How to Avoid a Darkening Debt Storm in the Caribbean: Lessons from the Banking Union Framework in the Euro Area

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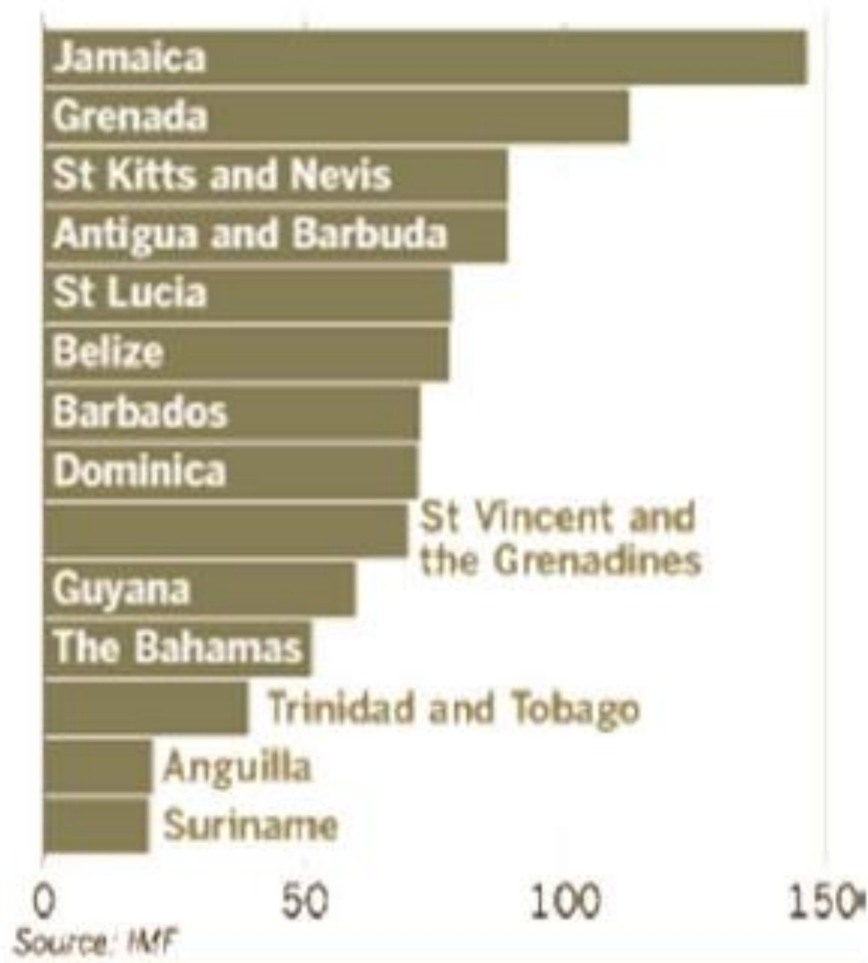
Disclaimer

- This presentation is based on joint work with Andrew Hughes Hallett, School of Public Policy, George Mason University, USA.
- The presentation draws on a draft report on fiscal imbalances in the Eastern Caribbean Currency Union prepared for the World Bank.
- Errors and shortcomings in the underlying report are exclusively the responsibility of the authors, and the views expressed in this presentation are those of the presenter and co-author - and do not necessarily represent those of the World Bank.

How to avoid a darkening debt storm in the Caribbean?

