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Houston, we have a problem! For three decades now we have been promoting the joys of a liberalised financial system and what has it brought us? “One massive financial crisis after the other” is the answer. This is not to say that liberalised finance brings no benefits. It has certainly made a substantial number of people extraordinarily rich. It may well have brought economic benefits, as well. On that, the evidence appears mixed. But of one point, there can be little doubt: the crises have been frequent and costly, not least for innocent bystanders. Fiscal costs have been particularly disturbing. Gerard Caprio and Daniela Klingebiel provide information on no fewer than 117 systemic banking crises (defined as ones in which much or all of bank capital was exhausted) in 93 countries (that is, half the world) since the late 1970s. In 27 of the crises for which they have been able to obtain the data, the fiscal cost of the bail out was 10 per cent of GDP, or more, sometimes vastly more.¹

This was not a happy story. But an optimist – me, for example – might still believe, or at least hope, that regulation was becoming better, management of financial institutions more adept and risk-management more sophisticated. Above all, such an optimist could – indeed, did – believe that the most advanced financial systems in the world, particularly that of the United States, represented a promised land of sophisticated new transactions-oriented finance.

I even wrote a piece on “the new financial capitalism” just before the crisis broke.² In this I argued that we have today “the triumph of the global over the local, of the speculator over the manager and of the financier over the producer. We are witnessing the transformation of mid-20th century managerial capitalism into global financial capitalism. Above all, the financial sector, which was placed in chains after the Depression of the 1930s, is once again unbound”. I concluded the piece, however, by noting that: “Our brave new capitalist world has many similarities to that of the early 1900s. But, in many ways, it has gone far beyond it. It brings exciting opportunities. But it is also largely untested”.

The test came remarkably promptly. This is why the latest crisis – the “subprime *cum* credit-freeze” of 2007 and 2008 – is, I believe, far and away the most significant of the crises of the last three decades. It may also end up as the costliest, in absolute terms, simply because its epicentre is the United States (though it will certainly not be the costliest in relation to gross domestic product).

What makes this crisis so significant? It tests the most evolved financial system we have. It emanates from the core of the world’s most advanced financial system and from transactions entered into by the most sophisticated financial institutions, which use the cleverest tools of securitisation and rely on the most sophisticated risk management. Even so, the financial system blew up: the commercial paper and inter-bank markets froze for months; the securitised paper turned out to be radioactive and the ratings proffered by ratings agencies to be fantasy; central banks had to pump in vast quantities of liquidity; and the panic-stricken Federal Reserve was forced to make unprecedented cuts in interest rates.

Moreover, losses just keep bleeding out. Nobody believes we have reached the end of them. Sovereign Wealth Funds have helped recapitalise damaged institutions. But it is far too early to be confident that a direct bail-out by the US government will be unnecessary. Nouriel Roubini of New York University’s Stern School of Business, not the most cautious of analysts, it is true, but largely accurate in his prognostications of the looming recession, has recently argued that total losses of the financial system might end up USD 3,000 billion.³ In that case the US financial system would presumably be bankrupt and the rescue might even cost US taxpayers 20 per cent of GDP. In any case, an indirect bail out by the Federal Reserve is already under way. Meanwhile, as a footnote, though it is hardly that, one of the UK’s most dynamic banks, Northern Rock, imploded, generating the first bank run for over a century and forcing the government, in effect, to guarantee the liabilities – yes, I do, alas, mean the entire liabilities – of the

¹ See Caprio and Klingebiel (2003).

² See Wolf (2007).

³ See www.rgemonitor.org.

British banking system. The United Kingdom prided itself on having as advanced a financial system and as sophisticated a system of regulation as anywhere. It can no longer do so, alas.

So what has gone wrong? That seems to me to be the first question. Why has an era of globalisation, economic convergence and low inflation led to a plethora of bubbles, crises and financial mishaps? In the newest edition of the late Charles Kindleberger's classic work on financial crises, Robert Aliber of the University of Chicago Graduate School of Business argues that "the years since the early 1970s are unprecedented in terms of the volatility in the prices of commodities, currencies, real estate and stocks, and the frequency and severity of financial crises".⁴ I do not know whether that is true. But this is certainly the only significant industry whose safety standards seem to be no higher than a century ago. So what, if anything, can or should we do about it? That will be my second question.

