On the Brink

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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

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.”

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
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
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

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**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?

“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)

Includes NAMA financing

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)


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