

The Financial Crisis and Financial Nationalism

Stijn Claessens

Assistant Director, Research Department, IMF

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to the Crisis***

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The Financial Crisis and Financial Nationalism

1. Financial crisis

- International spillovers: phases and mechanisms
- Interventions and international spillovers

2. Effect on competition and short-term policies

- Conceptual framework
- Policy actions and options

3. Medium term policy and reform options

- General national & international financial architecture
 - Cross-border banking: specific options
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International spillovers: phases and mechanisms

1. Direct links

- ❑ Exposure to the US subprime, CDOs, etc.
- ❑ Hitting European (IKB, BNP) and other banks
- ❑ Triggered turmoil in similar housing boom markets,

2. Liquidity

- ❑ Liquidity shortages, freezing of credit markets, stock markets declines, bank run on UK Northern Rock
 - ❑ Affected many markets (UK Sterling, Euro, SwFr)
 - ❑ \$-shortage ⇔ swaps between major central banks
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International spillovers: phases and mechanisms

3. Solvency concerns

- ❑ Recapitalization fallen short (SWFs), deficiencies in national resolution frameworks
- ❑ Lehman, AIG international spillovers
- ❑ October 2008, solvency concerns affecting systemically important global financial institutions
- ❑ Much government interventions

4. Real and financial sector links

- ❑ Perverse feedback loops in Q4 2008 and Q1 2009
 - ❑ Still large exposures at risks/vulnerabilities
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Interventions, while necessary, had international spillovers

- Liquidity provision
 - Not always well coordinated, e.g., shortage of dollars
 - Some countries left out, e.g., emerging markets
 - Guarantees of wholesale, retail deposits, others
 - Difference in coverage, terms, etc. led to capital flows, differences in spreads, sovereign risks (e.g., Ireland)
 - Regionally more coordinated (EU), globally not
 - Purchases or exchanges of assets
 - Much direct purchases & indirect support (Fed, ECB)
 - National focus & rules vary across countries inevitably
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Interventions, while necessary, had international spillovers

- Capital injections and other support to banks
 - Favoring national financial institutions (due to fiscal)
 - Few cross-border (Dexia, Fortis), but largely national
 - Ring-fencing of assets (UK-Iceland; Germany-Lehman)
 - Also legal, e.g., US domestic depositor preference
 - Purchases of non-performing assets
 - Little NPAs so far, but rules do differ, create distortions
 - Exit: to come, many coordination issues
 - Unwinding of guarantees, sale of state-ownership/assets
 - Risk distortions as unknown processes
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As crisis ongoing, government interventions likely continue

- Financial sector and other (monetary/fiscal) actions have not prevented adverse feedback, recessions
 - More financial sector actions still likely (needed)
 - Covering finance more comprehensively, e.g. insurance
 - Including housing and corporate sectors
 - Interventions will continue to distort
 - Much will affect cross-border activities
 - Need to consider effects on competition
 - Conceptual: system versus systemic-important
 - Policy actions and reform options
 - Medium-term reform options
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Interventions and competition

- Competition in financial sector is complex
 - Network externalities, sunk costs, economies of scale/scope, switching costs, substitution and complementarity, etc.
 - Hard to measure effective competition, give lack of data
 - Have to rely on first principles, open contestable markets
 - Interventions to save system can help competition
 - With coordination problems and systemic risks:
 - Avoid non-systemic to be eliminated can help competition
 - But when saving specific systemic financial institutions to save system, bias inevitable
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Principles for Interventions

- Aim at level playing field
 - Similar policy by all governments/authorities global
 - Across institutions, products (input/output), markets
 - Use “market-based” pricing schemes (pre-crisis)
 - Not easy to assure
 - Schemes: albeit some convergence, complexities e.g. EU
 - Differences in scale & scope of support, ability to backup
 - Decisions on individual actions still necessary, but hard
 - Regardless, undermines market by design
 - Competition: inefficient not necessarily eliminated
 - Institution: moral hazard in markets reinforced
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Cross-border generally problematic, given many public goods, and worse in crises

