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Open Letter to European Leaders on Europe's Banking Crisis: A Call to Action¹

This is a once-in-a-lifetime crisis. Trust among financial institutions is disappearing; fear may spread. Last week's US experience showed that saving one bank at a time won't work. A systemic response is needed and in Europe this means an EU-led initiative to recapitalise the banking sector. Unless European leaders immediately unite to address this crisis before it spirals out of control, they may find themselves fighting over how best to salvage the aftermath.

Europe is in the midst of a once-in-a-lifetime crisis. Every European knows what happened when financial markets seized up in the dark years of the 1930s. It is not an exaggeration to say that it could happen again if governments fail to act. We are not predicting that it will happen, but it is critical to know that this is what is at stake.

Trust among financial institutions is disappearing and there are risks that fear will spread more widely. Turmoil in financial markets must be stopped before it causes major damage to the real economy. The savings of hundreds of millions of Europeans are directly threatened. If the turmoil produces credit market paralysis, jobs and businesses will be destroyed on a massive scale. A further weakening of the real economy would put more loans at risk and create a vicious cycle of falling asset prices, deteriorating ability to repay loans, and diminishing credit flows.

Actions by US policymakers are welcome, but they are not sufficient. Decisive policy action is required in Europe as well.

Policy spillovers: European-level actions to supplement and coordinate national actions

The US authorities learned last week that saving one bank at a time won't work; a systemic crisis demands a systemic response.

In Europe, saving one bank at a time means either a rescue effort mounted by one nation, despite important spillovers to neighbouring countries, or last-minute improvised coordination and agreement about fiscal burden sharing. The national responses and ad-hoc cooperative efforts to date have been useful. Yet interdependence among European banks is too deep and too wide-spread for national responses or case-by-case coordination to be enough. Each national policy intervention and each cooperative intervention by a small number of countries can have unpredictable implications for other European nations. It is critical that national authorities sit together and coordinate their responses, developing Europe-wide solutions where appropriate.

Now is the time to act while the situation still appears manageable. Last week's events in the US demonstrate that financial crises do not evolve smoothly and predictably. One unexpected event can trigger a cascade of failures and panics that become increasingly difficult to control.

Solutions

Many solutions will be part of the answer. In the US, dealing with the immediate crisis requires restoring liquidity to money and credit markets, and creating the conditions for the resumption of the securitisation of prime mortgages and other illiquid but sufficiently homogeneous and transparent assets. In Europe, the key problem is high leverage among the internationally active large banks. Hence the EU contribution must be centred on a recapitalisation of the banking sector, through the injection of public equity or through mandatory debt-to-equity conversions. This has to be done at the EU level (e.g. through the EIB). The current approach of rescuing one institution after another with national funds will lead to a Balkanisation of the European banking sector. Agreeing a harmonised level for deposit insurance would also be important.

To prevent future crises of this nature, regulation of the European financial markets and institutions at the European level will also be required.

The problem is not a lack of understanding of how to stop financial crises. The problem is a lack of political will.

Unless European leaders immediately unite to address this crisis before it spirals out of control, they may find themselves fighting over how best to salvage the aftermath.

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¹ Economists can sign this letter at <http://voxeu.eu>.