

UNFINISHED BUSINESS

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

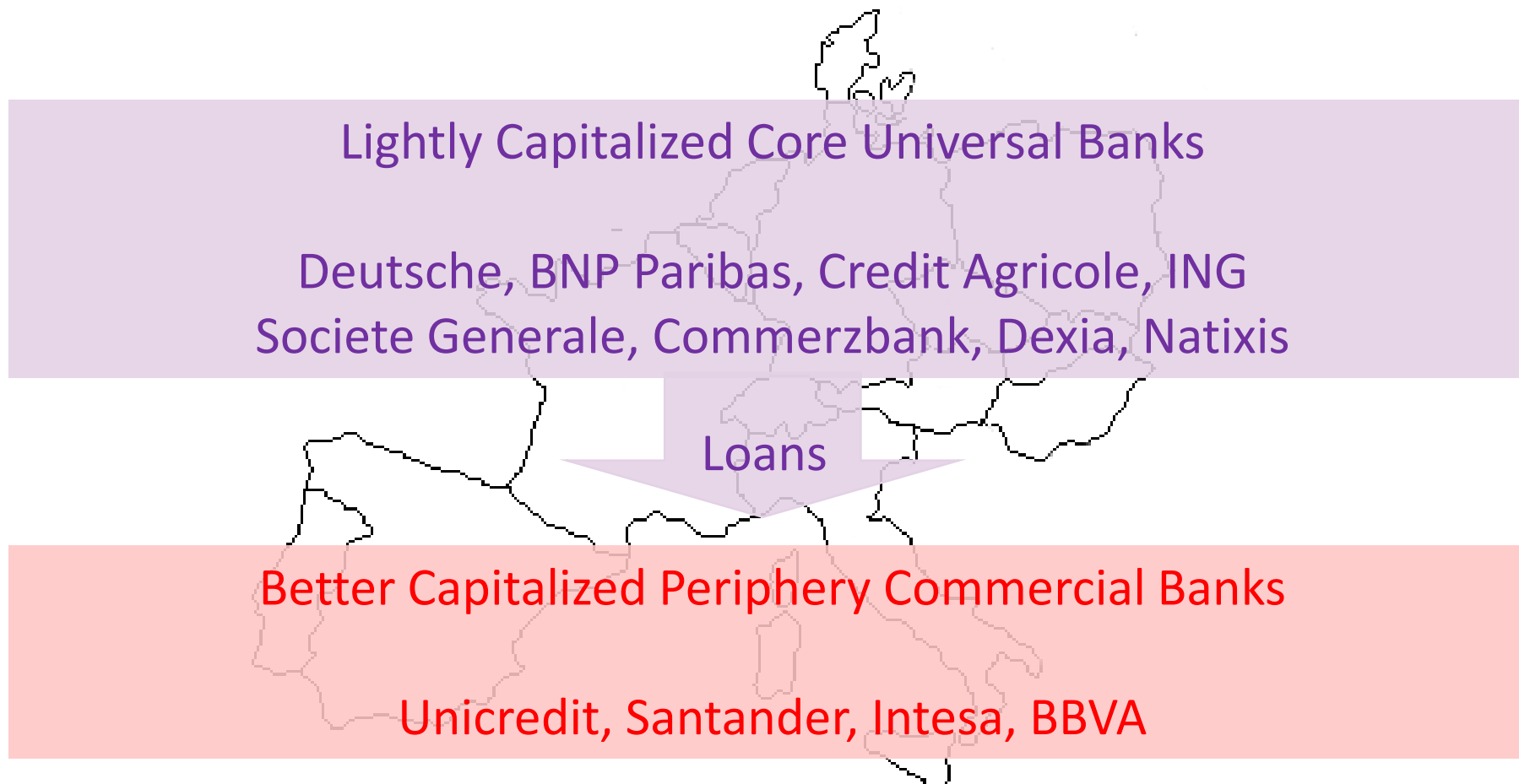
MARTIN WOLF

Anatomy of the North Atlantic Financial Crisis

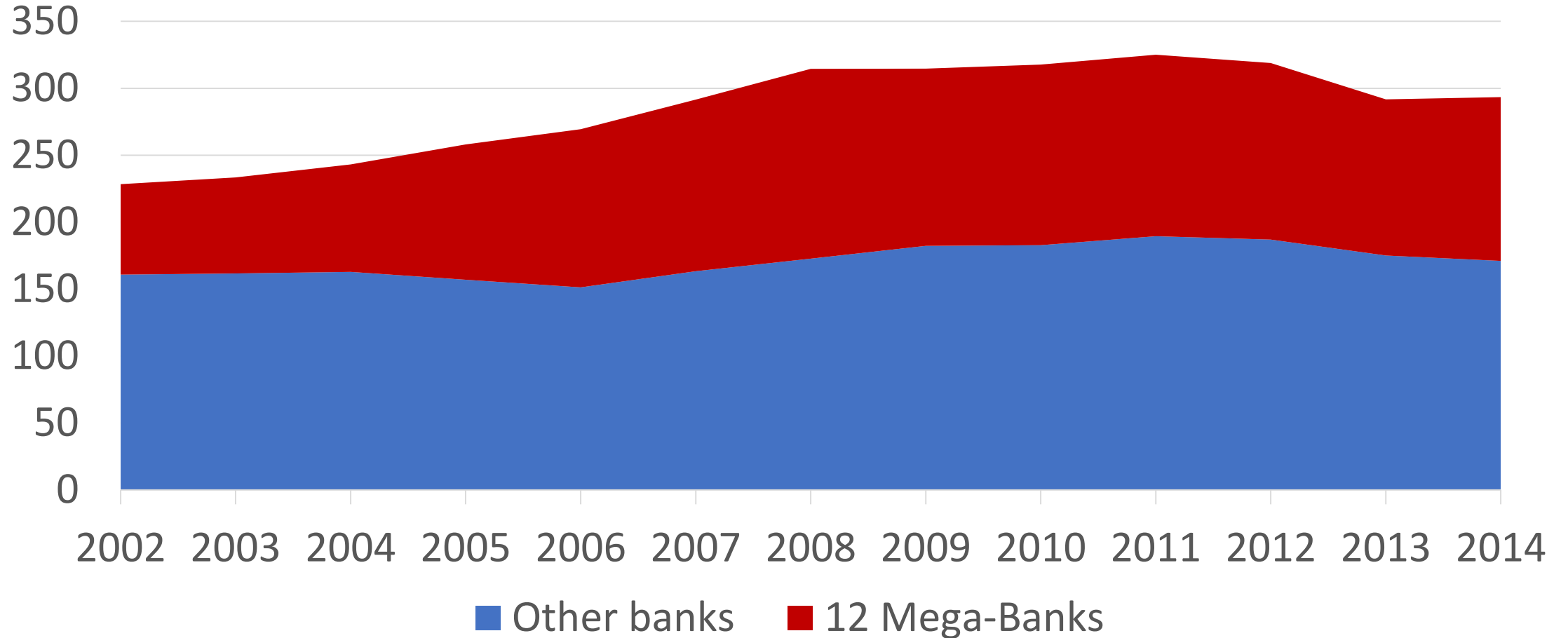
