Andreas Dombret: Shadow banking and the roots of international cooperation

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at a reception to bid farewell to Mr Winfried Liedtke, financial attaché, and to welcome his successor, Mr Thomas Notheis, Beijing, 29 October 2014.

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Ladies and gentlemen

Welcome to our reception here in Beijing. I am happy to have the opportunity to officially thank the Bundesbank's departing representative, Winfried Liedtke, and to welcome his successor, Thomas Notheis.

Allow me to say a few words on the roots of international cooperation. Not too long ago the saying was that when the United States sneezes, the world catches a cold. This is certainly still true, and the turbulence following the Federal Reserve's announcement of tapering was a case in point.

However, the world economy of today is no longer a unipolar system. Take China as an example. China is now the second largest economy in the world, and the IMF estimates that, measured in purchasing power parities, China might have overtaken the United States in 2014 to become the world's largest economy.

Thus, China is an important player on the global stage. According to IMF data, China accounted for more than one third of global economic growth in 2014. At the same time, it promotes growth in other parts of the world through trade linkages or direct investment. Over the past six years, Chinese imports grew by an average of 12% per annum while China's foreign direct investment reached a new record in 2013 with a total of more than US$ 100 billion.

However, no one can deny that a global player can also be a global risk: when China sneezes, the world might catch a cold, too. Consequently, the IMF has recently warned that a hard landing in China might pose a risk to the world economy.

Nevertheless, globalisation has not just taken us from a world economy that was dominated by one country to a world economy that is dominated by two countries. The world in which we live has become very small over the past decades. And in a small world, every policymaker in every country must be aware that his or her decisions can influence other countries as well.

The world is interconnected by a close-knit network of trade relations and through a globalised financial system. Financial markets in particular have become integrated to such a degree that a small distortion at one end of the world can quickly spread and affect the entire system. In 2008, the failure of a single investment bank in the United States sparked a global financial crisis and a worldwide recession.

Having acknowledged that financial crises today are global in scope, the G20 embarked on an ambitious agenda to reform global financial regulation. And they have made significant progress. The new Basel III rules will ensure that banks hold more and better capital. At the same time, new liquidity standards will ensure that banks have sound funding structures. These and other measures will make the global banking system more stable.

However, there is always the other side of the coin: tougher rules for banks might lead to regulatory arbitrage where risky activities are shifted toward unregulated areas of the financial system. One current example is the growth of the shadow banking sector, where financial enterprises conduct business which creates bank-like risks but is either regulated insufficiently or not at all.

The Financial Stability Board estimates that the assets of non-bank financial intermediaries grew by US$ 5 trillion in 2012 and now stand at US$ 71 trillion. Non-bank financial intermediaries represent about half of banking system assets and 117% of global GDP. And China is no exception here. According to the IMF, the size of the Chinese shadow banking sector has more than tripled since 2008 and reached 35% of GDP in March 2014. The IMF estimates that China has the fifth largest shadow banking sector in dollar terms among those jurisdictions which are members of the Financial Stability Board.

A growing shadow banking sector is something regulators have to watch closely – not just in China but in other countries, too. Shadow banking participants undertake maturity and liquidity transformation, they engage in the transfer of credit risk, and they operate with leverage. This means they carry out a range of bank-like functions which are associated with bank-like risks.

At the same time, however, there are two key differences compared to the regular banking system. First, shadow banking participants and activities are not subject to banking regulation. Second, shadow banking participants generally have no access to central bank liquidity, nor do they benefit from public backstops such as deposit insurance schemes.

The consequence of this structure is a latent risk of runs on shadow banking participants. A run may lead to liquidity bottlenecks which can only be cleared by rapid deleveraging. That in turn may contribute to a collapse in prices on the financial markets, and thus exacerbate the problems in a procyclical fashion.

In addition, the structure of many of the transactions conducted in the shadow banking system means that the participants are closely interconnected. Thus, contagion effects within the system are highly likely. These systemic risks within the shadow banking system may then spill over into the regular banking system, which is often directly or indirectly linked to the shadow banking system.

Thus, the shadow banking system may well be a source of systemic risk. Accordingly, it is very high up on the G20 reform agenda. In this context, let me make one thing absolutely clear: the purpose of regulation is not to proscribe shadow banking activities or to drive participants out of the market when such activities and participants engender no systemic risk. The sole aim of regulation is to put a brake on systemic risk. We have certainly made some progress on this issue but we still have further to go.

Because the growth of the shadow banking sector is a global issue, further cooperation is needed to make the financial system a safer place. And international cooperation always starts at the personal level, with personal relations forming the root of successful cooperation. This is where our representatives here in Beijing come into play. Their task is to build networks, to share information and ideas, to explain the Bundesbank's positions and to facilitate cooperation.

For the past three years, Winfried Liedtke has served as the Bundesbank's representative in Beijing. And judging from the distinguished crowd gathered here today, he has done an excellent job. I would therefore like to thank him personally and in the name of the Bundesbank for his service.

I would also like to take the opportunity to welcome our new representative, Thomas Notheis. For the past four years, Thomas Notheis has served as the Bundesbank's representative in Mumbai, meaning that he is not new to either the world of economic diplomacy or to Asia. Some of you have already met him, and I am certain that he will be a worthy successor to Winfried Liedtke.

Having a representative here in Beijing shows that the Deutsche Bundesbank acknowledges the global importance of the Chinese economy and its role in global financial markets. I strongly believe that our presence here in Beijing will deepen friendship and cooperation, not only between Thomas Notheis and his peers but also between the Deutsche Bundesbank and the Central Bank of China, and eventually between Germany and China.

Thank you!