The crisis: policy lessons and policy challenges

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"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
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

<table>
<thead>
<tr>
<th>Country</th>
<th>Luxembourg</th>
<th>Ireland</th>
<th>Belgium</th>
<th>Switzerland</th>
<th>United Kingdom</th>
<th>France</th>
<th>Germany</th>
<th>Netherlands</th>
<th>Japan</th>
<th>China</th>
<th>Russia</th>
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<tbody>
<tr>
<td>Treasury</td>
<td>113%</td>
<td>0%</td>
<td>3%</td>
<td>9%</td>
<td>2%</td>
<td>1%</td>
<td>3%</td>
<td>2%</td>
<td>14%</td>
<td>14%</td>
<td>8%</td>
</tr>
<tr>
<td>Agency</td>
<td>84%</td>
<td>12%</td>
<td>7%</td>
<td>4%</td>
<td>1%</td>
<td>0%</td>
<td>5%</td>
<td>1%</td>
<td>1%</td>
<td>11%</td>
<td>9%</td>
</tr>
<tr>
<td>Corporate</td>
<td>746%</td>
<td>83%</td>
<td>70%</td>
<td>22%</td>
<td>15%</td>
<td>8%</td>
<td>8%</td>
<td>12%</td>
<td>8%</td>
<td>2%</td>
<td>0%</td>
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</table>

Foreign Holdings of US bonds (in % of GDP)

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

No surprise Asia was hit through trade

Bilateral trade exposure as percentage of GDP, 2006

Source: Cohan-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

Debt to GDP ratios, 1999 and 2007

Source: Eurostat, ECB, Fed, Barclays capital

Some questions are easier to answer (7)

No surprise financial paralysis is having major consequences

Crisis profiles (Finland, Japan, Korea, Sweden)

Source: Pisani-Ferry and Van Pottelsberghe (2009)
..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

Crisis

Micro roots
- Insufficient regulation
- Misguided regulation
- Monetary policy failure
- Global imbalances
- Asset shortage
- Exchange rate policies

Black Swan
- Lack of resilience

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

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**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

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
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?

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
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

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