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Stopping the Panic in Europe

FROM TODAY'S WALL STREET JOURNAL EUROPE

The financial storm has now hit Europe. Governments scrambled yesterday and over the weekend to rescue banks whose shares were in free fall as their short-term lending dried up. Given yesterday's failure of the Paulson plan in the U.S. Congress, the actions were necessary and fortuitous.

In a meeting late Sunday that included European Central Bank head Jean-Claude Trichet, the governments of Belgium, the Netherlands and Luxembourg agreed to inject €11.2 billion into Fortis. Each government got a 49% share of the bank's operations in its country, giving the word "multinational" a whole new meaning.

As the three governments put public money on the line, they seem to be trying their best to keep the costs to taxpayers under control by pushing through asset sales. ABN Amro, whose Dutch retail operations Fortis bought just before the financial crisis started a year ago, is high on the list. In Britain, Bradford & Bingley was brought under control of the government, which is selling the mortgage lender's retail branches and deposits.

Meanwhile, a consortium of German private banks, backed by state guarantees from Berlin, stepped in with a €35 billion lifeline to Hypo Real Estate, one of Europe's largest real estate, project finance and local government lenders. Governments in Russia, Denmark and Iceland also had to help out banks with funding problems.

Moral hazard was yesterday's problem; today it's all about saving the financial markets. We are no friends of bailouts, but the recent steps taken in the U.S. and Europe are signs of progress as governments are adding public capital where private money is missing to stabilize the system. The failure of Fortis would have had causes further losses at some U.S. banks, spreading contagion further.

These steps are an improvement on the ad hoc bailouts of last year; the aim is to put out small fires before they spread and become larger ones. While governments need to use good judgment and restraint on the bank takeovers, now is the time to act given the risk of a financial breakdown.

It was only last week that Hank Paulson, following his announcement of a $700 billion rescue package, suggested that Europe get ready with its own contingency plan. Governments from Berlin to Paris were quick to reject the U.S. Treasury Secretary's suggestion. Perhaps it was posturing so as not to spook the market.

But there was also a whiff of gloating. German Finance Minister Peer Steinbrück declared the end of American financial hegemony. The front page of the current Der Spiegel shows the Statue of Liberty's torch extinguished, beneath a headline that reads "The Price of Hubris." What's German for *schadenfreude*? Oh, right.

As the market turmoil shows, the global credit mania has been replaced by a global panic. The U.S. committed the original sin with easy money from the Federal Reserve and the turbocharger of Fannie Mae and Freddie Mac. But everyone enjoyed the credit euphoria while it lasted, and it was broader than the U.S. real estate market or subprime lending. Europe had its own property bubbles in Spain, Ireland, the U.K. and elsewhere. It also had its share of bankers who relied on complex securitization and risky growth models that outstripped their capital cushion when losses arrived.

In some ways, Europe's exuberance even surpassed Wall Street's "hubris." The dozen largest European banks have an average overall leverage ratio -- shareholder equity to total assets -- of 35, compared with less than 20 for the largest U.S. banks, according to Daniel Gross and Stefano Micossi at the Center for European Policy Studies. At the end of last year, Deutsche Bank's leverage ratio stood at 52.5. By the end of June, Barclays Bank's was 61.3.

Nobody suggests that all of these balance sheet positions are equally tainted. But the figures illustrate the potential magnitude of the problem as short-term lending freezes up because banks mistrust each other. The Paulson plan was an attempt to create a market for some of the toxic assets, as well as store them until markets stabilize. European banks with significant operations in the U.S. would have been able to take direct advantage by auctioning their assets to the Treasury.

But that's not an option that banks like Fortis, without major U.S. operations, would have. Europe may therefore need its own Paulson plan, and that's where things get tricky. European banks are increasingly transnational, but their taxpayers -- and tax collectors -- aren't. Putting taxpayer money on the line to pay for the mistakes of bankers is a hard sell under any circumstances. Doing so for a foreign bank that doesn't have significant operations in one's country is even harder.

That said, the EU has a tradition of solidarity. Citizens pay (unwisely) billions of euros to subsidize farmers and infrastructure projects around the Continent. These programs have always benefited some countries more than others.

Showing solidarity to save the financial system may not be such a stretch.

The alternative is to continue with piecemeal nationalizations and cooperation between governments as needed. It's gone smoothly so far in the case of Fortis. But the Benelux countries have a long history of working together. Would it be as seamless between, say, German and French governments, should such cooperation be required? We have our doubts. Europe may need its own more strategic financial intervention.

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