



Banks and sovereign debt in Europe

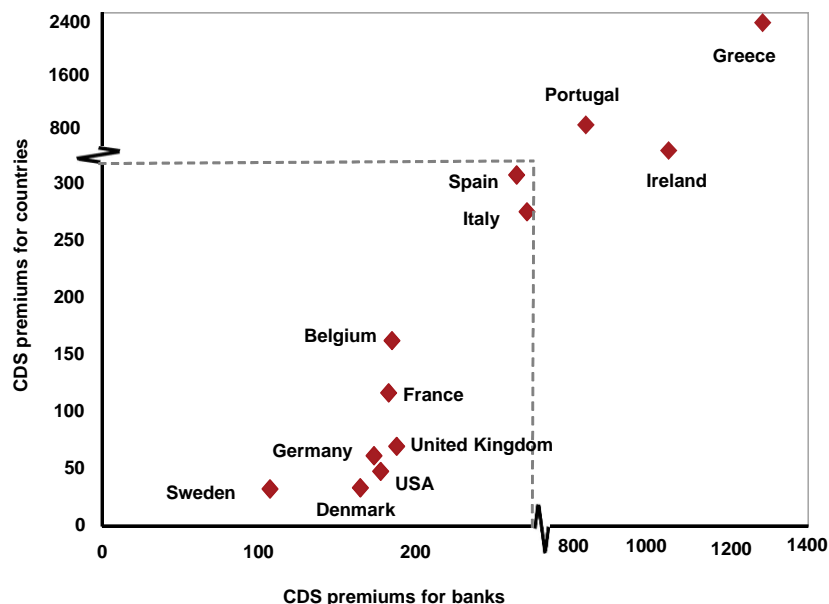
University of Lisbon

Lars Nyberg, 19 January 2012

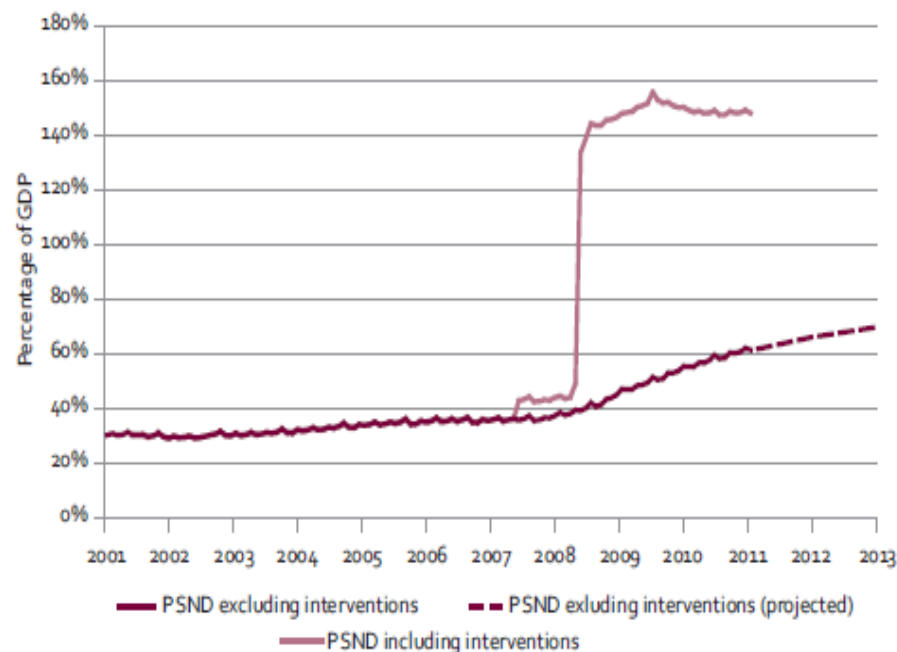
- **Sovereign debt and banking problems in Europe.**
 - Sweden's experiences in the 1990's – anything to learn?
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Sovereign debt and banking problems are tightly intertwined

