THIRD PART

G20 Financial Stability Board, financial supervision, rules, regulations, standards and codes

Jean-Claude TRICHET, former President, ECB

Thank you very much for the transition, because I am partly responsible for the fact that we did not yet address the G20, the FSB and all that goes with it, as we were so fascinated by the previous discussion. I am ready to take the blame, but I think we had a very good discussion, one that was very active, interactive and stimulating.

I would suggest we concentrate now on global governance, so you have two aspects to the G20, macro policies and their optimisation on the one hand, and on the other the whole definition of rules, regulations, standards, codes, and you name it that go with the FSB and all the standard setters. I could see the extent to which you were pessimistic on the G20. Can I be a little contrarian in order to start the discussion?

Before the crisis, we had the G7. The G7 had an exclusive monopoly on informal discussions between the main shareholders of the IFIs and the global economy; they were discussing between themselves and were pretending that they had a dominant influence in all economic domains, whether financial or the real economy. Since the crisis, the G7 has passed the baton to the G20, so it is a dramatic structural change. The advanced economies have recognised that they could not have this exclusivity, and we are now much more inclusive, with a lot of difficulties and problems of course, not surprisingly, but I will give you my own understanding. We changed everything in informal global governance at the same moment, at the level of Heads and at the level of Ministers and Governors.

As regards the central banks, we transformed the G10 – which was our way of having restricted informal monitoring – in the Global Economy Meeting and enlarged the board of directors of the BIS, of which Jean-Pierre has been the President. It was under your own presidency that we fantastically improved the governance of this key element in global cooperation. We had the famous Basel Committee enlarged to include all the systemic standard setters and supervisory authorities in the world, not just restricting it to the constituency of the advanced economies but with all systemic emerging countries.

There was a dramatic change in terms of setting the new Basel III agreement, the capital requirement standards, the liquidity ratio and so forth. I left four years ago, but I had more problems inside the advanced economies than between the advanced economies and the emerging world, and I take it that that is probably still the same. Therefore, global governance changed dramatically.

The understanding I have in interpreting what John says is that his sentiment, which is absolutely right, is that we make more progress in the standards and codes under the coordination of the Basel rules and so forth than as regards macro-policy coordination. The mutual assessment process exists, but I understand your frustration. However, the global imbalances have still been considerably reduced, but you will tell me that they have been reduced under pressure of the crisis, not that it was a deliberate ex ante action. However, I would not say that this process has been useless. I understand the frustration at the IMF; it is not up to your expectations, and everybody knows the extent to which you were personally active in this domain, but still it exists, still it is inclusive, and it should help. When the US Congress does not want to go along the lines that are strongly suggested by the global consensus, we have a problem and that does not simplify things.

Turning now to the other side of the coin, namely the FSB, I really take it that we still have a lot of progress to make, but it would be too negative, in my opinion, to say nothing has been done. A lot of things have been done and a lot remains to be done. I fully accept Daniel's view that we still have a very dangerous world, but today's world, with today's rules, in comparison with what existed in 2007, has obviously dramatically changed in many areas. We still have a lot to do in terms of shadow banking, and we are only starting on that.

We certainly have also a lot to do in terms of derivatives and so forth, and to ensure that the OTCs are correctly treated, and we could embark on a long list of workshops which have to continue actively working. However, taking into account our present mood, which is not very positive, I would say, since we are after all in a World Policy Conference, global governance has improved, under the pressure of the crisis and with a sword in the back of the advanced economies in particular. We will see what happens. Nobody has said there was a fantastic advance in Turkey in the occasion of the last G20 meeting; that is obvious. But the FSB had prepared the meeting very well, and the decision on TLAC, for instance, was an appropriate one.

One of us wanted to say a word on TLAC. John, you have the floor.

John LIPSKY, Senior Fellow, Foreign Policy Institute at Johns Hopkins University's Paul H. Nitze School of Advanced International Studies (SAIS); former First Deputy Managing Director, IMF

I suppose I do not have to tell anyone here what TLAC is – Total Loss Absorbing Capacity for the 30 G-SIBs – and the question, of course, is whether or not this is excessive activism. You did not have to be a genius in the wake of the crisis to figure out that the financial system had been undercapitalised and needed substantial increases. Whether the TLAC and the burden it is placing on the 30 G-SIBs will be useful or an excessive burden still remains an open question, along with the favourable treatment within the TLAC of the so-called emerging market G-SIBs, whom we all know well. The requirement that the TLAC includes so-called CoCos -- contingent liabilities -- is an as-yet untested innovation.

