

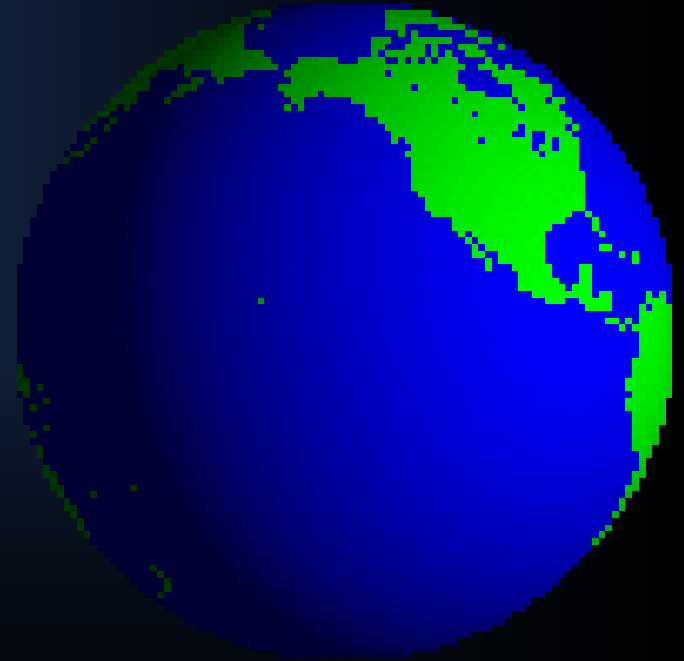


How to Shut Down the Global Casino

The case for more liability

Hans-Werner Sinn

AEA Meetings Philadelphia
January 2014



Economic globalization 1990 - 2007

- World GDP + 64 %
- Trade + 199 %
- Financial transactions + 1,007 %

Summary of the argument

- Financial industry invented opaque financial products
- Competition of laxity implied excessive deregulation
- Gambling with limited liability
- Huge net capital flows and current account imbalances
- Overheating, bubbles, recession
- Policy recommendation:
more equity, more liability



