Regaining Financial Stability: Taming Financial Markets Is a Must
- a focus on NMSs -

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4 September 2010

Sequence of presentation

- 1. Financial stability (FS): from benign neglect to a principal concern (The Great Moderation as a "Great Misperception"); the role of Structure (as against policy weaknesses)
- 2. Deep financial integration: are NMSs a case of fortune reversal?
- 3. Financial markets need to be tamed (Reform of Regulation and Supervision + dealing with capital flows)
- 4. Issues to ponder on

1. Rediscovering the FS concern in mature economies (I)

- Rediscovering the FS concern in mature economies (previous crises impacted, mainly, emerging economies); the current crisis gripped most markets
- Something is structurally wrong with the global structure (global financial markets) –when policies are geared toward complying with markets' pressure(what Fr. Perroux called "l'emprise de la structure"/the power of structure) this is a cause of major concern
- A paradigm shift (from Fama to Minsky)?
- The role of Structure (institutional and policy arrangements) vs. national policy weaknesses
- Rediscovering systemic risks: complexity and inter-connectedness (Black Swan vs. White Swan…); networks (A.Haldane: "Deregulation swept aside banking segregation and, with it, decomposability of the financial network. The upshot was a predictable lack of network robustness")

1. Rediscovering the FS concern (II)

- Not all financial innovation is good;
- Inadequate risk models
- Financial markets can misallocate resources (overshooting) and enhance global imbalances (Sheila Bair: "the bust was clear evidence that capital was misallocated and could have been put to more productive use", FT, 24 August, 2010)
- An oversized financial sector (rent-seeking and "policy capture", Simon Johnson)
- Banking performs an essential public utility function; it can do much good, but it can also do much harm…
- The dangers of excessive trading;
- A crisis of deep financial integration. This explains the strains in the EMU (deep financial integration asks for appropriate policy and institutional underpinnings)

1. Rediscovering the FS concern (III)

- Outside Europe and the US and learning from crises, emerging economies tried to forestall shocks by: accumulation of HC reserves as a buffer (a high premium on them); this trend was reinforced by “industrial policies” aims; uphill financial flows…
- But the complexion of markets is not God given; it depends on policies, regulation and supervision structures
- Banking should get back to its roots (Volcker’s rules, Lord Turner, EU reforms…)
- Regulations need to be comprehensive (the shadow banking sector, HFs and PEFs, derivatives)
- Regaining FS implies reforming Structure and repairing policies

1. Rediscovering the FS concern (IV)

- Redefining monetary policy: Price stability + FS: no more simple rules
- Operating in a stochastic (more uncertain and interconnected) environment: what is prudent fiscal/overall policy? (ex: Ireland, Spain)

2. Why the focus on NMSs? (I)

- A global crisis with huge externality effects: the role of Structure (global; EU arrangements)
- Deep financial integration, in the EU: EU rules (the Single Market)
- The EU as a highly financially integrated area, but where national prerogatives (regulatory and fiscal) stay powerful
- Downhill financial flows: the textbook conventional wisdom
- Insignificant exposure to toxic products
- The EU seen as a shelter
- Contrast it to emerging economies' behavior elsewhere: a premium on holding considerable currency reserves after the Asian and Latin American crises (plus industrial policies)

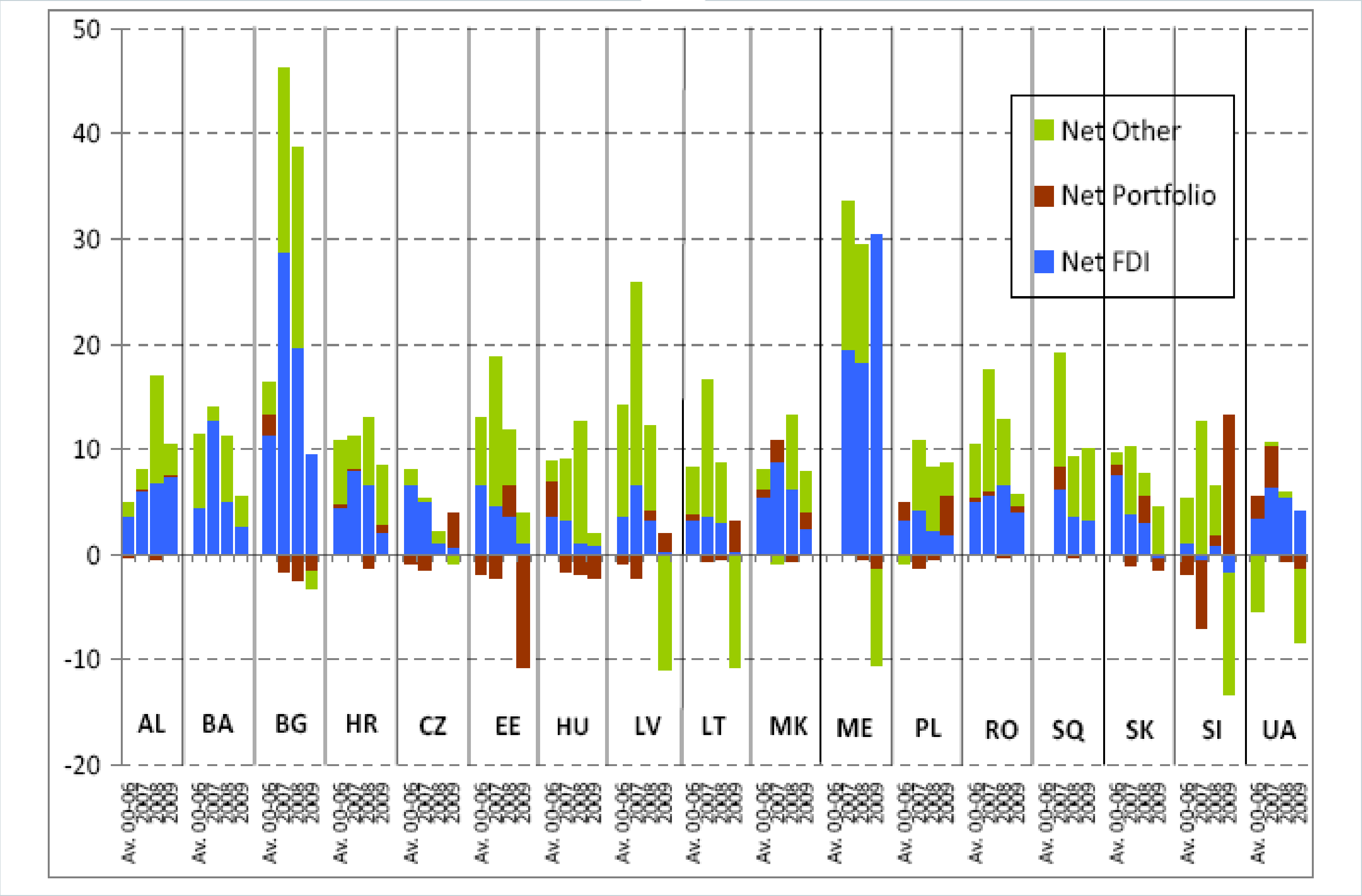
2.Why the focus on NMSs?(II)

