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Presented by
Professor Adrian Blundell-Wignall
Sydney University, and former Director of Financial & Enterprise Affairs at the OECD. Author of: “Globalisation and Finance at the Crossroads”
My task today

– I was asked to give my view on the current global situation since the crisis? Are the themes of unbalanced globalization (China saving glut), financial innovation and regulatory failure still intact? Are new themes looming large?

– The crisis response was supposed to be (a) emergency liquidity (b) deal with bad assets (c) recapitalize banks (d) regulatory reform. Only the USA more-or-less followed this. Europe & Japan are another story.

– Then came QE, which morphed from emergency liquidity to a “bad bank” role (US and Europe). It has morphed again into an exchange rate strategy for Japan and Europe (that they would never admit to).

– China’s growth and its global political strategies are the basis of the trade war. Over-investment reduces returns, causes excess capacity, deflation, & hollows out the middle class.

– Over-investment is always accompanied by financial crises—this time China is in the centre. Their attempts to control spiraling debt on-and-off balance sheet will result in very slow growth. This will cause further policy errors—like low and negative interest rates. All of this is bad for banks, investment decisions, & resource allocation.

– A perspective on the trade war.

– Europe is a particular problem as it did not deal with the crisis. Its central economic flaw is the euro. The banking and liquidity problems remain elevated.

– Brexit. The UK will do well to get out of Europe.

– Fintech will raise new problems to deal with beyond the China crisis.

– Comment on regulatory reform
Setting the Scene: US PEs, Inflation and Bonds. Does it Make Sense?

– PE’s rise when inflation falls.
– The Crisis saw a positive relationship due to fear of deflation.
– Bonds are flat since 2014.
– So the markets are expecting China, trade wars, Brexit, QE, negative rates all mean rising trend growth.
– Does it make sense?
## QE & Monetary Policy Distorting Markets

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<td></td>
<td>(% per annum)</td>
<td></td>
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<tr>
<td>CPI</td>
<td>2.60</td>
<td>1.98</td>
<td>1.76</td>
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<tr>
<td>S&amp;P 500</td>
<td>5.79</td>
<td>3.07</td>
<td>11.57</td>
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<tr>
<td>Real S&amp;P</td>
<td>3.19</td>
<td>1.09</td>
<td>9.81</td>
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<tr>
<td>Real Div Yield</td>
<td>1.35</td>
<td>-0.03</td>
<td>0.25</td>
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<tr>
<td>Real S&amp;P Tot. Ret.</td>
<td>4.53</td>
<td>1.06</td>
<td>10.06</td>
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<tr>
<td>10 yr</td>
<td>4.85</td>
<td>3.34</td>
<td>2.49</td>
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<tr>
<td>Real 10 yr</td>
<td>2.25</td>
<td>1.36</td>
<td>0.73</td>
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<tr>
<td>Asset Allocation Return</td>
<td></td>
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<tr>
<td>Real 60% equity 40% Bonds</td>
<td>3.62</td>
<td>1.18</td>
<td>6.33</td>
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GSIB ROE Recoveries Point to Where Banking Problems Remain. This Colours Monetary Policy.
Productivity Falling, Buybacks Instead of Investment. What Does Sweden Do?

- No minimum wages. Strong union involvement.
- Most equal income distribution.
- R&D expenditure 3.3% GDP (OECD 2.3%).
- Low subsidies to R&D. Pays Soc. Sec. contrib. of staff working on commercial R&D—low taxes to attract foreign talent.
- Foreign sales focus.
Hollowing out: changes in shares of employment by pay category, 2000-2017

Employment Share Change 2017 vs 2000

Chg. in Share

Australia  Austria  Belgium  Denmark  Finland  France  Germany  Greece  Ireland  Italy  Netherlands  Norway  Portugal  Spain  Sweden  United Kingdom  United States

Primary & Lower Secondary
Upper Secondary not Tertiary
Tertiary
World Output Gap, Inflation & Real Bond Rate (US)

Global Excess Capacity & Inflation

- World Output Gap (RHS)
- CPI
- Real Bond Rate

% Output Gap


World Output Gap: -0.07, -0.02, 0.03, 0.08, 0.13, 0.18
CPI: -5, -3, -1, 1, 3, 5, 7, 9, 11, 13, 15
Real Bond Rate: 0.13, 0.08, 0.03, -0.02, -0.07
Lead Indicator: What the Fed is Worried About Now--Recession

Lead Indicator: % Chg: N/Rural, S&P, China Imp, ISM ORD/INV, IFO

- %

-20

0

20

30

Jan-85 Jan-87 Jan-89 Jan-91 Jan-93 Jan-95 Jan-97 Jan-99 Jan-01 Jan-03 Jan-05 Jan-07 Jan-09 Jan-11 Jan-13 Jan-15 Jan-17 Jan-19

Lead Indic

Indust Prod USA
QE: Central Banks As Bad Banks & Exch. Rate Manipulators?

