The globalisation of the financial markets following the global financial crisis

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The global financial crisis seems to have led to a break in the trend in recent decades toward a closer international integration of financial markets. To a certain extent, this relates to the effects of the ongoing euro crisis, which can be expected to diminish as the crisis subsides. However, new regulations probably also have a role to play and these may have a more lasting effect. Greater fragmentation of the financial markets would result in costs in the form of poorer capital allocation, risk diversification and competition on the banking market. At European level, a properly structured banking union could help to prevent such outcomes. The Swedish banks currently enjoy a favourable competitive situation, partly because they are seen as safe counterparties compared with many other European banks. Nevertheless, stronger European banks outside Sweden are also preferable from a Swedish perspective, since they improve competition and reduce the risk of pressure on the financial markets.

Introduction

When Lehman Brothers filed for bankruptcy protection on 15 September 2008, the international financial markets had already been showing signs of strain for over a year. The spreads on the interbank markets had been increased since summer 2007, not just in the United States, but also in the eurozone and the UK. Spreads also began to increase in Sweden in summer 2007. During this period, it was still unclear to most people just how much impact problems on the financial markets would have on the global real economy.

However, the fall of Lehman Brothers triggered an exceptionally rapid reduction in economic activity in large parts of the world. The financial disruption had its origins in problems on the US housing market, but it quickly affected the real economy around the world as a result of the strong globalisation of the financial markets. Globalisation had been underway for several decades, driven by a combination of political decisions to facilitate trading in financial assets and technical progress within information and communications.

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The fact that the shock spread so rapidly and had such major consequences for the real economy, has led to the globalisation of the financial markets being viewed to some extent in a new light. The efficiency gains of more integrated markets have come to be weighed against possible risks in terms of maintaining the stability of the financial system. Policy-makers have become considerably more sceptical about financial integration. Particularly in countries with large financial sectors, the positive view of their own banks' international competitiveness has been tempered with concern about what a banking crisis can do to the economy. The experiences of countries such as Iceland and Ireland are alarming, where a collapse of the banking system wreaked havoc on public finances.

This article discusses how the pros and cons of financial integration can be viewed in light of the financial crisis and how the crisis has affected the integration process. The article also considers what changes new regulations for financial institutions may bring. Sweden is a country with a large financial sector relative to the economy as a whole. The Swedish authorities have therefore actively sought to tighten up requirements on the banks. The Swedish banks have also been quick to meet these requirements, even where they have only been issued in the form of recommendations. Their good level of compliance also seems to provide some competitive advantages, which improve the banks' ability to expand abroad and thus grow even larger.

The article begins with a discussion of the pros and cons of the international integration of the financial markets. This is followed by a section on how the financial crisis has affected the level of international integration on these markets. In some areas, integration seems to have declined but it is difficult to know whether this is a temporary or more lasting effect. Following this section, there is a discussion of new regulations and frameworks which have been introduced or are about to be introduced. Finally, I discuss what the consequences of the changed conditions on the financial markets can be expected to involve for Sweden.

Pros and cons of financial integration

EFFICIENCY GAINS AND IMPROVED RISK DIVERSIFICATION

The globalisation of the financial markets involves several aspects of financial integration:[1]

- opportunities for companies to invest abroad and to finance domestic investments using share capital or loans from abroad,
- opportunities for individual and institutional investors to trade in foreign securities, such as shares and bonds, and
- opportunities for banks to expand abroad and lend on international interbank markets.

[1] Alsén (2009) provides a comprehensive review of the globalisation of the financial market.

According to the theoretical literature, there are potentially major benefits from internationally integrated financial markets. Two main benefits are usually assumed:

- a better international allocation of capital, and
- a better diversification of risk.

A better allocation of capital can be obtained because savings in countries where the real return on capital is relatively low can be used to finance investments in countries where the real return on capital is relatively high. This generates potential gains as the limited investments which can be financed using total global savings are made where they provide the best return. The international trading of financial assets therefore enables the separation of national savings and national investments. The savings generated in developed countries with high income levels, such as Sweden, can be used to finance investments in rapidly growing developing countries, for example, where there is a great deal of scope for investments to increase productivity. The expected return on Swedish savings would be higher in this case, while at the same time, the financing of investments in emerging economies would be expected to help income levels in these economies move more quickly towards those of Sweden.

Whenever researchers have attempted to quantify this type of gain, however, they have found no evidence to suggest that it would be particularly large. An often cited study by Gourinchas and Jeanne (2006), for example, has concluded that the welfare benefits of going from a situation without any capital mobility to a situation with completely free movement of capital is roughly equivalent to a one per cent increase in consumption for a typical emerging economy.[2] One reason for the comparatively small estimated gains is that the low level of labour productivity associated with a low income level seems not to be primarily the result of a lack of capital, but is dependent on other factors, such as poorly functioning institutions.

The ability of financial integration to enable the better diversification of risk is due to the fact that the volatility in a country's income may be reduced as households own foreign assets, provided that macroeconomic developments differ between countries. Households are thus able to avoid reducing their consumption should the country experience a negative shock by holding assets with a return that is instead dependent on developments abroad. The results of empirical studies of the gains financial integration may bring as a consequence of better risk diversification are mixed – there are studies which indicate significant gains, but also studies which do not find any gains at all.[3]

Despite strong theoretical arguments for significant economic gains, the empirical literature as a whole therefore does not strongly support the idea that the globalisation of financial markets really has resulted in such gains. It is hard to say, however, whether this is because of the difficulty in measuring the gains which have nevertheless been made, or whether the gains are in fact small.

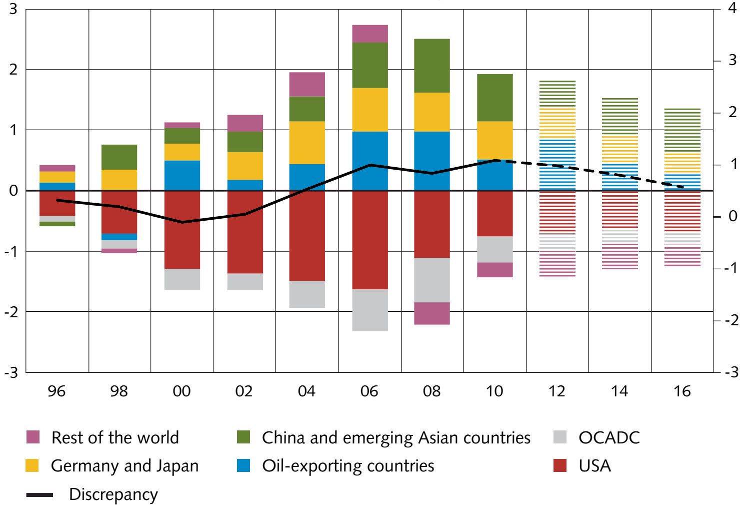
[2] There are studies which identify more significant effects, however, such as Hoxha, Kalemli-Ozcan and Vollrath (2009).

