

Reform Options of Financial Systems

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Credit systems, credit expansion and bubbles

- Deregulation of financial systems in the 1970s and 1980s
 - Deregulation of domestic and international financial systems
 - Increased importance of non-bank financial institutions
 - Breakdown of the segmented financial system (end of the Glass-Steagal-Act from the 1930s)
 - Shadow banking system and its financing
 - Increase of derivatives markets
 - Procyclical regulations
 - Bank based risk models (Basel II)
 - Fair Value Accounting
- A super bubble developed
- Key problem: central bank has no control over the credit expansion it finances

There good theoretical understanding of credit driven bubbles

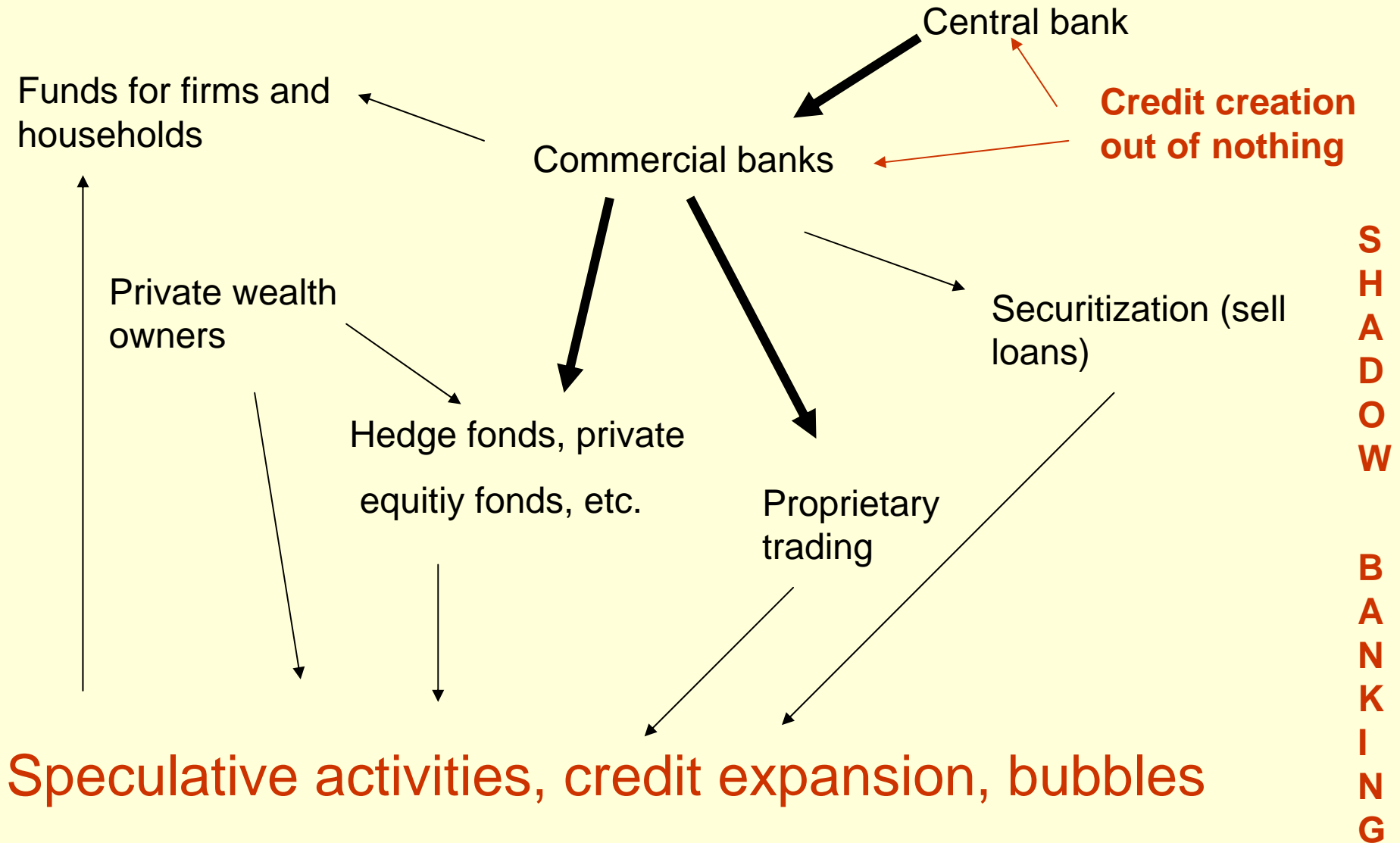
- Credit expansions and bubbles

for example Irving Fisher and Hyman Minsky

- Asset price deflations, financial market distortions and deflation

- Fisher- Minsky distorted financial systems and deflation
- Keynes wage deflation

Main features of the neoliberal credit expansion model



Indebtedness of economic sectors in percent of GDP

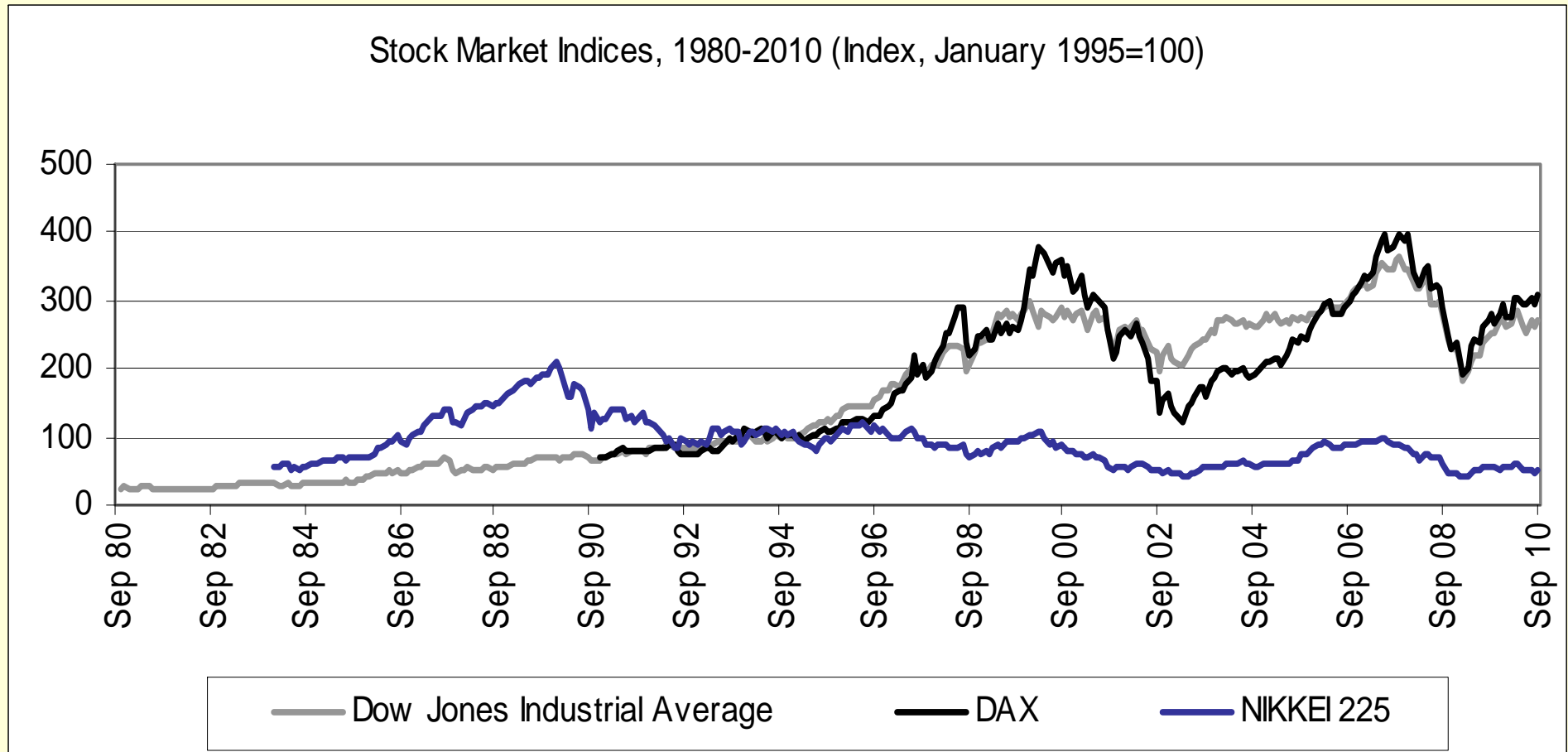
Yearly averages in business cycles in per cent

