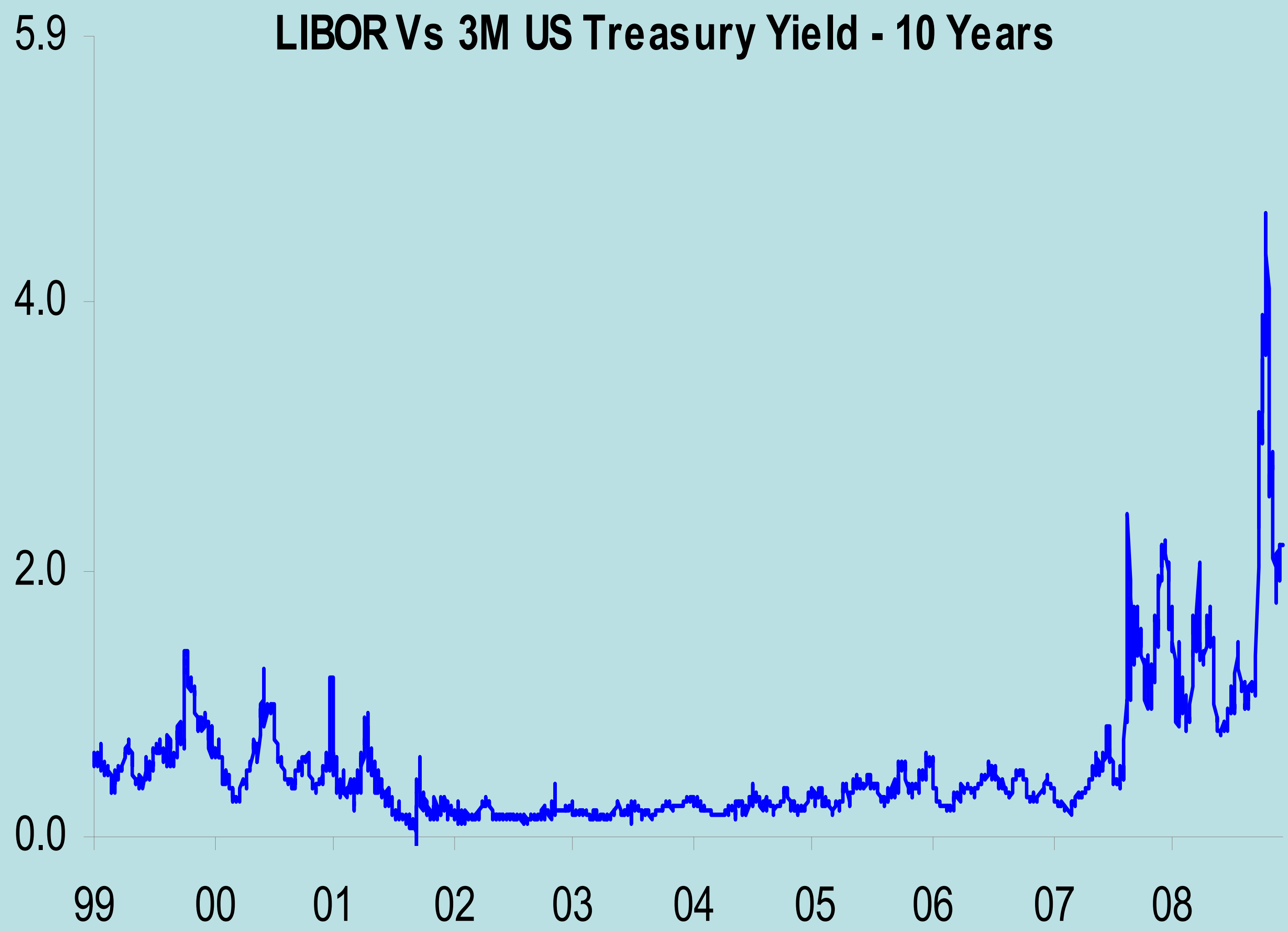
National Bank of Romania

December 10, 2008

How Different is the World after the Financial Turmoil?

Max Watson

Fellow of Wolfson,College, Oxford
Associate Fellow, Chatham House
Director of Research, John Howell and Co Ltd


LIBOR Vs 3M US Treasury Yield - 10 Years
5.9
4.0
2.0
0.0
99
00
01
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08

Hiatus or Turning-point?

- Breakdown of private sector intermediation will clearly trigger tougher regulation...

- Does it also put in question:

  => role of privately-owned banks?

  => viability of “Anglo-Saxon” capitalism?

  => medium-term growth and stability in EU?

Outline

- Major political questioning of market-based financial systems in EU, while in short run US is seeking to "float off the problem" more aggressively...

- To put in perspective, review 3 dimensions:
  - => severity of the crisis
  - => policy sources of the crisis
  - => handling of the crisis, in short run
  - => lessons of crisis for medium & long term

Severity

- Not V-shaped setback in financial / real economy...

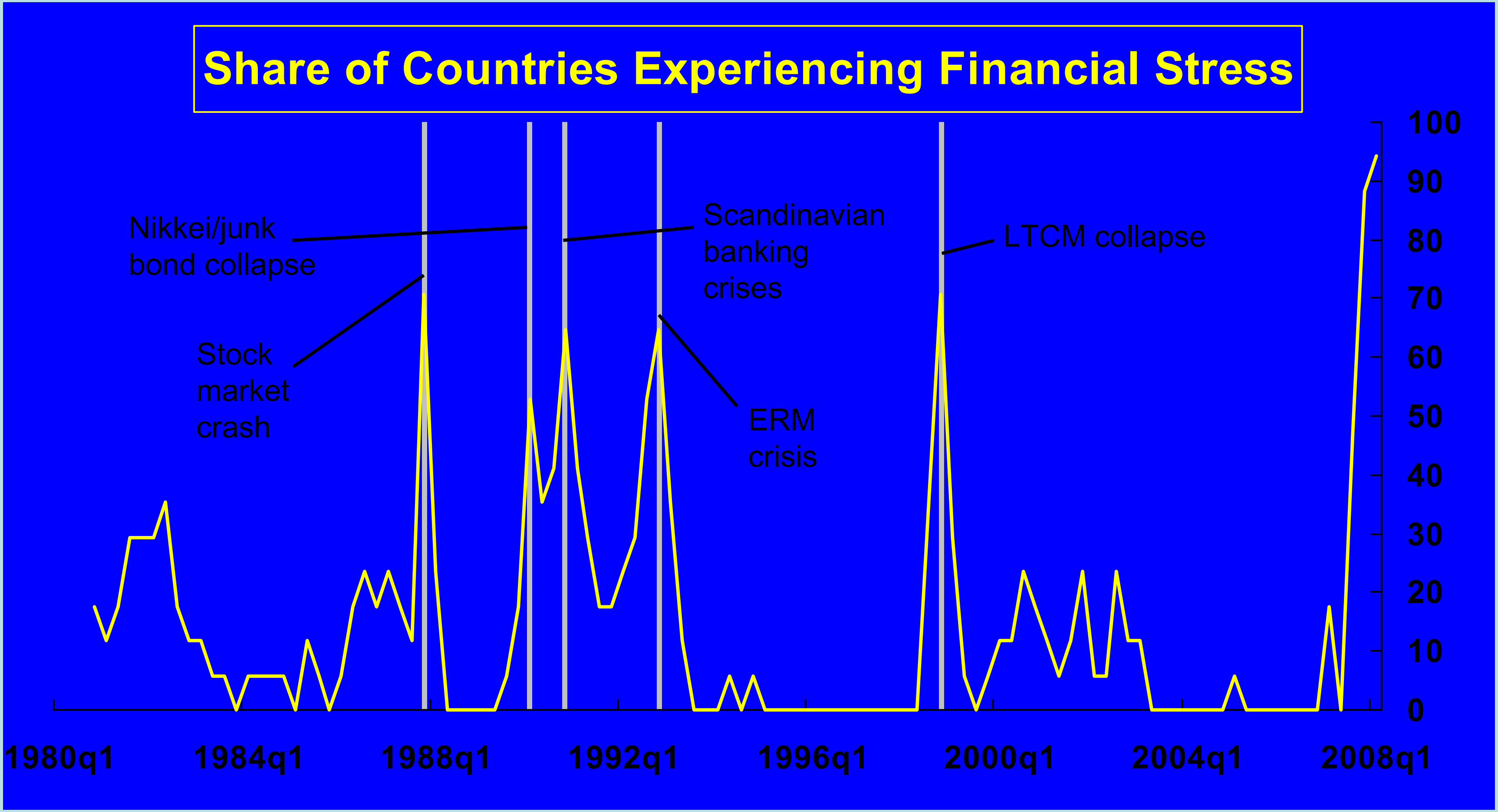
- More severe than other post-war recessions:

  => affects all countries simultaneously

  => deadweight debt / bogus liquidity in private balance sheets – clean-up takes time

