Editorial - Dozing on the volcano

New German government will bring no changes in EU policies

The German election campaign and the complicated procedure for establishing a new government have lead to a stand still of half a year in the management of the EU crisis. It will last at least until Christmas until the new government will start working.

As the liberal party, FDP, has been wiped out from the parliament, Merkel has lost her coalition partner. Although her party had with 41,5% a good score, Merkel needs a new partner to have a stable government. As things stand, this will be the Social Democrats (SPD). The SPD reached only a meagre result of 25,7%, but has a majority in the second chamber, which represents the 15 federal states, and could therefore block many projects. As the SPD was not benefitting from the last coalition with Merkel between 2005 and 2009 there is also some reluctance inside the party to go for a new similar coalition. All this makes the procedure complicated and time consuming.

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Whatever the outcome, there will be no substantial changes of the German position with regard to the European crisis. If in other countries, in particular in the crisis countries and France, there were hopes that a new government would make a difference, they will be disappointed. Even in previous years the SPD supported Merkel - albeit with some accompanying critical rhetoric - on issues ranging from her method of bailing out banks to the austerity policies.

Also in the election campaign, the EU crisis was no issue. Referring to a movie from the "roaring twenties" with the title The Dance on the Volcano, German philosopher, Jürgen Habermas, was describing the situation as Dozing on the Volcano!

In the current negotiations, the SPD has already given up modest demands such as Eurobonds. The only new element will be some Billions of Euro to mitigate youth unemployment in the crisis countries. But in substance there is a deep-rooted consensus: both Christian Democrats and Social Democrats defend the German development model, which is based on a neo-mercantilist concept of export for German products at any price. The relative high share of industrialisation with automobile and machinery on top, is not only based on big corporations like Volkswagen and BMW but also on a strong involvement of medium-sized enterprises with globally competitive, high tech products. This coalition of interests even integrates the employees and trade unions of the export sector. Just as the UK economy is dependent on the City of London, the German economy is like a junkie, who cannot live without the excessive competitiveness of its export industry. The new government in Berlin will remain stoned.
Summaries of the articles in this newsletter

Unanswered questions in the EC’s roadmap to tackle shadow banking

Shadow banking that provides credit in an unregulated way, still poses a threat to the whole financial sector. The European Commission (EC) has come up with a roadmap to tackle the many different actors and products of the shadow banking system. As an important step, the EC proposed a Regulation on Money Market Funds (MMFs) on 4 September 2013 but it is not clear whether the new law will be approved before the election time of the European Parliament (March –May 2013). Many further steps of the roadmap need to be taken and crucial steps are missing, e.g. tackling routing capital between shadow banking entities through off-shore centres such as the Netherlands and Luxembourg.

For the full detailed article see below.

Will the Banking Union save the Euro?

Agreement on new supervisory regime for big banks in the Eurozone

The first step for a banking union in the Eurozone has been decided: from November 2014 onwards, the European Central Bank (ECB) will directly supervise 130 out of the 6000 banks in the Eurozone. In the preparation phase, the ECB will implement bank stress tests. If the tests are realistic, several banks will have to be either recapitalised or shut down. Recapitalisation would have to happen nationally, which would lead to major difficulties in crisis countries. The other 2 steps that will create the pillars of the banking union are the Single Resolution Mechanism (SRM) and a single savings account protection system, the specifics of which are far from being agreed upon. There is a sharp conflict over decision powers and who will pay for failing banks. The official date for the implementation of the SRM is 2018. For the savings account protection fund, a deadline has not even been set. The whole banking union project might remain unachieved or be watered down to an extent that it will not be able to meet the expectations. But even if it were fully implemented, it does not have the capability to prevent the break-up of the Euro, as it does not repair the root causes of the misconstruction of the currency.

For the full detailed article see below.
Unanswered questions in the EC’s roadmap to tackle shadow banking

By Rodrigo Fernandez, SOMO, and Myriam Vander Stichele, SOMO

Photo by Eadaoin O'Sullivan

On 4 September 2013, the European Commission (EC) published a ‘roadmap’ on how to regulate the shadow banking sector. It proposed a Regulation on money market funds (MMFs: see below) as part of the set of measures already taken and others to be taken in the future.

Shadow banking covers complex forms of intermediating credit outside the regulated traditional banking system. The use of innovative forms of intermediation increased the level of borrowing (i.e. ‘leverage’) in developed economies, particularly since the 1990s, and is widely recognised as being a prime instigator of the financial crisis.