	<i>Business Cycles</i>	1971-75	1976-82	1983-91	1992-01	2002-09
USA	<i>General Government</i>	46.5	44.7	59.5	66.2	64.8
	<i>Non-financial Business</i>	75.4	93.2	106.0	109.0	125.2
	<i>Private Households & NGOs</i>	46.8	49.8	59.0	69.8	94.8
	<i>Business Cycles</i>	1971-75	1976-81	1982-91¹	1992-02	2003-09
UK	<i>General Government</i>	66.7	55.7	45.1	44.4	47.1
	<i>Non-financial Business</i>	—	—	199.5	243.9	258.5
	<i>Private Households & NGOs</i>	—	—	70.0	74.7	103.1
	<i>Business Cycles</i>	1971-75	1976-82	1983-93²	1994-03	2004-09
GER	<i>General Government</i>	19.2	29.8	40.6	58.5	67.5
	<i>Non-financial Business³</i>	—	—	111.9	149.3	167.1
	<i>Private Households & NGOs³</i>	—	—	55.5	69.0	66.3
	<i>Business Cycles</i>	1971-74	1975-86	1987-93	1994-99	2000-09
Japan	<i>General Government</i>	15.5	50.7	71.5	106.4	173.4
	<i>Non-financial Business</i>	168.9	196.0	312.1	282.1	262.4
	<i>Private Households & NGOs</i>	41.5	55.2	74.9	84.7	81.7