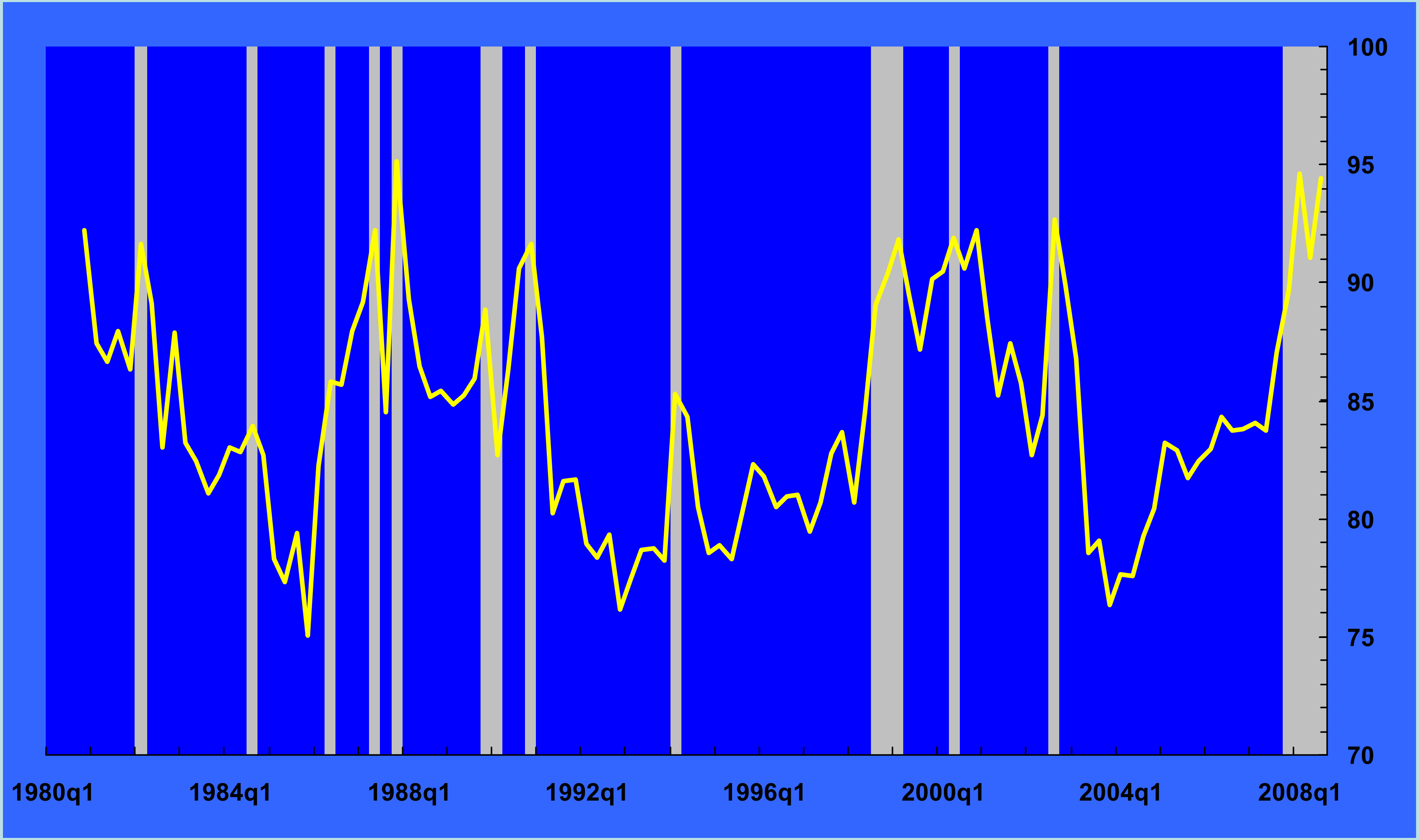
  => fiscal and monetary capacity to be re-built... state involvement will take time to wind back

