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Stress Test Is No Shortcut to Stability

By Mohamed El-Erian

As we count down to 23 July, many will ask if the announcement of stress test results for European banks is a game-changer. Will the testing of 91 European banks by regulators place the region back on the path of financial stability? After all, a similar approach in the US last year is believed by many to have contributed to the normalisation of financial markets there.

The answer to the question comes in two parts: understanding the context of the stress test, and identifying the five things that would enable the test to contribute meaningfully to financial normalisation.

The pursuit of a stress test is based on solid economic insights on how markets function (or, more accurately, malfunction) when there are large information failures. Both theory and practice show that such failures reduce market activity, and also make it very difficult for good institutions to distinguish themselves from bad ones.

Today's European interbank market is clogged as a result of uncertainties regarding the exposure – direct and indirect – of banks to the sovereign debt crisis in the region.

Many market participants have retreated to the sidelines, awaiting better information on the outlook for banks' balance sheets. Meanwhile, several banks (and their governments) believe that they are being unfairly punished by markets that, in their opinion, are subject to over-generalisation and excessive timidity.

Given this situation, Europe would be in the midst of a major banking crisis if the European Central Bank had not become the major counterparty to both sides of the interbank market. Weak banks go to the ECB for liquidity. Strong banks deposit their excess funds at the ECB rather than face other banks in the interbank market.

Europe cannot return to financial normality without a properly functioning market. Moreover, the longer the duality persists, the greater the risk of a disorderly reduction in credit, and also of capital flight.

No wonder the ECB and governments are so eager to improve the functioning of the interbank market. Their hope is that the stress test will provide the catalyst. For this hope to become reality, five things must happen.

First, the stress test must be encompassing in its coverage, applying to both strong and weak institutions. Yes, some will fail the test, but this is a better outcome overall than undermining the credibility of the policy approach by allowing only passing banks to participate. In this regard, we should take comfort from recent European decisions to expand the coverage of the test.

Second, the test must be robust in its design, particularly when it comes to its scenario assumptions. This involves being realistic about potential losses in

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stressed scenarios on account of exposure to property and sovereign bond holdings. As yet, we do not have enough information to assess whether this condition will be met.

Third, enough detailed information must be disseminated to allow the private sector to reverse-engineer the test. There is a sense of hesitancy among European officials when it comes to such a high degree of transparency.

Fourth, governments must be clear as to what will happen after the test. Recapitalisation and, where needed, mergers and closures must be credibly pursued. We are yet to hear enough on this.

Fifth – and this is where Europe's stress test differs significantly from that conducted in the US last year – the results must engender confidence that banks can handle the macro challenges facing Europe as a whole. This is by far the most limiting aspect when it comes to the potential effectiveness of the policy approach in Europe.

Last year's stress test in the US applied to institutions that were the main cause of the financial instabilities, and the government had budgetary room to support the sector. Europe's situation is different. The concern about banks is a derived concern, reflecting worries about sovereign debt in some countries and the overall economic situation; and there are greater limits today on budgetary resources.

European officials can do a lot to make the stress test credible; and they should. But, unfortunately, they cannot turn it into a catalyst for Europe's return to financial normality. Regrettably, this is a much bigger challenge. It was long in the making and will require a more comprehensive solution whose implementation is inherently more complex and protracted.

About the author:

Dr. El-Erian is CEO and co-CIO of PIMCO and is based in the Newport Beach office. He re-joined PIMCO at the end of 2007 after serving for two years as president and CEO of Harvard Management Company, the entity that manages Harvard's endowment and related accounts. Dr. El-Erian also served as a member of the faculty of Harvard Business School. He first joined PIMCO in 1999 and was a senior member of PIMCO's portfolio management and investment strategy group. Before coming to PIMCO, Dr. El-Erian was a managing director at Salomon Smith Barney/Citigroup in London and before that, he spent 15 years at the International Monetary Fund in Washington, D.C. Dr. El-Erian has published widely on international economic and finance topics. His book, *When Markets Collide*, was a *New York Times* and *Wall Street Journal* bestseller, won the *Financial Times*/Goldman Sachs 2008 Business Book of the Year and was named a book of the year by *The Economist*. Dr. El-Erian has served on several boards and committees, including the U.S. Treasury Borrowing Advisory Committee, the International Center for Research on Women, and the IMF's Committee of Eminent Persons. He is currently a board member of the NBER and the Peterson Institute for International Economics. He holds a master's degree and doctorate in economics from Oxford University and received his undergraduate degree from Cambridge University.

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