- The reality check:
- The most severely hit region among emerging economies; but the impact varied….national policies& vulnerabilities matter
- The financial channel as the main shock transmitter (vs. the trade based narrative, EBRD)
- The NMS/CESEE region witnessed a very sharp capital flows reversal during 2008-2009 : 10% of GDP on average (figure: 1: capital outflows in the Baltic countries and Ukraine)
- But no meltdown of financial systems
- Instead: deep worries about future economic growth (is the growth model appropriate?)
- The external environment and debt stabilization

2.1 Features of deep financial integration

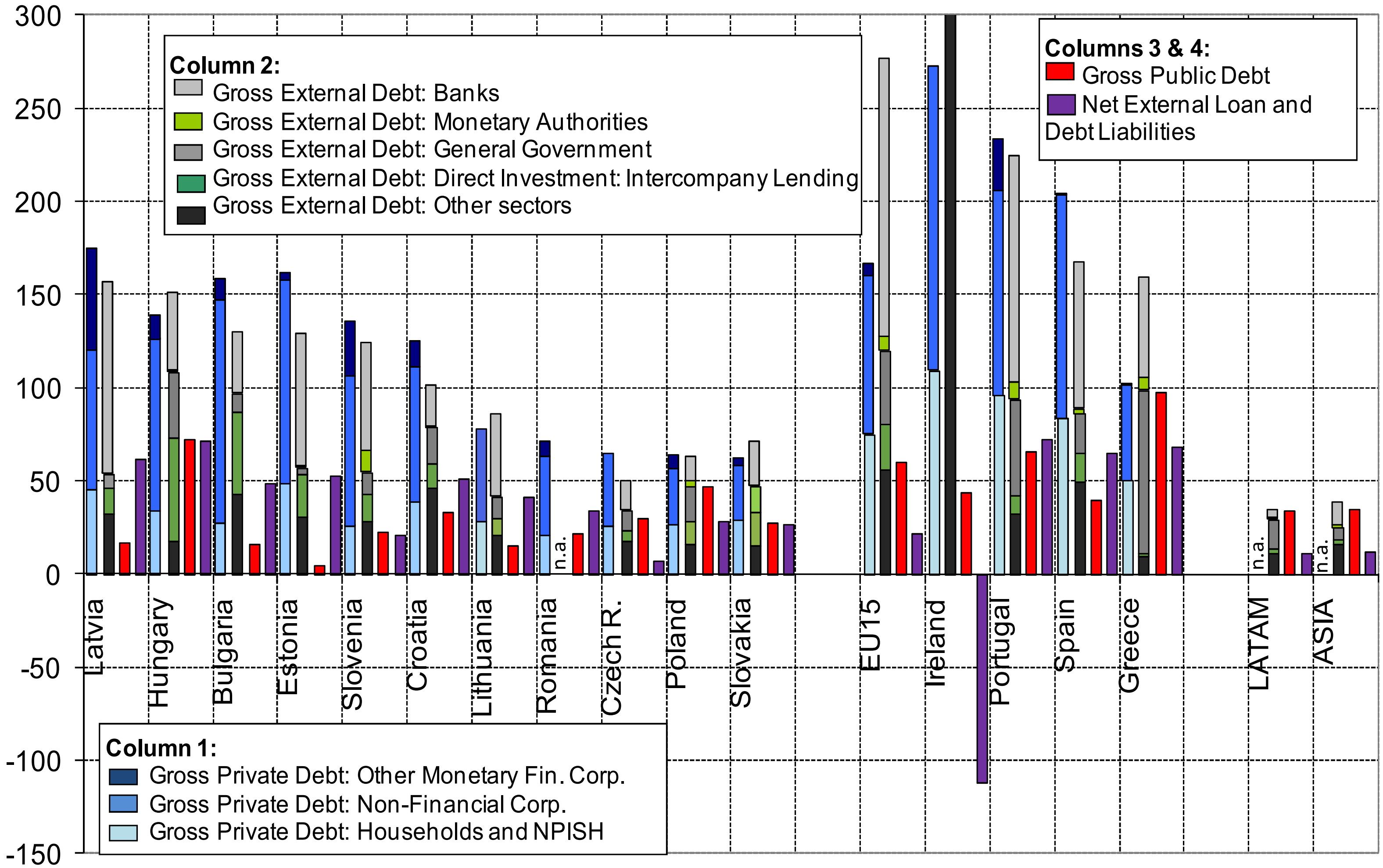
- Opening of the capital account: a rule of the game in the EU (the case of the NMSs)
- reliance on massive capital imports (fig.1); only 4 countries avoided skyrocketing external (private) debt (fig.2) a skewed structure of capital ownership (fig.4)
- bank credit: the overwhelming source of external funding

Fig. 1: Net capital flows to NMSs/CESEE countries (% of GDP)