[3] See, for example, Kose, Prasad and Terrones (2009).

A key observation is that the pattern for countries' net flows of capital does not follow what is theoretically expected in a situation where the capital markets are fully integrated. One way of studying the net flows is to follow the current account, which shows the difference between what is produced and what is absorbed during a given time period. If the value of what is absorbed exceeds the value of what is produced, there is a deficit which must be covered through an inflow of capital – a loan – from abroad. The loan must be repaid with interest in the future, however. When that day comes, the value of what is produced must exceed the value of what is absorbed, for example by exports of goods and services exceeding imports of goods and services. Countries with a current account deficit import capital, while countries with a current account surplus export capital. Those countries which import capital have a lower level of savings than is required to finance their own investments. Countries which export capital have a higher level of savings than is required to finance their own investments.

With fully integrated capital markets, we would expect that capital-rich high-income countries would tend to have a current account surplus and low-income countries with a shortage of capital would have a current account deficit. As can be seen from Chart 1, China and the emerging economies in Asia have had a surplus since the late 1990s, while the United States has had a large deficit for a long period. The United States is actually the country that imports the most capital in the world. China's capital markets are of course not particularly integrated with the rest of the world – the Chinese currency, renminbi, is not fully convertible to other currencies, for example. It is therefore not particularly surprising that China's capital flows cannot be explained by what would be expected in fully integrated capital markets. However, the phenomenon as such – that a relatively poor but rapidly growing country exports capital to a rich country with considerably less growth potential – appears to be the wrong way round and is often referred to in terms of global imbalances.

Chart 1. Current account of countries and regions, percentage of total global GDP



Note. OCADC comprise Bulgaria, Croatia, the Czech Republic, Romania, Hungary, Ireland, Lithuania, Poland, Portugal, Estonia, Greece, Spain, Turkey and the United Kingdom. The discrepancy arises because the total deficit does not exactly correspond to the total surplus.

Source: IMF WEO April 2012

These imbalances are often quoted as a contributory factor to the global financial crisis of 2008-2009. The widespread access to credit in the United States was partly the result of the rest of the world's willingness to invest in US assets and is considered to have contributed to the rapid increase in debt and thereby to greater vulnerability. As Table 1 shows, global savings increased between 2001 and 2008 from around 21 per cent to around 24 per cent of global GDP. In contrast, savings in the United States fell significantly during this period, from around 16 per cent to around 12 per cent. Savings increased primarily in China, the emerging economies in Asia, Germany and oil-exporting countries.

Table 1. Savings (S), investments (I) and the difference (S-I) as a proportion of GDP in each country or group of countries (percentage)

	2001			2008			2011		
	S	**I**	**S-I**	**S**	**I**	**S-I**	**S**	**I**	**S-I**
USA	16.5	19.1	-2.6	13.4	18.1	-4.7	12.2	15.5	-3.3
China	37.6	36.3	1.3	53.2	44	9.2	51.3	48.6	2.7
Emerging economies in Asia	27.6	24.2	3.4	32.6	27.6	5	32.6	25.9	6.7
Germany	19.5	19.5	0	25.5	19.3	6.2	23.9	18.3	5.6
Oil-exporting countries	33.3	24.8	8.5	38.9	25.6	13.3	36.4	24.7	11.7
World	21.4	21.5	-0.1	24.2	23.8	0.4	23.9	23.4	0.5

Note. Savings and investments for the world as a whole are the same size by definition. The fact that they are slightly different in the table is the result of measurement errors.

Sources: Berg (2012, table 17.3, page 365) and IMF (2012a, 2012b)

There are several potential explanations for this development. The low level of savings in the United States is partially the result of negative savings in the public sector; in other words a large, persistent budget deficit. According to the twin deficit hypothesis, there is a strong positive correlation between a budget deficit and a current account deficit.[4] However, US household savings were also low throughout the first decade of this century and a large proportion of the growth in consumption in the US has been driven by credit. In China, the lack of publicly provided social security systems has created a need for high levels of saving among households. So, although investment has been very high in China, savings have been even higher. Cabellero, Fahri and Gourinchas (2009) suggest that the lack of traded financial instruments in China results in savings being channelled, to a great extent, through capital flows to a country such as the United States, with well-developed financial markets. According to their analysis, this may continue for as long as this difference in financial development exists.[5]

Table 1 also shows that US savings as a proportion of GDP fell further between 2008 and 2011 by more than one percentage point. At the same time, investments as a proportion of GDP fell by over 2.5 percentage points. The reduced difference between savings and investments is reflected in a reduced current account deficit (see Chart 1). If the proportion of investments returns to the levels seen in the United States prior to the financial crisis, the current account deficit can be expected to increase again.

Countries with persistently large current account deficits often run into problems. The deficit in itself means that an initially negative net asset position vis-à-vis the rest of the world increasingly becomes larger, and sooner or later this debt must be repaid. If the creditors lose confidence in the country's economic prospects, they may not be willing to refinance the loans, which risks triggering a crisis where the country must move quickly from a deficit to a surplus.

Many developing and emerging economies with large, persistent current account deficits have been affected by a sudden dramatic reduction in or complete evaporation of the willingness of the rest of the world to finance further deficits. This affected many countries in Asia, for example, during the so-called Asian crisis.[6] The only ways of moving from a deficit to a surplus are either by obtaining more income from abroad – for example through increased exports – or by reducing expenditure on payments going abroad – for example through reduced imports. It is rarely possible to increase exports in the short term, so in practice it is imports that must be reduced through lower consumption and less investment. This takes place through a general downturn in the economy, where production and incomes may fall significantly – a process which can lead to social unrest and political instability.

[4] See Normandin (1999), for example.

[5] The idea that the US could have a current account deficit for the foreseeable future is also supported by an analysis by Gourinchas and Rey (2007), which shows that the US nevertheless has a net inflow in terms of return on assets and liabilities compared with the rest of the world.

[6] See, for example, Corsetti, Pesenti and Roubini (1999).

Before the financial crisis, there were many who expected something like this to happen to the United States. What triggered the global financial crisis in 2008-2009, however, was in many ways a different process. It was not about a sudden reduction in the world's willingness to invest in US assets, but was more a crisis of confidence within the US financial sector, which was heavily indebted and exposed to bad mortgage loans through complex financial products. When the problems on the US financial market spread and developed into a global financial crisis, the world's interest in investing its assets in US securities actually increased, which among other things resulted in an appreciation of the dollar and falling interest rates for US government securities.

