Towards a Sustainable Financial System

International seminar organized by the Swedish House of Finance, Global Utmaning and the Financial Markets Group at the London School of Economics.

Sponsored by Riksbankens Jubileumsfond, Vinnova and the Swedish House of Finance.
Preface

On September 12th-13th 2013, the Swedish think tank Global Utmaning (GU) together with the Swedish House of Finance (SHoF) and the Financial Markets Group at the London School of Economics (LSE), organized the high-level international seminar - "TOWARDS A SUSTAINABLE FINANCIAL SYSTEM" in Stockholm.

The responsible Scientific Committee consisted of Professor Charles Goodhart, London School of Economics, Professor Carlo Jaeger, Beijing Normal University, Professor Per Strömberg, SHoF, Professor Emeritus Alexander Swoboda, Graduate Institute of International and Development Studies, Geneva, Adj. Professor Pehr Wissén, Managing Director, Institute for Financial Research, Kristina Persson, President of GU, former Deputy Governor at the Riksbank and Ulf Dahlsten, Research Associate at LSE, Senior Advisor at GU.

The seminar was made possible by financing from Riksbankens Jubileumsfond, Vinnova and the Swedish House of Finance.

The break-down of Bretton-Woods, the liberalization of global finance and emerging information technologies have created a new environment for financial markets. The 2007-2008 financial crisis has exposed new systemic risks, created uncertainty about the functioning of the financial markets and especially the role of shadow banks and innovative instruments.

The marked rise in volumes of the financial system and of financial investments, which risk driving asset bubbles, has also been increasingly discussed. The issue is how to ensure a sustainable financial system that supports real investments, an economic recovery and sustainable growth.
Towards a Sustainable Financial System  
– an introduction

Riksbank Governor Stefan Ingves

Financial crises around the globe have put significant costs on the society during the last decades. In the light of these crises there are some key drivers of reform that can be identified. Too low quality and quantity of capital, too high leverage, no liquidity framework, high interconnectedness and systemic risk as well as “too big to fail” are all key points in the drive to reform.

The regulatory response to these crises is the Basel III regulatory framework. With strengthened capital requirements for systemically important banks, cap on bank leverage, and new requirements on bank liquidity, the objective and aim is to reduce the probability as well as the severity of future banking crises.

“In Sweden a relatively stronger focus is being placed on banks’ structural liquidity risks compared to other countries. The major Swedish banks’ progress towards the requirements shows currently a higher requirement at 12 % compared to the Basel requirement at 9.5% if the contra cyclical buffer and the capital conservation buffer are included. Requirements may however be raised for systemically important institutions as well as stricter requirements for systemically important banks.

What are we trying to achieve with this? We are trying to achieve improved quality and quantity of capital, lower leverage and a liquidity framework as well to avoid the central bank role as lender of first resort. We also want to avoid the situation of institutions being ‘too big to fail’ and the central bank having to step in to buy a bank for 1 SEK at 2 in the morning.

Some key drivers of reform

Banks are complaining that with the new requirements it will be too expensive to do repos. But ultimately, we don’t want to finance high risk loans with short term debt. Today Swedish banks are heavily dependent on market funding, which is good in terms of short term liquidity but poor in terms of structural liquidity. What is then beyond the Basel III regulation? The aim is a framework for dealing with failing banks and bail-in capital. With better regulation comes enhanced financial stability and a more sustainable financial system, resulting in a much stronger real economy.

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The future of financial supervision and regulation

Martin Andersson, Director General at Finansinspektionen

History shows that successful crisis management can return the economy to the level before the crisis, but it cannot catch-up with the level we would have been in otherwise - that’s the permanent cost of crises. Alan Greenspan, former Governor of the Fed, once said that:

“Monetary policy should take away the punch bowl when the party is best.”

The regulatory authorities are here not to solve the problems of the financial sector but to make sure that the financial sector is providing the basic services to the economy. Even though we don’t have all the answers in all situations - we still must have the ability to act quickly and decisively. But there is at the same time the need for a more open and transparent decision making process.

Weak banks don’t provide services for the economy as they are too busy to take care of their own balance sheets, so we need them to have bigger and better buffers. In the Swedish case we do have banks that thanks to their easy access to borrow cheaply have bigger and better buffers, and have stopped complaining about the high capital requirements.