HOW THE FINANCIAL CRISIS CAME ABOUT
AND WHAT NEEDS TO BE DONE NOW

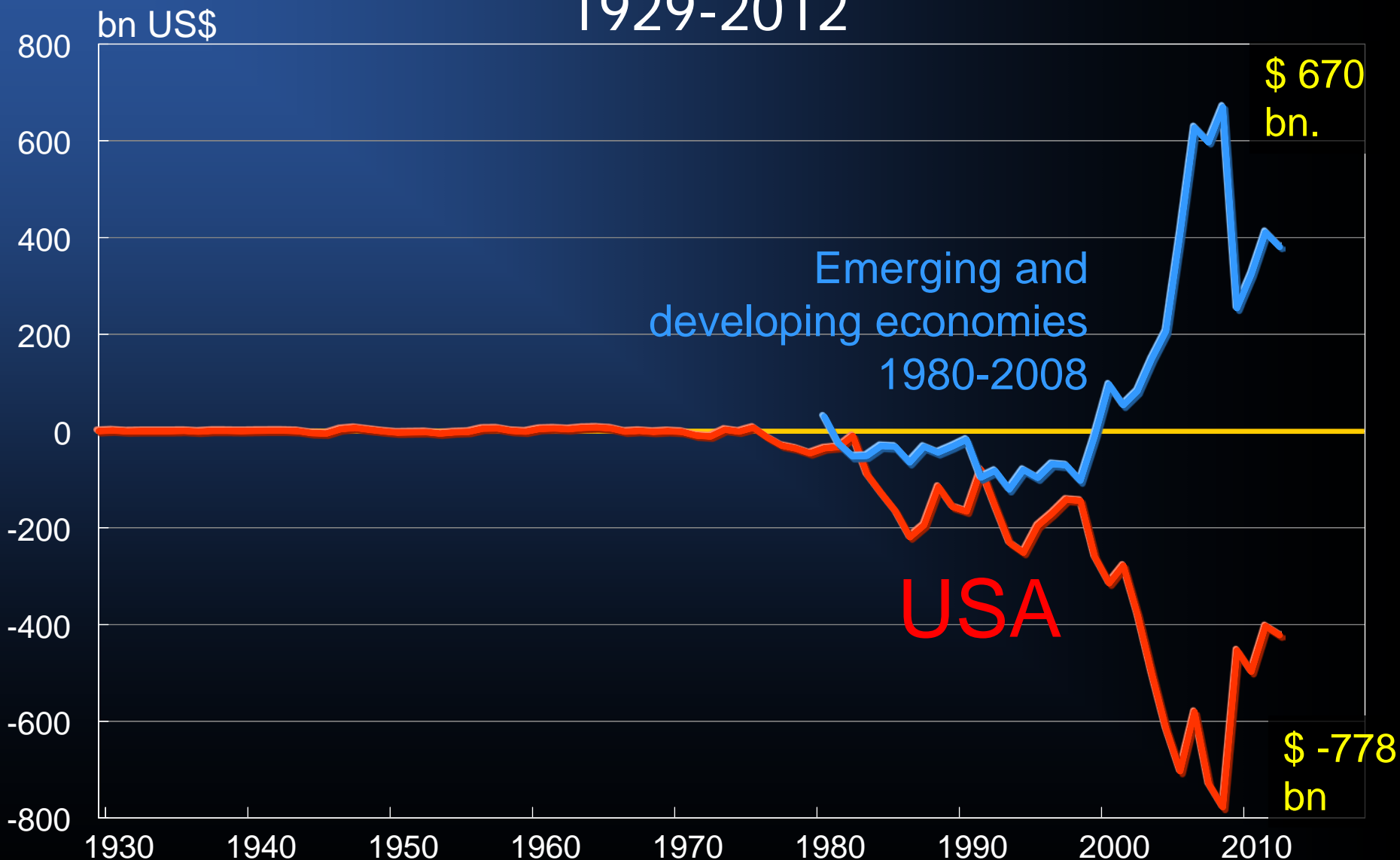
Oxford University Press

H.-W. Sinn,
*The New Systems
Competition*

Yrjö Jahnsson Lectures,
Basil Blackwell: Oxford 2003

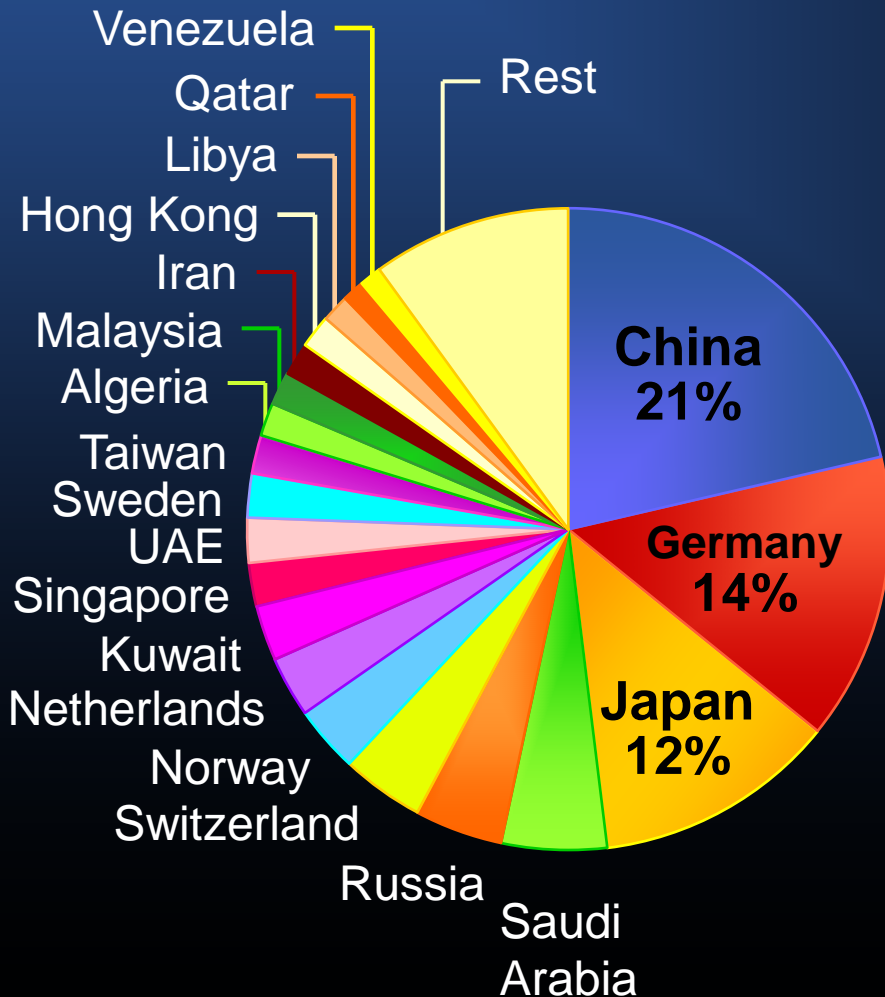
US capital imports

Current account surplus/net capital export 1929-2012

