The *Bank Crisis* Is Not Over

By Hans-Werner Sinn

And muddling through is no answer.

As America's various rescue plans take hold, stock markets are recovering somewhat. The S&P 500 price/earnings ratio is gradually climbing back to its long-term average of sixteen. Bank shares in particular are rebounding, and some banks have even succeeded in repaying at least part of their government-provided capital.

But, as I point out in my new book *Casino Capitalism*, this may only be a temporary improvement in expectations rather than a sign of permanent recovery, as the size of the banks' hidden losses on their balance sheets is probably enormous. According to the International Monetary Fund's most recent estimates, the total write-offs on financial claims in this crisis will be $4.05 trillion for the United States, Japan, the Eurozone, and the United Kingdom, of which the United States alone will have to absorb $2.7 trillion.

But according to my calculations of Bloomberg data, just $1.12 trillion had actually been written off worldwide by February, 2009. This suggests that only a quarter of the necessary write-offs have been realized.

For the United States and Switzerland, this is particularly bad news, as in both countries the realized write-offs already amount to 53 percent and 54 percent of the aggregate balance sheets of their national banking systems, which corresponds to 4.4 percent or 15 percent of GDP, respectively. The Netherlands, the United Kingdom, and Germany should also be concerned, as they come next in the ranking of countries whose banking systems have been hit hardest

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by the crisis. Their write-offs were 2.0 percent, 4.2 percent, and 2.8 percent of GDP, respectively, which corresponds to 11 percent, 16 percent, and 22 percent of the aggregate equity stock of their banking systems.

These frightening numbers raise doubts about the stability of the West's financial system, and they dwarf all measures, such as "bad banks" and government guarantees, that attempt to solve a mere liquidity crisis. The banking system is not primarily suffering from a temporary breakdown of the inter-bank market and a transitory decline in asset values that could be overcome simply by waiting for recovery. Rather, the banking system is at the brink of insolvency, with a permanent loss in equity capital.

The prices of structured securities such as collateralized debt obligations have come down, because the institutional fraud of a multi-fold chain of securitizations has been detected. Cash-back loans to NINJA (No Income, No Job, and No Assets) customers that included voluminous fees to brokers and were securitized and structured up to 60 times do not represent any value. And if the structuring process created 70 percent triple-A rated paper out of what on average were B-value loans, there must have been fundamental flaws in the rating process, which will not disappear simply because the economy or the stock market recover.

Moreover, defaults on securitized credit card debt and commercial loans to companies that are driven to bankruptcy are still to come. They will continue to deprive the banking system of its equity capital, with little chance of it being recouped in the near future.

Accounting rules are generous enough to allow banks to keep many losses under the carpet for the time being. But it is only a matter of time until banks are forced to reveal the truth. Thus, there is no point in waiting for miracles. That mistake was made by the Japanese, who tried, unsuccessfully, to muddle through, only to end up with eighteen years of stagnation.

In today's crisis, muddling through would be a recipe for a continuation of the crisis and secular stagnation of the type once described by Alvin Hansen, a contemporary of Keynes. Hansen predicted that capitalism would suffer from a permanent underinvestment crisis. Banks would scale down their balance sheets in proportion to their reported equity losses and exacerbate the credit crunch from which the world is already suffering today.

Bad banks that are constructed generously enough to provide banks with hidden equity injections are one way to avoid or mitigate the credit crunch. But establishing them would be a bad idea, because to do so would imply government subsidization of banks, thereby creating incentives for imprudent behavior in the long run. After all, one reason for the banking crisis was that banks expected governments to bail them out in case of trouble.

A better way to help banks and prevent them from simply deleveraging their business would be to establish full transparency and provide fresh money from taxpayers. But governments should not make gifts. Instead, they should become partners of private shareholders, endowing the banks temporarily with new equity capital until the crisis is over. This rescue strategy has a double advantage. It helps banks immediately, and it creates the right incentives for future behavior, as banks will know that the government will not prevent private equity capital from being destroyed in a crisis.

This type of rescue strategy also makes it possible to increase the required supervisory equity-asset ratios of banks in the midst of the crisis without risking a credit crunch. If government becomes a partner, it may well endow the banks immediately with the equity required to sustain their business. Banks would again trust each other, and the inter-bank market would be reestablished. Of course, from a political perspective, reforms such as these can best be carried out when the crisis is acute, not when Wall Street believes it can go back to business as usual. The time for reform is now. ◆

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