The crisis: policy lessons and policy challenges

Presentation at WIFO-OENB Symposium, Vienna, 5 November 2009

Jean Pisani-Ferry

Partially based on joint paper with A. Bénassy-Quéré, B. Coeuré and P. Jacquet

1

"I have noticed that many people are put off from our teaching because we know the answer to everything. Couldn't we in the interests of propaganda draw up a list of questions which appear to us completely unresolved?"

Bertolt Brecht

2

Ongoing debates

- **Why the crisis?**
  - Why did the crisis occur?
  - Why did it engulf the whole financial system?
  - Why have its consequences been so severe?
- **Has the policy response been right?**
  - Short term crisis containment
  - Longer term policy reforms
- **The Queen's question: why have economists not seen it coming?**
  - And therefore are they qualified to make recommendations for reforms?

Some questions are easier to answer (1)

No surprise the O&D model deteriorated credit quality

- **Unlimited securitisation made lenders less wary of the individual creditworthiness of the borrower (Berndt and Gupta 2009)**
- **This is just one of many micro failures**

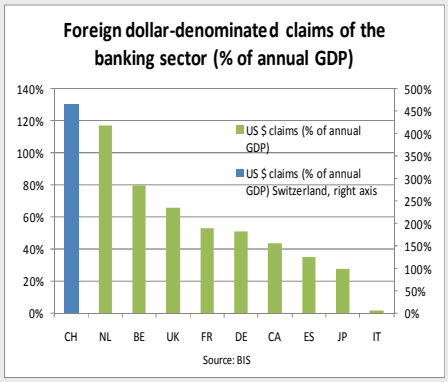
Some questions are easier to answer (2)

No surprise Europe was hit by the financial crisis, not Asia

Foreign Holdings of US bonds (in % of GDP)

	Mid 2007		
	Treasury	Agency	Corporate
Luxembourg	113%	84%	746%
Ireland	6%	12%	83%
Belgium	3%	7%	70%
Switzerland	9%	4%	22%
United Kingdom	2%	1%	15%
Netherlands	2%	3%	12%
Germany	1%	0%	3%
Japan	14%	5%	3%
France	1%	0%	2%
Korea	4%	7%	2%
China	14%	11%	1%
Russia	3%	9%	0%

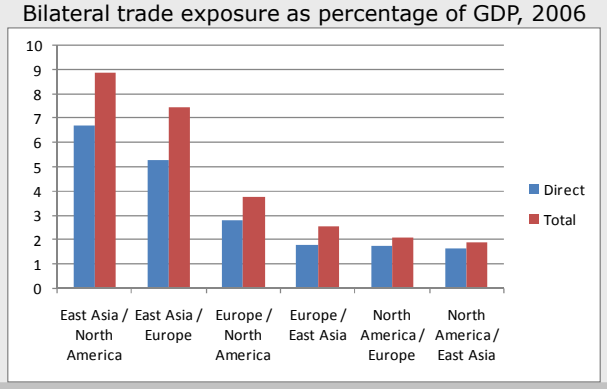
Source: U.S. portfolio surveys, Milesi-Feretti (2009), Bruegel calculations



Some questions are easier to answer (3)

No surprise Asia was hit through trade

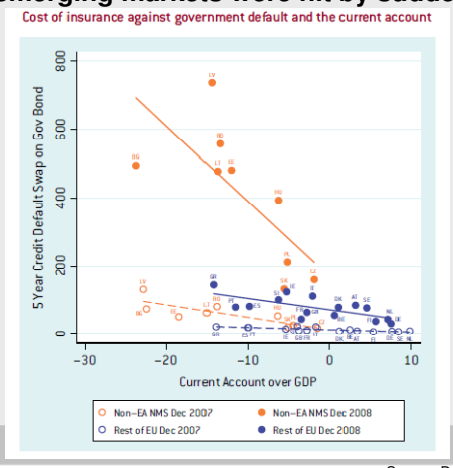
Bilateral trade exposure as percentage of GDP, 2006



Source: Cohen-Setton and Pisani-Ferry (2008)

Some questions are easier to answer (4)

