Australian Business Economists

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Sydney, 17 July 2012

GLOBAL ECONOMICS & MARKETS, JULY 2012

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(The views expressed here are my own & do not reflect those of the OECD or its member governments)

OECD
BETTER POLICIES FOR BETTER LIVES

Fundamental Inconsistencies in the Global Adjustment Process

- The $ Block emerging countries (maintaining undervalued exchange rates) kill the international adjustment process.
- Undervalued exchange rates force recession excess monetary ease choice, biasing the world to asset inflation bubbles as the supply shock & job loss keeps the lid on inflation.
- State capitalism influences the nature and direction of capital flows—not to where asset prices fell the most, but to meet strategic goals of resource and food certainty.
- Global imbalances persist.
- Jobs are exported and up-skilling at home is limited as a response.
- Huge inequality emerged (finance sector versus low skilled) and is setting in motion political trends towards less globalisation. The social mood is changing.

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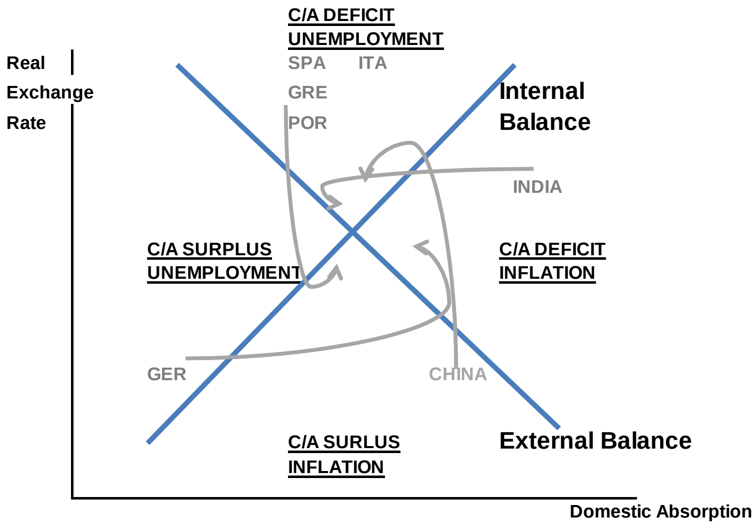
Global Inconsistency: Exchange Rate Zone Unpalatable Choices



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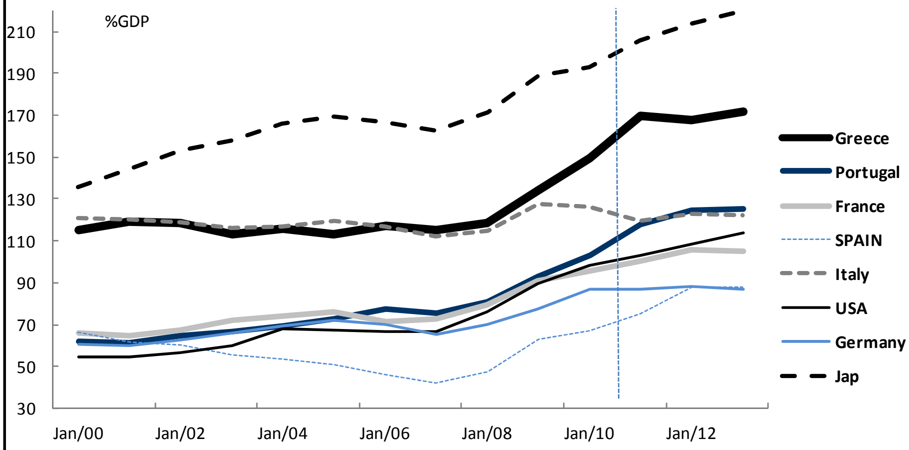
Sovereign Debt Projections



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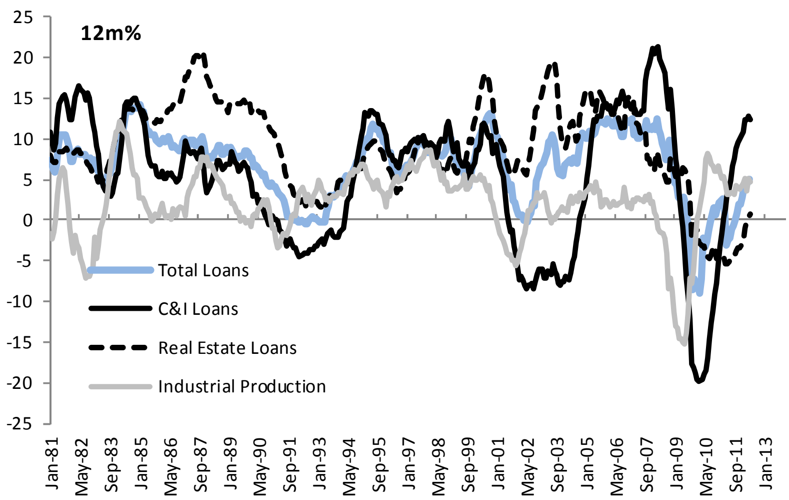
Bank Lending USA



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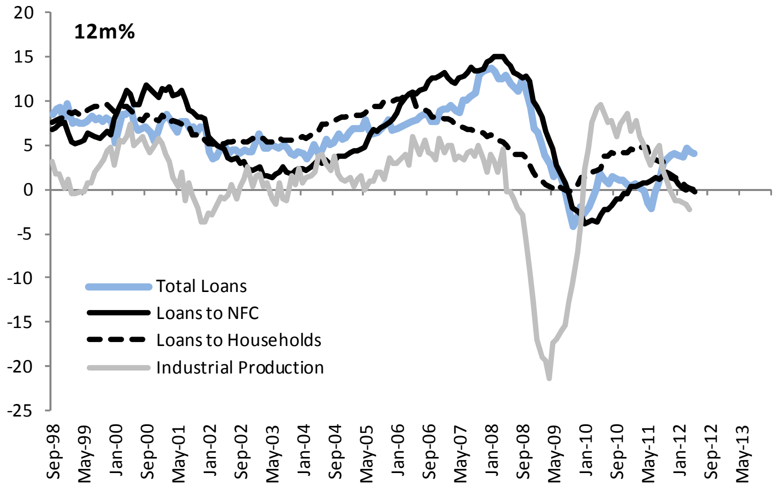
Bank Lending Euro Area



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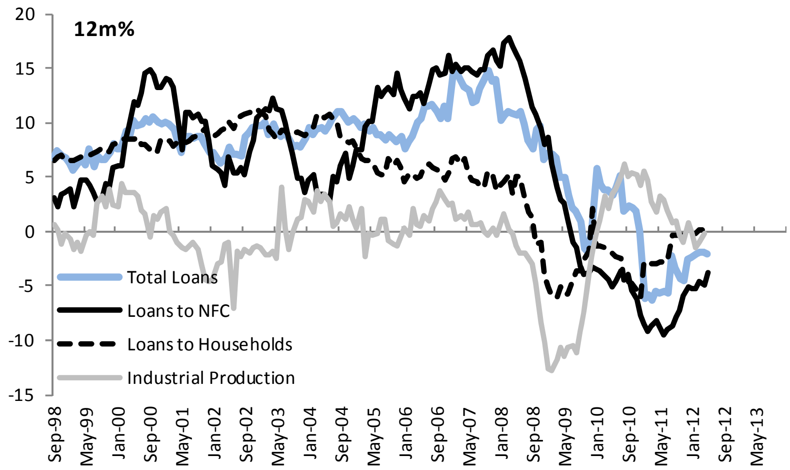
Bank Lending UK