IMF Severity Metric: Length & Spread



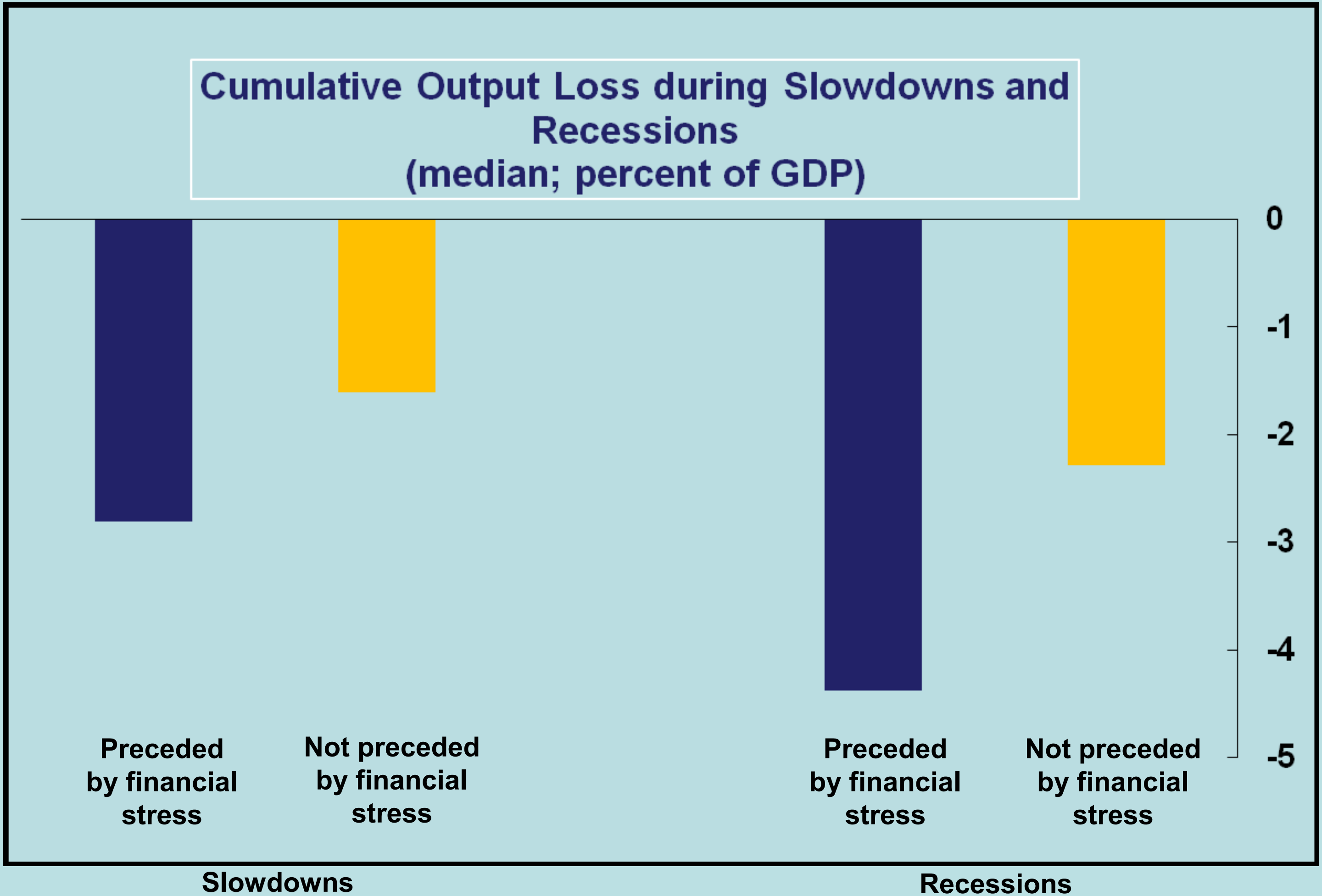
Adapted from IMF WEO 10-08 Ch. IV

IMF Financial Stress Indicator: USA



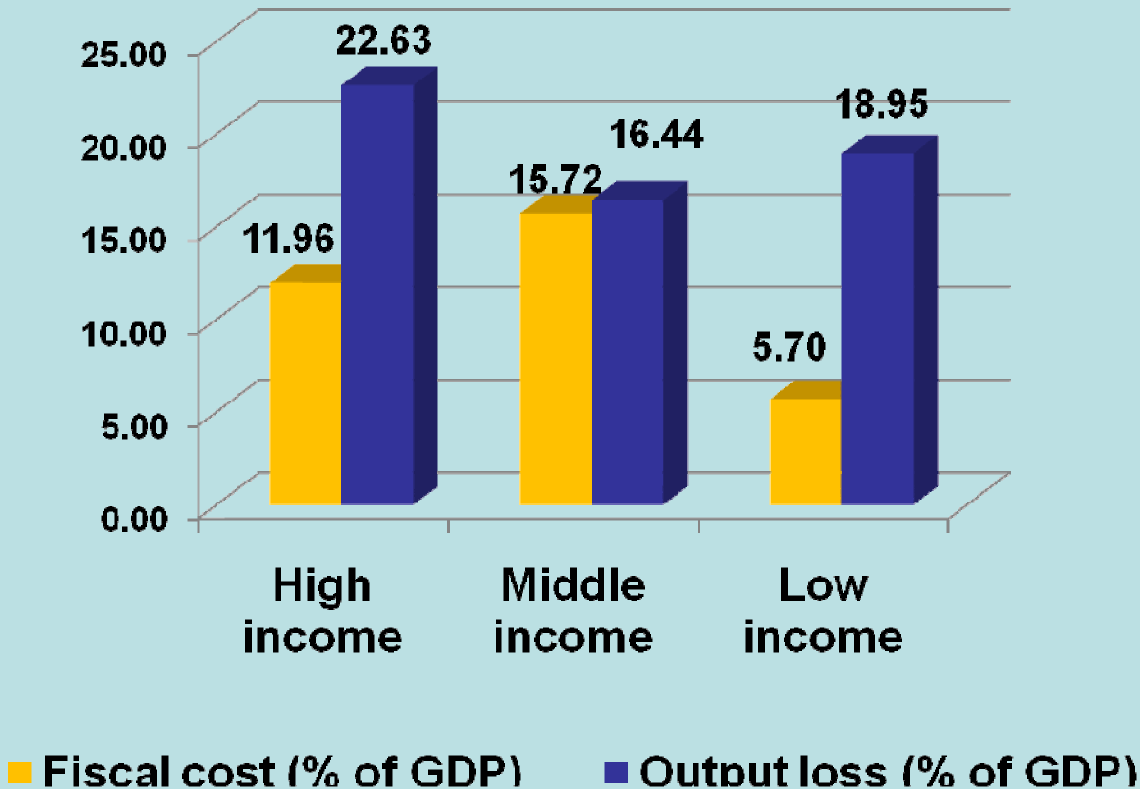
Adapted from IMF WEO 10-08 Ch. IV

Economic downturns tend to be more severe when preceded by financial stress...



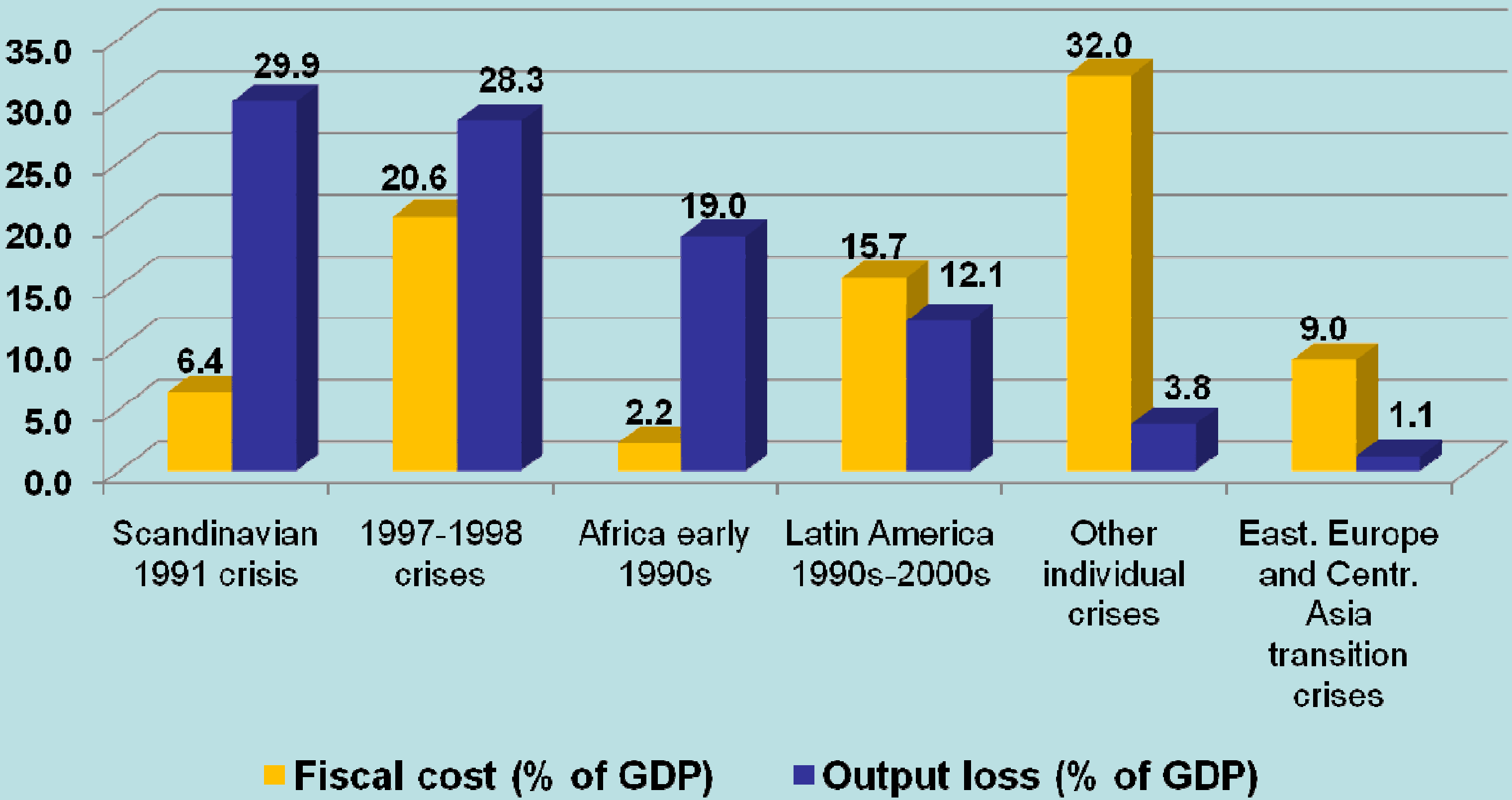
Adapted from IMF WEO 10-08 Ch. IV

Fiscal & Output Costs of Systemic Banking Crises, post-1990 (% of GDP)



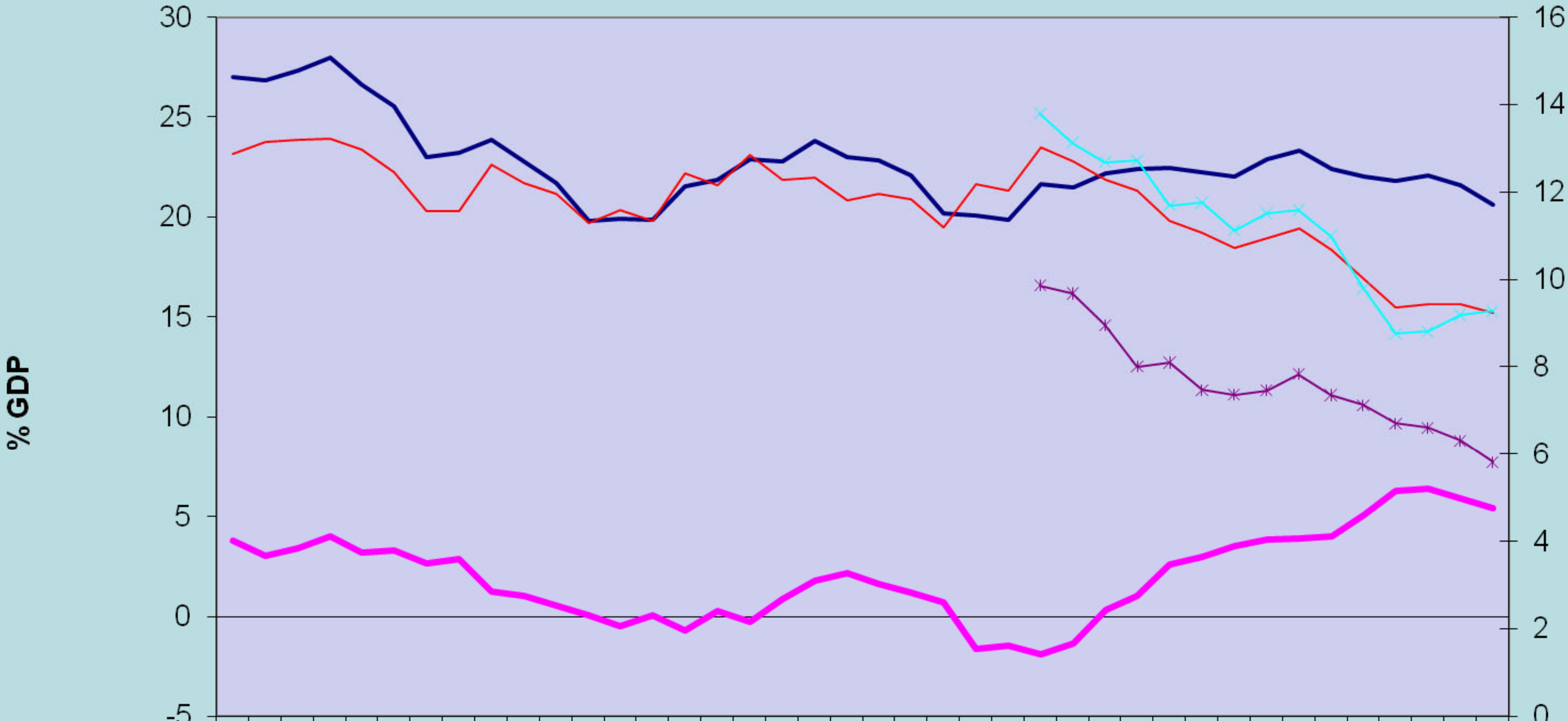
Source: Laeven and Valencia (2008) "Systemic banking crises: A new database"

