The Banker's Comment - Jean-Pierre Patat

A former central banker looks at the news

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Each month, Jean-Pierre Patat, Honorary Director-General of the Banque de France and a TAC ECONOMICS advisor, offers his own point of view, on the economic and financial views, with total editorial freedom.
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Figure of the month: 132, the number killed in Paris on November 13th, victims of absurd hatred.

Lower earnings for European banks.

Almost all banks on the continent are publishing revenues and earning lower than the past few years. Three reasons might explain these changes:

- The very low level of interest rates. Without taking exorbitant margins that competition will not permit, credit rates barely cover related operating costs.

- The new prudential requirements from Basle. A reason vigorously put forward by banks: de-facto tripling equity capital stricto sensu (paid-up equity); creation of a 2.25% buffer against losses linked to cycles; counter-cyclical equity capital up from 0.25% to 2.25% (without even mentioning TLAC: *Total Loss Absorbing Capacity* – see below). That seems a lot, but is it necessarily harmful to profits? According to the Bank of International Settlements, if banks replace resources from bond issues by equity capital, they reduce their debt levels and can hope for better ratings from agencies and hence borrow at an improved cost.

- The very great reduction in proprietary trading of market instruments. The banks appear to be taking seriously the new regulations which ask them to extract these operations from their banking balance sheets and put them into dedicated subsidiaries with specific resources (an even more draconian measure could be adopted in Brussels).

Where in 2007, products of client operations (credit distribution, handling deposits and savings accounts) counted for 18% in revenues and their proprietary trading operations for 58%, in 2014 those figures were 50% and 30%. Yet, income from client operations on average covers only 50% of working costs. The appreciable support of resources proprietary trading allowed banks to cover those costs with good profitability and with a reasonable credit cost.

The weight of this cost "absorber" seems to have diminished greatly under the effect of measures that are both popular and seen as indispensable to avoid the financial tensions of recent years. This is a misplaced belief though since, with rare exceptions, the establishments that sank during the crisis were narrowly specialized and the universal European banks in the main stood up well.

A brake on African growth, of which the bases were not in any case too solid.

According to the IMF, average GDP growth in Africa is expected to be less than 4% as against 6% these last years. The "take-off" would therefore be hampered. Let it be admitted that the author of this chronicle (who has worked a great deal for Africa) did not really believe in this take-off, because the strong growth did not result from economic development policies but rather from the higher commodity prices and strong Chinese demand (for those same raw materials). The reversal or weakening of these two factors is hard felt. Nigeria's case (whose soil has a glut of oil but where Lagos suffers frequent, long electricity cuts) and that of Angola are revealing in that respect. Let us remember that the "Asian tigers" (Korea, Taiwan, Hong Kong, Singapore) had none of those coveted raw materials but they ensured their take-off by a policy aiming to create a real productive sector based not on God-given resources, but rather on investment, education and skills training for the workforce – a policy still lacking in Africa.

Special Drawing Rights (SDR). It is not enough to be a bright invention to have a future.

An American scholar pleads in a recent article for a more important role for SDR as an international currency to the detriment of the dollar. Introduced in 1960 at a time when what was feared was the shortage of international settlement tools, SDR proceeds no doubt from the most intelligent basic idea possible of an international currency. It must of course circulate in sufficient quantity and assume all the functions of a currency. But the US is keeping a close watch. Unable to torpedo it, they manage, thanks to their voting rights giving minority blocking at the IMF, to strictly limit the development of this instrument – arising from (horror of horrors!) the imagination of the French, always aiming low blows at the dollar. New allocations are rare and their distribution mode – proportional to the member countries' quotas – are absurd, since those who need it most are often those who benefit from it the least; these are obstacles to using SDR as a currency of international settlement and payment for credits. Right now, everything is being done to limit the role of an instrument which people are again talking of, but now this is to ask if it might not be appropriate to include the Chinese Yuan … in violation of the rules governing the make-up of the basket which can only include freely convertible currencies.

Expression of the month: TLAC, Total Loss Absorbing Capacity.

Conceived by the Financial Stability Board (FSB), this has just been adopted by the last G20. This new ratio for capital equity imposes on the 30 largest world banks (4 French) a cushion capital of 16 to 20% of assets weighted for risk. Two remarks: the sum of new ratios is becoming impressive and banks are not wrong to denounce a regulatory pressure that is somewhat messy. The ratio is far from being as restrictive as it seems. Apart from the fact that it does not yet appear to have a precise definition of the nature of the required equity capital, the numerator's weighting considerably lightens the true ratio weighting – that is to say in relationship to the total unweighted assets - which is low (the banks stand firmly against a leverage effect ratio taking into account the totality of assets with no weighting at all). Finally, weighting still rests on judgement of credit establishments in respect of the risks presented by their assets: a "decentralizing" practice which lends itself to illusion.

The disappointments of the weak euro.

The spectacular depreciation of the single currency seems to have had no significant effect on exports. Witness the decrease in German sales overseas and the negative impact on growth in the 3rd quarter for French exports. But, they tell us, what we expect from the lowering of the euro is something else – an increase in the price of imports and thence an inflation pick-up in the zone. Always this single-minded obsession with gaining a price increase of 2%, whereas it is clearly seen that low inflation encourages consumption, hence growth. "There is no danger of deflation in the euro zone" firmly declared Jens Weidmann, President of the Bundesbank. Unfortunately, no-one listens.