The Eurozone: A fragile monetary union in need of reforms…

Gross government debt in the Caribbean, per cent of GDP, 2012

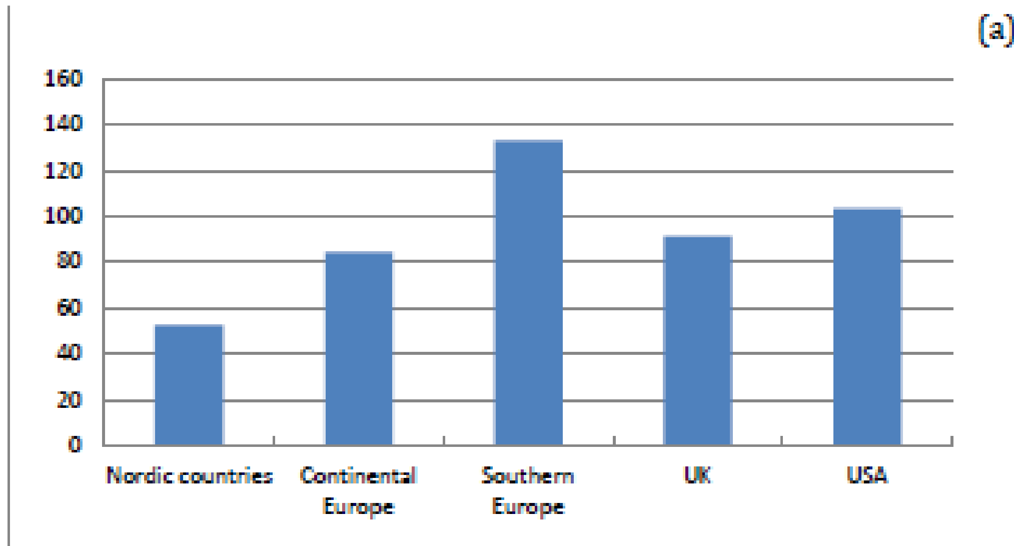


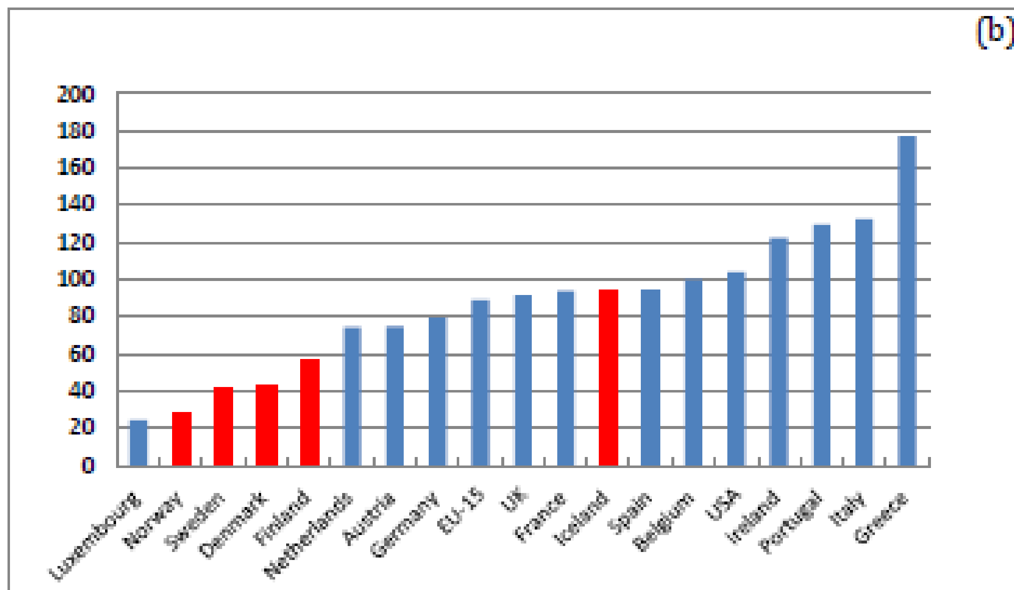
Public debt: ECCU vs EA

	2006	2007	2008	2009	2010	2011	2012	2013
(a) EA								
Finland	39,6	35,2	33,9	43,5	48,6	49,0	53,3*	56,9*
Germany	67,9	65,4	66,8	74,5	82,5	80,5	82,0	80,4*
France	64,1	64,2	68,2	79,2	82,3	86,0	90,3	92,7*
Greece	107,5	107,3	112,5	129,3	147,9	170,6	158,5	179,5*
Ireland	24,6	25,0	44,5	64,9	92,2	106,5	117,1	122,0*
Italy	106,3	103,3	106,1	116,4	119,3	120,8	127,0	130,6*
Portugal	63,7	68,3	71,6	83,1	93,2	108,0	123,0*	122,3*
Spain	39,7	36,3	40,2	53,9	61,3	69,1	84,1	91,8*
Euro area	68,6	66,4	70,3	80,0	85,6	88,1	92,9	95,0
(b) ECCU								
Antigua and Barbuda	90,9	79,2	77,3	102,5	90,8	92,9	89,2	91,9*
Dominica	79,0	73,0	65,3	64,2	69,9	70,7	72,2*	73,6*
Grenada	93,4	89,5	84,4	97,7	104,3	109,0	112,6	116,1*
St. Kitts and Nevis	145,3	134,0	131,0	148,5	163,9	153,6	89,3	83,0*
St. Lucia	59,4	57,5	57,1	61,3	66,0	71,1	78,4	84,8*
St. Vincent and the Grenadines	63,8	55,6	57,3	64,6	66,2	67,8	70,2*	74,2*

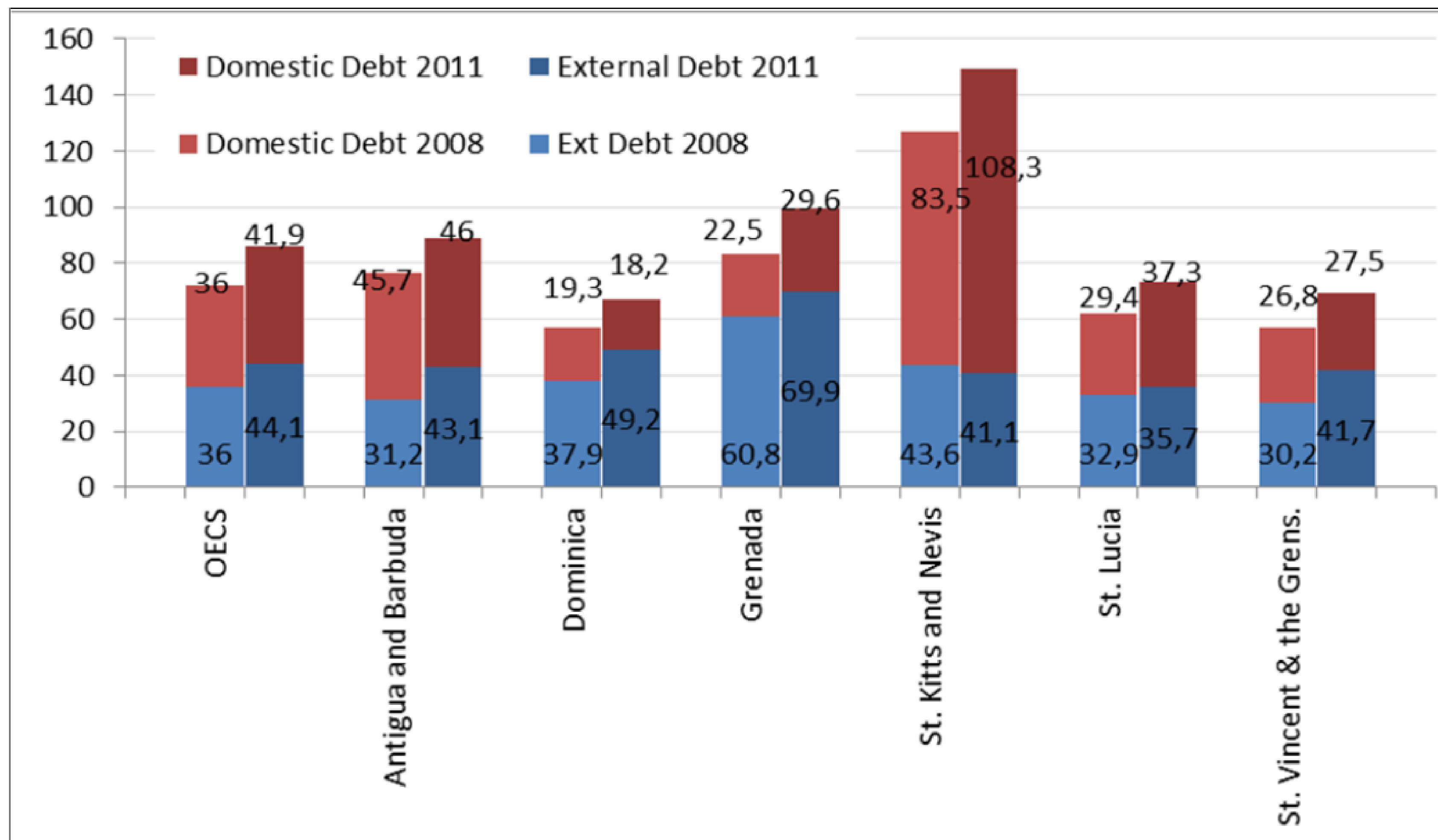
*Estimates. Source: IMF, World Economic Outlook Database, April 2013

