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Cover illustration by Joe Cummings
Preface

The idea for this anthology came from a chance conversation with Minos Zombanakis – the Euromarket legend, who now spends most of his time in a beautiful villa above his boyhood village in Crete. (Lucky sod.) One of the ways in which Minos keeps the little grey cells working is by organising an annual seminar in Athens, to which he has invited friends, former colleagues and (occasionally) old rivals for the last 30 years to ruminate on the big issues of the day.

Today, there is no bigger issue than the crisis that afflicts the global financial system – and that threatens us with an economic recession, perhaps depression, as severe as anything we have experienced in (depending on which Cassandra we listen to) 20, 50 or even 100 years.

It is a grim prospect. But, as Minos pointed out, we are doing ourselves no favours by assuming that this crisis is unique and that we have nothing to learn from those who lived (and managed their way) through the UK’s secondary banking crisis, the LDC debt crisis, the Continental Illinois debacle, LTCM, the ‘tequila’ crisis, the Nordic meltdown, the Asian crisis, the Russian debacle etc. etc. The problem is that, in the City and on Wall St., a generation has come to mean no more than five or 10 years; people come, make their money, and go – sometimes into public service (especially, it seems, if they spent any time at Goldman Sachs), but often into a low-profile retirement. But, when they go, they carry with them wisdom that is denied to their callow (but cocky) successors.

It’s a problem – one that is recognized every time a group of 50 plus-ers gets around a table in New York or London. It is not unique to finance, but most people would accept that it is a more acute problem in the financial sphere than elsewhere. Institutional memory is very short. Figures like Andre Meyer and Sigmund Warburg dominated Wall St. and the City for decades, but they are long gone, and there seem to be no replacements.

But scratch around, and what do you find?

The answer is a lot of people who were extremely influential not very long ago, who lived through turbulent times of their own – and who, quite rightly, believe that their experience gives them something to offer to policymakers and supervisors in the present situation. Some of these, represented in the present volume, are regular or occasional attendees at Minos’s annual jamboree. Others are good friends – of Minos, of the Centre for the Study of Financial Innovation (the small think-tank that I run, and that I am going to rename the ‘Not me, Guv Institute’), of David Potter, of my colleagues Jane Fuller and David Lascelles, and/or of myself.

They are an awesome crowd. They include former finance ministers and central bankers, one former prime minister, former regulators, journalists, and, of course, former bankers – including John Reed, who ran Citibank at its peak, and Sir Jeremy Morse and Sir Brian Pearse, who ran Lloyds and Midland respectively.

I don’t intend to try to summarize what the 32 contributors have to offer – not least because it would be impossible to do justice to their arguments. But I would emphasise the surprising support that several writers offer for some kind of return to Glass-Steagall; call it narrow banking, or utility banking, it clearly has an appeal. My own view, is that any institution which benefits from the umbrella of regulation must be regulatable – which means it must not be too big to regulate, too complex to regulate, or too interconnected to regulate. But don’t get me started. Instead, read what a lot of people, who know a lot more than I do about financial services, have to say about the mess we find ourselves in today.

Finally, a few words of thanks. First, to Minos Zombanakis and to my colleagues at the CSFI. And also to those who helped with individual contributions and with translations (in particular, Åke Wredén, Paul Burnett, Chris Nuttall, and Alison Brooks).

Andrew Hilton
Director
CSFI, London
When the surge in oil revenues left Saudi Arabia, at the end of the 1970s, with an enormous financial surplus, we in Riyadh faced the problem of investing this surplus. What we wanted were short or medium-term instruments that could be easily liquidated as the absorptive capacity of the national economy grew. Unfortunately, the investment vehicles then available in the main international money-markets were not large enough to accommodate such sums in the normal course of business. As a result, special measures had to be taken by some of the major Western countries to issue bonds that could absorb this huge (at least, by the standards of the day) surplus.

Only a few years later, however, financial markets had grown to the point where much larger sums than we had commanded could be absorbed routinely.

At the end of World War II, the political leaders of the victorious countries showed extraordinary farsightedness when they looked at the state of the world and its future prospects. What they set out to do was to rearrange the global “landscape” by establishing new international institutions. Their purpose was not only to maintain world peace and to settle international conflicts, but also to control economic competition among the wartime Allies and to finance the new investments needed to rebuild what the War had destroyed. These new institutions proved surprisingly effective - in spite of the emergence of a Cold War that divided the world only a few years after the War’s end. In particular, the Marshall Plan helped to rebuild Europe and to increase and improve its productive capacity.

Pioneer programs like the Plan paved the way for a huge expansion in public and private investment and for new patterns of global trade - leading in turn to the emergence of large banking and financial conglomerates that operated on a worldwide scale. Technological developments, especially in the IT area, added further momentum to the expansion of these institutions. They also opened wide the horizons for the growth of household income in Europe and America, while creating new investment opportunities, particularly in the personal savings area. The rise in living standards throughout the West was self-sustaining; it led to an increase in demand for goods and services, which in turn pushed manufacturers and financial institutions to further expand their businesses.

All these developments in international investment and trade strengthened the pillars of the free market system and encouraged more countries to adopt it and to open their doors to freer trade and to modern management techniques. This enlarged the markets for the products of the advanced Western countries, which, in turn, began to import more and more products from the developing world. Thus, the growth of international trade gave the emerging markets a new platform for their own economic growth.

Not everything went smoothly. But, after some difficult experiences with the inflation that resulted from this expansion, manufacturers in advanced Western countries found that they could reduce their costs by increasing production, not in their own home base, but in developing countries where wages were low. Western companies were thus able to boost their output of goods and services at a lower cost - which increased consumption in their own countries and, more broadly, throughout the world. As a consequence, Western governments found that it was possible to achieve faster growth without being exposed to rising inflation. This opened up new horizons to international trade, which boomed.

All of this was accompanied by the extraordinary development of the communications media. The entire industry came to be dominated by companies whose profits depended on commercials and advertising that encouraged personal consumption and that created demand for new consumer
items. This increased demand, in turn, encouraged financial institutions to provide new retail banking products, and the resulting competition among banks led to an enormous expansion in credit. Meanwhile, governments - anxious to boost treasury coffers - discovered that booming household consumption offered a good opportunity to impose new taxes that proved significant sources of revenue.

Moreover, the increased demand for new retail banking products did not stop there. Financial institutions began offering new products to international banks. It also led to the creation of a new world of offshore institutions and tax havens – all of which were set up by the banks to invest back in the advanced Western countries. For many banks, these offshore institutions quickly became the largest items on their books.

When considering all of this, the enormous impact of the Soviet Union’s collapse cannot be ignored. This was not just a shift in the balance of power in favour of Western countries; it also led to an increased feeling of confidence and optimism among businesses and investors and encouraged Western leaders to boost their support for the free market economy to expand without limits.

That was clearly a good thing. But the enormous increase in the funds invested with the largest financial institutions also led to changing attitudes towards risk itself, to the way managers applied risk assessment standards and to the power of these standards to influence their decisions.

The downside of this in the banking area was that fierce competition weakened the commitment to apply tough credit risk standards. Neither politicians, nor lawmakers, nor regulators were able to oppose this – in part because of the influence that the financial institutions enjoyed in the political arena and in part because of the sheer prosperity that expansion brought with it. Moreover, the prolonged expansion inevitably increased the influence of the media and PR companies – who, in turn, pushed for still more expansion.

As a result, the general atmosphere, especially in the United States, became wildly enthusiastic and supportive of pushing the free market system to its limits - to quote Deutsche’s Josef Ackerman, one of the most remarkable bank leaders in Europe.

Why is this relevant?

It is important because it shows that the world banking crisis and its repercussions are not just the result of mistakes made by a few risk managers. They are the result of long-term factors played out in market economies; factors that so boosted the confidence and influence of the business and banking sectors in the main international financial markets as to make it easy to abuse the system and to distort its application – all in the name of sustaining profits and maintaining growth.

One final point: the recent financial crisis has had a negative impact not only on the free market system, but also on the cooperation needed to manage the international financial and trade systems. Both require the United States and the European Union to do what they were forced to do at an earlier time - namely, to maintain international cooperation through the Bretton Woods institutions and other bodies, and to do it in a way that permits all other countries to participate in the management of global finance, trade and investment.

Going forward, we must also avoid placing excessive trust in the free market system, and we must admit that, in the light of lessons drawn from the crisis, there should be a new approach to the free-market system – one which will include new rules for both markets and for the regulatory bodies. It should also include amended guidelines on the use of financial and monetary policy tools. Governments must be free to implement these guidelines without being required by Western countries or by the Bretton Woods institutions to rule out direct government involvement (whether alone or in partnership with the private sector) in their countries’ economies on the pretext that to do so would violate free-market principles.

- The present crisis has its roots in the enormous success of the post-War, Western economic model and in its attitudes to risk.
- In trying to resolve the problems that have been thrown up, the key is cooperation – not just between the US and EU, but cooperation that “permits all other countries to participate in the management of global finance, trade and investment”.
- We need a new approach to the free-market system – one that gives a bigger role to government.
The first thing to appreciate is that crises come in many different shapes and sizes.

In the last 40 years, financial and banking crises have taken place in single economies (e.g. the S&L crisis in the US), in regions (e.g. the ERM crisis) or globally (e.g. Asia-Russia crisis of 1997-98, and the current credit crunch). The IMF identified 124 systemic banking crises over the 1970-2007 period and found that they are triggered variously by a sharp increase in non-performing loans, capital inadequacy, a sharp increase in real interest rates, currency mismatches, depositor runs on banks and asset price bubbles.

A brief historical perspective is helpful in comparing the current financial crisis with previous episodes:

- In the 1970s, the UK was faced with a crisis due to its massive deficit spending and a run on the pound - forcing it to borrow £2.7 billion from the IMF.

- In the 1980s, the Latin American crisis occurred mainly because of the region’s heavy reliance on external borrowing from US banks, combined with governments’ imprudent fiscal policies. As the debt service burden became unbearable, due to sharply higher interest rates, Mexico was the first country to announce a debt moratorium in 1982 - with Brazil following in 1987.

- The US Savings & Loan crisis of the 1980s and 1990s was triggered by the inflation of the late 1970s, coupled with high real interest rates. S&Ls were badly managed and inadequately supervised. Consequently, hundreds failed during the 1986-1995 period, costing the US taxpayer about US $160 billion or 2% of GDP.

- Japan hit a prolonged recession and deflation in the 1990s, following a real estate and stock market collapse in the 1980s. By 2002, the Japanese financial system had more than US $1 trillion in bad loans, and the cost of the bailout to the government was estimated at 24% of GDP. The government and the Bank of Japan were too slow and hesitant in taking remedial action. However, with hindsight, one can see that a crisis was probably needed to highlight the deficiencies of ‘collusive’ regulation.

- During the late 1990s, the Asian crisis unfolded as the regional banks’ asset/liability and currency mismatches reached unmanageable levels. Speculators took advantage of banks’ balance sheet vulnerability, creating self-fulfilling panics. Ultimately, Asian central banks had to abandon their pegs due to their inadequate forex reserves.

Today, we are faced with the most severe financial crisis since the 1930s.

The inadequate capitalization of financial institutions, the overleveraging of investment bank balance sheets (30 to 40 times capital), a phenomenal growth in non-financial debt, acceleration of securitisation and dismal supervisory oversight have all been the drivers of what has become a “financial tsunami”. However, despite the evidence of growing leverage and a steady rise in bank credit, policymakers continued to believe that the market was ultimately self-correcting. Other factors contributing to the crisis included:

- faulty behaviour in the private sector by companies focused on high bonus levels and short-term profits;

- the unrealistic ratings given to complex structured products; and
the willingness of monoline insurance companies to guarantee structured securities without having adequate capital to back them.

In fact, the entire financial system was inadequately capitalized, but faulty risk management systems obscured this. Accounting systems based on “fair value” and “mark-to-market” also failed under stressed market conditions, creating serious valuation problems.

As far as the appropriate policy response to a financial crisis is concerned, there is little agreement on what constitutes best practice. Responses tend to depend on the nature of the crisis, and governments have, therefore, employed a broad range of policies.

They typically start with regulatory forbearance and generous liquidity support to the banks. The reason is that a key component of almost every systemic banking crisis is too little bank capital - which calls for bank restructuring in the form of government bailouts. There is plenty of evidence that government bailouts generate moral hazard, but when it comes to maintaining financial stability, governments do not have the luxury to wait for a perfect solution. The economic cost of no action can be enormous, since bank runs are far more expensive than bailouts.

As part of the current crisis is a conventional banking crisis, the problem is not just liquidity but a shortage of bank capital. Accordingly, most countries have already injected unprecedented amounts of capital, guaranteed customer deposits, reliquefied the system and lowered policy rates.

According to the IMF database covering the universe of systemic banking crises from 1970 to 2007, the average fiscal cost was about 15% of GDP for each country involved. This is three times the cost of the US TARP - so the ultimate fiscal cost could be much higher. Indeed, recent bailouts of individual financial institutions and extensions of government guarantees for deposits and money market funds have already added significant contingent fiscal liabilities.

Global losses arising from the US financial crisis have been projected by the IMF to reach US $1.4 trillion, with around US $725-820 billion expected to be borne by the global banking system. An alternative projection produced by the Bank of England suggests that combined mark-to-market losses across the US, the Euro area and the UK have already reached US $2.8 trillion.

The IMF has also estimated that recessions preceded by banking crises are on average three times more serious than those where a banking crisis has not occurred. This highlights the importance of resolving a crisis speedily and effectively - and not counting the bailout cost too much.

While each financial crisis has its own characteristics, there are striking similarities between the post-2007 US-led global financial crisis and previous episodes in terms of adverse effects on asset prices, recession and rising public debt. The majority of historical crises are preceded by financial liberalisation. New unregulated, or lightly regulated, financial entities emerge – and appear to enhance the stability of the system by bringing in new skills and encouraging competition. They do enhance stability in some ways, but not enough attention tends to be paid by regulators to the ways in which they destabilise the system.

As noted, previous crises have been limited to countries or regions, often outside the core of the global financial system. In contrast, the current financial crisis began in the advanced economies, which were under the illusion that their risk management tools were sophisticated and that it was only the emerging markets that were vulnerable to wild market gyrations. What they discovered is that countries are exposed not only to market failure but also to the moral failure of market-oriented policies.

What are the lessons that we should draw from the history of financial crises? I suggest several:

- **Credit growth & asset price inflation**: Central bankers bear part of the blame for allowing a long period of easy money, asset price inflation and rapid credit growth.

- **Overleveraging for short-term profits**: Overleveraging continued without check and resulted in a serious shortage of equity capital relative to commitments.

- **Complexity/opacity of structured products**: Financial innovation was profitable and resulted in complex products bundling increasingly poor-quality loans, which gave upfront profits to the originators.

- **Rating agencies**: Credit rating agencies facilitated the sale of structured products through “fanciful” ratings of structured products (structured products and bonds were rated on the same scale). The combining of rating and advisory services has also raised questions about the independence of the ratings attached to such products. When events started to unfold, rating agencies were slow to reassess the value of affected products.

- **Deficiency in external oversight and internal governance**: Regulators did not co-operate sufficiently,
or share information. Internal governance failed in an atmosphere of greed.

- **Panic selling of risky assets**: A massive re-rating of risk is virtually unprecedented - and scary to watch. It was this sudden shift from highly risk-loving to highly risk-hating that caused the deleveraging and the depth of the crisis.

- **Dealing with financial crises**: Recent events have tested the ability of central banks and the other authorities to respond to financial crises. A key theme has been that central banks need a better array of tools (including lender of last resort facilities) to alleviate stresses in financial markets. Flexibility in arrangements is important.

- **Macro-prudential policies**: The BIS has always emphasised focusing on systemic risks, rather than on individual institutions, and looking at shared exposure to common shocks. Some instability is a normal part of a capitalist economy. But the huge bubbles in equities and housing over the past decade are not normal. The aim is clear: it is neither to prevent institutions from going bust nor to eliminate the cycle of boom and bust. The former is undesirable and the latter impossible. The aim is just to reduce the frequency and severity of crises.

There are also lessons to be drawn about the role of the IMF.

The IMF is increasingly involved in bailout packages as individual countries succumb to the credit crisis (Hungary, Ukraine, Pakistan and Iceland). It is also under pressure to identify deficiencies in countries’ regulatory frameworks and to recommend remedial actions, but many countries will object to the Fund's interference in their domestic arrangements (including the US, with about 17% of the votes when only 15% are needed to block a major reform). Major changes in the IMF’s role are likely to involve altering voting rights as well: for example, China still has less voting power than Belgium and The Netherlands combined.

The IMF has an undervalued function which it has played for a number of years, which is basically setting information and disclosure standards for governments and financial institutions. It can help override crises by providing early warnings, which would do more to improve the stability of the capital markets than any lending or regulatory function.

In conclusion, the world is different from the 1930s and 1970s for two reasons. It is globalised and highly connected, and policymakers understand the dangers of both rapid inflation (1970s error) and protectionist and deflationary policies (1930s mistakes). Nevertheless, governments and regulators have both failed by pursuing over-expansionary monetary policies, combined with poor supervision of the financial system. Inadequate capital, overleveraging, an unsustainable level of household debt in advanced economies and the culture of complex securitisation have been at the heart of the crisis. Wall Street greed and events such as the collapse of Lehman Bros. are also to blame.

The credit markets’ cool response to dramatic policy moves by Western governments highlights the deep-rooted nature of current concerns. It seems logical to call in the IMF as the premier supra-governmental organisation in this field. The G-20 finance ministers and central bank governors have also called for the IMF to beef up its early-warning capability. However, the IMF’s failure to provide advance warning for most of the major financial crises of the last two decades and its record of suggesting inappropriate remedies after the fact raise serious questions about its ability to oversee financial markets.

Any list of what is needed to deal with such a serious crisis will be long and controversial. But, at a minimum, measures are needed to:

- strengthen supervision and prudential oversight;
- improve transparency and the valuation of financial instruments;
- reform the role and use of credit rating agencies; and
- introduce robust arrangements for dealing with stress in the financial system by paying more attention to asset prices and using some counter-cyclical tools (e.g. altering prudential financial ratios to make banks more conservative during asset bubbles).

- Central bankers bear part of the blame for their easy money policies.
- But regulators really missed a trick – permitting excessive leverage, opacity, complexity etc. and for not imposing adequate oversight.
- Perhaps both central banks and regulators need better tools – and we certainly need better macroeconomic policies. However, don’t forget: “Some instability is a normal part of a capitalist economy.”
- Beef up the IMF – particularly voting rights and its early warning role.
It is standard today to argue that the current crisis is the worst since the Great Depression - and, by implication, much worse than the Latin debt crisis of the 1980s and Argentina in 2001, or South East Asia and Russia in the late 1990s. The fact is that we are in the midst of a truly major crisis for industrial countries - and that this, in turn, is seriously affecting emerging markets. But the other crises were extremely severe, usually involving a collapse or near-collapse of banking systems and a sharp contraction in output.

The Latin American crisis of the 1980s was particularly spectacular, leading to a general suspension of debt payments, a sharp fall in the value of currencies (along with exchange controls) and, most importantly, a rise in unemployment alongside a major fall in output. But the problems of South America did not lead to a worldwide recession - and, for the most part, industrial countries were little affected. Still, looking back, it is easy to argue that most crises or bubbles have their origins in too much borrowing, an excess expansion of credit and a belief that the new period of expansion can go on forever. On this score, there is little difference between that of South America in the 1980s and the current one.

Of course, today, all the industrial world is in recession whether in the US, Europe or Japan. Stock markets have fallen not only in the industrial world but in emerging markets, as commodity prices plunge and exports are badly affected by the problems of industrial countries. As can be seen below, few countries escaped in 2008 - and the worry is that something similar may be repeated in 2009:

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<th>Stock Market Prices 2008</th>
<th>Year End 07</th>
<th>Dec. 31, 08</th>
<th>% Change*</th>
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<td>8,776</td>
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<td>Euro</td>
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<td>World (MSCI)</td>
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</tr>
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</table>

*In local currencies

This is the first time since WWII that all industrial countries have simultaneously fallen into recession, but it would be wrong to suggest that banking crises are simply a feature of the emerging world. For example, in a recent work, Carmen Reinhart of the University of Maryland and Ken Rogoff of Harvard looked at 14 “severe” banking failures. These covered both developed and developing countries - including Japan, which suffered from a truly monumental banking collapse in the 1990s. There have been almost as many crises in industrial as in emerging markets; so it is more realistic to argue that there is little difference among countries, whether they be emerging or industrial.

Nevertheless, in many respects, the current banking crisis is different in not only being more widespread but bigger in scope and scale than anything since WWII - particularly as “toxic” assets were distributed around the world. Moreover, in the Latin crises of earlier years, most of the lending came from banks, with little money coming from the capital markets. Now, this has all changed with the explosion in credit coming from the capital markets in one way or another. Securitization of mortgages, credit default swaps and all forms of derivatives started with banks keeping a substantial proportion of assets for their own balance sheets. But this has dramatically changed, with more and more assets being...
sold to the market. Like Mae West, who once said, “I was born Snow White – then I drifted”, the banking system of the 21st century contributed to its own downfall.

The reality is that the “new” banking system is broken, and there is little doubt that the aftermath will bring in an era of more regulation and supervision.

Very importantly, leverage was a feature of the “new” system with financial institutions borrowing 40 times their capital and more. But this is changing fast, with leverage being rapidly reduced. Similarly, it is doubtful (to put it mildly) that Basel 2 will be allowed to put so much emphasis on models for the determination of capital levels. There is a strong probability that banks are in the process of becoming more like public utilities, at least for the big systematically important ones, with limits on what they can do. There is even a serious proposal to bring back leverage ratios for banks. By the same token, the larger hedge funds and venture capital firms are likely to be subjected to regulation as the public demands protection against what have turned out to be major predators taking money on a massive scale in the good years and simply closing their operations in bad years.

The overall result is that the halcyon days of little over eighteen months ago - when financial institutions accounted for 40% of the DJIA’s profits, when the bond market players were kings of the jungle, when venture capital firms were able to buy companies and leverage themselves up by gigantic amounts and when hedge funds ruled the universe - are gone. In this sense, there are definite similarities with earlier crises. There is no doubt that South America changed its banking supervision, that there was a period of consolidation as weaker banks went to the wall and that new and better economic policies were introduced - including radically better exchange rate systems. Today, it is more regulation across the board. This is the new mantra, but the theme is the same; the public demands a safer system in which to work and invest its funds. Supervision and regulation are definitely a growth industry.

Again, there is another similarity between the current crisis and the Latin American debt crisis almost 30 years ago. Once investors began to worry about risks in 2007, it did not take much more than an instant before capital markets shut for virtually everyone. The perception of risk changed overnight - just as problems in Argentina and Mexico in the 1980s almost immediately spread across the entire Continent as new capital dried up.

The fact of the matter is that risk perceptions can and do change dramatically from time to time, and that they are basically impossible to forecast. Consequently, bankers keep on lending or raising capital when a crisis is just around the corner - but are invariably surprised when it hits. The underlying assumption is that something good will happen, that the IMF will come to the rescue for emerging markets or that the general attitude towards risk will not change. In other words, extrapolation of the trend becomes the accepted wisdom of the time.

But the key issue now is what happens next?

More government and central bank money has been injected into the system in the last year than at any time in history, and yet there is little to show so far for it in terms of getting the various economies moving. The likely US budget deficit in the fiscal year beginning October 1, 2008 will probably exceed 10% of GDP once the Obama Administration has injected another $800-$1,000 billion into the economy. The same applies to the UK and Japan, while interest rates are rapidly approaching zero percent across the globe. Interestingly, Professors Reinhart and Rogoff say that downturns that follow a financial crisis lead to an average fall in GDP over 9%, and that it takes almost two years to reach bottom. Moreover, the unemployment rate increases by an average of 7 percentage points (US joblessness would rise to 11% if this happens) and reaches a peak almost five years after its rise began. Just as important is the shape of the recovery, whenever that happens. Here, there is a good chance that the rise in output in the industrial world, led by the United States, will be slow as savings rates are raised and as people learn to live on smaller amounts of credit.

Also, today, luxury stores are doing much worse than was forecast because individuals are becoming more cautious - whether they are rich or poor. Most average citizens are frightened, whether because of job insecurity or stock market losses, and it is difficult to see why this should change any time soon - especially as job losses mount. In addition, a slow pick-up in the industrial world runs the risk of encouraging protectionism, which was a major curse of the 1930s. Also, another reason for being cautious about the speed of any future recovery is that, ahead of any significant recovery, governments and central banks will have to begin raising taxes and interest rates to mop-up the massive stimulus and liquidity packages that have been pumped into the world economy.

Of course, such problems are a long way off, with economists from both left and right arguing for more and more stimulus packages to get the different economies moving. Any semblance of budget restraint has gone out of the window - especially in the United States and the United Kingdom,
though other countries are beginning to follow suit. Keynes is back with a vengeance, with public works being a very popular order of the day. This is appropriate given the state of the world economy, but it is also relevant to think about whether there is a future problem of inflation being built into the system. Unless taxes are indeed raised and interest rates moved sharply up, there is a risk that inflation will rear into ugly head again. Will the period ushered in by Paul Volcker - who broke the back of inflation in the early 1980s - come to an end 30 years later?

Clearly, no one knows the answers to these questions. But plenty of people are starting to worry about the possibility of future inflation. The good news is that financial institutions may be constrained in what they can do, so that the possibility of another massive expansion in credit is low. Even so, there are concerns that governments and central banks will be slow to respond once the world economy begins to recover.

This, however, is a problem for tomorrow, with the world economy expected to grow only 1-2% in 2009 and with the US economy likely to contract by up to 3%. Already, commodity prices have plunged, with oil dropping from US$147 a barrel in the middle of 2008 to below US$40. Hence there are real worries that the US will enter a period of very slow growth, with prices of assets falling across a broad spectrum - just like Japan in the 1990s. Put bluntly, while inflation might be a future threat, deflation is an immediate possibility:

- Don’t assume there is an easy way out. The crisis has similarities to the Latin crisis but it is bigger and, in its relationship with capital markets, different and trickier to handle.
- More regulation is inevitable. The public demands a reduction in risk-taking.
- There is also a serious danger that the approach taken to the problem by the authorities could lead to much higher inflation down the line.

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<tr>
<th>Industrialised Economies’ Growth Forecast</th>
<th>(Real GDP, % Change)</th>
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<td>2008</td>
<td>2009</td>
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<tr>
<td>Canada</td>
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<td>Euro Zone</td>
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<td>Japan</td>
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<td>United Kingdom</td>
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<td>United States</td>
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<td>Developed Markets</td>
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<tr>
<th>Emerging Economies’ Growth Forecast</th>
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<tr>
<td>2008</td>
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<td>China</td>
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<td>India</td>
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<td>Venezuela</td>
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This is the reason why so much emphasis is being given to stimulating bank lending. As long as lending is virtually non-existent, the world economy is unlikely to recover. But the experience in Latin America is that it took years before the international capital markets opened up for most countries after the 1980s debt crisis. Given that banks have lost over $1 trillion in write-offs of bad assets, with investors losing trillions of dollars in the stock market (about $7 trillion in the United States alone), why will bank lending and investment risk-taking start again?

Even if this pessimism is only partly correct, it means that more and more reliance has to be placed on action by the authorities - particularly on fiscal policy. Yet this can easily become a “Catch 22”-type situation, with the need for bigger and bigger budget deficits growing as the world economy becomes weaker and weaker. The risk is that, if this happens, governments may never actually do enough and will continue to lag behind a deteriorating economy. Latin Americans called the 1980s “the lost decade”; let’s hope that the next few years (especially for the industrial world) are not too similar.
In the mid-nineteenth century, as now, a new President came to Washington from Illinois. His immediate priorities, as now, were a war and national financial stress. There was a need to finance the war, but also to restructure the banking system and to establish a national currency.

In response, President Lincoln established the system of national banks to issue a “uniform” currency by operating under new banking standards. Those banks were then deployed to purchase US government bonds for war finance. The Treasury also established the Office of the Comptroller of Currency to regulate and supervise those banks through a small army of national bank examiners. Hugh McCulloch, the first Comptroller of Currency and later Treasury Secretary, advised the banks in 1863 to:

“Pursue a straightforward, upright, legitimate banking business. Never be tempted by the prospect of large returns to do anything but what may properly be done under the National Currency Act. Splendid financiering is not legitimate banking and splendid financiers are generally either humbugs or rascals.”

Another new President has arrived from Illinois. He faces two priorities, wars and a financial system mess, both burdening the real economy and the Federal Treasury. He needs to stabilize the financial system nationally and globally, stimulate the economy towards some level of recovery, and issue plenty of bonds to finance these challenges. He also needs to deal with 21st century humbugs and rascals.

Since the Second World War, the financial system has been stressed many times. For the most part, the stress has been centered on deposit-taking institutions, and caused by concentrations of risk, essentially credit risks embedded in a product, industry or sector. The pattern for every build-up to the problem, and for resolving them, has generally been the same. There are business model pressures to grow earnings. Liquidity/reserves/capital ratios deteriorate to gear up earnings. Credits expand; concentrations of risk build.

A sort of Gresham’s Law takes hold wherein bad underwriting drives out good underwriting, bad deals infect or drive out good deals, good lenders leave the game quietly while poor lenders carry on. Increasing comfort from extrapolation leads to increasingly pathetic underwriting and a sharp spike in risk concentrations. Somewhere just beyond the midpoint of the spike, a loss exposure explodes, but market participants perceive an anomalous event, rather than an event indicative of the accruing crisis. This denial phase lasts until enough surprises move participants into the shock and paralysis phases. Their inaction usually compounds ultimate losses.

Since this history is bank-centric and credit was syndicated among banks, stabilization and recovery efforts for a troubled credit cycle commonly occurred under private sector statesmanship, through creditor committee schemes to manage a way out of crisis. Perhaps official chaperones assisted crisis management with liquidity facilities - and in the case of the LDC debt crisis in the 1980s, with debt rescheduling facilities as well.

Critical in understanding these past dynamics is the fact that, while banks may have been slow to identify a building crisis, once it occurred, the size and dimensions were readily identified and dealt with because of the loan syndication process, which required the “lead” to keep a piece of the loan as well as manage/track the loan on behalf of syndication members. A solid knowledge of the problem facilitated managing it, as well as managing any necessary official support. Generally, while the “system” may have been experiencing a significant problem, it wasn’t flying blind. There was transparency, not opacity. These credit committee operations, alone or jointly
with official participants, sustained the financial intermediary process, gradually revived credit flows and generally achieved a “soft landing” across the home country economies – even though, in the LDC and Japanese crises at least, the individual economies suffered considerably.

Central to management of past crises has been this feature of knowing the depth and breadth of them.

The more current and accurate the information available, the better managers can tailor the response. The more tailored the response, the less the crisis is likely to escalate. For instance, at the time of the Chiasso affair, it appeared that the Swiss authorities had no idea of the size of the foreign exchange problem at Credit Suisse’s Chiasso branch, threw resources into it and scared everybody about the size of the hole. Equally, the fringe/secondary bank crisis in London seemed to have been made worse by the under-reaction of the authorities. The Herstatt episode, in Germany, indicated that the authorities did not have a clue about what happened, which more than rattled exchange markets. While US authorities may not have prevented all crises, their regime for gathering data and other prudential information in the past facilitated a rapid understanding of the various risk dimensions that needed to be managed.

Importantly, assisting the management process of past crises in the US was the deployment of Federal Bank Examiners to establish values for non-traded or illiquid assets across troubled institutions. In essence, the Federal Bank Examiners reviewed assets and placed them in categories entitled “special mention”, “substandard”, “doubtful” and “loss”. This categorization scheme reflected the degree of both illiquidity and insolvency inherent in troubled assets. The Examiners then assessed provisions to the loan loss reserve based on each bucket, so assets categorized “special mention” would attract a 10% reserve, “substandard” 20-30%, “doubtful” 50%+, and loss $100%. This valuation scheme was not precise, but it was deployed compatibly and consistently across institutions, thereby providing an orderly and directionally correct picture of what needed to be managed systemically as well as at the institution level. It proved central to the resolution of the LDC debt crisis during the 1980s, as well as sorting out the regional bank/S&L crises of the early 1990s.

Another feature of past crises has been their primarily domestic nature, albeit with some international linkages. True, the LDC debt crisis was far more global, involving some 100 lending banks, 16 borrowing countries, various central banks and all the multilateral financial institutions. But for the most part, a crisis was a national matter, affecting local banks, monetary authorities and the domestic economy. Importantly, some sort of crisis would occur perhaps every five or six years - sufficiently frequent for authorities and institutions to stay sharp in their risk management and crisis management skills.

Now, the media has made many parallels between President Lincoln and President Obama – but it has not yet mentioned that the most direct parallel is the financial/fiscal/economic challenge Obama faces. The current crisis is really the first US “systemic” episode since 1992. So the financial system has not been “cleansed” for 16 years. During that time, one might conclude that plenty of complacency, an unrealistic sense of resilience and extrapolation comfort has taken root. Put simply, less frequent experience of trouble makes it harder to identify and deal with it when it does occur.

Plenty has happened since 1992.

In particular, much of the activity in the financial services sector has become “marketized” through securitizations and derivative contracts. The exposures have then been disbursed electronically across the world – a bit out of sight, out of mind – and these have proven to be terribly difficult to collate during this crisis. Significant activity also broke out from under various official regulatory umbrellas, and apparently away from internal governance, making risk exposures opaque to everyone, including the institutions’ management and directors. Over 16 years, developments in technology and telecommunications also permitted exponential growth in the capacity for complexity, volume, recordkeeping and the geographical reach of transactions.

Systemically large, “universal”, financial institutions also emerged, which became (perhaps) too geographically dispersed to control, too culturally diverse to govern, too complex to understand, and simply too beyond the grasp of directors, management and official overseers. Since 1992, accounting standards became more religiously pro-cyclical, and, when blended with the Prompt Corrective Action provisions of the 1991 FDIC Act, created a nuclear cocktail as mark-to-market standards transformed liquidity issues quickly into solvency issues for US banks. After 10 years of effort, Basel II remains very much a work-in-progress - having encouraged pro-cyclical behavior among financial institutions, as well as having promoted reliance on flawed models and rating agencies. And, whatever happened to “TRUST BUT VERIFY”?

For that matter, whatever happened to “constructive ambiguity”?

President Obama comes into the Oval Office facing “unusual and exigent” conditions in the financial system that have
caused an international emergency requiring “whatever it takes” use of public taxpayer financing to stabilize the financial system and prevent economic collapse. The losses in the financial system are staggering. The rot in components of residential finance is massive. The knock-on effects to the real economy are enormous in terms of the industry’s financial losses and employee redundancy. So, second round effects are about to further whack financial institutions in terms of losses on consumer credit, retail establishments and retail/commercial real estate. The FDIC has 177 banks on its “troubled” list - and mentions “several dozen” more to come. President Obama also inherits some $8 trillion in US government commitments to support the financial system, with $3 trillion drawn, as well as the $5 trillion in obligations of Fannie Mae and Freddie Mac, and the lingering implicit support of $1 trillion to the Federal Home Loan Banks.

The current crisis reminds the public-at-large of the social utility that the financial system provides and the public utility nature of financial institutions. The US public wants reform, both across the financial system and within financial institutions. So do other national constituencies of the financial system. The globally interdependent financial system has long been a scheme of mutual opportunity, but now brings mutual vulnerability. Further, the surplus countries are insisting on a new financial system that is “fit and proper” and on more representation in decisions on the way finance is governed. Safe to say, President Sarkozy’s “le laissez-faire, c’est fini” will apply to financial institutions deemed too important to disappear, too connected to be disconnected.

More oversight and more intrusive examination by governments will occur. Central banks will regain a role in bank supervision from a macro-surveillance perspective. The IMF, the FSF, the BIS and central banks are all gearing up again to be partners with prudential supervisors. No significant pool of capital will escape the new regulatory regime. The initial thrust will be: TRUST little, VERIFY much; more international co-operation and co-ordination; new countercyclical policies for liquidity, reserves/capital and, I dare say, smoothing of earnings. The best and brightest financiers failed the test of the marketplace and defaulted to taxpayer bailouts. Policymakers have had to intervene.

There is no discussion (yet) of an exit strategy by government. Rather, the talk is about retrospection, retribution, re-regulation and restructuring. Expect plenty of study of the crisis by commissions, legislators and academia. Expect plenty of investigations, grand juries, civil/criminal proceedings. Re-regulation will deal with systemic oversight, institutional supervision and examinations, perhaps some disaggregation by institutions of non-core businesses. Lastly, for sure, there will be regulatory restructuring, such as consolidation of the deposit-taking supervisors, new systemic prudential powers at the Federal Reserve, a merger of the SEC and CFTC into a new “markets’” regulatory agency, and creation in the Treasury of a new Federal insurance regulator.

The goal is to create a more efficient and comprehensive system of oversight. But will it have value? Will it have teeth and bite as necessary? The primary need is to restore trust/faith/confidence in the integrity of financial intermediation globally. Whatever policy packages develop must satisfy the need to restore trust.

It may indeed turn out that we go “Barack to the future”, that the systemically critical financial institutions become public utilities managed by the “best of the steadiest”, with privately-owned slow-growth dividend-focused shares. Once again, public policy views financial institutions as “special” – and it will treat them as such.
What does the great credit crunch imply for competitive capitalism?

There are two reactions that, to my mind, are clearly wrong. One is to say that it has no implications, and to blame what has happened on too much regulation and intervention - such as efforts in the US to extend home ownership to poorer citizens. These may have been counterproductive, if well-intentioned; but it is implausible to blame them alone for the narrowly averted collapse of the world monetary system. Whatever your analysis, the widespread fear provoked by recent financial events will ensure that there is no “glad confident morning” for free market principles for a long time to come. Or to put it more crudely, those of us who champion free markets have egg on our faces.

At the other extreme, there are those who say – delightedly or otherwise – “So much the worse for capitalism. Let’s go back to Karl Marx.” This has been personified by that grand poseur, the French president Nicolas Sarkozy, who has taken care to be photographed holding a copy of Das Kapital – I doubt if he got as far as the first page.

Nor do I suppose he has read the eloquent defence of market capitalism provided by none other than JM Keynes in the concluding chapter of his 1936 General Theory. Keynes remarked that the advantages of what he called “individualism” are “partly advantages of efficiency – the advantages of decentralisation and the play of self-interest… But, above all, individualism, if it can be purged of its defects and its abuses, is the best safeguard of personal liberty in the sense that, compared with any other system, it greatly widens the field for the exercise of personal choice. It is also the best safeguard of the variety of life, which emerges precisely from this extended field of personal choice, the loss of which is the greatest of all the losses of the homogenous or totalitarian state.”

Keynes was far from a “market fundamentalist”, and I will not claim that his defence of market individualism was a continuing or even frequent theme. But when he was in this mood, the case he made was far more eloquent than that of most card-carrying libertarians. In any case, I go along with Keynes’s linking of individual liberty to choice in competitive markets. This has never excluded carefully targeted income redistribution, the provision of key public services or action against flagrant externalities. And, of course, Keynes had already said long before that “money will not manage itself” - which should perhaps now be amended to “money and credit will not manage themselves”.

This takes us to the heart of our present discontents.

But allow me to first embark on what might seem to be a digression, via a book entitled Vienna & Chicago - Friends or Foes, by Mark Skousen. It is about the rift between two 20th century free market schools, who agreed on most policy issues but were separated by profound intellectual divisions. This might seem so “last century”, but I found it surprisingly enlightening. You do not have to agree with all, or even any, of the extreme laissez-faire policies on which the two schools are said to agree to learn from their work.

The Chicago of the title refers to the teachings of Milton Friedman who, for most observers, symbolised that school. Vienna stands for the so-called Austrian School. I say so-called because, since World War Two, its adherents are to be found anywhere except Austria – in fact mostly in the United States, and many of them within a few miles of Grand Central Station.

The school was, of course, genuinely Austrian in its origins. It arose in opposition to two main currents of late 19th
century thinking. One was Marxism, which was then highly influential in the German-speaking world. The other was the German Historical School, which opposed all economic theory – as if facts could speak for themselves. The best known 20th century “Austrians” were Ludwig von Mises and Friedrich Hayek, who spent the latter halves of their lives in the US and the UK respectively. It was the first of these who, perhaps carried away in his reaction to the German historicists, advocated purely deductive reasoning without resort to historical or statistical data. This extreme a priori attitude was mainly developed after von Mises arrived in the US in 1940 and was no longer in contact with policy circles in his native land. He occasionally justified his attitude as an application of the “synthetic a priori” of the great German philosopher Immanuel Kant. American followers of von Mises did investigate in some detail such matters as the Great Depression, but insisted that they were merely “illustrating” their theories.

May I risk saying that these latter day so-called Austrians are best viewed at a distance, as one of their distinguishing features was their intolerance? Even Hayek, who became better known as a political theorist after his 1944 Road to Serfdom, was sometimes regarded as beyond the pale because he flirted with Karl Popper’s doctrine of empirical falsification, and was not a pure enough supporter of laissez-faire. One of the American Austrians is said to have received hate mail because he produced a very simple semi-mathematical presentation of his theories. I myself was fiercely attacked for calling Joseph Schumpeter an “Austrian”. Von Mises himself was denounced as a socialist by the Russian-born libertarian writer, Ayn Rand, whose novels sold several times more than all the works of free market economists put together.

The contrasting Friedmanite espousal of empirical testing of hypotheses is well known, and widely accepted. But even here there are a few subtleties. One Chicago economist gave the game away when he explained the idea of how the economy works – for instance, a study purporting to show that minimum wages leave employment unaffected - neither ignore it nor accept it blindly but worry away at the tests until you find a flaw. I prefer this approach to that of economists and journalists who change their world outlook with bewildering rapidity as one study succeeds and contradicts another. But the corollary is that other schools must be allowed their priors, and the argument becomes more of a fight than some would regard as seemly.