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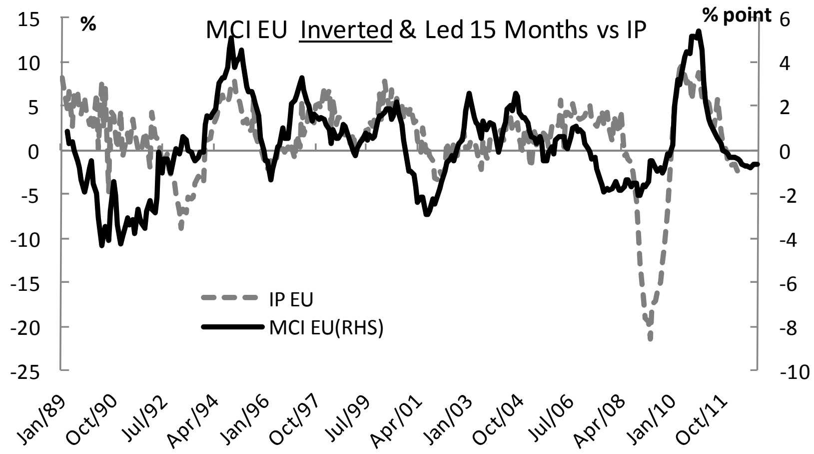
Monetary Conditions & IP Growth Forecast in Euro Area



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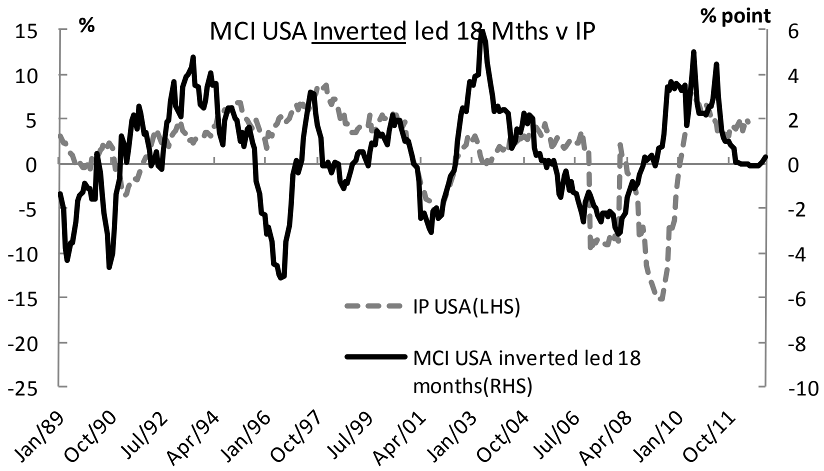
Monetary Conditions & IP Growth Forecast in the USA



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Lessons of the Financial Crisis

- The global monetary system based on short-term bank liabilities became totally dysfunctional in the crisis, and will continue to do so until fixed. 4 lessons emerge:
- (1) TBTF: led to risk being under priced via the cross-subsidisation from implicit and explicit government & lender-of-last-resort guarantees for short-term bank liabilities.
- (2) Leverage: became too high and regulators made it easy for financial firms to avoid capital (Basel & other rule changes).
- (3) Interconnectedness (counterparty) risk: Innovation plus deregulation led to high-risk derivatives-based financial products on a massive scale, so that problems in one multiply and governments are forced to perpetuate TBTF of see total collapse of the financial system.
- (4) Conflicts of interest: Corporate governance for self interest of managers and traders. Search for fees and returns from socially useless products that arbitrage the tax and rebulatory system

Financial Models/Frameworks & the Under Pricing of Risk

- Financial theories & practice contributed to the crisis.
- The Efficient Markets Theory: implied that passive management is good, passive & ETF's became large undermining diversity of views & corporate governance.
- Modern Portfolio Theory: says you can choose your risk/return point & diversify risk. The crisis shows correlations are not fixed & can move to 1.0 in high volatility periods.
- Modigliani Miller: says debt versus equity doesn't matter—so we got a huge private equity deal by the finance sector on the world economy. Taxpayers will be paying it for years.
- Black Scholes: says we can build derivative securities to mimic the price & return characteristics of stock and bonds. We got a derivatives boom & massive interconnectedness & liquidity crises.
- Agency theory: that shareholders are principals & overseers of the board, who acts as their agent in 'good faith'—disclosing conflicts, not making personal gain, & fidelity to the firm. In financial firms the opposite has been true.

Basel III & Time Profile of Max Leverage for Individual Banks

	Regulatory Capital Requirements Time Profile						
	2013	2014	2015	2016	2017	2018	2019
Core T1/RWA	0.035	0.04	0.045	0.045	0.045	0.045	0.045
Core+Buffer/RWA	0.035	0.04	0.045	0.05125	0.0575	0.06375	0.07
T1/RWA	0.045	0.055	0.06	0.06	0.06	0.06	0.06
LR	0.03	0.03	0.03	0.03	0.03	0.03	0.03
	Max. Allowed Leverage to the Capital Concept for a Constant RWA/TA Assumption						
RBS RWA/TA	0.320						
Core+Buffer/RWA	89.3	78.1	69.4	61.0	54.3	49.0	44.6
Barclays RWA/TA	0.267						
Core+Buffer/RWA	107.0	93.6	83.2	73.1	65.1	58.8	53.5
DBK RWA/TA	0.182						
Core+Buffer/RWA	157.0	137.4	122.1	107.2	95.6	86.2	78.5
BNP RWA/TA	0.301						
Core+Buffer/RWA	94.9	83.1	73.8	64.8	57.8	52.1	47.5
Santander RWA/TA	0.497						
Core+Buffer/RWA	57.5	50.3	44.7	39.3	35.0	31.6	28.7
HSBC RWA/TA	0.449						
Core+Buffer/RWA	63.6	55.7	49.5	43.5	38.7	34.9	31.8
UBS RWA/TA	0.151						
Core+Buffer/RWA	189.2	165.6	147.2	129.2	115.2	103.9	94.6
Citi RWA/TA	0.388						
Core+Buffer/RWA	73.6	64.4	57.3	50.3	44.8	40.4	36.8
MS RWA/TA	0.199						
Core+Buffer/RWA	143.6	125.6	111.7	98.1	87.4	78.8	71.8
JPM RWA/TA	0.329						
Core+Buffer/RWA	86.8	76.0	67.5	59.3	52.9	47.7	43.4
GS RWA/TA	0.271						
Core+Buffer/RWA	105.4	92.3	82.0	72.0	64.2	57.9	52.7
BAC RWA/TA	0.39						
Core+Buffer/RWA	73.3	64.1	57.0	50.0	44.6	40.2	36.6

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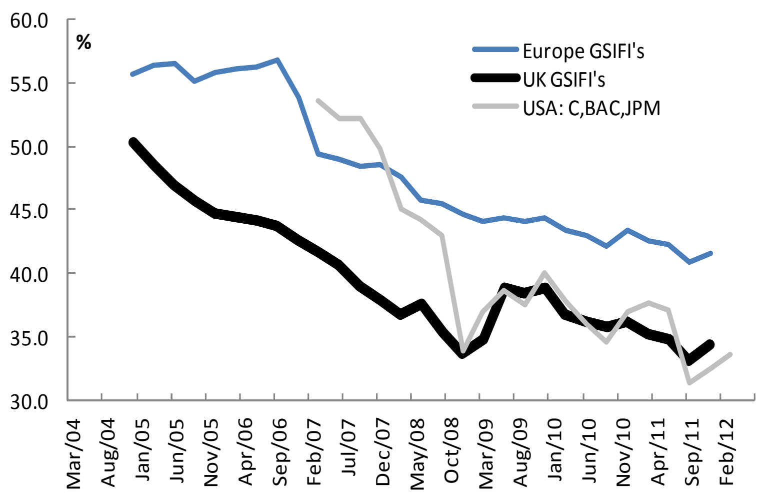
RWA/Total Assets GSIFI Banks



