Sunday Wrap

Happy Sunday from Berlin, the city that "rocks", according to Elon Musk (which is difficult to disagree with).

So, November 14 came and went without president Trump imposing the threatened (up to) 25% tariffs on US import of European cars and auto parts; a threat based – bizarrely – on national security legislation. In the end, the decision to hold off for was not hugely surprising. Trump's domestic political problems are mounting at a (for him) worrying pace, while his much-touted trade policy strategy has run into problems, as illustrated by the impasse on the "Phase 1" deal with China. And, without a doubt, the EU had made it clear behind the scene that US tariffs would be met with proportionate counter-measures, targeting (I suspect) production in the swing states. Even Trump must be aware of the limitations for how many fronts he can fight at the same time.

With the threat of auto tariffs on the backburner for the time being, I'll turn to two more exciting topics, namely:

- **Banking union and the confusion about banks' sovereign exposure.**
- **Elon Musk' announcement on Tuesday that he has picked Berlin as the location for Tesla's European production and design center, and what that tells you about cars, Germany and other things…**

1. Banking union and the confusion about banks' sovereign exposure.

Last Sunday, I discussed German Finance Minister Scholz' call for an acceleration of decisions on the banking union and his proposal to deepen it. As I argued, it's a very welcome initiative, with many positive aspects, which deserves serious consideration.

I won't repeat what I wrote a week ago, but rather dig a bit deeper on one specific aspect on which I received a particularly large number of comments, namely the issue of banks' sovereign (home country) exposure and the need for risk reduction in this area.

To remind you, in addition to several other constructive parts, Scholz appeared to make two important concessions towards the "Southern European stance" (not the right term, but you know what I mean) in the area of the long-standing debate of "risk reduction" vs. "risk sharing": Rather than insisting on "risk reduction" as a pre-condition for any "risk sharing", Scholz implied that these two aspects can be pursued simultaneously, and he put numbers on how much "risk reduction" he believes is ultimately needed.

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The two areas identified for "risk reduction" of banks' balance sheets relate to the level of non-performing exposure (NPE) and the holding of home-country sovereign debt. (As I have discussed before, the issue of risk really is a good deal more complex than that, but I won't go back to that discussion again today.)

On NPEs, Scholz signed onto the European Banking Authority's (EBA) guidelines that banks bring their gross NPE level down below 5% and the net level below 2.5%. To me, this is very reasonable.

And on the issue of sequencing, Scholz noted at a Bloomberg event here in Berlin this past Thursday that a lot of progress has already been made on cutting NPEs. To remind you, on EBA data, among eurozone countries only Greece (20.8%), Cyprus (11.6%), Portugal (4.4%), Italy (3.7%) and Ireland (3.3%) now exceed the 2.5% ceiling for net-NPEs. Apart from Ireland, which has a relatively low gross-NPE (below 5%), the same countries, as well as Slovenia, also exceed the 5% gross-NPE ceiling.

Of course, the 5.0% and 2.5% targets for gross and net NPEs are for individual banks, not national averages, and as Scholz pointed out at the Bloomberg event, a lot has been achieved in this respect by "some large Italian banks". Scholz was probably too polite to name names, but I'm not: As of the end of September, on a group level UniCredit's net-NPE level had dropped to just 2.3% (5.7% gross), while core-NPEs stood at 1.5% net and 3.6% gross. (As I am sure you are aware, management is committed to eliminate all non-core NPEs by 2021, and if you don't know the guy in charge of that, rest assured - it'll happen!)

The issue of defining – and limiting - banks' exposure to their home country (and correlated assets) is more complex than the definition of NPEs - but it's still worth pursuing, of course. However, in my assessment, Scholz' approach here is a tad too rudimentary – as is most of the public and academic debate for that matter.

Before I explain my point, let me be very clear: I am a supporter of putting tougher limits on banks' sovereign (home country) exposure, properly defined, as I'll discuss below. But I am very worried about the implications of identifying, and changing, such limits based on changing risk assessments of the sovereigns.

I'll first remind you of the present state of affairs before I then illustrate the key issues:

In the present regime, the Basel Committee has assigned risk weights for sovereign exposure (the weight depends on the ratings), but under European capital requirement rules there is an exemption which assigns zero risk to all "exposures to Member States' central government" denominated in the domestic currency. That said, supervisors (and markets) keep a close eye on the exposure and may ask for a reduction in such exposure. Also, banks have internal capital planning procedures like ICAAP where sovereign exposure has to be considered.

Importantly, this European set-up is no different from the practice in every other developed economy. Trust me, not a single OECD country assigns an ex ante risk to its own sovereign in its own currency (and while the euro is shared among members, it is still any member's "own currency" and not the product of a currency board).