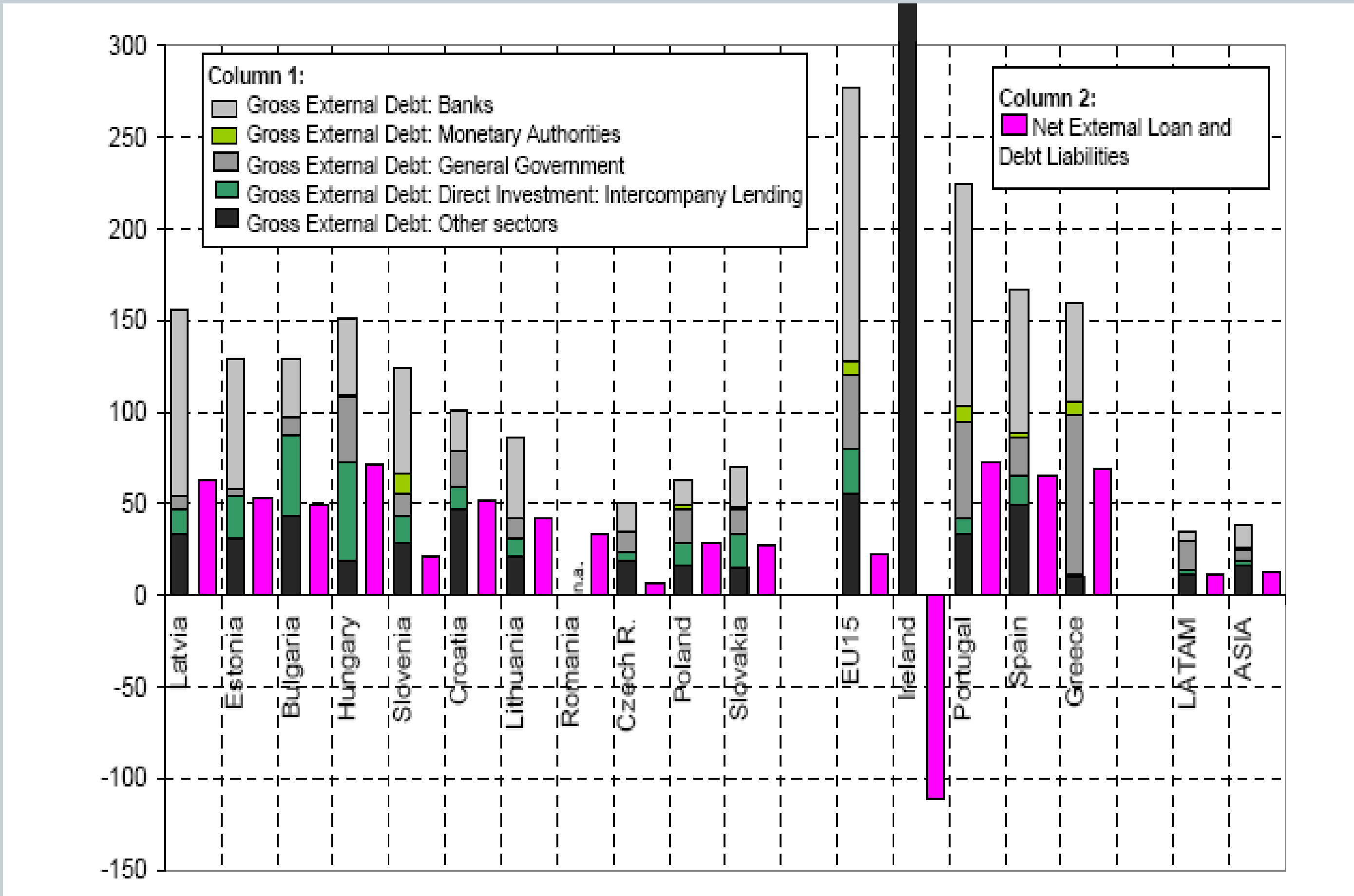
Source: IMF

Fig.2: Indebtedness (% of GDP), 2008



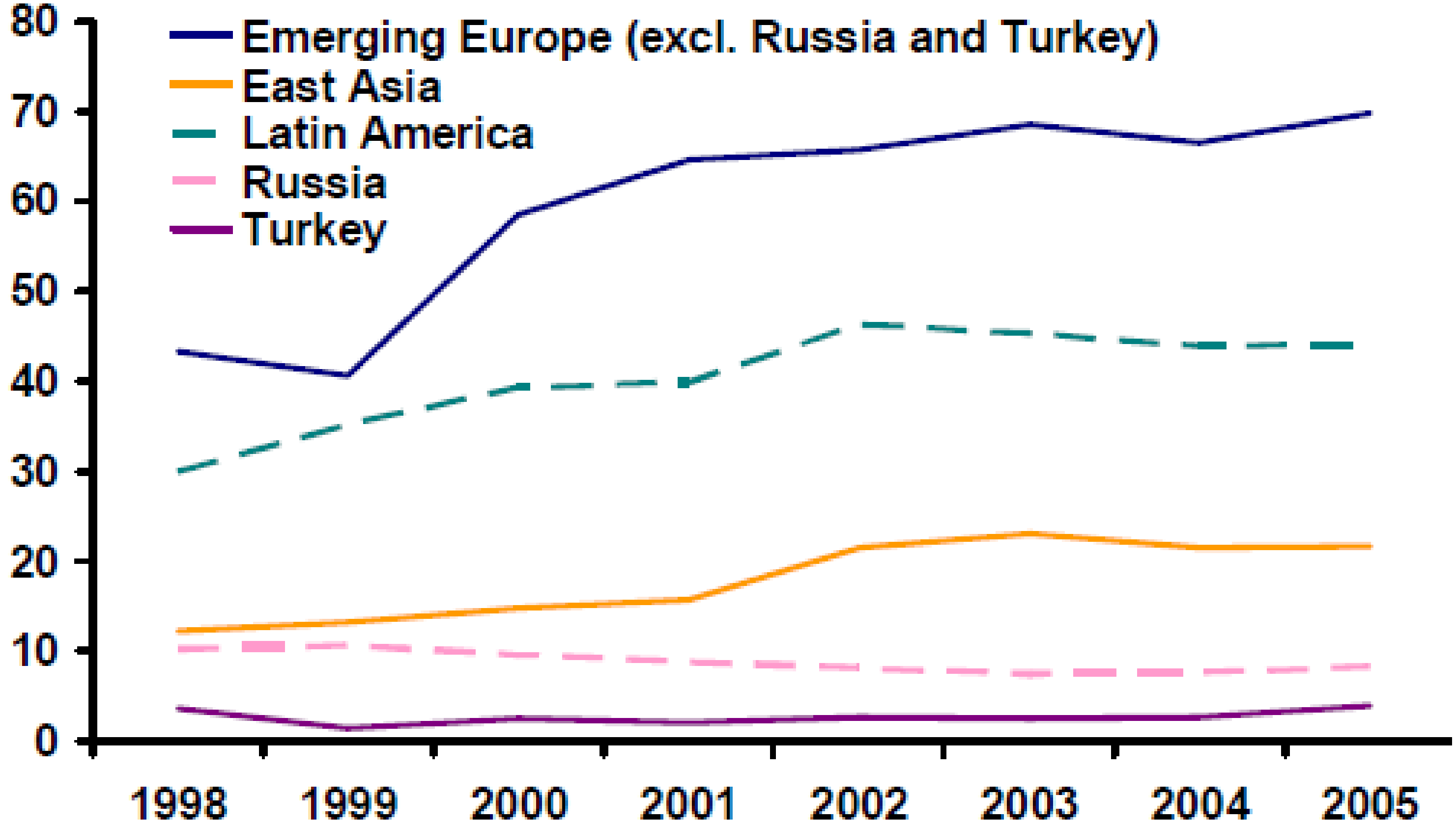
Source: Eurostat,IMF

Fig. 3: External debt (% of GDP), 2008



Source: Eurostat, IMF

Fig.4: Foreign bank ownership, 1998-2005 (Assets owned by foreign banks as a per cent of banking system assets)



Source: Chart 6b from Berglöf et al. (2009)

2.1 Financial integration, but…

- Restricted access to liquidity when markets froze…
- The collateral policy of the ECB: one-sided