RISKS ASSOCIATED WITH LARGE GROSS FLOWS

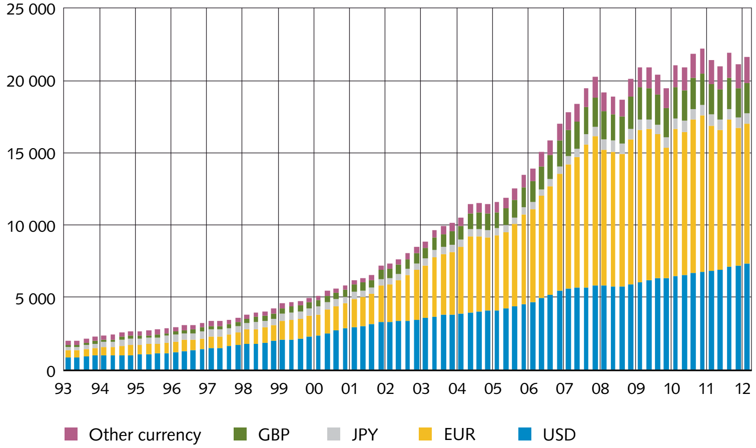
Behind the net flows of capital which are reflected in the current accounts, there are very large gross flows. These gross flows can affect the stability of the system over and above the global imbalances caused by the net flows. Some even believe that any stability problems caused by the net flows are dwarfed by those caused by the gross flows.[7] The net flows which a current account surplus or deficit entails, result in a change in the wealth position vis-à-vis other countries, as a surplus increases net assets and a deficit net liabilities vis-à-vis the rest of the world. However, these changes in the wealth position can be almost negligible relative to the changes which result from capital gains and losses on the stock of assets and liabilities which the country has in relation to the rest of the world. These gains and losses arise partly because the value of various types of assets changes and partly because the exchange rate moves, changing the value in domestic currency of assets and liabilities denominated in foreign currency.

It would appear that the large gross flows derive to a great extent from various types of debt instruments, particularly short-term loans within the banking sector (Obstfeld, 2012). Chart 2 shows the outstanding stocks of interest-bearing securities which are traded on the international money and bond markets. These stocks increased strongly until the financial crisis hit, but since then they have remained quite stable at just over the USD 20 trillion mark. As the chart shows, a large proportion of international trading in interest-bearing securities takes place in securities denominated in EUR. The majority of these securities are issued by banks and other financial institutions.[8]

[7] See, for example, Borio and Disyatat (2011).

[8] In September 2012, financial companies were the issuers of around 75 per cent of the outstanding stock of international interest-bearing securities (BIS, 2012).

Chart 2. International trading in interest-bearing securities by currency, value of stocks, USD billion



Note. Before 1999 the category EUR consists of interest-bearing securities in the currencies of the initial euro area countries and the European Currency Unit (ECU).

Source: BIS (2012)

Trading in debt instruments involving large volumes may create risks for financial stability. This is because short-term loans tend to increase the refinancing risk and thereby the risk of liquidity problems spreading rapidly through the system, affecting more financial institutions. The gross flows create problems because the foreign assets acquired by certain players in the market cannot be used to cover the liabilities generated by others in a situation where the latter experience liquidity problems.

This is therefore one way in which the globalisation of the financial markets can have a negative impact on financial stability. Large gross flows of capital bring a risk of major knock-on effects between different markets, where problems in one country spread to other countries and there is a snowball effect where the problems get bigger and bigger, as do the costs of handling them.

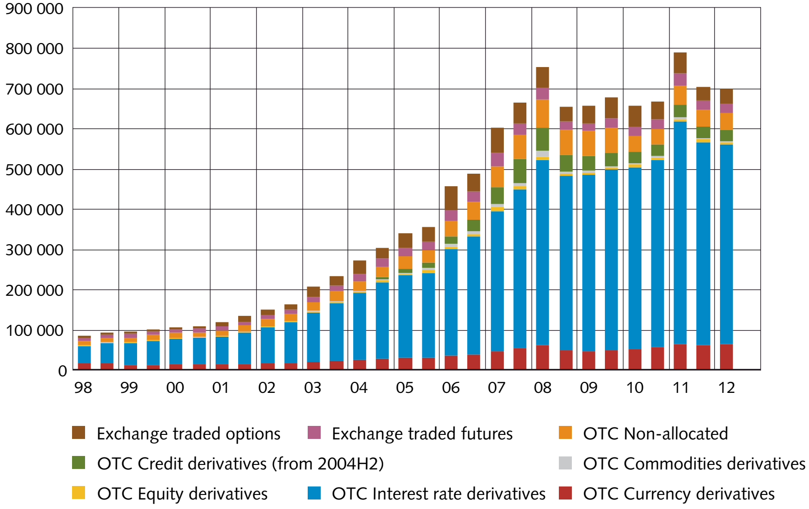
RISKS ASSOCIATED WITH DERIVATIVES TRADING

One segment of the financial market that has come under scrutiny in connection with the financial crisis is the market for financial derivatives. Derivatives are securities which are linked to the value of an underlying asset, such as shares, bonds, commodities or currencies. They are used, among other things, to hedge against a fall in value of the underlying assets and can therefore improve risk management. However, there are also obvious speculative elements to derivatives trading. It enables bets that the value of the underlying asset will move in a certain direction. The wrong bet can result in very heavy losses. Derivatives are also often complex, which may have contributed to the difficulty of both the supervisory authorities and the management of the institutions trading in derivatives to grasp the risks involved. The major insurance corporation AIG (American

International Group), for example, made such large losses on credit derivatives in 2008 that the company would have gone bankrupt without the support of the US government.

International trade in derivatives grew very strongly during the years leading up to the financial crisis. Chart 3 shows that the outstanding value of derivatives traded on international markets amounted to around USD 750 trillion in 2008. Since then, this value has remained comparatively stable at around USD 700 trillion.

Chart 3. International derivatives market, nominal outstanding amount, USD billion



Sources: BIS "OTC derivatives statistics" and "Exchange traded derivatives"

Most derivatives trading takes place on the OTC market, that is outside organised exchanges, and the underlying assets are primarily interest-bearing instruments. The fact that such a large proportion of trading takes place without a central counterparty makes it difficult for the authorities to obtain adequate information about the trade in order to see the risks involved. In recent years, efforts have been made at an international level to get more of the trading in derivatives onto exchanges or other kinds of central counterparty.