I | What has gone wrong?

How do we explain this pattern of repeated failure? The alternative perspectives on crises are particularly well displayed in discussions of the most recent one, that in the United States.

One view is that this crisis, like most others, is largely the product of an irretrievably defective financial system. An email I received a few weeks ago laid out the charge: the crisis, it asserted, is the product of "greedy, immoral, solely self-interested and self-delusional decisions made throughout the 2000s, and earlier, by very real human beings at the very top of the financial food chain".

The argument would be that a liberalised financial system, which offers opportunities for extraordinary profits, has a parallel capacity for generating self-feeding mistakes. The story is familiar: financial innovation and an enthusiasm for risk-taking generate rapid increases in credit, which drive up asset prices, thereby justifying still more credit expansion and yet higher asset prices. Then comes a top to asset prices,

panic selling, a credit freeze, mass insolvency and recession. An unregulated credit system, then, is inherently unstable and destabilising.

This is the line of argument associated with the late Hyman Minsky, who taught at Washington University, St Louis. George Magnus of UBS distinguished himself by arguing early that the present crisis is a Minsky moment: "A collapse of debt structures and entities in the wake of asset price decay, the breakdown of 'normal' banking functions and the active intervention of central banks". This followed an extraordinary dependence on credit growth in the recent cycle.

Economists would offer two contrasting explanations for this fragility. One is in terms of rational responses to incentives. Another is in terms of the short-sightedness of human beings. The contrast then is between misdirected intelligence and simple folly.

Those who emphasise rationality can readily point to the incentives for the financial sector to take undue risk. This is the result of the interaction of "asymmetric information" – the fact that insiders know more than anybody else what is going on – with "moral hazard" – the perception that the government will rescue financial institutions if enough of them fall into difficulty at the same time. There is evident truth in both propositions: if, for example, the UK government feels obliged to rescue a modest-sized mortgage bank, such as Northern Rock, moral hazard is rife.

An obvious reaction to this line of argument is that the failure was one of regulation. If regulators had done their job, by ensuring prudent mortgage lending, curbing the growth of off-balance-sheet vehicles, overseeing regulatory agencies, and so forth, the crisis would never have happened. Yet it is also evident that everybody involved – borrowers, lenders and regulators, too – are all too often swept away in tides of euphoria and panic. To err is human. That is one of the reasons regulation is rarely countercyclical: regulators are swept away, as well. The financial deregulation and securitisation of the most recent cycle merely encouraged an unusually wide circle of people to believe they would be winners, while somebody else would bear the risks and, ultimately, the costs.

⁴ See Kindleberger and Aliber (2005).

An alternative view is that this is a crisis not of markets, but of government intervention. Governments provide the explicit and implicit guarantees. Governments heavily distort the market for housing, particularly in the United States, *via* government-subsidies for long-term lending. Governments subsidise borrowing in the tax code. At the same time, governments do not – or perhaps cannot – create a regulatory regime capable of offsetting the incentives for perverse behaviour created by such subsidies.

Yet there is a very different perspective. The argument here is that US monetary policy was too loose for too long after the collapse of the Wall Street bubble in 2000 and the terrorist outrage of September 11 2001. This critique is widely shared among economists, including John Taylor of Stanford University.⁵ The view is also popular in financial markets: “It isn’t our fault; it’s the fault of Alan Greenspan, that ‘serial bubble blower’”.

The argument that the crisis is the product of a gross monetary disorder has three variants: the orthodox view is simply that a mistake was made; a slightly less orthodox view is that the mistake was intellectual – the Fed’s determination to ignore asset prices in the formation of monetary policy; a still less orthodox view is that man-made (fiat) money is inherently unstable. All will then be solved when, as Mr. Greenspan himself believed, the world goes back on to gold. Human beings must, like Odysseus, be chained to the mast of gold if they are to avoid repeated monetary shipwrecks.

