Financial Stability Implications of Changing Global Finance: Policy Panel

Global Finance in Transition

May 7 and 8, 2013

İstanbul, Turkey
Outline

1. The Financial System
   - 2. Weak Growth
   - 3. Unprecedented Monetary Stimulus
   - 4. Withdrawing the Monetary Accommodation
   - 5. Final Remarks
Objectives of Reforms

- Reduce the probability and the impact of banks’ failures.

- Ending “Too-big-to-fail.”

- Increase transparency in OTC Markets.

- Review perimeter of regulation and prevent regulatory arbitrage.

- Align incentives.
Main Reforms

- Increase quality and quantity of capital.
- Improve banks supervision and resolution.
- OTC standardization, central clearing reporting, LEI.
- Strengthen regulation of shadow banking system.
- Rating agencies, compensations practices, accounting standards.
Uneven progress in implementation of reforms and capital restoration

Progress in implementation of the Basel Capital Framework

<table>
<thead>
<tr>
<th></th>
<th>Basel II</th>
<th>Basel 2.5</th>
<th>Basel III</th>
</tr>
</thead>
<tbody>
<tr>
<td>Completed</td>
<td>24</td>
<td>22</td>
<td>11</td>
</tr>
<tr>
<td>Pending</td>
<td>3</td>
<td>5</td>
<td>16</td>
</tr>
<tr>
<td>Total</td>
<td>27</td>
<td>27</td>
<td>27</td>
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Price to book ratios\(^1/\)

<table>
<thead>
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<th>Percent</th>
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<tbody>
<tr>
<td>1.5</td>
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<tr>
<td>1.0</td>
</tr>
<tr>
<td>0.5</td>
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<td>0.0</td>
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</tbody>
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Data as of April 2013. 1/ Weighted average of banks in region by assets. 2/ Bank of America, JP Morgan, Citigroup, Morgan Stanley and Wells Fargo. 3/ BNP Paribas, Credit Agricole, Societe Generale, Natixis, Deutsche, Commerzbank, Unicredit, Intesa, Santander, BBVA, ING, and Dexia. Source: Bloomberg.
National Initiatives beyond the International agreed Reforms

- Volcker Rule.
- Vickers.
- Liikanen Report.
- German and French Initiatives.
- Subsidiarisation.
Dichotomy between economic and legal reality

- **Global Banks managed as an unique economic entity.**

- **Legal responsibilities remain within national borders.**

- **Difficult to implement single point of entry resolution strategies.**
Unintended Consequences

- Home-bias.
- Liquidity in host EMEs.
- Uneven playing field in host-countries.
- Infrastructure financing.
- Balkanization.
After the world financial crisis there has been significant progress in improving the financial system.

### Risks:

1. *Uneven implementation.*
2. *Coordination.*
3. *Unintended consequences.*
US Reference Rates: 1970-2013
Percent

Source: Bloomberg.
Central Banks' Balance Sheets
As a Percent of GDP

Source: National Central Banks and Haver Analytics.
Libor-OIS Spread
3 day moving-average in basis points

1/ Libor – Eonia
Source: Bloomberg.
US: Household Debt
As a percent of Disposable Personal Income

US: Household Debt
As a percent of Net Worth

US: Composite-20 Case-Shiller Housing Price Index
Index 2000=100, s.a.

Source: Federal Reserve.

Source: Federal Reserve.

s.a./ Seasonally adjusted.
Source: Case-Shiller, S&P.
Eurozone: Net Balance with the Eurosystem (Target2)
Cumulative Flows, Billion Euros

Source: National Central Banks.

Eurozone: Unit Labor Costs Relative to Germany
Index 2000 = 100

Source: European Commission.
US: Credit of Financial Institutions to the Non Financial Private Sector

Eurozone: Credit of Financial Institutions to the Non Financial Private Sector

Source: Federal Reserve.

Source: ECB.
Global Growth
Percent

Source: International Monetary Fund.
Current Accounts
As a Percent of GDP

- U.K., Portugal, Ireland, Greece, Spain and EM
- Rest of the World
- Germany and Japan
- Oil Exporting Countries
- China and Emerging Asia
- U.S.
- Discrepancy

Source: International Monetary Fund, World Economic Outlook Database, April 2013.
Multilateral Real Effective Exchange Rate

Index 2001 = 100

Source: Bank of International Settlements, as of March 2013.
Weak growth has led to unprecedented monetary stimulus in advanced economies.

Risks:

1. *Is it the appropriate tool?*
2. *Prolonged stagnation.*
3. *Unchartered waters.*
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US: Average Yield of Corporate Bonds

Percent

Source: Bloomberg.
Accumulated Capital Flows into Emerging Markets (Bonds)

Accumulated Capital Flows into Emerging Markets (Equity)

Source: EPFR.
Nominal Exchange Rates
Index January 1, 2008 = 100

Source: Bloomberg.
The unprecedented monetary stimulus can have steep financial stability costs, some of which may not even be yet identified.

- **Risks:**
  1. Mispricing of risk.
  2. Dependence on low interest rates.
  3. Asset price bubbles.
  4. Risk concentration.
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Eurozone: Headline CPI Inflation
Year over Year

US: Headline CPI and Personal Consumption Expenditures Inflation
Year over year

Source: Eurostat.
Source: BLS and BEA.
Withdrawing or gradually reverting the extraordinary monetary accommodation poses big challenges.

- Risks:
  1. Domestic costs.
  2. Externalities.
  3. Orderly vs. disorderly scenarios.
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Final Remarks

1 The effort of international financial reform is designed to:

- Align incentives more effectively.
- Price risk efficiently.
- Make the global financial system more resilient.

2 There are presently important risks to this effort:

- In an open, highly interconnected world, the system must be efficiently integrated.
- Fragmentation, balkanization.
- Theory of the second best issues.
- Unintended consequences for EMDEs.
- Unleveled playing field.
Final Remarks

3. What role is the global financial system playing in the global economy’s adjustment process, in light of very accommodative monetary policies?

- US has possibly made the most progress.
- Europe still in a difficult situation.
- Reform effort will possibly lead to higher interest rates. Monetary policy in this case is possibly [and understandably] working in opposite direction.
- Large probability of, again, mispricing of risk.

4. Highly accommodative monetary policies should be part, in many cases, of the adjustment mechanism.

- Other policies.
- Huge flows to EMEs. Volatility. Asset price bubbles a distinct possibility. Macroeconomic management issues (Monetary, fiscal and macro prudential).
- For EMEs growth, potential problems could arise. Level playing field, balkanization, home bias, trade finance, project finance.
Final Remarks

5 Global growth equilibrium seems to have slowed down. The global financial system should give sustainable support to growth or, at least, not hinder it and certainly, with a reduced probability of crises. However, in advanced economies there seems to be an important problem of sustained productivity growth. Monetary policy can’t do it alone.

6 Everybody should be preparing for an eventual increase in interest rates in the US. This scenario can certainly be a very complicated one, with or without the FED having to sell assets.

7 Thank you.