The concerning factor is the high level of Swedish household debt, which now worryingly has been showing some signs of picking up pace again. If this pattern continues and if we see more signs we will have to take more action as the private debt level is a weak spot in the Swedish economy. We do not however see a Swedish housing bubble for the time being.

“Monetary policy should take away the punch bowl when the party is best.”

“...contribute to a stable financial system characterised by a high level of confidence and well-functioning markets... while at the same time providing comprehensive protection for consumers...

Finally we must ask ourselves how long we can live in a society where profits are privatized and losses are socialized. What we cannot have is a dysfunctional system that can only “live” as long as we have positive economic growth.

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Bank vs. Non-Bank Credit in Europe

Nicolas Véron, Senior Fellow, Bruegel (Brussels)
Visiting Fellow, Peterson Institute for International Economics (Washington)

In the financial system of a given economy the mutual interaction between bank and non-bank intermediation as well as the existence of non-bank structures with bank-like risks are often referred to as “shadow banking”. During the years of the recent financial crisis, developments in Europe and the US have led to non-bank credit channels often being portrayed as “shadow banking” - which has given rise to a consideration of the risks they may pose to financial stability. Due to the lack of reliable and comparable data, this view remains incomplete.

Much of the recent debate in the wake of the financial crisis has focused on concerns about shadow banking. There has been a common assumption that all non-bank credit intermediation may take the form of shadow banking. More research is necessary to clearly distinguish between shadow banking and non-bank credit in order to frame the assessments of new policy initiatives.

In the developed economies the available evidence shows a correlation between higher resilience against systemic risk and the development of non-bank credit. With this knowledge, policy should better aim at strengthening the infrastructure for the gradual development of sustainable non-bank credit provision by removing obstacles to the development of sustainable non-bank credit intermediation.

Significant resources should also be allocated by central banks and financial authorities to improve the quality of statistical information on financial system. One of the greatest obstacles to evidence-based policymaking is the lack of statistical evidence. Better data would ensure the proper regulation of non-bank credit channels while reaping the potentially large economic benefit of their continued development.

The Swedish Perspective

Peter Norman, Minister for Financial Markets

At the onset of the financial crisis, the risks in the financial systems were underestimated and the Lehman crash is a clear example of how one failure led to another. Today, financial stability is a necessity for a European recovery, but European monetary policy need more support from fiscal policy in order to succeed. Not least in the countries where the banking sector still is fragile, financial stability is a prerequisite both for a recovery and for long term growth. Our lesson from the financial crisis is that there are large costs of crises on society, both on the international level as well as in Sweden, due to its large financial sector.

On the European level, the balance sheet of Irish banks quickly grew very disproportionate before the crisis. By 2007 the housing market reached its peak and housing prices fell followed by rising unemployment for the first time in 15 years. This was followed by years of negative economic growth and by 2010 the Irish government issued a bank bailout.

“Given the Irish example the importance of managing financial risk cannot be underestimated.”

To avoid similar developments there are precautionary measures to be taken. For instance strengthened supervision, higher capital and liquidity requirements, risk weight floor for capital requirements of banks mortgage lending and loan-to-value caps.

However, due to high exposure to financial risks, further action is motivated. Sweden is more exposed to financial risk than many other countries and the debt burden of Swedish households is most worrying. Banks aggregate balance sheets in Sweden are about 4 times GDP and are only matched by Switzerland and England. Sweden is thus very exposed. The debt burden in Sweden has almost doubled since 1995, consequently, the Swedish government proposes further reforms.

First, the Financial Supervisory Authority (FSA) is given the main responsibility for the financial stability toolbox. Second, banks shoulder costs for extra-large foreign reserves, and third - the creation of a financial stability council. Fourth, the creation of a stabilization fund to be turn into a proper fund with financial resources. And lastly, the goal of a sounder amortization culture; with more assistance with repayment plans. In all, prudence and the cautious use of instruments, is the key to obtaining a sustainable financial system.

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Do we have a resilient global financial system?

Lord Turner, former Chairman of the Financial Services Authority

One fundamental insight of the way credit extension creates purchasing power was made by Knut Wicksell. He asked the question what the consequences were of payments being made based on credit rather than notes and coins. Even if we would have a "simple credit economy", with credit simply extended on a bilateral basis between businesses; it would in itself create purchasing power beyond that of pure metallic money.

If one goes beyond this to a system of organized credit, with commercial banks and deposit money as the fundamental form of payments, it clearly creates purchasing power ex-nihilo, out of nothing.