Money Base
- United Kingdom
- Japan
- Eurozone
- Fed Monetary Base

Initially About Liquidity & bad bank role

Interbank Rates
- USA
- Japan
- Swiss
- Euro Area
- UK

$bn

Jan-07, Sep-07, May-08, Jan-09, Sep-09, May-10, Jan-11, Sep-11, May-12, Jan-13, Sep-13, May-14, Jan-15, Sep-15, May-16, Jan-17, Sep-17, May-18, Jan-19
The Problems with QE

– Weakest recovery in the post war period and no inflation after a decade of the easiest money of all time. Slipping into recession risk again. Excuses: trade tensions, Brexit, uncertainty.

– Central banks claim negative rates & QE flooding the interbank market will force investment in risky assets & reflate the economy—of course that’s nonsense.

– We are to believe that US, EU, JAP & UK banks need $14.5tn to trade with each other, when $3.4tn was enough in 2006??

– They use the cash to trade riskier assets & currency in secondary market. Its “churning”. Investors plunge into equities, but it’s also the secondary market —nothing to do with raising new money for investment.

– QE=bad bank + currency play (beggar my neighbor).

– “Bad bank” because no one knows what assets held by central banks are worth in the event of a recession or higher rates. The coupons on these assets are higher than cash rates—banks could easily buy it all back if they were offered—they certainly have the cash. But no one wants to do it.

– Putting assets with central banks doesn’t destroy risk—just hides risk.
CHINA: BELT AND ROAD

One Belt, One Road
An economic land belt of countries on the original Silk Road, with a maritime route linking China, Africa and the Mediterranean.
China Glut: Saving Investment Strategy

Gross national savings (% of Total 52 countries)

Other EMEs
- Korea, Singapore, Chinese Taipei and Hong Kong
- Europe (incl. UK and Switzerland)

BRIIS
- Australia & New Zealand
- United States

China
- Japan

Years: 1995 to 2017
Belt & Road & MIC 2025: Foreign Company Investments 2005-2018, $1.15tn

Cum. to Dec. 2018 Company Investments $1,154bn

- BRI
- MENA (ex-BRI)
- Sub-Saharan Africa (ex BRI)
- South America (ex-BRI)
- United States
- East Asia (ex-BRI)
- Other North America
- Europe (ex-BRI)
- Australia
Belt & Road: Foreign Construction Contracts
Since 2005-2018, $804bn

Cum. to Dec. 2018 Construction Contracts $804bn

- BRI
- MENA (ex-BRI)
- Sub-Saharan Africa (ex BRI)
- South America
- United States
- Other North America
- Europe (ex-BRI)
- East Asia (ex-BRI)
- Australia
CHINA MISTAKES: Bank Credit and Lost Decades

Bank Credit to NF Sector % GDP

- Jap Av GDP Growth
- Aust
- US
- Jap
- China
- Euro Area
Debt as Share of GDP: USA, China, Euro Area, Japan
US Securitisation Compared to China

% GDP

- Total
- US Securitised (inc. Fannie and Freddie)
- China Shadow Banking
- China WMPs

1985 1987 1989 1991 1993 1995 1997 1999 2001 2003 2005 2007 2009 2011 2013 2015 2017
China Can’t Afford to Have Equities Fall: WMPs Would Move to Negative Equity

- Overinvestment, falling returns.
- Finance by SOE banks.
- Tried to reel in credit after GFC, but its quantitative approach led to WMPs & other off-balance-sheet activity.
- Can’t afford an equity collapse.
Trade War: How China Breaks the Rules

– There is a large literature on disputes with China since WTO—official, academic and judicial.

– Topic headings include: technology transfer requirements; violations of the Trade Related Aspects of Intellectual Property Rights (TRIPS), including IP theft, copyright infringement and counterfeiting; subsidies; State-Owned Enterprises (SOEs) that operate on non-commercial terms (including subsidised lending via SOE banks); use of taxation as a trade weapon; rare earth export quotas; import restrictions (including via technical barriers to trade); dumping; absence of national treatment for foreign banks and payment companies; non-participation in the Government Procurement Agreement in any meaningful way; and capital controls and related exchange rate manipulation techniques.

