The G20 and financial stability

by Michael Heise

The annual meetings of the heads of state and government of the G20 are an offshoot of the financial crisis. The first time they met in this constellation was in 2008 to discuss what global measures needed to be taken to stabilize the financial markets. And since then much has been undertaken on the initiative of the G20. Capital and liquidity requirements on banks and other financial services providers were ratcheted up, certain transactions prohibited and bonus systems adjusted to prevent excessive risk-taking. In addition, monitoring by the supervisors, in particular of systemically important institutions, has been stepped up massively. As a result of these efforts the financial system in the advanced western world is more robust and more resilient than it was prior to the financial crisis. However, the rulebook established over the past few years does contain a number of contradictions and inconsistencies.

In particular, the preferential treatment of government bonds, which are deemed risk-free and for which banks therefore do not have to set aside capital, is having serious consequences. With the banks still having large holdings on their books, doubts about the sustainability of a country’s public finances can also destabilize the banking sector. The absence of capital requirements for government bonds also runs counter to the endeavors of central banks to channel more money into the private sector. Banks involved in corporate finance have to set aside substantially more capital for that than for government bonds. Capital requirements result not only from potential defaults but also from temporary price fluctuations. These, however, are of no relevance for long-term investors.

Whereas regulatory initiatives launched by the G20 were aimed at reducing risks on the financial markets, the impact of monetary policy goes in a completely different direction. Around the globe we are seeing a rapid accumulation of debt and credit risks. According to the International Banking Association, total debt has risen from 276 percent of global GDP in 2007 to 327 percent in 2017. Whereas in the advanced economies the major financial crisis still casts a shadow and private sector debt is rising only moderately, in many emerging markets, above all in China, we have been witnessing an accelerated buildup of debt for years. The idea that such credit bubbles could be brought under control solely via sound regulation is naïve since the ultra-loose monetary policy, which flooded the financial markets with liquidity and prompted banks to lend at low or even negative rates, is bound to lead to excesses on the lending markets sooner or later. Some of the responsibility to gradually slow down the growth in debt also rests with the central banks. This should be top of the agenda at the next G20 gathering of finance ministers and central bank governors.