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Criteria for a Workable Approach Towards Bank Levies and Bank Restructuring

Memo for the June 2010 meeting of the G-20 in Toronto

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SUMMARY RECOMMENDATIONS

1. One of the major lessons from the current financial crisis refers to the systemic dimension of financial risk which had been almost completely neglected by bankers and supervisors in the pre-2007 years.
2. Accordingly, the most needed change in financial regulation, in order to avoid a repetition of such a crisis in the future, consists of influencing individual bank behaviour such that systemic risk is decreased. This objective is new and distinct from what Basle II was intended to achieve.
3. It is important, therefore, to evaluate proposed new regulatory instruments on the ground of whether or not they contribute to a reduction, or containment of systemic risk. We see two new regulatory measures of paramount importance: the introduction of a Systemic Risk Charge (SRC), and the implementation of a transparent bank resolution regime. Both measures complement each other, thus both have to be realized to be effective.
4. We propose a **Systemic Risk Charge** (SRC), a levy capturing the contribution of any individual bank to the overall systemic risk which is distinct from the institution's own default risk. The SRC is set up such that the more systemic risk a bank contributes, the higher is the cost it has to bear. Therefore, the SRC serves to internalize the cost of systemic risk which, up to now, was borne by the taxpayer.
5. Major details of our SRC refer to the use of debt that may be converted into equity when systemic risk threatens the stability of the banking system. Also, the SRC raises some revenues for government.
6. The SRC has to be compared to several bank levies currently debated. The Financial Transaction Tax (FTT) does not directly address systemic risk and is therefore inferior to a SRC. Nevertheless, a FTT may offer the opportunity to subsidize on-exchange trading at the expense of off-exchange (over-the-counter, OTC) transactions, thereby enhancing financial market stability. The Financial Activity Tax (FAT) is similar to a VAT on financial services. It is the least adequate instrument among all instruments discussed above to limit systemic risk.
7. **Bank resolution regime**: No instrument to contain systemic risk can be effective unless the restructuring of bank debt, and the ensuing loss given default to creditors, is a real possibility. As the crisis has taught, bank restructuring is very difficult in light of contagion risk between major banks. We therefore need a regulatory procedure

that allows winding down banks, even large banks, on short notice. Among other things, the procedure will require to distinguish systemically relevant exposures from those that are irrelevant. Only the former will be saved with government money, and it will then be the task of the supervisor to ensure a sufficient amount of non-systemically relevant debt on the balance sheet of all banks.

8. Further issues discussed in this policy paper and its appendices refer to the necessity of a global level playing field, or the lack thereof, for these new regulatory measures; the convergence of our SRC proposal with what is expected to be long-term outcome of Basle III discussions; as well as the role of global imbalances.

A. Introduction: The issues

At the time of writing this memo, the risk of states defaulting on their debt has been added to the already impressive list of issues on the international political agenda. The enumeration of issues that policy makers have to deal with simultaneously is daunting. Stabilizing large international banks; activating the interbank market, allowing Central Banks to retreat from their current role in bank funding; ensuring market liquidity and pushing back OTC markets; enhancing transparency and risk management in derivatives markets and allowing authorities to have an overview of risks, old and new; addressing the rise of systemic risk and finding appropriate counter-measures; finding a workable solution for the Too-Big-To-Fail problem of large international banks; defining a strategy to cope with the default of states, including the restructuring of state debt; designing and implementing exit strategies for the consolidation of fiscal deficits - apart from issues relating to rating agencies, hedge funds, and accounting rules.

The list is certainly not complete, but its length and the breadth of issues involved suggest the risk that policy makers are bogged down by the complexity of integrating the many proposals into a coherent strategy. In this memo, therefore, we will try to focus on two issues which we believe to be at the very heart of any serious attempt to stabilize world financial markets. For that end, we have to make choices, and we have to leave aside issues which, although relevant for a new financial order of markets, are either sufficiently covered in pending regulation (i.e. the design work is well under way, as it is the case with rating agencies, and a regulation for central clearing in derivatives markets), or which are of lesser strategic importance, and may be dealt with once the acute crisis is over.

