Chapman Global Finance Conference: September 2019

Presented by

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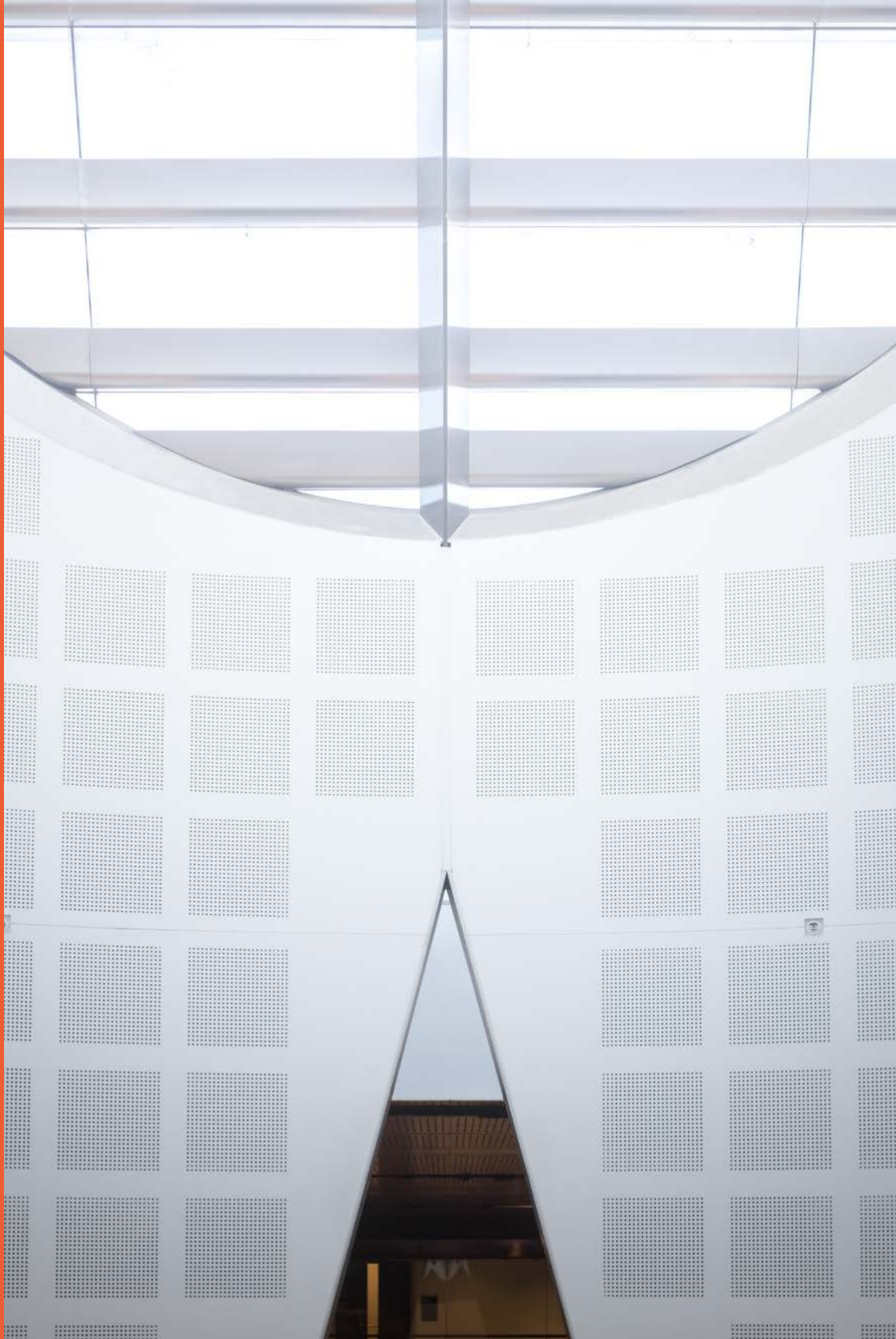
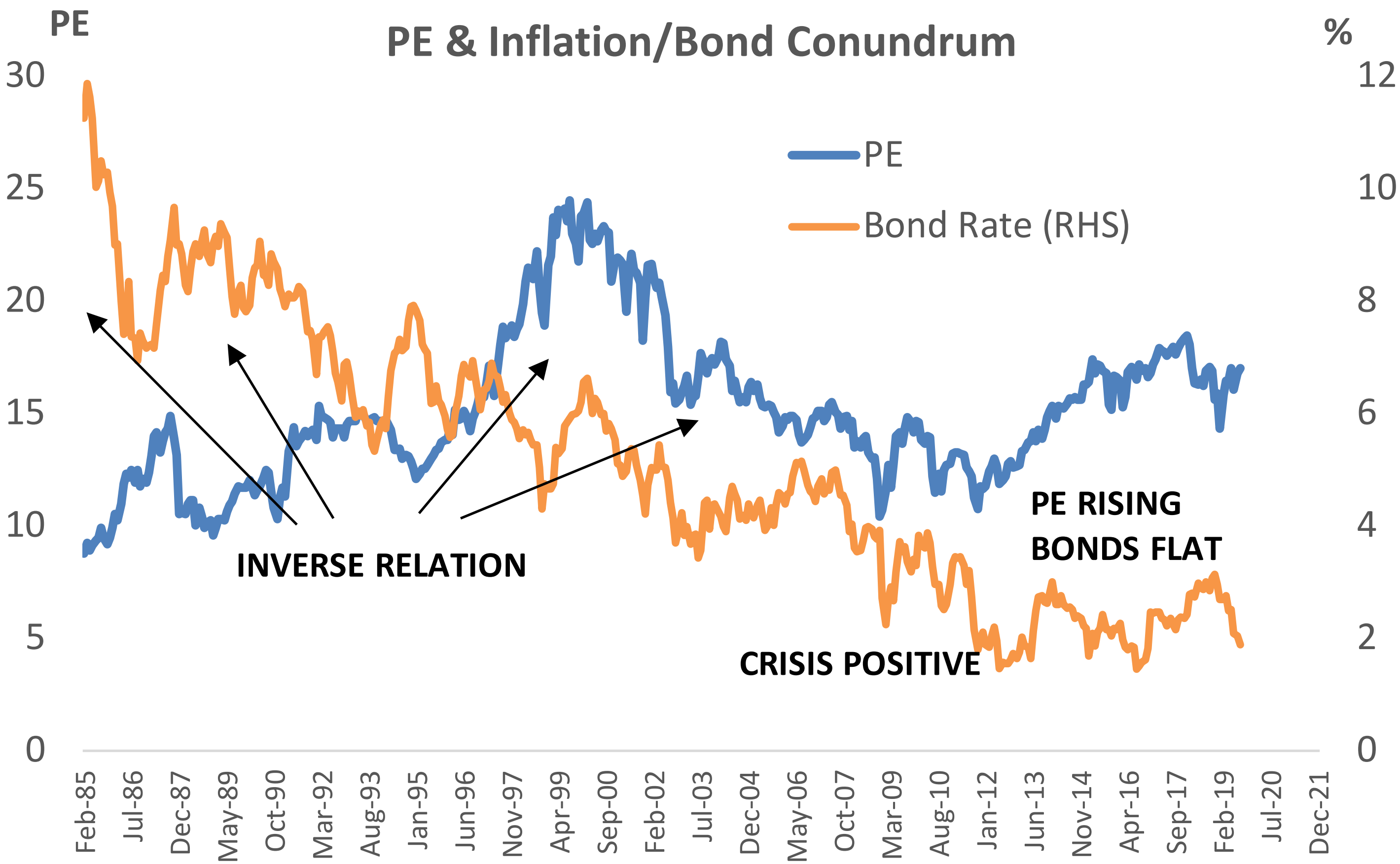
THE UNIVERSITY OF SYDNEY



My task today

- I was asked to give my view on the current global situation since the crisis? Are the themes of unbalanced globalization (China saving glut), financial innovation and regulatory failure still intact? Are new themes looming large?
- The crisis response was supposed to be (a) emergency liquidity (b) deal with bad assets (c) recapitalize banks (d) regulatory reform. Only the USA more-or-less followed this. Europe & Japan are another story.
- Then came QE, which morphed from emergency liquidity to a "*bad bank*" role (US and Europe). It has morphed again into an exchange rate strategy for Japan and Europe (that they would never admit to).
- China's growth and its global political strategies are the basis of the trade war. Over-investment reduces returns, causes excess capacity, deflation, & hollows out the middle class.
- Over-investment is always accompanied by financial crises—this time China is in the centre. Their attempts to control spiraling debt on-and-off balance sheet will result in very slow growth. This will cause further policy errors—like low and negative interest rates. All of this is bad for banks, investment decisions, & resource allocation.
- A perspective on the trade war.
- Europe is a particular problem as it did not deal with the crisis. Its central economic flaw is the euro. The banking and liquidity problems remain elevated.
- Brexit. The UK will do well to get out of Europe.
- Fintech will raise new problems to deal with beyond the China crisis.
- Comment on regulatory reform

Setting the Scene: US PEs, Inflation and Bonds. Does it Make Sense?

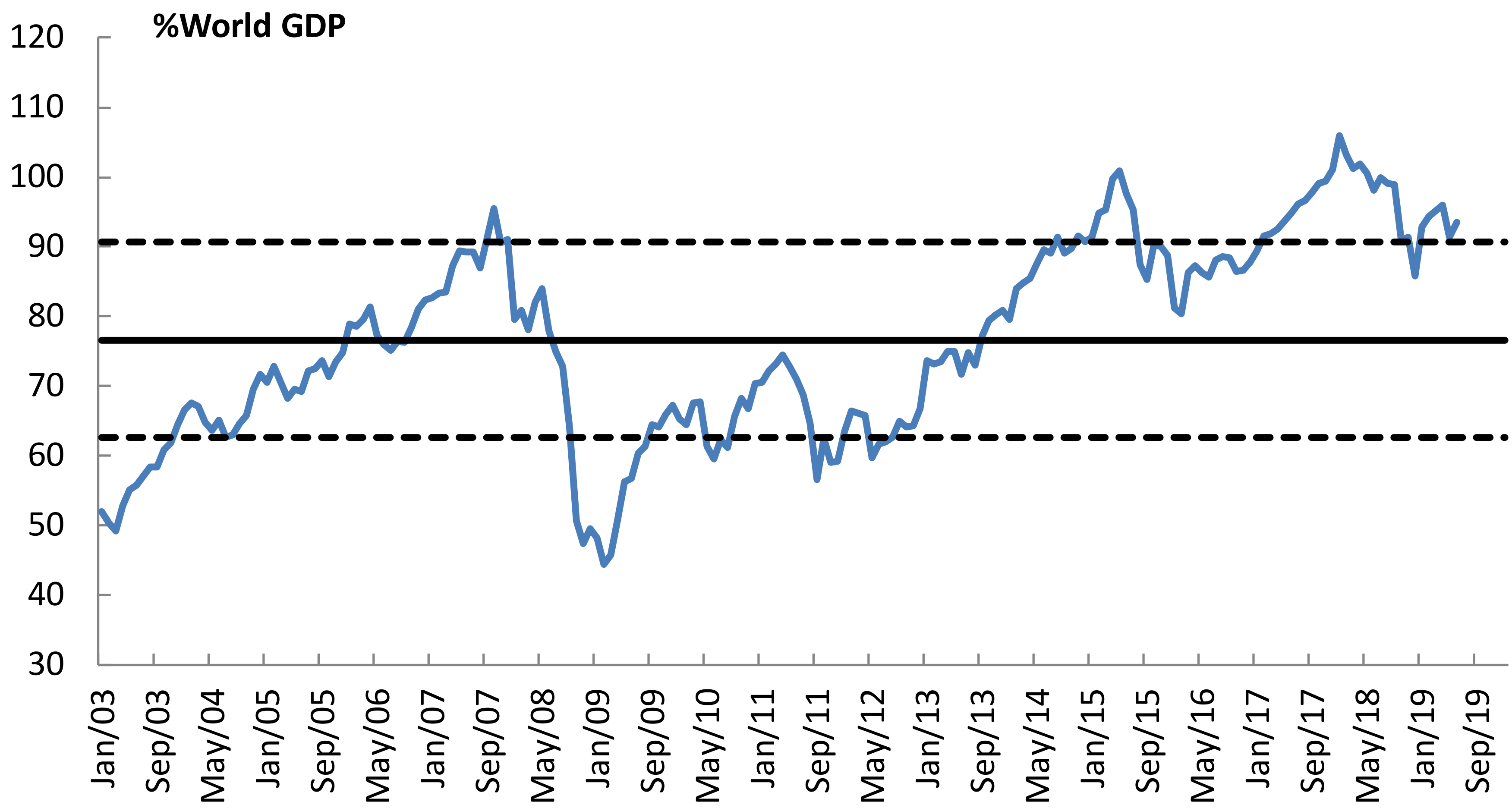


- PE's rise when inflation falls.
- The Crisis saw a positive relationship due to fear of deflation.
- Bonds are flat since 2014.
- So the markets are expecting China, trade wars, Brexit, QE, negative rates all mean rising trend growth.
- Does it make sense?

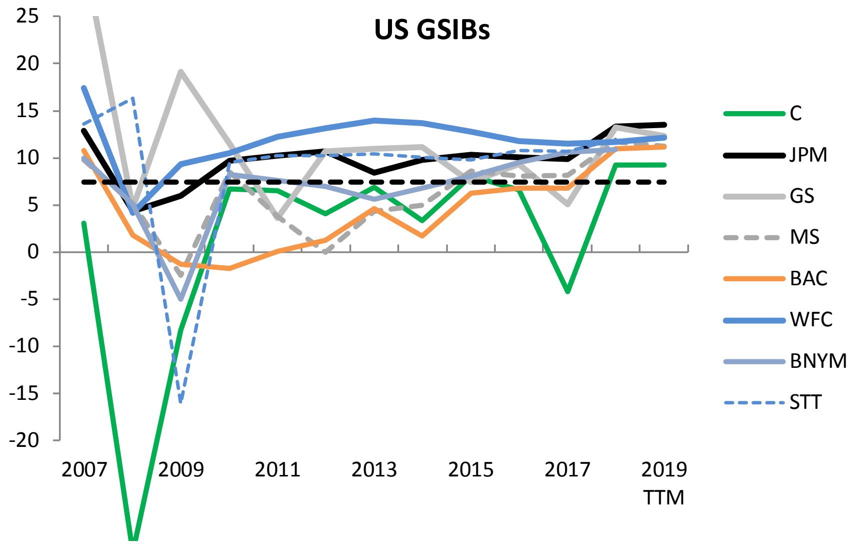
QE & Monetary Policy Distorting Markets

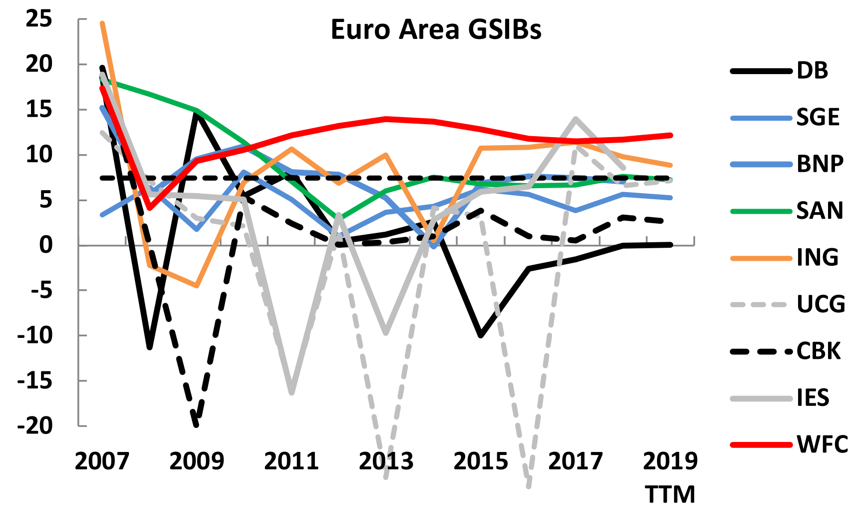
	1920-2019	2000-2019	2009-2019
		(% per annum)	
CPI	2.60	1.98	1.76
S&P 500	5.79	3.07	11.57
Real S&P	3.19	1.09	9.81
Real Div Yield	1.35	-0.03	0.25
Real S&P Tot. Ret.	4.53	1.06	10.06
10 yr	4.85	3.34	2.49
Real 10 yr	2.25	1.36	0.73
Asset Allocation Return Real 60% equity 40% Bonds	3.62	1.18	6.33