No surprise emerging markets were hit by sudden stops

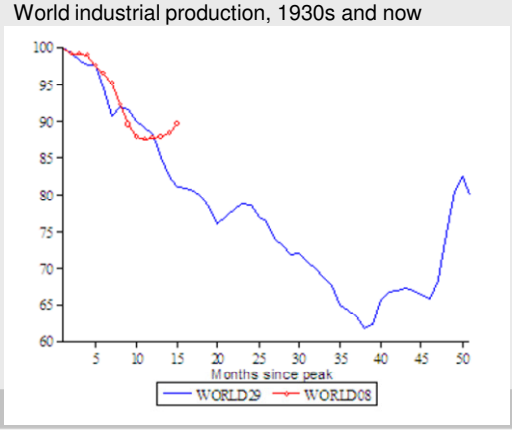


Source: Darvas and Pisani-Ferry (2008)

Some questions are easier to answer (5)

Little surprise output collapsed as fast as during the 1930s

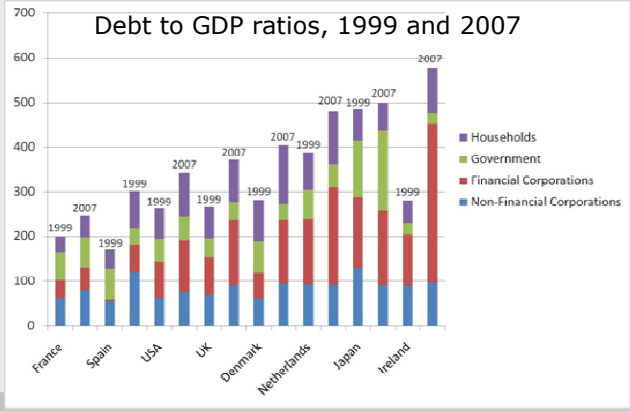
World industrial production, 1930s and now



Source: Eichengreen and O'Rourke 2009

Some questions are easier to answer (6)

No surprise many countries now need to deleverage

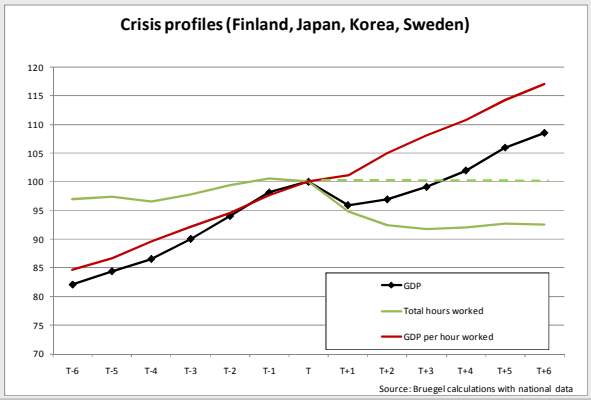


9

Source: Eurostat, ECB, Fed, Barclays capital

Some questions are easier to answer (7)

No surprise financial paralysis is having major consequences



Source: Pisani-Ferry and Van Pottelsberghe (2009)

10

..and many more

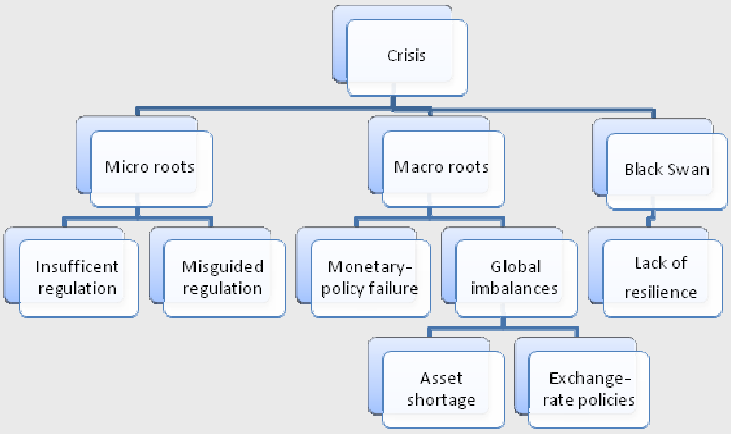
- Economists have many useful things to say about the crisis
- But some questions are harder to answer (and they may not be answered before long: Friedman's take on the Great Depression came thirty years after, and Bernanke's fifty)

