Financial Reform or Financial Restructuring: *Role of Credit in EMEs*

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Central Bank of Argentina Money and Banking Conference, 2015
5 June 2015, Buenos Aires

Key Points

- Central banks entered into unconventional policies because the political economy of fiscal policy was unable to act decisively and toughly with financial crisis
- Complex regulations do not solve structural issues
- World entered into an escalation game in global credit at lower and lower interest rates, forcing adjustments at the exchange rate level – currency wars
- EMEs will pay for Advanced country QE through higher real rates, devaluation, slower growth – those who reform fastest wins
- Financial Structure is debt-oriented, fragile and unequal. Given high volatility due to changing demographics, urbanization, technology, globalization and climate change, equity and risk-sharing key to future financial sector restructuring

Section 1

Global Growth Uncertainties

Addressing the New Normal

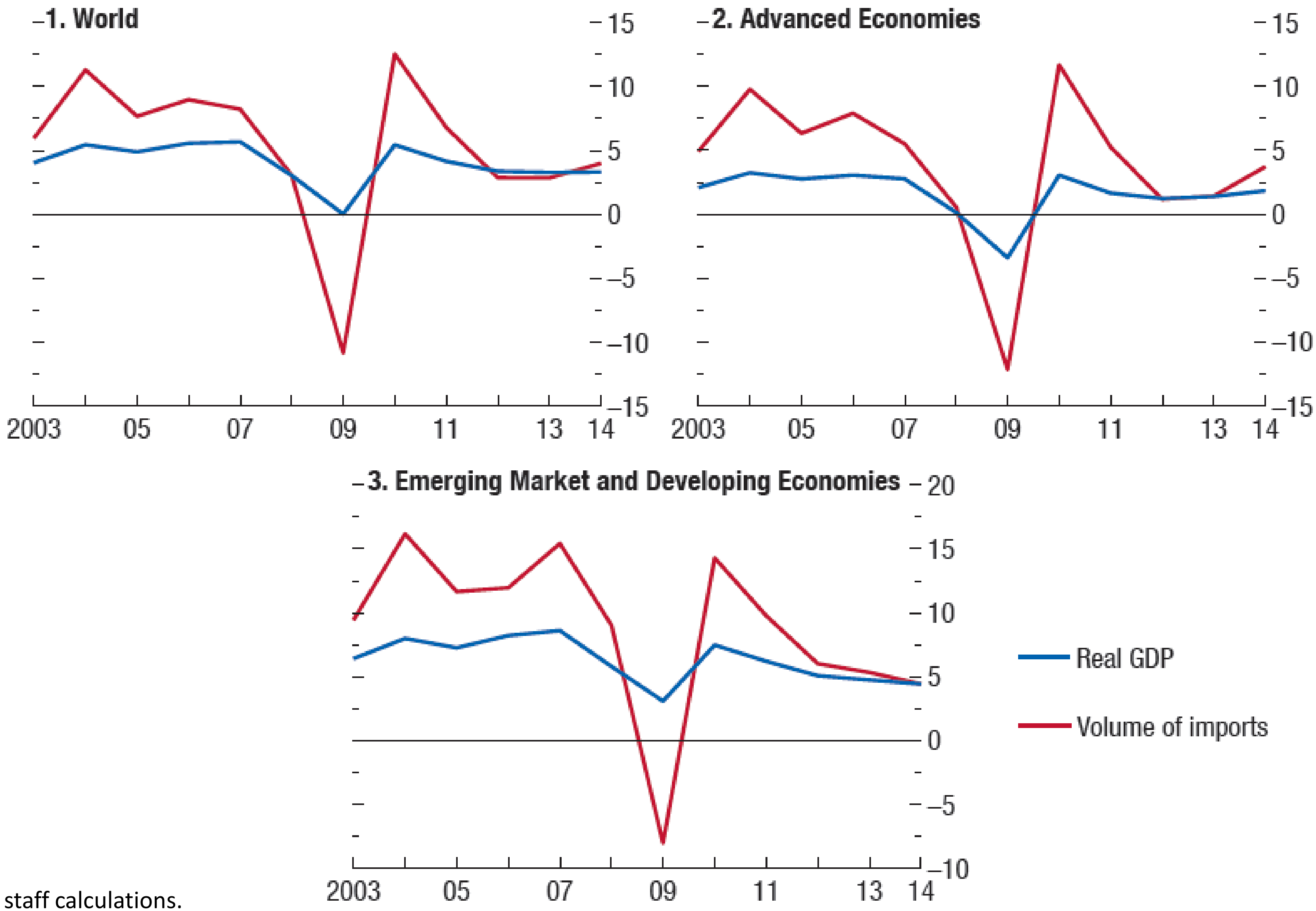
6 Global Game-Changers

1. *Demographics* – Aging Rich; Unemployed Youth
2. *Urbanization* – Terrorism, fundamentalism, urban-unemployed under-class
3. *Disruptive Technology* – Drones, robotization, 3D printing, job-destruction, winner-take-all
4. *Fragmenting Globalization* – Emergence of non-state players and Multi-polar tensions
5. *Climate Change* – Natural disasters, food, water and energy insecurity
6. *Financialization* – Debt overhang, QE and EME crises

= Old Economy being re-priced; Volatile New Economy

Risks of Secular Stagnation – productivity slowing

Growth in Real GDP and Volume of Imports, (Percent)



Source: IMF staff calculations.
Source: IMF. 2015. "[World Economic Outlook April 2015, Uneven Growth: Short- and Long-term Factors](#)."

