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## “The Specificity of the Current Crisis”

by

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There can be no doubt that we are in the midst of the most severe financial crisis since the nineteen thirties, with repercussions on the “real” economy which, in terms of output and employment losses, are more severe than anything we have witnessed since the end of the war. It is with this observation in mind that I would like to share with you some thoughts on our prospects to get out of our predicament, and at the same time put in place reforms that would enhance for the future our crisis resistance ability. But I do this with a great deal of humility – because almost every day throws up new pieces of information, which trigger new questions requiring new answers. As I have been repeatedly saying over the past few years, we are navigating in waters uncharted by reliable historical evidence.

Let me begin by a sort of personal “examen de conscience”. The 2001 Report by the Committee of Wise Men on the Regulation of European Securities Markets respected the mandate received from ECOFIN not to discuss prudential matters. This was to some extent, but not entirely, justified by the fact that we were dealing with the regulatory process of the securities markets where the focus of regulation was not predominantly on prudential matters. The rest of the financial industry, notably the banks, were drawn into the process at a later stage. However, despite this limitation of our mandate, we did not resist the temptation to include in our Report the following recommendation: *“While the Committee strongly believes that large, deep, liquid and innovative financial markets will result in substantial efficiency gains and will therefore bring individual benefits to European citizens, it also believes that greater efficiency does not necessarily go hand in hand with enhanced stability. Increased integration of securities markets entails more interconnection between financial intermediaries on a cross-border basis, increasing their exposure to common shocks. It is not within the remit of this Committee to evaluate such risks, and even less to make recommendations on how to deal with them. However, given the growing interlinkages between all segments of the securities markets and the full range of financial intermediaries, the Committee believes that there is an urgent need to strengthen cooperation at the European level between financial market regulators and the institutions in charge of micro and macro prudential supervision. The ECOFIN Council should ask the Economic and Financial Committee to report on the development of this cooperation.”*

Some ministers grumbled a little about our overstepping the mandate, but they did so rather politely, while a few very weighty market participants (whose name I prefer to forget) complained far more loudly that we were displaying a regrettable ignorance about the spontaneously stabilizing ability of markets.

Be that as it may, I am now asking myself: with our current experience, would I still sign this quotation from our report? I would of course endorse the warning about the crisis breeding environment created by our globalised, innovative and deregulated markets. But, perhaps more controversially, I would also endorse the part of this quotation which attributes to such markets the virtue of enhancing efficiency.

I would, however, now add a major qualification. I would say that the general welfare effects of increased efficiency could be reduced, or even wiped out, if we were unable or unwilling to put in place solid defenses against the possibility that unavoidable (and up to a point useful) crisis manifestations turn into a full blown systemic crisis. Bankruptcies perform a salutary function – as long as they are kept under control. But a systemic crisis implies the meltdown of the financial system, potentially leading to double digit and lasting declines in GDP and large scale, and also lasting, unemployment. The social cost of this happening would not be acceptable and would by far outweigh whatever future efficiency gains might arise. Since the management and even more the resolution of such a crisis amount to a monumental task, no effort should be spared to enhance our systemic crisis *prevention* capability.

Are we now moving in the right direction? There are good news, but also justified concerns.

Before looking at these good news, let me try to briefly identify what went wrong. It is not true that there were no warnings about a potential crisis: I could quote dozens of warnings from, say, 2005 onwards, which signaled the gradual, and then accelerating erosion of risk awareness. This, in combination with the fact that the world was “awash” with liquidity, was leading towards the mispricing of assets. The miserable savings performance of US households was well documented, the sustainability of the real estate boom in the US questioned, and more broadly on both sides of the Atlantic one could identify clear signs of an unbridled appetite for leveraging. Much of these warnings came from individuals: academic or business economists, specialists in finance and well known journalists. I myself have been on record in participating in these warnings. The ECB itself was beginning to be worried: witness its half yearly *Financial Stability Reviews*, its stress testing exercises and its President’s public statements – although for understandable reasons the language it used was not alarmist. And we should not forget the numerous warnings by the economists of the Bank for International Settlements both in the Bank’s annual reports and in path breaking research papers.

