*Fiscal Competition & Economic Freedom*

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# Financial & Fiscal Features Newsletter

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## The Cosy Consensus finally breaks. ECB Board Rancour Boils Over.

by Gordon Kerr and John Butler, with Enrico Colombatto

***Despite the attention offered by the media to Russian banking and foreign exchange markets, tensions are growing in the ECB. Some ECB Board members are unconvinced of the stance the ECB President is taking, doubting that the introduced policy would be effective, let alone constitutional. We explain the economics behind these tensions and review in this light the road how we got here in the financial crisis.***

For much of the past month the mainstream media focussed on problems being experienced by the Central Bank of Russia as the Rouble fell sharply on the foreign exchange markets – 40% from its high of the year against the US Dollar- owing to a combination of oil price declines and US led western financial sanctions. These sanctions included strictures forbidding European banks from rolling over loans to Russian entities, banks, municipalities and the sovereign itself. The impression that the intelligent, if innocent, reader would derive is that western economies continue to set the example which Russia strives to follow, and, because of its bad behaviour in Ukraine, Russia is now getting the bloody nose it deserves.

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## Meaningless capital adequacy supervision, markets back to all time highs

by Gordon Kerr and John Butler, with Enrico Colombatto

***Our November Newsletter's analysis has been echoed by other commentators. Banks continue to be undercapitalised and a new Leverage Ratio cannot help. Governments continue to borrow heavily and the financial market seems to be in another bubble.***

Other commentators have since echoed our November Newsletter's criticism of the EBA's stress tests. Entities as diverse as the Danish Institute for International Studies, and Keefe, Bruyette & Woods Inc. have published reports claiming that the test results are virtually meaningless and that SIFI banks such as France's Paribas and Germany's Deutsche Bank are insufficiently capitalised to survive a recurrence of 2008 volatility levels.
With criminal investigators now trawling through the affairs of Banco Espírito Santo in Portugal, and depositors of Bulgaria's Corporate Commercial Bank still hoping that their government will honour its €100,000 deposit guarantees some 6 months after the bank was taken under state control, there are few signs of

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*The **Institute for Research in Economic and Fiscal Issues** was founded in 2002 to establish an efficient platform to investigate fiscal and taxation questions. Eager to cross knowledge from economics, statistics, law studies and politics, IREF seeks to create a starting place for thoughts and proposals about taxation policy.*

## (cont'd) Cosy consensus breaks .....

However, the smugness exuded by certain western political leaders over the impact of the sanctions may soon prove embarrassing as the scale of Europe's monetary policy errors starts to dawn on previously supportive media. Our [November Newsletter]() suggested that tensions were rising among the ECB's governing Council, with nearly half this 24 person body opposed to the idea of a € 1 trillion sovereign bond purchase scheme. These tensions have now exploded into the public domain.

### Tensions Within ECB

The ECB's management team is directly accountable to a 6 person Executive Board. On December 5th three board members, Sabine Lautenschlaeger of Germany, Yves Mersch of Luxembourg and Benoit Coeure of France, refused to endorse President Draghi's latest routine policy statement. The public flare up was ostensibly merely a disagreement over a verb; whether the putative € 1 trillion 'stimulus' should be presented as either "expected" or "intended" to head off Eurozone deflation risks. But this semantic trivia masks deep and, we suspect, irreconcilable tensions.

*The public flare up was ostensibly merely a disagreement over a verb; whether the putative € 1 trillion 'stimulus' was either "expected" or "intended" to head off Eurozone deflation risks. But this masks deep and, we suspect, irreconcilable tensions.*

Commentators sympathetic to ECB President Draghi talk of the difficulties that this collapse in his personal support presents to Europe's leaders. In this sense they refer to Europe in its widest context, the EU28. Even in Britain, where popular opinion and most media now call for "Brexit" (BRitish EXIT from EU) in 2017, top ministers pray that the European debt crisis remains in abeyance at least until the May 2015 elections are out of the way.