– These have contributed to rapid Chinese penetration of other markets—particularly into the United States.
Trade War: Import Penetration by China and of China

After WTO
China share of country imports rises sharply.
China has over 20% of US imports.
Other country shares of China fall despite the 30% apprec. of RMB.

Except resources (AUS) & high tech (GER)
Trade War: Shares of World Merchandise Trade

Share of World Trade in Goods

% WORLD TOTAL

USA
UK
Japan
Canada
FRA+ITA+SPA
Germany
Australia
China
HK+KOR+SING
IN+IND+MAL.
BRA+MEX+SA

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TRADE WAR: Large Countries Have to Consume Most of Their GDP—Like the USA, over 80%
TRADE WAR KEY: China Price versus Tariffs

To date average tariff rate is around 18-20% covering 50% of imports. Import price from China not affected, falling a little. 10% Deprec. RMB on 100% imports offsets net cost. No deadweight losses as tariff rev. can be used to cut taxes elsewhere.
EUROPE: Asymmetric shocks & the euro area. The Commission has always misled from the start

“...........there are grounds for believing that the incidence of asymmetric shocks will be limited for various reasons. In the past, the asymmetric character of shocks was considerably amplified by diverging monetary, exchange rate and budgetary policies. In EMU, with a common monetary policy and exchange rate and with consensus and limits on budgetary policies, such developments will become much more rare and much smaller, leading to better prospects for more cyclical convergence.....(and).... The single currency will unleash competitive forces that will strengthen the incentives for structural reforms, thereby improving the chances for reducing unemployment.”
(European Commission, 1998)

- Nonsense in theory and nonsense in practice.
- The China shock is the biggest asymmetric real shock ever—favouring the north (they are vertically integrated via high tech investment goods), and hurting the south (they compete directly with BRI countries in manufacturing).
- Forcing internal devaluation on the south devastates growth, and this pulls back the north.
- The cumulative GDP loss gap won’t be restored, not ever.
GDP Shares: Who’s Making Room for China?

Nom. GDP Shares of World GDP


%
Europe’s Problem Number 1: The Euro.
Europe’s Problem Number 2: Not Dealing With the Banking Crisis

- **The US has dealt with the NPLs** which peaked around 4% of loans in 2010 and have declined in every year since then for large and small banks.

- **NPLs of large banks in the UK** were as high as 18% of loans in 2010, but have been dealt with in a highly successful way since then. Small-bank-NPLs **peaked in 2012** at 6.5%, and have since been reduced to a still too large but a “good try” 2.5% of loans.

- **In the euro area** nothing remotely similar has occurred. Large-bank-NPLs rose to a peak of 8% in 2014, and remain at 6.8% in 2017. Small-bank-NPLs also rose to 8% in 2014, and have hardly declined at all since then, marking a strong contrast with other countries. There is considerable country diversity, with the south of Europe being much worse due to the state of the economy referred to earlier.

- **The problem of hidden bad assets** is greatest in the GSIB banks, where QE is most critical (holding assets and lending cash by the ECB); and boosting asset prices via low rates, to help the market value of assets.
Sovereign Debt Crisis Gone, but the Euro Banks are Wobbly After a Decade of Poor Policy.

– While sovereign debt problems brought on by the lack of a fiscal union in 2012 clearly spilled across borders due to large bank exposures to these obligations—noted earlier—this is not the case now. The CDS spreads for sovereigns in Europe has continued, on average, to narrow since the Banking Union came into effect (see the pale blue bars)—the ECB is playing a big role here.

– But this has not stopped the extreme volatility in euro banks CDS from blowing out in 2016-17 and again in 2018. Two large German GSIBs seem always to be a factor in these moves (despite the stronger German economy). The situation in Europe is in strong contrast to GSIBs in the USA.

– The sell-off in 2016 was the result of continuing weak bank earnings, chaos in Deutsche Bank’s CoCos and the arbitrariness of resolution policy treatment of bond holders in Portugal.

– While sovereign debt spillovers may have been a motivation for the Banking Union, this doesn't appear to be the case now. The banking system is doing this all by itself.
Europe: GSIB Subordinated Debt & Sovereign Spreads

Basis Pts


EU SOV CDS  Santander
Unicredit  Deutsche
Soc Gen  Credit Ag
BNP  Sanpaolo
ING  Barclays
Commerz
Target 2 Balances: Will Germany Ever be Paid?

GER C/A surplus + Cap Inflows of those who want safe assets > GER D for foreign assets.

The gap is plugged by official financing (central bank claims and liabilities vis-à-vis each other).

This earns zero or negative returns.

What to do? Will GER be paid?

Same issue for the Swiss, but they aren't locked to the euro (so buy a matching foreign equities portfolio).