CROSS-BORDER BANKING ACTIVITIES

Another aspect of financial integration is the increased significance of cross-border activities for banks. The experiences of the past few years have shown that it can be very difficult and costly to deal with banks beset by problems in a cross-border context. This is partly because there are many stakeholders involved in the process and partly because the rules for winding up a financial institution are even more inadequate internationally than they are nationally. Since governments are accountable to their respective parliaments, and ultimately the voters, there is also a strong tendency to favour national solutions. During the financial crisis there were also several poorly coordinated crisis solutions implemented, which resulted in extensive government support being given to banks.[9]

Nevertheless, there are some who maintain that cross-border banking as a whole strengthens rather than weakens financial stability.[10] Foreign banks are generally not as susceptible to government pressure to lend to "prioritised borrowers" as domestic banks, particularly if the latter are partially state-owned. Foreign banks can therefore help to increase the overall quality of loan portfolios. Since foreign banks are active on more than one market, they also usually have a more geographically diversified credit portfolio. This means that they run less of a risk of being affected by any pressures which may be brought to bear on the local market. They also generally have better conditions for obtaining international financing and may therefore find it easier to deal with any liquidity problems that may arise.

The financial crisis and the degree of integration

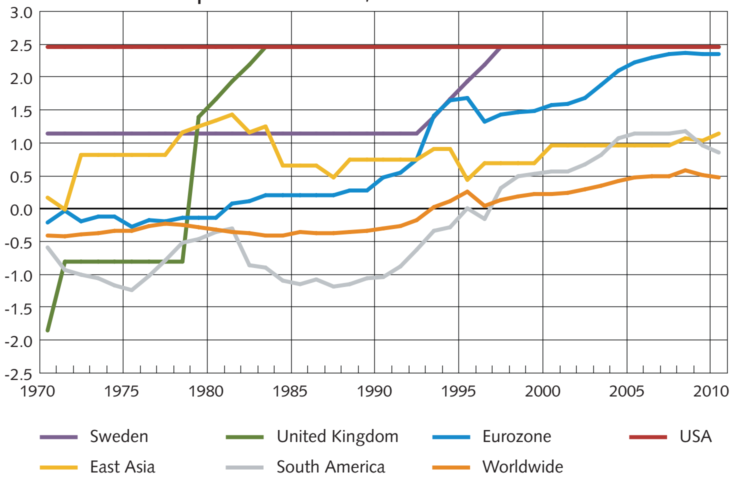
Globalised financial markets are usually considered to be a modern phenomenon. However, much of the internationalisation that has taken place since the early 1980s is in some respects a return to the situation that prevailed before the outbreak of the First World War. At that time, the financial markets around the world were highly developed and there were large movements of capital between countries.[11] In contrast, during the period from the depression of the 1930s to the end of the 1970s, the financial markets were regulated and opportunities to buy foreign assets were limited. During the 1980s, most restrictions were gradually lifted in Western countries and Japan, and the economies were once again opened up to capital flows. During the 1990s, developments in information and communication technology contributed to even greater financial integration and new financial instruments were created and launched on the market.

FINANCIAL OPENNESS

One way of studying developments in relation to the regulation of cross-border financial transactions is to gauge the so-called financial openness of countries. A measurement of this is shown in Chart 4. According to this, financial openness for the world as a whole has gradually increased since the 1980s. The increase has been especially noticeable in Europe.

[9] The handling of Fortis and the default of the Icelandic banks are clear examples of this.
[10] See, for example, Barba Navaretti, Calzolari, Pozzolo and Levi (2010), Goldberg (2002, 2004, 2008).
[11] See, for example, Obstfeld and Taylor (2004).

Chart 4. Financial openness of countries, Chinn-Ito index



Note. The index is based on binary dummy variables which codify the tabulation of restrictions for cross-border financial transactions as reported in the IMF *Annual Report on Exchange Arrangements and Exchange Restrictions* (AREAER). The data used for the various geographical areas is unweighted averages. For further information, see Chinn and Ito (2008).

Sources: http://web.pdx.edu/~ito/Chinn-Ito_website.htm and the Riksbank

It is difficult to say with any degree of certainty what effect the financial crisis has had on this trend, as it is only a relatively short time since the crisis hit and the world has still not returned to normality. What was originally a global financial crisis has now turned into a European debt crisis, which continues to create pressure on the financial markets. Chart 4 nevertheless shows that the increase in financial openness for the world as a whole has tailed off in recent years.[12] The underlying trends here are for less openness in South America and slightly increased openness in Asian countries. As the chart shows, South America has a history of a lack of financial openness and it was actually only towards the end of the 1990s that financial openness in South American countries, as measured here, exceeded the average for the world as a whole.

One consequence of the financial crisis has been very low monetary policy rates in those countries whose real economy has been hit especially hard. This applies to the United States, the eurozone and the United Kingdom. Many emerging economies have experienced a strong inflow of capital during this period, which to a certain extent originates from the investors' strategy of generating arbitrage profits by borrowing at low interest rates in the United States, Europe and Japan and then investing at higher interest rates in the emerging economies, so-called "carry trade". In countries that are subject to such capital inflows, the inflows may be considered a destabilising force, as they create upwards pressure on asset prices and the value of the currency. Many countries have also taken steps to limit such inflows, such as Brazil, South Korea, Peru and Thailand. In Brazil, in particular, there have been a lot of strains with regard to capital inflows from countries

[12] The index measures a country's openness based on its capital account. It was introduced by Chinn and Ito (2006).

with low policy rates and representatives of the Brazilian government have even spoken of a "currency war".[13] The fact that the central banks of many countries are also attempting to keep long-term interest rates low through the purchase of assets and other unconventional methods, has further fuelled the debate about a currency war.

Whether the measures to restrict the inflow of capital have had any positive effect is currently the subject of widespread discussion, without any consensus having been reached.[14] However, a lot of attention has been directed towards the fact that an organisation such as the International Monetary Fund (IMF), which previously has advocated free capital movements, has revised its position and is now stressing the problems that capital flows may bring (IMF, 2012c). The IMF also considers that the decision-makers in the countries which generate capital outflows have a responsibility and should bear in mind how their decisions affect the economic and financial stability of other countries.