Consolidated government gross debt, percentage of GDP, 2013



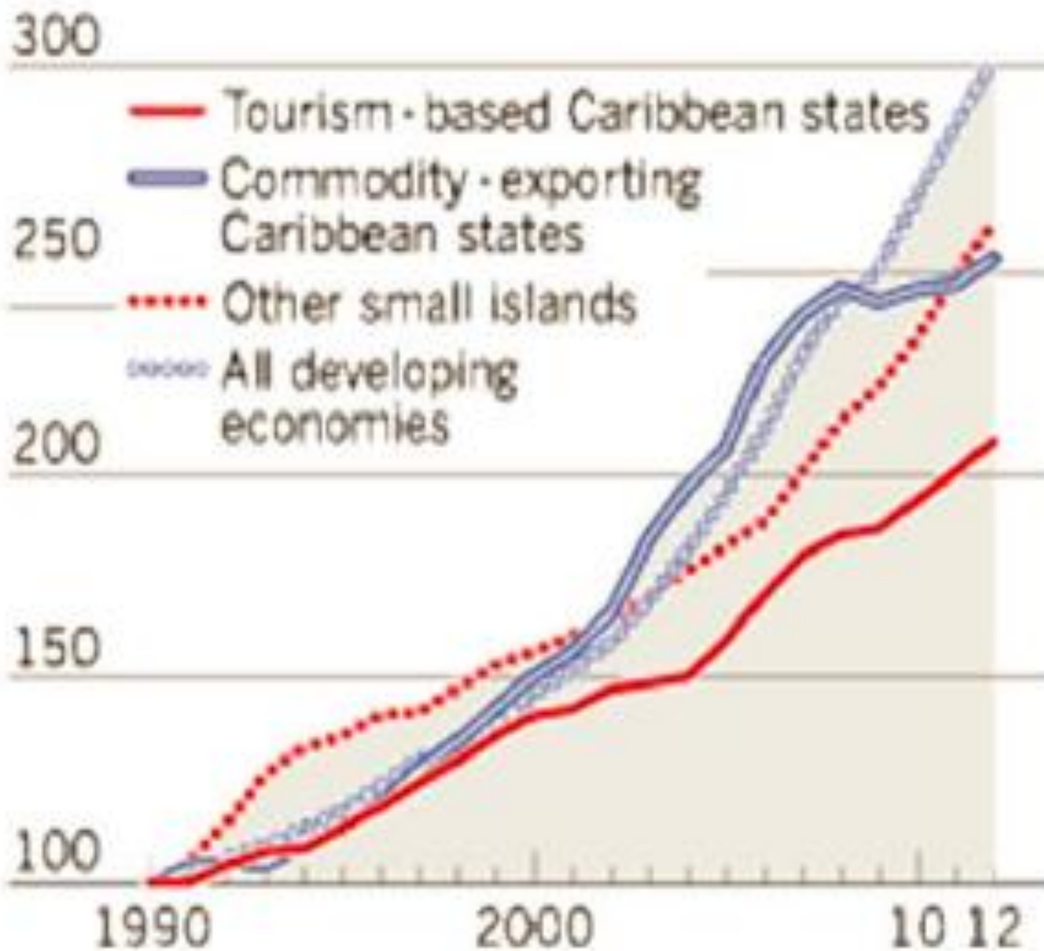


Composition of OECS public debt on domestic and foreign creditors



Source: IMF, World Economic Outlook Database, April 2012

Caribbean GDP growth compared with developing economies



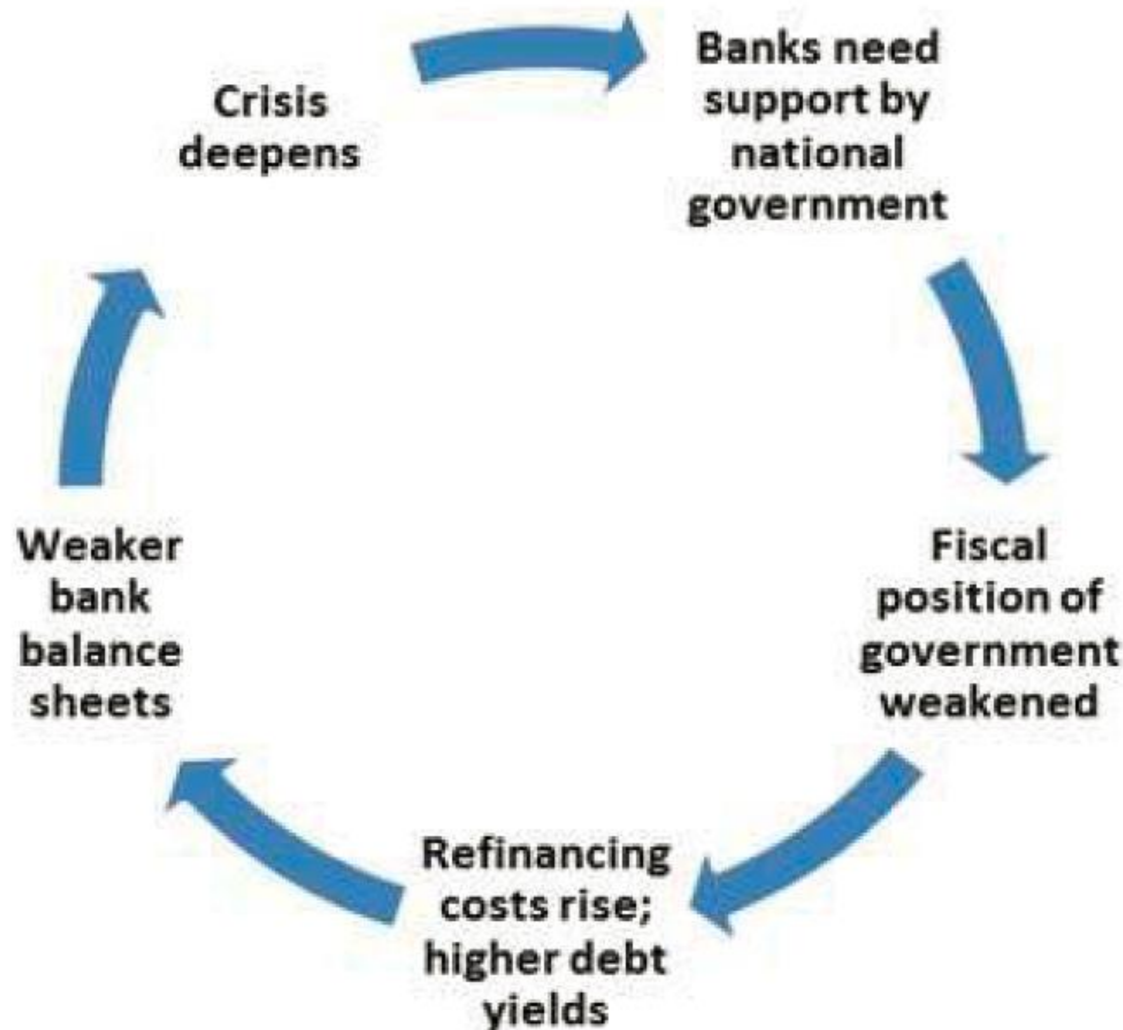
Debts are a *symptom* - not a *cause* of the region's underlying malaise…