Growing Fragility of European Banking

- **'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**

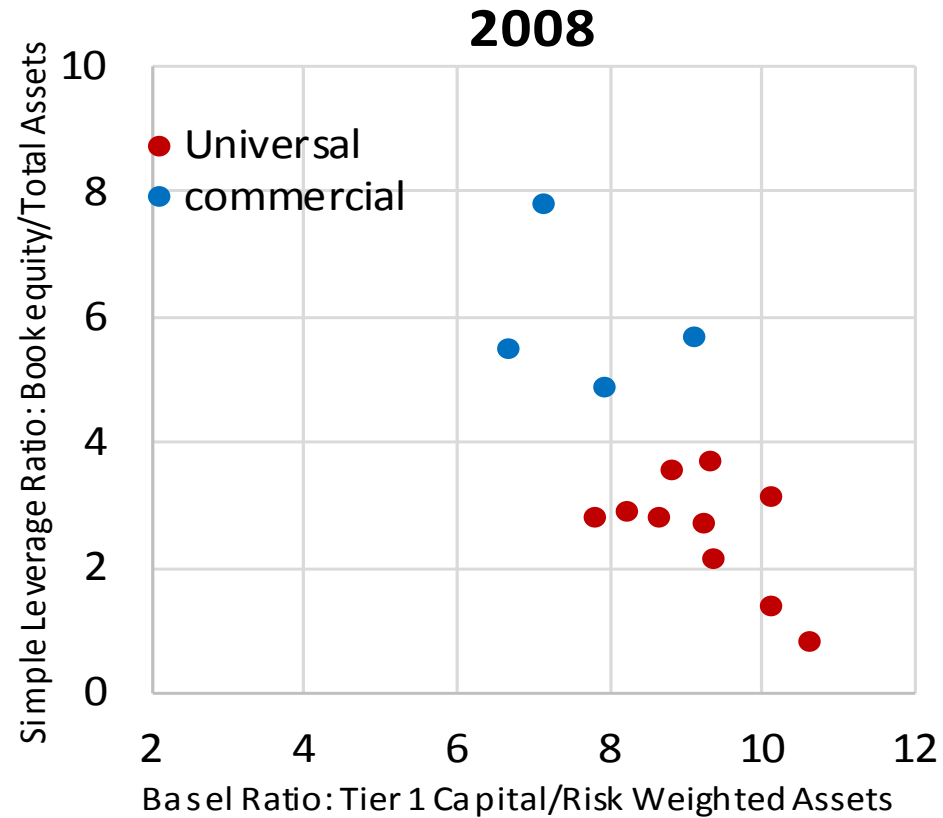
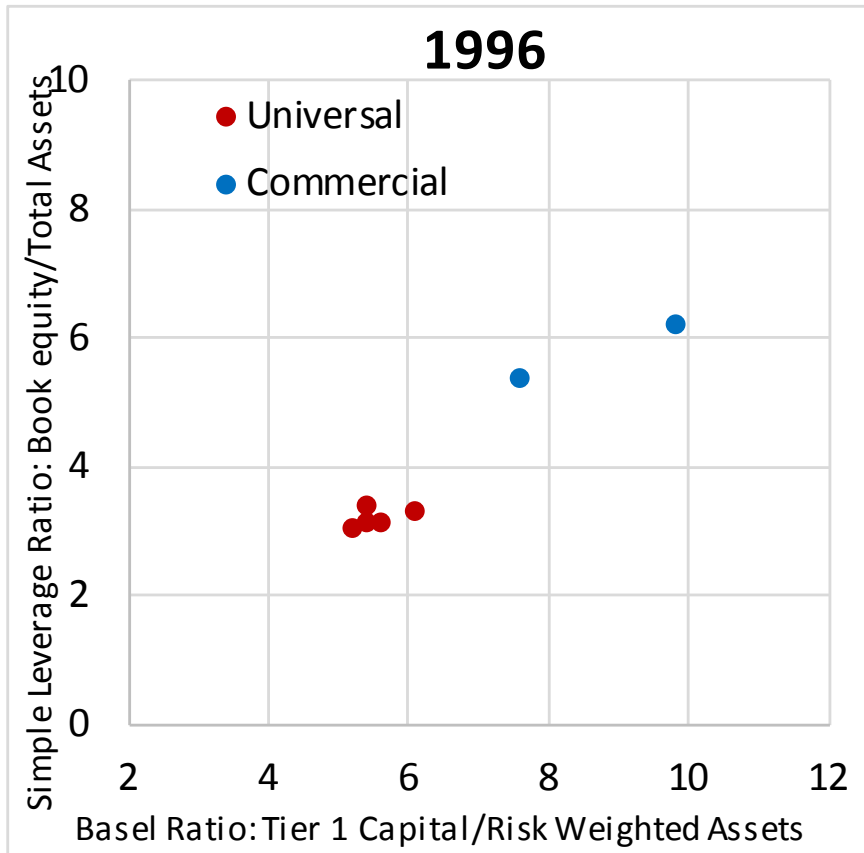
Structure of Euro Area Banking