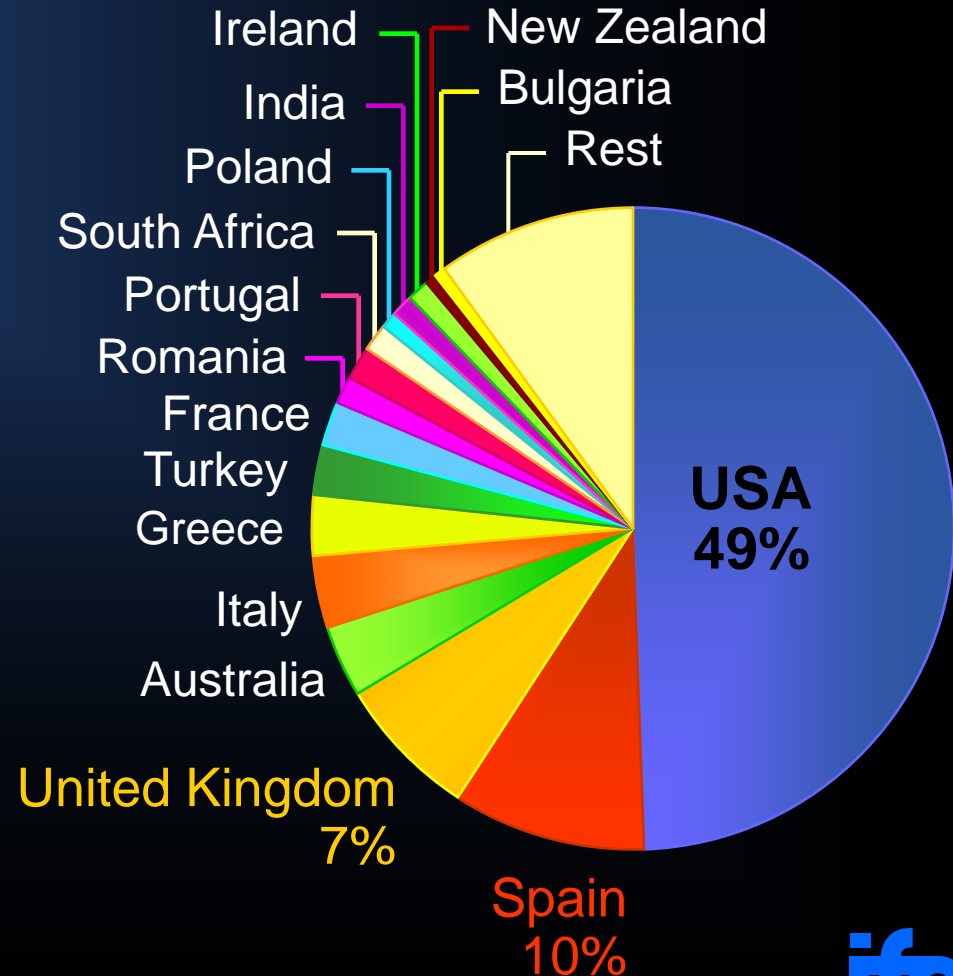


Breakdown of net capital exports and imports: shares in 2007

Net capital exports



Net capital imports



Treasury bills to China



Hot potatoes to Europe



- Mortgage-backed securities (MBS)
- Collateralized debt obligations (CDO)

Savings glut?