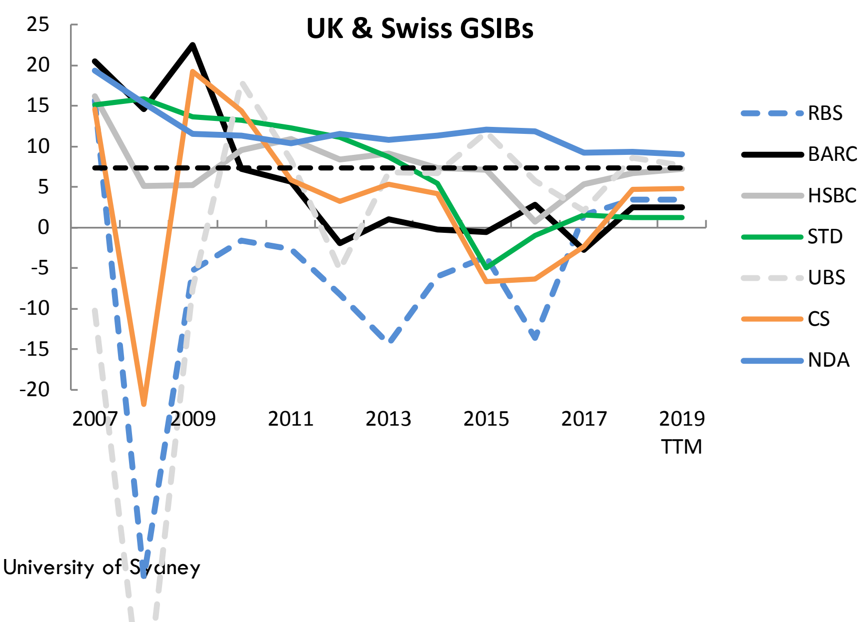
World Market Cap to World GDP

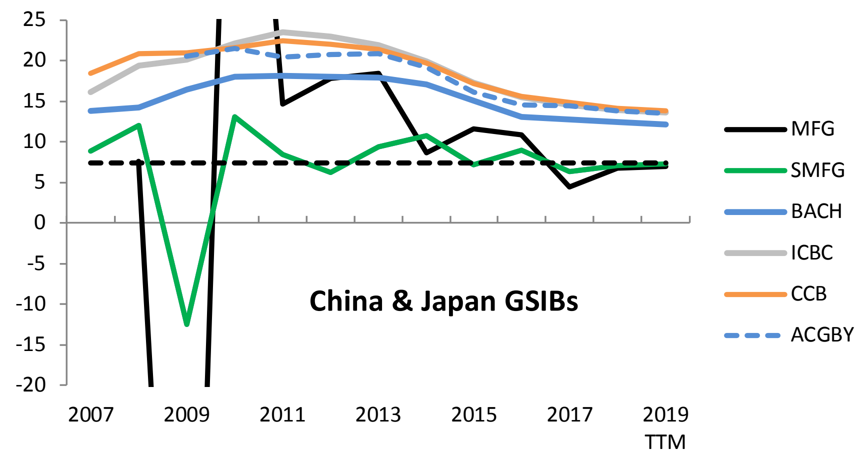


GSIB ROE Recoveries Point to Where Banking Problems Remain. This Colours Monetary Policy.

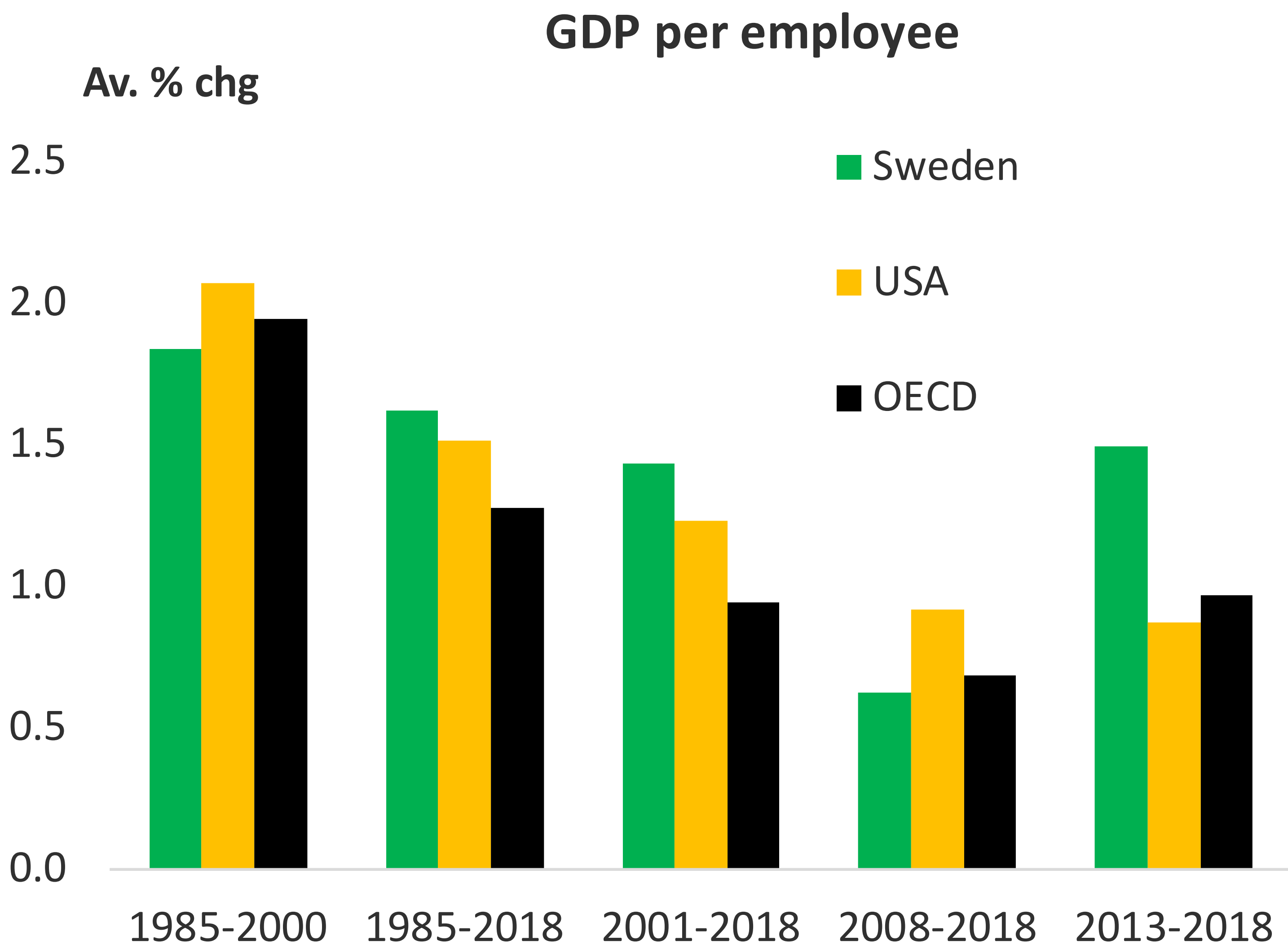






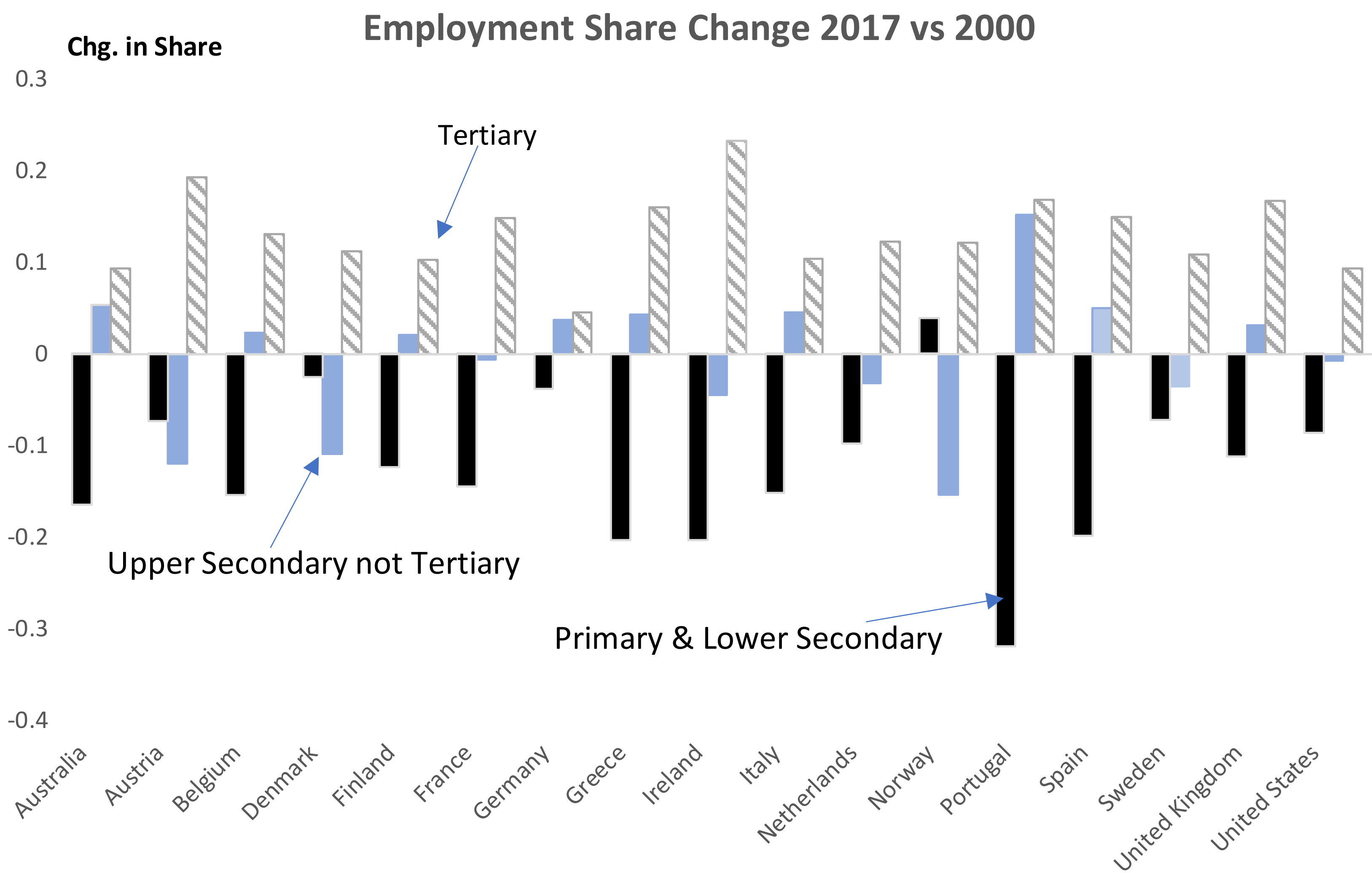


Productivity Falling, Buybacks Instead of Investment. What Does Sweden Do?

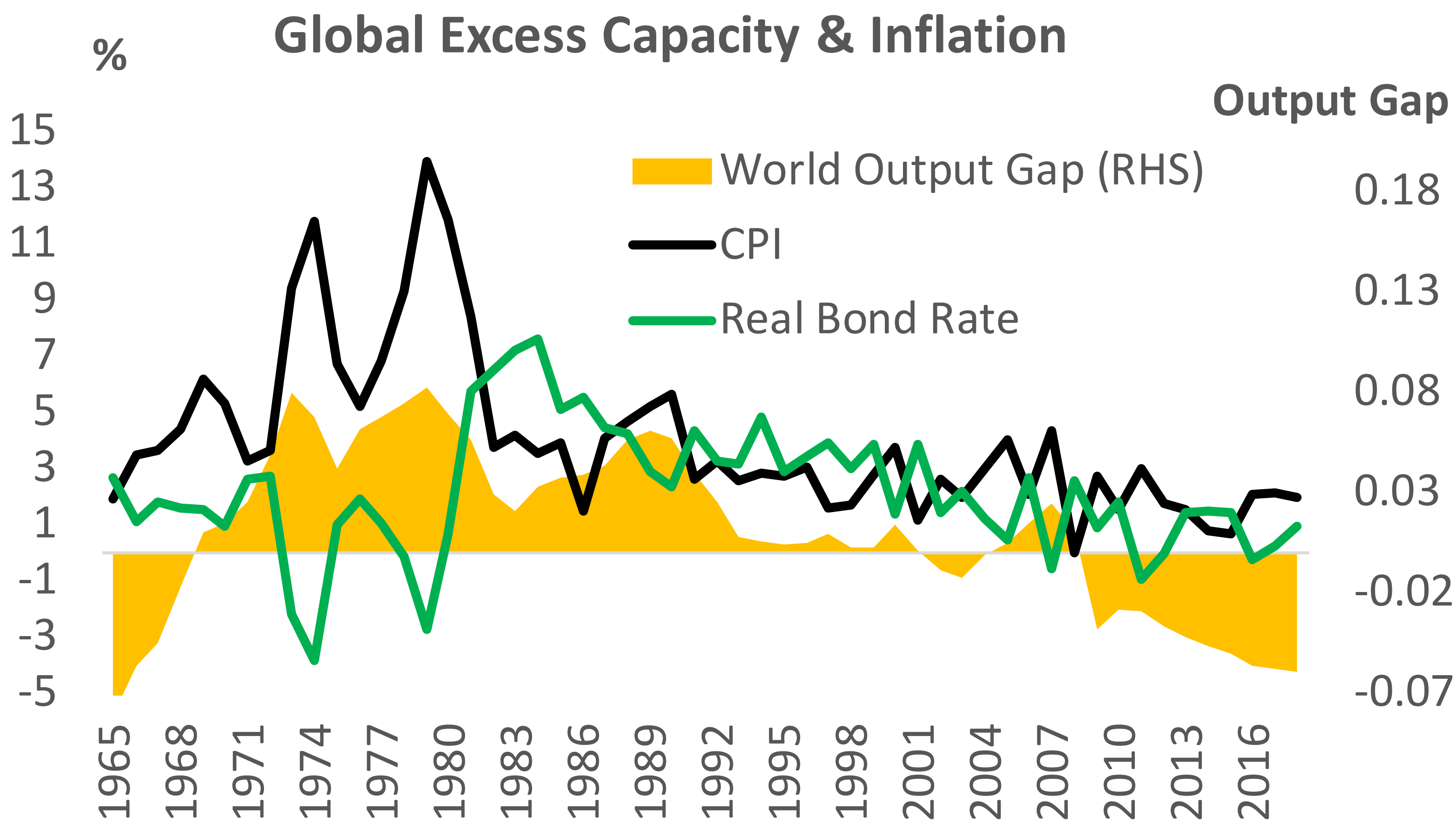


- No minimum wages. Strong union involvement.
- Most equal income distribution.
- R&D expenditure 3.3% GDP (OECD 2.3%).
- Low subsidies to R&D. Pays Soc. Sec. contrib. of staff working on commercial R&D—low taxes to attract foreign talent.
- Foreign sales focus.

