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Financial Crisis: High Cost of "non Europe"

We are currently witnessing the first truly European financial crisis. However, national governments continue to insist that "their" banks are safe and that they cannot be asked to pay up for problems in other countries. In a nutshell, this is the conundrum facing Europe today.

Until recently the refrain on this side of the Atlantic had been that the financial crisis started with reckless real estate lending in the USA and that there was no reason to be concerned about the stability of the European financial system. However, this illusion has now been shattered. The European banking sector is now clearly in difficulties. The underlying reason for the problems in Europe is different from that in the USA. In Europe real estate lending has remained limited in most countries (Ireland and Spain are the main exceptions), but the large, internationally active banking groups in Europe have built up unprecedented levels of leverage. They are now subject to the global de-leveraging pressure. Hence the continuing pressure on those banks in Europe which do not have adequate capital to withstand even temporary funding problems.

For highly leveraged banks which rely on short-term financing a funding crisis can quickly lead to bankruptcy. Northern Rock should have been a warning; but the temptation to think that "it cannot happen here" proved too strong. In a process of de-leveraging the weakest will fall first, but their downfall affects confidence in the entire banking system, precipitating further problems somewhere else. The interbank market has emerged as the main vehicle for contagion because it is close to seizing up. The crisis is thus no longer one of individual banks, but a systemic one of the entire banking system.

During a systemic banking/financial crisis, fiscal policy becomes the decisive instrument. This is why the Federal Reserve has been marginalised in the USA and has lost its independence. The key question for Europe is whether the euro area is, or could soon be, in a similar situation. For the ECB the key operational issue is thus whether it should focus on reducing the stress on the banking system instead of worrying about inflation.

The combination of high commodity prices and acute financial market stress has for some time now faced central bankers on both sides of the Atlantic with the choice between focussing on avoiding the mistakes of the 1930s (support the banking system) and those of the 1970/80s (fight inflation).

The US government has made up its mind: given the danger of a wholesale breakdown of the US financial system it seems more important to avoid the risk of a long and deep recession than that of a decade of higher inflation. In Europe policymakers do not seem able to make up their minds. For the ECB, until recently the trade-off seemed different: the danger of an engrained rise in inflation is higher in Europe because of significant pockets of backwards wage indexation and, until recently, the stress on the financial system seemed less acute.

In the USA a systemic approach to prevent the crises from spreading was adopted only when the stress level in the financial sector reached unprecedented levels. National policymakers in Europe have so far failed to see that they are in a similar situation.

What could be done to prevent a (systemic) European-wide banking crisis?

Monetary policy will not be effective. When capital becomes the key constraint limiting bank lending there is little central banks can achieve in the short run. Lower policy rates should, but not always will, create an upward sloping yield curve and thus increase bank profits, thus restoring a proper capital base over time. But lower interest rates have little impact on banks' capital in the very short run as it takes time for a flow of profits to affect the stock of capital in the banking system. Lower policy rates might also serve to restore confidence, and thus alleviate the pressure for deleveraging, but this effect is uncertain.

Central banks may also try to increase liquidity in the system, but if this liquidity is just hoarded by the public and the banks this will not solve the fundamental problem. Liquidity hoarding, of course, is linked to a lack of confidence in the banking system, which in turn might be due to a lack of capital, but as the experience in the euro area shows, even an (at least apparently) well capitalised banking sector can seize up when banks no longer trust one another.

If the key problem is one of insufficient capital in the banking system (which cannot be restored instantaneously by monetary policy), the proper solution can only come from the treasury, namely a massive public sector infusion of capital. A group of European economists has recently launched a public appeal to Europe's leaders to finance jointly a European fund of around € 300 billion to shore up the capital of the large international banking groups (See Open Letter to European Leaders on the Banking Crisis: A Call to Action, p. 267 of this issue). Other economists have developed different proposals, but the general thrust of the advice coming from the academic world is quite clear: the turmoil on European financial markets will continue as long as political leaders fail to understand the systemic nature of the problem they must confront. Experience has amply shown that uncoordinated rescue operations, far from restoring confidence, further fuel fears by savers and investors and move us closer towards a fully fledged banking crisis in Europe. Behind the banking crisis, the likelihood of a serious economic downturn is also looming larger and larger.

If Finance Ministers refuse to consider a joint European approach to this crisis the only remaining alternative to a systemic banking crisis is a quick balkanisation of the EU banking system. This is already happening as uncoordinated national rescue operations typically concentrate on saving "our banks", as the case of Fortis showed. The recent decision of the Irish government to extend a guarantee only to Irish banks goes in the same direction. Moreover, all large European banks have subsidiaries – separate legal entities with separate balance sheets – in each country in which they operate. At the same time, asset and liability management is (or at least used to be until recently) centralised, including cash and liquidity reserves, which in times of stress will be ordered back to the parent, with subsidiaries receiving in exchange paper which would be worthless in case of insolvency. This is why host country regulators will from now on insist that each subsidiary be independent enough (and also have enough liquidity) to survive the insolvency of its parent. The European banking market is thus falling apart. The survivors will be the large national champions, which are either directly state owned or depend on the government for guarantees. We might still have a common currency, but there will no longer be a euro area wide integrated banking and financial market.

The cost of "non Europe" can be very high indeed.

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