The Telegraph

The Deutsche Bank crisis could take Angela Merkel down – and the Euro

MATTHEW LYNN

26 SEPTEMBER 2016 • 4:43PM

Deutsche Bank shares have tumbled as the crisis around the lender has grown

There are some words that make such an unlikely pairing that we find it hard to put them together. Italy and efficiency, for example. Or Bake Off and Channel 4. And 'Germany' and 'banking crisis' is another one. Our image of German banks, and the German economy, as completely rock solid is so strong that it takes a lot to persuade us they might be in trouble.

And yet it has become increasingly hard to ignore the slow-motion car crash that is Deutsche Bank, or to avoid the conclusion that something very nasty is developing at what was once seen as Europe's strongest financial institution. Its shares have been in free-fall for a year, touching a new low of 10.7 euros on Monday, down from 27 euros a year ago. Over the weekend, the German Chancellor Angela Merkel waded into the mess, briefing that there could be no government bail-out of the bank.

But hold on. Surely that is an extra-ordinary decision? If the German government does not stand behind the bank, then inevitably all its counter-parties – the other banks and institutions it deals with – are going to start feeling very nervous about trading with it. As we know from 2008, once confidence starts to evaporate, a bank is in big, big trouble. In fact, if Deutsche does go down, it is looking increasingly likely that it will take Merkel with it – and quite possibly the euro as well.

Deutsche Bank has been wobbly for a year now. Back in July, it announced a slump in profits and revenues. Back in February, the Bank's co-CEO John Cryan put out a statement re-assuring staff and investors that the institution was 'rock solid' amid an earlier slide in the share price. Anyone whose memory stretches back a whole eight years will know that is the kind of thing bank CEOs say about three minutes before the whole thing goes pop.

Ever since then, the news has gone from bad to worse. Deutsche has struggled to cuts costs and restore profitability, legal challenges have mounted, and then earlier this month the US Justice Department hit the bank with a $14 billion fine over sales of mortgage securities. In its pomp, Deutsche could have written out a cheque with a nonchalant shrug. Right now, no one is sure where it can get the money from.

The damage can be seen in its share price. Last October, the shares were at 27 euros. Back in 2007, they were over 100 euros, and even in the spring of 2009, when banks were crashing all across the world, they were still trading at close on 17 euros. For most of this year they have been sliding fast. On Monday, they crashed again, down another 6pc. Its bonds have slumped as well, while the cost of credit default swaps – essentially a way of hedging against a collapse – have jumped. It all has a very 2008 feel to it.

To make matters worse, the German government looks to have abandoned it to its grisly fate. An article in Focus magazine quoted senior officials as saying the German Chancellor Angela Merkel was adamant that bank would not be rescued. There could be no state assistance if the bank was unable to raise the capital it needs to stay afloat, and she was not planning to intervene to get the American fine reduced. If it was in trouble, it was on its own.

There is, of course, something to be said for a hard-line position. It is hard to be sure the massive bank bail-outs of 2008 were such a great idea. Perhaps we would be better off now if a few had been allowed to fail. That said, Merkel is surely playing with fire. In the markets, investors, along with other financial institutions, have rightly or wrongly come to assume that major banks are, as the saying has it, 'too big to fail'. You didn't really have to worry about how solid they were, because if the crunch came the state would always ride to the rescue.

In Germany, that appears not to be the case – certainly for Deutsche, and possibly for its next biggest player, Commerzbank, which is hardly looking much healthier. Would you want to trade a few billion with Deutsche right now, and would you feel sure you'd get paid next month? Nope, thought not. The risk is that confidence evaporates – and as we know, once that is gone a bank is not long for this world.

True, Merkel's position is understandable. The politics of a Deutsche rescue are terrible. Germany, with is Chancellor taking the lead, has set itself up as the guardian of financial responsibility within the euro-zone. Two years ago, it casually let the Greek bank system go to the wall, allowing the cash machines to be closed down as a way of whipping the rebellious Syriza government back into line. This year, there has been an unfolding Italian crisis, as bad debts mount, and yet Germany has insisted on enforcing euro-zone rules that say depositors – that is, ordinary people – have to shoulder some of the losses when a bank is in trouble.

Italy's banking crisis has set a precedent for Germany's response to Deutsche's woes

For Germany to then turn around and say, actually we are bailing out our own bank, while letting everyone else’s fail, looks, to put it mildly, just a little inconsistent. Heck, a few people might even start to wonder if there was one rule for Germany, and another one for the rest. In truth, it would become impossible to maintain a hard-line in Italy, and probably in Greece as well.

And yet, if Deutsche Bank went down, and the German Government didn’t step in with a rescue, that would be a huge blow to Europe’s largest economy – and the global financial system. No one really knows where the losses would end up, or what the knock-on impact would be. It would almost certainly land a fatal blow to the Italian banking system, and the French and Spanish banks would be next. Even worse, the euro-zone economy, with France and Italy already back at zero growth, and still struggling with the impact of Brexit, is hardly in any shape to withstand a shock of that magnitude.

A rock and a hard place are hardly adequate to describe the options Merkel may soon find herself facing. The politics of a rescue are terrible, but the economics of a collapse are even worse. By ruling out a rescue, she may well have solved the immediate political problem. Yet when the crisis gets worse, as it may do at any moment, it is impossible to believe she will stick to that line. A bailout of some sort will be cobbled together – even if the damage to Merkel’s already fraying reputation for competence will be catastrophic.

In fact, Merkel is playing a very dangerous game with Deutsche – and one that could easily go badly wrong. If her refusal to sanction a bail-out is responsible for a Deutsche collapse that could easily end her Chancellorship. But if she rescues it, the euro might start to unravel. It is hardly surprising that the markets are watching the relentless decline in its share price with mounting horror.