- An increase in public debt *may* result from fiscal irresponsibility – but does not necessarily…
- It can happen just as easily from poor macroeconomic fundamentals…
- The Caribbean economies are very small and are vulnerable to a variety of shocks… Three examples:
  - First, hurricanes cause periodic devastation – but they are only partly to blame for the debt problems…
  - Second, Venezuela may end the discounted oil shipments - so oil prices will go up…
  - Third, the January 2009 collapse of CL Financial in T&T - the Caribbean's Lehman Brothers, rattling almost every country in the region. The IMF has estimated the cost of the CLF collapse at 3.5 per cent of GDP on average for the Caribbean countries – rising to more than 10 per cent for T&T...

Debts are a *symptom* - not a *cause* of the region's underlying malaise…

- Again: the appropriate policy response should allow for the particular circumstance underlying the fiscal problem…
- Therefore, policies directed exclusively at obtaining fiscal discipline may be too narrow.
- Members of a monetary union are likely to be especially vulnerable to "sudden stops" and banking crises, due to the absence of a lender of last resort.
- In the Eurozone, banking union seeks to address this issues, thus preventing banking failures to end up with the tax payers – and the real economy…
- Steps have been taken to cut the "deadly embrace" between sovereigns and banks…

The vicious circle between banks and public finances



The vicious circle between banks and public finances

- Households run into debt problems…
- This shows up as a banking crisis…
- The banks won't be stuck with the bill and pass it on to the government…
- This leads to an increase in sovereign debt…
- Debt burdened sovereigns pass on the bill to its citizens…
- Fiscal pain with higher taxes or spending cuts - and possibly seigniorage, bail-outs, defaults…

Another illustration: External imbalance

- Suppose a CA deficit appears – for whatever reason (e.g., higher oil price)…
- Then either the government has to run a deficit, or private savings must fall relative to investment to restore equilibrium…
- **NIA: (S-I) + (T-G) = (X-IM+p)**
- In a downturn, however, savings tend to rise and investment to fall…
- So the most likely outcome is that the government deficit will rise…

Another illustration: Sudden stops

- Demand for assets in ”problem countries” will collapse, especially in a currency union where individual countries are deprived of a lender of last resort…
- Asset sales can be sent to low-risk countries without major transactions costs:
  – in the EA to Germany, Finland etc. in the north
  – In the ECCU to the US…
- This leads to liquidity crisis and increased borrowing costs…
- In principle, this could occur without “actively irresponsible” fiscal decisions…

General government net lending

	2006	2007	2008	2009	2010	2011	2012	2013
			(a) EA					
Finland	4.1	5.3	4.3	-2.7	-2.8	-0.9	-1.7*	-2.0*
Germany	-1.6	0.2	-0.1	-3.1	-4.1	-0.8	0.2	-0.3*
France	-2.4	-2.7	-3.3	-7.6	-7.1	-5.2	-4.6*	-3.7*
Greece	-6.0	-6.8	-9.9	-15.6	-10.7	-9.4	-6.4	-4.6*
Ireland	2.9	0.1	-7.4	-13.9	-30.9	-13.4	-7.7	-7.5*
Italy	-3.4	-1.6	-2.7	-5.4	-4.3	-3.7	-3.0	-2.6*
Portugal	-3.7	-3.2	-3.7	-10.2	-9.8	-4.4	-4.9*	-5.5*
Spain	2.4	1.9	-4.5	-11.2	-9.7	-9.4	-10.3	-6.6*
Euro area	-1.3	-0.7	-2.1	-6.3	-6.2	-4.1	-3.6	-2.9
			(b) ECCU					
Antigua and Barbuda	-8.8	-5.0	-5.7	-18.2	-0.2	-3.6	-1.2	-6.6*
Dominica	3.0	1.8	0.7	-0.3	-3.5	-4.5	-3.8*	-3.4*
Grenada	-5.6	-6.3	-4.1	-5.2	-3.1	-4.4	-4.7	-6.1*
St. Kitts and Nevis	-3.9	-3.5	-3.9	-2.9	-7.8	1.8	5.2	2.2*
St. Lucia	-5.9	-1.9	-0.9	-3.1	-4.8	-6.9	-11.9	-9.4*
St. Vincent and the Grenadines	-3.1	-3.1	-1.4	-3.2	-5.4	-3.6	-2.7*	-2.8*

