On the Brink

Simon Johnson
MIT and PIIE
http://BaselineScenario.com
Based on joint work with Peter Boone

Presented at the Global Economic Prospects meeting,
Peterson Institute for International Economics,
Washington, DC,
September 9, 2011

Mussa's Principle

"The time has long since past for public officials and central banks to stop kissing and start kicking the posteriors of bankers whose self-interest diverges substantially from the public interest." (p.11)

- Need to raise capital ratios of European banks, to reflect risks of falling market value of sovereign debt holdings
  - They need more loss-absorbing shareholder equity relative to their assets
- The right approach, in general, is to use tough stress tests to determine potential losses
  - But two rounds of such tests have failed to provide transparency or establish credibility

Source: Michael Mussa, "Global Economic Prospects as of September 9, 2011", PIIE paper

Lagarde's Proposal

- "Second, banks need urgent recapitalization. They must be strong enough to withstand the risks of sovereigns and weak growth. This is key to cutting the chains of contagion."
- "The most efficient solution would be mandatory substantial recapitalization—seeking private resources first, but using public funds if necessary."
- "One option would be to mobilize EFSF or other European-wide funding to recapitalize banks directly, which would avoid placing even greater burdens on vulnerable sovereigns."

Source: Christine Lagarde, speech at Kansas City Fed conference, Jackson Hole, August 27 2011, http://www.imf.org/external/np/speeches/2011/082711.htm

Ackermann's Rule

- "What's been demanded from well-known figures, that banks face mandatory recapitalizations, I think nothing at all of that."(1)
- "It's stating the obvious that many European banks would not survive having to revalue sovereign debt held on the banking book at market levels"(2)

Sources

1. Josef Ackermann, quoted in Bloomberg news story, http://www.bloomberg.com/news/2011-09-01/ackermann-rejects-lagarde-s-drive-for-mandatory-increases-in-bank-capital.html
2. Josef Ackermann, quoted in Reuters blog, http://blogs.reuters.com/james-saft/2011/09/06/europes-banks-wag-the-dog/

Ackermann's Rule, Applied

- "Frankfurt-based Deutsche Bank is "more strongly capitalized than ever before," and is having "absolutely no problems" with refinancing, he said"[1]
- Deutsche Bank financial position (June 30, 2011)[2]
  - Assets: 1.849 trillion euros
  - Total equity: 51.678 billion euros
  - Leverage (assets/equity): 35.78[3]
- Capital ratios (equity/RWA, based on risk-weighted assets of 320 billion euros)[4]
  - Tier 1: 14.0% (up from 12.3% at the end of 2010)
  - Core tier 1 (without hybrids): 10.2%
- "Risk-weighted assets were € 320 billion as of June 30, 2011, € 26 billion lower than at the end of 2010, largely reflecting reductions in credit risk as well as changes in foreign exchange rates."

Sources
1. Josef Ackermann, quoted in Bloomberg news story, http://www.bloomberg.com/news/2011-09-01/ackermann-rejects-lagarde-s-drive-for-mandatory-increases-in-bank-capital.html
2. http://annualreport.deutsche-bank.com/2011/q2/managementreport/financialposition.html
3. http://annualreport.deutsche-bank.com/2011/q2/managementreport/financialposition/balancesheetmanagement.html
4. http://annualreport.deutsche-bank.com/2011/q2/managementreport/financialposition/regulatorycapital.html

Ackermann's Rule, Scaled

- GDP (2011 forecast)[1]
  - Germany: 2.57 trillion euros
  - Italy: 1.59 trillion euros
  - Euro area: 9.45 trillion euros
  - European Union: 12.66 trillion euros
- General government gross debt (end of 2010)[2]
  - Germany: 2.08 trillion euros
  - Italy: 1.84 trillion euros
  - Euro area: 7.84 trillion euros
  - European Union: 9.83 trillion euros
- Highly leveraged growth model
  - United States and UK: private sector boom-bust; resulting sharp increasing in public sector debt (also Ireland, Spain)
  - Eurozone, with variation: high levels public debt during the boom; rely predominantly on bank financing; supported by Basel II principles

Sources

(1) Eurostat database, queried on September 8, 2011, GDP at market prices, annual series

(2) Eurostat database, queried on September 8, 2011, general government gross debt, annual series

Who Has What Kind Of Fiscal Space?

running out of fiscal space, it should not be taken to imply that exceeding the debt limit is inevitable in such cases. Rather, the message is that countries in this situation need to implement fiscal adjustment efforts that are extraordinary by their historical standards—either on a one-time basis (driving their debt below their debt limit and back on track toward its long-run level) or involving structural reforms that raise their sustainable debt limit.

