

The big gamble

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Despite cuts in interest rates, the problems on the US real estate and banking markets have not yet been solved and form the epicenter of a financial crisis in the OECD countries. The wave of asset-backed securities in the 1990s, in which the banks passed their credits on to the capital market, led to dubious developments.

In view of the crisis faced by the British bank Northern Rock, which caused an almost unprecedented shock in Britain, the economist Paul J.J. Welfens sees the inadequate protection of deposits and poor banking supervision in Britain – and in other OECD countries - as the root of the problem. In an article on the ongoing banking crisis recently published in the Springer journal *International Economics and Economic Policy*, he writes that the leading finance centers are responsible for the shocking international crisis characterized by a loss of confidence in major markets.

Along with their British counterparts, the large US banks lost all sense of proportion in the 1990s, harboring unreasonable expectations of a return on equity of 25-30 percent. With interest rates at four percent for risk-free government bonds, the difference of up to 30 percent corresponds to a risk premium of 26 percent.

According to Welfens, President of the European Institute for International Economic Relations (EIIW) at the University of Wuppertal, Germany, the banks' behavior amounts to a casino mentality. In his article, he writes that such large commitments on the part of the banks are a very high risk investment.

Compared with the rates of equity of 10-15 percent traditionally regarded as normal, the targets in New York and London appear excessive; they are not sustainable and are ultimately dangerous for the global economy. Welfens believes that the crisis will continue or reoccur if banking supervision systems are not improved and sensible tax reforms carried out in both the USA and the EU, thus creating new incentives for more sustainable investment strategies. New and better rules under the heading of Basel III are required.

Welfens predicts that risk premiums will continue to grow in 2008/09. Extensive recapitalization of US banks and of banks and funds in Britain and Switzerland, drawing on sovereign wealth funds from China, Singapore and Arab countries, shows that the only way to strengthen capital resources sufficiently in a new setting is often to use external sources of capital.

The problems faced by several German regional banks and the alarming developments at IKB Deutsche Industriebank, which has been bailed out at a cost of several billion euros to the taxpayer, point to poor risk management. In Welfens' view, "The stricter lending criteria will force banks to strengthen their capital resources and to reduce loan growth, which will have foreseeable dampening effects on the economy. The EU should push the US to come up with structural reforms; the US system is unstable and causing serious global instabilities."

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