Such sympathisers appear to believe that monetary policy 'solutions' can somehow be found. They concede that President Draghi's day-to-day handling of his relations with his governors is suboptimal, that he is tired of Frankfurt and deserves to be retired upwards to the presidency of Italy. They argue that the tensions have arisen only recently; firstly at Jackson Hole in August when Draghi noted the decline in expectations for inflation and appeared to promise a policy response. Then they criticise the head of the Bundesbank, Jens Weidmann, for rocking the boat. But the deterioration in relations between Weidmann and Draghi is not personal, it is far more serious than that and would obtain whoever was at the helm of the ECB. Weidmann personally testified in a German court in October, arguing that Draghi's proposed Outright Monetary Transactions programme is at odds with the German constitution.

### Germany & Grundgesetz

Suggestions that Draghi has failed to come up with a policy response to economic deterioration in Europe are unfair. Draghi has indeed proposed a policy response (the € 1 trillion bond purchase programme) in as plain language as a modern central banker can be expected to articulate. The problem is that Germany, and a growing number of Eurozone national central bank chiefs, reject this policy.

*Weidmann insists that the capital adequacy rules must incorporate a non-zero risk weighting for sovereign debt; otherwise countries could always stuff their bad debt into their banks, only to have them subsequently bailed out by other countries!*

The slow pace of the appearance of the ECB Board schism stems from Weidmann's acute grasp of his obligation to tread carefully in these matters, which are highly political. The German government officially supports a banking

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## (cont'd) Meaningless capital adequacy .....

systemic solvency of banks in any European country.

The mainstream has generally united behind calls for the new Leverage Ratio to form the basis of further assessments of bank health. They are misguided. This Leverage ratio is now being actively gamed as banks eliminate from the reckoning their credit derivatives exposure by purchasing matching derivatives from third party 'insurers'. In other words, if we consider an exact repeat of the 2008 sub-prime debacle in our new Leverage Ratio world, all the major players would today appear solvent under this test of capitalization, but all would fail when sub-prime turns sour. Their exposures simply do not appear on the numerator side of the equation because they have all purchased insurance from AIG, even though its default on such insurance is certain.

Financial markets have now recovered all their October losses and are reaching for new highs; low yields, narrow spreads, record stock market valuations. A growing chorus of astute commentators are calling this a huge bubble and are calling for central banks to ease off lest this blows up. Joining this chorus is the Bank for International Settlements, whose Board includes central bank chiefs such as Carney of Britain and Kuroda of Japan. At page 7 of its December Quarterly Review, in a section entitled "Growing Signs of Fragility" it states: "recent developments suggest that markets are becoming increasingly fragile. Global equity markets plummeted in early August and mid-October. Mid-October's extreme intraday price movements underscore how sensitive markets have become to even small surprises."

Unless the ECB Board unites behind a new flood of sovereign and private asset purchases, which has never looked less likely, readers should expect this fragility to erupt soon. ■

## (cont'd) Cosy consensus breaks .....

union – if certain conditions are met. So Weidmann goes along with that, but then he insists, perfectly correctly, that if it were to go ahead the capital adequacy rules must incorporate a non-zero risk weighting for sovereign debt, because otherwise countries could always stuff their bad debt into their banks, only to have the banks subsequently bailed out by other countries such as Germany! So, rather than see sovereign bonds of weak countries purchased by the ECB at inflated prices, Weidmann wants to see them downrated by Mrs Noue's centralised banking supervision team (whose stress tests we reported in our November Newsletter) in order to encourage national central banks to identify and resolve struggling commercial banks. He is therefore being consistent, once his position and motives are understood. It is also believed that, in response to the ECB's other proposed new idea: to buy asset backed securities, that Weidmann and others are demanding that the credit quality qualification bar be raised to such a level that almost no securities actually qualify. This is a subtle way to continue to oppose a policy which was forced through despite being opposed by Weidmann and at least six other ECB council members.

