMU: the 1989-1991 Weltanschauung

- Efficient market hypothesis (**EMH**)
 - Financial markets will discipline profligate borrowers
 - No contagions , financial panics or bubbles
- Price stability, with no reference to “financial stability”
 - No Lender-of-last-resort (**NLOLR**)
- “It is mostly fiscal” (**IMF**)
 - **Lawson doctrine**: benign neglect of private flows and balance of payments
- Economic union: single market + competition + structural reforms
- Own-house-in-order (**OHIO**)- “**No bail-out**” (UK version)
- **Subsidiarity**
 - “Decisions are taken as closely as possible to the citizens” (Protocol n^o 2)
 - A single currency desirable, but not essential for monetary union

EMU: the 1992 Maastricht Treaty

- Excessive deficit procedure (**EDP**)
- Zero Risk Weight (**ZRW**) for sovereign public bonds
- No mutual guarantee of debts
 - *“The Union [and Member States] shall not be liable for or assume the commitments of governments or public bodies of any Member State”* (art. 125.1 TFEU)
 - The colloquial term *“no bail-out”*, even if legally inaccurate, remained in use.
- **“Tietmeyer’s rule”**: *“Each member of the Governing Council shall have one vote”* (art. 10.1 of ECB Protocol)
 - It made the ECB a genuine European, trans-national institution.
- **“Padoa Schioppa’s enabling clause”**: *“The Council may unanimously confer specific tasks upon the ECB concerning prudential supervision”* (art. 127.6 of TFEU).

EMU's design failures: what the "founding fathers" knew



- “There are known knowns: these are things we know we know.
- We also know that there are known unknowns.

That is to say, we know there are some things we do not know.

- But there are also unknown unknowns, the ones that we don't know we don't know”.

(Donald Rumsfeld, 12-2-2002)

EMU's design failures: a Rumsfeld + 's typology

State of mind	Problems	
	Predictable	Unpredictable
Awareness	1. <i>Known knowns</i> ("challenges")	2. <i>Known Unknowns</i> ("down-side risks")
Ignorance or neglect	4. <i>Predictable Surprises</i> ("policy failures")	3. <i>Unknown Unknowns</i> ("tail risks", "black swans")

Oscar Wilde´s curse: predictable surprise or black swan?



“When the Gods want to punish us, they answer our prayers”

(Sir Robert Chiltern, *“An ideal husband”*, 1895)

Chancellor Kohl granted Spain´s prayers, so that during 1997-2007 we enjoyed the low German interest rates we had always prayed for.

Unfortunately,

- Spain was not fully prepared for this “positive shock” and key imbalances emerged.
- Our real estate bubble was compounded, paradoxically, by our competitive banking system and mortgage market.

Second Best Theorem: in the presence of distortions (negative real interest rates), a blessing (competitive banking system) can become a curse (real estate bubble).

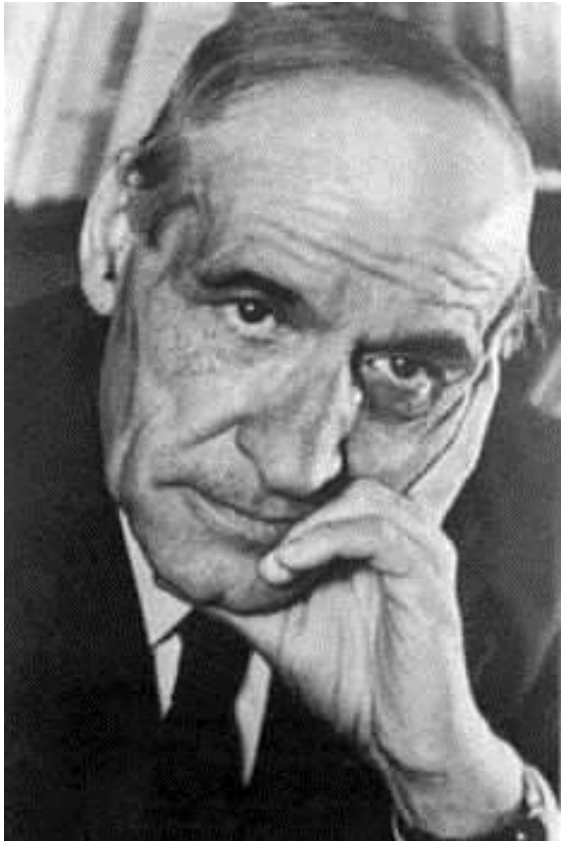
Monetary union's design failures

State of mind	Problems	
	Predictable	Unpredictable
Awareness	<ul style="list-style-type: none"> • <i>“One-size-fits-all” monetary policy</i> • <i>Post-entry relaxation of budgetary adjustment in highly indebted countries</i> • <i>Absence of LOLR</i> 	
Ignorance or neglect	<ul style="list-style-type: none"> • <i>Post-entry real estate bubbles (Spain, Ireland...)</i> • <i>"Banks are European in life, but national in death" (Mervin King)</i> 	<ul style="list-style-type: none"> • <i>Financial melt-down, liquidity crisis and banking failures</i> • <i>“Deadly embrace” between banks and sovereign risks</i> • <i>Doubts on irreversibility of euro (“redenomination risk”, “euro penalty”...)</i> • <i>Financial market fragmentation: end of the single market and lack of fungibility of euro bank money</i>