Fiscal and Output Costs of Crises by Region (% of GDP)



Source: Laeven and Valencia (2008) "Systemic banking crises: A new database"

Spain Gross Saving 1970 – 2008



	70	71	72	73	74	75	76	77	78	79	80	81	82	83	84	85	86	87	88	89
Gross national saving	27.00398	26.84472	27.32622	27.99807	26.64104	25.55412	22.98317	23.20749	23.89952	22.77733	21.71723	19.79932	19.8964	19.87481	21.52487	21.87461	22.89982	22.77751	23.80897	23.0227
Gross saving; g. government	3.80888	3.05982	3.457535	4.046296	3.209976	3.30434	2.645587	2.893896	1.260418	1.058837	0.535308	0.057974	-0.48758	0.046878	-0.67072	0.26643	-0.25149	0.880232	1.792383	2.180333
Gross saving; private sector	23.1949	23.7891	23.86789	23.94881	23.43106	22.24978	20.33758	20.31379	22.6351	21.71889	21.18192	19.74134	20.38398	19.82793	22.19558	21.60818	23.11811	21.89728	22.0166	20.84237
Gross saving; corporations (rhs)																				
Gross saving; households (rhs)																				

	90	91	92	93	94	95	96	97	98	99	00	01	02	03	04	05	06	07	08	09
Gross national saving	22.81579	22.08813	20.172	20.07843	19.85982	21.65785	21.46311	22.20308	22.38342	22.44138	22.25928	22.02231	22.87611	23.35129	22.39187	22.03247	21.78349	22.08882	21.56367	20.63114
Gross saving; g. government	1.64621	1.189858	0.695445	-1.61697	-1.46885	-1.87833	-1.32825	0.319891	1.040807	2.637333	3.01747	3.528888	3.889259	3.920407	4.034757	5.108592	6.309266	6.410101	5.92471	5.41071
Gross saving; private sector	21.17058	20.89828	19.47655	21.6954	21.32447	23.53619	22.79136	21.88319	21.34282	19.80405	19.24181	18.49362	18.98682	19.43088	18.35711	16.92388	15.47422	15.67882	15.63896	15.22043
Gross saving; corporations (rhs)						13.79602	13.12933	12.69128	12.72083	11.69876	11.76192	11.12597	11.5191	11.58841	10.99184	9.798698	8.784121	8.811127	9.190198	9.281523
Gross saving; households (rhs)						9.863485	9.67891	8.959142	8.013635	8.105293	7.479893	7.387854	7.467711	7.842474	7.385288	7.124883	6.710101	6.611084	6.3136	5.823494

Policy Sources

Monetary policy: US too easy too long; plus low EMC $ pegs. Eastern Europe imported euro area monetary conditions. More generally, inflation targets too short-term and narrow.

Fiscal policy: US, UK applied fiscal stimulus and failed to claw it back in boom. In all economies with financial booms, stance was more expansionary than estimated (due to transient receipts).

Risk management: In US, risk management only for "downside risks." Upward ratcheting of money and public debt.

Regulation: Major errors (cf. Spanish foresight on provisions, SIVs); plus failure to internalise macroprudential risk climate

Crisis Management

- Deep differences beyond "Brown menu":

  => US far more activist (incl. FRB assets, quantitative easing) and shareholder-friendly. More severe problems... But also "float off" the problem

  => € area ample liquidity injections, but deep fear of roller-coaster (money, budget, EC bail-outs)

  => UK slower on money; major dissent on fiscal


LIBOR Vs 3M US Treasury Yield - 6 Months
6.3
4.7
3.2
1.6
0.0
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec

Lessons?

- Truly a crisis of capitalism. Even in US will provoke attacks on equity, efficiency, sheer safety, of finance

- So two sets of options, looking to medium term:

  1 => Tweak heavily regulatory architecture... and/or

  => Mixed economy model with heavy state role

  2 => Claw back liquidity/public debt aggressively in med. term (risk management symmetry)... or

  Risk roller-coaster with lower fiscal capacity

Emerging Markets I

- Crucial vulnerability is external financing
- Which are mainly (but not only) private sector-driven
- In many cases, savings were plausibly used...

- But key concerns lie in

  => Risk of sudden stop by common lenders

  => Balance sheet risks (esp. unhedged fx)

External Current Account Deficits in Eastern Europe (2007)

(in percent of GDP)

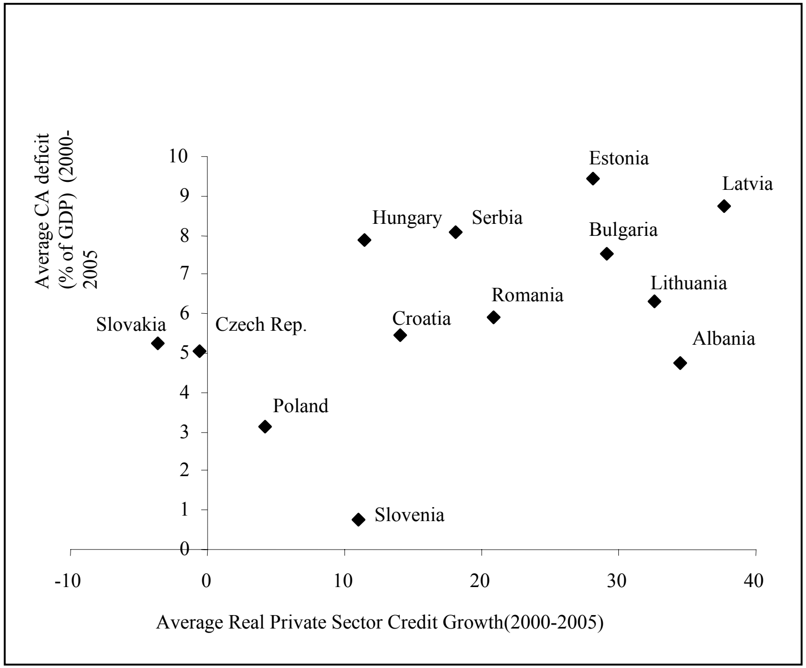
Hard Peg Cases		Floating and Intermediate Cases	
Bulgaria	-18.1	Czech Republic	-2.8
Estonia	-14.6	Hungary	-4.4
Latvia	-23.8	Poland	-4.3
Lithuania	-13.9	Romania	-13.7
		Slovakia	-4.4
BiH	-15.3	Albania	-7.4
		Croatia	-8.5
		fYRoM	-2.8
		Serbia	-14.7

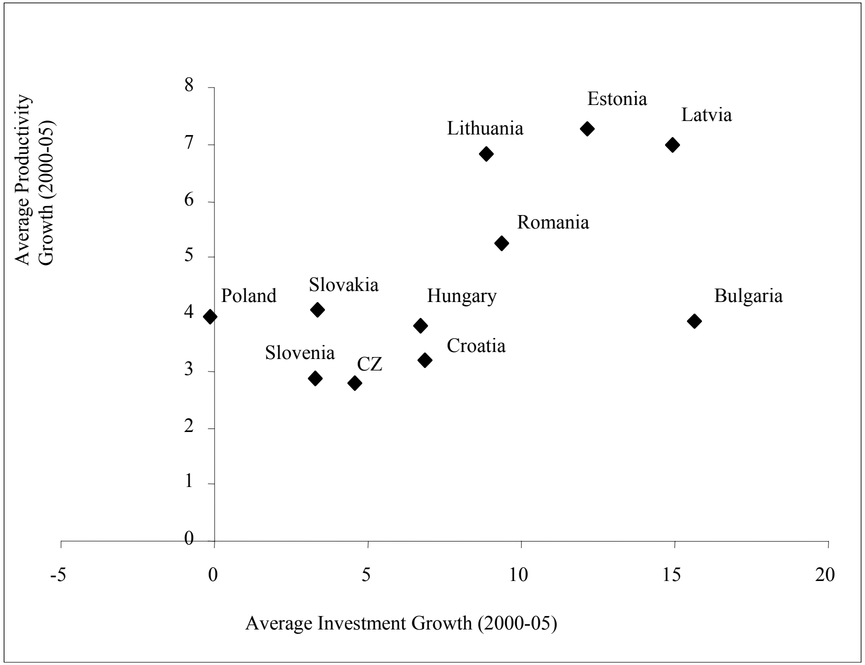
Source: European Commission for EU Member States and Candidates and IMF for others; this table excludes cases that use the euro as a currency

