



Global Financial and Eurozone Reform: Five questions on a common theme

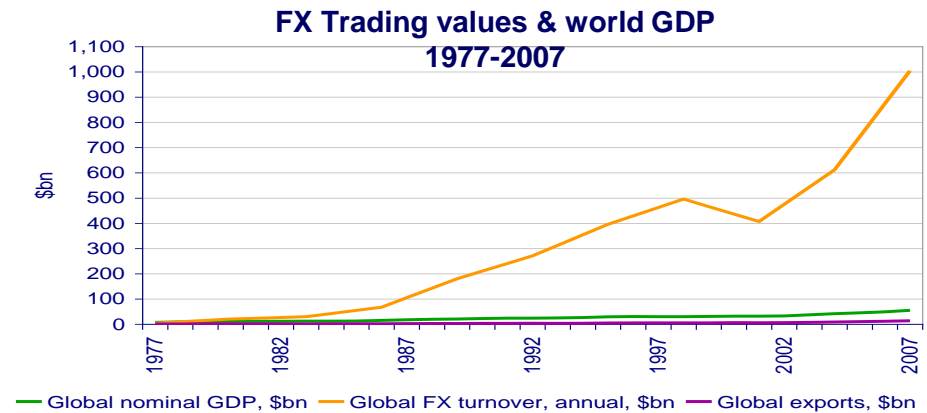
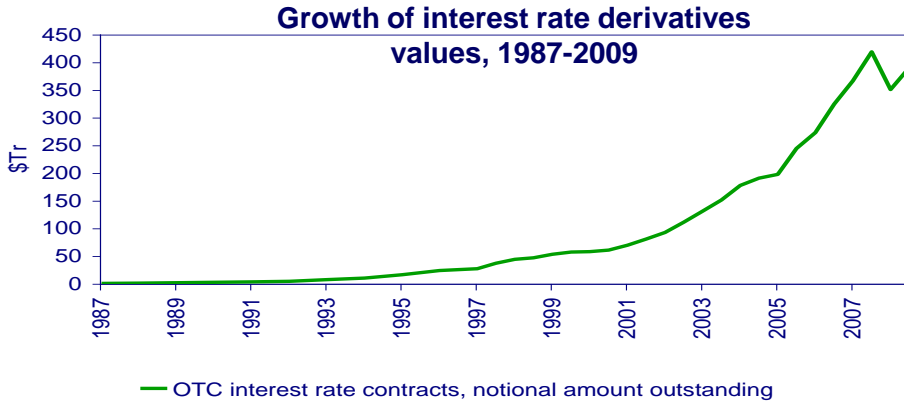
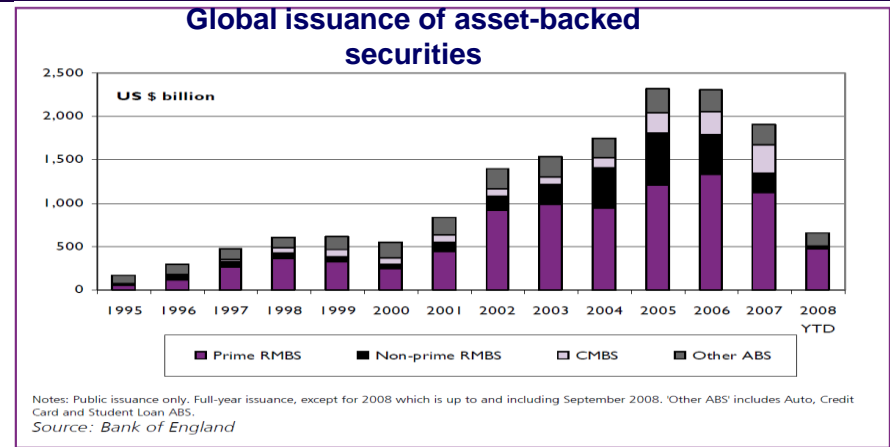
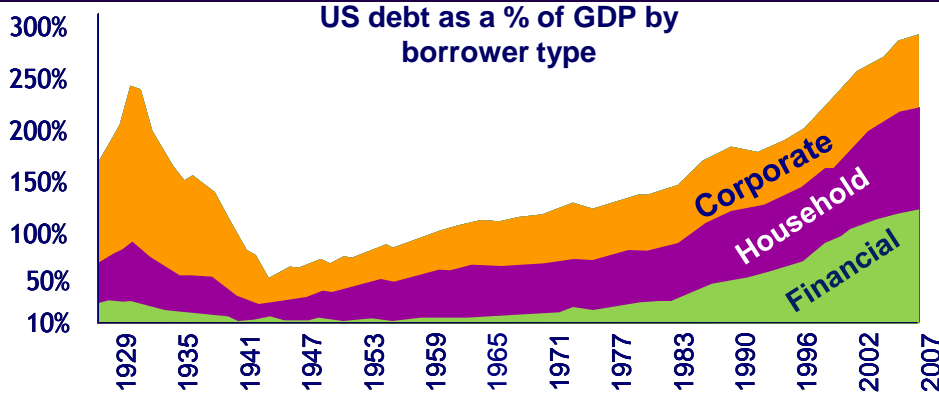
Adair Turner

Riksbank
Stockholm, 18 February 2013

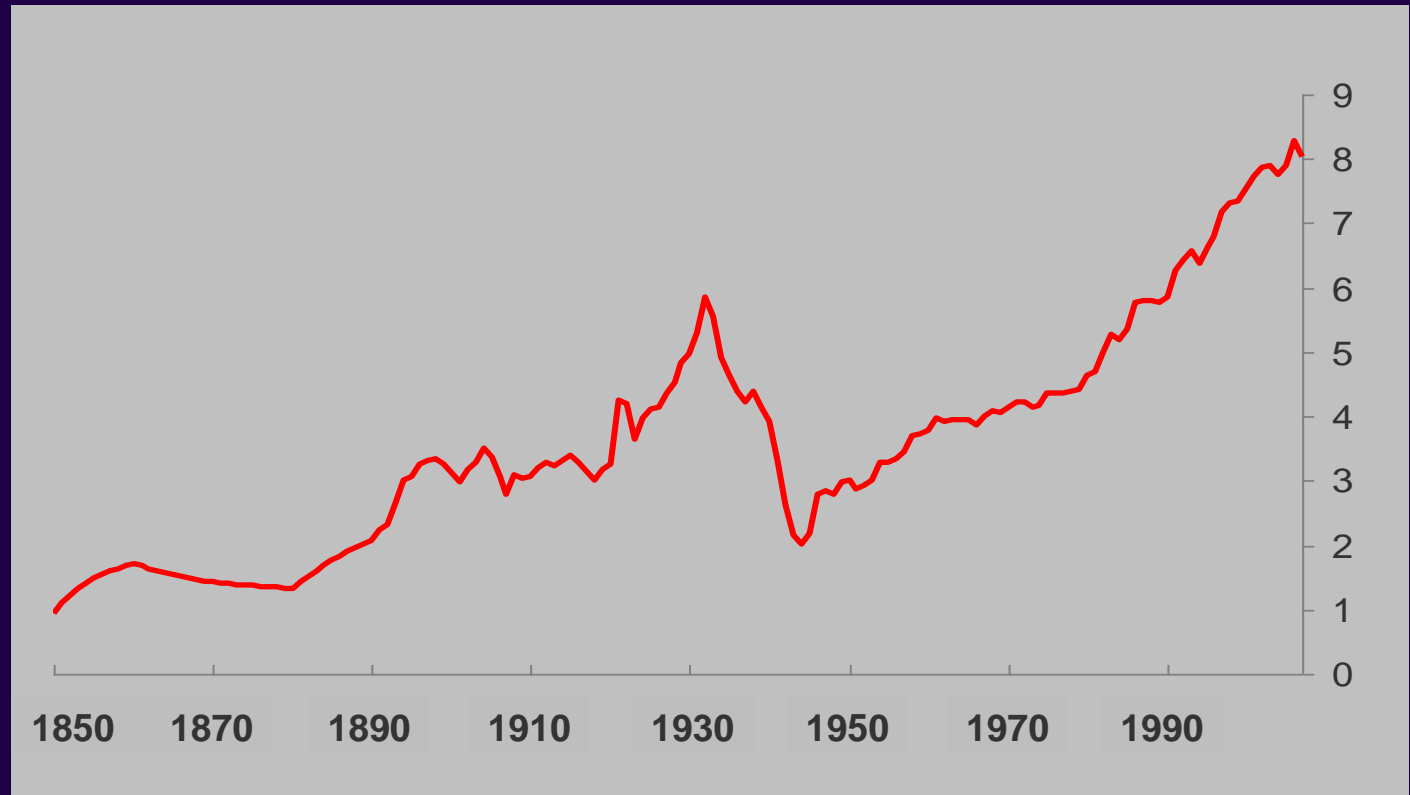
Five questions on a common theme

- ❖ Are optimal capital ratios higher still than Basel III standards, and if so, what should we do about it?
- ❖ Should macro-prudential regulators seek to constrain aggregate economy wide leverage and if so, how?
- ❖ How much federalism is needed to make the Eurozone a sustainable and successful monetary union?
- ❖ Are we too worried about fragmentation of global banking?
- ❖ Should banks have the right to cross-border branching within the European Union?