- Support to operations of banking groups (offered by home country governments): focus on home markets
- Significant contagion effects

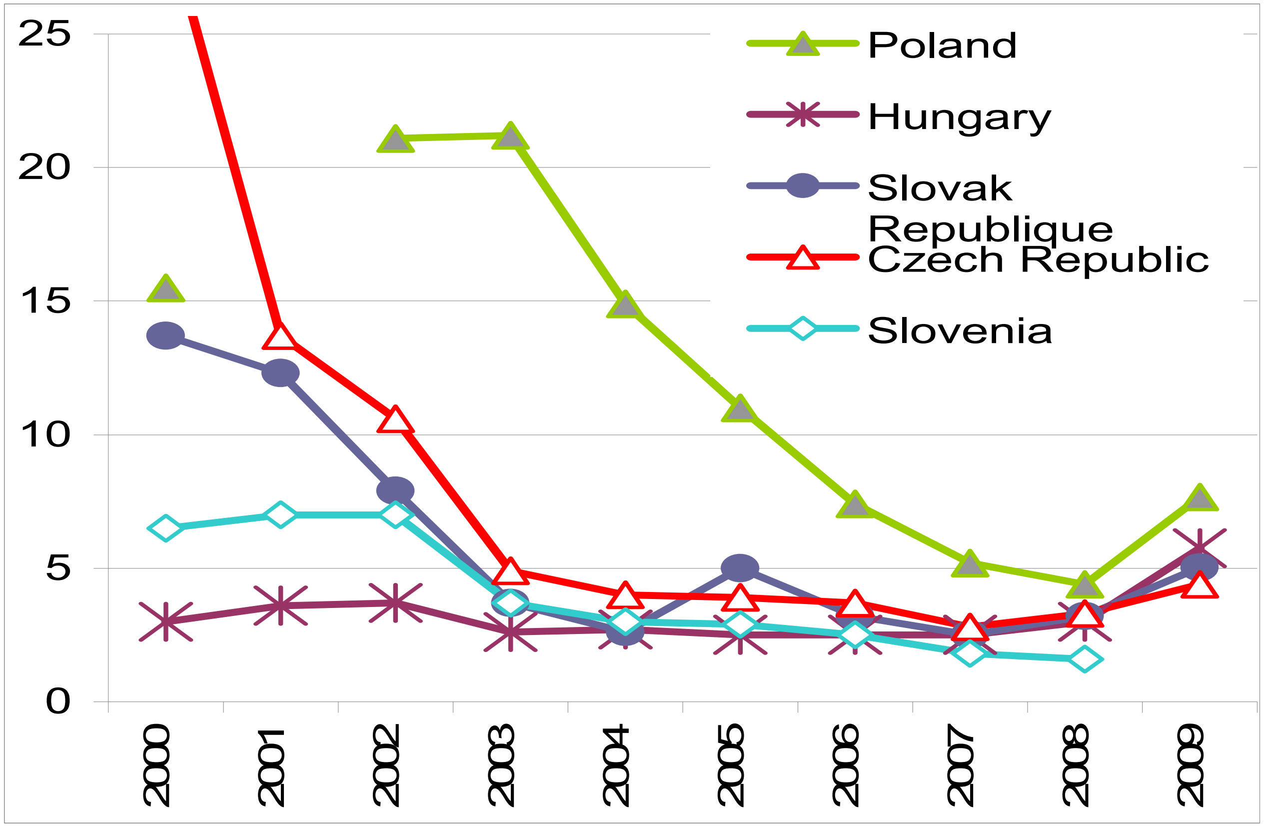
2.2 Why no meltdown?

- The pre-crisis state of banking systems in most of the Region
- Multilateral responses (medium term financial support conditional on fiscal consolidation and economic reforms)
- Frontloading of EU funds
- The “Vienna Initiative”
- The rescue packages for parent banks(!)