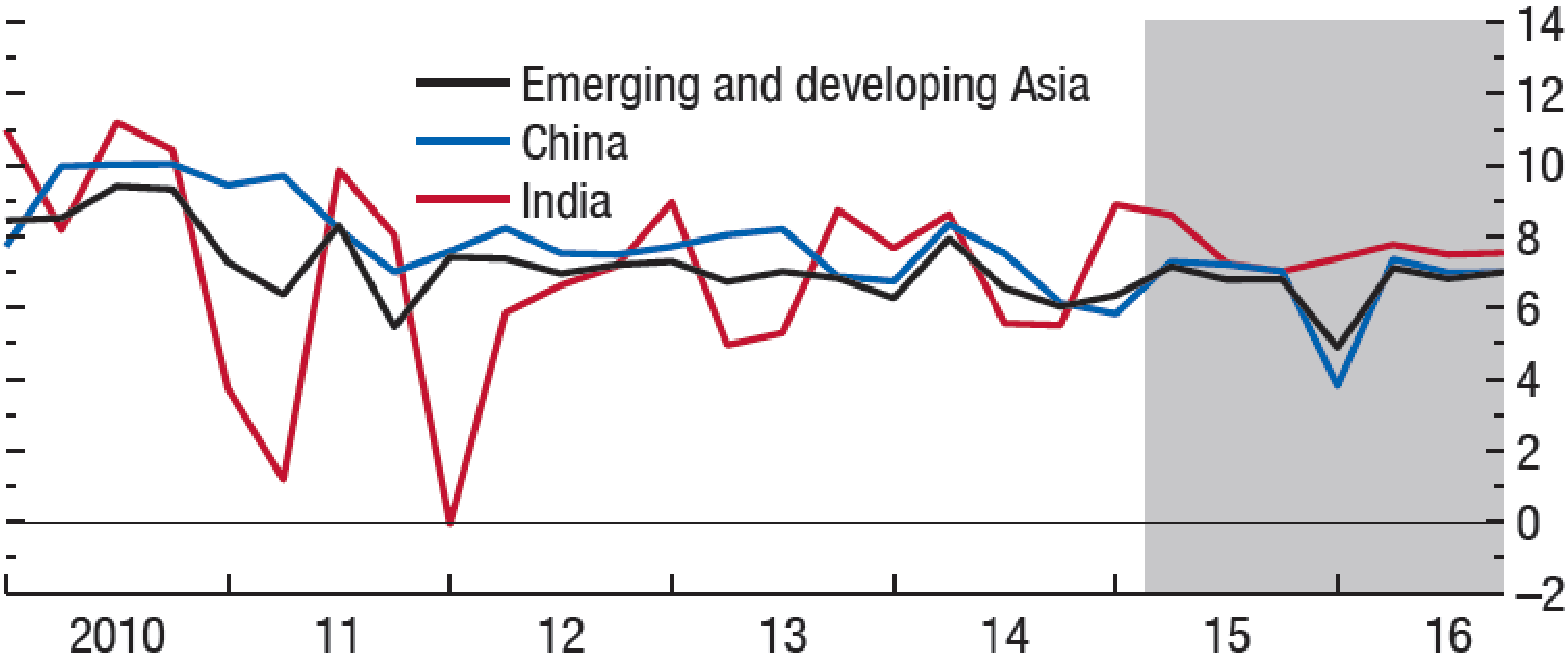
China Slowing to Around 6% by 2016

	Year over Year			
			Projections	
	2013	2014	2015	2016
World Output[2]	**3.4**	**3.4**	**3.5**	**3.8**
Advanced Economies	**1.4**	**1.8**	**2.4**	**2.4**
United States	2.2	2.4	3.1	3.1
Euro Area[3]	–0.5	0.9	1.5	1.6
Germany	0.2	1.6	1.6	1.7
France	0.3	0.4	1.2	1.5
Italy	–1.7	–0.4	0.5	1.1
Spain	–1.2	1.4	2.5	2.0
Japan	1.6	–0.1	1.0	1.2
United Kingdom	1.7	2.6	2.7	2.3
Canada	2.0	2.5	2.2	2.0
Other Advanced Economies[4]	2.2	2.8	2.8	3.1
Emerging Market and Developing Economies[5]	**5.0**	**4.6**	**4.3**	**4.7**
Commonwealth of Independent States	2.2	1.0	–2.6	0.3
Russia	1.3	0.6	–3.8	–1.1
Excluding Russia	4.2	1.9	0.4	3.2
Emerging and Developing Asia	7.0	6.8	6.6	6.4
China	7.8	7.4	6.8	6.3
India[6]	6.9	7.2	7.5	7.5
ASEAN-5[7]	5.2	4.6	5.2	5.3

Source: IMF. 2015. "World Economic Outlook April 2015, Uneven Growth: Short- and Long-term Factors."

