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The Crisis of Financial Markets and the Real Economy

The current crises has been adumbrated by a normal slump of the real economy and dramatically exacerbated by the financial crisis (starting form fall 2007), leading up to the most acute recession of the post-War period. A global recovery will not succeed without a shore-up of the financial system. This contribution attempts at outlining the main aspects of the expansion of leveraging as well as of the decrease of the debt-equity ratio (deleveraging).

Historically speaking, the debt finance/equity finance ratio has never been higher than during the last years. Debt finance facilitates economic expansion, but pushes up systemic risks accordingly. It was the explicit philosophy of this period that when the prices of goods do not exceed a specific benchmark (ECB: 2%), this is not considered a jeopardy for economic stability. It went largely unnoticed that simultaneously, asset inflation bubbles were forming. Generally, it may be stated that economies with a high share of debt finance are significantly less shock-resistant than those with a low share: Debts have to be repaid with interest on a specific day, otherwise problems occur; in the case of several debtors, also problems for the bank. In case equity capital quota are high, equity is devalued for some time. This can be compensated after the crisis.

Several factors have caused this unique leverage level

The Basel II regulation system mainly decrees that instead of a general level of 8% capital requirement for credit risks the banks now have to calculate a differentiated capital backing quota on the basis of risk classes defined through a rating procedure. This means that that risks with high credit ratings require less and risks with low ratings require more capital backing. During the economic boom in the last years many assets had received top ratings, among other things the famous ABS securities by which US risks were traded worldwide. In the final analysis, Basel II has led to an expansion of the possibilities to generate credits. Unfortunately, it turned out that Basel II generated pro-cyclical effects during the downturn.

- During the slump, the client and borrower ratings deteriorate, which necessarily entails a higher capital backing of the bank. One of the consequences of this process is that the participation capital which has been placed at the disposal of the banks by the Austrian state has primarily been used to raise their equity stock.

- The transition from the traditional creditor-oriented balancing system according to the /Austrian/ Enterprise Act (UGB) to an investor-oriented balancing system under the International Financial Reporting Standards (IFRS) includes, as an essential innovation, valuation at actual market prices. This principle, in tandem with a fixed capital backing rate, is sufficient to spawn a pernicious pro-cyclical effect, which leads to a strong expansion during the boom and to a disproportional contraction of debt finance by banks during the downturn.

- Special vehicles: In hindsight, the mushrooming of the so-called *special purpose vehicles viz. special investment vehicles* was particularly surprising. These facilities were regularly 100%

subsidiaries of a bank. The outsourced companies neither had an obligation to consolidate, nor were they audited by the financial supervision authorities or the national banks. These special vehicles were an additional possibility to expand debt finance leaving equity wholly or partly untouched.

- *Credit default swaps (CDS):* Although this development did not directly promote the expansion of credit capital, it did permit risky business ventures which did not have to be backed by large equity quotas. The emergence of CDS markets thus led to higher banking risks. Issuing bank guarantees for a fee is no recent innovation, but a hoary business practice. During the last years, however, this sort of business has led to the emergence of huge markets. The real economy made ample use of it since this promised more predictability and security. The only concern was that the institution extending the guarantee did not have to provide equity backing or did so with insufficient means only.

Which changes of the financial system will be necessary?

1. The above considerations warrant the conclusion that as a first step, special purpose vehicles should be outlawed by a new European financial regulation package, which is still to be elaborated. All risks must be made visible in the balance.

2. The collapsed ABS/ABCP markets will recover only slowly. Principally, hedging risks by securitizing claims in a new instrument is a good idea, as along as the purchasers of this security are able to assess the quality of the debtor themselves. If they have to resort exclusively to the recommendations of a rating agency, developments like those we can observe at present cannot be excluded.

3. Balancing according to IFRS has the advantage that the investor obtains a much better insight into the company than it was the case with the previous balancing rules. Many managers regret that building silent reserves is no longer possible under IFRS and that therefore shock sensitivity has increased. A return to a creditor-oriented balancing system according to the Trade Act (HGB) or the Enterprise Act (UGB) does, however, not seem to be a viable solution.

4. The fact that the Basel II regulation system has strong pro-cyclical effects and is causing the banks headaches at this point is a property of this principally rational innovation which should be taken into account in the current haggling about new regulations.

5. Generally speaking, the financial system and the real economy will need relatively more equity than prior to the crisis, because the expansion of debt capital can no longer occur in its unbridled pre-crisis form. Naturally, during the boom, the Basel II system viz. the improved rating of borrowers will scale down the necessity of capital backing. This implies that a part of the committed equity will be available for expansion. Balancing under IFRS will have the same effect. Whether there will be sufficient equity for the new financing vehicles, remains open. Probably, banks and other financial agents will have to be more active as equity procurers than in the past.