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185

How to save Spain's banks – and the eurozone

By Wolfgang Münchau

If you want to know whether any set of proposals for a European banking union is sensible, you should ask the following simple question: will it render Spain's position in the eurozone sustainable?

The Spanish government has confirmed that it is now ready to seek EU aid. But the idea for the European Financial Stability Facility to lend money to the Spanish bank recapitalisation fund, known by its Spanish initials Frob, does not meet this test. It reshuffles debt from one end of the Spanish economy to another. Spain's total debt was 363 per cent of gross domestic product in mid-2011, according to a report by the McKinsey Global Institute, and with the prospect of a severe economic depression ahead, its crisis cannot be solved through a combination of austerity and liquidity support. The eurozone must recognise that some form of debt relief, or default, will be inevitable.

This could come through various channels. One way would be for a eurozone agency to inject direct equity into the Spanish banking system, and then break it up. Such a system does not yet exist. It requires a new inter-governmental treaty that would sit alongside the existing eurozone crises treaties – the fiscal pact, and the treaties of the EFSF and the European Stability Mechanism. So what elements should a treaty on a banking union contain for it to meet our test?

First, a deposit insurance corporation that insures the euro value of each bank deposit up to an agreed ceiling, say €50,000. The European Council should give an immediate political commitment that it would make good such losses even in the most extreme circumstances. The political commitment should be followed up with the creation of a formal deposit insurance company, perhaps implicitly backed by the European Central Bank.

Second, a recapitalisation and resolution authority that is workable and large enough. Ideally, such an authority would be completely centralised. The European Commission's resolution proposal last week was entirely useless because it stuck to the principle that each country resolves its own banks. This is utter madness in a monetary union. Unless you separate the Spanish prime minister from his banks, you will not re-establish trust in the system. After what happened at Bankia, no one in their right minds believes any published account of a government-backed Spanish bank. We have to get real here. Most people involved in financial regulation in the EU are totally oblivious to the constraints of a monetary union.

Third, bank regulation and supervision. This is the area that will interact most with European legislation – an annoying complication. The question to be answered by the EU summit on June 28-29 is whether the eurozone should go it alone, or whether the European Banking Authority – an EU level institution – should fulfil that role.

Fourth, following a commitment to a banking union, the European Council should agree interim measures for Spain with a commitment to applying the new institutional rules when they become active. As a first step, there is probably no alternative to an EFSF loan to the Frob. But this must be accompanied by a commitment to turn the loan into equity. That would require restructuring with the aim of shrinking the Spanish banking sector.

What about the loftier goals of a fiscal and political union? EU leaders should now focus on the banking union first because it is the most important and the most urgent element of a fiscal union. Once this is agreed, they should proceed to discuss how such a banking union can be embedded in a wider fiscal and political union. Such a process would probably take several months, and may not be ready until December. A monetary union without a full banking union is unthinkable in an internal market. But there are different plausible constructs of a wider fiscal union.

EU leaders should not revert to the complacent mood of the last two and a half years. The world is watching them. A seasoned EU observer told me this week that whereas until recently financial markets knew nothing about EU politics, they now know too much.

The European Council should not even think about a "political agreement". They need to agree details. Investors want to know whether there will be burden-sharing; joint equity in Europe's banks; a joint resolution authority; and deposit insurance. They want to know how these ideas will be organised, their legal status and how they interact with existing institutions. They want to know this so they can judge for themselves whether Spain can be saved or not. Spain's situation is simply not sustainable with present market interest rates and institutional arrangements, and nor is Italy's.

I said last week that I was more optimistic than the new market consensus. That optimism is premised on a substantial agreement. If they fudge it, I, too, would conclude that it is time to prepare for the end of the eurozone.

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