India will Overtake China Growth Rate, but EME Growth will Remain Resilient

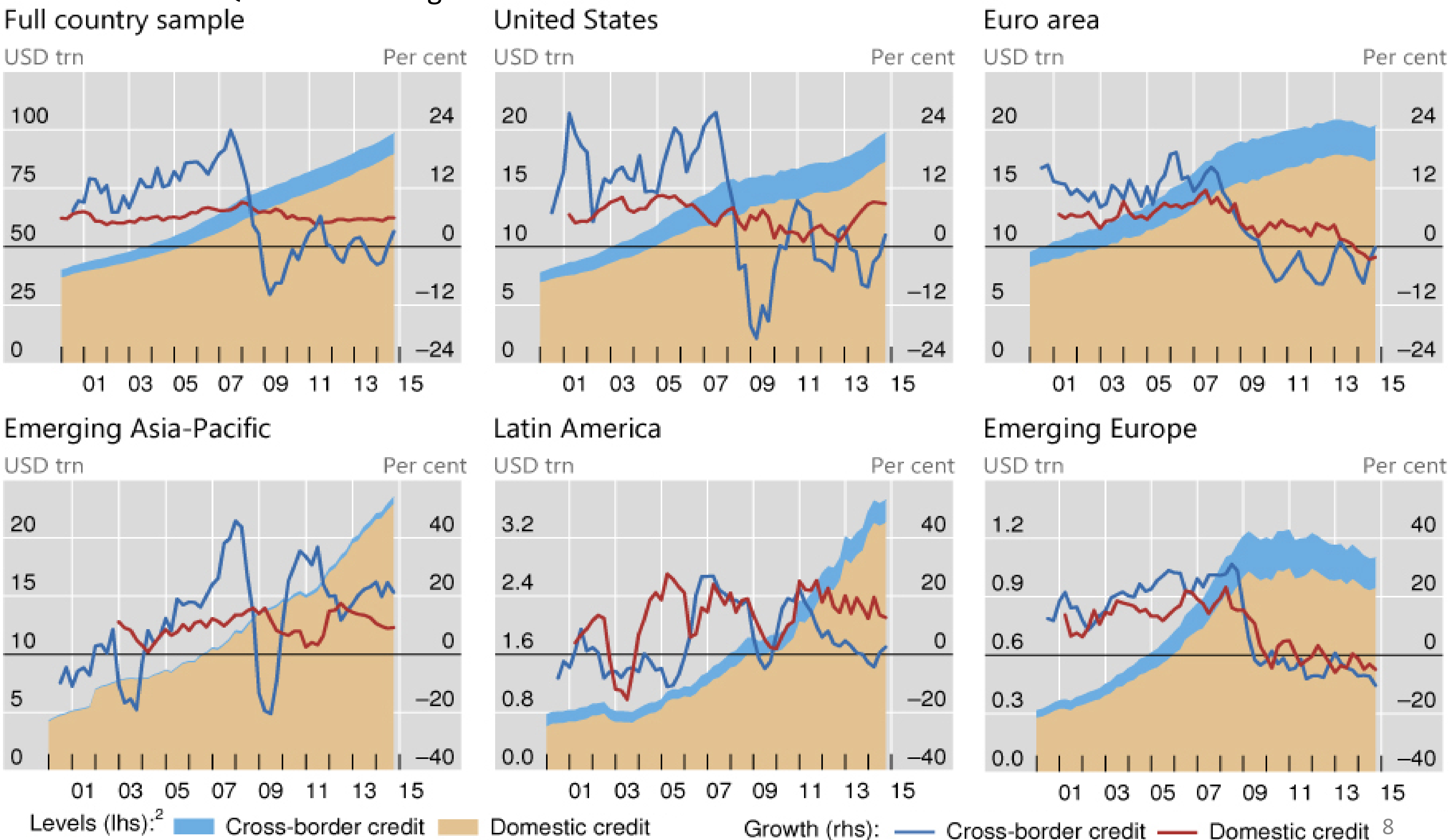
GDP Growth Forecasts



Source: IMF. 2015. "World Economic Outlook April 2015, Uneven Growth: Short- and Long-term Factors."

Debt: Debt Overhang and Fast EME Debt Growth

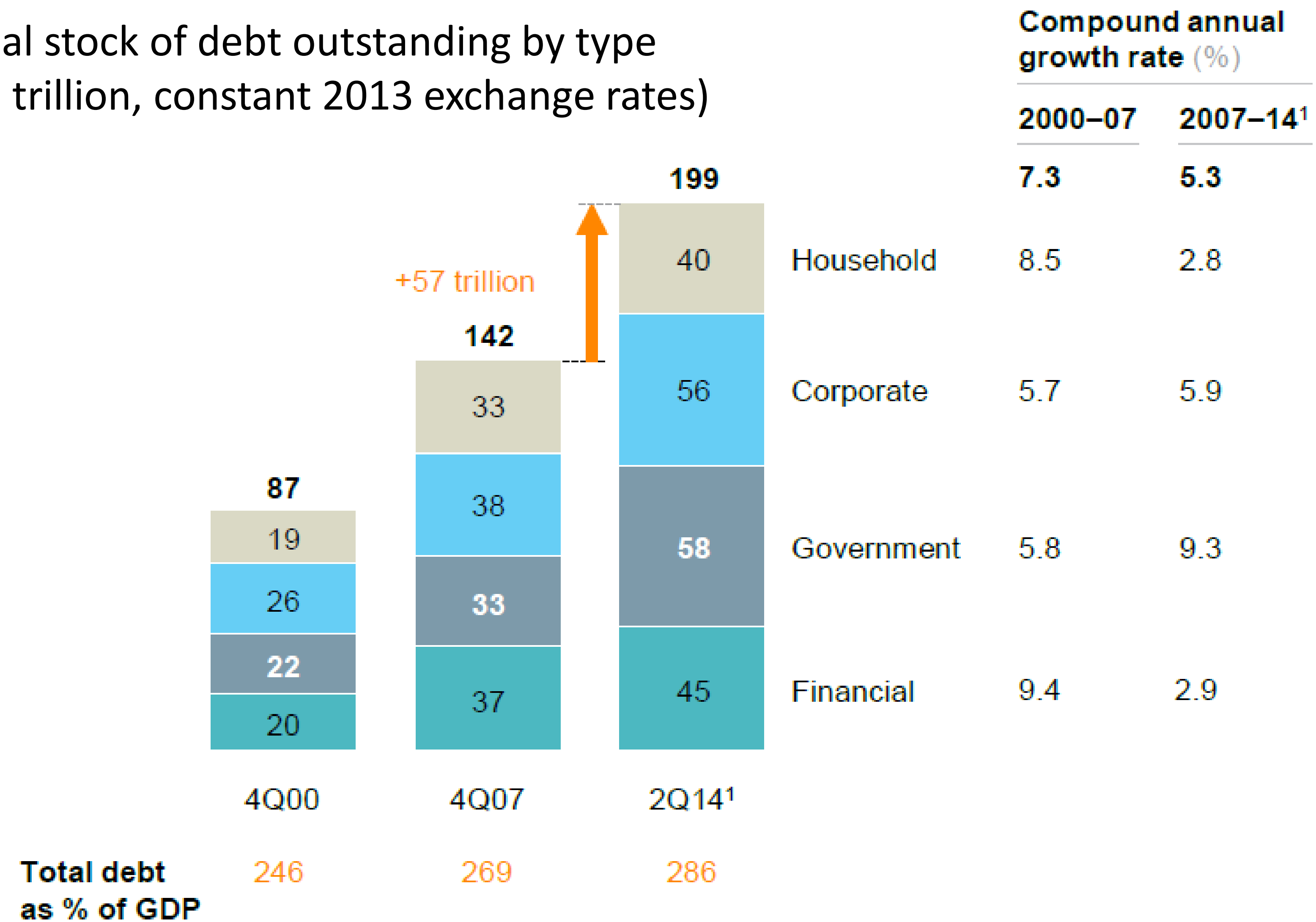
Global Bank Credit Aggregates, by Borrower Region
At constant end-Q3 2014 exchange rates



Source: BIS. 2015. “Highlights of Global Financing Flows.”

