Financial Stability: An Elusive Target

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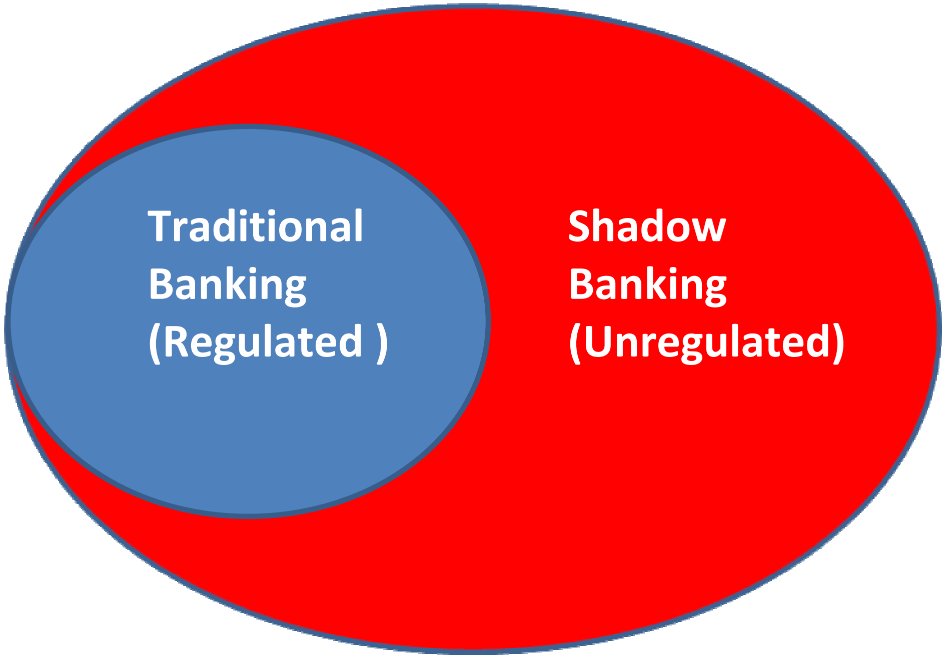
Traditional banking: intermediation between savers and investors. Supports growth, but loans are illiquid with small returns. Low leverage to curb risk.

Shadow banking: issue of bonds, derivatives; big profits through commissions, liquid assets, higher leverage capacity; higher returns to investors.

