Marco Onado

“Can we put the genius back in the bottle? Banks and finance after the crisis

Conference on

European financial systems

In and out of the crisis

Siena, April 1-2, 2011

Agenda

- The biggest financial crisis, ever
- The transformation of banking in the last 30 years (the genius came out of the bottle)
- The theory we forgot and the need for reassessing the financial system's contribution to investment and growth
- How to fix it: a review

1. The dimension of the crisis

What is the cost of the crisis? Haldane: from a narrow to broader interpretations

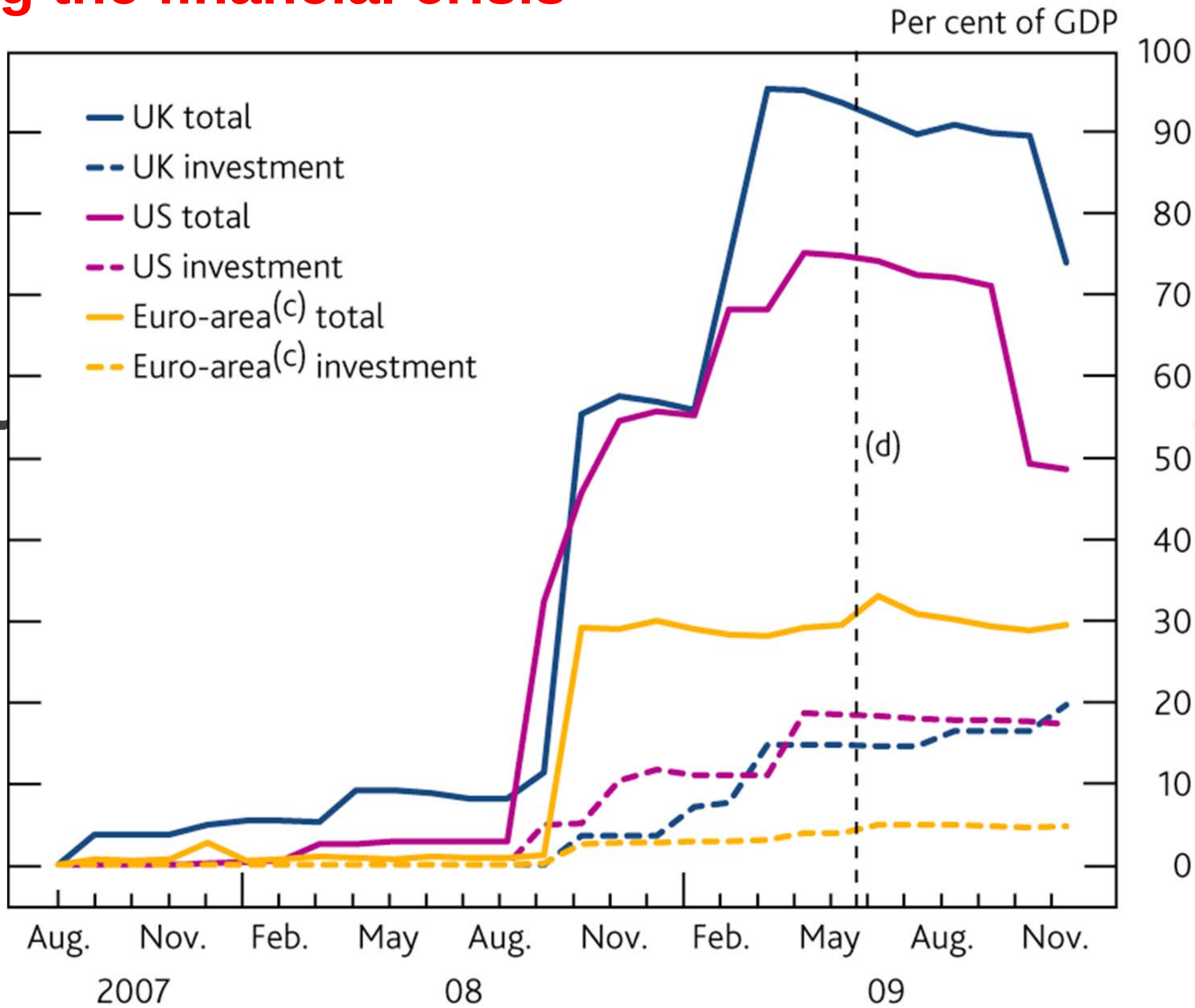
- **Wealth transfer from the government to the banks as a result of the bailout**
  - US $ 100 bn, < 1 per cent of gdp
  - UK £ 20 bn > per cent of gdp
- **Loss of output in 2009**
  - World: $ 4 tn
  - UK: £ 140 bn
- **Permanent loss of output**
  - World: between $ 60 and 200 tn
  - UK: between £ 1.8 and 7.4 tn

