A·U·G·U·R

Challenges for Europe in the world, 2030

SEVENTH FRAMEWORK PROGRAMME

Financial markets and international regulation

Final Report : Scenarios to 2030

WP 2

Financial regulation

- Systemic failure in financial markets resulting in severe losses in welfare, has been fundamental characteristic of economic activity for the past 40 years.
- Financial stability is a global public good. Financial regulation is a matter for national jurisdictions. Since the deregulation of the 1970s there has been a persistent tension between liberalisation and regulation.

Regulatory failure

- “A striking aspect of the turmoil has been the extent of risk management weaknesses and failings at regulated and sophisticated firms”.
  - G7 finance ministers, April 2007
- “The modern risk-management paradigm held sway for decades. The whole intellectual edifice, however, collapsed in the summer of last year.”
  - Alan Greenspan, US House of Representatives, October 2008

Deregulated developments

First, the development of the structured finance market

Second, the dramatic growth of the credit derivatives market.

And, *third*, the use of value-at-risk (VAR) models in risk management by firms and regulators greatly increased the homogeneity of market practices, exacerbating the volatility in markets in the face of an extreme event.

“Financialisation”

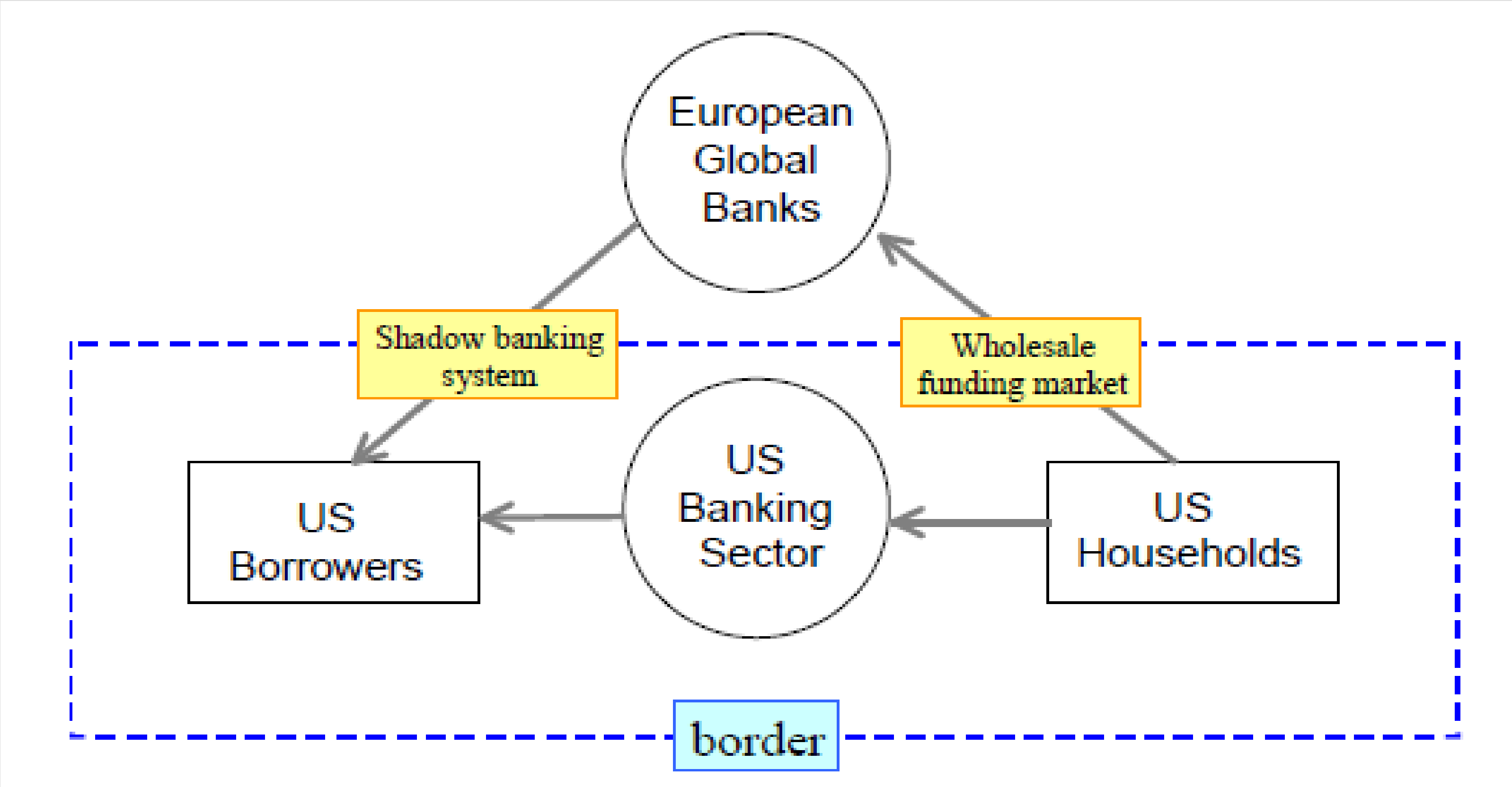
Growth of world nominal gdp 1978-2012: 5.8%pa