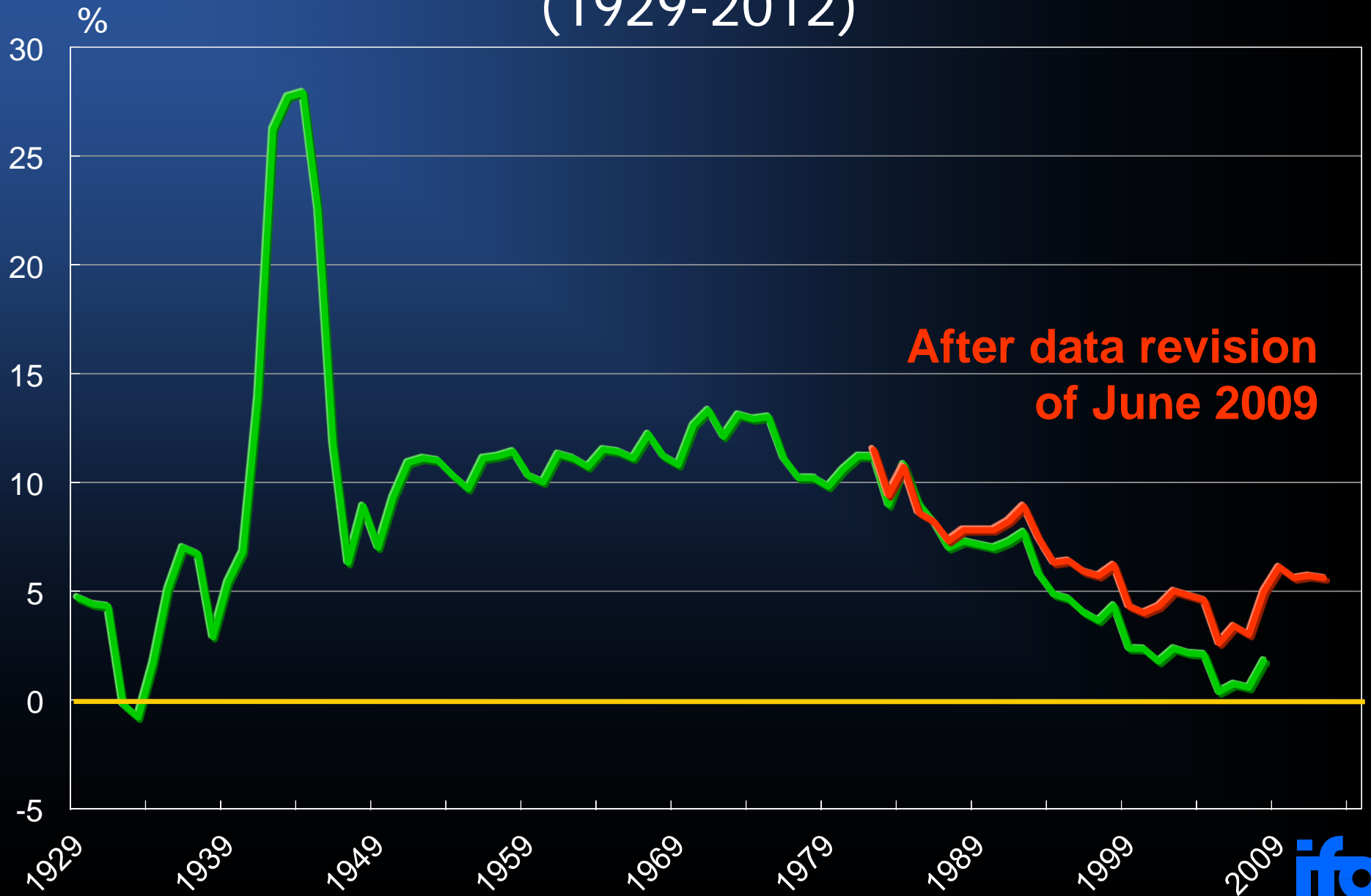
Ben Bernanke, Bundesbank speech (2007)

Savings glut?

Ben Bernanke, Bundesbank speech (2007)

“These external imbalances are to a significant extent a market phenomenon and, in the case of the US deficit, reflect the attractiveness of both the US economy and the depth, liquidity, and legal safeguards associated with its capital markets.”

