Money & Currency

HOW MUCH CONFIDENCE DO YOU HAVE IN YOUR NATION'S BANKING SYSTEM?

FEATURING

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The global banking system is the fundamental conduit of value within nations and across borders. Since the last global financial crisis, however, the role of banks as a repository of value has come increasingly into question. Today, with a fragile recovery in so much of the world, banks and those who manage and regulate them are under attack. We asked our panel of global experts how this crisis of confidence is playing out in their nation or region.

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NON-PERFORMING CHINA
ANN LEE

China's exposure to bad loans through its shadow banking system has been the latest topic du jour. While China's banks undoubtedly will face non-performing loans as the economy slows and rebalances to a more services-oriented economy, the risk that China's banking system will collapse and cause a hard landing is rather remote. The reason has a lot to do with the overall financial structure of China. Since it is a country with a relatively closed capital account and owes very little debt to foreigners relative to its reserves, the Chinese monetary authorities have many tools at their disposal to recapitalize their banks and keep their financial system stable. Should large numbers of loans on China's Big Four state-owned banks default, the Chinese government can modify those loans and still tell the banks to continue lending. The Chinese Central Bank can also ensure banks stay afloat by engaging in unconventional quantitative easing measures not dissimilar to those used by the U.S. Federal Reserve to nurse American banks to health after the financial crisis of 2008. Even if the shadow banking system causes a chain reaction, the authorities can quickly inject liquidity back into the system by relaxing existing polices like loan-to-deposit ratios. Finally, the size of outstanding credit as a percentage of GDP in China is much lower than in many other countries, such as the UK, Switzerland, or Japan, thus making the problem manageable.

Ann Lee is a former visiting professor of macroeconomics at Peking University, and author of What the U.S. Can Learn from China.

GREEKS BEARING DEPOSITS
THEODORE PELAGIDIS

Deposits in Greek financial institutions declined by about €100 billion ($139 billion) between December 2009 and July 2012. This outflow can be linked to uncertainties over a possible bankruptcy of the state, exit from the eurozone, rumors that undeclared funds would be ferreted out, political uncertainty, and the need of households and businesses to cover current tax payments and expenses that can no longer be financed by their cash flow. The ultimate formation of a pro-European coalition government in early summer 2012 vastly decreased political risk and led to the stabilization of the deposits.

The financing gap resulting from all the above factors was filled at the time by fellow members of the eurozone. This Emergency Liquidity Assistance (ELA) allowed the Greek financial system to deal with the massive outflow of deposits, replenished part of the losses incurred by Greek banks, and restored supervisory capital to levels that allowed "too big to fail" Greek banks to participate in the euro-system. The gradual increase of deposits since then, approaching €161 billion today, reflects a return of confidence in the safety of the Greek banking system.

But ELA remains at a high level, and a further reduction of this dependence, planned for 2015 to 2017, will pose a challenge unless Greek banks regain access to wholesale market financing, and the deposit base recovers strongly. Rebuilding deposits will require a strong recovery of the real economy, which will strengthen banks' balance sheets by vastly reducing the sky-high non-performing loans, which still hover at the 35 percent mark.

Theodore Pelagidis, professor of economics at the University of Piraeus, Greece, has been a NATO scholar at Harvard University, a senior fellow at the London School of Economics, and a Fulbright fellow at Columbia University.

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SOUTH AFRICAN CONFIDENCE LEILA FOURIE

South Africa's financial sector accounts for over 20 percent of the nation's GDP and employs 12 percent of the formal sector. Its banks displayed considerable resilience through the recent financial crisis, maintaining high capital adequacy ratios, liquidity, and double digit returns on equity. In global markets, South Africa is well known for being progressive in adopting regulatory reforms.

Downside risks to the banking sector include the negative effects of quantitative easing, the rise in the number of indebted consumers, sluggish economic growth, and high currency volatility. Notwithstanding these potential risks, growth is promising, including participation in the broader African agenda, in which South African banks are heavily invested. Above all, the nation's financial sector is founded on prudent regulation of well capitalized, liquid, and highly profitable banks.

Leila Fourie is Post-Trade Director at the Johannesburg Stock Exchange.

BRAZILIAN SMOOTHING FERNANDO MARQUES

Confidence is a core issue for emerging markets, since minor changes in the levels of trust can lead to the collapse of an entire policy framework. As the Brazilian banking system changed, industry regulation played a key role in reducing moral hazard and smoothing the effects of bad banking cases. So even during the global financial crisis, the domestic sector performed well, sustaining the key market indexes above the average for the 2000s.

This financial solidity was one feature that encouraged institutions to spread their branch networks, leading to a 78 percent rise in banking transactions over the past five years. During the 2008 crisis, government banks led a credit expansion, financing the housing sector, while private institutions provided resources for durable goods consumption, like vehicles and household appliances.

Still, the increasing demand for credit and the resilience of the financial industry did not mean lower rates for consumers, since the effective costs of some credit cards still reach a ceiling of 300 percent per year. Banks attribute the persistent level of payment default to such figures among the world's highest. Consumers blame shameless greed, but indebtedness is cutting into ever larger portions of family income. Thus, the table for mutual distrust is set. Does the banking system have deep structural flaws, or are borrowers careless financial adventurers? A deep confidence gap can cut either way and can be tricky to quantify, especially in Brazil.