2.3 State of the banking systems

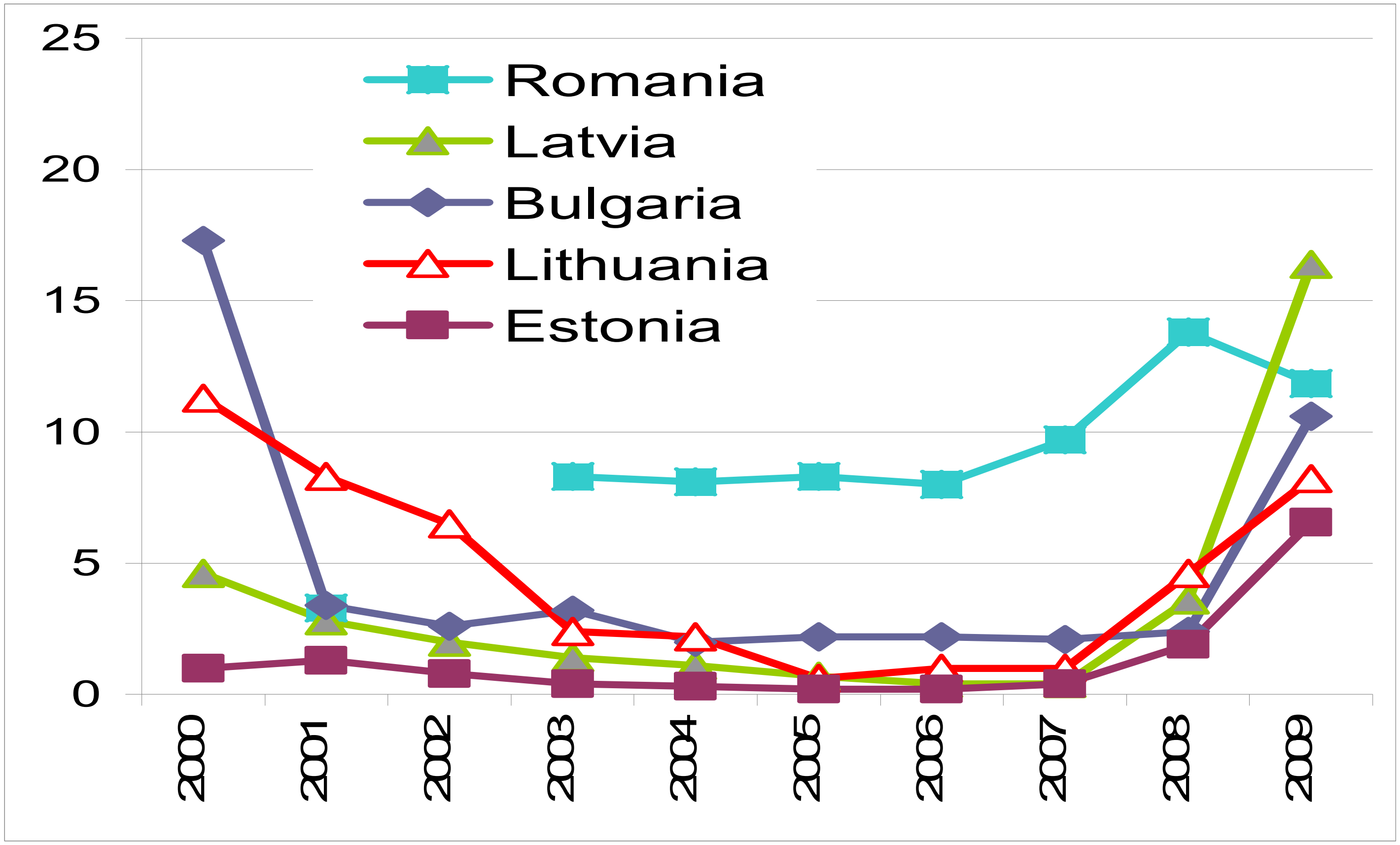
- Stress tests
- The rise in the share of NPLs (figure 5), but well below Asia a decade ago (it does not reflect the extent of bad loans since rescheduled debt may not be included)
- Bank returns on equity and assets declined but remained positive in 2009 (except Ukraine, the Baltic countries and Montenegro, Table 1)

Fig. 5 Share of non-performing loans, 2000-2009 I



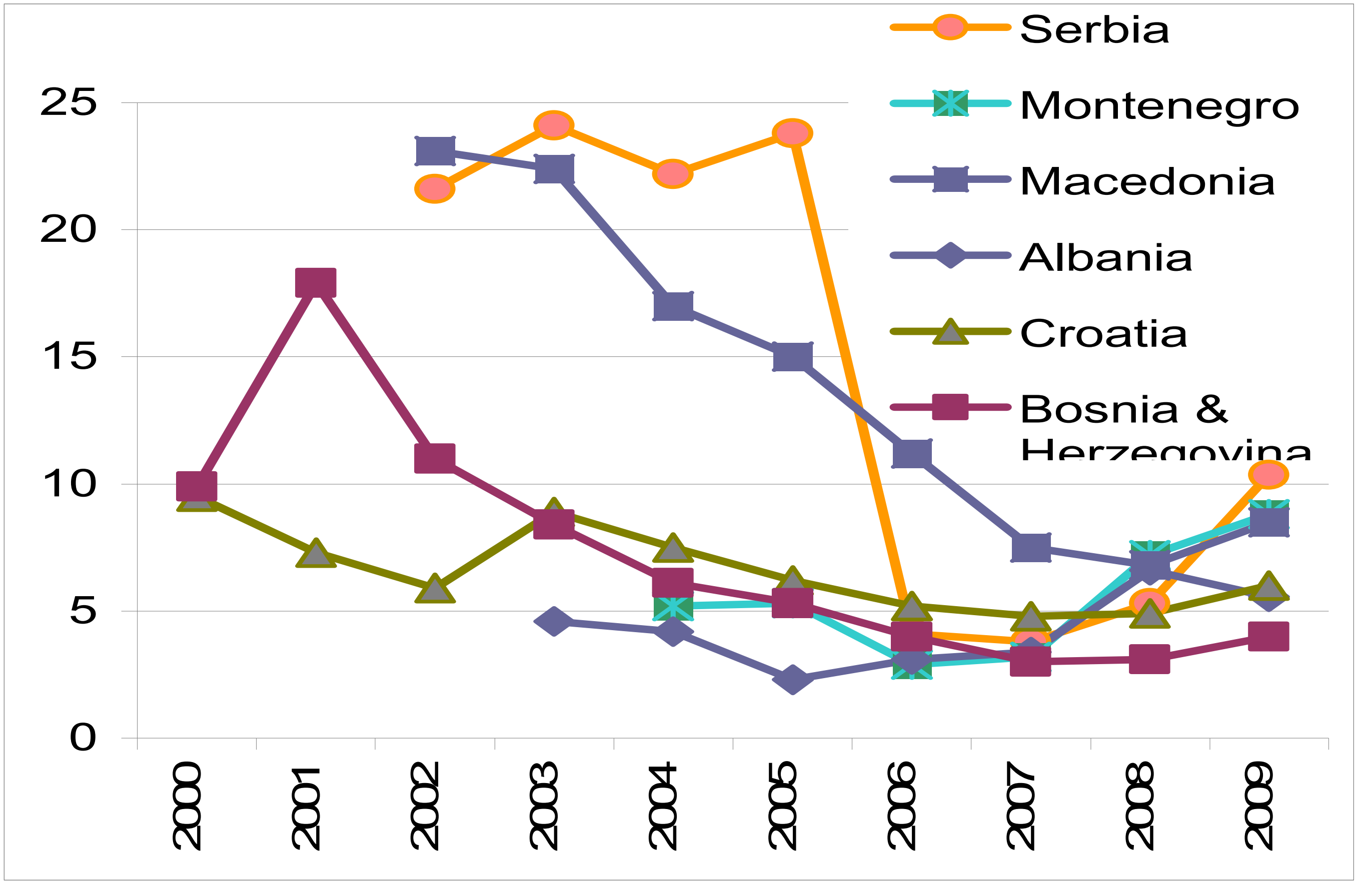
Note: Data refer to end of the year
Source: IMF GFSR October 2009, EBRD, and Berglöf et al. (2009)