The issues we believe to be crucial, and for which a harmonized approach among all countries with serious banking problems (US, UK, EU) seems indeed most relevant, are two: putting a price tag on the production of systemic risk in order to lower the level of systemic risk in the financial system and, second, bringing default risk back to banks and their creditors. Both issues serve to re-empower financial markets to discipline management, and to limit institutional risk taking. However, both issues involve significant changes in the regulation of financial markets and institutions, and a strengthening of supervisory activities far beyond the point we see today.

Concerning the long-term consequences of these interventions, a reduction of the level of financial activities and their profitability is likely, particularly in wholesale and investment banking.

The structure of this memorandum is as follows. In section B the importance of bank levies in the form of a systemic risk-related charge is emphasized and a suitable format is suggested, along with a discussion of its main alternatives in the current political debate, the Financial Stability Contribution and the Financial Activity Tax. Section C then looks at the design of an effective bank resolution regime. Section D summarizes the main arguments from the previous sections, and discusses four complementary questions, namely (i) the interplay between bank levy and the effective resolution regime, (ii) the correspondence to the Basle II agenda, (iii) whether a global level playing field is required, and (iv) what the costs of such a systemic risk-related regulation may be.

B IMPOSING A SYSTEMIC RISK CHARGE (BANK LEVIES; "BANKENABGABE")

The idea to impose a new levy on banks, on top of the capital charges already imposed by Basel II and on the fees set by national deposit insurance schemes, can be found in several proposals by policy makers in the US, in Germany, and by the IMF. The main distinction between these proposals relates to the ex-post or the ex-ante nature of the levy. An example for an ex-post charge is the Financial Crisis Responsibility fee (FCR), proposed by the US government. In contrast, a Financial Stability Contribution (FSC), recently suggested by the IMF, implements an ex-ante charge.

In line with our suggestions written prior to the 2009 meeting in Pittsburgh, we see little merit in any variant of an ex-post charge.[1] In contrast, we strongly support the creation of an effective ex-ante scheme. The ideal ex-ante scheme serves two purposes. First, internalizing the social cost of systemic risk on the level of the individual bank and second, accumulating a sufficiently large amount of funds allowing authorities to back their rescue measures in case of a banking crisis. Note that both purposes are new in the sense that they are non-existent in the current regulatory system.

However, the details of the scheme matter a lot, defining the ultimate value for crisis prevention. We believe the following institutional details to be of key importance in designing a reasonable systemic risk charge.

- First, the levy or charge will be imposed regularly (quarterly, or annually) in order to give clear incentives for lowering systemic risk.
- Second, the levy will apply to all institutions that potentially contribute to systemic risk and/or that eventually would benefit from a rescue operation.[2]
- Third, the base for setting the charge should be variable, rather than flat, reflecting the current assessment of the bank's contribution to overall systemic risk. At initiation of the scheme, as there are no reliable metrics for systemic risk available, the charge may be based on size (e.g.: total liabilities minus tier-1 equity, minus insured deposits), as well as a measure of interconnectedness (e.g.: the ratio of interbank liabilities to total assets)
- Fourth, the absolute value of the overall charge should depend on the assessment of the systemic risk; it should not be fixed at any given level, to retain strong incentives for a system-wide reduction of systemic risk (e.g.: lowering interconnectedness, portfolio correlations and maturity mismatches).[3] To have an impact on bank management decision making, and thus to engender a safer banking system, the

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[1] The reason is that because we are facing the results of a systemic financial risk, charging for state help ex-post does not properly distinguish between causer and claimant of these risks, and therefore does not set incentives to lower systemic risk. This is not to deny that an ex-post charge would have one advantage: it would raise revenues. See also Issing-Commission: Preparatory Comments for the G-20 Meeting in Pittsburgh, memo, September 2, 2009.

[2] There is no financial institution which is excluded from consideration at the outset, although for some institutions and for some periods the charge may be set at zero.

[3] Based on a poll among executives in the financial industry in Germany in which 500 were asked and 200 responded, the charge should be set at around 10 basis points of the aggregate balance sheet of the banking system if systemic risk is low, and at 50 bp for high systemic risk, translating into a bank levy of € 1 billion to € 5 billion per annum, depending on systemic risk contribution (Source: CFS, April 2010).

charge should be set at a high enough level – arguably above the €1.2 billion currently discussed for an annual bank levy on German banks.

