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A Canadian Perspective on Europe's Post-crisis Financial Governance Regime

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Five years ago, Europe was in the midst of a full-blown sovereign debt crisis, when the new government in Greece announced that the fiscal deficit for 2009 would be around 15 percent of GDP rather than 6 percent, as the previous government had originally forecast. This news sent sovereign bond investors into a panic, which caused yields demanded on Greek public debt to rise to the point of becoming unsustainable. This situation eventually required euro area member states and the International Monetary Fund (IMF) to come to Greece's rescue with financial bailouts. Ireland, Portugal, Spain, and Cyprus would soon follow Greece down the path of sovereign debt crisis and bailout.

In good part, these sovereign debt crises in the euro area were the result of the global financial crisis that began in the United States in the spring of 2007 and crossed the Pond soon thereafter. The failure or near-failure of a large number of banks across the

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European Union (EU) forced governments not only to come to creditors' rescue through bank bailouts, but to also undertake fiscal stimuli to soften the negative impact that the recession was causing on their economies. In times of economic uncertainty, such pressures on the public purse led investors to demand much higher interest rates (i.e., yields) in exchange for holding European governments' bonds (Germany being the exception, since its bonds were considered a safe haven), given that the risk of default had increased in line with debt levels.

This stress in the market for Eurozone sovereign bonds fed back into banks' balance sheets and further threatened their stability. This is because banks usually hold large amounts of government bonds in their books as investment. This feedback mechanism came to be known as the "doom-loop" because sovereign debt problems create more instability for the banks, which in turn adds to the potential debt burden of governments if they have to come to the banks' rescue (again, in many cases), and so on and so forth. For the euro area, it became crucial to break this so-called doom-loop in order to put an end to Europe's economic crisis.

Three things were done in order to break the doom-loop. First, a number of governments were bailed out with public funds from the IMF and the other euro area member states through the European Financial Stability Facility and, later on, the European Stability Mechanism. Second, the European Central Bank (ECB) injected massive amounts of liquidity into the Eurozone banking system, ultimately helping the banks sell a large portion of their holdings of bankrupt government debt to the ECB. Finally, the euro area decided to establish a European Banking Union (EBU), which has made the ECB the sole supervisor of the euro area's largest banks under the Single Supervisory Mechanism (SSM). The EBU has also led to the creation of a Single Resolution Mechanism (SRM), which sets the rules for the winding down of a failed bank supervised by the SSM, including how much the bank's creditors will be paid back, if at all.

With the EBU, the Eurozone has moved much closer to the integrated financial supervisory framework used in Canada. Hopefully, it will be as effective as the Canadian system, which successfully avoided the financial crises that hit Europe and the United States in 2007-2009.

Five years ago, I criticized the Eurozone for having a weak, fragmented financial governance regime (Leblond 2011). Given the increasingly integrated (i.e., cross-border) nature of banking inside the Eurozone, it made little sense to have a system of banking supervision that resided nationally with the member states. National supervision of banks made even less sense because the lender-of-last-resort burden lies ultimately at the supranational level with the ECB, as the sovereign debt crisis has clearly demonstrated (Leblond 2014, 291-92).

If the ECB bears the ultimate responsibility for ensuring the stability of the Eurozone's banking system by providing liquidity and financing to the banks, then it should also have the means to ensure that the banks it is ultimately on the hook for behave adequately and do not represent an undue risk for the ECB and the Eurozone's financial stability. If not in the ECB's hands, banking supervision should at the very least be handled by a strong and independent supranational agency that collaborates closely with the ECB to monitor individual financial institutions as well as the system as a whole.

This is the type of governance system that exists in Canada. The Office of the Superintendent of Financial Institutions of Canada (OSFI) is responsible for supervising individual financial institutions and keeping them on a tight leash, while the Bank of Canada is in charge of supervising the Canadian financial system's stability. As for the resolution of insolvent banks in Canada, it rests with the Canadian Deposit Insurance Corporation (CDIC). These organizations, along with the federal Department of Finance, meet at least once a month to share information, assess risks in the Canadian financial system, and bring corrective actions, if necessary.

I argued (Leblond 2011) that this governance regime explains why there was no banking crisis in Canada in 2007-2009, even while banks were failing in Europe and the United States, Canada's two largest trade and investment partners. For this reason, I suggested that the EU, but more importantly the euro area, adopt a financial governance regime that followed the Canadian model. However, I concluded that the reforms that were envisaged by the EU at the time came far short of the Canadian model: "If a crisis is a terrible thing to waste [...], then EU member states are missing an opportunity to make their financial system not only more stable but also more competitive" (Leblond 2011, 176).

Somewhat ironically perhaps, the financial crisis actually got worse for the euro area, as it developed into a full-blown sovereign debt crisis that came to threaten the Eurozone's integrity itself (Chang and Leblond 2015). Only then did the member states take the required measures and put in place a supranational financial governance regime *à la Canadienne* with the creation of the EBU. So, in the end, the euro area managed not to waste its crisis, even if it unfortunately had to suffer a lot more in order to do so.

References

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