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Bank union may be too late for euro

Paul Taylor

INSIDE EUROPE

PARIS Signs are growing that Europe's economic and monetary union may be fragmenting faster than policy makers can repair it.

Euro zone leaders agreed in principle June 29 to establish a joint banking supervisor for the 17-nation common currency area, based on the European Central Bank, although most of the crucial details remain to be worked out. The proposal was a tentative first step toward a European banking union that could eventually feature a joint deposit guarantee and a bank resolution fund to prevent bank runs or collapses from sending shock waves around the Continent.

The leaders agreed that the euro zone's permanent bailout fund, the €500 billion, or $620 billion, European Stability Mechanism, would be able to inject capital directly into banks on strict conditions once the joint supervisor was established.

But the rush to put the first elements of such a system in place by next year may come too late. Deposit flight from Spanish banks has been gaining pace, and it is not clear that a euro zone agreement to lend Madrid as much as €100 billion in rescue funds will reverse the flows if investors fear Spain may need a full sovereign bailout. Many banks are reorganizing, or being forced to reorganize, along national lines, accentuating a deepening north-south divide within the currency bloc.

An invisible financial wall, potentially as dangerous as the Iron Curtain that once divided Eastern and Western Europe, is slowly being erected inside the euro area.

The interest rate gap between North European creditor countries like Germany and the Netherlands, whose borrowing costs are at an all-time low, and southern debtor countries like Spain and Italy, where bond yields have risen nearly to pre-euro levels, threatens to entrench a lasting divergence.

Because government credit ratings and bond yields effectively set a floor for the borrowing costs of banks and businesses in their jurisdiction, the best-managed Spanish or Italian banks or companies have to pay far more for loans, if they can get them, than their worst-managed German or Dutch peers.

The longer that situation goes on, the smaller the chance of a recovery in Southern Europe, and the bigger the wealth gap between north and south will grow. With ever-higher unemployment and poverty levels in southern countries, a political backlash — already fierce in Greece and seething in Spain and Italy — seems inexorable.

The European Central Bank president, Mario Draghi, acknowledged as he cut interest rates last week that the north-south disconnect was making it more difficult to run a single monetary policy. Two huge injections of cheap three-year loans into the euro zone banking system this year, amounting to €1 trillion, bought only a few months' respite. "It is not clear that there are measures that can be effective in a highly fragmented area," Mr. Draghi said.

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Conservative German economists led by Hans-Werner Sinn, head of the Ifo Institute, are warning of dire consequences for Germany from ballooning claims via the E.C.B.'s system for settling payments among national central banks, known as Target2. If a southern country were to default or leave the euro, they contend, Germany would be left with an astronomical bill, far beyond its theoretical limit of a €211 billion liability for euro zone bailout funds.

As long as the European monetary union is permanent and irreversible, such cross-border claims and capital flows within the currency area should not matter any more than money moving between Texas and California does. But even the faintest prospect of a day of reckoning changes that calculus radically.

In such a case, money would flood into German assets considered "safe" and out of securities and deposits in countries seen as at risk of leaving the monetary union. Some pessimists say we are already witnessing the early signs of such a process.

Any event that makes a euro exit by Greece, the most heavily indebted member state, look more likely seems bound to accelerate those flows, despite repeated statements by E.U. leaders that Greece is a unique case.

"If it does occur, a crisis will propagate itself through the Target payments system of the European System of Central Banks," the U.S. economist Peter Garber, now a global strategist with Deutsche Bank, wrote in a prophetic 1999 research paper.

Either member governments would always be willing to let their central banks give unlimited credit to one another, in which case collapse would be impossible, or they might be unwilling to provide boundless credit, "and this will set the parameters for the dynamics of collapse," Mr. Garber wrote.

"The problem is that at the time of a sovereign debt crisis, large portions of a national balance sheet may suddenly flee to the E.C.B.'s books, possibly overwhelming the capacity of a bailout fund to absorb the entire hit," he wrote in 2010, after the start of the Greek crisis, in a report for Deutsche Bank.

European officials tend to roll their eyes at such theories, insisting that the euro is forever, so the issue does not arise. In practice, regulators in some E.U. countries are moving quietly to try to reduce their home banks' exposure to such an eventuality. The E.C.B. itself last week set a limit on the amount of state-backed bank bonds that banks could use as collateral in its lending operations.

Whether a euro zone banking supervisor would be able to overrule such curbs is one of the many uncertainties left by the deal reached at the summit meeting. In any case, common supervision without joint deposit insurance may be insufficient to reverse capital flight.

The German chancellor, Angela Merkel, eager to shield her grumpy taxpayers, has so far rejected any sharing of liability for guaranteeing bank deposits or winding up failed banks.

Veteran E.U. watchers say political determination to make the common currency irreversible will drive euro zone leaders to give birth to a full banking union, and the decision to create a joint supervisor effectively got them pregnant.

But for now, Europe's financial disintegration seems to be moving faster than the forces of financial integration.

Paul Taylor is a Reuters correspondent.

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