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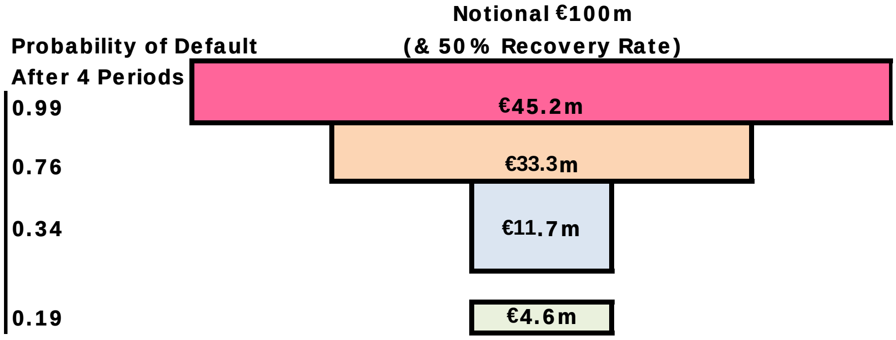
Collateral: the CDS the Atomic Bomb Graph



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US Government Payouts to AIG-GSIFI Counterparties

(billions of US dollars)

Institution	Collateral postings for credit default swaps*	Payments to securities lending counterparties**	Total	As a share of capital*** at end-2008
Goldman Sachs	8.1	4.8	12.9	29.1%
Societe Generale	11.0	0.9	11.9	28.9%
Deutsche Bank	5.4	6.4	11.9	37.4%
Barclays	1.5	7.0	8.5	20.0%
Merrill Lynch	4.9	1.9	6.8	77.4%
Bank of America	0.7	4.5	5.2	9.1%
UBS	3.3	1.7	5.0	25.2%
BNP Paribas	…	4.9	4.9	8.3%
HSBC	0.2	3.3	3.5	5.3%
[memo: Bank of America after its merger with Merrill Lynch]			12.0	*[18.1%]*

*Direct payments from AIG through end-2008 plus payments by Maiden Lane III, a financing entity established by AIG and the New York Federal Reserve Bank to purchase underlying securities.
**September 18-December 12, 2008.
***Common equity net of goodwill; net of all intangible assets for Merrill Lynch and HSBC.

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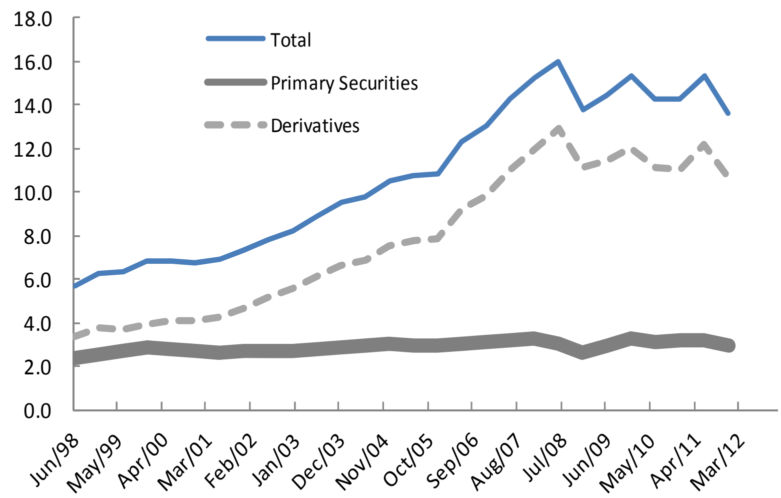
Derivatives vs Primary Securities % World GDP



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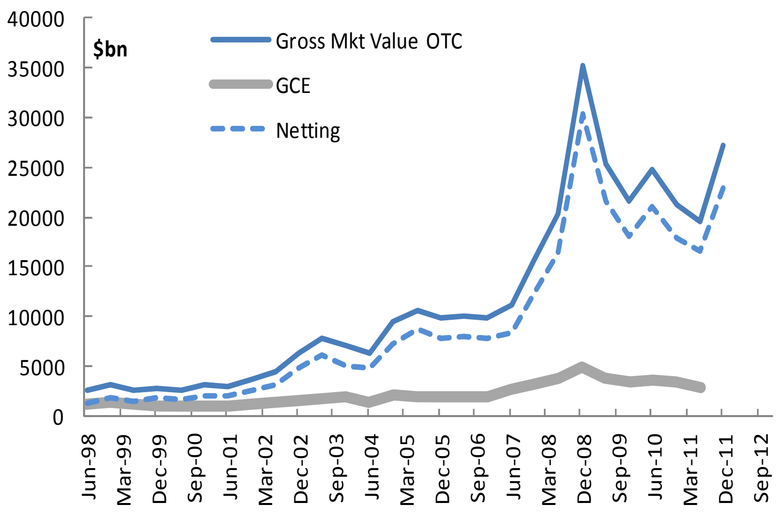
Derivatives: Gross Market Value, Netting & Gross Credit Exposure



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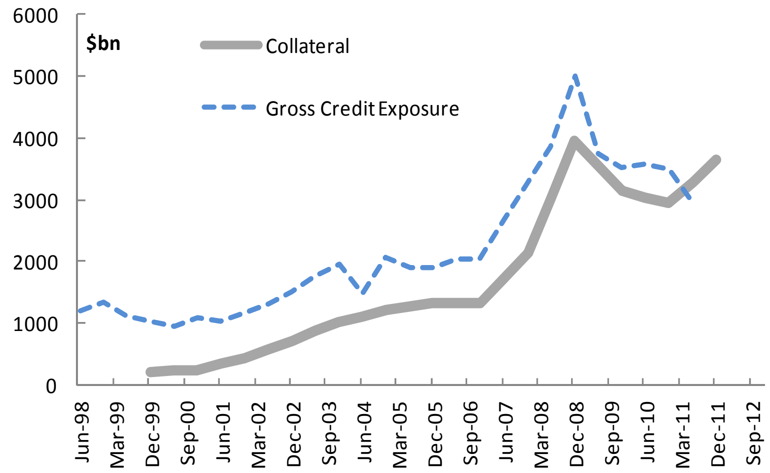
Collateral vs Gross Credit Exposure



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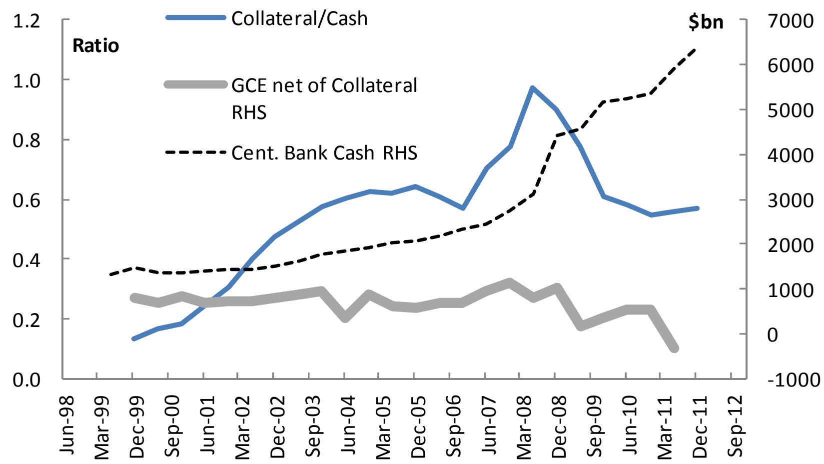
Central Banks QE All About Collateral



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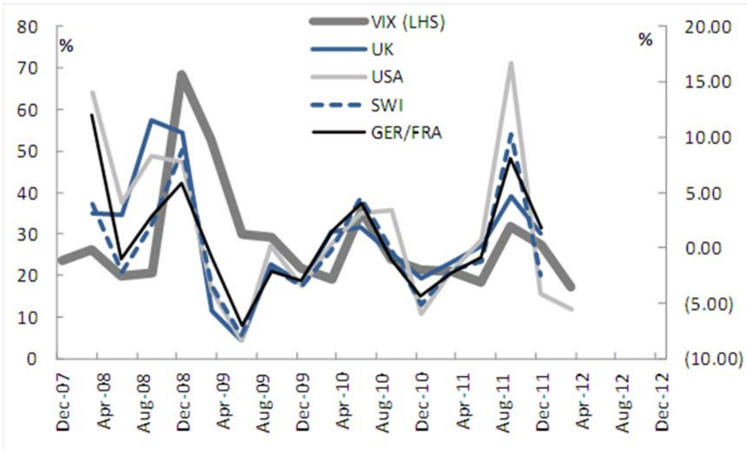
Derivatives Contribution to Bank Balance Sheets versus the VIX