S.E. Europe: Fiscal Deficits and Private Sector Balances (in %of GDP)

	Fiscal Deficits 2000	Fiscal Deficits 2007	Households and Firms 2000	Households and Firms 2007
Albania	-9.2	-3.9	+1.8	-6.0
BiH	-8.3	-1.4	-8.1	-11.1
Bulgaria	-0.5	2.3	-5.1	-18.5
Croatia	-7.5	-2.6	+5.1	-5.7
Frmr. Ygslv. Rep. of Mac.	+2.5	-1.0	+4.4	0
Montenegro	-6.9	3.0	+2.4	-26.0
Romania	-3.8	-2.5	+0.2	-6.3
Serbia	-0.9	-2.3	-4.2	-9.7
	-4.3	-1.0	-0.4	-10.4

Use of Savings Plausible



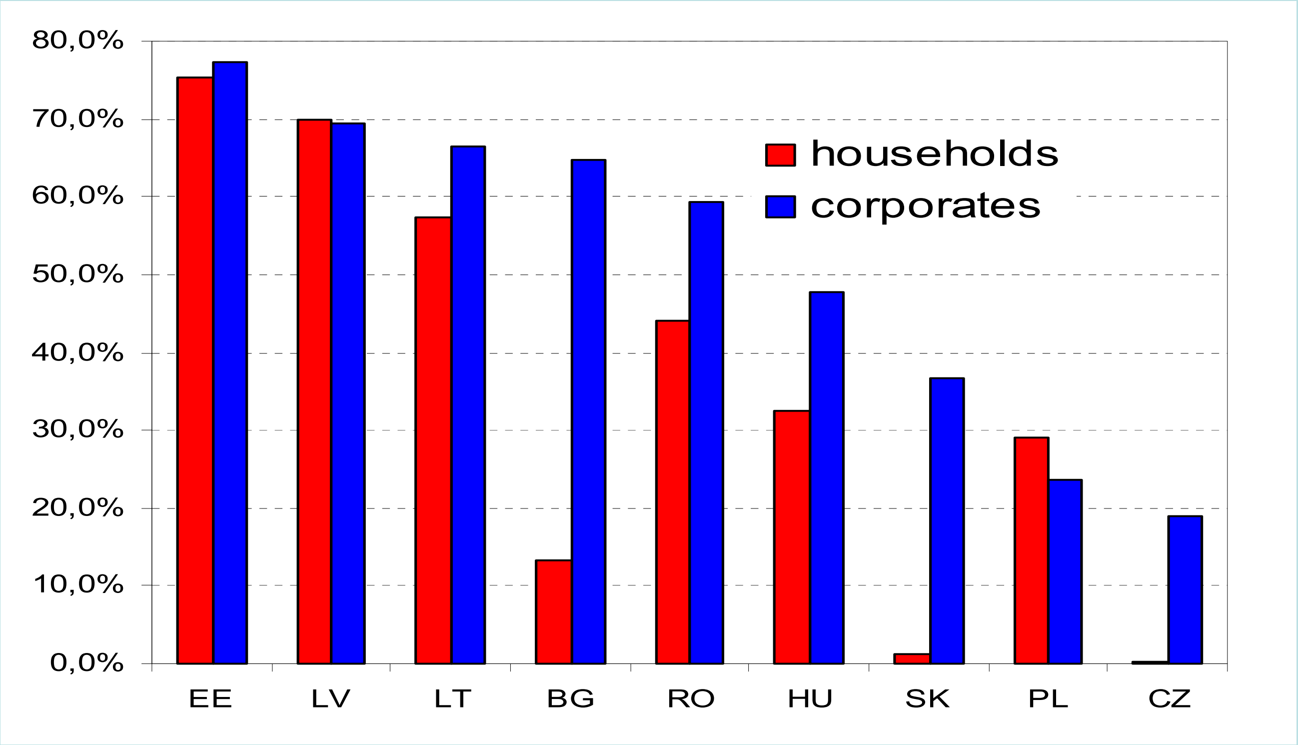


Structure of Banking Sectors: S. E. Europe

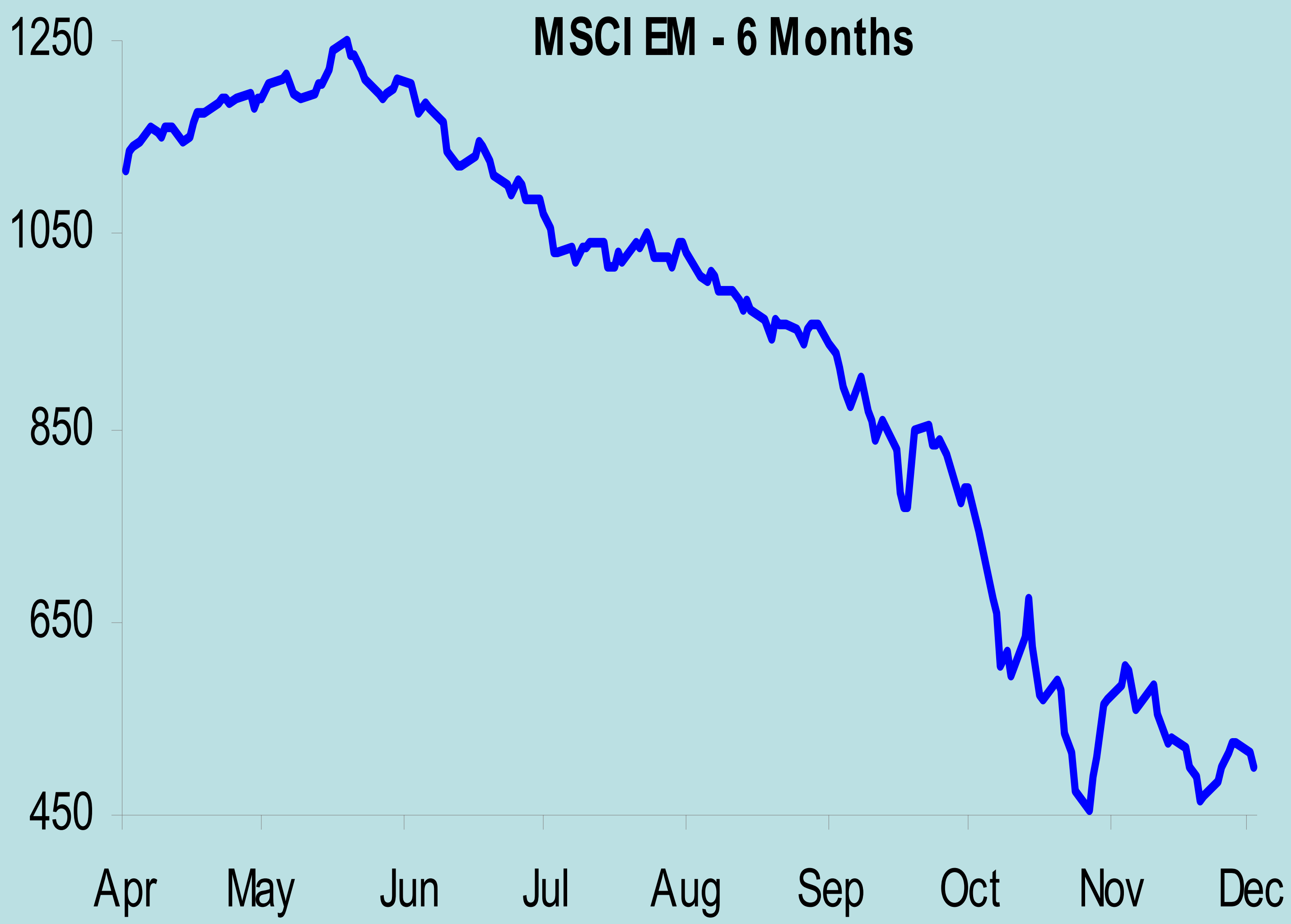
	Number of banks	*Market share %*			
		Foreign-owned banks	Private domestic banks	State-owned banks	Top five
Croatia	34	91	6	3	74
BiH	33	91	5	4	61
Bulgaria	34	75	23	2	55
fYRoM	20	51	47	2	76
Romania	33	60	33	7	60
Serbia	40	66	10	24	-
Albania	16	92	0	8	77
Montenegro	10	88	7	5	-

Sources: Mihaljek; EBRD, data for 2005 [and 2004 for top five banks]