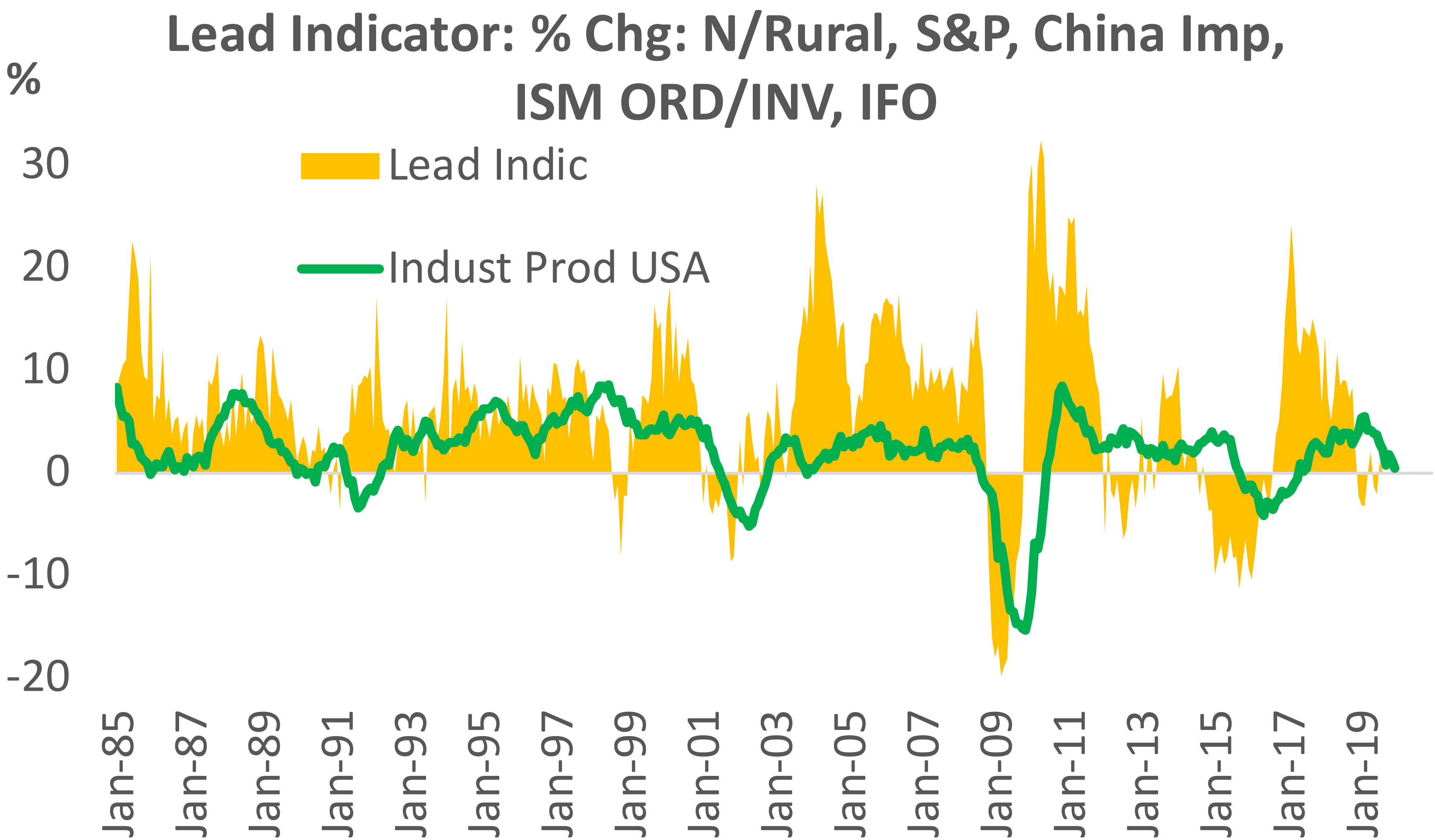
Hollowing out: changes in shares of employment by pay category, 2000-2017



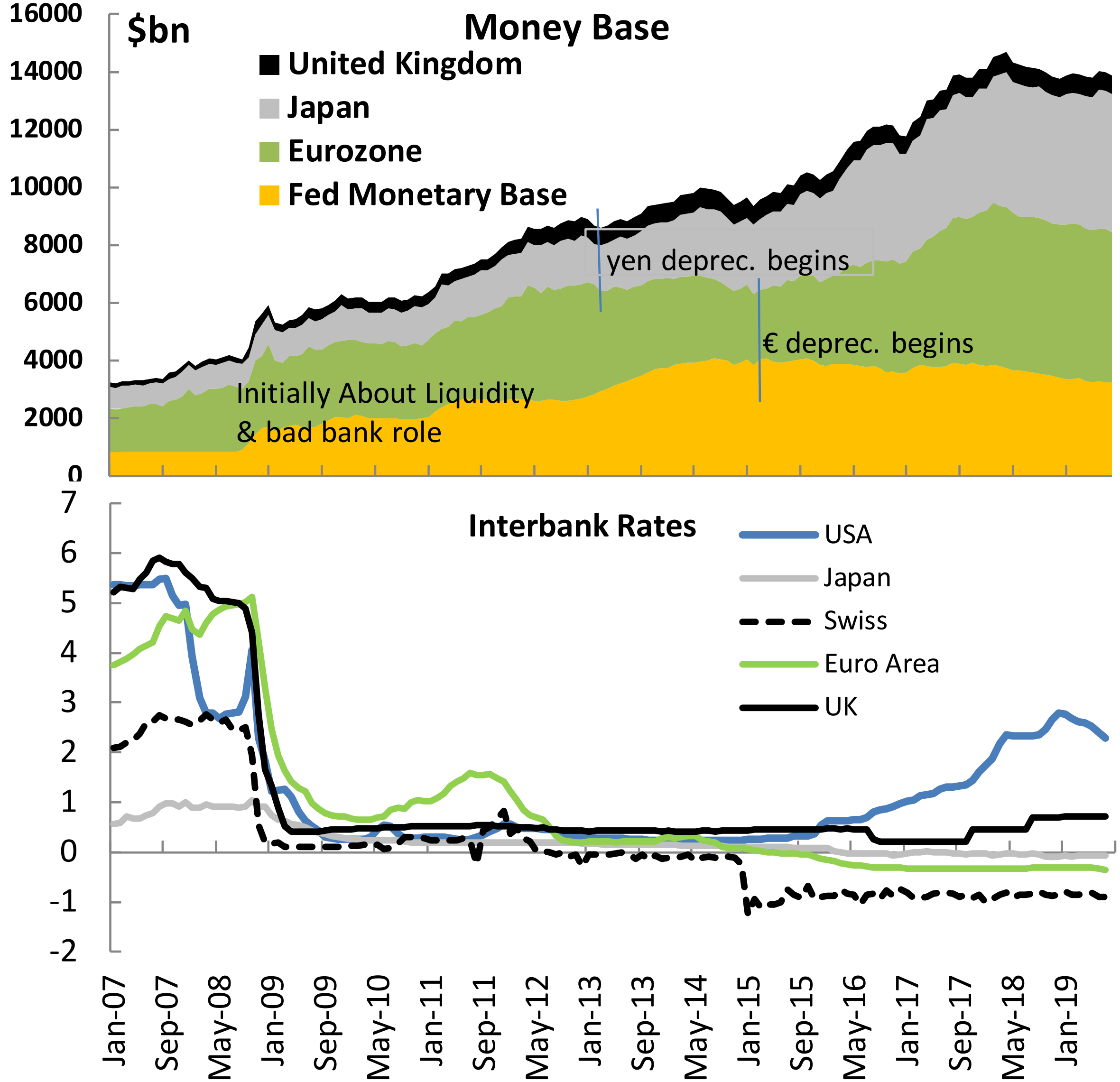
World Output Gap, Inflation & Real Bond Rate (US)



Lead Indicator: What the Fed is Worried About Now-- Recession



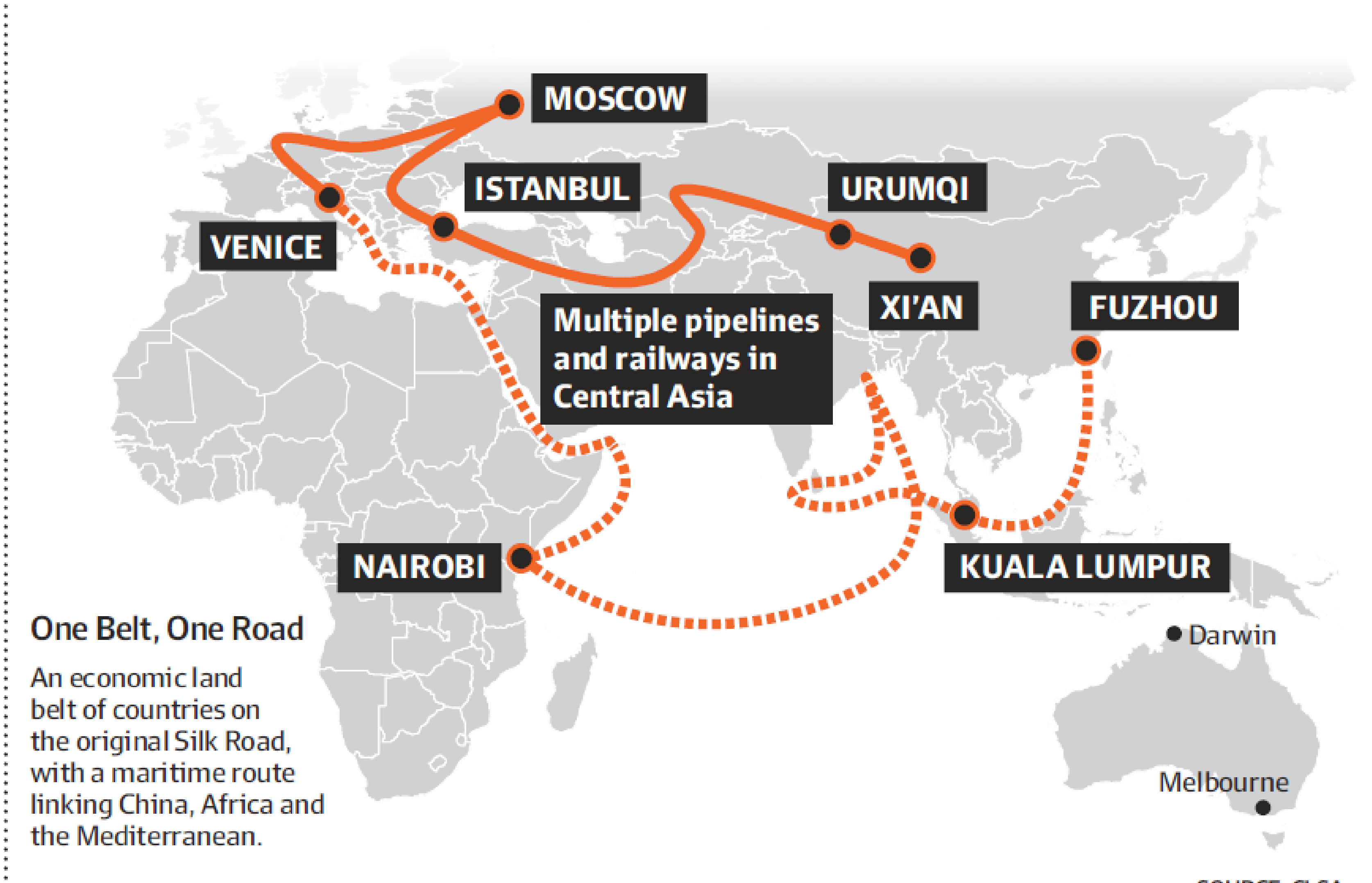
QE: Central Banks As Bad Banks & Exch. Rate Manipulators?



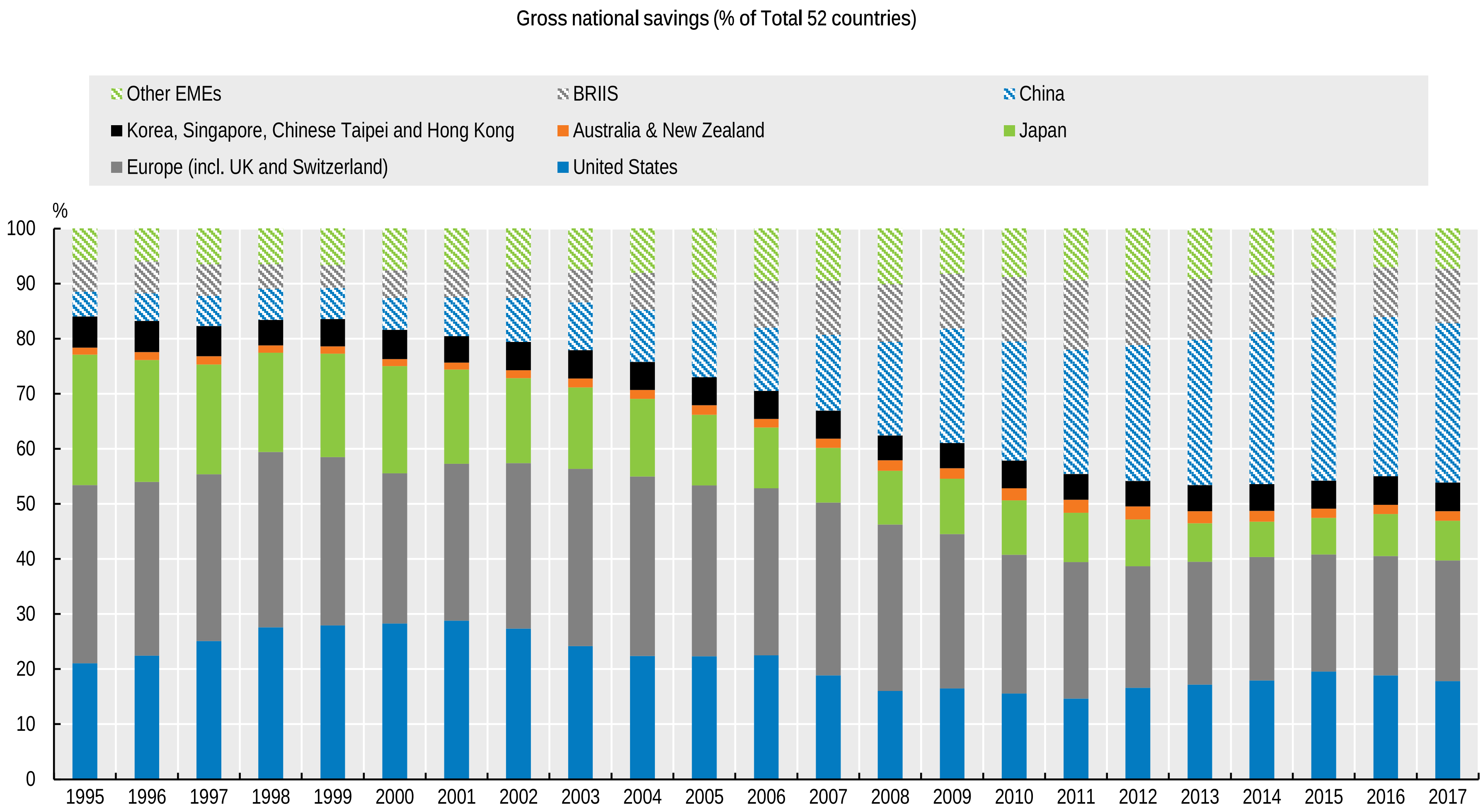
The Problems with QE

– Weakest recovery in the post war period and no inflation after a decade of the easiest money of all time. Slipping into recession risk again. Excuses: trade tensions, Brexit, uncertainty.
– Central banks claim negative rates & QE flooding the interbank market will force investment in risky assets & reflate the economy—of course that's nonsense.
– We are to believe that US, EU, JAP & UK banks need $14.5tn to trade with each other, when $3.4tn was enough in 2006??
– They use the cash to trade riskier assets & currency in secondary market. Its "churning". Investors plunge into equities, but it's also the secondary market —nothing to do with raising new money for investment.
– QE=bad bank + currency play (beggar my neighbor).
– "Bad bank" because no one knows what assets held by central banks are worth in the event of a recession or higher rates. The coupons on these assets are higher than cash rates—banks could easily buy it all back if they were offered—they certainly have the cash. But no one wants to do it.
– Putting assets with central banks doesn't destroy risk—just hides risk.