*Estimates. Source: IMF, World Economic Outlook Database, April 2013

Current account balance

	2006	2007	2008	2009	2010	2011	2012	2013
				(a) EA				
Finland	4.2	4.3	2.6	1.7	1.5	-1.6	-1.7	-1.7*
Germany	6.2	7.4	6.2	6.0	6.2	6.2	7.0	6.0*
France	-0. 6	-1.0	-1.7	-1.3	-1.6	-1.9	-2.4	-1.3*
Greece	-11.4	-14.6	-14.9	-11.2	-10.1	-9.9	-2.9	-0.3*
Ireland	-3.5	-5.4	-5.7	-2.3	1.1	1.1	4.9*	3.4*
Italy	-1.5	-1.3	-2.8	-2.0	-3.5	-3.1	-0.5	0.3*
Portugal	-10.7	-10.1	-12.6	-10.9	-10.6	-7.0	-1.5	0.1*
Spain	-9.0	-10.0	-9.6	-4.8	-4.5	-3.7	-1.1	1.1*
EA	0.5	0.4	-0.7	0.2	0.5	0.6	1.8	2.3
				(b) ECCU				
Antigua/ Barbuda	-26.3	-30.0	-25.9	-19.4	-14.7	-10.8	-12.8*	-13.1*
Dominica	-13.0	-21.1	-27.5	-21.2	-16.2	-12.8	-13.4*	-13.8*
Grenada	-29.6	-27.7	-25.3	-23.6	-24.1	-23.3*	-22.9*	-23.4*
St. Kitts/ Nevis	-14.1	-18.2	-27.6	-27.4	-22.4	-15.6	-13.5*	-15.9*
St. Lucia	-30.6	-30.6	-29.2	-11.7	-16.9	-20.1	-19.1*	-18.2*
St.Vincent/ Grenadines	-19.5	-28.0	-33.1	-29.3	-30.6	-28.8	-27.8*	-26.8*

* Estimates. Source: IMF, World Economic Outlook Database, April 2013

Private savings-investment gap

	2006	2007	2008	2009	2010	2011	2012	2013
(c) EA								
Finland	0. 1	-1.1	-1.7	4.5	4.3	-0.7	0.7*	0.3*
Germany	7.9	7.2	6.3	9.0	10.4	7.0	6.8	6.4*
France	1.8	1.7	1.6	6.2	5.5	3.2	2.3*	2.4*
Greece	-5.3	-7.8	-5.0	4.4	0.6	-0.5	3.5	4.3*
Ireland	-6.4	-5.4	1.7	11.6	32.0	14.5	12.7	10.9*
Italy	1.9	0.3	-0.2	3.4	0.8	0.6	2.5	2.9*
Portugal	-7.0	-6.9	-8.9	-0.6	-0.5	-2.8	2.8*	5.6*
Spain	-11.3	-11.9	-5.1	6.4	5.2	5.7	9.2	7.7*
EA	1.9	1.1	1.5	6.7	6.7	4.7	5.5	5.4
(d) ECCU								
Antigua/ Barbuda	-17.5	-24.9	-20.1	-1.1	-14.5	-7.2	-11.5*	-6.5*
Dominica	-16.0	-22. 9	-28.2	-20.9	-12.7	-8.4	-9.6*	-10.4*
Grenada	-23.9	-21.4	-21.2	-18.4	-20.9	-18.9*	-18.3*	-17.3*
St. Kitts/ Nevis	-10.2	-14.6	-23.7	-24.5	-14.6	-17.4	-18.7*	-18.2*
St. Lucia	-24.6	-28.7	-28.3	-8.6	-12.1	-13.2	-7.2*	-8.8*
St.Vincent/ Grenadines	-16.5	-24.9	-31.8	-26.0	-25.2	-25.1	-25.1*	-24.0*

* Estimates. Source: IMF, World Economic Outlook Database, April 2012

ECCU: fiscal imbalances the main risk?

- First look at the data suggests:
  - By far the biggest imbalances are in the current account
  - Then in the savings-investment financing gap
  - Private financing therefore covers the larger part of the external deficits but not by enough
- This leads to accumulation of public debt
  - The ECCU countries are thus open to big risk from sudden financing stops or capital reversals
- We are primarily concerned here with sudden deteriorations in the savings-investment gap itself, and the sudden improvements which reflect a drop in investment…

Causality?

- Stable patterns in ECCU, except:
  - Private investment-savings gap in 2008-09
  - The current account balance in 2008-10
  - Government net lending in 2009-11
- Lagged effect with respect to fiscal gap may tell something about *causality*:
  - Imbalances start with private sector external payments which are *not* fully financed by capital inflows from abroad
  - In fact, those inflows tend to dry up before the external deficits fall
  - This throws the problem into fiscal deficits and public debt…

EA – ECCU comparison

- The ECCUs biggest problem is current account deficits
- The EAs largest problem is fiscal deficits, augmented by external imbalances in Greece, Portugal (and Germany!) before 2012
- The EA deficits have been worse (4-5% of GDP) than those in the ECCU (3-4% of GDP)
- Current account imbalances in the ECCU are four to five times larger (about 15 to 30 % of GDP) than those in the EA (less than 2% of GDP, and mostly in surplus)
- The upshot is that ECCUs main problem is a private sector one in the first instance, and official policy should be adapted to deal with that…

Right policy response?

- Not to say that fiscal deficit and debt reductions would **not** be an important component of policy and structural reform.
- But the private sector imbalances are considerably *larger* and evidently feed through to induce increased fiscal deficits and public debt.
- Policies should therefore be directed at increasing savings, growth or employment.
- Improving the balance of trade and net investment incomes or remittances would have the biggest impact on:
  - Improving economic performance,
  - Reducing the risk of periodic financial crises,
  - Reducing the pressures on fiscal budgets and escalating public debt.

Right policy response?

- These figures make the differences between what might otherwise appear to be a common excess debt problem in the ECCU and EA clear:
- To account for those differences, the policy prescriptions need to be different.
- In that regard, it is in important to note that the savings-investment gaps have all turned positive since 2008 in the EA which, with improving trade balances…
- Means the EA has shifted private sector deficits onto the public budget. In the ECCU, there are no such changes in the sign of the private savings-investment gaps or the size of the external deficits.
- Their imbalances remain in the private sector.

Right policy response?

- Europe is now at a point where consolidation policies could operate on the public sector.
- This calls for a distinction between fiscal consolidations and restructuring - now that growth and private sector balances are returning to normal…
- The premature use of austerity policies which had probably delayed that return to a "business as usual" equilibrium in the EA.
- In the ECCU, by contrast, the need is for policies explicitly directed at restructuring the private sector.

Right policy response?

- The implication is that financial regulation and policy oversight has to cover the consequences of *all* these imbalances:
  - prevent one kind of imbalance morphing into another,
  - remove any excess imbalances,
- The implication is that the ECCU will need better institutions ("framework conditions") rather than specific policies to achieve that in a world where countries have different objectives, different priorities and different time frames.