Table 4. Estimated Probability of Given Fiscal Space (In percent)

	Projected Market Interest Rate			Model-implied Interest Rate		
	FS > 0	FS > 50	FS >100	FS > 0	FS > 50	FS >100
Australia	99.8	99.5	99.5	99.8	99.8	99.8
Austria	97.9	97.8	75.1	81.4	81.4	38.1
Belgium	95.9	89.7	2.9	95.5	92.0	5.2
Canada	92.2	92.1	70.3	80.9	80.9	57.1
Denmark	100.0	100.0	100.0	100.0	100.0	100.0
Finland	96.2	96.0	69.3	72.8	72.8	37.1
France	88.7	86.6	12.0	65.5	63.1	4.3
Germany	93.0	92.3	35.3	82.6	82.3	25.8
Greece	6.3	0.1	0.1	0.3	0.0	0.0
Iceland	49.1	44.0	5.8	57.9	57.3	20.4
Ireland	66.0	55.9	1.7	60.9	58.8	4.3
Israel	97.1	97.1	80.7	95.1	95.1	81.4
Italy	17.3	1.7	0.2	0.1	0.1	0.1
Japan	0.1	0.1	0.1	0.0	0.0	0.0
Korea	100.0	100.0	100.0	100.0	100.0	100.0
Netherlands	99.3	99.2	83.1	81.0	80.8	35.1
New Zealand	93.3	93.0	92.1	94.5	94.5	94.5
Norway	100.0	100.0	100.0	99.9	99.9	99.9
Portugal	34.4	27.1	0.4	27.6	23.8	0.5
Spain	69.9	61.0	1.6	82.6	79.8	6.3
Sweden	99.9	99.9	99.9	71.3	71.3	70.6
United Kingdom	78.1	75.9	8.9	69.3	68.9	12.1
United States	71.8	52.2	1.2	82.9	71.2	2.8
Median	93.0	92.1	35.3	81.0	79.8	25.8
Mean	75.9	72.2	45.2	69.7	68.4	38.9

Source: IMF staff estimates.
Note: Red and yellow cells indicate probability less than 50 percent, and between 50 and 85 percent, respectively.

Source: Jonathan D. Ostry, Atish R. Ghosh, Jun I. Kim, Mahvash S. Quereshi, "Fiscal Space," IMF Staff Position Note, September 1, 2010

