EUROPEAN ECONOMICS UPDATE
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CAPITAL ECONOMICS

Could a banking crisis add to Greek woes?

- **Greek bond yields have continued to surge as doubts remain over whether the euro-zone will actually be able to provide financial support to Greece. But a growing worry is that the ongoing crisis prompts Greek households and firms to remove their money from domestic banks and deposit it elsewhere, causing a domestic banking crisis. Needless to say, this would only add to the Government's woes.**
- Data recently published by the Bank of Greece show that Greek banks' domestic non-government deposits fell by nearly €9bn (or about 4%) in the first two months of the year. Reports suggest that a key factor behind the fall may have been wealthy depositors transferring assets abroad in response to the uncertainty created by the ongoing Greek fiscal crisis.
- **It is certainly too soon to conclude that these recent developments are inevitably the start of a worrying trend.** Deposits are still very high by historical standards and monthly declines are not uncommon. (See Chart 1.) What's more, even if a few wealthy individuals have moved assets out of Greece, this does not mean that the average man on the street will follow suit. Note too that deposits could be quickly repatriated as and when prospects improve.
- **But concerns about the health of the banking system remain.** Recently, requests have been made by four banks for access to the remaining funds from the Government's bank support package that was set up in 2008. **Meanwhile, there is no sign that banks are weaning themselves off central bank funds.** In February, Bank of Greece lending to banks rose to €61.1bn (or 14% of total bank assets), a record high.
- Accordingly, it is by no means impossible that increasing numbers of depositors withdraw funds from Greek banks and that this escalates into a full-blown run on the banking system. This would leave the Government with no choice but to step in and provide support.
- **Were this to happen, the Government might be able to avoid pouring large amounts of money into the banking sector.** It could provide a blanket guarantee on deposits, as Ireland did for six domestic banks in 2008. Such a contingent guarantee would have no immediate impact on the public finances. But given the dire state of the public finances, it may not provide depositors with much reassurance.
- **What's more, the possibility of a costly intervention in the banking sector could lead to a further surge in government bond yields.** After all, banks' deposits amount to over 110% of GDP. Were the Government forced to pick up a hefty tab, its debt to GDP ratio could potentially reach astronomic levels, particularly if the banking crisis prompted the recession to deepen further.
- With many banks in the remainder of the euro-zone having heavy exposures to Greece (see Chart 2), a banking crisis would undoubtedly have significant knock-on effects on the remainder of the region too. Accordingly, other governments in the region could be dragged into the crisis and might be forced to provide further financial assistance to Greece.
- **In all, then, while we are by no means arguing that Greece is on the cusp of a new banking crisis, the risks are growing. With the medium-term outlook for the Greek economy still highly uncertain and pretty grim, the crisis is far from being resolved.**

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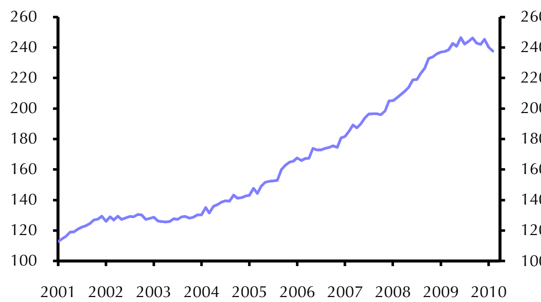
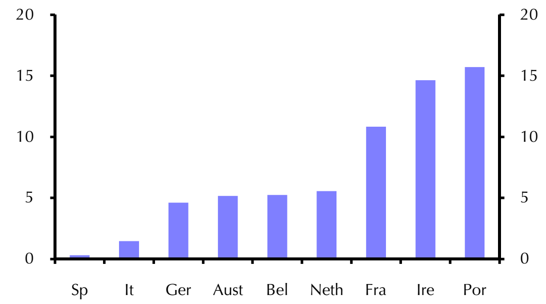
Chart 1: Greek Domestic Bank Deposits (€bn)



Source – Bank of Greece

Chart 2: Foreign Banks' Exposure to Greece (% of GDP)



Source – Thomson Datastream, BIS