A fundamental insight is what banks actually do. We sometimes say that banks take deposits from households and then lend it to entrepreneurs or businesses. But this is a bad description of what banks do. What banks actually do is to create both a loan and the money in that entrepreneurs account.

Furthermore, we can have over-investment cycles even if all credit is extended to support real investment in physical capital. Contrary to the textbooks, most credit is not extended for that reason. Sometimes it is extended to businesses to finance real investments projects, but most of the time is extended to business speculators or investors simply to finance the purchase of existing assets.

Estimates of the balance in the UK 2009 suggests that out of £ 1.9 billion bank credit extended, only 13-14 % was provided to support productive investment projects. Once one realizes that that is what credit does in a modern economy we introduce a whole new possibility of the impact of credit.

Increased extended credit drives increased asset prices which then drive changes in the behavior of both borrowers and lenders. Borrowers note that the prices of assets are rising and believes it to be sensible to borrow more money, which implies that the demand for credit goes up. The increase in asset prices starts a self-reinforcing cycle of extended demand and supply. These cycles of credit and asset prices of existing assets are fundamental to the dynamics of credit in a modern economy.

If the central bank of the given economy tries to slow down a commercial real estate lending boom by increasing interest rates it is likely to do significant harm to real productive investment in the non-commercial real estate sectors of the economy - long before a slowdown of the boom in the commercial real estate area. There is therefore a danger that if one simply relies entirely on the interest rate to control credit cycles you get a problem.

"We have tended toward a way of thinking about the credit creation process which is simply not true, our textbooks convey oversimplified assumptions..."

The implications for policy are the following: Price stability alone is an insufficient focus, but financial stability alone is also an insufficient focus as even solvent banks can create credit cycles. Credit cycles matter in themselves, categories of credit matter in themselves and levels of leverage matter in themselves. This means that not it is not sufficient to add financial stability as a new stand alone central bank responsibility, we also need to head towards an integrated management with constraint on the credit cycle via a combination of interest rate policy and macro prudential tools. And finally we need the restoration of the use of quantitative reserve requirements and direct constraints on different categories of borrowers.

The conclusion is that the credit cycle and the level of leverage are crucial economic variables which we need to pay attention to and did not pay adequate attention to before the crisis. In order to pay attention to them and deal with them effectively we need to go well beyond the current new conventional wisdom that we need to add financial stability as a parallel but separate focus to monetary stability. What we need is a new approach, integrating across monetary policy and financial stability issues in order to control and constrain the credit cycle.

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How to incentivize the financial system to support investments in the real economy...

Karolina Ekholm, Deputy Governor

Do we want to incentivize the financial system to support investment in the real economy or should we instead create a stable financial system that fosters economic growth?

Financial development supports economic growth but only up to a certain point. It is relevant to ask whether the decline in bank lending these last years is due to slow economic growth or to supply driven factors. However it seems that demand is probably a more important and probable factor today. The current low level of investments in the banking sector is believed to have to do with current market expectations of continued weak demand development.

Is there any evidence that higher capital requirements have any negative effect on economic growth? From the banking industry the answer is usually yes, but academic research says otherwise. For instance Admati and Hellwig (2013) reject the assumption that higher capital requirements have negative effects on economic growth. The only problem is that shareholders are reluctant to issue new equity since it would benefit creditors at the expense of shareholders. Aghion (2013) has a more neutral view since there is a risk that higher capital requirements may hold back lending to firms with lower asset tangibility, these firms tend to often be the most innovative ones too.

The conclusion is that a larger financial sector is not necessarily better from an economic long-run growth perspective. The current situation indicates a continued situation of low levels of investment and corporate lending in advanced economies and further weak expectations of demand development.

The on-going Basel process is tedious and slow work and runs the risk of meeting a lot of resistance. However these factors should not be used as arguments for watering down proposals of financial sector reforms. Reform is needed to make the aggregate economy more resilient to large adverse shocks.

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Sustainable financial system: “Is there an equity gap?”

Professor Per Strömberg, Stockholm School of Economics

The financial crisis saw a simultaneous reduction in lending and investment. One of the issues in understanding the crisis is determining whether this was supply- or demand-driven. Even if the financial crisis caused a reduction in lending in weaker banks it is not clear what the net effects on firms are. The real effects of the financial crisis on investment of large public corporations were quite small, the real victims are more likely the small private firms (SME), where bank financing is the only alternative. Although there is not much solid crisis evidence due to the lack of data, previous crisis evidence on bank lending channels suggests that small private firms are more affected than larger ones. This is quite significant since small private firms are very important for job creation. Even for newly started firms, bank debt is much more important than equity – contrary to popular belief.

