

**Topic** European Financial Markets and the Policy Response

**Date** July 6, 2010 <15:00pm-17:00pm>

**Participants**

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**Issues for discussion**

- (1) European financial markets and economic trends  
 (2) The responses by policy authorities

- (3) Outlook for Greek aid package

**Summary of comments**

**1. European financial markets and economic trends**

**Inoue <Organizer>:**

- I would like to review several issues regarding market trends and policy responses in light of impressions from my recent visit. First, while general concerns have diminished, participants of money and government bond markets are focusing on the risks of financial institutions thought to have substantial exposure to specific countries. Not only has the ECB's role as "market maker of last resort" become more important, but its efforts have created a situation in which stresses are no longer reflected in market indicators. One interpretation of the weak response to the ECB's dollar-fund auctions is that leading financial institutions' efforts to trim dollar assets has reduced the need for dollar fundraising itself.
- Second, there were conflicting views on the ECB's purchases of government debt. Discussion focused on the transparency of the policy decision when the program was introduced and on the seemingly different stances among the central banks in the region. There have also been calls for (1) a framework specifying which issues are to be purchased and what the objective is and (2) improved transparency regarding the purchases. There are concerns about the longer-term implications in the event the ECB eventually incurs a loss on its government debt portfolio.
- A third issue is the stress tests of European financial institutions. In late June, it had only been announced that the results for individual banks would be disclosed. Although the improved disclosure was welcomed, market players noted the problems, including (1) the program's coverage of

medium-sized financial institutions, which were the source of problems in the current crisis, and (2) stress triggered by sovereign risk. The ultimate problem is how financial institutions deemed to be undercapitalized will go about bolstering their capital bases. A few countries have prepared frameworks for capital injection, and such plans would likely face strong political opposition. Some pointed out that, in addition to the risk of a concentration of fundraising needs, there was also a risk that the tests would be implemented in such a way as to minimize the need for capital enhancement.

- Fourth, there may be the side effects caused when global investors unhappy with the sovereign risks move their funds to places like Germany and Switzerland. The financial environment in Germany is quite accommodative as a result of the low interest rate policy and the euro's weakness, and corporate earnings are strong. In Switzerland, the Swiss National Bank has raised its inflation forecast even as the Swiss franc has made large gains. Although asset-price inflation may not be an urgent problem, an extended period of monetary accommodation could be an issue of macro-prudential policy.

**Mr. Uchida :**

- The spread between 10-year Greek and German government debt now exceeds 1,000 basis points, and for a time the Greek yield curve inverted, with two-year bonds yielding more than 10-year bonds. When viewed in light of past instances of heavily indebted countries, these phenomena suggest the market is pricing in the risk of a debt restructuring. Market sentiment on Spain is much more relaxed in spite of the

sovereign downgrade, partly because of the announcement by the European Commission of the creation of a European Financial Stability Facility (EFSF), the ECB's policy response, and the fact that recent Spanish debt auctions went smoothly. In addition, CDS spreads on European financial institutions have not widened substantially, even though Spain's cajas (savings banks) have attracted a great deal of attention and, in general, bad debts are increasing as the economy weakens. General speaking, although there is no panic in Europe today, a crisis continues to develop beneath the surface.

- A key development at major European financial institutions involves efforts to deleverage further and to increase the "safe assets" such as government debt in anticipation of tougher liquidity ratio requirements or the adoption of new restrictions on leverage. A reduction in leverage is necessary inasmuch as such institutions traditionally employed a large amount of borrowed money, but we need to closely monitor the impact of such efforts on the real economy.
- The fact that the pound has fallen further than the euro may have come as a surprise. It is largely attributable to investors who are as worried about British fiscal deficits as about deficits in the PIIGS. Some also see the BOE's supply of funds under quantitative easing as a reason to sell the pound.

**Mr. Fukuda :**

- There was substantial demand when leading central banks resumed their dollar-funds operations in May, but demand subsequently dried up. Nor have LIBOR-OIS spreads risen to worrisome levels, although they have increased somewhat in recent weeks. All in all, I think the type and magnitude of market stresses differ greatly from conditions in 2008.