Fiscal root of the problem: GER & SWI don't issue enough gov. bonds to satisfy demand for safe assets (even for their own pension funds).
So: What Interest Rate Policy for the Fed?

- No central banks can normalize until China plays by the rules.
- Negative rates in EU & Japan is to make a contribution to servicing the high coupons on the assets they hold.
- QE pushes the exchange rate down.
- China’s debt & globalization approach = problem for everyone.
- The Fed doesn’t want to be on the wrong end of currency strategies, but the big problem is deflation and global excess capacity. If China can be brought back into being responsible, global deflation might disappear. Hardly likely though.
- That is the clue to the Fed’s next moves and when it can get back to the normalization process: when the global output gap becomes positive.
- Perhaps the coming China slowdown.
BREXIT: UK Hamstrung by Chaotic Euro Area

UK & Swiss Exports to EU 15 & to World
- SWI Goods EU15
- SWI Goods Other
- SWI Services Exp
- UK G&S Exp
- UK Goods Exp
- UK Goods EU14

% GDP

UK Joins EU
Single Mkt
China WTO

Brexit: Agglomerations & History (Rumours of the Death of London—again) (Forex)

OTC FOREX TURNOVER $bn Daily

- AUS
- FRA
- GER
- HK
- JAP
- SIN
- SWI
- UK
- USA
- NRL
- OTH

- 2,406
- 1,272
- 823
- 85
- 121
- 181
- 116
- 517
- 399
- 437

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Brexit: Agglomerations & History (Rumours of the Death of London—again) (OTC Int Rates)

OTC INT RATE DAILY T/ OVER $bn

- AUS
- FRA
- GER
- HK
- JAP
- SIN
- SWI
- UK
- USA
- NRL
- OTH

1,241

1,180

22
136
141
31
110
56
58
8

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Fintech—Rapid Pace on 3 Fronts

3 Fronts: (1) Fintech start-up companies: in a wide range of areas including, inter alia: data and analytics, lending, crowd funding, capital markets, blockchain, digital currencies and payments, wealthtech, insurance, personal finance management, middle and back office, Regtech, and Suptech. (2) Incumbent banks: with legacy mainframe and related software that needs to be changed in order to defend their businesses from what could prove to be major disruption. (3) The large technology companies (Bigtech):

US Companies: Amazon, which has AmazonPay for all merchants; and Amazon Lending for businesses that sell via Amazon using tech-based credit scores; Google, which has taken a stake in Lending Club—looking to leverage Google’s internet knowledge to service customers. Facebook, WhatsApp getting into the act.

Chinese are well in front of everyone else: Alibaba owns Ant Financial (which has AliPay—a payment app, Sesame —credit scoring biometrics; Zhou Cai Bao—P2P lending; Yu’e Bao—a money market fund; MyBank—online virtual bank; Huabei—credit wallet for shoppers to repay in 1 month after delivery; JieBei—mobile phone based lending). Tencent (owns WeChat with 980m messaging users, and has Weixin Pay with multi-function Apps for payments and financial services, and WeBank—an online bank offering MMFs, SME loans and micro credit). JD.com, and Baidu (search engine with Baidu Financial Service Group and Baidu Wallet).

These companies are developing global business ecosystems that include finance as an integral part, i.e. one-stop shops to buy things, sell things and to transfer funds. Ant Financial has just raised $14bn via note issues to develop blockchain technology for its insurance and payments businesses.
Forces Acting on the Financial Landscape

**BANK INCUMBENTS RESPONDING**
- Cash Flow Mature Businesses into New Products
- Build Own Technology Teams
- Acquire Promising Businesses-Portfolio Approach
- Venture Capital Equity Stakes
- Alliances: Sell Through Fintech Businesses

**FINTECH STARTUPS**
- Blockchain payments
- P2P, Crowd Funding
- Security Biometrics
- Mobile Payments & Billing
- Online Research Tools

**TECH CO. GIANTS**
- Amazon, Google
- Facebook/WhatsApp
- Alibaba, Ant Financial (Yu’e Bao), Baidu, JD.com
- Tencent; WeChat

**ENABLING TECHNOLOGY**
- Automation, Machine Learning, Artificial Intelligence, IoT
- Connected Devices, Cloud, Big Data

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**More Like Allies than Foes?**

- Prescriptive licencing
- KYC imposed & costly
- Low compet. High Switch Costs

- Central Intermediary preferred
  - (Offsite Back-up, Encryption)

- Baby Boomers
  - Poor awareness of tech

- Banks, Particularly in Europe
  - Still Struggling to raise Capital

- Sticky Customers
  - Poor Education & Awareness
  - Low sensitivity to fees

**Likely Main Threat to Banks**

- Lite-touch/Industry standards
- KYC digitalised
- Favourable competition laws e.g. PSD2

- New Architecture Needed
  - Blockchain Distributed Ledger

- Millennials Demography
  - Customer expectations changing

- Large Tech Raises Capital Easily
  - Fintech finds Bank & Large Tech Investors

- Bank Misconduct Perceived
  - High sensitivity to excess fees
  - Jump technologies esp. EMEs
  - High cost of bank legacy systems
  - Cash flow and investable capital
Is this Big Tech/Fintech S-curve Possible?