Fernando Marques, trade research analyst at Federação das indústrias do Estado de São Paulo, is a graduate student at the International Relations Institute of the Universidade de São Paulo.

COLOMBIA'S IMPROVING CRISIS JOSÉ ANTONIO OCAMPO

The Colombian banking system has improved throughout the most recent global financial crisis, as have the systems of other countries in the region and the developing world. Some of this improvement may be attributed to earlier crises of the 1980s and 1990s, but the system has been refined considerably and has improved in many ways. Today, service offerings are greater and, despite the crisis, Colombia has maintained its investment banks.

The challenges of Colombia's banking system are linked to how the banking sys-

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tem responds to investment from households and how much access to financial services is offered. In terms of access, while large enterprises have access to all services, small- and medium-sized enterprises struggle to gain access. The extent of access to financial services is an indicator of quality for the banking system. And while Colombia has improved substantially, it still has a long way to go. One good sign is the strength of private banking institutions besides its central bank. In general, the banking system has responded to the increase in demand, but there are still many challenges ahead, specifically in guaranteeing access to financial services to small- and medium-sized enterprises.

José Antonio Ocampo, former director of the Banco de la República (Central Bank of Colombia) and finance minister, is a candidate for World Bank president.

BANKING & GOVERNMENT MASSIMO ANTONINI

Confidence in the banking system is fundamentally confidence in the government that backs it. If anyone needed a reminder of this, the recent financial crisis must have done the job. All the basic functions we expect from the banking system imply risk-taking. We want banks to engage in "maturity transformation," allocate savings to productive activities, and facilitate payments between various sectors of the economy. All these activities involve risk. If we want a smoothly functioning banking system, we must accept that it may need government support. This support may be financial, but the government must also support the banking sector through an adequate regulatory framework. While risk-taking cannot be avoided, excessive risk-taking should be discouraged. Yet knowledge that governments will help in a crisis generates an obvious incentive for excessive risk-taking. Therefore, confidence in the banking sector must mean confidence that government finances and the regulatory framework are solid enough that when the next crisis occurs, the consequences are not so disruptive.

Are we there yet? I am afraid not. Efforts to address the weakness of public finances and existing regulations are evident. We are—slowly—moving in the right direction, but much remains to be done. We can be cautiously optimistic that some lessons have been learned. But this is a job that will never be done. The macro-prudential and regulatory framework will require constant monitoring and updating. So am I confident? Let us say: not yet.

Massimo Antonini is an Italian economics fellow at St. Peters College, Oxford.

BOTTOM-UP OR TRICKLE-DOWN PRITHVI NAIK

The Indian banking system is the great elephant tied between two schools' tug-o-war. On one hand, Amartya Sen and Jean Dreze advocate a bottom-up approach to economic growth and development, while on the other hand, Jagdish Bhagwati and Aravind Panagariya suggest that trickle-down effects are the best way forward for the nation.

One way financial turmoil in India can manifest itself is through the collapse of our highly esteemed banking system. Large amounts of non-performing assets and lapses in regulation and supervision can cause the collapse. However, recent reforms by the Reserve Bank of India—increasing the capital adequacy ratio, more stringent controls on non-performing assets, and limits on exposure to the weakest of borrowers, have helped curb the possibility of default.

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Still, the probability of default by public sector banks is greater than private sector banks, as public sector banks are heavily politicized. Most public sector banks hold large quantities of government securities to ensure returns, without the risk of lending to borrowers whose probability of default is high. Such a system, however, is highly inefficient, and the central bank is addressing these issues.

The Reserve Bank of India adheres to international banking standards, which provides some comfort to the general population. There is no doubt the Indian system is inefficient and riddled with loopholes and vested interests. But as economist Aravind Panagariya points out, the central bank has always been a lender of last resort and has never let any bank fail in the country's history.

Prithvi Naik is a researcher at Sarla Anil Modi School of Economics, NMIMS University in Mumbai.

CANADIAN RESILIENCE
NEIL BRITTO

A banking system deserves confidence when its financial institutions, capital markets, and payment and insurance systems are effective and well regulated. The Canadian banking system has proven resilient throughout the financial crisis and received international praise, with 81 percent of Canadians holding a favorable impression of banks in Canada, an increase from 59 percent in 2001.

In 2013, the World Economic Forum ranked Canadian banks as the world's soundest for the sixth consecutive year. Historically, Canada has a strong record of financial stability relative to the United States. Canadians often derive confidence from favorable comparisons to the United States, and recent research suggests that Canada has experienced few banking crises comparable to the 16 experienced by the United States since the early 19th century. Former Governor of the Bank of Canada Mark Carney was lauded as the Central Bank's superstar for his role in managing the effects of the financial crisis in Canada. This success led to Carney's recent appointment as Governor of the Bank of England. Such an export of a Canadian leader leads to confidence that benefits not only such individuals, but the institutions and system they represent.

Still, even the most stable banking system has vulnerabilities. Canada can continually improve regulation and address the financial literacy issues that remain as challenges to the current system. Also, credit losses at major banks remain low despite levels of consumer debt that are now 164 percent of average personal income—higher than Australia, the United States, and the United Kingdom, and likely to increase relative to those countries.

Canadians' risk-adverse nature is often considered a national shortcoming. But restraints throughout the country's banking system have proven to be a source of confidence and pride for Canadians.

Neil Britto is a Canadian researcher and executive director of the Intersector Project, which studies cross-sector collaboration.

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