The Chicago and Austrian schools were separated by more than an argument over economic method. They had, for instance, radically opposing ideas about the origins of the Great Depression of the 1930s – and that has resonance today. Friedman and his followers believed that monetary policy was fine in the late 1920s, when US economic growth was brisk and consumer price inflation negligible. The Austrians, by contrast, located the origins of the Depression in just that period when a soaring Wall Street boom culminated in the Great Crash of 1929. This argument prefigured uncannily the recent spat between supporters of Alan Greenspan, who celebrated the long period of low inflation and buoyant economic growth over which he presided, and his critics, who blamed him for living in a fool’s paradise in which an asset boom was allowed to get out of control. The Austrians insisted that what matters is not just how much money is injected into the system, but where it is injected into circulation. As Skousen remarks: “Lately the answer has been the banks, the mortgage companies and Wall St.”

In the original Austrian version, the argument is that “over-investment” in the upward phase of the business cycle is financed by “forced savings”. But how do we apply this to a globalised world, where a boom in the US and the UK was financed from Asian and OPEC savings surpluses without any great compression of average consumer living standards? The Austrians very plausibly say that the worst damage done in an inflationary boom is the distortion of relative prices, and not just their absolute level. To carry this further, we need empirical studies of relative product prices over the cycle.

Themes from the Austrian school have been echoed by impeccably “Anglo-Saxon” writers. A good example is George Cooper, who has worked for several financial institutions and ended up as London head of interest research at JP Morgan. A few months ago, he produced a short and well written book, The Origin of Financial Crises.

Cooper’s main contention is that the market for capital is entirely different from that for consumer goods. His key distinction is between products that are valued for their own sake and those valued wholly or partly for their future resale value – and therefore prone to bubbles. Care is needed because bubbles can take place in products that few accountants or economists would regard as capital, an example being the Dutch Tulip Mania of the early 18th century. On the other hand, the purchase of a cotton mill is nowadays rarely undertaken for a speculative capital gain.

These considerations lead to Cooper’s main contention that asset markets are peculiarly vulnerable to boom and bust, and are therefore the real destabilising force in the financial system. This provides an important underpinning of the case for central banks, or the politicians who set their targets, to widen their definition of inflation beyond consumer prices.
But first a related issue: the efficient markets hypothesis, on which Cooper understandably pours scorn. This started with innocent and necessary observations, such as the irrelevance of a share's past performance to its future behaviour. Unfortunately, it blossomed out into the belief that assets are always and everywhere correctly priced. Indeed, there were analysts who believed that the Nasdaq Composite was correctly priced at 1,140 in March 1996, again correctly priced at 5,048 in March 2000 and still correctly priced in October 2002 when it fell back to 1,140.

I will take Cooper's word that the efficient markets hypothesis lies at the basis of the models prepared by those famous rocket scientists. In diluted form, these theories may be behind the reluctance of modern central banks to act on asset bubbles.

Not surprisingly, Cooper traces recent difficulties to the rapid growth of credit encouraged by the Fed’s ultra-cheap money policy of a few years ago. One of the few people who definitely warned that asset bubbles could lead to monetary instability, even if consumer inflation seemed under control, was William White, until recently economic adviser to the BIS. I don’t know how he resists the temptation to go round saying “I told you so”.

A policy on asset prices will not be easy to devise. One only has to think of the diversity of views about the correct multiple of wage earnings to apply to find the equilibrium value of the UK housing stock. Yet however difficult it is, I feel confident that the rethink in the wake of the present credit crunch, is bound to make more room for asset prices in central bank objectives than exists today, even at the cost of some intellectual untidiness. The old school Fed chairman William McChesney Martin once said that the Fed's job was “to take away the punchbowl just when the party gets going”. His words do not translate easily into numerical targets, but they may still be right.

Jumping off a bit, I should like to put forward a proposal which is certainly not original, but a revival of a very old one.

I cannot be the only person who, as an adolescent, was shocked to discover that banks did not have enough cash in their vaults to repay more than a small proportion of their depositors. “Fractional reserve banking”, as the system is called, arose when medieval goldsmiths discovered that they could safely re-lend most of the precious metals in their vaults since their depositors would not normally all ask to be repaid at the same time.

The great virtue of the system was supposed to be that it economised on holdings of gold. But even when paper money came in, the habit continued. Indeed, one of the most sympathetic characters in Elizabeth Gaskell’s Cranford lost all her money in a bank crash.

The fractional reserve system was severely queried by some US economists in the aftermath of the Great Depression, when one-quarter of the US money stock disappeared almost overnight – a more important event than the better-known 1929 stock exchange crash. One of the principal critics was the Chicago professor Henry Simons, author of A Positive Program for Laissez Faire. Simons once had a great influence on Chicago economists such as Milton Friedman, but was later repudiated, presumably because he had too much positive programme and not enough laissez-faire.

Simons proposed the creation of pure deposit-taking institutions (now often called narrow banks), holding 100 per cent reserves, whose assets had to be held in currency or Federal Reserve deposits or very short-term government securities. So, barring a break-up of the US, or similar disasters, a depositor could always get his or her money back - and quickly. Other financial institutions, whether or not called banks, would carry on paying interest and looking for more profitable investments. But the ordinary citizen would know that he was on his own if he invested in them.

What has finally won me over to this idea is the realisation that we nearly have in the UK a government-sponsored narrow bank, entitled National Savings & Investments.

NS&I was originally set up by the Palmerston government of 1861 as the Post Office Savings Bank. It became, under the last Conservative government, “an executive agency of the Chancellor”. Some of its instruments can already be cashed at short notice, and a few are even indexed against inflation. Until recently, national savings products were regarded as dull compared with the attractions of marketable fixed interest securities; but, clearly, safety and risk aversion have become more important. If NS&I were to become the 100 per cent reserve bank Simons had in mind, some modest changes would be required, such as enabling depositors to write cheques against at least some of its instruments and to be less exclusively concerned with government funding. It would also need to publicise the banking nature of its facilities. It could then become equivalent to “money under the mattress”.

This suggestion is not a panacea. Plenty of depositors will look for returns more exciting than such banks will be able to provide. They will not always be good at pricing risk, and borrowers and lenders will still be subject to cycles of optimism and pessimism. Nevertheless, I am now sympathetic to the idea of narrow banking.
I do not want to end up by talking about banks, but about something far more fundamental. For there is something ridiculous about the present crisis - just as there was in the crisis of the early 1930s. Genuine problems arise when resources are scarce and there are competing demands on them. A problem of abundance (which is what we have) should be a rare cause for rejoicing – if only the monetary system did not get in the way. The attitude of the popular media, which treats the crisis as a natural catastrophe and tries to bully people into saving and scrimping, is a harmful absurdity. It reminds me of the Cambridge colleges which cancelled their feasts in the 1930s to help the economy, or the deluded people who write cheques to the Government to reduce the national debt.

There is something more specific about the present conjuncture. In early 2007, central banks and governments ran into a familiar dilemma when recessionary forces suggested that their economies needed a stimulus, but rising inflation suggested they needed a check. However often we have been in this situation, there is still no clear-cut answer about what to do. But with the plunge in oil and commodity prices, all that has changed. Inflation is rapidly coming down – even if the headline numbers still reflect lags in the disinflationary forces working through the system.

We cannot know how long this window of opportunity to stimulate the economy without stoking up inflation will last. It may be weeks or several years. Much will depend on whether, how soon and to what extent resource shortages reappear and impose new speed limits on world growth. But let us make the most of this window while it is still open.

I have a final thought which goes back to the “Austrian” economists.

Most of both the Chicago and the other US or UK-based economists of this school ultimately built their case for free competitive markets on consumer sovereignty, which they extended into arcane financial areas through concepts such as the “efficient markets” hypothesis. Hayek was different. He insisted on the importance of rules – general maxims of conduct as well as legal enactments – which embodied more inherited wisdom than any one person or group of persons could articulate from first principles or statistical studies. This attitude reflected his long residence in the UK and his respectful study of conservative thinkers such as Edmund Burke. He certainly accepted that inherited attitudes could be challenged, but one at a time and not through a repudiation of all history and tradition.

I have to admit that, for a long time, this traditionalism struck me as insufficiently radical; and I disliked its application to areas such as education or statute law. Conversely, little was said about globalised financial markets, which hardly existed at the time. It is, however, difficult to believe that Hayek would have approved of the disregard for time-honoured rules of financial prudence by bankers out to make a fast buck. Such distortions neither destroy the case for a competitive market order based on the rule of law, nor establish any kind of case for central planning – which, inevitably produces even greater perversions.

This essay is based on a talk given at the London School of Economics and Political Science in November 2008.
Peter Cooke

Some comments on the current scene and its antecedents

Peter Cooke is best remembered for his chairmanship of the so-called Cooke Committee at the BIS – more formally known as the Basel (then, Basle) Committee on Banking Supervision. He was responsible for formulation and introduction of the first risk-weighted capital rules for major international banks, now known as Basel 1. He was also Head of Banking Supervision at the Bank of England. Following his retirement from the Bank, he was for a decade chairman of the global regulatory advisory practice of PricewaterhouseCoopers in London. He has also been an advisor to and non-executive director of a range of banks and other financial organisations. He is a member of the CSFI’s Governing Council.

It would be a brave man who attempted a definitive analysis of the causes of the present turmoil. It would be an even braver one who offered a definitive recipe for a solution to the crisis. The debate will run for a long time. What follows are just some personal thoughts, drawing on past experience.

Three caveats should be applied to my comments. First, it is now exactly 20 years since I laid down my regulatory baton; the world has moved on and the financial environment has changed enormously. Second, I have no wish, in an “I told you so” mode, to add to the burdens of those who are currently wrestling with the challenge of restoring confidence and good order to the international financial system. Third, memory is fallible and large chunks of what could well be relevant background have disappeared into the deep well of recollection never to be recovered. But I plunge on nonetheless.

When I began my sentence as a bank supervisor in the mid-1970s, markets were very different to today. Globalisation had hardly begun to manifest itself. Supervisory co-operation between national bank supervisors (they still characterised themselves as supervisors, not regulators) was in its infancy.

Nevertheless, the aftermath of the first oil shock and the collapse of several banks, notably Franklin National in the US and Herstatt in Germany, in the early 1970s, persuaded the G10 Governors (whose banks at that time held 90 per cent of the world’s cross-border banking business) to anticipate and improve their ability to deal with shocks to the international system. This need was recognised particularly by the UK, which had had to cope with the fallout of the secondary banking crisis. The Governors’ debates at the Bank for International Settlements led to the formation of the Basel Supervisors Committee to maintain an overview of cross-border banking business, while a parallel body – the Euro-currency Standing Committee as it was then called – focused more on monitoring macro-economic developments. In the UK, at a national level, the governor’s eyebrows were still a potent force, and in the City the ultimate sanction was still to be blackballed from the Club. The UK, unlike many of its developed country confrères, still had no legislation covering the banking industry as a whole, only a smattering of laws governing certain aspects of business undertaken by banks. It could be said that the UK had supervision (of a sort) but little regulation, whereas other major countries had regulation – a framework of law covering banking businesses – but little ongoing supervision beyond monitoring certain legal imperatives.

It was all a very different world to today.

But change was on the way. The practice of banks keeping hidden reserves was increasingly being called into question. Competition and credit controls, introduced into the UK in the early 1970s, removed the earlier system of ceiling controls on bank lending, which acted as a prudential, as well as a monetary, control technique. Banks were set free to determine their own levels of lending, and the growth of the euro-markets greatly increased the wholesale funding element and the cross-border exposure within banks’ balance sheets. At the same time, these trends put pressure on banks’ capital adequacy and led to the supervisors’ efforts, in the 1980s, to achieve some capital underpinning to the international banking system.
- in particular through the provisions of the Basle Accord on Capital Adequacy in 1988 (or Basel 1 as it has come to be called).

In the subsequent 20 years, many of the changes then beginning to occur have moved on apace. Transparency has increased (most would say improved), enabling the marketplace better to assess the soundness of banking businesses, hidden reserves have gone, and the accountants have won the day on mark-to-market valuation - further reducing the banks' ability to cushion against shocks. Major banks (who may now be regretting it) persuaded the supervisors to agree to reduced capital adequacy requirements when “justified” by sophisticated modeling techniques, instead of being bound by the much cruder measures of Basel 1 - which they claimed unreasonably constrained their competitiveness and their profitability.

But, most significantly, those 20 years have seen an enormous growth in banks' access to a global funding wholesale deposit market, rather than relying on the traditional retail deposit base of banks’ non-banking customers.

All these developments, for better or worse, have reduced the ability of banks to run their own businesses soundly without being knocked off course by unanticipated macro-economic or macro-prudential developments. It has become more and more the case with this inter-twining of global banking business that, in the words of the Tom Lehrer song, “we’ll all go together when we go”.

There seem to me, however, to be two features of the banking industry that have not changed, and to which supervisors should always have careful regard.

The first is the herd instinct. Whatever the merits, or demerits, of a new technique or new product, bankers all too often feel they should follow their peers for fear of losing out to the competition. I recall a conversation with the chief executive of a UK clearing bank, at a time when some constraints on the expansion of lending were being advised by the Bank of England, who said that he could not afford to follow a more cautious policy because it might cause him to lose market share - which, once lost, was not easily recovered.

The second feature of the banking business, often quoted, is that bankers never learn from their predecessors’ mistakes. Similar misjudgments seem to be made every time a new cadre of management comes in and the macro-economic cycle comes round again.

On the first characteristic of bankers, when I was a supervisor I used to recount my supervisory nightmare. The scene was a mega international conference hotel at which a whole fleet of stretch limos was drawing up to the entrance, disgorging its cargo of prosperous bankers. On the back of each of the limos was an identical bumper sticker. It read: “Two million lemmings can’t be wrong.” Another recollection that demonstrates how bankers don’t change that much is from the time of the Mexican default crisis in 1982. I was in Toronto for the Annual Meetings of the IMF and World Bank. A senior central bank Governor quoted to me the comment of a very senior international banker who had said to him: “Times are terrible. Even those who cannot afford to repay have stopped borrowing.”

Turning to the present situation, I should like to comment briefly on four aspects. First, the interaction of monetary/economic and prudential policy; second, the interaction of capital and liquidity management; third, the role of capital in the banking system; and finally, the management and regulation of bank liquidity.

1. Monetary/economic policy vs prudential policy.
   The objectives of these two aspects of public policy can be in conflict. For instance, one of the early arguments for taking responsibility for prudential supervision away from the Bank of England was that it could find itself being pulled in different directions on policy issues – most particularly, that a need for monetary tightening could put undesirable pressure on banks’ balance sheets, and thus have an impact on the soundness of the system.

   This has never seemed to me a very powerful argument. I still believe that the different demands of monetary or general economic policy and prudential policy are best handled by a sensible balancing of the two within the same agency. Accordingly, it has always been my view that the supervisory role should not have been removed from the Bank. Furthermore, the financial stability role and the overall macro judgment that needs to be made about the state of the market as a whole, although not perhaps as much to the fore in the Bank’s priorities as they could have been in recent years, are best undertaken alongside responsibility for the supervision of individual institutions and within the same supervisory authority.

   Politically, this may not be a policy option now. But one possible variant could be to adopt some of the features of the German system, as I remember it, whereby the Bundesaufsichtsamts – the Federal Regulatory Agency – has
overall responsibility for the legal regulatory framework, but much of the contact with and supervision of individual banks is undertaken within the Bundesbank’s regional network. The tripartite arrangement introduced in the UK a decade ago is now widely criticized. It is fair to say that each party has a role to play, but I believe the responsibilities could be better drawn. I have always felt that a clear distinction can and should be made between, on the one hand, the systemic soundness of the banking system and the soundness of the individual institutions within that system and, on the other hand, the official regime created in response to the demands of consumerism and the official response to those pressures through consumer protection legislation and the day to day relationship between consumers and financial services organisations. Insufficient attention seems to me to have been given to this division of the different aspects of the regulation of financial markets: they are very different sorts of regulation.

I note in passing, with regret, that the old dictum of “caveat emptor” seems increasingly to have been consigned to the wastepaper basket.

2. Capital and liquidity adequacy. Capital adequacy has always been a cornerstone of the market - and of banks’ own assessment of financial soundness. In recent years, however, I think it has been overemphasised (perhaps because it is more easily measured) at the expense of liquidity adequacy - which, in “olden days”, was given equal prominence by the market and by banks’ own managements. It has been too readily assumed that if adequate capital can be demonstrated, liquidity will always be forthcoming.

When I first came into banking, more than 50 years ago, the major banks in the UK maintained a 30 per cent liquidity ratio in cash or readily liquefiable assets – principally UK Treasury bills or gilt-edged securities. I believe the current liquidity ratio of major banks – similarly defined – is in many cases below 5 per cent. How much better it would be for banks to have the old liquidity cushion or something like it, with indirect government support through open market operations, rather than direct intervention in the form of partial nationalisation. In our early discussions at Basel, the importance of the twin pillars of capital and liquidity adequacy were well recognized. But proposals on liquidity, seeking to explore possible common approaches to its management, always foundered because national regulations, the structure of national markets and the importance of different elements of liquidity for national monetary techniques and objectives made efforts at standardization much more difficult than in the case of capital. Maybe more effort should have been, or should be, devoted to standards for liquidity to run alongside those for capital.

3. The role of capital. Capital and liquidity, but particularly capital, are only buffers - a first line of defence. But capital itself is underpinned by confidence. If confidence is lost, then no amount of capital will save a bank, as recent events have shown. I believe it is correct to say that every bank that has failed in the last two or three decades met the supervisor's minimum capital requirement at the time.

Watching recent events, it has been very difficult to understand how the precise amount of new capital granted by governments to troubled institutions has been arrived at. Optimally, it should have been based on a supervisory assessment of the extent of the deterioration that has occurred in an individual bank’s balance sheet - and thus the amount of new capital required to plug the gap. Just as likely, I suspect, is that, with little time to make a detailed study of the book, it was rather the amount that, it was judged by supervisors, would be seen by the market as filling the confidence gap.

In the 1970s and 1980s, the major banks in France and Japan, to name but two, were trading happily with capital ratios of around 2 per cent. They could do this, in the case of France, because they were at that time nationalised and, in the case of Japan, because the markets believed they were part of “Japan Inc” - and that the Japanese authorities would always stand behind them. In the event, the Japanese pushed the boat out too far - and the subsequent correction led to the stagnation of the 1990s. In the same period, the capital backing of the Swiss banks was in excess of 10 per cent. These inequalities were mitigated, to some degree, by the Basel Accord of 1988 which introduced a significant convergence of major banks’ capital requirements. But I think that today there is still a considerable divergence in different parts of the world on what constitutes “adequate” capital to fit a country’s particular economic circumstances – witness the numerous efforts in many countries to bolster individual banks’ capital to different perceived desirable levels. In reality, after these moves, I suspect that there is now plenty of capital, on traditional measures, in most major banks. An increasing realization that this is the case may help open up banks’ willingness to lend to each other.

Basel 1 had only limited objectives: to level the competitive playing field and to establish a floor, or base, level of
capital adequacy for international banks to underpin the soundness of the international financial system. It had inconsistencies and some broad-brush generalisations, particularly on readings of risk. But it never pretended to be the last word: rather, it was the first step in assessing the soundness of a bank, and much more detailed assessment of other aspects of a bank’s business were required. And it was always promoted as a minimum level, not necessarily a sufficient level. But it came, perhaps inevitably, to have something of the character of a tablet of stone, and major banks began to wriggle under the supposed constraints it created through its application in different national regimes.

Basel 2, now up and running – albeit haltingly (although I am not sure where it is going) – is currently the name of the game. It goes much wider, of course, than just capital adequacy, with its more sophisticated analysis of risk and its emphasis on the other two pillars of supervisory controls and market discipline. It is no doubt a valuable aid to national supervisors against which they can test the adequacy of their own systems. But it seems to me to be too complex ever to be acceptable in its entirety as THE global system. Moreover, some very significant problems seem to have emerged in the first pillar of capital in particular, supervisor’s willingness to rely on the judgment of rating agencies and the banks’ own models in setting their standards.

4. The management and regulation of bank liquidity.
   I have already referred to some aspects of bank liquidity and the feeling that it has been perhaps the poor relation in recent years as far as regulatory attention is concerned. But the comprehensive collapse of the wholesale market in the current crisis has been an unexpected phenomenon, fuelled by the lemming-like behaviour of the banking sector and not forecast by even the most doom-laden pundit. Furthermore, I am not sure, even with hindsight, that the experience of earlier banking crises could have given clues to its likely severity.

The major new feature of the market in recent years has been the growing practice of packaging or wrapping assets, credit default swaps and all the associated exotica, and marketing them in such a way that the original assets (usually credit enhanced and given a status they did not always deserve) seemed to disappear into the ether; they could not easily be unbundled or tracked or, importantly, fully taken on board in assessing risk in the marketplace. This development has markedly exacerbated the merry-go-round of the wholesale markets - and has greatly muddied transparency overall so that it became very difficult for banks, faced with uncertainty, to judge the current strength of their counterparties in the market. At the same time, in an unprecedented peaceful decade in international banking, politicians were keen to see continuing growth in the real economy and were happy for banks to inflate their balance sheets to that end. Regulators in many countries took their eye off the macro-prudential consequences of this trend.

It was the unchecked growth of this new market and the associated acceptance of the trend by the regulators which, I believe, has had most to do with the unprecedented loss of confidence among banks, many of whose directors (either individually or collectively) have admitted to not fully understanding the new instruments being created or the risks being run. The sub-prime lending crisis in the US may have been a serious collective rush of blood to the head by the banking industry, but it can hardly have been the trigger for the global crisis without other underlying causes being present at the same time.

The growing culture of greed, which has seriously damaged public confidence in bankers, needs to be contained. Bankers themselves must pay more attention to the importance of balancing their responsibility to shareholders with that to their depositors.

So, we are where we are. It is inconceivable that the major banks in the developed economies will be allowed to fail. Hopefully, the injection of new capital into many of them will be sufficient to restore confidence and enable them to absorb the asset impairment that is yet to be fully revealed. But it is still difficult to judge what precisely is the amount of capital that will satisfy these conditions, or the liquidity regime that should be devised. Repairs to the system will almost certainly take some time and the international banking system will limp along for a while. In the UK, some public ownership was probably a necessary part of any effort to stabilise the market. Its undoing, however, will not be easy. Confident interbank lending has still not resumed and, looking forward at the moment, I can see no clear way to achieve the withdrawal of the public sector’s involvement - assuming, as I imagine most would agree, that this is a desirable medium-term objective.

One final thought. The global character of the crisis has raised the issue of a global regulatory body to oversee the global marketplace and to anticipate future systemic threats.

Interestingly enough, this brings us back to the seminal thinking behind the creation of the Basel Committee almost 35 years ago. But the market is so much bigger
- Beware the herd instinct among bankers. And remember: “bankers never learn from their predecessors’ mistakes”.

- The argument for taking supervisory authority away from the BoE were always weak. Even if the decision cannot be reversed, look at hybrid schemes – eg in Germany.

- We need to focus a lot more on liquidity – as we did 50 years ago. As for capital, the real issue is confidence – not whether a bank has hit a particular level of capital.

- Maybe it is time for some Really Big Think – a global organisation “with a macro-prudential brief to monitor, advise and influence trends and developments in the global marketplace”?

now and the players infinitely more numerous, so a more heavyweight body may be required – an international organisation, designed to be not a doctrinaire global regulator and rule setter, but rather one with a macro-prudential brief to monitor, advise and influence trends and developments in the global marketplace, with an authority that national bodies on their own cannot possess. This will not be easy to achieve. The seeds of such a body can be seen recently in bodies like the Financial Stability Forum at the BIS. But more teeth and weight (internationally agreed) will be needed. Creation of such a body may well need to become part of a global review of the panoply of official bodies contributing to the goal of sustaining international economic growth and development in a capitalist world, perhaps including redesign of the Bretton Woods institutions created for an earlier economic order. Grandiose stuff, but I suspect we will have to think big to get ourselves out of the mess we find ourselves in.
The world is in the throes of arguably the most complex and threatening financial crisis in 75 years, perhaps ever. One of the reasons for the complexity is that the financial systems of advanced economies have become increasingly more sophisticated and interconnected, particularly in the past two decades. As a result, resolving the present crisis requires a wider range of responses from regulators and governments across a broader range of institutions and markets than ever before.

Of course, some of the lessons from earlier periods of financial distress remain valid. Maturity mismatches and credit problems in the banking system have played a large part in present difficulties, as they have in the past. But this time, we have not just a banking crisis on our hands, but one that directly involves capital markets. This distinguishes it, at least in degree, from earlier emergencies going back to the 1930s.

As of January 2009, financial systems remain highly fragile, despite the unprecedented extent of the measures taken by governments and central banks. Matters would probably be worse without these actions. But the fact that the crisis has persisted, after huge injections of liquidity, massive capital infusions to financial institutions and dramatic monetary easing, is an indication of the difficulty and complexity of the situation.

A key issue is how far this financial crisis will impair the real economy. To the extent that it does, of course, financial conditions will receive a further negative blow. The more severe the recession, the greater the credit losses the banks will face. Still, bad though current prospects are, there are reasonable grounds to expect that there will not be a re-run of the 1930s. While the recession that began last year will probably prove to be the worst of the post-War period, it is not likely to become a full-scale depression, nor should the US and Europe suffer the same decade-long economic weakness as Japan in the 1990s. The reason is that policy makers have learned a great deal since the 1930s about how to respond to a severe economic contraction. The responses required include some combination of:

- flooding the system with liquidity;
- recapitalising the banking system;
- reducing interest rates rapidly; and
- expansionary fiscal measures.

This is much different from what was done in the 1930s. Then, following the stock market crash, orthodox economics favoured balancing the budget and allowing monetary disciplines to work. In the current crisis, monetary policy turned expansionary as soon as it became clear how serious the situation was. Central banks have aggressively cut interest rates and created liquidity. Budget deficits have already been allowed to increase, and there is little doubt this will go much further. In short, official policy has recognised the need to do “whatever it takes” to stimulate spending and recovery. None of this has yet arrested the decline in economic activity. But the willingness and ability of governments and central banks to do whatever it takes to get economies moving again should eventually prevent this recession from turning into a depression. The economic consequences are already severe, and may well get worse in 2009, but there is every prospect that the damage will eventually be contained by policy action.

Of course, dealing with the current crisis and reviving economic activity is only part of the needed response. There must also be a search for means to reduce the risks of future episodes of financial distress. It is not too early to begin the process of examining the vulnerabilities that led to the present difficulties and what precipitated the crisis.

There have been failings in many areas. A long list of vulnerabilities could be constructed, including:

- weaknesses in the “originate to distribute” model of financial intermediation;
- flawed credit ratings;
- lax underwriting of mortgages;
- global financial imbalances;
- mark-to-market accounting;
- perverse incentives in compensation structures;
- poor risk management in financial institutions;
- overly complex new financial instruments;
- inadequate regulation – and many others.

All these aspects of the functioning of the system have to be carefully analysed and improvements implemented. But it is also useful to consider whether there are some unifying themes that link these various shortcomings and help explain why national and international financial systems seem to be subject to periodic booms and crashes. For while there are undoubtedly many features that are specific to the current crisis, there are also many similarities with earlier episodes of financial stress. Perhaps the most fundamental is the tendency to procyclicality in the financial system. In part this may be due to basic human nature: the tendency to swing from excessive optimism to excessive pessimism (or the alternation of greed and fear), and the willingness to believe that “this time it’s different”. But there are also aspects of the working of financial markets that tend to create or amplify underlying economic cycles.

When some positive development occurs that causes an economy to begin to expand, asset prices start to rise, collateral values increase and market participants benefit from leverage. This encourages financial institutions to lend more, which in turn allows a further expansion of activity and bidding up of asset prices. Leverage, made possible by financial intermediation, and facilitated by specialised instruments, adds to the process. Those that are highly leveraged see the returns from investment augmented and the apparent risk of their activities decline. A seemingly virtuous circle is created, in which the internal dynamics of economic behaviour add to the boom.

But of course, at some stage, an outside event occurs that causes market participants to question the sustainability of indefinite upward movement and pushes the process into reverse. The virtuous circle then becomes a vicious downward spiral.

Financial institutions are not unaware of these dangers, but the risk management techniques they have employed to guard against them have historically proved inadequate. To simplify somewhat, statistically-based risk management relies on the twin assumptions that the future will be more or less like the past, and that risk profiles can be continuously adjusted in liquid markets. These assumptions, which were always dubious, have been comprehensively contradicted in the current crisis.

Financial prices regularly display movements that conventional statistics suggest should occur only once in millions of years. And market prices have discontinuities that should not exist if markets were truly liquid.

Risk management, moreover, often fails to take into account endogenous sources of risk. For example, capital requirements, which are one of the main foundations of financial regulation, are based on an assessment of the credit quality of an asset portfolio at a point in time. They do not adequately take into account the risk of a downward migration of credit quality as an economy slides into recession. Nor do they allow for the changes in market conditions that occur as the actions of one player cause prices to move and other players to respond.

Take the bursting of the housing bubble in the US. Those exposed to deleveraging had to liquidate assets to reflect funding constraints. But the sale of assets resulted in lower asset values, which of course reduced the equity held by other companies, causing them to deleverage in the same way. Deleveraging fed into declining asset prices, drying up liquidity and perpetuating a downward spiral. Almost inevitably, the capital markets froze up.

So risk management policies failed because they did not anticipate the inability, in this situation of frozen markets and no buyers, for positions to be adjusted on a real-time basis. And they did not appreciate the interconnectedness amongst institutions, not just through their direct lending but through their dealings in capital markets.

The regulatory system has also suffered from similar shortcomings. First, it did not cover important non-bank players in capital markets. The activities of these institutions can be similar to those of banks in causing shifts in asset prices, liquidity and other market conditions. Hedge funds are the most obvious example, but there were also insurance companies, such as AIG, and industrial companies, such as GE Capital. Indeed, any large company with its own treasury department buying and selling instruments qualifies as a participant.

A second shortcoming of traditional prudential regulation is that it focused on micro-prudential vulnerabilities without taking adequate account of the macro-prudential picture. Supervisors concentrated on whether individual institutions had the capital to protect themselves, rather than on a macro assessment of the system as a whole.
So while they knew about the credit quality of a bank’s balance sheet, they were relatively less focused on how that credit quality would be affected by generalised market turbulence, or on how a credit portfolio could be funded under stress conditions.

Neither private financial institutions nor their regulators anticipated the conditions under which markets would cease to function normally. The implicit assumption was made that if a bank or another financial institution had solid assets, it would always be able to fund itself. It was not recognised that where complex securitised assets are concerned, there is no fully satisfactory way for an outsider to judge the quality of the asset. In the presence of such uncertainty, market participants often simply withdrew from the market. Assets lost liquidity, values dropped and funding dried up. We saw that with Northern Rock in the UK, and then with Bear Stearns and Lehman Brothers in the US.

Given the above systemic failings exposed by the financial crisis, new approaches to regulation will be needed if the global financial system is to be more stable in future. These new approaches will need to deal with some of the root causes of the procyclicality in the financial system and will need to buttress the forces that promote macro-prudential (or systemic) stability.

The first line of defence against crisis is an adequate level of capital in the financial system. This requires a re-assessment not only of the absolute quantity of capital, but also the risks that capital cushions might be called upon to meet. Regulation will need to develop metrics to measure liquidity risks in the system, and propose techniques (including appropriately adjusted capital cushions) to protect against them. Regulation will also need to better assess ways in which market dynamics can translate into unexpectedly severe price movements and the potential for systemic stress.

We also need to examine ways in which the vulnerabilities that contributed to the present crisis, vulnerabilities that built up in the good times of economic expansion, are adequately contained in future. One technique that may be worth examining is to restrain the build up of imbalances by the use of additional capital requirements in periods of rapid credit expansion. It may be difficult confidently to distinguish a sustainable from an unsustainable boom, but it is usually the case that asset price rises accompanied by rapid credit expansion have a greater risk of bursting in a potentially disruptive way.

This would be one way of limiting excessive leverage. It may be worth considering other alternatives as well, such as a suitably defined overall leverage ratio, loan-to-value limits for particular contracts (eg residential mortgages), and so on.

Given the role complex structured instruments have played in the current crisis, some have advocated stricter controls over the use of these instruments. While this reaction is understandable, it would not necessarily improve the functioning of the system. The problem has been not so much the complexity of the instruments as the failure of their users to understand properly the risks involved. So the more appropriate approach is to ensure that regulatory incentives and corporate governance practices encourage more disciplined approaches to risk taking, and the maintenance of a suitable cushion of capital against the risks that remain.

The more capital is held in the system, not just by banks but by other participants, the safer the system is likely to be, and the less liquidity transformation takes place the safer the system is likely to be. One needed reform is to ensure that important players outside the banking system are subject to similar risk-management disciplines as banks. This can be achieved by some combination of direct regulation and indirect regulation through dealings with regulated counterparties.

We probably need, therefore, to look at all of the elements of what is sometimes called the shadow banking system, as well as at the off-balance-sheet activities of regulated institutions. This would include capital market participants that are non-banks – insurance companies, large industrial companies with big treasury departments and private pools of capital – hedge funds and private equity firms.

In some cases, this might mean transparency rather than capital regulation – it is very difficult to regulate hedge funds because they change their positions quickly on a real-time basis. But by enhancing the degree of transparency in the large private pools of capital, it would be much easier for other participants in the market to see where the vulnerabilities are building up. One such example might be “crowded trades”, where many institutions have made similar directional bets on particular developments and there is a vulnerability if those bets turn out to be wrong.

Besides the question of the content of future regulation to enhance stability, there is also the question of who should regulate and who should have the primary responsibility for dealing with systemic crises. This has become a huge issue.

Hitherto, most observers have seen central banks as being at the centre of crisis resolution. In one sense, this remains true. Central banks have always had injecting liquidity into the system as part of their crisis-resolution arsenal. The original formulation of this responsibility is in Walter Bagehot’s *Lombard Street* – central banks should lend freely in a crisis, but only on good collateral. The corollary was that central
banks should not provide solvency support, nor should they lend outside the banking system.

But today’s situation is complicated by the fact that it is not a bank-based system any more; it is much more capital market-based. Simply providing liquidity to banks is not enough because the banks do not just need liquidity, they need more capital and an ability to unload some of their weak assets.

So crisis resolution has involved much more capital support of the banking system. Public-sector lenders have been taking credit risk on banks and, with government involvement, this is all being brought into the political process. Additional government spending is another stimulus and all of these elements represent a much broader package of crisis resolution than has typically been the case in past financial crises in developed countries.

The agencies responsible for crisis resolution need to improve their co-operation now that this is in the hands of the public sector in the shape of treasuries, central banks and non-central bank regulators. Much stronger mechanisms are needed than have existed in the past to ensure that those three are all pulling in the same direction.

In the case of the UK, there is a tripartite system whereby the Treasury, the Bank of England and the FSA are supposed to meet and work out a common approach to crisis resolution. That obviously did not work perfectly in the case of Northern Rock, and the British authorities are now engaged in strengthening that co-operation.

In the US, the spreading crisis has been dealt with through an ad hoc series of measures, not all fully consistent with those that went before and came after. The Federal Reserve has been at the centre of crisis management; but the government has had to intervene with enormous public resources to support the financial system.

The huge public sector involvement as provider of capital for the financial system sets up a medium term “exit problem”. Once the system is stabilised again and the economy begins to recover, how do we get the public sector out of the financial system, and what is the degree of involvement for the long term?

Government has taken large chunks of preferred shares which are convertible into equity in all sorts of financial institutions. The institutions may eventually reclaim full ownership, but it will be very difficult to turn the clock back completely having once intervened to save the financial system.

From a global perspective, there has been much debate on whether a new Bretton Woods is needed to prevent future crises. One needs to realise, however, how much the global economy has changed since the days of Bretton Woods.

When the Bretton Woods international financial system was established in 1944, there was relatively little capital flow between countries and most of the key decisions on exchange rates, capital movements and balance of payments adjustment were carried out by governments.

Sixty-five years later, we have moved from a government-directed system to a market-determined one. By and large, exchange rates float, international capital flows take place through unregulated private markets, and market forces take care of ensuring the consistency of developments in different countries.

A new Bretton Woods would have to take account of the fact that it is market forces that allocate resources, in particular financial resources. Insofar as official policies have an impact on the process, the key role is played by those responsible for regulating financial institutions and markets. This means that regulators are much more influential now than they were when the original Bretton Woods system was established. We see that in the powerful committees of regulators such as the Basel Committee and the International Organisation of Securities Commissions (IOSCO).

For this and other reasons, it would not be practical in this multi-dimensional world, with many different sources of power and influence over the way in which markets work, to come up with anything as ambitious and all-encompassing as a new Bretton Woods system. What is more feasible is to work on the way in which the existing system is regulated and try to remove the sources of instability and strengthen the forces of stability.

This probably means working on co-operative consultative international mechanisms rather than trying to come up with new powers for a new international organisation. We are nowhere near to having a political consensus that would allow the creation of a global financial authority.

We do have the Financial Stability Forum, based at the Bank for International Settlements in Basel, which brings together senior representatives from national and international financial authorities. It was set up in the wake of the Asian crisis 10 years ago. It is the only international grouping that brings together regulators, central banks and finance ministries. There is, a fortiori in the present crisis, a need to strengthen collaboration between those three groups.
The FSF does have weaknesses, however: it was based on the G7 so it does not have a wider international legitimacy. It also lacks any decision-making authority – it is, as its name implies, a forum.

So it is not the answer, but it is a mechanism which has helped to point out weaknesses in financial systems and this has helped to co-ordinate responses to dealing with these weaknesses. It should be a central feature of arrangements to strengthen the stability of the international financial system. The FSF, with suitable changes in its membership and governance, could have three purposes:

- First, to ensure that financial regulation takes proper account of overall systemic stability objectives. For example, the FSF could be used as a means to check the stability properties of regulations proposed by the Basel Committee and the International Accounting Standards Board. It could provide a check on the prudential rules established by the financial standards setters to ensure that those standards are both internationally consistent and globally stabilising.

- The second function could be a kind of early warning system for vulnerabilities in the global financial system to bring to the attention, (and hopefully prompt the action) of governments when there are potentially destabilising developments. Problems always build up in good times and materialise in bad times, so the challenge is to get attention and action in good times because nobody, in my experience, really wants to be told the problem is building up.

- The third function could be harmonising crisis responses. Consider the haphazard and inconsistent way in which financial guarantees were provided to banking systems in the current crisis. The Irish government guaranteed all deposits of Irish banks, which immediately caused an outflow of funds from the UK to Ireland, and so the UK had an even more sweeping guarantee, which then caused problems elsewhere.

At the very least, the FSF could provide for information exchange and hopefully more orderly co-ordination of policy responses in time of crisis. I am not naïve enough to think that there would be a fully consistent international response, but that would be one way of trying to harmonise responses.

I would also advocate strengthening the International Monetary Fund so that there could be some mechanism to moderate the kinds of global balance of payments disequilibria that probably played a contributory role in this crisis. China had huge surpluses, and the recycling of those surpluses into the United States probably helped to keep interest rates low in the US – creating the demand for mortgage-backed securities that kept the housing boom going for longer than it might otherwise have done.

If the IMF had been allowed to play a stronger role in helping prevent the acceleration of Chinese surpluses and the maintenance of the US deficit, it would have been a good thing.

In summary, I do not believe there is a magic bullet in a new global financial authority, both for political reasons and because the financial system is much more complex than when the Bretton Woods institutions were created. However, there is room to strengthen the co-operative mechanisms that were allowed to atrophy in a prolonged period of benign economic conditions.

- Common features of this and other crises include;
  - a tendency to pro-cyclicality in the financial system; and risk management depends on assumptions that the future will resemble the past and that markets will remain liquid.
  - The unique feature is that this is not a bank-based system any more. It is capital market-based.
  - Regulators tended to miss important non-bank players in capital markets. They also focus on micro-prudential issues, and often miss the macro.
  - Looking forward, regulators will have to address liquidity risk and may have to impose additional capital requirements in periods of credit expansion. And they must capture the ‘shadow’ banking system.
  - We need stronger international regulatory cooperation, with new agencies involved.
  - What about the ‘exit problem’? How do we get the public sector out of the financial system?
  - Don’t try to build a second Bretton Woods; work with the existing system – eg the FSF and the IMF.
Over the past quarter century, we have experienced periods of debt crisis and systemic disruption in the international financial system about a half-dozen times, depending on your definition. Do these tumultuous experiences provide useful insights for dealing with today’s debt and financial system problems, and for designing an effective and smoothly functioning financial system for the future? Look, as one example, at the Latin American debt crisis which began in the early 1980s - one of the earliest and biggest crises of the period, which included a number of Latin American debtor nations and also spread later to Eastern Europe and to the Philippines.

The environment of the early 1980s was in some ways similar to today. It was a period of huge growth in international imbalances, reflecting the oil crisis of the 1970s, which had caused developing countries and others to be suddenly faced with finding ways to pay massive bills for oil imports. It was also a period of huge growth of international liquidity, with oil producers accumulating vast financial reserves and searching for investment opportunities.

Those conditions contributed both to a massive build-up in demand for international financing by Latin American and other developing nations, and to a massive supply of available liquidity for financing. The result was over-lending by creditors and over-borrowing by debtors - the accumulation of very large debts, much of them denominated in dollars and based on floating or short-term interest rates, at a time when interest rates had risen to levels much higher than a few years earlier.

As with so many financial problems, probably the best way of dealing with the 1980s debt crisis would have been not to let it happen in the first place. Bank regulators saw the build-up in debts to Latin America, but did little to stop it. In creditor and debtor countries alike, there had been widespread tolerance of the sovereign debt build-up after the oil crisis - reflecting a legitimate concern that to require oil-importing LDCs to adjust too abruptly to the oil price shocks would risk deep depression and beggar-thy-neighbour policies in the oil-importing world, and that it would increase world-wide payments problems.