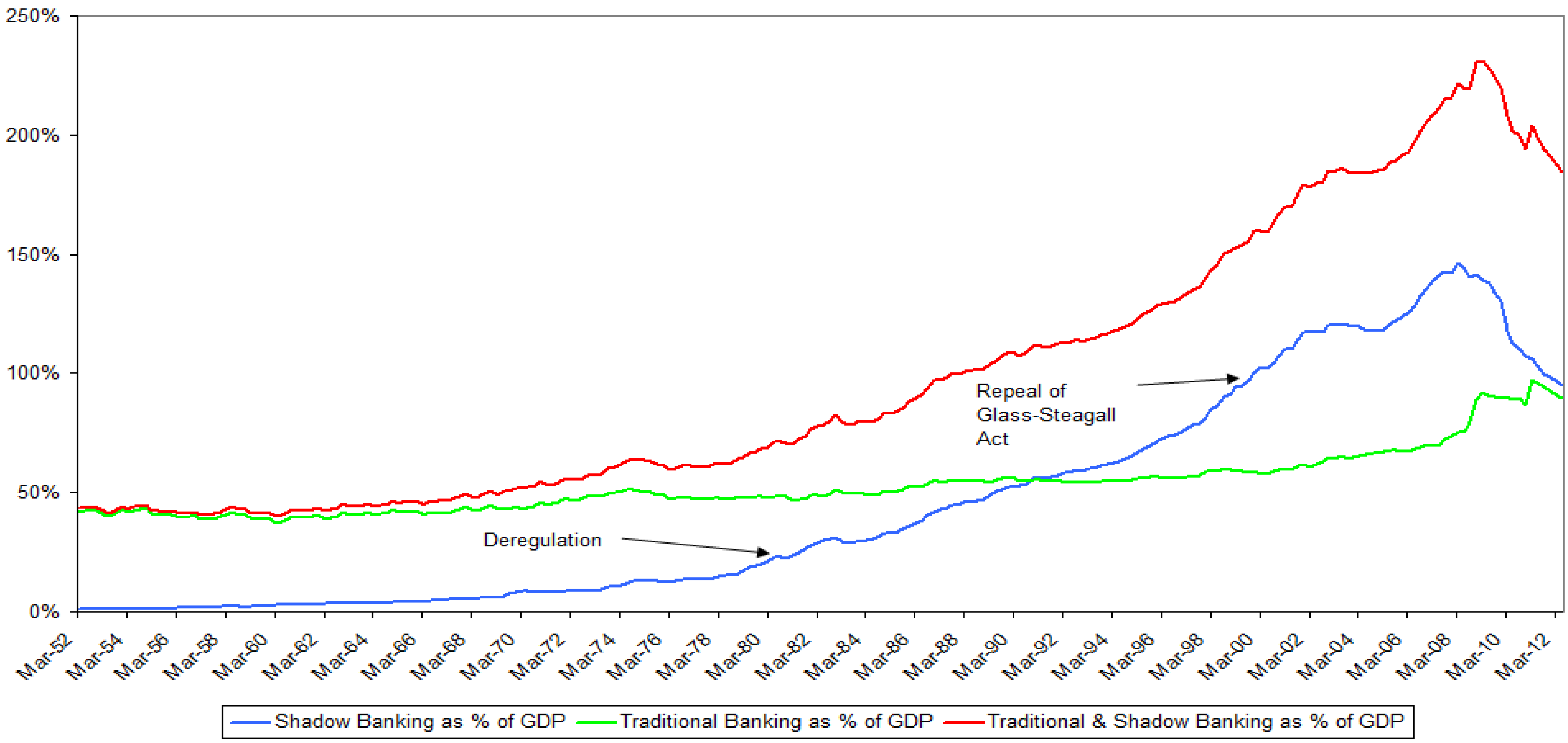


Financial Stability: An elusive target

- Before the Glass-Steagall Act (1933) banking and financial crises were the norm and occurred very frequently. Ten year recovery.
- The Glass-Steagall Act achieved its objective of preventing financial crises by separating commercial from investment banks.
- The repeal of the Act (1999) accelerated the expansion of liquidity that financed a series of bubbles (internet, housing, commodities, shipping, US Treasuries). The amplitude of business cycles has markedly increased.
- Belief in 'efficient market hypothesis' (EMH), namely that all unfettered markets clear continuously thereby making disequilibria, such as bubbles, highly unlikely, is at the root of the crisis.
- As a result, potential systemic risk was ignored and financial regulation and supervision "were increasingly light-touch and reliant on self-correcting market forces" (IMF, 2010, p. 7); and, indeed, in the case of 'shadow banking' it was completely absent.
- As the liquidity has not been drained, it remains a threat to financial stability making it an elusive target.

