

Banking Union: Ireland vs. Nevada, an illustration of the importance of an integrated banking system

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Ireland and Nevada share several important characteristics, as reflected in table below. They have similar populations (2.7 to 4.5 million) and similar levels of GDP (\$120-200 billion). The most important similarity is, however, that they both experienced an exceptionally strong housing boom – and bust. The result of the same boom-bust cycle for the real economy can be seen in the unemployment rate, which followed an almost identical pattern as shown in Figure 1.

Table 1. Ireland and Nevada compared

	Nevada	Ireland
Population (in million, 2011)	2.7	4.5
GDP (in \$ billion, 2011)	120	200
Average net migration rate since ‘bust’ (2008) as percent of total population	0.32%	0.09%
Unemployment rate (2011)	13.5%	14.4%

Sources: Eurostat and BEA, US Census Bureau.

However, there is one fundamental difference between the two: when the boom turned to bust, Nevada did not experience any local financial crisis and the state government did not have to be bailed out.

The key difference between Nevada and Ireland is that banking problems in the US are taken care of at the federal level (the US is a banking union), whereas in the euro area, responsibility for banking losses remains national.

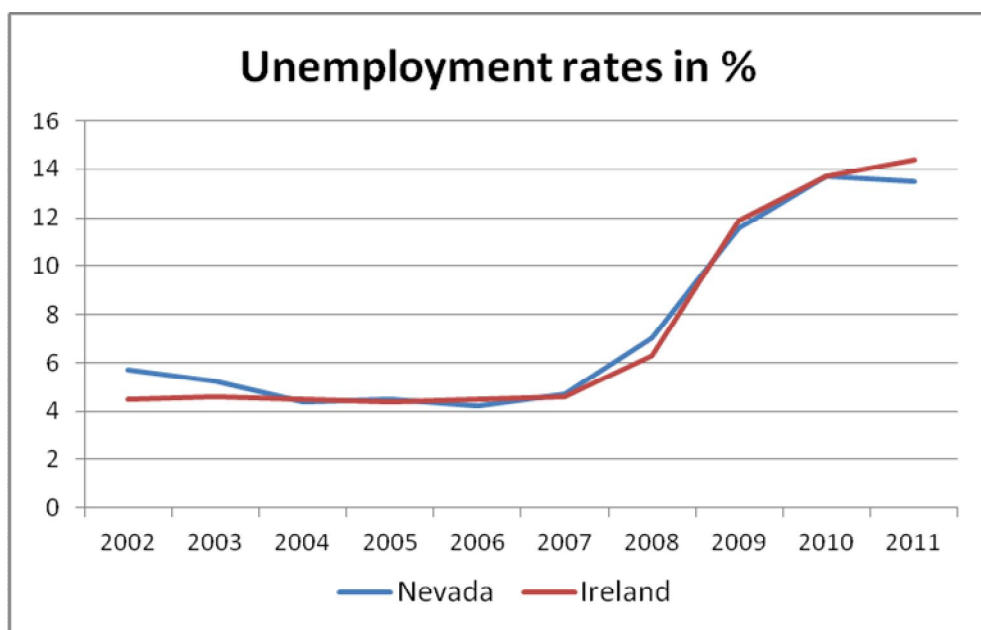
Local banks in Nevada experienced huge losses (just like in Ireland) and many of them became insolvent, but this did not lead to any disruption of the local banking system as these banks were seized by the Federal Deposit Insurance Corporation (FDIC), which covered the losses and transferred the operations to other, stronger banks. In 2008-09, the FDIC thus closed 11 banks headquartered in the state, with assets of over \$40 billion, or about 30% of state GDP. The losses for the FDIC in these rescue/restructuring operations amounted to about \$4 billion.

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Figure 1. The boom/bust cycle in unemployment: Ireland vs. Nevada



Sources: Eurostat and US Bureau of Labour Statistics (BLS).

Other losses were borne at the federal level when residents of Nevada defaulted in large numbers on their home mortgages. The two federal institutions that re-finance mortgages have lost between them about \$8 billion since 2008.

The federal institutions of the US banking union thus provided Nevada with a 'shock' absorber of about 10% of GDP, not in the form of loans, but in the form of an (*ex-post*) transfer because losses of this magnitude were borne at the federal level. (Against this transfer one would of course have to set the insurance premia paid by banks in Nevada prior to the bust. But they are likely to have been an order of magnitude smaller.)

Of course, a lot of the banking business in Nevada was (and still is) conducted by 'foreign' banks, i.e. by out-of-state banks, which just took the losses from their Nevada operations on their books and could set them against profits made elsewhere.¹ This is another way in which an integrated banking market can provide insurance against local financial shocks. One might call this a 'private' banking union (or a truly integrated banking market). It is impossible to estimate the size of this additional shock absorber, but the losses absorbed by out-of-state banks might very well have been as large again as the ones borne by the federal institutions.

¹ The experience of Washington Mutual (WaMu) constitutes a somewhat special case. The biggest bank to have failed in US history, a mortgage specialist, WaMu had its headquarters in Nevada (although the name suggests otherwise) and some small operations there. However, its failure did not lead to any local losses as Washington Mutual was seized by the FDIC and its banking operations were sold for a very low sum to another large US bank (JP Morgan Chase) – but without any loss for the FDIC. Such an 'overnight' operation would have been impossible in Europe where no euro area wide institution would have carried through a cross border takeover of this size. Moreover, WaMu received about \$80 billion in low-cost financing from the US Federal Home Loan Bank. Irish banks received massive amounts of low-cost emergency liquidity assistance from the European Central Bank, but the Central Bank of Ireland had to guarantee these loans, which was not the case for any bank in Nevada.

In Europe, this 'private' banking union also does not exist. Only the Baltic countries, whose banks are held to a large extent in foreign hands, benefited from a similar protection against losses provided by the Scandinavian headquarters of their local banks. By contrast, most of the real estate lending in Ireland (and Spain) had been extended by local banks so that most of the losses remained local (without any federal institution to provide insurance).

The comparison between Nevada and Ireland thus illustrates very well the shock-absorbing capacity of an integrated banking system and a banking union. For Nevada, the banking union resulted in a transfer worth over 10%, possibly up to 20% of its GDP. Nevada is admittedly an extreme example of the housing boom and bust. Nevertheless, this example illustrates the general point that a banking union can provide more shock-absorbing capacity than could ever be provided by any 'fiscal capacity' that is currently being contemplated for the euro area.