Avoiding the Next Financial Crisis

Asian Journal of Political Economy


This Version is available at:
http://hdl.handle.net/10419/194588

Terms of use:
Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.
Avoiding the Next Financial Crisis

Dr Farizan Tarudin
Universiti Malaya

Abstract

"Over-the-counter derivative contracts bind institutions together in a network of opaque, credit risks the size and characteristics of which can change rapidly and can be said to be not understood with a high degree of precision, including by market participants themselves.' (Garry J. Schinasi, 2006). In the light of the subprime crisis, this analysis of one of the financial experts of the International Monetary Fund (IMF) appears particularly premonitory. Throughout his book analyzing financial instability, Schinasi argues that the developments in contemporary finance have resulted in a decline in transparency of transactions and opacification of how to take risks, both at home and abroad, the eyes of public actors only in the eyes of private actors. Now that the empirical demonstration of this general principle is made, what are the proposed answers to try to remedy it? Four major solutions seem to be distinguishable. The first favors reflection on the content of monetary policy. The other three recognize a purely financial dimension to recent slippages and propose regulatory interventions of different intensities.

The first line of reflection places the quality of monetary policy at the center of the debate (Kirrane 2017). As the Annual Report has shown 2006 BIS, over the past 30 years, the share of wages in the value added of the world's top 10 economies has been sharply downward, particularly in the United States. The maintenance of a high level of consumption was therefore only possible by a rise in household indebtedness, all the more sustained as the US central bank adopted a policy that was durably accommodative and that the abundance of global liquidity maintained the long-term interest rates at a low level. This low level of interest rates has, according to Malcolm D. Knight (2008), the chief executive BRI's, several negative effects: an excessive search for returns by financial investors and therefore risk taking based on a strong leverage, and the rise of stock market asset bubbles, at the time of the new economy, then real estate.

A monetary policy that has been too relaxed for a long time appears to be at the origin of an excess of indebtedness that serves as a financial booster for the rise of bubbles, hence the debate initiated last March/April about Alan Greenspan's responsibility in the current crisis. He had explained in 2002 how a central bank should react in the event of arise strong and continuous in asset prices: do nothing. A principle of non-intervention justified by the fact that, on the one hand, a central banker can never know really when there is a speculative bubble or not and that, on the other hand, when a bubble occurs, make it to disengage claims to raise interest rates to such a high level that it is likely to kill the entire economy. Better wait until the bubble bursts
alone. At that point, if it creates a bit of financial panic, it is sufficient that the central bank drastically lowers interest rates and increases liquidity in circulation to restore confidence. "Even with all the authority to intervene, it is not credible to think that regulators could have prevented the subprime debacle". Greenspan reaffirms in the Financial Times on April 7. If the former head of the Federal Reserve System, the central bank of the United States, is not responsible for the global liquidity spree created by Asian central banks, his reasoning has been doubly flawed. On the one hand, panic management has demanded much more than a rate cut and a traditional injection of liquidity. On the other hand, in an article presenting the foreseeable and unpredictable aspects of the debacle, Malcolm D. Knight (2008) explains that "the signs of a underpricing risk were not difficult to detect", as well as "the operation of the system was critically dependent on liquidity" and that" the stronger association between banks and other players in the financial market" was obvious. If these three anchors of the crisis appeared so clear to the BIS, the failure of intervention of the American central bank is revealed as a fault of regulation (Brender, 2008) and attests the need for a regulator of quality - in the United States and elsewhere - as an essential condition for the prevention of future crises.

As for the second track, it follows the logic of Alan Greenspan that any attempt at regulatory interventions, with the exception of those to manage the crisis and save institutions in difficulty, is doomed to failure. There are two reasons for this: - the first is that the financial innovations that brought the crisis - derivatives, securitization, structured products - are healthy in essence but have been victims of excesses, deviance, by irresponsible actors, black sheep of a contemporary finance that, moreover, works perfectly (Lorenzi 2008, Schiller 2008, Simon 2008); - the second is the inability, even for the regulator of good will, to intervene wisely. It is then up to private actors to discipline themselves to avoid any new crisis (Joint Forum, 2008), for example through the implementation of a code of conduct signed on a voluntary basis (Institute of international finance, 2008).

Among the analysts who recognize a dimension purely financial cause to the crisis, this position is a minority. First of all, it is belied by the facts. Between 1971 and 2008, the global economy experienced no less than twenty-four financial crises major, on average one every one and a half years. If we stick to the work of Michaël Bordo et al. (2001) on the frequency of exchange crises, banking, twins, and that we add the stock market crises, the contemporary period appears marked by a degree of financial instability at least equal to - and more likely than - the inter-war period (Plihon, 2008). So there is a particular problem with finance contemporary whose crisis of "subprime" is only the last avatar. Next, Kindleberger (1989) and Kirrane (2018) have shown that if deviant behavior is frequently found in finance, it is usually the sign of periods of euphoria financial marked by destabilizing speculation.

In addition, recent surveys of supervisors point out how much confidence in the capabilities self-regulatory of private actors is misplaced. The Senior Supervisors Group (2008) investigated the fall of 2007, after the onset of the crisis, in the eleven largest and most sophisticated financial institutions on the planet to assess their risk management. His report is overwhelming for supporters of self-regulation. The best institutions have identified the source of potential problems, which will be real, as early as summer 2006, one year before the crisis. They have rigorously studied asset valuations and tight control of their balance sheets, off-balance sheet
assets and capital. They conducted their own risk assessments, both quantitative and qualitative, in a dynamic manner, in order to incorporate any new parameter, and without trusting agencies rating whose opinions seemed to underestimate their risks.

