

The European Banking Disunion

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The purpose of the euro was to create fully integrated financial markets; but, since the start of the financial crisis in 2008, markets have increasingly separated along national lines. So the future of the eurozone depends on whether that trend continues or is reversed and Europe's financial markets in the end become fully integrated. But either outcome would be preferable to something in between – neither fish nor fowl. Unfortunately, that is where the eurozone appears to be headed.

The trend toward renationalisation can be seen clearly in the figure below. Until about 2008, the cross-border claims of banks based in the eurozone core (essentially Germany and its smaller neighbours) toward the eurozone periphery grew quickly, multiplying several times. But since the end of the credit boom in 2008 they have plummeted from about €1.6 trillion (\$2.2 trillion) to less than half that amount.¹

This trend might well continue until cross-border claims become so small that they are no longer systemically important – as was the case before the introduction of the euro. At the current pace, this point might be reached within a few years. The financial integration brought about by the euro would be largely unwound.

Officially, renationalisation is anathema. But it has its benefits. The system-wide impact of national shocks is less severe when cross-border debt is low. A bank default in any one country would no longer trigger a crisis elsewhere, because any losses would stop at the border.

Moreover, national banking systems can now separate more easily, because the peripheral countries' current accounts have already achieved a rough balance, with all but Greece expected to record a small external surplus in 2014. With the exception of Greece, the peripheral countries will not need any capital inflows in the near future.

This is a key development. A few years ago, countries like Spain and Portugal were running large current-account deficits and needed capital inflows totalling roughly 10% of their GDP. The breakdown of cross-border bank lending thus represented a powerful negative shock for them. But, with current-account surpluses, renationalisation of banking, by limiting the international transmission of financial shocks, can be a stabilising force.

¹ Part of the difference has ended up on the European Central Bank's (ECB) balance sheet, but this cannot be a permanent solution.

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This is not a theoretical proposition. Italian savers, for example, still hold a significant volume of foreign assets (including German bonds), and foreign investors still hold a sizeable share of Italian government bonds. But interest rates on longer-term Italian government bonds (and Italian private-sector borrowing costs) are about 250 basis points higher than those on the German equivalents (this is the risk premium). Under full renationalisation, Italian investors would sell their foreign assets and acquire domestic bonds, which would insulate Italy from financial shocks abroad and lower the interest-rate burden for the economy as a whole.

Meanwhile, foreigners still hold Italian government bonds worth about 30% of GDP. If these bonds were acquired by Italian investors (who would have to sell an equivalent amount of low-yielding foreign assets), Italians would save the equivalent of 0.73% of their country's GDP. Any risk premium that the Italian government might still have to pay would no longer go to foreigners, but to Italian savers, whose incomes would increase – a net gain for the country.

Moreover, if Italians held all Italian public debt, any increase in the risk premium would be less burdensome. Even if the risk premium doubled, to 500 basis points, the Italian government's debt-service costs would rise, but the money would be paid to Italian investors (whose higher incomes could then be taxed away).