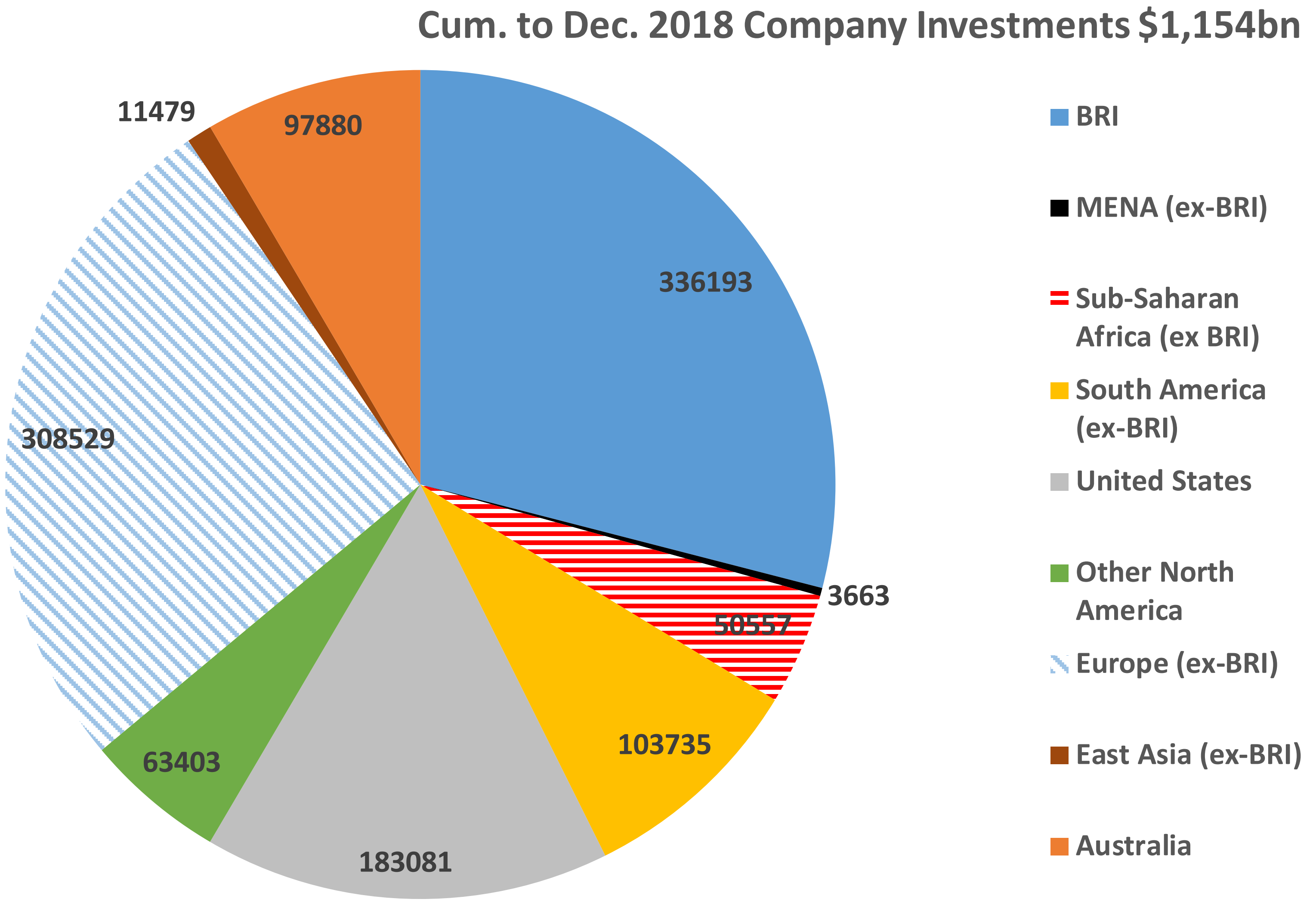
CHINA: BELT AND ROAD



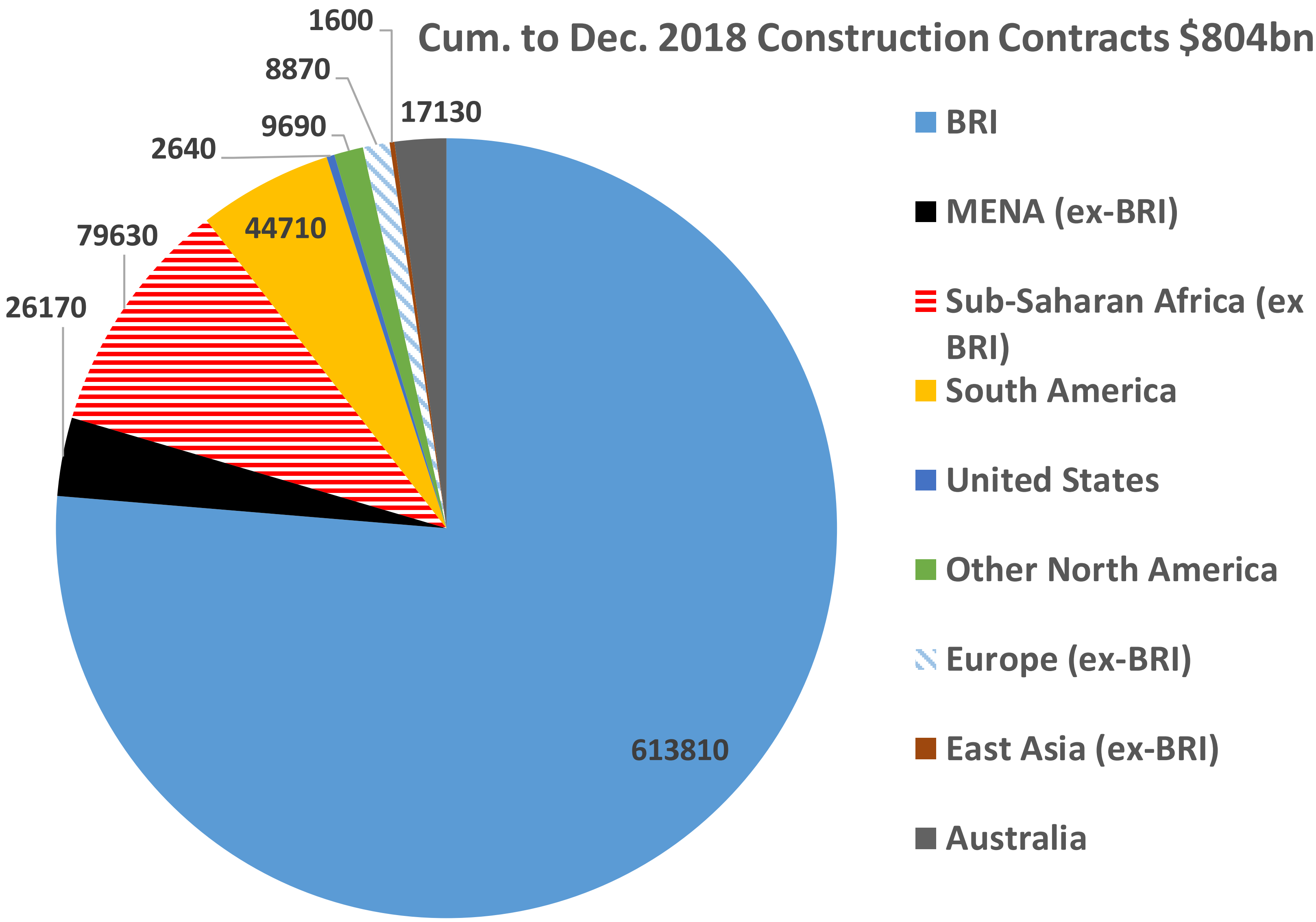
China Glut: Saving Investment Strategy



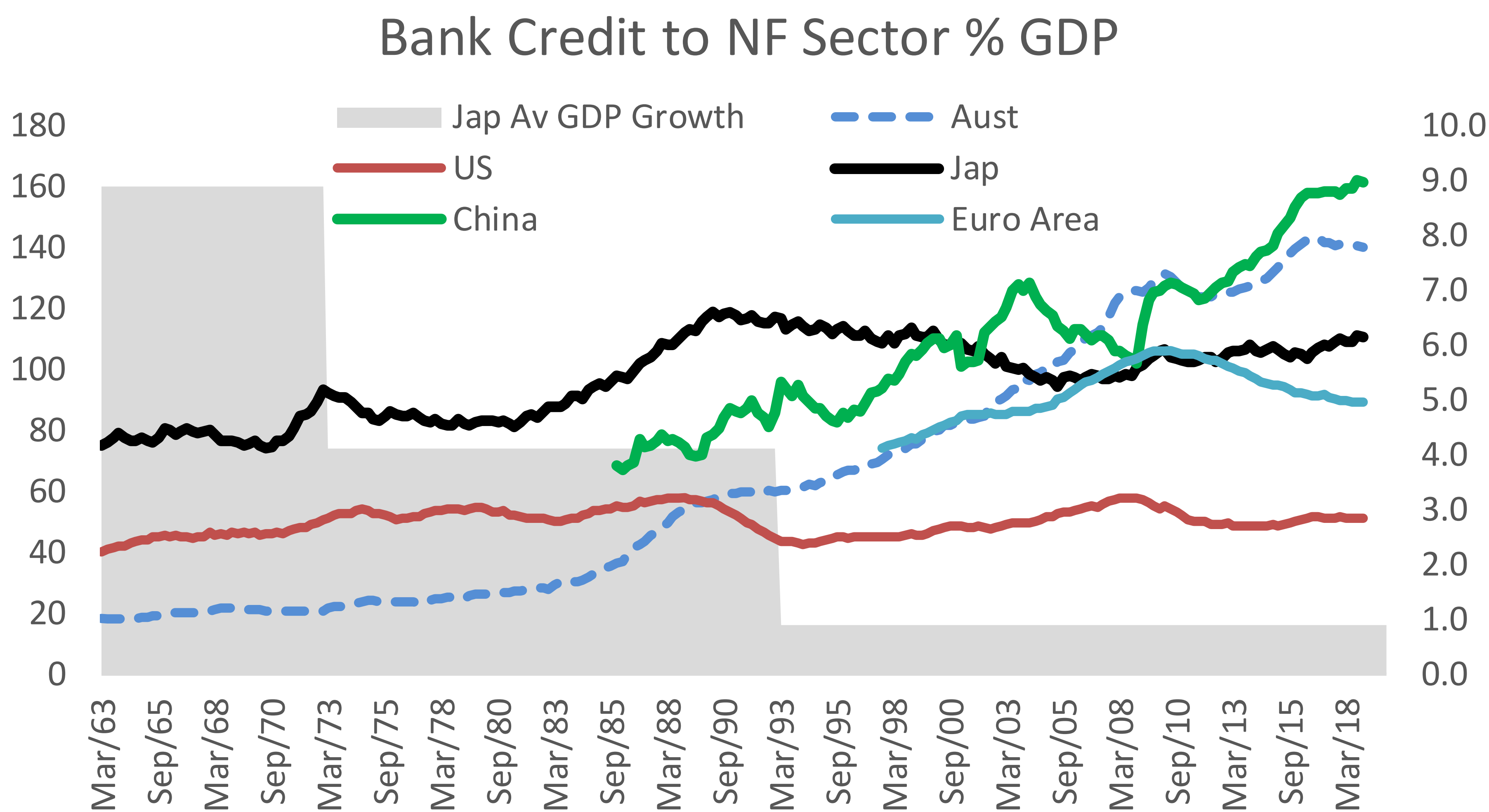
Belt & Road & MIC 2025: Foreign Company Investments 2005-2018,$1.15tn



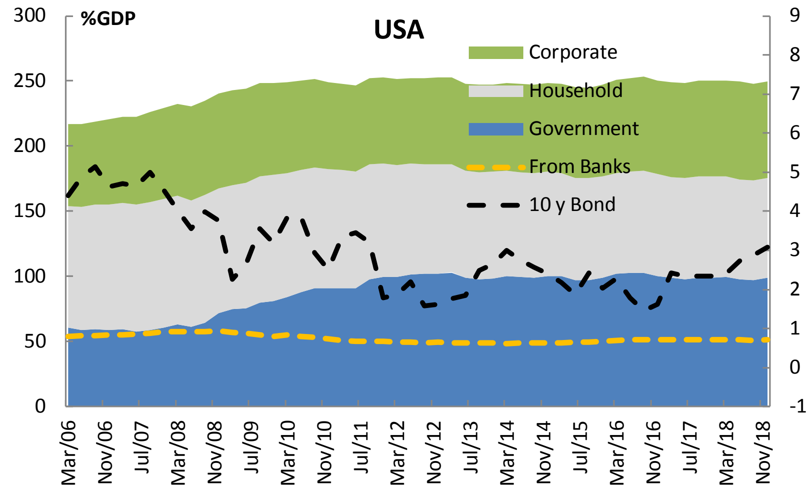
Belt & Road: Foreign Construction Contracts Since 2005-2018, $804bn

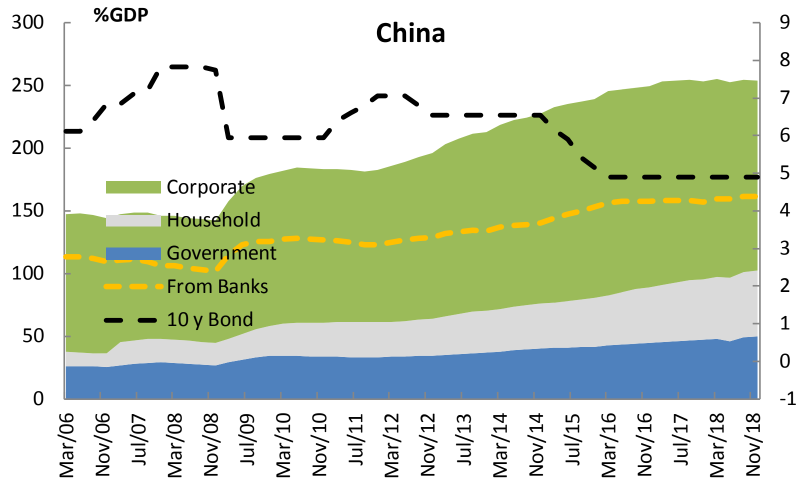


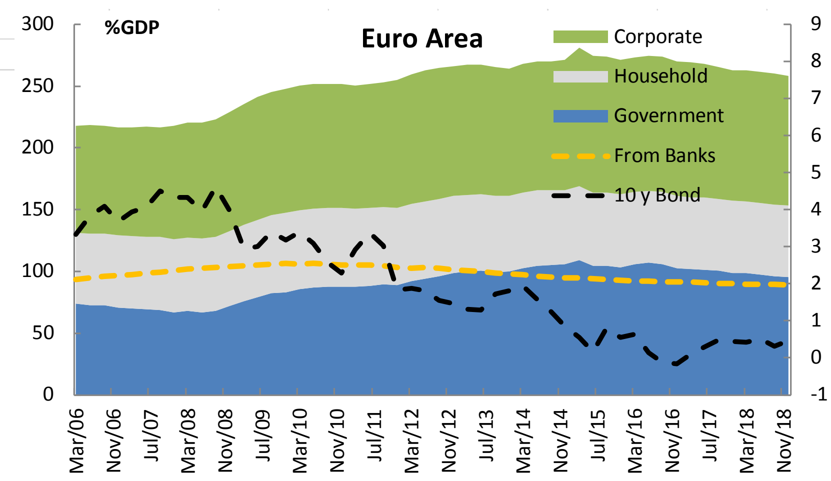
CHINA MISTAKES: Bank Credit and Lost Decades