Measures of increasing financial intensity



Share of the financial industry in US GDP



Source: Philippon, T (2008), *The Evolution of the US Financial Industry from 1860 to 2007: Theory and Evidence*. (As referenced by Andrew Haldane in *The Future of Finance*, LSE Report, 2010)

Market perception of private credit risk



Non-investment grade corporate bond spreads



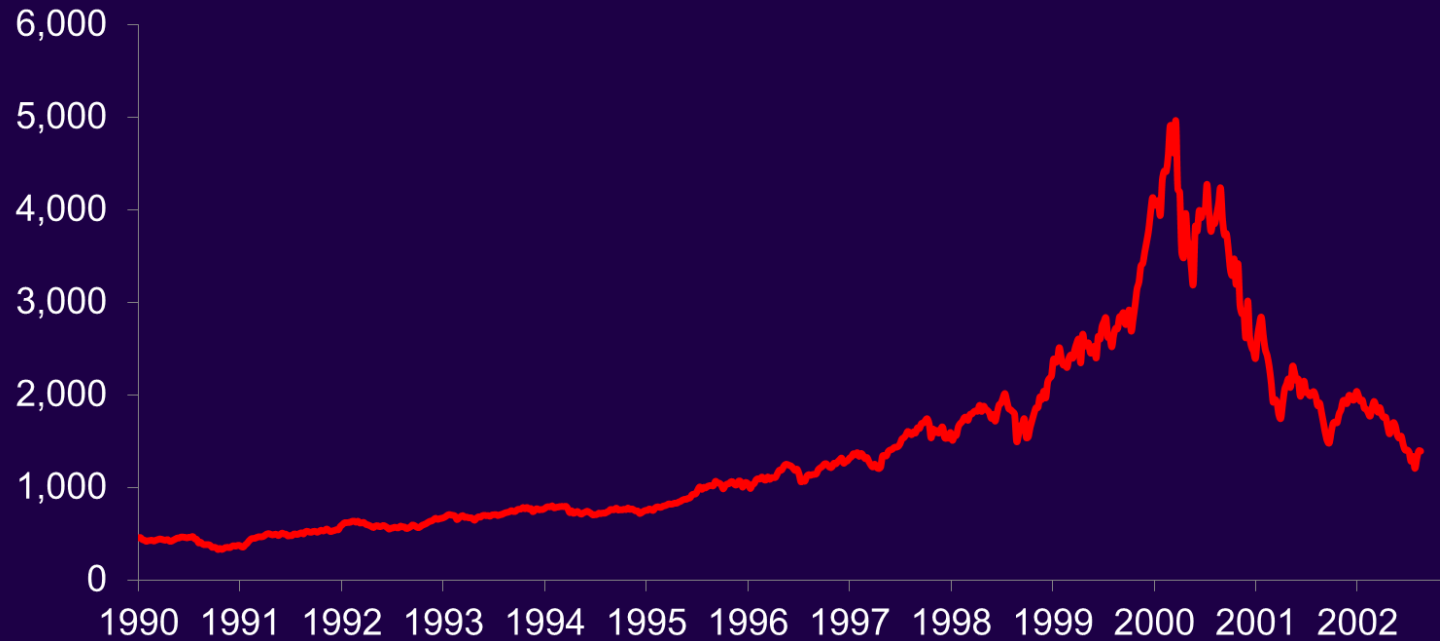
Average CDS of major financial firms



Firms included: Ambac, Aviva, Banco Santander, Barclays, Berkshire Hathaway, Bradford & Bingley, Citigroup, Deutsche Bank, Fortis, HBOS, Lehman Brothers, Merrill Lynch, Morgan Stanley, National Australia Bank, Royal Bank of Scotland and UBS
CDS series peaks at 6.54% in September 2008.

Source: Moody's KMV, FSA calculations

NASDAQ index: 1990 – 2002



Source: Datastream

Three drivers of financial instability

- ❖ Debt contracts create specific risks
- ❖ Unregulated bank credit and private money creation is inherently unstable
- ❖ Lending secured against real assets can be strongly pro-cyclical

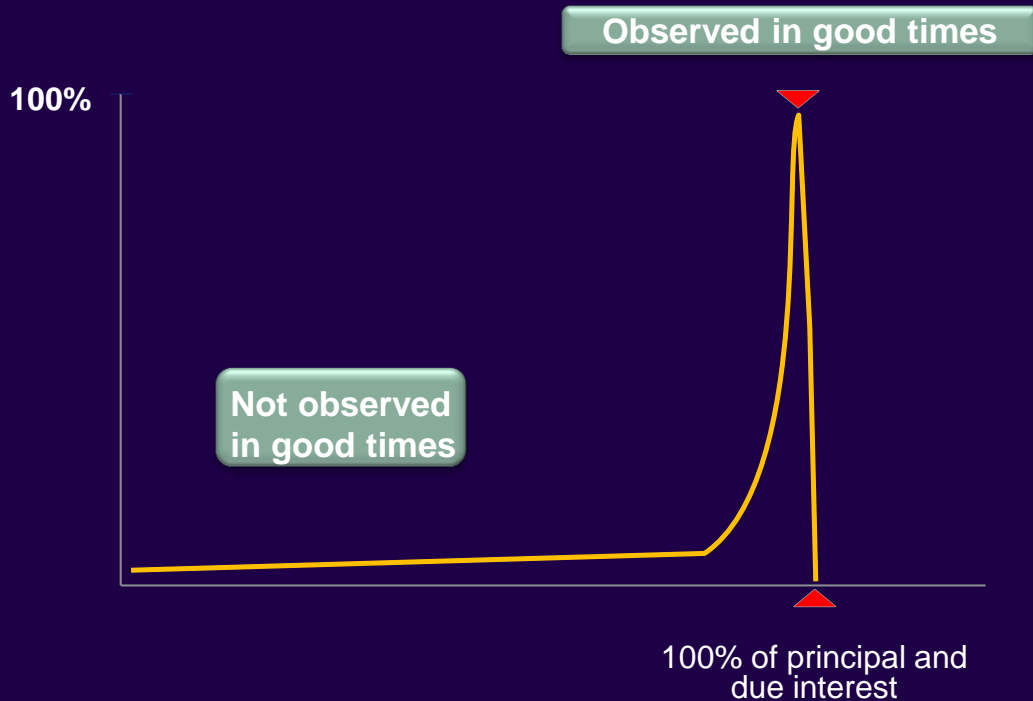


Real economy leverage, credit creation dynamics, and credit/asset price cycles are crucial macro-economic variables, and phenomena

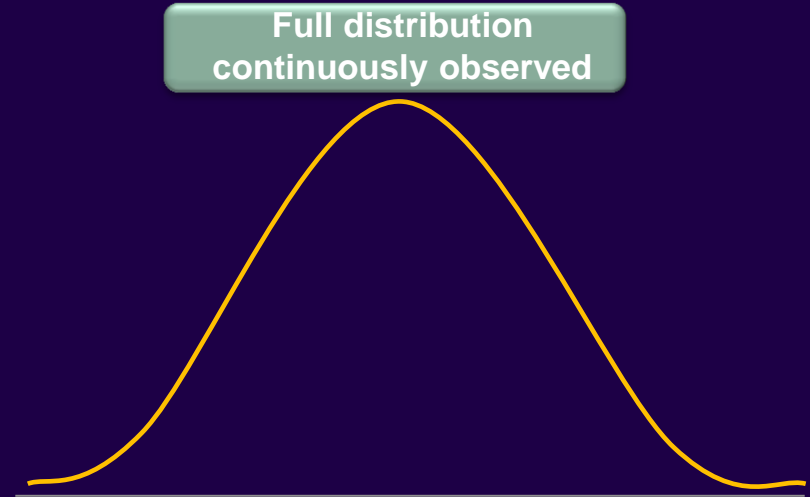
Observed payout distributions for debt and equity



