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Global financial crisis a year later: Still a lot to worry about

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A year after the outbreak of the global financial crisis, Charles Goodhart, emeritus professor of banking and finance at the London School of Economics, says we'll be "jolly lucky" if the global crisis winds down smoothly. One point he makes here is that even in advanced economies, the pace of recovery will differ and must be re-evaluated whenever the economic data are updated. Also, economic decisions are often influenced by the social and political climate. The fact that the main danger has moved from banks to public entities is a factor that some recent proposals do not seem to have taken into account. On the other hand, Carmen Reinhart, author with Kenneth S. Rogoff of *This Time It's Different: Eight Centuries of Financial Folly*, points out the recovery this time has already taken far longer than any other since World War II. She attributes many of today's economic problems to the opacity of the balance sheets of financial institutions, although she notes that bank failures "have been as much a result of poor enforcement — supervisors looking the other way — as of poor or nonexistent lending standards." Both professors support the proposal to charge a levy on the largest banks to make financial institutions lend prudently.

***The Brazilian Economy* — A year and a half after the outbreak of the financial crisis, there seems to be hope that the worst is over. What is your take on the current situation in world financial markets?**

Charles Goodhart — The situation keeps changing. The crisis has taken many twists. The main danger has moved on from banks to public bodies — not only sovereign debt per se, but also liabilities to public bodies, such as subsidiary states and municipalities. This raises a new problem, because the difficulties of public bodies can feed through to banks.

In a recent book, Ken Rogoff and Carmen Reinhart maintain that recoveries from recessions caused by financial crisis are slower and shallower than recoveries from other recessions, and that the US subprime financial crisis is hardly unique. With banks still repairing their balance sheets, recovery in the advanced economies is slow, with little credit expansion to the private sector. Is the recovery in advanced economies going to be protracted?

Carmen Reinhart — The recovery already has been protracted. Since World War II recoveries have tended to average less than a year. This time subprime problems arose in August 2007, economies deteriorated throughout 2008, and we're still not back on track. The signs of recovery may be everywhere, but how sustainable are they? There are still a lot of issues to be resolved.

Charles Goodhart — It's extremely difficult to tell. For instance, as a commodity economy, Canada is on a different track from the US, the UK, Japan, and the EU economies. Also, in the US, for instance, the recovery looks to be reasonably broad-based, but there was only a brief upturn in Japan and the UK. We must constantly evaluate the latest figures as they appear.

On this side of the Atlantic US states, such as California, are in a dire debt situation. On the other side, things are equally dire in EU countries like the PIGS (Portugal, Italy, Greece, and Spain). How should these debt crises be addressed? And should the IMF play a role in resolving the problems of the PIGS?

Carmen Reinhart — What's been done in Europe is a reasonable step in the right direction, because it buys some time for its economies to adjust and to digest what's happened and what needs to happen. Financial markets don't like surprises. Greece will have to restructure its debt. That cannot be avoided, but the steps taken to delay it may mitigate the contagion. Surprise and high leverage are an unholy combination.

The restructuring debt in Argentina in 2001 was death by a thousand cuts, but there was no real surprise because what ultimately happened had been widely anticipated.

Charles Goodhart — The circumstances of each country make a difference. A number of countries have decided on internal devaluation; they have cut wages and prices.

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This path is painful: Among the Baltic states, for instance, Latvia has been willing to take this route. Ireland also moved early adopting tough fiscal measures. The resulting fall in nominal incomes naturally has a negative effect on output and employment. The social and political climate in southern economies in Europe is not conducive to this solution. Political elites there have been influential in diverting the fiscal and monetary authorities from considering such options. Of course, the only result for them in the end is more internal devaluation, because tax revenues are going down.

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Many emerging market economies are experiencing a fast recovery to the point of overheating and inflation surges. In particular, China is booming and may be experiencing a real estate price bubble. Is there a chance that if its real estate bubble bursts, the boom in China could brake to a halt?

Carmen Reinhart — Any boom can crash, but there are more imminent things to worry about. The recovery in advanced economies is fragile; the amount of debt accumulated by the world's largest economies is scary. Keep in mind that China is a tightly controlled, very closed economy. It's in a reasonably good position to manage the consequences of a bursting real estate bubble.