So what are the alternatives to bank debt? Since bank lending is yet to be fully recovered and the effects of Basel III regulation on SME lending are still unclear, there are some suggestive options. One is that “shadow banking” will take care of it with factoring receivables, leasing and trade credits. However these types of financing are only suitable for certain types of investments and are dependent on bank credit supply nevertheless. The second option is the up-and-coming alternative of micro-bonds, with listed or unlisted issues of €50 M. These investors are typically individuals in close vicinity of the firm or take the form of small-scale crowd-funding.

Is there then an equity gap for companies? In the aggregate, external equity is a relatively small component compared to own equity and debt. External financing is particular hard for the early stage firms where their low initial profits limit their debt capacity, leading to problems such as adverse selection and moral hazard.

The failure of the market to support entrepreneurs and innovative firms is coming at a cost to the economy as the possible benefits and spillovers from these firms’ R&D are lost. Government intervention in entrepreneurial finance (government sponsored venture capital funds) is one solution to cope with this market failure. But most important is inside equity, that is, retained earnings and personal savings as well as “agency-free” funding. One clear policy implication of this is to make it easier to generate inside equity by improving the financial supply for small firms. For instance with indirect rather than direct measures such as tax reductions on corporate and personal levels.

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Sustainability, Finance and a Proposal from China

Dr. Armin Haas, Institute for Advanced Sustainability Studies e.V. (IASS Potsdam)

Are we moving towards a multi-polar world of reserve currencies? Many take this development for granted, not least the media, but academics are skeptical in terms of sustainability. A system might show disruptive economic and political dynamics should it be based on more than one national reserve currency. Countries that are issuing reserve currencies are likely to find it difficult maintaining their currency valuation and at the same time providing liquidity to the rest of the world.

The situation of the stability of a multi-polar reserve system relates to the three-body problem of celestial mechanics. That is, in time-continuous systems deterministic chaos can arise once a system is expanded from two variables to three or more state variables. A useful metaphor can be the astronomical illustration of a solar-system: In a bi-solar system, the two suns circle each other in order. But what happens if you add a third sun in to the system? The answer is deterministic chaos. Is that how we want currencies to behave? Is this what a three-currency system would look like? We don’t know but we can’t rule it out.

There are many possible scenarios for disorderly economic dynamics in a world of multi-polar reserve systems. But the system also suffers from a key problem of our civilization which is the tendency to postpone risks so that they are neglected in today’s decision-making. Thus attempting to just stabilize the current monetary system may cause even bigger crises in the future.

A vision of a sustainable solution to this problem was conceived by Keynes in the 1940s; the international reserve currency “Bancor”. In this he envisioned a global monetary system with the scheme for delivering sufficient growth and liquidity for all nations, as well as keeping macro-economic imbalances from destabilizing further. In short, the Bancor was a fiat currency used for stabilizing commodity prices via commodity shock buffer stocks. Instead of Keynes vision of the Bancor, the world ended up with Special Drawing Rights (SDR) with the IMF and the World Bank as global financial institutions.

To this background, the Governor of the Chinese Central Bank, Zhou Xiaochuan, proposed a long term aim of creating an international reserve currency with a stable valuation benchmark. In the short term he proposed to strengthen the role of SDRs in order to facilitate the transition to the long term goal. There is a Chinese metaphor: “You get to a river and there is no bridge, what do you do? You look for the first stone in the water and then the next”: there is no guarantee this will get you across, but it might. The possible stones in the water could be a world government with the power to tax. The possibility to use the Bank of International Settlements (BIS) as a candidate for controlling an international reserve currency instead of the IMF could be also promising.