As soon as the debt crisis started - with Mexico announcing in August 1982 that it was unable to meet its debt-servicing obligations - creditor and debtor governments initiated intensive discussions with all the parties to seek appropriate ways of dealing with the problem.

In time, officials and financial market participants were able to hammer out imaginative and acceptable solutions, based on certain important principles:

1. First and foremost, those managing the process, in particular the official representatives, placed major emphasis on keeping the financial system alive and functioning. This prime objective over-rote other objectives and reflected the enormous magnitude of the 1980s debt problem, with many Latin American nations endangered and with the banking systems in the US and elsewhere highly vulnerable. This emphasis on keeping the system going meant assisting both sides in maintaining flows of funds, at least at some level. On the debtor side, short-term financing was at times arranged if there were a danger of imminent default; on the creditor side, regulators in the US and elsewhere engaged in “regulatory forbearance”, so that bank balance sheets adjusted gradually, rather than abruptly, to the risks that the banks had assumed on these loans.

2. Those managing the process showed considerable imagination in creating individual creditor committees for each of the debtor countries, providing a useful framework for testing different approaches and ideas, and facilitating negotiations for working out new approaches to novel and complex issues.
3 A range of governments, international institutions and other bodies participated in helping to craft and support workable agreements. Creditor governments and central banks played a major role, serving as brokers in pressing both sides to make reasonable accommodations to reach workable agreements, and at times providing some (mainly temporary) financing to prevent defaults and keep the system functioning. The IMF played a central role, providing its financial assistance in ways that would encourage the parties to strengthen macro-economic and other policies of the debtor countries, encouraging actions by both sides to reach agreements on payments and reschedulings, and helping to compel co-operation by the small number of banks who tried to be “free riders” and not provide their share of financing.

4 Care was taken to deal with the debt problem at a measured pace - slowly, carefully, one step at a time. Those managing the process sought broadly equitable treatment for all participants, using the same basic principles, while showing some flexibility in adjusting for different circumstances in different cases. Gradually, over almost a decade, in a process of three distinct phases, the debt problem was brought under control and finally ended in the early 1990s, with the remaining less liquid debts swapped into marketable obligations.

Thus, the result of much effort by the many parties involved in the 1980s debt crisis was, in time, a successful negotiation and resolution of the major Latin American government debt problems. But that did not mean that after a decade of successful hard work and pain, we had found the key to all of the secrets of how to deal with such crises. We might have hoped that the market had learned and that governmental institutions had learned - and they did. But soon after the 1980s crisis had ended, it was followed by the Mexican crisis of 1994, then the Asian and Russian crises, and so on. Resolving the Latin American debt crisis did not provide us with a solution that would enable us to prevent or easily resolve all future debt crises.

Indeed, one conclusion of our experience of the past quarter century is this: debt crises are like Tolstoy’s unhappy families - every debt crisis is a crisis for its own unhappy reasons in its own unhappy way.

What about today?

At the present time, we are once again in the midst of a serious financial crisis. But in looking for solutions, we cannot regard today’s crisis as the same as the Latin American one. The differences between the underlying financial environment then and now, between those past debts and our present debts, between the macro-economic issues of that period and the current period, are important and immense.

How the underlying financial system has changed

The underlying financial structure has, of course, changed profoundly since the 1980s. We have experienced a prolonged period of huge and rapid expansion in the entire financial sector, reflecting globalisation, deregulation, an explosive move into financial engineering with complex and opaque new instruments and techniques, rapidly growing macroeconomic imbalances and liquidity, much borrowing and much lending. The financial sector’s pursuit of ever increased business activity – more and more transactions of larger and larger size with higher and higher yields - has led to an enormous rise in financial risk-taking and greatly increased leveraging in banking and other financial institutions.

As Nancy Jacklin (former US executive director at the IMF) put it, we have replaced our credit culture with a trading culture - with financial intermediaries focusing on the amounts the assets they acquire can be sold for in the short term, and with less attention to what the intrinsic value would be in the longer term. We have tended towards becoming a culture of day traders and speculators, and we did not always see the risk in our behaviour because of the long period of appreciating asset values that we were experiencing. As Peter Fisher (former Under-secretary US Treasury) said, the credit process became grounded not in analysis of lender default/ability to pay, but almost wholly on the basis of the market value of assets provided as collateral.

On top of this, we have adopted changes in accounting and risk management practices that arguably may reinforce excesses in certain situations:

- It is widely held that present mark-to-market rules can encourage the trading culture, overstate the strength of a bank’s condition when asset prices are rising but, particularly in situations when assets are illiquid, understate values and force rapid deleveraging when asset prices are falling. It is recognised that mark-to-market can help to fairly present the value of the business of asset trading, but there are many questions as to whether it is appropriate for all financial institutions in all situations. Moreover, in illiquid markets, efforts to mark-to-market have sometimes been derailed with accusations of “marking-to-muddle” and “marking -to-myth”.

- Mathematical models for trading strategies and risk management may also not always perform as well as
desired. It has long been recognised that probability formulas for measuring volatility, which originated in the world of physics, do not always perform as well as desired in some financial markets. There can be problems of not having a long enough period of history covered, or enough transactions to provide a reliable record for calculations. It may also be that, unlike the world of physics, financial markets may be influenced not only by random events, but also by the actions of individual market participants who can change their minds as events unfold. There are many stale jokes among traders about “Oh yes, a two-sigma event happens only once every fifty years - we had three of those last Wednesday!”

- Many financial institutions have modified their activities in ways that may add to risk: much larger amounts have been shifted “off balance sheet” and the scale of leverage has been sharply increased. In addition, the performance of rating agencies and oversight by regulatory bodies have become more difficult and less rigorous— and therefore less effective—in an environment of extraordinary levels of activity, complex financial engineering and, importantly, widespread opaqueness.

During the period when these practices were developing and increasing, there were strong incentives for market participants to join in. No one wanted to stop the party, or to stick to traditional intermediation practices, at the risk of being left out of a system in which everyone appeared to be prospering.

**How the debt structure has changed**

With these major changes in the financial environment, the size and structure of international debt have also been transformed since the 1980s.

The debts that were the cause and focus of the 1980s crisis were, in a word, transparent. They were known and clearly defined in terms of participants, structure, amounts, terms and conditions. They were mainly the debts of Latin American governments - sovereign debtors, not private debtors - and had resulted from loans by banks, not other creditors, with the originating banks still holding the bulk of the loans on their own balance sheets. Although a large number of banks had some piece of that debt, the bulk of it was in the hands of a limited number of major international banking institutions. It was, therefore, possible to deal directly with the main interested parties - to get representatives of both debtors and creditors together in a room, along with, when appropriate, the IMF, creditor governments and others, and work together to exchange views and ideas, make proposals, and try to hammer out acceptable compromise solutions.

That was vastly different from today’s troubled debt structure, which is characterised by its opaqueness. Nowadays, debt is huge in amount, and widely dispersed (and redispersed) throughout our large, deregulated and globalised financial system. Risk has been transferred (and retransferred) through a host of complex new financial instruments, with little transparency not only to the public but even to the participating parties and the regulators.

**How the US macro-economic environment and policy issues have changed**

Another major difference from the 1980s in the US and a number of other creditor countries is that today we face a particularly difficult set of issues related to the formulation of policies to deal with the credit crisis and manage our economies.

The full magnitude of the problem was not generally a matter of concern as the debts were accumulating. But now there is widespread acceptance of the need for remedial action. Specifically, concerns have been raised in many quarters about the present strength and soundness of many financial institutions.

One way to think of the problem is to see the massive outstanding credits of financial institutions in the US and many other countries as a serious problem of over-leveraging. Our banks and other financial institutions have a much higher level of leverage than at earlier times, resulting from the huge increase in the volume of transactions, without comparable increases in the banks’ own capital. Widespread concerns have been expressed that a number of financial institutions are dangerously stretched and over-leveraged.

But at the same time, we also face the major problem that the US and much of the entire world is in a serious recession, by all accounts the worst and widest recession in many decades; and many are of the view that that this recession will continue (and perhaps worsen) for several more years.

Thus, in the US, we must simultaneously deal with problems of:

- excessive debts;
- over-leveraging - not only by our banks and other financial institutions but also by home-owners and other consumers; and
- a major recession.
There can be a serious issue of conflict in the policies called for to meet our different objectives. For instance, concerns about excessive debt and over-leveraged banks would normally call for reduced lending by those institutions and deleveraging; but the simultaneous concern about deepening recession would argue against deleveraging – and, indeed, would call for increased lending. The US authorities must make sensitive decisions and carry out nuanced policies to try to meet these varying and sometimes conflicting goals. In today’s unprecedented circumstances, there have been new and unfamiliar steps - the introduction of the TARP (Troubled Asset Relief Program) and Treasury and Federal Reserve lending actions to assist certain financial institutions and impaired financial markets in particular situations. Also, in this novel environment, there have been some switches and reversals in policy moves, as the authorities try alternative approaches in their search for ways of dealing with these conflicting problems.

Pressure is also strong to make other moves for the purpose of building a stronger and more viable financial system. Many have expressed interest in proposals to strengthen the role of the regulators and to reverse some of the past deregulation, or to limit some of the complex new techniques and financial engineering, in the search for ways to contribute to a stronger system for the future.

However, in comparing today’s financial crisis with the Latin American debt crisis of the 1980s, we should recognise that there is a basic and fundamental difference in the consequences of the two crises:

- The 1980s crisis was clearly defined, transparent and focused on loans to a limited number of foreign sovereign borrowers. In that case, under those conditions, it proved possible to contain the crisis and prevent it from broadening into a full-blown financial panic and systemic collapse.
- The present financial crisis has worked in the opposite way. It is amorphous, opaque, and widely dispersed - embracing a broad range of problems, related not only to foreign debt but also to vast US debt, associated with the collapse of the residential real estate market and other factors. Coupled with uncertainties about credit risk and financial system viability, this has culminated in a full systemic financial crisis. In the present case, negative feedback from the massive credit market disturbances have adversely affected our economy in a fundamental way.

In summary, in the 1980s, it proved possible to contain the debt crisis and prevent it from broadening into a full systemic crisis, whereas in the present case, powerful negative feedback from the credit crisis has affected the entire real economy, and on a global basis.

Learning to deal with international crises is a complex and difficult matter.

Certainly, we need to learn from the past. But we need to learn it well - which experience applies today, which experience does not, how it should be used or not used? From youth, we are taught to learn from the mistakes of history so that we do not have to repeat them; but we are also cautioned not to be a general fighting the last war. But learning from the past is the easy part. We need to take account of much more than the lessons of the past. As the experience of our present credit crisis shows, we need to be fully aware of the present - the world we live in.

The authorities must know the structure and trends of the economy, and be fully informed of all aspects of the financial markets and how they are functioning, in order to make the sensitive and subtle decisions that are required. They must also take account of the future, including the structure of a more viable financial system, looking for likely future trends and developments in a changing world.

Thus, managing international financial crises calls for a multiple focus and widespread observation - we need to learn from the past, understand the present, and anticipate the future.
Mervyn King, bracing himself to lend money to banks against tram-tickets, can reflect that he and the Bank of England have been here before. In 1825, his predecessor, Jeremiah Harman, had to pull out all the stops. London’s banks had overreached - one of them raised £200 million for the Republic of Poyais, which turned out not to exist - and panic had followed. “We lent by every possible means and in modes we had never adopted before”, Harman said afterwards. “We made advances to an immense amount and we were not on some occasions over-nice. Seeing the dreadful state in which the public was, we rendered every assistance in our power.”

Forty years later, when the most trusted private bank in England, Overend, Gurney & Co, sank and threatened to suck others down with it, Walter Bagehot drew the moral. In *Lombard Street*, his classic account of the money market, he made an analysis of panic and prescribed a remedy. At first, he said, it amounts to a kind of vague conversation: is A.B. as good as he used to be? Has not C.D. lost money? The rumours spread, the lenders run for cover, the market dries up. A panic grows by what it feeds on. The cure, Bagehot said, was to make money plentiful. The Bank, as lender of last resort, must draw on its reserves – “a kind of ultimate Treasury, where the last shilling of the country is deposited and kept” – to lend when no-one else will. That is what it is there for. The lender must take security and charge a proper rate of interest, but above all it must not hold back. In time, calm will return, credit will revive and all will be well again.

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Nonsense, said Thomson Hankey - economist, Member of Parliament, sometime Governor of the Bank and author of a guide to London restaurants. It was mischievous to suggest that the Bank should keep money on tap to help flighty bankers out of trouble. This would only encourage them: “Unless such a doctrine is repudiated, the difficulty of pursuing any sound principle of banking in London will always be very great.”

Banking was not in itself a difficult business, said Hankey, so long as the would-be banker learned the difference between a bill of exchange and a mortgage. Forgetting that difference or ignoring it - treating a mortgage as though it were as close to cash as a cheque, processing the mortgages, bundling them up, buying and selling them on the same false assumption - turned out to be the downfall of ambitious bankers on both sides of the Atlantic.

Hankey had warned them:

“Ready money is a most valuable thing. Everyone is constantly endeavouring to make it profitable and at the same time to retain its use as ready money, which is simply impossible. It is the constant attempt to perform this miracle which leads to all sorts of confusion with regard to credit. The Bank of England has long been expected to perform this miracle. It is the attempt to force the Bank to do so which has led to the greater number of the difficulties which have occurred on every occasion of monetary panics during the last twenty years.”

On every occasion, so he might have added, some hapless banker would be sure to call it unforeseeable.

Over time, Bagehot prevailed, and well over a century later his argument still holds the field. *Lombard Street* remains in print and makes vivid reading, but Hankey’s *Principles of Banking* is a rarity¹. My copy used to belong to the United States Treasury, and we must hope that its library has kept a duplicate, for the Treasury’s masters can now see what happens when sound principles fly out of the window.

Alan Greenspan is the central banker who pushed Bagehot’s doctrine as far as it would go, and further. At the US Federal

¹ Actually, it was reprinted by Bastian Books (Canada) in 2008 – in an apparently large-type edition. AH.
Reserve, he was thought to display supernatural powers as he pulled off rescue after rescue. His warnings against irrational exuberance were disregarded. Surely everything would be all right, so long as he was there? The markets came to know this as the Greenspan Put: heads we win, tails he sees us through.

When the dotcom bubble burst, at the turn of the century, Greenspan moved in to rescue the market with cheap and plentiful money. Soon enough, this found its way into American house prices, and a new bubble began to inflate.

Bankers sought to profit by it, inventing new kinds of paper to trade with each other and multiplying their risks. Greenspan looked on, gnomically. Central bankers, he explained, should not be expected to spot bubbles - just to mop up the mess when they went pop.

An earlier Fed chairman, William Martin, saw it differently: “I’m the man”, he said, “who takes away the punchbowl when the party’s getting good.”

This, of course, did not make him the party’s most popular man. Central bankers, like other bankers, ought not to aspire to popularity, but sometimes they do. The Bank for International Settlements, which is their own central bank, warned them against ‘asymmetrical’ policies: “Failure to respond to these imbalances” (by which the BIS meant bubbles) “either using monetary policy or another instrument, may ultimately increase the risk of both financial instability and subsequently deflation.” How tempting for central bankers to believe in a new paradigm where this would never happen.

Martin, in his day, was something of a Hankeyist. Mervyn King is another. He rebuked the banks for their excesses, he flagged up the risks they were running, and he warned them that every rescue made the next more likely.

How they resented it. When their troubles came on them, a year ago, and multiplied, they hurried to blame him. He still gave them the textbook Bagehot treatment. They could borrow from the Bank, at a proper rate of interest, but on an ever-rising scale. As time went on, he became less selective about his security. Still the contagion of fear spread, as Bagehot foretold, from the lesser names to the greater. In the end, the remedy proposed went beyond Bagehot and was something new in Lombard Street.

Instead of borrowing more from the lender of last resort, the banks needed to strengthen their balance sheets and qualify to borrow more from other people. Under stress twenty years earlier, they had turned to their shareholders to raise more capital - the annual rights issue (as the wags explained) to pay the dividend. More recently, new shareholders were lured in - and winced as their investments went downhill. Some banks found that the supply of willing backers had run out, and were within hours of closing their doors. Enter Her Majesty’s Treasury, armed with every last shilling in the country, as the investor of last resort.

So, all these years later, Bagehot and Hankey are still at odds – and, of course, they are both right.

It was Bagehot, after all, who said that the mistakes of a sanguine manager are far more to be dreaded than the thefts of a dishonest manager. How the banks fell over each other to hire sanguine young engineers to devise new ways of losing money - as if the old ways had not worked perfectly well. Hankey thought that good banking would only flourish so long as bad banking was punished - and that, he might now have added, goes for central banking, too.

It was complacent of the Fed to keep the punchbowl filled as the party grew more hectic. It was wrong that the Bank of England had to measure inflation by a yardstick from which Gordon Brown, as Chancellor, had cunningly excluded house prices. The cost of housing is the biggest single element in the cost of living, but the Bank was formally instructed to ignore it. No wonder that it gave mixed signals to the great British house party. When King tried to hold the punchbowl back, he was voted down, with his chief economist in the majority. Central bankers, from now on, will watch for bubbles.

It will, no doubt, be a while before the next bubble inflates, and the banks - the survivors, at least - may have been sufficiently frightened to find their way back to sound principles. Flighty banks have flown into the ground; banks with an old-fashioned preference for ample reserves and deposits now find themselves vindicated. Hankey rides again - that is to say, until next time.

An earlier version of ‘Thomson Hankey rides again’ was published in Spectator Business.
Charles Goodhart is the nearest that UK academia has to the US model of a first-rate theoretical economist who refuses to be imprisoned in his ivory tower and who demands a role in economic and monetary policymaking. From 1985 to 2002, he was the Norman Sosnow professor of banking and finance at the London School of Economics. He is a former member of the Bank of England’s Monetary Policy Committee and co-founder (with the present Bank Governor, Mervyn King) of the Financial Markets Group. He also spent 17 years as a monetary adviser at the Bank of England, becoming chief adviser in 1980. He is a member of the CSFI’s Governing Council.

In several respects, the nearest analogy to the financial crisis that began in 2007 is the Latin American debt crisis of 1982. Then, as now, a whole category of loans made by the large international banks, loans which had previously been highly profitable and successful, went sour. Then, it was sovereign loans to LDCs (mostly in Latin America); now, it is sub-prime mortgages. Then, as now, the focus of the crisis lay with the money-centre banks in New York, but participations (in the syndicated loans) spread to the major banks in the UK, Germany and Switzerland. Then, as now, these large international banks, especially those in New York, were widely rumoured to be insolvent, should a mark-to-market accounting approach have been applied to their assets.

Then, as now, events were enlivened by a memorable, but misguided, quote from the CEO of Citibank. Then, it was Walter Wriston’s dictum that ‘sovereign countries do not go bankrupt’; this time, it was Chuck Prince’s statement that, so long as ‘the music’ kept playing, Citibank would continue ‘to dance’. Perhaps an essential protection against future crises is to ensure that any future CEO of Citi has no gift whatsoever for turning a memorable phrase (if there still is a Citi).

Be that as it may, a potential financial disaster in 1982 - which could easily have been as bad, or even worse, than 2007-08 - was prevented, by excellent crisis management, from entering a self-amplifying spiral of deleveraging and asset price falls, such as has led to the present credit crunch. How was this achieved? It was done by the use of mechanisms that, since the 1990s, have been roundly condemned as improper - to wit “evergreening”, forbearance and non-transparent (i.e. not mark-to-market) accounting.

Start with evergreening. The countries that had threatened to default (Mexico, Argentina and Brazil) were, in effect, offered new bank loans, whose major, perhaps sole, purpose was to enable them to continue current payments on their existing loans. Naturally, some of the Western banks, especially smaller members of the syndicates, demurred at the thought of throwing good money after bad. At which point, the central banks involved applied extreme moral pressure for them to do just that. And when such pressure was unavailing for one reason or another, the central bank helped find equitable ways to divide up the share of the departing bank among the remaining members of the syndicate.

With such evergreening successfully preventing a formal default, the banks did not have to write off their loans. True, the market price of those loans had collapsed, and on a mark-to-market basis, it is believed that several (most, all?) of US money-centre banks were insolvent (such is the sensitivity of this issue that we still have no authoritative account). But on a historic-cost basis, the loans remained performing: they could be, and were, written down slowly, as the US and the world economy recovered from the 1980-82 slump.

The central banks were, of course, not only privy, but indeed central, to the rescue/recovery programme, which involved forbearance from enforcing closure/bankruptcy of the weakened commercial banking system. Perhaps this experience of evergreening and forbearance may have led bankers everywhere consciously to adopt riskier strategies subsequently (moral hazard); but I am not aware of any convincing evidence to this effect.

Of course, this recovery exercise, pursued jointly by central banks and the large international commercial banks, was
much easier to put into operation in 1982 than in 2007-08. In 1982, there were only three major potential defaulters, and a handful of other dodgy sovereign borrowers, mostly in Eastern Europe and in the rest of Latin America. In 2007-08, there were tens of thousands of defaulting mortgagers. In 1982, the bulk of the loans were made by a small number of really large banks, who knew each other (and their respective central banks) intimately. Much of the trouble and strife in mounting the rescue occurred in trying to corral the smaller banks in the syndicates, who were not part of the ‘in-crowd’. Contrast this with current arrangements under securitisation. Here, the original mortgages have their cash flows so ‘sliced and diced’ into tranches etc. that it becomes barely possible to identify a counterpart lender to the potentially defaulting debtor. So we could not, even had we wanted to do so, have handled the current crisis as it was handled in 1982.

Yet the similarities between the major shocks that impacted the banking systems in 1982 and in 2007-08 (and that continue to affect us in 2009, and beyond) do lead one to ask whether there are any lessons that can be drawn from the earlier crisis for our present difficulties. I think there are. There are three issues that I shall discuss:

- the need to halt systemic defaults;

- the pros and cons of transparency; and

- the definition of solvency.

Besides crystallising losses, systemic defaults have widespread externalities, i.e. the losses to society greatly outweigh the losses to the defaulter. Moreover, the enforced sales of the assets involved, especially if such sales are rapid, lower the assessed value for the remaining holders of such assets and their creditors. This can, and often does, generate a self-amplifying spiral of further defaults and price declines, aggravated by withdrawals of fresh credit from the sector. Moreover, if the assets involved, including human skills as well as (sometimes specialised) equipment and buildings, are not sold off at a sufficiently low price so that they can be put back into immediate operation, they will rot, atrophy and lose value - and in the case of unused buildings often be vandalised.

But surely failure and bankruptcy are a necessary discipline of capitalism, and measures to prevent foreclosure will lead to moral hazard? Yes, up to a point. But when the failures are systemic, the danger is that one will end up with a morally disciplined, but totally devastated, economy.

In 1982, Mexico, Argentina and Brazil were, in a sense, bailed out. Did this result in yet laxer future behaviour by them and other LDCs? Perhaps, but supporting evidence is not easy to find. Meanwhile in 2007-08, the authorities generally did too little, too late to halt the foreclosures (and subsequent auctions) of defaulting mortgages. The result has been continuing declines in housing prices, threatening an ever widening circle of negative equity and future foreclosures, empty houses and general misery. Amid all the innovative measures to restore liquidity, capital and confidence to the banking system, not enough has been done, or done quickly enough, to check the epidemic of foreclosure.

Of course, the problem we have faced this time round is much more difficult. How does one prevent foreclosures without so penalising the lender that future mortgage terms would have to become more onerous, to offset the greater risk that creditors would then expect to face (a kind of inverse moral hazard)? Indeed, how does one strike an implicit deal with lenders, as well as borrowers, when securitisation means that the identity of the lender has itself become ‘sliced and diced’? Nevertheless, it is difficult to see any early conclusion to the continued grinding-down process of foreclosures and house price declines without some innovative policy response on this front.

A wider issue related to the same housing sector is that the housing price cycle has been greatly exacerbated by the cycle in loan-to-value ratios (LTVs). LTVs rose to 100% and above at the height of the cycle, allowing everyone, including pure speculators, on to the housing ladder without them having to produce any equity. Now, that has reversed, with LTVs falling to 75 per cent for new borrowers. So long as new borrowers cannot scrabble together the much larger required deposit, house price declines, even massive overshoots, will not necessarily restore the housing market to balance. Perhaps a temporary (fixed amount) subsidy to first-time buyers could be a sensible measure, especially if that subsidy was to decline over time.

Let us turn next to transparency.

In general, transparency is indeed good, like honesty. But personal relationships cannot usually survive undiluted honesty, and it may be that financial relationships cannot always survive undiluted transparency. We need to be careful in our prostrations before this icon. In order to deal with the ‘stigma’ problem, whereby a commercial bank accessing the central bank for liquidity assistance, even when it is done for technical reasons, may lose its reputation and standing in private markets, the Bank of England has opted for greater secrecy. Why should a central bank have greater leeway to hide its operations than a commercial bank? In stressed markets, the only apparent prices may be those arising
from sales that have been forced by distress, or driven by speculators seeking to manipulate the situation, in conditions where few are willing to take any position. In what sense are these the result of an exchange between willing buyer and willing seller?

Of course, in general, transparency is good, but generalities do not cover all specific instances. Moreover, transparency cannot, by itself, resolve uncertainty. There was, throughout 2007-08, great uncertainty about how much further house prices would fall and how much defaults would rise. Yet, for much of this period, there was much silly talk that if only banks would transparently and truly report the full extent of their losses from RMBS etc, then a bottom would be reached, and the system could move on and forward. But how could such a bottom be reached when no bottom was in sight for the underlying assets? Commentators often ascribed the fact that banks continued to report extra losses to a prior lack of transparency, whereas it was more likely due to a continuing worsening in the state of the underlying assets.

That brings me to the final issue, which is the definition of solvency.

You might think that solvency is a binary, on/off, condition. A firm, or person, is either solvent or insolvent. Think again. On inspection, solvency is almost as fuzzy a condition as liquidity. Indeed, the clearest definition of insolvency, i.e. when someone cannot pay bills as they fall due, relates to liquidity. But suppose that the debtor can pay, then the secondary definition of insolvency is that the value of that entity’s assets is less than that of its liabilities.

Now that may sound straightforward, but how do you value such assets (and liabilities)? Do you value them on a historic cost basis? On a current mark-to-market basis? In terms of what the assets might fetch in liquidation? Or on the basis of the discounted value of future (uncertain) cash flows? There are, at least, four quite different methods of valuation, so we can count five (including the first, ability to pay bills) definitions.

So was Northern Rock solvent in September 2007, or in February 2008 when it was nationalised? By the first (ability to pay) definition, it was insolvent in September, but solvent in February. On a historic cost basis, it was almost certainly solvent in September, and probably so in February. On a mark-to-market basis it may have been solvent in September, but was probably (almost certainly) insolvent in February. On a liquidation basis, it was possibly (probably) insolvent in September, and surely so in February. On a forward-looking basis, remembering that a sharp future decline in UK housing prices and in UK output/employment was clearly coming by September 2007, Northern Rock was probably insolvent in September (having unwisely expanded mortgage lending dramatically at very high LTVs in 2006-07), and surely so in February.

So, when it comes to the Bagehot dictum that a central bank should lend only to an illiquid bank when that bank is clearly solvent, is that a practically operational precept? My own answer would be emphatically ‘No’. In a crisis/panic, most banks would probably be insolvent on a liquidation basis, and if mark-to-market valuations are driven down by distress sales and then applied, maybe on such a basis also. What matters, I would suggest, is instead a judgment about the likelihood of a sufficient recovery in (asset) values; that is largely a subjective issue, and often uncertain. Seen in this light, was Northern Rock solvent in September 2007, or February 2008? My answer would be that it was dubious, at best, in September, and that the bank was clearly insolvent by February. But that has to remain a matter of judgment, not a simple question of fact.
As always, everything started with greed and euphoria. In the late 1980s, the Japanese economy was basking in the comfort of a booming asset market. Credit was easy because the central bank was anxious to offset the deflationary effect of the sharp appreciation of the yen, which took place as the result of the Plaza Accord in October 1985. There was strong confidence that the Japanese economy would maintain robust growth. Demand for housing and office space continued to grow. The availability of land, however, was absolutely limited because of the country’s geographical location. The obvious conclusion was that the price of land and buildings would keep rising.

Nobody doubted that simple logic. People with little financial means rushed to invest in real and financial assets, and banks were eager to finance such investment as long as they could secure an asset as collateral. Between 1985 and 1990, the price of commercial property in Japan rose threefold and stock prices soared almost fourfold.

By 1987, it was obvious that the Japanese asset market was in a clear state of bubble. Nevertheless, the Bank of Japan did not perceive the asset bubble to be a serious threat to the economy. After all, consumer prices remained reasonably stable. Inflation does only harm to people’s lives, but an asset bubble benefits many people. It was only in 1989 that the central bank realised the damage caused by the asset bubble and started to contain it.

This was its first mistake. When the central bank belatedly applied the brakes, it made things worse by doing it too forcefully, raising interest rates from 2.5 per cent to 6.0 per cent in a matter of 18 months. The government compounded this mistake by instructing banks to reduce their lending to real estate businesses. The bubble burst. Asset and stock prices collapsed.

After the bursting of the asset price bubble, the Japanese economy had to suffer a long period of stagnation, which lasted for more than 10 years. It is often dubbed a “lost decade” for Japan. In fact, the lost decade was created, not just by the bursting of the asset price bubble, but by a whole series of mistakes by the government and the central bank. It was also exacerbated by wrong judgments by the private sector.

The collapse of the bubble economy destroyed the bloated assets of the corporate and household sectors. Employment and consumption both fell. The central bank, again belatedly, eased monetary policy, cutting interest rates and injecting liquidity. However, the private sector’s response was sluggish. With balance sheets badly damaged, it simply had no appetite to consume or to invest. Banks were overloaded with bad loans and had no incentive to lend.

During the bubble period, Japan’s corporate sector had accumulated excess debt, excess capacity and excess employment. The break-even point rose and productivity declined. In hindsight, the banks should have reduced their bad loans more aggressively, either by putting up provisions or by writing them off much earlier. The corporate sector should also have carried out an aggressive restructuring to eliminate the three excesses.

Unfortunately, what happened was a simple case of inertia. People were still obsessed with the success story of the 1970s, when the Japanese economy recovered miraculously from the damage of the oil crises. This time too, they assumed things would improve and that bad loans would disappear.

Along with Shijuro Ogata (who has also contributed to this volume), Toyoo Gyohten was, for more than a decade, the ubiquitous face of Japanese officialdom in international financial circles. A fluent English-speaker (he can actually make impromptu jokes in English), Mr Gyohten served for many years at the Ministry of Finance, retiring in 1989 as Vice-Minister for International Affairs. Since then, he has been chairman of the Bank of Tokyo (1992-96) and, since 1995, President of the Institute for International Monetary Affairs. He has also been a special adviser/envoy to two Prime Ministers, Keizo Obuchi and Taro Aso.
So, they just waited. They avoided painful surgery and let the tumour get worse.

The government was no better than the private sector. During the 1990s, it spent $600bn on various public works such as highways, ports, airfields, etc. In many cases, projects did not have a strong economic justification. They certainly benefited landowners and general contractors, but many failed to demonstrate a multiplier effect. Thus, aggressive fiscal stimulus ended up generating a much worse fiscal position without producing a tangible recovery.

The real recovery of the Japanese economy came only after the near collapse of the financial system in 1997, when several major banks and security houses failed. As a result, serious efforts by the government and the private sector were launched and produced at real result in 2002. So, the experience of the “lost decade” of the Japanese economy has left us with many valuable lessons.

Initially, the bubble was created by the age-old human sin of greed, coupled with euphoria. Then we, as policy-makers, made several mistakes - mistakes in the timing of policy implementation, mistakes in the selection of policy instruments (fiscal or monetary? macro or micro?). We also made mistakes in choosing our policy objective – should it be structural reform, external balance, higher growth, or a stronger, weaker or stable exchange rate?

All in all, I would argue that Japan’s “lost decade” was basically a home-made “boom and bust”, the like of which we can find many times in history. However, mistakes made in the process of working it out ensured that the case was more serious and the solution more prolonged.

Now, let’s look at what we see today.

The sub-prime crisis of 2007 started with the housing market bubble in the US. This was not very much different from many previous bubbles, including the Japanese asset bubble of the late 1980s. It was the product of easy credit, greed and euphoria. However, there is a fundamental difference between the sub-prime crisis and other bubble-and-burst episodes. This time it has happened in a completely new economic environment. The reason is that, during the last two decades, there have been fundamental changes in the world economy. What are these changes? I would point to two:

- The first is globalisation. The collapse of the Soviet Union in 1989 established a new global paradigm based upon democracy and the market economy. The world became flat, and, as a result, all the components of economic activity (such as goods, services, money, people and, information) were able to move around freely. World markets became very much more unified.

- The second is securitisation, enabled by revolutionary progress in financial engineering taking full advantage of advanced information technology. A staggering number of financial assets were created and traded. Yet, amazingly, very few people knew accurately the real value of these assets. People, swimming in euphoria, did not bother themselves to question what seemed like a good thing for everyone.

All in all, the combination of easy credit, greed, euphoria, globalisation and securitisation has converted the world economy into a financial Tower of Babel.

The most tragic aspect of this development was the fact that no market players or regulators fully understood the implications of the sea-change, or were aware of the enormous risks it produced. They could not (and did not) anticipate that one day the fantastic profit-creating machine would come to a stop – and, indeed, go into reverse. In particular, regulators failed to realise that they were faced with new products, new players and new markets. They were simply not prepared. When the first signs of crisis appeared in the spring of 2007, they did not understand its seriousness and remained optimistic. As the crisis was unfolding, they were always behind the curve and were forced to take action in a haphazard fashion.

When house prices started to fall, the price of securitised instruments that included sub-prime loans inevitably tumbled. The deterioration spread to other securitised assets. Because of the arcane process of securitisation and the lack of accountability on the part of people who were trading such instruments, it was not possible for market participants to see the bottom of the fall. Indeed, nobody could tell the real value of the assets. Suspicions about prices and about the financial position of holders of those assets, therefore, became contagious. Confidence between trading partners was lost, and when confidence is lost, finance is dead. A severe case of credit crunch followed, threatening a financial meltdown in October 2008. Central banks and governments of North America and Europe employed all conceivable measures to arrest this meltdown, but it still looked like a fire sale. At the beginning of 2009, the situation is still hanging in a delicate balance.

The agonising feature of the current crisis is that the financial crisis has spread to the real economy with terrible speed and
The world economy, which celebrated universally positive growth in 2005, will suffer its slowest growth for decades in 2009. The main reason is that the financial crisis hit the world economy at a time when global imbalances were at a historic level.

Take the US economy, which accounts for one quarter of world output. It has been driven in recent years by strong household consumption — but, since the 1990s, American households have only increased their consumption by eating into their savings and by increasing debt. In the early 21st century, their net savings ratio actually fell into negative territory. Moreover, strong consumption in the US meant strong imports, because consumer goods manufacturing was vanishing. Large US imports meant a large current account deficit and large imports from the rest of the world, particularly from Asia and the Middle East. In other words, prodigious American consumption supported world growth. The housing boom, which gave birth to the sub-prime market, was a major supporter of American consumption, American imports - and, therefore, of global growth.

The bursting of the housing bubble and the collapse of the sub-prime loan market, therefore, hit the centre of American consumption. The fall of house and stock prices dealt a severe blow to consumption and cut down imports.

It is obvious that the collapse of securitised financial assets and the sharp fall in US imports quickly cooled global growth. It is also clear that the crux of the problem with the real economy in the US still lies in the housing market. Until the housing market hits bottom, the US economy cannot see any light at the end of the tunnel. So far, the American authorities have been too much occupied with problems in the financial market. For the new Obama Administration, improvement of the housing market must be the top priority.

What lies beyond the current crisis? What are the issues we will be faced with in the post-crisis period? As I have alluded to in my argument so far, the problems which created the current crisis are linked to fundamental and historic issues in the world economy.

First, what are we going to do with the model of financial capitalism we have created? The Anglo-Saxon financial model, which was to seek maximum profit by pushing leverage to the extreme, has failed. To mix my metaphors, the freewheeling financial orgy has hit a wall. Should the financial industry now be treated as a public utility and regulated as such? How can we alter the ethos of greed, and establish our financial business more on the basis of trust and modesty?

Second, what are we going to do with the world economic structure, which has been built upon growing global imbalances? Can (or should) the US reduce its consumption and imports, and can (or should) surplus countries in Asia and the Middle East reduce their savings and exports? Can (or should) the world tolerate the inevitable pain of adjustment?

Third, what are we going to do with the change in the global balance of power? The hegemonic position of the US in world affairs has been dented by recent events such as the Iraq war and the financial crisis. Also, the US is now more challenged by countries such as China, Russia, Iran, Brazil, India, etc. Although the US dollar is still the world’s key currency, and there is no other currency likely to overtake it, global confidence in the dollar has been eroding gradually due to the worsening US debt position and the weakening status of its financial industry. If the dollar continues to weaken while no other currency (including the euro, yen or renminbi) can take on its role, the global monetary situation will tend to be unstable. Can (or should) the world launch a serious discussion about reform of the global monetary system?

The current crisis certainly has elements we inherited from the last century. But it also has elements that make it a crisis unique to the 21st century. In dealing with it, we need to understand that we are dealing with structural problems of a historic nature, and that there isn’t an easy guide from recent history.
Crises are almost always unforeseen - and similarly easily forgotten. This means that every crisis tends to be considered unique.

That is a mistake - as is very clear from Charles Kindleberger’s book ‘Manias, Panics and Crashes’ which has been published in five editions. Paul Samuelson wrote about the fourth edition that, sometime in the next five years, you will kick yourself for not reading and re-reading the book. It covers the several hundred years since the Dutch tulip crisis at the beginning of the 17th century and shows how crises and instability have increased. It emphasises that the last 50 years are the most volatile both within countries (in particular, the housing sector) and between countries (exchange rate crises).

Over the years, I have come to share with Kindleberger a rather agnostic attitude as to whether it is possible to squeeze human behaviour into simplified models that might allow us to foresee and perhaps mitigate or even prevent crises.

This agnosticism applies to the present crisis, which developed slowly from the summer of 2007 (the US subprime market) in a way that was considered manageable, but which exploded in September and October 2008 in a way that caught everybody by surprise and created an unparalleled political reaction all over the world. The crisis exposed the fact that the banking system in almost all developed countries had over-expanded credit creation.

Generally, the banking system has facilitated economic progress by permitting the application of deposits (ie savings) to various purposes (notably investment and other forms of lending). This is a useful task, but when a crisis blows up there is inevitably a witch hunt to find out who is responsible: the manager, the borrower, the central bank, the system, the swindlers - or somebody else?

The usual model is that the central bank is felt to hold the key to the system. After all, it creates high-powered money ex nihilo, out of which the banking system is thought to create a predictable credit expansion and money supply.

It is, however, a fallacy that credit expansion is predictable in this sense. Central banks, are to a large extent, only observers of the credit expansion by the banks. The expansion of credit is fundamentally demand-driven.

The next step in my argument is that almost all requests for loans from the banks are to a large extent motivated by expectations. It is generally accepted that expectations play an important role in decision-making, but a solid model is lacking.

Markets see expectations in terms of available information. They assume that rational behaviour by participants will tend to create stability in a market, except when unforeseen shocks disturb equilibrium - eg when the US authorities stunned the market by refusing to rescue Lehman Brothers. Other economists – among them Kindleberger – assume that people are occasionally caught by psychological waves that are far from mechanical and that may well lead to instability. Whatever model you use, it is increasingly true that instability is a ‘bottom line’ event, and that we live in a period of increasing instability.

The key problem in most crises is the balance sheet of the banks. Banks’ liabilities are mostly denominated in fixed monetary terms, whereas assets – loans, shares, and bonds – have a value that moves with the market price. If there are losses, they may well exceed the capital of the bank - and depositors may start a run on the bank in order to save their money.
Over the last 150 years, the political reaction to this threat has been increasingly urgent. First came the understanding in the United Kingdom that the central bank should provide liquidity so that the banks themselves could handle a run by depositors. Second, most countries required banks to put up a minimum amount of capital. Third, bank inspection was introduced - and was gradually tightened, even though supervisors are hardly better equipped to foresee crises than the markets themselves.

Whatever, instability has increased over time – and that has meant that the political system has increasingly felt obliged to undertake direct intervention.

Initially, it was acknowledged that some banks were too big to fail; more recently, it seems that, there is almost no bank that is small enough to fail. In addition, ordinary deposits have been guaranteed, and the system in many countries has effectively been transformed into an insurance system – albeit one run by the banks.

The present instability is the continuation of a long-run development. It is, however, more widespread. A run on banks by other banks is a salient feature of the present problem, and serious difficulties in providing capital from the market is a big barrier to a return to ordinary conditions.

A logical solution to the liquidity problem would be to extend the deposit insurance system to cover all deposits - but with an increasing premium for banks that use the short-term interbank market to finance their credit expansion. Such behaviour has caused trouble over the years. It is not solely the reckless Icelandic performance that bears witness to this point. It may be that subordinated capital should be used as a bridge until markets normalise. In the longer run, however, minimum capital requirements probably should be raised to 15 - 20 per cent.

In conclusion, these two elements present a least cost solution which is in line with developments over the last decades. It does not seem realistic to try to regulate credit instruments if losses are connected with a downturn in the business cycle. This must be handled with fiscal or other stimuli.