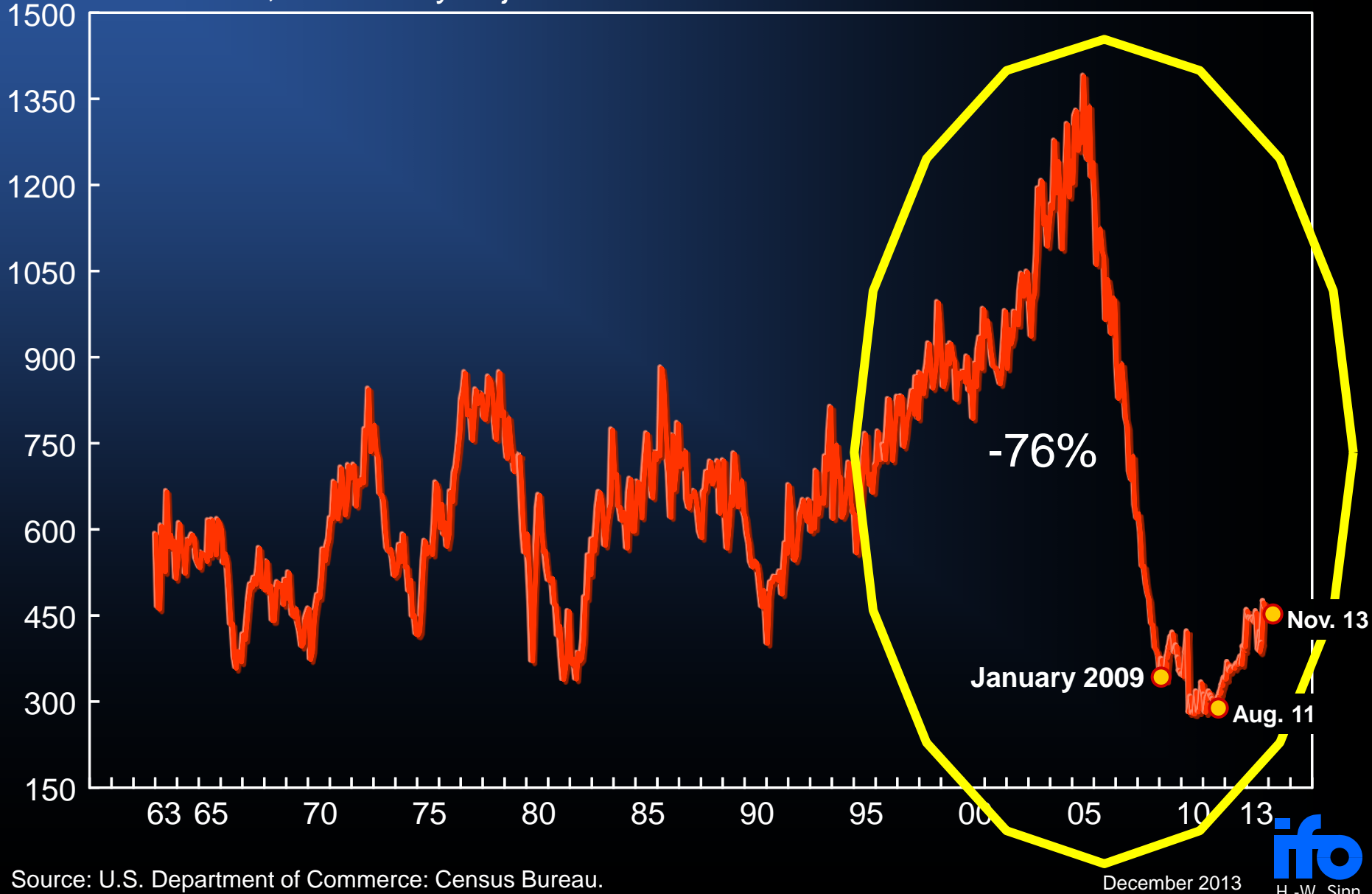
Savings rate of private US households (1929-2012)



The bursting bubble

New home sales in the US

Thousands, seasonally adjusted



Source: U.S. Department of Commerce: Census Bureau.

December 2013

US house prices – Case-Shiller Index



The regulatory causes

Regulatory deficiencies

- 2004 S.E.C. decisions
- Off-balance sheet business
- Mark-to-market principle
- Basel: low risk weights
- Competition of laxity

Limited liability, opaqueness and expected bail-outs create casino-like attitudes

- Undercapitalization
- Excessive risk-taking



Equity-asset ratios and returns on equity in 2006

	Equity/asset ratio (%)	Return on equity before tax	Standard & Poors long	Moody's long
Bear Stearns †	3.5	25.9	A	A2
Goldman Sachs	4.3	40.7	AA-	Aa3
Lehman Brothers †	3.8	30.8	A+	A1
Merrill Lynch †	4.6	25.1	A+	A1

