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# What next for Europe's financial markets?

*CEPS Commentary/14 October 2008*

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What began as a 'subprime' crisis in the US has clearly mutated into a crisis of financial markets around the globe. Why did this happen? The answer lies in the evolution of the European banking market since the introduction of the euro. A small number of banks grew into large, internationally integrated banking groups which are obviously too big too fail, but also close to being 'too big to be saved', by any single national government. However, this would by its own not have precipitated a crisis if these institutions had been solidly capitalised. But during the generally benign financial market conditions over the first decade of the euro, regulators had permitted these large European banking groups to reach excessively high levels of leverage. This is why European banks ran into great difficulties when general financial market conditions worsened suddenly. Most of the large European banks depend at the margin on short-term financing from the market. When this type of financing dried up after the bankruptcy of Lehman, many of the large European banks were close to bankruptcy because the lack of short-term funding would have forced a fire sale of their assets which would have led to large losses.

This type of systemic crisis was not foreseen when the euro was created. Hence the EU was totally unprepared when what was supposed to be a US problem (subprime crisis originating in the US housing sector) suddenly mutated into a European banking crisis after the failure of Lehman.

The ensuing confusion showed how much more difficult it is to manage an integrated banking market in an area in which there is no fiscal solidarity and even limited regulatory convergence. At first (in late September), the suggestion to create a European fund to recapitalise banks was brushed aside, in the first instance by the German finance minister. The main reason for this, almost instinctive reaction was the fear that Germany would have to pay for the cost of bank failures elsewhere. Underlying this position was the attitude, shared almost until the very end, by many finance ministers in Europe that 'our banks are safe'. This uncooperative attitude led financial markets to the conclusion that a systemic banking crisis had become possible because in the absence of collective action it was clear that some European banks, whose balance sheet was larger than the GDP of the larger member countries, had become 'too big to be saved' (by any one individual government in the context of a generalised banking crisis). Financial markets therefore fell into near-panic conditions.

In the end, disaster was averted at the special emergency summit (October 12), nominally of the euro area countries, but in reality in the presence of the UK, which was instrumental for two reasons: the UK harbours in London most of the European interbank market and, by lucky coincidence, the UK had adopted a couple of days earlier exactly the type of package which, according to all experts, was needed to stop the banking crisis, namely a combination of bank recapitalisation and guarantees for interbank lending.

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The essential point of the 'action plan' of the euro area countries agreed upon on the 12th of October was thus that all of them were to take action in the same direction: re-capitalise banks and give guarantees for the interbank market. In Europe, declarations of intent are usually not followed immediately by action. But this time proved to be different because the pressure from markets was perceived so strongly by all governments. Within 24 hours of the agreement, most euro area government had presented a concrete plan to support their banks with (at least potential) commitment totalling about €1,500 billion. This sum is more than three times the $700 billion 'Troubled Assets Recovery Plan' or TARP of the US. Moreover, on the following day, the US announced that the thrust of its own plan had been changed along the lines of the European plan: more funds available for bank recapitalisation and more guarantees for interbank lending.

Moreover, the October 12 euro area summit produced another important result, namely a statement of the obvious: European governments will not let any systemically important bank fail. Re-stating this position was important to reduce the sense of panic prevailing in financial markets when perceived counter party risk increased sharply after the default of Lehman.

Where does this leave Europe's financial markets? In contrast to the US, losses from housing related activities should be relatively minor in Europe (except Spain and Ireland). This implies that the key issue in Europe is not how to make up massive losses in the banking system, but how to resolve a coordination problem which led to the disappearance of the vital inter-bank market. With confidence re-established the European banking system should be able to resume gradually its vital function of providing credit to the real economy.

However, Europe's banking and wider financial system will now be very different. Most large banks have effectively been at least partially nationalised. This applies in particular to the large international banking groups which perform the function of 'money centre' banks. These banks had channelled funds from a myriad of smaller banks with excess deposits to others that need funds for credits to enterprises and households. These large groups will have to greatly reduce their activities because they have now become acutely aware of the so-called counterparty risk that they are constantly running. In reality this risk should be close to zero under present circumstances because European governments have extended a blanket guarantee to all banks. But the turmoil of September/October 2008 will remain in their collective memory and induce them to take much more caution.

The key change in Europe's financial markets, however, is that national policy-makers have now understood at great cost the potential fiscal consequences of faulty banking regulation and supervision. Nation states were not willing to transfer the responsibility for banking regulation to the European level. They had now to take over their national banking system. They will no longer just favour the expansion of their national champions, but become more stringent in enforcing all risk-reduction mechanisms. However, they will also do this for the subsidiaries and branches of foreign banks. Subsidiaries will be required to hold enough capital to be able to withstand an insolvency of the parent, and even for branches regulators will insist on mechanisms (called ring fencing of assets) that guarantee that even a branch can honour its local commitment in case of problems with the foreign parent bank. The European banking market will thus be divided along national lines. Moreover, since each national guarantee scheme is slightly different, banks in different countries will, at least for a time, no longer compete on a level playing field.

Europe adopted a common currency which created an integrated banking market, hoping that the absence of fiscal solidarity would not be tested. The test has now come. A total breakdown was avoided in the short run. But the cost of the lack of fiscal solidarity will set back the integration of European financial markets by decades.

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*As early as April 2006, with the publication of "A world out of balance?", CEPS provided an analysis of the forthcoming problems by diagnosing a bubble in real estate markets.* See: *A world out of balance?,* Special Report of the CEPS Macroeconomic Policy Group, Daniel Gros, Thomas Mayer and Angel Ubide, April 2006