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RAHN: Europe's worsening crisis

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COMMENTARY:

BRATISLAVA, Slovakia -- This pleasant city on the Danube River is considered part of eastern Europe, although it is only as about as far from Vienna as Washington is from Baltimore (about 35 miles) and is, in fact, near the geographical center of the European continent.

Slovakia was the poorer part of the former Republic of Czechoslovakia until 1993 when the country split in two parts, one being Slovakia (the Slovak Republic) and the other the Czech Republic. Economic growth languished until a reform government took over in 1998, established a set of policies that gave it one of the highest growth rates in Europe (average of 7.2 percent from 2004 to 2008), and made it the world's 20th-freest economy, lagging behind only Estonia among the former communist countries.

While Slovakia has been doing many things correctly, its fellow European neighbors to the west have not; and their actions have put their own economies into recession as well as those of eastern Europe. The United States is generally blamed for setting off the global recession, which is only partially true.

It is true that the Federal Reserve's excessive low-interest rate policies, the mismanagement of the government-sponsored Fannie Mae and Freddie Mac mortgage institutions, and overleveraging by some of the big private investment banks did create much of the housing bubble in the United States. Yet, it is also true that actions by the Bank of England and the Blair/Brown government in the United Kingdom created most of the British housing bubble.

Also, low-interest-rate policies by the European Central Bank (which creates the euro) supported much of the housing bubble in many European countries from Spain's Atlantic coast all the way to the Black Sea coast in Bulgaria.

Many EU countries in eastern Europe have had larger problems because of their dependence on foreign banks and the fact many home loans were written in euros or Swiss francs rather than their domestic currencies. (Five European banks account for two-thirds of eastern Europe's loan exposure.)

On May 15, a meeting sponsored by several think tanks in Slovakia and Vienna's Hayek Institute was held here in Bratislava to discuss the current situation and what should be done. Nobel laureate in economics Myron S. Scholes spoke, as did several other prominent European and American economists. There was nearly unanimous agreement that the financial crisis was not only primarily caused by governments, but that the solution was less rather than more government spending - and less but more focused financial regulation.

Europe's economy has lagged considerably behind that of the United States during the last quarter-century. A great deal of Europe's poor performance can be explained by a larger government sector (higher taxes and government spending) than had characterized the U.S. economy - at least up to now. Europe has also suffered from a much worse demographic situation than that in the United States.

Because of very low birthrates, European countries have an unfavorable dependency ratio (number of people receiving retirement pensions versus number of workers) compared to the United States. And this will only get much worse. Italy, and many of the countries in eastern Europe, are already losing population, and Germany is not far behind. Given these structural problems, it will be very difficult for much of Europe to achieve a quick and robust recovery.

European banks face a different situation from banks in the United States. In the United States, companies rely on banks for a much smaller portion of their capital needs than do companies in Europe. American companies are more prone to tap stock and bond markets for financing than their European counterparts.

As the recession deepens, more and more European banks will face nonperforming business loans, and, unlike the United States, there is no eurowide institution (like the Fed) with the authority or capability of serving as the lender of last resort for the private banks. Many of the individual countries in the EU are too small (unlike France or Germany) to be able to bail out their big banks. Since they cannot, they will not.

These banks may have no choice but to let some of their subsidiaries fail in some of the eastern European countries in order to preserve the parent bank.

However, big banks in small countries, knowing they have no recourse to a large government to bail them out, appear to have been more prudent in designing ways to protect their core activities and the parent bank.

Germany has the largest economy in Europe, and it now appears the recession in Germany will be deeper than that in the United States or the United Kingdom. Hence, the German taxpayer is not likely to bail out European neighbors and their banks. The European Union Treaty (Maastricht) clearly states that the "Community" is not responsible for financial obligations made by any "Member State."

The International Monetary Fund Global Financial Stability Report of April 2009 estimated global financial write-downs might now be as great as $4.1 trillion, with a sizable share originating in Europe. Banks are expected to bear about two-thirds of these write-downs, with the rest spread among other financial institutions.

Some European bankers claim these IMF estimates are greatly overstated. For the sake of both Europe and the world, let's hope these bankers are correct.

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