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Basel III CVA Charge for Counterparty Risk

A. Diverse Counterparties	
P1: Netting Set 1	
IRS up	100
CDS down	-90
Net	**10**
P2: Netting Set 2	
IRS up	90
CDS down	-100
Net	**-10**

B. Concentration Case	
One netting Set	
IRS up	100
CDS down	-90
IRS up	90
CDS down	-100
Net	**0**

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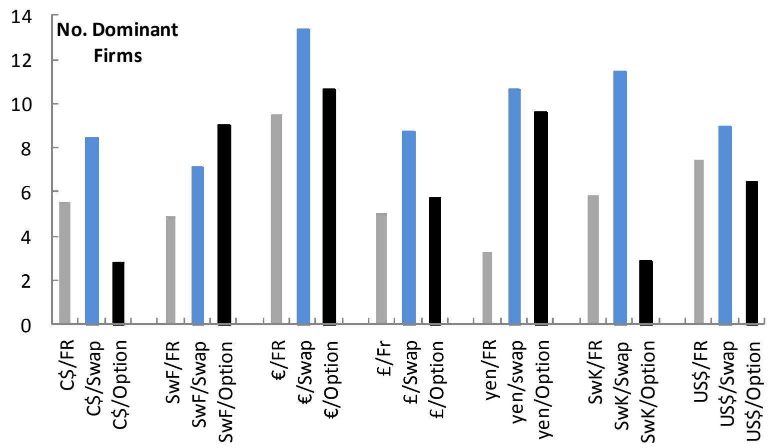
Herfindahl: Interest Rate Derivatives; Bank/Non-bank



Volcker, Vickers and NOHC

Regulatory Approaches to Bank Separation

	Vickers	Volcker Rule	Non Operating Holding Company (NOHC)
AIM	Insulate retail banking & SME lending from international shocks in capital markets. Improve resolvability within groups. Better prudential safety of core functions of banking. Reduce taxpayer risk.	Reduce speculative losses to banks & focus on intermediary functions serving customers.	Better allocation of risk and improved resolvability. Continuous provision of services by some affiliates in the group in the face of distress in some others.
Features	Ring-fence retail from w/sale & investment bank (IB) divisions within a holding Co. Tougher capital standards for ring-fenced bank, but not for IB. Promoting competition in retail banks & IB's separately was the main driver. Foreign branches are welcome to join the retail space.	Prohibits proprietary trading by any insured depository instit. in commodities, financial securities & derivatives that do not benefit customers. (Banks & BHC's included) Prohibits deposit. instits. from investing in priv. equity firms & hedge funds (no more 3% of any 1 firms capital & no more than 3% of the banks capital in all such investments) to ensure bank capital isnt standing behind them.	The parent is non-operating, raises equity and invests in ring-fenced affilaites with their own governance. Ring fenced entities (e.g.the bank from securities businesses), are essential in order to protect against creditors of distressed affiliates seeking redress against the others in the group. This allocates risk more efficiently between the prudentially regulated bank & less regulated entities.
Functions	Maintains all business units in the group. Bank mandated to take deposits & provide overdrafts/loans. Bank prohibited from: structuring OTC derivatives; equity & ETF functions; security market making; underwriting; services outside the EEA. Trade finance & aspects of W/sale are not excluded.	Permitted activities: traditional banking, trading in US government debt; underwriting & making markets (broking only); risk mitigating hedging; trading for customers; liquidity management; investments in 'Small Business Inv. Companies"; limited investments in covered funds in asset management & advisory busisnesses; foreign trading by non-US banks; foreign covered fund activities of non-US banks.	Maintains all business units in the group. Decides on the regulatory treatment of each--with banks being more heavily regulated for capital & with dep. insurance for retail investors. Banking vs securities functions are the broad divide. Risk is priced differently in the different segments with the price of risk rising in the less regulated. The volume of functions is determined by supply & demand at prices reflecting the true risks, not by detailed rules on what can & cant be done.
Administrative & industry concerns.	UK banks and lobbyists claim that it is difficult to implement & have convinced the authorities to give them until 2019 to sort it out. They would do well to examine the NOHC legislation in Australia. Applies to foreign subsidiaries operating in the UK.	A disadvantage to US & foreign deposit-taking institutions in the USA Extra-territoriality as it applies to foreign banks operating in the US. Foreign parents can do all the prop trading etc, as long as their branches or subsidiaries in the US do not. Banks have to separate functions according to whether they are intermediating for a client or trading on their own account--this is difficult to monitor. Making a market for example requires principle risk. Some foreign governments claim it will reduce the liquidity on trading in their own bonds.	It is not mandatory (Macquarrie Bank only). Easy to implement--entities & functions defined by prudential regulator & balance other laws. Restructure instruments grant relief to regulatory impediments to separation arising from corporate income tax tax laws to the entities specified by the prudential regulator.'Transfer certificates' issued provide for the transfer of assets & liabilities between the entities. This was carried out by MQG in the same year as the enabling act was passed. Does not apply to foreign banks, or any bank choosing not to implement (at this stage).
Effective date	2019--linked to Basel III timetable.	2012 (July)	2007 (July)

What Sort of Securities Businesses to Exclude?

- What is Proprietary trading?
- --Origination?
- --OTC derivatives?
- --Directional prop. Trading?
- --RV prop. trading?
- --L-term security holdings?
- --Market making?
  --Underwriting
- Hedge funds, private equity & SPV's?
- NOHC Structure better than Glass-Steagall and Volcker, like Vickers.

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Fundamental Inconsistencies: the Euro Area

- The Euro Area was not properly thought out, and now markets ponder more integration versus disintegration.
- As with the $-block countries more generally, the international adjustment process is destroyed.
- Cost competitiveness differences amount to 30% in north south comparisons.
- One-size-fits-all monetary policy led to mortgage boom busts in many countries, and financial regulation of banks was much more lax than in the USA, leading to high leverage and high risk derivatives products.
- Countries tried to compensate by fiscal cheating as unemployment pressures mounted
- Now the problem is first and foremost a banking system crisis on top of the a currency union problem—we need to stop calling it a sovereign crisis, this is the residual, and we don't know what the ultimate fiscal cost of fixing the banks will be.
- You cant have fiscal retrenchment before you fix the banking system—negative fiscal multipliers with a dysfunctional banking system is a disaster. There is a sequencing problem: (1) Fix the banking system now; (2) Decide on what the euro area is to be; (3) fiscal and structural adjustment over the longer run.
- The banking system needs €750bn new capital at least. It could cost nothing with a TARP approach.
- Honest accounting and a TARP style operation with equity warrants, starting in Germany & working south. ECB bridge funding via an ESM with banking licence of EIB sponsored SPV.
- A Charlemagne euro versus a southern euro has been discussed in the markets.
- Europe needs and will get Vickers in my view.

