Recession and Banks – Fiat Euro! 52/2013

The Eurocrisis has become boring in 2013, did it not?

Do you remember the year 2012? In the spring, Greece bankrupted, subsequently it had parliament elections twice and the whole Europe was afraid of possible victory of SYRIZA communists or Golden Dawn neo-Nazis. Following, we were saving Spanish banks and Cyprus and Slovenia were also on the brink of bankruptcy. But in the summer of 2012, the ECB prepared the OMT program of bonds purchasing and the crisis has become quite boring.

However, in March the shock of Cyprian crisis took its place. Even though many had been speaking about probable solution, nobody took it seriously until it was too late. The Cyprian finance sector full of check and balances could not handle the losses following the Greek bankruptcy and after the ECB interrupted the liquidity flow (the ELA program), government was forced to bailout banks with their own resources.

Though, the bailout was different this time. Financial losses were not a burden only for taxpayers' shoulders, but also for creditors of Cypriot banks and also larger depositors had to participate. ATMs stopped working, trans-border flows of money froze and the euro currency unofficially split in two: the normal euro and the Cypriot euro.

Even though Europe got over this problem, the continent has been changed. National budgets stopped being interesting. The Fiscal Compact entered into force on January 1. This treaty supposed to force politicians to behave more responsibly and not to think only in a time horizon of next elections, but in a couple of months it became obvious, that countries will break also this treaty regularly. Budget deficits in the most of the countries are still in the red and public debt is rising. The EU is trapped somewhere between a recession and stagnation and everybody is looking up to German industry, which is like an one-eyed among blind as it keeps European economy above water. Despite of this, ratings of European bonds have decreased in 2013.

In 2013 the connection between public budgets and fractional-reserve central banking system has been revealed. Bigger and bigger share of government bonds ends in portfolios of local banks or in the ECB, which accepts them as collateral. Thus, budget deficits and growing debt will continue to be a reality until the ECB will not be able to keep the financial system operational.

The recent situation seems to be clear also to European representatives, therefore in the year 2013 preparations of upcoming formation of a banking union have continued. After the creation of the first pillar ended, the preparation of the second pillar took its place. While the first pillar is based on common bank supervision, the second pillar is represented by a common resolution fund and common rules on failed bank handling. In December, the final proposal has been concluded and now we are waiting for a final decision. However, three major issues remain unsolved.

Firstly, it is the question of government bond risk weight. A big stress-test of the European banking system is supposed to happen in 2014. Rumor says it will be a quite strict test, and if it reveals to be so, it will not be able to evaluate sovereign bonds owned by banks as risk-free. This has been happening until now, but after the Greek bankruptcy, nobody believes in risk-free sovereign bonds anymore and the stress-test would be pointless. On the other hand, if the regulator does not evaluate them as risk-free, it could lead to a destabilization of the recently calm bond markets, especially in the most problematic countries like Spain and Italy.

The second question is related to the first one – what to do with banks, which will be identified as undercapitalized? Or better to say – who is going to pay the recapitalization? Following the Spanish success, relevant Members will be probably tempted to ask the rest of us for help…

The last question is the most important one. When is all this going to end? The eurozone debt is equal to 90% of annual GDP and it is still growing. Even though optimists expect the annual GDP growth of 1-2%, this would not reverse the tendency of debt growth, neither stop it, but only slow it down. The demographic transition continues as well, and several countries were able to slightly improve their situation only thanks to tax increases, temporary policies, and putting aside necessary capital expenses, what are measures, which cannot be effective forever. Besides, economy of the whole region is increasingly burdened with non-sensual regulations, goals, programs, and policies (my favorite one is the regulation of toilet tank volume).

This stagnation can last months, maybe even years. The year 2014 might be the same as the previous one – full of scrambles on banking union rules and on question, what should be paid from the European budget and what from the national ones. News might be still full of 0.2% annual GDP growth and budget deficits, which will be finally lower than 3%, but just not this year. Or maybe some bank will fall and initiate a snowballing, which will change the whole eurozone.

I do not know the future of Europe. But what I know is, that personal happiness is not dependent on economic situation only, therefore let I and the whole INESS wish you all good in the year 2014.

Martin Vlachynský 27/12/2013
Translated by Roman Ujbányai 6/1/2014