

Marketplace



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‘The eurozone shambles has been the worst setback for European integration since the 1940s’

The eurozone, contrary to the self-image of some of its most prominent spokesmen, does not dominate the world: it accounts for only about a sixth of global output. Nevertheless, fears of its break-up are routinely given as the main reason for expecting 2012 to be a difficult year for the world economy. Why could the eurozone’s travails do so much damage to those countries which have had the good sense to keep their own currencies? As so often in the last few troubled years, the answer lies in the banking system.

Banks provide transactions services to their depositors. As they are conducted in “money” (that is, an asset with total nominal value certainty, at least in principle), banks’ assets must also be characterised by nominal value certainty (also in principle) and be very safe. Unfortunately, safe assets offer low returns. In order to overcome the low returns and provide their shareholders with respectable profits on their equity, banks need to “gear up” their balance sheets. Whereas non-bank businesses rarely have debts that are more than two or three times their equity, commercial banks often borrow 15 or 20 times their equity. If things go wrong, this leverage can have ruinous effects on banks’ customers and the wider economy, which explains Thomas Jefferson’s often-quoted remark that banking institutions are more dangerous to a nation’s liberties than standing armies.

Commercial banks therefore submit to extensive regulation from a very special organisation known as “the central bank”, which is the issuer of the safest monetary asset of all (legal-tender notes or “cash”). The regulations specify that a proportion of commercial bank assets must be held in so-called “liquid” form. All being well, in an emergency liquid assets can be converted into cash, quickly and with little bother or expense, perhaps with the central bank’s help. Again all being well, the easy injection of extra cash into banks and money markets ought to end any crisis of confidence.

The classic liquid, safe assets for these purposes are government securities and deposits that banks keep with each other (“inter-bank deposits”). In a traditional monetary jurisdiction both government securities and inter-bank deposits are virtually certain to be repaid in full. In the extreme governments can borrow from the central bank,

a prerogative which is akin to their power to tax. The implied freedom from default risk has meant that, under the Basle rules set by the Bank for International Settlements, banks do not need to hold capital against holdings of government securities. Inter-bank deposits are not of quite the same calibre, but five years ago they also would have been deemed very safe.

But the eurozone is not a traditional monetary jurisdiction. On the contrary, it is a remarkable experiment of a kind never before attempted, in which 17 governments and nations share one currency and central bank. Under its founding document, the Maastricht Treaty of 1992, the European Central Bank was forbidden to lend on overdraft to governments. Member governments therefore could not borrow freely from the central bank. In that sense, they had lost part of their power to tax and reduced their own creditworthiness. Even worse, countries can leave the eurozone and restore national currencies, in which case deposits lodged in the banks of countries exiting the single currency could be redenominated into new local currencies. Such redenominations, and other contract upheavals, could overnight wipe out 20 or 30 per cent of the value of inter-bank deposits.

The essence of the eurozone banking crisis is that, since the closure of the international wholesale money markets in August 2007, sovereign debt and inter-bank claims have lost a great deal of value and become extremely risky assets in a way that is inconceivable in the standard one-government, one-money situation found in most of the world. Indeed, if the eurozone broke up, hundreds of banks within it would be bust. If mishandled, the implications could be disastrous not only for the eurozone, but also for the rest of the world.

Repeat: banks can be geared up to 15 or 20 times. So if banks in North America or Japan were to hold claims on eurozone banks equal to a mere 7 or 8 per cent of assets they too would be endangered by the eurozone’s disintegration, even if their main businesses are thousands of miles away and for the most part in good shape. That is why the rest of the world must worry about the eurozone’s tensions and difficulties. Whatever happens, the eurozone shambles has been the worst setback to the cause of European integration since the 1940s.