Correlation between CDS premiums for states and banks

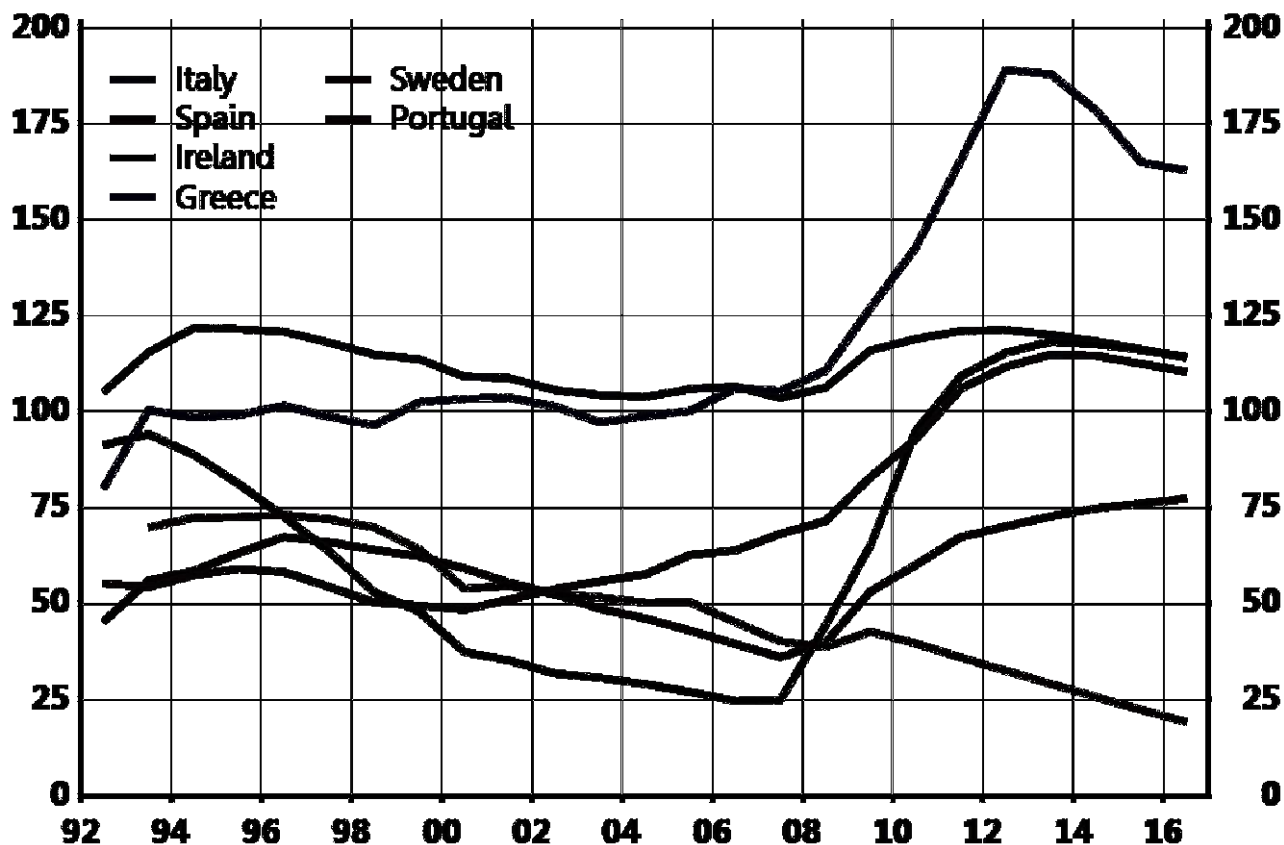


Public Sector Net Debt in the United Kingdom, 2001-2013



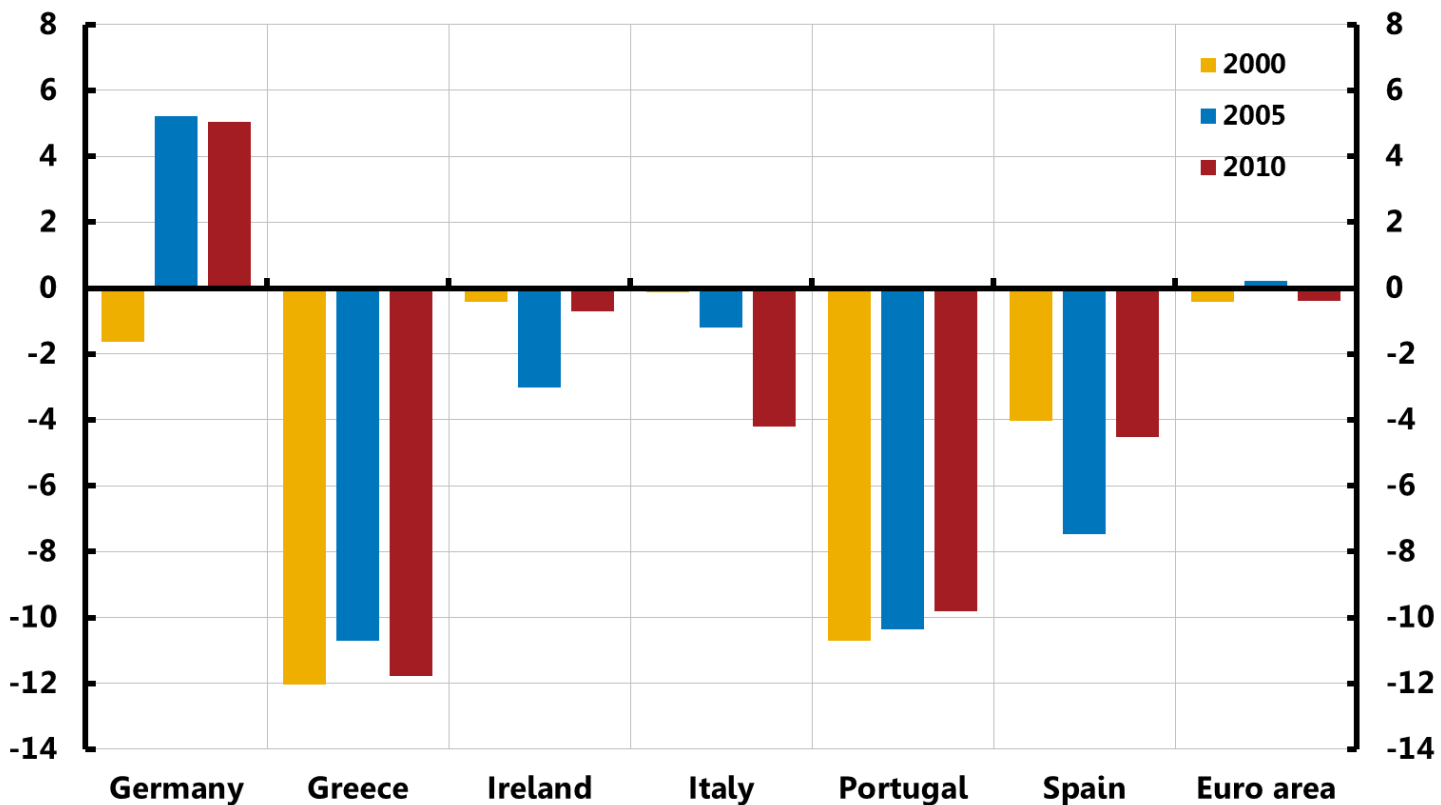
Increasing debt – but for different reasons