Charles Goodhart — There are always risks and there have often been sharp reversals in Chinese asset markets. The general belief is that Chinese economic power will carry it through even if the bubble bursts.

Niall Ferguson has called it a delusion that creating more debt and spending can resolve a crisis that resulted in the first place from excessive debt. The bailout of large banks has translated into large public debt that raises fears about fiscal sustainability in many advanced economies. Ferguson suggests that a single huge debt restructuring that would give bondholders of insolvent institutions equity, and put the institutions under government administration (as happened in the banking crisis in Scandinavian countries). Would this have been a better alternative for handling financial crises?

Carmen Reinhart — What the Scandinavian countries restructured was private debt. Restructuring public debt is not so simple. Keep in mind, too, that restructuring is equivalent to a partial default.

Charles Goodhart — If, as it appears, the main danger is no longer banks but the debt of public bodies, how would you turn public sector debt into equities? This is especially apparent in the PIGS, where the threat to solvency clearly comes from the debt of the governments. There is also the question of who bears the burden. Bondholders have entered into a contractual relationship in good faith. How do you tell them, in effect, that you are going to take away their money?

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What is the origin of the "too big to fail" policy? It seems to create a fundamental obstacle to a sound banking system by providing incentives to banks engaging in risky activities.

Carmen Reinhart — Too big to fail is not a policy, it's a reality. Since World War II there have been frequent banking crises, but there has seldom been major government intervention. Through the 1970s crises were few, but they have been much more common since the 1980s because there are not so many capital controls. There have been more and more crises requiring institutional — systemic — bailouts. Another reason for the new scale of intervention crises is the increasing opaqueness of balance sheets. It's the interconnectedness that makes institutions "too big." Also, because balance sheets are so opaque, it's hard to understand what's really happening with them. It's very unfortunate.

Charles Goodhart — We've moved away from "too big to fail." Yet there is still the problem that big financial institutions can't be closed because the ripple effects could be severe. There might be a haircut on creditors, but there are simply too many people involved in the transactions of international financial institutions who would be affected. That is not to say that a form of bankruptcy might not be possible, where shareholders lose and management goes but the entity keeps on operating. Closure and liquidation are more problematic. What would happen if a big bank's assets were dumped on the markets?

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Should central banks have a procedure for intervening quietly in insolvent banks? For instance, the Central Bank of Brazil can close them down without lengthy legal procedures and without disrupting the banking system. Is there any reason why, after rescuing the financial system, insolvent banks should be closed?

Carmen Reinhart — Yes, there should be procedures. But one problem is that not just central banks but even the manager in private institutions do not understand the implications of the opacity of balance sheets and the interconnectedness of institutions. They're finding out the hard way nowadays.

Charles Goodhart — Yes. Central banks are supposed to have responsibility for resolving bank problems, but most of them can only provide liquidity. They need to be equipped for countercyclical regulation.

How should central banks address price asset bubbles? The more risk-sensitive Basle II capital adequacy ratios and the move to "mark-to-market" accounting seem to have made regulatory systems more procyclical. Prof. Charles Goodhart suggested that central banks cannot achieve price and financial stability with interest rates alone, and that

regulation should be countercyclical to dampen asset booms and smooth bursting bubbles.

Carmen Reinhart — The main job of central banks is to manage inflation. It's hard for them to systematically burst bubbles, but it might behoove them to enhance policy to make it more eclectic and to be more aware of what's happening with credit aggregates, what's happening when credit is piling up frantically. One reason there were fewer crises earlier was that the central bank would move faster to increase margin requirements.[1] We haven't seen that instrument used lately.

Charles Goodhart — This question is similar to the previous one in a sense, because again the answer is yes, and again the problem is that Basle II and mark-to-market have indeed made regulatory systems more procyclical. Financial regulation in general needs considerable rethinking.

What do you think about the proposed (Paul) Volcker rule for limiting the proprietary activities of banks? Volcker said that "adding further layers of risk to the inherent risks of essential commercial bank functions doesn't make sense, not when those risks arise from more speculative activities better suited to other areas of the financial markets."