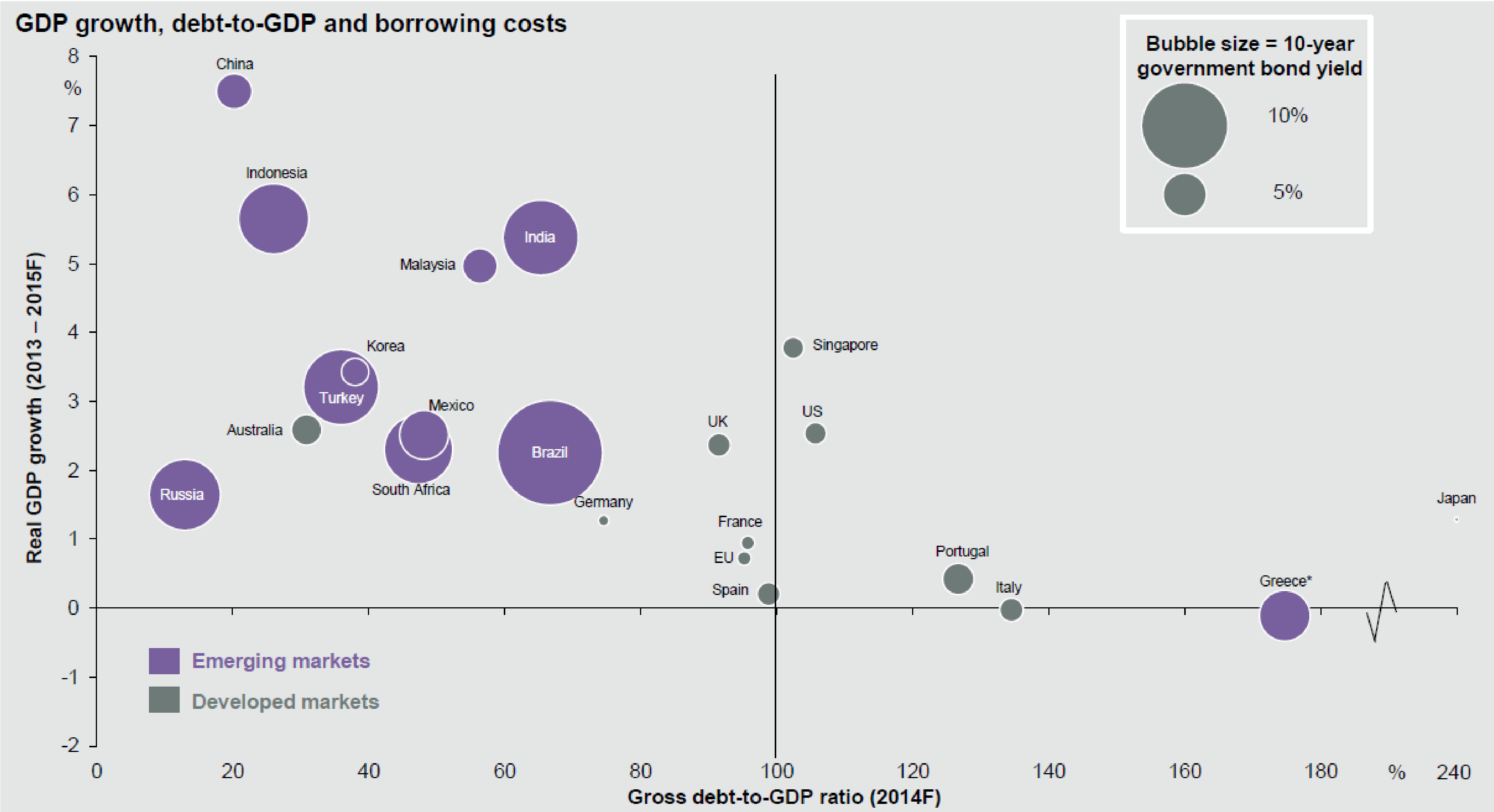
Global Debt increased to $200+ trn – McKinsey

Global stock of debt outstanding by type
(US$ trillion, constant 2013 exchange rates)



Note: 2Q14 data for advanced economies and China; 4Q13 data for other developing economies.
Source: Haver Analytics; national sources; *World economic outlook, IMF; BIS; McKinsey Global Institute analysis*
Source: McKinsey. 2015. "Debt and (not much) Deleveraging ."

Advanced Country Sovereign Debt Stress (June 2014)

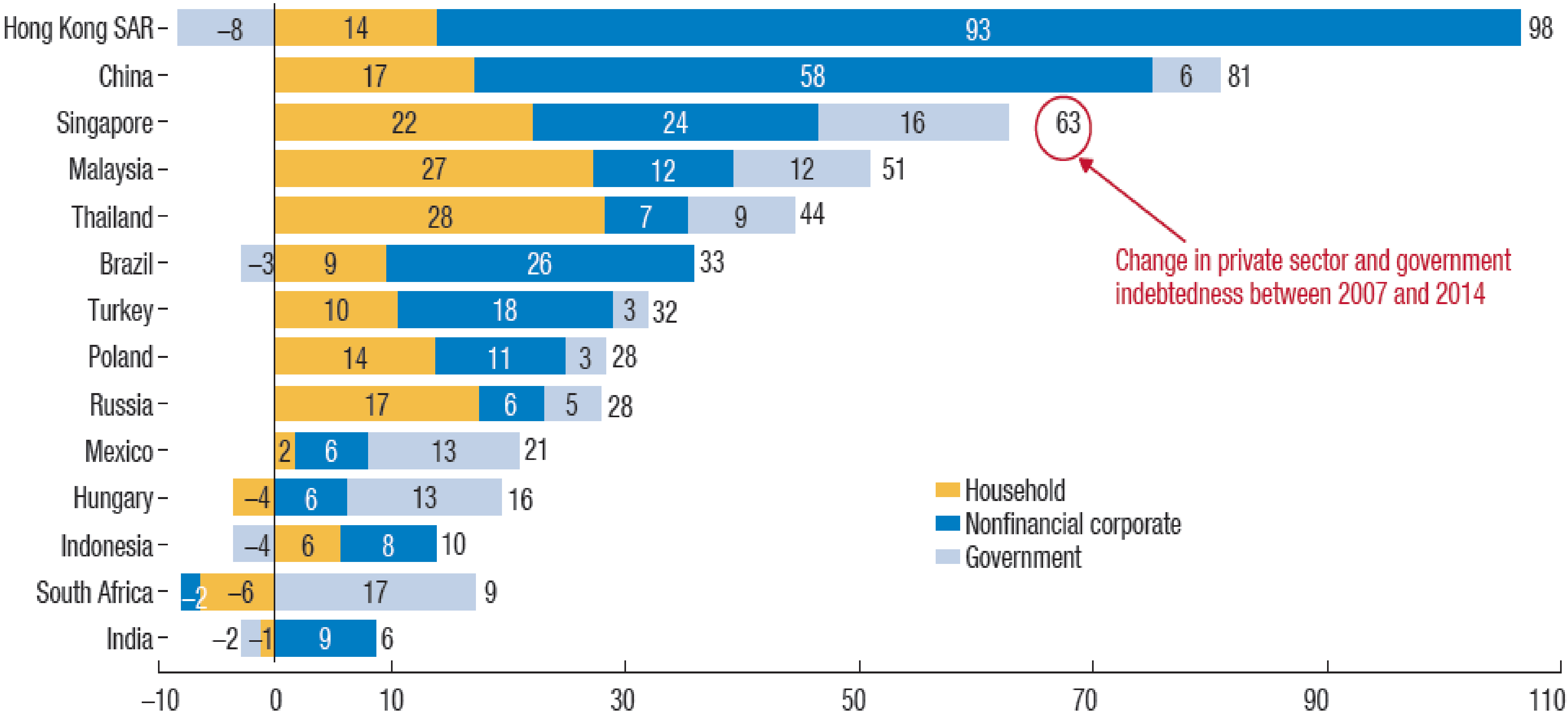


Source: IMF World Economic Outlook April 2014, FactSet, Barclays, J.P. Morgan Asset Management. Borrowing costs based on local currency debt. EU overall borrowing cost based on Barclays Capital Euro-Aggregate 7-10 Year Treasury Index. South Africa's borrowing costs are based on seven-year government bond yield due to data availability. *Greece was reclassified as an emerging market in November 2013. Guide to the Markets - Europe. Data as at 30 June 2014.