Big Tech and Start Ups partner up, invest to re-imagine finance.

Banks that can raise capital invest but legacy problems not overcome quickly enough. Mixed joint ventures with startups.

Banks that are unwilling or unable to raise capital to re-engineer their business models.

CASH FLOW

TIME
Regulatory Reform Leaves a Lot to be Desired

– The reform process in the West in Basel III leaves much to be desired following the fiasco of Basel II—recovery was based on central bank and taxpayer support.

– Banks have achieved holding the status quo on business models, with small concessions on regulations—& regulatory capture gaining strength under Trump. Risk can never be destroyed, but those holding it can be changed. Banks are in the process of doing this—risk is being shifted to shadow banking, pension funds and insurance companies.

– We now move towards the exit strategy, and then put it all on hold. Volatility will test the new regulatory nks & environment. Europe is far from this—due to NPLs and banking book rubbish. Holders of illiquid securities will be tested—search for yield is a super highway in but a goat track on the way out.
Regulatory Reform in Advanced Countries

– The BCBS reforms for Basel III in the 1st stage consisted introduced change: an improved the definition of capital; a capital conservation buffer; a Higher Loss Absorption Requirement for global systemically important banks (G-SIBs); a better framework for market risk, securitisation and counterparty credit risk; a Liquidity Coverage Ratio; and a Net Stable Funding Ratio.

– A final stage of Basel III reforms was published in December 2017:
  --Enhancing the standardised approach to credit risk;
  --Constraining the inputs to internal models;
  --A revision to the credit valuation adjustment (CVA) capital charge for derivatives;
  --A revised method for operational risk;
  --A leverage ratio buffer for GSIBs; and
  --Output floors when using internal models

– The G20, IOSCO and Dodd Frank collateral and derivative rules were added to the reform process.

– The Financial Stability Board organised the Total Loss Absorbing Capacity framework which formalises bail in mechanisms in the event of resolution.

– This new framework is to be tested in the regime change under way with the normalisation of monetary policy and any volatility that may accompany the process.
Some EU Banking Union Flaws

– The Single Resolution Fund (SRF) for the 19 countries is inadequate at present. It is to be built up with contributions from banks over a long period (2016-2023) to reach a target of 1% of deposits. On 1 July 2018 the SRF had accumulated 0.4%, or €24.9bn for $5.6tn of covered deposits. By contrast the FDIC Deposit Insurance ratio is currently at 1.3% of deposits, or $93bn of $7.3tn insured deposits, with a fiscal union to back it up if needed.

– To have access to the SRF in the event of resolution, the institution must have bailed in 8% of total liabilities before these limited funds can be tapped.

– This requires eligible bail in securities of sufficient scale. Hence the EU has introduced MREL (Minimum Requirements for own funds and Eligible Liabilities) which applies to all significant banks (not just GSIBs as with TLAC).

– In the BU the SRB has suggested this MREL should be at around double regulatory capital—say 25-27% of RWA, to be imposed on all significant institutions. This is much tougher than TLAC—and underlines just how much national governments don’t want to be on the hook for paying for other country’s banking problems.

– Resolution must be applied with a “no-creditor-worse-off” provision, which is there to prevent uncompensated risk transfer between different classes of creditors to the banks.
This is Where the Problems Start

- **MREL is set on a bank-by-bank** basis by supervisors (size, location, business models, etc. risking all kinds of moral hazard).

- There is **no general subordination requirement** for the instruments at this stage. Depending on what the criteria actually are, the EBA has estimated that there could be a €130bn-€285bn shortfall of eligible securities (in an end 2016 study).

- **An FSB survey** suggests that half of its members do not have legal administrative powers to impose losses on creditors or to convert bonds into equity—some in Europe.

- **To meet the “no-creditor-worse-off” criteria** requires a clear set of such rules and valuation methods—which requires, at minimum, that bail-in instruments are subordinated bonds that can be clearly identified contractually and which have well-defined trigger criteria—recognisable and priced by investors. This is not present in Europe.