Haldane’s comment

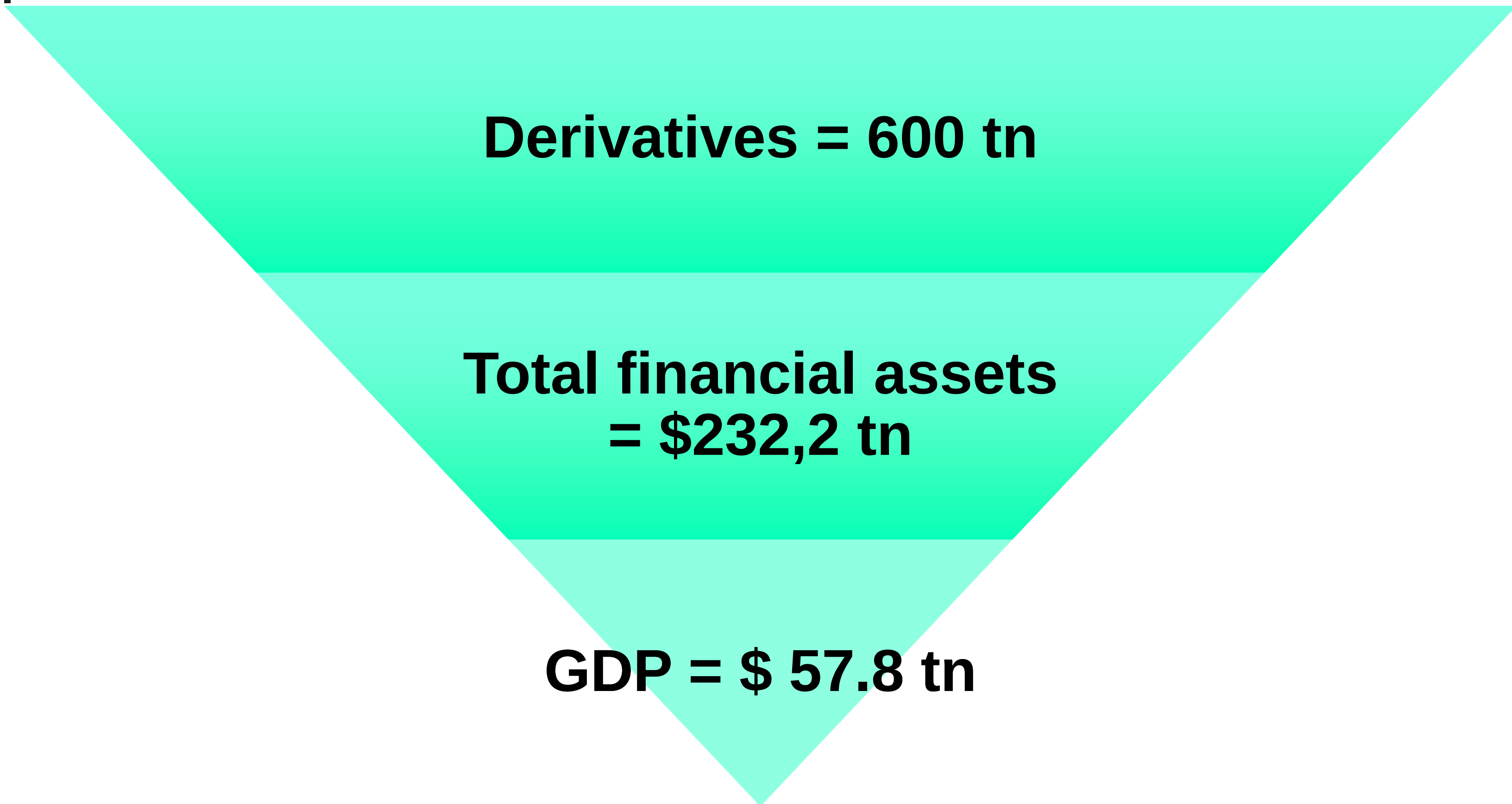
- As Nobel-prize winning physicist Richard Feynman observed, to call these numbers “astronomical” would be to do astronomy a disservice: there are only hundreds of billions of stars in the galaxy.
- “Economical” might be a better description.

