The Cross Border Bank Run Has Ended Europe’s Policy of Kicking the Can down the Road.  
It’s Fill or Kill Time for Germany

Last week Mario Draghi, the head of the European Central Bank, castigated European heads of state. He pointed out that for over two years European policy makers have consistently waited till the 11th hour to respond to critical issues, and in so doing they have continually spent the maximum they needed to stabilize their economic situation. He went on to say that the current loss of confidence in Europe was producing an unstable banking system, and that the ECB is not in a position to rescue the system. Instead, he argued, a powerful pan-European response was needed in the very short run. Implicitly he was saying that in the current situation, waiting till the last minute could prove to be wildly costly for all of Europe, and as such he was imploring elected officials to act with a sense of urgency.

Why is Draghi so worried? What does he want heads of State to agree to? And what will they likely do in the weeks and months ahead?

Clearly, Draghi’s anxious words reflect growing evidence that a Europe is in the middle stages of a bank run. Bank runs, as we learned in the aftermath of the Lehman default, can overwhelm financial markets, shut off credit to the real economy, and thereby deliver devastating real economy retrenchment. Draghi is first and foremost begging the elected leaders of Europe to rapidly create a European area banking system, with deposit insurance, to stem the tide of money outflows that are building momentum in Greece, Spain, Portugal and Italy, and lately even in France. These flows are dangerous, in and of themselves. The flows were initially from the “periphery” of Europe, but now they are from virtually every country other than Germany. These flows are also symptomatic of a growing loss of confidence in the overall European system.

Germany has already committed a lot of money to stabilizing Europe. This commitment will continue to rise, unless Germany were unilaterally to leave the euro. Otherwise Germany, one way or another, will find itself backstopping much of the European financial system, and indeed is close to this already.

Why can’t Germany limit its commitment to bank rescue? The European bank payments system compels Germany to lend the weak sisters of Europe large sums, on a daily basis. Indeed, as the bank run builds momentum Germany’s exposure to banks in the rest of the euro zone will continue to climb from its already high level. And it is this automatic increase in German bank exposure, that suggests that Angela Merkel, in the weeks immediately ahead, will sign off on the creation of some form of European banking union. Such a union, unthinkable in German minds a few short months ago, is the only real chance Europe has to stem the cross border bank run that is now in full bloom in Greece and building momentum in Spain and Italy. It’s also the least cost solution for Germany.

A Bank Run Based On Geography, Not Bank Financial Solvency

How did Europe slide into this most dangerous of financial situations? The crisis has been ongoing for two years, but the Greek election, and the subsequent inability of Greece to create a coalition government called into question the nation’s willingness to honor its commitments hammered out in the agreement it signed off on with the ECB, the IMF and the European Commission. The vocal declaration from the
radical left, that they would reject the deal outright, if put in charge, led German and other strong
economy officials to declare that a Grexit—a Greek exit from the euro—could be managed. But this
brinksmanship from Germany had unintended consequences. **The game was on!**

Up until a few weeks ago, all European officials declared at all moments that there were no conditions
that could lead to a nation leaving the euro. Suddenly that was no longer true. Contagion fears—if
Greece can be thrown out, why not Spain and Italy—quickly appeared. This produced a quick
calculation. If my money is in a bank in a nation at risk, I might go to bed with 10,000 euros and wake up
with 10,000 pesetas. In other words, my deposit was guaranteed, but the currency value of the deposit was
not. The simple remedy? Open an account in Germany. Wire transfer the money. Conduct business, still
in euros, but from an institution that might convert your euros to deutschmarks. And in growing numbers,
first businesses and then individuals have been making just this kind of transfer.

The dynamic described above is unusual, in the sense that people are not fleeing weak institutions.
Instead they are motivated by geography. Nonetheless, in other respects, this has all the dangerous aspects
of a bank run. It will cost you almost nothing if your fears prove unfounded. But you may well avoid a
wild decline in the value of your funds if disaster does unfold. It’s a self-fulfilling prophesy. Spanish
depositors fear that Spain will leave the euro zone. In their haste to pull money out of Spanish banks,
they ensure that Spain leaves the euro zone.

**The Bundesbank as Unintended Lender of Last Resort**

Publically available, though lagged, Central Bank data makes it clear that as of April, a bank run was in
full force in Greece and that a bank ‘trot’ was taking hold in Spain and Italy. **Target2** statistics reveal that
Spain and Italy borrowings from the ECB had mushroomed from roughly 150 billion euros to close to
300 billion euros, over the first four months of 2012. Germany, in mirror image, registered **loans** to the
ECB of nearly 700 billion euros. May data is unavailable, but almost certainly witnessed a material
acceleration of flows.

What compels Germany to send money to the ECB? Follow the flows. The Spaniard moves his money
from Bankia to Deutschebank. Deutschebank, now awash in excess cash, deposits its excess reserves with
the Bundesbank. The Bundesbank, in turn, lends these funds to the ECB. The ECB then lends them to
Spain and Italy and...The result? The bank run, left unchecked, compels the Bundesbank to lend ever
larger amounts to the periphery, via the ECB. Thus, without a vote in Germany, or a proclamation from
Angela Merkel, the German monetary authority becomes the lender of last resort to frayed Greek, Spanish
and Italian banks.