Source: JP Morgan. 2014. Market Insights.

EME Debt Increase from Corporates

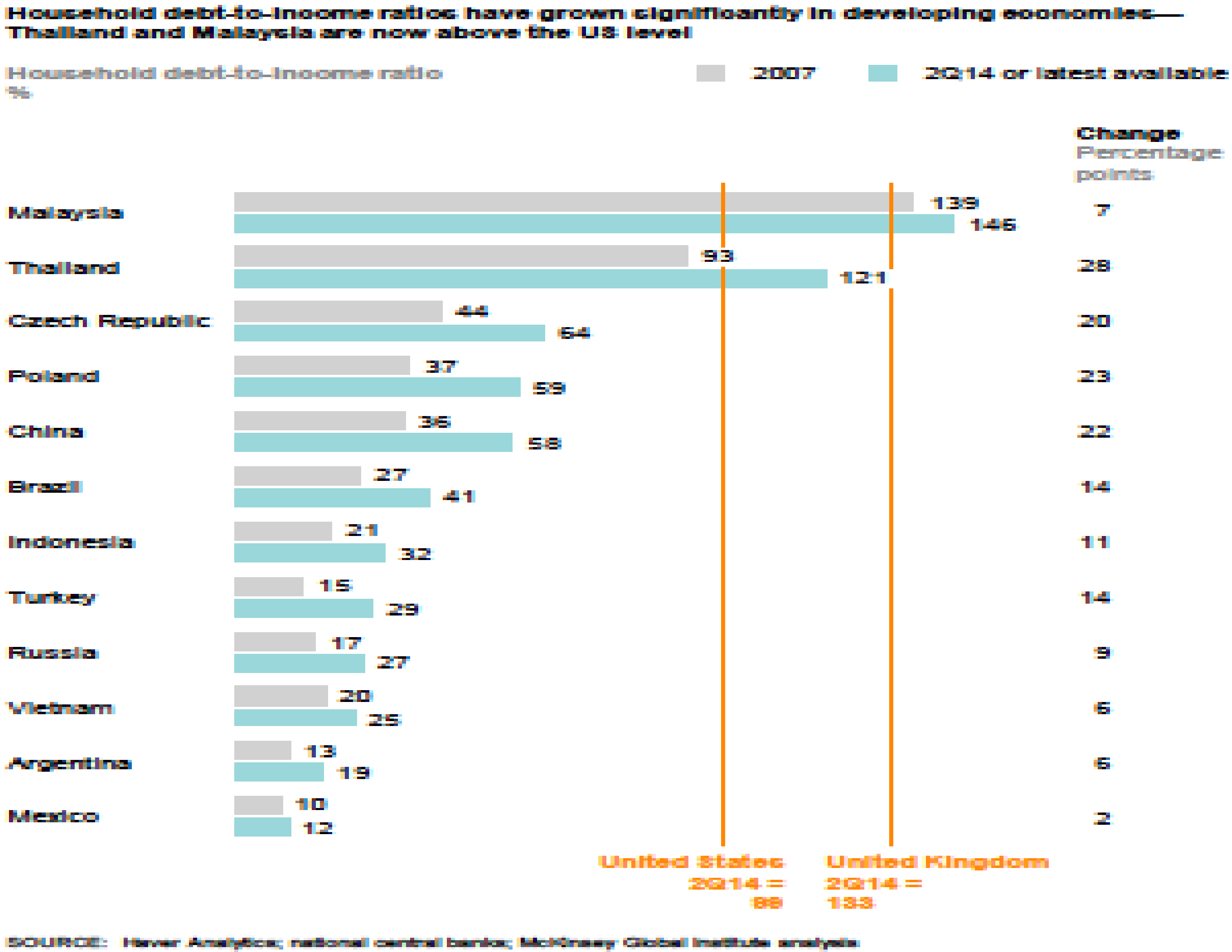
Change in Private Sector and Government Indebtedness between 2007 and 2014
(As a share of GDP; percentage points)



Sources: Bank for International Settlements; Morgan Stanley; national authorities; IMF, World Economic Outlook database; and IMF staff calculations.
Note: Data for Malaysia are from Bank Negara Malaysia, and the change in debt is between 2008 and 2014.

Source: IMF. 2015. Global Financial Stability Report April 2015. "Navigating Monetary Policy Challenges and Managing Risks."

EME Household Debt Increased



Global Financial System is Debt-oriented and Leveraged

Debt to GDP ratios - Advanced economies 275% and EMEs 175% (BIS 2014)

In US$ trn

	GDP	Total reserves minus gold	Stock market capitali-zation	Debt securities	Bank assets	Bonds, Equities, and Bank Assets	Bonds, equities, bank assets in % of GDP
World	75.5	12.1	62.6	97.3	126.7	286.6	379.7
EU	16.7	0.6	12.6	30.0	48.7	91.3	546.7
US	16.8	0.1	22.3	34.5	15.9	72.7	433.5
Japan	4.9	1.2	4.6	12.3	11.5	28.4	576.5
UK	2.7	0.1	4.0	5.8	10.4	20.2	754.0
Emerging markets	29.1	8.0	11.2	11.2	33.9	56.4	193.7
of which: Asia	13.8	4.7	6.0	5.8	24.3	36.1	261.6
of which: China	9.5	3.8	3.4	4.1	20.2	27.6	291.7

Source: IMF, GFSR, April 2015.

Debt-bias is risk-shifting and tax-related

- Debt shifts risks to borrower, whilst loan losses and interest costs are tax deductible.
- Cost of equity is higher than debt, but capital losses are not tax-deductible and dividends are often double-taxed
- Equity for SME difficult to access through IPO relative to borrowing from banks
- Corporate owners prefer to issue debt rather than capital to avoid dilution of control
- Excessive debt creates huge social and wealth inequities – poor and weaker get into debt trap with higher real interest rates
- Equity is risk-sharing and risk-absorbing for system as a whole

Section 2

Finance Out of Alignment

Real sector derailed by short-termism culture, resulting in trust evaporating in FIs

Financial Ecosystem Not Serving Real Sector

1980: 100% of GDP – 2013: 380% of GDP – Increasing Leverage

There must be Limits to Financialization and Consumption

Source: CFA Institute. Toward a Sustainable Financial Ecosystem.

