To save the eurozone, save the banks

If the eurozone is to save itself, it will have to face the real crisis: its banking sector. Far too much time has been spent on fiscal policy when the existential threat to the eurozone is the ongoing collapse of bank lending in the weak economies, as Gavyn Davies recognises. Yes, fiscal policy counts, but the debate commonly framed between “austerity” (more deficit reduction) and “growth” (more deficit spending) is a serious distraction to the survival of the currency union.

The 2008 financial crisis in Europe and the US arose from excessive bank lending during the 2000s caused by deregulation and excess liquidity from the Federal Reserve and the European Central Bank. The excess liquidity found its way to a variety of sub-prime borrowers. There was a housing bubble in the US, UK, Ireland and Spain; a corporate-acquisitions bubble in Iceland; and a public sector spending binge in Greece.

When the easy credit stopped in 2008, the banking sector was over-leveraged and under-capitalised. Bank assets – including mortgage-backed securities, corporate acquisitions, and government bonds – were heavily impaired, so that bank capital plummeted. A financial panic ensued after the Lehman collapse, with banks ceasing to lend to one another or to blue-chip companies. Liquidity dried up. The US and Europe plunged into a very steep downturn.

This was not a typical Keynesian downturn resulting from a fall of aggregate demand, though aggregate demand certainly declined as net worth in housing and equities also fell sharply. The dramatic decline in output in late 2008 and early 2009 resulted mainly from the lack of working capital at enterprises rather than inadequate aggregate demand. Non-financial companies slashed their workforces and sold off inventories in order to replenish liquidity that the banks were no longer providing.

The Fed correctly flooded the economy with liquidity after the Lehman collapse, thereby ending the banking panic by the spring of 2009. The US banks gradually recapitalized through the infusion of public funds (the Troubled Asset Relief Program), the profits on near-zero-interest loans from the Fed, the recovery of asset prices, and the infusion of new equity. The US fiscal stimulus may have played a small role in the start of the US recovery in 2009 but the Fed’s effort to reverse the financial panic was the dominant factor.

The eurozone, by contrast, failed to redress its equally severe banking crisis, especially in the weakest eurozone economies. The Greek banks, with their large holdings of Greek government bonds, suffered a catastrophic loss of capital. When rumors began in December 2009 that Greece might default on its sovereign debt and leave the eurozone, Greece’s banks could no longer float securities or attract deposits or inter-bank lines of credit.

From early 2010 onward, the Greek banks looked to the ECB as their lender of last resort, yet the ECB was constantly ambivalent about its responsibility in this arena. Rumours swirled that Greek would be pushed from the eurozone and that the ECB would reject collateral offered by the Greek banks. Depositors began to flee the Greek banking sector, with bank deposits in Greek monetary institutions peaking in the spring of 2010 and declining thereafter. As deposits fell, and without access to the
international capital markets, Greek banks slashed their loan portfolios, leading to a devastating economic contraction that continues to deepen.

The Greek economy is collapsing not mainly from fiscal austerity or the lack of external competitiveness but from the chronic lack of working capital. Greece’s small and medium-sized enterprises can no longer obtain funding. Since 2010, Greece has been trying to stabilize a sophisticated modern economy while its banking sector is shrinking dramatically. It just doesn’t work. The shutdown of Greece’s banking sector brings to mind the dramatic shrinkage of bank lending during 1929-33 in the Great Depression.

Europe’s banking squeeze extends beyond Greece. Overnight deposits have declined since mid-2010 in the banking sectors of several other eurozone countries, including Ireland, Portugal, and Spain. In response, bank lending in those economies has also been cut, causing the current double-dip recession. And the reduction of bank loans could easily intensify if eurozone banks now try to raise their capital-asset ratios by cutting lending rather than by raising fresh capital.

There is still no evidence that European authorities, and notably German politicians, recognize the priority of rescuing the eurozone banks, and especially the banks in Greece and other weak economies. The European Banking Authority is tightening capital adequacy standards without paying enough attention to the ensuing steep credit squeeze. The focus on budget cutting in these circumstances is not only misguided but tragically inapt. Governments cannot close their budget deficits if payroll taxation is plummeting because payrolls themselves are being deeply squeezed.

The bank panic is Greece is now accelerating, and could easily push Greece out of the Eurozone unless decisive actions are taken to prevent a massive run on the Greek banks. If such a run occurs, and drives Greece to leave the euro, Greece’s exit would most likely create an even greater calamity, as Portugal, Spain and perhaps Italy, suffer rapid withdrawals of bank deposits as well. The Eurozone’s unwillingness to keep Greece in the union would create a powerful one-way bet against the survival of the currency union in several other countries as well.

The eurozone has one last chance. Here are the key steps. Re-establish working capital in the weak economies; re-capitalize the banks, using ample public funds as needed; insist that the ECB be a more vigorous lender of last resort for the banking sector. In short, Europe must fight the ongoing banking collapse with the resolve needed to save Europe from a self-inflicted collapse. Credible fiscal policies and increased investments in human capital and infrastructure are surely part of long-term recovery, but the fiscal crisis can be addressed only after Europe’s tottering banking sector has been rescued.