Right policy response?

- Recent experience in the EA has shown that macro imbalances, if not held in check or reduced, can also pose serious structural problems.
- This has important implications for the design of financial policies and regulation procedures:
  - a possible loss of financial control and uncertainty in the currency union;
  - the difficulty of imposing sufficient discipline on the borrowers;
  - the need to prevent a build-up of debt (public or private) in any participating economy, and what to do about it if it happens (the resolution mechanism);
  - recognition that escalations in public debt can happen just as easily from excess private debt and asset bubbles, as it can from fiscal irresponsibility; and
  - that a coordinating mechanism is needed to ensure that the borrowing done by either party is consistent with the overall macroeconomic strategy of the currency union.

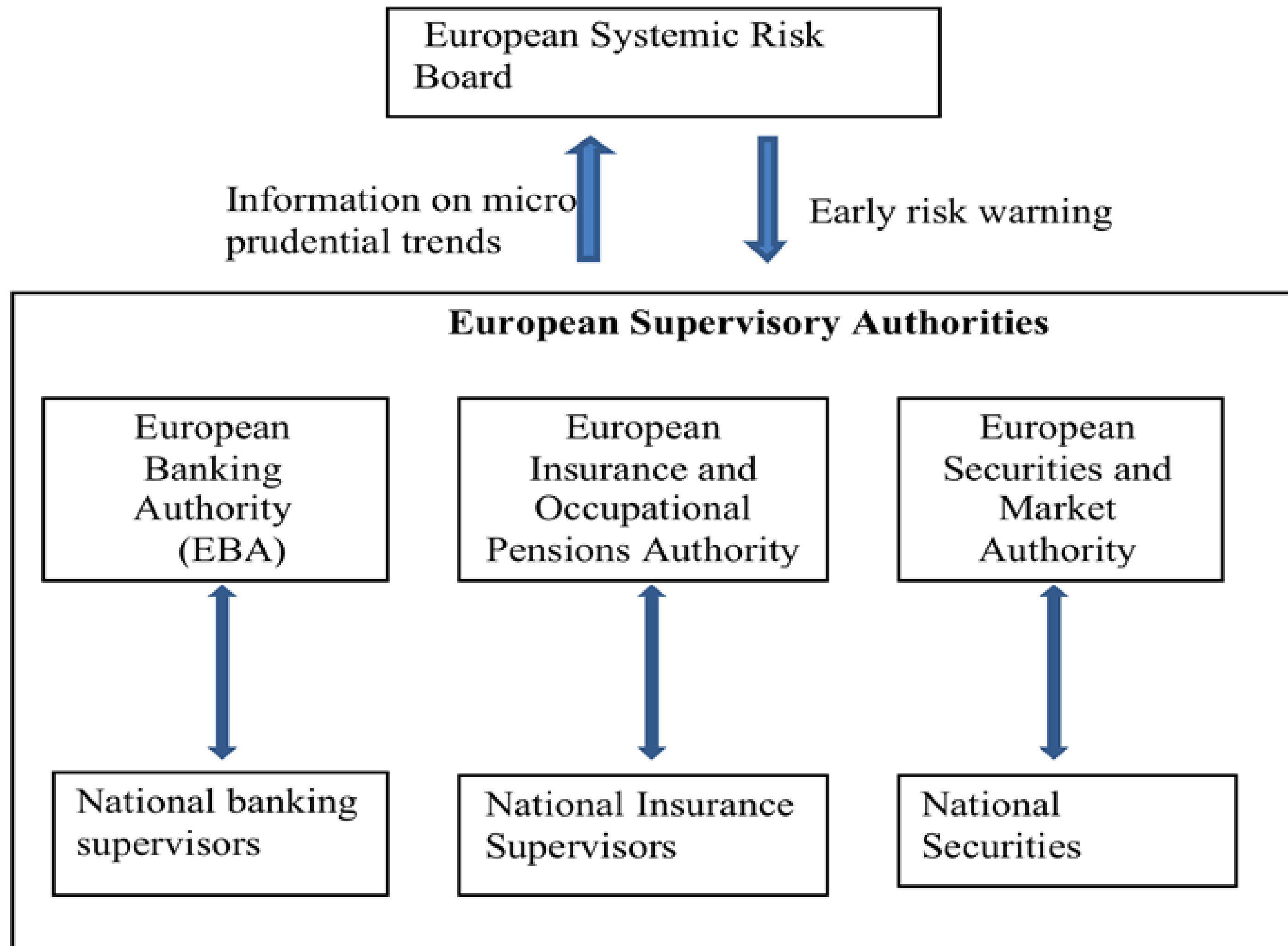
Regulation and common or mutualized bonds

- There is no issue of financial regulation or conduct for those involved in the issuance or management of national debt in the ECCU
- Why? Because 100% of financial sector activities already fall under common ECCU legislation and regulatory practice.
- From this point of view, mutual "C-bonds" would just be one more player in the market, much like the municipal or corporate bonds tha already exist.
- The issue is how to manage the debt, and prevent an excessive build up of debt that disrupts the ECCU economy or the thrust of ECCU policies.

Jointly administered rescue funds

- Under the **European Systemic Risk Board** legislation in the EA:
  - member states must participate in a private sector bail-out on the basis of proportional activity levels if *not* doing so would damage financial services in another jurisdiction, and thereby violate the single market.
- ECCU should adopt the same position:
  - on the argument that it will be in the interest of any participant to proportionately bail out an institution not headquartered in its own jurisdiction since not to do so would precipitate the financial collapse of an institution, and possibly others, operating in that jurisdiction.

New European Regulatory structure



The separation principle: governance arrangements

- We need to create a regime that separates private sector risk from public risk.
- The governance arrangements need to recognise that sovereign debt problems are often caused by financing stops and trade imbalances that arise in the private sector, rather than fiscal irresponsibility per se…
- The new regime should
  - provide a lender of last resort mechanism to underpin stability in the private markets…
  - impose fiscal constraints to rule out the chances of a sovereign default.
- The former requires a rigorous system of financial regulation
  - now being developed in Europe, called *Banking Union*…
- The latter requires a system of debt limits or targets with effective sanctions, such as a debt protocol operated by an independent *fiscal policy council* – a wachdog…

The separation principle: governance arrangements

- Having separated the two components into separate institutions, problems in the financial sector can be treated on merit with targeted lending of last resort where needed.
- By contrast, unsustainable fiscal policies will eventually be ruled out by the fiscal policy council through a technocratic device, in effect suspending the policy process until sustainability can be restored.
- In normal times, the markets and financial sector firms may pursue their own interests without constraint – unless their decisions would predictably lead to insolvency.