1. The dimension of the crisis

Public sector interventions in selected countries during the financial crisis



The financial pyramid 2009



The volume of trading

- **Forex trading: from 11 times global trading value in 1980 to 73 times today (A.Turner)**
- **Interest rate derivatives trading has grown from nil in 1980 to $390 trillion in mid-2009 (A.Turner)**
- **Bis, QR dec 10: The $4 tn question: daily average foreign exchange market turnover reached $4 trillion in April 2010, 20% higher than in 2007 (3.5 attributed to broker-dealers and other financial institutions)**

Not only too big

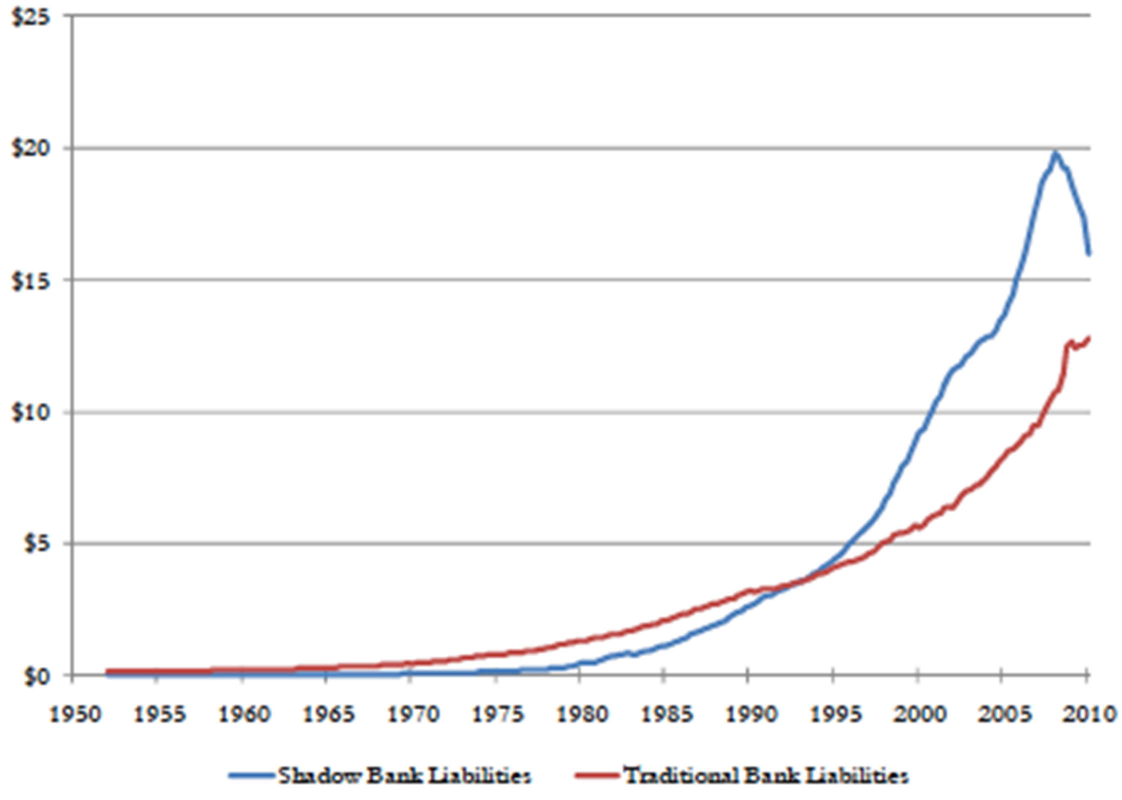
- More and more complex
- Less and less transparent
- More and more interconnected