There are good reasons why countries don't assign risk weights to themselves, the sovereign. Estimating the risk of default is difficult even in the best of circumstances (say for corporates), but sovereign defaults have happened so rarely that properly identifying and estimating the factors that determine such defaults is virtually impossible. Indeed, as far as I know, the only statistically significant factor is whether the country has defaulted in the past.

There are good reasons for this, namely that sovereign default in the country's own currency will always – and only - be a matter of "a lack of political will to pay", rather than "a lack of ability to pay". After all, sovereigns can always raise taxes and/or cut other expenditures.

But there are also practical reasons for not assigning ex ante risk to the sovereign. To have a well-functioning financial market, you need a risk-free rate for banks and other financial institutions to anchor their balance sheets, and as a base for investors to price other assets (which is important for efficient resource allocation.) More concretely, sovereign bonds are key for liquidity management, and while liquidity is abundant right now, risk-weighting the sovereign bonds would most likely effect liquidity in the future.

Call me old-fashioned, but when we discuss risk weighting of the sovereigns I worry that we are messing with the very foundation of our institutions which have underpinned European living standards for over a hundred years. We know the real answer to the eurozone dilemma, namely a common euro-denominated risk-free rate, which requires some degree of fiscal union. We also know that that's not politically feasible now, but do keep in mind that this entire debate in the eurozone of sovereign limits based on risk assessment takes us into completely unchartered territory, which – in my view – could put financial stability at risk. Again, for me, limits on sovereign exposure are fine, changing limits based on changing risk assessments (by whom?) is not.

So, now on to Scholz' proposal, which recognizes some of these concerns: As part of the bigger deal of getting common deposit insurance, etc., Scholz proposes to change the European capital regulation framework (CRR/CRD) and to skip the exemption from Basel. Instead, he advocates zero weighting for up to 33% of Tier1 capital with risk weights increasing above that level, depending on concentration and rating of the exposure. He says that "the 33% allowance reflects the need of banks to hold for regulatory purposes and for refinancing operations with the central bank a certain amount of safe and liquid assets."

Now putting aside the issue of risk-weights, I'll make the following two observations on the demand for banks' sovereign exposure limits, which I strongly support:

First, it's important to define "sovereign" correctly. Too much of the debate so far has focused on banks' exposure to the home country "central government" as the convenient proxy for "sovereign exposure". Yet, we all know from the debate about sovereign debt, fiscal policy, etc., that the relevant concept is "general government", i.e. central government plus regional governments, etc., rather than just the central government. This is also the relevant concept in this context, unless you can persuade everybody in the courts, markets, etc., that financial trouble in any one regional government of a country has no bearing on the financial situation in any other region or for the central government, i.e., no explicit or implicit guarantees and no realistic political pressure that would lead to any bailout of any sort.

Using "general government" debt, rather than just "central governing" debt, is also important because of the vast differences between the degree of central vs federal government among eurozone members. Specifically, limiting only the holding of central government debt (as opposed to general government debt) would significantly favor banks in federal states, like Germany, vs banks in more centralized countries, like France.

To help frame the issue in a more quantifiable way, let me remind you of banks' exposure to their home country sovereigns, properly defined as "general government". Funny enough, these numbers are not so easily available, but my (and your) great luck is that Michael Teig, who is in charge of this sort of stuff in my team, knows more about the data and how to think about European banks' balance sheets than most others, and he put some very cool tables together for me.

Here is a list of banks by nationality and their share of “general government home country sovereign exposure”, as a share of banks’ own funds, based on EBA statistics: Estonia (610%), Finland (247%), Portugal (159%), France (130%), Italy (129%), Luxembourg (125%), Spain (122%), Germany (113%), Belgium (99%), Netherlands (90%), Slovenia (86%), Malta (48%), Ireland (43%), Greece (42%), Austria (40%), Cyprus (25%). Now, do you spot the problem of home-country sovereign bias, and the differences between countries?

In any case, sure, we want banks to diversify their holdings away from home country sovereign exposure, so here are Michael’s numbers for what eurozone banks already hold of non-domestic eurozone sovereign exposure, again as a share of banks’ own funds, and – in the parentheses – the share of own funds they hold of non-eurozone sovereigns: Belgium 161% (153%), Luxembourg 82% (131%), Italy 58% (40%), Netherlands 50% (26%), Portugal 51% (40%), France 40% (54%), Slovenia 47% (39%), Germany 35% (51%), and so on. (All data available from Michael upon request, of course).

As you can see, banks in some countries already hold very diversified – and huge! - sovereign exposure. If we assume the sovereigns are uncorrelated, then that’s a good picture, but things are more complex than that. Short term, yield correlation among the various eurozone govies is positive, but less than one. That said, during the past ten years, in periods of tension, correlation between Italy and Germany turns negative, reflecting the flight to quality. So yes, further diversification of banks’ exposure to eurozone sovereign debt, properly calibrated, would be a good thing.