General government debt in some European countries, percent of GDP



Where is competitiveness the problem?

Current account balance in some European countries,
percent of GDP

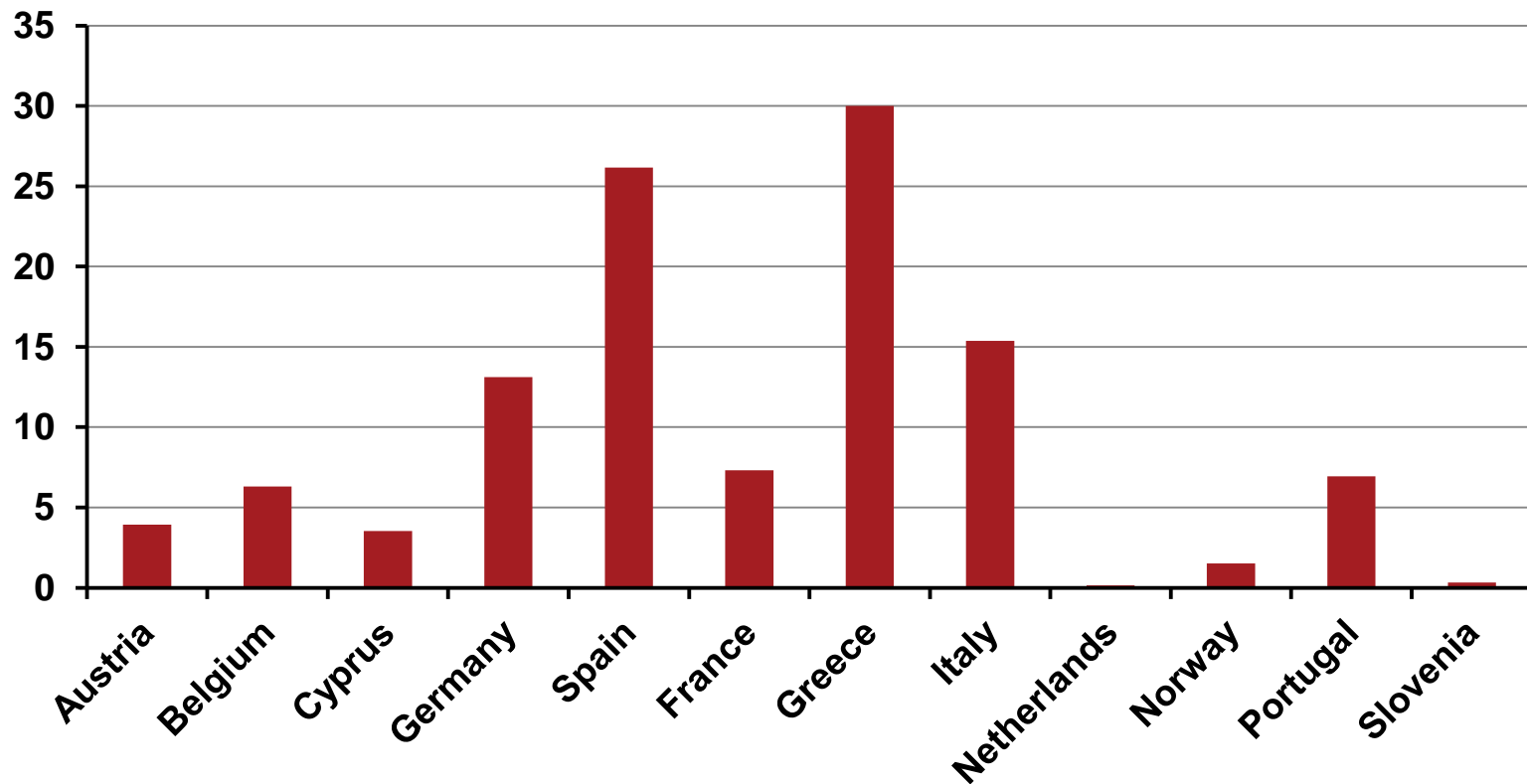


Some observations

- Low interest rates for a long period give trouble. Governments, business and households all borrow too much.
 - Real estate crises are usually disastrous for the banking system.