Since the crisis in 2008, there has been a debate among policy makers, notably, the IMF, the US Federal Reserve (FED), the Financial Stability Board (FSB), the G20 and since 2012 the European Commission. In the first years, the emphasis was on defining, understanding and grasping this web of transnational connections between different actors like money market funds (MMFs: see below), hedge funds, special purpose vehicles (SPVs) and structured investment vehicles (SIVs) mostly based in tax havens, repo-markets, institutional investors, and investment banks. The first mapping exercises by the New York FED and the FSB quantified the flows of shadow banking entities, their geography and types of interconnections. In 2011, the size of shadow banking was estimated by the FSB to be €51 trillion Euro (€16.8 trillion in the Eurozone), representing 25-30% of the total financial system. The mapping studies produced alarming conclusions concerning systemic risks associated to shadow banking, and called for policy interventions.

The EU commission followed in March of 2012 with a green paper on shadow banking which was open for consultation. At the end of 2012, the European Parliament and the European Systemic Risk Board (ESRB) raised concerns about shadow banking and MMFs, and their recommendations are reflected in the EC’s proposals.

An important step of the EC’s roadmap is the draft Regulation published on 4 September to reduce the risks of MMF’s. Money market funds (MMFs) are mutual investment funds that sell shares to institutional investors or individuals who use them as more profitable alternatives to (short term) saving accounts. MMF shares can be sold at any moment, which can lead to a final crisis if all money is withdrawn at the same time. Part of the MMFs guarantee constant share value, typically 1 dollar or 1 Euro a share. MMFs invest in short term debt instruments mostly by governments (owning ca. 22% of government short term debt in Europe), banks (owning 38% of short-term debt issued by the banking sector) and other corporations - and therefore are important short term credit providers to banks and governments. However, nine out of the ten biggest EU MMF managers are sponsored by commercial banks that have to provide
funding in time of sudden decreasing value to the assets of MMFs.

The EC’s proposals mainly stipulate that MMFs should:

- hold a cash buffer (3% of their assets), when they guarantee constant value per share,
- hold financial instruments that can be converted into cash daily (10% of their assets) or weekly (an additional 20% of their assets),
- have better risk assessments systems of their assets and their clients.

While these attempts to regulate this sector and introduce capital requirements should be welcomed, we must look at the broader picture to assess whether this is a step in the right direction. Also, EU initiatives have to be put in context of broader strategies to strengthen the oversight and regulation of shadow banking by the FSB.

MMFs are prime elements of the vast pool of shadow banking intermediated capital, which brings together actors that, for reasons of their own, share an interest in dealing in this opaque part of the financial system. According to the September 2013 Quarterly Review of the Bank for International Settlements (BIS), the post-crisis environment fueled the use of shadow banking. Multinational corporations lend out to MMFs since they can continue to build up large cash pools in tax havens, which are still not closed, and investment opportunities in the austerity ridden EU remains low. Institutional investors are confronted by low yields due to low interest rate environment, and are therefore motivated to be engaged in money market funds. Regulatory changes in the capital requirements for banks, and reforms in the OTC derivatives markets, all lead to increasing demand for high quality collateral, but as the supply of high quality collateral is lagging, money is flowing to the less regulated shadow banking.

As more actors, including central banks, systemic banks, pension funds and insurance companies, become increasingly active and dependent on shadow banking, the systemic risks, already well documented by policy makers, are growing and the shadow banking system remains highly unstable, lacking a public back stop. Also shadow banking is dangerously pro-cyclic in nature.

Therefore the future next steps of the EU roadmap are crucial. Most importantly is the strategy to mitigate spill-over effects between shadow banking and the regular banking system. For the moment, the continued reliance by banks on shadow banking entities for funding is strengthening the relation of banking and shadow banking and is increasing potential spill-over effects. The EC road map remains unclear on how it intends to disentangle banking from shadow banking and only proposes to regulate how banks should relate to non-regulated entities. Another critical issue is transparency, as indicated by the EC. At the moment research points to the pivotal role of Luxembourg, the Netherlands and Ireland in shadow banking activities since these countries are in practice offshore centers where capital is routed between shadow banking entities. This issue needs to be addressed urgently and is absent in the roadmap.

On the one hand we see how post crisis dynamics continue to feed the use of shadow banking by different actors, requiring a faster, more stringent and more comprehensive response. On the other hand we see that the attempts to setup a regulatory framework is
moving very slowly with little substantive results and the window of opportunity to act, with the collapse of Lehman Brothers fresh on the minds of the electorate, is fading.