These are the interesting ones

A shortlist of harder-to-answer questions

1. Underlying causes of the crisis
2. Reform priorities
3. Lessons for policy economists

Underlying causes



Pure micro roots

- **Compelling evidence of micro failures**
  - O&D model and moral hazard
  - SIVs
  - Conflicts of interest in the rating business
  - Compensation practices and risk-taking
  - Procyclicality of capital ratios
- **What is surprising is not the complexity of mechanisms involved, rather that prevailing practices violated elementary contract theory**
- **Why so many failures?**
  - Insufficient regulation?
  - Inadequate regulation?
  - Regulatory capture?
- **Political economy remains to be written**

Is the micro story sufficient?

- **Failures did not appear in the mid-2000s**
- **Need for macro story?**

"The fundamental underlying factor which made the crisis possible was the ample liquidity and the related low interest rate conditions which prevailed globally since the mid nineties".

Larosière report, 2009

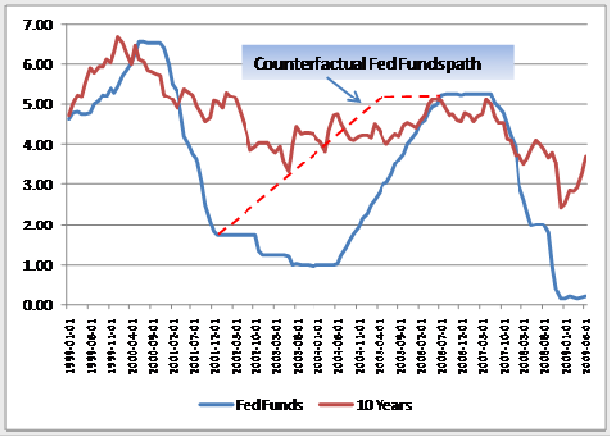
"At the core of the crisis lay an interplay between macro-imbalances which had grown rapidly in the last ten years, and financial market developments and innovations".

Turner review, 2009

- **However more than one macro story**

A failure of monetary policy?

The Taylor critique: is it sufficient?



A consequence of macro imbalances?

- **Imbalances thesis put forward by central bankers (Bernanke), regulators (Turner, Larosière) and academics (Caballero et al., Rajan), but no consensus**
- **Some empirical support for global savings glut – low interest rates link (Warnok and Warnok 2009)**
- **But why?**
  - Asset shortage theory is nice rationalisation but lacks empirical backing (explains private inflows, not public inflows)
  - Bretton Woods 2 theory has empirical support but lacks analytical underpinnings
- **More research needed there to underpin prescriptions**

17

Channels of paralysis

- **US losses on non-prime mortgage (Oct. 2008): $100bn = 0.7% of US GDP = 0.2% of world GDP**
- **US losses on MBS securities: $500bn**
  US S&L losses (early 1990s): equivalent to $1700bn

Do we understand why small causes had huge effects?

- **Contamination theory: transformation of information-insensitive debt into information-sensitive debt (Gorton, 2009)**
- **Fragility theory**

  "Complexity got the better of us" **(Lloyd Blankfein)**

Significantly different implications

18

A Black Swan?

"The system acts as a mutual insurance device with disturbances dispersed and dissipated. Connectivity engenders robustness. Risk-sharing – diversification – prevails.

But beyond a certain range, the system can flip the wrong side of the knife-edge. Interconnections serve as shock-amplifiers, not dampeners, as losses cascade. The system acts not as a mutual insurance device but as a mutual incendiary device.

In just about every non-financial discipline [the combination of increased complexity and reduced diversity] would have set alarm bells ringing. Based on their experience, complexity plus homogeneity did not spell stability; it spelt fragility."