 - If a nation cannot borrow internationally, it will be even more difficult for its banks.
 - In most countries the financial system has become too large. It must eventually shrink.
 - There is a lack of bank capital – but how big?
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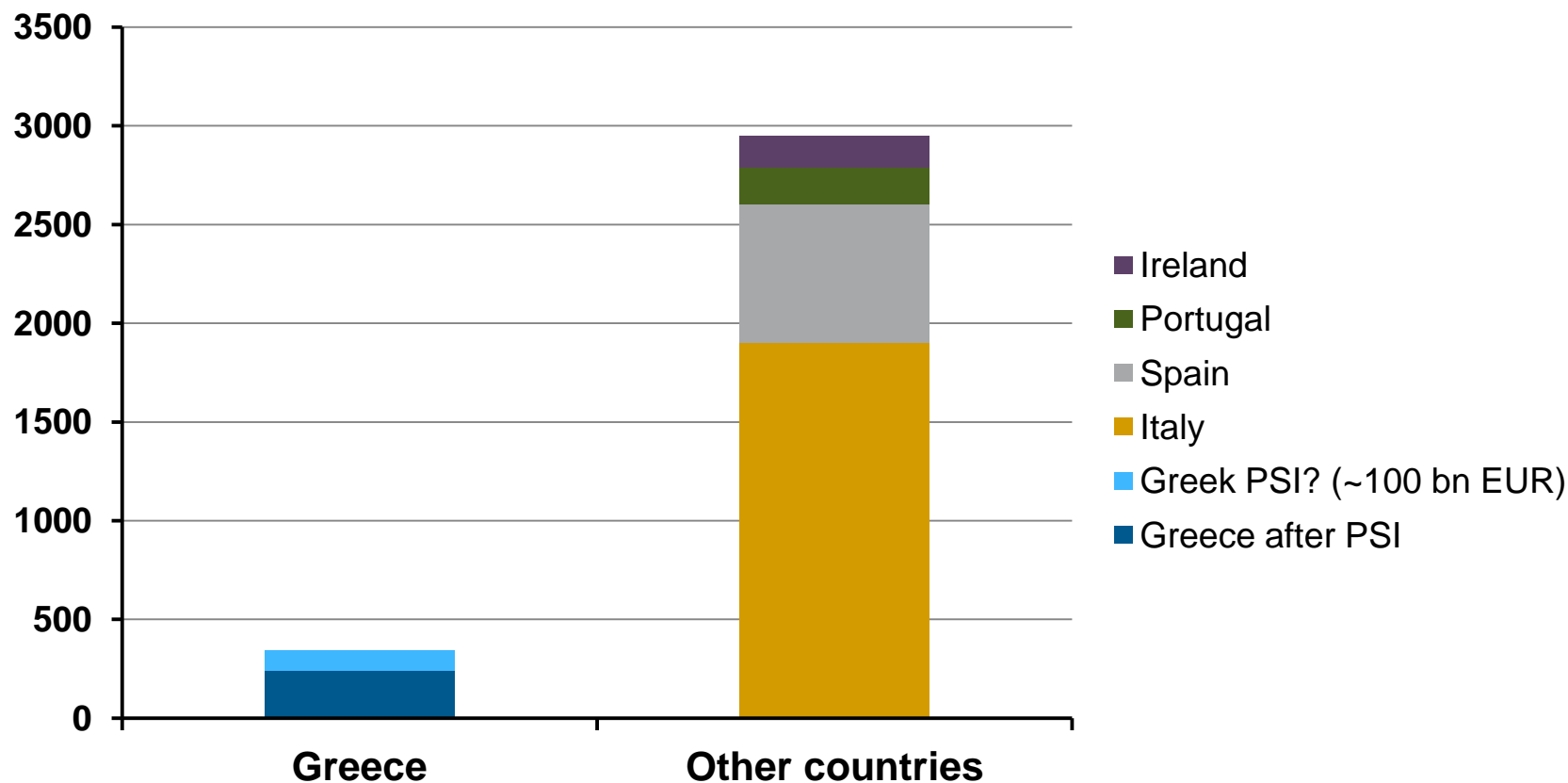
The EBA recapitalisation plan