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Governance of the Global Market

Ulf Dahlsten, fellow senior research, London School of Economics and senior advisor to Global Challenge

The ever increasing global market economy is only matched by a weak intergovernmental order based upon networking and consensus. The deregulation of the financial markets in the 70’s and 80’s came without an international legislation, international regulator, lender of last resort or a resolution mechanism. The system ended up with reliance of trust in self-regulation, a system which we now are paying the price for and are now trying to remedy. This problem is more than just a technicality. As countries have for many reasons different priorities and difficulties agreeing between themselves, the issue is how to create strong enough links between the governance of a global financial system and national public policies without ending up with a one size that does not fit all. In other words, ending up with a global regulatory regime that is insufficient in scope and strength and does not solve the global economic imbalances it was created for. There is however cooperation among international political leaders. The Financial Stability Board has become an important link between the G10 of central bankers and the G20 that is now being led by the heads of state and prime ministers. The strength of this present order is above all the assembled knowledge of hundreds of economists and central bankers, as well as the fact that it is well supported by civil servants in the International Monetary Fund and in the Bank of International Settlement. The weakness of the present situation lies instead in the decision process and in the implementation and the risk for regulatory capture in that final phase. A proper work distribution and a powerful institution are thus missing. Some of the problems with intergovernmental cooperation and networking on the one hand and national implementation on the other are; Limited scope, Lack of authority, Lack of transparency, Lack of accountability and that the room for manoeuvre by nation-states has declined. A partly supranational regime with strict controls of the financial markets was established at Bretton Woods after World War II. But heavy deregulations in the 70’s and the decision to liberalize the financial markets on a global scale, without any supranational structures in place were to take it one step too far. The global markets, and especially the financial market, regained the upper hand in relation to the political system. What is more, liberalization of the financial markets has contributed to an unreasonably skewed distribution of income and wealth within countries. There is thus a strong need to reduce the complexity of the financial system and to create firewalls between what is international finance and what financial activities within a currency area are. Banks are after all creating broad money on behalf of the currency owners, normally the nation-states, and to take away the responsibility for that money creation and the risks involved from the currency owners is questionable. Currency owners must be able to adapt the regulations to their own situation and control the money creation and the lending done by banks on their behalf.

Firing the Bank of International Settlements^

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Firing the Bank of International Settlements^

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Towards a More Sustainable Regulatory Process - Regulatory Capture and Mitigating Strategies

Dr. Stefano Pagliari, City University of London

In the dynamic and technically complex environment of the financial markets, policymakers and market participants are in their interaction for financial market regulation marked by a contradiction. In order to stay shoulder with rapidly changing financial markets and monitor the build-up of risks, the regulatory authorities are required to develop a close and constant interaction with the market participants. However, this close interaction between regulators and market actors has been described as opening the regulatory process to the risk of improperly favoring narrow industry interests. This contradiction in the regulatory process is generally known as "regulatory capture". The impact and influence of regulatory capture has attracted much attention in the aftermath of the crisis, where the undue influence of special interests has affected a relaxation of the regulatory constraints in the period preceding the crisis.

One policy approach by which this risk can be mitigated is by enhancing the plurality of voices in the policymaking process. Reforms in the mandate of regulatory agencies, staffing, funding and changes in the internal decision making progress are sets of proposals set to mitigate the risk. The reinforcement or implementation of external scrutiny in order to correct for biased regulatory decisions which otherwise might favor special interests is needed. The measures of scrutiny also include increased transparency of the regulatory process and the strengthening of the oversight against the risk of capture from other regulatory agencies from within- and outside the country. There is also the need to emphasize the attention and understanding of the process through which financial regulations are planned and implemented, in order to ultimately create a more resilient financial regulatory system.

An Optimal Bank Structure

Adrian Blundell-Wignall, Special Advisor for Financial Markets to the Secretary-General, OECD

Although some years already have passed since the start of the crisis, the financial problem is not yet solved. Reform to cope with the problems requires creating a financial system that adds value rather than subtract value for itself. This is unfortunately not happening. In order to address the financial problem correctly it is useful to understand the underlying factors to the crisis. The interaction between financial innovation and regulatory change, at a time of artificially low interest rates resulted in several most significant factors.

The assumption of ‘Too Big to Fail’ (TBTF) led to risk being under-priced through cross-subsidization from government and other lender of last resort guarantees. The other key factor was that leverage became too high and that regulators made it far too easy for financial businesses to avoid capital and regulatory changes. It also saw the innovation in business models focused on derivatives-based and securitization financial products, increasing the complexity and interconnectedness of risk which could then multiply through the system. This implied that traditional banking mixed together with losses in products of high complexity, implied that traditional banking mixed together with losses in products of high complexity, resulting in deleveraging and a drop in lending which failed to support recovery. The last key factor was the conflict of interest of corporate governance among managers and traders.

The Basel III rules are already outdated in that they failed to support recovery. The last key factor was the conflict of interest of corporate governance among managers and traders.