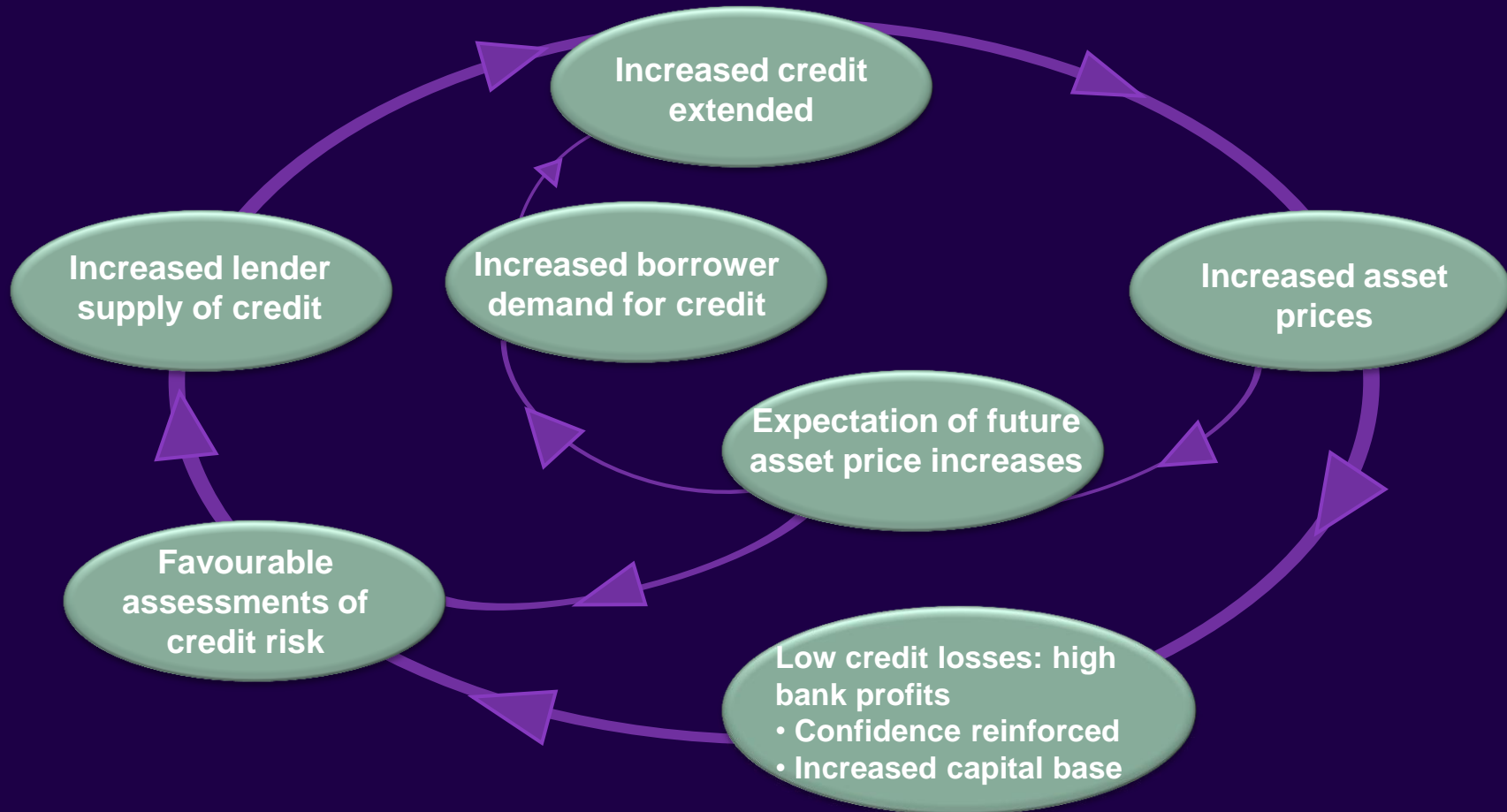
Debt payouts



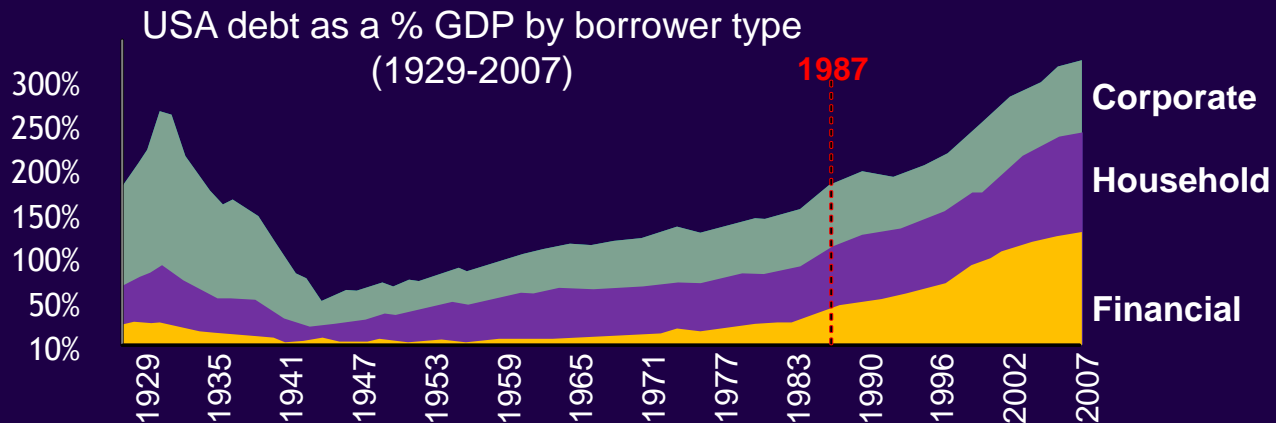
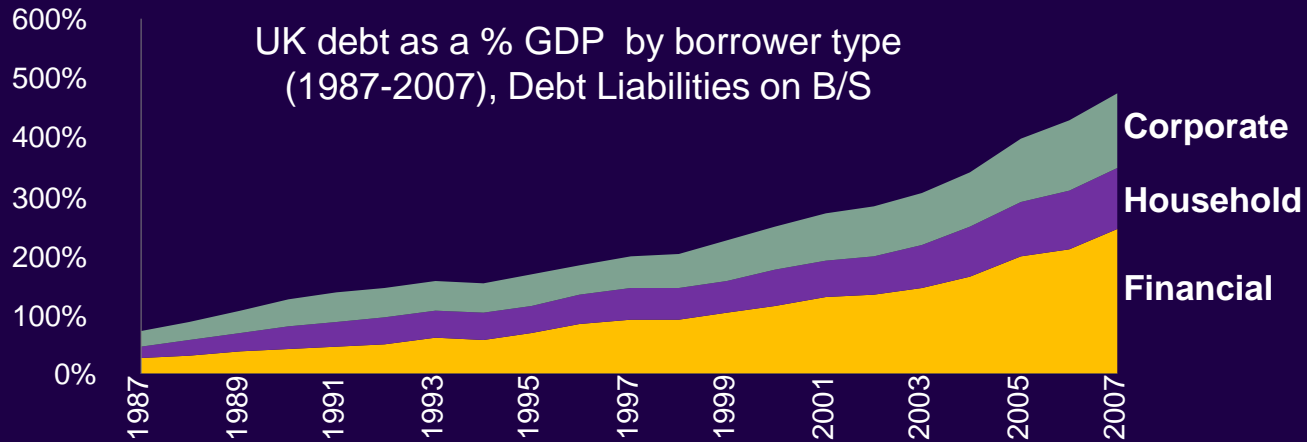
Equity payouts



