Thoughts on the European Credit Crisis

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Credit Crises

• Recent credit crises in nearly all of the developed countries:
  – 1990s Japan: Real estate and stock market bubble, leads to a banking crisis.
  – 2009-present Europe: Sovereign debt bubble, seems to be leading to a banking crisis and/or potential break of union.

• Necessary conditions for a credit crisis:
  1. Mispriced credit on a macro scale (large losses on bad loans)
  2. Propagation mechanism: undercapitalized banks/bad risk management.
Prior crises

• Japan
  – Mispriced credit caused by
    – Excess liquidity: BOJ offset of Post Plaza Accord revaluation of yen
    – Extrapolation of past experiences: “Home/land prices never fall” and loans are risk-free since housing collateral is valuable.
  – Bad bank risk management and a false belief in effective regulation
  – Failure to quickly write down losses.

• US
  – Mispriced credit
    – Excess liquidity: Fed (cuts to 1%, raising rates very slowly) and shadow banking system.
    – “Home/land prices never fall”
  – Bad bank risk management and a false belief in effective regulation.
  – Fed stops raising rates in 2006, injects liquidity, failure to write down losses.
Greenspan’s biography (2007, p. 229)

- When speaking of the extraordinary rate cuts in 2003 by the Fed:

  “We were willing to chance that by cutting rates we might foster a bubble, an inflationary boom of some sort, which we would subsequently have to address.”

- Be careful what you ask for...
Europe’s credit crisis

• Mispriced credit: EU/ECB/markets dogmatic belief of no sovereigns default.
  – Bad credits (PIIGS) were able to borrow at extremely low rates.
  – Large increase in sovereign debt holdings after US crisis by banks and ECB
  – Structural imbalances (David Beim’s presentation)

• Propagation mechanism: Europe (unlike U.S.) has always had a banking centric financial system
  – Everyone, including governments borrow directly from banks (not true of US)
  – Banks are giant hedge funds holding securities instead of loans (why?)
  – Sovereign debt concerns=banking crisis.

• Misdiagnosis: illiquidity for solvency
  – ECB/EU providing banks financing (PIIG debt as collateral) and ECB/EU/IMF providing insolvent countries liquidity.
  – Failure to quickly write down losses.
Banking centric European financial system

Banking System Assets as a Percentage of GDP

Source: National Central Banks, OECD, Bloomberg, Barclays Capital.
For more details on the European banking system, please see the presentation “How much capital does each bank need?” by Simon Samuels dated November 18, 2010.
Stock of loans held on bank balance sheets (2009 Q1 = 100)

Source: ECB; News N Economics; Data current as of July 2011
* Households include nonprofit institutions serving households
Loan data for non-financial corporations and households are adjusted for sales and securitization
Lesson from history: “Those who cannot remember the past are condemned to repeat it.”

• Or, more aptly:

“We learn from history that we learn nothing from history.”
Bertrand Russell

“It’s frightening to think that you might not know something, but more frightening to think that, by and large, the world is run by people who have faith that they know exactly what’s going on.”
Amos Tversky
Things to worry about

1. So far, politicians are willing to break social contracts (e.g., cut pensions) before financial contracts (e.g., default).

2. European banks as a strong multiplier of financial distress.

3. Europe is extremely anti-markets
   - Forced “voluntary” restructuring to avoid CDS event & Tobin tax

4. Political/governance implications
   - If ECB doesn’t like PM, oust by not buying bonds (Italy/Greece)

• The worst is yet to come.