There are several suggestions to be made for an improved business model for banks. Among many is the separation of core deposit banks and high risk securities activities to a non-operating holding company structure should the bank group go beyond 10 % or more of derivatives assets, with additional strengthening should wholesale funding go beyond 20 %. The core bank is safer as the subsidiary bank will not benefit from government guarantees and will also be smaller, making them more prudent and highly resolvable.

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Too Complex to Fail  
- Concentration and Complexity in Financial Networks

Professor Stefano Battiston, Zurich University

With what key dimensions can one determine to what extent the financial system is unsustainable or sustainable? Each unique dimension - Concentration, Complexity, Interdependence and Notion of economic value - with its own role and interplay, need to be viewed in the context of a more stable banking organization.

The key dimension of interdependence is explained by that the financial system consists of interconnected market players and assets, where banks’ balance sheets are interlocked through different contract types. The system as a whole affects and is affected by the real side of the economy, where institutions, households and investors are highly interdependent.

The key dimension of complexity can be explained by the complexity of individual financial instruments and contract networks. The complexity of financial instruments such as derivatives is illustrated on the asset side of the top 25 banks during the years of 2004-2012, where the share of derivatives reached 30-40 % of total assets. As the assets of one bank is the liabilities of another bank, the probability of default and market value of debt, is highly interdependent. The uncertainty of market participants’ balance sheets risks transforming into larger uncertainty over high default probabilities of market participants.

Concentration refers to the number of relevant market actors in the game, where fewer actors mean higher concentration. The implication of higher concentration is higher chances of market power as well as more concentrated risk. Should the system fall all the actors would break down. In a system with high concentration and high interdependence, where big players are interconnected with each other by financial contracts, systemic risk is increased as a single big player is able to affect the others. There is also an increased risk of regulatory capture as all players share similar economic interests.

The regulatory policies needed to address these risks and a restructuring of the organization of the banks could take various forms: for example through the splitting up of banks’ commercial and investment arms, as long as one can address the complexity, interdependence and concentration at the same time.

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The Branch is the Bank

Magnus Ugglä – General Manager Handelsbanken International Executive Vice President, Handelsbanken

Handelsbanken is a universal bank with a nationwide branch network in 24 countries, where Sweden, Denmark, Norway, Finland, Netherlands and the UK are considered to be its home markets. Since the early 1970s, the bank’s organization has been strongly decentralized, putting business decisions and relationship agreements close to the customer. For the past 41 years, Handelsbanken has kept the same business model and is one of the most cost-effective full-service banks in all of Europe, as well as having higher return on equity than the average similar banks. The return on shareholder’s equity since 1973 until this day has been consistently higher than comparable banks such as SEB, Swedbank and Nordea.

The goal of Handelsbanken is to have higher profitability than the average competitor in Handelsbanken’s home markets and this goal is to be achieved by having lower costs and more satisfied customers than its competitors.

The most important means of control are an effective financial control system, corporate culture and corporate policy. The fundamental concept is that the methods for work and organization are based upon the responsibility of the branches for the individual customer and not on product areas or market segments which are the central units of responsibility.

The concept is further established by promoting the interaction between highly-trained specialists, branches and efficient support functions. This decentralized model is well illustrated by the growth development in the UK, where the excellent income/expense trend for Handelsbanken’s branches has brought over 100 branches to the UK.

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The Risks with Excessive Money Creation

**Professor Lorenzo Bini Smaghi, Harvard University and former Member of the Executive Board of the European Central Bank**

The world of stabilizing monetary policy is locked in a dilemma with risks on two sides. Should monetary policy use tightening measures too soon it risks putting the economy at risk as it helters recovery. On the other hand there is a large risk that tightening monetary policies too late fuels the economy more than needed, sowing the seeds of the next crisis. With this in mind, it is very important to assess monetary policies with a forward-looking manner and forecast the economic situation.

"Much of this crisis was a case of too easy money for too long..."

The big issue with a forward-looking attitude and economic forecasts is that cyclical changes are very difficult to forecast. In this sense, risk management plays a big and important part. However there have been some biases in risk management in the past where the natural tendency of central bankers have been to think that tightening monetary policies too early is more risky than tightening too late. What we really want to do is to postpone problems. Unfortunately there is a big illusion among central bankers that it is always possible to catch up if you chose to tighten later. Markets do learn from this behavior and anticipate change, and start to raise the interest rates early, while central banks struggle to convince markets that they are wrong. This involves convincing markets that the central bank will accommodate for far more inflation than what was previously thought even though it is not in their own interest. Nor do they want to tell markets that the economy is in much worse condition that what the politicians are stating.