- Fifth, the aggregate level of the systemic risk charge – assuming it will be collected over several years without being tapped for bank rescues in the interim - may be capped at some reasonable level, for example 5% of GDP (which approximates the cost to society of the bank bail-outs observed in Germany over the years 2007-2009).
- Sixth, the systemic risk charge should be constructed such that it retains its disciplining effect on systemic bank risk even if the just-mentioned cap (e.g. 5% of GDP) has been reached. Thus, in order to retain the disciplining power of a positive price for systemic risk even when the contribution to the fund were low, the stock of accumulated systemic risk contributions have to be priced. This can be easily achieved if an appropriate reinvestment strategy via coupon bonds is pursued.[4] In this case, the systemic risk charge has no immediate liquidity effect on banks (which is an advantage), as it lowers current profits and bonuses, and simultaneously increases outstanding debt. As with all bonds, the coupon has to be paid at all times, even if the capped amount has been reached.[5]

Following up on the last paragraph, we advise against cumulating the systemic risk charges into a central fund, which is hoarded and kept as a buffer against an eventual crisis. Instead we prefer the immediate re-investment into the very financial institution that paid the charge (as mentioned already). The reason is mainly pragmatic. With the reinvestment of the amounts levied, the buffers against a systematic crisis are essentially stored at the level of the individual institutions. This reduces the possibilities for cross-subsidization between institutions.[6] Furthermore, since no large reserve fund is set up, there is no need to oversee the investment strategy of what otherwise would be a fund of significant size (funds in the order of 5 % GDP amount to roughly 1/10 of Germany's stock market capitalization (2007)). Finally, if the reserve amounts are reinvested into the banking system, there is no risk of a fiscal seizure of the funds in question. The latter

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[4] In this case the systemic risk charge is immediately reinvested into the very bank that paid the charge in the form of a coupon bond. The issuer of the bond (which equals the bank having paid the systemic risk charge) thus adds the charge to its outstanding fixed income liabilities – and now regularly has to service its debt.

[5] Note that the systemic risk charge, together with the reinvestment policy just described, also generates, revenues, either directly via a levy, or indirectly via the reinvested funds sold as coupon bonds to market investors.

[6] Cross subsidization between banking groups is an often-heard argument against a systemic risk charge, or a bank levy, particularly by representatives of Savings Banks and Cooperative Banks in Germany.

would pose a political risk when ever the budgetary situation is tight, and the systemic risk of the banking system is judged as low.

Finally, referring to the buffering function of the accumulated reserves, the use of contingent convertibles (Cocos, 'Wandelschuldverschreibungen') has been discussed recently, particularly in the UK and the US. Cocos may be a valuable addition to the above suggestions, enhancing the crisis management role of the rescue fund. Contingent convertibles are bonds which at any time may be swapped into shares of the issuing bank. The right to trigger the swap of debt against equity is defined at issue time, and it should be allocated either to a European Systemic Risk Board (chaired with the ECB), or to the national supervisor.

Overall, there are good reasons to set up an ex-ante systemic risk charge (a Financial Stability Contribution), assuming a careful design of the entire scheme, as outlined in this section. However, apart from the raising funds we find no good reason to support ex-post oriented one-time levies on banks, like the Financial Crisis Responsibility Fee (proposed by the US government), as such schemes do not help to address systemic risk but may weaken the resiliency of the financial system.[7]

C. SETTING UP A RESOLUTION REGIME FOR LARGE BANKS

We emphasize the importance of credibility in systemic risk prevention. 'Credibility' means that both bondholders and shareholders (i.e. creditors and owners) of financial institutions are convinced beyond any doubt that in case of a financial crisis - be it systemic or not - they cannot expect to be bailed out of any sort. To the contrary, they ought to foresee with clarity the seniority by which each party will be held liable in case of a sudden financial crisis. The anticipation of how bank rescues will effectively work is crucial not only for all parties involved, bondholders, shareholders and management, it is

[7] Since the one-time levy is likely to reduce bank equity capital (by lowering retained earnings) over an extended period, the Financial Crisis Responsibility fee may actually weaken banks' capital base and may effectively contribute to the next crisis. Similarly, the Financial Activity Tax (FAT), proposed by the IMF in its April 2010 Interim Report for The G-20, is also deficient. A FAT-charge proportional to bank profits and compensation expense, as suggested in the document, does not lead to increased capital buffers, nor does it induce institutions to reduce their systemic risk exposure. Rather, as a tax on gross earnings, the FAT may induce banks to hold more debt, and to increase risk taking. Furthermore, the introduction of a FAT (which is similar to a VAT on bank transactions) distracts attention from the issue of systemic risk (which is beyond the control of individual institutions), and into the direction of individual bank responsibility (which will be difficult to prove anyway).

also a precondition for a proper reflection of default risk in market prices and corporate ratings.[8]

A viable workout scheme should have the following features.