A cost/benefit analysis of our credit system would, as a positive element, stress its flexibility in financing progress - but at the cost of being unstable.
The nadir of the 1929 stock market crash coincided with my birth. So that was too early; but the several crashes and crises during my adult life, while nothing like as serious as the Great Depression, have nevertheless made their mark. Although some were hardly noticed on Main Street, others seemed so awful at the time that it was impossible to see how recovery would ever be possible. There always is recovery, however - though recovery from what we are facing now may be years ahead.

In attempting to draw lessons from previous crises, I disregard those caused by events exogenous to the financial sector. The oil shock of 1973 is an example. The crises worth looking at are those generated within the financial sector, and particularly those that followed misguided legislation or regulation.

The 1974 “fringe” bank crisis comes into this category. I remember it because I was involved. It was precipitated by changes brought about by the introduction in 1971 of something called “Competition & Credit Control”, a government measure intended to increase competition in the banking sector that had been designed by the Bank of England. Without going into detail, the change loosened the grip of the major clearing banks on the sterling credit market, thereby opening the market directly to secondary banks. It set in place a system requiring “reserve assets” of just 12.5 per cent of deposits, thereby increasing enormously the maximum multiplier for advances, while removing lending ceiling restrictions. Massive increases in credit were thus made available, and lending to the property market greatly expanded. A property boom followed at once.

The new freedoms were available to the secondary bank sector, but these institutions remained regulated by the Board of Trade and were not supervised by the Bank of England. In retrospect, this was an obvious mistake, because the Board of Trade had no experience in regulating commercial banking.

At the time, I was a non-executive director of Mercantile Credit, which was a respected name among the secondary banks. Its lending was mainly to support instalment credit transactions generated by retailers of motor cars and electrical goods. The lending was of good quality. Furthermore, Barclays held 18 per cent of our shares, which provided additional confidence. But, as could have been foreseen, the whole sector increased its lending in property, blowing up what was becoming a bubble.

Inevitably, inflation increased – following which, so did interest rates as the authorities tried to control it. No surprise, then, that the property market crashed in 1973.

As the property market crashed, bad lending by some secondary banks was exposed. Names like Cedar Holdings come to mind. Soon, credit from the money market started to get tight, and when trouble was exposed at other fringe banks such as Moorgate and Mercantile (the name coincidence was particularly unfortunate for Mercantile Credit), all secondary banks found it impossible to obtain deposits from the money market, without distinction between good and bad. The whole sector was barred. This was in effect a run.

The Bank of England, led by a new governor, Gordon Richardson, saw the danger to the whole system and acted. The Bank set up a “lifeboat”. At its simplest, this was a scheme under which the big High Street banks bought up, and thereby rescued from bankruptcy, the secondary banks. For instance, Mercantile Credit was sold to Barclays for a price that was so low it reflected the fact that there was no other option. Barclays got what turned out to be a very good bargain.

These events taught me several lessons.

The first was to be sure of one’s deposits, avoiding excessive loan losses of course, but also making allowance for the fact...
that it is not only the bank’s own behaviour which can cause a run, but outside market conditions, often influenced by the fear of contagion. Depositors do not like risks, and they know that when one bank makes losses because the market to which it has been lending turns sour, others may do so too. A whole sector can be ostracised as the result of the failure of one bank.

Another realisation was how easily big changes (such as Competition & Credit Control) can lead to unforeseen consequences, and how slow the authorities (in that case the Treasury) are to see the effect of relaxing credit availability. Action to correct excessive lending and to prevent a bubble developing has to be taken quickly.

On the more positive side, I also saw that quick and decisive action by the Bank of England to prevent systemic damage could be effective. It is clear that strong leadership from the central bank, demonstrating to the main players how it is in their own self interest to contribute to a rescue, can yield results.

This principle was, incidentally, used to great effect by the New York Fed, under the leadership of Gerry Corrigan, in extinguishing the crisis created by the failure of Long Term Capital Management – an event that future generations may find it hard to believe was ever allowed to happen. The story is too well known to warrant repetition, but in retrospect it seems hard to understand how rational money managers and bankers could extend so much credit (gearing was at one stage over 30 times) to a trading operation based on mathematical theory which effectively disregarded market experience.

In my view, there is not much that is new or especially useful to be learned from the Latin American (1980s) or Asian (1990s) debt crises, or indeed from the Russian default (1998). All these are the kind of events that unfortunately happen periodically - particularly following the opening up of new markets, when the herd instinct, i.e. fashion, overwhelms reason in banks’ lending policies. Wasteful, sad and unnecessary; but occasionally inevitable.

A more rewarding collapse to study is the US Savings & Loan Insurance Corporation (FSLIC). It was a stable sector; so stable that the 3-6-3 joke was coined: pay 3 per cent on deposits, lend on mortgage at 6 per cent and be on the golf course by 3 pm. But by the end of the 1970s, this formula could no longer work. Inflation had reached 13 per cent and the Fed had raised interest rates sharply. So the government set in train a process of deregulation intended to save the S&L sector. Under the new legislation, S&Ls could invest in property directly and in securities. And they could pay depositors whatever interest they decided. But the insurance on deposits (with the limit raised to $100,000) remained in place. Deposit insurance meant that poor quality S&Ls could get deposits as easily as good ones. There was no premium for quality.

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It should have been obvious what would happen. The thrift industry rapidly became a by-word for excess, and the emergence of fraud was not long behind.

The losses made by S&Ls were gigantic. Although the first S&L closure came in March 1984, when the debacle could already be seen emerging, the authorities did not act very quickly. The catastrophe became much worse than need have been the case had action been taken sooner. Every time an S&L was closed, FSLIC lost money, paying out the insured depositor without the assets needed to cover the payment. By 1986, FSLIC was insolvent. In the end, 500 S&Ls collapsed and the Resolution Trust Corporation was set up to take over the ruins, which it did successfully in the sense that it cleared up the mess. But the cost to the US taxpayer was over $160 billion. More than 500 individuals were convicted of fraud and other offences, and two-thirds were jailed.

It was, up till then, the worst (ie the most expensive) financial collapse in history. In my view, the disaster can be traced back directly to ill- advised deregulation with inadequate consideration of the potential consequences, and a reaction that was much too slow when these consequences started to appear.

Then came the securitisation of mortgage debts. Current dogma is that this process is the begetter of all our present trouble. There is in truth in this, of course; but why did securitisation start and how did it take hold?

The great housing boom in the US created an enormous quantity of mortgages. With banking and securities businesses having been combined, it was natural for clever people to find a way of bundling up mortgage debt in order to sell it to investors. Selling bank debt to investors outside the banking sector was, after all, nothing new. And in a period
of low interest rates, it was obviously attractive to banks to do business that paid them a commission on sale but which disposed of the risk inherent in the debt, leaving them free to do more lending.

What was new was that much of the growth in mortgage debt was "sub-prime". In my view, this can be traced directly to various pieces of legislation passed by Congress in an attempt to counteract discrimination against minorities. A noble objective, no doubt, but pretty well bound to lead to bad lending decisions. For it effectively meant that if you were in the retail mortgage lending business at all, you had to lend a certain proportion to doubtful borrowers, many of whom were obvious bad risks. An example of such legislation was the Community Reinvestment Act of 1977. When combined with the law in many states restricting personal liability on mortgage debt secured on repossessed homes (allowing borrowers to walk away free of further obligation if the value of their house went below the mortgage debt, and to post back the keys), this amounted to a formula guaranteeing trouble.

Anyway, securitisation of loans boomed - aided and abetted by the ability to slice up the securitised debt into tranches and to get high credit ratings from the rating agencies for the senior tranches. This process made poor quality mortgages seem like high quality debt securities and therefore saleable to investment fund managers.

This sleight of hand was fully visible to the authorities. Indeed, it seems to have been approved of. It was thought that it enabled risk to be sold on to investors who were well able to afford it - in turn, lessening the risk retained by the banking system, which could thus better answer the credit demands of the rest of the economy. Little did the authorities realise that, in fact, much of the risk actually remained with the banks.

I mention all this because, although it is obvious to everyone that banks made huge and expensive errors by acquiring sub-prime debt, the process was visible to regulators and supervisors - and because the existence of so much sub-prime stuff in the first place was due to what I think was defective legislation in the US.

Banking supervision actually made things worse. The reason is that the minimum capital requirements laid down by the Basel Accord attributed to the super-senior tranche of securitised mortgage debt the lowest capital requirement, thereby encouraging every bank to acquire and hold such debt, which they did in big quantities. How the inherent defect in this was overlooked is a mystery, but it is a significant factor because the losses made by banks on these assets are very large indeed. To me, it shows the dangers of relying on prescriptive regulation alone to achieve the intended result.

We are now beginning to see the consequences of this gigantic man-made catastrophe emerge in human terms, as bankruptcies and unemployment rise. The action being taken to counteract the slide into depression, namely the creation of vast amounts of theoretically (and potentially) available credit, with low or zero interest rates, may work. Will it counteract the damage done to confidence by the antics and inept pronouncements of political leaders? It is intended to generate demand for economic activity, but it is nevertheless an experiment the results of which are as yet unknown. It certainly discourages retail savings, and it removes spending power and confidence from those who have capital saved.

The shortage of savings is a serious lacuna in the present situation. One of the consequences of globalisation and freedom of capital flows has been the ability of one part of the world to live on the savings of another part. The Western world has been living on the savings of Far Eastern workers. In the US, and indeed in the UK, the household savings ratio has fallen over the last 10 years from a barely respectable figure (7 per cent in the UK) to (effectively) zero. It does not take much imagination to realise how dangerous this is. If governments pay no attention to it, then banks and financial institutions need to. Banks need retail deposits to ensure not only profitability, but also safety. Over-reliance on credit markets is dangerous.

Furthermore, without a strong domestic base supported by adequate retail deposits, it becomes dangerous for a bank to conduct a substantial proportion of its business in currencies other than its home country currency. Iceland has discovered this too late. A bank doing substantial international business has to be based in a strong economy. This means an economy where domestic consumption does not exceed production other than its home country currency. Iceland has discovered this too late. A bank doing substantial international business has to be based in a strong economy. This means an economy where domestic consumption does not exceed production for too long: where prolonged balance of payments deficits do not lead to a weakened domestic base, and where the ability to do business in foreign currency is not limited by the problems of the domestic economy. A version of this problem is emerging in the eurozone, and how this will be handled is unknown.

Another issue we all have to face is the growth of institutions that are "too big to fail". We have got these now, as everyone knows. But the trouble is that not only is there the obvious risk of moral hazard, but such institutions tend to become too big to manage. How many
- We need to be far more careful to avoid the kind of infectious loss of confidence that can create a run.
- We also need quick and decisive action by regulators (including the central bank) to prevent systemic damage. (Gerry Corrigan’s role in the LTCM is a model.)
- The closest parallel to what we face today is the S&L crisis – caused by “ill-advised deregulation with inadequate consideration of the potential consequences, and a reaction that was much too slow”.
- Don’t exonerate Congress – and the unintended consequences of legislation designed to protect minorities.
- “Without a strong domestic base supported by adequate retail deposits, it becomes dangerous for a bank to conduct a substantial proportion of its business in currencies other than its home country currency” – Iceland? Or the UK?
- Are institutions that are “too big to fail” really “too big to manage”?

bank boards really understood the risks attached to the derivative instruments that were the basis of large slices of their business?

So my conclusions (which may seem a bit banal) are these:

- A successful international, and financial sector needs a sound economy without enduring balance of payments deficits.

- A sound economy needs to ensure not only a sound currency but also a level of domestic saving that supports this. It also requires banks and financial institutions to be well managed, and to be subject to supervision and regulation operated by people who really know and understand the businesses. And to counteract the moral hazard inherent in the “too big to fail” principle, banks which fail have to be taken temporarily into public ownership with no compensation for shareholders (the equity value of banks that cannot repay deposit liabilities is zero) or managers. They must lose, and be seen to lose.

This all requires substantial changes of attitude and policy.
Henry Kaufman

Financial consequences of the credit crisis

Henry Kaufman is a legend on Wall Street. For many years, he was a senior partner at Salomon Brothers, a member of its Executive Committee and in charge of all research activities. He was such an influential figure that his own firm was prohibited from trading on his bond market recommendations ahead of public pronouncements – unique testimony to his stature. Since his retirement from Salomon, Dr. Kaufman has run his own investment company, Henry Kaufman & Company, Inc. He has also been a major benefactor to several charities and educational establishments, notably the Kaufman Center, the Institute of International Education, and New York University’s Stern School of Business. He is a member of the CSFI’s Governing Council.

The credit crisis and the forces behind it will have profound consequences on financial markets for years to come. There have been more than a dozen financial crises since the Second World War. But the aftermath of each was transitory, and markets rebounded rather quickly. The current crisis will be different. Its consequences will usher in profound structural, behavioural and regulatory changes. I want to summarise 10 of these consequences and elaborate on one – the reform of official supervision of financial institutions.1

To begin with, the current crisis will bring to an end a decade-long period of ballooning non-financial debt. Going back to the 1980s, the rapid expansion of non-financial debt has been a key driver of US economic growth. The magnitude of this debt explosion – facilitated by markets and readily accepted by borrowers – has been unprecedented. Since 2000, non-financial debt has outpaced the growth of nominal GDP by nearly $8 trillion – more than double the $3.5 trillion gap of the 1990s, which was already excessive. But debt-driven growth is unsustainable - and indeed the techniques and institutions that generated the tidal wave of debt creation are now in disarray. We are already seeing a dramatic slowdown in the rate of growth of household and business debt, a trend that will continue.

Second, the financial crisis will dramatically slow securitisation. The explosion of debt was made possible by the massive securitisation of assets. Yet current marking-to-market practices are not uniform, and therefore they inject risk and uncertainty into the financial system. These practices will remain under a cloud until standards and rules are put in place to better control the practice of marking-to-market, and to ensure that issuers of securitised debt will share lending risks. One way or another, the use of matrices or models to set prices for liquidating and trading assets will come to an end, and the pace of securitisation will slow.

Third, in spite of the turmoil in markets, US government borrowing will continue to swell. This would have been true even if Republicans had held on to the White House. The recent explosion of Federal borrowing will continue for at least a few more years. We have already seen that as Federal revenues slow, spending increases and funds are needed to rescue additional financial institutions – borrowing in FY 2009 could exceed $2 trillion. As a result, the Federal government will find itself competing for funds against waning private sector demands. But there is a silver lining: the combination of shrinking private sector demands and expanding Federal demands will, on balance, improve the credit quality of many portfolios. The key question will be whether policymakers can define and implement a strategy that will slow government borrowing as private sector credit demands reassert themselves in the medium term.

The task of reprivatising housing finance will be extremely difficult, a fourth consequence of the financial crisis. In spite of the best intentions of government officials, the nationalisation of residential housing through the Federal takeover of Fannie Mae and Freddie Mac will take years to reverse, assuming it ever happens. This is because, for homeowners, the cost of securing mortgage finance directly from the US government is much lower than the cost of financing through private institutions - as well as

1 This article is adapted from remarks delivered by Dr Kaufman at a conference given by the Institute of International Bankers in New York in November 2008.
lower than the cost that prevailed while Fannie and Freddie were still functioning as governmentally-sponsored agencies. Therefore, shifting residential housing finance back to more expensive private-sector institutions will require considerable political will.

A fifth consequence is more positive: Americans will begin to save again.

The personal savings rate (as a percentage of disposable family income) has been weak for years, and actually fell below zero in 2006. Since then, it has barely remained positive. Although this perplexes many economists, I see no mystery. The erosion of personal savings is chiefly the result of massive debt creation. As Americans have been offered an array of enticing new credit instruments, their borrowing habits – indeed their attitudes towards taking on more debt – have relaxed. A brief review of debt and savings rates since 1960 shows the correlation. From 1960 to 1990, the growth of non-financial debt exceeded that of nominal GDP by 1.5 times on average, while the savings rate averaged 9 per cent per year. From 1991 to 2000, debt exceeded the growth of GDP by 1.8 times, while the savings rate averaged 4.7 per cent. Since 2001, debt has grown twice as fast as GDP, while the savings rate has averaged a mere 1.4 per cent.

The lesson is clear: if the savings rate is to return to healthy levels, we must put an end to the reckless creation of debt.

Sixth, risk modelling will lose popularity. Because most techniques used to model risk in financial institutions are backward looking (in the sense that they rest on historical data), they are essentially useless in times of fundamental structural change - such as the markets are undergoing now. Elaborate modelling formulas for options and other complex financial derivatives, which are useful for dynamic hedging under normal circumstances, are of little use when transactions cannot be made without huge price concessions. Stated differently, most models rest on assumptions about normal, rational financial behaviour – and, therefore, lose their predictive power during times of financial euphoria or panic.

Fallout from the financial crisis has also undermined international portfolio diversification as an investment strategy. Long heralded by portfolio practitioners and leading academics, international diversification has failed the test posed by the current credit crisis. Indeed, many non-US stock indices have fallen even more than US equity markets - a trend especially pronounced in popular developing countries, despite a belief among investors that their economies would perform largely independently of the industrialised world. This expectation of ‘decoupling’ has proved to be illusory. The fact is, developing nations depend heavily on the developed world to consume their products and services and to finance their business activities. They still lack the deep financial markets and strong legal structures needed to support their political systems – weaknesses that are quickly exposed by increasingly globalised financial markets. When liquidity is ample and credit readily available, developing economies thrive; but when global credit comes under pressure, they suffer even more than their more developed counterparts. This is why the strategy of international portfolio diversification needs to be rethought for it to remain an abiding principle of asset allocation.

Eighth, the US dollar will remain the key reserve currency. So far, it has withstood the financial crisis with remarkable success. Indeed, instead of falling, it has rallied in most foreign exchange markets. To be sure, the dollar has benefited from the precipitous fall in the price of commodities, most notably oil. It will remain the key reserve currency for some time to come, even though periodically it will come under pressure. In contrast, the dollar’s chief rival, the euro, faces serious challenges: a business recession, a sharp drop in corporate profits and the constraint posed by over-leveraged financial institutions. The US confronts some of the same problems but, unlike Europe, it is unified politically. Growing Russian belligerence also casts a shadow over Europe.

The most profound long-term consequence of the current credit crisis, the ninth item on my list, is the sharp acceleration in financial concentration.

Reinforcing a trend that had already reached epic proportions, leading independent investment banks have been subsumed into large financial conglomerates that are controlled by commercial banking entities, as have giant deposit institutions. Within the next year, many smaller institutions will also lose their independent identities. Today, more than half of all non-financial debt is held by the top 15 institutions. These were the very firms that played a central role in creating debt on an unprecedented scale through a process of massive securitisation via complex new credit instruments. They also pushed for legal structures that made many aspects of the markets opaque.

In the years ahead, the influence of these financial conglomerates will become overwhelming. Most importantly, they will undermine any move towards greater economic democracy. They are and will continue to be infested with conflicts of interest because of their multiple roles in securities underwriting, in lending and investing, in the making of secondary markets, and in the management of other people’s money. And because there will be fewer market participants of importance, the volatility of financial assets is likely to remain
high. Through their global reach, these sprawling firms will transmit financial contagion even more quickly than it spread in the current crisis. Plus, when that abates, the pricing power of these huge conglomerates will grow significantly, at the expense of borrowers and investors.

Finally, the turmoil in financial markets and its aftermath will ensure that the stakes associated with regulatory reform are very high. While the need for reform of financial markets is widely acknowledged, what is less well understood is the extraordinary balancing act that US lawmakers must achieve. On the one hand, the new regulatory regime needs to be comprehensive enough to take into account major structural changes that have unfolded in recent decades. On the other hand, it must assure reasonable credit growth and competitive credit markets. Every new measure will impinge on embedded interests, making the whole enterprise – essential as it is to our nation’s economic health – a major political contest.

How, then, are we to navigate this difficult regulatory terrain? Let me outline some of my long-standing proposals for improving the official supervision of our financial institutions.

The centerpiece of an effective new regulatory regime, it seems to me, should be a new kind of institution for regulatory oversight, which we can provisionally call the Federal Financial Oversight Authority. This Authority would oversee only the largest US-based institutions – the huge conglomerates engaged in a broad range of on and off balance sheet activities that I mentioned earlier. The FFOA would assess capital adequacy, the soundness of trading practices, vulnerability to conflicts of interest and other measures of stability and competitiveness. It would also set guidelines for participants in financial derivatives markets, such as the extent to which the issuers of securitised debt (the underwriters) will share the lending risk and limits on the trading of credit derivatives.

The chairman of the new Authority should serve as a voting member of the Federal Reserve’s Open Market Committee in order to ensure the nation’s monetary authorities have his (or her) valuable input about the well-being of our largest institutions. This kind of input has been sorely lacking in recent decades. And, in my view, the FFOA chairman and the chairman of the Fed should be required to co-sign an annual report to Congress on the safety and soundness of the financial institutions under their purview.

The FFOA should also publish credit ratings for institutions under its supervision – ratings that would replace those of private agencies. It seems clear that the private agencies have been overwhelmed by the challenge of garnering enough information to provide timely and meaningful ratings. The new authority should also be required to approve board members of major financial institutions. It should determine whether new board members have a working knowledge of accounting, literacy in qualitative risk analysis, and proficiency with information technology. It should also meet the board of major institutions to review results of examinations.

Finally, unified international supervision is essential in today’s global financial markets. Therefore, other leading economies throughout the world should be strongly encouraged, as I have advocated for many years, to establish supervisory authorities akin to the FFOA that would cooperate closely with each other.

With careful and appropriate measures, we can emerge from the current turmoil with financial markets and institutions that are more competitive, more responsible and better supervised. Or we can allow events to dictate our fate. The coming months and years will be critical.

This essay is based on a speech delivered before the Institute of International Bankers Conference on November 17, 2008.

- An end to “ballooning non-financial debt”, a slowdown in securitisation, an explosion of Federal borrowing, a continuing problem of housing finance, a pick-up in personal savings, disillusionment with modeling and portfolio diversification, and a sharp acceleration in financial turmoil.
- The dollar to remain as the key reserve currency – not least because of growing pressures in the eurozone.
- The stakes with regard to financial reform are very high – suggesting a role for a new oversight body, tentatively the Federal Financial Oversight Authority. The FFOA would concentrate on the larger institutions, assessing capital adequacy, trading practices etc. It would publish credit ratings and approve board members, and would cooperate cross-border.
It is hard to count up the number of times that bankers, regulators, and scalded investors have tried to defend themselves over the past year or so with convenient excuses, like “who could have predicted the financial meltdown?” Or “the financial crisis was totally unprecedented”. Such excuses are invalid. To the contrary, financial markets have been roiled by repeated upheavals over the past forty years. The most damaging, to the global economy and to political stability, were:

- the LDC debt crises of the 1980s;
- the multi-country banking and thrift industry implosions of the late 1980s and early 1990s; and
- the Asian debt collapse of the late 1990s and its aftershocks that dragged down Russia, Brazil, and Long Term Capital Management.

The broad outlines of each of those shocks, and others in earlier periods, followed a pattern much like what we have been experiencing in the past couple of years.

The origin of crises is normally a substantial shift in financial wealth from the public at large to a relatively small number of “new rich” institutions, typically foreign. Concentrating wealth and decision-making into fewer hands undermines market efficiency and lays the groundwork for eventual excesses. It’s not easy to invest a windfall intelligently.

In particular, the “new rich” are usually more risk averse than the average investor, and weight capital preservation higher than achieving high rates of return. So they shun equity markets. Instead, they prefer fixed-income investments. They favor lending to governments or entities that are judged to be effectively government-backed, whether or not they legally are. They lean toward short-term assets, but can be lured into longer-term securities when government yield curves are upward sloping. They usually need considerable convincing to stray into corporate bonds or securitized instruments. Yet, if they become persuaded, they can easily drive down relative yields on such assets to levels that more judicious risk appraisals could not support.

In past credit booms and busts, dramatic increases in oil prices have been responsible for the wealth transfer. That was certainly true after the Iranian revolution in the late seventies and during the run-up in prices in 2008. But recurrent real estate bubbles also have been damaging, since they are inevitably associated with far greater than average leverage than any other sector of the economy. And they usually have plenty of supporters, both among the developers, builders and bankers directly involved and among public officials. Financial regulators have repeatedly underestimated the dangers of rapid growth in credit extended to real estate - and so have “new rich” investors. Neither seems to realize how destabilizing deleveraging can be when it eventually takes hold as a glut of real estate ensues and loans go into default.

The key problem is that large financial intermediaries earn handsome fees serving as go-betweens. That was true during the petro-dollar recycling of the 1970s, and it has been an even more prominent aspect of every credit expansion since. At the outset of a credit boom, the packagers, underwriters and traders normally avoid retaining a meaningful portion of the financial instruments they are originating or marketing. But that doesn’t last. As early investors enjoy handsome rates of return, investment bankers become more attracted to their own products. This can be dangerous to financial health - even fatal, as we have all learned with the downfall of Bear Stearns, Lehman, and AIG this time round.

A credit boom is lubricated by an array of facilitators.
Some come from the private sector. Credit rating agencies are the most familiar. They tend to be backward-looking, assessing credit quality on the basis of recent debt servicing performance. So, during credit expansions, when lenders are being repaid and debt servicing burdens appear benign, they tend to overrate creditworthiness. Naturally, that spurs further credit creation, as “new rich” institutional investors skip over the footnote (inserted with tongue in cheek to avert eventual lawsuits) that tells them not to invest on the basis of rating agency “opinions”.

Another set of facilitators are the model builders. These in-house experts at sell-side institutions would use the latest statistical programs on the fastest computers to manipulate data and purportedly show that individual risks were limited and that diversification among an array of loans or securities could reduce portfolio risk substantially further. They naturally were drawing on databases that necessarily were restricted to the limited time horizons of the latest financial innovations, when everything seemed to be going smoothly. But both internal management and buy-side clients found the results highly reassuring, despite the obvious limitations of small sample sizes.

Other facilitators are from the public sector. Bank supervisors behave much like credit rating agencies, giving inordinate weight to whether loans are current, and resisting evaluation of low-probability, potentially higher-cost future scenarios. Policymakers in finance ministries, central banks and other financial regulatory institutions also lean toward optimism about the creditworthiness of classes of borrowers. Similarly, politicians rarely, if ever, raise doubts about the sustainability of rapid credit creation. After all, credit growth spurs greater business activity, higher levels of employment, more profits, and enlarged tax revenues. Members of Congress and similar elected officials in the legislatures of other countries are often sharply critical of regulators who seek to curb the flow of credit.

Credit booms would be far less frequent if risk managers within private financial institutions were empowered to raise warning flags that were taken seriously by top management. But that is never the case when money is being made from the origination, marketing, and trading of new loans and securities based on them. Instead, during the gravy days, risk management departments are normally viewed as overhead, rather than as contributors to long-term profitability. What is worse, analysts are often intimidated by loan originators, packagers, and traders. It is not unheard of for the few brave risk assessors who raise concerns about the scale and composition of exposures to be fired for asking embarrassing questions about growing exposures to particular classes of borrowers or to specific capital market instruments. After all, during the early phases of a credit expansion, the lending and investing decisions that the dealmakers make appear to be on solid ground and are still profitable.

But then something happens that leads to a sudden increase in debt servicing problems. Overbuilding of commercial real estate is a common trigger, since attainable rents quickly tumble when vacancy rates inch up even marginally. A reversal of commodity prices can threaten leveraged investments in oil, aluminum, or wheat. A business recession can lead to an abrupt contraction of new orders and a rapid build-up of unwanted inventories.

The trouble with secondary markets, whether for loans or for fixed-income securities, is that trading quickly reflects such shifts in fundamentals. Credit quality yield spreads on existing assets widen sharply. Within weeks or months, sometimes even days, what had been readily marketable becomes illiquid. As secondary markets seize up, financial institutions look to governments and central banks for assistance. Usually the largest institutions, deemed to be systemically important, are bailed out – but not before large numbers of investors are left holding unmarketable securities and are often forced to realize significant losses.

The events of 2008 certainly fit this profile. But so did earlier financial shocks dating back to the 1970s.

When Argentina, then Mexico, followed by Brazil and the Philippines got in trouble in 1982, markets seized up in a matter of days. Loans that could be syndicated fairly easily in June 1982 were entirely frozen by the end of July. Much the same swiftness was echoed in 1990 and early 1991. Equity values of major US banks dropped like stones and credit quality yield spreads soared as doubts about the solvency of several institutions multiplied, as serious problems with commercial real estate loans and leveraged buyouts surfaced. Similarly, the seizing up of Thailand’s access to the credit markets in the summer of 1997 touched off a region-wide financial scare. But it didn’t hit everybody at once. For several months after Thailand struggled to stay solvent, the markets traded South Korean official and private sector debt as if nothing had happened. As late as October 1997, the rating agencies were content to rate the credit quality of Korea Export-Import Bank, a large issuer of debt in the Eurodollar bond market, as the equivalent of IBM. Within five weeks, as concerns over the country’s financial health snowballed amidst news of unreported outflows from official foreign currency reserves and an explosion of short-term indebtedness, the rating agencies reacted vindictively. By December, with Korea begging for IMF and US government
support to avoid default, the country's debt rating was slashed to near the bottom of the junk bond tranche.

Against this backdrop, the progressive meltdown of a large portion of the world's financial system that began in 2007 and continued into 2009, with ever-increasing public sector involvement in trying to hold the system together, should be viewed as just another example, albeit the costliest and perhaps the scariest, of a string of convulsions that has rocked the markets since the 1970s. All the elements were in place:

- The “new rich” financial institutions that dominated the buy-side were lazy and cheap: lazy in the sense that they did not perform their own due-diligence on the riskiness of the complex securities they were acquiring and cheap because they did not retain objective risk analysts to do it for them.

- The investment banks that packaged loans into securities, and then repackaged the securities into even more complicated collateralized loan obligations, sold them without giving much thought to how the securities would perform under adverse circumstances. And they even believed their own sales pitches and held so many of their own concoctions that they were threatened with insolvency themselves when values collapsed.

- The rating agencies that assessed the creditworthiness of the securities were conflicted, since they were also earning handsome fees for advising packagers on how to structure deals in order to achieve the highest possible ratings. And they certainly did little or nothing to disclose these conflicts of interest to potential buyers of securities.

- The regulators barely noticed what was going on - and in fact took no action to prevent abusive lending practices, such as liar loans (in which borrowers misrepresented their incomes or assets), exploding ARMs (adjustable rate mortgages where future adjustments would always be upwards, regardless of the movement in money market yields), and steep pre-payment penalties. In the US and some other countries, no one in authority seemed to be aware of the fact that housing prices could go down as well as up, or was willing to ask what would happen to the market in collateralized debt obligations if large numbers of home buyers could no longer meet their obligations. They also turned a blind eye to excesses in the leveraged loan market, the auction rate securities market (where retail investors were exposed to the virtual illiquidity of assets that had been sold as if they were as good as US Treasury bills), and the credit default swap market (which led to the collapse of AIG, followed by the largest US Government bail-out of a financial institution in history).

Of course, many underlying borrowers, whether in the home mortgage market or in the infinitely more sophisticated leveraged buy-out business, were reckless. They often are. That is why generation after generation of lending officers has had to be trained to evaluate creditworthiness and turn down shaky applicants. Securitization dulled that instinct, as did LDC loan syndication in the 1970s and early 1980s or in subsequent versions in the financial crises that followed.

So what happens next?

The buy-side is ashamed and distrustful. Sell-side is reticent. Rating agencies are vindictive (and scared of being put out of business). Regulators don’t have a clue what they should be doing. Underlying borrowers are shut out unless they can borrow from a government agency. Politicians are pointing fingers at all of the above.

Will the lessons from credit booms and busts finally be taken to heart after this spectacular version? We can only hope, but don’t cross your fingers.
Manfred Lahnstein

An immediate challenge for Europe

The unfolding twin crises of the financial markets and the “real economy” have led to a flurry of summit meetings at all international levels, with the G20, in mid-November, as their provisional climax. The markets have not been impressed very much – no wonder since markets tend to react to facts and rumours, not to declarations of intent.

We should not be unduly critical about the Washington meeting, however. The principles formulated there are correct and important. Since the issues to be addressed are extremely complicated, it will take time to reach concrete solutions. And at the next meeting in April, President Obama will be an active participant. This being said, I still doubt if we have yet seen the beginning of a better worldwide economic order. It has certainly been correct, even overdue, to adapt the antiquated G7 structures to a changed international reality. It remains to be seen, however, if this leads to a new, stress-proof system.

It is against this background that we should remind ourselves that we are not only French, British, Italians or Germans in the G20. We live in the European Union and - as important in the context - we have the euro as our common currency. That is why the EU - and, even more so, the euro-zone - will have to define a common position as soon as possible. It is this common position which will have to be presented to the rest of the World, whoever will represent us there. And the timetable for the solution of our pressing problems should be ours. We should thus not be dependent on others, not even on “World Summits”.

What does this mean?

Be it financial and economic fire-fighting or addressing its deeper causes, we have to vigorously defend the “acquis communautaire”, the unified market and our competition rules. We need an attractive offer for the Doha negotiations. We have to keep up our development aid efforts. And we have to co-ordinate our programmes to fight recession a lot better than we have done hitherto. Just to quote one example: A 12-month moratorium concerning protectionist measures has been agreed upon in Washington. This strange crutch does not help us at all inside the EU. We have to do without any protectionism, under whatever appealing disguise it may be advocated. Together, we have to define the limits of public sector debt. If we do not do that, all dams will break - as we may well observe in the US.

It is equally important for the eurozone to define its own role and its specific responsibility within the EU. After all, we have to defend our greatest accomplishment, our common currency. Since we live in a common monetary space, the necessary regulation of the financial markets is no longer a national matter. This is the great difference between us and the other G20 members. We need common rules, not just harmonised ones.

There cannot be any “regulatory arbitrage” inside the eurozone, allowing shrewd actors to profit from different rules between member countries. This means that cross-border financial activities have to be monitored and controlled across eurozone borders. We thus need so-called “group supervision” for all branches of the financial industry, which we should entrust to the ECB. Furthermore, the ECB and the “euro group” should be an active part of all attempts to address the solvency problem.

This is the only way to avoid the market distortions that we can already observe. These distortions will be created even if national rescue packages are acceptable under EU competition rules.

The G20 intends to force all financial institutions to back their securities and derivatives with sufficient capital. That
is good and necessary. But, what stops us from making this a binding rule right away? Equally, the G20 intends to supervise the activities of the credit rating agencies much more closely. Again, this is good and necessary. Well, why don’t we build a public rating agency for the eurozone, truly independent of all commercial interests and the ensuing conflicts?

The G20 intends to create a set of principles for evaluating complex financial instruments and products. Once more: good and necessary. But, why do we feel constrained inside the eurozone from introducing our own compulsory registration and licensing mechanism for all those instruments and products?

The euro-zone should invite other European countries inside the EU (the UK in particular) and outside the EU (Switzerland in particular) to be its partners in such a common effort.

By the way: we should not be unduly frightened that, if we do this, “regulatory arbitrage” will work against us. Sooner or later the benefits of a well-managed monetary and economic space such as the euro-zone will outweigh any short-term advantages of more lenient regulation.

In parallel, we have to reach closer convergence of our national economic and fiscal policies. The wide range of interest rates for long-term government bonds is a disquieting sign. If our economies drift further apart, we risk uprooting the basis of our common currency. It is for the same reason that we should refrain from offering the “euro umbrella” to all those in Europe, the currencies of which risk becoming an object of speculation. Resolute help, from the ECB for instance, is the better solution here.

A not so theoretical question: what would have happened if we had not had the euro? It is not hard to imagine that a currency crisis would have compounded the turmoil in financial markets and in the real economy.

In such a way, the EU in general, and the eurozone in particular, should make good use of the time during which worldwide rules will be worked out. We should be aware that the next G20 conference will study interim reports from its working parties - but it will not come to precise solutions. In the meantime, the financial crisis and a spreading recession will march on. Both follow their own calendar. And that should be the only important calendar for us.
Robert Monks

No innocent shareholder

Bob Monks is a legend. He rowed for Harvard in 1953, and won a blue for Cambridge in 1955 (defeating Oxford by 16 lengths). Described by *Sports Illustrated* as ‘husky’, he went on to found Institutional Shareholder Services, the LENS investment fund, and Lens Governance Advisors. He is a prolific author and activist on corporate governance issues – and even had a book written about him, ‘A Traitor to his Class’ (by Hilary Rosenberg). He has been described by George Soros as “a master negotiator and an effective instrument of change”.

“To my mind there is no such thing as an innocent purchaser of stocks. It is entirely contrary, not only to our laws, but what ought to be our whole attitude toward investments, that the person who has a chance of profit by going into an enterprise, or the chance of getting a larger return than he could get on a perfectly safe mortgage or bond – that he should have chance of gain without any responsibility.”

Louis D. Brandeis

The great American drama is the effort to accommodate democracy and capitalism, wealth and fairness. The last hundred years of this struggle have witnessed recurring cycles of “irrational exuberance” and “once in a thousand years” depressions. Today, the US is experiencing the most unequal distribution of wealth since 1928, the year before the stock market crashed. Is this the necessary price of corporate success?

Louis Brandeis, as lawyer, public servant and Supreme Court Justice had an eye and a voice for conduct inimical to a free society; and he had an aversion to size, particularly to large corporate complexes. He would have agreed with the trenchant conclusion of Charles Lindbloom’s book: “Enormously large, rich in resources, the big corporations command more resources than do most government units. They can also, over a broad range, insist that government meet their demands, even if these demands run counter to those of citizens…And they exercise unusual veto powers.” To sum up: “The large private corporation fits oddly into democratic theory and vision. Indeed, it does not fit.”

The Rich win, the public loses

Peddling exotic instruments is not new. In February 1932, appearing before the Committee on Interstate and Foreign Commerce of the US House of Representatives, Joseph Eastman described what he called “the outstanding vice” of the Van Sweringen holding companies: “Having purchased at high prices mere stock equities in various railroad companies, they made the investment a basis for the issuance of bonds and preferred stock which they sold to investors, retaining control through a margin of common shares and reducing the investment necessary for such control by further pyramiding processes...” One needs only change a few words to describe the process of securitizing sub-prime home mortgage loans and their fragmentation into security categories, such as mezzanine CDOs, which misled investors and was, arguably, the single causative factor of the financial crisis of 2008. The one constant is that no normal customer, and precious few professional advisers, could understand what they were actually being offered.

Even though people’s apparent willingness to make fools of themselves persists, there should be a minimum level of disclosure required.

We need inquire of the Van Sweringen pyramids as of the current crop of CDOs, what public purpose did they serve?

At some point in the assemblage of the Van Sweringen debt mountains, there was money raised that had a socially useful purpose – building railroads, improving customer service or some such. Clearly, at some point, financing started to be done only for the investment banking fees. There was no public good to be derived from the pyramids. Brandeis

comments that these loans "were incurred unnecessarily. They represent, in the main, not improvement in the New Haven or in the Boston & Maine Railroads, but money borrowed either to pay for stocks in other companies, which companies could not afford to buy, or to pay dividends which had not been earned."

It can be said that securitization of mortgages has a valid purpose – it expands the capacity of banks to finance home building and acquisition. What is the value added by creating separate tranches of these securitized instruments, with supposedly reliable credit characteristics?

Leaving aside critical considerations such as abandonment of responsibility for continued monitoring of the soundness of the mortgage, and the virtual fraud of "credit rating" agencies, there remains the question: is there a valid public purpose for this transaction? If not, this is simply another manifestation of the public ultimately underwriting a gigantic casino, the proceeds of which go to those politically well situated and the losses of which are born by the public.

Turning to the present, as Michael Lewis and David Einhorn wrote in the New York Times, in January 2009: "Whatever credit defaults are in theory, in practice they have become mainly side bets on whether some company or some subprime mortgage-backed bond, some municipality or even the United States government will go bust." At some point, should not transactions with the potential to threaten national financial stability be restricted, unless there is some public good to balance the risks?

This is a polite formulation of a question that might better be put – why do we continue not only to permit but to underwrite the thieves in threatening first our credit and, ultimately, our capital?

The Golden Rule – those with the gold rule

The long-time Secretary of the Treasury at the time of the stock market crash of 1929 and the subsequent depression was Andrew Mellon, one of the richest men in the US. During the recent “crash”, the Treasury Secretary was Hank Paulson, one of the richest men in the US.

Mellon spent his life after retiring from the Treasury fighting Justice Department charges of tax evasion, at the same time as bestowing his great art collection and endowment as a National Gallery. Paulson acquired his vast wealth under the circumstances prevailing during his suzerainty at Goldman Sachs and was twice blessed by his selfless commitment to public service. First, he was required to divest himself of his holdings in Goldman, which were then at a historically high price and which he would not have been entitled to redeem in their entirety had he retired in the private sector; and second, he was allowed indefinite postponement of capital taxes on what were virtually all gains. He, too, has committed his wealth to charity. The most successful proponents of the prevailing system are unlikely to understand its profound shortcomings, to say nothing of providing credible leadership for a country in need.

Dogma triumphs over commonsense

In each great crisis, there appear prominent public figures, members of Congress and the Senate, who inflict vast damage by virtue of being both powerful and wrong. The Smoot-Hawley Tariff Act has long been recognized for intensifying and prolonging the business downturn of the 1930s; Senator Phil Gramm – famously dismissed from the McCain campaign in 2008 for characterizing those concerned with the economy as “whiners” – muscled through the repeal of the Glass-Steagall Act, the 1930s reform which separated commercial and investment banks. Historians may well point to this single deed as the structural cause enabling the depression of 2008/09.

The lobbying power of the financial industry has always been substantial. And yet its manifestation in recent times has exceeded the lyric warning of Justice Brandeis, dissenting in Liggett v. Lee:

“The prevalence of the corporation in America has led men of this generation to act, at times, as if the privilege of doing business in corporate form were inherent in the citizen, and has led them to accept the evils attendant upon the free and unrestricted use of the corporate mechanism as if these evils were the inescapable price of civilized life, and hence, to be borne with resignation. Throughout the greater part of our history, a different view prevailed. Although the value of this instrumentality in commerce and industry was fully recognized, incorporation for business was commonly denied long after it had been freely granted for religious, educational, and charitable purposes. It was denied because of fear. Fear of encroachment upon the liberties and opportunities of the individual. Fear of the subjugation of labor to capital. Fear of monopoly. Fear that the absorption of capital by corporations, and their perpetual life, might bring evils similar to those which attended mortmain.”