The weakest point in the link: the shadow banking system

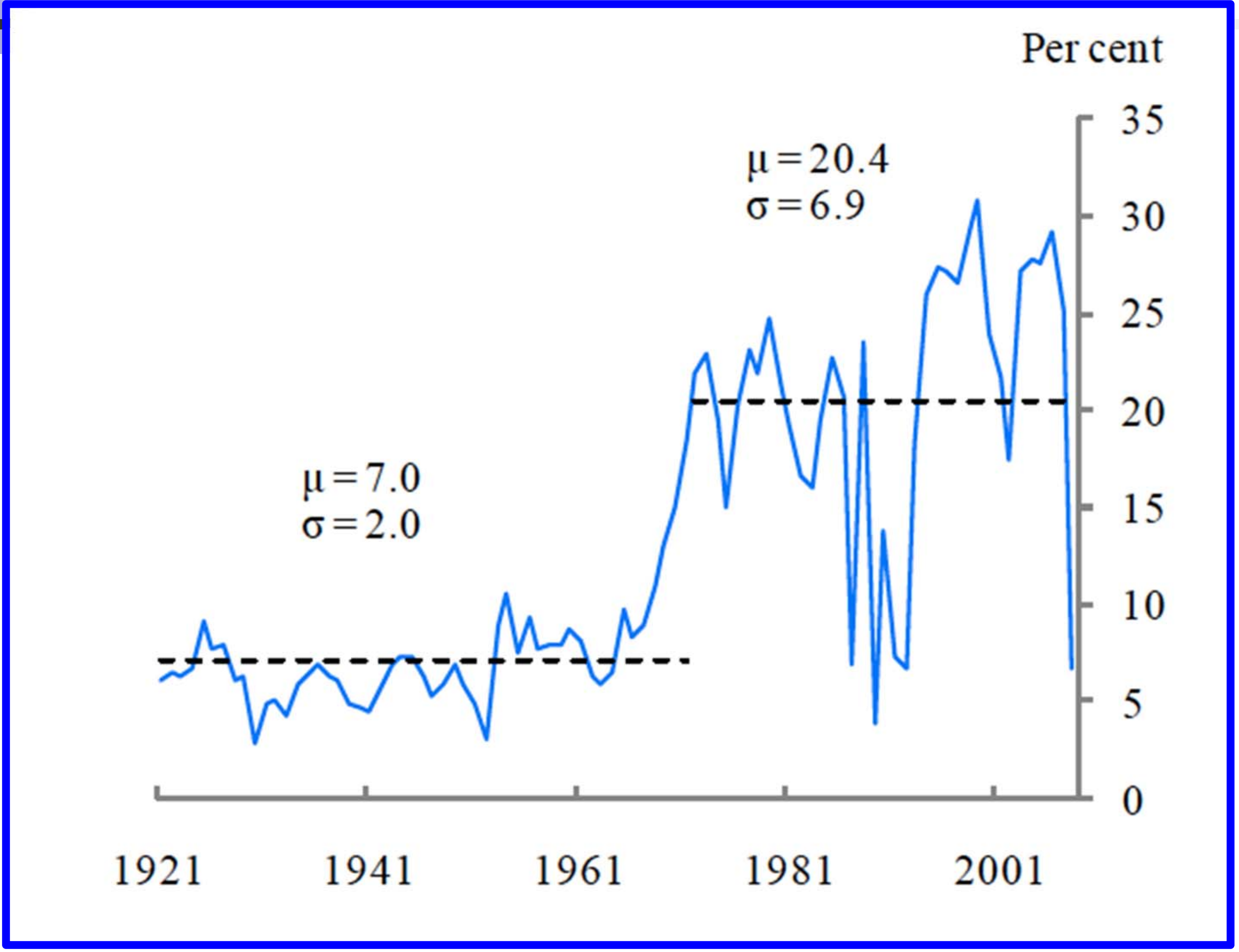
- **Portions of the financial system undetected (?) by regulators' radar screen**
- **Agents offering banking services without being regulated as banks**
  - Money market mutual funds
  - SIV and other vehicles
  - Repo market