**Ms. Nemoto :**

- Given the size and complexity of cross-border credits, I think one of the reasons for concerns about risks at European financial institutions is uncertainty about the channels through which the stresses would be transmitted. It was fiscal deficits that refocused attention on problems in central and eastern Europe. In addition to Austrian banks, institutions in Spain, Belgium and Greece have also lent a great deal of money to borrowers in these countries. Moreover, the loans carry exchange rate risk.

**Mr. Uchida :**

- Of the central and eastern European nations, Romania and Hungary are now carrying out IMF-approved economic programs, and the three Baltic nations have implemented tough austerity policies. In central and eastern Europe, people are willing to accept the pain implied by austerity policies because memories of the communist era are still fresh in their minds and they want to remain part of the Eurozone. The three Baltic nations have faced four debt crises since gaining independence from the former Soviet Union in 1991 and in

each case have implemented tough deflationary policies. As a result, their economies have grown more competitive on global markets, and the value of their housing stock and income levels have increased by nearly 300%. The question is whether southern Europeans would be willing to shoulder the same kinds of sacrifices.

**Mr. Fukuda :**

- I do not think the economic environment for Europe will be exceptionally tough. Although fiscal policy is likely to see substantial tightening going forward, the fall of the euro should provide a substantial accommodative effect.

**Ms. Nemoto :**

- Some 60% of all trade by EMU countries is with other EMU members, so I think any benefits from the weaker euro may be limited. We also need to keep a close eye on foreign currency-denominated lending. Some 30% of the personal loans extended by Austrian banks, for example, are said to be denominated in Swiss francs. I worry that a drop in the euro will not only increase leverage but also cause bad loans to increase as the burden on debtors grows.

**Mr. Uchida :**

- The biggest problem for the EMU in terms of the real economy lies in the large competitive disparities between EMU members. When the euro plunges as it has recently, there are countries—like Germany—that are able to take advantage of the situation and benefit from a strong boost to corporate earnings, and countries that are not. Germans probably see this ability as flowing from past structural reform efforts, and that may be one reason why Germans are less than enthusiastic about providing support to Greece and other problem nations. Maintaining a system like the EMU will require efforts to maintain a competitive balance.

## 2. The responses by policy authorities

### (1) Responses by the ECB

**Mr. Uchida :**

- When it became clear that the ECB would not roll over the 1-year LTRO maturing on 1 July, the markets grew increasingly concerned about the ability of financial institutions that had procured funds in these operations to refinance. € 442bn of LTROs matured on 1 July. Of this amount, the ECB supplied €240bn in the form of 1-week MROs and 3-month LTROs and absorbed the remaining €200bn with excess reserves. The ECB has since continued to supply funds—mainly in the form of 3-month LTROs—and as yet there has been no major turbulence in the market. That said, the very existence of these concerns points to the existence of financial institutions that are heavily dependent on the ECB for their fundraising needs.
- That the recent problems in Europe did not lead to the kind of

panic seen in autumn 2008 can be attributed to two factors. One is the EU's introduction of a large-scale safety net in the form of the EFSF. The other is the ECB's quick intervention in the markets. The plentiful supply of liquidity by the ECB is significant in that it provides the same kind of support for financial institution funding that the BOJ's program of quantitative easing once did.

**Ms. Nemoto :**

- The central bank is responsible for fully 15% of funds being provided to the Greek banking sector, and this high degree of dependence is expected to continue. Greek banks tend to be rather small. If Spanish banks were to fall into the same kind of situation, the impact would be greater inasmuch as much larger banks would come to depend on the central bank.

**Mr. Fukuda :**

- While there may be some financial institutions that can obtain funds only from the ECB, I suspect there are also institutions that have borrowed from the central bank because the terms are more attractive than those in the market. This may not be particularly problematic if it is temporary, but if it persists for an extended period of time—as it did during Japan's quantitative easing era—it leads to the issue of moral hazard.