Mega-Banks Expanded Unsustainably (Euro area bank assets as a ratio to GDP)



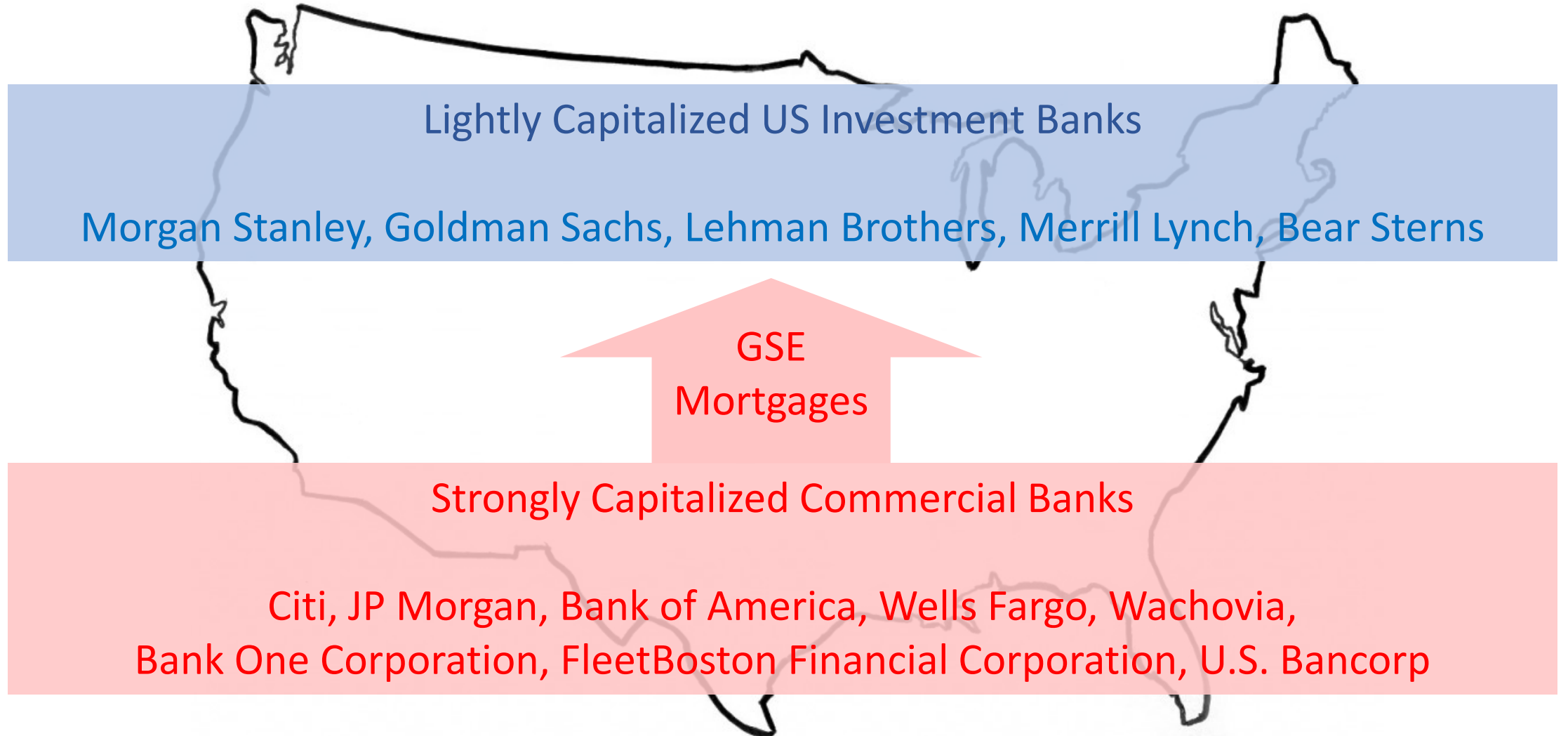
Large Universal European Banks Exploited Internal Risk Models and Became More Fragile