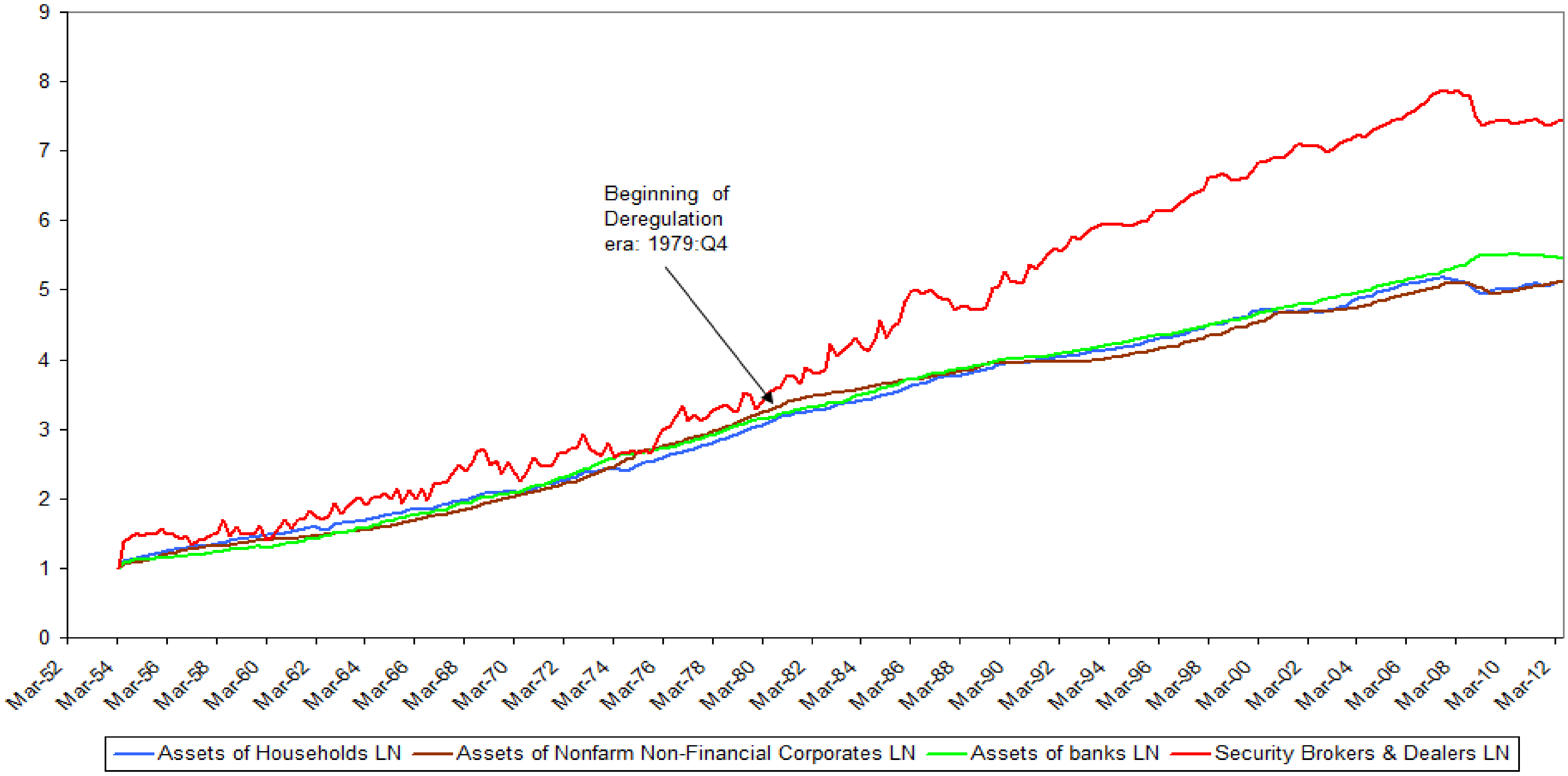
Too much liquidity ($15 trillion in the US) is the problem. Bank deleverage has been modest ($6 trillion).