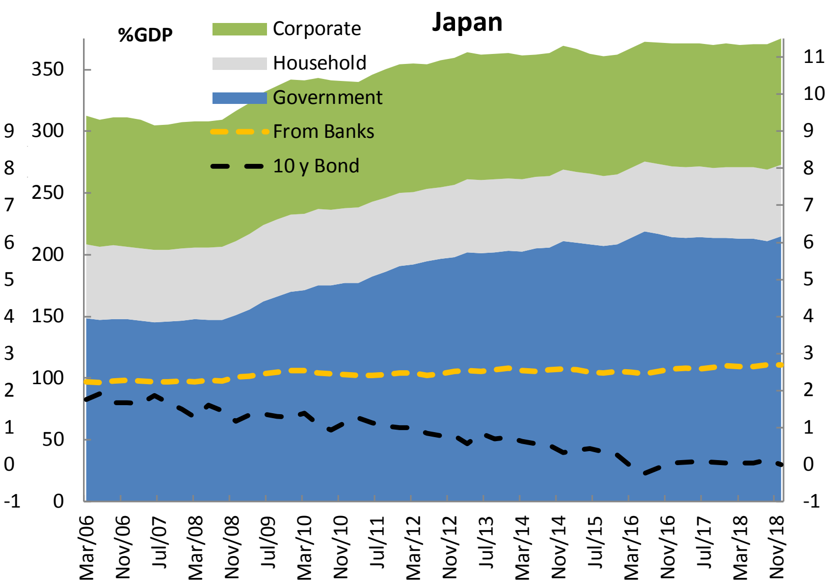


Debt as Share of GDP: USA, China, Euro Area, Japan

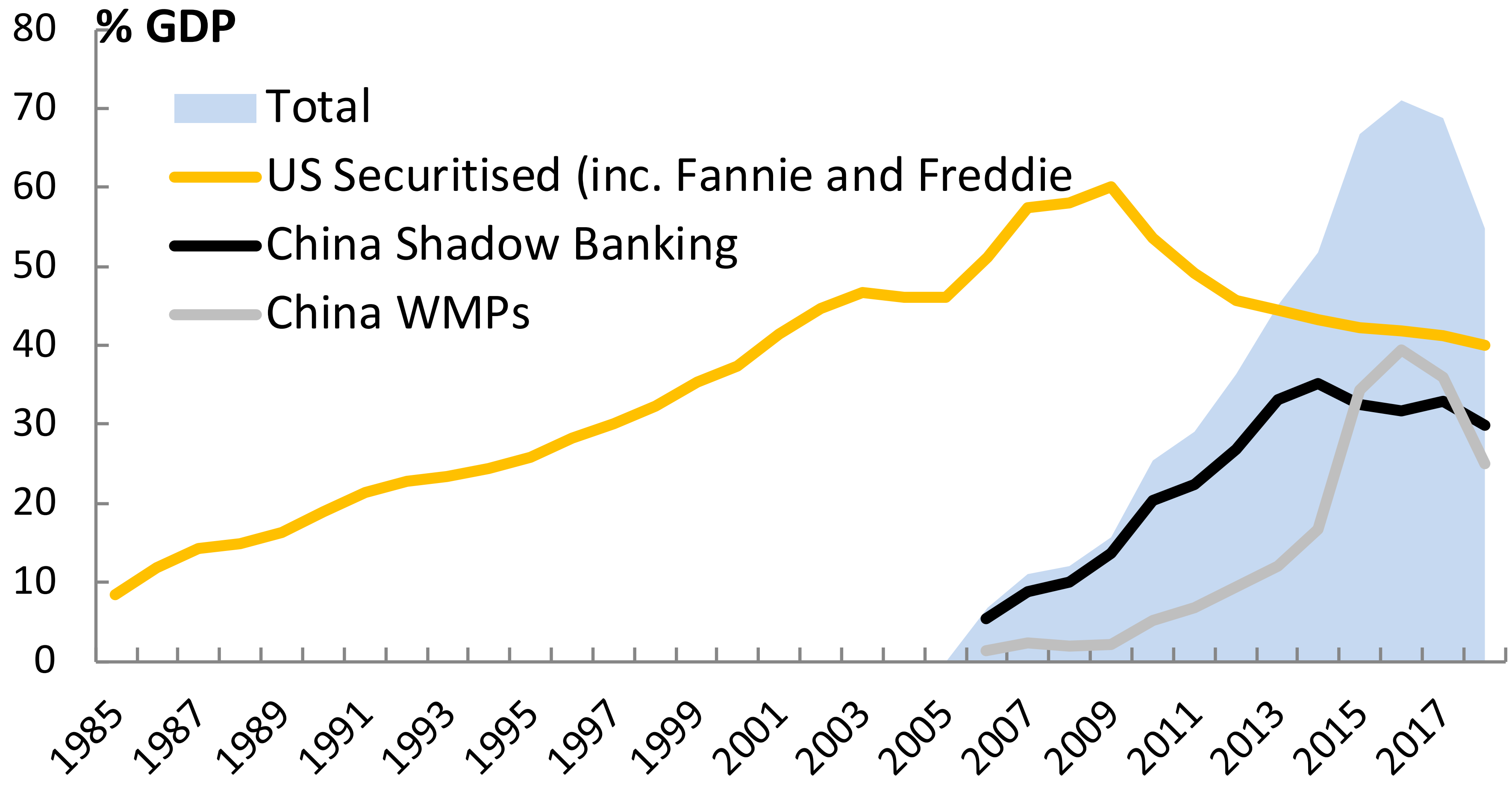




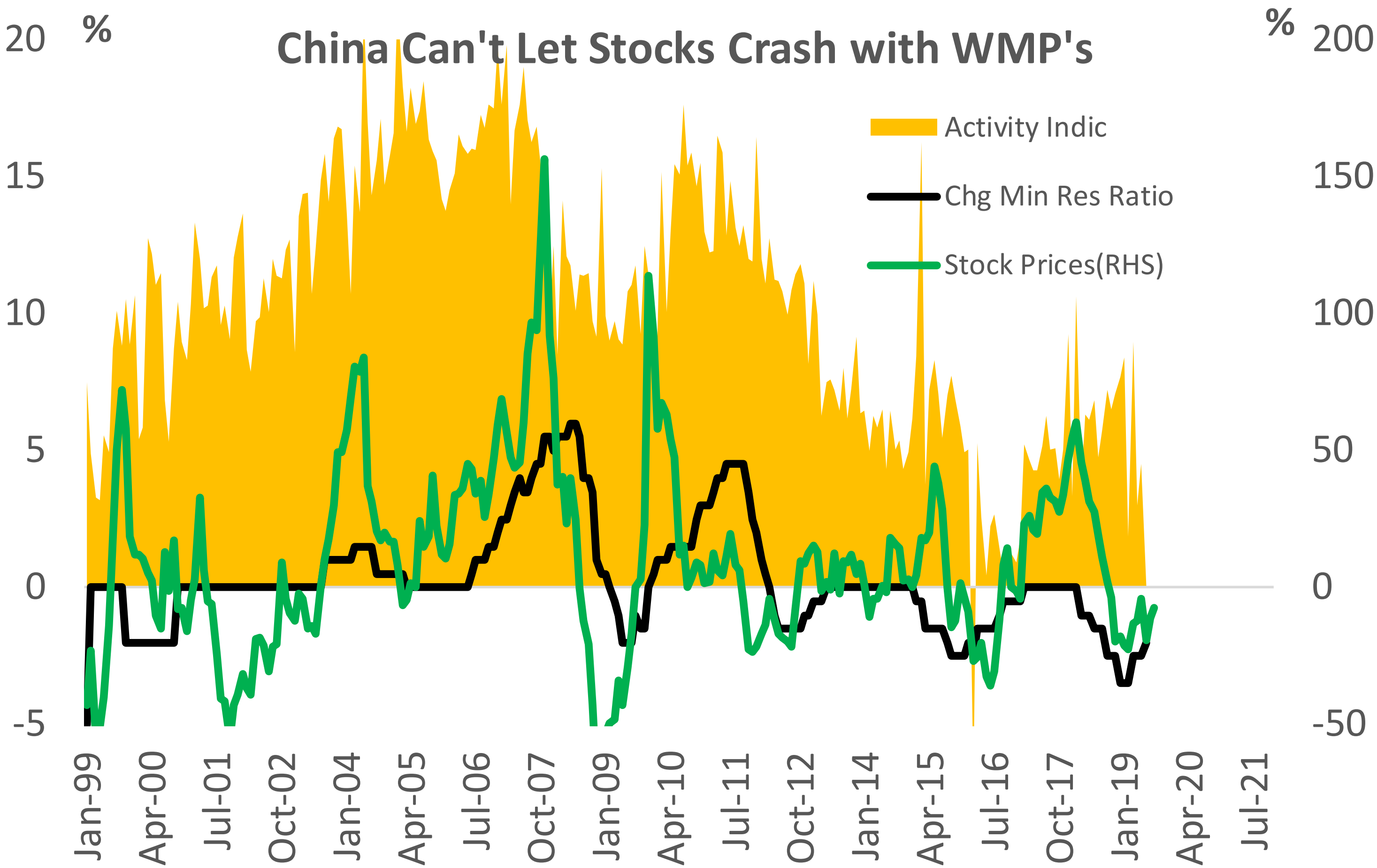




US Securitisation Compared to China



China Can't Afford to Have Equities Fall: WMPs Would Move to Negative Equity

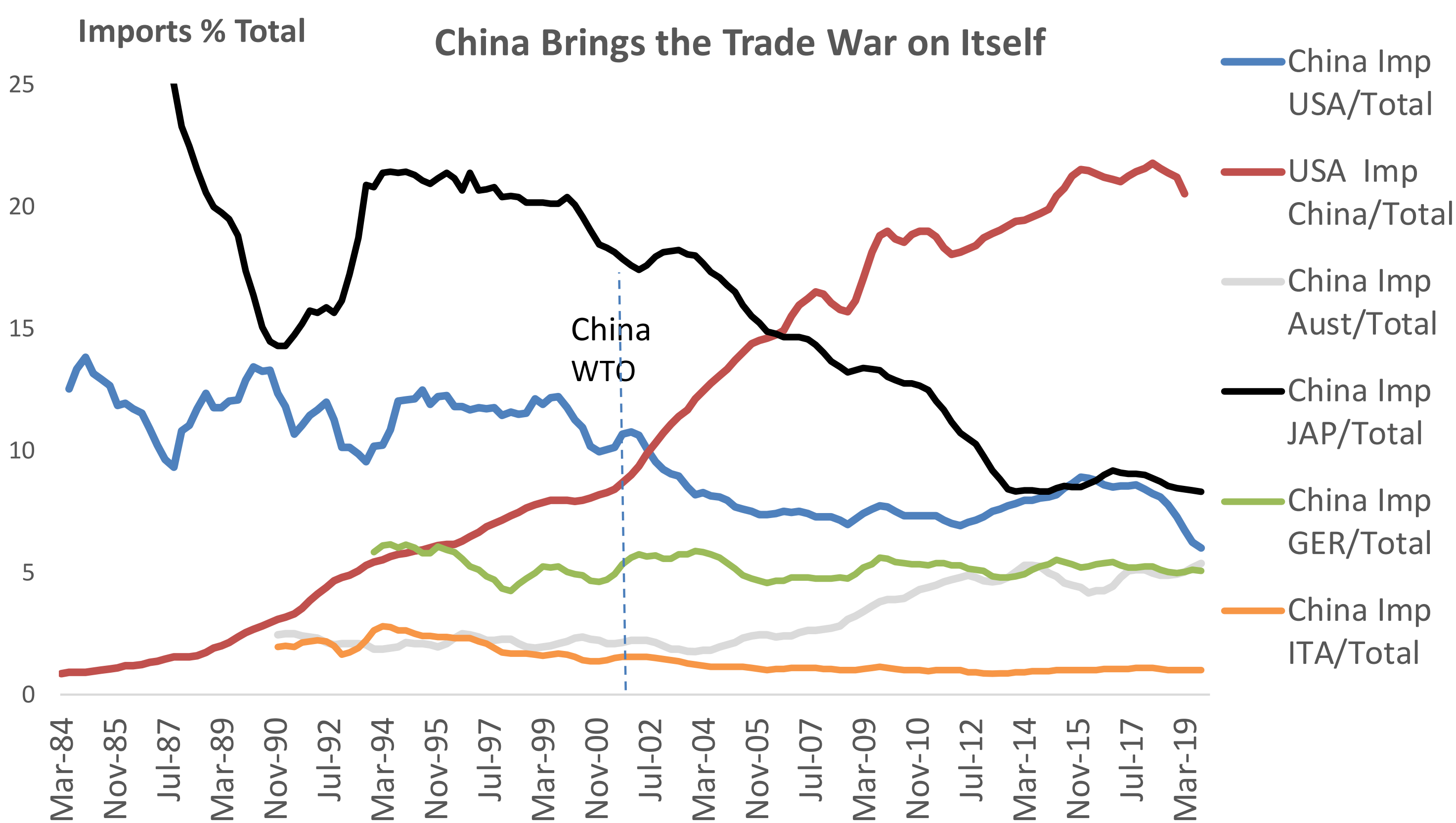


- Over investment, falling returns.
- Finance by SOE banks.
- Tried to reel in credit after GFC, but its quantitative approach led to WMPs & other off-bal-sheet activity.
- Can't afford an equity collapse.

Trade War: How China Breaks the Rules

– There is a large literature on disputes with China since WTO—official, academic and judicial.
– Topic headings include: technology transfer requirements; violations of the Trade Related Aspects of Intellectual Property Rights (TRIPS), including IP theft, copyright infringement and counterfeiting; subsidies; State-Owned Enterprises (SOEs) that operate on non-commercial terms (including subsidised lending via SOE banks); use of taxation as a trade weapons; rare earth export quotas; import restrictions (including via technical barriers to trade); dumping; absence of national treatment for foreign banks and payment companies; non-participation in the Government Procurement Agreement in any meaningful way; and capital controls and related exchange rate manipulation techniques.
– These have contributed to rapid Chinese penetration of other markets—particularly into the United States.

Trade War: Import Penetration by China and of China



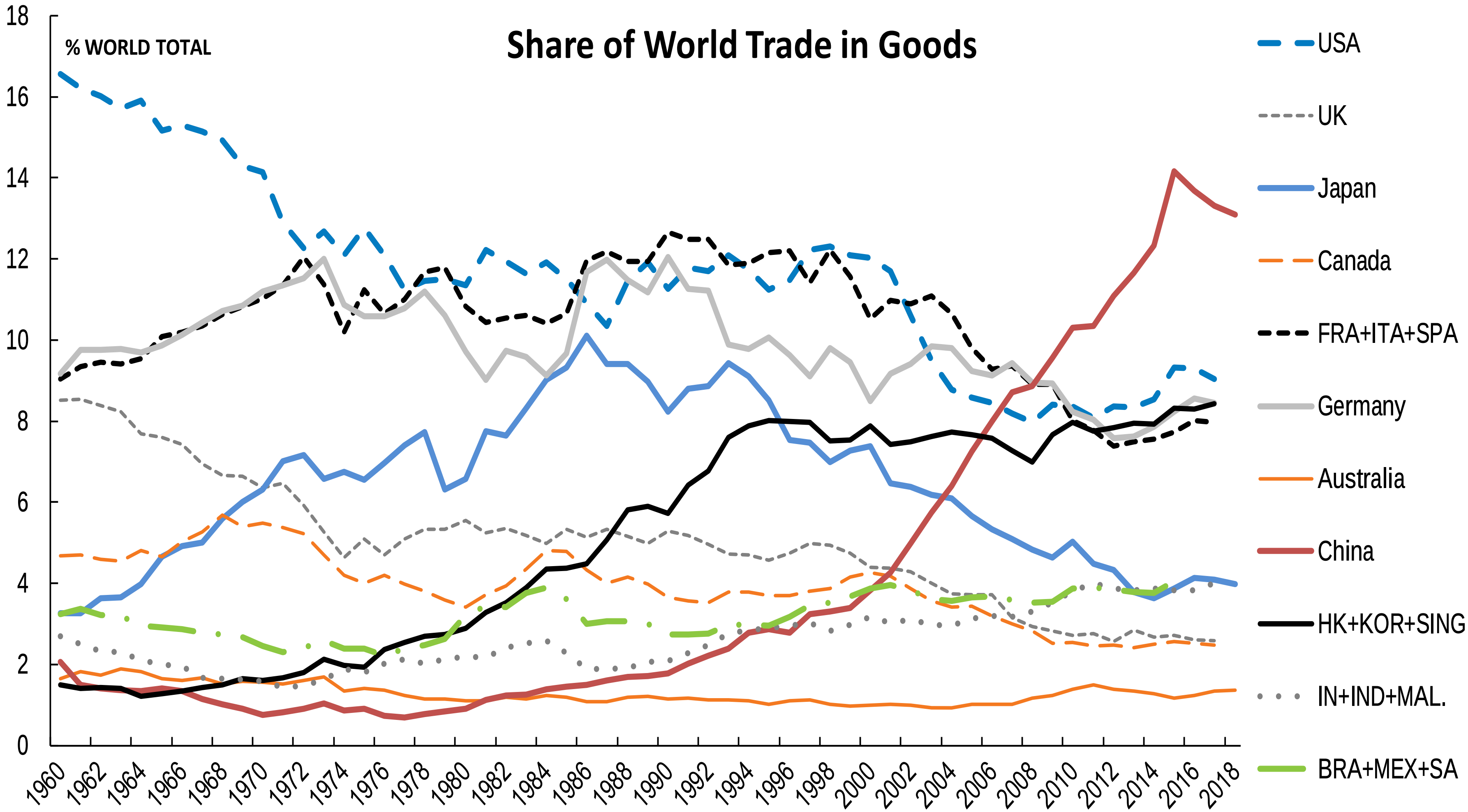
After WTO China share of country imports rises sharply.

China has over 20% of US imports.