Growing Fragility of US Investment Banking

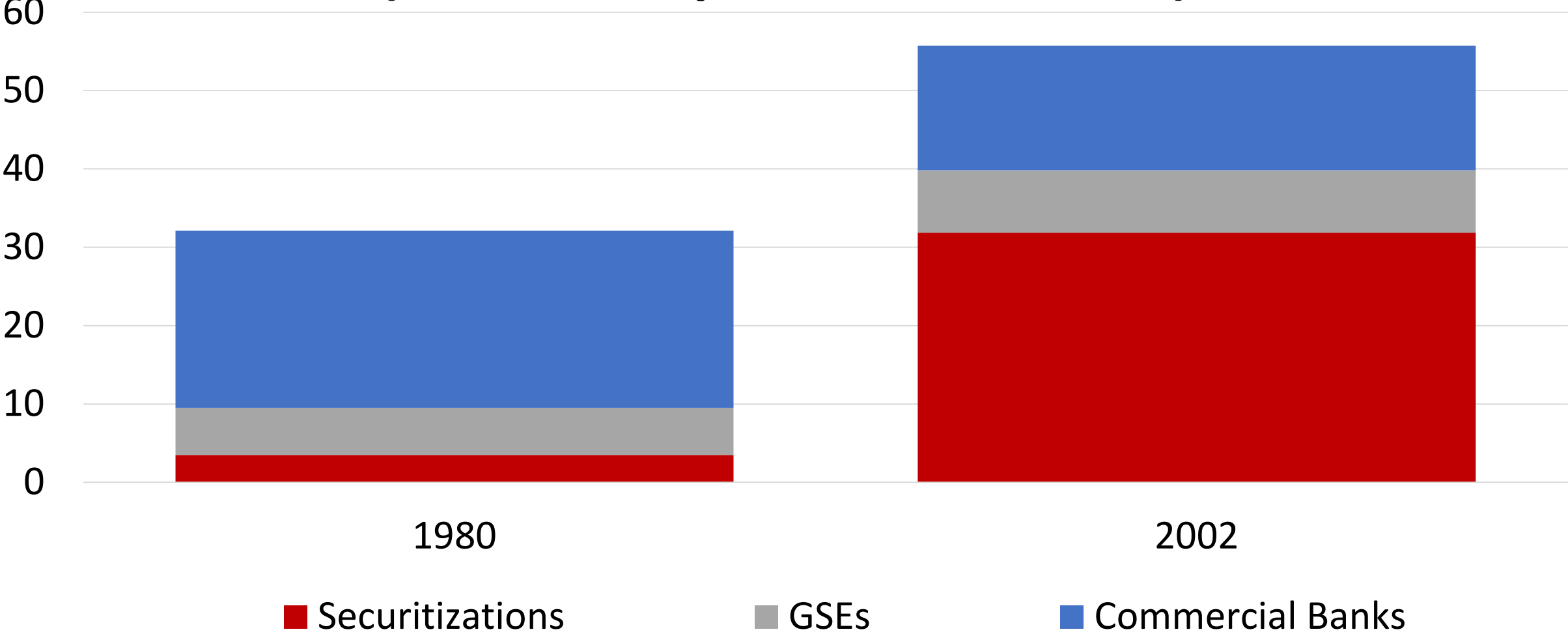
- Commercial Banks Better Regulated than Investment Banks**
- Inflation & Deposit Caps Sent Deposits to Shadow Banking**
- Securitization Followed, Driven by Regulatory Arbitrage**
- US Banking Undermined by Shadow/Investment Banks**

Structure of US Banking in 2002



Banks Sold Most Mortgages To Markets by 2002

(Assets as a percent of US GDP)