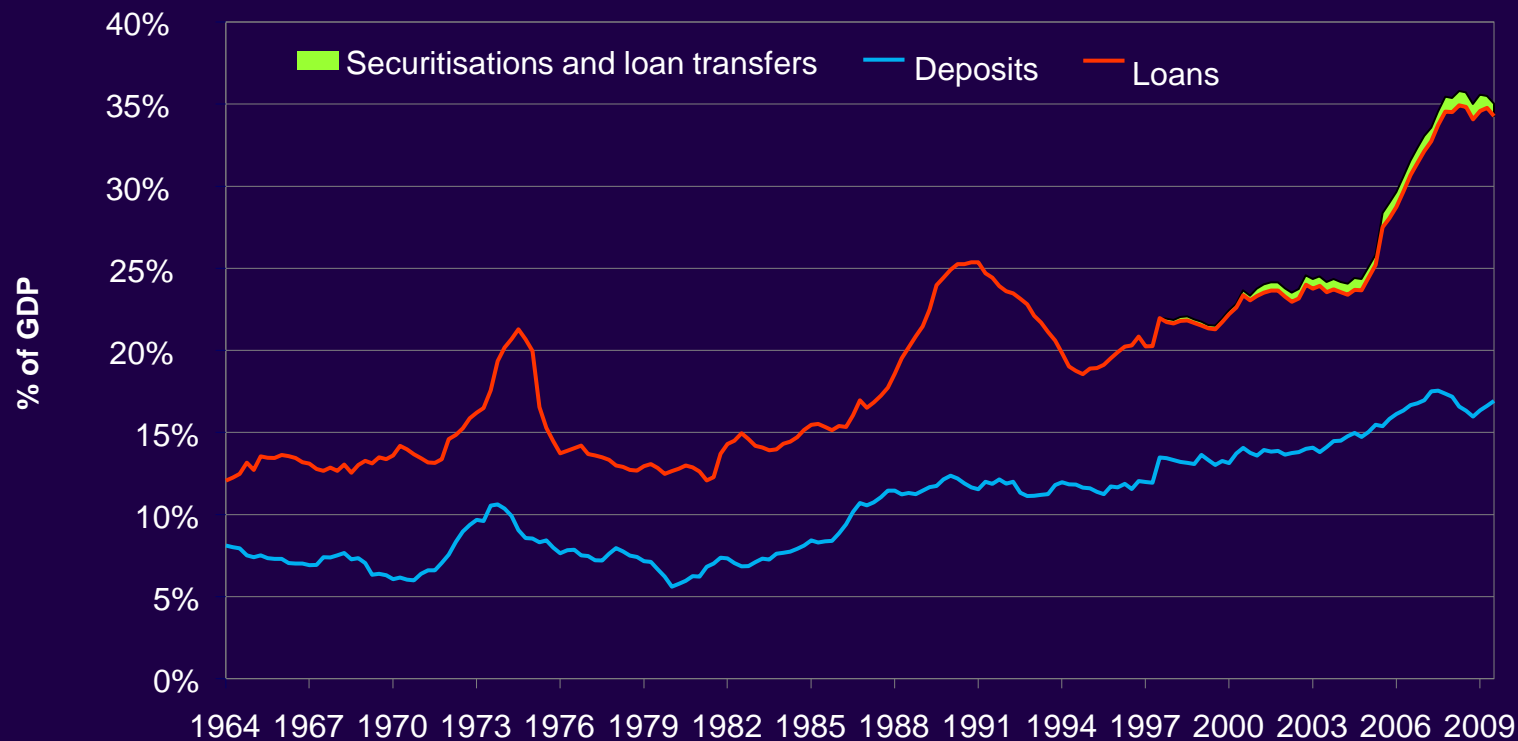
Credit and asset price cycles: the upswing



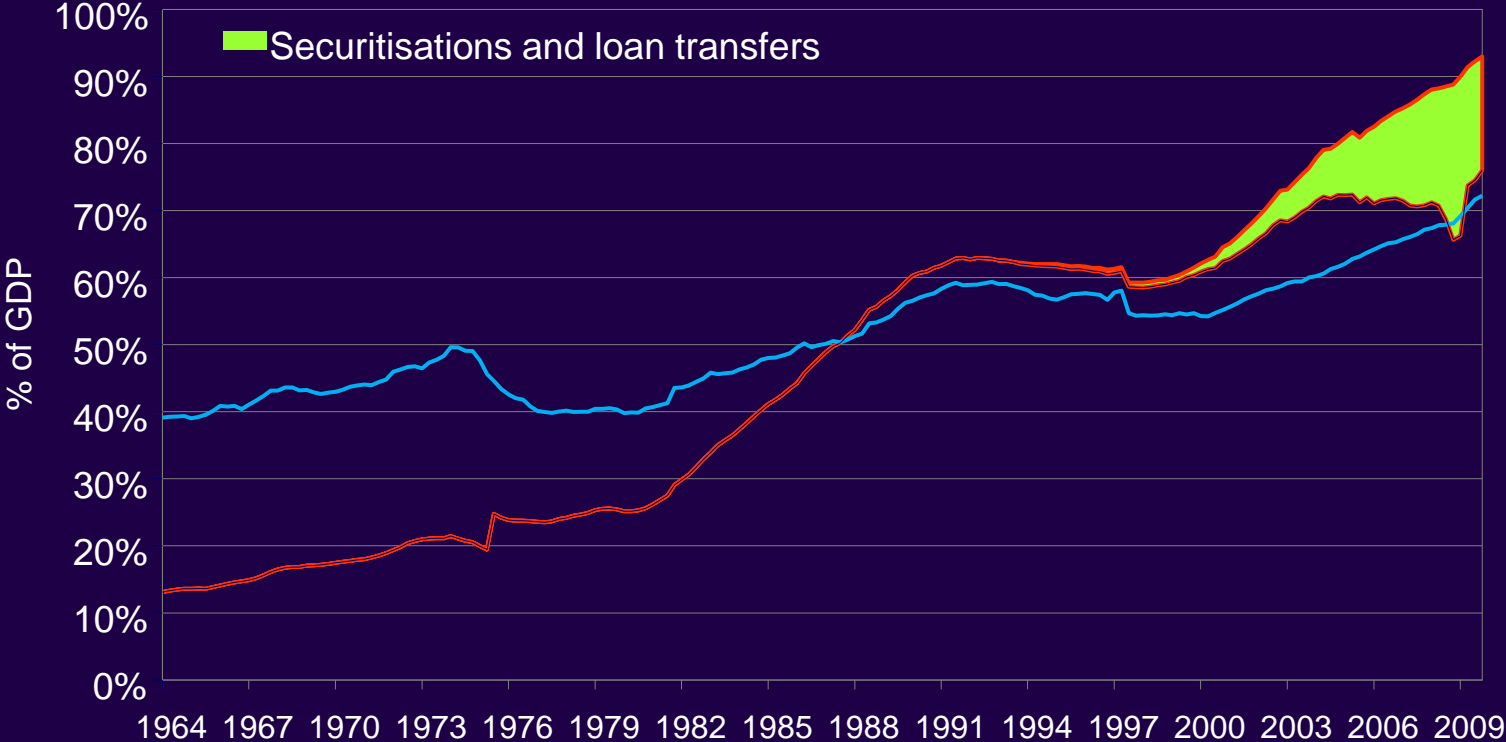
Leverage in real and financial sectors



Private non-financial corporate deposits and loans: 1964 – 2009



Household deposits and loans: 1964 – 2009



Source: Bank of England, Tables A4.3, A4.1

Financial deepening: the pre-crisis consensus



❖ Neutral:

