A response to the critics

Some English-language media have interpreted the appeal initiated by Walter Krämer and signed by over 170 German-speaking economists as being against a European banking union. This is a misconception. The appeal does not even mention a banking union in the sense of common supervision of the Eurozone's banks. Its main concern is what joint liability for banking debt, despite best intentions and sensible-sounding rules, may really mean.

By Walter Krämer and Hans-Werner Sinn

Germany's Chancellor Merkel has accused more than 200 economics professors who have signed an open appeal against the socialisation of bank debt of not having properly read the statement accompanying the decisions adopted at the last EU Summit. These decisions, she asserts, are not about accepting additional liability for banks and do not change the status quo. Assuming any liability for banks remains just as off bounds as assuming liability for states is. German Minister of Finance Wolfgang Schäuble adds that the ESM has not been turned into a bailout package for banks.

We categorically reject the allegation that our appeal misinformed the public. The text of the Summit decision reads: "When an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could, following a regular decision, have the possibility to recapitalize banks directly." This decision was greeted euphorically by the financial markets because, unlike the previous wording of the ESM Treaty, it opened up the possibility of using ESM funds directly to recapitalise banks. This releases the crisis-afflicted states from any liability for funds made available via the ESM to bail out banks and, above all, means that bank creditors may no longer have to take responsibility for their own investment decisions. The Summit decision has been interpreted in precisely this way all over the world. We can only imagine that the German federal government sees the facts differently because it does not wish to unsettle the public.

Normally a bank's owners are liable for its losses. If these losses reduce the bank's equity to below the regulatory minimum, it must either declare insolvency or restructure. In this case its creditors are also liable and must recapitalise the bank by giving up their claims. This can take the form of converting debt into equity, with the old owners relinquishing their stock.

According to the summit decision, the ESM should now assume responsibility for recapitalising ailing banks instead of their creditors. This effectively protects creditors from any losses. In other words, the ESM covers not only the public debt of the countries affected by the crisis, but now also the debts of their banks, thereby effectively protecting those holding claims against such banks from any losses.

The appeal makes reference to the fact that the bank debts of the crisis-afflicted countries total 9.2 trillion euros, while government debt amounts to "just" 3.3 trillion euros. Our main concern is the magnitude of the sums at stake. We fear that the still solvent Eurozone countries may let themselves be drawn into accepting a financial responsibility that they will subsequently be unable to cast off. Protecting a state's creditors from losses is a Herculean task that already looks almost impossible. Protecting bank creditors on top of that is far beyond the capabilities of the countries that remain economically sound. The financial markets' elation at Germany's readiness to cover the losses should worry the taxpayers of Europe's still solid economies as much as it concerns us.

The appeal that we signed does not oppose common supervision of European banks. It makes no reference whatsoever to this issue. In this respect we, and presumably many of those who also signed the appeal, agree that Europe should have a common banking supervision. Such common supervision is a necessity simply because national banking regulation tends to buckle under the pressure of systems competition: every national regulatory body has an incentive to be slightly more lax when regulating its own banks than its foreign counterparts, in order to keep banking business in the country. Our earlier academic work on the issue of systems competition provides ample proof of this.

Common banking supervision, however, does not mean that the huge write-off losses sustained by Southern Europe's banks should be shared. These losses arose after a huge credit bubble burst, which was created as the euro ushered in interest rate convergence. The need for banks to disclose these losses on their books is becoming more pressing with every month that passes, because the concealment skills of the accountants are reaching their limit. Instead of imposing the burden on third parties not involved it is much fairer and better from an incentive perspective if it is borne by the banks' owners and creditors. In fact, debt-equity swaps are the appropriate means of dealing with this problem. Policy-makers should develop an orderly European procedure for banks to be recapitalised by their own creditors, because only the latter possess the necessary assets and ultimately, it was the creditors who decided to accept the risk of the bank going bankrupt when taking their decision to invest in it.

A common restructuring fund or common deposit insurance, which some economists have recommended, do not appear advisable either, because it is hard to see how abuse of such funds could be avoided if these instruments are set up and then applied retroactively for losses sustained before the single supervisory authority has been founded. In view of the fact that the deposits of the banks in the crisis-afflicted countries alone, which form part of the banks' debts, total 3.6 trillion euros, it seems far too risky to even contemplate the idea.

The provisional ceiling to the volume of the ESM is no protection against additional burdens, for the mechanism to expand liability is already built into the ESM Treaty. The structural majority of debtor countries in EU institutions will empty all of the ESM's coffers of whatever funds they contain and will push for them to be filled up again should they start to look depleted. Pretty rules will not put a stop to this. The history of the euro is characterised by repeated violations of treaties and of self-imposed rules, ranging from the violation of the no-bail-out clause to the waiving of the conditions attached to ESM bail-out funds. The sequence of events is always the same: first the solvent countries are encouraged to open up their wallets with the promise of keeping things within bounds by establishing politically-defined limits and imposing rules of behaviour, and then these limits and rules are simply dumped and forgotten once the wallet is on the table. This game has been played so many times in the recent past that it is hard to understand how the German government and some of our colleagues still hope that things could turn out any differently this time.

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