Why should Germany care? Euro zone members states other than Germany likely owe a trillion euros, or
even more, to the ECB and the ECB owes this sum to Germany. As the bank run continues, the sums will
get even larger. But these debts will not be honored in euros if the currency union breaks up. In such
circumstances Germany will owe depositors of the periphery euros or d-marks, but it will have to fight to
get perhaps half of what it lent to other central banks.

**The Compelling Case for Germany to Accept a Euro Area Banking System**

As the details above make clear, German **inaction** has the potential to lead to an enormous additional
commitment to the rest of the euro zone, without improving the chances that the euro survives. German
acceptance of a euro area banking system, in contrast, does commit Germany to backing other nations
European banks. But it holds out the promise of stemming the bank run, and in so doing it increases the
chances of the euro’s survival and could stem the panic and be much cheaper for Germany.
Beyond the Immediate Crisis: The Imponderables Remain

Greece, Clearly Insolvent, A Failed State, With No Way to reconcile its circumstances

The German narrative of the origins of the crisis was from lack of fiscal discipline. This is largely a misdiagnosis. Most euro zone countries had manageable primary budget deficits before the crisis. Some had primary surpluses. The one country that does fit the “lack of discipline” view is Greece. It still doesn’t have an effective tax collection system. The debt level that it has built up cannot be serviced over time, even after the recent haircuts. It is seldom helpful to view the resolution of financial crises in morality play terms, but Angela Merkel can’t help this, and in the case of Greece alone, she has a point.

Of course the world has recognized that Greece is insolvent for over two years. European policy makers over that two year period, nonetheless, insisted that Greece was redeemable and offered up a succession of rescue efforts. Why deny the Greek situation? These efforts reflected a belief that a Greek default and euro exit could prove contagious. Now, however, the contagion is upon us and there may be little upside to continuing to pretend that a simple solution for Greece can be found. Indeed, declaring the truth about Greece, might offer some legitimacy to other efforts. One way or another, Greece seems destined to leave the euro soon.

Spain and Italy and the ECB: Can Lender of Last resort Put Borrowing costs at levels that work for these key countries.

For any country to leave the euro zone risks enormous contagion. There is no “safe” way of doing it. But it just might work if, following Greek exit, the ECB and European policy makers were to behave preemptively and on a massive scale, drawing a line in the sand at the Greek exit. In addition to guaranteeing deposits across the euro zone in euros, this would have to make the sovereign borrowing costs of Spain, Italy and other euro countries manageable. Just as there is a self-fulfilling prophesy in bank runs, the same applies to sovereign borrowing. As an example, Italy has a primary surplus. If Italy can borrow at low interest rates, then Italy is solvent, and investors are right to buy Italian bonds at low yields. But if Italy is forced to pay high interest rates, then the country is insolvent, and investors are right to charge high rates. Euro bonds would be one way of resolving this problem. A quicker and easier way would be for the ECB to commit to buying the sovereign debt of all euro zone countries at a fixed small spread over corresponding maturity German bonds. The magic of this solution is that the credible commitment to do so might be enough—they ECB might not even have to buy bonds in size.

One Shot at the Big Bazooka

The strategy we describe would have a very good chance of resolving the immediate crisis. Unfortunately, if the past is any guide, European policymakers will prefer a “compromise” of taking a half-measure, thinking that this brings at least half of the gain. But half measures will do nothing. Policymakers will have to go back and try again at even greater cost (if they get another shot). That’s the point Mario Draghi was making. But following a hypothetical Greek exit, we would be in totally uncharted territory. Europe may well have only one shot at getting this right.

Austerity as a Nightmare and the Need for a Pro-Growth Strategy

The austerity approach has been based on an Alice-in-Wonderland reasoning—at odds with both commonsense and the available evidence—that fiscal contraction is somehow not really contractionary. Yes euro zone countries need tighter fiscal policy in the long-run. So does the US, to an even greater
extent. But tightening fiscal policy during a downturn starts two vicious cycles going. One is that fiscal tightening weakens the economy, possibly driving debt/GDP ratios up not down. The other is that it weakens the banking system, adding new demands to the public purse. A much better solution is to delay austerity, while making a clear commitment today to shore up finances over coming decades. Announcing phased-in plans to raise retirement ages is an excellent place to start.

**Relative Unit labor Costs: Can Europe Escape the Gold Standard Death Grip?**

Unit labor costs in different countries often diverge over time. This has clearly happened in Europe, with massive divergence between labor costs in Germany and the periphery. With flexible exchange rates, there would be a natural solution: countries with higher unit labor costs devalue their currencies. But the fixed euro exchange rate, like the earlier gold standard, has shut this mechanism off. Unlike ending the bank run, this is not something that can be resolved quickly. But the strategy of letting high unemployment in peripheral countries drive them into greater competitiveness will take many years in the more flexible economies (like Ireland) and decades in other economies (like Portugal). If Europe is to survive, some internal devaluation needs to happen on a much faster time frame. It probably can be done, but by a mix of several policies rather than relying on one alone. One approach is to raise sales tax and lower labor taxes in high labor cost countries. Another is structural reform and improving labor market mobility across the euro zone. None of this will make the adjustment quick or easy, but real progress could be made in reasonable time.