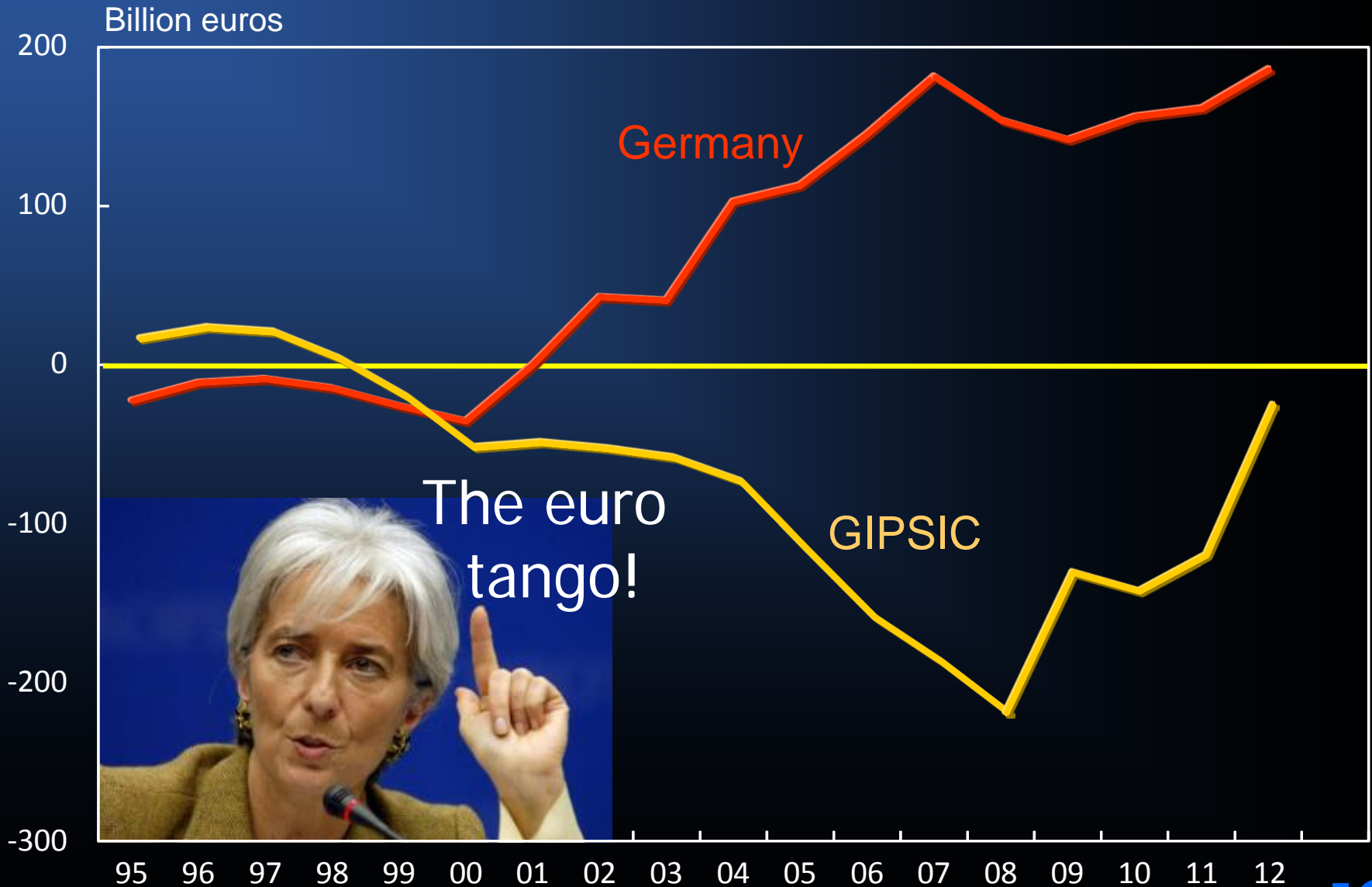
Main Street gambled as mortgage loans are non-recourse