"The ECB is becoming a political actor, like it or not..."

So policy for guidance is time inconsistent unless central banks start acting and go back directly to the market. One example of markets expectations and monetary tightening occurred in 1994 when the US Federal Reserve surprised the markets and tightened too slow which later created an economic bubble.

There are several big challenges for stabilization policies. One challenge is how to better interact and synchronize monetary policy with fiscal and structural policies. One example of this is that every time the ECB has stepped in to act on the market, incentives have been removed to use other policies to take action. We have therefore come to move to a new equilibrium of policies - monetary policy is an instrument that can take away the pressure from politicians. This means central bankers have come much closer to politics and where the ECB, FED and BOJ have become real political actors. This has become a dangerous situation and is one of the many casualties of this crisis.

To see and learn more from this presentation, visit:
http://blog.svd.se/ervenkaspengar/2013/09/15/har-vi-skapat-ett-monster/

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The money supply and its impacts in China

**Yu Yongding, Chinese Academy of Social Sciences and former member of the Policy Committee of the People’s Bank of China**

What is the applied format of supply side policies in China? The dominant monetary theories are the exogenous and endogenous creation of money, where the exogenous supply side format is the applied format in China. In the Western countries on the other hand, the most accepted way is the endogenous demand driven creation of money. The exogeneity of money supply is conditional on the stability of the multiplier as well as on the exogeneity of the monetary base. In China however, these two conditions for the exogeneity of money supply are not being met entirely. This is in large due to the difficulty in controlling the monetary base, which has been overwhelmingly expanded from the increase in foreign exchange reserves. In order to cope with these increasing large inflows of foreign exchange, the People’s Bank of China (PBOC) has used sterilization policies to offset the influence of this increased influx on the monetary base. However the control over the monetary base is passive and imprecise and actions in terms of quantity and timing is unstable which causes misallocation of financial resources. So how has China’s monetary policy been conducted? There has been a much higher growth rate of M2 supply than that of the nominal growth rate of GDP and China has the highest M2-to-GDP in the world, but inflation remains relatively low over these past three decades. The failure in credit and monetary targeting has led the PBOC to use a different target measure as a reference for the implementation of its monetary policies, namely Total Social Finance (TSF). TSF is a term created by the central bank in order to monitor the aggregate financing apart from Yuan bank loans. Since 2002 the share of bank loans in TSF fell from 91.9% to 52.1% in 2012, and by December 2012, this number was only 28 %. This trend fits the goal of financial reforms to reduce the excessive reliance on bank loans in the economy. The very high growth rate of money supply versus the low level of inflation is puzzling. The growth rate of money has been persistently higher than that of the nominal GDP growth rate, which is worrying with uncertain implications. Some suggestions to answer this puzzle are that the high saving rate of the household sector not only uses money as means of exchange, but also as a store of value. This in particular as the capital market remains underdeveloped, making saving deposits the most dominant form of store of value. The other issue is that asset bubbles reduce the inflation pressure on the real economy, that is; when money is chasing assets rather than goods, inflation pressure will be reduced. Taking into consideration high house price growth and incorporating it into CPI, the inflation could show to be much higher than anticipated. And last, continued loose monetary policy allows leverage to increase even more, which increases the likelihood of financial crisis.

To see more from this presentation: https://www.slideshare.net/GlobalUtmaning/yu-yongding-chinese-acca
The Chicago Plan Revisited

Dr. Michael Kumhof, International Monetary Fund

The Great Depression forced a deep debate about how to make the financial system safer, which later culminated in the so called Chicago Plan. The Chicago Plan visualized the separation of the credit and monetary functions of the banking system by requiring a 100 percent reserve backing for deposits and was supported by many famous economists such as Irving Fisher and Milton Friedman. The advantages of the plan were the better control over business cycle fluctuations, with contractions and increases in the supply of bank-created money and bank credit. It furthermore proposed the complete elimination of bank runs and the reduction of public and private debt.

The key insight in understanding the functioning of banks is their role as money creators. Contrary to the textbooks and common belief, the banks’ role are as money creators and not as intermediaries, that is; loans come before the deposit.

