Prof. Dr. Hansjörg Herr, Berlin School of Economics and Law

Hansjörg Herr is professor for Supranational Integration at the Berlin School of Economics and Law and at his university the economic director for the MA Labour Policies and Globalisation of the Global Labour University

Prof. Dr. Rainer Stachuletz, State Bank of Vietnam

Rainer Stachuletz is professor for Finance at the Berlin School of Economics and Law. Currently he is working as a consultant of the State Bank of Vietnam at the Banking Academy in Hanoi.

Reform options of Financial Systems

The neoliberal globalisation project gained speed in the late 1970s through market-radical policies in the United Kingdom and the United States. Domestic and international financial systems have been increasingly liberalised and deregulated with the following important results:

a) Integration of financial systems

The deeper integration of international financial markets resulting from the deregulation of capital flows together with the switch to flexible exchange rates after the breakdown of the Bretton Woods System created a new source of shocks and uncertainty and a new field of speculation.

b) An increasing role of non-bank financial institutions

Non-bank financial institutions like investment banks, hedge funds, private equity funds, etc. became important players. These institutions usually have a speculative orientation, look for high short-term returns and work partly with extreme leverages. Due to a naïve liberalization beginning in the Anglo-Saxon countries, the previously existing borderlines between commercial banks and non-bank financial institutions blurred. In countries with universal banking systems non-bank financial institutions, which had been unimportant or even non-existent, started to play a bigger role. Non-bank financial institutions did not only use their own huge funds for their speculative activities; moreover they tapped the commercial banking system to mobilise additional funds for diverse investments in- and outside the financial markets. Thus commercial banks became automatically more exposed to extreme kinds of risk. In addition, once sheltered segments of the financial market like the real estate sector had become fully integrated in national and international financial markets.

c) Development of a shadow financial system

A shadow financial system with a low level or no regulation flourished and became an important part of the financial system. Most non-bank financial institutions are located in this shadow financial system. Low regulated offshore centres became international financial centres providing tax evasion, money laundering and other internationally organized criminal activities.

d) Securitisation, financial innovation and derivatives

Securitisation exploded after the 1970s and led to a bulk of new derivatives: Firms and financial institutions preferred to hold short-term marketable papers instead of bank deposits; economic units of all types issued a growing variety of debt securities to get funds; banks sold their rearranged credit portfolios to non-bank financial institutions and rating agencies, a cartel of three private firms without any legally binding mandate and any government supervision were put in a ridiculous dual position: first they were consulting how to design those credit derivatives, then taking the function of even evaluating their quality thereby decisively determining their cost of capital.

Derivatives originally are to reduce price related risks of financial instruments e.g. changing asset prices, the price of foreign currencies or changing interest rates. The pricing of those derivatives is relatively transparent, the derivatives are marketable. Default risks and other qualitative risks (weather, temperature, natural disasters) are evidently hard to price, thus less tradable and unlikely to be manageable by derivative instruments. Nevertheless those products – hardly to standardize or even to value – were developed and actively traded on less regulated Over the Counter (OTC) markets.

The fundamental problem with risk markets is that these help to reduce the risk of one trading partner, but will increase the risk of others. Risk will not disappear by trade but differently allocated. As in many cases, frequently both contract partners where speculators, the market transformed finally into a big casino where governments and tax-payers became unquestioned the guarantors. For example, due to moral hazard and political ignorance the market for credit risk derivatives exploded with the known disastrous consequences.

Kommentar [W1]: Be specific. The other trading partner can then go and ofset that risk through another trade.

e) Central banks and supervisors became toothless

Given the new confusing and uncontrollable complexity created by unleashed market players, central banks in the new financial system became harmless onlookers. In fact the interest rate remained as their only tool to control price level changes, asset price bubbles, exchange rate movements and GDP growth. By this they were confronted with the dilemma to stop stock market and real estate bubbles without bringing the real economy into a sharp recession or to stimulate the economy without the risk of goods market inflation and overheating. Whatever central banks are doing, evidently any case of credit expansion or contraction policy triggered by them cannot be guided to productive purposes as they have no instruments to influence credit allocation. Due to unstable international capital flows monetary policy in many historical episodes had to follow the primacy of external stabilisation and could not follow domestic needs.

As a consequence, asset price bubbles in all asset markets with partly disastrous economic consequences have become more frequent and much graver – e.g. the real estate and stock market bubble in Japan in the second half of the 1990s, the internet bubble in most western countries in the late 1990s, the real estate and stock market bubble in the 2000s which led to the outbreak of the "subprime crisis" in 2007. At the same time exchange rate volatility and increasing current account imbalances added to the instability of financial markets.

Frequently price bubbles went along with credit expansion, in many cases not financing real activities. The general picture is that indebtedness partially increased in an extreme way. For example, private household's debt in percent of GDP in the US increased from below 50 per cent in the 1970s to over 100 per cent in the end 2000s, enterprise's debt increased in the same period from around 75 per cent to over 125 per cent. UK household's debt is now over 100 per cent of GDP, enterprise's debt over 250 per cent. [1] Also government's debt to GDP in many countries increased sharply over the last decades.