Four FAILures of Mainstream Finance

- Fragility – Concentration + Leverage = Systemic Fragility. Cheap funding = higher consumption accelerated natural resource depletion. Investments went short-term but did not help "green" investments
- Addiction – To speed, scale and capture – Faster, more leveraged, information/tax/regulatory arbitrage/moving to shadows
- Inequity – Financial repression hurts poor. Lack of financial inclusion. Rich borrow at favorable rates/have better collateral/more leverage = higher private return at social cost. S&P 500 CEOs' salary 331X average wage (2013), compared to 46X 30 years ago. AE monetary policy subsidized Eurozone financial sector by US$300 billion (2011-2012)
- Liquidity-driven – Sustainable only through central bank liquidity creation with asset bubbles. Excess credit + Greenspan Put + QE = Liquidity driven bubbles and low interest rates – hurting savers, pensioners, and rewarding short-term speculation

Source: Andrew Sheng. 2014. *International Monetary System and Sustainability.* Shanghai. INET and Shanghai Development Research Foundation; AFL/CIO Executive Paywatch; IMF Global Financial Stability Report April 2014, Chapter 3, pp103-132.

Five Facts on New IMS

1. FX trading markets averaged \$5.3 trillion per day in April 2013, up from \$3.3 trillion in April 2007. 2012 Global merchandise trade (X+M) \$30 trillion (6 days FX trading) and \$6.6 trillion G4 monetary base ≈ 1 day trading
2. US Congress torpedoing IMF quota reforms; IMF and multilateral development banks (WB, ADB etc) constrained in lending due to unwillingness to increase capital
3. Fed's \$333 billion dollar swap lines to only 5 central banks: UK, ECB, Japan, Canada and Switzerland)
4. PBOC \$426 billion bilateral currency swaps with 26 central banks, focusing on trade facilitation
5. CDB Balance sheet of \$1.3 trillion larger than IMF + World Bank together; AIIB, Silk Road Fund, BRICS Bank new sources of funding

Escalating Growth in Central Bank Balance Sheets (2007-2013)

- Central bank balance sheets have grown from roughly 3% of global financial assets in 2007 to 8% ($22.6 trn) of total financial assets of $282 trn (IMF/FSB estimates) or 30% of world GDP.
- Advanced country central bank balance sheets are smaller, but as high as 80% of GDP (SNB)
- EME central banks larger as % of GDP due to high FX reserves and bank based systems (PBC at 50% of GDP).
- Since crisis, Fed and BoE B/S 4X, ECB as high as 3X
- Big 5 (Fed, ECB, BoE, BoJ, PBC) increased BS from 22% of their GDP to 32% of GDP or 17% of their M2 to 21% of M2

Welcome to QE world

- Global central bank assets, including FX reserves, now total $22.6 trillion, a sum larger than the combined GDP of the US and Japan.
- Eighty-three percent of the world's equity market cap is currently supported by zero interest rate policies; and
- 50% of all government bonds in the world currently yield 1% or less.

Source: BAML Global Research, WEF Forum, November 2014

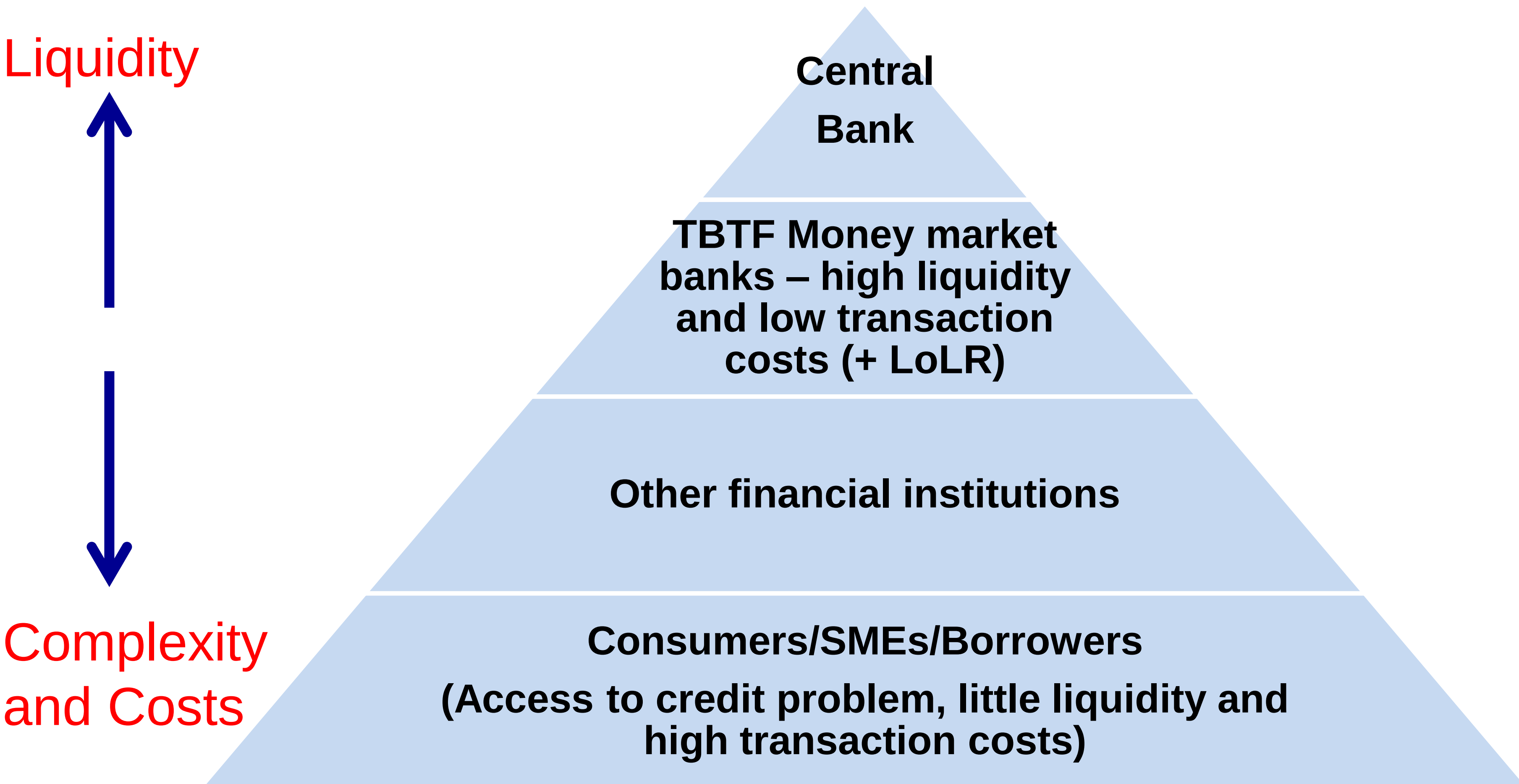
Central Bank Balance Sheet Expansion and Resource Allocation

