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Banks and Sovereigns. Fatally United, in Good and Bad Times

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Official optimism is now pervasive, in Brussels as in other European capitals. For sure, the euro area's situation is improving, tensions have eased, and the outlook has turned rosier. One can even harbor hope that the International Monetary Fund's update of the World Economic Outlook (due on January 21) might, for the first time since the start of the crisis, see an upward revision to the eurozone's growth projections. The resulting greater confidence is auspicious, as any recovery needs positive expectations as an underpinning. The progress achieved should thus not be belittled; it is impolitic to remove the punch bowl before the party even begins. At the same time, it is not helpful – Indeed it is harmful – to indulge in premature optimism that would weaken any reform drive, already so very tenuous in Italy.

Among the drivers of the new-found optimism are the falls in government debt yields, observed throughout the periphery (with highly successful bond auctions in Ireland, Portugal and Spain), and the rally in bank shares, similarly widespread. Both trends have gathered pace since the beginning of the year and, in and of themselves, are clearly positive. The narrowing of the BTP-Bund spread to close to 200 basis points – its lowest level since 2011 – generates much-needed savings in the Italian Treasury's debt servicing bill. Though still infinitesimal compared to the mountain of debt, every euro saved is valuable in the current circumstances. The strengthening of bank balance sheets, for its part, has long been needed and called for by all supervisory authorities, with the European Central Bank in the lead.

But it is the symbiotic nexus between the two phenomena that is of concern. It stands as clear evidence that the pernicious link between banks and sovereigns (the "doom loop"), far from being broken, has actually intensified, despite repeated commitments of multiple European summits. Banks have continued to stuff their portfolios with government paper, and relentlessly so. Indeed, that is where the ECB's injections of exceptional liquidity (LTROs) have ended up: in Italy alone, the banks' holdings of government bonds doubled from €200 billion at end-2011 to €403 billion in the latest Bank of Italy survey (November 2013). At the same time, loans to businesses and households have been cut back, and there is no sign of recovery – indeed, the credit crunch might even be intensifying. In the circumstances, any new liquidity operation by the ECB, were it to occur, is likely to be targeted to financing firms and households, in a European variant of the Bank of England's Funding for Lending scheme.

So while the situation for the real economy has remained grim, it has offered the banks an opportunity they could hardly turn down. The rise in non-performing loans prescribed prudence in lending, the ECB's injections of liquidity provided scope for profitable arbitrage, and the rally in sovereign bonds strengthened banks' balance sheets. The STOXX Europe bank index rose by almost 35% from its lows of last summer, with a quarter of the improvement concentrated in the first two weeks of 2014. This trend was even more pronounced in Italy: the shares comprising the FTSE Italia Bank index soared by 60% in the past six months. In 2013 as a whole, the market capitalization of the Italian banking sector rose by €20 billion, reaching a total of €82 billion.

The fact that the link between sovereigns and banks has now taken on a virtuous veneer does not however annul its destabilizing potential. It is the mirror-image of a relationship that remains basically toxic and potentially explosive, ready to detonate as soon as the current government bond rally were to reverse. While the marriage vow of two young newlyweds – united "for better for worse, for richer for poorer, in sickness and in health" – expresses commendable mutual support through good and bad times, the relationship that continues to tie European governments and their banks is more in the nature of an ominous fatal attraction.

It is since June 2012 that European leaders have repeatedly affirmed the imperative need "to break the vicious circle between banks and sovereigns." Indeed, it is this very objective that initially inspired the banking union project, but that the political agreement reached at the last EU summit left largely unfulfilled. The remaining hope for some remedy comes from the ongoing negotiations between the Council, the Commission and the European Parliament on the final legislative text, and that it give rise to a banking union that is truly more "genuine" (to use the term of the Commission's initial blueprint of November 2012, and taken up also by the ECB). Failing which, the remedy will most likely come in due course from the pressure of events, as so often happens in Europe. Needless to say that this is not the most desirable of ways.

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