The implementation of the Chicago Plan would instead shift the role of money creation exclusively to the central bank, making banks true intermediaries.

This in turn would make it much easier to control business cycle fluctuations and sudden increases and contractions of bank credit, as well as better control over the supply of bank-created money. It would prevent credit cycles and keep inflation at low levels since the quantity of money in private hands remains unchanged.

To see more: https://www.slideshare.net/GlobalUtmaning/pres-chicagosep2013stockholminfinal

Corporate credit and business cycles

Professor Bo Becker, Stockholm School of Economics

Corporate credit is important to firms and investors alike, as it enables investments in new physical and intangible capital. However, corporate credit is extremely cyclical.

For one, frictional cyclicity refers to the information and agency problem, which unfortunately we do not know much about. Asymmetric information increases difficulty in the borrowing market as banks have considerable information at all times, whereas the agency problem concerns the difficulty of motivating one party to act in the best interest of another rather than his own. Second, demand cyclicity implies the obvious fact that firms wish to invest less in bad times and thus need less funding. This is supported by evidence since even the least constrained firms in the economy tend to invest less during recessions. Third, the evidence on supply cyclicity shows that firms issue more commercial papers and borrow less during bad times, where a given firm often gets a loan during good times but issues bonds in bad times.

One important factor believed to contribute to the credit cycle are the investors propensity to buy riskier assets in order to achieve higher yields. The largest institutional holders of corporate bonds, which are insurance companies, tends to reach for yield when choosing their investments. These insurance firms prefer to hold higher rated bonds which are consistent with lower rated bonds bearing higher capital requirement. The portfolios held by these companies are systematically biased toward higher yield, as they are conditional on credit ratings.

This behavior of reaching-for-yield is believed to exist both in the primary and secondary market, as well as being robust to various issuer and bond controls. This activity is most pronounced during economic expansions, thus being related to the business cycle as well as to firms with poor corporate governance for which capital requirement is more binding.

To see and learn more from this presentation, visit: https://www.slideshare.net/GlobalUtmaning/bo-becker
The risks with excessive money creation

Huw Pill, Chief Economist, Goldman Sachs

During the financial crisis, central banks across the world rapidly expanded their balance sheets in response to the global economic slowdown. In what ways does the central bank use its stabilization instruments, and what are they? First, one needs to distinguish between central bank instruments such as monetary policy from credit policy. Monetary policy is when the central bank buys conventional assets and expands its balance sheets with so called quantitative easing, with no real assumption of risk. Credit policy on the other hand is not the central bank real expansion of balance sheets, but rather its composition of assets holdings.

One correct way of thinking about central bank credit policy is that it is debt-financed fiscal policy. For instance, subsidizing debtors at the expense of savers, the investment in risky assets and the risk-taking by central banks, these are all extensions of fiscal policies. As credit measures are fiscal in nature, their effectiveness should therefore be judged on a public policy basis and not a monetary policy one.

The so called Outright Monetary Transaction program (OMT), where central banks issue put options on sovereign debt, solves the problem of bad equilibrium of unstable fiscal positions, high credit risk, default risk premium and high sovereign yields. It also involves solving a coordination failure in the private sector, as central bank rhetoric can solve and shift market expectations to a Pareto-superior point.

In conclusion, central banks are banks, meaning they should focus their attention to the credit quality of their own asset portfolio. The risk is otherwise that their balance sheets might not add up, thus implying fiscal dominance and ultimately increased inflation. However this is avoidable, but the risk remains that central bankers assume too much responsibility and try to solve problems that they cannot solve. The main aim should be the focus on asset quality rather than the quantity of money created.

To see and learn more from this presentation, visit:
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This paper presents a summarized version of the key-note speeches from the international seminar organized by the Swedish House of Finance, Global Utmaning and the Financial Markets Group at the London School of Economics. The seminar was made possible with financing from Riksbankens Jubileumsfond, Vinnova and the Swedish House of Finance.

The break-down of Bretton-Woods, the liberalization of global finance and emerging information technologies have created a new environment for financial markets. The 2007-2008 financial crisis has exposed new systemic risks, created uncertainty about the functioning of the financial markets and especially the role of shadow banks and innovative instruments.

The marked rise in volumes of the financial system and of financial investments, which risks driving asset bubbles, has also been increasingly discussed. The issue is how to ensure a sustainable financial system that supports real investments, an economic recovery and sustainable growth.