EU Inaction on Banks Grows Ever Costlier

By Nicolas Veron

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The European Union faces an existential crisis that results from three simultaneous challenges. The most visible one is fiscal. Several member states have poorly managed their finances, and the eurozone policy framework has been toothless in getting them to address their complacency. The second is about competitiveness. Property bubbles and a benign international environment have until recently masked the loss of economic fitness of countries that now require painful structural reforms, such as freeing labor markets and breaking corporatist holds on services sectors. But equally important is the third challenge – that of addressing Europe's banking fragility, which has been at the core of the dramatic policy developments since the beginning of May.

In much of the public discussion, the concern about contagion from Greece has focused on the vulnerability of Spain, Portugal and other countries that might find themselves unable to refinance themselves at reasonable conditions. In fact, the fear that Greece's difficulties could undermine the stability of Europe's banking system, which holds most of its debt, is the main reason why the eurozone and International Monetary Fund have bailed out Greece without going directly for debt restructuring. Banks exposed to the Greek debt risk could become insolvent, sending shockwaves through the system just as Lehman did in 2008. The apparent seizing up of interbank markets at the end of the first week of May, more than anything else, is what prompted eurozone leaders and the European Central Bank to preempt market panic and announce their huge €500 billion backstop, plus half as much from the IMF.

The European banking system has been in a state of severe fragility since at least the post-Lehman shock; the ensuing public liquidity assistance had the perverse additional effect of encouraging the weaker banks to overinvest in high-yield debt such as Greece's. If banks had started 2010 with stronger balance sheets, broader options could have been considered by policymakers, including a Greek debt restructuring which may need to happen eventually anyway, and whose cost could have been minimized if it had been engineered earlier.

Some European banks certainly have strong balance sheets. But the system is only as strong as its weakest links, and we don't even know exactly where these are. A clear lesson of past systemic banking crises is that they can only be solved through a process of triage under which undercapitalized banks are publicly identified, and restructured or wound up by government if the market cannot provide them the additional capital they need.

A year ago, the US publicly "stress-tested" all its largest banks, spurring a wave of market-driven recapitalizations which is now seen as a major policy success. Sadly, the EU still has done nothing comparable, for a number of reasons. Political leaders, including those in France and Germany, are deeply captured by national banking establishments determined to preserve their perpetuation. Insidiously, the same leaders simultaneously adopted a virulent anti-finance, anti-market rhetoric, which makes it all the more difficult to explain to their voters how the banking system can be restored to soundness.

Meanwhile, national bank supervisors are unwilling to acknowledge the full extent of their massive oversight failures of the past decade. Furthermore, economic nationalism, combined with the EU legal framework, makes national officials fear that revealing the sorry state of some banking “champions” could make them takeover targets for “foreigners” from other European countries. Partly for this reason, the necessary triage and restructuring probably needs to be carried out at supranational level to be effective.

But as a result of existing treaties, the EU institutions lack the executive decision-making capacity to defend the European common good against the demands of special interests – in spite of the best efforts of the European Central Bank, which has no supervisory duties, and of the European Commission’s competition services, which could only act on individual cases of state aid but without a system-wide prudential mandate. Barack Obama last year shrewdly remarked that “political interaction in Europe is not that different from the US Senate (…) everybody has their own particular issues and their own particular politics.” Alas, only centralized executive actions can restructure a banking system, a process that involves many hard choices that the diplomatic ways of EU decision-making have proven unable to deliver.

The EU must now find a way to clean up its financial institutions rapidly in order to strengthen themselves against the possibility of sovereign defaults, and also prepare the ground for a credible EU-level supervisory framework without which the aspiration to build an integrated market cannot be fulfilled. Banking reform has become as urgent as fiscal adjustment, and as important for stability as enhancing Europe’s growth potential and fixing the eurozone’s fiscal policy framework. Failing to achieve comprehensive EU bank restructuring before the expiration of the eurozone’s new three-year stabilization mechanism could have devastating consequences. The clock is ticking.

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