The fight against red lining:
Community Reinvestment Act
1977/1994

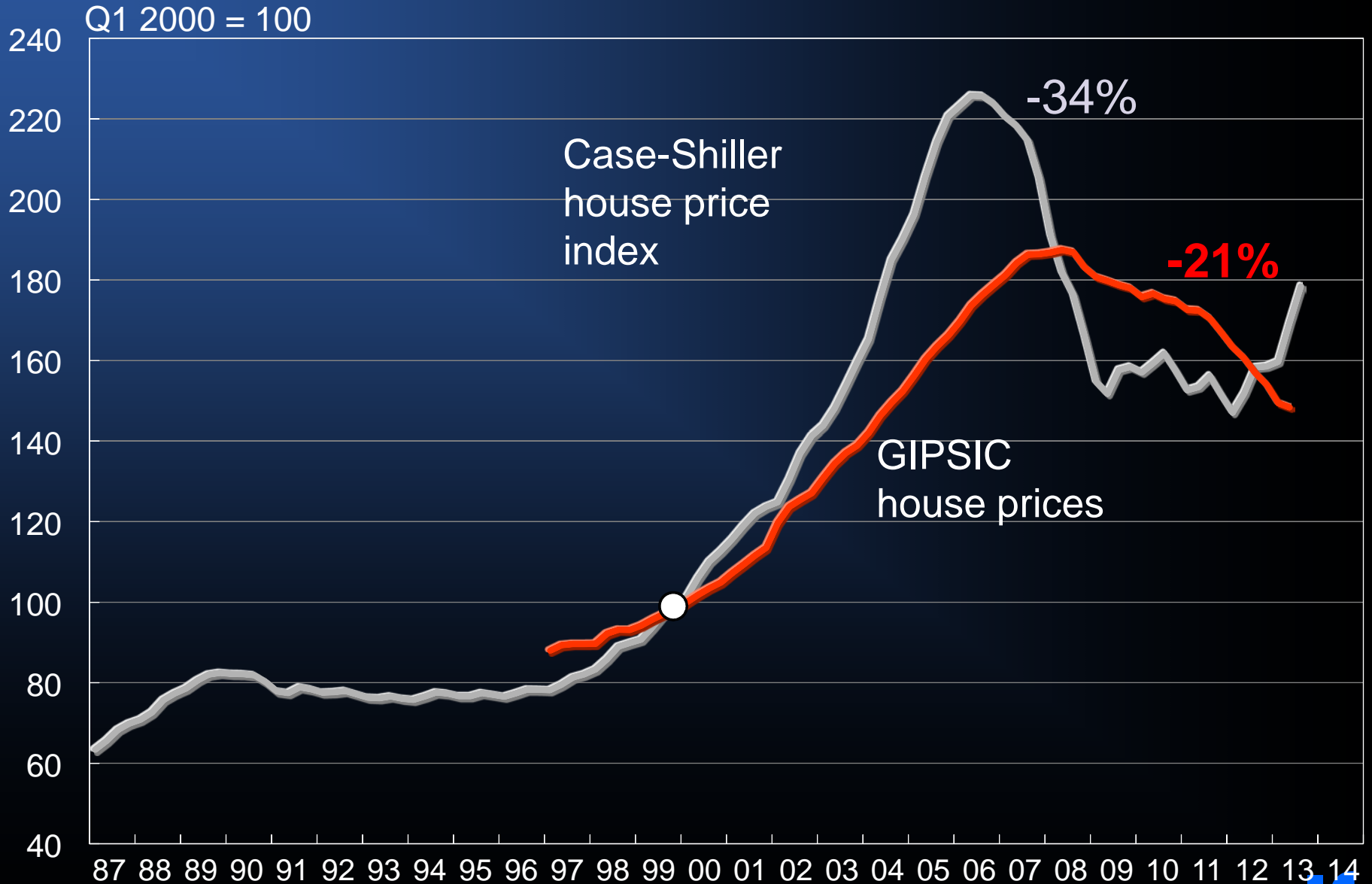
Euro-internal imbalances

Current account surplus/ net capital export



Source: Eurostat, April 2013.

Property prices in the GIPSIC countries



Implicit bail-out guarantees

and

explicit risk sharing by national central banks

implied excessive expansion of banking credit

in southern Europe and Ireland, sucking in

resources from abroad

Policy recommendations

- Much more equity
- Contingent Convertible Bonds (CoCos)
- All activities in balance sheet
- Basel III with better (or no) risk weights
- Rating agencies to be paid by the buyers
- Anticyclical leverage ratio
- Lowest-value principle (Colbert)
- Bankruptcy procedures for banks and states
- International regulatory harmonization

