

Financial crisis and state aid in the
EU:
a more economic approach

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Outline

- The worst financial and economic crisis after the Great Depression
- Roots of the crisis and reforms required
- A cost-benefit analysis
- The way ahead

The worst financial crisis

Table 1.3. Estimates of Financial Sector Potential Writedowns (2007-2010) as of April 2009

(In billions of U.S. dollars)

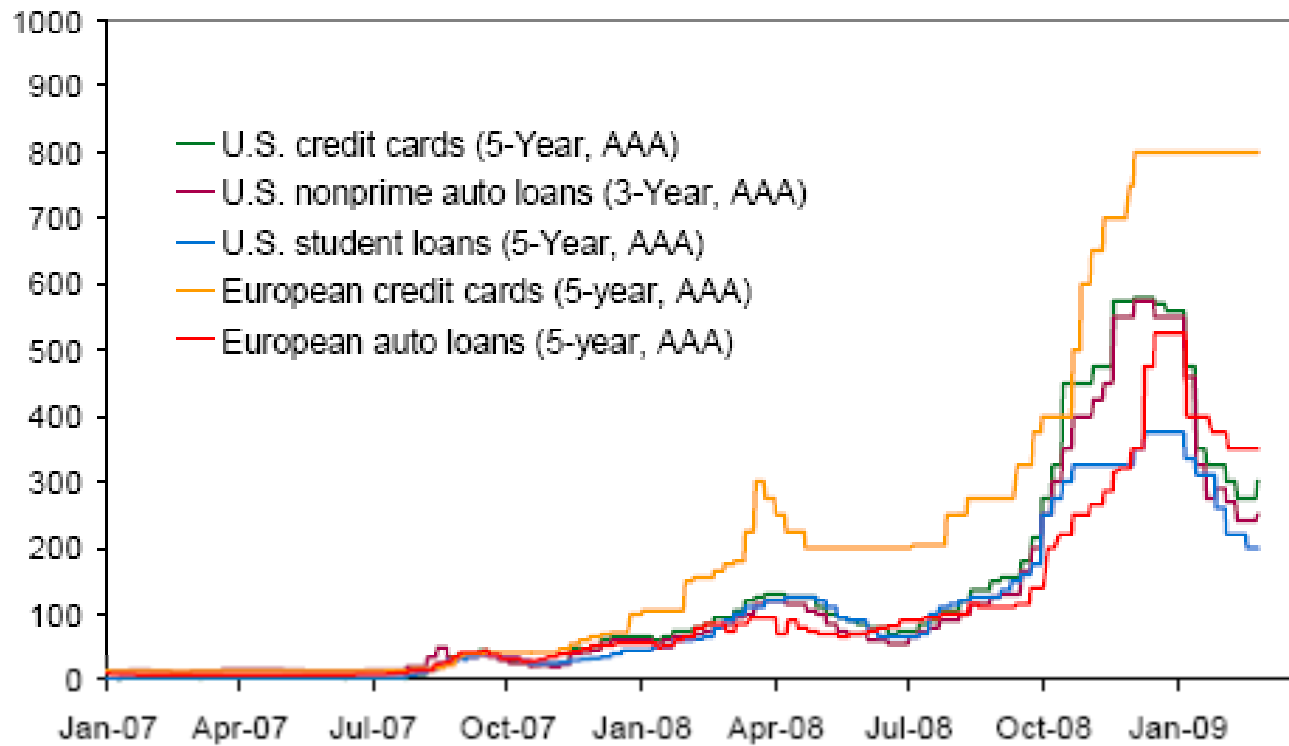
	Outstanding	Estimated Writedowns					Implied Cumulative Loss Rate (Percent)
		October 2008 GFSR	April 2009 GFSR	Banks ¹	Insurers	Other ²	
United States							
Loans							
Residential mortgage	5,117	170	431	206	22	204	8.4
Commercial mortgage	1,913	90	187	116	9	62	9.8
Consumer	1,914	45	272	169	14	89	14.2
Corporate	1,895	120	98	61	5	32	5.2
Municipal	2,669	...	80	50	4	26	3.0
Total for loans	13,507	425	1,068	601	53	414	7.9
Securities							
Residential mortgage	6,940	580	990	604	99	287	14.3
Commercial mortgage	640	160	223	136	22	65	34.8
Consumer	677	...	96	59	10	28	14.2
Corporate	4,790	240	335	204	33	97	7.0
Total for securities	13,047	980	1,644	1,002	164	477	12.6
Total for loans and securities	26,554	1,405	2,712	1,604	218	890	10.2