I was interested in whether there was any other commentary about this, or whether it is generally taken by this well-informed crew that this is necessary and productive rather than a step a bit too far.

Jean-Claude TRICHET, former President, ECB

The requirements are very high, and I was a little surprised to see that the FSB was publishing the impact of these new rules. The impact is quite big in terms of growth and in terms of GDP. The argument, of course, is that if we have a catastrophe then the price is absolutely gigantic.

Akinari HORII, former Assistant Governor, Bank of Japan, Special Adviser of The Canon Institute for Global Studies

I was a member of the FSB until I stepped down from the BOJ in 2010. I have always been critical of this tougher regulation in itself. TLAC, in my opinion, is too much. Animal spirits, as I said, are in short supply, and it is wrong to put more burdens on financial intermediaries. Both regulation and supervision tend to be pro-cyclical. When the bubble burst and people got angry at banks, it created political momentum to penalise them; the economy was in bad shape, so they were attacking banks.

I am very sceptical, from a more technical point of view, about the effectiveness or efficiency of CoCos. CoCos are a debt, so it is not normal distribution, and therefore, just like the bonds and commercial papers issued by Lehman Brothers, the prices that stayed at almost 100% until all of a sudden they dropped to zero, unlike equity whose price change is more monotonous. When a particular bank's soundness is in question in the market, then CoCos will become a trigger of financial crisis, because a CoCo price drops all of a sudden and the question is how to convert it into equity at that time. CoCos, in my opinion, will not be workable, particularly from a technical point of view, and a TLAC is, once again, too much of a burden at this time.

Jean-Claude TRICHET, former President, ECB

It is good that we have contrarians. Please reflect on your last words, because it is very important in wrapping up to communicate to us any last messages you might have. This is the great benefit of such a meeting.

Bozidar DJELIC, Managing Director, Head of Central & Eastern Europe, Lazard Sovereign Group; former Deputy Prime Minister of Serbia

It is probably exaggeration of the one part of international collaboration that works, which is Basel III and all its outgrowth – 'It is working, so let us do more.' Let us not forget the following underlying fact, which being technical is probably not exciting to many people. When we met in Seoul, that was the day when the America FASB, the accounting board, announced that they would not coordinate and harmonise with the international accounting standards, full stop. Why was this? It was because of power and sheer lobbying. They wanted to be masters of how they count the beans in America. It means that when you look at all those things, you are not necessarily comparing apples and pears.

Secondly, after a lot of debate, it was accepted that the banks would be judged by their own internal models, valued risk, and in fact a lot of people were saying that since they were too smart for us to regulate them, they would make it crude and simple, so there is one measure, which is leverage. However, that is one, and nobody looks at this one. I do not see it reported so often. Actually, what carries the day, because that is the core of Basel, is risk-weighted assets, and risk-weighted assets come from bean-counting and your internal model, so you leave the floor open to everybody within the bank, the risk function and so forth. It is very difficult, having worked at a very large bank myself for a few years, for a long-suffering regulator to decipher what the hell is inside. They say it is standard, of course, but it is quite difficult.

The third point is about TLAC and so forth. The truth is, and I will close with the realpolitik of it, we did not have this big Glass-Steagall Act, despite what was announced. Many in America would say it is because Obama spent all his capital on healthcare reform and could not take on Wall Street at the same time. Going back to Europe and to France, when Mr Michel Barnier courageously said, 'Let us do this,' his dear friends, the big French universal banks, said, 'You might not be able to come back home, my friend,' and indeed he did not. Where is he? The French said that the big banks were one of their few competitive advantages and had not sinned so much, perhaps having evaded some sanctions, a 'Tour de Fraud,' as the US Justice Department referred to evading sanctions on trade, but they were not the big sinners in terms of rotten paper.

Therefore, in the end, we are not counting the same way, the risks and models are proper to each bank, more or less, and thirdly, we did not break up the big ones, so we make it up by looking at the total loss absorption capacity and so forth. There is a lot of work involved and a lot of potential fuel for problems to come, because the underlying issues were not necessarily dealt with, but progress has been made.

