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The cost of 'non-Europe'?

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Daniel Gros and Stefano Micossi*

Turmoil is spreading across European financial markets as political leaders fail to understand the systemic nature of the problem they face. Uncoordinated rescue operations, far from restoring confidence, are further fuelling fears among savers and investors, and pushing Europe toward a full-fledged banking crisis. Behind the banking crisis, the likelihood of a serious economic downturn looms ever larger.

If this weekend's meeting of leaders hosted by French President Nicolas Sarkozy was a harbinger of what we can expect from the deliberations of European authorities in the coming weeks, the situation can only get worse. Nothing was decided at this summit of the self-styled European G-4, as the leaders of the large EU member countries insisted on going it alone. The reason why this approach can only make the crisis worse is simple: A European banking crisis cannot be stopped by uncoordinated national measures which appear not only inadequate, but contradictory.

Two euro-area countries—Greece and Germany—have now introduced a blanket guarantee of deposits. Their move puts pressure on other capitals to follow suit without dispelling fears among foreign depositors of Greek and German banks, who wonder whether the guarantee will also be valid for them. They had been preceded last week by Ireland, which to Britain's dismay had provided its six largest banks with full protection not only of its depositors but also its creditors.

Making matters worse, the initial rescue packages for Fortis and Hypo Real Estate have collapsed, showing that these initially widely applauded deals were not robust.

In the case of Fortis, a public injection of capital of around Œ10 billion by three governments (the Netherlands, Belgium and Luxembourg) failed to dispel investors' fears since the bank's funding difficulties were not resolved. Behind the scenes the National Central Bank of Belgium had given the ailing group an emergency credit of over Œ40 billion, but even this was not enough. During this past weekend the Dutch authorities simply nationalized "their" piece of the bank by buying out the remaining 51% of Fortis Netherlands, which had remained originally in private hands.

But this left Belgium and Luxembourg to collect the debris. As even the remainder of Fortis proved to be too large for the Belgian government, which is already highly indebted, French bank BNP Paribas had to be called to the rescue. However, this only ratchets up the problem as BNP Paribas now has probably increased its leverage ratio, which was already above 30 before last weekend's deal. BNP is now becoming too large to be saved by France alone.

As for Germany's giant mortgage bank Hypo Real Estate, the original rescue deal had to be renegotiated last weekend as well. The German banks involved temporarily withdrew their support as it became clear that potential losses were much larger than originally revealed. The German government has forced them back into the deal, but at this point it is not clear what the losses will be and who will bear them.

* Daniel Gros is Director of CEPS; Stefano Micossi is Director of Assonime, a business association and think-tank in Rome. This Commentary is co-published in today's Wall Street Journal Europe.

In Italy, a capital increase decided over the past weekend has apparently not managed to reassure investors in Unicredit. This large and well-managed universal bank has large assets in Germany and Eastern Europe, but its shares continue to plunge in the stock market.

The proximate cause for the problems is different in each case, but the general pattern is quite clear: Any bank that does not have enough liquidity to survive a withdrawal of funds is at risk.

The attention of our confused European leaders has also turned to other matters that may soothe disgruntled taxpayers but cannot help restore orderly market conditions—such as limitations on executive pay and risk-taking by financial intermediaries and mark-to-market accounting rules. The suspension of these accounting principles at this time could in fact scare markets even more, as it would increase doubts of the real value of the assets on banks' balance sheets. They also talk of relaxing the budget-deficit limits of the EU's Growth and Stability Pact: another sign of a purely national approach to a crisis that well surpasses the national dimension.

What European leaders should be discussing instead is clear.

First, there is a need for a common European scheme to shore up capital of distressed banks. The wholesale money market is no longer working as banks have lost confidence in each other, while raising funds with longer maturities is becoming increasingly difficult. A European scheme entailing large-scale and simultaneous injection of capital into large cross-border banks thus is the indispensable element to restore confidence. We estimate that an injection of around Œ300 billion should be sufficient to shore up the large European banks with the weakest capital bases.

In the case of Fortis, a much smaller injection of capital was not sufficient. But Fortis could not be saved this way because there are too many other banks in Europe which tend to hoard their funds because they also have too little capital. If all banks receive a capital injection, they should be willing to participate again in the interbank-loan market.

We should stress that the funds for this scheme would initially be raised from capital markets and not drawn from national budgets. However, national governments would have to provide for their redemption in case of losses due to a banking failure. In this case, the attendant burden should fall on national governments according to the source of the loss. In other words, German taxpayers would be asked to bear much of the cost of rescuing a German bank but not as much of the burden for a French bank.

Second, a coordinated injection of capital by national governments requires a clear center of joint responsibility for the supervision and liquidity support of cross-border European banks. National authorities do not currently have an incentive to provide their European partners with full information on the real situation of their banks. For any Europe-wide support scheme to succeed, this information must be centralized with the European Central Bank, which would be able to take up the task fairly rapidly.

Let's hope that national economics and finance ministers will be able to address the real problem at their forthcoming meeting, and come up with adequate solutions to avoid a full-scale banking crisis in Europe.

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