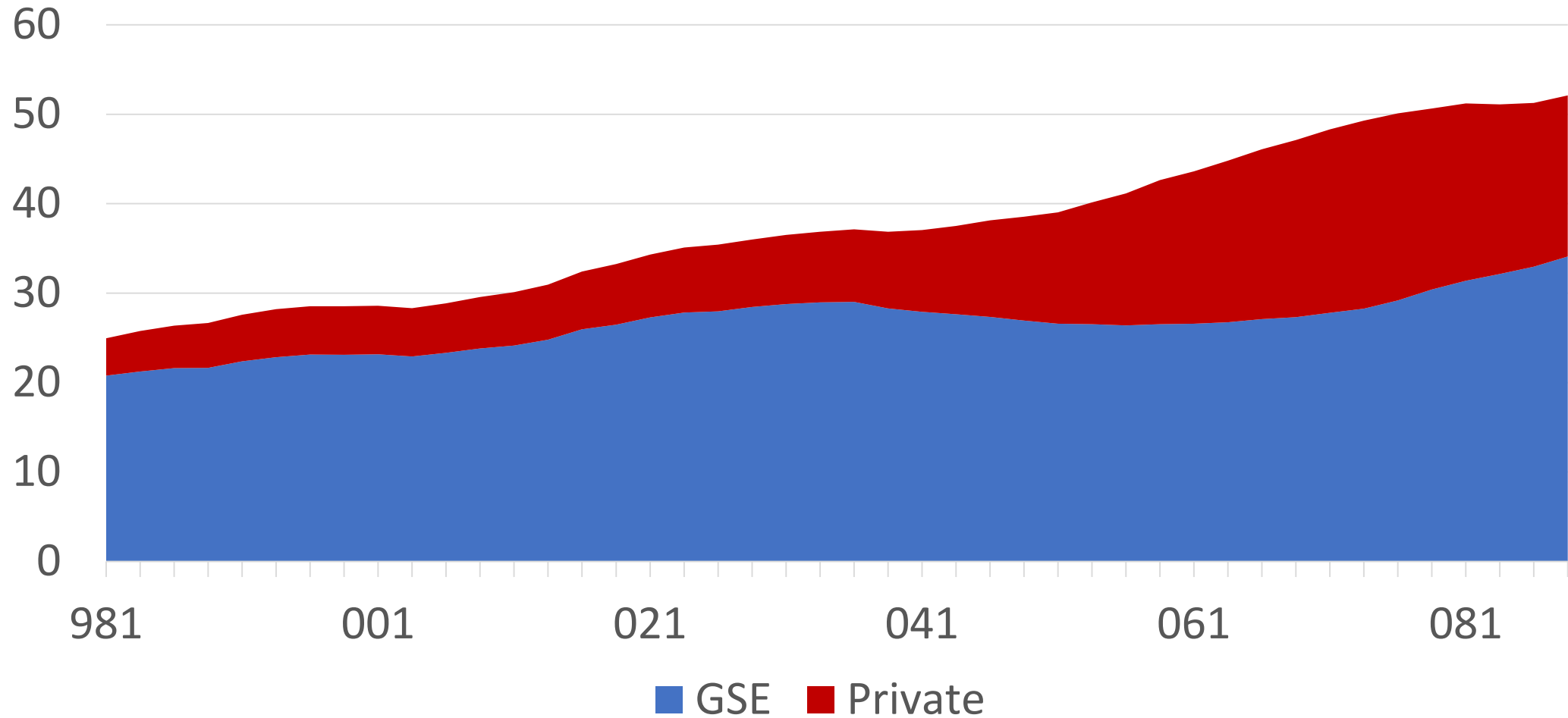
Source: US Flow of Funds

2003 SEC Decision on Repo Collateral

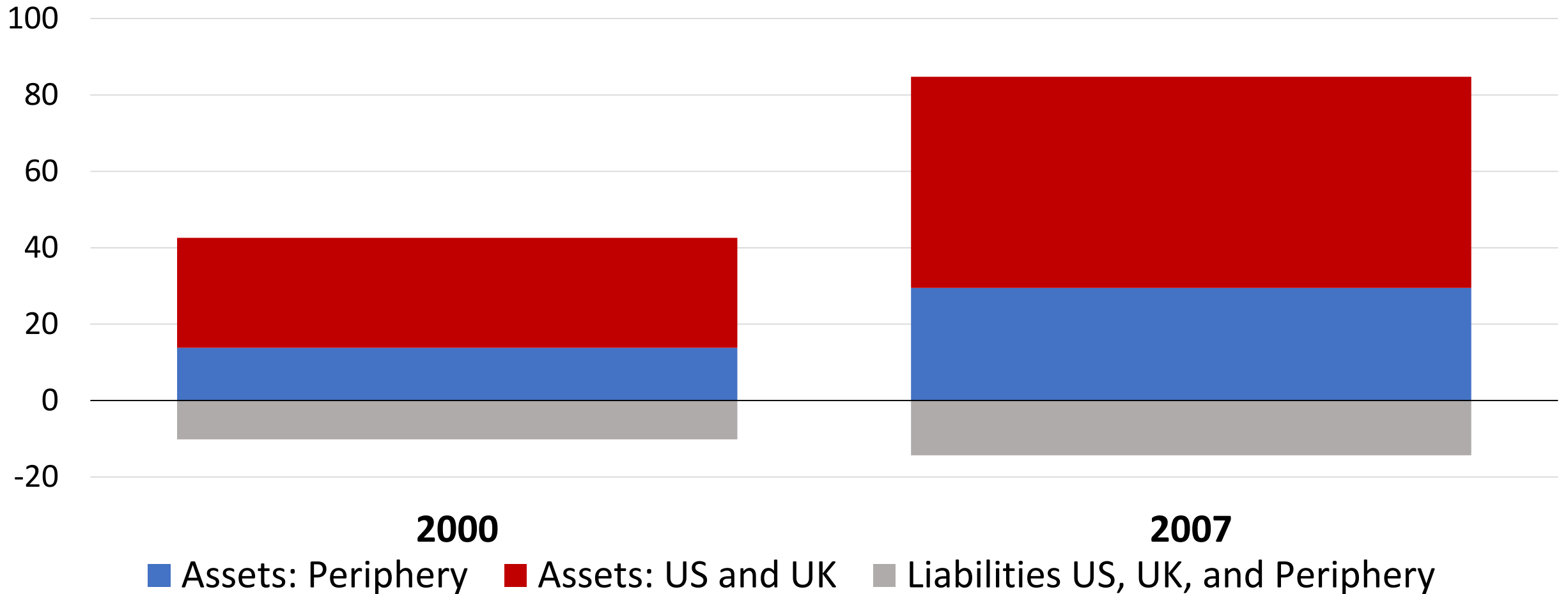
- **'03 Decision Widened Collateral in Two Important Ways**
- **Mortgage-Based Securities, Boosted Private Securitizations**
- **Safe Foreign Paper, Drove North Atlantic Financial Drift**
- **Destabilized US Securitization and Linked Europe and US**