There were however two things that went wrong. None of us foresaw the violence of the crisis, the astronomic figures involved and the speed of contamination both geographically and across sectors of the financial industry. Even more disturbing was the lack of preventive *policy action* by the authorities. There are, of course, excuses. One such policy action could have been taken in the field of financial regulations. However, adjusting the regulations to new circumstances or widening the perimeter of regulations is a drawn-out process, and moreover one that requires active international cooperation at the global level. Efforts in this direction *were* undertaken, but I did not notice any sense of urgency. A good example is the way the US authorities handled the implementation (or rather the non implementation) of Basel II. Another preventive policy action could have been an attempt to tackle the excess liquidity problem – which has played a major role in eroding risk awareness – via the implementation of a restraining monetary policy. For a number of good or bad reasons this did not happen. More about this in a few minutes.

In stark contrast with this depressing experience, the single most important piece of good news has been that when serious market disturbances erupted in early August 2007 (the word “crisis” was still a taboo and remained so for quite some time), central banks almost immediately began acting as lenders of last resort, by supplying liquidity to the markets. The leading role was played by the ECB, which within a matter of hours pumped liquidity into the system for amounts without historical precedent. And this was done by an institution which had been derided by most US and British observers and a good part of the academic community for being handicapped by its anti-inflationary “obsession” and its complex institutional structure which imposed, so ran the argument, a consensus-based decision making process – making it clearly unfit for dealing with a crisis situation. The active involvement of all major central banks in the crisis handling process has continued unabated since then, with the result that their balance sheet has considerably expanded. The unwinding of this process will require a great deal of skill, but this is the price to pay for the fact that central bank action has prevented a deep and dangerous crisis from turning into a clear-cut systemic crisis.

The second, equally important good news has been that when it appeared that a number of systemically significant banks were beginning to experience liquidity-cum-solvency problems, governments stepped in, and bailed out, or at least gave a helping hand, to the institutions in question. This exercise followed a bewildering variety of patterns, but given the size and the complexity of the challenges, it has so far been on the whole surprisingly well managed and quite efficient, with the Lehman story constituting the single major – almost disastrous blunder. I must confess that I did not expect such a performance – especially in the case of the governments of the smaller European countries. Admittedly, the story is far from over, but it has so far significantly contributed to ensuring that our financial systems continue to function.

The third good news concerns fiscal policy. Quite rightly, given the deleterious impact of the financial crisis on economic activity, all governments have accepted the deterioration of their fiscal balances. In the case of the European countries this meant that they let the automatic stabilizers do their work, and on top of this added discretionary stimulative measures. The size and the nature of these measures vary considerably among the countries, but most of them go in the right direction. Of course, as time goes by, increasing attention will have to be paid to the exit scenario. As we all know these measures had to be timely (broadly speaking, they respected this criterion), they had to be well targeted (this was also more or less respected), but now we have to make sure that there will be no doubt about their temporary nature. And, about this, doubts are beginning to arise.

The fourth good news is that everything financial has not become dysfunctional. The financial infrastructure has passed the test. The payment systems continued to function properly. The organized exchanges – stock exchanges, government debt markets and the currency markets – have not run into major difficulties. The clearing, settlement and payment systems deserve particular praise. Few people (even among financial market participants, let alone the governments and the general public) are aware of the amount of effort that has been invested over the past twenty years into enhancing the crisis resistance capability of these systems. This investment has been rewarded by high returns.

So far so good. But what about the future? It is not enough to avoid major mistakes in handling the consequences of the current crisis. We should also want to avoid in the future the repetition of a crisis of this depth and generality. Are we on the right path towards correcting those features of our financial systems that bear a major responsibility for getting us into such a crisis?

There are some reasonably encouraging news in this respect too. In a half a dozen fields reform initiatives have been proposed, and are at a more or less advanced stage of discussion both at the European and the global (G-20) levels. None of these initiatives have reached or even approached the implementation levels, and we all know that obstacles to agreement predominantly emerge when the decision makers are compelled to read the fine print. I have observed, however, a lot of convergence in the identification of the shortcomings of our current arrangements, and even (though to a lesser extent) in the reform proposals.