"Emerging markets need to be very careful… . Prudence in borrowing is the lesson to take to heart, or it will all end in tears."

Carmen Reinhart

Carmen Reinhart — If the intent is to try to make institutions smaller, it's a step in the right direction. But big v. small is not the only issue. Opaqueness is also a big problem, and I'm not sure the proposed rule will help there. Limiting size and limiting interconnectivity will take real expertise. You have to understand the interconnections to set the lines. And if we go into panic mode, smaller institutions may also have to be bailed out. Institutions can set up shadows and third parties to appear smaller. To return to my theme: We really need more transparency. We really need to get rid of opaque balance sheets. But the default position of policymakers has been to blink and bail out.

Charles Goodhart — Applying the Volcker rule will require making some very difficult distinctions. At one extreme, it might be easy to prohibit bank involvement with hedge funds, but beyond that it may be much trickier.

Unlike Volcker, who thinks the problem is structural and better supervision is not enough, Alan Blinder does not believe bank regulators need to wait for new legislation from Congress. They should use the authority they have to raise banks' capital and supervise more closely trading in riskier assets. Is this enough to prevent another financial crisis?

Carmen Reinhart — Realistically, failures in the run-up to crises have been as much a result of poor enforcement—supervisors looking the other way — as of poor or nonexistent standards for lending, where lenders weren't following the most basic rules for granting credit and focusing on debt-to-income ratios, for example in plain vanilla transactions.

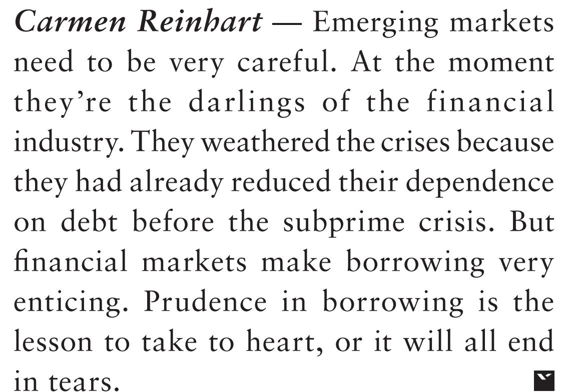
Charles Goodhart — Supervision must involve some kind of sanctions. The general outlines of the sanctions, though not the specifics, must be agreed on through the legislature. It's no good to simply impose sanctions on their own. The rules must be set within the boundaries of the general democratic system.

Where do you think financial regulation is heading? And what do you think about the proposal endorsed by the IMF to charge a levy on the largest banks for the cost of any future government rescue and a tax based on bank profits and compensation? Are these the right incentives for financial institutions to not take excessive risks?

Carmen Reinhart — I'm all for preprovisioning. Because too big to fail is a reality, institutions expect to be bailed out, which induces risk-taking and negative behavior. If they take on more risk, there'll be more crises. Preprovisioning would make institutions internalize their responsibility.

Governments today have to look everything they can to raise revenue because they have huge deficits and huge debt. Relative to other areas, financial institutions have not been heavily taxed.

Charles Goodhart — The time for the idea of a bank tax has probably come, especially since most governments need cash, and bankers are deeply unpopular. However, any such tax ought to relate to systemic dangers, such as the size and riskiness of positions determined ex ante. It should, in other words, be more preventive of systemic risk. A tax on assets and liabilities would apply ex post — it would be backward-looking. You can't get rid of that kind of risk by cleaning up afterward. There's too much likelihood of contagion. In sum, we'll be jolly lucky if we're really on the way out of the crisis. There may be many more twists to come.



And the emerging market countries?

Carmen Reinhart — Emerging markets need to be very careful. At the moment they're the darlings of the financial industry. They weathered the crises because they had already reduced their dependence on debt before the subprime crisis. But financial markets make borrowing very enticing. Prudence in borrowing is the lesson to take to heart, or it will all end in tears.

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[1] The amount that an investor must deposit in a margin account before buying on margin or selling short, as required by the Federal Reserve Board's Regulation T.

(Translation: Pinheiro Ronci)