10-30-2011 15:23

PRINT

Europe risks economic well-being

By Mauro F. Guillen and Emilio Ontiveros

GLOBAL ECONOMY

Mauro Guillen
Wharton School professor of management
Emilio Ontiveros
Universidad Autónoma de Madrid professor

While the first phase of the global economic and financial crisis was triggered by securitization troubles in the United States financial system, the present phase has Europe as its epicenter and has to do with the impact of bad government bonds on the banking system. The European sovereign debt crisis is complex primarily because European banks own much of the bad debt of peripheral countries.

The perils of this situation became readily apparent in the summer of 2010. According to the Organization for Economic Cooperation and Development, at the time German banks carried on their balance sheets €74.3 billion worth of Greek, Irish, Portuguese and Spanish government bonds, an amount equivalent to 48 percent of their highest-quality capital, the so-called tier 1. French banks owned €25.5 billion or 14 percent of their tier 1 capital.

This metamorphosis of the global financial crisis has coincided with the inability of policymakers to isolate the problem and solve it. The problems have spread from the government sector to the banking system, and the non-financial sector is also being affected because credit flows have not been restored to pre-crisis levels.

Economies with bank-based financial systems as opposed to market-based ones are suffering more. In the U.S. and the UK, companies can rely on a large and liquid stock market. A more vibrant venture capital and private equity sector also helps firms of various sizes with their financing needs. In most of continental Europe, by contrast, most companies rely on bank credit to a much greater extent, as much as three quarters of their external funding.

Only the very large firms have a more balanced financing structure. Not surprisingly, many companies in Europe feel financially choked. They are not in a position to invest and create jobs, which further exacerbates the economic downturn.
This situation essentially presents policymakers and politicians with two options. The first would be to bail out peripheral countries if they become unable to refinance their debts.

The second would be to restructure peripheral debt in such a way that bondholders take a hit, thus making it necessary to rescue some of the banks with the highest exposure, especially the German banks, the Greek banks — whose holdings of Greek sovereign debt equaled 226 percent of their tier 1 capital in 2010, and the Portuguese banks (69 percent).

If Spanish government debt were to be restructured, Spanish banks would also be pushed down the precipice because of their huge exposure, equivalent to 113 percent of their tier 1 capital. In the event that Italian government bonds lost value, the exposure of German banks would double and that of French banks nearly treble. The capital of Italian banks would be virtually wiped out.

Thus, the debate in Europe nowadays is more about whether to use taxpayer funds to rescue countries or to bail out the banks. The Economist has recently projected that those with the greatest problems would be Royal Bank of Scotland, Deutsche Bank, Societe Generale, UniCredit, Groupe BPCE, Commerzbank and Bankia. The Franco-Belgian banking giant Dexia was nationalized in October, 2011 in part as a result of the fallout from the debt crisis. In recent months, the European Central Bank has intervened directly in the government bond market by purchasing Spanish and Italian debt, in an attempt to prevent the sovereign debt crisis from further damaging the balance sheets of the banks.

Europe’s woes have the potential of threatening the long-term growth potential of the continent's economy. Without credit, the private sector will starve. Without investment, innovation will stall. More jobs may be destroyed and fewer new ones will be created. Europe is risking not just financial stability but also economic well-being.

And as the world's second largest financial market and consumer market, continued problems in Europe could bring trouble across the Atlantic and throughout the emerging world. Europe's problems are theirs to solve, but the consequences may be owned by the entire global economy.

Mauro F. Guillen is Director of the Lauder Institute at the Wharton School. Emilio Ontiveros is President of AFI and a Professor at Universidad Autonoma de Madrid.