A final perspective is that the crisis is the consequence neither of financial fragility nor of mistakes by important central banks. It is the result of global macroeconomic disorder, particularly the massive flows of surplus capital from Asian emerging economies (notably China), oil exporters and a few high-income countries and, in addition, the financial surpluses of the corporate sectors of many countries. This was a global real interest rate shock, with particular force in the United States, where the capital was directed.

In this perspective, central banks and so financial markets were merely reacting to the global economic environment. Surplus savings meant not only low real interest rates, but a need to generate high levels of offsetting demand in capital-importing countries, of which the United States was much the most important.

In this view (which I largely share) the Fed could have avoided pursuing what seem like excessively expansionary monetary policies only if it had been willing to accept a prolonged recession, possibly a slump. But it had neither the desire nor, indeed, the mandate to allow any such thing. The Fed’s dilemma then was that the only way to sustain domestic demand at levels high enough to offset the capital inflow (both private and official) was *via* a credit boom. This generated excessively high asset prices, particularly in housing. It has left, as a painful legacy, stretched balance sheets in both the non-financial and financial sectors: debt deflation, here, alas, we come. This is not to deny that the Fed over-egged the pudding. But it had reasons for doing so.

When I read these analyses, I am reminded of the story in which four people are told to go into a dark room, hold on to whatever they find and then say what it is. One says it is a snake. Another says it is a leathery sail. A third says it is a tree trunk. The last says it is a pull rope.

It is, of course, an elephant. The point that it is, indeed, an elephant comes out clearly when one looks at the similarity with earlier crises. In a recent column (February 26th 2008), I argued that most crises began with capital inflows from foreigners seduced by tales of an economic El Dorado. This generated low real interest rates and a widening current account deficit. Domestic borrowing and spending surged, particularly investment in property. Asset prices soared, borrowing increased and the capital inflow grew. Finally, the bubble burst, capital flooded out and the banking system, burdened with mountains of bad debt, imploded. With variations, this story has been repeated time and again. It has been particularly common in emerging economies. But it is also familiar to those who have followed the US economy in the 2000s.

5 See Taylor (2007).

2| What can be done?

I want to conclude with a discussion of the lessons of this painful experience. I have to stress that my thinking is at an early stage. I no longer know what I used to think I knew. But I also do not know what I think now. So the discussion will lay out alternatives, in two main areas: regulation and monetary policy.

2| I Regulation

Optimistic opponents of further regulation argue that the banks have learnt their lesson and will behave more responsibly in future. Pessimistic opponents fear that legislators might create a Sarbanes-Oxley squared. The Act passed by the US Congress in 2002, after Enron and other scandals, was bad enough, they say. The banks might now suffer something worse.

My reply to the optimists is “dream on”. To the pessimists, I respond: yes, the danger of over-regulation is real, but so is that of doing nothing at all.

Two points shine out about the financial system over the past three decades: its ability to generate crises, and the mismatch between public risk and private reward.

It is true, on the first point, that none of the financial crises of this period has gravely damaged the world economy, although some have devastated individual economies. But it is probably just a matter of time. It is also true, on the second point, that the banking sector is the recipient of massive explicit and implicit public subsidies: it is largely guaranteed against liquidity risk; many of its liabilities seem to be contingent claims on the state; and central banks create an upward-sloping yield curve whenever banks are decapitalised, thereby offering a direct transfer to any institution able to borrow at the low rate and lend at the higher one. In addition, banking institutions suffer from huge agency problems – between clients and institutions, shareholders and management and management and other staff. All this is also exacerbated by the difficulty of monitoring the quality of transactions until long after the event.

The United States itself looks almost like a giant hedge fund. The profits of financial companies jumped from below 5 per cent of total corporate profits, after tax, in 1982 to 41 per cent in 2007, even though their share of corporate value added only rose from 8 to 16 per cent. Banking profit margins have been strong, until recently. Now, at last, earnings per share and valuations have collapsed.

Yet can anything effective be done to contain the risk-taking this implies? To answer this, we must distinguish “micro-prudential” controls over institutions from “macro-prudential controls” over the entire system.