The deregulation of financial systems starting in the 1970s produced an unsustainable credit expansion for almost all sectors in many countries and a general layering of debts. Bubbles, unsustainable credit expansions, international exchange rate turbulences and growing current account imbalances indicate a more and more fragile financial system. Even the current crisis could be overcome, without fundamental changes a new bubble with probably even more disastrous consequences will necessarily develop.

As a fundamental reform option we favour a financial system in the tradition of the Glass-Steagall Act and the original Volker Plan. These plans were much more radical than the watered-down legislation which were passed in the US in July 2010.

How could a blueprint of a stable financial system which serves economic development look like?

The financial system should be divided into banks and non-bank financial institutions. Such a regulation implies a distinctive wall between banks, being the major source of finance for the firms, and more risk-oriented and even speculative non-bank financial institutions.

[1] Fed, Flow of Funds Accounts Database 2010; UK Office for National Statistics Economic Accounts Database 2010.

Commercial banks are then forbidden to engage in proprietary trading, e.g. speculating with own or borrowed money; they are not allowed to own investment banks, hedge funds or private equity funds and even not allowed to give credit to those institutions and other non-banks. If the latter want to get funds for their businesses they are forced to attract money held by households. These funds will create sufficient risk capital for start-ups and risky innovations which are not financed by commercial banks. Financial or any other business relations to institutions outside the regulated financial systems (e.g. offshore) are strictly banned.

The allocation of loans originated by banks should be regulated by the central banks. Loans to the real estate sector can be as well quantitatively restricted as consumption credits. Equity holdings for such credits could be discretionary changed by monetary authorities. This would allow anti-cyclical equity holding in contrast to Basel II which leads to unwanted pro-cyclical effects.

Real estate financing and large parts of the private equity industry (e.g. leveraged buy out projects) with their special social and finally also financial dimensions could be considered a special case and permitted only to specialised and state licensed institutions. The real estate market can be made a special segment with regulated credit relationships to the rest of the financial system.

Banks in a naively liberalized environment are triggered to follow aggressive and risky business strategies to defend or increase their market share. To bring the cop back to the beat, in a regulated financial system competition among commercial banks could be limited by fixing for example real deposit rates of commercial banks. Also ceilings for interest rates could be given by central banks. In a very highly regulated system the central bank could even fix interest rates and at the same time the quantity of credits the banks are allowed to give. Such a system would ration the credit volume, but credit rationing part of all financial systems. The advantage of such a regulated credit rationing system is that restrictive monetary policy can be implemented without increasing interest rates.

Derivatives should be sold and bought only in regulated and controlled markets. Strictly controlled position limits shall exclude speculative attacks. Only certain standardized and by a supervision agency checked products should be allowed and only certain agents with licences should take part in the market (for example the future market for oil). Securitisation of credits to a certain extent should be possible. If the originator of a loan is forced to keep a substantial part of the loan in its books and derivatives are standardized securitisation is harmless.

Last not least such a system needs international capital controls to give central banks instruments to control unstable international capital flows. Current account imbalances should be kept small. The debates during the Bretton Woods negotiations in the 1940s could be a starting point for the development of such a system.

A financial system outlined above is not imaginary. It existed in the US as well as in most other industrial countries after World War II. Even comprehensively regulated systems existed and partially still exist in different versions in all East Asian miracle countries (Japan, South Korea, Malaysia, Taiwan, etc.) after World War II. The Chinese financial system after 1978 also fits to such a system. Financial systems in these countries offered sufficient and cheap credit for the enterprise sector and thus stimulated growth and employment without financial market instability.

For many the above blueprint of a reformed financial system seems to be politically not enforceable. In the present situation this is correct. However, the fragility of the financial system will continue. History may create a window of opportunity for a change. If such an opportunity comes it should be known what to do.

Further Readings:

S. Dullien, H. Herr, EU Financial Market Reform. International Policy Analysis 2010, Friedrich Ebert Foundation, http://library.fes.de/pdf-files/id/ipa/07242.pdf

C.A.E. Goodhart, The Regulatory Response to the Financial Crisis, Cheltenham 2009

J.M. Keynes, J.M, Proposal for an International Clearing Union (1941), in: The Collected Writings of John Maynard Keynes, Volume XXV, Activities 1940-1944, London 1980, pp. 42-66

H. Herr, R. Stachuletz, Die Immobilien-Bubble – Makro- und mikroökonomische Entstehungsmuster nachhaltiger Instabilitäten und Wege aus der Krise. In: M. Kühnberger, M. Wilke (Hrsg.), Immobilienbewertung: Methoden und Probleme in Rechnungswesen, Besteuerung und Finanzwirtschaft. Stuttgart 2010, S. 365-394.

S. Dullien, H. Herr, C. Kellermann, Der gute Kapitalismus – und was sich dafür nach der Krise ändern müsste, Bielefeld 2009.