The tragedy of Goldman Sachs

The tragic story starts and the tragic story ends with Goldman Sachs. In his famous book on the Great Crash, John K.
Galbraith recites the following colloquy before a Senate committee in 1932:

“Senator Couzens: Did Goldman, Sachs and Company organize the Goldman Sachs Trading Corporation?

Mr Sachs: Yes, Sir.

Senator Couzens: And it sold its stock to the public?

Mr. Sachs: A portion of it. The firms invested originally in ten per cent of the entire issue for the sum of $10,000,000.

Senator Couzens: And the other ninety percent was sold to the public?

Mr Sachs: Yes, Sir.

Senator Couzens: At what price?

Mr Sachs: At 104. This is the old stock…….The stock was split two for one.

Senator Couzens: And what is the price of the stock now?

Mr Sachs: Approximately 1 ¾.”

The inspired leadership of Sidney Weinberg, John Whitehead and John Weinberg over the succeeding half century brought Goldman Sachs to a position of prestige and respect throughout the financial world. Their commitment to the customer’s interest informed a generation of the finest leaders of Wall Street. Hiring only the best people from the points of view of ability and character, this leadership transformed Goldman Sachs into a great company. Alas, this beacon of decency was too soon extinguished. Michael Lewis is the poet laureate of Wall Street’s other side (the side other than obscene profits). In earlier books, he managed to evoke an image of the realities of Wall Street brokerage operations, more specifically bond traders, and peculiarly Salomon Bros. During a recent ironic lunch with John Gutfreund, the principal target of his famous satire Liar’s Poker, Lewis reflects on the precise act that began the collapse of traditional Wall Street:

“John Gutfreund did violence to the Wall Street social order — and got himself dubbed the King of Wall Street — when he turned Salomon Brothers from a private partnership into Wall Street’s first public corporation. He ignored the outrage of Salomon’s retired partners. (‘I was disgusted by his materialism,’ William Salomon, the son of the firm’s founder, who had made Gutfreund CEO only after he’d promised never to sell the firm, had told me.) He lifted a giant middle finger at the moral disapproval of his fellow Wall Street CEOs. And he seized the day. He and the other partners not only made a quick killing; they transferred the ultimate financial risk from themselves to their shareholders. It didn’t, in the end, make a great deal of sense for the shareholders… But it made fantastic sense for the investment bankers. From that moment, though, the Wall Street firm became a black box… No investment bank owned by its employees would have levered itself 35 to 1 or bought and held $50 billion in mezzanine CDOs.”

John Weinberg and John Whitehead, in retirement, argued against Goldman Sachs going public. Greed won. Hank Paulson, an ironic “hero” of this tale, led a major repositioning of Goldman Sachs’s strategy and its franchise in the financial world. Goldman Sachs changed the definition of “client” to be someone who accepted what was offered to him, notwithstanding Goldman taking a preferable position in the same situation.

In his book, The Partnership, Charles D. Ellis describes how Singapore’s Government Investment Corporation, one of the leading institutions in the world, learned how it was being treated. “The senior investment officer, Ng Kok Song, called John Thain to protest, ‘Is this the way you want to treat an important client?’ ‘You were offered what the firm is offering. If you don’t wish to participate in this deal, this will, of course be entirely your decision. Our responsibility is to offer you the same terms we offer all other major clients. What the firm does with its own account is separate.’”

Goldman abandoned the commitment to putting its customers’ interest first. Its drive was for maximization of its own portfolio. Sic transit gloria mundi.

Malignant oversight

The Securities and Exchange Commission, long ineffective in protecting shareholder rights, became in the George W. Bush Administration an obstacle.

Joel Seligman, President of the University of Rochester and a leading authority on the history of the SEC, explained its current problems rather gently. After remarking that Congress had been comfortable with “vast unregulated areas”, he criticized the message sent to enforcement by “the failure

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since 2005 to increase the enforcement budget. And some commissioners whose skepticism about enforcement may have undermined the SEC’s effectiveness.4

I have elsewhere described personal frustrations in dealing with this once admired agency and recently wrote: “The SEC today exudes dysfunctionality.” Historians may well point to the SEC’s role in the Madoff ‘Ponzi scheme’ as the nadir of public responsibility. Sir David Walker was quoted by the Financial Times as saying:

“Created to protect investors from financial predators, the commission has somehow evolved into a mechanism for protecting financial predators with political clout from investors. (The task it has performed most diligently during this crisis has been to question, intimidate and impose rules on short-sellers – the only market players who have a financial incentive to expose fraud and abuse.)”

Even Sir David, who has performed all measure of tasks with reference to the finance industry with integrity and discretion, ultimately reflects the commercial pressure that has come to define the standards of the financial world: “I think were we to require private equity executives in the UK to disclose their compensation arrangements which, as I’ve said, I think is not necessary and inappropriate, but were we to do so, their ability to move offshore or to ensure that the relevant contract was not with the UK jurisdiction, would be remarkably easy, but they won’t do that.”

Eliot Spitzer in testifying before the Senate Banking Committee, after a productive career of identifying and prosecuting conflicts of interest at numerous interstices in the financial processes, said categorically: “Self regulation does not work.” That experienced judgment notwithstanding, the continuing refrain of conservative orthodoxy echoes throughout the policy community. “Policymakers must ensure that the result is not a legacy of political control of the financial system, threatening the efficiency of markets and the principle of private ownership”, as David C John, senior research fellow at the Heritage Foundation puts it.5

We arrive at a situation where individuals pay themselves currently unimaginable wealth to the level that the value of their equity is close to meaningless. Meanwhile, the losses are socialized. The current American situation poses many as yet unanswered questions:

- What credibility can be accorded a “rescue package” that focuses on a single industry, that purports to permit the purchase of “toxic assets”, never acquires a single one, and then proceeds to force-feed the money into already solvent institutions. Obviously, the beneficiaries of this policy do well relative to everyone else. Who chooses them? If AIG were accorded the same measure of tolerant support as Goldman Sachs, would it not be a survivor? And its shareholders wealthy?

- Why should the finance industry, in contrast with say the automotive industry, be signaled out for rescue with Federal funds? There can no question but that the incompetence of the auto industry can only begin to rival the destruction created by the investment bankers.

- Why should Goldman Sachs and Morgan Stanley be afforded a retreat into single bank holding companies, while Merrill was forced into merger and Bear Sterns and Lehman into liquidation?

- In February 2009, the Congressional Oversight Panel monitoring the Troubled Asset Relief Program (TARP) reported that the Paulson Treasury paid significantly more for the assets than they were worth. The panel’s analysis revealed that the Treasury only received $66 for each $100 it paid to acquire the 10 largest assets – some $78bn. The taxpayers will need to know whether there is any pattern favoring particular banks in these discrepancies and, if so, what is the explanation.

- Did Federal bail-out money really get applied to paying bonuses to executives (not necessarily the CEO, yet!) in the financial services industry?

**Moral hazard**

Much has been written on the problem of “moral hazard”. The concept has frequently been adduced to explain why the government permitted Lehman Brothers to go into bankruptcy rather than be accorded the same assistance as other of its investment banking counterparts. Why Lehman out of all the candidates?

Ultimately, the question is: did the principal executives of some or all of the major investment banks know that the Federal government would have no alternative but to take steps to assure that they did not fail?

We must go back to Long-Term Capital Management – when those primarily responsible for Salomon Bros’ dubious dominance of Federal debt underwritings retreated north to Greenwich to

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5 David C. John, Treasury’s Bank Capital Purchase Program: Avoiding a Dangerous Legacy, The Heritage Foundation.
start LTCM, whose subsequent “appointment in Samara” was ameliorated by the intervention of the New York investment banks, stimulated by the New York Fed. This event created a new reality. Private parties can create business relationships, the implications of which sufficiently threaten the “public good” so as to require government intervention. There will come a time when we will be able to understand how greed could persuade intelligent, experienced executives to adopt such strategies and incur such levels of debt. Until a better explanation is forthcoming, one is driven to the simple and cynical view – “heads we win, tails the government picks up the pieces”.

Only historians will know whether a Treasury Department, staffed from top to bottom by Goldman Sachs alumni, somehow “signaled” to a privileged few that the game – 33:1 borrowings, secured by incomprehensible assets – could proceed, confident that there would be an ultimate Federal bail-out in restructuring, guarantee or cash.

Race to reform

There is vast enthusiasm for specific and wide-reaching reform, much as there was 70 years ago with Glass-Steagall separating banking, the Public Utility Holding Company Act destroying the pyramids and the Investment Company Act prohibiting multiple classes of voting stock. In more recent times, in the 60 days following the bankruptcy of WorldCom, President Bush decided that there may be more than the odd bad apple in the barrel and signed the Sarbanes-Oxley Act. There is certainly room for selective statutory action, but extreme care has to be observed to avoid creating new problems by partially addressing those currently identified. The working models are in place – transparency and fiduciary responsibility, the problem continues to be lack of enforcement.

Years ago, Brandeis wrote to Robert W. Bruere:

“Refuse to accept as inevitable any evil in business (eg irregularity of employment). Refuse to tolerate any immoral practice (eg espionage). But do not believe that you can find a universal remedy for evil conditions or immoral practices in effecting a fundamental change in society (as by State Socialism). And do not pin too much faith on legislation. Remedial institutions are apt to fall under the control of the enemy and to become instruments of oppression. Seek for betterment within the broad lines of existing institutions. Do so by attacking evil in situ; and proceed from the individual to the general. Remember that progress is necessarily slow; that remedies are necessarily tentative; that because of varying conditions there must be much and constant enquiry into facts…. And much experimentation…”

The least innocent owners

The ultimate problem is the failure of those whose money is really at stake – the pensioners, the beneficiaries of trusts, the owners of mutual funds – to inform themselves, to act or to require those legally responsible to act. In today's world, it is not flesh and blood human beings who are the legal shareholders; it is large institutions, often with conflicting interests, who own a majority of the public stock of American companies. Until and unless these highly compensated institutions act like real “owners”, the sad drama of corporate cyclical collapse predictably will continue.
The two financial crises of my working life that seem most relevant to the present one were the UK’s “fringe bank” crisis of 1974-75 and the Latin American debt crisis of the 1980s.

In 1974-75, as today, we were coming to the end of an extended boom, and the conjunctural conditions (oil shock and double-digit inflation) were probably more frightening than today’s. Many small UK banks had been over-lending, and so had some of the bigger banks. Swift action by the Bank of England and the clearing banks established a “lifeboat” on lines first seen in the first Baring crisis of 1891. This lifeboat not only kept the ailing secondary banks going until it could be determined whether they were insolvent (and should be closed) or merely illiquid (and should be re-floated). It also kept the bigger banks together, so that there could be no mutual loss of confidence among them, such as has afflicted the interbank market this time. Financial journalists reported the crisis in responsible fashion, and one of them, Margaret Reid, subsequently wrote a good book about it.

The Latin American debt crisis began, like the present one, in the money markets, when Mexico and then Brazil found that creditors were unwilling to renew their short-term borrowing lines. The problem quickly spread by contagion, even to such countries as Colombia and Paraguay which had pursued conservative policies. The authorities quickly realised that many banks that had over-lent to Latin America were themselves at risk. At the suggestion of Gordon Richardson, governor of the Bank of England, and with bold leadership from Jacques de Larosière at the IMF and Paul Volcker at the Federal Reserve, the first ever international “lifeboat” operation was mounted. Hundreds of banks were persuaded not to call their loans and, over 10 years, the crisis was successfully managed down.

No such lifeboats have been launched this time. The crisis blew up too quickly; too many banks, and too many types of bank, were involved. New regulatory structures had not only failed to curb banking excesses, but had also weakened the power of the central banks to respond to the crisis. All this will need thorough analysis before the next time round.

Meanwhile, large parts of the banking structure are being shored up by governments, who have felt the need to save large and small commercial banks, investment banks and mortgage banks alike. When more normal working is resumed, no doubt much of the recent unsound financial engineering will have been discarded, and there will be new regulation to keep securitisation, which undermines lending prudence, out of banking. But I am doubtful whether the relative financial stability of the last 60 years can be restored, for several reasons.

One way back to stability would be to return to the first principles of commercial banking. A bank, by definition, collects a pool of short-term deposits and lends most of them out at longer term, thus earning enough to cover its costs and remunerate its shareholders. However prudently managed, it cannot be immune to a run in a general loss of confidence; but history shows that this risk is minimised if its deposits are all retail and widely spread. Suppose therefore that, in future, commercial banks were forbidden to gear up by borrowing in the wholesale markets. That might arguably work in countries with large domestic savings; but in big economies with low savings rates like the US and UK, the commercial banking system would probably become too small to satisfy current popular expectations. Until those expectations have shrunk, the genie cannot easily be put back into the bottle.

If on the other hand, and as current government pronouncements seem to suggest, the system is reconstructed largely as it was but with the worst excesses removed, then I fear that the subsequent cyclical pattern

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Sir Jeremy Morse

Back to first principles?

Sir Jeremy was chairman of Lloyds Bank from 1977 to 1993, and chancellor of the University of Bristol from 1989 to 2003. One of the most influential British bankers of his generation, he was extremely active in international efforts to handle both petrodollar recycling and the Latin American debt crisis. He is also a prolific writer of crossword clues and on chess problems.

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Meanwhile, large parts of the banking structure are being shored up by governments, who have felt the need to save large and small commercial banks, investment banks and mortgage banks alike. When more normal working is resumed, no doubt much of the recent unsound financial engineering will have been discarded, and there will be new regulation to keep securitisation, which undermines lending prudence, out of banking. But I am doubtful whether the relative financial stability of the last 60 years can be restored, for several reasons.

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If on the other hand, and as current government pronouncements seem to suggest, the system is reconstructed largely as it was but with the worst excesses removed, then I fear that the subsequent cyclical pattern
would be likely to resemble that of the 19th century more than the 20th, i.e. less inflationary but with harsher downturns. Confidence is bound to be fragile after the present shock, and any downturns will be megaphoned by media and governments: in these conditions, we should expect periodic financial crashes.

If, contrary to my fears, markets and policy-makers can find a way between the horns of the dilemma which I have posed, neither shrinking the commercial banking system nor reconstructing it on an unstable basis, they will have done well.

- Why was it not possible to launch a central bank ‘lifeboat’ this time round?
- We may have to live with a more volatile banking environment in the future, if only because it will probably prove impossible to restrict commercial banks’ access to wholesale funding – even if we were minded to try. Unfortunately, a return to the system as was seems likely to produce harsher downturns, albeit with less inflation.
Looking back at the international financial crises over the past 30 years, I find that I was only personally involved in the debt crisis of the early 1980s. Then, I was an official of the Bank of Japan and one of the negotiators of central bank co-operation through the Bank for International Settlements.

I gratefully recall the strong leadership of Fritz Leutwiler, Gordon Richardson, Paul Volcker, Jacques de Larosière and Haruo Mayekawa, who managed to organize effective international co-operation to overcome that crisis. Even though they are no longer so directly involved this time, it is still worth comparing that crisis with the current one.

In the early 1980s, the crisis was mostly that of sovereign borrowing by a few emerging countries from internationally active major banks - and the problem loans were booked on the balance sheets of those lending banks. By contrast, in the current crisis, owing to the securitisation of financial assets, the impact of instability has been widely spread and is much more complex.

Except for the crisis of the early 1980s, I have been more or less a bystander, but I can draw the following lessons from my own observations:

1. **Do not forget the cyclicality of economic changes:** One of the major common factors in recent international financial crises is the pro-cyclicality of human behaviour. When economic conditions are comfortable for too long with low interest rates and positive economic growth, lenders-borrowers and investors-investees tend to become over-optimistic and over-ambitious, ignoring the inevitability of cyclical changes.

2. **Do not overlook early-warning signs:** At the micro level, it is most desirable for lenders-borrowers and investors-investees to keep improving their own risk management and corporate governance - possibly with the help of truly independent outside directors and/or advisors.

Policy-makers are hesitant to disrupt the favourable trends, even after they start to sense the emergence of excesses. Even regulations can function pro-cyclically - as happened in Japan, where a portion of unrealised capital gains on securities owned by banks were counted in Tier II capital. As a result, higher stock prices - pro-cyclically and unnecessarily - increased banks’ capital ratios and their ability to lend.

Once the bubble bursts and the economic cycle turns around, however, lenders-borrowers, investors-investees, policy-makers and regulators are liable to overreact. Their individual reactions are understandable, but the collective impact pro-cyclically intensifies the economic downturn and increases non-performing loans and funding difficulties, thereby creating a serious financial crisis.

In addition, from our experience during the debt crisis of the early 1980s and the Asian financial crisis of the late 1990s, emerging countries (which naturally aspire to advance their economies) tend to assume the continuation of a favourable economic and financial environment and to formulate over-ambitious projects beyond their means. It should have been the responsibility of the international organisations and lenders-investors to warn such countries against the dangers as good financial advisors, but lenders-investors themselves are liable to try to expand their own business in such countries - particularly when their domestic business is not so buoyant.

It is therefore necessary to keep in mind the inevitability of cyclical changes - and to try to reduce cyclical fluctuations.
At the policy-makers’ level it is important to monitor not only traditional economic indicators, such as consumer prices, real economic growth and monetary aggregates, but also other equally important indicators, such as:

- asset prices;
- exchange rates;
- access to all financial facilities; and even
- the size of open (excess asset or excess liabilities) positions of major players in financial markets

Exchange rates and access to financial facilities give some clues to the possible scale of financial flows in case of financial instability.

Even if data on all the above indicators can be obtained and even if the figures show signs of possible financial instability, it is not always easy to apply effective brakes to economic and financial activities. Simple warnings by policy-makers may not be effective - as shown by the further big rise in stock prices after Alan Greenspan’s famous warning on “irrational exuberance”.

The best approach for policy-makers when warnings alone are not effective is more active use of regulatory supervision of financial activities. Simple warnings by policy-makers may not be effective - as shown by the further big rise in stock prices after Alan Greenspan’s famous warning on “irrational exuberance”.

Regardless of differences in the regulatory framework between countries, it is desirable for central bankers to get involved more in regulatory problems - and also for prudential and macro-economic policies to be more effectively co-ordinated. In addition, regulatory supervision should be expanded to cover systematically important non-bank financial institutions as well.

Return to basics: In the name of financial innovation, some of the basic principles of finance seem to have been ignored. Now is the time to return to basics. I have the following suggestions:

- Though financial problems often originate on the asset side of balance sheets, in the form of non-performing loans or depreciation of other financial assets, financial instability is usually aggravated by the subsequent loss of market confidence in the institutions involved and their growing difficulty in securing liquidity and replenishing capital from market sources. The crucial importance of own capital, rather than the ability to leverage, should not be forgotten.

- Though the original purpose of securitisation (diversification of risks) is understandable, originators of securitised assets should always be mindful of their systemic responsibility to minimise the contagion of bad risks. Securitisation and other forms of financial innovation should not be accompanied by laxity in risk assessment.

- Too complex financial devices, which are beyond the comprehension of top executives of the institutions involved, should be discouraged - and even forbidden.

- If asset prices are overly inflated, despite the continued stability of consumer prices, and if exchange rates are so misaligned that this leads to further enlargement of international imbalances, such a situation should be regarded as an omen for the possible emergence of serious financial instability.

- A more open dialogue between credit rating agencies and accountants, on the one hand, and financial institutions, on the other, might offer a common sense solution to the inherent problem of “conflict of interest” between the fee-receiving reviewers and fee-paying reviewees. This should be in addition to the introduction of codes of conduct by regulators, or by the rating agencies and accountants themselves.

- Regulatory supervision should be more principles-based, rather than rules-based. Mark-to-market rules should be modified when credible market prices are not quotable. In such a situation, I wonder if financial assets without maturity dates, such as stocks, could be marked to their original value or their lowest value so far in order to simplify accounting.

Try global solutions for global problems: Since economic and financial activities are already globalised and most financial problems are easily contagious, international co-operation is an absolute necessity and should be further strengthened in the areas of macro-economic policies and regulatory supervision, as well as accounting and banking practices.
Furthermore, it should be noted that often – and particularly in our current crisis – excess liquidity, which is one of the major causes of the crisis, is closely linked with the problems of global imbalances, mostly between the US and the rest of the world, especially the countries of East Asia such as China and Japan. Large current account imbalances between the US and East Asia, the reluctance of East Asian countries to appreciate their currencies, through heavy exchange market intervention or too low interest rates, and East Asia’s willingness to invest external surplus in the US in the form of foreign exchange reserves or thorough direct and portfolio investment and the carry trade – these factors all enabled Americans to enjoy stable prices, low interest rates and positive economic growth with very easy monetary conditions.

Such a situation was comfortable for both sides, since Americans were able to continue personal consumption at fairly stable domestic prices while East Asian countries were able to continue export-led growth. But before too long, too easy monetary conditions in the US generated the financial crisis which we are now facing.

In order to overcome the current crisis, it is urgent, of course, for all countries to take every possible macro-economic policy action to reverse the decline of the global economy without further recourse to protectionism. For the longer run, however, it is equally important for Americans to reduce their excess spending gradually - and for East Asian economies to pursue more domestic demand growth. Unfortunately, although this has been said many times, it has yet to be achieved.

- Don’t forget the cycle. Every good thing comes to an end.
- Watch asset prices and open positions as early warning signs of problems to come.
- Don’t be seduced by the joys of financial innovation.
- Boost international cooperation.
In the unlikely event that a newly-appointed CEO of a UK or European financial institution asks me for some advice as he/she faces up to the tasks ahead, I would suggest that some prominence be given to two aspects.

First, have a very close look at any existing American exposure - especially if there is any suggestion that it should be increased. In the same context, a close study of the legal aspects of operating in America should be undertaken, because the potential losses from claims can be overwhelming. Second, I would push him or her to ensure that there is a thorough understanding of the chain of command to what I would call the ‘bowels’ of the bank. In other words, to the people who see the transactions passing through the books day in and day out - because they have a greater understanding of the market pressures than anyone else. By this, I mean that encouragement to these people to comment (and report) on who is settling at the last minute at the end of the day, and which institution is giving the appearance of being out of control of its book, can be very helpful in identifying potential risks - and avoiding them.

I must say that, in my experience, neither of these issues is given the attention which it deserves. Even if there is a lingering feeling that they are important, there is a tendency “not to be confused by facts”.

Exposure to the huge American market is obviously very tempting - and, on the face of it, potentially very profitable. But how many real success stories are there, and how many billions of pounds have been lost pursuing the American dream?

Sadly, the experience of failure is not easily embedded into corporate memory. In the early 1980s, for instance Midland invested in Crocker National, a mid-sized California bank with a strong reputation for customer service - and, at the time, at least from the viewpoint of a competitor, it looked to be a masterstroke. So much so, in fact, that Barclays was keen to make a similar acquisition in order to consolidate all its US businesses into a single sound institution. Crocker was, at the time of its acquisition by Midland, sound - but far too much leeway was given to the American management, and the end result was a loss estimated to be in the region of £3.6 billion. As a result, there was great concern that Midland might not survive, but fortunately Hongkong & Shanghai took a 14.9% stake - and announced that it would make a full bid in due course. This gave considerable comfort to the City.

When in November 1990, Hongkong & Shanghai pulled out, alarm bells really did start to ring in the City. I well remember that in Barclays we reviewed our daylight exposure to Midland - and were greatly concerned to find that, at certain times of the day, it could be many billions of pounds.

Not surprisingly, we took action to reduce our exposure. But the question still has to be asked: How many times since that catastrophic series of events have British companies invested huge sums in America without introducing rigorous control mechanisms, leaving existing managements in almost sole control?

It is almost beyond comprehension that the difficulties caused by the collapse of the sub-prime mortgage market in America have brought about such astonishing losses in global markets. It is very difficult to understand fully how it is that losses in what one could have assumed to be a limited and contained market have spread to country after country - and to commodities right across the board.

Sir Brian Pearse

Lessons from the US – and listening to the bowels of the bank
And yet it would not have taken much for bank executives to look behind the pieces of paper which were being traded, and to see the weakness of the underlying assets. Was it appreciated by those around the world who bought the paper that vast sums were being lent on mile after mile of US homes in trailer parks?

So many eyes were taken off the ball. When I was working in the US, I visited one of the Texas branches of our finance company. I asked the manager about the state of the market. He said “It’s dreadful. Just look at this”. He proceeded to show me three drawers full of keys. I had not realized until then that US customers simply threw the keys back to the lending office, and fled across state lines to avoid their liabilities.

Was the purchase of Household Finance by HSBC - which was seen at the time as an unusual downmarket step by the bank - solely driven by the sharp reduction in interest costs which would ensue? Initially, of course, that did happen - but at what cost later?

How was it that experiences like this, which lost banks very large sums of money, did not become embedded in corporate memory - or were simply ignored?

I moved to the US for Barclays in 1982. One of our businesses at that time was Barclays American, which was formerly American Credit. It was not intrinsically a bad business, but the recession of the early eighties meant that its bad debt exposure rocketed. I spent about one day a week engaged in damage limitation dealing with this business, which was based in Charlotte. Yet, within only twelve years, all this experience had been forgotten.

I mentioned at the outset the huge liabilities which can arise in taking on the American legal situation. I regret that I can quote many examples from personal experience. For instance, an employee in the US was dismissed for poor time-keeping and for unsatisfactory work. His lawyer wrote to us claiming wrongful dismissal, and claiming US$75,000. We refused to pay – so, he became a whistleblower by writing to Washington claiming that we had ignored directives in the completion of legal documentation. Suffice it to say that we settled for nearly US$4 million. I do not need to go any further on this, except to say that it would be quite wrong to assume that the legal system in America operates (or is governed) in a similar way to that in the UK.

I would like to think that if there was ever any suggestion of a legal action against any company in which I was involved, I would assume the worst, assess the risk – and then quadruple it. And I would aim to settle as soon as possible.

Senior managements of many institutions in many countries stand accused today of ‘taking their eyes off the ball’ – and, no doubt, they will reflect on their failings for years to come. But it is now essential to identify what went wrong at many levels. For instance, fingers have been pointed at lax regulation, and this area certainly should be examined. It is interesting to reflect that one of the earliest CSFI reports was a (pseudonymous) paper entitled “UK financial supervision: a blueprint for a change”. Published in May 1994, it was a far-sighted review of the role of the Bank of England in supervision – including a suggestion that the arrangements then current had fallen behind fast-changing events in the financial services industry. It went on to make the point that the blurring of territorial boundaries between the banking, building society and investment industries had made the task of ensuring effective supervision almost impossible.

Naturally, there were strong views at the Bank suggesting that it would find it impossible to continue to function as a lender of last resort if it also found itself without involvement in and control of the supervision of banks. At the time, I had much sympathy with that view - although it was already beginning to be clear that the amounts which might be required in the event of a run on a bank were already beyond its means, and that Treasury intervention would be required. Recent events have confirmed that concerns about the lender of last resort function were probably overstated. The amounts required have become so large that the responsibility inevitably has to be that of government itself.

In essence, the proposals put forward by the CSFI on the split between monetary policy and supervision were close to the mark when Labour took office in 1997. There were, however, two substantial differences:

- First, the CSFI had proposed that a Financial Services Supervisory Commission should be created as a statutory commission answerable to Parliament. This would have included a Commissioner and a Board of Supervision, including representatives of the financial services industry, the business community and the Bank of England.

- Second, it was made clear that it would not be the role of this Commission to provide consumer protection, which was to be provided through the Banking Ombudsman.

In the event, the FSA was made responsible to the Treasury, and that meant that there was a substantial influence by the consumer lobby.
I was a member of the Bank of England’s Board of Banking Supervision at the time. This was purely an advisory Board with no powers, which normally met every two months or so to hear any concerns which might be outlined by the Governor or Deputy Governor and to offer comment and advice. There were times when it met much more frequently if a very serious situation was developing. It was a privilege to be part of that little team which included Dennis Weatherstone of JP Morgan, and Harry Taylor of Manufacturers Hanover, Both, sadly, died in 2007.

The Board was able to witness at first hand the establishment and operation of the FSA – at least, until 2002, when we were disbanded. I well remember our final meeting, when Weatherstone suggested he had two concerns about the FSA as then constituted. First, he said, there was a danger of it becoming a “box ticking” exercise; second, the influence of the consumerists might be too strong and City experience might be inadequate. Although Howard Davies, the FSA’s first chief executive, kept tight control of both aspects, it seems that there has been recently some slippage, and that a hard City view has been lacking.

Regulation is likely to be at the forefront as we try to recover from the current situation. No doubt, there will be many suggestions as to what changes should be made. My concern is that regulators will be given a more and more dominant position. At the beginning of this article, I mentioned the need for management to be close to those in the ‘bowels’ of the bank - and exactly the same is required of regulators. It is very difficult indeed to be a really effective regulator if there is no detailed knowledge of the markets being funneled up the line.

I have always regarded it as a pity that the FSA was positioned in Canary Wharf, leaving the Bank of England situated miles away in the City. In an ideal world, I would like to have seen much closer interaction between the two organisations.

- Be truly, deeply skeptical about US exposure. America is tempting – but it is difficult, and very litigious.
- Watch what is happening in the bowels of the bank – and make sure that those who actually process the transactions have access to top management.
- Don’t let bank supervision be highjacked by consumer interests. Learn from the Bank’s Board of Banking Supervision. And build much closer links between the BoE and the FSA.
“Old men forget: yet all shall be forgot. But he’ll remember with advantages what feats he did that day”

William Shakespeare

This year marks the 50th anniversary of the “reverse yield gap”, the point at which equities started yielding less than bonds (despite the higher risk), which occurred in 1959. This is all to do with inflation of asset prices being higher than monetary inflation. All that is happening now is that the process is reversing.

The only new thing about the current crisis and the next few years’ adjustment is that several things happened together. They have all happened before, when many Emperors were seen to have no clothes. In this case, asset-driven bankers, the failure of corporate governance, supine institutional shareholders, an admiring press and sleepy and out-of-touch regulators combined to ignore what was happening - and the lessons of history. Remember Walt Wriston, Chairman of Citibank, saying: “Countries don’t go bust” - and fast forward to the Latin American debt crisis and, of course, on to today.

While it is not possible to make a hit parade of how to apportion the blame, each of these groups lost sight of what was going on over the last 50 years (and previous historical precedents). Rudyard Kipling was singularly prescient when writing The Gods of the Copybook Headings in 1919:

“As I pass through my incarnations in every age and race, I make my proper prostrations to the Gods of the Marketplace. Peering through reverent fingers, I watch them flourish and fall, and the Gods of the Copybook Headings, I notice, outlast them all...”

Clearly, one has to start with the banks, the bankers and their boards. The triple boobys abandoned the fundamental principle of banking - that it is, first and foremost, about garnering deposits, guarding them carefully and then lending some on a prudent basis. They became infatuated with the notion that it was all about assets, and that the liabilities could look after themselves. It appeared they had discovered a limitless upside, driven by ever more imprudent leverage. This was exactly what happened with the fringe bank crisis in 1973. (For those who don’t remember, this was a group of unregulated banks who relied on the wholesale money market to provide funding for increasingly leveraged property deals.)

Furthermore, the speed of asset growth left such boring things as documentation, settlement risk and counterparty risk lagging way behind. Remember the lessons of the Herstatt Bank collapse in Germany in 1974, and the unexpected consequences on settlement across time zones, and look at the unwinding problems arising daily following the collapse of Lehman Brothers.

Another critical factor that softened attitudes both inside and outside Lehman prior to the crisis was the apparent abandonment of the “moral hazard” argument following LTCM’s collapse and rescue in 1998. “Too big to fail” meant that boards and management thought (largely correctly) that, if they got into trouble, they would be bailed out.

The theoretical economic lesson, and observable fact, that bankers failed to appreciate, was that the only reason for the apparent infallibility of the model was that asset price inflation continually exceeded monetary inflation. There were plenty of mini-bubbles that burst (including property), but the relative
brevity of these “blips” blinded bankers, politicians, investors and regulators. Rather surprisingly, the biggest bubble of all to burst in the last half century – Japan in 1990 – seems to have passed all the masters of the universe by. The Japanese deflation, into which the rest of the world will now probably sink, should have given 18 years of lessons to be learnt. I wrote in 2004 that “every bank should have a Japanese on its board”.

The interesting question is why did Greed constantly ignore Fear about over-leverage or asset price inflation?

The answer lies in the fruits of successful Greed, namely salary and bonus inflation. This can now be seen as proof of one of Christopher Fildes’s dicta: that the system has become the ultimate triumph of Marxism as “the workers get everything and the shareholders get nothing”. Who remembers the debate in the 1970s about the excessive level of forex traders’ compensation, and how they were unfairly exploiting their “special knowledge”? It was not long before ignorant and unthinking managers found to their cost the risks of having a “highly profitable” business that they did not understand (remember Citibank in Amsterdam, Credit Suisse Chiasso and so on till Barings). Any banker worth his salt (or, perhaps, who went through a lengthy and rigorous training programme in a bank rather than a grocery) knows that, if something is too good to be true, it probably is. You were always wary about making too much from a few clients, or about dealing strategies of which the management had little experience. As the late Sir Dennis Weatherstone, former chairman and CEO of JP Morgan, always said (as an ex-forex trader): “If I don’t understand it, then you cannot do it.”

When the gap between the highest and lowest paid widens, two things may happen: a political revolution or a financial reverse that levels things up. Let’s hope, given we have the highest historical mismatch, that it is a financial correction that does the trick.

In the UK and elsewhere, there has been a dangerous tendency to split regulation and central bank management of the currency and money markets. We are now seeing how short-sighted this policy has been - nowhere more clearly than in London. There is no substitute for the regulator being a participant in the markets it regulates.

The Bank of England used to have a real feel for what was happening in the markets; indeed it blew the whistle on fringe banks even though it was not responsible for their regulation (which lay with a government department in Whitehall).

The Bank’s officials picked up all the gossip in the bar of the Overseas Bankers Club, located just by its back door.

They were also able to judge the sagacity and integrity of key market participants with intelligence gathered from their day-to-day market dealings. In the 1960s, the Discount Market (RIP) eschewed the interbank market (despite the arbitrage opportunities) because the Discount Market was uncertain about the wisdom of its unfettered development. They were 40 years too soon. Remember the Co-op Commercial Bank funding crisis, in the early 1970s?

The constitution, compensation and capabilities of non-executives on the boards of the banks and investment banks has been a major contributor to corporate blindness.

The lessons – from Robert Maxwell and Alan Bond to Conrad Black – on paying big salaries to pliable board members should have been clear to all, especially regulators and investors, as everyone jumped on the gravy train. But no; the boards increasingly “went along with management” and failed to ask searching questions. How many non-executive board members of the banks and investment banks were traders, “liability men” or members of credit committees?

The strongest banks around today are those that continued to heed JP Morgan’s early 20th century description of a banker: “He should firstly be the guardian of his customer’s deposits, secondly he should be a friend, advisor and counsellor, and finally to lend some of his deposits on a prudent basis.”

The apogee of this asset-driven failure to comprehend the fundamental nature of banking was the arrival in 2007 of “Cov-Lite” lending. This, actually, was the top-of-the-market signal; everything went downhill from then.

Very little attention has been paid to the role of the media in all of this.

Curiously (but rather encouragingly), journalists have not on the whole joined the gravy train. Indeed, they have maintained a rather hairshirt approach to compensation. This masks, however, the PR-driven entertainment culture, where all the costs are born by companies and institutions. This has produced over the years a tendency for the press to act as ‘groupies’ - proffering admiration and favourable coverage to apparently rich, powerful and successful people from Bernie Cornfeld at the Investors Overseas Services mutual fund through Robert Maxwell to Fred Goodwin. We shall see whether any of the Russian oligarchs and other “tall poppies” fall into this category.

The credit rating agencies have come in for a lot of stick. This is largely because credit committees, top management and boards mistook a AAA rating – based on the ultimate collectability of a debt – for an indication of liquidity. They assumed that a AAA
rating of a structured instrument meant it was liquid in the same
way as gilts or high-grade corporate bonds. As credit committees
nodded through the AAA structures with five-year maturities, the
banks continued to borrow short (thinking they could always sell
the structured product). As any banker should know, borrowing
short to lend long is the forerunner of disaster (Overend Gurney
in the 19th century is the oft-quoted example).

Another group that has come in for much unfair blame is the
hedge funds.

The word “hedge fund” covers a multitude of types of business
and investment strategy (all of which are pretty transparent to
investors, who also tend to co-invest alongside management).
The fundamental proposition is to try to make returns in both
up and down markets – the latter having been ignored for
decades by “long only” funds. Of course, the Hedgies too got
carried away by leverage, and also got greedy when shorting
stocks. Anyone who remembers the Australian mining boom
of the late 1960s will recall Poseidon, which went from 10p to
£100 - and how people shorting it were ruined. Shorting creates
unlimited downside risk, as was so clearly demonstrated in the
recent “cornering” of shorters of VW.

So what is the conclusion? Where are we going? Are there
yet more unutilised experiences that could help?

- Nothing new under the sun – except that lots of
Problems have hit at the same time. Plus:
  - too few wise heads in the City; too little knowledge
in the Bank of England of just what’s going on;
too little market experience on boards; and too
much temptation put in the way of the media’s
critical faculties.
  - Big fear that we are trying to cure a problem
caused by over-leverage with a massive dose of
new government leverage. Are we heading for
deflation on an unprecedented scale?

The unlearned lessons of the last 50 years (and a bit of history)
that have got us into this mess have produced an orgy of
kneel jerk political reactions to support the banking system
and to trigger a rapid fall in asset prices. One wonders what
regulators and politicians were doing from July 2007, when
the word “credit crunch” entered the lexicon, until bursting
into action 14 months later with apparently no initial idea of
what to do. This is reminiscent of the 1920s and early 1930s
when nearly three years elapsed between the stock market
crash (when a few bankers jumped off the roof) and the real
flood of bankruptcies in 1932.

This time, the gap will be much shorter due to improved
communications and globalisation; but the same problems
will occur.

It is ironic that a crisis largely caused by over-leverage has
prompted a massive increase in government leverage, so we
are actually exacerbating the problem. The result of this will
be a longer period of deflation. There will be a reversion to the
Keynesian attitude to goods and services, which is that when
the supply goes up the price goes down. When asset prices fall
faster than the decline in inflation and the cost of money, then any
increase in the supply of money will reduce its price (ie interest
rate). The Friedman-inspired notion (that has sadly become totally
ingrained in bankers, treasuries and politicians) that an increase
in the supply of money will lead to a rise in its price was correct
when real asset prices were rising faster than inflation. Markets
expected this response. Now, we are in the reverse situation,
where the massive increase in the supply of money will cause
its price to fall, just like any other economic good or service. The
present policy response will, therefore, massively exacerbate the
problem. We are heading for deflation, the severity and length of
which will depend on how rapidly “belt tightening”, saving ahead
of consumption and reduced government expenditure take hold.
The signs are not at all good.

There is a silver lining for the UK, however. The continued
fall in the value of the pound (another example of increased
supply lowering the price) will at least help a regeneration of
UK manufacturing and exports, and will stimulate tourism.
There is widespread agreement that the scope and scale of the current crisis surpasses anything experienced since reliable records of such events were collected. The adoption of the so-called market model in almost every country around the world, together with the growth and spread of capital markets – every country should have one, according to conventional economic thinking in recent years – together with the dismantling of obstacles to financial institutions of all kinds to operate in any market of their choosing, places us in a system that has never been more inter-connected. The circuit-board of the global financial system has become vastly more complex, and its signals communicate much more quickly, than at any time in the past.

These developments create the potential for significant advances in economic welfare, as well as for the destruction of value on a massive scale; but they are scale-and-scope factors, not underlying causes. They may magnify and expand the gains and losses from economic and financial intercourse, but do not really explain how or why those swings in economic and financial values occur. For that, a thorough analysis of recent social and economic history would be needed.

Nevertheless some significant signposts can be identified.

Systemic crises in the last 30 years have usually been caused by a mixture of macro-economic imbalances and structural change. The UK fringe bank crisis of the early 1970s is a classic case. The adoption of a new system of monetary control, with a resulting rapid expansion in monetary aggregates, and a contemporaneous relaxation of government controls on commercial property, led to the formation of a new sub-set of financial institutions. These quickly over-extended themselves and encountered great difficulties when interest rates were raised to correct the internal and external imbalances that had developed. The threat to the banking system was averted only through the Bank of England’s ‘lifeboat’.

While the macro-economic policy elements differ, the same story explains the crisis in 1982-84 when the inability of a number of Latin American countries to service their foreign currency obligations almost brought the entire international banking system to its knees; in 1991-93, when intervention by the Bank of England again prevented problems among new smaller, wholesale-funded banks from spreading quickly up the banking chain; in 1997-98, when fiscal, monetary and exchange rate imbalances combined with market liberalisation in South East Asia to create circumstances that resulted in a regional collapse; in the early 1990s in Sweden, where a decision to permit foreign banks to participate in the financial system in the form of branches came at a time when domestic monetary and exchange rate policies permitted a rapid expansion of bank lending and a subsequent collapse of the entire banking system; and, of course, in recent years, when huge imbalances in fiscal, monetary and exchange rate policies among major countries created the conditions for the current crisis.

Mistaken or poorly timed macro-economic policies may not by themselves make financial crises inevitable – although it is difficult to identify a systemic crisis at either the national or international level that does not have an explanation that lies at least in part in macro-economic causes. But the mixture of deregulation and structural change, together with inappropriate fiscal, monetary or exchange rate policies, seems especially malign.