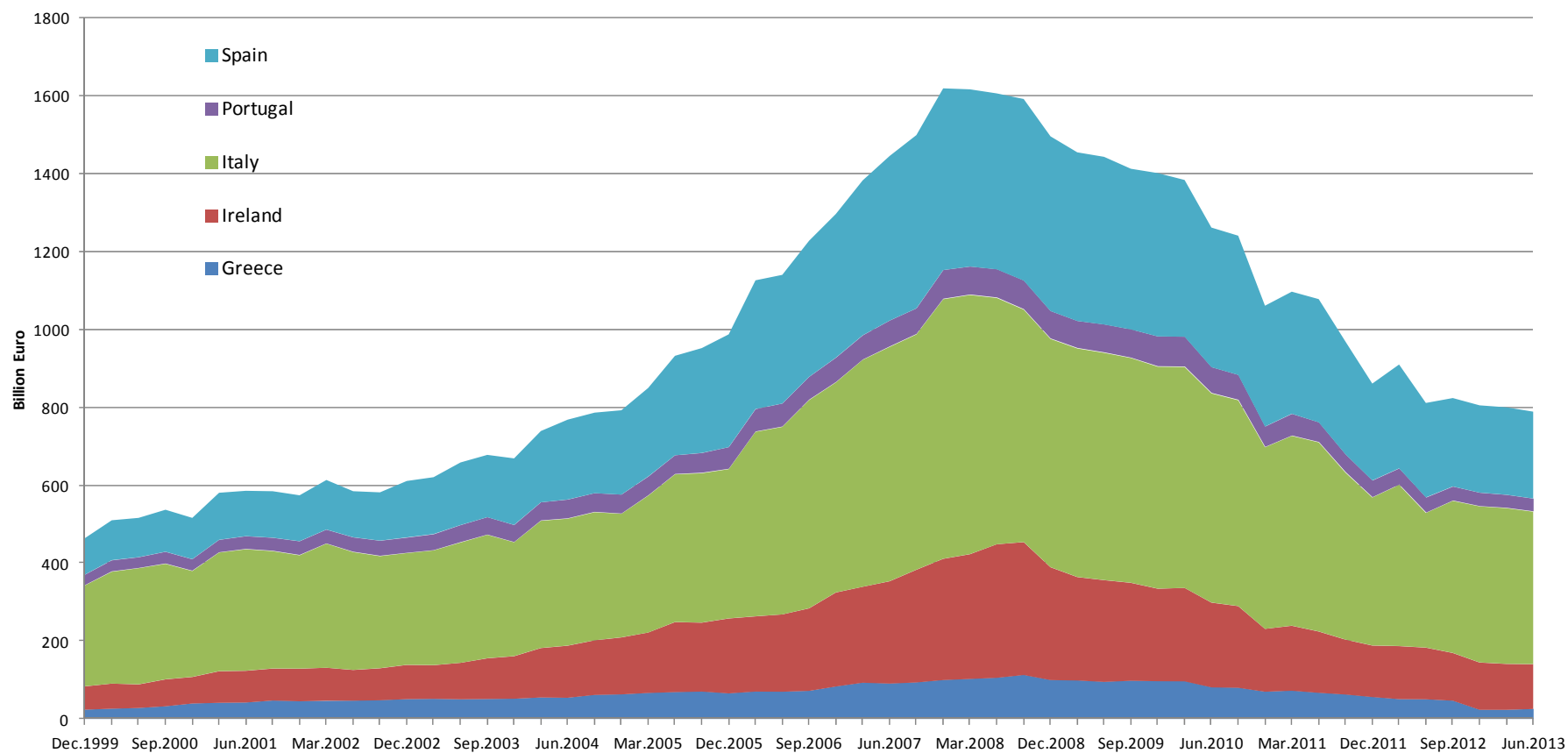
The opposite of the renationalisation scenario is complete integration of eurozone financial markets. Officially, this is the aim of establishing a European banking union. With a full banking union, cross-border lending should resume and remain stable, as common institutions would absorb national shocks. Interest rates would then converge to a low level, fostering recovery in the periphery and making it easier to stabilise public finances.

Unfortunately, a fully-fledged banking union is unlikely to be achieved anytime soon. The ECB is set to take over supervision of the 120 largest banks, which account for the bulk of eurozone banking assets, but the next required steps are already in doubt. Most governments de facto oppose a 'single resolution mechanism' (SRM in Brussels jargon), because it would mean that they could no longer control their own banks. Deposit insurance is not even being considered. And there are legal and political obstacles to creating a true common backstop.

As long as the fiscal backstops for banks remain national, there can be no level playing field. In this scenario, integration could at most take the form of 'colonisation,' under which banks from fiscally strong countries use their lower cost of capital to buy up banks in fiscally weak countries. Even in the unlikely event that colonisation encountered no political resistance, it would not lead to a very efficient banking system.

The eurozone thus risks becoming stuck in an unstable status quo, with banks' cross-border claims large enough to transmit national shocks to the entire system, but financial integration not deep enough to ensure that capital flows freely throughout the currency area. If a full banking union proves impossible, it might be preferable to let the trend toward renationalisation run its course. At least the eurozone would then enjoy some stability.

EA Core* consolidated foreign claims vis-à-vis the periphery



Note: EA Core entails Germany, Austria, France, Netherlands and Belgium.

Source: BIS, Table 9b.