

## The bank credit crisis and its impact on growth

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The financial sector, and in particular the banks, has been at the heart of the economic crisis ever since Lehman Brothers went bankrupt five years ago. The global financial crisis was, at least in part, to blame on banks taking unsustainable risk, driven by a race for higher and higher returns with greed epitomised for many by the size of bankers' bonuses. The subsequent bail-outs and recapitalisations of banks in many countries – necessary to preserve global financial stability – added insult to injury, especially when banks, despite public bail-outs, seemed to return to some of the behaviours witnessed before the crisis.

At the European level, the result has been a flurry of activity: from legislation to curb bankers' bonuses and stipulate capital requirements to attempts to introduce a Financial Transaction Tax by a group of eleven willing EU countries, including France and Germany, showing the momentum, as well as the difficulties, in trying to regulate the financial sector more tightly. At the heart of these actions is the desire to prevent unnecessary and intransparent risk-taking and ensuring that private debt does not become public debt again.

The largest and most prominent action at EU level is the Banking Union. A full Banking Union – comprising three key elements: common supervision of banks, a bank restructuring and resolution mechanism and a common deposit guarantee scheme – would help to achieve the abovementioned goals.

However, many question marks still remain, driven by uncertainty over the political will behind creating such an ambitious European approach. While the first element (a common supervisor, in the form of the ECB) is likely to be in place in 2014, an agreement on the coverage of the common resolution mechanism is still outstanding and will likely exclude a number of smaller (but potentially risky) banks. As for the common deposit guarantee scheme, this looks likely to be permanently off the table.

But even when the (incomplete) Banking Union is in place and working effectively (which will take some time yet), it is unlikely to have an impact on a serious current crisis faced by businesses, especially in the crisis countries: the availability and cost of investment capital, which is crucial in Europe, as much private investment activity in SMEs is financed through bank loans (as opposed to raising capital by issuing equity, i.e. shares).

Paradoxically, the requirements of banks to lend more prudently and to have a sound asset base (as part of the so-called Basel requirements) also make banks more reluctant to provide this kind of capital to SMEs. But at the heart of this reluctance to lend is the risk profile of the crisis countries. The political and economic situation in the crisis countries adds risks to any lending activity, which is counterbalanced by higher interest payments, making investments more costly in the crisis countries.

So, despite record low interest rates and money being pumped into the banking sector to encourage lending, the banks are not providing the capital needed. Such a shortfall in investment capital will erode the competitiveness and productive capacity of firms, leading to preventable bankruptcies and, over time, reducing growth and thus eroding these countries' recovery and long-term economic health.

## ***What can be done?***

The (full) Banking Union, if successfully implemented, is a step in the right direction but it will not produce the results in the short term which are needed to help the economic recovery of the crisis countries. Europe needs to do more. There is a need to remove barriers to cross-border investment, for example in terms of rules governing pension fund investments. Building on the, so far limited, activities of the European Investment Bank, we should have an ambitious provision of low-interest public capital where clear market failures can be identified.

But to make a big difference, we have to address the heart of the matter: the additional political and economic risk. While a real long-term solution of the Euro crisis remains a key building block, in the short term, a European Investment Guarantee Scheme<sup>1</sup> could provide the insurance needed to invest and would be beneficial for the entire Eurozone. Such a scheme would provide a form of public insurance (potentially backed by EIB assets) to cover excessive risks for private investors or lenders when investing or providing finance in the crisis countries.

But, to address this fundamental problem at the heart of the Euro crisis, political will is needed. Politicians need to not only focus on the Banking Union but also on ways of addressing excessive risk in the crisis countries to boost investment and to get credit flowing again to viable firms.

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<sup>1</sup> For further details, please see [http://www.epc.eu/pub\\_details.php?cat\\_id=4&pub\\_id=3400](http://www.epc.eu/pub_details.php?cat_id=4&pub_id=3400)