- First, the legal foundation for a quick resolution of a distressed financial institution has to be set up. In Germany, this will likely be an amendment to the specific banking law (KWG) rather than to insolvency code (InsO). In this regard, shareholders should not be allowed to hold up a quick resolution process, possibly implying the dilution of the ownership title.
- Second, the resolution scheme has to define the trade-off between averting contagion on the one hand, and preventing creditor bailout on the other hand. Both are desirable objectives, but they are intricately interdependent. In fact, while a creditor bailout prevents bank contagion in the short run, it leads to even higher level of systemic risk in the long run – due to moral hazard. To stop the vicious circle between bailout and risk buildup in the banking markets, we suggest relying on the re-establishment of creditor responsibility. Lenders will understand ex-ante that debt if held by investors outside the financial system will be sacrificed in a crisis – leading early on to higher credit spreads for such bank bonds. At the other end of the spectrum are bank liabilities held by other financial institutions which, in a moment of crisis, will produce contagion if not bailed out.
- Third, in order to be credible, the conditional bailout rule just specified has to be tied to a minimum requirement on the share of non-bank outside bond financing. This is because otherwise, i.e. with no such minimum requirement, the debt of troubled banks will be sold to systemically relevant institutions, as they are able to pay the highest prices. A minimum requirement, monitored by the supervisory authorities, will limit – and most likely shrink- the size of the interbank market, as outside bond financing by non-banks will become significantly more costly than today.
- Fourth, there are possibly further requirements needed to handle the contagion risk stemming from pending derivatives contracts, in particular options and credit

[8] As recent academic research has shown, because government bailouts of banks were widely expected after mid 2007, CDS spreads as well as rating information no longer are a valid measure of the bank's default risk proper. Rather, spreads and ratings reflect the compound expectation that banks pay back their obligations <u>or</u> are bailed out. This argument shows that much of the current critique concerning the role of market prices (CDS spreads) and rating agencies heard in public rests on a misunderstanding. A similar point can be made for government debt.

insurance contracts (CDS). Most of these concerns are covered if a workable solution for a central clearing (and margining) of derivative contracts is enacted.

D. CONCLUSION: GOING FORWARD

In this concluding section we will deal with implications of our main suggestions, the introduction of a systemic risk charge (this 'bank levy' is developed in section B) and the implementation of a bank resolution scheme (Section C).

(i) Interplay of systemic risk charge and the bank resolution scheme

We have focused our memo on these two issues because they hinge together closely. Actually, the systemic risk charge can also 'work', that is: achieve its objective of lowering systemic risk in the financial system, if the fear of real losses is shared among the bank creditors. Eventually it will be their intervention, either by raising the credit spread or by outright rationing, that will constrain banks in setting up systemically risky business models once again. However, losses to creditors will be credible only if all market participants anticipate that in a potential default they will definitely not be bailed out. This latter requirement, however, is invalid without a decent resolution scheme, as abundant evidence over the past 3 years has shown.

(ii) Correspondence to Basle III

The relevant committees in Basle are currently revising the Basle Accord, heading for an enlarged Basle III regulation. These new rules are widely expected to address the systemic risk issue by additional capital charges relating to some measure of systemic risk. In this sense, the suggestions in this memorandum on systemic risk charges (section B) are complementary to what Basel III may achieve. They are, however, not substitutes and should therefore not be traded-off against the Basle rule. The main reason for this assessment is that the new proposed Basle rules are still vague on how to measure and implement a systemic risk component as a capital charge. Furthermore, a new accord has to be accepted by countries around the globe – many of which have not been affected by the current credit crisis. These countries may therefore be less inclined to counter systemic risk than the most affected countries, US, UK and EU. Also, the Basle III rules focus exclusively on capital charges, while our suggestions go beyond capital charges and target the build-up of conditional equity capital – which is serviced as debt, and which therefore enters bank decision making as a true cost factor. Finally, and given that we believe systemic risk to be the single most important construction site for a new and safer financial order, we support a parallel strategy to impose systemic risk charges – as Basle III and the G-20 initiatives here pursue a common objective.

