Financial Stability in an Unstable World

The Rôle of Central Banks

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1. The main drivers of financial stability

2. Monetary policy as the backbone of financial stability

3. Financial regulation: Basel III ratios

4. The main threats to financial stability
1. The main drivers of financial stability

**Financial crises: the need for financial regulation**

- Over the past 50 years, the world has known a succession of crises, on average every three years.

- Financial crises affected both developed and developing countries of the world.

- The most recent and important ones were:
  1. 1994: Mexican crisis
  2. 1997: Asian banking crisis
  3. 2000: Argentina
  4. 2002: Turkey, Venezuela
  5. 2007: US financial crisis
  6. 2010: Eurozone sovereign crisis
  7. 2015: Chinese stock market crisis

- The **Basel III framework** is the only worldwide attempt to create consistency in financial regulation, and is still being implemented.

- The **2007 US financial crisis** was a systemic financial crisis mostly generated by banks.

- The **EU crisis** was a systemic financial crisis due to overspill of sovereign debt problems.

- The European criteria on sovereign borrowing have not been, and are not being implemented rigorously.

- While there are stringent regulations applied to the financial sector, there is no equivalent for **fiscal discipline**.
1. The main drivers of financial stability

Monetary policy limitations: independence or autonomy?

- Monetary policy is the prerogative of central banks.
- Without fiscal discipline, there is no way monetary policies will suffice.
- In Europe, for one monetary policy in the Eurozone, there are 19 fiscal policies of the individual Member States.
- The US treasury has become an antifraud department and has hardly any fiscal policy.
- Quantitative easing policies have increased the size of central bank balance sheets.
- However, it is the central banks in the US, Europe, the UK and Japan that avoided the systemic explosion of developed and developing economies.

- Central banks are pleading for the strengthening of their independence.
- However, they are, everywhere, at various degrees, dependent on politics, parliaments and executive powers, namely through the appointment of their leadership.
- The “dual mandate” has put the central banks in charge of job creation and growth stimulus making their monetary policy restrained
- The regulatory role of central banks is critical to financial stability: does it create conflicts of interest?
1. The main drivers of financial stability

Central banks’ balance sheets: a $17.5 trillion risk

Central Bank Balance Sheets: PBOC, Fed, ECB, BOJ, SNB, BOE, BoC, CBC, Riksbank
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Negative interest rates?

FOLLOWING INTEREST RATES AS THEY DIP BELOW ZERO

So far, central banks in four countries and the Eurozone have adopted negative interest rates.

- Japan and Europe had to resort to negative interest rates.
- The US Federal Reserve moved towards increasing interest rates.
- The Abenomics led Japan to negative interest rates despite a 200% ratio of debt to equity.
- Low interest rates were due either to foreign exchange policies or policies stimulating the economy.
- The ECB negative interest rates policy was effectively subsidizing weak countries rather than stimulating the Eurozone.
- Negative interest rates expropriate savers.
- An interest rate policy that does not adequately remunerate the risks is inherently unstable.
- Subsidizing governments through low interest rates delays the necessary economic reforms.

Source: Bloomberg, as of 03/18/2016
Monetary policy as the backbone of financial stability

Quantitative easing and the impossible exit

- There is no empirical evidence that quantitative easing stimulates the economy and creates jobs
- The ECB continues to increase its QE by 60 billion euros a month, in vain
- The Abenomics led the Bank of Japan to hold $3.2 trillion of the Japanese Government Bonds
- This mechanism is a disguised way of using central bank balance sheets to place public debt: $8 trillion of public debt are held by the Fed, the ECB and the Bank of Japan
- As shown here, the QE has effectively allowed banks to increase their excessive reserves in the same proportion as the QE operations
- QE has not led to an increase in loans and not led to the real economy
- The so-called unorthodox monetary policy creates a risk on the exit
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Capital adequacy and Systemic Financial Institutions

<table>
<thead>
<tr>
<th>Basel III ratios</th>
<th>Common equity</th>
<th>All Tier 1 capital</th>
<th>Total capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum</td>
<td>4.5%</td>
<td>6.0%</td>
<td>8.0%</td>
</tr>
<tr>
<td>Conservation buffer</td>
<td>2.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minimum plus conservation buffer</td>
<td>7.0%</td>
<td>8.5%</td>
<td>10.5%</td>
</tr>
<tr>
<td>Countercyclical buffer *</td>
<td>0-2.5%</td>
<td></td>
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</tbody>
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* Common equity or other fully loss-absorbing capital
Source: BIS

- One of the direct consequences of the US financial crisis is the revision of banks’ capital adequacy ratios.
- As exemplified by the Italian situation, the ratios, once again favor government debt.
- Asian banks are far from reaching the capital adequacy ratios, while European and US are, by and large, compliant already.
- As proved by the Italian banking crisis, the classification of “Non Performing Loans” is not strict enough to provide stability.
- Global and regional SIFI banks are requested to have further layers of capital and deemed to be too big to fail.
- It is unclear whether banks can issue fresh capital or bonds to consolidate their balance sheet.
3. Monetary policy as the backbone of financial stability

