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Capital and Crisis in Europe

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For the second year in a row I was honored to accompany a delegation from the National Association for Business Economics (NABE) to Europe. We met with economists, bankers, and central banks in London, Paris and Stockholm in late September. In Stockholm we attended a two day seminar hosted by Swedbank, a large Swedish bank. In addition to presentations about the Euro Zone crisis, Swedbank gathered economists, political analysts and military experts from a variety of countries to discuss developments in Eastern Europe and Russia.

A benefit of travelling with experts from the United States and meeting with similar European colleagues is a clear, detailed discussion of similarities and differences between our economic and financial systems. Outlined below are some of the basic differences between American and European financial systems and some of the implications of those differences for the ongoing crisis in the Euro Zone.

The Problem of Capital in Europe

Financial systems in Continental European countries such as France, Germany, Spain and Italy are “bank dominated” in contradistinction to the “capital markets” oriented financial systems found in the United States and the United Kingdom. Banks supply roughly 75% of all capital in Continental European countries through traditional deposit and lending services. Stock and bond markets supply the remainder, typically to very large companies and the government. What is missing is the incredible diversity of non-bank financial institutions we take for granted in our own society such as loan

originators or wholesalers, credit pools, dedicated leasing companies, factors, mezzanine and hard money lending, or asset-backed securities, just to name a few. The situation in the United States (and to a lesser extent the United Kingdom) is the inverse, with banks supplying perhaps 25% and a highly variegated financial ecosystem supplying the remaining 75%.

A more detailed analysis is beyond the scope of this letter, but at the core of this difference are distinctive legal philosophies and systems. The varieties of Roman Civil Law found in the countries of Continental Europe tend to restrict the channels through which capital can be raised and deployed while British Common Law is more conducive to financial innovation, alternative financial institutions and capital markets development.

Even more distinctive is the direct link between some European banks and their governments. For example, Spanish savings banks called “Cajas” maintained very little capital, instead relying on regional government guarantees to uphold depositor confidence. At the peak of the housing bubble the Cajas grew to supply 60% of all credit in Spain and nearly 100% of home mortgage lending.

Loan defaults overwhelmed the Cajas minimal capital just as the recession decimated the tax base. Regional government guarantees ultimately proved worthless and Spanish government bondholders feared that bank bailout costs could fatally weaken national government finances. These investor worries coincided with and contributed to mounting panic about the broader survival of the Euro currency bloc. Investors sold Spanish bonds, pushing interest rates to unsustainable levels and choking off Spain’s access to credit. Recognizing the precarious nature of government finances depositors withdrew their funds from Spanish banks, i.e. a “run” on Spanish banks ensued.

Compounding the economic damage was the fact that very few solvent borrowers could turn to alternative financiers to raise capital. Unlike companies or real estate investors in the U.S. who had a variety of alternative options (perhaps at much higher cost, but nonetheless available), Spanish businesses were often forced to slash overhead to stay alive. The lack of alternative financial channels was a key reason why the Spanish unemployment rate skyrocketed to 28%. At the height of our financial crisis in the U.S. money continued to flow, albeit more slowly and costly, as opposed to Spain where it stopped completely.

Over the past year Spain took aggressive action to address some of its banking problems. Other Euro Zone governments pitched in to help recapitalize Spanish banks, and Spain is privatizing its Cajas to break the direct link with the government. The banking system appears to be stabilizing along with the broader economy.

Ironically the other Euro Zone country with the greatest direct connection between government finances and the banking system is Germany. While Germany remains strong for now, many outside analysts are concerned that the German banking system could someday pose a threat similar to what happened in Spain. Banks in France and Italy are better capitalized with a much higher proportion of private sector investment. Similar to the rest of Continental Europe, however, alternatives to banks are very limited. The problem in France and, particularly so, in Italy is not government guarantees, but the

proportion of bank assets held in government bonds. In this regard, Italy is now the troubled country to watch.

Italy's debt-to-GDP ratio is 120% and Italy carries the most government debt of any European nation. Much of this debt is owned by Italian banks, putting them at risk if Italian government bonds drop further in value. Worries about Italy's commitment to the Euro, domestic political instability, lackluster commitment to necessary reforms and poor government finances keep Italian interest rates significantly higher than in Germany or France. Higher interest rates increase funding costs for Italian banks. Both lending and the economy are contracting, albeit at a slower pace than one year ago. Unfortunately, Italian businesses also have very few options other than the banks.

Periodic Crises Will be Required to Motivate Action

As I noted last year after a similar visit to Europe, Europe is now a crucible of reform. The pressure to implement positive reforms, however, varies according to the degree of financial pressure facing each country's government. Spain is an aggressive reformer because the Spaniards' alternatives are dire if they do not implement important changes. Elsewhere the motivation for reform depends on the pressure coming from government bond markets. With somewhat lower interest rates than one year ago, Italy now faces more moderate pressure. As a result, the Italian government responded with very timid reforms. Most likely more bond market panics will be required to motivate significant action from the Italians. France faces longer-term financial dilemmas, but French interest rates remain low and government bond markets are stable for now. The French government is not pushing proactive reforms, however, and could fall into the bond market's crosshairs in the coming years.

European economies are, in general, either stabilizing or slowly improving, but the Euro Zone crisis is far from over. Perhaps things are quiet for the moment, but politicians in Italy and France are dithering when much bolder action is required. The government bond markets will continue to be the primary catalyst for economic reform in Europe, but only in response to periodic crises. Countries currently under more intense pressure, such as Spain, could become a better home for our investment dollars as they implement reforms and their economies rebound. Among the needed reforms will be laws authorizing alternatives to traditional banking. Many Europeans now understand that excessive dependence on this single financial channel can foster instability, particularly if excessive debt invalidates the government's ability to provide an effective backstop. We will be looking for opportunities that unfold from changes to Europe's financial systems.