Share of non-performing loans, 2000-2009 II



Note: Data refer to end of the year
Source: IMF GFSR October 2009, EBRD, and Berglöf et al. (2009)

Share of non-performing loans, 2000-2009 III



Note: Data refer to end of the year
Source: IMF GFSR October 2009, EBRD, and Berglöf et al. (2009)

Tabel 1: Bank return and capital adequacy (per cent), 2003-2009

	Bank Return on Assets			Bank Return on Equity			Capital Adequacy			
	2003-07	2008	2009	2003-07	2008	2009	2003-07	2008	2009	(Month of 2009)
Czech Rep.	1.3	1.2	1.3	24.7	21.7	23.4	12.4	12.3	13.7	June
Hungary	1.7	1.1	1.1	22.3	11.6	15.3	11.4	11.1	12.3	June
Poland	1.4	1.5	1.1	17.6	20.7	15.6	13.8	11.2	11.7	April
Slovakia	1.2	1.0	0.3	14.6	14.1	4.1	16.3	11.1	12.2	May
Slovenia	1.1	0.7	…	13.9	9.0	…	11.2	10.5	…	
Bulgaria	2.2	2.1	1.6	22.7	23.1	15.7	16.5	14.9	16.5	March
Estonia	2.0	1.2	0.8	21.0	13.2	8.7	11.3	13.3	15.2	March
Latvia	1.9	0.3	-1.6	23.0	4.6	-19.7	11.0	11.8	12.8	May
Lithuania	1.4	1.2	-0.1	17.5	16.1	-1.0	11.5	12.9	13.9	March
Romania	2.0	1.7	…	16.0	18.1	…	18.9	12.3	…	
Albania	1.4	0.9	…	20.7	11.4	…	20.8	17.2	…	
Bosnia & H.	0.7	0.4	0.3	6.6	4.3	3.4	18.3	16.3	16.3	March
Croatia	1.6	1.6	…	13.8	10.1	…	15.8	14.5	…	
Macedonia	1.2	1.4	0.2	8.0	12.5	1.8	21.1	16.2	16.5	March
Montenegro	0.6	-0.6	-1.5	4.0	-6.9	-17.8	24.4	15.0	12.4	March
Serbia	0.6	2.1	1.5	4.1	10.7	7.8	27.5	21.9	21.2	June
Ukraine	1.3	1.0	-3.3	1.3	1.0	-3.3	15.0	14.0	14.5	June
EU15	0.7	0.2	...	14.0	0.4	...	12.5	12.2	...	
Asia	1.4	1.2	...	16.4	14.3	...	15.4	14.2	...	
Latam	1.9	1.7	1.9	18.3	18.7	19.1	15.3	14.6	15.5	mostly May

Note: the last column of the table shows the month for which the 2009 data refer to
Source: IMF GFSR October 2009

2.4. Cross border bank ownership and financial stability (I)

- The business status of foreign banks (exposure of foreign banks, table 2)
- Inconsistencies of the EU framework: cross border operations while R&S and fiscal prerogatives are national;
- Tense home- and host country regulators/supervisors relationship (distribution of tasks; limited ability of host authorities to protect national markets; the balance of power in Colleges)
- Inadequate burden-sharing arrangements;

