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briefing note

# LESSONS FROM THE FINANCIAL CRISIS: THE CASE FOR A TWIN-TRACK REPONSE

*By Philip Whyte*

The credit crunch has unleashed widespread anger outside the financial sector. And rightly so. Not only have taxpayers had to bail out an industry that is uncommonly well rewarded. But the effects of the credit crunch on the real economy are likely to be painful and prolonged – not least on the jobs market. Main Street, as Americans say, will pay dearly for the mistakes on Wall Street. Unsurprisingly, a fierce debate is now raging about how the world got itself into such a mess – and how it should avoid doing so again in the future.

In the UK and the US, blame has been directed primarily at a profession – financiers. In both countries, politicians and the public have paid particular attention to the egregious asymmetry from which the financial sector benefits. High-flying bankers, critics point out, receive large salaries and bonuses when the times are good – while their employers can count on being bailed out by the state when the business cycle turns. This mismatch between private reward and public risk is not just unjust. It is destabilising, because it provides the financial sector with the closest thing to a one way bet: heads it wins, tails the taxpayer loses.

In much of continental Europe, criticism has tended to focus on a broader system – the Anglo-American model of capitalism. A common refrain across Europe is that the crisis is the product of Anglo-Saxon profligacy and the lightly regulated model of finance that fed it. On this view, light regulation, arm's length finance and incomprehensible financial innovation begat irresponsible lending – and the rest of the world is now suffering from the fall-out. The lesson seems clear: jettison 'neo-liberalism', re-embrace more traditional models of finance and tighten the regulatory screw to prevent such a crisis ever occurring again.

Each interpretation has something going for it. Compensation structures in the financial sector do seem to encourage risky short-term behaviour. And financial innovation has been a factor in the current crisis. Securitisation, for example, was supposed to have reduced risk by spreading it more widely. In practice, it ratcheted up the overall level of risk in the international financial system, because originators of loans had no incentive to assess the creditworthiness of borrowers, and credit rating agencies fell short. As Jagdish Bhagwati has remarked, financial innovation did not result in creative destruction, but in destructive creation.

Neither account, however, is completely satisfying. Numerous employees at Lehman Brothers had shares tied up in the firm – and consequently had a personal interest in the firm's survival. Yet it still went under. Nor are crises unique to Anglo-American capitalism. Since the early 1980s, crises have hit countries with systems as diverse as Mexico, Japan, Sweden, Finland, Thailand, Indonesia and South Korea. Each time, it has been common to explain the crisis by reference to country-specific factors. Many western observers, for example, attributed the East Asian crisis in 1997 to local forms of 'crony capitalism'.

The financial sector is not crisis-prone because it is American, Japanese, or Swedish. It is crisis prone – period. Why? The reason, as Hyman Minsky pointed out, is that prolonged periods of stability tend to breed instability. Financial crises usually germinate during periods of sustained prosperity when complacency sets in, lending standards weaken, and risk aversion falls. In time, speculative euphoria develops. At some point,

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debt exceeds what borrowers can service with their incomes and the speculative bubble bursts. A crisis results in which lenders are forced to rein in credit – with grim repercussions for the real economy.

So the root cause of the current crisis was not Anglo-American capitalism (although securitisation magnified the subsequent debacle). It was the 'Great Moderation' – that is, the period of high growth, low inflation and exceptionally cheap money that the world economy enjoyed between 2003 and 2007. The extraordinary levels of leverage that developed in parts of the world during this period can only be understood against this backdrop. Interest rates remained persistently low because central banks in countries like the US had to support domestic demand to accommodate surplus savings in Asia – or put up with much lower growth.

A comprehensive response to the crisis must therefore contain at least two strands. The first, which has received the least attention to date, needs to address the relationship between monetary policy and macroeconomic imbalances. One question is whether central banks that pursue inflation targets should be less 'pure' than they have been and 'lean against the wind' by raising interest rates when faced with sharp rises in asset prices. Another issue concerns how different monetary policy frameworks interact. Since one country's external surplus is another's deficit, the relentless accumulation of foreign exchange reserves by countries such as China is not conducive to international financial stability.

The second strand should focus on regulation. In the EU, the European Commission is proposing legislation that would regulate credit rating agencies and force originators to retain a 'material economic interest' in securitised assets. In essence, these proposals try to ensure that securitisation does not result in a systematic under-pricing of risk. Equally important, however, are discussions in the Basle Committee on Banking Supervision to try and reduce the pro-cyclicality of bank lending. Regulators need to ensure that banks hold more capital, or increase levels of provisioning, when lending and asset prices are growing strongly.

Few politically engaged commentators have pressed for a twin-track response to the financial crisis. Why? Because the left tends to blame the crisis on regulatory failures and to deny that excessively loose monetary policy played any role – unsurprisingly, as left-of-centre commentators are always castigating central banks for subordinating economic growth to the fight against inflation. The right, by contrast, is more inclined to argue that the crisis was the result of monetary, rather than regulatory, laxity – an interpretation that stems from the belief that there is always too much regulation and that governments are always culprits.

For the time being, the tide is with the political 'left'. In the Anglo-Saxon world, as well as continental Europe, the financial sector will emerge as a more regulated industry than before. But it is important that changes in regulation be well designed and not go over the top. There is no free lunch: tighter regulations will have costs. Take capital requirements. Requiring banks to hold more capital may look prudent, but it is a price that will be paid for by customers in the form of higher borrowing costs. So careful thought needs to be given to what the optimum level of capital should be – and the scale of the event it should withstand.

Regulatory reforms are desirable and politically inevitable. But financial services are already the most regulated sector in the economy (even in the Anglo-Saxon world). Regulatory reforms may mitigate future crises, but they will not legislate them out of existence. Indeed, it is possible that regulatory rules are set to be tightened – but that the factors which contributed to surplus savings in Asia and huge levels of household debt in parts of the developed world will remain unaddressed. If this is the case, we are unlikely to emerge with an international financial system that is any more stable than the one we have had hitherto.

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