REDUCED BANK LENDING

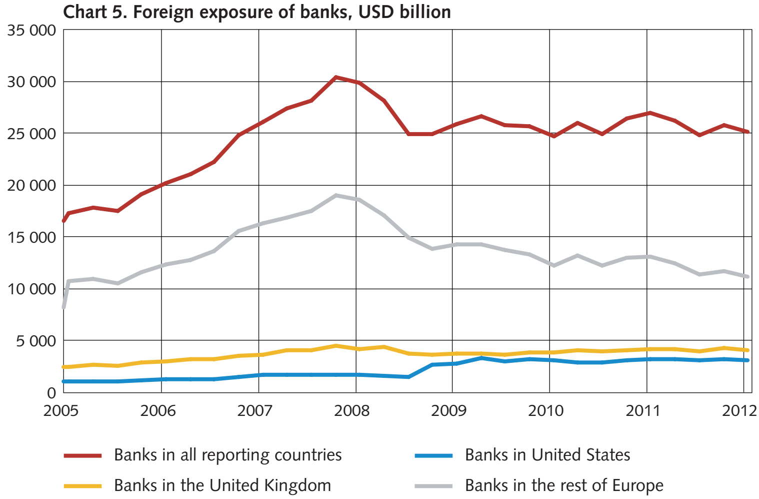
The emerging economies may be affected by other indirect effects of the handling of the financial crisis, however. As a result of the more stringent capital requirements imposed on the banks both by the authorities and by potential investors in the wake of the financial crisis, many banks have had to reduce their balance sheets. Banks with cross-border activities often cut back on their lending abroad first. This can create problems in countries where the banking sector is dominated by foreign-owned banks – which is often the case in emerging economies – as there is a risk of a reduction in the supply of credit, which in turn can dampen economic activity. To a certain extent, a reduced supply of bank credit can be expected to have the opposite effect on the economy compared with capital inflows. The effect on a particular emerging economy of the expansionary monetary policy of the United States, Japan and Europe and the more stringent requirements on the banks therefore depends on which effect dominates.

The Bank for International Settlements (BIS) collects data on the foreign assets and exposures of banks. Chart 5 shows the foreign exposure of banks since 2005 according to data from the BIS. This is not a perfect measurement of the banks' lending abroad, but it gives an idea of how their foreign assets evolve. For the world as a whole, we can see a clear increase in these exposures in the years leading up to the financial crisis, followed by a marked fall in 2008. Since then, exposures have remained at a more or less constant level. We can see that there are no signs of reduced exposure for UK and US banks – in the latter case quite the reverse, as exposures increased slightly in 2008-2009. In contrast, the foreign exposures of banks in the rest of Europe have clearly declined.

[13] Brazilian finance minister Guido Mantega warned of a currency war in September 2010.

[14] A study by Klein (2012) finds these measures to have little effect, for example.

Chart 5. Foreign exposure of banks, USD billion



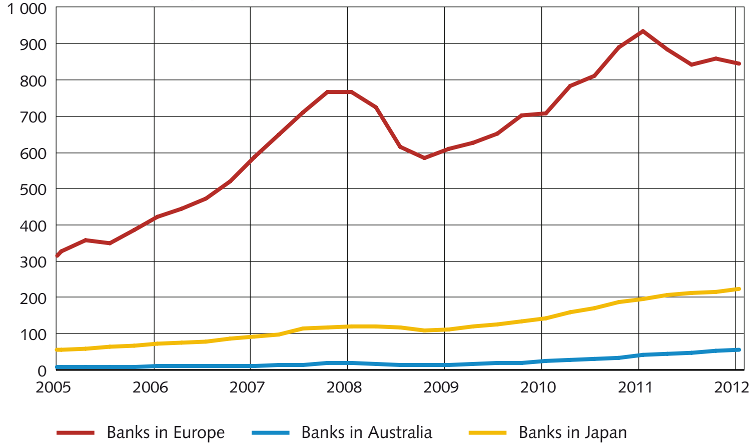
Note. Banks in all reporting countries include those countries whose banks (at least 90 per cent of the banking system in the respective country) report to the BIS. There are 30 of these countries in total. Banks in the rest of Europe include banks in all European countries which report to the BIS, excluding the United Kingdom.

Source: BIS

The IMF has highlighted the risk that the reduction of European banks' activities in Asia may create problems in terms of access to trade credits and financing of major investment projects there (IMF, 2012d, chapter 2). European banks have typically dominated within these market segments. To a certain extent, this creates opportunities for banks from other countries to increase their market shares. However, financing major investment projects, in particular, is a highly specialised activity and it can be difficult for other banks to fully compensate the reduced supply of credit from European banks, since this often requires syndicated loans with long maturity.

With regard to trade credits, on the other hand, it appears that banks from other regions have taken over some of the market shares of the European banks in Asia. There are indications of this in particular with regard to Australian and Japanese banks. Chart 6 shows the exposures of banks to countries in Asia divided into European, Japanese and Australian banks. It can clearly be seen that the exposures of the European banks to countries in Asia fell significantly in 2008 but then started to increase again. However, the chart suggests that these exposures then fell during 2011. It appears that the exposures of Japanese and Australian banks to countries in Asia have increased somewhat, although overall they are at a considerably lower level than those of the European banks.

Chart 6. Bank exposures to countries in Asia, USD billion

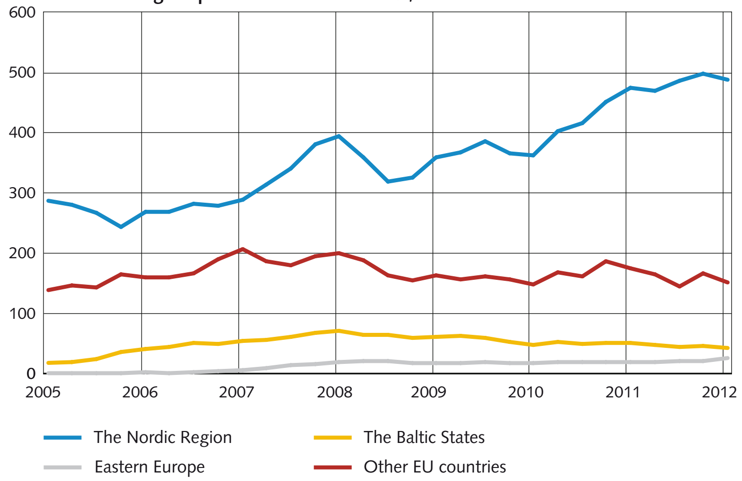


Note. The data in the chart refers to banks which report to the BIS. Japan is excluded from countries in Asia.

Source: BIS

The foreign exposures of Swedish banks have generally not declined. This can be seen in Chart 7. Exposures in the Nordic countries have continued to increase, while exposures in the Baltic States have fallen off. Exposures in the rest of Europe have remained relatively constant since 2005.

Chart 7. Foreign exposures of Swedish banks, USD billion

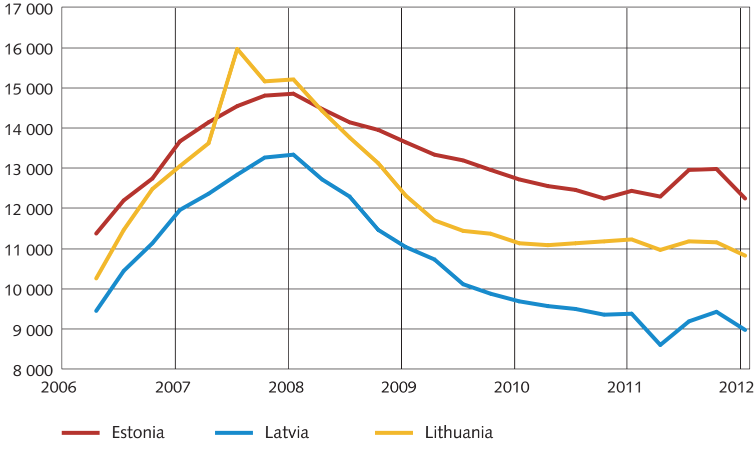


Note. The data for other EU countries excludes the Baltic States and Poland. Eastern Europe comprises Poland, Ukraine and Russia.