(iii) A global level playing field?

An often-heard argument claims that regulatory change must assure a global level playing field before being implemented, as otherwise the financial industry will simply migrate to other financial centers. Nevertheless, we must also be conscious of the risk that making a full level playing field a precondition for regulatory reform could well play into the hands of lobbying groups combating serious regulatory change. Moreover, we would point out that some regulatory reforms carry a much greater risk of encouraging such migration than others. In this regard, differences across countries with respect to bank levies would seem inherently less dangerous than differences with respect to other regulatory instruments.

There is a hierarchy of regulatory steps that need to be taken to minimize the likelihood that taxpayers will be forced to bear part of the burden of bank failures. Top of the list would be measures to ensure that banks charge properly for the risks they take. This insures that expected losses can be paid for out of the flow of net incomes. Second, there must be measures to ensure increases to provisions whenever it becomes clear that the actual level of risks exceeds that earlier expected. Third, banks must hold adequate capital for unexpected losses, such that they have a stock of reserves allowing them to ward off bankruptcy even in very difficult circumstances. These requirements are onerous, and differences across major financial markets could well encourage financial institutions to move in response. It is for this reason that the primacy of the Basel III process, which seeks a global level playing field with respect to such regulations, is absolutely essential. In contrast, we believe that with respect to a bank levy in the sense of a Systemic Risk Charge, global harmonization is very desirable but need not be fully realized. Similarly, bank resolution (or insolvency) has to be transparent. Again, requesting a perfect level playing field is not needed – striving for harmonization and, very importantly, striving for transparency as to the emergency plans across different countries will be sufficient at the outset. Once strategies for bank resolution are implemented in different places, there will likely be a trend to harmonized procedures over time, while it may prove tricky to achieve full harmonization at day zero.

To these general arguments one might add some further thoughts pertinent to the banking architecture in different countries. First, to the extent that retail banking is concerned, the introduction of a systemic risk charge will have only limited effect on financial centers since the business is fundamentally local. Particularly in retail banking we expect a risk-sensitive systemic charge to support the rebuilding of the financial architecture towards safer banking systems.[9] Second, as far as investment banking is concerned, there is a true risk of business migration to a center of gravity (which is the market place with lowest regulatory standards). Transparency about the neglect of systemic risk in those centers might have a limiting effect on migration. However, for most countries – including Germany- this is not the main segment of the business anyway, as investment banking is largely a UK and a US market.

(iv) Cost of regulation

The achievements expected from any regulatory change have to be weighted against their costs. Given the huge burden on taxpayers from the recent bailouts, the main item on the plus side of the regulation is the avoidance of future bailouts, and the corresponding drain on state finances. On the minus side one must expect rising costs of doing banking business. More concretely, we expect the added costs of a systemic risk charge (i.e. the incidence of the charge) to be borne overwhelmingly by bank borrowers (and other bank customers), while shareholders will bear less. The implied rise in the cost of lending may lead to a reduction in outstanding credit, and a shrinking of banks balance sheets. While this will certainly have economic effects, we should not forget that one cannot have deleveraging of the financial system <u>and</u> unchanged lending to firms at the same time. Thus, the expected rise in credit costs, and the implied reduction in overall lending is consistent with the stabilization of the overall financial system, and therefore to some extent unavoidable. Having said this, and assuming that a given local financial system contributes below average to systemic risk (see our discussion on financial architecture in (iii), above), in the longer run, average borrowing costs may actually not rise. Thus, if the systemic risk charge is set at a high enough level, it will not only induce banks to choose a less systemically vulnerable architecture, it will also shift business from high to low risk institutions. We conclude that at present an overall assessment of the cost of a systemic

[9] For instance, specific structural features of the financial system may actually prove to be advantageous. In this respect the multi-pillar banking system found in Germany has probably similar systemic risk-reducing attributes as the two-tier banking architecture found among savings cooperative banks. There may be corresponding characteristics in other countries that differ with respect to their systemic risk implications.

risk charge cannot be settled since the rise of borrower costs may differ substantially between markets.