Figure 1: Liabilities of Shadow and Traditional US Banking



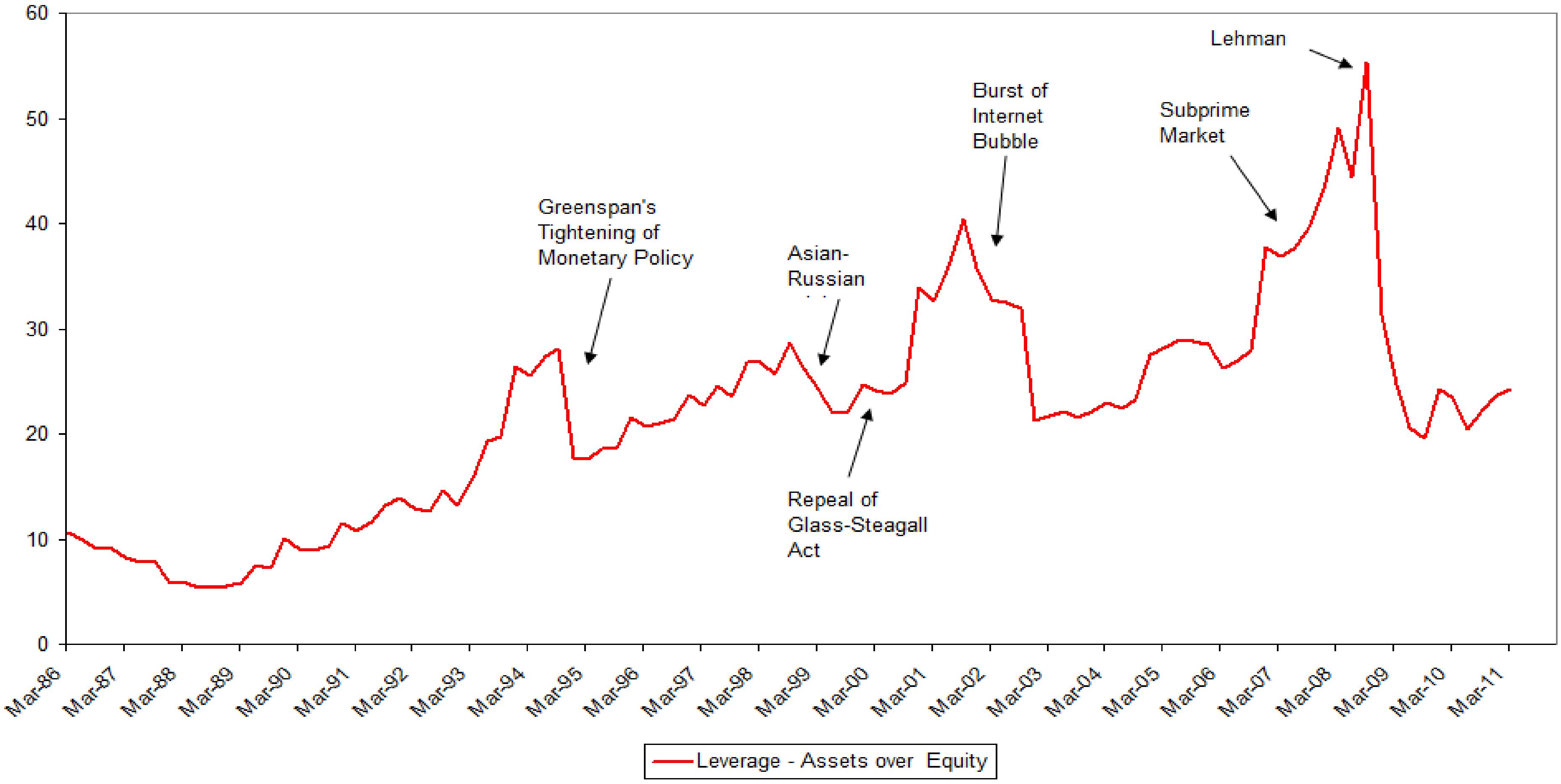
The excessive liquidity is entirely due to an overexpansion of security brokers and dealers (i.e. old investment banks).

Figure 2: Growth of Assets of Four Sectors in the US (in logs 1954=1)

