

Learning from a crisis

Financial Market Turbulence

Wednesday afternoon, 4 June 2008

Moderator: Robert Kuttner, Co-Editor, *The American Prospect*

Adrian Blundell-Wignall, Deputy Director, Financial and Enterprise Affairs, OECD

Padma Desai, Director, Center for Transitional Economies, Columbia University, United States

Jan Frait, Head, Financial Stability, Czech National Bank

Susan George, Board Chair, Transnational Institute

The moderator, **Robert Kuttner**, opened the discussion by noting that the recent financial crisis has called into question the notion that financial markets are efficient and that the preceding phase of financial innovation was desirable. Some argue that central bank intervention has now resolved the issue, while others maintain that the system is broken and needs reform and/or tighter regulation. The Basle II regulations on capital requirements have also been questioned as being insufficient. All of this raises the issue as to what reforms are needed, and whether any changes should be mandatory.

Adrian Blundell-Wignall warned that the present situation could mark the beginning of a crisis, which could still take some time to work itself out. Banks by their nature are very highly leveraged institutions, which make them vulnerable to brutal changes in financial markets. On current estimates, the banks in the US alone probably require around \$90 billion in new capital just to stand still. If they are to grow their balance sheets, their capital needs would be larger. Estimates of the total cost of the current crisis have been continually revised upwards, but according to the OECD's latest estimates could amount to \$400bn.

According to Mr Blundell-Wignall, the roots of the current crisis can be traced back to 2004, when the Basle II regulations governing banks' capital requirements were being drawn up. The banks themselves were given too much say in what these capital requirements should be, and the regulations were consequently too lax. In addition, restrictions placed on the two major US mortgage securitisation firms, Fannie Mae and Freddie Mac, left a void that the commercial banks rushed to fill. In consequence, the total value of securitised mortgages rose from around \$800 billion at the end of 2004 to \$2.1 trillion two years later. Regulatory overlap was essentially a big part of the problem, and what is needed now is the introduction of a more uniform, coherent and stringent system of regulation.

Padma Desai compared the crises of 1991 and 1997, which affected certain specific markets, to the current global one. The crisis we are going through now is partly characterised by rising prices for oil and food, which are primary and essential commodities. Ms Desai puts forth the notion that if measures are to be taken, they must

not merely be “Anglo-American” in scope, noting that “international measures are needed”.

Why did this crisis arise? Was it inadequate regulation or was the system fundamentally flawed? The US Federal Reserve acted quickly by bringing interest rates down from 5.25% to 2% to ease liquidity problems. But part of the problem was the earlier period of very loose monetary policy from 2002 onwards, during which capital inflows from other countries, particularly the Asian economies, were financing the US deficit and keeping US interest rates at an artificially low level. With this in mind, recent excessive consumption trends in the US need to be curbed urgently. So far, the sub-prime crisis has almost exclusively affected the US, but the spike in food and commodity prices is a global problem. Petrol subsidies in India cost taxpayers \$50 billion a year, about 3% of GDP, and the government is under pressure to cut these, despite this being an election year. Inflation is affecting economies around the world, but Ms Desai wondered if measures could be taken to ease these problems internationally, rather than just bailing out the US.

Jan Frait offered some insights based on the experience of the Czech Republic, which emerged from a major financial crisis around 10 years ago and, through a combination of better bank supervision and a smarter monetary policy, repositioned its economy towards growth. At that time the Czech currency, the koruna, had become quite sensitive to changes in global financial markets as it was used as a funding currency for carry trades. Despite the fact that the koruna’s tendency was to appreciate, making life difficult for domestic exporters, the monetary authorities openly adopted the position that they would not soften the blow artificially, explaining repeatedly that theirs was a small economy and that businesses just had to learn to weather global headwinds. A second component of Czech monetary policy was to keep rates similar to those adopted by the Federal Reserve since 9/11, even in the face of appreciation pressures. This policy has helped to insulate households from exchange rate risk since there was no incentive to borrow money overseas. In addition it spared the currency from some classes of speculator and tempered the overly optimistic expectations of the corporate sector.

Applying lessons learned from the Czech experience on the current financial crisis, he recommended a closer examination of the role of monetary policy in reducing financial market volatility. He called for a debate on a mechanism to adjust and coordinate worldwide monetary policy, and suggested that it is probably also time to reduce the traditional asymmetry in monetary policy, whereby central bankers are quick to cut rates in times and crisis but too slow to raise them during economic upturns. Finally Mr Frait counselled caution regarding the crafting of more regulations, arguing that financial institutions are largely capable of learning and correcting themselves.

Susan George blamed the current financial crisis on private financial institutions. In Ms George’s view, mergers between financial institutions have resulted in firms that are seen as being too big to be allowed to fail. In order to maintain growth in profits, these firms increasingly felt obliged to “bottom fish”, to take on ever-riskier investments. The

rating agencies did not flag these risks, and regulators did not spot the risks either. Some institutions, including the hedge funds, were not regulated at all. Poor risks were passed through the financial system. Banks also moved some of their assets off balance sheet to circumvent capital requirements. In Ms George's view, "the banks are like water, they go around regulations like water goes round stones in a stream".

But the consequences of the crisis have a real and human dimension, not just a financial one, and should not be allowed to happen again. Ms George noted that the "too big to fail" argument had to be eliminated, and that any institution that is truly too big to fail belongs in the public sector. She also suggested limits on financial sector bonuses and salaries, the elimination of tax havens, and the introduction of a differential interest rate system involving higher borrowing costs for speculative activity and a lower rate for real investments. Finally, she argued for measures to oblige the banks to invest in worthy, green projects and to support the transition to a low carbon economy.

The first of several **questions from the floor** asked how to go about building confidence in a currency. Mr Blundell-Wignall noted that the most important consideration is the implementation of sound macroeconomic policies. Ms Desai added that as well as sound policies, the means of implementation are important, i.e. that financial institutions need to be strong and well-regulated. Ms George noted that in order to attract strong direct investment, a country needs sound fundamentals, such as a stable legal system, high education levels, and a good balance between wage levels and productivity. Another participant noted the approach adopted by the Swedish government in responding to the banking crisis there in the early 1990s, which involved stripping the poorly performing assets from the banking system and placing them in a separate institution. These assets were later sold off once they had begun to perform again. However, Mr Blundell-Wignall warned that this approach is costly to the public sector, while Mr Frait added that although it is an expensive approach it did resolve the problem quickly and with limited fall-out.

Another participant asked whether the panel felt that ongoing global imbalances could cause further financial problems in the future. Mr Blundell-Wignall commented that distortions in the global economy, such as China's fixed exchange rate and limits on oil supply, will always have the potential to cause problems. Ms George concurred that further turbulence is likely, particularly as speculation pressures appear to have shifted from financial instruments to commodities, including food.

MS/HEC-AK, PS, MZAB