Too Big To Fail In Action

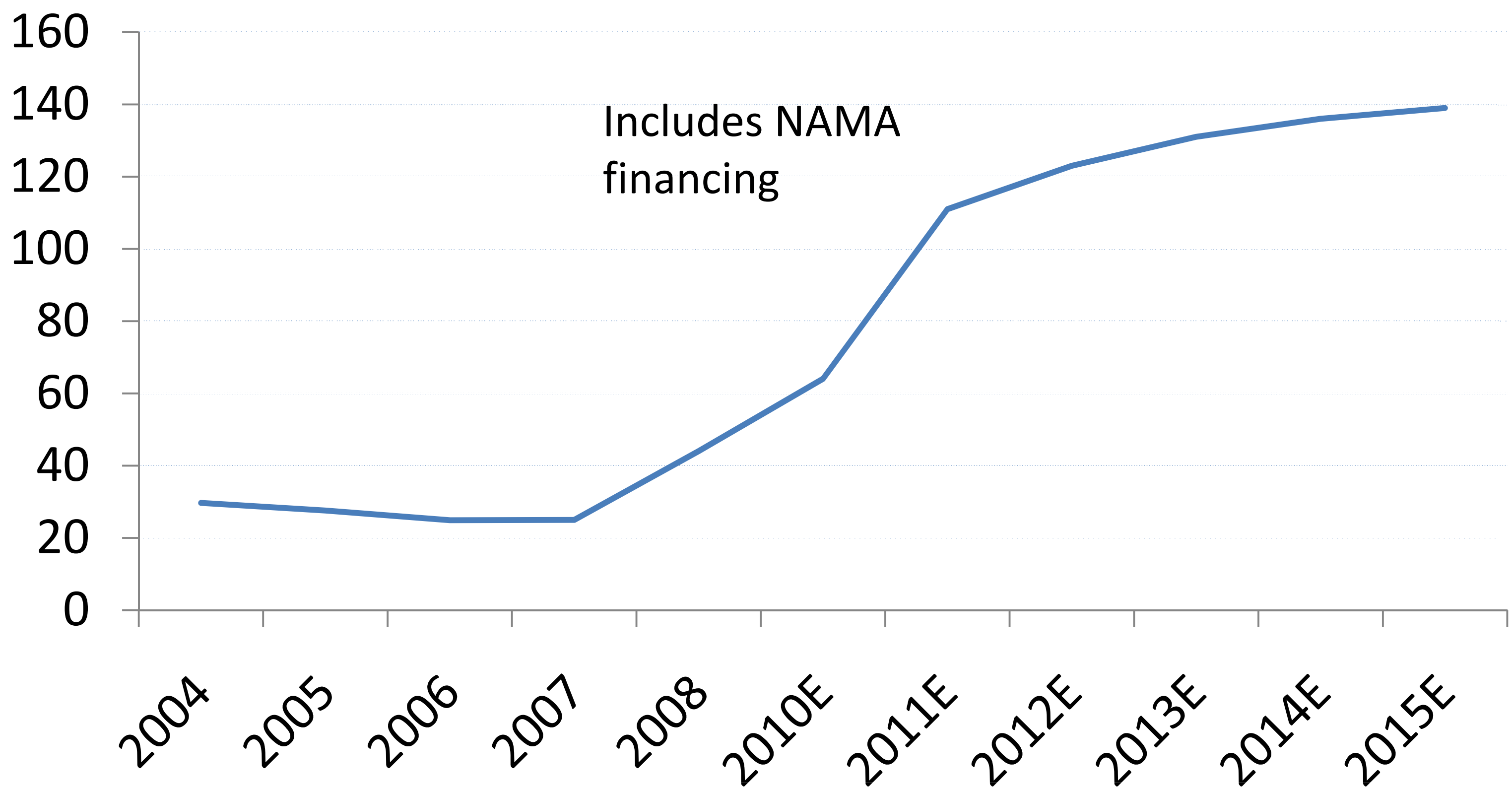
"Maybe not explicitly, but what are the chances that TD bank will not be bailed out if it did something stupid?"

Ed Clark, President and CEO Toronto Dominion Bank, on an investor roadshow selling TD preference shares, January 2009

License Plate of Robert Kindler, vice-chairman of Morgan Stanley (after the crisis)

Too Big To Save In Action: Irish Public Debt/GDP

(2004-2015E)



Source: Peter Boone and Simon Johnson, "Will The Politics of Global Moral Hazard Sink Us Again? " In The Future of Finance http://harr123et.files.wordpress.com/2010/07/futureoffinance-chapter101.pdf

What Does This Imply For The European Central Bank?

- Price stability, the sole mandate:
  - Jean-Claude Trichet (Sept 8, 2011): “Impeccable” record, inflation at 1.55% per annum over 12-13 years
  - Jurgen Stark: announced resignation (Sept 9, 2011), effective end of the year

  “A person familiar with the matter said Mr. Stark is leaving due to a conflict over the bank's bond-purchase program.”(1)
- For more background and alternative scenarios, see Peter Boone and Simon Johnson, Europe on the Brink, PIIE policy paper, July 2011, http://www.iie.com/publications/pb/pb11-13.pdf

Source: WSJ news alert, 10:01am September 9, 2011, “ECB’s Stark resigns, rattling markets.”