Source: BIS

The picture is a little different, however, if we focus on the Swedish banks' lending in the Baltic States, which can be seen in Chart 8.[15] The Swedish banks have clearly reduced their lending there as a result of the financial crisis. This is particularly true of Latvia and Lithuania, while the reduction is less pronounced in Estonia.

Chart 8. Swedish banks' lending in the Baltic States, EUR million



Sources: The banks' annual reports and the Riksbank

On the whole, it appears that countries in Eastern and Central Europe have been hit the hardest by the reduction in banks' lending abroad. The reduction in bank lending in emerging economies is largely driven by the problems the banks are experiencing. Since banks experiencing problems are primarily banks from the eurozone and as it is mostly these banks that have foreign operations in eastern and central Europe, the cutbacks there have been particularly severe.[16] Whether this constitutes an economic problem for these countries is not easy to determine, however. In some respects, the development in eastern and central Europe has been reminiscent of that in southern Europe and Ireland before the crisis, with large current account deficits combined with rapidly rising unit labour costs, indicating a deterioration in competitiveness. This development was probably not sustainable in the long run. More restrictive lending should therefore at least partially represent an adjustment to the underlying growth conditions, which may not have fully justified the growth in credit observed before the crisis.

[15] The exposures shown in Chart 7 are reported on the basis of the country which ultimately bears the risk, which is not always the same as the country where the lending takes place. Therefore, the exposures shown in Chart 7 differ from those shown in Chart 8.

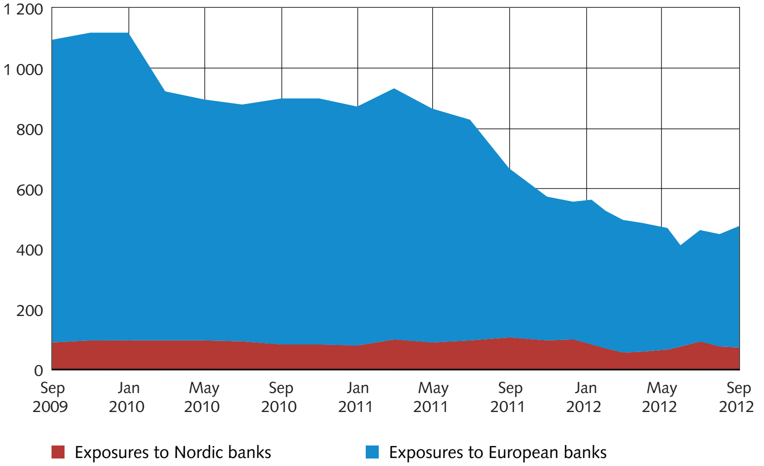
[16] For an empirical analysis of the factors behind the reduction in lending in emerging economies, see Avdjiev, Kuti and Takáts (2012).

THE INTERBANK MARKET

According to the latest statistics from the BIS, activity on the international banking markets has recently declined considerably (BIS, 2012, 2013). Cross-border claims between banks have contracted every quarter since Q4 2011 (the latest provisional statistics relate to Q3 2012). During the second quarter of 2012, cross-border claims between banks in developed economies reduced by USD 344 billion. Most of this reduction can be attributed to reduced claims on banks in the UK and the United States. A smaller portion can be attributed to reduced lending to banks in the eurozone, primarily in Germany, Spain and the Netherlands. The reduction in cross-border claims was mainly driven by a reduction in loans between various parts of international banking groups.

The Swedish banks appear to have remained relatively unaffected by the reduced activity on the interbank market, however. They continue to enjoy good access to funding, not least short-term funding in USD. Chart 9 shows how the US money market funds' exposures to European banks have developed since the financial crisis. These funds have reduced their total exposures to European banks by over half, from around USD 1 100 billion during autumn 2009 to around USD 500 billion during autumn 2012. Their exposures to the Nordic banks have remained more or less constant during this period, however.

Chart 9. US money market funds' exposures, USD billion



Sources: Fitch Ratings and the Riksbank

Thus, overall there is a clear indication that the financial crisis has set globalisation back somewhat. Some countries have reintroduced restrictions on capital inflows. Some cross-border banks have focused their activities more on their home countries, thereby becoming more national in nature. It is too early to tell whether this development is temporary – something which in the future will appear as a kink in the curves – or a new trend.

New rules create new challenges

New regulations for the activities of financial institutions are being drawn up and introduced around the world. This may result in more lasting changes of the global financial markets. The new regulations are more stringent and are being designed on the basis of the deficiencies revealed during the financial crisis. Extensive efforts have been made internationally in recent years to implement new regulations. The aim has been to dramatically reduce the likelihood of a global financial crisis happening again and to ensure that the costs of future global crises will be significantly lower should they nevertheless arise.

Some believe that the recent regulation brings a risk of returning to the world as it was before the days of deregulation, with financial markets performing their basic functions poorly: that is processing payments, turning savings into financing, and managing risks. This was also a world with significantly less internationally integrated financial markets than in recent decades. Others believe, in contrast, that the new rules are not strict enough and are far too close to the situation before the financial crisis. It is difficult to determine exactly what the right approach is in this area, so the discussions about how the regulations should be designed are in all certainty set to continue.

BASEL III ACCORD

For Sweden, the regulations agreed upon within the EU are of major importance, since these can be expected to be binding. The EU reforms are affected in turn by the negotiations underway at international level to agree on which rules all countries should introduce. The Basel Committee, which is an international committee that makes recommendations on banking regulations, has been working since the financial crisis to provide new recommendations in precisely this area. The new recommendations are known as the Basel III Accord (Basel Committee on Banking Supervision, 2010a, 2010b). The basic principles of the new regulations are that the banks will be required to hold more and better-quality capital and to have liquidity buffers.