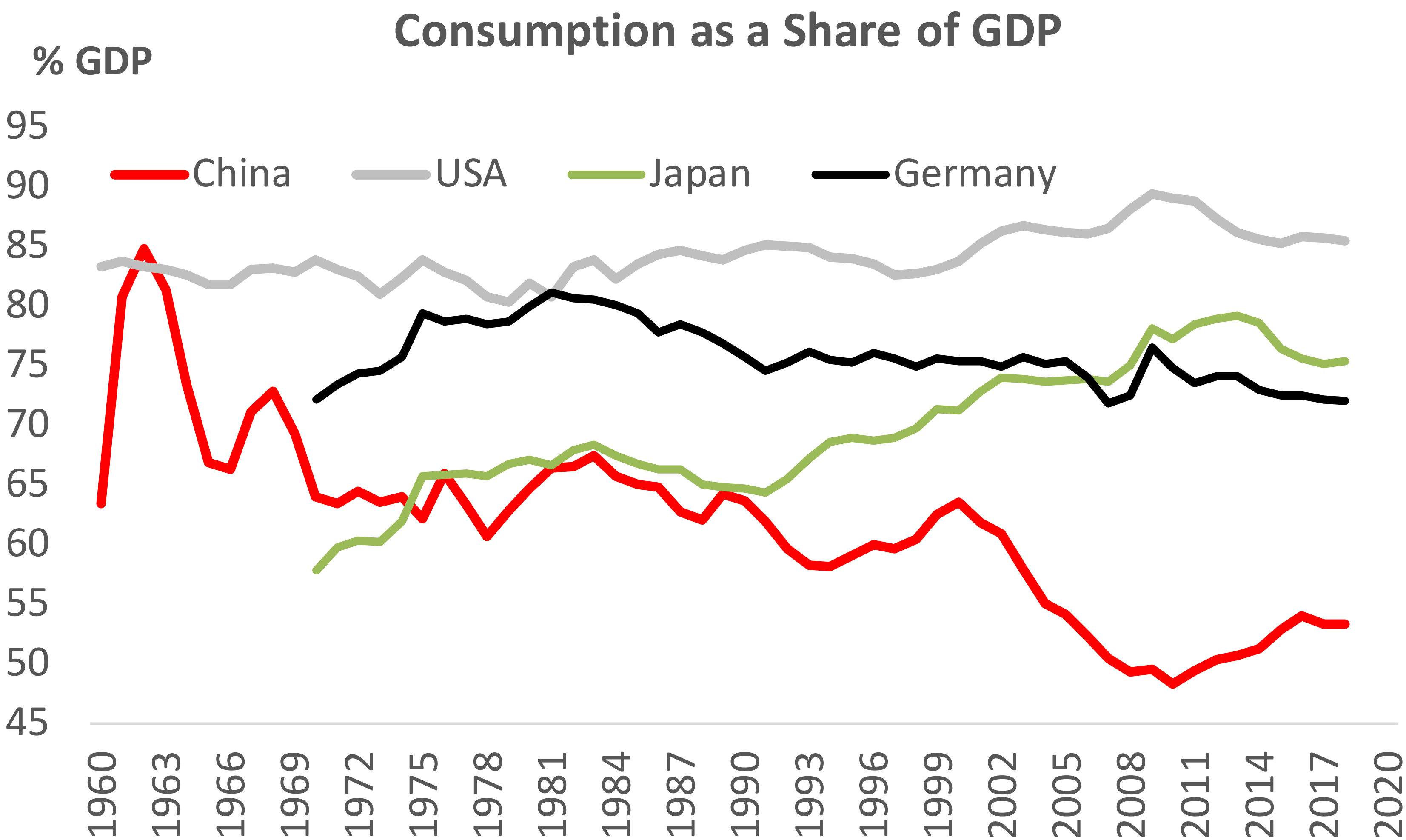
Other country shares of China fall despite the 30% apprec. of RMB.

– Except resources (AUS) & high tech (GER)

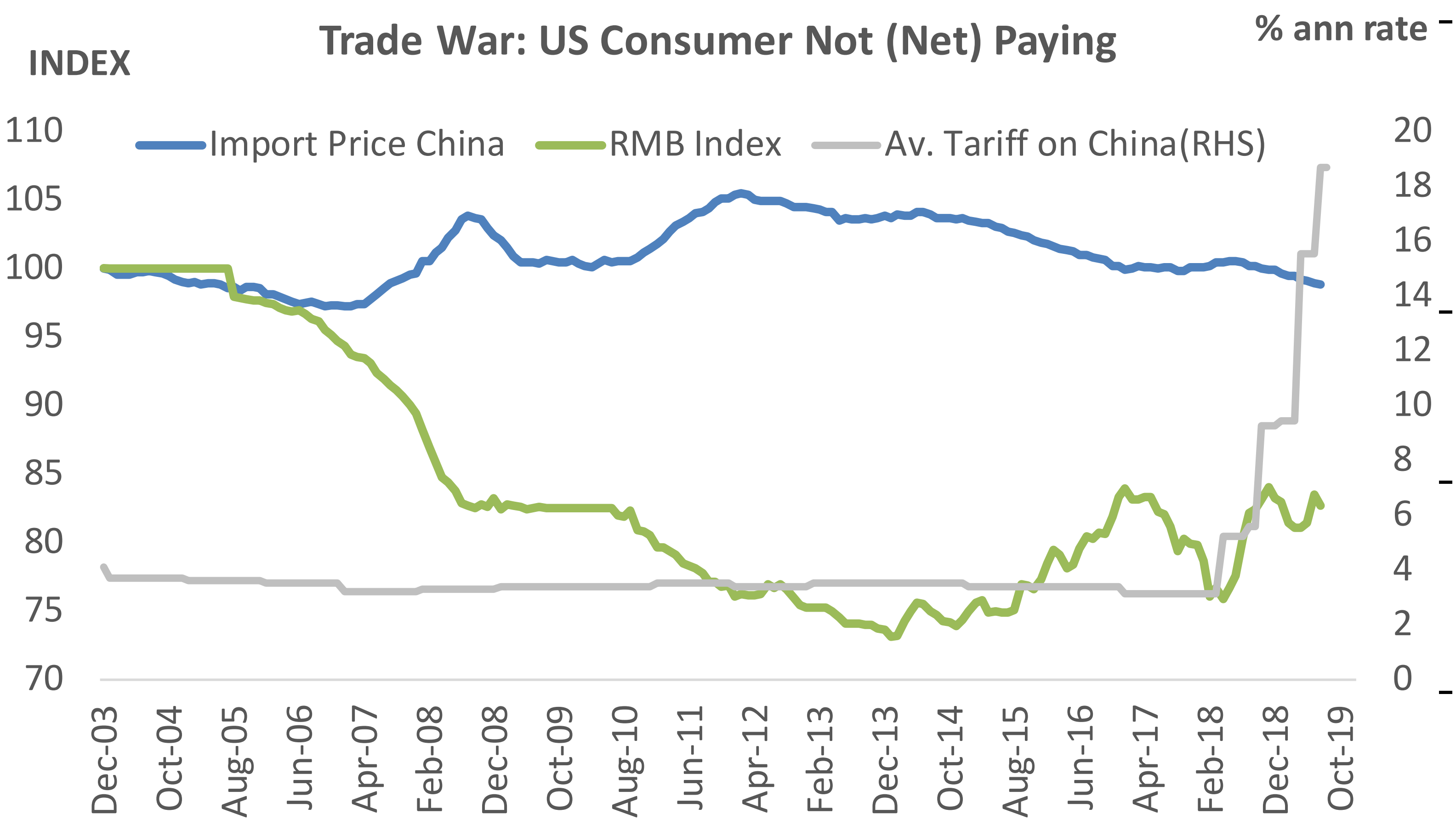
Trade War: Shares of World Merchandise Trade



TRADE WAR: Large Countries Have to Consume Most of Their GDP—Like the USA, over 80%



TRADE WAR KEY: China Price versus Tariffs

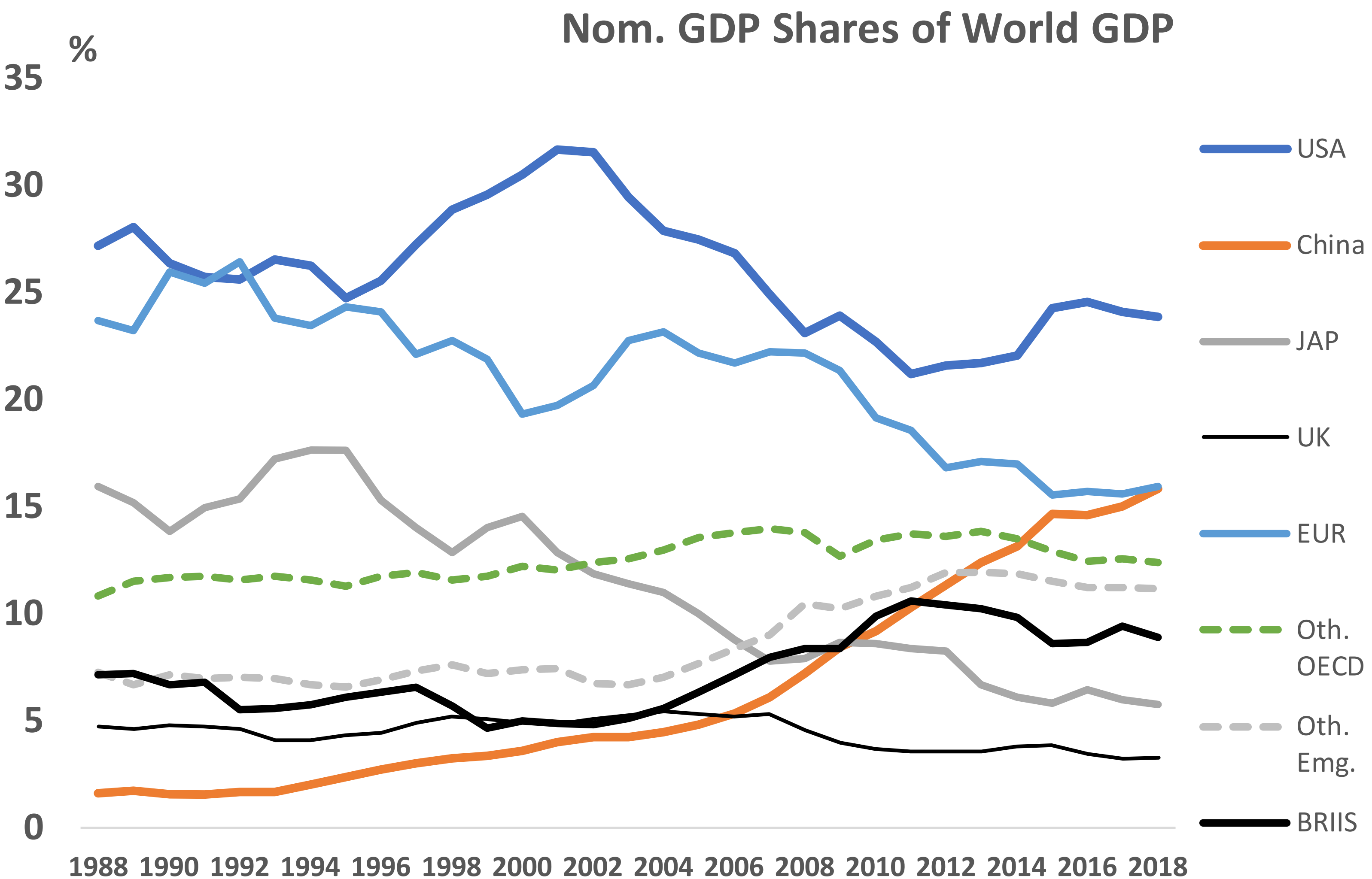


- To date average tariff rate is around 18-20% covering 50% of imports.
- Import price from China not affected, falling a little.
- 10% Deprec. RMB on 100% imports offsets net cost.
- No deadweight losses as tariff rev. can be used to cut taxes elsewhere.

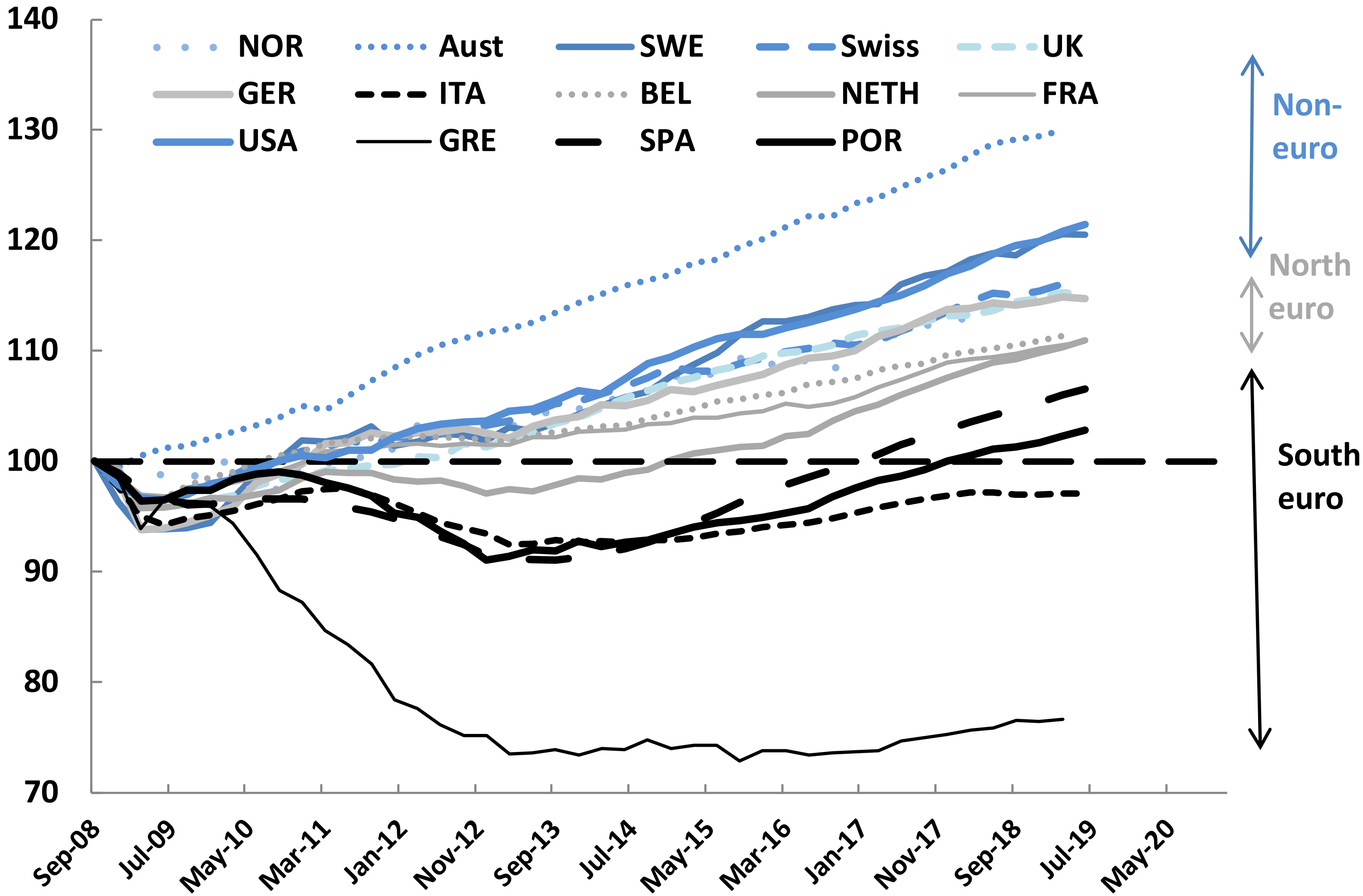
EUROPE: Asymmetric shocks & the euro area. The Commission has always misled from the start

– *"……...there are grounds for believing that the incidence of asymmetric shocks will be limited for various reasons. In the past, the asymmetric character of shocks was considerably amplified by diverging monetary, exchange rate and budgetary policies. In EMU, with a common monetary policy and exchange rate and with consensus and limits on budgetary policies, such developments will become much more rare and much smaller, leading to better prospects for more cyclical convergence…..(and)… The single currency will unleash competitive forces that will strengthen the incentives for structural reforms, thereby improving the chances for reducing unemployment."* **(*European Commission, 1998*)**
– Nonsense in theory and nonsense in practice.
– The China shock is the biggest asymmetric real shock ever—favouring the north (they are vertically integrated via high tech investment goods), and hurting the south (they compete directly with BRI countries in manufacturing).
– Forcing internal devaluation on the south devastates growth, and this pulls back the north.
– The cumulative GDP loss gap won't be restored, not ever.

GDP Shares: Who's Making Room for China?



Europe's Problem Number 1: The Euro.