The MMF industry is already lobbying against the EC legislative proposal arguing that the costs of holding buffers and liquidity will make the MMFs unprofitable and make an important form of credit disappear. Given that many other EU financial draft laws are still in the pipeline and should be finalised before the period of the European Parliament (EP) elections (March-May 2014), it is unclear whether the EC’s MMF proposal will be discussed and adopted before March 2014. What will happen after a new EP and EC are in place, is even less to be predicted.

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**Will the Banking Union save the Euro?**

*By Peter Wahl, WEED*

On 15 October 2013, the EU finance ministers gave green light for the establishment of the first pillar of a European banking union: the Single Supervisory Mechanism (SSM), which gives the European Central Bank (ECB) the right to supervise the 130 biggest banks in the Eurozone (which have assets of more than €30 billion or constitute at least 20% of their home country’s GDP).

**The most ambitious project since the Euro**

The banking union is the most ambitious project of the EU since the implementation of the Euro. Its basic idea is to prevent that taxpayers’ money must be used again to bail out banks in case of a bank failure or a financial crisis. Also, the vicious circle should be broken, which exists between failing banks. The cycle involves increasing public debt through bail-outs, loss of creditworthiness of a country, shrinking value of government bonds, shrinking assets of the banks that hold the bonds, more banks failing. The expectation is that the banking union is the pathway to save the currency union.

The project consists of three main components:

1. the new single supervisory structure (which has been agreed now),
2. a Single Resolution Mechanism (SRM) and a Single Bank Resolution Fund, for which a draft regulation has been presented by the Commission in July,
3. a fund or mechanism to protect deposits of savers up to a certain threshold (‘deposit guarantee system’), for instance €100,000.

**Conflict over decision making and who pays**

The new supervisory structure is the easiest exercise among the three. The other two components, however, are far from being agreed upon. This is not surprising, as there are two highly sensitive issues involved: who decides whether a bank should be shut down...
and who pays for the consequences? Given the potential amounts of money involved, national interests are clashing. Countries, like Spain, whose banks are in bad shape, hope to get the problem solved through the European Stability Mechanism (ESM). The present rules, however, allow only for the financing of a country and not for the private sector. The recapitalisation of banks can now be channelled through the respective government, but this is tied to strict conditionality, i.e. fiscal discipline and austerity. Spain and others want to avoid exactly this. Germany, in return, is against using the ESM to refinance private banks under the present conditions.

As for the decision, whether a bank should be declared bankrupt, the Commission requires this right for itself, whereas Germany – and others, which hide behind Berlin – do not want to give additional powers to Brussels. Instead, a committee of national supervisors should decide, thus keeping more power at national level.

The recent EU summit (24-25 October 2013) had the issue on the agenda. But as the meeting was overshadowed by the US-espionage case against Merkel there was no decision of substance. The summit declaration only mentions a schedule for the further process.

The hour of truth – stress tests for banks
The new single supervision mechanism will enter into force in November 2014. But before the ECB will take over its new role, there will be a stress test for the banks that will come under its supervision. It can be taken for granted that among the 130 banks there will be several that will not pass, if the test is realistic. In that case, the banks would have either to be recapitalised or shut down. However, it is unclear who would provide them with fresh money. Several banks in the crisis countries are in such a difficult situation that they will not be able to increase their capital, and so is their government. In other words, the stress test might lead to a critical situation for the European banking system, and for the Euro, in the coming months.

Uncertain future for a the resolution mechanism
The establishment of the entire banking union is officially envisaged for 2018. The core element of the SRM is the idea to hold the owners and creditors of a bank responsible instead of the tax payers. Therefore, a cascade of liabilities with nine categories is established: the first to lose their money are the shareholders of the respective bank, then come holders of risky instruments, junior creditors, senior creditors (bond holders), big investors (holding above €100,000), small savers, enterprises with less than 250 employees or an annual turnover under €50 million, banks with close ties to the insolvent institute and finally all other EU-banks. If there is still the need to provide further money the ESM should come in. However, as this last point is controversial, Merkel would be ready for a compromise about the use of ESM funds under the following conditions:

- “harmonisation” in areas such as labour markets and age of retirement,
- a system of automatic fiscal discipline. Such an auto-pilot on budgets would mean that member states give up a substantial part of their sovereignty,
- before ESM money is used, national parliaments have to agree.
As a resolution often has to be implemented through emergency measures over a weekend, the involvement of national parliaments would be a prohibitive barrier to apply for help from the ESM.