	Outstanding	Estimated Writedowns				Implied Cumulative Loss Rate (Percent)	
		October 2008 GFSR	April 2009 GFSR	Banks ¹	Insurers		Other ²
Europe³							
Loans							
Residential mortgage	4,632	...	192	119	10	63	4.1
Commercial mortgage	2,137	...	105	65	5	34	4.9
Consumer	2,467	...	175	109	9	58	7.1
Corporate	11,523	...	416	258	21	137	3.6
Total for loans	20,759	...	888	551	44	292	4.3
Securities							
Residential mortgage	1,390	...	195	119	19	56	14.0
Commercial mortgage	181	...	31	19	3	9	17.4
Consumer	250	...	18	11	2	5	7.1
Corporate	1,227	...	61	37	6	18	5.0
Total for securities	3,048	...	305	186	31	89	10.0
Total for loans and securities	23,807	...	1,193	737	75	381	5.0

	Outstanding	Estimated Writedowns					Implied Cumulative Loss Rate (Percent)
		October 2008 GFSR	April 2009 GFSR	Banks ¹	Insurers	Other ²	
Japan							
Loans							
Consumer loans	3,230	...	65	58	3	3	2.0
Corporate loans	3,339	...	67	60	3	3	2.0
Total for loans	6,569	...	131	118	7	7	2.0
Securities							
Corporate debt	789	...	17	11	2	5	2.2
Total for loans and securities	7,358	...	➔ 149	129	8	12	2.0
Total for all loans	40,835	...	2,087	1,271	104	712	5.1
Total for all securities	16,884	...	1,966	1,199	197	570	11.6
Total for all loans and securities	57,719	...	➔ 4,054	2,470	301	1,283	7.0

Figure 1.23. Spreads on Consumer Credit Asset-Backed Securities
(In basis points, spread to swaps)

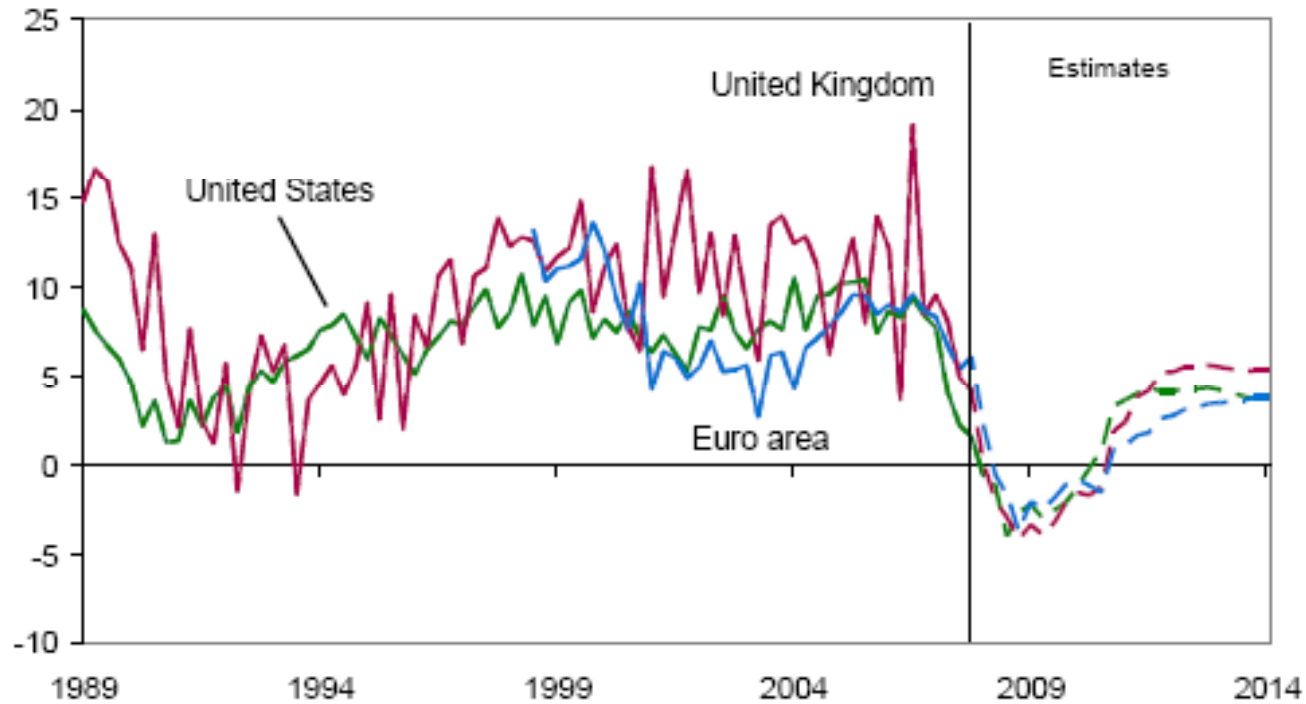


Sources: JPMorgan & Co.; Morgan Stanley; and Markit.

