

A New Era for Global Banking

Desmond Lachman

Handelsblatt

October 20, 2008

In response to the global financial market crisis, G-7 policymakers have taken dramatic, albeit belated, steps to arrest a global financial market meltdown. Yet, despite these efforts, it is far from clear whether these measures will be nearly enough to prevent the worst global economic recession in the post-war period. It is also not clear whether these measures will be sufficient to either forestall the further nationalization of a wide swath of the global banking system or to prevent an excessive over-regulation of the financial system.

At the heart of the present global financial market crisis has been a vicious process of asset price deflation and financial system de-leveraging. This process, which has been on a scale without precedent in the post-war period, has close parallels with similar processes characterizing the global economy in the 1930s and with the Japanese experience following the bursting of its asset price bubbles in 1989.

While the bursting of the US housing market bubble towards the end of 2006 might have been the factor that precipitated the present the process of asset price deflation, that process has now gone considerably beyond the housing market. Since the beginning of this year, global equity prices have declined by around 35 percent, while the overall decline in US asset prices, including homes, equities, and bonds, has now reduced US household wealth by over 80 percentage points of GDP over the past year.

Falling asset prices have forced the banks to recognize large loan losses, which has considerably eroded the bank capital on which their lending operations are based. This has induced the banking sector to both sell assets and cutback dramatically on lending in an effort to mend highly impaired balance sheets. That in turn has inflicted considerable damage to the real sector of the global economy, which will be all too plainly visible over the next few months.

To date, banks at the global level have recognized over US\$550 billion in loan losses but they have only raised around US\$400 billion in new capital. In coming months, one must expect bank loan losses to rise considerably as the global recession deepens. This is underlined by IMF estimates that now estimate that the eventual loan losses to the international financial system will amount to around US\$1.4 trillion.

To their shame, G-7 policymakers were exceedingly slow to recognize the very nature and severity of the present recession. Worse still, it took a crash in global equity markets and the freezing up of global credit markets, before policymakers recognized that the banking system's problems were more those of capital inadequacy and solvency rather than those of liquidity.

Mercifully, over the past week, individual G-7 countries have at last announced bold measures to infuse much needed capital into the banks as well as steps to expand depositor protection and to guarantee inter-bank lending. In time, these measures should be sufficient to

allow the global banking system to return to normalcy. However, it would appear that these measures have come far too late to prevent a severe global recession over the next six months, particularly in view of the recent freezing of global credit markets and the panic in global equity markets.

If the expected recession over the next two quarters is not to morph into something very much nastier and more protracted, G-7 policymakers will need to engage in coordinated fiscal policy stimulus and monetary policy easing in order to support global aggregate demand. This would particularly seem to be the case in view of the fact that at the same time that the banks have been reducing the size of their balance sheets, the all important non-bank financial institutions, including the hedge funds, private equity funds, and structured investment vehicles, have also been forced to dramatically de-leverage their portfolios.

One has to expect that the de-leveraging by the non-banks, which at least in the United States are more important than the banks in overall financial market intermediation, will now continue apace despite the bold measures to shore up the banking sector. This is because of the inevitable step up in redemptions from these funds that will occur as a result of poor performance as well as of the increased margins that the banks will now require from these funds as they try to reduce risk exposure.

When the dust finally settles on today's global financial crisis, the world will find itself with a radically changed financial system. A large part of the banking sector will be partially or wholly nationalized, while the remaining part will be largely concentrated in the hands of a relatively few strong mega-banks. At the same time, the investment banks will have largely exited the scene, while the hedge funds and structured investment vehicles will have been more than halved in size.

More disturbingly, there is almost certain to be a strong political backlash against the global financial system that will find its expression in an excessive over-regulation of financial service activities that will stifle competition and innovation. If America's experience with the Sarbanes-Oxley legislation following the demise of Enron and Worldcom is any guide, one must expect the global political pendulum to swing from a financial market regime characterized by under-regulation to one where the heavy hand of government over-regulation will be with us for many years to come.