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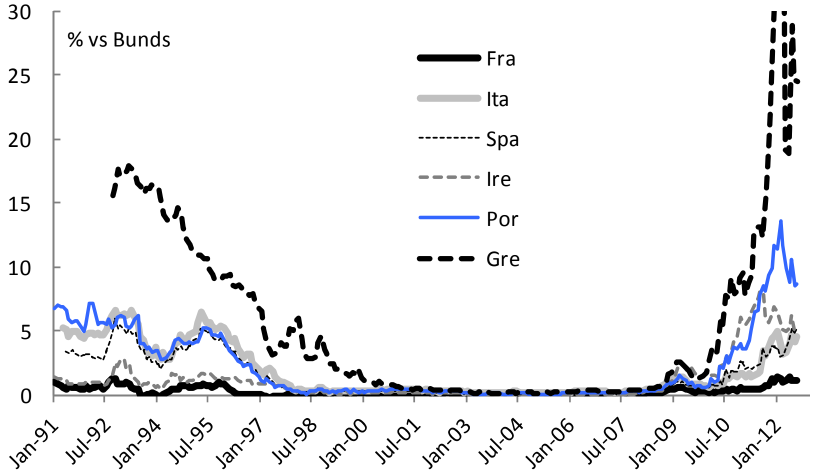
Euro Area Sovereign Spreads to Bunds



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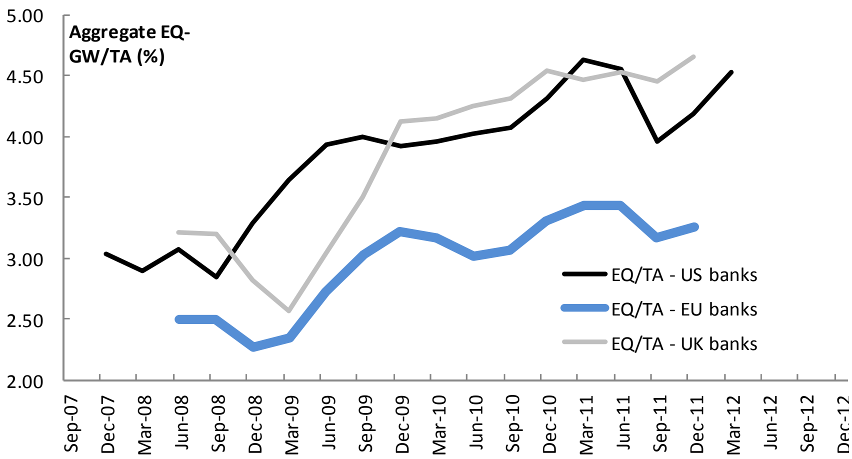
Equity Ratio: US, UK and Euro Area Banks



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Equity Ratios Pre and Post Crisis

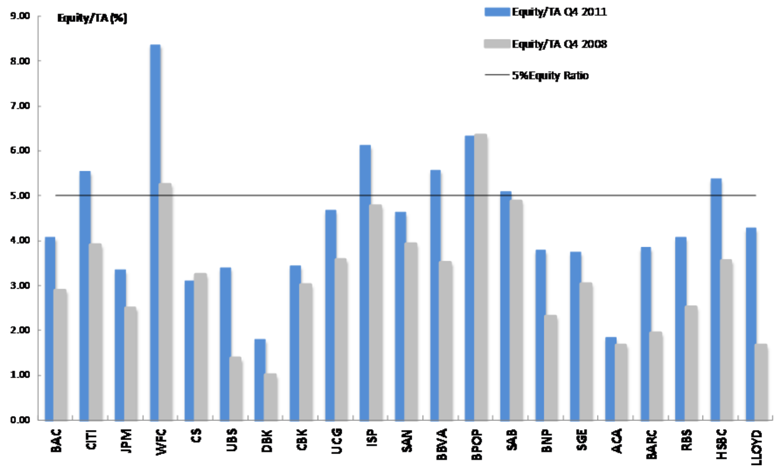

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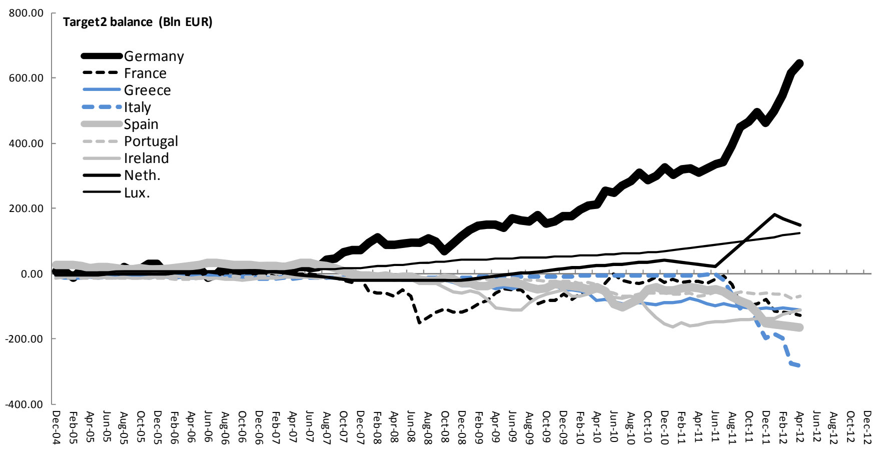
Fig 30: Target 2 Balances, European System of Central Banks



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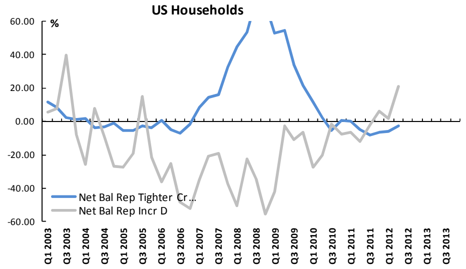
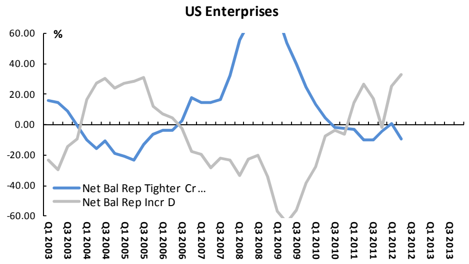
Lending Standards & Demand, US Households & Enterprises





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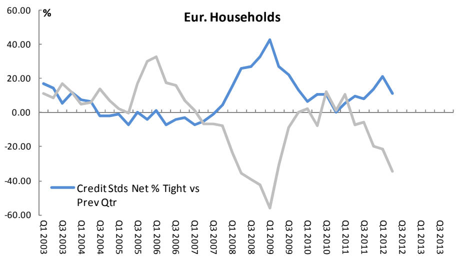
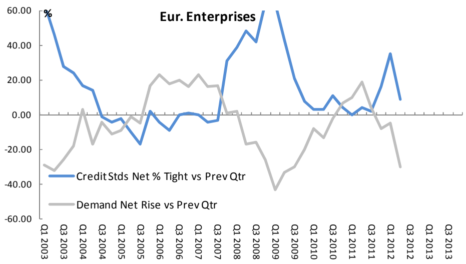
Lending Standards & Demand, EUROPE Households & Enterprises





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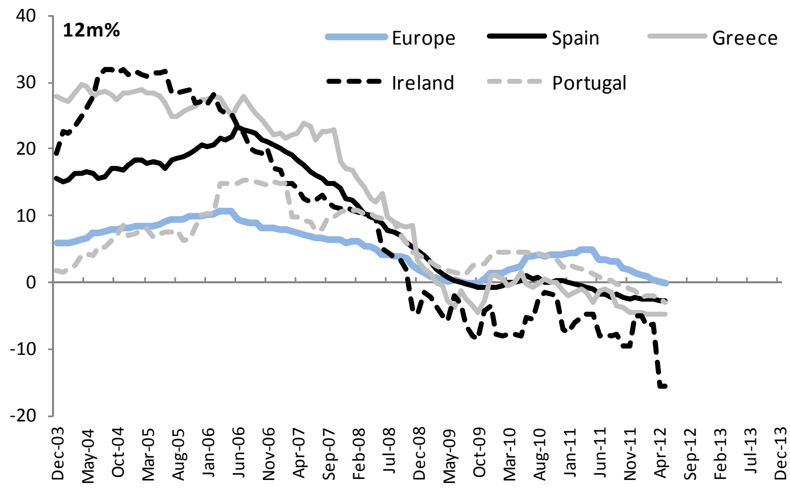
Lending to Households Periphery