Second, it’s important to define “banks” correctly and relevantly for this objective of breaking the so-called “doom-loop”. There are two aspects to the question of defining “banks” in this context:

On the one hand, in a proper banking union, you want stronger pan-European banks (both to support pan-European businesses, but also, thereby, to benefit from more diversified – and thereby safer – balance sheets.) Therefore, you would obviously consider whatever limits (single name sovereign limits, properly defined, as per above) to apply to the bank groups’ consolidated balance sheets rather than to the national units of the banking groups since, in a proper banking union, pan-European banks would have full discretion to move capital and liquidity across borders.

On the other hand, should you limit the exposure to what’s on the banks’ own balance sheet, or include the sovereign holdings of fully owned non-bank subsidiaries, e.g. insurance companies? Presumably that’ll depend on whether you believe that trouble on the balance sheet of a fully owned subsidiary, can be kept completely isolated from the bank-mothership’s balance sheet. In other words, will an insurance company or pension fund be allowed to default without a call on the bank that owns it 100%? Personally, I think that would take more political guts than what we have seen so far.

So, all in all, tighter limits on banks’ home-country sovereign exposure, and encouragement to diversify, would be a welcome move as part of the banking union, but we need to be sure both “sovereign” and “banks” are properly defined for the purpose.

2. Tesla picks Berlin, and what that tells you about cars and Germany – and Berlin...

As I'm sure you noticed, this past Tuesday, Elon Musk announced that Tesla will build its first European factory and design center in Berlin – because "Berlin rocks". Reportedly, the new "Gigafactory 4", to be built just south of the city, will be completed by 2021 and will produce the Y-model as well as the Model-3, employing up to some 7,000 people. The creative design center will be placed in the city.

During the announcement, Musk shared the stage with Volkswagen CEO, Herbert Diess, who praised Musk like only you can praise a competitor who pushes you forward… As you probably know, VW has already announced plans for several fully electric cars in direct competition with various Tesla models, and a promise to produce more than 22 million electric cars in the next decade.

And this all comes just weeks after the German government announced its "Klimapaket", which includes a pledge to support the establishing of about one million public charging points (compared to just 20,000 now), plus 100,000 fast-charging places, as well as additional subsidies (co-financed by the industry) to get up to 10 million electric vehicles registered in Germany by 2030.

The decision to base Tesla Europe in Berlin, on top of the VW announcement, sends at least four pretty strong messages:

First, the doomsday prophecies about German automakers – some even having claimed that they were facing a "Kodak moment" – look increasingly silly. Not only do the three major German automakers already own more patents in this area than anyone else, but Musk referred explicitly to the impressive state of German engineering and the availability of skilled labor, as well as creativity in Berlin, as reasons for his decision to locate here. The fact that German auto workers make about EUR 27 per hour, well above the USD 18 average pay at Tesla's US factories, and even further apart from wage levels in Central Europe, is not a decisive issue. As the economists among you will recognize, Musk's decision to locate here in Germany looks a lot like what Paul Krugman got his Nobel prize for in 2008. (And as I am sure the British press, including the Boris Johnson supporting ones, must have reported, in spite of successive UK governments having lobbied Musk to place at least the design center in the UK, uncertainties associated with Brexit had ruled out the UK as the place for his European operations, he said.)

As Automotive News Europe headlined its article on Tesla's decision: "Tesla and Berlin are a perfect match", adding that while it may seem as a cheeky move by Tesla to move "into the land of its top competitors … Tesla isn't the cheeky challenger here – the German automakers are, when it comes to EVs. Musk, in a sense, is buying insurance against being overtaken technologically".

Second, the widespread (and somewhat justified) concern about economic developments in the Eastern part of Germany received some comfort. Along with the Tesla decision (the factory will be in the state of Brandenburg), VW's plant for the new all-electric ID3 car in Zwickau and CATL's battery plants in Erfurt, there is hope that Eastern Germany now – 30 years after the fall of the wall – might develop into Europe's EV hub. This, in turn, will strengthen the entire supply industries throughout Germany.

Third, the outlook for car sales is not as gloomy as many will have you believe. Yes, demographics, urbanization and the increasing culture of sharing tell a story of less future demand for cars, but Europe still look like the world's second biggest market, after China, during the next decade.

Fourth, did I mention that "Berlin rocks"? Seriously, Berlin has been establishing itself for some years now as a tech and creative center, not only in Germany, but in Europe (and my friends here at the coffee house add "in the world"), and Musk's decision to build his European operation here lends further support to this trend.

… and that's the way it is…

I wish you a continued good Sunday,

Best

Erik

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This report was completed and first published on 17 November 2019 at 13:05.

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