The reasons are not difficult to establish. Deregulation is usually a response to the perceived failure of existing institutional arrangements. Restrictions on financial activity tend either to be counter-productive or actively circumvented. An accommodative monetary policy seems right: there is little point in stifling the operation of a more open market regime by adopting a tight monetary stance. Such a structure often means new participants, domestic or foreign, who compete vigorously to establish a position.

Brian Quinn

Déjà-vu? or “This time it’s different”?

Brian Quinn was Executive Director of the Bank of England from 1988 to 1996, and acting Deputy Governor. At the Bank, he had responsibility for financial supervision. Prior to joining the Bank, he worked with the IMF. Following his retirement, he spent a happy and productive decade as chairman of Glasgow Celtic.
in the new market. Incumbents, whose risk management muscles were developed in a less challenging environment, respond by going rapidly out along the risk curve. Interest rates are raised to slow the rapid rise of financial activity; and the weaker players find themselves unable to cope. This abruptly changes the climate for investors and depositors.

Alternatively, asset bubbles form, awaiting the event that causes them to pop, catching the established as well as the recently arrived. The larger the upswing the bigger and more numerous the bubbles.

No attempt to understand what is going on at present can neglect human psychology and sociology during upswings and downswings in the cycle. These are the truly common underlying factors in financial and economic crises.

The pattern is familiar, apparently inevitable and symmetrical. A period of steady growth in incomes and wealth generates feelings of expansiveness among businesses, consumers and regulators. Bankers and investors first respond to greater opportunities, then, frequently goaded by competition and drawing comfort from the belief that everyone else is doing it, become active promoters of borrowing, lending and investing. They persuade themselves that this time they have calculated the risk of loss and priced it accurately, ignoring objective market indicators of relative riskiness – of which there have never been more than at present – and effectively subcontracting what is supposed to be their speciality, credit assessment, to rating agencies whose reliability has time after time been exposed as faulty.

The same process occurs with borrowers and investors who load up with risk, either in the form of bank and credit card borrowing, or by chasing higher yields and capital gains from their savings; in many cases funding this search by further borrowing. What is the essential difference between borrowing to take a long position on an exotic derivative product and borrowing to the limit from a bank or building society to participate in the buy-to-let market?

The role of the press and media has to be added to the mix. Despite their claim that they merely act as the messenger reflecting public views, they clearly create a climate of opinion, or at the very least enhance it both on the way up and on the way down. Records are set wherever they can be found, particularly when the cycle turns downwards. Not all of this is deliberate or prompted solely by commercial considerations. Journalists and editors are almost certainly carried along by what is actually happening; but they are very willing accomplices. Robert Shiller’s book “Irrational Exuberance”, based on the US stock market performance over a period of 130 years, contains a chapter with valuable insights into the role of the press and media in investor cycles.

To summarise, the particular mix of ingredients that characterise the present crisis is unique; but that is true for all previous episodes of this kind. However, there appear to be certain identifiable common factors operating first at the national level and, more recently, at the international level as financial markets become more conjoined. These include fiscal, monetary and external imbalances usually resulting from errors in macro-economic policy. This time it appears to be bigger and broader but in essence it repeats history in the wider sense, if making it in a narrower sense. They also include what appears to be an innate tendency of humans to extrapolate their feelings and behaviour, growing ever-more optimistic in the upswing and increasingly alarmed in the downswing. The higher you go, the further you fall, in each case leaving objective fundamentals and rationality far behind.

Does this mean that episodes of this kind are bound to recur? Probably. The quants or their successors will resurrect like dragon’s teeth. After a pause, the circuit board and individual chips will develop further and we will persuade ourselves that, this time, it really is different.

In the meantime, what can be done to strengthen the system we have got (I assume that the market based system will continue to prevail, all known alternatives having failed)? Here are a few for consideration:

1. Develop a much better understanding of how macro-economic, macro-prudential and micro-prudential policies and events interact. There is a lamentable lack of research into these relationships. Central banks, with their place at the centre of the economic and financial system, are best placed to do this job.

2. Recognise that there is a trade-off between the amount of competition in financial markets and the quantum of risk taking. With virtually open doors into...
any country, commercial and investment banks forget their discipline in their effort to establish a presence or protect a market position. Economic pricing of credit disappears in the red mist. Moral hazard can have several destabilising consequences, including maintaining excess capacity.

3. It is risky, if not mistaken, to put prudential supervision and consumer protection in the same institution. Regulation of the utility aspects of financial products and services calls for different skills and knowledge from maintaining safety and soundness. In the upswing of the cycle prudential issues are crowded out by the politically sensitive demands of policy holders, individual investors and borrowers. There is then a conflict within regulatory authorities that reinforces cyclical trends. Devising the correct regulatory structure is admittedly difficult; but there is a serious question regarding the mixed functions of an integrated authority.

4. Resurrect commonsense at the expense of algorithms. This is not a Luddite sentiment. The technique of risk assessment, pricing, etc., has improved enormously in recent years. But sitting down, looking out of the window and asking yourself as a banker or supervisor “can this be right” also has its place.

5. Accountants and auditors of financial institutions (and other businesses) should be less inclined to regard their standards as biblical statements. Had the last generation of auditors insisted on banks providing in full for all possible bad and doubtful claims on Latin American countries in the early 1980s, the damage done to economies around the world might well have been catastrophic. Recent developments on the matter of fair value accounting give some encouragement that the lesson is being learned, but possibly later than it need have been.

6. Temper expectations of the value of corporate governance in preventing the urge to join the herd. Much more can be done to enable non-executive directors to understand the business model and arcane financial products, especially when assembled by rocket scientists. But unless they attend day by day and thereby risk confusing their role, they cannot really understand all that is going on in a business that is operating in fast changing and highly competitive markets. Limit board papers to a total of 30 pages of documentation. The number is arbitrary – but so are the lines in a sonnet, and that works.

7. Transparency is also important – critical even. But again have realistic expectations. Including 20 pages in Annual Reports describing activities in derivatives can amount to obfuscation, not transparency. It is like passing round copies of the Highway Code at the annual office Christmas party - put aside to be read later.

8. Do not extend regulation to matters of compensation; that is doomed to failure. By all means expect supervisors to probe compensation policies and their likely effects and, at the margin, reflect this in their assessments of the riskiness of the institution. But ordinarily those damaged most by excessive compensation are the shareholders; they should apply the necessary disciplines and sanctions, difficult though that may be in today’s highly competitive markets for skilled people.
While I do not have sufficient contextual knowledge of the 1929-32 experience to draw any comparisons, it seems quite clear that today’s financial crisis is singular along many dimensions when compared with the series of post-War disruptions. At the same time, however, the private and public policy responses to these older problems can be instructive to us today.

Today’s situation is so different because it started in the banking sector, has engulfed the principal US and European players and has spread from the financial sector to the real economy – and then back to the financial sector as a result of the dysfunction of the banking system itself. More typically, crises follow from external macro shocks that produce price changes or customer problems that then ripple through the banking sector’s balance sheets, finding weaknesses that create localized (though possibly severe) credit problems for a few or many institutions. I cannot remember an occasion of system-wide dysfunction other than Japan in the eighties.

Our current problems also seem to have had a much deeper impact on the financial sector and the functioning of markets than usual - and so are much more dangerous. As always, macro responses will be essential, but dealing with the financial sector will be center stage for both governments and managements.

As I see it, and I fully understand that each observer has his/her own point of view, the central issue underlying today’s situation is that, with the advent of securitization and the adoption of risk-adjusted capital regimes, we effectively “decapitalized” the core financial players. (I roughly estimate that we are short about $800 billion.)

What I mean by this is that securitization took assets off balance sheets, where they had attracted both capital and reserves, and turned them into investment products. The risks inherent in the products were to be widely distributed amongst sophisticated investors who would absorb those risks as a diminution of investment returns. The need for explicit capital allocation was, therefore, eliminated. As it has turned out, however, the risks actually became quite concentrated.

The notion of risk-adjusted capital further reduced capital by suggesting that models, which are inevitably based on history, could capture the risk inherent in a balance sheet and prescribe the relevant capital requirement. This dynamic reduces capital in periods when times have been historically good and leaves the system unable to deal with a shock or other deviations from the historical experience when these come about. I believe the pro-cyclicality of this logic is a problem, as is the notion that we know where risks are a priori.

Having decapitalized the system, we simply needed a credit shock to bring it down.

As it happened, the shock came from sub-prime US mortgages – though the collapse was greatly aggravated by the lack of transparency (indeed, opaqueness) at the level of institutions and also at the level of instruments (complex products). Since the market grasped immediately that the key players were seriously short of capital, liquidity dried up and we had a series of runs. Most of these (but unpredictably, at least until recently), were “short-stopped” by government intervention. Moreover, new private capital was initially attracted into a few institutions. However, as the dimensions of the problem became more apparent, as these were aggravated by the weakness in the real economy, as we saw mark-to-market write-offs relating to complex products and as the market tried to understand the actions
of the government itself, private capital disappeared. The major players, with a very few exceptions, are now effectively in the hands of the government.

Some observers have cited low interest rates as being responsible for crazy lending and borrowing and/or for developing a demand for synthetic investment products that could deliver higher returns. While I think that behaviorally this is true, I make the assumption that a robust financial sector should be able to function without serious problems in periods of both high and low interest rates. If appropriately capitalized, it most likely would. Temptations to mis-lend or to reach for high risk returns always exist, but these cannot be allowed to bring the system down.

So where are we now?

The core financial system is still undercapitalized. However, liquidity problems are slowly dissipating as an umbrella of government guarantees has been deployed. Significant losses have been taken, but no market to remove questionable assets from financial balance sheets has yet developed. The need to restructure the industry and its regulatory matrix is widely recognized, but such restructuring has yet to be started; investors have a good reason to sell, but little current reason to buy. The government is the owner of last resort. True, there are still important players and sectors of the industry that have not been caught up in the core problem, but the real economy is weighing even on them.

The real economy has been hurt. Hurt first by the collapse of the over-financed housing sector, then hurt by the dysfunction of the financial sector, then by the contraction of the financial sector itself. US GNP is probably down by something more than 5% on a run-rate basis, unemployment is up, markets and consumers are scared. Virtually all asset prices are down by 40%, which has produced an important wealth effect. World GNP for 2009 is likely to be significantly impacted since, clearly, our economy today is global. Coupling reigns supreme.

Importantly, governments are deeply engaged. Engaged first in restoring liquidity, then in injecting capital into the system and currently in deploying all of their monetary and fiscal tools to offset the contraction of activity in the real economy.

Let me now ask the key question: What have previous crises taught us?

First, history tells us that governments are highly likely to be successful in their efforts. Markets will clear; the economy will rebound.

Second, history tells us that the banking system will have to get the questionable assets off its balance sheet, and a market for these must develop.

Third, a new model (and structure) for the financial sector will inevitably emerge. It must be one that ensures that the essential role of the sector in serving the real economy is maintained - and that prospective earnings, returns and risks are sufficiently attractive to bring forth appropriate levels of private capital to support the industry. I would guess that the industry will shrink by 35%, and that returns will fall. However, innovation will certainly return.

Fourth, a regulatory and governance structure that can reasonably be thought to protect the real economy from the effects of a meltdown of this sort in the future, while preserving the essential function and innovative capacity of the sector, will have to be designed and implemented. A new design must deal with accounting issues, the functioning of rating agencies and boards as well as capital and liquidity rules for the industry itself. Presumably, it will be international in scope.

In thinking of a future structure, it is worth noting a few things that could be relevant. I have already highlighted the role of securitization and the new focus on risk-based capital in decapitalizing the industry. That is extremely relevant for the industry's future structure. We should also be conscious of some important changes in actors, objectives and performances.

Since the eighties, when the US competitive performance was seen to have slipped and managements were thought to be lethargic and self-focused, investors have become dominant. In response, shareholder value has become the central objective for managements. In parallel, compensation practices have become generous. In essence, if shareholders did well there was little limit on compensation. New actors have emerged and are important - namely, hedge funds and private equity investors. And, importantly, new roles have emerged: banks, both investment and commercial, have added important and sometimes even dominant proprietary investing and proprietary trading activities to their more traditional role of customer-focused intermediaries. This follows from “shareholder value” as it is designed to enhance returns, or put another way, to further leverage capital.

Not surprisingly, mistakes were made. In particular:

- regulators (as one should have expected) tended to be swept along by the industry;
- remuneration incentives that were supposed to be linked to performance turned out to have a dynamic of their own;
- the rating agencies failed to provide the early warning they promised; and

- boards and managements took their eyes off the ball.

In addition, the industry itself became insensitive to practices that essentially abused its customers. This started with analyst

- The key problem was the massive ‘decapitalization’ of the key US financial players. Now, it is to create a market for the dodgy assets that must come off bank balance sheets.

- Any solution must involve a new regulatory structure, taking more notice of management incentives.

problems, then insurance broker issues, issues with mutual funds, issues with specialists on the floor of the Exchanges, and more recently issues over the origination of mortgages.

All of these will be relevant to any discussion about the future of the industry.

Thus, the agenda for 2009 is a full one. The macro economy is currently the focus. Additionally, I argue, the banks must rid their balance sheet of questionable assets and put forward future business models that can attract new capital (which can also be earned from operations and asset sales) and eventually displace the government’s investment. And, likely as not in 2009, a new regulatory structure must emerge. Discussions on all of this will be extensive. As mentioned, there are many lessons to be learned, but the context within which the global system functions is of essential importance to us all. A full agenda, indeed.
The so-called secondary banking crisis in the UK in the 1970s was largely a domestic affair – but it has chilling lessons for today's global markets.

There were three key features to the crisis:

- A relaxation of regulation was implemented in September 1971, in a framework described by the Bank of England as “Competition and Credit Control”. There were good reasons in principle for making such changes, but bank regulators always face the risk that events will not work out as they intend. The policy was scrapped after little more than two years, a period in which enormous damage was done.

- Freed suddenly from controls, the banks expanded their lending on a huge scale. Sterling lending to UK borrowers rose 150 per cent by the end of 1973. Instead of lending primarily to industrial and commercial clients, as the authorities had hoped, and thus promoting broad economic growth, the banks focused almost entirely on the property and financial sectors.

- Eventually, the wholesale money market froze. It had been assumed by bankers, even fringe ones, that the interbank market had boundless liquidity. However much lending business was taken on to the books, it could always be financed. But quite suddenly depositors realised that the credit risks had risen sharply and they were not being properly rewarded.

The background to the crisis was that the British economy had become sluggish in the post-War years, and the banking system was performing poorly, partly because governments regularly resorted to credit squeezes to protect sterling, partly because tough controls on the banks had encouraged the growth of a secondary banking sector, the so-called “fringe banks” which operated under a much more liberal regime. The Bank of England promoted “Competition and Credit Control” to restore some dynamism and to permit the clearing banks to fight back against growing competition from the newcomers.

The Bank’s consultative document, published in May 1971 with the backing of the Heath government, proposed the abolition of quantitative ceilings on lending, but at the same time the clearers would be expected to abandon their interest rate cartel and compete more strongly with the secondary banks.

However, the launch of the new regime coincided with the Conservative government’s latest attempts to boost the British economy with a package of tax and interest rate cuts. This triggered a period of rapid monetary growth and intense financial speculation. But Tony Barber, the Chancellor of the Exchequer, declared that any curbs on speculation would interfere with the government’s economic growth targets. The property bubble duly expanded at a hectic pace; house price inflation, which had been only 6 per cent in 1970, rose to 40 per cent by the end of 1972. Commercial property also soared in value.

The clearing banks could now compete more easily, but remained trapped by a culture of controls and ceilings. Loan applications had to pass slowly through a web of bureaucracy. This did not fit well into a climate of frenzied wheeler-dealing. Fringe banks, in contrast, had close relationships with property speculators and were prepared to make almost instant decisions. Interest rates were high, and perhaps the levels of security were weak, but what did that matter when property values were climbing at 30 per cent a year? In any property bubble, lending appears to create its own security; cautious bankers win no business.

A leading property lender was the Knightsbridge firm of Dalton Barton, led by “Black Jack” Dellal (who today, in his 80s, is still a well-known property trader). By early 1972, the
previously little-known fringe bank was running full-page
advertisements in leading papers such as the Financial Times
proclaiming a Shakespearean message: “There is a tide in the
affairs of men which, taken at the flood, leads on to fortune.”
It is worth completing, which the advertisements did not, the
tidal passage from Julius Caesar: “Omitted, all the voyage of
their life is bound by shallows and in misery.”

Shrewdly, Dellal sold out in 1972 to a minor City merchant
bank, Keyser Ullmann. Timing is everything in the property
market - and in fringe banking.

The bubble was inflating rapidly. By early 1973, retail price
inflation had reached 9 per cent, against a menacing
international background, including the breakdown of the
Bretton Woods currency arrangements and the beginnings of
the oil price shocks. The stock market began to fall, and
the Minimum Lending Rate went up to 11½ per cent in July
and 13 per cent in November. With the coal miners on strike,
a three-day working week loomed. The secondary banking
sector came under severe pressure. Barber's emergency
mini-Budget on December 17 finished it off. Hire purchase
controls were reintroduced and the banking “corset” was
imposed – a limit on the growth of liabilities. “Competition
and Credit Control” was comprehensively abandoned after
only two years and three months.

On the stock market, the share prices of several fringe banks
went into free fall, and the first casualty was London & County
Securities in late November. The wholesale money markets
also closed to the secondary sector. There was a run on
deposits, although because these were wholesale rather
than retail deposits there was no visible evidence in the form
of queues round the block, of the kind that provided such
dramatic evidence of the fall of Northern Rock in 2007.

The City of London began to build its defences. On December
19, it organised the first meeting of the Fringe Banks Standing
Committee with a proposal to set up a secret £1,000 million
support fund, mainly contributed by the clearing banks.
This “lifeboat” eventually peaked at over £1,200 million (the
equivalent of £10 billion in 2008 money), overshooting the
clearers’ limits to reach £1,285 million in March 1975 – the
Bank of England had to top it up.

Next to crash was Cedar Holdings, just before Christmas.
By mid-January, a score of casualty banks was being
supported. Eventually the number of “passengers” reached
about 35, not counting one or two other banks – notably
Slater Walker Securities – which were supported separately.
Several other basically sound financial institutions had to be
rescued in the panicky conditions. These included United
Domains Trust, the leading instalment credit group, which
eventually emerged from the lifeboat, while its slightly smaller
rival Mercantile Credit was taken over by Barclays Bank.

If the initial objective of the support operation was to tide over the
troubled fringe banks until conditions improved, it soon became
clear that there was no way back for many of them. Orderly
liquidation became the goal, with as little damage as possible to
the City's markets. The plug was eventually pulled even on the
once mighty Slater Walker Securities in October 1975.

By then, the lifeboat itself was in an extended run-off stage.
The operation succeeded in protecting depositors against
losses, but shareholders and bondholders were badly hit. As
for the overall expense of the bail-out to the clearing banks,
the Bank of England and the Treasury, no official estimates
have ever been forthcoming, although an unofficial cost to the
taxpayer of £100 million was ventured in 1978. (Participating
clearers reckoned it cost them £50m, or £10m each, which
they considered to be money well spent.)

A favourable factor was that the secondary banking sector
was almost entirely domestic and its operations were limited
to sterling (although in one or two cases the fringe banks had
begun operating in the then-small Euromarkets). Moreover,
there was a clear difference, in practice if not necessarily in
law, between the clearing banks and merchant banks, on the
one hand, and the secondary banks on the other. Many of the
fringe banks were regulated by the Department of Trade
and Industry, which in the early 1970s had been readily supplying
new banking licences.

Clearing banks had close relationships with their regulatory
body, the Bank of England; top merchant banks had the
special kudos of being represented by the Accepting
Houses Committee which was the ultimate “club” in the
City of London - members were customarily admitted to
the Bank of England’s inner sanctums. There was no cross
contamination between the primary and secondary groups,
except for one nasty moment on November 29, 1974, when
the City was swept by rumours that NatWest was in trouble.
NatWest felt it was necessary to put out a public denial and
it quickly calmed the markets.

It took years to sort out the mess in the banking and property
markets. Only after the Conservatives came back to power in
1979 under Margaret Thatcher did the financial system start
building a base for future growth. Almost immediately the new
government abolished foreign exchange controls, which helped
to open up the London markets to foreign institutions. Within a
few years, the London Stock Exchange had been deregulated
too, giving further impetus to the City’s internationalisation.
We can now jump forward to the 21st century. But although there are some similarities between the crises of 1973 and 2008/09 – notably the sudden freezing of the interbank markets – there are important differences too.

The broad comparisons can be summarised as follows:

- Regulation had again been sidelined, and governments were obsessed with growth. Nowhere was this more true than in the UK, where Gordon Brown regularly boasted during his 10 years as Chancellor of the Exchequer of promoting continuous expansion. A lending bubble – in both the personal and corporate sectors – was key to this. There was also international competition in financial services, and the Financial Services Authority - having largely displaced the Bank of England as the main regulator since 1997 - came under pressure to provide “light touch regulation” to improve the City of London’s competitiveness. The British government was delighted as business drained towards London from Frankfurt and Paris, not to mention New York.

- Bubbles expanded once again in housing and the commercial property market. House prices tripled in the 10 years during which Gordon Brown occupied the Treasury, but the risks were scarcely considered worthy of attention despite the historical experience of housing bubbles in the early 1970s and again in the late 1980s. A booming commercial property market was tolerated as evidence of economic growth and not of potential financial instability.

- By the summer of 2007, pressures were becoming intense. Northern Rock was the first to collapse because it relied for funds primarily not on the wholesale deposit, or interbank, market but on the global market for securitised mortgage-backed instruments. The failure of this market was triggered by the serious weakness of the US housing market. Markets remained fearful, and it was only a year later that the interbank deposit markets froze. In 1973, this had been a domestic British phenomenon, but in 2008 it was more or less global.

The dangerous temptation of house price bubbles for vote-seeking politicians is a common theme here. Unlike general price inflation, a strong rise in house values is regarded favourably by a majority of the population. Only a minority, who are not home owners, and probably do not vote very diligently, are possible losers. Wealth can be created almost out of nowhere and can fuel consumer spending and therefore economic growth. Rapid house price inflation promotes the popularity of incumbent governments. Only if the bubbles eventually burst does the vengeance of the voters become evident – as with the landslide defeat of the Tories in the General Election of 1997.

An important consideration here is the danger of negative equity. Buyers who have chased prices up in a booming house market, and who have borrowed 90 per cent or even 100 per cent of valuation, are seriously vulnerable to subsequent price corrections. They will not be able to move for years, until house prices eventually rise again, and may in the meantime be seriously exposed to high mortgage interest rates, not to mention personal hazards such as marital breakdowns or job losses. In the UK, they do not even have the option of tossing the keys into the lender’s letterbox and walking away, as they often do in the US where they cannot be subsequently pursued for negative equity.

Negative equity proved to be a big problem in the UK in the early 1990s. This was the time when the new-built suburb of Bradley Stoke, just north of Bristol, became dubbed “Sadly Broke”. The Nationwide Building Society’s UK House Price Index peaked in the first quarter of 1990 and fell towards an eventual trough in the fourth quarter of 1995. This represented a fall of 15 per cent in nominal terms, while in real terms – adjusted for retail price inflation then running at about 3 per cent a year – the total decline was 31 per cent. The consequences were severe.

In the late 1970s, rapid general price inflation came to the rescue. House prices fell in real but not in nominal terms. The pain of the adjustment was felt by building society depositors who received much less than the rate of inflation on their savings (especially after tax). By the late 1970s, wage inflation had pushed up the affordability of houses – according to the earnings-based formula common among mortgage lenders at the time – and the market became buoyant again.

Today, the British government is proclaiming that inflation will stay low. It may actually hit zero late in 2009, though only because of the temporary reduction of value-added tax. If so, there will be no easy escape for overstretched home owners with big mortgages. And what if we move into a phase of actual Japanese-style, or early 1930s-type, deflation? Not only will millions of home owners be embarrassed as their personal balance sheets become insolvent but mortgage banks will find their security seriously eroded.

At the macroeconomic level, consideration must be given to the appropriate pace of monetary growth. Between 2003 and 2008, broad money growth accelerated to an annual pace of around 14 per cent. This applied not just in the UK but also in the eurozone.
This was nowhere near the levels of monetary expansion in the UK in the early 1970s, but it was clearly inappropriate for economies growing at about 2½ per cent a year and with inflation of 2 per cent or so. The implication was that money was cascading into speculative finance and property-related activities just as had happened in the UK in 1972 and 1973.

Politicians will always put a favourable gloss on such anomalous statistics. They will say that rapid monetary expansion is a symptom of strong economic growth and is essential to sustain it, or that it reflects the gaining of global market share.

Monetary authorities have a poor record of clamping down on such excesses, although the old Bundesbank in Germany had a powerful reputation and the European Central Bank has done a little better than some others: better, anyway, than the US Federal Reserve which actually stopped calculating and publishing its M3, or broad money, aggregate in March 2006, claiming that the cost was no longer justifiable.

An important difference between the two crises was that the UK markets were almost self-contained in 1973 – when foreign exchange controls were still being applied – but after 2000 the banking industry had become largely internationalised. The pressures of global competition were in one important respect quite dangerous: the politicians, and the regulators, were strongly tempted to allow the London-based markets to rip in order to improve the global strength of the City of London. It is not at all surprising that this ended in tears.

After 1975, the secondary banks in the UK were left to wither. Dozens disappeared, although the big banks, and a few durable smaller ones, survived. But it took years for the commercial property market to recover. Only after about 1983 did the British economy begin to grow steadily again at declining rates of inflation.

But in the current crisis almost all the big banks have had to be bailed out. Many have passed under the partial (or even, in one or two cases, majority) ownership of the government. There is no possibility of applying a test of survival according to market forces, allowing banks in serious trouble to disappear. They are too big to fail.

There is also the potential for political and commercial forces to clash disastrously. For example, the housing market requires much lower prices to balance itself, but a prolonged decline will be politically very awkward if it creates huge amounts of negative equity. Hence the bizarre proposal to encourage mortgage lending to be restored to 2007 levels while the house price indices are still tumbling. There is also pressure to promote lending to small businesses. But should troubled banks be expected to take on risky lending at a particularly difficult period of the economic cycle?

The biggest problem can be described as one of “moral hazard”. This lay partly behind the enormous risks taken on by banks in the period 1995 to 2007. Bankers decided that they could demand enormous personal rewards from the upside potential of risky business expansion, but that the downside would be protected by the government and, if necessary, by the taxpayer. In the late 1990s, the US Federal Reserve chairman Alan Greenspan gained a reputation for offering a “Greenspan put”. When the markets wobbled. In 2003, the Fed slashed interest rates to just 1 per cent to support a recovery in the US economy, but it also had the effect of fuelling a global credit explosion.

Now, moral hazard has been defined even more clearly. Banks are too important to be allowed to fail and they have been bailed out on an enormous scale – with one or two unlucky or unwise exceptions such as Lehman Brothers. The implications for the governance of banks are enormous and have yet to be seriously considered.

Here are a few likely consequences:

- Regulators will have to tighten up on prudential controls and should play scant regard to commercial incentives or national ambitions in the global marketplace.
- Central banks must shed the arrogance and complacency acquired during a “golden age” which led straight into the greatest global banking system crash since the early 1930s.
- Bankers must control their risks more accurately and expect to suffer severe penalties when they exceed agreed limits.

Both of the episodes of systemic banking failure considered in this article have highlighted the deficiencies in top-down vigilance. National treasuries or regulators, or both, must monitor the overall size of banking liabilities and respond quickly when they appear to be growing too fast. Qualitative as well as quantitative tests will have to be applied. In what has become an entirely global marketplace, this will not be at all practicable without seamless cross-border co-operation. Certainly, it will require a step-change in vigilance and discipline to achieve consistent success. One of the problems is that data is unlikely to prove reliable. When regulatory standards are raised, the incentives for cheating are increased too. There was a good example after the Bank of England introduced its restrictive “corset” on UK banks in 1973, a system imposing
supplementary special deposits on banks that grew too fast. When the corset was eventually abolished in 1980, there was a surge of growth in the official money supply figures as distortions were removed.

In a rather similar way, a huge problem developed from 2000 onwards, when banks chafed under the increasingly tight reins of the Basel Committee’s rules, but discovered that enormous amounts of business could be channelled off official balance sheets using vehicles such as “conduits”.

The enormous but shaky edifice of “shadow banking” became the key to the subsequent banking system collapse. A post mortem into how the regulators in so many countries were easily and comprehensively bamboozled has yet to be conducted. But the immediate point is that it will all happen again unless the information systems accessible to the regulators make it impossible - and they act on that information.

A further daunting challenge to the regulators is that they must have the back-up powers and the sheer nerve to challenge the biggest and most successful banks.

The traditional role of bank supervisors was to protect the system against weak banks in case they caused systemic damage. The Bank of England monitored the Bank of Credit and Commerce International for many years, for instance, before finally cancelling its UK licence in 1991 (an act which it had to defend in court some years later). Another example was the nursing by the US Federal Reserve of a number of big US banks, including Citibank, through the Latin American lending crisis in the 1980s. In strict accounting terms, some of these banks were technically insolvent, but they were allowed to continue to trade their way back to financial health eventually.

The modern challenge for the regulators is posed by institutions which seek to expand aggressively, and the hazards can be typified by the case of Northern Rock, the British mortgage bank which early in 2007 was still gobbling up market share. It was a glaring example of a bank taking excessive risks in the pursuit of very short-term business objectives. But it was scarcely challenged by the Financial Services Authority, apart from being encouraged to conduct more “stress-testing” of its business model. In the event, Northern Rock was stress-tested by the market and it collapsed within a few weeks.

Northern Rock was a rather small-scale example. Several global investment banks were taking enormous risks and plunged towards collapse or required emergency rescue operations in 2008: they included Bear Stearns, Merrill Lynch and Lehman Brothers. The risk is that the more durable investment banks, such as Goldman Sachs and Morgan Stanley, plus a host of smaller contenders, intend to carry on and are likely to prosper during the next boom, whenever that comes. In the 1970s, London’s irritating secondary banks could be allowed to wither away and disappear. Today’s global investment banks will not fade out of sight so easily. To some extent the problem has been addressed by repositioning the top investment banks within a more conventional framework of commercial banking. But more will have to be done to impose constraints of governance - and to limit the personal incentives of the most powerful individuals.

- Politicians must eschew the temptation to pump up housing bubbles. It seems like an easy win, but the problem of negative equity is enormous – and it will be a huge problem if there is real deflation.
- Regulators will have to tighten up on prudential controls – regardless of commercial incentives or national ambitions. Plus, they need much better information – and must act on it, even with the biggest and most powerful institutions.
- Bankers must control risks more accurately – and suffer severe penalties when they exceed limits.

I am then reminded of transactions: floating rate notes, short-term bonds. Pricing at any cost – even though the pricing would likely bury underwriters under their own tombstones.

It was a time when Ministries of Finance controlled who could borrow in their currency – and even then only with “domestic” underwriters. For 30 years, no borrowing by any “foreign” borrower in France or Italy or the United Kingdom. Zero coupon bonds, perpetual bonds. Ah, if we borrowers could only have both in the same instrument – zero coupon and perpetual maturity.

And competition. Fierce competition between Amro and ABN, between Swiss Bank Corporation, Credit Suisse and Union Bank. The Swiss had good reason to compete for mandates: their underwriting commission was higher than the prevailing interest rate. Intense competition between Nomura, Daiwa, Yamauchi, Nikko. Between Deutsche Bank and Dresdner.

Inevitably, over time, circumstances led to change and complexity:

- We first worried about how to hedge against inflation. For a decade, interest rates had fluctuated less than 1%. Then came inflation. How to protect investors?

Answer: Invest in short-term bonds or at floating rates. The Bundesbank was upset. It did not like instruments that could provide a hedge against inflation. It was concerned it would remove the political pressures against inflation.

- Then how to hedge currency risk – after currencies were “unfixed” in the early 1970s?

Answer: Futures and derivatives - first to hedge, then to speculate.

- There was still a risk left in the bond market. How to limit credit risk?

Answer: Credit swaps.

- Then how to manage liabilities, which we wanted to dispose of either because we wanted to stem losses or take the gains arising from currency or interest rate fluctuations?

Answer: The swap market. The world of liability management came into being.

- How to hide mistakes?

Answer: Off-balance-sheet trades. Don’t mark-to-market. That led to a sense of unreality. That is, until very recently when auditors, partly from fear of being accomplices, began to mark-to-market – with a vengeance, valuing assets well below their underlying cash flows. But not marking to market the liability side of the balance sheet, only the asset side, creating an asymmetry – the cause of great turmoil and pain currently.

- How to avoid reporting losses?

Answer: Keep lending. For banks, the LDC debt crisis in the early eighties provided the opportunity. A rolling loan gathers no loss.
- How to lend without fear of the capacity of borrowers to repay?

Answer: Securitisation. Package the asset and get rid of it fast. Not to worry about prudential lending standards. A very dangerous development.

- How to avoid risk?

Answer: Structured finance and credit enhancement. Let someone else figure out how to hedge the protection we were providing.

- How to compete?

Answer: First, repeal Glass-Steagall. Then, develop a compensation system which rewards success and hardly penalises failure. Again, an asymmetry that would inevitably lead to an incentive to take risk.

- How to avoid disclosure of what we were doing?

Answer: Form a hedge fund.

- How to increase our return on capital?

Answer: Leverage, or manage other people’s money – or both.

But despite these activities, risk never disappeared. It was simply shared or hidden or unreported, and in a world of increased leverage, it was to be ignored only at one’s peril.

Permit me, therefore, to repeat here in 2009 what I wrote 25 years ago:

1. **Liquidity risk**: You think you are precisely hedged, but the product is so esoteric and idiosyncratic that you cannot sell it because there is simply no market for the product. You may want to either capture a profit or minimise a loss, and you can find no buyers. This is typical in the OTC derivative market or parts of the mortgage-backed securities market.

2. **Credit risk**: Your counterparty has lost money and defaults. You were on the right side of the market; unfortunately your counterparty was on the wrong side. Or, your counterparty would ordinarily be just fine, but its counterparties, strangers to you, default.

3. **Legal risk**: The laws in Asia and Western Europe are not nearly as clear as those in the United States. You believe that you are totally netted with a particular counterparty; that you had a net zero position and, in the event of default and bankruptcy, you would be protected. It turns out that the netting rules outside the United States are not so clear, and you may have to get in line with other creditors or depositors.

4. **Event risk**: A war takes place; an earthquake occurs; a flood of a magnitude not seen in a hundred years washes over the land; a cartel falls apart; oil prices quadruple; tax laws change, and the market in which you had an open position, or even hedged, moves in a magnitude not only unforeseen, but totally outside past models. They always do. We are in trouble.

5. **Basis risk**: You thought you were hedged. You believed that investment A hedged instrument B. You were long in one, short in the other. They, in fact, moved in the same direction. The three-year Treasury note in which you were long deteriorated in price, but unhappily, the five-year note, in which you had a short position, increased in price. You lost both ways. The only perfect hedge is in a Japanese garden.

6. **Leverage risk**: You are so leveraged that even a small market movement will prompt a margin call. The security which is out of line will move back to its normal position on the yield curve, but someone out there, for one reason or another, has chosen to put pressure on a particular coupon, a particular security, at a particular point on the yield curve, and while over the next week or two it will surely come back into line, in the meantime, you must liquidate. Worse, liquidation is difficult because the product is idiosyncratic. Your loss becomes very visible.

7. **Operational risk**: Back-office systems, yours or someone else’s, fall apart; credit monitoring systems break down; documentation is flawed; transcription and recording mistakes are made; settlements are delayed; systems do not capture fully the nature of the transaction -- the computer program doesn’t yet cover that kind of transaction (they are working on it). And, it is all quite expensive to put in place and keep it up to date. And, most important, there is no natural constituency to support the financial and resource expenditures that are needed, particularly if you are not supposed to be a profit centre and are trying to keep quiet the risks you are taking.
Despite the above, the financial community believed it could immunise itself somehow from all risk either by shifting the risk to someone else, hedging the risk, hiding the risk off-balance sheet, securitising the asset or simply not reporting it in a meaningful way to senior management.

The result was inevitable. One scandal or market disaster after another: the LDC debt crisis; Barings, Orange County, Daiwa, Sumitomo, LTCM, Salomon Brothers, Merrill Lynch, Enron. The current crisis is no different. It has a far greater impact, however, because of the domino effect, leverage, short selling, a run on banks and the resulting virtual standstill in the availability of credit.

Given recent events, there is the inevitable call for more regulation. But not to worry. (There are three saving graces. I hope I am wrong, but the danger is that I am right.)

First, the regulators have little idea what happens at the trading desk, how institutions finance themselves, with whom, with what kind of instruments, how derivatives are used to reduce capital requirements. They are not cognisant of the latest arcane forms of derivatives, how accounting rules mask risk (or increase it). They cannot “read” the risk books (nor can most senior managers even in the firms). They are not up-to-date with the latest forms of structured finance, how they are hedged, financed or leveraged, let alone the complex forms of collateralised debt obligations or the credit default swap market. Regulators, therefore, are not likely to regulate what really counts without a detailed understanding of the way different instruments are used and reported and exactly how the algorithms work.

Second, regulatory agencies, even within a country let alone world-wide, have different agendas, values and constituencies. They are not likely to agree on meaningful control over capital, leverage and securitisation.

Third, derivatives, even in their most arcane forms, fundamentally use government paper as collateral. If derivatives were limited, controlled or inhibited it would surely reduce the need for that collateral and, therefore, make it much more difficult to finance government deficits. Basically, that is why central banks historically have been reluctant to tamper with that market. Conclusion: Regulators will not mess with it.

In retrospect, I don’t think much has changed over the years. It all comes down to why people do what they do. It may be appropriate, therefore, to speculate on what Sigmund Freud might have said about us. He, better than anyone, analysed and knew us quite well:

- he would have explained the use of derivatives and financial engineering as denial – the pretence that we are doing one thing when we really mean to do something else – we are not speculating, only hedging;
- the relationship between the client and his banker is one of ambivalence and reliance on a father figure;
- the use of accounting conventions – the absence of reality testing;
- the work environment as the pleasure/pain principle – current pleasure for future pain, let someone else pick up the pieces;
- doubling our bets in response to loss is counter phobic behaviour;
- termination therapy is what happens when the CFO and Treasurer get caught;
- transference – how the trader seeks to shift responsibility to his or her superior when the string runs out;
- leveraging is bulimia;
- dynamic hedging is desensitising;
- “I really prefer clearance and back-office work” – anal compulsive;
- “I relied on the risk manager” is but an interpretation of dreams; and
- the ultimate in narcissism, “I am the market.”

Now, other than therapy, what might a manager do in recognising risk – beyond, of course –, understanding exactly what business he or she is in and exactly what the traders and financial managers do for a living?

First, it might be useful to admit some basic “characteristics” of our profession.

We respond to peer pressure. Develop and then sell that magic zero coupon bond with a perpetual maturity, so that a borrower need pay neither interest nor principal. We want to capture rewards quickly and visibly - so we can look good if we can’t be good. We deny blame or responsibility. We seek not to be identified as the provider
of unwisdom. We do not measure opportunities lost. We rely on sympathetic accounting conventions. We design performance measures to cover up error. They are called benchmarks. Senior management is rarely as informed as operational managers. We make decisions based on: Will we be found out? Discovered? Identified as the wrongdoer? The recommender of unwisdom? Will we be hassled - by peers, superiors, the bureaucracy? Do we really want to have to explain this stuff to someone who spent his or her life in sales or marketing? We are subject to the herd instinct. Leverage is fun.

Though this is not the place to detail how we might get through the current crisis, there are some very interesting and useful ideas out there which might alleviate some of the current stresses. But beyond those market changes and government interventions, there remains the fundamental question as to how the business of finance is managed. I have some concluding suggestions:

- Admit we are not sure of all the risks.
- Admit what we don’t know.
- Ask “what if?” Quantify ‘what if?’
- Clarify precisely what we are trying to do.
- Ignore accounting conventions. They are not useful risk management tools; they are designed to make our lives easier and comfortable.
- Always measure opportunities lost.
- Never penalise those who work for us for mistakes or reward them for being right about markets. It will go to their heads, is counterproductive and, in any event, material compensation will not correlate with their ability to predict the future next time.
- Ask for alternative approaches and costs to meet objectives.
- Spend resources on systems and people smarter than we are.
- Talk to them.
- Do not hire or maintain staff whose ethics are such that you would not want them to marry your son or daughter, or your mother or father.
- Try to figure out why the transaction makes sense to your counterparty.
- Most important, be modest. Admit to unsuredness and uncertainty.
When I look at the state of the international economy, at my own country, Germany, and at Europe in early 2009, I must confess that almost none of the problems that I have previously experienced had either the breadth or depth that we are faced with today – with one exception: the Great Depression of the early 1930s.

Although I was a child, only eight years old at the time, my memories of 1932 and the years following are very vivid. My home town (Penzberg in Upper Bavaria) was economically dependent on the local coal-mining industry. The crisis took on a visible, physical form as the mountains of unsold coal built up at the mine. The miners were laid off one day a week, and sometimes two. And not only were they not paid for those days, they received no assistance either. Unemployment rose. In the winter, the jobless would gather at the crack of dawn, armed with shovels, in the hope of being given work by the local council clearing snow. In the summer, the unemployed and men on short-time working would meet in the centre of town and discuss the political situation extremely animatedly. It was almost near to civil war: political clashes between predominantly Communist-organised mineworkers and the paramilitary troops of the Nazis (SA, SS) from non-socialist neighbouring towns, and the deployment of police troops, became common. I myself became acquainted with poverty in many families, for on pay-day at the mine my father would send me out to collect small payments on account from people who owed his shop money. Things slowly began to change from 1933 onwards, as the German economy began to recover.