Jean-Claude TRICHET, former President, ECB

Unfortunately, we have no time to have a full-fledged debate, but I hear the universal banks in Europe asking where it started, Bear Stearns, Lehman Brothers, or Merrill Lynch. You can align all the investment banks, so perhaps Glass-Steagall is fantastic, but bizarrely, it was precisely the investment banks that were the trigger for the trauma.

Daniel DAIANU, member of the Board of the Central Bank of Romania; former Finance Minister of Romania

I see eye-to-eye with a lot of what Bozidar has just said, but TLAC, in my view, has little to do with subdued animal spirits. Remember that at the start of the crisis people were saying that this was caused by a credit crunch and so on. And then they realised there was a demand crunch too. There is a lot of cheap credit nowadays and not much demand; this is a reality. Secondly, I believe that there should be much tougher capital and liquidity requirements for banks, and if we can impose a severe leverage ratio, I am very much in favour of that. I am also in favour of a new Glass-Steagall legislation, and last but not least, I think we need to reexamine universal banking, acknowledge its flaws; there is, arguably, a deep crisis of universal banking. John Reed, in the piece he wrote for the *FT* recently, is right in my opinion – universal banks have a very hard time in managing complexity, in optimising what is happening inside, in-house, so something has to be done about it.

Jean-Claude TRICHET, former President, ECB

Lehman had no problem. Bear and Stearns had no problem?

Daniel DAIANU, member of the Board of the Central Bank of Romania; former Finance Minister of Romania

Those were investment banks. I refer to traditional banks that tried to copy, increasingly, investment banks in their operations.

Jean-Claude TRICHET, former President, ECB

We have an immense problem.

Daniel DAIANU, member of the Board of the Central Bank of Romania; former Finance Minister of Romania

Mr Chairman, with all due respect, I will say something, although I am using a dirty word: much of the shit in the balance sheets of German and other banks is because they tried to copy the behaviour and the balance sheets of American and British banks. They should have stayed with classical banking; As John said, 50% to 60% of the toxic products were in the balance sheets of European banks.

Jean-Claude TRICHET, former President, ECB

That is true, because Europe is saving and the US is not saving, so when you are saving and have a current account surplus, you have to export your savings, which is one of the problems I am always telling my German friends about, because they are exporting 8.5% of their GDP every year. Who wants to take the floor right now with a very clear message?

Akinari HORII, former Assistant Governor, Bank of Japan, Special Adviser of The Canon Institute for Global Studies

I may sound a bit too old-fashioned, but in order to have a sound banking system, perhaps prudent supervision is more important than just a set of good regulations, how individual supervisors will address individual bank issues. It is true that central banking, to a certain extent, rather than wearing a strait jacket of inflation targeting or some labour market indicators, needs common sense as well as expert views. Central banks and supervisors were allowed to use their wisdom in the past. When I was young I was told about fit and proper tests for bank management on the supervision side, and you had to examine good and bad CEOs in those days. Nowadays, fit and proper tests are still there, but they just check whether they are listed in racketeer organisations or whatever. I sit on the board of a big insurance company, and every time we buy an American insurance company, they take my fingerprints, all ten fingers, every time. That is a part of a fit and proper test, but it is not what I meant it should be. Regarding the central banks' lender of the last resort function, there was also wisdom of constructive ambiguity, but we are no longer allowed to use this kind of traditional wisdom freely.

Jean-Claude TRICHET, former President, ECB

It is a good message. Do we have any other points?

Korn CHATIKAVANIJ, former Finance Minister of Thailand

I am sitting here feeling a little frustrated, because I am pretending that we will have a communique after this. The world is waiting to see what our conclusion is on issues related to the global economy and the financial world, and I am not sure that we have a message for them yet. I was an observer at the Pittsburgh and London G20s, as Thailand was chairing ASEAN at that time and we had an observer seat, and funnily enough I remember a very optimistic atmosphere, given the depth of the crisis that we faced at that time, that there would be joint action. There was a very clear message that everybody was on the same page; it was an unusual atmosphere. One of the most important conclusions in London, in fact, was the task of reviving the IMF, which subsequently failed, unfortunately, and now we reach the conclusion today that the central banks have done their job and run their course.