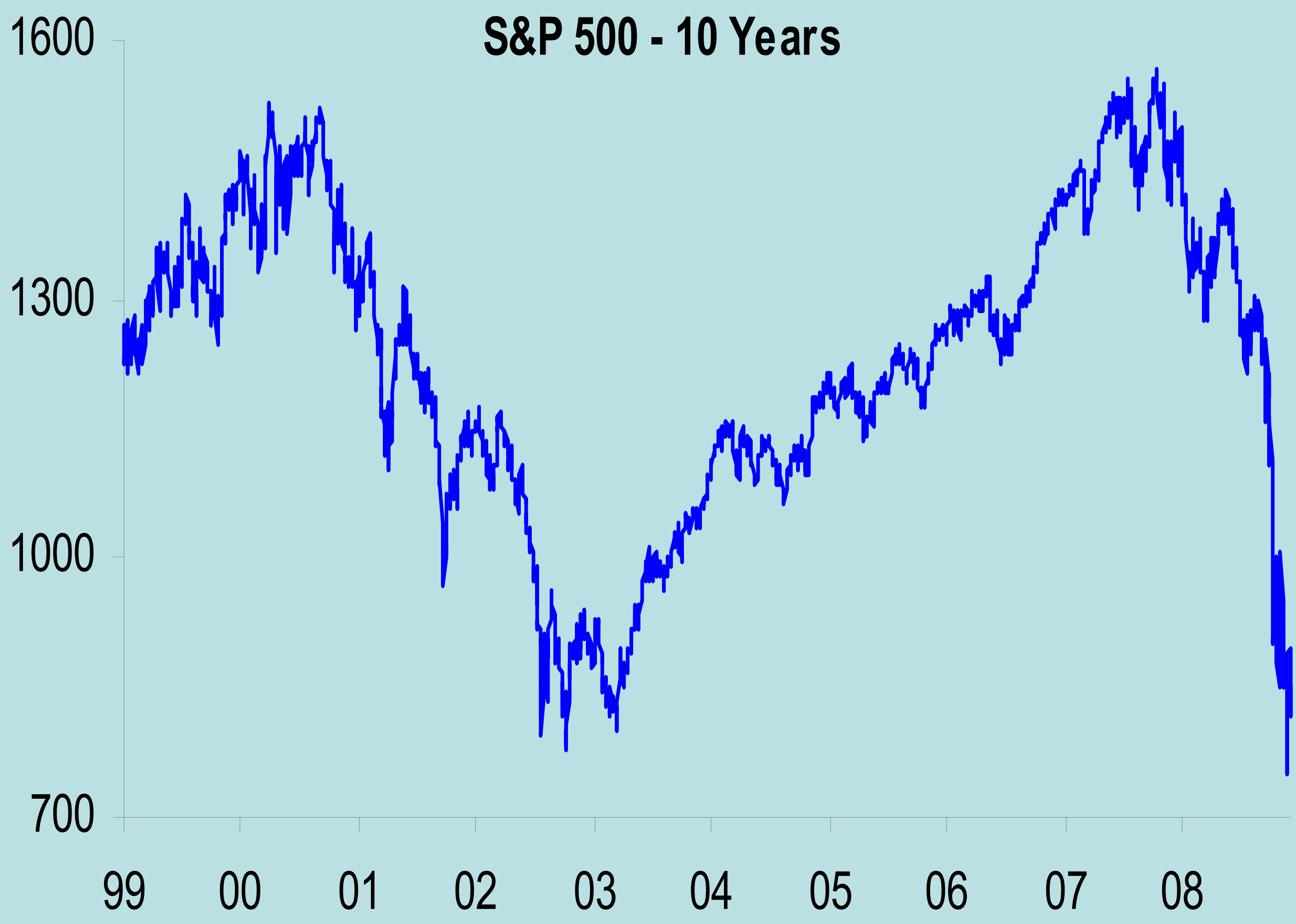
Foreign currency lending (% of total, 2007)



Source – European Commission


MSCI EM - 6 Months
1250
1050
850
650
450
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec