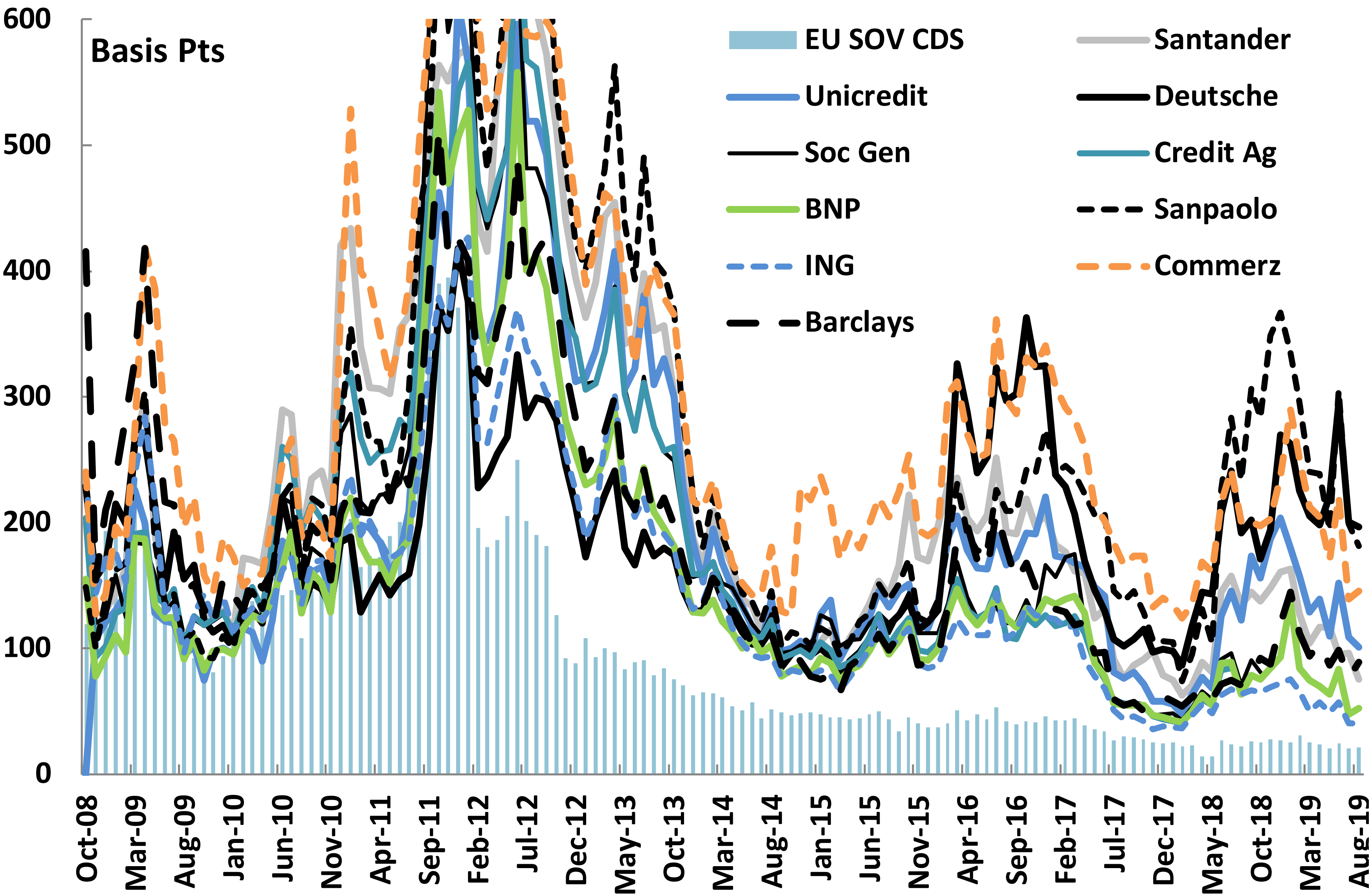
Europe's Problem Number 2: Not Dealing With the Banking Crisis

- **The US has dealt with the NPLs** which peaked around 4% of loans in 2010 and have declined in every year since then for large and small banks.
- **NPLs of large banks in the UK** were as high as 18% of loans in 2010, but have been dealt with in a highly successful way since then. **Small-bank-NPLs peaked in 2012** at 6.5%, and have since been reduced to a still too large but a "*good try*" 2.5% of loans.
- **In the euro area** nothing remotely similar has occurred. Large-bank-NPLs rose to a peak of 8% in 2014, and remain at 6.8% in 2017. Small-bank-NPLs also rose to 8% in 2014, and have hardly declined at all since then, marking a strong contrast with other countries. There is considerable country diversity, with **the south of Europe being much worse** due to the state of the economy referred to earlier.
- **The problem of hidden bad assets** is greatest in the GSIB banks, where QE is most critical (holding assets and lending cash by the ECB); and boosting asset prices via low rates, to help the market value of assets.

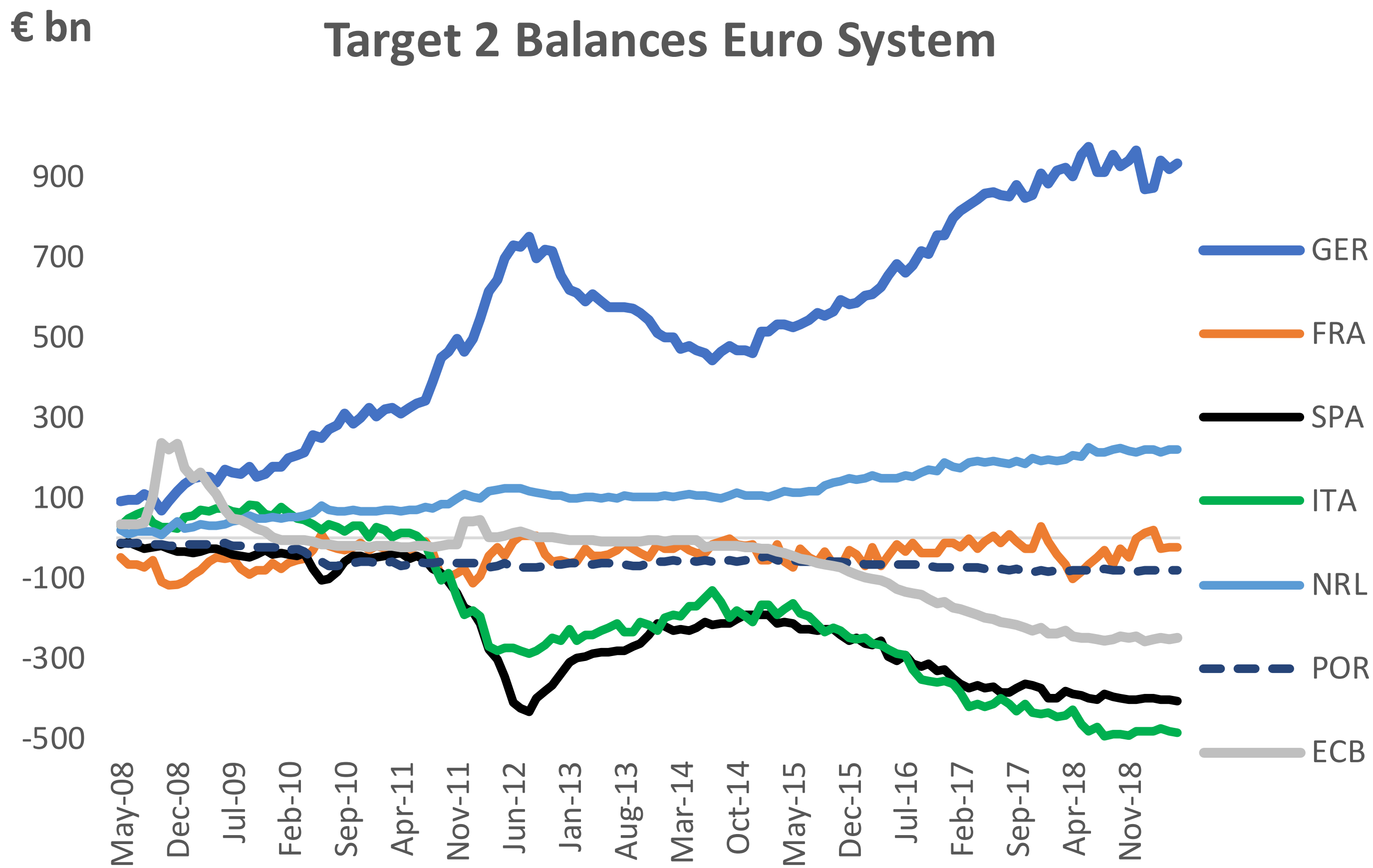
Sovereign Debt Crisis Gone, but the Euro Banks are Wobbly After a Decade of Poor Policy.

- While **sovereign debt problems** brought on by the lack of a fiscal union in **2012** clearly spilled across borders due to large bank exposures to these obligations—noted earlier—this is not the case now. **The CDS spreads for sovereigns in Europe** has continued, on average, to narrow since the Banking Union came into effect (see the pale blue bars)—the ECB is playing a big role here.
- **But this has not stopped the extreme volatility in euro banks** CDS from blowing out in 2016-17 and again in 2018. Two large German GSIBs seem always to be a factor in these moves (despite the stronger German economy). The situation in Europe is in strong contrast to GSIBs in the USA.
- **The sell-off in 2016** was the result of continuing weak bank earnings, chaos in Deutsche Bank's CoCos and the arbitrariness of resolution policy treatment of bond holders in Portugal.
- While sovereign debt spillovers may have been a motivation for the Banking Union, this doesn't appear to be the case now. **The banking system is doing this all by itself.**

Europe: GSIB Subordinated Debt & Sovereign Spreads



Target 2 Balances: Will Germany Ever be Paid?

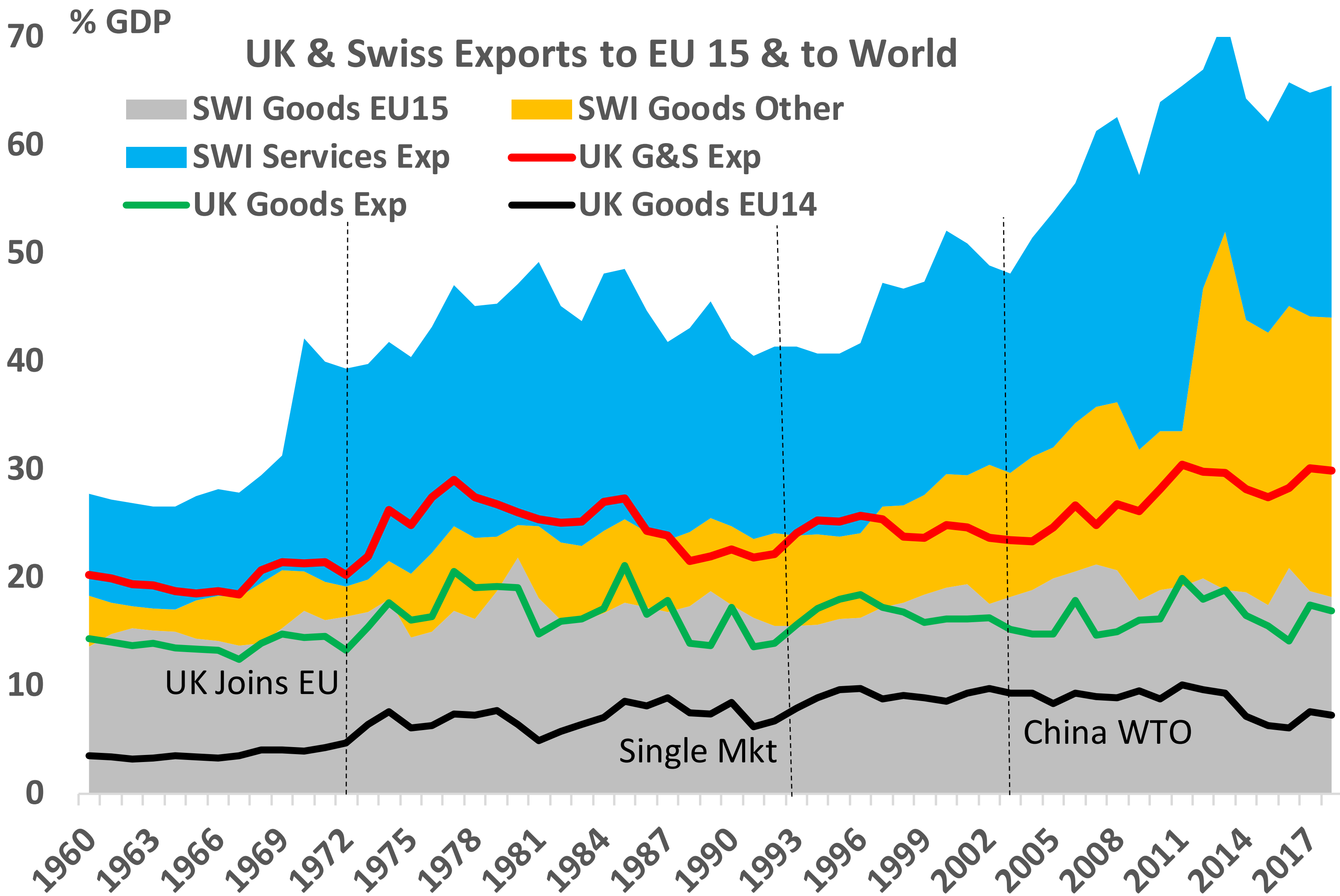


- GER C/A surplus + Cap Inflows of those who want safe assets > GER D for foreign assets.
- The gap is plugged by official financing (central bank claims and liabilities vis each other).
- This earns zero or negative returns.
- What to do? Will GER be paid?
- Same issue for the Swiss, but they aren't locked to the euro (so buy a matching foreign equities portfolio).
- Fiscal root of the problem: GER & SWI don't issue enough gov. bonds to satisfy demand for safe assets (even for their own pension funds).

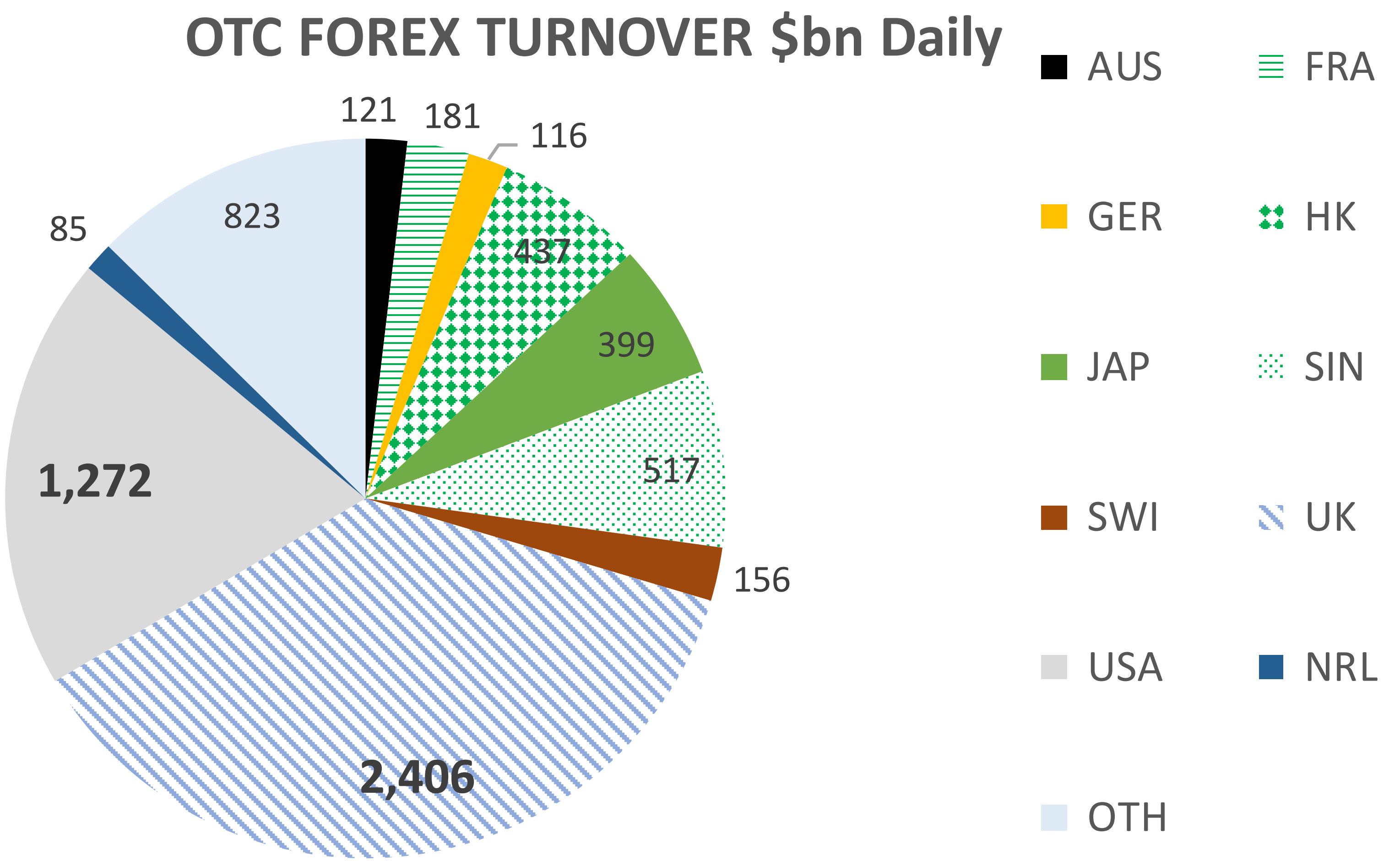
So: What Interest Rate Policy for the Fed?