Growth of assets of the banks 1978-2012: 15%pa

Banks’ balance sheets are now around 20 times greater, relative to the given underlying GDP, than was the case 34 years ago

The international market in sovereign bonds has is now worth around $100 trillion, 140% world GDP; the largest component being $33 trillion of US bonds, 220% US GDP.

Regulatory arbitrage



Eurozone

Divergent unit labour costs *which is a feature of all existing monetary unions*. **The establishment of an "optimum currency area" is a myth.**

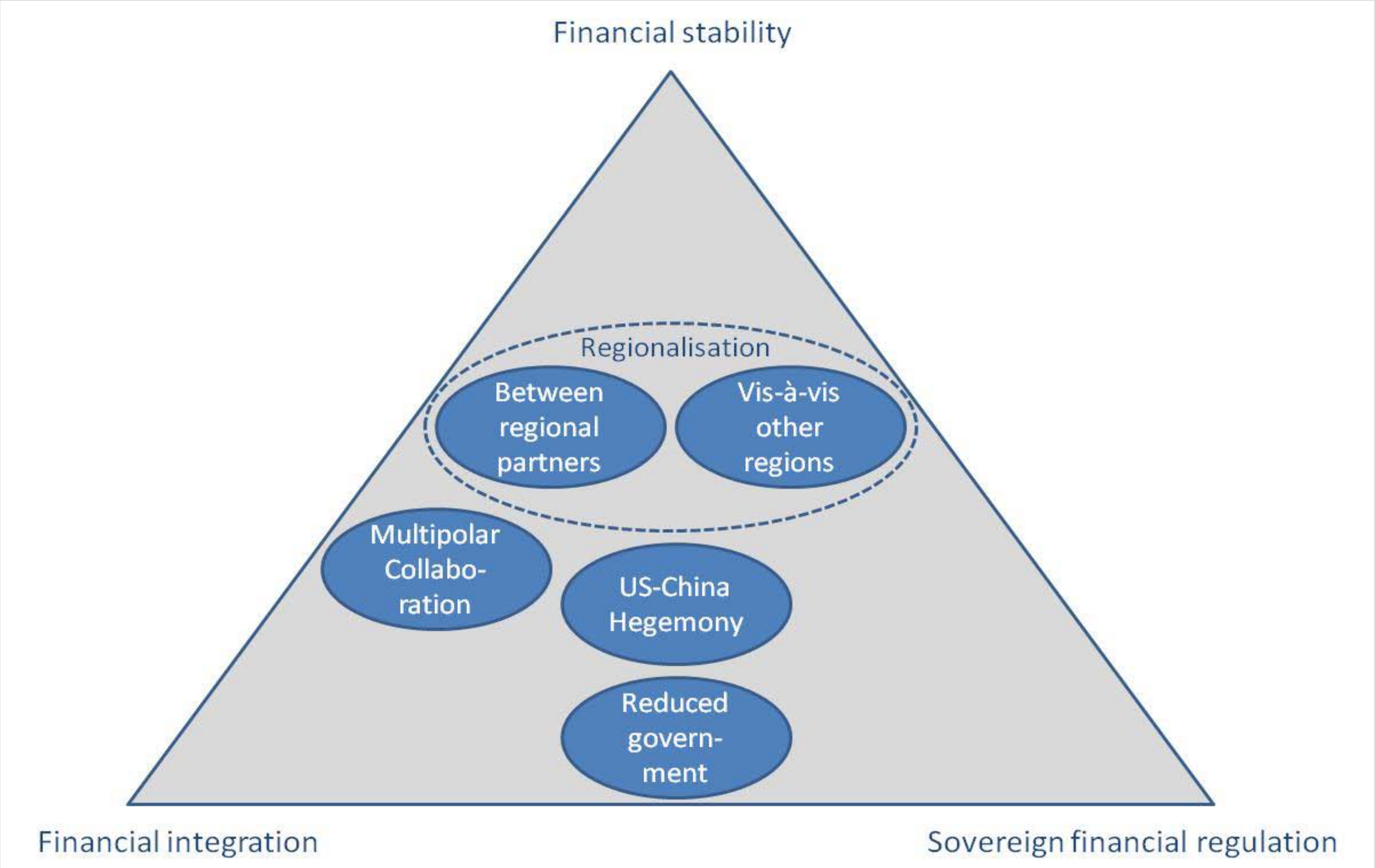
Massive flows of funds between different sovereigns at no foreign exchange cost.