The separation principle: governance arrangements

- We suggest a jointly run bailout vehicle, with the following characteristics:
  - mutually owned and operated,
  - run independently of governments,
  - Mutualisation of debt is to be avoided in order to preserve market discipline on the *individual* issuers of debt.
  - Necessary to limit the impact of *moral hazard* as far as possible on the issuers in the market for debt.

The separation principle and governance arrangements: Caribbean perspective

- A fund for private sector bailouts should be set up and operated by a financial stability board run by the ECCB.
- It suggests a fund of guarantees, public ownership, or contributions supplied by member institutions, paid out as deemed necessary by the Financial Stability Board on an institution by institution basis.
- The funds in question should be lent/paid directly to the financial institutions themselves, not via either government
- should be regarded as being conditionally available to any institution in the union.
- If public ownership proves necessary, then that institution will become jointly owned (on a shareholder basis) by the participating fiscal and lending authorities.

The separation principle and governance arrangements: Caribbean perspective

- The size of fund and its ability to borrow have been controversial issues in Europe.
- This needs further thought in the Caribbean context…
- Since the ECCB's ability to expand its balance sheet and accept collateral for liquidity financing would lie behind any guarantees, those concerns may be less controversial than in Europe.

New European Regulatory structure

- On the whole these are important institutional changes that give significant powers to European authorities.
- But, national supervisors maintain their powers for the day-to-day supervision of the institutions and markets under their jurisdiction.
- They will, therefore, also continue to have privileged access to information.
- The question arises about how smooth the information sharing between national and European authorities will be in practice.
- Experience shows that those who have the primary access to information are often reluctant to share this information.
- But BANKING UNION changes all this…

Common supervisory framework

- ECB becomes the common supervisor from end of 2014 on in the framework of **banking union**…
- Within the ECB there will be a Board of Supervisors consisting of the representatives of the 18 Eurozone member states and four ECB representatives.
- This Board will have the authority to supervise the "systemic" banks in the Eurozone.
- These are the banks with a balance sheet exceeding €30 billion or 20% of the national GDP (about 200 banks).

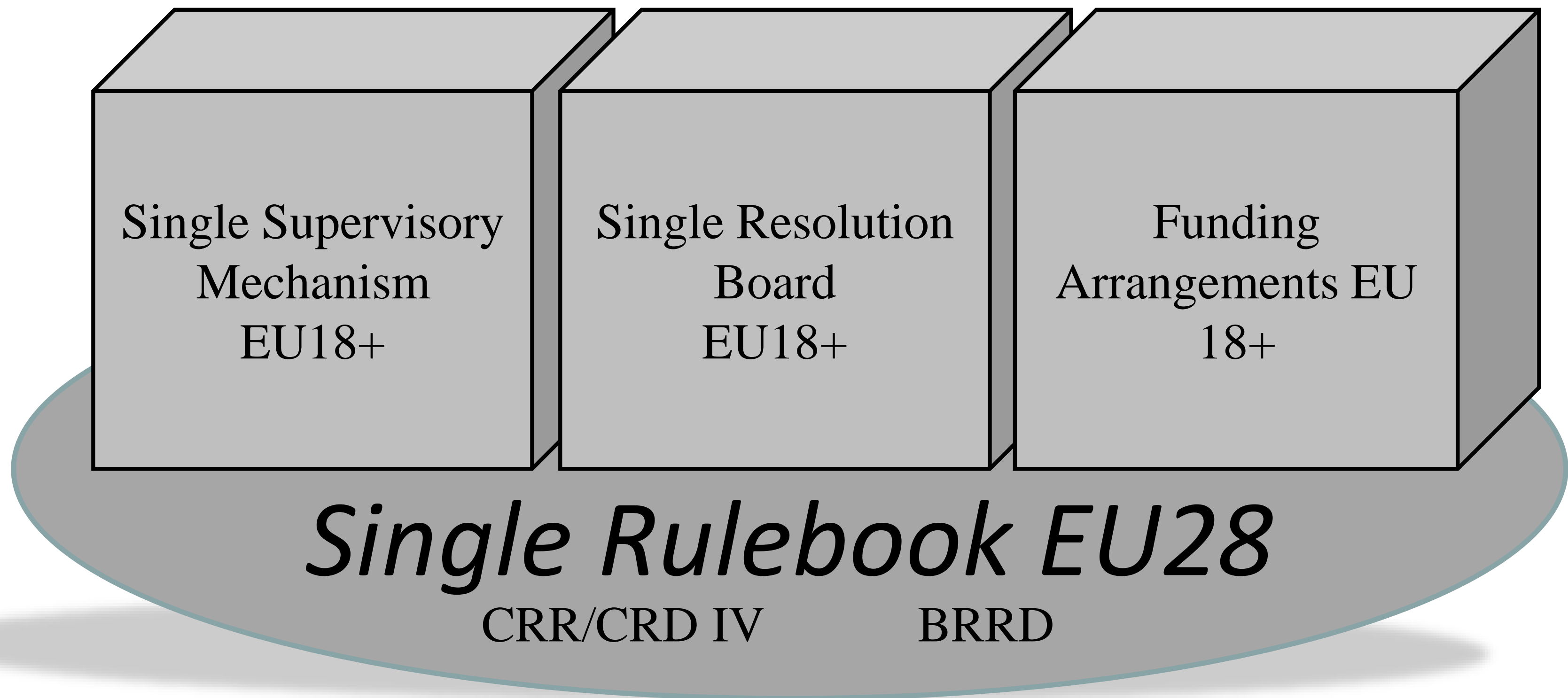
Common supervisory framework

- This supervisory authority includes
  - the auditing of the balance sheets,
  - the imposition of fines, the recapitalization of the banks
  - their closing down when necessary.
- These are very intrusive powers that have been given to the ECB.
- The supervision of the 6000 smaller banks remains vested with the national supervisors.
- However, the ECB Board of Supervisors is empowered to issue instructions to these smaller banks if the national supervisors fail to act.