The problem is that we do not know what is next, and the onus of responsibility is with politicians, with governments, but there is no forum. The G20 is not working, the IMF cannot be expected to work, and competing agencies are being created. That is causing concern for everybody, but certainly for the smaller and medium-sized economies, not least because there is still great expectation among the people, and I am speaking as a politician here. I hear about high levels of youth unemployment in Europe and aspirational lower-middle class people in Asia, and given very low rates of growth and no alternative solution to resolve that problem, I fear that sensible politicians will lose out to populists all over the world, and this is a concern.

Unfortunately, I do not have a solution to present to the table, except for the sense that this is a time for all economies to get together and try to recreate that atmosphere we had at the earlier G20s, and of course that is the job of politicians. Our message should be to get our act together, because our job, as central bankers in this case, is done.

Marek BELKA, President, National Bank of Poland

I will just give a parting thought for today's discussion. Out of the TPP and WTO, the G20 and the IMF, you could say that the G20 is an outgrowth of the lack of capacity to change the voice and representation of the IMF, so you need to give voice to others who were blocked, and that is how it was done. I will just say that in a more complex and interdependent world – which is a big platitude, but it is true – the public aspect of global international institutions has actually grown, it is going up and not down, but actually, when you look at them, the IMF, WTO and World Bank are being degraded, and that is something which should be addressed. Therefore, that should probably be one of the messages, that the world has a common interest, because that is how it is built, in making sure that somehow our dear American friends find a way for those Republicans who want America to lead to vote to ensure that the IMF is allowed the necessary voice and reforms, which is the only way to avoid fragmentation, with American and other leadership being diluted.

That would be my parting thought. TPP might well be creating more problems than wealth because it is divisive in the region. It might create more jockeying for position, so no matter how difficult it is, let us make sure the WTO finishes the bloody Doha round, if it is to exist.

Jean-Claude TRICHET, former President, ECB

I will just make things clear. We exchange views, we have a multi-ocular vision, we do not pretend to have a communique, but we have a great deal of consensus.

Sean CLEARY, Executive Vice-Chairman of the FutureWorld Foundation and Chairman of Strategic Concepts (Pty) Ltd

My first remark is that I had no intention of blaming central bankers for the current condition. I hope that was clear from the beginning, but I just want to state it for the record. I am much more concerned about the implications of the situation in which we find ourselves today now that the central bankers, by definition, have to step back, than I am about what the central bankers did to get us through the crisis. Therefore, the first thing we need today is, quite frankly, a comprehensive sense of how the economy functions. Most of the time, when we ask the questions that we are asking – why we cannot get our 2% inflation target, why this massive backlog in corporate savings is sitting uninvested under present circumstances – it means we do not know the answers to those things, and we do not know the answers because we do not really understand how the economy works today. I would venture a hypothesis that it is the excessive financialisation of economic activity and the level of disaggregation between the financial and the real economies that leave us without instruments to measure accurately, but that is purely a hypothesis; we need an evidence base in order to determine policy going forward.

I have one proposition around the question that you asked, though, about labour. There have been declining returns to labour and increasing returns to capital in all of the advanced economies over, essentially, the past 30 years in the

Anglo-Saxon economies and the last 15 or 16 years in continental Europe. Japan is a special case that you can comment on much more extensively. The really concerning factor about that, however, is that the technological revolution on which we are now at the beginning of the cusp is likely to increase that highly significantly. Breakthrough technologies in terms of infotech, biotech, nanotech and cognotech are likely to displace very large numbers of persons at the lower end of the income scale out of labour markets over the course of the next ten years, and if one wants a historical reference point, it might be the Industrial Revolution somewhere between 1780 and 1850.

That will be a huge challenge going forward, and the implications of all of that in respect of what governments should properly do in respect of structural reform in the aggregate, and how banking should play a proper role in respect of financial intermediation, are completely unclear to me. I hope the rest of you have much more insight into that; I really do not. I think TLAC and similar types of regulation under present circumstances are actually causing banks to become more risk-averse and to start to apply financial resource into positional goods, because if you can do it in respect of real estate, if you can do it in respect of extremely valuable Impressionist paintings – such as the USD 170 million that went on the Modigliani just ten days ago – you have something to recover. Your collateral is secured, you are not taking a risk on growth, and therefore the diversion away from productive investment and into positional goods is actually quite understandable in the context of the level of regulation we face.