Private Mortgage Securities Surged After 2003

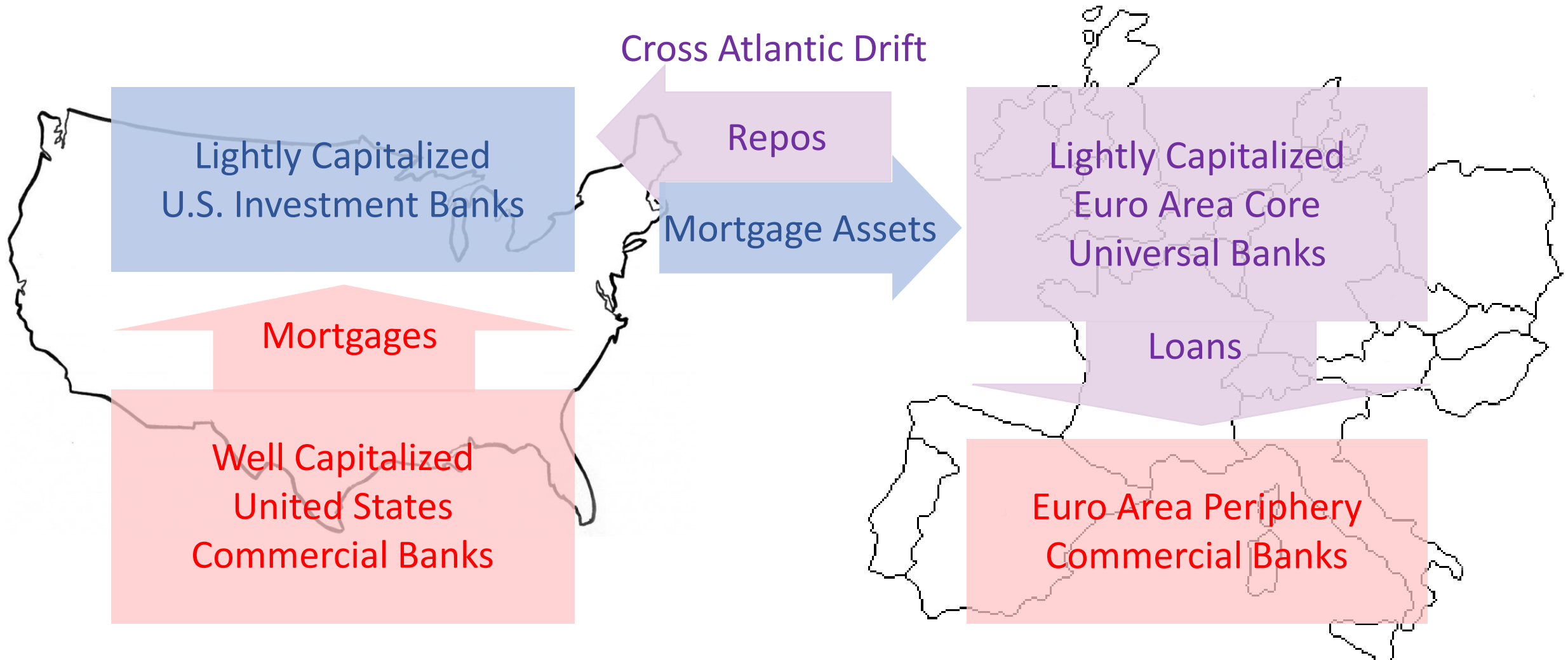
(Assets as a percent of US GDP)



Core Euro Area Banks Expanded Rapidly Overseas (Assets and Liabilities as a percent of GDP)