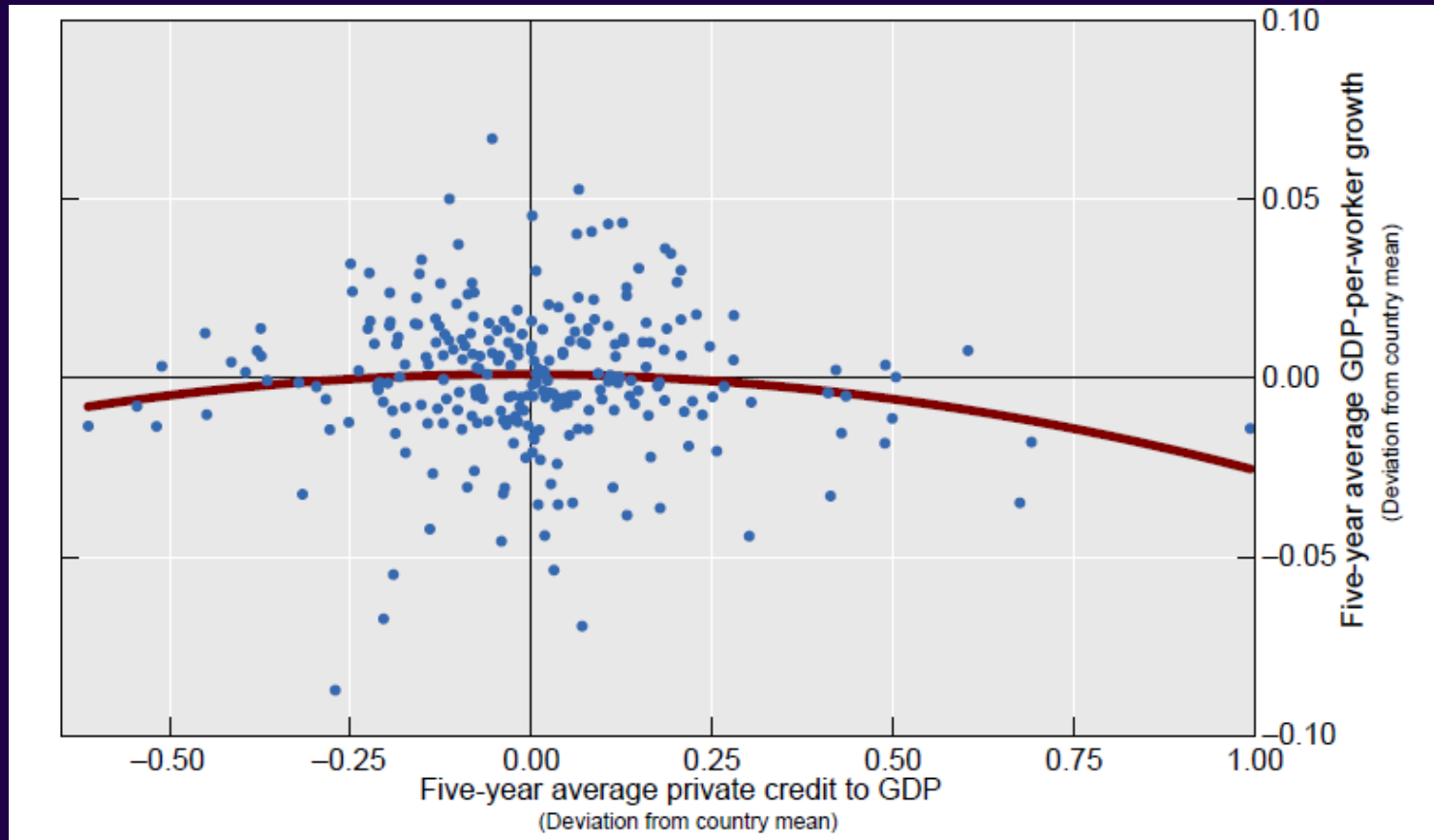
“We assumed we could ignore the details of the financial system”
(Olivier Blanchard, October 2012)

The dominant new Keynesian model of monetary economics *“lacks an account of financial intermediation, so that money, credit and banking play no meaningful role”*
(Mervyn King, October 2012)

❖ Welcome:

Axiomatically beneficial since reflects more complete markets and contracts between rational private agents

Private credit to GDP ratio and growth

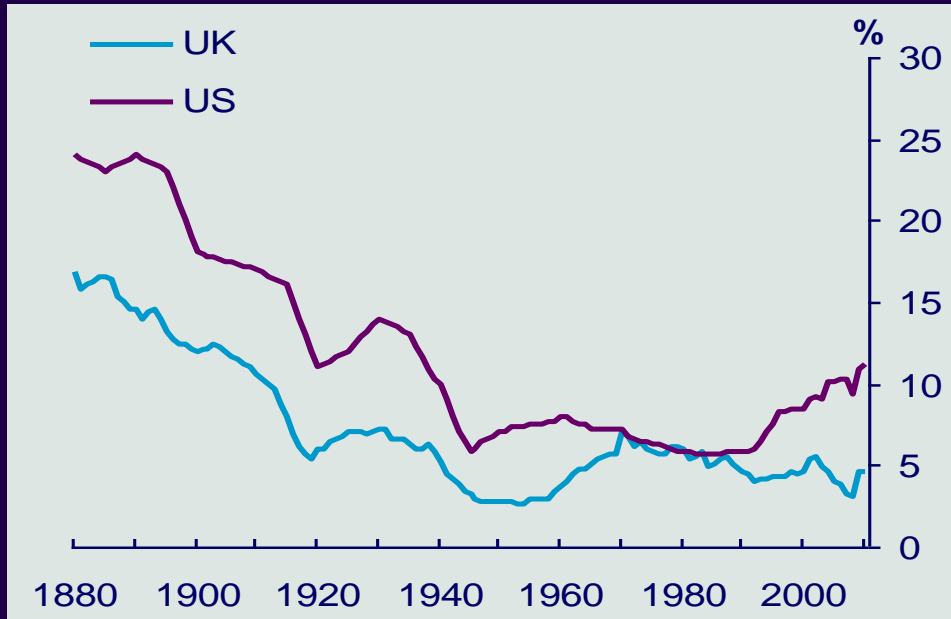


Source: S. Cecchetti, BIS Working Paper No. 381 "Reassessing the impact of finance and growth"

Long-term trends in bank capital & liquidity ratios

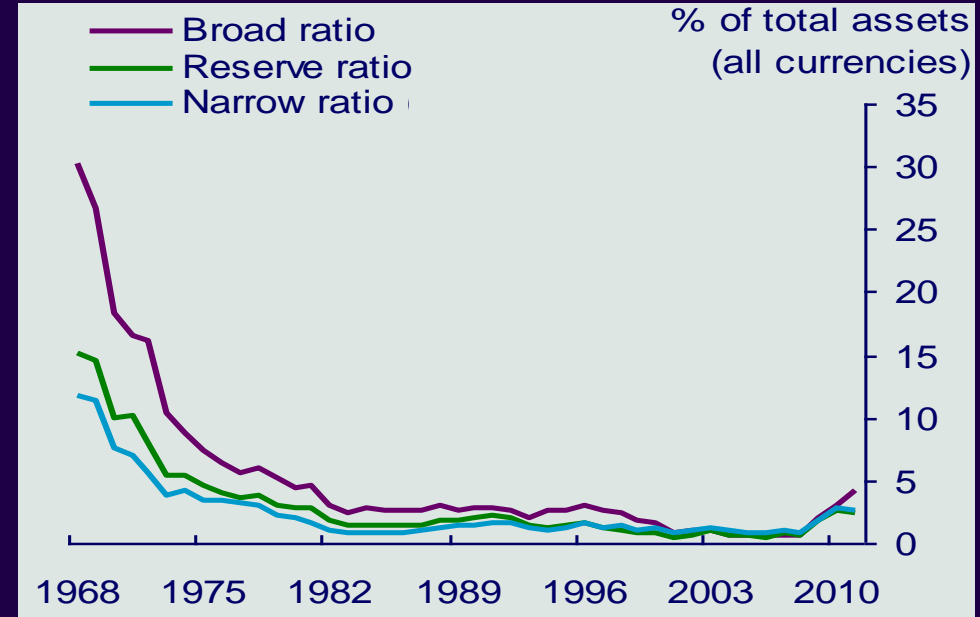


Capital ratios for US and UK banks



Source: US: Berger, A. Herring, R and Szegö, G (1995) and FDIC.
UK: Sheppard, D.K (1971), BBA and Bank of England calculations.

Sterling liquid assets



Source: Bank of England and Bank calculations.

Five questions on a common theme

- ❖ Are optimal capital ratios higher still than Basel III standards, and if so, what should we do about it?
- ❖ Should macro-prudential regulators seek to constrain aggregate economy wide leverage and if so, how?
- ❖ How much federalism is needed to make the Eurozone a sustainable and successful monetary union?
- ❖ Are we too worried about fragmentation of global banking?
- ❖ Should banks have the right to cross-border branching within the European Union?