Table 2 Exposure to CESEE (per cent of home country GDP), September 2009

	Austria	Belgium	Sweden	Greece	Italy	Netherlands	Portugal	Switzerland	Germany	France	Denmark
Czech Republic	16.9	10.9	0.0	0.0	0.7	0.6	0.0	0.1	0.4	1.3	0.0
Hungary	10.3	4.0	0.1	0.0	1.3	0.7	0.2	0.2	1.0	0.5	0.1
Poland	3.8	4.9	2.1	0.0	2.0	4.6	6.6	1.8	1.7	0.9	0.5
Slovak Republic	8.2	2.0	0.0	0.0	0.9	0.2	0.1	0.0	0.1	0.2	0.0
Slovenia	2.8	0.5	0.0	0.0	0.4	0.1	0.1	0.0	0.4	0.1	0.0
CE-5 total	**42.0**	**22.3**	**2.3**	**0.1**	**5.3**	**6.2**	**6.9**	**2.1**	**3.6**	**3.0**	**0.7**
Bulgaria	1.6	0.5	0.0	3.1	0.4	0.1		1.4	0.1	0.2	0.0
Estonia	0.1	0.0	6.6	0.0	0.0	0.0		0.0	0.0	0.0	0.1
Latvia	0.2	0.0	5.2	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.1
Lithuania	0.1	0.0	6.0	0.0	0.0	0.0	0.0	0.1	0.1	0.0	0.2
Romania	11.1	0.2	0.0	5.7	0.6	1.3	0.3	1.3	0.1	0.6	0.0
BB-5 total	**12.9**	**0.7**	**17.8**	**8.8**	**1.1**	**1.3**	**0.3**	**2.7**	**0.5**	**0.8**	**0.5**
Albania		0.0	0.0	0.6	0.1	0.0		0.0	0.0	0.0	0.0
Bosnia & Herzegovina	1.1	0.0	0.0	0.0	0.2	0.0		0.0	0.1	0.0	0.0
Croatia	6.8	0.1	0.0	0.0	1.5	0.0	0.0	0.0	0.5	0.3	0.0
Macedonia	0.1	0.0	0.0	0.5	0.0	0.0		0.0	0.0	0.0	0.0
Montenegro	0.0	0.0	0.0	0.0	0.1	0.0		0.0	0.0	0.0	0.0
Serbia	1.6	0.0	0.0	1.4	0.3	0.0	0.0	0.4	0.1	0.1	0.0
Western Balkan total	**9.6**	**0.1**	**0.0**	**2.6**	**2.1**	**0.0**	**0.0**	**0.5**	**0.8**	**0.4**	**0.0**
Ukraine	2.6	0.0	0.8	0.2	0.1	0.3	0.0	1.1	0.1	0.3	0.0
Total for all 17 countries	**67.1**	**23.1**	**20.9**	**11.6**	**8.6**	**7.9**	**7.2**	**6.4**	**5.0**	**4.4**	**1.2**
Total for all 17 countries in EUR billions	**172**	**73**	**57**	**27**	**123**	**43**	**11**	**21**	**111**	**79**	**3**

Source: BIS (bank exposure) and IMF(GDP)

2.4 Cross border bank ownership (II)

- Cross border operations and contagion effects ask for more harmonized R&S (Padoa Schioppa: a common rule book); but lack of fiscal integration (burden sharing arrangements) fragments markets and policy responses;
- Solving the above mentioned contradiction is crucial for the future of European integration
- the ESRC and the three Authorities are moves in the right direction as would be reforms in the governance of the EMU (EU)
- But the content of R&S is essential as is dealing with the burden-sharing arrangements issue

3. Regaining Financial Stability

- National policy issues
- The external context and debt stabilization (ex: if economic growth rates stay low and costs of debt servicing are high…)
- Dealing with Structure (international/EU institutional and policy arrangements: regulatory and supervision frameworks)

3.1 Regaining FS: national policies and EU arrangements

- Lending prospects and economic recovery (effects of deleveraging);
- Crisis resolution
- Liquidity and solvency risks
- Combat boom and bust creating lending

3.1.1 Dealing with deleveraging

- The credit crunch as a the main channel for crisis transmission (figure 6), though there are differences…
- Deleveraging takes time; its impact on credit resumption, on economic recovery
- Is there a room of maneuver?

  - macroeconomic policy;

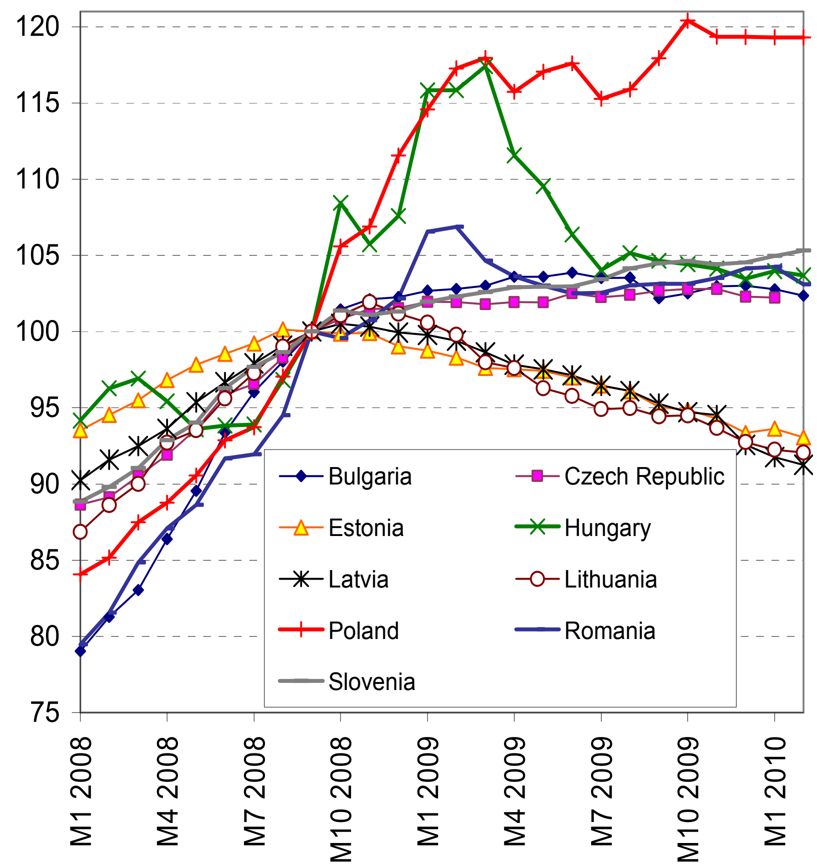
  - currency devaluation ?