*The battle for the ECB is hardly over. Weidmann could resign from the Bundesbank in protest.*

And if that battle is lost, the Bundesbank may raise the stakes in their opposition at the national level, potentially precipitating a crisis. In other words, Weidmann could resign from the Bundesbank in protest. He might be joined by one or more Bundesbank colleagues. He might also be joined by Lautenschlaeger, who could resign her seat on the ECB Executive Board. So the ECB might win the battle but lose the war for the euro. The Bundesbank holds this card up its sleeve, even if it does not say so publicly.

These events bring into sharp focus one question; if the planned € 1 trillion stimulus is now dropped, given this opposition, what alternative policies remain to be deployed, either by Draghi or his replacement?

## How the Eurozone Crisis Unrolled

As we approach the end of another calendar year of the crisis, this question is perhaps best answered by reviewing the six clear phases of the Eurozone economic crisis.

**6 phases of the EUROZONE CRISIS *so far...***

**Phase 1, 1999 & EURO**
*The introduction of the euro in 1999.* Whilst eliminating exchange rate risk this event also introduced the exceptionally powerful ECB, equipped with tools such as Emergency Liquidity Assistance (ELA), and the ability to purchase large amounts of banking assets through repo activities. These muscles were intended to present the new institution as a towering pillar of strength, but instead merely encouraged opportunistic lending to weaker southern European countries.

**Phase 2, 2007 & TARGET**
*The interbank TARGET settlement system.* As the Great Financial Crisis (GFC) erupted in 2007/8, lenders pulled back from weak countries but the ECB encouraged national central banks to negate market demands for structural adjustments by extending ELAs and other forms of credit that merely built up within the ECB's own settlement system.

**Phase 3, 2010 & SMP**
In early 2010 credit conditions worsened for the weakest countries. The ECB introduced its Securities and Markets Programme, essentially buying sovereign bonds that it had previously held only as collateral. This reduced credit spreads and encouraged the weakest countries to borrow even more.

**Phase 4, 2011-12 & ESM**
Because of Bundesbank objections to the legality of SMP, which pretty clearly offended restrictions against sovereign bailouts hardwired into the ECB's constitution, financial policy engineers came up with the idea of establishing new institutions whose express raison d'être was to buy bonds of ailing sovereigns. The European Financial Stability Facility and the European Financial Stabilisation Mechanism were thus created and later became the European Stability Mechanism (ESM).

**Phase 5, 2012 & OMT**
*"Do whatever it takes".* On 6 September 2012, as the markets reacted to the small size of ESM etc., funds and capital flew out of Spain and Italy, the ECB played its ultimate card – the size limit on ESM was abolished and the ECB stood ready to buy any amount of assets through its new Outright Monetary Transactions (OMT) programme. Short sellers were scared away and spreads declined dramatically, to levels that pertained prior to the 2008 GFC. No OMT purchases were actually made.

**Phase 6, 2013-4 & Banking Union**
Despite the success of OMT, other assets on the books of commercial banks became problematic as property prices fell in various countries. Since it was increasingly apparent that insolvent banks had not only precipitated the 07/08 crisis, but that the bailouts had failed magically to restore solvency, the ECB decided to make ESM funds available for bank recapitalisation. This led to a perceived need for centralised supervision, commonly agreed mechanisms to resolve failed banks, and even mutual deposit insurance. But whilst the Bundesbank has always welcomed the centralised authority and control of the new European Banking Authority, it has never expressed support for increasing German liabilities any further through bank deposit insurance.

**2015....?**
**See our predictions below.**

## Beyond the New Year

This sorry tale of successive failed 'solutions' is fully understood by central bank heads of northern countries. For this and other reasons, your authors consider it highly unlikely that mutually guaranteed Eurobonds, or massive QE, or any other new 'solutions' will attract the support of the Bundesbank and its ECB council friends.

It therefore follows that **we are in the final phase of the game of pretence that bailing out dystopian banks with borrowed public funds and, when lenders would advance no more, the printing presses, could conceivably prevent economies from experiencing the consequences of the bursting of the 2008 credit bubbles**.

As Japan leads the way in the global 'beggar thy neighbour' tactic of currency debasement, central bankers in Russia might be considering new and more intelligent ways of turning the tables against their critics. With modest national debts and plenty of hard assets, they hold all the cards. ■

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