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The only way to stop a eurozone bank run

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By Wolfgang Münchau

If you want to know what will drive the eurozone to destruction, my advice would be to follow the money, and ignore the real economy.

I am exaggerating, of course, but only a little.

The distortions in competitiveness between eurozone member states are important, but in the short run, I would ignore them for three reasons.

First, the competitiveness gap is not as big as some of the estimates suggest. I am especially wary of analysis that shows a divergence of unit labour costs, or other national price indices, since 1999 when the euro was introduced. Germany entered the eurozone with an overvalued exchange rate, which has exaggerated the extent of the subsequent adjustment made by Germany compared with others.

Second, the imbalances between surplus and deficit countries have got smaller, and will continue to do so, albeit very slowly. While I, too, believe that the European Central Bank's inflation target is too low, further reductions in imbalances are possible as long as Germany produces above average inflation.

Third, a lack of competitiveness may imply misery, but does not necessarily trigger a break-up.

I can see only one mechanism that could force a collapse of the eurozone: a generalised bank run in several countries. A sovereign state would normally have instruments to handle the danger efficiently, before and after: through a deposit insurance, restrictions on bank withdrawals, and central bank emergency liquidity procedures. But the eurozone is not a state.

The best way to think about bank runs is the 1983 model by Douglas Diamond and Philip Dybvig, US professors of finance, who found that a bank run is one of several rational outcomes of a demand deposit contract between a saver and a bank. The bank lends long. Savers can withdraw at short notice. If a group of savers withdraws, a bank can normally handle this with ease, but if withdrawals exceed a certain threshold, the dynamics of a self-fulfilling bank run set in.

The important point of this model is that a bank run can be perfectly rational. One is reminded of the statement by Sir Mervyn King, governor of the Bank of England, who once said that it may not be rational to start a bank run, but it is rational to participate in one.

In this spirit, it is perfectly rational for Greek and Spanish savers to take their money out of the banks. If, in addition, there is speculation that Greece might leave the eurozone, then it is rational that Greek savers take their money out of the country.

Should Greece leave the eurozone, it will almost certainly have to impose capital controls and deposit freezes. Since the cost of transferring a savings account from Athens to Frankfurt is negligible, such action constitutes cheap insurance against a potentially catastrophic event.

I would go as far as to say that it would be economically irrational for savers to keep their money in Greece under the present circumstances.

Then there is Spain. A Spanish saver in Bankia is confronted with the following questions: Does the balance sheet give a true and fair depiction of the risks? Is the Spanish government's deposit insurance credible? Is Bankia safe now that it is partly nationalised?

My answers to these questions would be "no", "no" and "no". In the absence of a European backstop, Spain has a similar problem to that of Ireland. The Spanish state is too weak to provide sufficient guarantees to the banking system. The refusal by Bankia's auditors to sign off on the accounts has raised suspicions about accounting practices, which are probably not confined to Bankia. In Spain, there is not so much an immediate risk of a eurozone exit – the risk is with the banks themselves.

Spanish press reports suggested that last week Spanish savers withdrew about €1bn in deposits in Bankia – less than 1 per cent of the deposit base. This is not a bank run. But it may be the beginning of one. And as Sir Mervyn said, it may then be rational to take part.

What makes bank runs so lethal in the eurozone is the legal framework. The most important rights conferred by the EU to its citizens are the four fundamental freedoms – of movement of labour, goods, services, and capital. Article 66 of the Treaty on the Functioning of the European Union says the freedom of capital movement can be suspended but only in relation to third countries. The article can be invoked to stop Greek outflows to Switzerland, but not to Germany, at least not legally. That is one of the reasons why a eurozone exit cannot be legally accomplished inside the EU.

The only policy that can credibly counter the threat of a self-reinforcing bank run in the eurozone would be a eurozone-wide deposit insurance and bank resolution regime – at eurozone level. In other words, you have to take the banks – all the banks – out of the control of their home country.

Such a scheme would, of course, not solve all of the eurozone's problems. But it would halt the dynamics that could actually soon destroy it.