Overall shortfall after including sovereign capital buffer,
billions of euros



The Greek problem is not big – but it must be solved

Government consolidated gross debt,
billions of euros



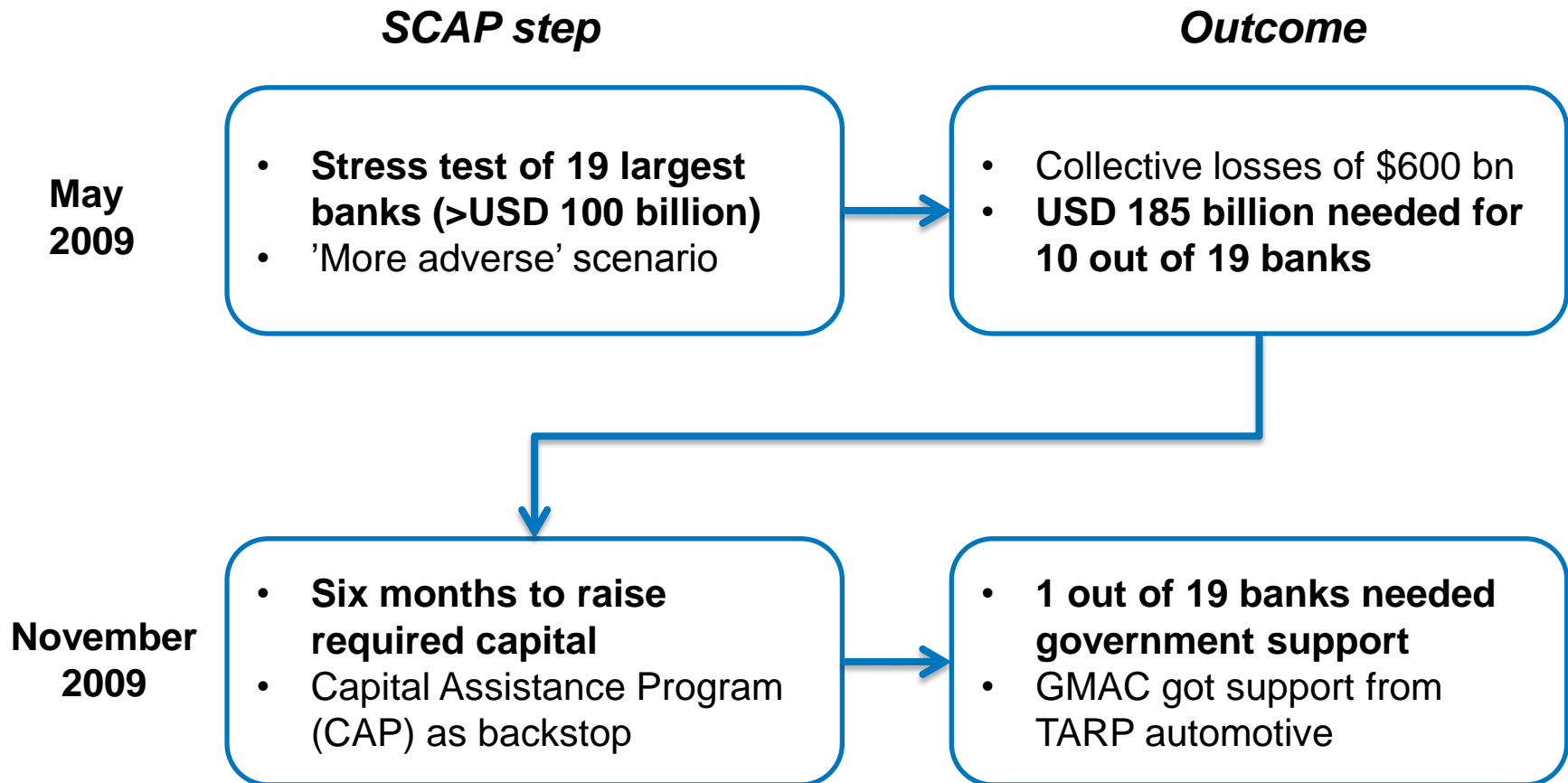
Market confidence seriously hurt by the political process



- Too little delivered too late.
- Statements of little credibility (Greece will be able to pay its debt).
- Private Sector Involvement a mistake (as done)! Just created contagion.