The size of the shadow banking system

Figure 1: Shadow Bank Liabilities vs. Traditional Bank Liabilities, *$ trillion*[4]



Roe in the UK: a tale of two worlds



The general reaction to the increase of size and complexity

- **A. Turner: A rise in intellectual confidence that this growth in scale and complexity was adding economic value, making the global economy both more efficient and less risky**
- **The spreading of risks was making the international financial system more robust and more resilient (see Bis, Annual reports)**

3. The theory we forgot

Economic theory and growth: the received wisdom

- Financial deepening is beneficial to economic development (uncertainty on the direction of causation, not on the link)
- Therefore, financial repression is harmful
- Developed economies have bigger and more efficient financial systems
- Arm’s-length systems based on markets are more efficient than relationship lending systems based on banks (Rajan-Zingales)

Theory of banking: the received wisdom

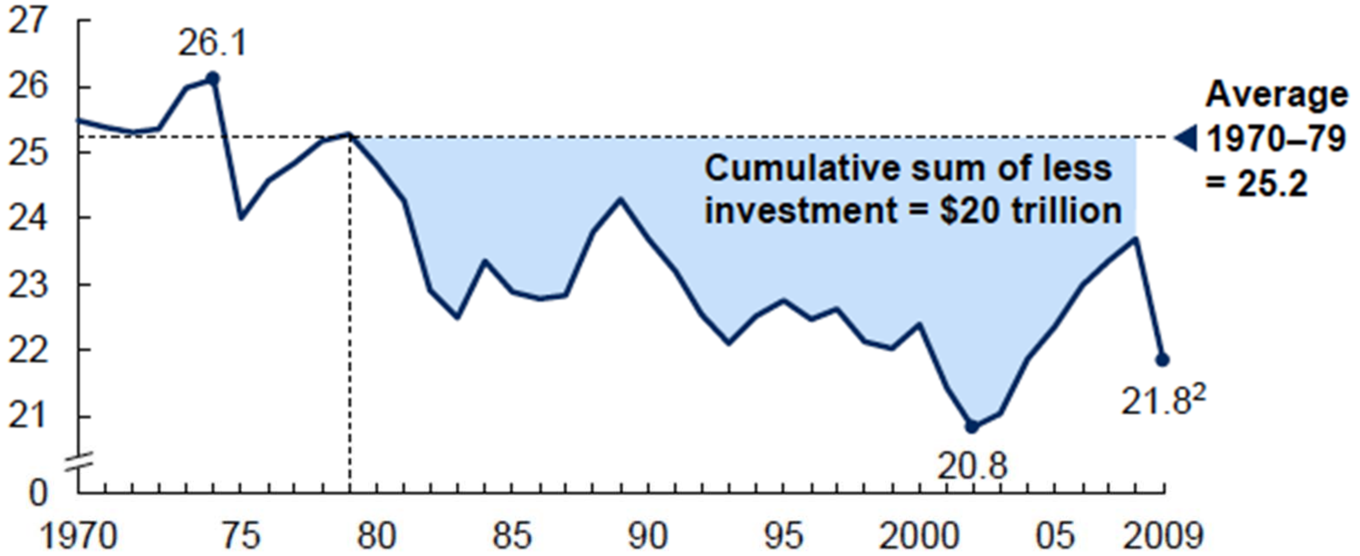
- **Banks are inherently unstable because of their liquid liabilities, illiquid assets (fractional banking) and high leverage**
  - Walter Bagehot - Jack Revell – Diamond-Dybvig
- **Financial systems are subjects to crisis**
  - Minsky-Kindleberger
- **Risk is endogenous**
- **Finance is beneficial if it favours investment and growth**