Annexes 1 and 2

Annex 1. An Assessment of Financial Transaction and Activities Taxes

There are now a very large number of proposals outstanding to tax financial institutions in unusual ways. This is playing to political populism, since financial institutions are generally thought to have "caused" the recent financial and economic crisis. As well, cash strapped governments are now actively looking for new sources of revenues. Further, such taxes seem broadly consistent with the longer term regulatory objective of reining in large financial institutions.

These are powerful arguments for implementation, in spite of some clear drawbacks from doing so. While government with affected banking systems seem more supportive of these suggestion, countries like Canada, Australia and South Africa, whose banks were not much affected by the recent crisis, are strongly opposed.

It is important to note that these proposals coming out of different national capitals differ in significant ways. Not least, they often have different and even conflicting objectives. A number of the "levy" proposals do share the objective of building up a fund that would cover the fiscal costs of future crises. None of them, however, seeks to recoup the total costs of banking crises which would have to add in losses to GNP. Perhaps most importantly, none of them seems concerned about crisis prevention.

Further, it is not clear how these various proposals mesh with the proposals coming out of Basel, which have been internationally negotiated and have the benefit of some internal consistency. This concern is further strengthened when one considers the implications of different national deposit insurance schemes. These are also a form of tax on financial institutions designed to lower the cost to taxpayers in the event of failure. At the worst, implementation of one or another of theses different national proposals could do more harm than good.

In the rest of this note, we briefly review a number of the proposals that have been made to tax financial institutions, and point out some of their shortcomings. Whether they will suffice to offset the powerful forces for implementation (discussed in the first paragraph above) we think is unlikely. In this context, our proposal (put forward in section B of the main text of this memorandum) is welcome in that its "levy" component looks "punitive". Its adoption might then reduce the pressure to implement other proposals that are inherently less sensible.

Our proposed 'systemic risk charge'

The most important thing is to establish clearly the objective the proposed measure seeks to achieve. Our proposal has the clear objective of reducing systemic risk. This is good, since in our view this is the single most important issue we need to deal with looking forward. Further, this proposed levy is directly linked to the issue of resolution procedures, which is crucial. Another insurance scheme, without an increase in the costs of failure, is a clear invitation to moral hazard. Indeed, this resolution issue ought logically to have priority. First we should establish what the resolution process is, and the likely cost to the fiscal framework looking forward, and then we can determine whether a levy is needed and how big it should be.

Of course, as with the other proposals, this one also suffers from an overlap with the Basel III proposals. As far as we can tell, the levy proposed by us is very similar to the "systemic" capital charge proposed under Basel III. The principal difference is that the capital increase would come out of retained earnings, leaving profits unchanged, whereas our proposal would probably reduce profits. But in the end, would not the funds available (either capital or the levy retained at the banks) be the same?

A "Tobin" tax on turnover in currency markets

The purpose of this tax, suggested years ago by James Tobin, was to make currency speculation more costly and to increase the capacity of central banks to change the setting of interest rates without affecting the exchange rate. In the end, there was a consensus that the proposed tax would not be efficient in achieving ether objective. The final nail in the coffin was the suggestion that it would have to be imposed internationally and that this would be very hard to do. On this latter point, the Swedes at one point tried imposing similar taxes on financial transactions more broadly, and their markets essentially moved to London. In contrast, there is apparently a turnover tax on stocks in the UK which has not had a similar result.

Lord Turner's turnover tax

Lord Turner has stated that the financial sector in the UK produces nothing of value (only "churning") and yet is handsomely paid for it. Moreover, given its size, it poses systemic risk to the entire UK economy. Therefore, he proposes a Financial Transactions Tax.

The main objective of a financial transaction tax (FTT) would be to avoid the artificial build-up leverage and balance sheets of financial institutions which have grown up to ten times faster than nominal GDP during the last decade or two. A FTT would make certain trading activities, like high-frequency trading, huge volumes of intra-bank and derivatives trading unprofitable and thus reduce the size and the risk of the financial system.

Gordon Brown's Financial Transactions Tax

This is intended to be a cross –border transactions tax, but its objective seems to be similar to that of a "levy". That is, its purpose is to build up a sum of money that would prefund the fiscal costs of a future crisis. Apparently the US is opposed to the suggestion, and it would in any event (assuming the numbers currently discussed) take many years to accumulate enough funds to cover even the direct fiscal costs of crises similar to those seen recently.

