

The BBVA Foundation presents the CESifo Report on the European economy 2009

Europe needs common regulations regarding the financial system for supervising banks and intermediaries

- The supervision of pan-European financial groups would be in the hands of the European Central Bank (ECB); in addition, according to the CESifo report, these groups would be required to subscribe for a European fund to insure deposits to complement national insurance.
- The report forecasts an unemployment rate of 17.1% for Spain in 2010.

The BBVA foundation presents the *CESifo Report on the European Economy 2009*, which, this year, has focused on the international financial crisis. The report also offers an analysis of the current economic situation and the future prospects for the world economy.



From left to right, Jan-Egbert Sturm, co-author of the report and lecturer at the the KOF Swiss Economic Institute and Xavier Vives, co-author and lecturer at the Public-Private Sector Research Centre of the IESE, and Rafael Pardo, director of the BBVA Foundation

CESifo is an organisation made up of the Center for Economic Studies of the University of Munich (CES) and the Ifo Institute for Economic Research. Xavier Vives, collaborator of the BBVA Foundation and lecturer at the IESE, participates in the European Economic Advisory Group (EEAG), which draws up this annual report. In the current crisis context, the authors recommend that European countries agree on a common regulation system applying standards already existing for commercial banks to investment banks and financial intermediaries. This measure should be accompanied by the creation of a fund for insuring deposits under the supervision of the European Central Bank.

The financial crisis

This edition of the *CESifo Report* pays special attention to the micro and macro-economic roots of the financial crisis and does a detailed analysis on the process of securitization of subprime mortgages in the US mortgage market.

In the first place, a general underestimation of the fundamental risk and the liquidity risk meant that both the creation of subprime mortgages and the issue of AAA-rated ABS deriving from the underlying mortgage pool were excessive under any reasonable parameter. In the second place, several securitization layers, each of which involved some form of credit improvement and insurance, led to a loss of transparency in the ABS, which undermined the capacity of intermediaries to measure the amount and location of risk in their portfolio. Last of all, the diversification of risk was not real, as the highly rated ABS sold to institutional investors (pension funds, mutual funds, etc.) were guaranteed by intermediaries. When the crisis erupted, a large number of the ABS was repurchased by highly levered financial institutions. With a low level of transparency, the diversification of ABS among intermediaries created systemic risk by generating dangerous network externalities, which subsequently undermined the liquidity for many types of assets and for financial markets.

This report seeks to learn some lessons from the crisis, with an aim to defining the general principles to be followed in order to correct the system's failings. The merit of the different proposals does not lie in the fact that they are radical but rather in their consistency with the ultimate objectives of the governance of the financial system.

Some of these lessons are shared by many other institutions and academics. Financial intermediaries (for example, conduits and structured investment vehicles) which, like banks, are involved in maturity transformation and are prone to bank panic, should be subject to the same regulations and supervision as banks. Such regulation and supervision is motivated by the Government's implicit commitment to rescue financial intermediaries when their bankruptcy has systemic effects and produce negative externalities in the payment system.