**Mr. Uchida :**

- Although the situation described by Mr. Fukuda does in fact exist, trends in EONIA suggest that creditworthy European financial institutions are able to borrow more cheaply—at least in terms of interest rates—on the market.

**Mr. Yanagawa :**

- Panics can be addressed in the short term with a variety of measures, but if expanding existing measures is the only way to deal with rising concerns, we need to ask whether those measures are appropriate. Inasmuch as the recent problems emerged under the severe environment of slowing growth and widening fiscal deficits, I think a solution to economic and fiscal problems is more likely to be found when financial institutions face crisis-like conditions. That said, it is not realistic for the ECB to leave 20% of its powder dry during the crisis in order to elicit a strong policy response from individual governments. At the same time, my impression is that crisis measures have centered on the ECB, and I wonder whether this strategy is sustainable in the longer term.
- My greatest concern regards the ECB's purchases of government debt. In Europe, I can envision a scenario leading to a solution to banking system problems if we take into account post-stress test measures. However, ECB purchases of government debt are ultimately exposing the central bank to sovereign risk, which is a major problem in my view. The question here is how individual countries should divide the costs entailed by such interventions. While it may be possible to allocate such costs in places like Japan or the US, where

we are dealing with the fiscal and financial sectors of one nation, the issue becomes an extremely complex one in a place like Europe.

**Mr. Uchida :**

- The fiscal positions of Eurozone nations mean that European government debt carries sovereign risk, including credit risk. Accordingly, problems in government debt markets should be addressed with fiscal expenditures by individual governments. Increased ECB purchases of government debt will almost certainly undermine confidence in the euro and the ECB in the longer term. I am also skeptical about the plan to have central banks carry covered bonds on their books until maturity, even if the amounts involved are not so large.

**Mr. Watanabe :**

- Inasmuch as EMU nations share both a common currency and a policy rate, problems in a member country should be dealt with by the EMU as a whole; relative exchange rates and interest rates are of no help. Moreover, the lack of fiscal discipline means that the entire problem will ultimately come to rest on the ECB's shoulders.

**Inoue (Organizer) :**

- Some argued that if the ECB was the only European institution taking a “cosmopolitan” view of the EMU, then it could hardly be helped if the ECB was solely responsible for maintaining the EMU. Others, however, pointed out that once the initial panic had subsided and the risks became clearer, the focus should be shifted from an unlimited supply of funds by the ECB to more carefully targeted measures by national governments. In addition, some markets are beginning to price in a fundamental response to the problem, such as a restructuring of Greek government debt, but my impression was that there was less extreme.

**(2) Responses by policy authorities**

**Mr. Uchida :**

- Fiscal authorities' attempt to implement austerity measures to enable the financial sector to muddle along leaves longer-term problems intact. Europe's fundamental problem is that economic weakness and sovereign risk have impaired the balance sheets of financial institutions. This is an issue that can be solved only by stronger bank earnings, which in turn will require an economic recovery. European governments, however, are trying to implement fiscal consolidation policies that represent a step backwards in terms of solving the problems at financial institutions. If bad loans could actually be addressed in the short term even under a deflationary environment, it would definitely be a plus for the economy. But there would be few policy responses left if this “experiment” failed, bad loans increased further, and financial institutions began having difficulties refinancing their loans. From this perspective, the outlook appears quite

uncertain even though the markets appear to have calmed down for now, and there is the risk that something could trigger an abrupt resurgence of market concerns.

- While global fiscal consolidation is important in easing market concerns, we need to take a balanced approach in the event these measures start to weigh on the economy. For example, the austerity measures announced by UK Prime Minister David Cameron seek to reduce that country's fiscal deficit from 11% of GDP at present to less than 2% of GDP over a five-year period while keeping GDP growth at around 3%. Given the likely impact of fiscal consolidation, these goals are inconsistent barring a substantial increase in external demand. One means of boosting external demand is to pursue a weaker currency, and if the rest of the developed nations were to pursue a similar policy, Japan would bear the full brunt of the impact, which is clearly not a desirable outcome. The yen's nominal effective exchange rate has already risen by nearly 40% since the start of 2008.