Outline of the US *Supervisory Capital Assessment Program (SCAP)*



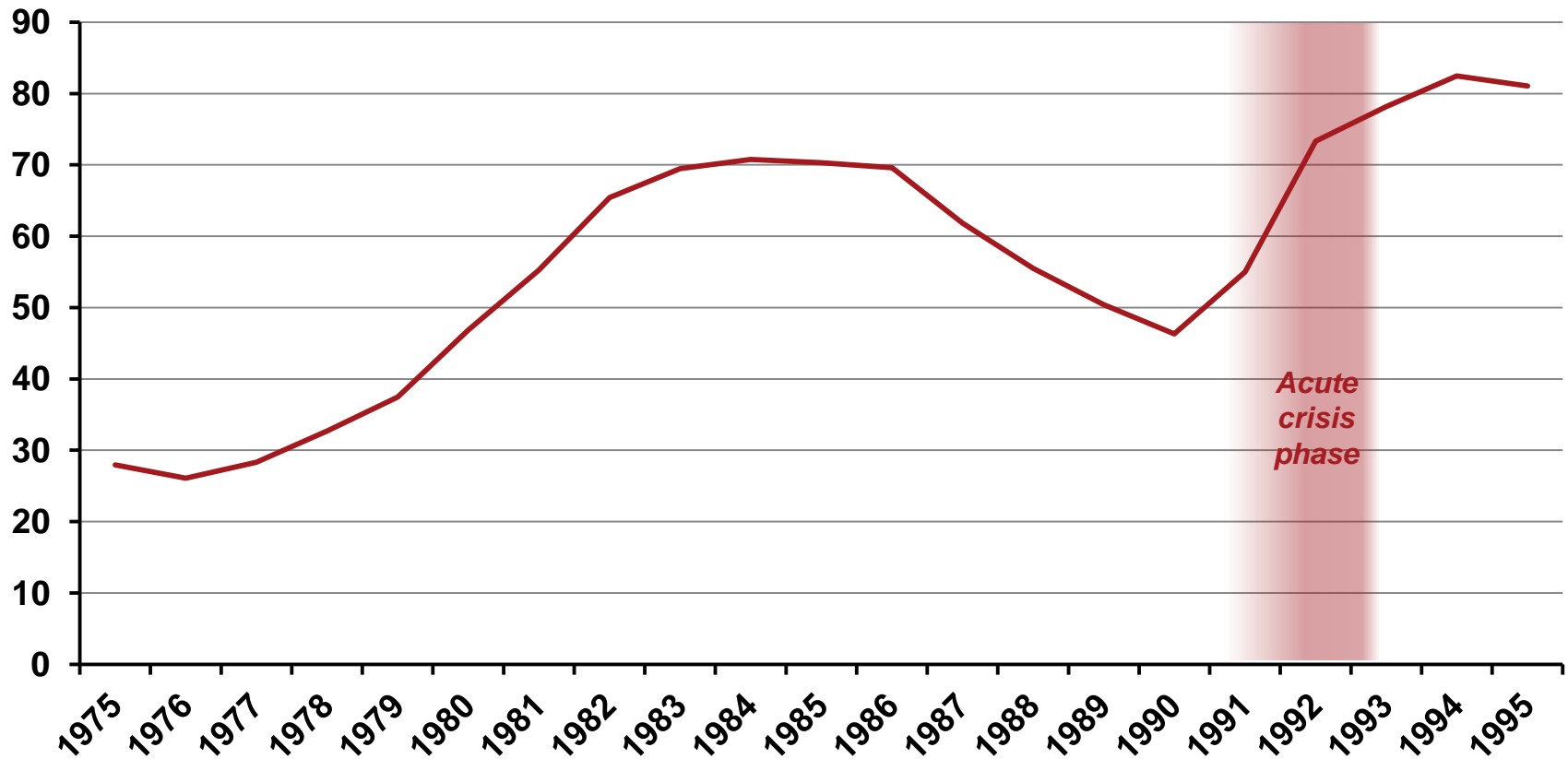
What to do?

- In Europe, we have tried to create a procedure for recapitalisation of banks, but failed so far.
 - Easy to ask for capital – but who will provide it?
 - No political agreement.
 - Credible backstops are missing – at least where most needed!
 - If market credibility is to be restored you have to
 - Show the holes in balance sheets
 - Show how to fill them
 - ECB credit will provide time, but nothing more! Will that time be used?
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- Sovereign debt and banking problems in Europe.
 - **Sweden's experiences in the 1990's – anything to learn?**
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The Swedish crisis 1990-92