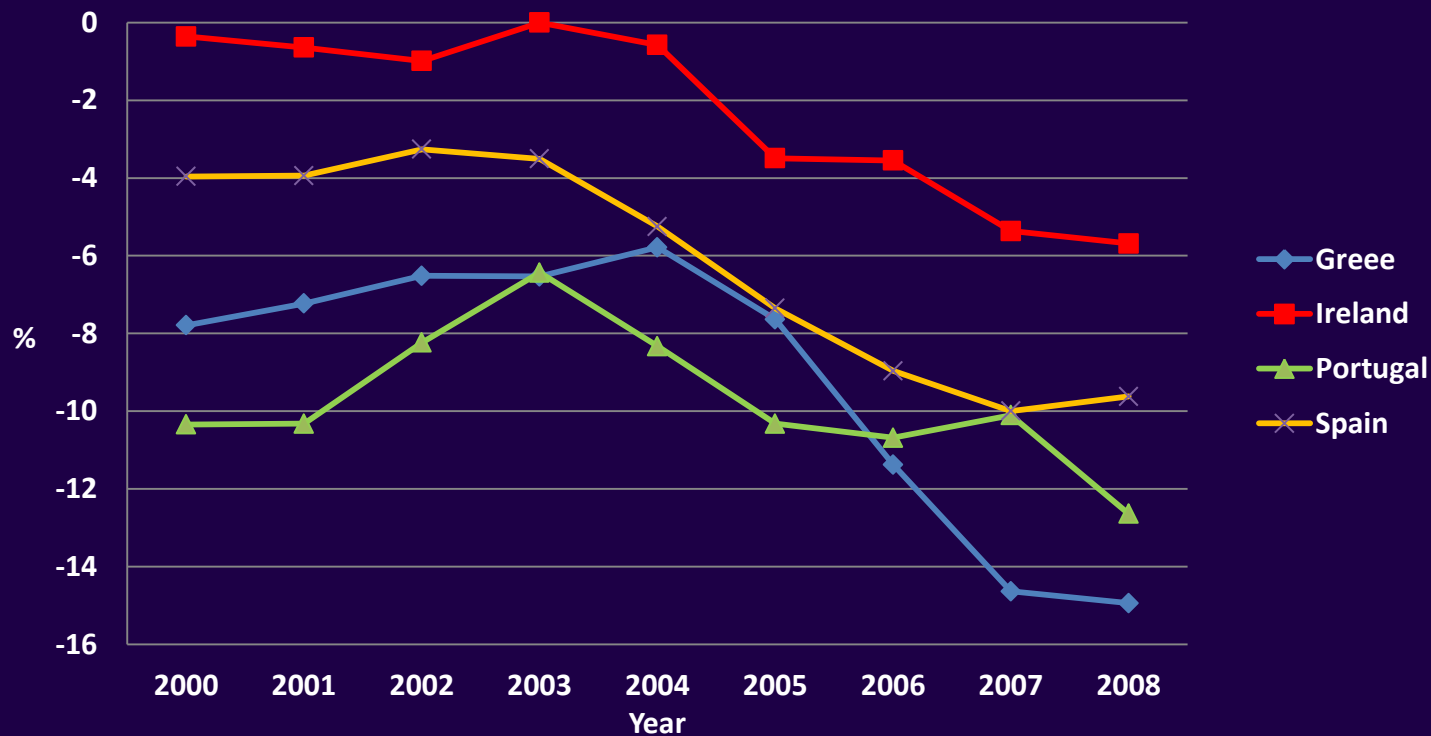
Single currency and single market completion

“A major effect of EMU is that balance of payments constraints will disappear [...] private markets will finance all viable borrowing, and savings and investment balances will no longer be constraints at the national level”

One Market, One Money, European Commission, 1990

Eurozone current account deficits

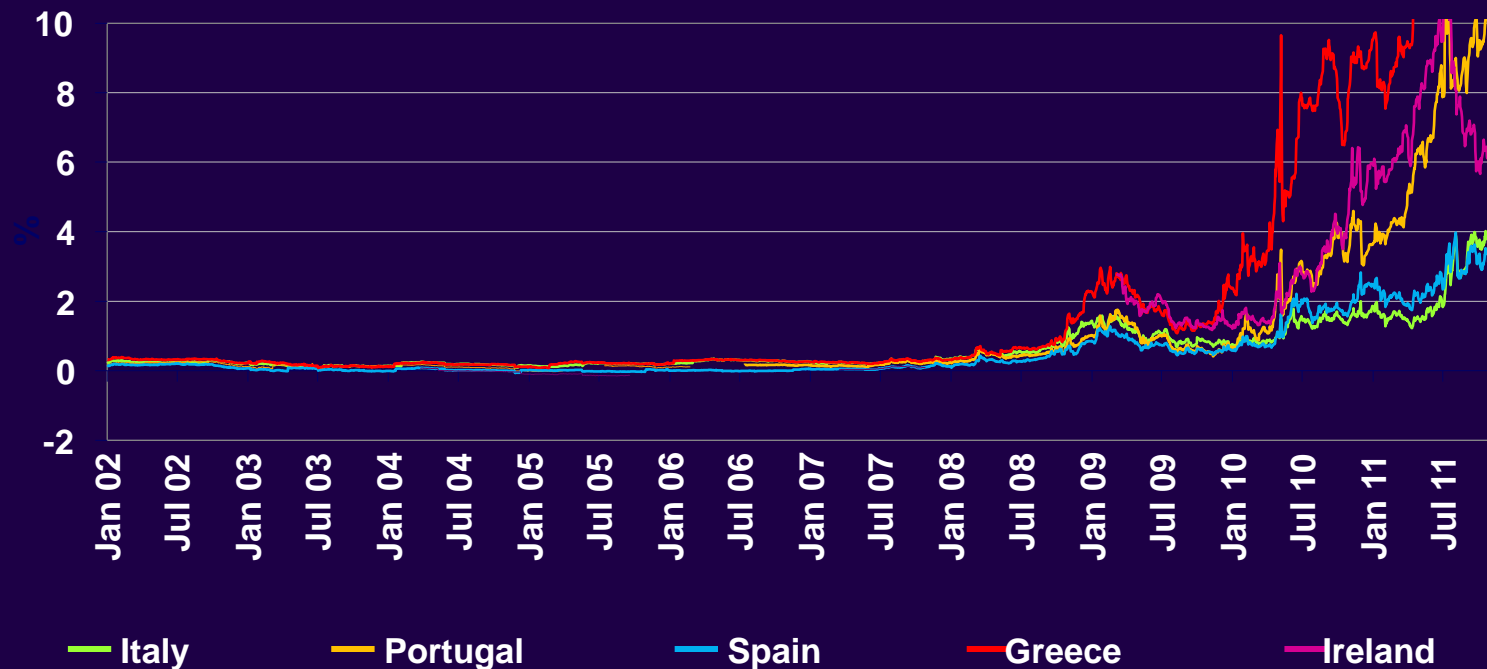
% of GDP 2000-2008



Source: International Monetary Fund, World Economic Outlook Database, October 2012

Eurozone government bond spreads

10 year benchmark spreads to German bunds



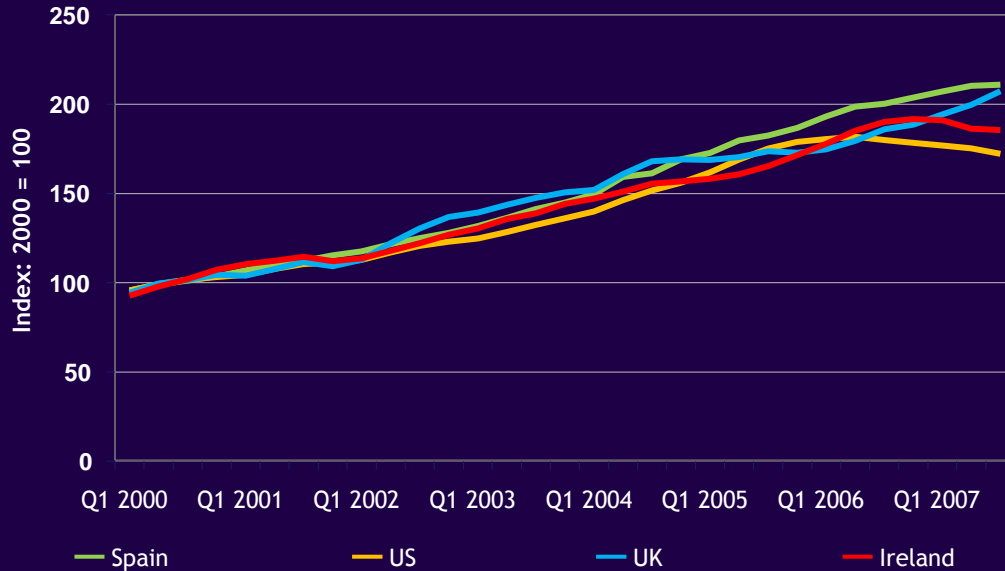
Source: Bloomberg

Note: Bloomberg doesn't quote a 10Y benchmark for Ireland and so 9Y has been used instead.