- Between 2006-2013, the top 5 central banks increased their balance sheets by US$9.9 trillion to a total of US$15 trillion. In growth terms, this is equivalent to 40.1% of the increase in world GDP of US$39.2 trillion over the same period, and 25.3% of the growth in world M2 money supply. All these happened without any uptick in inflation
- Central banks are no longer lender of last resort – they are buyers of first resort
- Regulation has reduced liquidity in key debt markets, so volatility has increased and central banks must step in to intervene to maintain stability

Central Bank Trap:
No Hard Budget Constraint – Always Soft Options

- Leadership comes from doing what is needed, not what is popular
- Fiscal action already trapped by unwillingness to take unpopular tough action or structural reforms
- Central bank intervention is "soft option", but cannot address structural issues, making system more dependent on soft money and low interest rates
- By expanding their balance sheets and willingness to intervene, without good theory and evidence that it works, central bank have become part of the structural "malaise" of liquidity trap with low growth

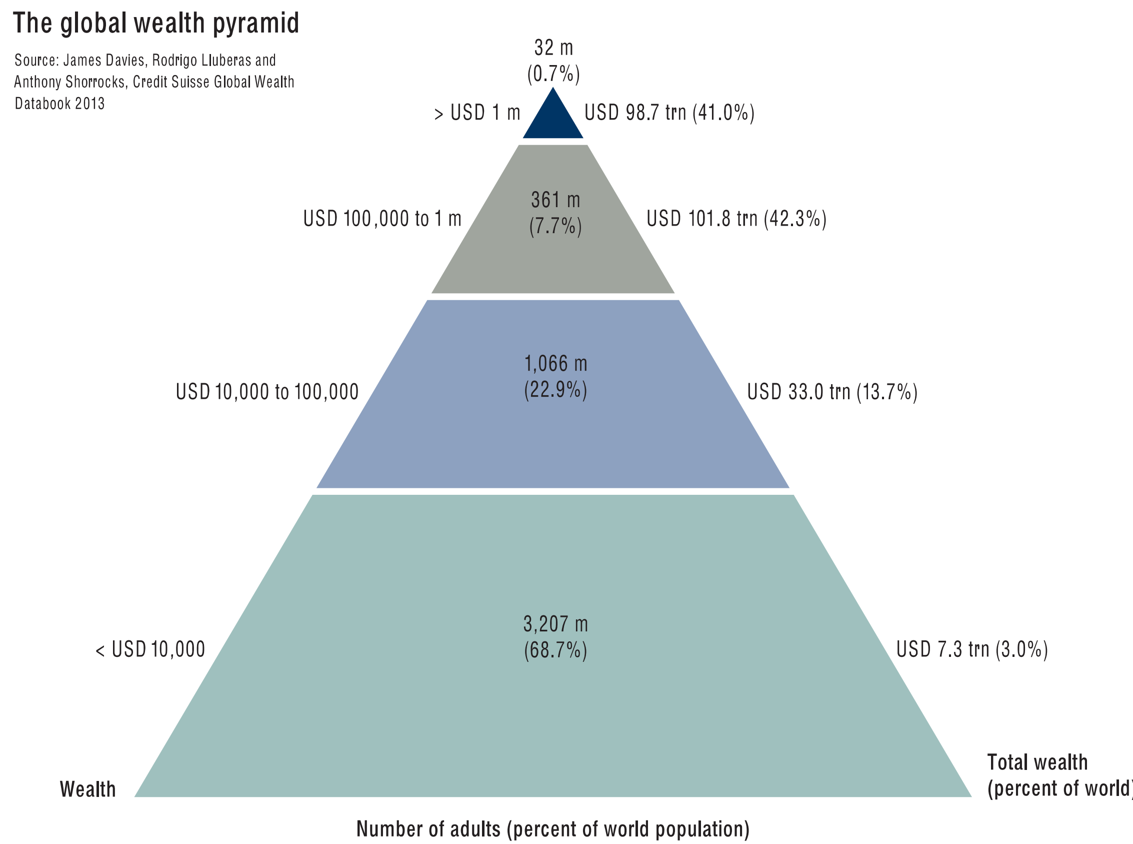
Implications of Hierarchical Legal Theory of Finance



Inequality: Rich Get Richer, Poor Get Poorer

- Piketty: r > g = Inequality
- Financialization part of process of increasing ROE through leverage
- As interest rate is pushed by central banks to near zero to protect financialization, then not only is inequality sustained, but also unsustainable consumption of natural resources
- If in long-run, return on investments in capital assets is higher than wages, then both income and wealth inequality worsens

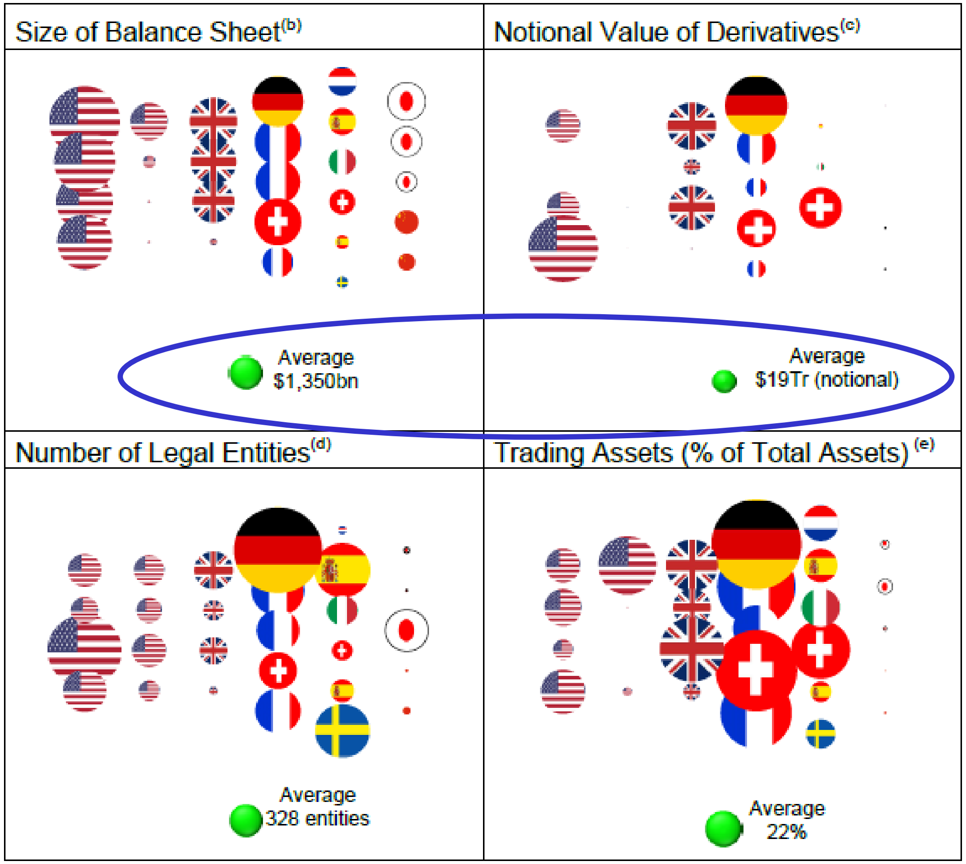
8.4% of population own 83.3% of global wealth