Government consolidated gross debt in Sweden,
1975-1995, percent of GDP

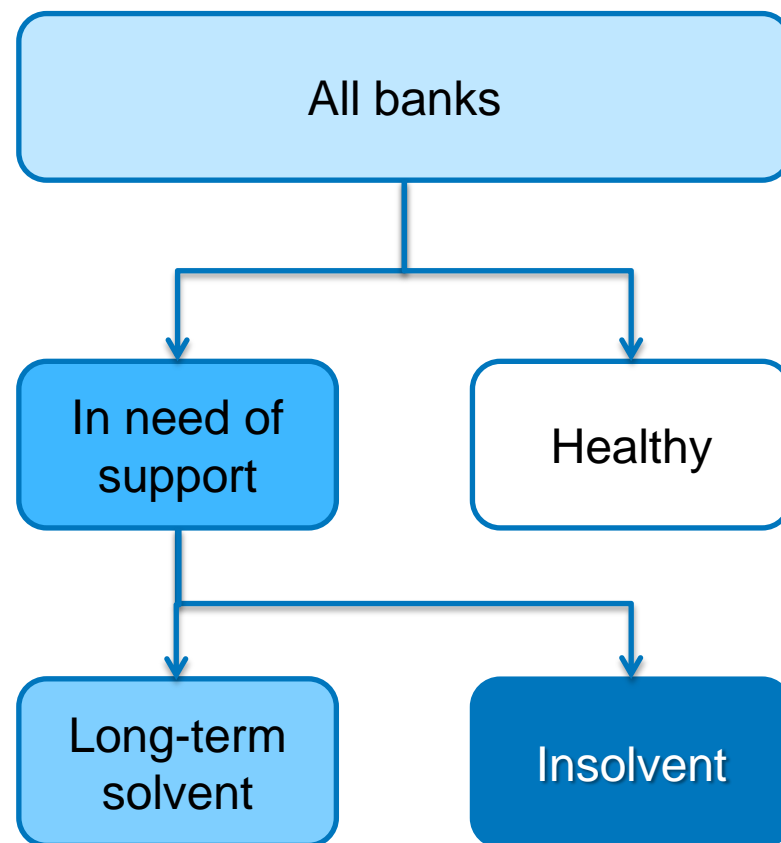


The banking crisis was met with a comprehensive package

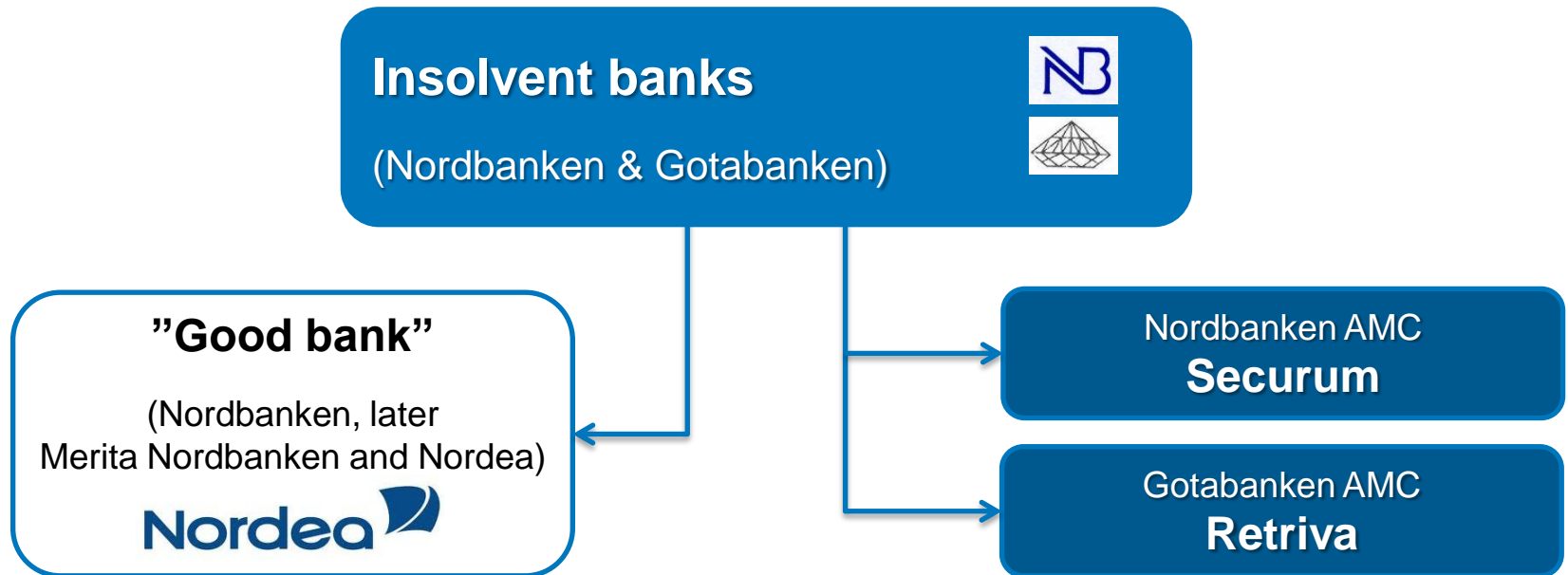
Elements of 1990's bank resolution

- Blanket guarantee
- Unanimous and swift political action
- Institutional setting
 - Bank support authority
- Transparency
- Macroeconomic policy
 - Floating currency
 - Austerity packages

Differentiated resolution policy



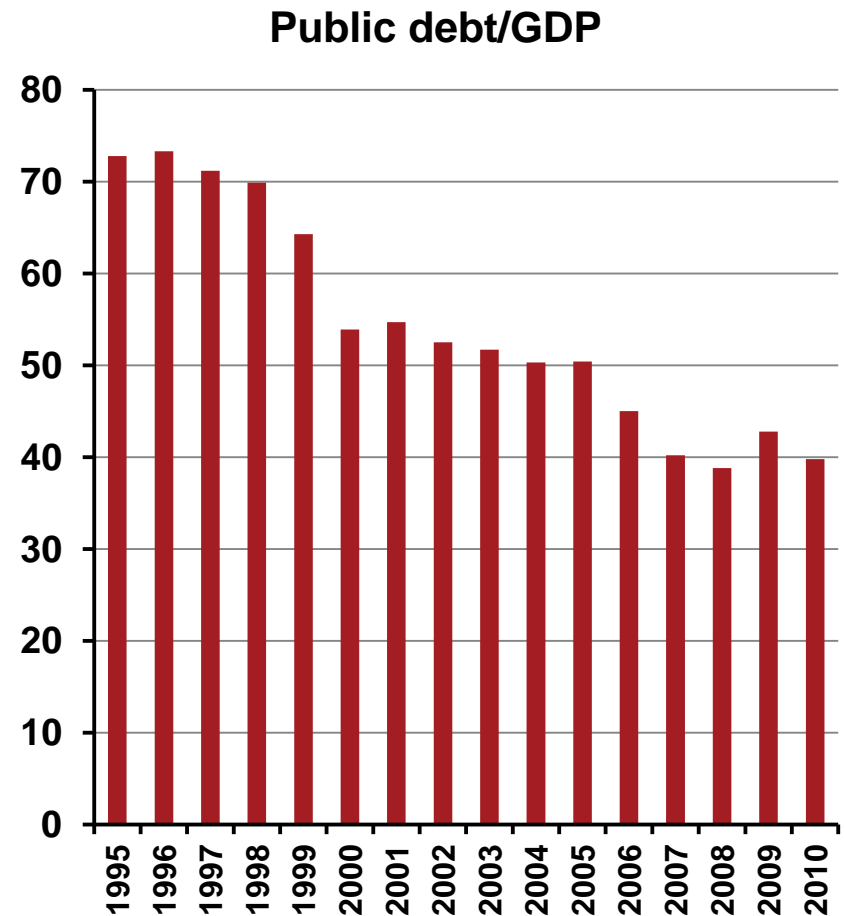
Bank resolution split up insolvent banks and created AMC