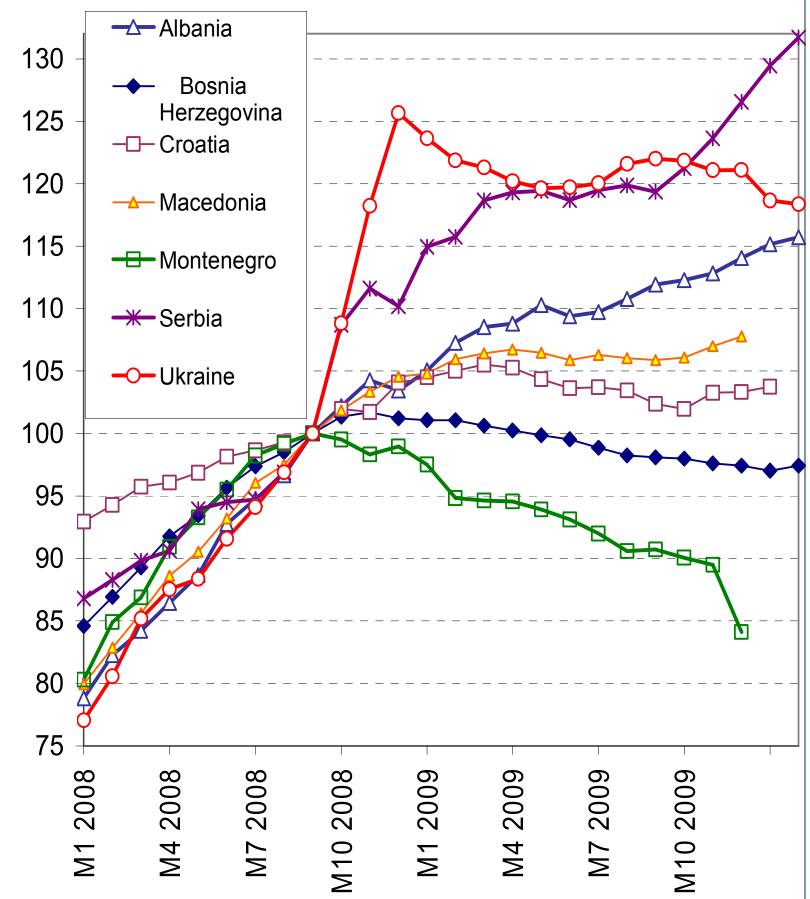
  - fostering credit via state owned banks

  - bad banks?

  - EU funds for crowding in commercial lending

Fig. 6: Credit to the private sector (in local currency, September 2008 = 100), January 2008 to February 2010





Source: IMF International Financial Statistics

3.1.2 Access to liquidity and solvency problems

- Rules on convergence of deposit guarantees
- EU and IFIs facilities
- Swap lines involving the ECB
- ECB's broadening of its collateral range to national currency denominated bonds
- A Fund to prop up currencies which are under attack…
- A gradual implementation of Basel III

3.1.3 Preventing future credit booms: longer term issue (I)

- Countercyclical capital and reserve requirements (including surcharges); dynamic provisioning against expected losses
- Limits on leverage; maturity mismatches and rate of credit expansion
- Similar capital requirements for foreign and local banks
- Measures to improve loan/deposit ratio

3.1.3 Preventing future credit booms (II):

- Turn branches into subsidiaries;
- Making foreign-owned subsidiaries subject to the same capital requirement calculations, and hold that in domestic assets, as the domestic banks;
- Imposing restrictions on the setting up of new bank subsidiaries in certain areas

3.1.3 Preventing future credit booms (III)

- Dealing with credit outsourcing: a/ national level (tax policy; encouraging domestic saving); b/ EU level (use Colleges; consolidated balance sheets; ESRB and EFC; monitoring of systemically important banks)
- Capital controls: not permitted in the EU
- The denomination of lending (balance-sheet problems; funding problem

3.1.4 Crisis resolution

- A Financial Stability Initiative
- Levying a tax on banks, an Insurance Fund (at EU or national level?) would help deal with distressed banks…a 'Debt Resolution Authority" (the burden sharing arrangements is key…)
- The need to address systemic risks; how to deal with oversized banks (including restrictions on leverage)…

3.2 The external environment and debt stabilization

- Can high economic growth rates be resumed?
- If risk premia stay high the costs of debt service may become overwhelming
- There are major differences among NMSs in this regard
- The role of EU instruments in helping NMSs obtain easier funding terms (when markets overshoot)

3.3 Structure: Taming financial markets is a must (I)

- Dealing with too big to fail (anti-trust law; capital requirements)
- Cap on leverage; capital and liquidity requirements (including HFs and PEFs)
- Discouraging speculative capital flows: the Volcker's rules…a version of Glass-Steagall (can banks and Gvts. in the EU restrict universal banking?)
- Transaction taxes (size of financial sector and nature of flows –contradicting Mirlees and Diamond (1971))
- No loopholes for trading of derivatives
- Global coordination (preventing regulatory arbitrage)

3.3 Taming financial markets (II)

- A return to the initial logic of Bretton Woods (the financial policy trilemma):
- capital controls
- Limiting volatility in exchange rates and commodity markets (buffer stocks, curbing naked short-selling)

4. Issues to ponder on (I)

- Disentangling private from public debt (an acute issue in the EU)
- When deficits compound the debt size burden
- What are relevant economic indicators?
- New risk models…
- Accounting rules: is "mark to market" appropriate when markets are highly dysfunctional?
- A deflationary bias in the conduct of monetary policy (pricking bubbles)? But would' n' t less instability support long-term growth?
- Implementing Basel III: too fast would stifle recovery; too slow would create prerequisites for a a new crisis (Jamie Dimon's statement)
- Debt deflation?
- Does size matter? (big vs. small economy)

4. Issues to ponder on (II)

- Unwinding global imbalances when zero-sum games are frequent
- EU: burden-sharing arrangements and resolution schemes (the political constraints in the EU)
- The geo-political constraints in G-20: bank competition, etc
- Demographics...
- Technology used for circumventing rules (ex: high-frequency trading)
- Natural disasters
- Social strain and economic (financial) instability
- An increasingly uncertain environment (complexity on the rise)
- Resilience (ability to withstand external and internal shocks) is a principal policy aim (Lamfalussy, 2000).
- Will societies turn more inward-looking? What will implications be for an open global system?

Final remarks

- The content of the reform of R&S of financial markets is fundamental: there is intellectual empathy between reforms in continental EU, US and UK
- Coordination in the G20 for consistent reforms worldwide (and avoiding regulatory arbitrage) is also key
- Is there an optimal size of openness (trade and finance-wise): think globally and relocate operations as a means for mitigating risks
- A three blocs-based global financial system?