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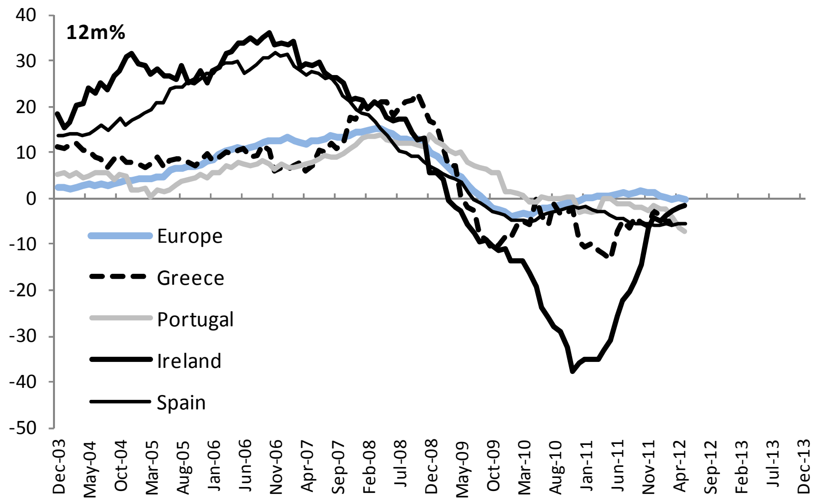
Lending to Non Fin. Corporations: Periphery of Euro Area



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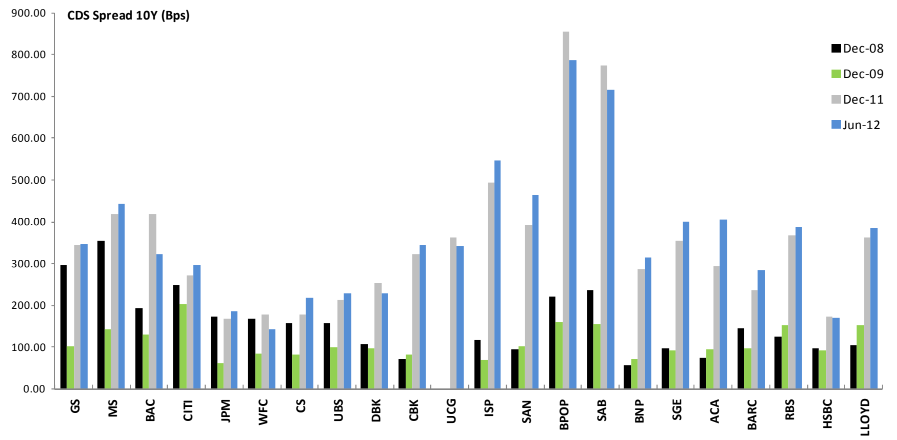
Bank 10-year CDS Spreads



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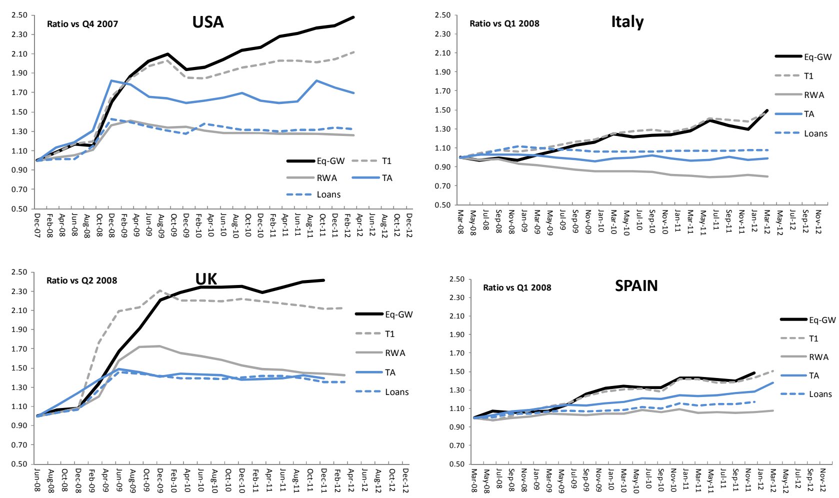
US & Europe GSIFI Banks: Good vs Bad Deleveraging



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Capital Needs in the Euro Area Banks

Overview of capital adequacy, United States and Europe

(aggregated banking system excluding monetary authoriy, end 2011)

	United States GAAP accounting ($billion)	United States With IFRS adjustment for derivatives at 6 large groups ($ billion)	Euro Area IFRS accounting (EUR billion)	United Kingdom IFRS accounting (GBP billion)
Tangible assets (TA)	13515	20240	33335	8071
Risk-weighted assets (RWA)	9351	9351	13842	3475
Ratio, RWA/TA	0.692	0.462	0.415	0.431
Core tier 1 requirement based on:				
2015 Basel rules (4.5% of RWA)	421	421	623	156
2019 Basel rules (7.0% of RWA)	655	655	969	243
EU capital exercise (9.0% of RWA)	832	832	1246	313
FDIC definition of "well-capitalized" (5% of tangible assets, non-RWA)*	676	1012	1667	404
Actual equity capital				
Tangible Equity	1185	1185	1189	284
(as share of Tan. Assets)	8.8%	5.9%	3.6%	3.5%
Estimated Core Tier 1 capital (Basel III basis)**	948	948	951	227
(as share of Tan. Assets)	7.0%	4.7%	2.9%	2.8%
Industry estimate (common equity)	969	969	1315	278
(as share of Tan. Assets)	7.2%	4.8%	3.9%	3.4%

* Note that this is more stringent than the actual FDIC standard, which uses Tier 1 capital.

** Assumes Basel III deductions reduce Tangible Equity by 20%, in line with 2012 EBA Monitoring Exercise results for Group 1 banks.

Source: FDIC, ECB; RWA for Euro Area and UK derived from IIF estimates; OECD calculations based on company accounts for US adjustment to IFRS .

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Euro Area Policy Options

	Policy	Advantages	Disadvantages
	FISCAL CONSOLIDATION, ETC.		
1	Fiscal consolidation. Fiscal compact rules for deficits and debt burdens in the future.	Debt reduction/affordability improves. Euro credibility improves.	Growth negatives undermines fiscal adjustment. Recession=banking system problems multiply.
2	Richer country transfers/debt haircuts.	Helps fund periphery. Euro viability improves.	Politically difficult/wrong incentives to adjust.
3	Governments allowed to issue Eurobonds.	Reduces costs for problem countries. "Transfers".	Increases costs/lower ratings for sound countries
	ECB ROLE		
4	Lender-of-last-resort funding including LTRO operations & reduced collateral requirements.	Provides banks with term funding & cash for collateral. Supports interbank lending. Avoids bank failures. Maintains orderly markets.	Encourages banks to buy 2yr sovereigns to pledge as collateral for margin call, etc., pressures. Greater concentration on the crisis assets.
5	Operations to put a firm lid on bond rates, or more general QE policies.	Avoids debt dynamics deteriorating. Supports a growth strategy.	None. Liquidity can be sterised if need be. (Is some inflation really a cost?)
6	Possible lender to the EFSF/ESM or IMF.	See below.	See below.
	EFSF/ESM ROLES/EIB		
7	Borrows & lends to governments. Buying cheap in secondary market. Invests in banks: recapitalisation. Buying from the ECB holdings of sovereign debt at discounted prices. EIB lends to SME's	Funding/& ability to restructure debt by passing on discounted prices to principal cuts. Helps recapitalise banks (some can't raise equity). Deals with losses from restructuring. Provides an ECB exit strategy. No CDS events. Supports jobs in the case of the EIB.	Credit rating downgrades of the governments involved. Inability to raise enough funds & the overall size of funds required is too high. Monetary impact if the bank capitalisation part is funded by the ECB (see below).
	POLICIES TO AUGMENT RESOURCES IF EFSF/ESM/IMF €1tn IS NOT ENOUGH		
8	Bank license for EFSF/ESM plus more leverage.	More fire power to deal with banks lack of capital & losses. ECB can be the creditor.	None in the short term. Longer-run inflation risks. Sterilisation of ECB balance sheet required.
9	EFSF capitalise EIB, allows securitisation of its balance sheet.	Increases resources via extra leverage in EIB, Can lend directly to SME's.	Limited private sector interest in investing in assets. Large guarantees=credit rating risk. Resources.
10	IMF funded by loans from the ECB.	No pressure on European budgets. IMF already a bank. Speed. Can lend for $ or € funding. Conditionality/debt restructuring role possible. Good credit rating. No treaty change required.	Stigma. Possible monetary impact if not sterilised.
11	SWF funds attracted via lending to IMF.	No monetary impact/IMF buys euros with $'s.	EU credit risk shifted onto the IMF.
12	**EURO FRACTURES**		
	Periphery countries forced to leave. Or large countries choose to leave.	Transforms sovereign credit risk into more manageable inflation risk. Competitiveness channel.	Inflation rises in some countries. Legal uncertainty on € contracts. Other countries leave/€ damaged.
	STRUCTURAL POLICY NEEDS		
13	Structural growth policies: labour markets, product markets, pensions.	Reduces the cost of fiscal consolidation & improved competitiveness via labour markets.	Political difficulties & civil unrest.
14	Leverage ratio 5%, based on more transparent accounting for hidden losses. Separation of retail & investment banking activities.	Deals with 2 forms of risk: leverage & contagion of domestic retail from high-risk globally-priced products. Risk fully priced/no TBTF. More stable SME lending.	None, as the approach envisages allowing time to achieve the leverage ratio.

