The Financial Crisis in the US and the European Union:

some subtle differences

By Yiannis Tirkides

The global financial crisis remains the dominant economic issue in the world today. This is so because of its severity and depth, its geographic reach, and systemic characteristics. The financial crisis started off as a liquidity crisis in the United States but quickly spread to the rest of the world, particularly Europe, where the problem is even more complex and will probably take longer to mend.

The problem started in the US as a liquidity crisis on the back of questionable mortgage lending. A considerable amount of mortgages were granted on weak credit criteria and low, so called, teaser interest rates, that were due to adjust to normal rates after a certain period, typically five years. But the reset rates would be considerably higher than the initial teaser rates and borrowers would be unable to meet their new payments. This led to massive foreclosures, which in turn put downward pressure on housing prices.

Additionally, the securitisation of mortgage loans compounded the problem further. Mortgages were bundled into securities and sold in the market. The initial mortgage loans were taken off banks' balance sheets, which allowed them to make yet more 'questionable' loans. At the same time these asset-backed securities were sold widely to investors at home and abroad. As these securities decreased in value investment houses, which are extremely vulnerable to a credit crunch, came under severe strain and some started to fail. In the wake of the crisis Investment houses cracked, and all but vanished, changing the landscape of US finance.

Some banks also came under pressure. However, when banks tumble the risks are systemic and require positive intervention. The Federal government acted forcefully coming forward with a $700 billion bail out plan in an attempt to address the problem of the non-liquidity of the mortgage-backed securities. By exchanging these for cash, the government removes non-tradable assets from banks' balance sheets allowing banks to restart the credit cycle.

Exposure to US sub-prime affected European banks but was not their main problem. European banks are facing a deeper banking crisis. The structure of European banking is very different from that in the US. European banks,

historically, maintain close links with industry. This secures that capital is readily available for steady growth and long-term investment but at the same time makes them more vulnerable to contagion. European banks are not only faced with their own home-grown sub-prime problem but more importantly they have to struggle with overexposure to the Balkan and Baltic regions. How did this come about?

The Euro-zone is a special situation, and its stability as a currency area is not exactly foolproof. It consists of a diversity of countries with different levels of development and financial depth; yet, these countries operate under the same one-fits-all monetary policy and under the same interest rate. This is prone to excess when traditionally higher inflation countries, like Spain, Italy and Ireland, find themselves awashed with cheap credit. Spain for instance built more houses in 2006 than Germany, France and the United Kingdom combined. The consumer and investment boom that followed was even stronger in the traditionally smaller and poorer countries of Eastern Europe that joined in 2004.

As banks became quite liberal in their lending practices they moved into these countries aggressively. Mainly Scandinavian, Greek, Austrian and Italian banks fuelled credit expansion in the Baltics and the Balkans. As a result the new member states of the Europe Union witnessed strong credit

expansions. But most of this credit came at the back of borrowed money. With these banks facing credit problems in their home markets, the easy credit environment in these countries naturally comes to an end.

The world is faced with its most serious financial crisis since the Great Depression. The crisis may have started in the US but it quickly spread to Europe where the problem may even be worse. The structure of European banking is different from that in the US in the sense that there are numerous connected relationships between banks and industry usually with the encouragement of the government. Whilst this situation secures long-term growth and investment, in times of crisis it is more prone to contagion effects. The current crisis in Europe raises serious issues of supra-national structures not only in terms of supervision but also for the central bank itself. But these are issues for another time!