So far, I cannot see – either in Europe or in North America – the consequences of a depression like those I saw during the 1930s. However, I would not rule out the possibility that the economic crisis might lead to greater poverty and to dangerous tensions in emerging countries.

What is so special about the present crisis that makes it different from a normal cyclical recession? The answer is, primarily, the global dimension of the financial and economic crisis.

The financial crisis – basically the “banking crisis” – has affected almost all developed economies. Led by North America and Europe, almost all countries have since mid 2007 found themselves forced to use government funds (and in that I also include central bank funds) to prevent the collapse of financial institutions, banks, investment houses and insurance companies. Where this did not happen, as in the case of Lehman Brothers, the systemic consequences were particularly far-reaching. This is new. Whatever insolvencies or impending insolvencies had occurred in individual countries since the Second World War generally had a limited international impact: that includes the S&L crisis in the US, the deep slump in the financial system in Japan or Sweden, and the 1997-98 Far East crisis. In contrast, the latest financial crisis, which started in the US, has manifested itself in the same way almost everywhere. In particular, liquidity flows between banks have dried up owing to a loss of mutual trust. Instead, liquidity has been provided by central banks, with huge amounts of central bank money being pumped into the system (e.g. in the US and Germany), with the holding of assets with the central bank being rewarded with comparatively high rates of interest, compared with the zero interest rate policy applied by central banks earlier.

At the same time, there has been emergency assistance provided by both governments and central banks. This proved vital to prevent the failure of a major bank - as shown by the negative example of Lehman Brothers, whose failure exacerbated the banking crisis worldwide at a time when it was believed that it was well on the way to being resolved. It will not be possible until a later date to judge whether governments were so shaken by the collapse of Lehman that...
they acted too generously in opening the public purse. At the moment, it certainly seems that the desire for ever-bigger aid packages is being fuelled by the fears that Lehman’s failure generated. Nevertheless, although the danger of a systemic collapse of the banking system was not unreal, it appears to have been averted.

That said, as of January 2009 there are grounds for fearing that the slump in economic growth will be deeper than in earlier recessions - and that it may, therefore, take longer to recover from than one would expect of a normal cyclical trend.

It is impossible to tell precisely whether banks really are restricting their lending. But the revival of the economy will undoubtedly be hampered by the fact that the world is still beset by major disequilibria, which must be reduced. Following their losses on both financial and non-financial assets, the confidence of consumers in the economic future is also depressed. All this may well mean the recession in the real economy lasts longer than previous experience would suggest.

If this fear is correct, what conclusions for economic policy action can we draw?

First, the financial sector must be stabilised, but it should not be provided with too much aid. The causes of the financial crisis lie, of course, in the excessive expansion of the financial sector in the past, owing to risks being underestimated by both financial institutions and the monetary authorities. The risk awareness of those involved must be increased, which means that the support measures must be limited in amount and time. Moreover, banks that receive support must accept a loss of income; responsibilities assumed by the State must be reversed again in the longer term and so on.

It is no less important that central banks reduce the (quantitatively) enormous expansion of central bank money to a normal level as soon as is feasible, in order to prevent a new wave of inflation. The expansion of the central bank’s balance sheet in the US, for example, was in 2008 alone far greater, in percentage terms, than in the four years of the Second World War from 1942 to 1945 – a time when it was helping to finance the war.

There have also been a lot of calls for banking supervision to be tightened up. It is certainly true that many banks ran into trouble because they outsourced their riskiest business to subsidiary companies that were not subject to supervision. Such problems must be remedied. But let us not overlook the inherent limitations of financial supervision. Experience shows that, for whatever reason, most failures or potential failures of banks could not have been prevented by means of financial supervision. Although loopholes in supervisory rules that are revealed tend to be closed by new regulations, new loopholes always open up. Deficiencies must be eliminated here, of course; in particular, information must be exchanged on a cross-border basis. But macroeconomic policy - that is, the monetary policy of central banks and the fiscal policy of governments – is no less important. Central banks and governments must set limits on the expansion of banks and must not give the impression that, if any bank experiences major financial difficulties, it can automatically expect government assistance.

At present, a lot of the action being taken is unfortunately going in the wrong direction. Major protective measures have been put in place in the US and Western Europe and new aid funds are being created, but there is no public debate taking place about the true causes of the crisis and the long-term consequences of the enormous state commitments being undertaken. That is something else that distinguishes the current situation from earlier cyclical downturns. Politicians tend to say: “Don’t look back now, just look forward. Extraordinary circumstances call for extraordinary measures.” These politicians have no idea that these were also the slogans of those who, politically, plunged Europe into the biggest disaster of the 20th century. In other words, I am, unfortunately, somewhat pessimistic about the end and the long-term consequences of the recession.
Turning points in the economy often reveal poor corporate governance design, not just now but in almost every episode over the past five decades. Near the top of economic expansions, share prices often soar at rates two to four times faster than expected. When the economy contracts, they often collapse, revealing shortcomings in corporate governance and a fundamental misunderstanding of the way markets function. Journalists, politicians – including the new US President – assure us that we are witnessing market failure almost everywhere. In fact, markets are revealing important information and providing guidance about the need to cleanse governance practices.

The really big surprise is that these problems are repetitive. When share prices soar, management receives unexpected gains from share options, which they typically exercise out of fear the gains will evaporate just as quickly. When share prices erode under other economic conditions, we learn about the need to rewrite the exercise price on options. After all, if share prices fall well below the exercise price, for all practical purposes motivation is lost.

In my 40-year career, beginning at Chase Manhattan Bank, I have realized just how difficult corporate governance is for boards of directors. In the mid-1960s, I was invited to attend loan committee meetings. To my dismay, it became clear that both incentives and promotions to higher levels of responsibility were tied to loan volume and market share, rather than loan repayment. I watched as credit quality to South American clients withered, and as real estate loans in the US and advances to smokestack industry everywhere deteriorated with hardly a whimper. It appeared to me that both boards and management were waiting to be bailed out by the next economic upturn – and time and again that is precisely what happened. The result was no change in corporate governance practices.

Then there was the quadrupling of oil prices in 1973-74, accompanied by an involuntary wealth transfer to OPEC, a sharp drop in GDP growth and an enormous expansion in government regulation. Inflation increased unexpectedly to 12 per cent, the prime interest rate to 20 per cent and 30-year government bonds yielded 15 per cent – all of which cut the price-to-earnings ratio on shares to only 4 from a level of 15-18.

In 1981-82, the US experienced its deepest recession in 50 years, with unemployment reaching 10 per cent - 16 per cent in the industrial heartland. Shares saw no net gain in almost nine years and executive compensation appeared broken. Once again, this was due to poor design and wrong measures, with critical lessons yet to be learned. However, all of this bad news was quickly forgotten with the Reagan Revolution that helped propel share prices up again. Stability in the 1990s under President Bill Clinton, accompanied by shares soaring at 2½ times the normal rate, led to inevitable criticism of executive compensation.

In upswings, managements are simply lucky, but CEOs are criticized in downturns as if the gains had all been planned. This despite three market crashes: 35 per cent in 1987, 40 per cent in 2000-01, and 40 per cent yet again in 2008. Each instance has been associated with loud criticism of corporate governance. How much is legitimate? Have boards abdicated their responsibilities? What is “fair” executive compensation? Is greed the cause of it all?

What is needed is a conceptually sound approach to corporate governance that can be employed in both good and bad times, even when shares are in a long-term funk. Boards should change the way they measure managerial performance, allocate capital and view incentives: not as bonuses, but rather as a participation in the creation of
discretionary value. The same approach needs to be used to allocate and prioritize capital expenditure, especially acquisition candidates, so that the board will know when to drop out of a bidding contest. The goal is not sales growth or earnings growth, but rather sustainable growth in discretionary value. In addition, corporate governance needs to deal with the role and responsibility of employees. The objective should be to have no employees at all, but rather partners in the creation of value. Employees at all levels should be able to earn variable compensation so that they feel a part of the process of building long-term value. Until now, employees have been viewed as corporate overhead. No wonder there is an adversarial relationship between hourly workers and management.

My main proposition is that the fundamental problem, which has existed for decades, lies in the way boards of directors measure management’s performance. Boards focus on the accounting framework, especially bottom-line profit, net profit after tax (NPAT), or earnings before interest, taxes, depreciation and amortization (EBITDA). Critically, there is evidence that the “lead steer” investors, who dominate the price-setting mechanism on stock markets, do not focus blindly on the accounting framework; rather, they make important adjustments to accounting results to convert these measures into economic reality.

Failure to make this adjustment leads management to undertake investments where the expected rate of return will often be less than the rate required for risk taking — the weighted average cost of debt and equity capital. If NPAT is the principal objective, all management must do to increase NPAT is to earn returns on capital that are greater than the after-tax borrowing rate. Even worse, setting EBITDA as the objective only requires returns on capital to be greater than zero. Using NPAT or EBITDA encourages management and boards of directors to uncap reasonable levels of debt-to-equity on the balance sheet because, with thin margins above the borrowing rate, management can only achieve significant growth in NPAT or EBITDA if the ratio of debt-to-equity is astronomical.

This is the proximate cause of the meltdown in housing, subprime mortgages and even in securitized collateralized mortgage obligations. Lenders aggressively made mortgage loans with no equity deposit required by the borrower. In my 40-year career, I had never witnessed such irresponsibility. Of course, this was largely caused by the House Banking & Currency Committee and the Senate Finance Committee, encouraging both Fannie Mae and Freddie Mac to relax borrowing standards so that people who otherwise would not qualify became prime borrowers, a truly preposterous situation. Push markets to their limits and beyond and the result is not market failure, but rather market meltdown. The players in that game paid dearly — as did their shareholders.

Further, the idea that Americans exported these preposterous ideas to the rest of the world, as has been claimed by journalists and economists outside the US, is disingenuous, to say the least. Banks that were considered the very best in the world, such as Royal Bank of Scotland, are now basket cases because of their excesses. Nobody forced them to do it.

**Drawbacks to market-based incentives**

Research into the functioning of markets over the past 50 years has demonstrated that about 50 per cent of share price changes are tied to factors exogenous to the firm, such as unexpected changes in the level of interest rates, inflationary expectations, GDP growth, foreign exchange rates, even in the activities of politicians as they alter regulation. Another 25 per cent of changes are tied to industry-specific factors such as the oil price for energy companies, or regulation of new drug approvals in the pharmaceuticals industry. Only the residual 25 per cent is tied to the discretionary performance of management. Thus, over the short or intermediate term, management rewards tied to changes in share price are crude at best and almost always lack focus. Share prices are simply much more variable than firms’ current and near-term prospects.

Second, market-based incentives (MBI), which include shares and share options, work poorly to motivate because today’s share price is the present value of all future prospects. This means that everything that is expected to happen to a firm is already impounded into today’s share price. Therefore, if management delivers precisely what is already expected, even profit growth of say 35 per cent a year, today’s share price only provides gains equal to the cost of equity capital, a poor return for a management team delivering such huge returns on net asset value. Therefore, management’s performance is almost always hope for unexpected gains in value that are attributable to the exogenous factors unrelated to company performance.

Back in the late 1970s when I was serving on the board of a company seeking a new CEO, the nominating committee of non-executive directors proposed to the candidates a formula for cash bonuses and a share option grant. Since the stock market had provided almost no net gain on shares for the prior nine years, I remember candidates telling us, ‘I would like a higher salary, a larger cash bonus and you can keep the stock options’. When the same
experience occurred at the end of the 1990s after shares had been galloping upwards at an annual rate of 23 per cent, the CEO candidates all said, “You can keep the salary, you can keep the cash bonus and just give me lots more stock options”. Managers like these are responding rationally to developments in the stock market. Unfortunately, boards of directors are often only too willing to give them what they want, which is a mistake.

Third, MBIs only work well at the level of CEO and for other senior executives who make global choices and thus have an impact on the firm’s consolidated results. Below this level, MBIs tied to company-wide consolidated performance simply cause a free-rider problem – sit back, relax and watch others create value. In contrast, ownership is good for employees, not because of motivation but because it enhances morale and a feeling of collegiality. The best way to achieve this is through the ownership of shares, not stock options; the latter are simply too risky.

A value-based management system addresses the shortcomings in governance revealed by economic or financial crises. The “6Ms” of this approach are: measurement, managing capital outlays, mindset, motivation, market communication and managing strategic planning. In applying a system that rewards all employees for the value they add to the business, three key points should be borne in mind:

1. **The goal of corporate governance is to allocate capital to the most value-enhancing investment opportunities:** Boards and management must attempt to increase the key driver of value. The question is: what is the driver? Is it dividends, bottom-line net profit, cash flow or free cash flow, EBITDA, return on capital, return on equity, the rate of growth in bottom-line net profit? Or is it economic value added (EVA) or some other measure of economic profit, such as residual income?

2. **Incentives can reinforce human capital behavior thereby aligning management and/or all employees with the interests of owner:** The question is how far down to cascade variable pay-for-performance. Right down to the shop floor? Why not rid the firm of employees and have the workers become value-change agents, where fixed costs, including wages, are minimized, while permitting variable pay to rise and fall with economic activity? The benefit to society is that the unemployment rate would not rise as economic activity falls. Instead variable pay would become the firm’s and the economy’s shock absorber. Only on rare occasions would employees be made redundant. This approach also saves the cost of training new hires when the economy recovers.

3. **Although MBIs possess the virtue of objectivity – management has no opportunity to manipulate the outcome – share prices contain too much noise to reward management and employees for their discretionary performance:** Noise is almost eliminated if the holder of the shares, or share options, is willing not to exercise for at least 10-12 years. Then noise is offset by counter-noise, ultimately revealing discretionary performance. But who would be willing to hold his/her pay-for-performance for a minimum of 10-12 years?

To address the shortcomings revealed by this economic and financial crisis, it is worth stressing two aspects of governance: how to measure performance and how to design incentive systems that motivate the whole workforce and align their interests with those of shareholders.

**Measuring performance**

All one must do to appreciate how poor NPAT is as a performance measure is to examine the ratio of market value to NAV. Over the past 30 years, this ratio has increased from a range of 1.5-3 to 7-10. Although the ratios have remained lower in banking, the boom years did see considerable inflation in the gap between NAV and market value. Almost all boards and senior management focus on bottom-line profit, or NPAT, which they believe is the principal driver of the share price. But to increase NPAT management must simply earn returns on total capital that exceed the after-tax borrowing rate. The cost of equity capital, the required return for risk on behalf of shareholders, is ignored. Thus, if boards set goals in terms of bottom-line profit growth, even if margins above the borrowing rate are small, rapid earnings growth can still be achieved as long as the company employs a high enough ratio of debt-to-equity. In fact, where margins are really squeezed, we can expect boards to be tempted to increase debt-to-equity ratios to as high as 40 to 1, exactly the problem at Bear Stearns and Lehman Brothers. Economic profit approaches reveal just how weak bottom-line profit and EBITDA are as desirable corporate objectives. Both will encourage management to misbehave. It is almost impossible to avoid it.

One final comment regarding the questionable use of growth in NPAT as a corporate objective: look at what determines the growth rate. The rate of growth in profit is equal to the return on total capital (ROTC) multiplied by the amount of new investment (I) divided by current profit.

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1 Operating profits minus a capital charge for both debt and equity (or capital multiplied by the spread between the rate of return on capital and the cost of capital).
Growth rate in profit = \frac{\text{ROTC}}{\text{NOPAT}}

It is clear that firms can achieve enormous profit growth even while earning very low returns on capital as long as they pour gigantic amounts into new investment. Just stating the goals in terms of a growth rate in profit can be expected to encourage management to pile on new investment, and that has been one of the main causes of the latest boom and bust.

Motivation

The most motivated people in any firm are the salesforce, who are paid on a commission basis. The same principle holds for value maximization. The goal is to provide employees with a percentage of the economic value that they add. However, to make sure people do not focus only on short-term results, as has been so problematic in investment banking, it is essential that a bonus banking system be used where only a portion of the current year’s declaration is paid out currently. The remainder is held at risk, subject to loss if the improvements that led to the declaration are not sustained in future years. Employees do not need a share certificate and legal title to behave like owners. They only need real money at risk.

Nobody is better off having the experience we have had in 2008, or in 2000, or 1987, or in 1981-82 or during the 1970s. Attacking management for excessive compensation makes no sense when one considers that almost all of it has been the result of unexpected excessive gains in share prices. Recall that as much as 75 per cent of share price changes are the result of factors over which management has almost no influence. Failing to recognize this can overwhelm us and even convince some of us that corporate governance has broken down. No doubt it has in some instances, but the best way to keep governance from breaking down is by using a simple, readily available, focused economic system of performance measurement. This results in better choices, easier monitoring and, most important of all, an almost perfect congruence between the interests of management (and other employees) and those of the shareholders.
Mark Tennant

The City of London in the 1970s

Hambros Bank at 41 Bishopsgate seemed to me a long way from the borders of South Armagh on that frosty morning in January 1974. Three months earlier I had been a military intelligence officer in the border area during the worst year of the troubles. Now I was about to embark on a career as a banker; and though clandestine operations in Northern Ireland may have been scary this felt far more forbidding.

The City in 1974 was very different from the place we know today. Computers had just been invented and Hambros had recently installed one. Research when I was at Chase in the 1990s showed that the computing power that covered the entire basement of 41 and 51 Bishopsgate would today fit into a handheld device.

I arrived at Hambros at the start of the three day week: commercial users were only allowed electricity on three consecutive days in seven due to a combination of striking miners and the oil shock. For the ensuing three months Hambros, along with the rest of the City, did something that today would be impossible: for two days a week we banked by candle light!

The economic and political backdrop was dire and, as today, we were entering uncharted waters. The fifties and sixties had brought fairly consistent economic growth, with low but rising interest rates. During the 1950s, the Bank Rate had averaged 3.96 per cent and in the 1960s, 5.93 per cent. During the 1970s the average rate almost doubled to 9.59 per cent, peaking in 1979 at 17 per cent.

Edward Heath’s Conservative government was in trouble. It had fought and largely lost the miners’ strike in 1973.

Oil prices were rising sharply following the Yom Kippur War, and the manufacturing trades unions were in militant mood.

The cornerstone of economic policy had been the introduction in 1971 of Competition and Credit Control (CCC) by the chancellor of the exchequer, Anthony Barber. The aim was to encourage competition among high street banks and lessen direct control of bank lending by the authorities. The result was plenty of competition but precious little credit control. The policy brought in a new form of interest rate management: the minimum lending rate (MLR). This replaced the old Bank Rate and was tied to the rate on Treasury Bills rounded up to the nearest ¼ per cent, with a further ½ per cent added on. The idea was that the demand for credit would set the rate of interest.

Theoretically, at a time when the world had just abandoned fixed exchange rates following the Smithsonian Agreement of 1971, the combination of a floating exchange rate and a Central Bank lending rate tied to the demand for credit should have led to fairly stable interest rates. It is perhaps worth noting that the rise in Bank Rate from 2 per cent to 2.5 per cent in 1951 was the first change since 1939. In practice, however, the world never really abandoned fixed parities and tended to manage interest rates in such a way as to hold currencies to some tie or other. As a result, the formulaic method of calculating MLR was tacitly abandoned soon after instigation, and for the rest of the 1970s interest rates – and everything else – became highly unstable. While during the 1950s there had been 14 changes in the Bank Rate and in the 1960s there had been 24, MLR was the subject of no fewer than 87 changes in the 1970s.

The result of CCC was a period of boom and bust, further exacerbated by the rise in oil prices, which partly mirrors our present cycle with the exception that the phenomenon, at least in its intensity, was local to the UK. There were two other big differences: first, the inflationary boom was fuelled by a seemingly uncontrollable wage spiral in an environment of strong unions and weak industrial management; and second, there was no spectre of deflation – so the chronological sequence differed. In the 1970s, the economy went from...
relatively low inflation to a property-led boom and recession. This was followed by a severe bout of inflation in the middle and end of the decade. The final bout of recession in the early 1980s both destroyed what was left of the UK's industrial base and terminally weakened the unions.

Compared with today, the City was a domestically focused closed shop. The banking community contained few overseas players and was controlled by the governor of the Bank of England. The four clearing banks were the key cogs in the financial wheel and they bent to the governor's will, as did the merchant banks and discount houses, through which the governor controlled banks' liquidity. Both these latter organisations were tacitly underwritten by the Bank (I am not aware that a formal agreement to this end ever existed).

The Stock Exchange was run and regulated by a committee of its members, which met on the 19th floor of the Stock Exchange building at the junction of Threadneedle and Throgmorton Streets. It operated on a single capacity system where the markets were made by jobbers. Broking firms operated pure agency business and were not permitted to take positions in stocks.

Received wisdom is that the big changes came in the 1980s with "Big Bang". In fact, these changes really started in the late 1960s and gathered pace during the following decade. Prior to about 1960, the stock market was largely dominated by private investors, the Church and Oxbridge colleges – but by the end of the decade, the influence of the individual was being replaced by an institutional environment. A new profession was emerging: the fund manager, personified by Hugh Jenkins at the National Coal Board Pension Scheme and Peter Moody at the Prudential. As we shall see later, it was a lunch with the Pru that ended the 1970s bear market.

In those days, fund managers, and indeed brokers, were relatively well paid, but earned only about 25 per cent more than their peers in industry and elsewhere. Today, that percentage is vastly higher – I often wonder whether they or the market created that extra economic value on which their remuneration is based.

The institutionalisation of the market meant there was a need for more thoroughgoing research and sales coverage. These factors combined with a dramatic decline in commissions, due to the bear markets in equities and gilts, to force consolidation in the broking and jobbing market. Between 1974 and 1980 the number of broking firms fell from 355 to 240, partly due to consolidation, but in the period from 1973 to 1975 many disappeared in the process known as "Hammering". At midday the chairman of The Stock Exchange would appear on the floor and read out the names of the demised firms. He would follow the announcement with a bang of his hammer. The demise of the regional stock exchanges combined with the increasing need for capital also caused the number of jobbers to collapse from 60 in 1960 to just 19 by 1980, of which three dominated the market.

However, the increased professionalism of an institutional market did not mean the end of the traditional City lunch – the penchant for fizzy water only began when the influence of the US banks took hold in the mid-1980s. Certainly lunch in the merchant banks was an institution in itself. Hambros, in common with the other Accepting Houses, fed its entire staff. It had no less than four and a half dining rooms, the half being screened off for sub-managers. Once you became a manager, you could have gin and tonic and wine with your lunch. The food and wine in the Chairman's dining room and those for guests were second to none. Indeed soon after I became head of credit in 1975, I was checking through the volumes of bank accounts to see which could be closed and came across an account in the name of Hambros Gibraltar. When I inquired what it was I was told to forget about it; it represented our wine "in bond", which was held somewhere under the Rock!

By the time I arrived, the equity market had peaked in May 1972 at 520 and had begun a long decline. In 1974 when I started in the gilts dealing room, the descent had become precipitate. Dealing volumes were negligible and the three dealers used to while away the time playing "Battleships" with the brokers over the direct lines. During the three months I was there we averaged three deals a day between us.

In October 1974, Labour returned to power with an increased majority and the final leg of the equity bear market began, the FTSE bottomed at 149.9 on December 12. After a Christmas rally, I arrived back in the dealing room on January 2 to grim faces. Burmah Oil, a FTSE 100 constituent, had announced that its tanker operations had rendered the company insolvent and it had been rescued by the Bank of England. The market had fallen back to its December low and, in the words of the head equity dealer, we were heading for a level of 130. The morning was sombre.

At 12.30, David Tapper, the senior gilt dealer, departed for lunch. The two of us who remained had sandwiches in the dealing room. We did not expect David back until 3pm as there simply was nothing for him to do. At ten minutes to two, to our amazement he returned. He put his umbrella in the rack and, without a word to us, picked up his telephone and flipped the left-hand cream plastic switch on the dealing consol. Bemused, I picked up the same line.
“Buy 5 million 12s of 84!”

“I beg your pardon David!” came the surprised voice of Steve Posford, head of the gilts department at Greenwells (later head of Salomon’s London fixed income operation).

“I said buy 5 million 12s of 84.”

“But David there’s no-one on either the Ackroyds or Wedd pitches, only Bluebuttons.”

“Well go and bloody find them and get that damned stock.”

The line went dead. Within five minutes David had given orders to buy £50m of gilts, a huge sum for a merchant bank in those days. The board went mad, lights flashed, brokers were screaming that there was no stock and no jobbers and David simply screamed back at them to get off their backsides and get him the stock. I went out into the stock office to warn the clerks of an impending rush, only to see them all looking out of the window on to Bishopsgate below. Down the street were running half the jobbing community of the City heading for the floor.

The famous lunch with the Pru had taken place at which the major fund managers had decided that the market was low enough and they agreed to buy it with every penny they had at 2pm. By mid-March the market had doubled and the smell of roasting bears lasted for years.

In early February 1975, I moved to work in credit. The shipping crisis was upon us and we were in the middle of a banking crisis.

In 1974, Capital and Counties and Vavasseur both went into liquidation and in 1975 Slater Walker followed. All three banks had been “rescued” by the Bank of England and in the latter case, Harold Wilson, the prime minister, had become controversially involved. At the time the rescues seemed seamless: they happened on a Friday night and over a weekend. In each case the Bank had a merchant bank as an adviser. In the case of Slater Walker it was Hambros.

On Friday night we were warned that we would be required over the weekend and at 9am on the Saturday we were briefed by the Bank’s regulatory team. My boss and I were despatched to examine the books of Slater Walker Isle of Man. There we found a loan book of about £2.5m of which £200,000 had been lent on the security of two gaelic long playing gramophone records to two Pakistani architects, who then vanished. The auditors, meanwhile, had allowed the bank simply to roll up the interest as indeed they did for most of the loans in the parent bank – shades, perhaps, of the treatment of CDOs 35 years later.

The reason for the seemingly simple nature of the rescues was that the Bank had an experienced team of supervisors, headed by Ian Plenderleith, who reported to the deputy governor. There were no queues of depositors in the streets and no retail panic. The lines of responsibility were clear and the Bank acted swiftly. In reality, though, the workout of Slater Walker took many years and the Treasury was internally deeply critical of the Bank for not spotting the difficulties earlier. “Asleep at the wheel,” was the verdict of one senior official: distrust between Treasury and Bank is nothing new.

The Secondary Banking Crisis was a direct result of a property bubble in commercial and residential property, which started with CCC and the release of controls on bank lending. As President Clinton did later, the government encouraged home ownership: personal sector holdings of physical assets rose accordingly, from 32.4 per cent of total assets in 1960 to 61.2 per cent by 1979. Of note is that in Germany during the 1960s and 1970s, interest rates on personal borrowing were consistently real, and renting was the norm. In the UK, however, real rates on personal borrowing had been largely negative. This helped propagate the concept of owning one’s own home, a notion that was further popularised by Margaret Thatcher a decade later. The assumption being that channelling savings into the purchase of ever-more expensive land is economically productive. Whether this capital would be better invested in wealth creation should now surely be a matter for debate.

The last four years of the 1970s were dominated by the government’s struggle to fund its debt. In September 1976 the UK government approached the IMF for a $3.9bn loan to support sterling – at the time, the largest amount ever sought from the agency. The terms of the loan required the UK to cut its deficit by 20 per cent, which meant, for UK policy makers, the end of Keynesian demand management and the ushering in of monetarism.

But controlling the money supply meant that sales of government debt to the non-bank private sector had to increase. The tactic the government broker used was to issue partly paid, or tap stocks. Usually these were 15 per cent paid and issued at a highly attractive rate. This led to a rush for gilts and a fall in yields; until, that is, the stock became fully paid, at which point everyone sold and rates ratcheted up again, always to a slightly higher level than at the outset. This was known as the Duke of York tactic and it culminated in the infamous February 1979 Battle of Watling Street. In those days gilts were issued through the Bank window, a
small office in Watling Street. Here, messengers from all the City institutions congregated with their firms’ application forms. The window shut promptly at 10am.

In February the Bank issued two new partly paid stocks: 13.5 per cent 1987 and 13.75 per cent 2000/03. The terms were so attractive that they were massively oversubscribed causing an affray at the window between various messengers. The situation was so bad that the police had to be called. The incident marked the peak in gilt yields, which then fell for the next 20 years.

Lessons learned

Are there lessons we can learn from the 1970s which might help navigate the current difficult waters? There are some clear similarities between the crises, but the one we face now is global and also bears some resemblance to the 1990s in Japan. However, mistakes were made in the 1970s which we should try not to repeat:

1. The main cause of market difficulties was a lack of control of the money supply when economic activity was rising – and subsequently poor control of bank lending. These mirror precisely the causes of the current crisis. The final cure was corrective action on the money supply, not a return to “Keynesian” demand management, which corrected the recessions of neither the mid-1970s nor the early 1980s. The current trend towards “Keynesian” economic management is potentially disastrous.

2. The way to avoid this type of bubble is to find reliable measures of the money supply. With the complexity inherent in the present banking system and the globalisation of money movements, the old measures of M3 and M4 are probably no longer good enough. Reliable targets should be established and published, and they must include a measure of property prices.

3. In the 1970s, the Bank was run by experienced bankers who were long-term practitioners i.e. not by 45-year-old investment bankers or academic economists. They also had a team of highly-experienced central bankers. There were clear lines of responsibility and decisions were taken extremely quickly. The control of securities markets is a completely different trade and should be kept separate. This does not mean a return to Glass-Steagall, but it does mean that capital adequacy for securities operations and those required for banking should be separate and should be regulated separately.

4. Globalisation is one of the greatest changes since the 1970s. The free movement of capital unleashed by the abandonment of Bretton Woods has been at the heart of global wealth creation. It would be folly for politicians and regulators to have a knee-jerk reaction to the current crisis and introduce regulation to inhibit that flow. To do so would be to fall into a trap similar to that into which the US government fell when it passed the disastrous Smoot-Hawley Act (1930). Yet the financial community must examine the investment banking model. Is there really enough capital to support the international trading books we currently run through the most volatile economic cycles? And can proprietary trading provide an adequate return on such capital, while at the same time paying 27-year-old traders hundreds of thousands of pounds?

5. Although not a 1970s event, the near collapse of Lloyd’s of London in the late 1980s gives us a guide for dealing with toxic assets. The reinsurance spiral and the CDO spiral have great similarities. For Lloyd’s the cure was Equitas, now owned by Warren Buffet. The world now needs a global Equitas overseen by The World Bank or the IMF into which all the banks’ toxic assets are placed at a value for each bank’s assets equating to the likely run off value, rather than the forced sale value. Banks would have a share in the new “Banquitas” in accordance with the value of the assets it placed and a contingent liability if run off losses exceeded available assets when the entity was wound up. This would achieve two objectives: first it would mutualise the toxic assets and make global unwinding far easier, and secondly it would remove the need to mark the assets to market every time a bank had to report. The liabilities for Banquitas would be contingent and reports from the work out group would be annual.

6. The outturn of the 1970s and early 1980s in the UK would suggest that if we move private debt into the public sector and run high budget deficits, then we will face a very steep recession in 2009 followed by a bond market crash, a bout of inflation (possibly stagflation) and then an even steeper recession while government finances are brought back to manageable levels.

The 1970s experience suggests that this is probably not the right approach. Deleveraging is a painful process and running a fiscal deficit does not help – it merely prolongs the agony. The problem is not the quantity of money in the system, of which there is now plenty, but the velocity. Throughout the 1970s, the savings rate was high and, paradoxically, it was particularly so during the periods when inflation was high. People save
- This is a problem of global capital flows and global institutions being governed by domestic regulation and domestic control of the money supply.
- The cure to the problems of the City in the 1970s was “corrective action on the money supply, not a return to Keynesian demand management”. We need to rethink the metrics of monetary policy.
- The Bank of England needs to reassert itself – and to rebuild its City experience.
- Don’t throw the baby out with the bathwater when it comes to protectionism or regulatory threat to global capital flows: remember Smoot-Hawley.

when they are concerned about their jobs. Therefore, the policies required are those that lower the cost of employment and make the job market more flexible. Put simply, this means making it easier not only to hire but also to fire people. If firing is easy and cheap, employers become much less concerned about hiring and there is no evidence that they necessarily want to fire their employees any more often.

In the early 1980s, Margaret Thatcher’s defeat of the trade unions and archaic working practices had the same effect. It reduced the cost of employment and drove us out of recession. Thus we need to lower, not raise, employers’ National Insurance contributions and sweep aside almost all recent employment legislation from maternity and paternity leave to employment tribunals, and prune much of the Health and Safety at Work regime. These are after all, as the chancellor suggests, “exceptional times”.
“A crisis cannot be resolved until confidence is restored”.

Stefan Ingves, Governor of the Riksbank

The present crisis is deep and far-reaching, but not altogether unique. To find the right way out of the present distress, leaders in finance, banking, business and politics will be helped by learning from earlier successes - and from previous blunders. It is up to the economists to develop theories on how our economic systems work, and to analyse and draw conclusions from what is happening. My task is to highlight the political side of the crisis. In the main, I will draw on Sweden’s experience, focusing on the banking troubles that we and our neighbours went through in the early 1990s.

Governments are currently under pressure to decide on policies to mitigate the impact of the crisis without having a complete picture of its causes, or being able to foresee how the measures taken will serve their intended purpose. They are forced to take urgent steps, ranging from preventing bank failures to saving industrial groups from bankruptcy and preventing families from losing their homes. The time for long-term thinking is limited, yet it is highly desirable since a great deal of money is involved.

Investing in infrastructure is a conventional way to create jobs in a crisis. It’s not all that easy though. Not many projects are ready to be implemented. If they are embarked on anyway, they usually suffer from poor planning. Even if well planned, it may take years before the money is spent. Useful they may be, but they will not do much to restart a crisis-hit economy.

Acting quickly is of the essence. But so is the need to avoid wrongful allocation of funds and short-term measures that might become obstacles to the fundamental changes needed to make the economy less crisis-sensitive. Ideally, crisis measures should pave the way for (or be part of) structural reforms that promote such long-term policies.

Two kinds of activities can be foreseen: one based on conventional ad hoc policies that risk cementing existing structural problems, for instance through an escalation of non-productive subsidies, and one that looks into the future and even dares to revisit things previously deemed politically too risky, or under a political taboo.

How to pay for a better environment is a good example. When the US Congress demanded more fuel-efficient cars, as a condition for the “bail out” of American automakers, it was a first step in the right direction. The next step must be to use the price mechanism (read taxes) to prevent the size and thirstiness of American (and other) cars from bouncing up and down with the rise and fall of the oil price. What people pay at the pump will have more of an impact on both producer and consumer behaviour than a letter from lawmakers in Washington DC (or other capitals).

A robust system

Every time the market economy system trembles, the croakers, the ideological malingers and the usual pessimists show up. Fortunately, they tend to be wrong. As a system, the market economy is, in fact, rather robust. Yes, we have again been reminded of how it can be damaged by careless lending and by the lack of regulatory curbs on excessive exposure to risk. But, as the Newsweek journalist, Fareed Zakaria, observes in his book The Post-American World: "The world’s politics seem deeply troubled, with daily reports of bombings, terror plots, rogue states, and civil strife. And yet the global economy forges ahead, not without significant interruptions and crises, but vigorously upward on the whole."

Zakaria has figures that show it. Between 2000 (the year before 9/11) and 2007 (the year before Mumbai), the world...
economy grew at its fastest rate in nearly four decades. This was the case not only in India, China and other Asian “tigers”. Of 124 countries with average yearly growth in 2006 and 2007 of 4 per cent or more, 30 were African. Nothing of this would have been possible if confidence in free trade and the market economy had not been strengthened.

How well the market economy works depends on how well it is maintained, and that in turn depends on how people think it is supposed to work. I see the daily practice of the market economy and modern capitalism as a “joint venture” between the public and the private sector. On one side, you have the regulators and other official and political institutions, and on the other the world of banking, industry and trade.

The idea that the free market system would, by definition, work better the fewer rules there were, and that the best would be to have no rules at all, is based on poor thinking. It becomes especially wrong when to that misconception is added that, if things go wrong, it is self-evident that the government should step in to cover the losses.

The discussion on whether the market economy works better with fewer or more regulations – as if they were all the same – does not make much sense. Some rules and restrictions are needed to strengthen the foundations of the market economy and free trade system; others might weaken those systems. On the whole, there seems to be a consensus that the problem this time was not the lack of regulation per se but that the regulators we needed were missing. Even Alan Greenspan admits that today.

Moreover, norms have been circumvented by newly invented and complex financial instruments and by juggling with off-balance sheet risks. Those who should have intervened against such practices, central banks and supervisory authorities (the US Federal Reserve among them), have generally been too passive. Some have failed because they made an ideology of permitting greater risks under slack supervision. That is how money became far too easy to get, and far too cheap.

Free trade is of crucial importance for sustainable welfare and progress, not least in developing countries. Protectionist steps, as a means to remedy the impact of the crisis, tend to do more harm than good - both in the short run and even in those longer-term situations where they are supposed to be beneficial. They only tend to prolong economic stagnation, reward lobbyism and obstruct investment in future production.

One must not forget that the current economic crisis is happening in a world that is also faced with an ecological crisis. Even after the economy is back on track, the environment will have to remain an integral part of our economic thinking. It is now a dimension of everything political. In no area is that more obvious than when it comes to energy. For measures aimed at restoring confidence in the banking system and alleviating the effects of industrial shipwrecks to be effective, they must adopt a far-sighted policy that promotes more efficient use of energy and that encourages investment in sustainable energy supplies.

Looking back

We can learn from earlier crises: not only from the way that political decisions contributed positively or negatively to resolution of the crisis, but also from how well, or not so well, countries were prepared for what happened. Obviously, this could be illustrated from the experiences of many countries. I’m choosing Sweden because that is where I have seen government from the inside. Plus, the way Sweden and some of its neighbours resolved a serious banking problem in the early 1990s has been cited in international discussions about what to do now. It may be that there are things to learn from that event, but, first, let’s put it in a historic perspective.

In the early 1920s, Sweden was hit by a short, sharp and home-made crisis affecting both banking and industry. This was in the aftermath of the bursting of a speculative bubble at the end of the First World War. In economic, but not in social, terms, Sweden got through this crisis relatively unharmed. In particular, the industrial sector went through needed structural reforms and became better able to withstand later crises. Lessons about the importance of sound money-market conditions were also learned and were imprinted in the memories of a generation of bankers and policymakers.

Lessons were also learned from the social strains caused by poverty and high unemployment in the early 1920s. As a result, when Sweden was dragged into the international depression of the 1930s, its labour market policies were made more generous. In the decades to come, a “Swedish model” emerged based on policies that encouraged mobility and re-training. A growing and politically stronger labour movement was part of this development.

What’s interesting and relevant for today is how Sweden, through the renewal of its industry and by introducing various welfare reforms in the early 1920s, was in better shape to weather the depression of the 1930s. Yet we were only at the beginning of building a welfare state.

After the depreciation of the krona in 1931 and a stimulative fiscal policy during the middle of the decade, Sweden emerged
comparatively quickly from this depression. More was learned about economic policies. For instance, Bertil Ohlin, a colleague of Keynes in the world of academic economics and later a Nobel Prize-winner, along with others in the Stockholm school of economics, contributed a well-reasoned rationale for an active policy to avoid depression and inflation.

Professor Ohlin later became a politician and leader of the Liberal Party (one of my predecessors in that role). His daughter, Anne Wibble, was Sweden’s finance minister during the crisis of the early 1990s. Her father would have approved of her performance.

An example of how what is helpful in the short run can develop into a long-term problem is provided by Sweden’s agricultural regulations, imposed around 1930 to avoid a socially disruptive crisis in the countryside. These seeded a decades-long culture of restrictions, provisions and subsidies that spread from agriculture to other areas, most noticeably housing. Fortunately, most of those policies have now been abandoned and have been replaced with better targeted ways of serving the same social purposes.

Devaluing the currency is another temptation for politicians.

True, the depreciation of 1931 helped Sweden through the Great Depression. But this probably made many of us slow to observe the risks in taking this short cut, rather than more painful budgetary adjustments. After the disintegration of the Bretton Woods system in the 1970s came high inflation and monetary turbulence. Devaluation followed devaluation, with one of the biggest as late as the autumn of 1982. This destructive spiral was not broken until it was generally understood that the policy of repeated devaluations was an important reason behind the banking crisis of the early 1990s.

In the second half of the 1970s, Sweden suffered another crisis – one which, at least initially, was of our own doing. This involved wage inflation fuelled by an income tax system with ridiculously high marginal rates. The ensuing industrial crisis was aggravated by the second round of rising oil prices in 1979-80. The European “stagflation” of these years seems to have punished Sweden especially hard.

It took a few years for it to become clear that feeding industry with generous subsidies and loans and introducing stimulus packages was not a good way to tackle a problem caused by production costs that, in some sectors, were too high for them to be competitive. The first attempt to change course entailed reducing our dependence on oil and making the tax system conducive for incentives to work. Budget policies were also made stricter, for instance by putting limits on the spending of local government. Parts of this initially met overwhelming political resistance. Selective industry subsidies were, however, abolished during the 1980s. The mistakes made in the regulation of agriculture were not repeated.

In this case, it was understood that, in the long run, the bad parts of a crisis policy can become permanent. As quickly as possible, a country should try to get rid of such policies before they put down roots in the system.

Lessons learned from unit costs being too high and devaluations too common prompted two important tax reforms in the early 1980s and early 1990s. In particular, income taxes were greatly reduced, and a jungle of deductions and hidden subsidies within the tax system were abolished. Around 1990, markets (including telecommunications, transport and financial services) were deregulated. The universal state pensions system was also reformed so that it became more sustainable. It was then given a built-in automatic stabiliser, which adjusts the system to demographic and economic changes. Thanks to this, Sweden has proved less vulnerable now that the country has again been hit by an international crisis.