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Asian Outlook, Following the Inconsistencies that Led to the Crisis

- Undervalued Asian & other managed rates is now leading to problems in the region.
- Chinese investment was based on wrong assumptions about OECD growth. There has been massive over investment in Asia. The whole Asia “business model” based on imports to re-export needs to be re-assessed.
- The West has been forced to respond with QE policies following the crisis.
- But this is subject to diminishing returns for the world economy: (1) Asian inflation, (2) the dysfunctional financial system with negative fiscal multipliers is leading to a coordinated slow down, (3) Dutch disease outside the $ block for commodity exporters.
- Implications for commodity prices.

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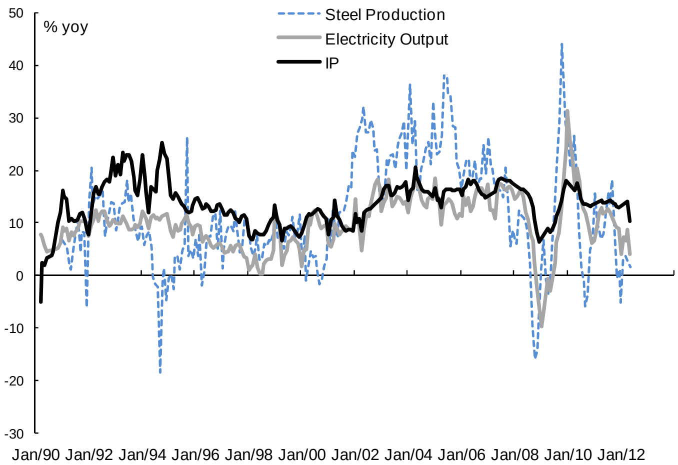
China Slowing



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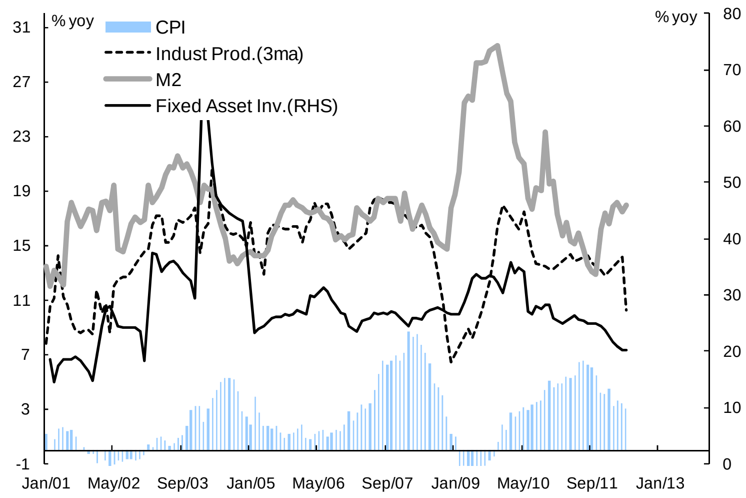
China: Economic Model Changing?



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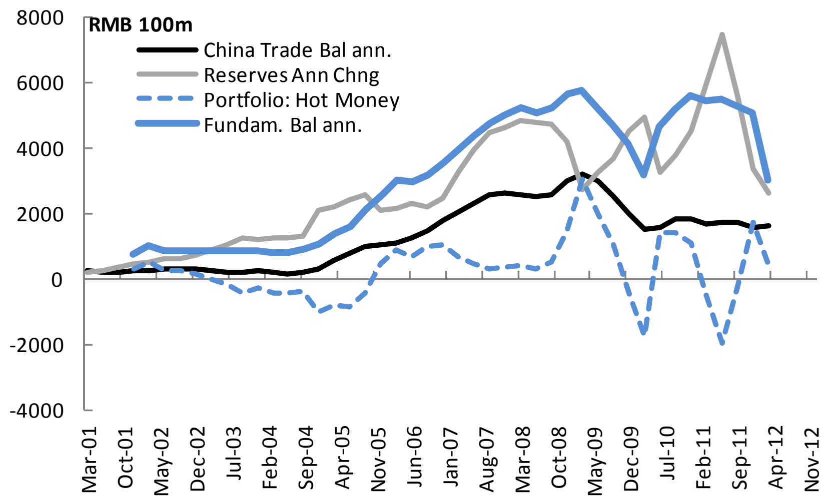
China: Business Model Change for Asia, Following Over Investment?



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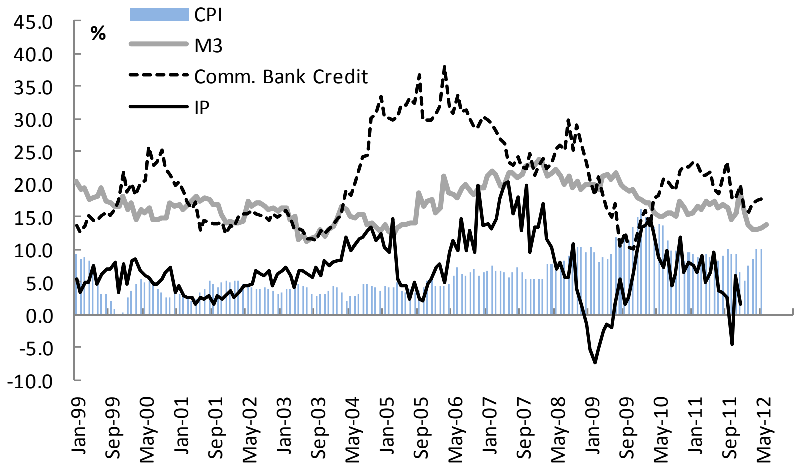
India's Credit Boom



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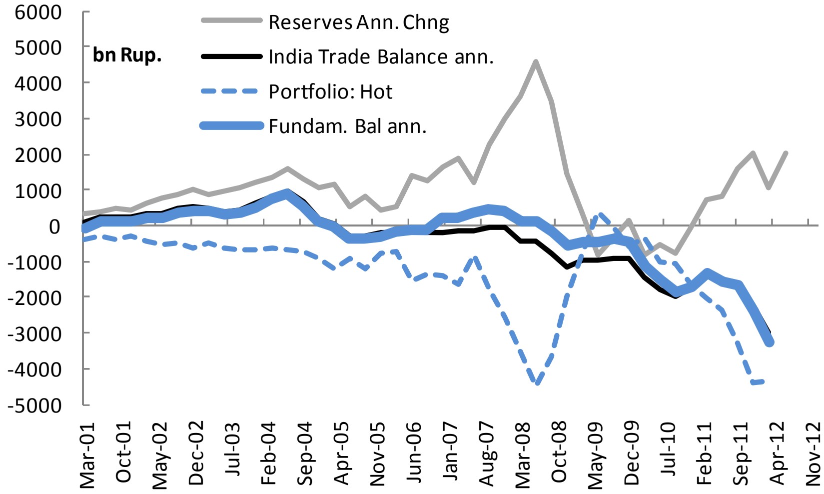
India: Fundamental Imbalance: Inflation & Buying Dollars!