MSCI EM - 10 Years
1400
1200
1000
800
600
400
200
99
00
01
02
03
04
05
06
07
08


S&P 500 - 10 Years
1600
1300
1000
700
99
00
01
02
03
04
05
06
07
08

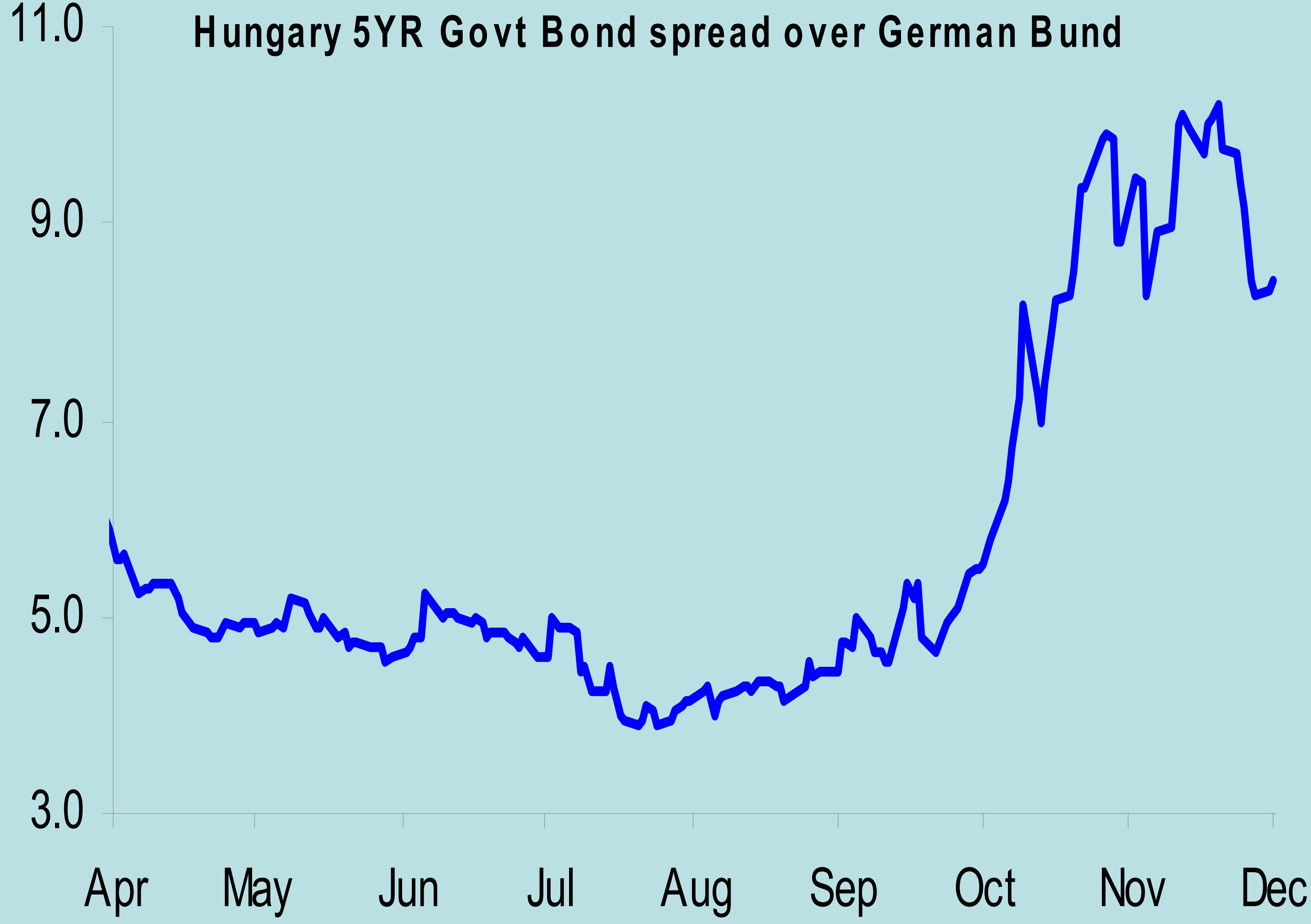
Emerging Markets II

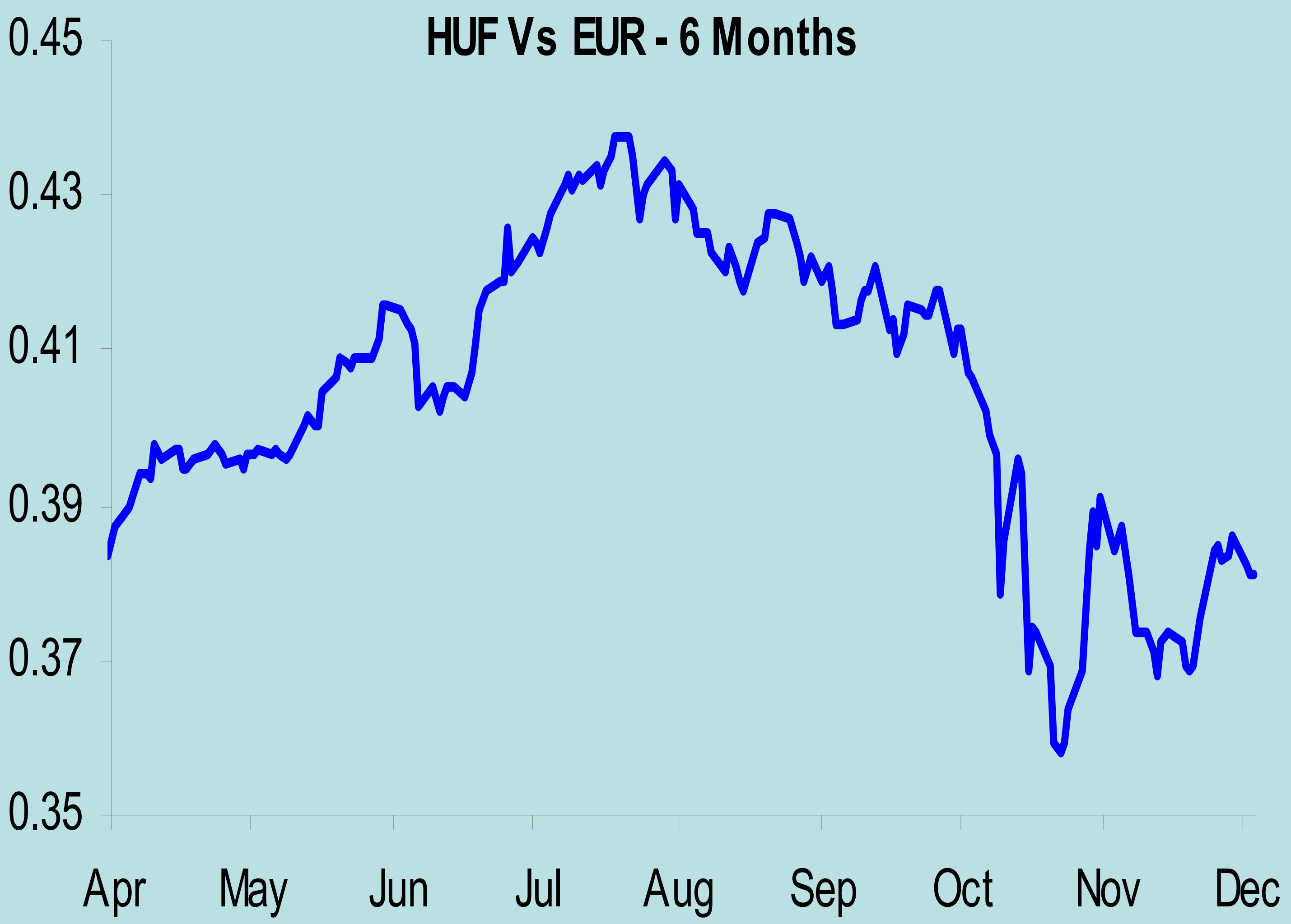
Near-term – Hungary as embryo model?

- IMF/EC fill official sector funding gap
- Foreign banks maintain exposure
- Home government bails out banks

+ Host government bails out households?
+ Limits on exchange market intervention??

Will hard pegs hold? Domestic confidence is key...


Hungary 5YR Govt Bond spread over German Bund
11.0
9.0
7.0
5.0
3.0
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec



HUF Vs EUR - 6 Months
0.45
0.43
0.41
0.39
0.37
0.35
Apr
May
Jun
Jul
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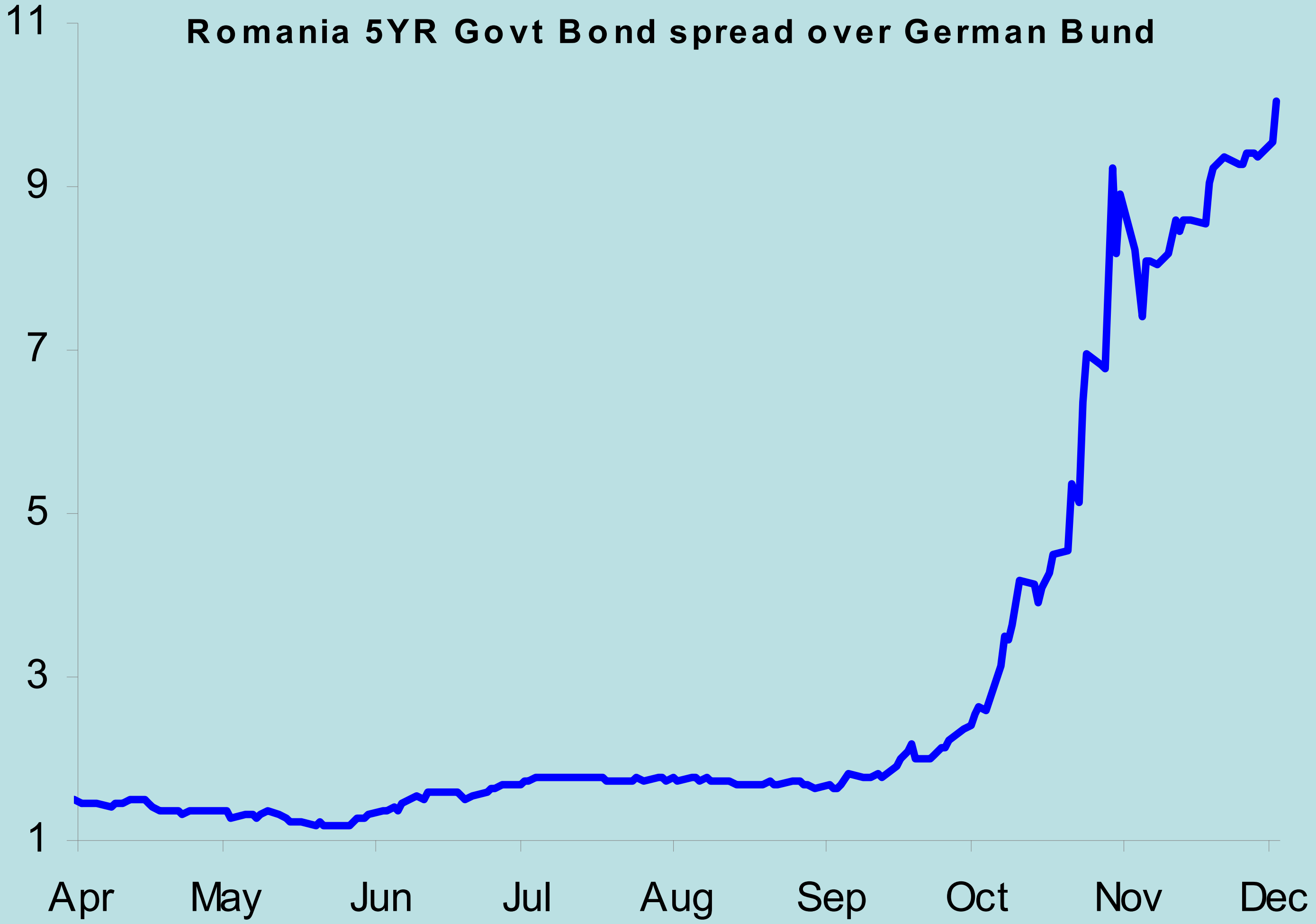
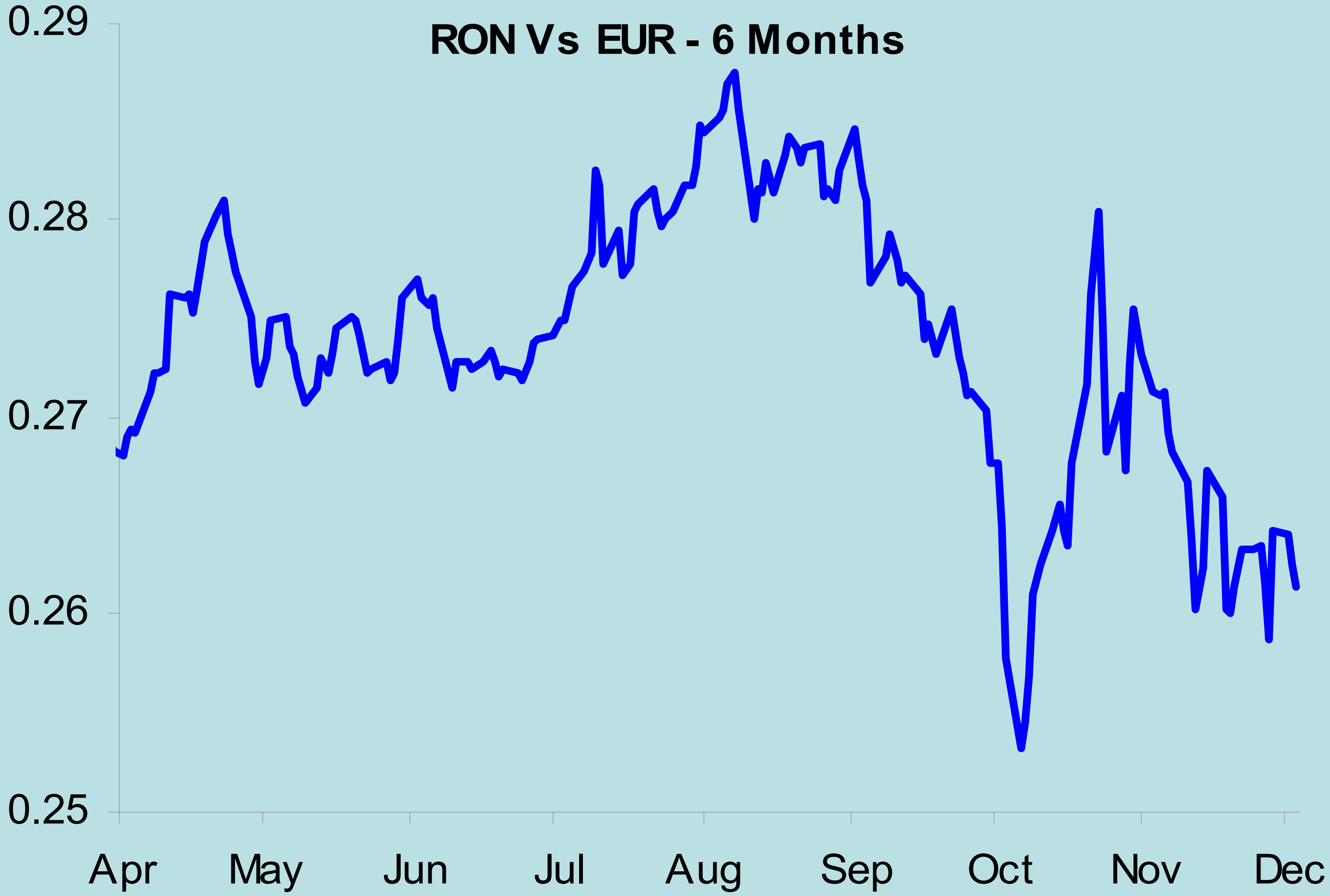
Sep
Oct
Nov
Dec