Work is currently underway to implement the Basel III Accord in many parts of the world. At EU level, the new requirements for how much and what kind of capital the banks must hold will be implemented in a new Directive and a new Regulation (usually referred to together as the CRD IV Package or CRD IV/CRR). The European Commission has submitted a proposal, on which there has not yet been a final decision. The Swedish government has been critical of some elements of this proposal. One such element is that the capital requirements imposed on banks within the EU should be completely harmonised. That is, they will not just be set on the basis of a specified minimum level, but will also have an upper limit, so-called maximum harmonisation. This is problematic from a Swedish perspective, since both the government and authorities such as Finansinspektionen (the Swedish financial supervisory authority) and the Riksbank want higher capital requirements than the minimum levels recommended by the Basel III Accord, which risk also becoming maximum levels. The argument for having higher capital requirements in Sweden is that the Swedish banks represent a greater risk than banks in other countries simply because of their size relative to the economy as a whole. The experiences of countries with small economies and a large banking sector – such as Ireland and Iceland – show that the consequences of a banking crisis can be disastrous. There is therefore good reason for the Swedish authorities to impose stricter requirements so as to make the Swedish banks less vulnerable.

However, so far this argument does not seem to have met with much sympathy in the negotiations on the CRD IV Package. The Commission's analysis has been based on the idea that capital requirements that are higher in one country than in other countries would risk giving a competitive advantage to that country's banks, as they would appear to be better and therefore able to obtain cheaper funding. The underlying justification for this approach is the desire to create rules which mean that all banks within the EU compete on the same terms, in other words, the desire to create a level playing field. If the authorities in one country impose stricter requirements than in the other countries, they would be guilty of so-called gold-plating, where a country gives its own banks a seal of approval which says they are better than the banks of other countries.

A EUROPEAN BANKING UNION

The CRD IV Package is part of a much larger package – launched by the Commission – which aims to create a European banking union. In early autumn 2012, a proposal was submitted for a single supervisory mechanism for banks within the eurozone, with the European Central Bank (ECB) as the responsible authority. The single supervisory mechanism is intended to represent the first step on the road to a banking union. The other steps involve a common deposit guarantee scheme and common rules for preventing bank failures and for intervening when a bank gets into financial trouble. In December 2012, the Council of the European Union agreed that from 1 March 2014, the ECB should assume responsibility for the supervision of larger banks in the eurozone. The other elements of the banking union proposal will be discussed during 2013.

It is widely recognised that an integrated European financial market is poorly suited to today's regulatory framework and institutional structures, where regulation, supervision, deposit guarantee schemes and crisis management are at national level. This has also been the subject of discussion for many years. The complexity of the problem has been appropriately described as the European financial trilemma. This refers to the impossibility of achieving the three goals of financial stability, financial integration and national financial independence at the same time (Schoenmaker, 2011).

Thus far, EU Member States have chosen to prioritise financial integration and their national decision-making powers. The financial crisis, however, has clearly shown that financial stability and financial integration cannot be achieved at the same time as pursuing a strict national policy. The initiative to raise not just banking regulation, but also supervision, the deposit guarantee system and the framework for handling financial institutions in crisis to a supranational level should therefore be welcomed.

However, as is often the case with new large-scale regulations, the devil is in the details. At present, there is only a detailed proposal for the first stage: establishing a single supervisory mechanism. Detailed proposals for the other two stages – a common deposit guarantee scheme and a common framework for bank resolution – will be submitted at a later date. However, a single supervisory mechanism without the other two elements in a banking union may result in a system that is at least as fragile as the previous entirely national regulations. It is difficult, for example, to foresee what would happen in a situation where the ECB decides to revoke a bank's permission to operate. Such a situation could be costly for the taxpayers in the bank's home country where the government is compelled to take over the bank or otherwise support it in order to avoid a banking crisis.

The single supervisory mechanism applies initially to the eurozone countries, although EU Member States outside the eurozone are allowed to participate on a voluntary basis. An important question for Sweden in the future is whether we should remain outside or join the banking union. The Swedish government has been critical of the proposal and declared that, at least initially, Sweden will not join. The government has stressed the need to be able to impose higher capital requirements on the banks and also to be able to influence the decisions made, something which was not possible for countries outside the eurozone in the Commission's original proposal. The government has also emphasised that it wants to ensure that Swedish tax revenues are not used to rescue banks in countries which have not taken adequate responsibility for ensuring that the banks are stable.

The government nevertheless appears willing to work towards a single mechanism for bank supervision that is designed in such a way that it will be possible for Sweden to join at a later date. In order for the government to want to join in the future, however, there probably has to be greater clarity with regard to how the other elements of a European banking union will be designed, as well as guarantees that Swedish taxpayers will not be forced to pay for failing banks in other countries.

The desire to create common frameworks can nevertheless be seen as something positive, as it would be a concern if the European banking market were to become more fragmented and national. One general problem with the banking sector is that it is highly concentrated and there is therefore a tendency towards anticompetitive behaviour. One reason for this high level of concentration is without doubt the relatively strict regulation compared with many other sectors. Regulations tend to create barriers to market entry and exit. At the same time, however, it seems that the dynamics of banking crises are such that the banking sector tends to become more concentrated after a crisis than it was before. A common solution when banks get into difficulty is to get a competitor to buy them. Sweden is a good example of this. The Swedish banking crisis in the early 1990s led the number of major banks to shrink from seven to four through acquisitions.

One of the few things that may reduce anticompetitive behaviour on a concentrated market is external competition. When new players enter local banking markets, this can result in increased competition and efficiency gains, which are passed on to consumers in the form of a wider range of financial services and lower prices.[17]

It is therefore important to safeguard the common banking market within the EU. This is far from easy, however, at a time when some countries are experiencing problems with their banking sectors. It would require these countries to deal with unrealised losses on the banks' balance sheets and to restructure the banking sector. But the stakes are high and powerful special interests may complicate the political process required to carry out restructuring.

MACROPRUDENTIAL SUPERVISION

There is a closely related and partially overlapping area where new regulations are being drawn up: macroprudential supervision. This is a policy area which aims to reduce the level of risk in the financial system as a whole, not just at individual institutions. Some of the tools used for this purpose include countercyclical capital buffers, lending ceilings, risk weights and liquidity requirements.

At European level, the European Systemic Risk Board (ESRB) has been formed. The ESRB is the body responsible for the overall macroprudential supervision of the financial system in the EU. Its tasks include collecting and analysing relevant information as well as identifying and assessing systemic risk. The ESRB does not have any direct regulatory powers of its own, however, but has to rely on the national authorities taking action when the Board issues warnings and recommendations.