Capital adequacy and Systemic Financial Institutions – in the US

<table>
<thead>
<tr>
<th>Basel III Global Liquidity Standard</th>
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</thead>
<tbody>
<tr>
<td>1. <strong>Liquidity Coverage Ratio (LCR)</strong></td>
</tr>
<tr>
<td>(To be introduced as on January 1,</td>
</tr>
<tr>
<td>2015)</td>
</tr>
<tr>
<td>Stock of high quality liquid assets</td>
</tr>
<tr>
<td>------------------------------------</td>
</tr>
<tr>
<td>100%</td>
</tr>
<tr>
<td>Total Net Cash out-flows over next</td>
</tr>
<tr>
<td>30 calendar days</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>2. <strong>Net Stable Funding Ratio (NSFR)</strong></td>
</tr>
<tr>
<td>(To be introduced as on January 1,</td>
</tr>
<tr>
<td>2018)</td>
</tr>
<tr>
<td>Available amount of stable funding</td>
</tr>
<tr>
<td>------------------------------------</td>
</tr>
<tr>
<td>100%</td>
</tr>
<tr>
<td>Required amount of stable funding</td>
</tr>
</tbody>
</table>

- The US financial crisis showed that banks can have adequate capital while facing a liquidity crisis.
- The Volcker Rule attempts to limit the ability of banks to use their equity and long term capital in a speculative way.
- Banks have resisted these rules and the White House will probably get rid of the Volcker rule.
- There are still some subjective aspects to “highly liquid assets” of “stable funding”.
- This will protect the banks who take deposits, but a crisis of liquidity could emerge from shadow banking.
- In a crisis, the likelihood that banks and even central banks might massively sell the same “highly liquid assets” could create a liquidity crunch.
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Leverage ratio is indispensable when some ratios are not risk weighted

- A leverage ratio is easy to calculate and does not allow cheating.
- It covers all the exposure (off- and on-balance sheet)
- The current level of 3% is highly disputed by banks.
- The proposal of the US Treasury on leverage ratios is to get rid of all restrictions if banks have a 10% leverage ratio.
- After all, the size of the balance sheet and off-balance sheet exposures of banks does matter and represents a systemic risks in most cases.

\[
SLR (\%) = \frac{\text{Tier 1 Capital}}{\text{Total Leverage Exposure}}
\]

As defined in Basel III and consisting of Common Equity Tier 1 and Additional Tier 1 capital, subject to adjustments, deductions and transitional arrangements.

Takes into account both on-balance sheet assets as well as off-balance sheet exposures such as derivatives, repo-style transactions and other off-balance sheet items.
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4. The main threats to financial stability
The inter dependency of banks, central banks and governments: the Bermuda triangle

- The externality of the Central banks has, for all practical purposes, been blurred by this new interdependency.
- Governments found it convenient to finance themselves through the banks and the central banks.
- 40% of the Japanese debt is at the Bank of Japan.
- A crisis could come from any of the three sets of players with an immediate contagion.
- The tourbillon would create an immediate systemic crisis.
- Unless governments exercise fiscal discipline, the efforts to improve financial regulation will not be effective.
- This interdependency is the source of conflicts of interests for central banks who are often favoring banks.
- Central banks are no longer the solution, but part of the problem.
The Chinese corporate debt

- The corporate debt in China exceeded 170% of GDP, i.e. $18 trillion.
- The IMF estimates that Non Performing Loans represent 16% of the Chinese GDP.
- The chart on the left demonstrates that the deleveraging of private corporate debt from its 2006 peak has been compensated by an increase of State Owned Enterprises (SOEs).
- The quality of shadow banking loans is worse than bank loans.
- Shadow banking amounts to $8 trillion without any form of stable funding.
- Banks also started shadow banking operations.
- Alibaba’s four-year-old Yu’e Bao surpassed JPMorgan’s U.S. government money market fund to become the world’s largest, with $170 billion of assets.
- Worryingly, these dynamics in credit and investment efficiency is similar to pre-crisis behavior.
- The Chinese Government is trying desperately to rein in this growth.

4. The main threats to financial stability
4. The main threats to financial stability

The Italian sovereign and banking crisis could be imminent

- With $2.5 trillion of sovereign debt, Italy represents eight times the Greek debt.
- A sovereign debt crisis would immediately become systemic.
- The banking crisis led to three recapitalizations of the third largest Italian bank, Monte dei Paschi di Siena.
- Italy recently announced it would liquidate two banks and inject $11 billion to avoid bankruptcy.
- The European Banking Union mechanisms have not been triggered and Italy had to step in, despite its own record debt level.
- The Italian local elections were not favorable to the current majority.
4. The main threats to financial stability

Central banks are no longer able to provide financial stability in an unstable world

Government debt is the largest systemic risk