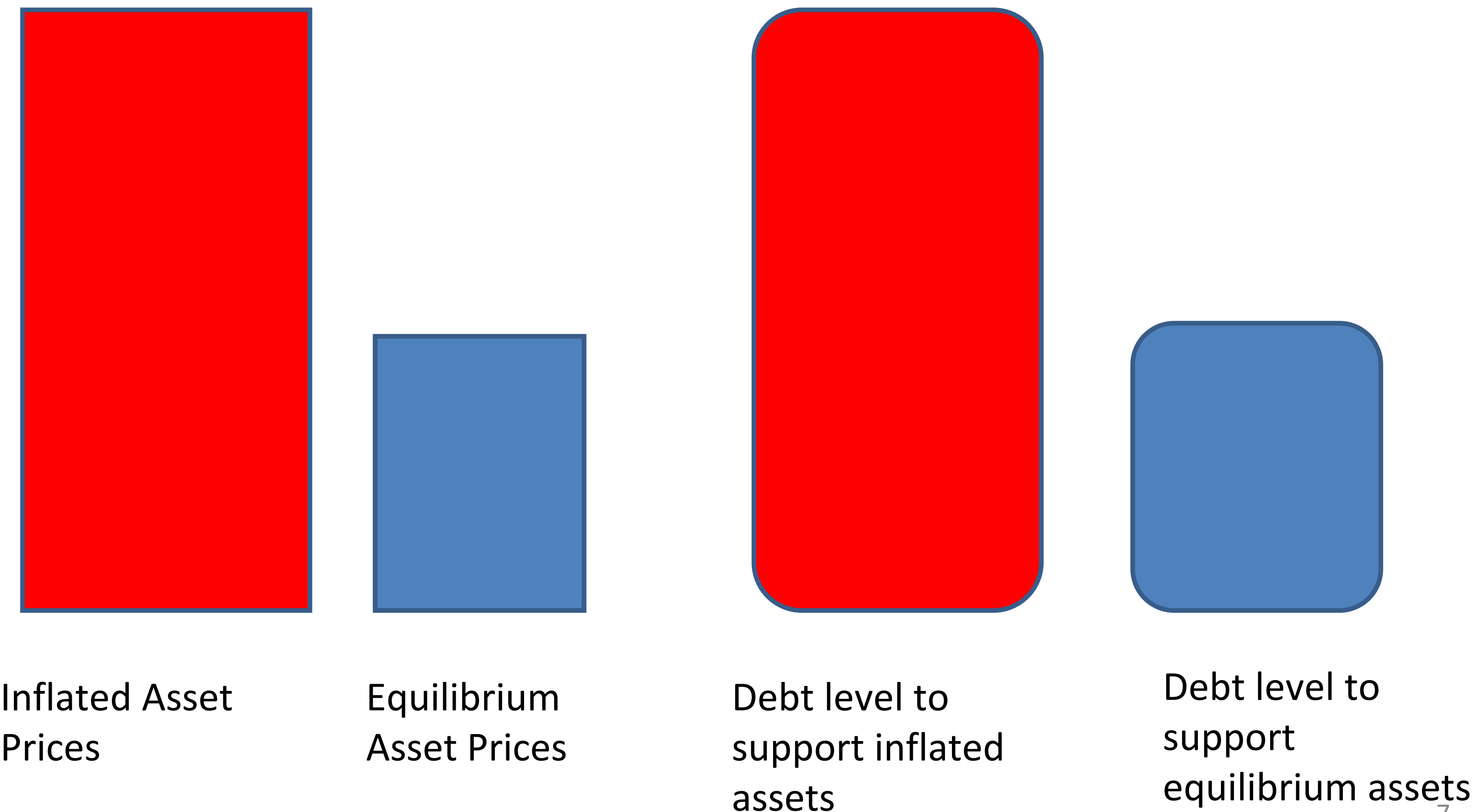


Risk appetite has returned to normal levels (excessive liquidity is not used)

Figure 3: Asset-Leverage of Investment Banks



Economic Policy Choices: restoration of inflated asset prices or asset and debt deflation (deleverage)



The Policy Dilemma

- Two conflicting objectives:
- Restore asset prices to pre-crisis levels to deter a 1930’s depression through debt deleveraging (Banks, Businesses and Households).
- Regulate the financial system and make it safer (higher core capital and liquidity ratios) to avoid future crises by forcing banks to deleverage.

The options of Financial Reform

Traditional banking:

(a) Stricter regulation and safer (higher capital and liquidity ratios).

(b) but with privileges: deposit insurance, liquidity assistance.

Shadow banking:

(a) bring it on par with the rest (stops deleveraging and perpetuates bubbles);

(b) keep them apart (deleverage possible);

(c) allow mingling, but ring-fence, such as Dodd-Frank, Vickers, EU, Basel (Herculean labour, if not impossible task).

Conclusions

- Separation of banks from shadow banks is the best policy option.
- It would reconcile the policymakers aim of restoring asset prices without debt deleveraging of traditional banking.
- It would prevent deleveraging of traditional banking and hence a faster return to growth.
- It would enable deleverage of shadow banking and hence drain the excess liquidity which has increased the amplitude of business cycles, thereby restoring financial stability and paving the way for faster growth.

Volcker rule

- The modern equivalent of restoring the Glass-Steagall Act.
- Separation of banking activities from propriety trading, hedge funds and private equity.
- Rationale: “provide a ‘safety net’ – in particular, deposit insurance and the provision of liquidity in emergencies – for commercial banks carrying out essential services. There is not, however, a similar rationale for public funds - taxpayer funds - protecting and supporting essentially proprietary and speculative activities. Hedge funds, private equity funds, and trading activities unrelated to customer needs and continuing banking relationships should stand on their own, without the subsidies implied by public support for depository institutions” (Volcker, p.1).
- Three elements:
- The first is that size matters - ‘if you are too big to fail, you are too big to exist’.
- Eliminate proprietary investments.
- The financial sector must be restructured.

Vickers: Ring-fencing than full separation

- Domestic retail banking should be inside the ring-fence.
- Global/wholesale investment banking should be outside the ring-fence.
- Provision of straightforward banking services to large domestic non-financial companies can be in or out the ring-fence.
- The aggregate balance sheet of UK banks is 4xGDP. On the criteria above 1/3 to 1/6 would be within the retail ring-fence.
- Regulatory requirements for capital, liquidity, funding and large exposures on a standalone basis.
- Relationship with the parent banking group at an arm's length.
- Independent governance to enforce the arm's length relationship.

- Is ring-fencing possible? Herculean labour, if not an impossible task.