The Committee which I chair at the request of the Belgian Government listed in its interim report six of these specific reform initiatives, relating to the following areas:

1. Securitisation in general, and the related “originate and distribute” business model;
2. Credit default swap (CDS) market;
3. Credit rating agencies;
4. Risk management;
5. Compensation schemes;

## 6. Procyclicality.

It is in the first three fields that our report adopted a reform approach that is somewhat more radical than most of the other reform proposals – perhaps because we made good use of the luxury of not having to reach a compromise, based on the lowest common denominator, already at the expert level.

As regards the originate and distribute model, we pleaded in favour of prohibiting (via strict market standards or, possibly, regulatory restrictions) the sequential restructuring of already structured assets, for the simple reason that any such restructuring makes it impossible to achieve simplification and greater transparency of products – an objective on which there seems to be a fairly general agreement.

As for the CDS market, we came out (as most other expert groups) in favour of CDS contracts being cleared within a central clearing counterparty framework, which would reduce systemic risk created by the CDS market and improve transparency and the reporting of its exposures. But we also added that CDS markets should be regulated in order to restrict the purchase of credit protection to the hedging of effective exposure to credit risk, thereby excluding that for speculative purposes CDSs are signed and bought by counterparties who have no exposure to the underlying credit risk.

As for ratings, we strongly insisted that financial regulation should stress the responsibility of asset managers and professional investors to undertake their own due diligence and not to outsource risk management to the rating agencies. For that reason, financial regulation should be revisited, with the objective of removing all prescriptive references to ratings.

Finally, I regard the content of the de Larosière Report, and the generally positive welcome it received a piece of good news in itself. I strongly support its main recommendations, and I do hope that they will be speedily adopted and implemented. That would surely enhance our future crisis resistance capability; and by giving a badly needed boost to confidence, an early implementation could accelerate the process of crisis resolution.

Now let me turn to my concerns, which I propose to list in (what I believe to be) their degree of not simply nuisance value, but outright destructive capability. And it is at this point that what I am going to say is beginning to bear a relation to the title of my conference.

*First concern.* I have just mentioned as an encouraging fact the analytical consensus on the deleterious role played by the six factors in the depth, violence and speedy contamination process of the current crisis. There is less consensus on the remedies, and as regards implementation, I am getting worried. With the single exception of the compensation systems, reforms in these areas require agreement at the global level – and not simply in terms of broad principles. Discussions and, more specifically, implementation

will be a time consuming and labour intensive process, and given the “cultural” differences among the main G-20 participants, success is by no means guaranteed.

*Second concern.* The bailing-out process of banks by the governments raises a series of challenges. Some can be handled by each government, without the need in all cases of a coordinated approach at the European or intergovernmental level: for instance, how to define and implement the role of government officials sitting on the boards of the bailed-out institutions. In those instances in which the institution has a cross-border structure there is of course need for an intergovernmental agreement. Similar problems will arise when the exit strategy has to be implemented. But there is one very clear case which deserves to receive close attention, and moreover a clear agreement at the European level. This is when as a counterpart to its financial support a government imposes a lending commitment by the bank to its nationals. I strongly support the initiative of the European Commission to take all the measures that will protect the proper functioning of the single market.

*Third concern.* There can be no doubt that the gradual erosion of risk awareness, and its almost complete disappearance during the winter of 2006/7, bears a (and perhaps *the*) major responsibility for the severity of our current crisis. And there can be no doubt either that the source of the voracious appetite for risk could be found in two developments.

One was excess liquidity. I am of course aware that there is no consensus about the definition, and even less about the measurement of excess liquidity (or for that matter of liquidity itself). But anyone who cares to remember the generalized, often frantic search for assets during those years that yielded a return only a shade higher than the one prevailing for treasury bills, yet carried a substantially higher risk, knows what I am talking about. The second source was the widely held belief of market participants that central banks – and this refers in particular to the Fed – which did precious little to discourage bubbles or overleveraging from arising, would bail them out in one way or other when the bubble bursts. This perceived asymmetry was the moral hazard contribution to boundless optimism.