– No central banks can normalize until China plays by the rules.
– Negative rates in EU & Japan is to make a contribution to servicing the high coupons on the assets they hold.
– QE pushes the exchange rate down.
– China's debt & globalization approach = problem for everyone.
– The Fed doesn't want to be on the wrong end of currency strategies, but the big problem is deflation and global excess capacity. If China can be brought back into being responsible, global deflation might disappear. Hardly likely though.
– That is the clue to the Fed's next moves and when it can get back to the normalization process: when the global output gap becomes positive.
– Perhaps the coming China slowdown.

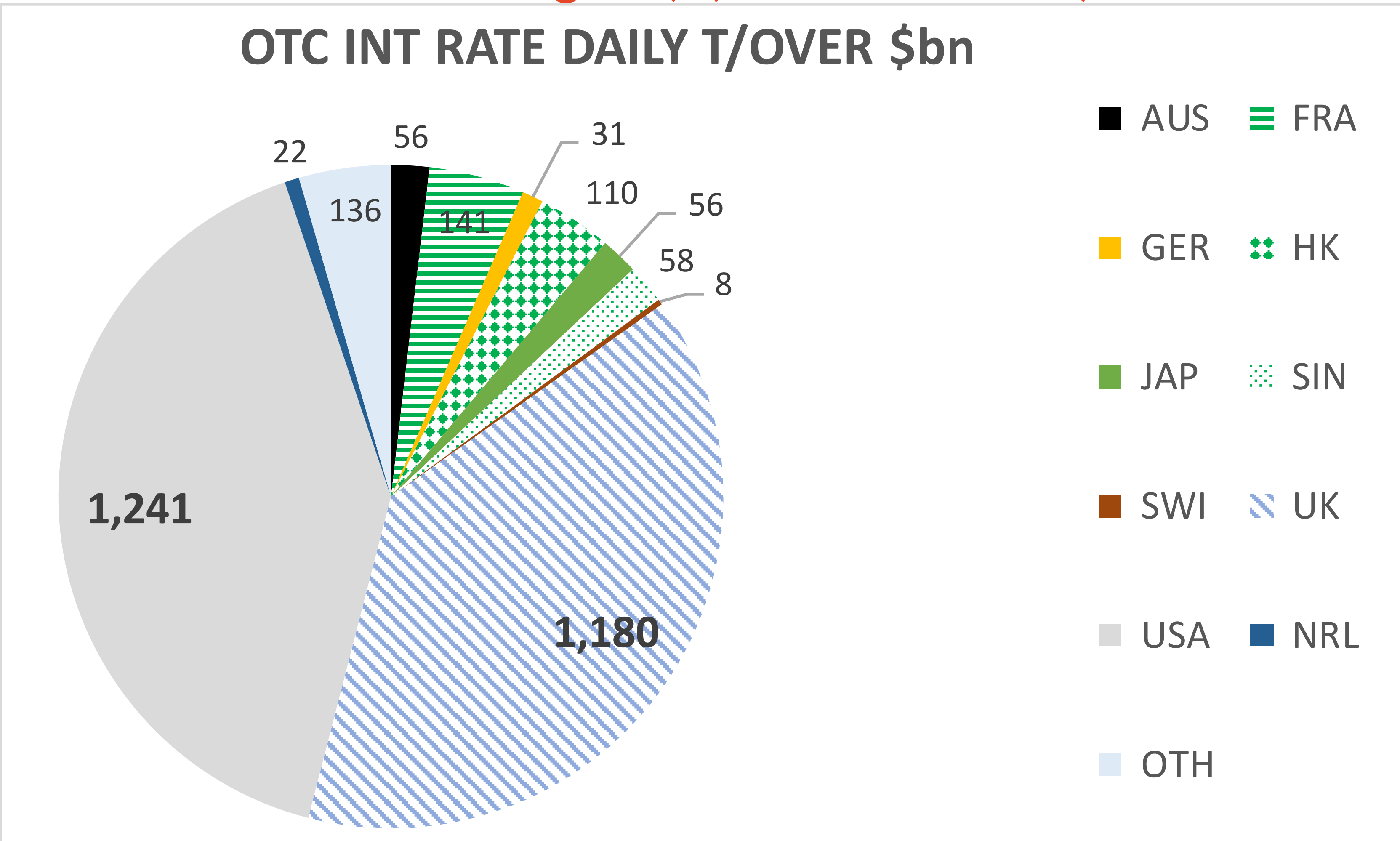
BREXIT: UK Hamstrung by Chaotic Euro Area



Brexit: Agglomerations & History (Rumours of the Death of London—again) (Forex)



Brexit: Agglomerations & History (Rumours of the Death of London—again) (OTC Int Rates)



Fintech—Rapid Pace on 3 Fronts

- **3 Fronts**: ***(1)*** *Fintech start-up companies*: in a wide range of areas including, inter alia: data and analytics, lending, crowd funding, capital markets, blockchain, digital currencies and payments, wealthtech, insurance, personal finance management, middle and back office, Regtech, and Suptech. **(2)** *Incumbent banks*: with legacy mainframe and related software that needs to be changed in order to defend their businesses from what could prove to be major disruption. **(3)** *The large technology companies (Bigtech)*:
- **US Companies**: **Amazon**, which has AmazonPay for all merchants; and Amazon Lending for businesses that sell via Amazon using tech-based credit scores); **Google**, which has taken a stake in *Lending Club*—looking to leverage Google's internet knowledge to service customers. **Facebook**, **WhatsApp** getting into the act.
- **Chinese are well in front of everyone else**: **Alibaba** owns *Ant Financial* (which has AliPay—a payment app, Sesame –credit scoring biometrics; Zhou Cai Bao—P2P lending; Yu'e Bao—a money market fund; MyBank—online virtual bank; Huabei—credit wallet for shoppers to repay in 1 month after delivery; JieBei—mobile phone based lending). **Tencent** (owns WeChat with 980m messaging users, and has Weixin Pay with multi-function Apps for payments and financial services, and WeBank—an online bank offering MMFs, SME loans and micro credit). **JD.com, and Baidu** (search engine with Baidu Financial Service Group and Baidu Wallet).
- These companies are developing global business ecosystems that include finance as an integral part, i.e. one-stop shops to buy things, sell things and to transfer funds. **Ant Financial** has just raised $14bn via note issues to develop blockchain technology for its insurance and payments businesses.

Forces Acting on the Financial Landscape

More Like Allies than Foes?

Likely Main Threat to Banks

??

BANK INCUMBENTS RESPONDING

Cash Flow Mature Businesses into New Products
Build Own Techology Teams
Acquire Promising Businesses-Portfolio Approach
Venture Capital Equity Stakes
Alliances: Sell Through Fintech Businesses

FINTECH STARTUPS

Blockchain payments
P2P, Crowd Funding
Security Biometrics
Mobile Payments & Billing
Online Research Tools

TECH CO. GIANTS

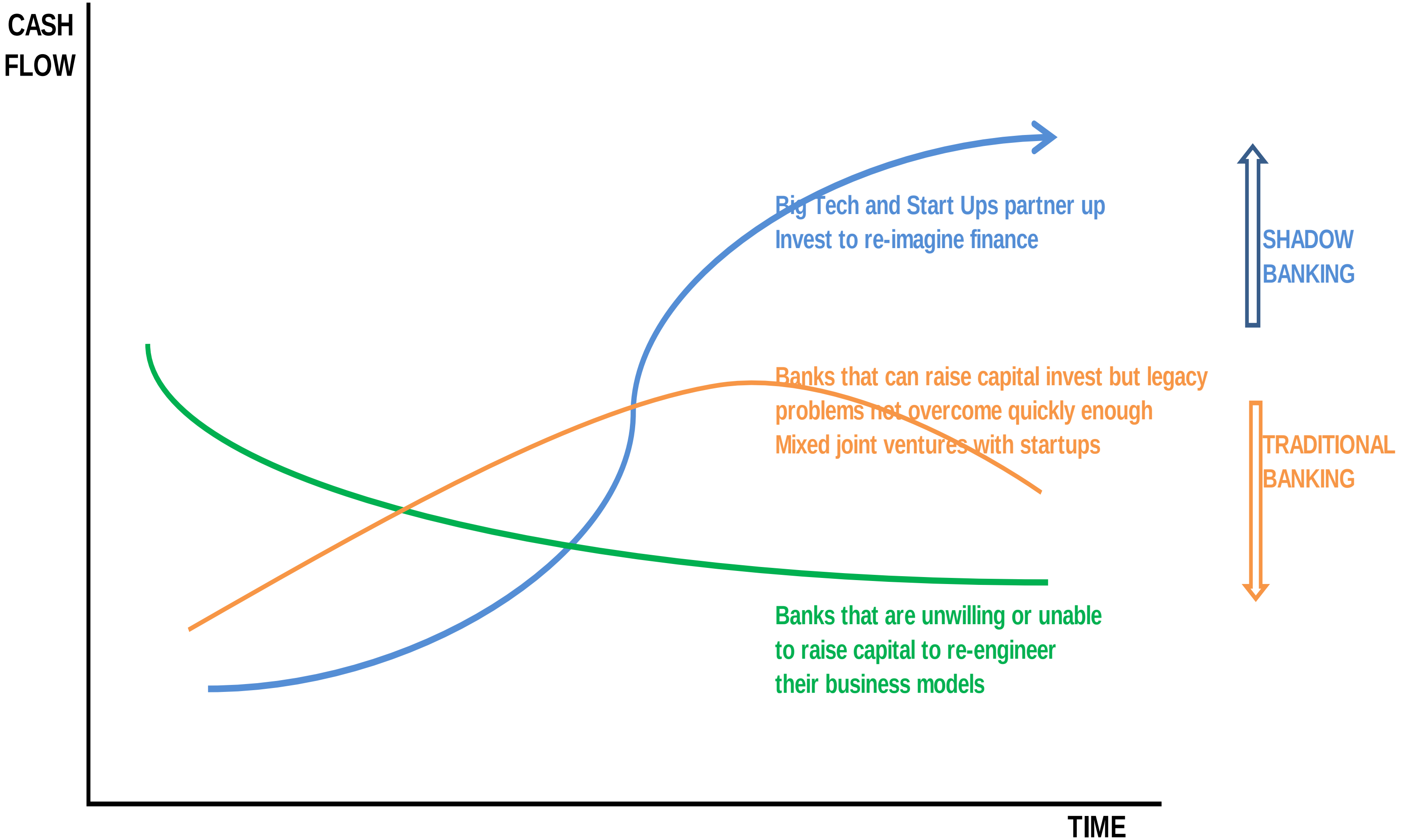
Amazon, Google
Facebook/WhatsApp
Alibaba, Ant Financial (Yu'e Bao), Baidu, JD.com
Tencent; WeChat

Bank incumbents		Tech / fintech
Prescriptive licencing KYC imposed & costly Low compet. High Switch Costs	REGTECH, SUPTECH, COMP vs FIN. STABILITY	Lite-touch/Industry standards KYC digitalised Favourable competition laws e.g. PSD2
Central Intermediary preferred (Offsite Back-up, Encryption)	CYBER SECURITY ISSUES CORRUPTION/LAUNDERING	New Archetecture Needed Blockchain Distributed Ledger
Baby Boomers Poor awareness of tech	GENERATIONAL BALANCE CONSUMER EXPECTATIONS	Millennials Demography Customer expectations changing
Banks, Particularly in Europe Still Struggling to raise Capital	CASHFLOW & THE ABILITY TO RAISE EQUITY CAPITAL	Large Tech Raises Capital Easily Fintech finds Bank & Large Tech Investors
Sticky Customers Poor Education & Awareness Low sensitivity to fees	TRUST, LOW RATES, HIGH COSTS, LEGACY SYSTEMS	Bank Misconduct Perceived High sensitivity to excess fees Jump technologies esp. EMEs High cost of bank legacy systems Cash flow and investable capital

ENABLING TECHNOLOGY

AUTOMATION, MACHINE LEARNING, ARTIFICIAL INTELLIGENCE, IoT CONNECTED DEVICES, CLOUD, BIG DATA

Is this Big Tech/Fintech S-curve Possible?



Regulatory Reform Leaves a Lot to be Desired

– The reform process in the West in Basel III leaves much to be desired following the fiasco of Basel II—recovery was based on central bank and taxpayer support.
– Banks have achieved holding the status quo on business models, with small concessions on regulations—& regulatory capture gaining strength under Trump. Risk can never be destroyed, but those holding it can be changed. Banks are in the process of doing this—risk is being shifted to shadow banking, pension funds and insurance companies.
– We now move towards the exit strategy, and then put it all on hold. Volatility will test the new regulatory nks & environment. Europe is far from this—due to NPLs and banking book rubbish. Holders of illiquid securities will be tested—search for yield is a super highway in but a goat track on the way out.

Regulatory Reform in Advanced Countries

- *The BCBS reforms for Basel III in the 1st stage consisted introduced change: an improved the definition of capital; a capital conservation buffer; a Higher Loss Absorption Requirement for global systemically important banks (G-SIBs); a better framework for market risk, securitisation and counterparty credit risk; a Liquidity Coverage Ratio; and a Net Stable Funding Ratio.*
- *A final stage of Basel III reforms was published in December 2017:*

  --Enhancing the standardised approach to credit risk;

  --Constraining the inputs to internal models;

  --A revision to the credit valuation adjustment (CVA) capital charge for derivatives;

  --A revised method for operational risk;

  --A leverage ratio buffer for GSIBs; and

  --Output floors when using internal models
- *The G20, IOSCO and Dodd Frank collateral and derivative rules were added to the reform process.*
- *The Financial Stability Board organised the Total Loss Absorbing Capacity framework which formalises bail in mechanisms in the event of resolution.*
- *This new framework is to be tested in the regime change under way with the normalisation of monetary policy and any volatility that may accompany the process.*

Some EU Banking Union Flaws

- **The Single Resolution Fund (SRF) for the 19 countries is inadequate** at present. It is to be built up with contributions from banks over a long period (2016-2023) to reach a target of 1% of deposits. On I July 2018 the SRF had accumulated 0.4%, or €24.9bn for $5,6tn of covered deposits. By contrast the FDIC Deposit Insurance ratio is currently at 1.3% of deposits, or $93bn of $7.3tn insured deposits, with a fiscal union to back it up if needed.
- **To have access to the SRF in the event of resolution**, the institution must have bailed in 8% of total liabilities before these limited funds can be tapped.
- **This requires eligible bail in securities of sufficient scale.** Hence the EU has introduced MREL (Minimum Requirements for own funds and Eligible Liabilities) which applies to all significant banks (not just GSIBs as with TLAC).
- In the BU the SRB has suggested this **MREL should be at around double regulatory capital—say** 25-27% of RWA, to be imposed on all significant institutions. This is much tougher than TLAC—and underlines just how much national governments don't want to be on the hook for paying for other country's banking problems.
- Resolution must be applied with a **"no-creditor-worse-off" provision**, which is there to prevent uncompensated risk transfer between different classes of creditors to the banks.

This is Where the Problems Start

- **MREL is set on a bank-by-bank** basis by supervisors (size, location, business models, etc risking all kinds of moral hazard).
- There is **no general subordination requirement** for the instruments at this stage. Depending on what the criteria actually are, the EBA has estimated that there could be a €130bn-€285bn shortfall of eligible securities (in an end 2016 study).
- **An FSB survey** suggests that half of its members do not have legal administrative powers to impose losses on creditors or to convert bonds into equity—some in Europe.
- **To meet the "no-creditor-worse-off" criteria** requires a clear set of such rules and valuation methods—which requires, at minimum, that bail-in instruments are subordinated bonds that can be clearly identified contractually and which have well-defined trigger criteria—recognisable and priced by investors. This is not present in Europe.