Obama's Financial Crisis Responsibility Fund

This is another proposal for a levy, but one related to the size of bank's non deposit liabilities. The purpose would again be to build up a fund to pay for future crises, but also to discourage banks from relying on short-term non-deposit funding.

While this latter objective sounds sensible, it runs the danger of severely restricting the use of the repo market for government bonds and indirectly the bond market itself. Given the government's financial needs, this could be counterproductive. Moreover, the tax might reduce the rate of return paid out to those who lend (via repos) to the big financial institutions. Again, since mutual fund, pension funds and others are already scrambling for yield, this might cause problems. Finally, some suggest that the tax might hinder the Fed which intends to use reverse repos to drain reserves from the banking system in the future.

The IMF's FAT tax

This is a hybrid proposal; a levy on liabilities less Tier 1 capital and deposits (of 1 percent) plus a financial activities tax to top up the levy if required. While subject to the various criticisms noted above, the IMF proposal was commissioned by the G-20, and might then have a greater chance of getting some international consensus for implementation. Implementation beyond the G-20 would be important to include key financial centers, such as Switzerland and Singapore, which are not members of the G-20 but are represented in the FSB.

Annex 2 How to deal with External Imbalances

Definition

An economic (external) imbalance is a situation which – ceteris paribus – is not sustainable. The deeper it goes and the longer it lasts the greater will be the costs of adjustment and the risk of a crisis.

A current account surplus or deficit is not per se an indication of an imbalance. There is a broad set of economic factors that determine current account positions of countries. Productivity developments, demographics and time preference may exert a significant influence on current account positions of countries and may induce large swings on the external positions of countries over time. A rich and ageing country like Germany e.g. should for a time have a current account surplus in order to build up a stock of foreign assets on which to draw once the relation between retired and working population has deteriorated further. Evidently, care must also be taken to ensure that the associated increase in the liabilities of debtors do not become so large as to become unserviceable.

Fallacy from the identity

The identity between the current account respectively net capital exports and the domestic investment-savings relation implies that current account positions are interdependent on a global level. Once the current account deficit in one country starts to decline the aggregate current account surplus in the rest of the world has to shrink accordingly.

The "identity" is now very often used for an excessively simple message: While the USA have to bring down their current account deficit, the major surplus countries China and Germany have to reduce their surpluses. This focus on bilateral relations ignores the global context. Nevertheless, considering the relevant quantities, the need for a significant contribution from the major creditor countries can hardly be denied.

Policy recommendations

The dominant view on how to deal with this challenge often seems to boil down to a simple recipe for demand management. Surplus countries should conduct an expansionary policy, while the advice for deficit countries goes in the opposite direction - always in r e l a t i v e terms.

This is very crude policy advice. Indeed, it might well end in unintended inflation or might even exacerbate both external and internal imbalances, as happened in Japan in the late 1980's. In particular, it ignores the importance of supply side measures that might serve to achieve the desired objectives in a much more sustainable way. Furthermore, .

- Subordinating macroeconomic policies to the current account ignores all other goals like control of public debt or inflation.
- There is no reliable model on the basis of which "relative" macroeconomic policies in different countries or regions could be coordinated (and monitored) in a consistent way.
- The empirical evidence suggests that today's global imbalances are mainly a result of imbalances in private savings around the world. Persistent low real interest rates in debtor countries have substantially contributed to this . Thus, economic policies that help raise the private savings rate in deficit countries and, depending on surplus countries' circumstances, policies that help lower savings and/or raise investment in surplus countries are in the national interest of these countries. Moreover, they would at the same time reduce global imbalances.
- Demand management is not an efficient tool to divert activities from the tradeable to the non-tradeable sector or vice versa.
- Countries with high current account surpluses and modest growth should strongly embark on structural reforms to promote both growth and employment.. Policy reforms that remove existing barriers to growth, in particular those that foster the domestic service sector , would clearly be in the national interest as well as in the interest of reducing trade imbalances both globally and within the euro area
- .Finally, it is not at all self evident that Germany should increase real wages to foster consumption and thereby reducing the current account surplus. Wage developments must remain anchored to conditions in the domestic labour market and productivity developments. Wage increases that ignore this requirement would likely lead to lower investment and lower employment and could, in the end, make no significant contribution to lowering the current account surplus as originally intended.