The politically insecure supply of oil during the 1970s and early 1980s, together with an increased awareness among the Swedish public of environmental problems such as acid rain and losses of biodiversity, made it possible to initiate savings of fossil fuels on a broad front. Nuclear power was also saved – albeit only after at times rather dramatic parliamentary commotion and a referendum.

This is important for Sweden’s position today, when the climate threat has emerged as a global problem of the first order. Sweden now has a comparatively favourable relationship between GNP and emissions of greenhouse gases. Had the efforts to reduce our dependence on oil not been inhibited by the temporarily low oil price during parts of the 1980s and 1990s, we would be in an even better position.

The Nordic countries in crisis

The structural reforms – which were often motivated by a lack of resources or by shortcomings in our economic policies – made it easier to resolve the banking crisis of the early 1990s. Some of Sweden’s neighbours were also involved and the leaders kept in touch. There were many similarities in background among the countries involved, and in the ways chosen to tackle the crisis; but it is worth noting some differences. Finland, for instance, had just left behind its imposed barter-trade commitments towards the Soviet Union. Denmark was a member of the European Community,
forerunner of the EU, while Sweden and Finland became members only after the crisis. Only Norway has lots of oil.

The key thing to understand is that, with the exception of the impact of the Second World War, this was the first time since the 1930s that entire banking systems in well-established industrial countries were seriously threatened with collapse. The general climate of inflation and financial carelessness during most of the 1980s already explains the crisis. In addition, while Sweden’s credit market had been substantially freed from rationing, interest rate regulations and other detailed controls, which was good, the authorities had failed to put in place more modern methods to prevent unsound credit expansion. In particular, the supervision of banks’ exposure to risk was inadequate. Fiscal policy also had been too weak for years. All of this is familiar in some big countries today.

The risk exposure of Swedish banks, primarily in the real estate market, had within a few years become far too high. A subsequent recession, caused by other problems, at first did not appear particularly worrisome. Then, during a few months in the autumn of 1992, the situation became critical, with accelerating credit losses in several banks. The values of highly mortgaged buildings declined, owing both to recession and to high real interest rates.

The value of collateral fell further when the central bank stepped up interest rates in defence of the krona. Interesting (at least as a piece of trivia) is that the so-called repo interest rate, during four days in September 1992 hit 500 (!) per cent. It later fell step by step, but it could not save the krona - and Sweden eventually had to leave the European Exchange Rate Mechanism.

It was soon clear that Swedish banks were all set to make losses amounting to around 13 per cent of GNP, far beyond what the central bank could cope with in its role as lender of last resort. This would correspond to the US and the UK seeing the capital base of their banks being undermined by some $1,800-1,900bn or nearly £190bn, respectively. In Sweden, such great losses on bad loans meant that the capital base of the whole banking sector risked being obliterated. All the more important banks, with one exception, were broke or at least seriously threatened.

Although the most dangerous phase was over within less than two years, GNP kept falling for three consecutive years and the unemployment figures kept rising. In the end, however, the loss of GNP turned out to be less than 5 per cent. As a result, one could conclude that Sweden had successfully fended off a depression, rather than the recession that we did endure.

How Sweden dealt with the banking crisis

The key is that the government took the lead in co-ordinating the various state institutions involved in dealing with the banking crisis. The central bank (the Riksbanken) played its role, in close co-operation with other authorities. As a result, general confidence in the banks and in the system of payments was soon restored. During the most critical phase of the crisis, huge budget deficits were accepted. From 1993, however, fiscal policies changed to enable a reconstruction of public finances. The country later enjoyed a long period of fairly steady growth and low inflation.

Six preconditions for recovery

How could such a serious banking crisis have been resolved in such a short time, even though none of the main actors had any experience of the situation they were suddenly faced with? The following six preconditions for a happy outcome were crucial:

- **Openness**: Thanks not least to the Swedish tradition of openness, the extent of the banks’ distress was not hidden. The banks were not allowed to value assets optimistically, or to delay painful but inevitable reconstruction measures.

- **Urgency**: Urgent measures to restore the capital base of banks were co-ordinated by a new Bank Support Authority, instituted by government and parliament for this task only.

- **Confidence**: A blanket guarantee by the government for the liabilities of the Swedish banks was issued. General confidence in the banking and payments systems was thereby restored without delay, before any dangerous runs on banks had occurred. The guarantee was a general one, but it was also temporary - and was withdrawn within less than four years.

- **Asset separation**: In the hardest hit banks, good and bad assets were separated. The latter were transferred to special state-owned companies for asset management and loan workouts. These were temporary arrangements that in all cases were terminated after a few years, with taxpayer costs much reduced.

- **Speed**: Thanks to these measures, reconstructed banks were able quickly to resume their normal functions in the economy. The recession did not go into a vicious circle leading to depression. When it
was realised that the situation was under control, the economy picked up.

- **Consensus:** Crisis management was supported by a broad political consensus. Government and opposition had informal deliberations about the measures to be taken. The most important legislation was supported in parliament by all parties, except an insignificant far right group.

It later became apparent that the way crisis management was pursued resulted in a surprisingly low cost for the taxpayer. The net cost for the state was limited to a mere 2 per cent of GNP. The treasury paid out more than 4 per cent of GNP to rescue some of the banks, but a good share of this money could be reclaimed. After the crisis, the government’s share in the banking sector remained relatively small. In Norway, in contrast, the banking system was to a great extent nationalised.

**What can be learned?**

In our globalised world, it is far easier to get through more or less serious crises if there is unity and co-operation, within countries and between them. This was understood by those who governed the Nordic countries in the early 1990s, and it might be the main reason behind the successful outcome. The same point should be emphasised when it comes to today’s banking crisis, with its effect on the world economy.

- “Money became far too easy to get, and far too cheap.”
- Don’t forget the background: “the current economic crisis is happening in a world that is also faced with an ecological crisis.”
- Start thinking now about how to avoid the bad parts of any reform package (e.g. protectionism) becoming entrenched in the system. Don’t let them put down roots.
- Governments must take the lead in coordinating the response of the various players – and in ensuring: openness, urgency, confidence, asset separation, speed and consensus.
- Let’s look at reform (or replacement) of the Bretton Woods institutions.

In summary, many things can be learned from earlier crises. In particular:

- Systemic banking crises should be resolved as promptly as possible. They should not be allowed to lead to a protracted weakness of the banking system or drawn-out stagnation.
- The market economy works better if governments maintain the soundness and stability of the credit markets through rules and supervision, and embrace free trade as a cornerstone of economic policy.
- Safeguards for the market economy should maintain a sound relationship between capital base and risks in lending, and not nurture a culture of rationing, where contacts and ability to influence decision-makers become more important than efficiency and entrepreneurship.
- A crisis should not be a pretext for industrialised countries to protect their domestic businesses against outsourcing and imports from developing countries.
- Even during a crisis, those activities and investments that are needed for long-term sustainability should be supported and expanded. Important examples are education, alternative sources of energy and more fuel-efficient motor vehicles.
- When emergency measures become necessary in the short run, there should be an exit strategy. If the government has to take over banks and other financial institutions, or has to give loans that are usually a responsibility of the private sector, this should be a temporary policy that is not continued when normal market conditions have been restored.
- Well designed social insurance and pensions systems, administered or guaranteed by the government, help sustain a nation’s economy in times of crisis and facilitate crisis management.
- The Bretton Woods institutions need to be reformed or replaced to fit today’s need for economic co-operation between nations and stability in the world economy.
Albert Wojnilower

To prevent it happening again

Dr Wojnilower began his Wall St career in 1951, at the New York Fed, where he became chief of domestic research. After a brief spell at what is now Citibank, he spent 22 years as chief economist at First Boston (and later CSFB) – in particular, sharing the spotlight with Henry Kaufman at Salomon (as Dr. Doom and Dr. Gloom). Like Dr K, he is a legend on the Street.

Betting on asset prices, as contrasted with investing in businesses, should be severely restricted, as is gambling in general. This lesson has been – painfully – learned many times in the past and is embodied in a wide range of existing laws and regulations. Unfortunately, many of these have been ignored and denigrated in recent years, by market participants, regulators and scholars alike.

It is only the rapidity and scope of the current problems that are out of the ordinary. That regulated institutions and market participants would attempt to evade the law was and is to be expected. That they would succeed in suborning some regulators, especially profit-seeking entities such as rating agencies, auditors, and appraisers, was probably inevitable. The only intrinsic surprise, at least to me, is that academics believing in “rational expectations” – a Panglossian cult that, in effect, alleges that everything the market does “is for the best in the best of all possible worlds” – captured the Federal Reserve, SEC and other government agencies. For ideological reasons, the governors of these agencies closed their eyes to violations of the law.

The price of goods and services for current use can be determined in open markets, though these are able to function only because of the observance and enforcement of a complex set of rules and practices. If the fruit is rotten or a car breaks down, the news spreads rapidly among customers and vendors. But in sharp contrast to a consumer or capital good, a financial asset has no use value – it is simply a claim on an uncertain future. Its price resonates to the mood of the market crowd. This crowd – often a herd of lemmings, but sometimes an aggressive mob – sets the price of financial assets from moment to moment. Like the gamblers in a casino, it focuses only on the next draw of the cards or roll of the dice. Not surprisingly, the financial crowd attracts and often is led by macho gamblers (male and female) – executives who demand that their subordinates (many of them also innate gamblers) take ever more risk.

Because fungible wealth can be deployed to exert control over other human beings, most people are motivated to amass such wealth (if only in self-protection), and many will take absurd risks in order to outdo their neighbours. To be all-powerful, one must be wealthier than everyone else; hence greed knows no bounds. Although, as with narcotic drugs, regulation of financial-market practices can never fully banish reckless searches for “highs”, abandoning the supervisory effort assures eventual breakdown of the system.

A useful but less emotive template is that of professional sports.

All organised sports depend on rules and boundaries – and referees. But even children are coached to evade the rules when the referee is not looking. They are instructed not to call infractions on themselves – that function belongs only to the referees. Thus players and referees are adversaries, not friends. To maximise earnings of owners and players, the rules of the game are continually revised in response to the changing tastes of the spectators, skills of the players and tactics to circumvent the rules. The referees are highly trained and supervised, not only for skill but also for probity. Nevertheless, although the referees themselves are policed, scandals involving participants including referees are uncovered from time to time. But without referees, and police to watch the referees, there would be no game. The same is true for financial markets.

Below are summarised some key rules that markets in financial instruments must follow if they are to serve a useful purpose. These need to be continually adjusted and strenuously enforced, as are the rules in professional sports.
In contrast to markets for financial instruments and derivatives, the markets for real estate and commodities usually trade objects that are for use rather than financial claims. On occasion, however, these markets are seized by levered speculation, a symptom of which is bizarre price fluctuations. They then become essentially markets in financial bets rather than goods and services. The debacle in sub-prime mortgages and related derivatives reflects what, in effect, was trading in financial futures rather than the trading of places to live. Some rules for real estate and commodities trading when they become subject to securities-market gambling are included below:

1. **Rewards for short-term gains should be abolished (with limited exceptions for bona-fide market-makers).** Years ago, the Republican election platform used to advocate major capital gains taxes on under-one-year gains, the tax rates falling on a sliding scale to zero on 10-year holdings. Warren Buffett has advocated a 100 per cent tax on short-term gains. Such measures would remove the instant rewards that attract gamblers. Indeed, many instruments should trade only once a day, which would give participants better and more equal opportunities to gather and consider new information. As a result, the resources devoted to financial trading probably would shrink substantially. And the country’s best minds would have to find their rewards in more long-range endeavours.

2. **Most financial firms (except those accepting government-insured deposits) should be required to be partnerships.** (This should include rating agencies, auditors and appraisers, to the extent these functions continue to be performed by profit-seeking enterprises.) Since such firms tend to be risk-prone, they should only be allowed to risk their own and not other people’s money. To be sure, the public may often be eager to supply these enterprises with limited-liability equity funds. That way people hope to “have their cake” in the form of sharing the gains that financial firms derive from “insider” trading and information, as well as “eating it, too”, by avoiding liability for unethical or illegal behaviour. To repeat, financial firms should have to be partnerships - as, until about 1970, most Wall Street firms were.

Nor should firms investing for their own account be allowed to manage the investment of others’ funds. The opportunities for self-dealing, front-running, etc. are simply too enticing. No intra-firm “Chinese Walls” are sufficiently impermeable. “Money management” should be a separate, fee-for-service business, subject to enforced fiduciary responsibility and “prudent man” rules. Most security analysis would be conducted as a fee-paid service to the money-management industry.

Except for registered market-makers and security dealers, financial partnerships would not need to “mark-to-market”, since errors of judgment would not affect the general public.

**Banks accepting insured deposits should be public utilities.** Their earnings should be modest but semi-assured. Compensation to key employees would be subject to ceilings. Mortgages and other loans to business and consumers would be held to customary examiner standards. However, these standards should vary counter-cyclically (riskier loans to non-financial borrowers would be encouraged in bad times) and loan defaults should be governmentally insured (subject to co-insurance). Some fraction of every loan that is securitised would have to be retained by the originator. While servicing may be contracted out, the maker of the loan should be left with sole responsibility and authority for negotiating loan modifications.

No off-balance sheet entities or transactions should be permitted. However, insured banks could, by themselves or in co-operation with other insured banks, securitise credit-card and other loans. Such securities should state each bank’s share of the underlying obligations.

If a systemic danger arises, it would make sense for the government and/or central bank to bolster the capital of such regulated utilities. At present, however, government funds are being wasted in bolstering essentially defunct institutions whose managements hope, eventually, to resume the same business model that caused them to fail. These institutions should be extinguished and their liabilities to one another written off. It is their non-financial clientele, creditors, employees, and possibly even shareholders, who should be subsidised, whether they deserve it or not, in order to sustain the macro-economy.

Money market funds were established, with the tacit connivance of the authorities who could have prohibited them, to evade the regulatory costs and supervision to which insured banks were subject. Money market funds should be made to accept the same obligations as insured banks, even if this puts many or all out of business.

**Prohibit short selling (except by market-makers within strict limits).** A short sale evidences the seller’s desire
for the (rapid) destruction of a business. It is an anti-social bet without any constructive purpose. The seller's interest becomes to assemble a lynch mob that will quickly execute the company being sold short, whether or not that company is guilty (bound to fail). The object of public policy should be to prevent lynch mobs (hedge funds), not to foster them.

In some markets, short sales are restricted. Until its incomprehensible removal by the SEC two years ago, the “uptick” rule restrained short sales on the New York Stock Exchange. Those whom the gods would destroy, they first make mad.

5. **Restrict Fannie Mae and Freddie Mac to insuring and securitising mortgages with prescribed maturities, down-payments, etc.** No security backed by any government-sponsored-enterprise mortgage collateral would be allowed to contain any non-mortgage instrument. Subsidised (sub-standard) GSE mortgages would only be acquired by other government agencies such as the Federal Housing Administration. All mortgages and mortgage securities insured or securitised by Fannie and Freddie should be sold promptly to the private sector, except for amounts the Fed or other government agencies may buy for policy reasons.

These agencies were established to create a national, as opposed to a locally fragmented, mortgage market. It was not originally intended for Fannie to have private-sector shareholders. Congress was lobbied to allow such ownership, in the interest of private parties seeking to gain easy profits by drawing on cheap government credit.

Had rules like this been in effect, sub-prime mortgages probably would not have been generated in significant volume.

6. **If other countries wish to tolerate untrustworthy practices, that is no reason for us to do so.** If they attract more business, the benefits and risks are theirs. If Basel-type international standards survive, the regulators rather than the banks, as currently, should establish the risk standards. If the risks involved cannot be made transparent to the regulators, then they are too opaque for bank managements as well.

7. **Commodities.** Recent developments in the oil and other commodities futures markets show again that whenever these become used for asset speculation by non-users or producers of the commodity, the market prices lose rhyme or reason. At least at such times, unregistered “outsiders” must be excluded to prevent major macroeconomic reverberations.

8. **Real estate.** If the suggestions made here are adopted, price bubbles in real estate are likely to be more restrained. When and where they do appear, regulators in the affected areas must become stricter. In general, price bubbles large enough to affect the macro-economy must be taken seriously by the Federal Reserve and countervailed by direct regulatory measures appropriate to the bubble.

The Fed should realise that small and predictable changes, whether increases or decreases, in short-term interest rates will fail to offset and may even exacerbate the markets’ propensity to take chances. In sum, the Fed and other government agencies must regard market participants as adversaries rather than friends, just as sports referees view the players as their adversaries, no matter how much they may admire and envy them for their talents. When the players and referees are friends, the sport is corrupted to everyone’s loss.

The economic growth of the US depends on a system that rewards long-term risk-taking, hard work and perseverance. Such a system cannot survive the competition for talent and capital that comes from an industry addicted to high-stakes short-term betting on the price of the lottery tickets we call securities.

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No point in summarising the main points: read it all. It is well worth the effort.
The Blame Game is well under way, even before the great financial crisis of 2007 and beyond is fully mature. The difficulty is not the number of suspects but the fact that they all appear to be equally guilty. One is reminded of Agatha Christie’s story *Murder on the Orient Express*, where Hercule Poirot discovers that each of the passengers connected with the victim had struck a knife blow, having conspired together, each with a separate motive. But of course, the first thrust was the fatal one and only a single arrest was justified. In the present case of the murder of the international financial system, multiple arrests are in order.

Might the first knife thrust be ascribed to Alan Greenspan at the macro-economic level?

Of course, this is simplistic, but the stage for the present crisis was certainly set by the low interest policy pursued by the Federal Reserve through two Administrations. Greenspan was convinced technology had changed the rules. It is said he was particularly impressed by the development of check-out activated stock ordering in supermarkets. Here was a solution to the inventory cycles which had plagued the demand-driven economic model. Furthermore, the increased productivity implications of technology also regulated labour supply and price. But, as a Merrill Lynch economist once explained to me, economies are based on a three-legged stool: capital, labour and raw materials. Inflation tends to attack one leg at a time, sometimes two in rapid sequence, almost never all three at once. In this case, inflation attacked the capital leg, expressed as financial assets, with a vengeance. On top of it all, assets that had not previously been entirely financial, houses for example, were securitised and made so.

Technology played a role – but not in quite the way Greenspan had assumed.

A second murderous knife can be placed in the hand of Michael Bloomberg. He developed software that allowed traders to value complex financial assets, and their volatility quotients, within nano-seconds. A belief quickly emerged that this same technology allowed the assessment of risk to be undertaken instantly and with unprecedented accuracy. Of course, a fundamental aspect of computer logic represents the “hidden hand” in judging the merit of this belief. Computer logic is best exemplified by the old story of the man with two watches: one broken and stopped, and one 10 minutes fast. He asks the computer which one to discard. The computer tells him to keep the one that is stopped as it is right twice a day whereas the other is never right. The computer’s conclusion is absolutely correct, but commonsense tells us its advice is nonsense. As financial intermediation became increasingly quant-driven, commonsense began to fade as a management tool.

Naturally, our two “murderers” identified so far had entirely benign and worthy motives – unlike Poirot’s culprits. For instance, Greenspan’s low interest rate policy unleashed an unprecedented expansion of global trade and investment, bringing new prosperity to millions. Bloomberg’s revolution allowed a huge expansion in the volume and velocity of financial intermediation, fuelling the global expansion (not to speak of an unprecedented growth in the relative profitability of finance as an activity).

All might have been well if:

- the culture of the people (as opposed to the computers) managing this process had remained stable; and
- the public policymakers and regulators charged with its oversight had understood what was happening and acted accordingly.
In searching for the public policy culprits, one needs look no further than the US Congresses that passed the affordable housing legislation enjoining banks to provide mortgages to previously unqualified borrowers. This was on the understanding that these could be passed to Fannie Mae and Freddie Mac for onward sale, exploiting these agencies’ ratings as Government-Sponsored Enterprises. Not only was the critical link between lender and borrower broken through securitisation, but the Office of Federal Housing Enterprise Oversight, charged with regulating the GSEs, failed miserably to discharge its responsibilities (clearly pointed out at the 2004 Congressional hearings on the issue), leading ultimately to the collapse of the two agencies. But the rot could still have been stopped by Wall Street if greed, irresponsibility, negligent risk management and sheer stupidity had not conspired to create a boom in the manufacture and distribution of super-securitised residential mortgages. These spilled over from the inadequate capacity of the original lenders and the GSEs, which acquired and passed them on.

It seems incredible that regulators should have ignored the screaming conflict involved in rating agencies collecting fees from the manufacturers of complex securities, which would have been totally unsaleable were it not for their investment grade ratings. Leaving aside their massive failure in risk assessment, the raison d’être of rating agencies, this sorry saga exemplifies the deterioration of what should be a prime function of regulators - to identify conflicts and to ensure they are managed through appropriate firewalls or other devices.

Among the suspects in this financial version of Murder on the Orient Express one must include the big accounting firms.

It is considered bad form to criticise them, and they hold moral sway because they combine the functions of GP and undertaker. They have struggled to manage the conflict inherent between their consulting practices and their audit side. Even the annual creation of new accounting standards in order to increase billable hours has not been enough. Despite the vested interests of the profession, whose billing hours are at risk, pressure to make standards internationally uniform has increased. The profession has legitimately sought to increase transparency in accounts, which have become increasingly complex. But attempts at reform can have a perverse effect – as can be seen in the growing number of notes to accounts. Indeed, the IASB’s fiddling with standards has actually made accounts more opaque as a result of their complexity and lack of continuity. Changes in asset valuation practices are themselves a major contributor to the current crisis. “Marking to market” where there is no market does not increase transparency, and the expression “fair value accounting” is entirely misleading.

The principle used to be that where a bank board certified that a position would be held to maturity, it could be carried at cost and amortised over its life. If it wasn’t for the trading mania that has infected banking, this would still be a reasonable position - and many of the CDOs and CLOs, and other bits of toxic waste, might well mature with minimum loss against amortised valuation.

Some might think that the hedge funds have got off lightly in this review of culprits.

Cursed with an all-encompassing label, no sector has ever suffered more from a misunderstanding of its business. Of course, it has never been in the hedge funds’ interest to be particularly transparent. The category includes an enormous spread of risk models, ranging from the ridiculously conservative to the wildly speculative – leverage degree being a key differentiator. When the dust has settled, however, and the weak have gone to the wall, the remaining sector will be judged by historians as having been the soundest and best managed of all. This is largely because the principals have been at risk themselves, and have behaved like proper owner/managers. Calls to contain or even eliminate them, much voiced by Socialist politicians on the Continent, merely demonstrate the appalling lack of understanding of financial markets by an entire political class, happy to reap the benefits of the sector in good times and befuddled by it in bad. Even the FSA seemed unaware that, in collapsing markets, short interest is a key to triggering a rally.

We have identified daggers in the collective hands of Congress, the regulators and the Street (of which the City of London is a substantial subsidiary). What lessons can we learn? Of equal moment is the question: can the victim be resuscitated, thereby reducing the charges from homicide to aggravated assault?

Nothing grates on contemporary ears like the voice of experience, particularly when it talks about “back to basics”. But since there is no other direction to go in at the moment, back might be the best option.

It has generally been a fundamental tenet of regulatory policy that a distinction between agency and principal functions must be maintained in all areas of financial intermediation. Yet regulatory reform and the institutional consequences have gradually eroded this basic and simple concept. Virtually all of the regulatory and institutional failures that have led to this crisis can be traced to the erosion of the distinction between agency and principal functions.

The Glass-Steagall Act, brought into law in the early 1930s after the crash of 1929, addressed conflicts between credit
provision and securities underwriting. A main complaint by those politicians pushing for the reform was that banks were using access to Federal funds to finance underwriting of speculative securities issues. But they were also using their lending power as a competitive tool to win capital issue mandates. (It is worth recalling that the Glass-Steagall Act also established the Federal Deposit Insurance Corporation.) Post-Depression, the Act was increasingly seen as defending the regional banks from being swallowed by the money-center banks, and this assured its continued political support.

As the competitive environment in all forms of financial intermediation became global, the restriction on US money-center banks from engaging in investment banking was perceived as placing them at a significant competitive disadvantage. This was particularly true as the European “universal” banks began to congregate in the City of London and started to become global powerhouses. The Clinton Administration finally repealed Glass-Steagall. This was a tragic mistake of public policy - and ironically has led to the virtual destruction of the traditional investment banking business model.

It is important to remember that, prior to repeal of Glass-Steagall, major banks conducted their securities business through affiliates. This preserved a modicum of policy and control separation between the two activities. The repeal of the Act produced a different construction as a two-way migration took place with investment banks increasingly engaging in commercial banking activity, funded wholesale, and commercial banks engaging in investment banking, particularly using their balance sheets to attract business. Previously, investment banks had funded their activity exclusively through collateralised borrowing, so called “street loans”. This placed a natural restraint on their equally natural exuberance. Now, investment banks entered the money markets with a vengeance and began to generate an increasing proportion of their revenue from highly leveraged proprietary trading. They were gradually blurring, and in some cases abandoning, their traditional agency function.

At one point, Morgan Stanley even wrote a letter to all its institutional clients, thanking them graciously for their past business but informing them that henceforth they would be considered counterparties, rather than agency clients, and that the firm would trade with them only when it suited. The business of investment banking became balance sheet-driven, rather than service-driven. The game was no longer to make money for the clients – it was to make money off the clients. As monolithic, all-purpose financial conglomerates have emerged through peer group consolidations, all pretence at providing a client-driven agency service has disappeared. Even advisory functions have become commodity products, designed to feed balance sheet-related activity.

Now, consolidation has reduced the main players to such a small number that adviser selection is driven entirely by conflict elimination rather than service quality. Only asset management has escaped relatively unscathed as the nature of the business precludes proprietary activity (except for the seeding of funds – which is where present industry losses have occurred). But it is runaway proprietary trading that has sown the seeds of the present disaster. The huge overspill in residential mortgage lending in the US had to go somewhere. If the regulatory system had controlled Wall Street’s insatiable appetite for tradable instruments, the brakes might have been applied in time.

Having spotted in the past the dangers of excessive leveraged buy-out lending and contained it; having seen a major crisis caused by residential mortgage lenders diversifying irresponsibly, and bailed them out; having experienced the difficulties inherent in off-market trading of securities without proper clearing and settlement facilities and forced their creation; having witnessed endless difficulties arising from off-balance-sheet activity and sent people to prison; having witnessed the failure of rating agencies to anticipate sovereign defaults and picked up the pieces; having seen secondary banks fail due to excessive reliance on wholesale funding and mounted rescues, how is it that public policymakers and regulators totally failed to spot the poison spreading throughout the financial system? Almost every excess that has caused the present crisis has been seen before in one form or another.

One turns inevitably to the City of London and its sovereign masters for an analysis of the litany of errors. This is because the City has become the epicentre of global finance, for all the well-documented reasons. Every major bank in the world has concentrated its trading-driven activity in this highly welcoming, middle time-zone haven.

Big Bang was originally about breaking the perceived monopoly of the London Stock Exchange. There was a flaw in this perception. Any exchange needs to be a quasi-monopoly to ensure maximum liquidity. But the eventual justification of the reforms became the need to ensure London’s competitive position in global finance. There were plenty of easier ways to control any adverse consequence of the LSE’s so-called dominance (which in any case didn’t even extend to non-sterling securities). But it became received wisdom that the clearing bank/discount house/merchant bank/broker/jobber model was out of date, undercapitalised and uncompetitive.

Very few questioned this basic assumption, and ardent defenders of Big Bang still abound. In fact, it was all a tragic mistake (and we all have bloody daggers in our hands here).
Overseas banks, primarily American, anticipating the end of Glass-Steagall, quickly seized control of the City, triggering the premature retirement of most of the Square Mile’s wisdom and experience. The separation between agency and principal functions was dealt a fatal blow. A complex, industry-funded regulatory system was introduced which, despite further reform, has become unwieldy and ineffective. A new culture was introduced replacing shame-based and reputation-focused ethical standards with a get-rich-quick, disloyal and loophole-hunting mentality – unimpeded by weak and slow enforcement.

The dominant cry, voiced over and over again, to justify unhealthy consolidations, was the demand for capital. Capital, capital, capital – one could not have enough of it. No one paused to consider why increased capital was required to provide financial services to clients. The clients were bigger, went the argument, and so the transactions were bigger, requiring more capital. (A quick analysis of the relative capital of intermediaries and the amounts raised for railroads and sovereign governments in the nineteenth century would have been useful.) It did not occur to regulators that the more capital invested the more you need to earn - and that in the absence of fixed commissions or other fair margin business, proprietary trading and speculative positioning of all kinds are the natural alternative. The financial industry is now seriously undercapitalised, and will emerge over-regulated, due to losses caused largely from having previously been overcapitalised and under-regulated.

A single fatal error in public policy is rare. They come in pairs and sometimes in threes – like aircraft crashes are thought to. Certainly all the weaknesses created by Big Bang and the first Financial Services Act were exacerbated by the decision to remove banking supervision from the Bank of England and place it in an agency which was then rendered even more ineffective by having every quasi-financial activity dumped into its regulatory lap.

Banking supervision - through a number of crises, an invasion of overseas-controlled banks, a sea change in banking practices and in banking business models - had been well administered by the Bank. Its prestige had ensured high-level staffing, and its daily participation in the market had ensured a flow of unofficial information on risk evolution. Its moral authority, characterised (and caricatured) by the “governor’s eyebrows”, was real and effective. Admittedly, the Bank’s position suffered from the unjustified legal attack following the BCCI collapse – though, strangely, during this unhappy saga, no one sought to question the ill-conceived lead regulator principle, which had placed ultimate supervisory control of a vast, non-European banking empire in the hands of the Luxembourg authorities. Stripped of its most important role (official discount rates having less and less monetary significance), the Bank lost all of its expertise, the supervisory staff having mostly taken early retirement, and was turned into an economic think-tank, while still retaining its lender-of-last-resort status. The so-called tripartite agreement, where ultimate responsibility is shared between the FSA, the Bank and the Treasury, has been a disaster. Even the Three Musketeers needed a fourth to be effective.

An argument in favour of regulatory consolidation (mirrored often in arguments in favour of industry consolidation) is that with so many practitioner businesses under one roof, a single regulator is more efficient. This begs the question of how any regulated, multi-product and multi-national business could conceivably be regulated by a single entity. All have compliance departments dealing with multiple regulators in multiple jurisdictions.

The FSA is an even more convincing case for unbundling than Citigroup. Never has so much been combined under one agency to so little effect.

The regulatory process has lost its way, but critics among the regulated are silenced for fear of retribution - or, more perniciously, because of the protection the current system gives the majors’ market shares. In an age when monopolistic tendencies are rapidly identified and stamped out, it is also remarkable that few have appreciated the fact that highly complex and compliance-intensive regulation is anti-competitive as it raises the cost of entry to newcomers; they cannot afford the compliance burden assumed by the established houses. In these circumstances, reform of the system has to be initiated through public policy. The practitioners are not motivated to do so.

The FSA’s “risk-based” approach has been fatally undermined by the Northern Rock case, where the risk assessment was based entirely on the nature of the asset side of the balance sheet, made up of nominally low-risk residential mortgages. The fact that the business was largely funded in the inter-bank market (bearing in mind that the bank had little access to the international market) and was therefore vulnerable to any hiccup, was ignored. Of what value is a bank supervisor that cannot identify a fundamentally flawed business model? There is no lack of goodwill and determination at the FSA, and its staff battles heroically against the overwhelming odds of being itself a flawed business model.

Now, one must turn to the all important element of culture. Sociologically unpopular as such a view might be and pace political correctness, it is undeniably the case that the leadership/management of the financial industry has passed from one type of individual to another.
Previously, the major players were in the hands of those who had already achieved social and financial standing (yes... usually through inheritance) and did not rely on any one year’s compensation to maintain their lifestyle. The preservation of reputation was the name of the game, and capital was assured in partnerships by controlling annual profit payouts. Job jumping was rare, and individuals recognised that their personal achievement was in large part due to the quality of the house they were employed by. Consolidation is the culprit here. It became impossible to maintain the traditional culture, which characterised both Wall Street and the City of London, within huge, multi-unit conglomerates. The fading of corporate loyalty also generated the extreme compensation practices that are now so reviled by the political class. Consultants exacerbated the trend with upward ratcheting peer group comparisons. It has become impossible to link even the highest level compensation structures with owner’s interests.

Business unit bonus pools now dominate, so that even when shareholders lose money, huge payouts are made to selected individuals based on their specialty performance, regardless of the overall result. But more importantly, the mentors that spawned new generations of bankers with a grounding in ethics are gone, to be replaced by “get rich quick” MBAs with high levels of numeracy and no sense of proportion.

There is no quick fix to this general, cultural problem, though institutional reform will eventually make an impact.

Where should we go from here?

Institutional reform on a fairly massive scale will be necessary, and it is to be hoped that the political class will not be deterred by the howls of protest that will ensue. “Unbundling” must be the theme. Consolidation in financial services, driven largely by peer group pressure and deal-hungry investment bankers, has been a disaster. But the first unbundling in the UK should not be the banks; it should be the regulatory machinery. There is no efficiency argument that can counter the failure of the present system.

The supervision of deposit-taking authorised banks should be returned to the Bank of England. The FSA should be downsized to concentrate entirely on wholesale securities markets. A separate entity should regulate the sale of all financial products to the public, including mortgages, life and casualty insurance, etc. This would certainly mean that providers and distributors would be accountable to three regulators. But the specificity of the regulatory reporting requirement would probably lead to a saving in compliance costs.

This new regulatory triumvirate would impose institutional reform. Investment banking and securities activity would have to be conducted in a subsidiary with independent governance, including a limitation on cross executive directorships with a deposit-taking parent and a requirement that a majority of the board be qualified independents. The regulation of securities activity would be product-based, rather than capital-based, and position limits would be imposed as a function of the risk profile of the product. “Chinese walls” would be imposed and monitored to separate securities underwriting and trading, principal activity (allowed only for liquidity provision purposes), asset management, private equity, etc. Deposit taking would be the most segregated of all activities. Such a regulatory regime would encourage unbundling by spin-offs to shareholders and outright sales.

The off-market activity in Credit Default Swaps and other derivatives needs significant regulatory attention. Clearing facilities should be a requirement of product authorisation, allowing volumes to be transparent. The ability of the industry to innovate should not be constrained – it is its life blood. But regulators have to keep up and be as innovative themselves as the innovating practitioners. This requires the new triumvirate to incorporate much greater practitioner expertise through advisory panels and participation in corporate governance.

Of all the misleading phrases in use, “principles-based” regulation has been the worst. We have lost all principles in financial services, in favour of hugely prescriptive regulation with weak enforcement, financial conglomerates unable to impose simple ethical standards, and markets attempting to defy the laws of nature – which are of course the most basic of principles. Only by rediscovering principles will the financial system return to health.
Following the crash of 1929, and the resulting bankruptcies of banks and business enterprises, the US Congress proceeded to pass the Glass-Steagall Act. This separated commercial banks from investment banks.

Under Glass-Steagall, commercial banks became “public utilities” governed by strict supervision. Even interest rate levels were fixed by Regulation Q. Emphasis was placed on the solvency of banks, with strict guidelines as to what portion of their capital could be exposed to a particular borrower. As a result, profits to shareholders were generally low, and operating expenses were strictly controlled. It was said, for example, that if you could not find a job in the government, you tried to get one with a commercial bank - meaning that remuneration for employment at a bank was lower than that for employment by the government.

This continued until the middle 1960s, when Walter Wriston, the chairman of Citibank and the undisputed leader of the US banking profession, came up with the pronouncement that commercial bank shareholders had the same rights as shareholders of other industries to maximize their profits. BANG! Citibank, and subsequently the rest of the US banks, replaced solvency as their main objective with ‘profit centres’. Departments and branches were given profit targets and a tough timetable for achieving them – which, naturally, pushed them to grant loans with higher risks. It was the beginning of a new era.

As lending expanded, banks had to raise more capital - either by issuing new shares or through mergers with other institutions. However, such mergers were tightly controlled by the Justice Department. If you wanted to merge, you had to prove that the merger would not compromise the competitiveness of the industry.

Just a few years later, the Eurodollar market was being established in London and the concept of LIBOR emerged – permitting the mobilization of funds to finance the requirements of sovereign countries, often from groups of banks. Initially, some banks were reluctant to participate in such consortia, if for no other reason than that they were losing their bilateral relations with particular borrowers, and thus had to forgo the collateral benefits in the form of deposits, the financing of commercial transactions etc. However, this reluctance did not last for long.

Soon afterwards, there was a sharp increase in the price of oil. This meant large surpluses in oil-producing countries that had to be recycled to finance the deficits of the oil-consuming countries.

The enormity of the amounts involved and the urgent need to satisfy the demands of the deficit countries broke all the rules and regulations under which the banks had been operating – albeit with the full knowledge and consent of the authorities. The major role in the recycling was undertaken by US banks; the Federal Reserve and the Treasury considered it a plus for America that the rest of the world depended on US banks for its financial requirements. The fact that these banks were providing loans that were sometimes larger than their own capital to individual countries, especially in Latin America, was totally (and conveniently) ignored. Inevitably, when some of these countries that had borrowed huge amounts could not service the debt, the LDC crisis started.

As part of the 40th anniversary celebrations of the Bretton Woods system, the Federal Reserve Bank of Boston invited a group of people (including myself) to a gathering in Bretton Woods, New Hampshire. That same day, Continental Illinois declared bankruptcy.

An attempt was made to get Chemical Bank to take Continental over, but when that failed to materialise, the
Fed stepped in – guaranteeing depositors for amounts way above FDIC limits, instead of allowing the bank to fail. A few days later, the then Secretary of the Treasury, Don Regan, announced that the US Government would not allow any big bank to fail.

Following that announcement, US banks felt themselves liberated; they could chase any new loans in order to increase their profitability, without paying attention to the magnitude of the risks they were taking on. As a result, the exposure of the banks became so enormous that - practically speaking - no US bank was solvent. The authorities pretended not to see this. Instead, they encouraged banks to merge with each other, ignoring anti-trust legislation. Plus, they helped in other ways. For instance, as the US banks struggled to survive, monetary policy changed, and the banks were able to rebuild their capital through a ‘positive carry’ on Government securities.

As the banks recovered from that crisis, they began thinking of other ways to maximize their profits. As a result, they started to finance LBOs, private equity funds, hedge funds, and whatever else sprang up in a deregulated environment – knowing that the Government would not allow them to fail, despite the risks they were taking.

They were right. Indeed, pressure for further deregulation was exerted on Congress and the regulatory authorities, culminating in the formal abolition of the Glass-Steagall Act in 1999 - allowing commercial banks to compete directly with investment banks in all kinds of transactions. Anything could be financed - provided only that it appeared profitable. At the same time, derivatives mushroomed – and, increasingly were carried outside the balance sheets of the banks, in the belief that, since every transaction had a counterparty, they were essentially self-liquidating. It is estimated that these off-balance sheet items now amount to about US $60 trillion - in other words, four times US GDP. Unfortunately, as some counterparties have failed, banks have had to subtract their losses from their capital - a ‘Sword of Damocles’ that still hangs over their heads.

In 2008, the balloon burst.

What should be done from now on? Here are some thoughts:

1. **All commercial banks should return to the status quo ante, i.e. they should go back to “utility banking”, tightly supervised by the relevant authorities. Emphasis should be placed on the solvency of such banks, as was the case before Walter Wriston changed the game.**

2. **The investment banks (if any survive) should return to their old functions, i.e. advising their corporate clients and arranging for their equity and debt requirements.**

3. **Fund management companies should continue to function - but their fee structure should be regulated by the SEC and by the relevant agencies in other countries. And investors in such funds should know the leverage, if any.**

4. **Hedge funds should be abolished unless they submit themselves to strict supervision. They should be incorporated in the countries where they operate. No offshore companies should be involved, so that transparency can be achieved. Their fee structure should be regulated by the appropriate Supervisory Authorities. Leveraging should be made public so that investors know what risk they are undertaking.**

5. **Private equity firms should not be allowed to acquire companies unless they can convince the appropriate authority of the validity of such an acquisition. Mergers and acquisitions should be subject to the approval of the national authorities, as was the case in the past, taking into consideration monopolistic tendencies - and definitely not at the cost of labour dismissals.**

6. **Securitisation of bundles of assets should be closely examined, and guidelines should be given by the regulators on the composition of instruments to be included. The financing of trade should be carried out by commercial banks, but only for self-liquidating transactions. Banks can also provide working capital, but should make sure that such funds will not be frozen as long-term debt.**

7. **As for the rating agencies, it is a scandal that they are not more strictly supervised. A supervisor is needed to make sure that there are no conflicts of interest involved, and that the ratings are not arbitrary.**

8. **Short-selling should be outlawed. It is unthinkable that someone like George Soros should be able to bring down the currency of a major industrialised country. The principle must be that you cannot sell something you do not possess.**

The role of the US dollar – which remains the predominant currency of both transactions and asset accumulation - creates enormous problems for the rest of the world, since it dominates global savings, and permits the US to finance its deficit to the detriment of the system. It also relieves the
US Government of the need to exercise fiscal discipline - resulting in the situation we are in today, in which the United States depends on China and Japan in order to survive.

As a result, we should seriously reconsider the recommendations made by the Bretton Woods Commission in the early 1990s, particularly on the need to develop 'parallel' currencies for transactions and for reserve asset accumulation.

Since the Commission reported, the euro has been created – with a generally positive impact on both the European economy and on the rest of the world. A similar Asian regional currency is badly needed – particularly given the threat to the global payments system posed by the enormous size of US liabilities to the rest of the world. So let's have a real debate over moving to a multicurrency world.

Finally, we must work together to strengthen multilateral institutions like the IMF – and we should let them operate under their original mandate. In the case of the Fund, that means as a provider of short term balance of payments support.

In my view, the financial system can only justify its existence if it helps to finance trade and development. It is not there to turn the world into a giant financial bazaar, and it is not there to allow a few smart bankers to enjoy huge riches at the expense of society.
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