

State of the Union / *By Michael Heise*

Europe Can Only Lead By Example

The financial crisis has plunged Europe, and the rest of the world, into what looks like the most savage recession since 1929. Germany is being hit particularly hard, with its former strength, exports, now proving to be a major weakness as global trade is collapsing.

The focus at present is understandably still very much on short-term crisis management—fixing the mess on the financial markets—and on revitalizing economies with demand management. EU leaders met last week to thrash out a joint approach to the G-20 summit in London on April 2. The size of the stimulus packages, the unprecedented low interest-rate environment and, most importantly, tumbling commodity and energy prices make a recovery likely in due course. But at the same time formidable challenges loom.

The greatest task right now is to find the right balance between the state and financial markets, guaranteeing stability while strengthening the forces of market growth in the long term. Europe can make a major contribution to this global effort by working for the extension of regulation to sectors that have so far hardly been covered at all, such as “shadow banks” (structured investment vehicles and conduits), hedge funds and rating agencies. In order to limit regulatory arbitrage, the world’s

financial centers need to harmonize international standards and improve international supervision.

Given the European Union’s experience with financial market integration, it has a good chance to shape this new global financial order. But to seize that opportunity, it needs to accelerate its own financial market reform.

The proposals to the European Commission earlier this month in the “High-Level Report on Financial Supervision” headed by Jacques de Larosière point the way. Specifically, the report recommends the establishment of two new bodies: a European System Risk Council to focus on macroprudential issues like credit bubbles and asset-price inflation, and a European System of Financial Supervisors—a decentralized network of national supervisors that will be more powerful than the current grouping.

The stability of economic development, though, requires not only better regulators but also better regulation. The pro-cyclicality of accounting standards and capital requirements for banks was a key contributing factor in this financial crisis. The current rules have led to the availability of large amounts of excess capital dur-

ing the boom, nourishing exuberance. Now, as recession bites, financial institutions are compelled to take massive impairments on their lending and security assets. At the same time, they are forced to hold much more capital in relation to their assets as the ratings for companies and securities are downgraded en masse.

But this only exacerbates the economic problem, prompting further downgrades of credit quality.

Despite lending cuts, risk-weighted assets continue to rise. In a knee-jerk reaction, lending policies become even more restrictive, escalating

the downward spiral. In the upcoming revision of the rules, these pro-cyclical effects must be curbed—for example by the inclusion of anticyclical provisions like those used in Spain, where the regulator demands that banks increase their capital in boom periods to create a risk buffer against times of recession.

What is more, at times of extreme market illiquidity, accounting should be based more on actual and expected payment streams from assets rather than on “market prices” that merely reflect isolated fire sales.

As necessary as a revision of the regula-

tory framework may be, we must not lose sight of the other aspects of our economy. Public coffers are stretched to the limit, unemployment is rising across our continent, and private-sector investment is plummeting. We urgently need to lay the foundation on which we can build tomorrow’s growth, employment and prosperity.

With a shrinking and aging population, as well as substantial “deleveraging” needs in the private sector, this really is a challenge. Even more than in the past, future growth will hinge on the pace of innovation and productivity. Investment conditions in Europe need to be improved, as physical capital is a carrier of technology and know-how.

Open markets are still the best guarantee for the efficient allocation of resources and hence of higher growth. The principles of competitive markets, the free movement of capital, freedom of establishment and the equal treatment of national and foreign-owned financial institutions must continue to apply. Backsliding into an era of nationally fragmented markets would be a disaster. If the EU wants to assume global responsibility at this time of crisis, it must ensure that such policies are shunned.

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Financial
market reform
must begin at
home.