

Europe's Banks, Europe's Crisis

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Europe continues to occupy centre stage of Act II of the global financial crisis, which has now mutated into a sovereign-debt crisis within the eurozone. How could this happen when, at least on paper, all problems had seemingly been resolved during May's extraordinary EU summit meeting, which created a European Financial Stability Facility (EFSF) and ensured total funding of close to \$1 trillion?

The promises made in early May have, in the meantime, been made more concrete. A 'special purpose vehicle' (SPV) has been established in Luxembourg, and can already count on hundreds of billions of euros in guarantees from member states.

If all the resources promised (€750 billion, including financing from the International Monetary Fund) were to be used fully, the EU could fully refinance all distressed countries (Portugal, Spain, and Ireland) for a couple of years. Moreover, the European Central Bank has shown willingness to buy government (and private) bonds if it deems that the functioning of the market has been impaired.

But this official financial firepower has left markets unimpressed. Spreads on Spanish government bonds continue to creep up, and are now higher than before the announcement of the EFSF. And there are ominous signs of tension in the interbank market, as more and more banks would rather deposit their money at the ECB than lend to other banks, which shows that confidence in the stability of the system has not been restored.

The explanation is simple: the problems that underlie the crisis (the precarious state of Greek public finances and that of the Spanish real estate sector) have not been solved. But they should actually be easily manageable in a pan-European context. Greece represents about 2% of the eurozone economy; even if it defaulted on its public debt, and the recovery value were only 50%, the losses would be about €150 billion, or just 1.5% of eurozone GDP.

The problems in Spain are likely to be somewhat larger, although official estimates of the losses in the Spanish banking system amount to only €100 billion. But the real problem in Spain might well lie elsewhere: the exposure of French, German, and other banks to Spain's real-estate sector. Many loans to Spanish developers will have to be written off. But, even in the worst case scenario, the combined losses

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of Spanish and other banks in the Spanish real-estate sector should not exceed €300 billion, or about 3% of EU GDP.

So, the real question is: why are problems of manageable proportion on Europe's periphery are paralysing the eurozone's entire banking system? After all, one would not expect the United States' banking system to collapse just because there was a housing bubble in California and the state of Michigan (similar in size to Greece) became insolvent.

A key reason why Europe's financial markets remain nervous is that, officially, there is no problem. Officially, Greece does not have a solvency problem, and the restructuring of its public debt is not an option. Similarly, in Spain the official line is that the domestic banking sector is well capitalised.

When dealing with financial-market turbulence, the first rule should be to acknowledge the truth and scale of the problems at hand. Greece's experience has shown that pretending that problems do not exist can result in a self-reinforcing spiral of increasing risk premia and declining confidence.

In this respect, the publication of the results of 'stress tests' conducted on the EU's 100 largest banks, promised for the end of July, is a clear step forward.

But there is a second and more disturbing reason why financial markets remain unsettled: large swathes of the European banking system remain vastly undercapitalised. According to ECB statistics, eurozone banks have about €20 of liabilities (including interbank debt) for every euro of capital and reserves. This implies that for every capital loss of one euro lurking in some bank, there will be about €20 of doubtful debt.

Even a worst-case scenario for Greece and Spain would imply losses of €450 billion at most. The funds mobilised so far under EFSF (€750 billion) would be amply sufficient to deal with all of this – provided that these potential losses are clearly identified and the necessary funds are earmarked to deal with them. Yet this is not the approach that is being followed.

Instead, European funding will be used only to bail out governments, which in turn need the money to bail out their banks. But, given the 20:1 liability-capital ratio in the banking sector, this approach implies that the funding requirements will become astronomical: compared to a €450 billion bill if potential losses remain undisclosed and dispersed, €9 trillion in debt guarantees would be needed to ensure the stability of the eurozone's banking system.

In short, rigorous stress testing of eurozone banks (followed by mandatory recapitalization) would require much less public funding than would continuing to extend blanket guarantees to everybody.

Europe cannot escape the crisis in its financial markets until it fixes its banks. Unfortunately, Europe's policy-makers have twice let themselves be misled by politically convenient views of the crisis – first in 2007/08, by supposing that the financial contagion came from the US, and nowadays, by blaming reckless fiscal policy in the southern eurozone.

But the real problem is that the EU's banking system is so weakly capitalised that it cannot take any losses, while also being so interconnected that problems in one country quickly put the entire system at risk. Until the banks' balance-sheet problems are dealt with decisively, financial markets will remain on edge.