- Bad assets to Asset Management Corporation (AMC)
 - Assets assigned conservative valuation to maintain trade
- Eventually, AMC liquidation revenues balanced bank support

A new fiscal policy framework

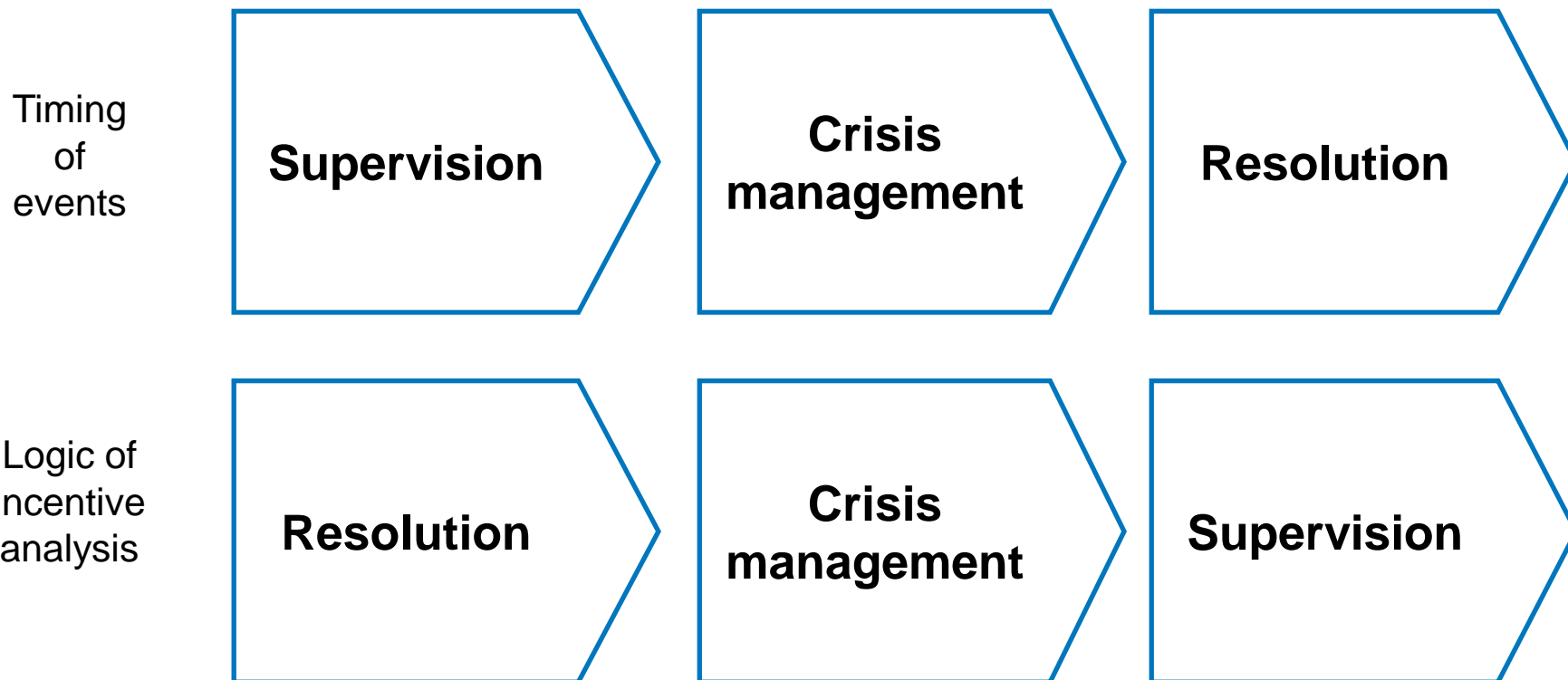
- Introduced in 2000
- An explicit surplus target:
1 percent of GDP on average
over a full business cycle
- A three-year rolling nominal
ceiling for central government
expenditures (including pension
system)
- Balanced municipal budgets
- A strict, top-down budgetary
process



Some conclusions on bank regulation

- Clear rules for the resolution of insolvent banks necessary (and on the way).
 - Bond holder participation important to avoid moral hazard – but not easy.
 - Cross border bank resolution most difficult because it involves issues of burden sharing.
 - My favorite – the idea of backward induction.
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Bank regulation should be based on backward induction



**And remember: Crisis make
necessary changes possible. Things
will be better in the end!**

Thank you