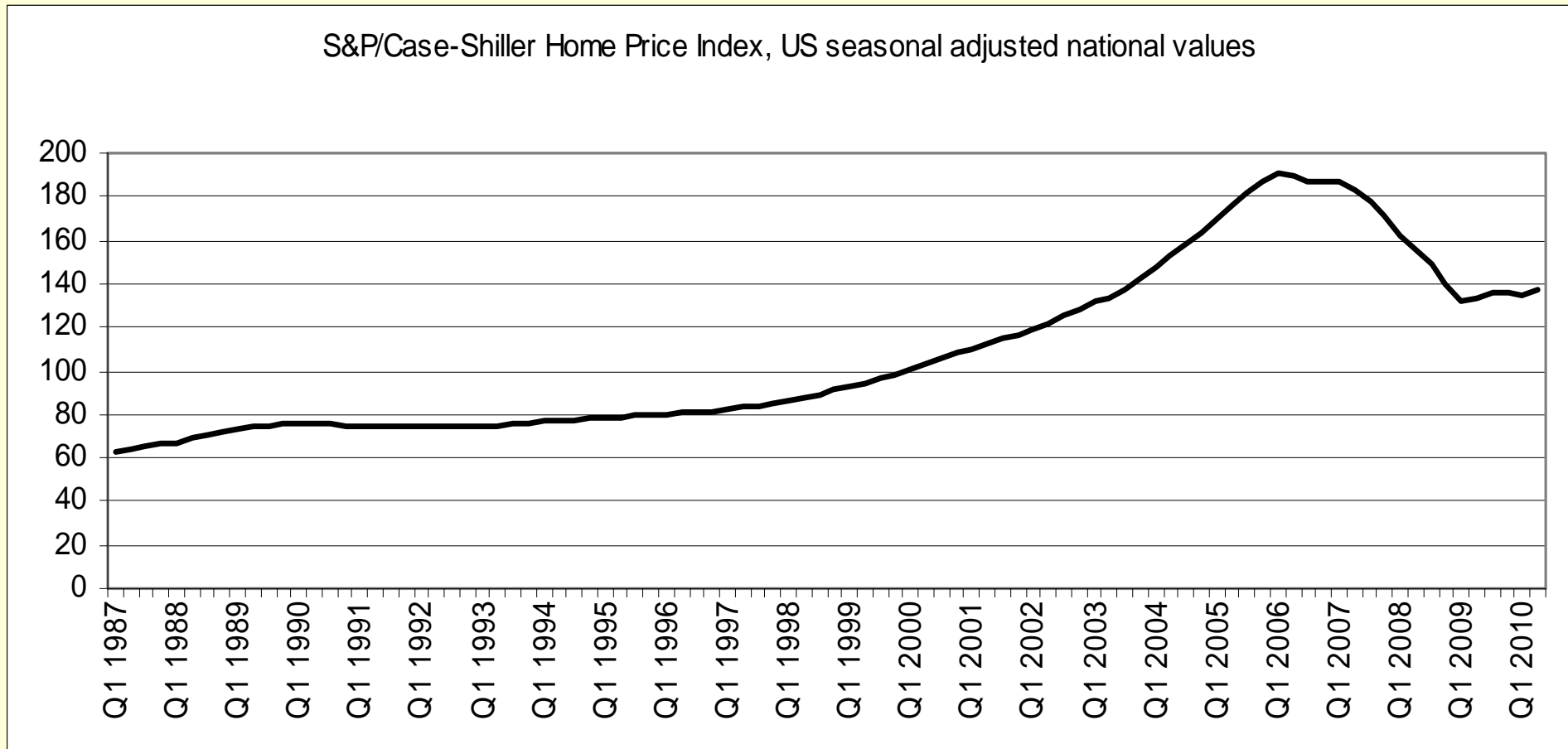
¹ Averages for non-financial business and private households & NGOs only refer to data from 1987-91. ² Averages for non-financial business and private households & NGOs only refer to data from 1991-93. ³ Data on indebtedness for the years 1991-2008 refers to the fourth quarter of each year, for 2009 to the third quarter.

Source: AMECO 2010, Fed Flow of Funds Accounts database 2010, UK Office for National Statistics Economic Accounts database 2010, Deutsche Bundesbank time series database 2010, BoJ Flow of Funds database 2010.