Also, this 'compromise' would lead to a further weakening of labour rights at the benefit of capital, and continue the race to the bottom in social standards. Against this backdrop, an increasing number of civil society actors, trade unionists and left-wing parties that in the past were pro-European would not be unhappy if this type of European integration fails. A group of civil society organisations is also worried about an additional 'Competitive Pact' that is being prepared, probably for the EU Summit in December 2013.

The third pillar of the banking union, an EU-wide deposit guarantee fund to be filled by contributions of the banks, is even further out of reach than the SRM. While the Commission and the crisis countries advocate a common fund, Germany and some others prefer a national solution. As things stand now, the entire project of the banking union risks to remain unachieved or watered down to an extent that it cannot in the end fulfil its purpose.

The crisis management in the Eurozone does not provide for transfer mechanisms. And given the balance of power it would be an illusion to believe that they would be possible in the foreseeable future. Also migration within the Eurozone, although taking place as a result of the crisis, is much more limited than in the inner German context. The banking union is not addressing the dramatic lack of competitiveness in the Southern countries and the imbalances resulting from there. On the contrary, as Merkel ties her consent to the SRM to a deepening of the austerity measures and as Germany tries at the same time to increase its export surplus, the crisis will sharpen, imbalances between countries and the heterogeneity will increase. It is therefore a question of time before the social and economic situation in the crisis countries will become totally unsustainable.

The banking union will not save the Euro

But even if it were established, the banking union would not prevent a break-up of the currency union, because it cannot deliver what a nation state has to provide if it wants its economy to hold together: this is a minimum of a balance between the regions with different levels of competitiveness and different economic structures. If the market does not lead to harmonisation – which is very often the case – the state has to compensate this through transfer mechanisms, which keep the living conditions in weaker regions at a sustainable level.

The German unification is an instructive example of that: the introduction of the Deutschmark in East Germany was accompanied by transfer payments of some 60 billion Euro per year, which went into social security systems and infrastructure in the East. Although more than 20 years after unification these payments continue to flow, the East has still not yet reached the same level of living conditions as the West. An additional mechanism to solve the problem is, of course, domestic migration. Two million people (12 per cent of the population) have moved from East to West since 1990, and another million has its workplace in the West while living still in the East.
Calendar of official events

For background to the official agenda of European institutions, see the following websites:

- The European Commission (EC)
- The Economic and Financial Affairs Council (ECOFIN)
- The European Council
- The Economics and Monetary Affairs Committee (ECON) of the European Parliament
- The Financial Stability Board

The links below give the website with updates and overviews of documents and dates related to the EU decision making process.

2013

November

- 4-5, ECON (Brussels): Meeting
- 7, Finance Watch (Brussels): Conference Five years on - What next for the financial reform agenda?
- 7-8 FSB (Basle): Plenary meeting
- 11, ECOFIN (Brussels): Meeting on Budget planning
- 13, ECON (Brussels): Hearing on European Long Term Investment Funds
- 22, Blockupy (Frankfurt): Strategy Meeting
- 25-26, ECON (Brussels): Meeting

December

- 1, G20: Australian Presidency begins
- 2, ECON (Brussels): Meeting
- 5, ECON (Brussels): Meeting
- 9, Eurogroup (Brussels): Meeting
- 9, EP (Strasbourg): Indicative plenary sitting date, 1st reading/single reading on Recovery and resolution framework for non-bank institutions
- 10, ECOFIN (Brussels): Meeting, probably work on Excessive Deficit Procedure and FTT
- 11, EP (Strasbourg): Indicative plenary sitting date on MiFID-II and MiFIR
- 12-13 NGOs (Brussels): TTIP strategy meeting
- 16-17, ECON (Brussels): Meeting
- 19, European Council (Brussels): Two-day Summit of heads of state
- 22, Eurogroup (Brussels): meeting

2014

January

- 1, Council (Brussels): Greek Presidency begins
- 20-21, ECON (Brussels): Meeting
- 22, LIBE/ECON (Brussels): Vote scheduled on Money laundering and terrorist financing
- 30, ECON (Brussels): Vote scheduled on Indices used as benchmarks in financial instruments and financial contracts
February

• 3, EP (Strasbourg): Indicative plenary sitting date, 1st reading/single reading on European Supervisory Authorities and on a Framework for recovery and resolution for credit institutions and investment firms

• 12, ECON (Brussels): Vote scheduled on Money Market Funds

• 13-14, European Council (Brussels): Meeting

• 22-23, G20 (Sydney): Finance Ministers and Central Bank Governors Meeting

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