The North Atlantic Financial Boom



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**

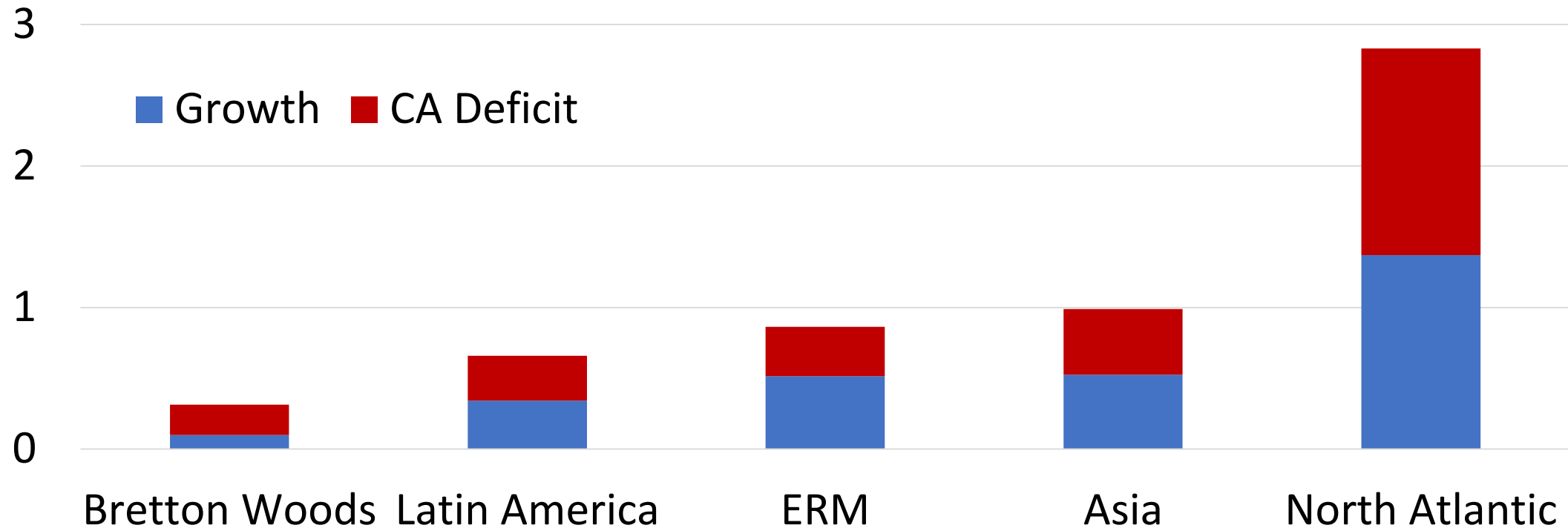
The Great Moderation

- **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

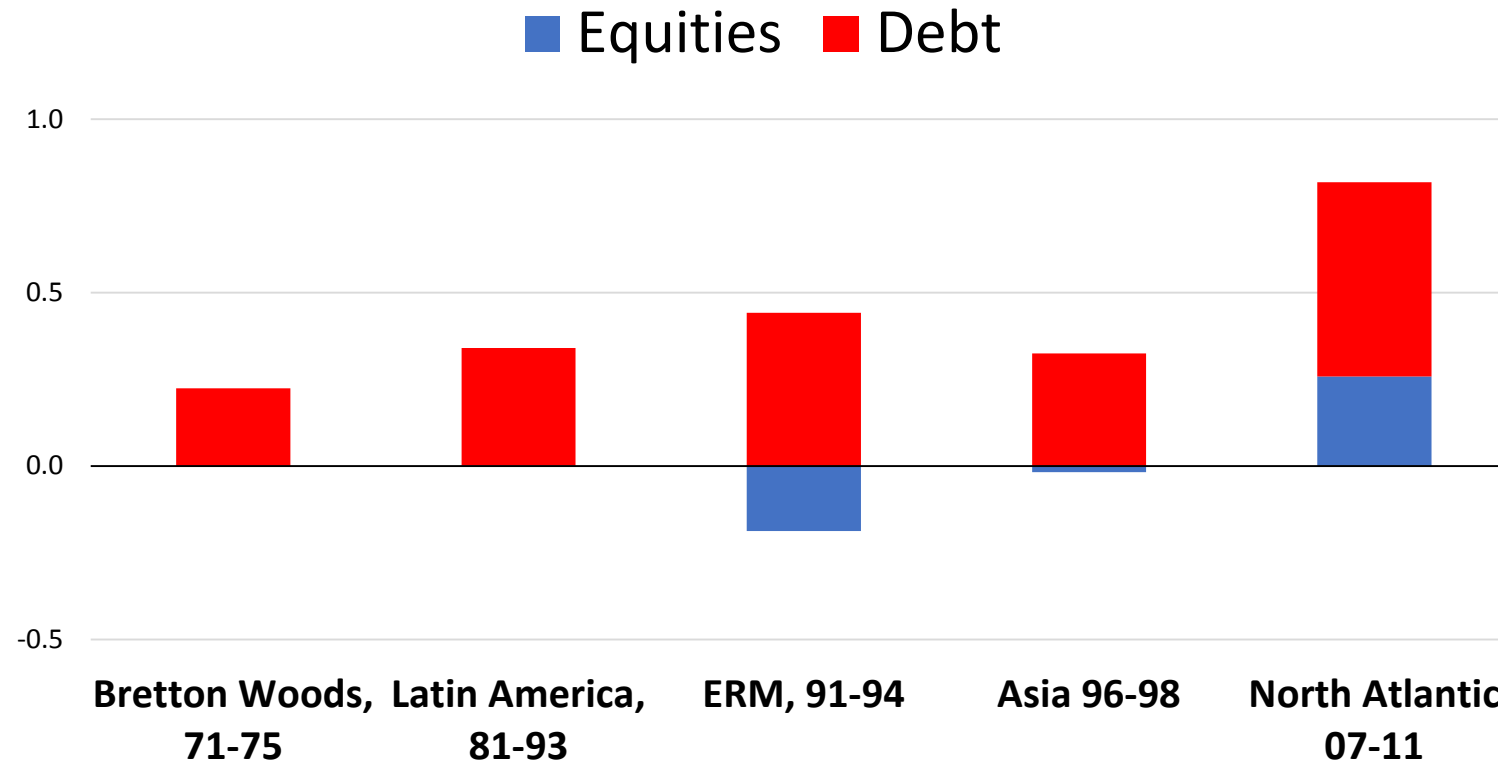
- **Belief in Small international Spillovers Undermined Economy by:**
- **Creating a Flawed Euro Area Architecture**
- **Diminishing Belief in Value of International Cooperation**
- **Macro Models Had No Meaningful Spillovers**