Romania 5YR Govt Bond spread over German Bund
11
9
7
5
3
1
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec


RON Vs EUR - 6 Months
0.29
0.28
0.27
0.26
0.25
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec

Emerging Markets III

- Road to euro quite too long, so...

- EU Integration plus Asian self-insurance
  - => Build up official reserves
  - => Build up bank liquidity
  - => Build up bank capital
  - => Build-up fiscal room (stock, flow)

This crisis makes insurance costs seem quite low

Who Guards the Guardians?

	Overview	Identified	Missed	False +
UK 4/07	Overall risks have Increased	Low risk premia Corp. leverage O&D incentives Imbalances Household debt	LCFI (flagged but ‘ remote) Commercial property Bank liquidity	
Germany 12/06	Stability improved further this year	Adj. To global Credit cycle Interplay of market risks CRT markets Growth; profits	Weakness of Landesbanken (praised new bus. models) Potential issues in med-size banks	Hedge funds Real estate funds
Spain 5/07	Quite optimistic Global risk Higher	Imbalances Changed risk perceptions Leverage/LBOs	Real estate co’s S/prime spillovers Securitisation risks not stressed	Geopol. risks Hedge funds

SEE: Moving to Frontier

Only a few fully-fledged SEE financial stability reports

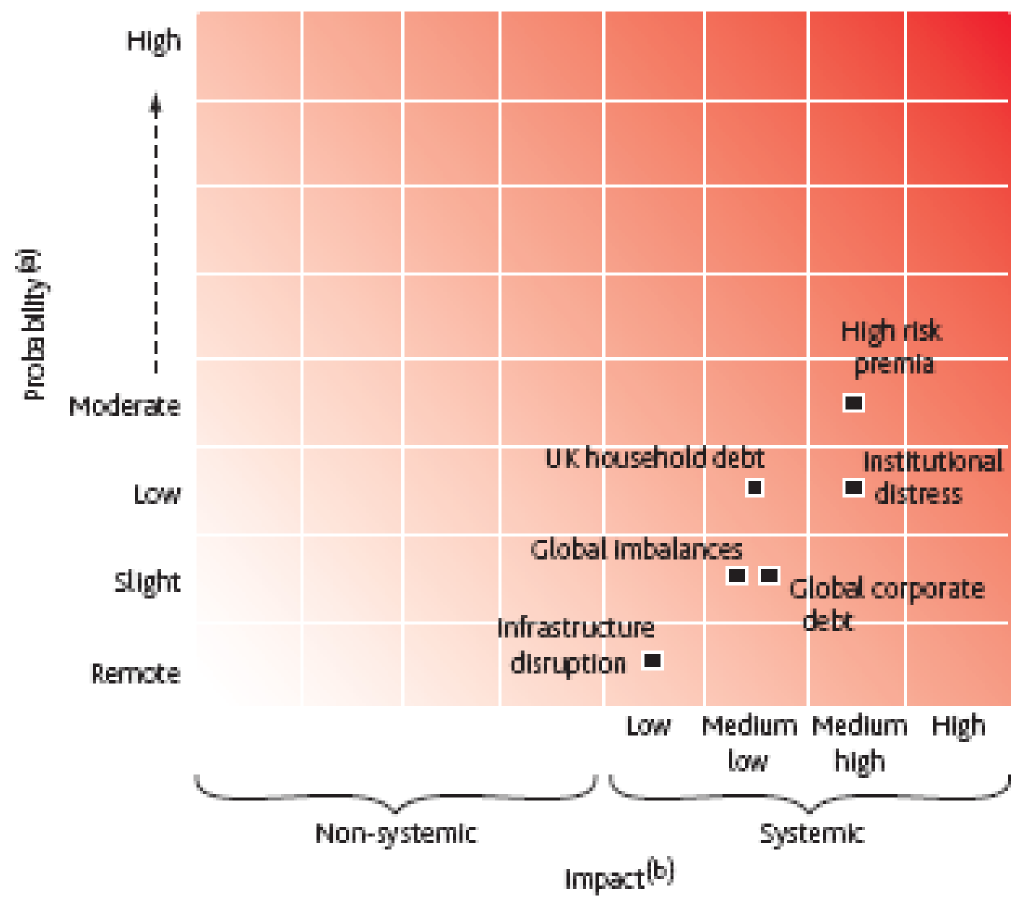
Strong features of these and financial sector reports:

- Presentation of data and sectoral approach...
- Probe well beyond financial sector

Priorities for near-term:

- Explore regional spillover risks more fully
- Highlight key structural vulnerabilities
- Develop articulated risk scenarios (cf. CNB, MNB)
- Develop targeted special issue chapters
- ...Analyse policy mix & pre-emption trade-offs

Judgement on levels of likelihood and impact of key sources of tail risk



Source: Bank assessment.

(a) Probability of a severe crystallisation of a vulnerability at some point over the next three years.

(b) Expected impact on financial stability if a vulnerability is triggered in a severe scenario. See *FSR* Chart 3.15 for details.

Source: Bank of England

Pushing the Frontier

1. The neglected risks: liquidity, operational risks

2.Next steps in integration of shocks: compound stress tests; interact balance sheet/national income analysis; next generation of DSGE models, with fully articulated financial sectors

3. Difficult challenges: macroeconomists & financial analysts' different frameworks for risks, equilibria; more forward-looking stress test scenarios; publish data so market can do own stress tests

4. Quantify policy/adjustment scenarios: output loss

FSR Effectiveness

How greater impact on markets & policy-makers?

=> quantify med.-term scenarios with linkages: explore risks; policy mix; crisis costs v. "insurance" costs

=> FSR = Flagship: target other products to audiences

=> develop risk scenarios into "war games"

More radical institutional approaches:

- financial stability committee external membership
- build stability assessment in supervisory review

... Leverage analysis via strengthened dialogue with EU

Conclusion: High Stakes

- Tighter regulation, but on what macro infrastructure?
- Strengthen macro policy, especially in US: more "peripheral vision;" symmetrical risk management.
- Incentives for US (dollar liabilities, market assets) are troubling... Re-run of boom-bust cycle with weaker fiscal capacity could truncate liberal finance even there
- EU may under-stimulate in sort term, and then leave state in new "commanding heights" of economy.

...We may ultimately need globally co-ordinated response to trends in liquidity, asset prices, imbalances
...Meanwhile, fiscal & monetary self insurance in EMCs

End of Presentation