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The Eurozone debt crisis: Is this a banking problem?

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The IMF has recently suggested the recapitalisation of Europe's banks as the most prudent way out of the continent's economic crisis. This column argues that such thinking is based on a flawed analysis of the problem and is an unhelpful distraction at best. Europe is facing a crisis of government debt. The true problem of the Eurozone is not its banking system.

The recent calls by the IMF for a recapitalisation of European banks are, to say the least, disconcerting. A few weeks after the European Banking Authority (EBA) stress tests highlighted the resilience of European banks, it is discouraging that IMF officials (see Lagarde 2011) keep coming up with an argument that should have been settled months ago. This debate diverts attention from the real policy decisions that can deal with the dire predicament of the Eurozone economy.

This policy proposal is the result, I believe, of a flawed analysis of the current stage of the financial crisis. At present, we are fundamentally facing a government debt crisis and not a banking crisis. Of course, banks face challenges, since they are in the midst of a broad deleveraging process affecting both private and public debts. But banks will be sound if government debt is sound, since the process of gradual deleveraging of the private sector is well underway in most countries and, as shown by the EBA tests, the banking system is already sufficiently capitalised to absorb any potential losses from the completion of this process.

According to the Institute of International Finance (IIF 2011), European banks have raised $414 billion in capital since 2008, compared to the $314 billion raised by US banks. The perception of problems arises from the fact that, relative to their asset base, European banks hold much more public debt than US banks.

It is important to have a correct diagnosis of the reasons why this mountain of debt, private and public, has accumulated. It is clear that between 1999 and 2007 the gradually enlarging external imbalances within the Eurozone were an unintended and harmful byproduct of the introduction of the euro. Absurdly, the markets priced all debts issued by Eurozone private and public agents at levels close to Eurozone reference rates. This market failure, coupled with an era of low interest rates, led to extremely benign financial conditions. The consequence was a dramatic underestimation of risks, wrong investment choices, and a misallocation of capital. The anticipated flow of capital from North to South happened with a vengeance, with incorrect market signals triggering mistaken decisions from both savers and investors.

A second part of the accumulated debt, mostly public, comes to some extent from the policy reaction to the global financial crisis, which led to the worsening of the public finances of many Eurozone states, as they attempted, more or less successfully, to cushion the effect of the global contraction on their economies. In some countries, however, profligate fiscal policies over many years were also responsible.

The current proposal of bank recapitalisation arises from a focus on the potential losses in the banking book of government debt. It has been argued that this debt should be marked to market, like the trading book, with substantial haircuts applied to sovereign holdings, at least of those countries under rescue programmes.

This is, of course, one possible approach to the crisis. It is based on the idea that the fundamental problem lies in the banks, and that it is investors that should pay for the wrong investment decisions that they took. If this recapitalisation is to come from the private sector, it is not clear what it will mean for the broader economy in terms of credit availability. If it is forced by the public sector (see Hau 2011 on this site), it will involve a further deterioration of the finances of many, if not all, members of the Eurozone, thus reinforcing the current vicious circle.

However, if we accept that the root cause of the current stage of the crisis is the excessive public debt overhang within the Eurozone, and the absence of clear mechanisms of burden sharing when countries face difficulties servicing their debt, then the nature of the solution is altogether different.

The solution must involve a Eurozone arrangement that facilitates the gradual deleveraging of the countries that built up excessive debts. This is in the interest of both creditor and debtor countries. It must be implemented by a combination of financial support instruments which are flexible enough to allow growth recovery in indebted countries, and monitored fiscal adjustment and structural reforms that ensure the long-run fiscal viability and competitiveness of these economies. This is the burden sharing that is needed: creditor countries providing the funding or insurance at reasonable costs, and debtor countries undergoing the short term costs of fiscal retrenchment and reform.

If this programme is successfully completed – and indeed the EU appears to be taking steps in this direction – then the overall solvency of the banking system need not suffer. After all, the real problems of the European banking systems have had quite different roots all along the financial crisis. Some banks have failed or been rescued due to their exposure to subprime toxic assets and derivatives. Others, due to their holdings of real estate assets in the context of property bubbles. Still others, due to maturity mismatch and poor management.

It is quite absurd to argue that banks should fail due to their exposure to sovereign debt. After all, this debt was characterised by the regulator itself as safe debt, with a zero weight in terms of capital allocation. How ironic that banks are deemed to have insufficient capital due to their exposure to an asset class that according to the official rules of the game, old and new, requires no capital.

Obviously, banks will have to take a hit for their holdings of Greek debt subject to restructuring, but it has been made clear that such restructuring is exceptional. The principle should be that sovereign debt in the Eurozone is indeed a safe asset.

There is much that has not worked well in Europe during the financial crisis. The rules that govern asset allocation by banks may be faulty and this is important in the wake of Basel III, which essentially endorses them (Gual 2011). But the true problem of the Eurozone is not its banking system. The true problem lies elsewhere, in the fact that Europe has built a monetary union with an inherent flaw – the absence of a sovereign safety net, since the debts accumulated by member states have been incurred in a currency that none controls. This issue, and not banking capitalisation, should be the focus of the policy debate.

The views expressed in this column are those of the author.

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