GSR, IMF: Credit crunch is going to be deep and last long (April 2009)

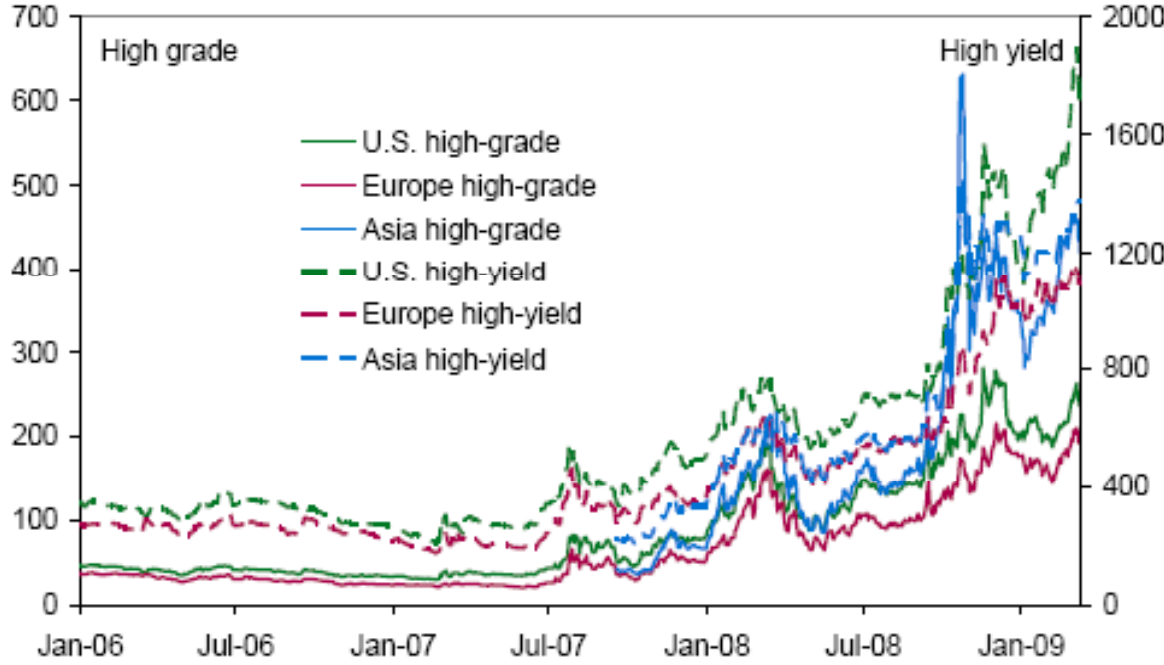
Figure 1.5. Private Sector Credit Growth

(Borrowing as a percentage of debt outstanding, quarter-on-quarter annualized, seasonally adjusted)



Source: IMF staff estimates.

Figure 1.26. Corporate Credit Default Swap Spreads
(In basis points)



Source: JPMorgan Chase & Co.

Table 1.4. Bank Equity Requirement Analysis*(in billions of dollars, unless shown)*

	United States ¹	Euro Area	United Kingdom	Other Mature Europe ²
Estimated Capital Positions at end-2008				
Total reported writedowns to end-2008	510	154	110	70
Capital raised to end-2008	391	243	110	48
Tier 1/RWA ratios at end-2008	10.4%	7.3%	9.2%	7.3%
TCE/TA end-2008	3.7%	2.5%	2.1%	2.3%
Scenario Bringing Forward Writedowns				
Expected Writedowns 2009-10 (1)	550	750	200	125
Writedown-adjusted Tier 1/RWA ratio	6.7%	1.1%	4.7%	1.7%
Writedown-adjusted TCE/TA	0.1%	-0.2%	0.4%	0.5%
Allowance for Expected Earnings				
Expected net retained earnings 2009 and 2010 (2) (after taxes and dividends)	300	600	175	100
Net drain on equity (retained earnings) 2009 and 2010 (3) = (1) - (2)	250	150	25	25
Equity Requirements				
Equity needed to reduce leverage to 25 times ³	275	375	125	100
Equity needed to reduce leverage to 17 times ⁴	500	725	250	225

Source: IMF staff estimates.

EU still needs about 1 trillion USD in bank equity requirements

The worst economic crisis

Table 1.1. Overview of the *World Economic Outlook* Projections
(Percent change, unless otherwise noted)