ECB operations in the repo market ensured that sovereign debt could be transformed into cash, easily and cheaply. Whilst eurozone states are prohibited from printing money, but they were provided with a financial facility that (so long as confidence lasted) was almost as good!

Regulatory failings today

- Macro-prudential measures: domestic treasuries and international rules.
- Risk weighted capital – echoing past failure
- Management of the liabilities side of the balance sheet
- Complexity
- Arbitrage

International regulatory dilemmas



Reduced government/muddling through

- Growing influence of **global** financial markets and multinational financial institutions
- Public debt in **Europe** is constrained by strict budgetary rules (e.g. fiscal compact treaty)
- **Governments** compete to attract financial firms by lowering regulation standards in a « race to the bottom »
- **Financial actors** circumvent the new rules and concentrate to face international competition.
- **Instability:**
  - Increased number of SIFIs.
  - Regulatory arbitrage

US-China accommodation/ EU break-up

- Slow growth resulting from austerity programmes in **Europe** results in unsustainable public debt: either debtor countries leave the Eurozone or creditor countries refuse to subsidise the periphery and decide to leave.
- **US and China** agree minimum standards of financial regulation. European financial regulation is predominantly national.
- **US investors** withdraw from Europe and focus on Asia.
- International financial institutions operating in European markets are weakened by **eurozone break-up**. European currencies are more vulnerable to speculative attacks except DM which becomes a safe haven for investors.

Regionalisation/multispeed Europe

- **Closer political and economic relationships** in several regions (EU, NAFTA and ASEAN).
- **4 currency blocs** are created within the EU (Sterling, DM, Latin and Eastern), managed by EU-wide authorities.
- **EU Regional Financial Authorities** establish the same regulatory constraints all over the region.
- **Financial cycles** are mitigated by internal exchange rate changes. Regional mechanisms are created to face times of stress in the three main regions.

Multilateral cooperation/towards federal Europe

- **World Financial Authority** implements non-complex supervision.
- **A European fiscal authority** manages a eurobond market that finances up to 3 percentage points of deficit/gdp. Only the UK remains outside the eurozone.
- **Average size of banks** increases to face higher regulatory costs and international competition. Asian banks better meet regulatory requirements grow loans faster than in western banks.
- **Nation-states renounce national prerogatives** and adopt similar rules. The regulatory structure of tax havens is reformed. There are very few regulatory arbitrage opportunities.

Future financial markets