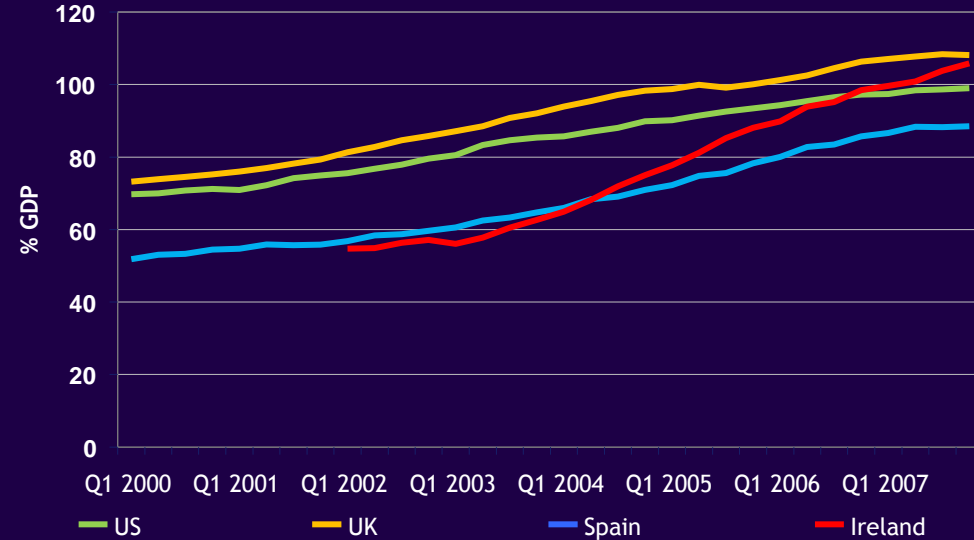
Credit extension and house prices



House prices 2000 – 2007



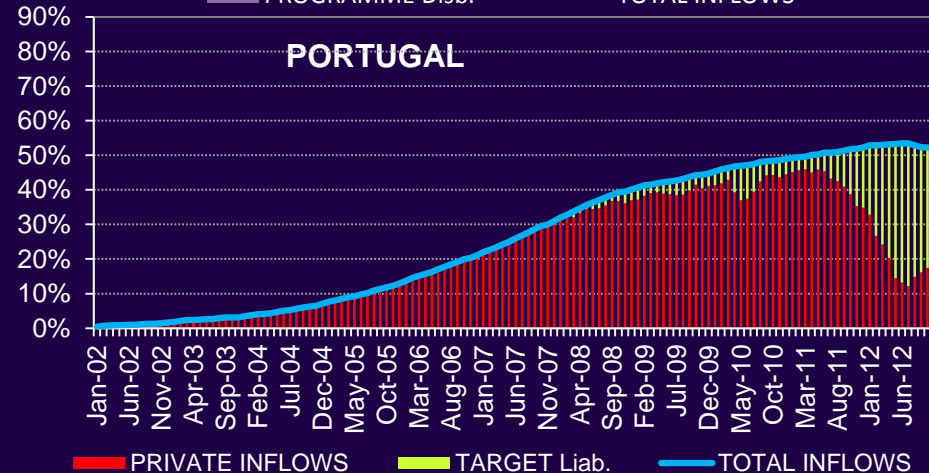
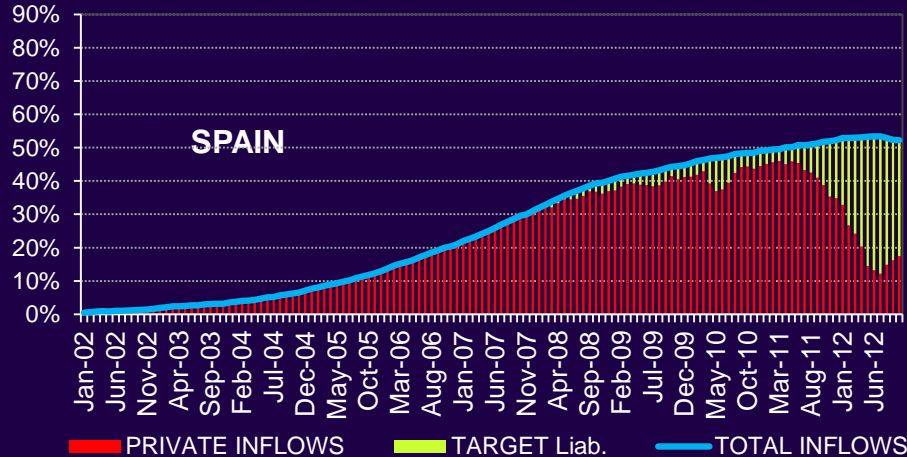
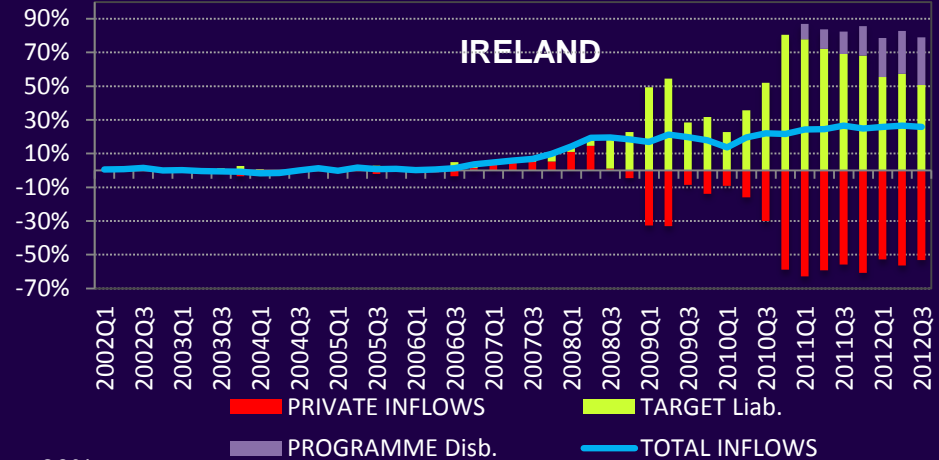
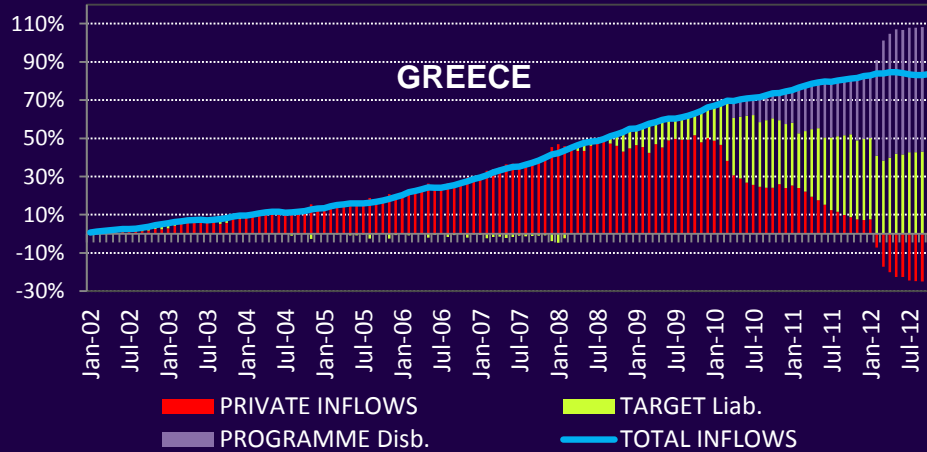
Household debt as a % of GDP 2000 – 2007



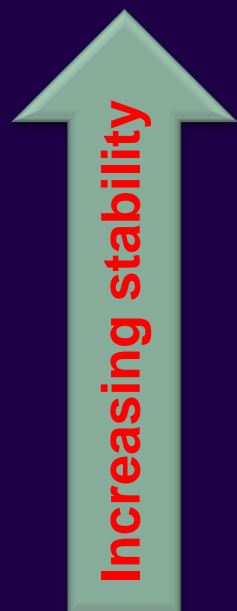
Source: BEA; ONS; ECB

Source: Ministry of Housing (Spain), S&P (US), DCLG

Decomposition of cumulative capital inflows (% of 2007 GDP)



