

# FUNDAMENTAL FORECASTS

Much has changed in the banking sector over the past 18 months. **Holger Schmieding**, chief European economist at Bank of America Merrill Lynch, tells Phin Foster how new regulations are set to evolve and why there will be a higher price to pay for risk for some time to come.

- Markets are unlikely to return to the low levels of risk which they were pricing up until 2008.
- Debate over regulation is likely to lead to more internationally compatible solutions.

It is not only banking operators who have been forced to review strategies, outlooks and fundamental disciplines as a result of the financial crisis; spare a thought for the economists.

Events were so sudden, violent and global in nature that many of the old adages ceased to apply. Hindsight can be a wonderful thing, but many people whose ultimate responsibility had been to foresee such dangers on the horizon did not like the flaws in their methods such clarity revealed.

'Within the analysis of economies and making forecasts we'll now be paying far more attention to financial issues,' acknowledges Holger Schmieding. 'Post-Lehman Brothers, financial events became the major driver in the economy. We've seen that happen for short periods in the past, but this has been something else.'

The chief European economist at Bank of America Merrill Lynch admits that

he and his team took some time to get their heads around the severity of events, although adds the caveat that they were at least aware of the likelihood of recession.

'It took many of us, including myself, quite a while in late-2008 to get a true feel for its scale,' he begins. 'We were warning that there might be a recession from mid-2008 and were quick to recognise that the fallout from the Lehman Brothers collapse would have a

recovery. 'There's always that potential,' he admits, 'but we're so aware of the potential issues within the sector that it would need to be both a major surprise and massive in scale in order to have serious impact.'

If such shocks to the system are in the past and the banking sector has moved into the recovery phase, it does not detract from the fact that we are looking at a totally different entity. Governmental

'This is an environment where a lot of financial engineering is needed and investment banks especially have a lot of opportunities; governments and companies need to finance themselves somehow.'

major impact on the economy. However, to come up with anything approaching a forecast of a 6% drop in German GDP or a fall of 4% in the Eurozone took us well into February or March of this year.'

With those economies officially out of recession, Schmieding does not expect to see any further surprises emerging from the banking industry that might derail

influence, mergers, closures, public outcry and debates over regulation have all made for an extremely challenging environment.

'We're unlikely to see a return to the low levels of risk which markets were pricing in right up until 2008,' believes Schmieding. 'Those financial activities that were based on low risk margins, underpinned by the fact that we saw few

defaults during the boom years, will be a lot more subdued from now on. For a long time to come, financial markets will reflect the fact that there is a higher price to pay for taking on risk than has previously been the case.'

This begs the question of whether there might be a danger of the banking system becoming overly risk averse. 'There is always that threat,' Schmieding acknowledges, 'but competition being what it is, if a major part of the sector was operating too cautiously relative to economic fundamentals, you would expect to see someone stepping into the breach.'

It is good to hear that some market fundamentals hold firm, but ongoing debate around regulation continues apace. Might the counter danger to risk aversion be that we are left with an industry unable to innovate or fully realise strategy due to excessive intervention and legislation?

The public mood means politicians might be tempted to seek populist solutions – 'no financial institution would want to wade into that debate in print,' Schmieding states – but a measured, thoughtful response is something that can only benefit all parties.

'In terms of regulation, at least we've got a serious international debate going on,' he observes. 'This is likely to lead to solutions that are more internationally compatible than was previously the case. In terms of policy making, there is some convergence at the central bank level, and no one will dispute that you need to watch asset prices in the future. A lesson learnt from the crisis is that inflation targeting is no longer good enough.'

### Facing uncertainty

While government intervention has moved the goalposts somewhat, it is still unclear how different a game the banking sector will be expected to play. In Schmieding's eyes, this is not down to a lack of transparency on the part of either party, simply that the rules are still being written.

'These are many questions that have still not been answered, but that is because conclusions will be reached on the go rather than through a single, overreaching strategy being mapped out,' he believes. 'It is all fully dependent upon how the banking sector performs, whether there

is a perceived need for governments to do more and therefore exert increased control. If the economy picks up, governments will see their stake in the banks as an investment, with the hope of eventually re-privatising their share at a profit. There is no formulated policy; we must wait to see how events unfold.'

And just as the financial sector played an integral role in bringing on the global economic crisis, so it will be essential in leading the economy onto the path of sustained revival and growth.

---

'Measures geared towards stabilisation are bearing fruit and we've seen throughout the year an easing in money market tensions; spreads are much lower than this time last year.'

---

'The banking sector is a major part of the recovery,' Schmieding believes. 'Measures geared towards stabilisation are bearing fruit and we've seen throughout the year an easing in money market tensions; spreads are much lower than this time last year.'

'This is an environment where a lot of financial engineering is needed and investment banks especially have a lot of opportunities; governments and companies need to finance themselves somehow. For good reason, commercial banks remain extremely risk-sensitive. There is a real market out there for investment banks to manage corporate and government bonds and that is helping the sector overall.'

With banks once again posting profits and things seemingly returning to some sense of normality, to what extent has the mentality of the sector changed long-term?

Many have accused the industry of suffering from dangerous levels of over-confidence prior to the crisis, but Schmieding believes that such failings were not sector specific.

'The culture across the board is usually a reflection of the wider economy,' he says. 'We had a period when almost everything in terms of policy across the world economy was going well, interest rates were low and risks did not materialise. The awareness of risk everywhere was probably below what it

should have been. I'm not going to single out any part of the system; it's a human phenomenon that when things are going well for so long attention shifts away from potential dangers.'

The lessons that have been learnt are universally applicable and the economist does not excuse his own profession from this observation. 'We've been brutally reminded that there is something called the economic cycle,' he says.

'It's unpredictable and there can be events like the post-Lehman financial markets heart attack which make for nasty downturns.'

'We just have to be humble enough to realise that when things are going well there's always the chance of a nasty surprise. Equally, we must take comfort from the hope that when things look at their worst something positive might come along.' FBA



### Holger Schmieding

Holger Schmieding is managing director and head of European economics at Bank of America in London. He previously worked for Continental Europe at Merrill Lynch, the International Monetary Fund in Washington, DC, and as assistant to the president and head of the research group on transformation countries at the Kiel Institute of World Economics, Germany.