	Year over Year			
	2007	2008	Projections	
			2009	2010
World output¹	5.2	3.2	-1.3	1.9
Advanced economies	2.7	0.9	-3.8	0.0
United States	2.0	1.1	-2.8	0.0
Euro area	2.7	0.9	-4.2	-0.4
Germany	2.5	1.3	-5.6	-1.0
France	2.1	0.7	-3.0	0.4
Italy	1.6	-1.0	-4.4	-0.4
Spain	3.7	1.2	-3.0	-0.7
Japan	2.4	-0.6	-6.2	0.5
United Kingdom	3.0	0.7	-4.1	-0.4
Canada	2.7	0.5	-2.5	1.2
Other advanced economies	4.7	1.6	-4.1	0.6
Newly industrialized Asian economies	5.7	1.5	-5.6	0.8
Emerging and developing economies ²	8.3	6.1	1.6	4.0
Africa	6.2	5.2	2.0	3.9
Sub-Saharan	6.9	5.5	1.7	3.8
Central and eastern Europe	5.4	2.9	-3.7	0.8
Commonwealth of Independent States	8.6	5.5	-5.1	1.2
Russia	8.1	5.6	-6.0	0.5
Excluding Russia	9.9	5.3	-2.9	3.1
Developing Asia	10.6	7.7	4.8	6.1
China	13.0	9.0	6.5	7.5
India	9.3	7.3	4.5	5.6

Roots of the crisis

- Liquidity bubble created by FED and other central banks after 2001
- Over-borrowing by household sector (and corporate sector) with too much risk taken by banking sector
- Massive regulatory failure in control of risk of the banking sector and capital markets (investment banks and derivatives markets)
- Lack of assessment of systemic risk and global risk

USA: Treasury and FED financial support programs		
In billions USD		
	Proposed	Used
TARP	700	510
FHLB	600	212
Money market funds	600	17
FDIC	500	0
Freddie and Fannie capital	200	14
Reserve US Fund	4	4
TALF	1,000	0
TAF	900	413
Commercial paper and other loans	236	93
Debt swaps	200	121
AIG	113	83
Bear Sterns	29	0
Citigroup	246	0
Bank of America	98	0
Morgan Stanley	9	0
Total	5,435	1,467
Fonte: NYT e WSJ.		

Europe bank rescue plans

billions euros

	Garantees	Capital injections	Total	Perc GDP	Efectively injected
UK	260	60	320	0.19	153
Germany	420	80	500	0.22	50
France	360	40	400	0.24	8
Italy			110	0.08	
Netherlands			200	0.42	56
Belgium			60	0.21	8
Austria			90	0.38	3
Sweden	150		150	0.51	
Spain			100	0.12	
Finland			50	0.32	
Portugal	20	2	22	0.15	3
Ireland			16	0.10	7
Denmark	4		4	0.02	12
Total	1210	182	2022	0.20	300

Policies and interventions needed

- We avoided the collapse of the US and EU financial systems
- And we avoided a depression (so far the rate of decrease in GDP is above 10% in the first quarter of 2009 in some countries like Japan)
- But we have not yet overcome the risk of a prolonged recession or very slow recovery (the Japanese syndrome)

Policy risks

- Just transferring the risk from private to public sector: public deficits and public debt sustainability
- Bank deleveraging may be disorderly: credit crunch lasts too long
- “Zombie banks” and “zombie firms” with protracted recession
- No correction in the regulatory framework
 - Creating the roots for the next financial crisis

Need for the Commission to take a strong position in state aid

- To avoid “subsidy races”
- Commitment problem of national governments (soft budget constraint) and government capture at national level
- Dynamic inconsistencies in government commitments

EU policy problems

- Large government debts and debt sustainability (Euro Stability Pact)
- Bank restructuring: how to restructure banks that have received help
 - Asset restructuring: how to deal with bad debts?
 - Problem of “toxic assets” paralyzing bank operations and prolonging debt crunch
 - Problem of “zombie” firms and insolvent households
 - Liquidation
 - Divestiture of assets
 - Private recapitalization
 - How much time to pay out loans?

Competition and financial stability policies

- Uncompetitive mergers (no clear trade-off)
 - Constraint: need of urgent solution
 - But usually there are alternative solutions
 - Intervention by a supervisory agency
 - State recapitalization
 - Takeover by a state agency (US solution during GD)
- State recapitalization or guarantees
 - Although a general measure, there is no accepted and clear rule for how and when to act
 - Distortionary effect of state aid
 - The bank can offer better conditions to depositors or to clients on loans than competitors

Restructuring problems

- For economists, aid would be justified if aid (lump-sum) leads to a simulation in PV of the value of the bank positive, compared with negative, without aid (indispensable)
- Shortest distortion: shortest time possible
- Limiting leakages: to stockholders, managers, staff
- Limiting distortions in bank policies (market based)

Conclusions

- Recovery depends on effective solution of banking crisis
- Seriousness of credit crunch signals that we may be up to a long period of recovery
- We cannot avoid deleveraging of all sectors of the economy
- There is the danger that “socialization of risk” is seen as a panacea, but this will not decrease the overall level of risk in the economy (it is simply a transfer from the private to the public sector)
- We need a solution to “toxic assets” and “zombie problem” to avoid the Japanese syndrome
- We need more measures to improve real sectors: increase in income and productivity and increase in household savings in the US