Andrew Haldane (2009)

Conclusion

- **Agreement on some of the causes of the crisis:**
  - Perverse incentives
  - Lack of information
  - Regulatory holes and regulatory capture
  - Piecemeal approach to financial stability
  - Lack of an effective warning mechanism
- **All this is true but does it answer the question?**
- **How good a guide for action?**

Reform priorities
Regulation

- **Significant G20 regulatory agenda this far:**
  - Closure of regulatory gaps (eliminate loopholes, havens)
  - Incentive realignment (compensations, countercyclical buffers)
  - Strengthening of market infrastructures (OTC markets)
  - Emergence of macroprudential approach
- **Sensible agenda**
- **Not yet in place, requires some more hard implementation work**
- **Not an easy task for large and diverse G20 (rules for Tatas or for Ferraris?)**

Limitations however

- **Agenda leaves aside some crucial issues**
  - Moral hazard, 2B2F
  - Structure and resilience of financial system
  - Growth-stability trade-offs (capital ratios)
  - Cross-border banking and size of financial sector

Less progress on macro front

- **Slow start until Pittsburgh (no consensus on role of monetary policy, macro imbalances)**
- **Fast move on macroprudential approach but uncertainty about what it can deliver**
  - An additional instrument? Or merely an embellished early warning system?
  - Europe / US differences
- **Uncertainty over feasible degree of coordination**
  - Is the G20 trying to achieve what neither the G7 nor the EU have achieved?

23

Further issues ahead

- **Monetary policy framework**
  - Science 0 – Art 1, deep consequences
- **International rules of the game**
  - Is the conversation on monetary regimes starting again for real?
- **Stress-tests for policies**
  - Public sector even worse than private sector

24

Lessons for policy economists

- **Part of broader debate on the role and responsibility of the economic profession**
- **Specific issues:**
  - Data dependence and information limitation: should we limit ourselves to working where there is light?
  - Reliance on models of limited scope: can we trade-off beauty for truth? Is there an optimal distance to beauty?
  - Cassandra's complex: can we afford warning about the coming catastrophes?
  - Risks of bias: how can we avoid capture and guarantee research integrity?

References

- Bénassy-Quéré, Agnès, Benoît Coeuré, Pierre Jacquet et Jean Pisani-Ferry (2010), *Economic Policy,* forthcoming, Oxford University Press.
- Bernanke, Ben (2005), "The Global Saving Glut and the U.S. Current Account Deficit," speech at the Sandridge Lecture, Virginia Association of Economics, March 10, Richmond, VA
- Berndt, Antje and Anurag Gupta (2009), "Moral Hazard and Adverse Selection in the Originate-to-Distribute Model of Bank Credit," unpublished manuscript
- Caballero, Ricardo, Emmanuel Fahri et Pierre-Olivier Gourinchas (2008), An Equilibrium Model of "Global Imbalances" and Low Interest Rates, *American Economic Review 2008, 98:1, 358–393*
- Cohen-Setton, Jérémie, and Jean Pisani-Ferry (2008), "Asia-Europe: The Third Link", *Bruegel Working Paper* No 2008/04, October
- Darvas, Zsolt, and Jean Pisani-Ferry (2008), "Avoiding a New European Divide", *Bruegel Policy Brief* No 2008/10, December.
- Eichengreen, Barry, et Kevin O'Rourke (2009), "A Tale of Two Depressions", Vox-EU, 4 juin.
- Eichengreen, Barry (2009), "The Last Temptation of Risk", mimeo
- FMI, *Global Financial Stability Report*
- Haldane, Andrew G. (2009), "Rethinking the financial network", speech at the Financial Student Association, Amsterdam, 28 April.
- Hellwig, Martin (2008), "The Causes of the Financial Crisis", *CESifo Forum 4/2008*, pp. 12-21.
- Pisani-Ferry, Jean, et Bruno van Pottelsberghe (2009), "Handle with Care: Post-Crisis Growth in the EU", *Bruegel Policy Brief* n° 2009-02, avril.
- Posen, Adam, et Nicolas Véron (2009), "A Solution for Europe's Banking Problem", *Bruegel Policy Brief* n° 2009-03, juin.
- Taylor, John (2009), *Getting Off Track,* Stanford.
- Warnock, Francis, and Veronica Cacdac Warnock (2009), "International Capital Flows and US Interest Rates", *Journal of International Money and Finance* 28, pp 903-919.