Mending EMU's design failures

- From the start of the crisis, the ECB acted as LOLR (August 2007 intervention, free-allocation of 3 year refinancing operations, flexible collateral policy, OMT...)
 - Hans Tietmeyer's "one member, one vote" essential, since it allowed that the Bundesbank was outvoted.
- We are already in our way towards a banking union
 - Padoa Schioppa's enabling clause (i.e. art. 127 of the TFUE) provided the legal basis for the new SSM, but is not enough for a "Single Resolution Mechanism" (SRM).
 - Seen from afar, significant progress has already been achieved. But fundamental economic policy reforms present inevitably two features:
 - Brinkmanship
 - Schopenhauer's cycle

Brinkmanship: no political "early corrective action"



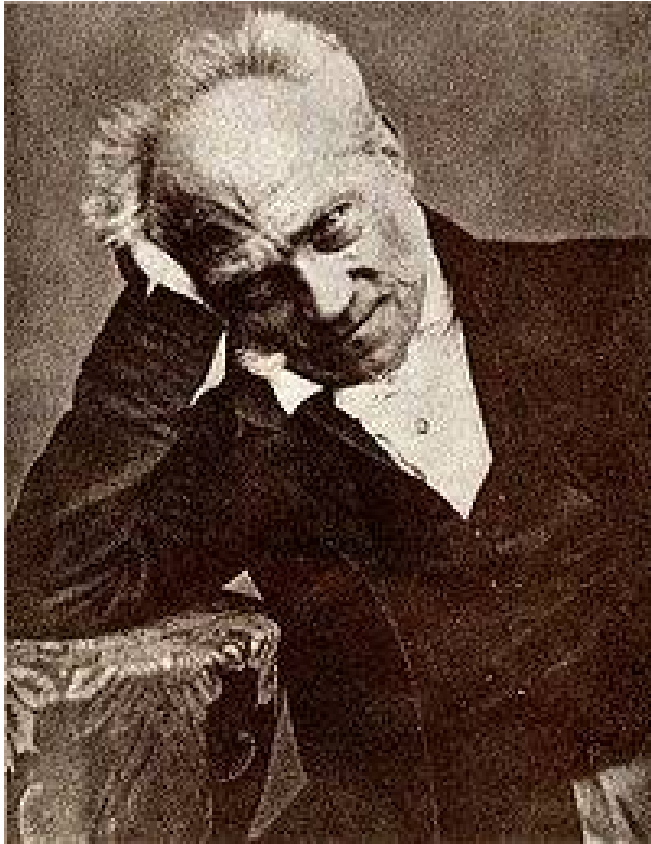
“The human species is too stupid to be grateful to someone who spares it an illness .

It is only when illness arrives and the citizen is in the throngs of pain that he feels a generous and exquisite gratefulness to the one who removes the pain who has afflicted him.

But without having first undergone the pain and suffering, he is deeply ungrateful”.

(José Ortega y Gasset, “El Error Berenguer”, 1930)

Political reforms: Schopenhauer's cycle



“All truth passes through three stages.

- First, it is ridiculed.*
- Second, it is violently opposed.*
- Third, it is accepted as being self-evident”*

Concluding remarks

- The Maastricht Treaty designed a “fair weather” monetary union, whose main weaknesses –particularly, the absence of a banking union- became apparent during the recent financial crisis.
- Even if the ECB has not a “dual mandate”, “price stability” must encompass “financial stability”. The seeds for this expanded ECB’s remit were planted in the Treaty by two of its most insightful founding fathers: Tommaso Padoa Schioppa and, indirectly, Hans Tietmeyer.
- Padoa-Schioppa often described the euro as “a currency without a State” and during the Maastricht negotiations Tietmeyer and many other German officials stressed that “in the long run a monetary union cannot survive without political union”.
- The financial crisis has proven them right: in the long run we are still alive because the eurozone is moving towards a banking union, even if the full trip will take years.
- Those of you at the ECB should be proud to work in a institution which is a role model of good European citizenship and, particularly in the case of its Legal Department under Antonio Sáinz de Vicuña’s leadership, has been at the forefront of Europe’s financial and political integration.

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