Financial stability has yet to return to international markets

By Alan Ahearne
Thursday October 23 2008

Policymakers may have won the latest battle, but they are still fighting the war to restore stability to financial markets. Recently announced rescue packages on both sides of the Atlantic have finally resulted in some easing in credit market conditions.

Measures of stress in global money markets have shown some improvement in the past week. In the United States, the gap between interest rates on three-month interbank loans and loans to the US government narrowed to 2.7 percentage points yesterday from a historical high of 4.6 percentage points on October 10.

Analysts consider a gap of more than one percentage point as an indicator of crisis. Risk and liquidity premiums have also declined a bit in Europe, especially in the UK.

Government guarantees of wholesale lending have played an important role in improving market confidence, as have interest rate cuts, talks of fiscal stimulus plans in the US, and injections of massive amounts of liquidity by central banks.

But, arguably, the key component of recent bailout plans has been the recapitalisation of banking systems.

Capital injections

This week saw Austria and Sweden join the list of countries planning capital injections into large banks -- a list that already includes Belgium, Britain, France, Germany, Italy, the Netherlands, and the US. Greater levels of capital will leave banks less vulnerable to changes in market conditions. That should encourage banks to trust each other again, thereby unfreezing interbank lending.

Two countries conspicuous by their absence from this list are Ireland and Spain. It is true that banks in both countries had little direct exposure to the US subprime mortgage market.

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They hold few toxic subprime assets that have inflicted huge losses and eroded capital in banks in other countries. But Irish and Spanish banks are heavily exposed to slumping property sectors -- and the potential losses on these loans are large compared with banks' capital.

Moreover, banks all over the world are moving away from business models based on the excessive leverage of recent years. This restructuring will require banks everywhere to have higher levels of capital relative to loans than in the past. Irish banks will be at a disadvantage if their capital remains below the new international norms.

Striking feature

One of the most striking features of the past week has been the stronger improvement in market sentiment in the United States compared with Europe. This divergence is most clearly seen in the extraordinary surge over recent days in the value of the dollar against the euro.

In part, the drop in the euro reflects the abrupt change in market expectations about the future path of interest rates in the euro area. Traders are now expecting the European Central Bank to cut interest rates by at least a full percentage point by next June.

As recently as two weeks ago, only half a percentage point of cuts was priced in.

In addition, worries about the risks of severe financial crises in some eastern European countries that have borrowed heavily from abroad over recent years are weighing on sentiment in Europe.

These countries are not part of the euro area, but euro area members such as Germany and Austria are significantly exposed.

The gap between Europe and the United States may also reflect some doubts about the ultimate effectiveness of the national rescue plans in Europe.

For sure, European governments have co-ordinated their national responses to the crisis, but there are considerable differences in the sizes of the packages and in some of the details.

Moreover, the fragmented nature of the system of banking oversight and supervision in Europe, which is essentially organised along national lines, raises concerns about the ability of European governments to rescue banks with significant cross-border operations.

As shown in a recent report that I wrote with some of my colleagues at the think-tank Bruegel, the number of cross-border banks with retail operations in several European countries has increased rapidly over the past decade and some of these banking groups are very large and active in many countries.

There were 33 cross-border banking groups in the euro area before the crisis began last year with assets accounting for more than 50pc of total euro area banking assets.

Moreover, 16 of these 33 banking groups were active in at least half of the euro area countries.

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Managing problems related to difficulties in a large cross-border bank is likely to be very complicated. Investors seem to have questions about whether Europe is equipped to deal with such problems. For starters, it is difficult to co-ordinate two or more national authorities even in a domestic crisis.

In a cross-border crisis, one must multiply the number of national authorities involved by the number of countries involved.

Moreover, conflicts of interest between the different countries may be substantial. Governments are typically reluctant to commit to sending taxpayers' funds to other countries to bail out the operations of banks in foreign countries. Some commentators have proposed a single European bailout fund -- along the lines of the $700bn package in the United States -- to which all EU governments would contribute.

This would have the advantage of creating a level playing field for Europe's banks. In addition, a commitment to joint action through such a fund might be more credible than a joint declaration to coordinate rescue efforts.

But it is hard to see how such a fund could be set up without true European fiscal federalism, which Europeans have always resisted. European governments would have to decide on how the fund would be financed.

In a truly integrated Europe, the cost of the bailout would fall on the entire European Union. After all, the US government is not asking the state of New York to pay for the entire US package, though Wall Street is a major culprit in the crisis and a large beneficiary of the bailout.

But open commitments by European governments to contribute to an EU fund whatever amount is necessary to shore up the banking system, are highly unlikely.

Meanwhile, the current wave of the crisis is ebbing away. But this should not be mistaken for the end of the turmoil.

The inevitable sharp slowdown in credit growth resulting from the crisis has all but guaranteed that the global economy faces a deep and prolonged downturn.

This means more bad news for housing markets, more foreclosures, and rising defaults on corporate and household debts. Another, potentially larger wave of credit losses is building.

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