On the former, the consensus of regulators seems to be that we need tweaks to the existing system. This could include: greater attention to liquidity management, alongside the focus on capital requirements in Basel II; more stress-testing of “value at risk” models; greater transparency throughout the businesses; and greater independence of ratings agencies from issuers.

I would argue, however, that none of this will make a sufficient difference. Regulators must also pay attention to the incentives – particularly the structure of pay – within the businesses. I would argue, in addition, that regulators would have to take a much tougher approach than most did in the past cycle. More broadly, there is a case for much higher capital requirements, particularly as a cushion against failure, combined with ruthless marking of assets and liabilities to market. I am also interested in the idea of forcing regulated banks to issue subordinated debt to one another, with the price being used as a relatively well-informed indicator of stress. Finally, originators must clearly be forced to hold the riskiest tranches of subsequently securitised loans on their books.

More radically still, we might ask whether the Glass-Steagall Act was really so unreasonable. A clear distinction exists between banking as a safe, low return utility, designed to provide services to the public at large, on the one hand, and investment banking, on the other. It is far from clear to me that combining a utility with a hedge fund is a good idea, not least because the result is close to being impossible to manage or regulate. Of course, one might wish to go even further and turn the utility part into narrow banks.

The bigger point still, however, concerns macro-prudential regulation. As William White of the Bank for International Settlement has noted, banks almost always get into trouble together.⁶ The most recent cycle of mad lending, followed by panic and revulsion, is a paradigmatic example.

One response would be to raise capital requirements counter-cyclically, in response to the growth of credit, as Charles Goodhart of the London School of Economics and Avinash Persaud of Intelligence Capital have suggested.⁷ They also suggest a variable maximum loan-to-value ratio for mortgages. Mr. White adds the need for tighter monetary policy.

These are all reasonable ideas. Yet, as Mr. White also notes, the strength of the pressures against taking “away the punchbowl just as the party gets going”, in former Fed Chairman William McChesney Martin’s famous phrase, is formidable. In addition to bureaucratic inertia, such action is subject both to unavoidable uncertainty about the dangers of current trends and to resistance from private interests. Furthermore, regulators are in constant danger of losing sight of the systemic wood for the institutional trees.

2 | 2 Monetary policy

The second area for consideration is monetary policy. Here the big question is what role should be played by asset prices in the formulation of monetary policy. The conventional wisdom – or at least the Federal Reserve’s conventional wisdom – has been that one cannot recognise bubbles before the event and can clean up the mess after it. I had an open mind on this proposition. No longer. It is now clear that neither proposition makes sense. One can judge when prices are moving a long way from fundamentals and it is hard to clean up the mess afterwards, particularly

if much debt has been accumulated, using the overpriced assets as collateral. Worse, this is a one-sided policy that tolerates booms, but not busts. It now seems clear that the best policy is to lean against the wind, when asset prices are soaring, even if that means pushing inflation below target for a while. This, after all, is not a situation in which deflation is a danger, by definition. The danger of deflation comes after the bust and the bigger the boom, particularly the asset price boom, the bigger the bust is also likely to be. Central banks must surely pay more attention to asset prices in future. It may be impossible to identify bubbles with confidence in advance. But central bankers will be expected to exercise their judgment, both before and after the fact.

I would add to all this the simple fact that freedom of US monetary policy has been seriously constrained by the monetary and exchange-rate policies of others, notably of China. Monetary disorders are global. If important countries pursue radically destabilising exchange rate policies, global monetary and balance of payments disorder is the inevitable consequence.

Those who do not learn from history are condemned to repeat it. A fundamental lesson concerns the way the financial system works. Outsiders were aware it had become a gigantic black box. But they were prepared to assume that those inside the box at least knew what was going on. This can hardly be true now. Worse, the institutions that prospered on the upside expect rescue on the downside. They are, alas, only too right to expect this. But this can hardly be a tolerable bargain between financial insiders and wider society. Is such mayhem the best we can expect? If so, how does one sustain broad public support for what appears so one-sided a game?

This crisis is a wake-up call. We are going to have to think again.

⁶ See White (2004).

⁷ See Goodhart and Persaud (2008).

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