My concern is that there is little structured discussion on how to prevent this happening again. I understand of course that priority should be given to crisis management measures. But these measures include the massive increase of the balance sheets of central banks, and this imposes on our authorities the duty to consider well ahead of time what sort of policy instruments should be used when there are signs of an unwelcome persistence of excessive market liquidity. The natural policy instrument would seem to be a restraining monetary policy. But this is more easily said than done. For one thing, even in a closed economy, the impact of monetary policy tightening on market liquidity is a complex matter. Expectations play a crucial role, and they can be remarkably volatile. For another, any policy action aiming at moderating bubbles is likely to receive much weaker public support (and this is an understatement) than an action aimed at price stability. Third, more important, we do not live in a closed economy, but in globalised money markets. Success of monetary policy tightening by the ECB would be conditioned by the participation of the major central banks –

and certainly of the Fed, which on the basis of past experience would unlikely be forthcoming. Fourth, even in the case of a coordinated central bank action one major source of excess market liquidity – the bizarre pattern of global payments imbalances – would not necessarily disappear. But despite all these observations, we are not entitled to sweep under the carpet a genuine problem.

*Fourth concern.* This brings me to my major concern, which is about the potentially unbalanced intensity and efficiency of the demand stimulating policy measures.

As a starting point we have to acknowledge a major fact. When we try to identify the causes of the current crisis, a relatively encouraging consensus is emerging on listing, as I have mentioned, the series of dysfunction in the operation of our highly innovative, globalised, financial markets. But this consensus should not lead us to forget that, for the first time since the end of the war global payments imbalances, and the domestic imbalances that lie behind them, have played a major role in intensifying the crisis.

For a great many years prior to the explosion of the subprime crisis, the US economy acted as the major demand led engine for the world economy. Anybody who cared to look at the national accounting figures of the United States could see that US households were playing a leading role in this respect. It also could be seen that with their savings ratio gradually moving towards zero, the sustainability of their appetite for buying and building houses crucially depended on the continued increase in real estate prices, which clearly could not go on for ever. At the same time, the export led growth of the Chinese economy, associated with an astronomically high, and historically unprecedented, household savings ratio, produced large payments surpluses, and a correspondingly fast growth of China's foreign exchange reserves – which to a large extent were invested in US treasury bills and bonds, thus preventing the increase in US medium-long term interest rates. In other words the excess spending of the world's richest economy was being financed by an admittedly booming, but still quite poor economy.

We all know how this came to an end – and how it has turned upside down the role played by the US in the world economy. Of this, many of the thrifty economies of Asia and Europe are now fully aware.

My concern is about the working of the adjustment mechanism. Are we going to have the appropriate coordination of macro-policies for ensuring the right outcome of the adjustment mechanism? The US private sector has entered a deleveraging process which will take time; and within this sector we have already noted the unavoidable upward adjustment of the savings ratio of households. This means that for quite some time the US is unlikely to be able to play the role of a global engine. That role should be played by the historically thrifty countries in Asia and Europe. I have a great deal of understanding for the lack of enthusiasm of the concerned countries to assume that responsibility. But the stakes are high.

I can imagine two equally unappealing scenarios. In the short run, if domestic demand in the US continues to decline, while at the same time the demand stimulation is too weak in the thrifty countries, there is a genuine risk that global activity continues to weaken. Or that, after a short impetus from the inventory cycle, the decline resumes its course. Banks, which are far from having cleaned up their balance sheets, would have to cope with the additional deterioration of their credit portfolios.

In the second scenario it would turn out that, under the influence of very powerful monetary and fiscal stimulus, US domestic demand, and in particular household consumption, not only stabilizes, but starts growing. This would surely be helpful for the rest of the world, but at the same time it would pave the way for preparing in a more distant future a repetition of today's crisis.

I hope that neither of these scenarios materializes, for both would have dire consequences for all of us. To avoid this happening explicit discussions at the highest level are unavoidable. To sum up, the specificity of this crisis is that it is the first genuinely global crisis – and this desperately cries out for global management. Will it be forthcoming?

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