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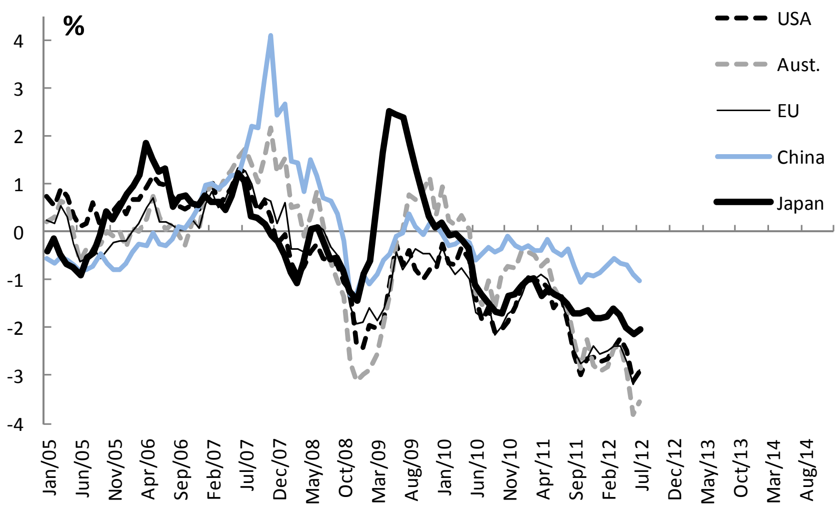
Market View

- To be more confident in the near term we need to see: (1) the European banking system crisis taken off the table with €750bn capital injection from here, to plug holes and build to a 5% leverage ratio. (2) the US fiscal cliff taken off the table. (3) China adjust its business model more quickly to demand stimulus at home and more upside to the currency to contain inflation. It could happen and generate a strong rally.
- But if not, a "riot point" will emerge once more to force sensible policy.
- Hedge funds and high frequency traders play these moves more quickly that the retail investor and many fund managers. You lose by timing as a retail investor.
- I believe in a barbell strategy of cash and equities—with the latter focused more on Australia and the USA. I will keep out of Japan and Asia. This will limit my regret factor for the unexpected events that may go either way.
- $A strength in the face of weak commodity prices—Euro crisis, Swiss intervention = less safe havens, $A centre stage. I still believe fundamentals will assert—so un-hedged foreign equity portfolios for me.

Equity Market Valuations



Asia Risk On/Off & Global Liquidity

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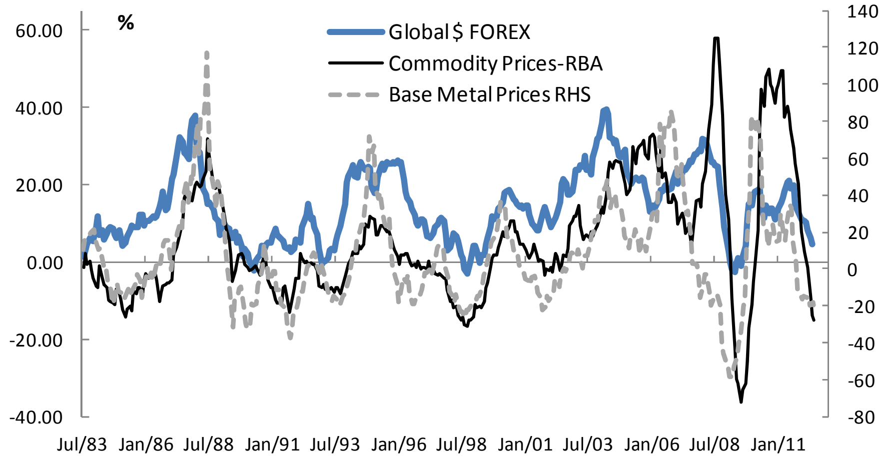
Global Forex Reserves & Commodity Prices



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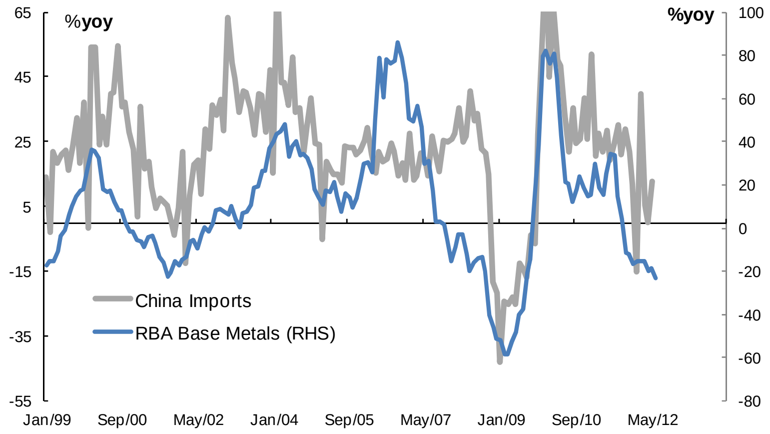
China Imports vs Base Metal Prices



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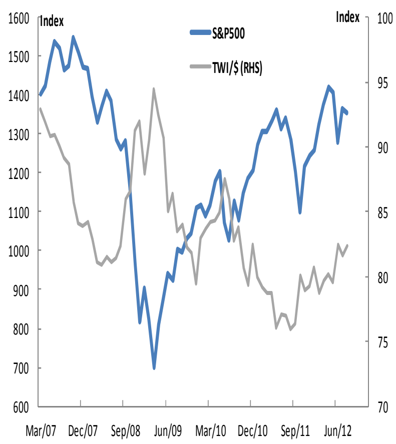
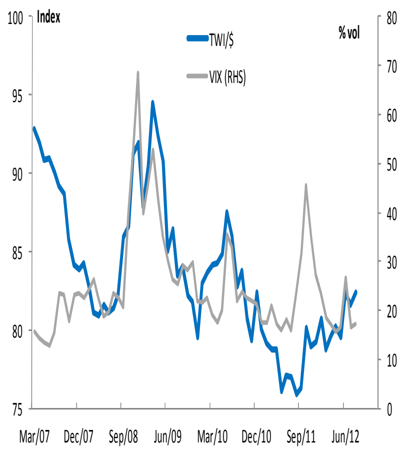
$, Equity Market & Vol: a Changed Pattern, But For How Long?





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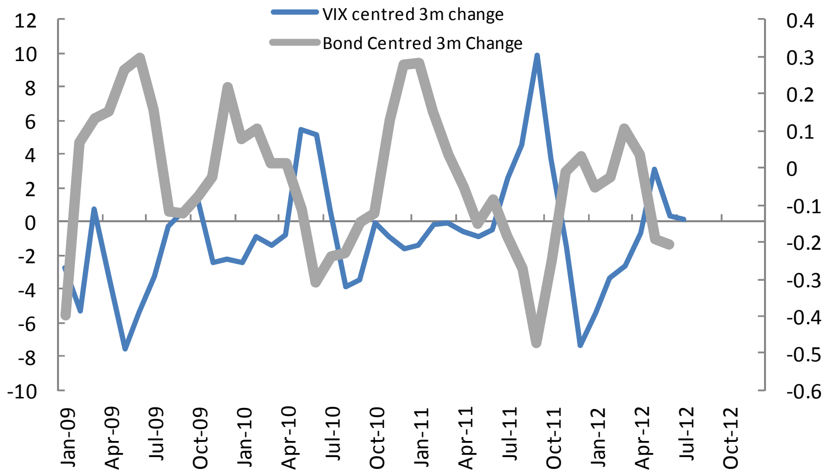
Equity Risk & US 10yr Bonds



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