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)



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

Banking Capital

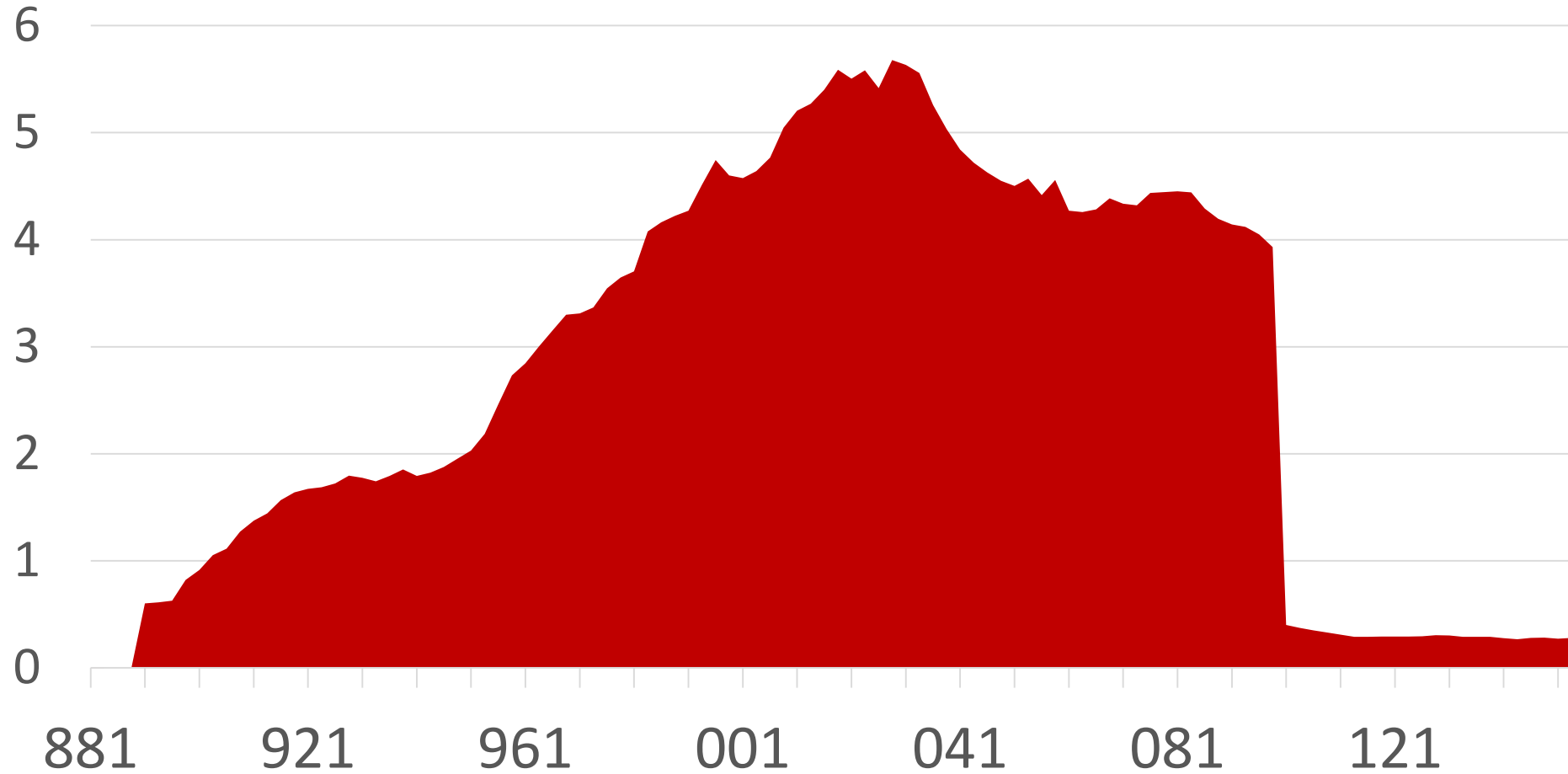
- **US Investment Banks Under (Tougher) Banking Regulation**
- **Euro Area Banks Under Higher Capital Ratios but...**
- **Euro Area Banks Still Use Internal Risk Models Extensively...**
- **US is dialing back on some capital requirements**

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)



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