Macroprudential supervision may also have effects on the degree of international integration of the financial markets. It is easy to imagine a conflict of objectives when countries are to carry out macroprudential supervision of what are fundamentally highly globalised markets. Increasing a countercyclical buffer in a country in order to reduce the vulnerability of the banks, for example, may have a negative impact on lending in other countries where the country's banks are established. The effect of introducing a mortgage ceiling in order to reduce household debt may be small if branches of foreign banks which are not covered by the mortgage ceiling increase their lending. Such cross-border externalities may create friction between countries and encourage a negative view of the high degree of integration from which the externalities ultimately derive. The ESRB is intended to be a forum where the EU Member States can inform other Member States of their macroprudential supervision and resolve any conflicts which arise from undesirable side effects in other countries. This will remain an important task of the ESRB, despite the fact that its role as the European macroprudential supervision body has become somewhat

[17] On the other hand, increased competition can have a negative impact on financial stability. Goodhart (2012) has maintained that the lack of competition was a major reason for the stability of the UK financial system between 1930 and 1970. He believes that bank managers take fewer risks if they can generate large profits without too much effort.

unclear in light of the ECB's new role as having ultimate responsibility for banking supervision within the eurozone.

CENTRAL COUNTERPARTY CLEARING OF FINANCIAL DERIVATIVES

As previously mentioned, work is currently underway at international level to steer some of the OTC trading in financial derivatives towards central counterparties. This work is being led by the Financial Stability Board (FSB), which is an international group primarily made up of representatives of the G20 countries. It wants all standardised derivative contracts to be traded through central counterparties and for OTC trading in derivatives to be linked to higher capital requirements.[18] If more derivative trading takes place with central counterparties, these counterparties can be expected to become key players on the financial markets. They may even become systemically important in the same way as a lot of banks are systemically important today. The authorities therefore need to ensure here that these parties have sufficient capital and properly functioning risk management, and that they can be wound down in an orderly manner if required.

Many central counterparties clear transactions in multiple currencies. In London, for example, LCH.Clearnet clears transactions in several currencies, including the euro. Similarly, in Stockholm NASDAQ OMX clears some transactions in euros. According to the ECB's location policy, however, significant amounts in euros should only be cleared by central counterparties in the eurozone, which may present a further obstacle to the continued globalisation of the financial markets.[19] The ECB's position is based on the view that supervisory bodies in the eurozone should exercise complete operational control over parties which influence the financial stability of the eurozone. However, if everyone adopts this view, central counterparties will inevitably become national in nature and some of the benefits of trading in multiple currencies will be lost. It is difficult to assess the size of these benefits, but it nevertheless appears to be an ineffecient solution for the global economy as a whole to have relatively small central counterparties clearing trade in derivatives in each individual currency area. A better solution would probably be to develop international cooperation in this area so that central banks and supervisory authorities support one another with the information necessary to ensure financial stability at home.

Conclusions and consequences for Sweden

International integration of financial markets is expected to bring economic gains, although it is not without risk. The risk relates to global imbalances reflected in large and persistent current account surpluses and deficits. If a deficit is no longer sustainable, countries may have problems adapting to a new situation. The risk also relates to large gross flows of

[18] See G20 communiqué from the summit in Pittsburgh in September 2009 (G20, 2009).

[19] This policy resulted in the UK government taking the ECB to the Court of Justice of the European Union in September 2011 for contravention of European Union law and of the internal market.

capital between countries. These create risk as the foreign liabilities that some parties have amassed cannot be covered by foreign assets amassed by other parties.

Very recently, however, it appears that the globalisation of the financial markets has come to something of a standstill and on some segments even started to reverse. It seems that this is largely the result of problems in the eurozone, as it mostly relates to reduced lending by and to European banks. It is entirely possible that globalisation will pick up again once the problems in the eurozone begin to subside. However, new regulations also probably play a role and their impact may be of a more lasting nature.

Greater fragmentation of the financial markets would result in costs in terms of poorer capital allocation, risk diversification, and competition on the banking market. At European level, however, a properly structured banking union could help to prevent such outcomes.

For Sweden, the plans for a European banking union are something which policy-makers need to deal with, whether or not Sweden participates. If Sweden does not participate, the ECB will nevertheless form part of the supervisory colleges that exist in order to enable authorities in different countries to work together on the supervision of cross-border banks. The ECB will be the supervisory authority for the eurozone countries and other EU Member States who choose to participate in the single supervisory mechanism. This means that even if Finansinspektionen holds the chairmanship of the colleges established for the Swedish banks, the ECB will probably have a major influence on the decisions made.[20] If Sweden were to join subsequently, the decisions on the supervision of Swedish banks would be made by the ECB, and Finansinspektionen would become a kind of branch office performing some of the day-to-day tasks of supervision. In both cases Swedish decision-makers would lose some of their control over the Swedish banks.

The Swedish banks currently enjoy a favourable competitive situation. The confidence in them on the international markets seems high and they are able to obtain comparatively cheap funding. They are relatively well-capitalised and have a good liquidity position. This makes them attractive counterparties. However, to a certain extent their favourable funding situation may be a consequence of the Swedish authorities imposing more stringent requirements regarding capital and liquidity than in many other EU Member States. From this perspective, the argument of "gold-plating" may have a certain bearing on the development of the Swedish banks. A side effect of the more stringent requirements may be that the Swedish banks are favoured in international competition and therefore are able to increase their market shares and grow even larger. This would be something of an irony, as the size of the banks is precisely the reason why Swedish authorities have been tougher than those in other countries.

[20] In the original proposal there was also a risk that the ECB's opinion would always prevail if supervisory authorities were in disagreement and the European Banking Authority (EBA) was called in to mediate. This was because in the initial proposal, the eurozone countries would always have a majority at the EBA in so-called binding mediation. This part of the proposal has been modified, however, and the voting rules are now intended to guarantee that countries outside the single supervisory mechanism will also be able to exercise influence over decisions.

The Swedish banks' good access to short-term funding in US dollars brings some risks from a stability perspective, as it may be difficult for the Riksbank to provide liquidity support in US dollars in a crisis situation. The Riksbank did provide such support during 2008 and 2009, but at that time the Riksbank, like many other central banks, had a swap agreement with the Federal Reserve which facilitated this support. The realisation that a liquidity crisis may involve currencies other than Swedish kronor is the reason why the Riksbank has recommended that the banks fulfil liquidity requirements in both US dollars and euros, which is something that the four major banks now do (Sveriges Riksbank, 2012, p. 18).

The most important reason for the favourable funding situation of the Swedish banks, however, is probably the euro crisis. This has resulted in Swedish banks appearing to be safer counterparties than many other European banks. As the euro crisis subsides, it can therefore be expected that the Swedish banks will lose some of the favourable competitive position they currently occupy. Although this would mean Swedish banks losing market shares, it would nevertheless be a very welcome development. Stronger European banks outside Sweden are preferable, even from a purely Swedish perspective. Sweden benefits from a well-functioning financial sector in the eurozone, as this not only promotes competition but also reduces the risk of pressure on the financial markets escalating in such a way that it also affects fundamentally sound banks.

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