Cross border capital flows: Hierarchy of economic value



Foreign direct investment

Equity portfolio flows

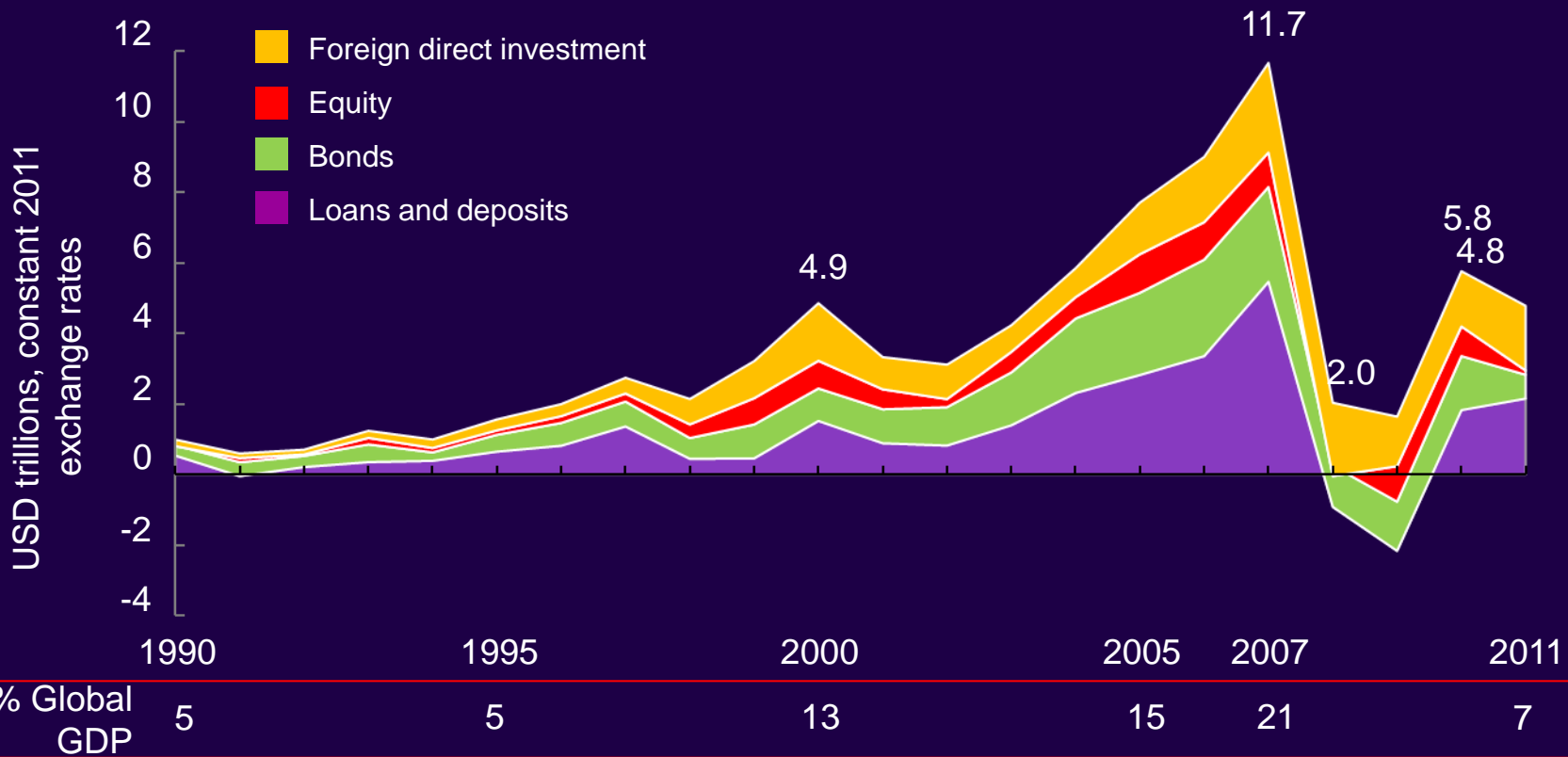
Debt portfolio flows

Long-term bank lending

Short-term bank lending

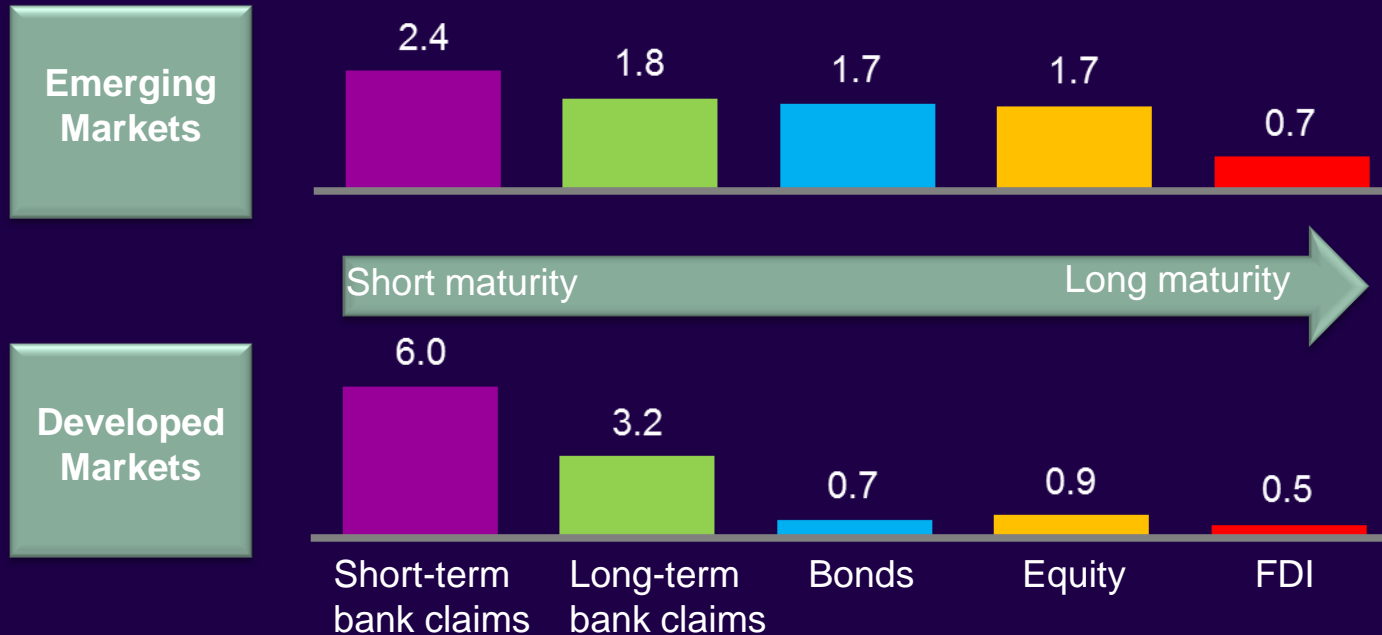
See: Committee on the Global Financial System: Report of the Working Group on Capital Flows to Emerging Market Economies, BIS, 2009

Total cross-border capital inflows: 1980–2011



Source: *Future of Long-term Finance*, Group of Thirty Report, MGI, December 2012

Coefficient of variation of inward cross-border flows by maturity




Source: *Future of Long-term Finance*, Group of Thirty Report, MGI, December 2012

Five questions on a common theme

- ❖ Are optimal capital ratios higher still than Basel III standards, and if so, what should we do about it?
- ❖ Should macro-prudential regulators seek to constrain aggregate economy wide leverage and if so, how?
- ❖ How much federalism is needed to make the Eurozone a sustainable and successful monetary union?
- ❖ Are we too worried about fragmentation of global banking?
- ❖ Should banks have the right to cross-border branching within the European Union?

Required steps to Eurozone long-term viability

A red oval containing the text 'Cutting the sovereign/bank solvency link'.

Cutting the
sovereign/bank
solvency link



- ❖ **Banking union** – including ability to recapitalising with “federal” resources
- ❖ **“Federal level” deposit insurance**
- ❖ **Eurobonds** – held as banking systems safe liquid assets
- ❖ **Significant but still limited** (e.g. 5% of GDP) **federal fiscal budget** – and associated automatic stabilisers
- ❖ **Macro-prudential levers deployable at national level?**

Five questions on a common theme

- ❖ Are optimal capital ratios higher still than Basel III standards, and if so, what should we do about it?
- ❖ Should macro-prudential regulators seek to constrain aggregate economy wide leverage and if so, how?
- ❖ How much federalism is needed to make the Eurozone a sustainable and successful monetary union?
- ❖ Are we too worried about fragmentation of global banking?
- ❖ Should banks have the right to cross-border branching within the European Union?