**Inoue (Moderator) :**

- The markets have expectations for an integrated EMU fiscal policy, and some have argued that the EFSF could become a model for one-stop financing by the EU in the future.

**Mr. Uchida :**

- For some time France has argued in favor of a common EU fiscal policy, and the EU summit on 23 June should be understood in this context.

**(3) Stress tests and the response by supervisory authorities**

**Mr. Fukuda :**

- The stress tests are a key focus for European financial institutions. Although the tests are expected to reveal a shortage of capital at many institutions, the basic approach to dealing with banks deemed capable of recovery should be an injection of public funds by national governments. In Japan, the measures approved by the "Sazanami Committee" did not effect a solution to the problem in the end. That experience suggests the need for tough asset inspections and a full-scale injection of public funds. However, Japan's experience since the Jusen crisis suggests just how hard it is to win legislative approval for injection of public funds into the banking system.

**Ms. Nemoto :**

- The US stress tests were conducted against the backdrop of the availability of TARP funds. In Europe, on the other hand, the tests were conducted without making it clear whether an injection of public funds would be available. I think this approach has the risk of amplifying market concerns. Also, I think improving disclosure by financial institutions will help to ease market concerns. In Greece, for example, bad loans are defined as loans delinquent for at least 180 days, as opposed

to the international standard of 90 days. It should come as no surprise that markets were skeptical when Greece tried to assure them that bad loans were not increasing. I think that, as in Japan, a substantial period of time will be needed to enhance transparency at European financial institutions.

**Mr. Uchida :**

- The US stress tests served to arrest market concerns and effectively marked a bottom in unease about the financial system. In light of this experience, I suspect participants at the EU summit expected a similar impact from the European stress tests. Spain has already announced a rescue package, the Fund for Orderly Bank Restructuring (FROB), for the cajas, and if an agreement can be reached on a regional reorganization by the end of June, they will be eligible for capital injections totaling €99bn. If we assume that the share of impaired loans at the cajas is equal to that of Ireland, they could be covered by existing equity capital and FROB funds. It was the backing of this kind of framework that allowed Spain to propose that small and medium-sized financial institutions like the cajas be included in the stress tests. Naturally, housing prices may have fallen further in Spain than in Ireland, and potential losses on securitized products held by UK and German financial institutions cannot be overlooked. The IMF's Global Financial Stability Report has also pointed out the delays in write-offs of bad loans by European financial institutions, and we cannot dismiss the possibility that the announcement of stress test results will lead to increased risk for financial institutions, at least in the short term.

**Inoue (Organizer) :**

- As for the injection of public funds based on the stress test results, some argue that, in addition to Spain's FROB, the credit guarantees provided by some national governments in response to the financial crisis could be utilized. In general, however, an uncertainty surrounds this issue. Many worry the results of the tests will be massaged so as to enable national governments to respond, much as was feared in the US.

**Ms. Nemoto :**

- Implementation of the Basel III capital requirements would have a significant impact on bank capital—financial institutions with a core Tier 1 capital ratio of 10%, for example, could see that ratio drop to around 6%. There is growing support for the argument that Basel III itself is too demanding, as it would accelerate the deleveraging process. Liquidity ratio restrictions pose another major problem for these institutions. Spanish banks, for example, have a loan-to-deposit ratio of some 150%, making them extremely dependent on wholesale funding. This structural problem is manifesting itself in the above-noted dependence on ECB funds, and a wide disparity exists between the current reality and the ideal world envisioned by the new regulations.

- Large banks—and not just those in Europe—are reporting an increased dependence on trading activities for their earnings. It is probably difficult for them to generate significant risk-adjusted profits through lending alone under current conditions. By continuing to implement accommodative monetary policies, central banks are providing incentives for financial institutions to behave in this way. Meanwhile, the current moves to rework financial regulation seek to restrict trading operations. Here again we have an inconsistency.