Stock market bubbles

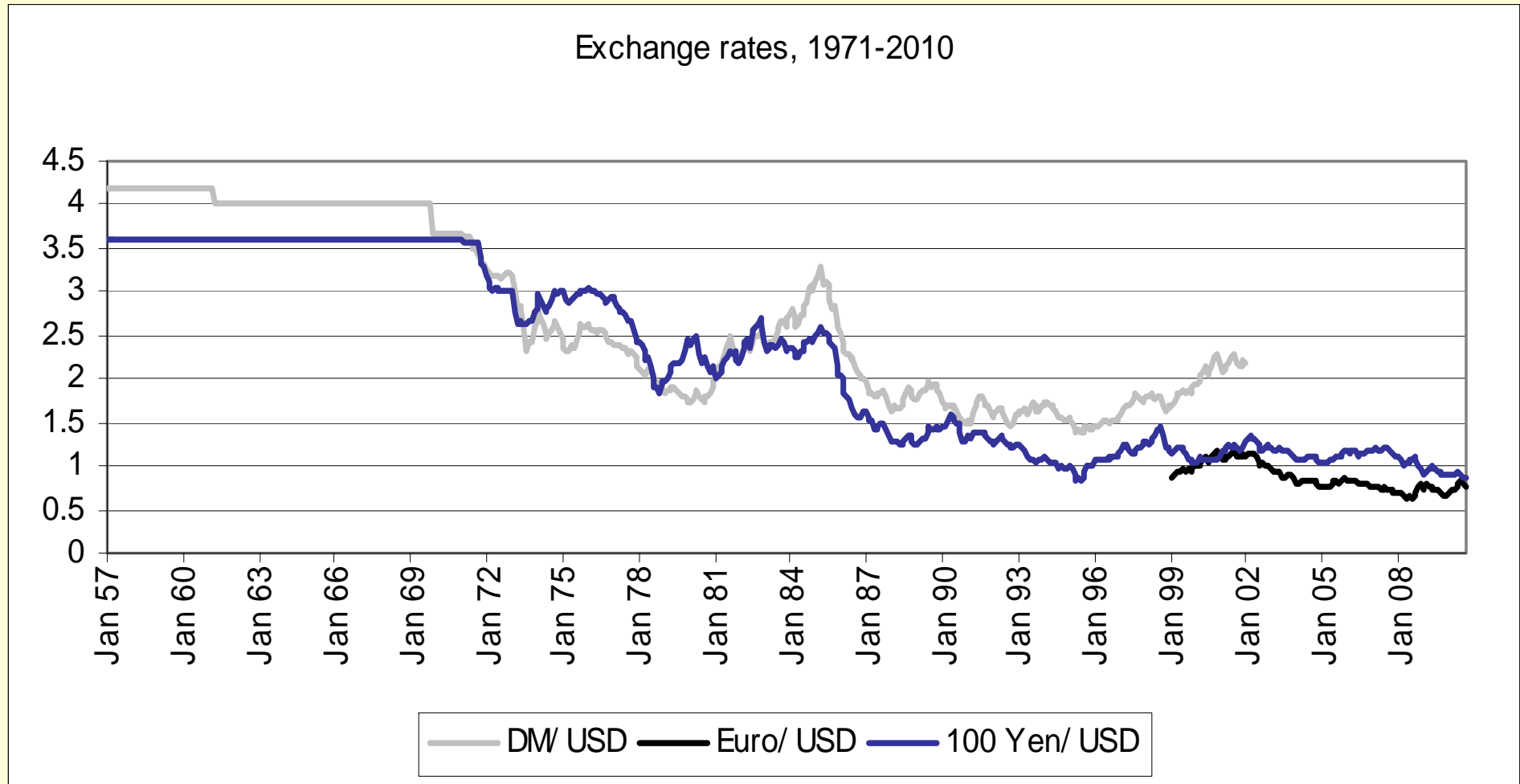


Real estate prices in the USA



Source: S&P/Case-Shiller Home Price Indices, U.S. National values, seasonally adjusted

