

The Future of the Financial System: Problems and Possible Solutions

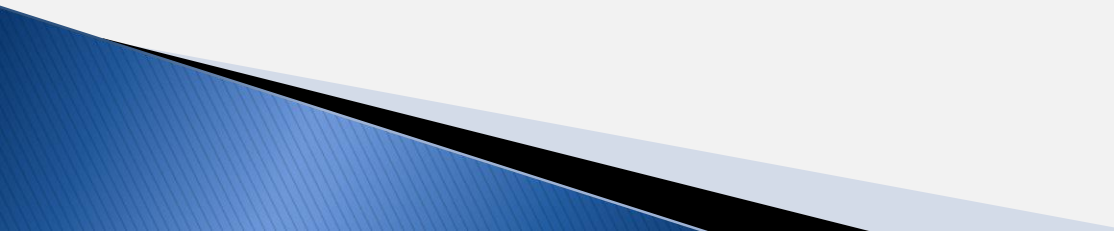
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Introduction

- ▶ A positive development: financial stability is increasingly associated with systemic risk
- ▶ Reducing systemic risk means reducing the Probability of Crisis and the Loss Given Crisis
- ▶ But, also some negative developments
 - Financial “imbalances“ are crowding out attention to “real“ imbalances, also driven by credit growth
 - The distinction being made between financial stability and price stability is false
 - Financial regulation can produce financial stability at the cost of growth

The Financial Sector Today

- ▶ The Minsky Moment and government support
 - ▶ Remaining uncertainties about the rude health of financial institutions
 - ▶ And further exposures given more economic weakness?
 - ▶ What is Plan B?
 - More of the same?
 - Or “exit policies” regardless?
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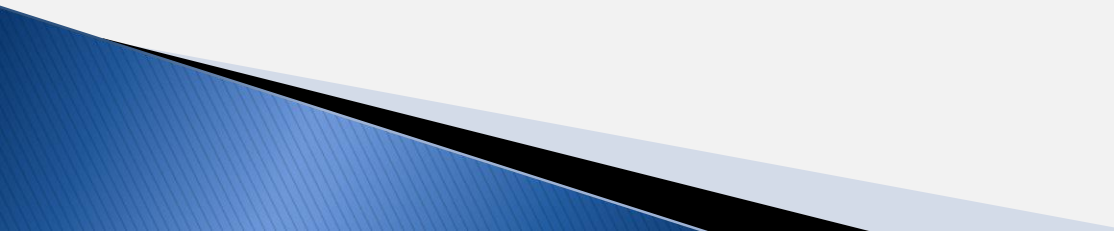
Near Term Problems in the Financial Sector

- ▶ New attitudes to risk or “business as usual“?
- ▶ Ultra low rates and Quantitative Easing
 - Inflationary expectations and bond prices
 - Asset price bubbles and capital flows to EME’s
 - Gambling for resurrection
- ▶ Procyclicality in regulatory behaviour
- ▶ Supporting national agendas at the expense of international cooperation

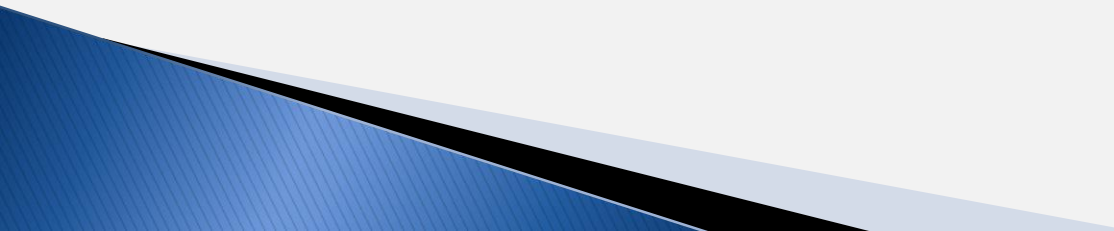
Medium Term Problems in the Financial Sector

- ▶ Problems arising from the crisis itself
 - Rising government debt and forced holdings by financial institutions
 - Capital controls
- ▶ Problems arising from the response to the crisis
 - Regulation leading to allocational inefficiency
 - Uncertainty about reforms impede credit growth
 - Attention to systemic risk inadequate or worse
 - Diminished “independence” of central banks

Longer term problems in the Financial Sector

- ▶ Procyclical behavior will increase as memories fade
 - ▶ Technology will drive further globalisation, securitisation and consolidation
 - ▶ The “Eight Hundred Years of Financial Folly” are not over yet
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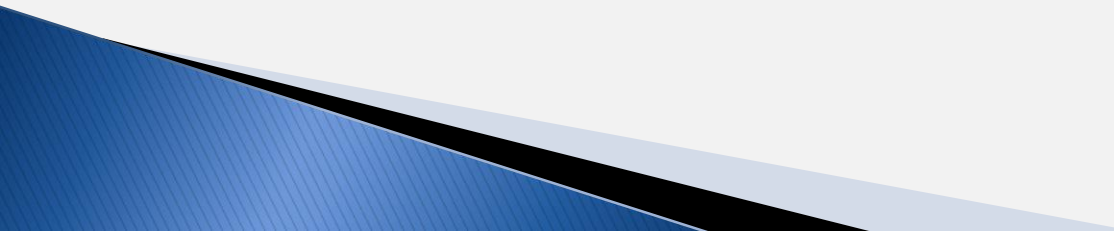
Solutions to Near Term Problems in the Financial Sector

- ▶ Carefully monitor maturity transformations and rely on other ways to raise capital
 - ▶ Conduct QE such that inflationary risks are minimized
 - ▶ In AME's with rising house prices, use macroprudential tools
 - ▶ In EMEs, let exchange rates rise and use macroprudential tools
 - ▶ Avoid “gold plating“ Basel 3; cooperate more
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Solutions to Medium Term Problems in the Financial Sector

- ▶ Problems arising from the crisis itself
 - Need exit policies from forced holdings of sovereign debt
 - Accept capital controls in response to a market failure; UIP does not hold
- ▶ Problems arising from the response to the crisis
 - Recognize and reverse bad regulation
 - Rethink fundamentally how to respond to systemic risk
 - Central banks should withdraw (asap) from activities with distributional implications

Solutions to Longer Term Problems in the Financial Sector

- ▶ Lean against the upswing using both macroprudential and monetary policies
 - ▶ Reexamine the use of safety net measures in the downswing
 - ▶ Take ex ante measures (deposit insurance schemes, MOU, bank insolvency legislation, etc.) to better manage inevitable crises
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Conclusion

- ▶ The financial sector as “The Achilles heel of capitalism“
 - ▶ Potentially leading to crises with social and political implications
 - ▶ Which warrants treating the problems of the financial sector seriously
 - ▶ But a window of political opportunity may have been missed, especially re SIFIs
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