

“The Present Crisis – Is Soft Management Enough?”

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Situation

- Economic growth since early 1990's partly financed by growing private and public debt (endemic over-leverage problem)
- Increasing contingent public liabilities (pensions, health, and other entitlements) supported this
- Government debt high or unsustainable in many/most developed countries (85-220% of GDP)
- Central banks (US, UK, ECB) all provided ample low-cost funds to banks
- Banks highly leveraged and invested in government debt (particularly EU)
- Authorities' credibility has eroded (extended unsuccessful management)
- Signs of political consequences (demonstrations, reconsidering financial economics, government changes)

Why now?

- US crisis 2007-8 destroyed trust in reliably low risk and existing risk management (reduced perceived sustainable leverage)
- Liquidity squeeze showed vulnerability of banks and reduced willingness to lend (money market seizure)
- Expected deleveraging and low growth implied questionable asset values
- Possibly accumulated fragility through private and public belief in efficient markets

What was done 1?

- Major international effort (G20 → IMF, FSB, Basle III)
 - Coordination efforts and much more stress on importance of macro-economic links/measures (stability of single institutions not enough to avoid crisis)
 - Bank capital increase, new countercyclical buffers, new leverage ratio, new liquidity buffer, risk management issues
 - Address TBTF issues through specific SIFI rules (capital, resolution plans)
 - New institutions specifically for stability
 - Fiscal stimulus and bank support (eurozone sovereign indebtedness 66→84% from 2007 to 2011)
- Generalized liquidity support through guarantees, central bank lending, forbearance
 - Little effort to base support on assessed solvency of individual banks (fear of contagion, maybe legacy of trust), instead easing of asset impairment recognition
 - Supported existing asset values, financial institutions and structures
 - Build-up of major problems for monetary policies in the future?
- Conditional funding for countries with high (Ireland, Portugal) or clearly unsustainable (Greece) debt
 - EU precondition: absence of any bank or sovereign default (except for Greece, late)
 - Traditional stabilization programs but strongly contractionary in EU (no devaluation)
 - Increasing IMF and EU (ESFS, ESF) resources for conditional lending
 - Outside pressure for credible decision-makers (Greece and Italy by markets, ECB, Germany)

What was done 2?

- Despite much more regulation and institutions:
 - Little direct effect on present crisis (market doubts continue)
 - Persistent failure to understand/notice warning signs not yet addressed
 - Instead adapting public institutions to the globalized finance system
- Effects of general fiscal expansion, easy money and accounting changes:
 - General support for existing real and financial asset values and structures
 - Accept existence and increase of moral hazard
 - Increasing constraints on public policy (indebtedness, collateral asset values)
- Public or private recapitalizations of often big banks with acute problems
 - Private support important (helped by fiscal and monetary ease)
 - Public support primarily when an institution was close to collapse (Northern Rock, Dexia twice, Fortis)
- Some effort at judging viability and solvency (stress tests) of individual banks but only modest credibility (EU)

What to do now 1?

- Crisis over when
 - Bank asset values are seen as realistic and backed by (much?) higher capital than before
 - Moral hazard has been sufficiently reduced to ensure return to strong credit and investment discipline
 - Sovereign debt burden has been reliably reduced by gifts, defaults or through higher nominal budget surpluses
 - Market credibility of public decision makers has recovered
- Generally easy policies and regulation are unlikely to deliver this
 - Asset values need backing of good growth prospects which at present remain uncertain at best
 - Moral hazard reduction really needs proof, e.g. a TBTF institution to orderly fail at private expense (words don't convince any more, actions do)
 - Continuing with easy fiscal policies requires access to substantial, low-cost funding (only central banks can definitely provide this) but
 - Central banks may not be willing to compromise their balance sheets without clear limits

What to do now 2?

- If so, proven crisis management policies likely to be needed (Nordics)
 - Assigning fiscal and monetary policies primarily to influence the real economy (creditworthiness) and inflation rate
 - Identifying and restructuring insolvent or problem banks at initially owners' and maybe funders' expense
 - Possibly managing impaired assets apart from good ones (bad bank in some form to enable bank management to concentrate on good lending)
 - Restoring solvency of perceived insolvent sovereigns (support from others or default?)
 - Present soft policy will, by then, have increased costs
- Because of present problems, additional measures might be needed
 - Removing rampant moral hazard (orderly failure of problem TBTF institutions)
 - Reduce size of banks and service palette of deposit institutions (since authorities repeatedly have proven unable to detect ongoing build-ups of systemic risk – cf. Nordics early 1990s, Asia late 1990s, US and EU mid-2000s; Volcker, King)
 - Establish simpler regulations (harder to get around) and hire really good (old) ex-bankers to handle supervision (harder to convince).