Contribution to overall production

Investments, what investments?

Global nominal investment rate[1] by year, 1970–2009

% of GDP, nominal values



$ trillion	1970	1980	1990	2000	2009
Investment	0.8	2.7	5.1	7.1	14.0[3]
GDP	3.1	10.8	21.7	31.7	59.7[3]

Adair Turner' conclusion

- There is no clear evidence that the growth in the scale and complexity of the financial system in the rich developed world over the last 20 to 30 years has driven increased growth or stability, and it is possible for financial activity to extract rents from the real economy rather than to deliver economy value.
- Financial innovation and deepening may in some ways and under some circumstances foster economic value creation, but that needs to be illustrated at the level of specific effects: it cannot be asserted a priori or on the basis of top level analysis.

Willem Buiter

- **Useful finance**
- **Useless finance**
- **Harmful finance**

  - Derivatives may improve the allocation of risk, but there is no guarantee that they will. It is my contention that the unbridled explosion of certain categories of derivatives has done considerable harm, and that it is necessary to regulate all derivatives trading.

First: change banks' business models

- **The Financial Stability Board**
  G20 Pittsburgh, September 20, 2009
  - **In recent months, expectations have taken hold in some parts of the private financial sector that the financial and regulatory system will remain little changed from its pre-crisis contours.**
  - **These expectations – that business will be able to go on just as before – need to be dispelled.**
- **Mervyn King 2010**
  - **Of all the many ways of organising banking, the worst is the one we have today.**

The main documents

- **FSA, The Turner Review**
- **LSE, The future of finance**
- **UK, Independent Commission on Banking, Issues Papers**
- **BIS, 80th Report 2010, ch. VI The future of the financial sector**
- **Ecb, The future evolution of the EU Banking sector**
  - Beyond Roe

4. How to fix it

The main proposals and their objectives

Capital adequacy 2.0 (credit risk, market risk, liquidity risk)	• Make banks more robust and resilient
Surcharges for systemically important financial institutions	• Control of systemic risk
Orderly resolution mechanisms	• Let them fail ,even if they are big
Counter-cyclical macroprudential supervision	• Risks arising from the macro scenario
Limits to proprietary trading	• Decrease complexity and riskiness
Move derivatives from otc to regulated or more organised markets	• Decrease interconnectedness and control counterparty risks
Tax on financial transactions	• Disincentive to risky activities

4. How to fix it

Meanwhile, we have to deal with three problems

- Hangover of the credit bubble in banks' books
- Assets of uncertain value (toxic problems of securitisation)
- Heavy reliance on trading (profitable but risky)

Wrapping it up

- **The crisis exploded after a long phase of financial evolution**
  - Increase of dimension and sophistication
  - Diminishing contribution to investment and growth
  - Historically high profits
  - Unbearable risks
- **Reducing the useless and the harmful part of finance is difficult, particularly in the short run**
  - Limited profitability and high risks of traditional credit
- **The political likelihood of significant changes is getting smaller and smaller**
- **Toomuch weight on Basel shoulders?**