**Mr. Uchida :**

- As tougher financial regulation has squeezed profits on financial operations in the US and Europe, banks have sought to pass on the costs to customers in the form of wider spreads. This is possible because the US and the European financial institutions have the ability to set prices. In Japan, the financial sector is structured in such a way that banks cannot pass on the costs of regulation to their customers.

**Ms. Nemoto :**

- Tougher regulation is estimated to have reduced profits by 30% to 40%, and the majority of this amount will eventually be passed on to customers. In Japan, on the other hand, passing on higher costs is difficult because of the excess supply characterizing the banking sector. Although the number of financial institutions has decreased, lending activity remains weak while deposits are rising, and banks continue to compete on the basis of price (ie low lending rates).

### 3. Outlook for Greek aid package

**Mr. Uchida:**

- Greek government debt issuance is currently being absorbed by EU and IMF funds totaling €110bn. Greek government debt held by private-sector financial institutions was effectively redeemed by the EU and the IMF, and the risk was also transferred to those two institutions. Similarly, by purchasing government debt the ECB has assumed risk that was previously borne by private-sector financial institutions. When the EFSF and other assistance programs wind down two years from now and Greece once again tries to issue debt on the market, investors are likely to demand a substantial premium, and in fact the debt may find no takers. The debt restructuring priced in by the market would come about as a result of a request by the Greek government in the event of an inability to refinance its debt. In that case, the EU, IMF, ECB and other public authorities would likely suffer significant losses. A 30% haircut seen in past debt restructurings in heavily indebted countries is therefore extremely unlikely. Instead, I suspect that existing support measures would be extended repeatedly, with the authorities attempting to provide a lifeline for Greece while allowing it to discontinue interest payments. Historically, the typical response in this type of situation would consist of a capital infusion by the IMF coupled

with a de facto debt waiver by private banks. In this case, however, the ECB's decision to purchase government debt has complicated the debate over the assumption of risk.

- In a typical sovereign debt crisis, the local currency plunges and interest rates soar, causing the country's effective debt burden to rise sharply. This, coupled with the collapse of the local financial system, severely depresses local residents' the standard of living. As long as Greece remains in the EMU, however, the debt crisis is unlikely to have a significant and visible impact on the daily lives. That makes it difficult for the Greeks to share a sense of crisis or understand the need for austerity measures.

**Mr. Fukuda :**

- For Greece, however, the costs of being ejected from the EMU would be extremely large. Consequently, I think the EU could use the threat of rejection from the EMU as a bargaining chip in persuading Greece to cooperate.

**Mr. Yanagawa :**

- I wonder whether the ECB will continue to place first priority on preserving the EMU in the event Greece's economic programs start to fail and the Greek government starts to argue that further austerity measures are impossible. Could this really serve as a bargaining chip given that Greece's exit from the EMU would have significant costs for the remaining nations as well as sharply higher interest rates and a plunging currency for Greece? News reports also suggest that Greece is not nearly as committed to dealing with the situation as were, for example, Korea or Argentina. It will be difficult to persuade Greece to take the necessary measures unless the crisis hits home to a certain extent.

**Mr. Watanabe :**

- Many observers are pessimistic about the outlook for Greece's economic programs. They note that the VAT is already quite high, leaving little room for further increases, and there is a major problem in terms of tax collection.

**Inoue (Organizer):**

- The standard prescription for heavily indebted nations—an injection of IMF funds coupled with the implementation of economic programs—should have been possible to administer in Greece. However, the EU and the ECB decided that problems relating to the survival of the EMU should be dealt with autonomously. I think this is understandable.

### 4. Adjournment

**Inoue (Organizer):**

- Finding a solution to the problems discussed today—including restoring fiscal discipline and reinforcing the European financial institutions—may require a great deal of time. I would like to return to this topic in the future as conditions warrant.

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