- Negative externalities
 - Poor regulation/supervision, limited ability of home countries to stand behind their institutions
 - Regulatory competition: common denominator
 - Positive externalities (“spill-ins”)
 - Stability benefits accruing to others, by importing services from well-regulated, well-funded markets
 - Coordination issues in general large but worse in crises
 - Ex-post burden-sharing: very hard to do ex-ante
 - Institutional uncertainties, e.g., resolution, create turmoil
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Short-term limited. Medium-term and cross-border activities specific options

- Short-term options limited
 - Interventions will remain national oriented
 - Still, some “predictable” events can be averted
 - Improve foremost national resolution frameworks
 - Medium-term: share better benefits & costs
 - Hard to design, coordinate, and implement completely new global or even regional solutions
 - Enhance international architecture in general
 - What to do for cross-border specifically?
 - Adopt specific options for cross-border
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Options for cross-border banking

- Current approach
 - Home-host supervision
 - Second (or third best) solutions
 - Increased *coordination* with less or no harmonization or convergence in rules
 - Increased *convergence* in rules and practices without increased coordination
 - *International bank charter*—a new regime
 - “First best”
 - World Financial Regulator (and Supervisor)
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Current approach

- Home-host principle (BCBS):
 - Has its limits, especially since foreign bank penetration has increased sharply
 - Many subsidiaries are large in host, but not always important for home, conflict of interests
 - And intragroup already many possible conflict of interests and governance issues
 - Improvements are possible, nevertheless have limits
 - (More) colleges for large international banks, but teeth?
 - And EU/EMU experience show limits (e.g., most foreign banks remain subs)
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Enhanced coordination approach

- Rules and practices need not converge fully
 - But actions to be coordinated
 - Ex-post actions for sure and somewhat ex-ante (rulings)
 - At individual financial institution's level (colleges)
 - At regional/global levels (ECB, De Larosiere, FSB, IMF,?)
 - Still much to be sorted out and many risks being left out
 - College governance, information to be sorted out
 - E.g., colleges do not consider systemic risks
 - And could risk complacency
 - “Coordination” is a nice word
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Decentralized, but converged approach

- Rules and practices (in all dimensions) converge
 - Regulation, supervision, accounting, resolution
 - By acting similar, coordination issues are reduced
 - E.g., same PCA, prepackaged bankruptcy, etc. make for fewer differences of opinion in financial crises
 - Still requires enforcement, oversight
 - Needs backup up of enhanced monitoring of practices
 - Ex-post burden sharing is very hard in practice, “Cross-border in life, but national in death”
 - Only fully consistent under a subs/holding model, costly
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A new regime: International Bank Charter (IBC)

- International banks can choose (or are forced) to charter with (new) international agency
 - New agency has all usual tools, including resolution, much of which is rules bound
 - Complemented by LoLR, liquidity, deposit insurance, recapitalization fund facilities (hard to do)
 - In exchange, banks can operate in “member” countries with no extra oversight
 - Lower compliance costs, more certainty
 - Countries could opt-in, but with sanctions for exit
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First best: World Financial Authority?

- International financial regulator/supervisor
 - Very demanding, not attainable (or desirable?)
 - Requirements similar for an FSA to work: know little
 - Needs to be complemented in many ways
 - Lender of last resort, liquidity, deposit insurance, recapitalization fund
 - Hard to govern given fuzzy mandate
 - E.g., how to set the voting structure: assets or liabilities, financial or real economic impact?
 - Experience with international governance: sobering
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Complementary, international financial architecture changes needed, regardless

- Information on exposures/risks
 - Surveillance of countries, systems
 - Mandatory compliance, less voluntary assessments
 - Regulatory governance, national/international
 - Understanding of macro-financial links
 - Early vulnerabilities' warning systems
 - International liquidity provision (for countries)
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