Exchange rate volatility

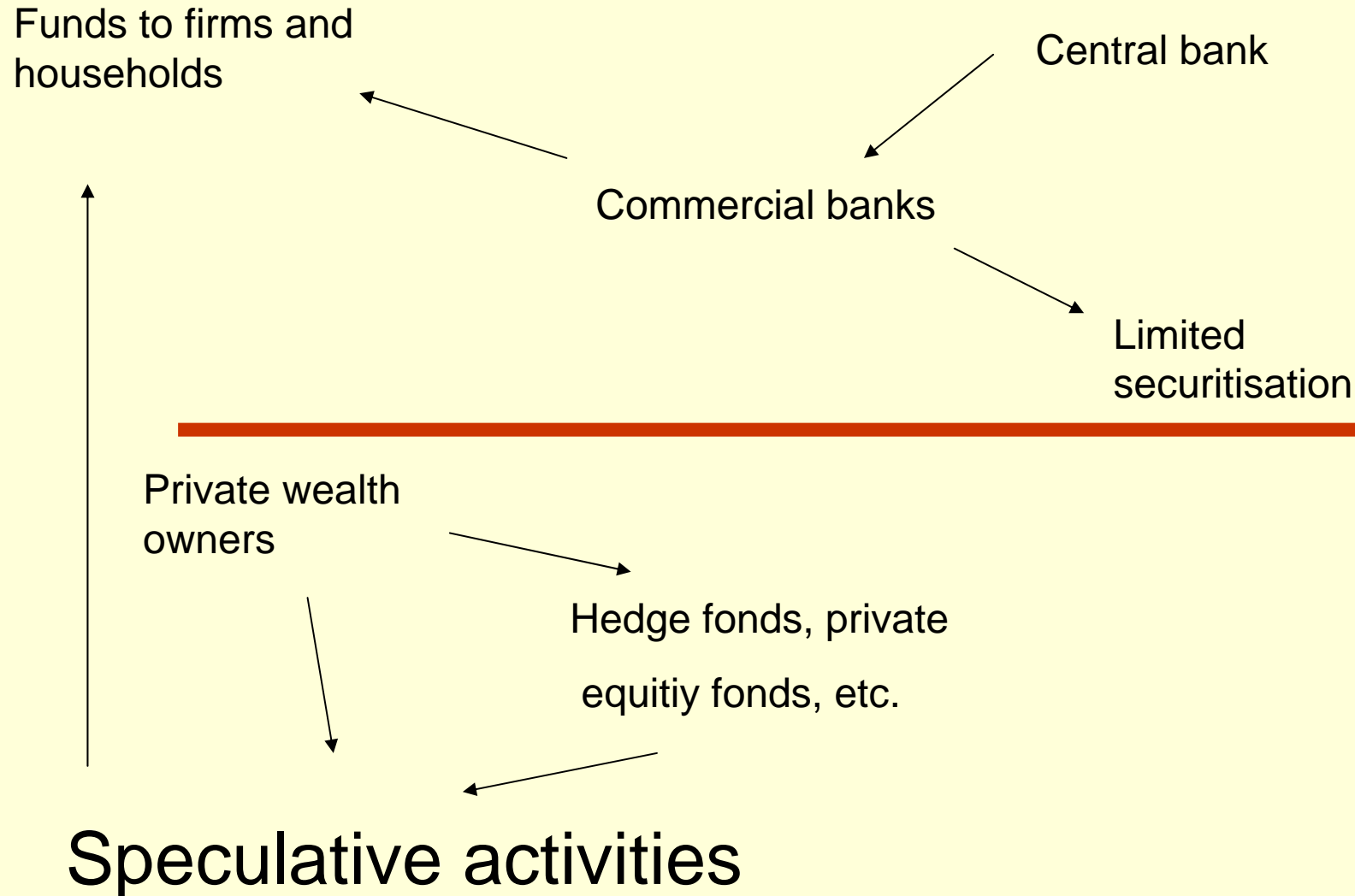


Source: IMF International Financial Statistics, Fed of St. Louis Federal Reserve Economic Data

Basic structures of a reformed financial system

- Main point: Control over credit creation by commercial banks financed by the central bank
 - No credit relations between commercial banks and non-bank financial institutions
 - No proprietary trading by commercial banks
 - Commercial banks are not allowed to own non-bank financial institutions
 - Banks have to keep bigger part of their granted loans in their own books
 - Central bank control of credit allocation
 - Real estate financing a special segment of financial markets
 - Control of consumption credits
 - Different equity holdings for different types of credits
- Additional points
 - Higher equity holding of commercial banks
 - Control of all financial institutions
 - Control of rating agencies
 - Derivatives
 - Standardization and approval by supervising authorities
 - Only organized markets
- Give central banks more instruments
 - Not only the interest rate
 - Influence credit allocation
 - Control of international capital flows

Main Features of a reformed financial system



A more radical version of financial system

- Direct credit quantity control of credits by central banks
 - Central banks control directly the loans granted by commercial banks
 - Credit ceilings
 - Window guidance
 - Central banks controls the credit allocation by changing reserve requirements, etc.
- Deposits and lending rates are fixed by central bank

Actual reform options

- Obama and EU plans
 - reduce proprietary trading
 - no ownership of non-bank financial institutions by commercial banks
- But: Credit relationship between commercial banks and non-bank financial institutions are not restricted
- Higher equity holding by commercial banks is positive but not sufficient (Basel III, Group of Governors and Heads of Supervision)
- Shadow banking system ins not sufficiently controlled
- Derivatives: no standardization and approval by supervising authorities

Thank you for your attention!