6.5.2 HANDOUT

THE NEW YORK TIMES

Euro vs. Invasion of the Zombie Banks

By Tyler Cowen
April16, 2011

Is a euro held in an Irish bank in Dublin, or in a Portuguese bank in Lisbon, as sound and secure as a euro in a German bank in Berlin? That apparently simple question holds the key to understanding why the euro zone may splinter and bring a new financial crisis.

In Ireland, there has been a "silent bank run" on financial institutions for much of the last year. In February, for instance, Irish private sector deposits dropped at an annual rate of 9.8 percent. That's largely because some depositors doubt the commitment of the Irish government to the euro. They fear that they will wake up one morning to frozen bank accounts, followed by the conversion of their euro deposits into a lesser-valued new Irish currency. Pre-emptively, the depositors send their money outside Ireland, where it still represents safe euros or perhaps sterling, accessible by bank transfers and A.T.M. cards.

This flight of capital reflects a centuries-old economic principle known as Gresham's Law, sometimes expressed casually as "bad money drives out good money." In this context, if two assets — euros inside and outside Ireland — are not equal in value in the eyes of the marketplace, sooner or later the legally fixed price parity will fall apart.

If enough depositors fear frozen accounts, the banks will be emptied out, and they also will require additional government bailouts, on top of the bailouts for the bad real estate loans. The banks come to resemble empty shells, conduits for public aid but shrinking and unprofitable as businesses — and, to a large extent, that is already the case in Ireland. Portugal is moving in this same direction, toward being a land inhabited by zombie banks.

It's the zombie banks that doom the current European bailout plans. On any single day, or even for a year or two, an economy can survive with zombie banks, but over time functional domestic banks are needed to allocate credit.

As it stands, European Union emergency facilities are marking time by lending more money to the fiscally troubled nations in the currency union. But these loans do not reverse the logic of Gresham's Law. For instance on its longer-term notes, Portugal is already paying yields in the range of 8 to 10 percent, and yet the Portuguese economy is shrinking. The Portuguese are digging deeper into debt, and confidence in the banking system and the fortitude of the Portuguese government is dwindling.

At this late point there's probably no way to escape the mess by cutting government spending in the troubled countries. This year Ireland has a budget deficit of more than 30 percent of G.D.P., whereas in Portugal it is 8.6 percent. Even the best economic reforms can take many years to pay off with concrete results, and with zombie banks a turnaround is even harder and perhaps impossible. Most important, immense government spending cuts are often unpopular and so investors wonder whether an ailing country's political system will see it through. The confidence problem remains.

A second option is a giant write-down of current debts, combined with national bailouts to the creditor banks. For instance, taking this approach, the Merkel government in Germany might acknowledge the status quo isn't working and speedily recapitalize the German banking system, while letting Ireland, Portugal and others off the hook for some of the money. It's easy to see why this policy isn't popular in Germany, and indeed, for years German politicians promised to their voters that such an outcome would never happen.

Another dramatic way out is for Ireland, Portugal or some other country to break from the euro and create a new and lesser-valued domestic currency, while also defaulting on some debts. Any such breakaway country would incur the wrath of the European Union and also might have trouble borrowing on international capital markets. There will be no easy exit path from the euro. Still, taking this approach, a resolution of some kind would be in place, no subsequent devaluation of bank deposits would be expected and the new lower-valued currency would improve growth. Also, the troubled countries already cannot borrow at workable interest rates.

There would be an associated problem, however: if any one euro zone country were to start exiting the euro, there would be bank runs on the other fiscally ailing countries. The richer European Union nations know this, and so they are toiling to keep everyone on board. But that conciliatory approach creates a new set of problems because any nation with an exit strategy suddenly has enormous leverage. Ireland or Portugal need only imply that without more aid it will be forced to leave the euro zone and bring down the proverbial house of cards. In both countries, aid agreements already are seen as a "work in progress," and it's not clear that the subsequent renegotiations have any end in sight, because an ailing country can always ask for a better deal the following year.

ALL of the ways forward look ugly but, sooner or later, some variation of at least one of them is likely. Unfortunately, they all share the property of lowering European bank values, whipsawing currencies, hurting business confidence and possibly ending the European Union as an effective institution for collective decisions. That's all because the euro, in retrospect, appears to have been a misguided attempt to equalize the values for some very unequal assets, namely the bank deposits of strong countries and those of weak countries.

To track the risk of a new financial crisis, focus on whether the troubled euro zone economies are seeing bank runs and capital flight. Then comes a fundamental question about human nature, namely: Why do we so often postpone admitting that short-run patches simply aren't going to work?

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Source:

Cowen, Tyler (2011, April 16). *Euro vs. Invasion of the Zombie Banks*. Retrieved August 2012 from *The New York Times*: http://www.nytimes.com/2011/04/17/business/17view.html

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