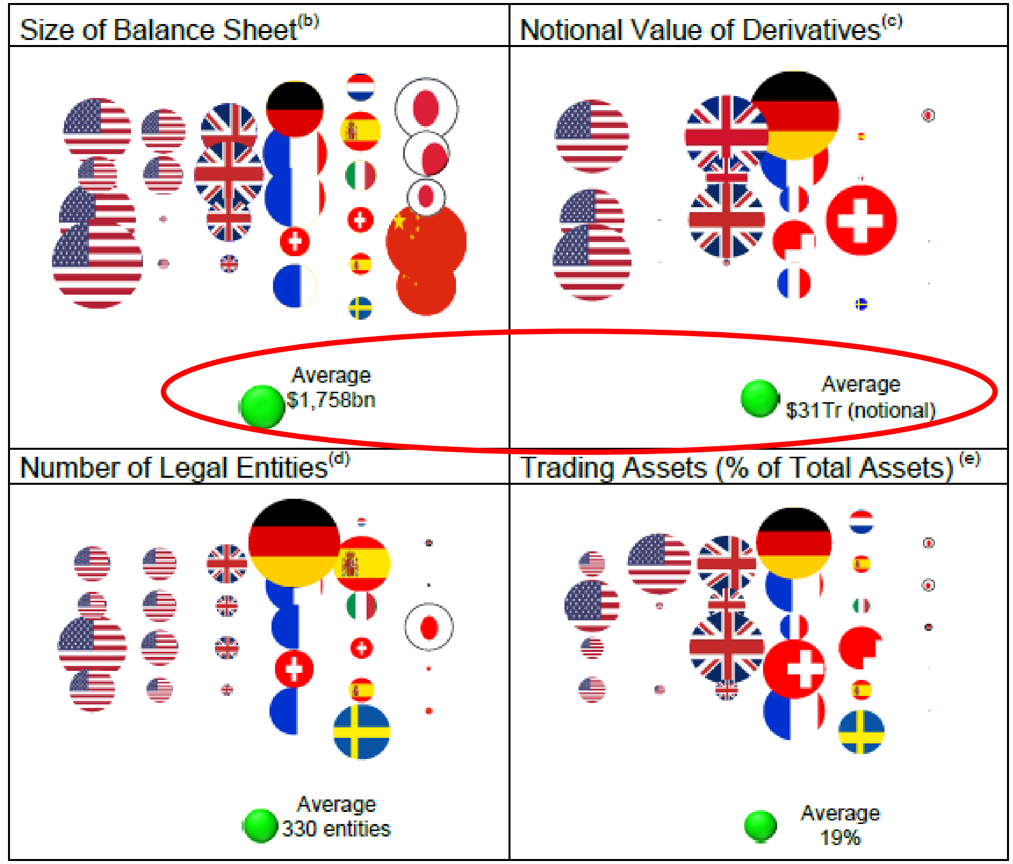
Source: Piketty, T. 2014. *Capitalism in the Twenty-First Century*. Belknap Press of Harvard University Press. Cambridge, Mass.

G-SIFIs Even More Powerful: *Average Size $1.8 trn. Balance Sheet + $31 trn. in Notional Derivatives*

G-SIFIs (2006)



G-SIFIs (2013)



Sources: SNL Financial, FDIC, bank annual reports, staff calculations.

Source: Andrew Haldane. 2015. "On Microscopes and Telescopes." Bank of England.

Key Questions on Long-Term Finance

State vs. Market

1. How do we make Financial sector more long-term – limits, scale, incentives?

System horizons: understanding dynamics of time and risk

2. How do we shift attitudes away from short-termism?

System Governance: principles, mandates and purpose

3. What can we do about it?
4. Role of central banks and regulatory architecture

How should finance support Equitable Economy?

6. Role of investors, monetary and fiscal policies

Tomorrow's financial system

7. What is role of citizens as consumers/ investors/ employees/ civil movements?

Section 3

Reforms to Realign Finance

EME Central Banks to take long-term view and lead system reform

State vs Market in Systemic Crisis

- **We are not just dealing with market failure, but system failure**
- No agent willing to take long-term action to break the unsustainable short-termism
- Someone has to take the lead in the global collective action trap
- Instead of adding complex solutions to complexity, we need to incentivize and create diverse solutions, but that takes leadership
- Central banks entered into rescue, because of inability of politicians and fiscal policy to act

Now is time for central banks to take lead to shift the focus from short-term “market-tweeking” to “long-term system reform” – investing in social impact assets that are inclusive and green

Values Must Change: e.g. Islamic Finance Promotes Risk-sharing and Ethics-based Finance

- Equity-based funding shares common threads with community and ethical banking, and socially responsible investing
- Risk-sharing rather than risk-shifting
- Recognizes Imperfect information: Returns determined ex-post

Islamic finance needs higher order of risk management:

- Avoid speculation and more focused on social impact of Islamic finance investments
- Have more capital, liquidity and deeper risk management capabilities
- Develop more hands-on management that nurtures and controls against risks of fraud

Source: Andrew Sheng. 2013. Islamic Finance as Social Impact Investing. Fung Global Institute.

Change will only happen if incentives change

- *Context* – Central banks withdraw or limit QE and allow interest rates to be market driven
- *Regulators* – enforce where it counts; impose hard budget constraint on bad lending and ethics breach
- *Policy – develop capital markets to deleverage*
- *Long-term investors* – think and act long-term
- *Retail investors* - do not tolerate bad behaviour on part of intermediaries
- *Profession* – strengthen discipline on ethics
- *Be human* – do not let the best be the enemy of the good.

Thank you

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