UNFINISHED BUSINESS

“Both original and persuasive, this book demonstrates that we still have important lessons to learn from this devastating crisis.”

MARTIN WOLF
Anatomy of the North Atlantic Financial Crisis
Growing Fragility of European Banking

- ’86 Single Market Act Solidified Universal Banking
- ’92 Maastricht Treaty Enshrined Regulatory Competition
- ’96 Market Risk Amendment Allowed Lower Capital Buffers
- Led to Growing Fragility in Northern European Banks
Structure of Euro Area Banking

Lightly Capitalized Core Universal Banks
Deutsche, BNP Paribas, Credit Agricole, ING
Societe Generale, Commerzbank, Dexia, Natixis

Better Capitalized Periphery Commercial Banks
Unicredit, Santander, Intesa, BBVA

Loans
Mega-Banks Expanded Unsustainably
(Euro area bank assets as a ratio to GDP)
Large Universal European Banks Exploited Internal Risk Models and Became More Fragile

**1996**
- Simple Leverage Ratio: Book equity/Total Assets
- Basel Ratio: Tier 1 Capital/Risk Weighted Assets

**2008**
- Simple Leverage Ratio: Book equity/Total Assets
- Basel Ratio: Tier 1 Capital/Risk Weighted Assets
Growing Fragility of US Investment Banking

• Commercial Banks Better Regulated than Investment Banks

• Inflation & Deposit Caps Sent Deposits to Shadow Banking

• Securitization Followed, Driven by Regulatory Arbitrage

• US Banking Undermined by Shadow/Investment Banks
Structure of US Banking in 2002

Lightly Capitalized US Investment Banks
Morgan Stanley, Goldman Sachs, Lehman Brothers, Merrill Lynch, Bear Sterns

GSE Mortgages

Strongly Capitalized Commercial Banks
Citi, JP Morgan, Bank of America, Wells Fargo, Wachovia, Bank One Corporation, FleetBoston Financial Corporation, U.S. Bancorp
Banks Sold Most Mortgages To Markets by 2002
(Assets as a percent of US GDP)

Source: US Flow of Funds
2003 SEC Decision on Repo Collateral

• ’03 Decision Widened Collateral in Two Important Ways

• Mortgage-Based Securities, Boosted Private Securitizations

• Safe Foreign Paper, Drove North Atlantic Financial Drift

• Destabilized US Securitization and Linked Europe and US
Private Mortgage Securities Surged After 2003
(Assets as a percent of US GDP)
Core Euro Area Banks Expanded Rapidly Overseas
(Assets and Liabilities as a percent of GDP)

Source: Bank for International Settlements
The North Atlantic Financial Boom

Lightly Capitalized U.S. Investment Banks

Well Capitalized United States Commercial Banks

Cross Atlantic Drift

repos

Mortgage Assets

Lightly Capitalized Euro Area Core Universal Banks

Loans

Euro Area Periphery Commercial Banks
Misdiagnosing The North Atlantic Economy
The Efficient Markets Hypothesis

• The Efficient Markets Hypothesis Undermined Economy by:

• Allowing Internal Risk Models to be Used for Capital Buffers

• Blinding Policy Makers to Domestic Financial Risks

• Macro Models had No Meaningful Financial Sector
The Great Moderation

- The Great Moderation Undermined the Economy by:
  - Deluding Central Banks About Power of Monetary Policy
  - Reducing Belief in Value of Domestic Policy Coordination
  - Macroeconomics Became Monetary Economics
Benign Neglect

- Belief in Small international Spillovers Undermined Economy by:
  - Creating a Flawed Euro Area Architecture
  - Diminishing Belief in Value of International Cooperation
  - Macro Models Had No Meaningful Spillovers
Costs of Global Crises Rose With Capital Mobility (Ratio to Global GDP)

Source: World Economic Outlook
Crisis Involved Debt Flows, Not Equity (Ratio to Global GDP)

Source: IMF WEO and IFS
Flawed Euro Architecture

• French and Germans Had Vary Different Ideas on Euro

• French: A Means to Economic Integration So Need Bailouts

• Germans: Only After Integration So NO Need For Bailouts

• Got French Early EMU With German No Bailout Clause
Completing The Cure
• US Investment Banks Under (Tougher) Banking Regulation

• Euro Area Banks Under Higher Capital Rations but...

• Euro Area Banks Still Use Internal Risk Models Extensively...

• US is dialing back on some capital requirements
Euro Area Architecture

• Major Banks Under ECB Supervision but...

• Bank Bail-Outs Still Basically National

• Financial Support for Countries in Crisis but Access Difficult

• Need to Complete Banking Union and Make Support Easier
Consumer Credit: Asset-Backed Security Stock
(Ratio to GDP)
“Both original and persuasive, this book demonstrates that we still have important lessons to learn from this devastating crisis.”

MARTIN WOLF