Common resolution

- Some steps were taken to cut the “deadly embrace” between sovereign and banks
- With a common resolution mechanism
- A common fund will be set up
- However, fund only will have resources of €55 billion, which is insufficient to deal with bank crisis that is systemic in nature
- Also governance of resolution authority is too complex and will not be able to act quickly in times of crisis

Key elements of the Banking Union



Political Agreement

The European Parliament and the Council reached a political agreement on the Single Resolution Mechanism **on 20 March 2014.**

The SRM is the **second pillar** of the Banking Union.

The SRM will ensure that potential future bank failures in the banking union are managed efficiently, with **minimal costs to taxpayers** and the real economy.

Scope of Single Resolution Mechanism

- **Mirrors the SSM:** all banks established in the Euro Area and other participating Member States
  - *Single Supervisor requires Single Board and Fund*

- As for the SSM, there is a **distribution of tasks between the Board and the NRAs**:
  - Board is directly responsible for cross-border and significant banks (›30bn)
  - NRAs are responsible for all other banks (*also to adopt resolution decisions, provided no use of the Fund is required*).

- But the Board is ultimately responsible for **all banks**.

Key principles for the SRM

- Decisions are European, but involve NRAs in view of significance of bank resolution for national economies
- Responsibility for supervision, resolution and funding is aligned at EU level
- Funding arrangements are not funded by taxpayer

Triggering Resolution in practice

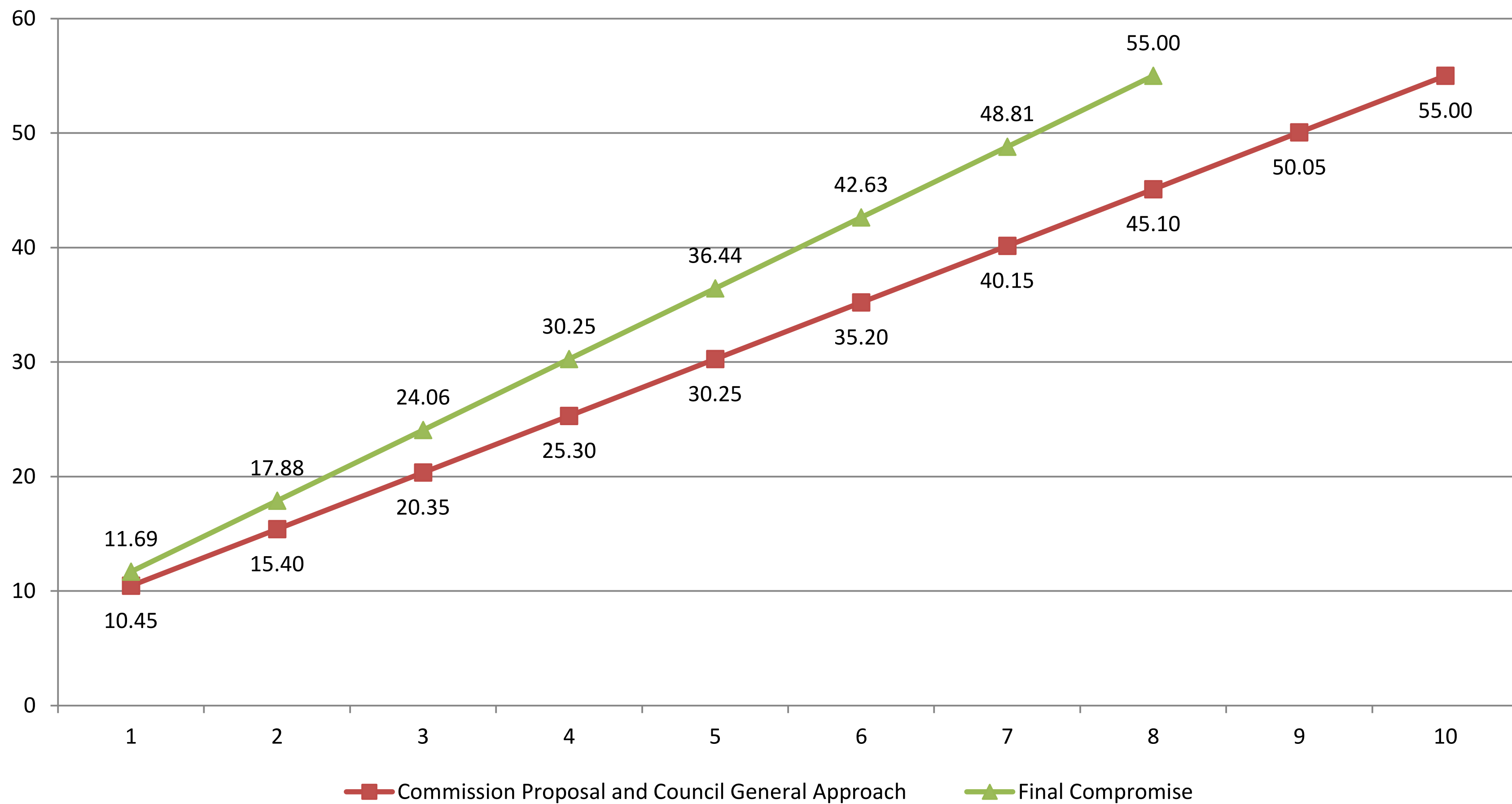
- Determination that the **(i) bank is failing/likely to fail** is generally made by ECB
  - Board may also if it has informed ECB, and the latter has not reacted within 3 days
- Board assesses if there is a **(ii) systemic threat** (public interest) and there is **(iii) no alternative private solution**
- If so, it adopts a **resolution scheme** in which it sets out the necessary resolution and funding measures
- Resolution scheme is submitted to **Commission** for endorsement or objection.

Role of the EU Institutions:

Commission and Council (Meroni functions)

- The **Commission** is in most cases the last instance deciding on resolution on the basis of the resolution scheme adopted by the Board
- The **Council** is also involved in some cases.
- Within 24 hours, the Commission shall either **endorse** or **object** to the resolution scheme (except in the cases where Council is competent)

Total fund size: EUR billion



Final compromise: accelerated, non-linear mutualization - more resources in common from year 6.