Unfortunately, these virtuous, behaviors sophisticated, and at the height of monitoring the impacts of financial innovations, were extremely minor. When the report focuses more specifically on how some large institutions have managed CDOs (Collateralized debt obligations) and SIV (Structured Investment Vehicles), the comment is even less diplomatic and leaves the impression that, translated into common vocabulary, the behaviors observed risks have evolved between greed and irresponsibility. The major international banks themselves have recognized how many of them had shown a great degree of amateurism – poor risk assessment, misunderstanding of the financial products used, incompetence of the boards of directors, etc. - (Institute of international finance, 2008). For all these reasons, two other avenues, more interventionist, are also in the debate.

The crisis has revealed the insufficiency of current prudential policies. Even before entering the scene completely, Basel II is already discredited. Asby highlighted the General Manager of the BIS (Knight,2008): "The high level of capitalization of the system Banking before the crisis was a source of pride and comfort for both market participants and for policymakers. And yet, the significant efforts currently being made by banks to strengthen their capital base show that capital buffers are considered too thin in terms of perceived risks. ": A statement shared by all supervisors (Senior Supervisors Group, 2008, Financial Stability Forum, 2008).

Faced with this situation, three paths are proposed. The first is to demand more transparency from financial institutions. Since the structured products at the heart of the crisis have been a source of opacity, it is enough to highlight them to avoid the harmful effects. It is to forget that what made the fortune - if one can say - of this kind of instruments financial, it is precisely that they are complex and opaque as well in terms of the risks taken as in the fiscal plan. Waiting for financial institutions to report that they are taking too much risk is like waiting for a tax cheater to declare his income. We can wait a long time. The second path calls for actors to be Private better prepared for events Extreme than the traditional models of value at risk have the greatest difficulty to take into account. It would be, for example, to reinforce the stress tests to allow to better appreciate the risks and to anticipate the exits of road.

If such a development seems desirable, it seems unfortunately, at least until now, difficult to put into practice. In its survey, the Senior Supervisors Group highlights how difficult it is for internal auditors to "persuade senior management and business lines to develop and pay sufficient attention to the results of stress scenarios that assume large price movements ". Since we will never prevent the financiers from taking too much risk, conclude the proponents of a third proposal, try to make these risks more expensive. For a return/risk given ratio, an operation that cannot support a standard capital cost is surely too risky. One way to increase the cost of risk is to deny banks full securitization of their assets risky and force them to keep some of them on the balance sheet. Another way is to reduce OTC transactions to markets that have proven successful in this area and to require a standardization priori of contracts related to innovations financial, current and future, all that is not allowed being prohibited. Yet another way is to add a macroprudential dimension to current policies by imposing on banks and other institutions
concerned an increased provisioning during fat periods to avoid the risk of procyclical prudential policies.

The Financial Stability Forum (2008) has thus detailed all the avenues that could contribute, by strengthening public regulation and capital constraints, to reducing excessive risk-taking by major private financial players. It was followed in this firm way in mid-April by the Basel Committee. All of this goes in the right direction, but as the best laws will never prevent assurances that gun owners will not use them to kill innocent people, the only long-term remedy is to reduce or even ban in some cases, arms sales.

Since the best prudential policies can never assure us that institutions financial will not take too many risks with financial, economic and social crises, the only way to intervene is to reduce capital movements, especially at the international level, in order to circumscribe the space of crises. The very fact that this type of proposal is in the debate shows a recent evolution of mentalities. No politician, economist or commentator "wise" and "sensible", could not put this kind of proposals on the table, a few years ago, without being immediately marginalized. Times have changed. In France, it was the former prime minister Édouard Balladur who was the furthest, stating: "If there are market operations that cannot be well controlled, should banks be allowed to continue them at the same time and risk of destabilizing the entire financial system? In the same vein, Martin Wolf, the leading economic columnist, Financial Times responds to those who fear an overreaction to Regulatory finance that "yes, the danger of over-regulation is real, but like nothing." Doing at [...] all the regulators will have to adopt a more severe attitude than they have done so far ". Even French liberal economists become advocates of financial re-regulation, like Christian Stoffaës (2008) diagnosing a "crisis in the banking industry, its structure and its regulation; not a simple reversal of the market " before concluding that" the era of deregulation is over "and that" the measures to prevent the crisis from being repeated are of the order of the legislator and the regulator ".

On the academic side, Dani Rodrik has called publicly for whistling the end of part of financial globalization (2008). A position that refers to a more detailed study in which it shows, step by step, that the benefits traditionally attributed to the freedom of capital are illusory (Rodrik and Subramanian, 2008). And Michel Aglietta (2008) suggests a long list of desirable reforms, ranging from a framework of securitization to the regulation of offshore markets, through measures to increase the cost of risk and a nationalization of credit rating agencies that establishes an extensive program of reorganization of finance. This position is reflected in financial protectionism start against international investment, not only related to the recent activism of sovereign funds: according to the data of the United Nations Conference on Trade and development (Unctad), the share of changes in national regulations for international investment in the direction of greater protectionism increased from 4.9% in 2002 to 20.1% in 2006. An evolution that is only one of the signs of a more general questioning of liberalism as a reference intellectual model and of a return to force of public policies in the economy, in particular in order to better regulate the effects of globalization (Chavagneux, 2008); a concern that the President of the seems to share United States when he states that "in the path that moves us towards job creation, we need two safeguards to avoid the return of past problems: we must put in place strict supervision of banks, credit distribution and investments; we must put an end to the possibility of speculating with the money of others... " :
but it was Franklin D. Roosevelt, in March 1933, a president confronted with the management of the consequences of the financial debacle of 1929.

**Bibliography**


INSTITUTE FOR INTERNATIONAL FINANCE, Interim report of the IIF committee on market best practices, April, 2008.


KNIGHT, Malcolm, D., *Now you see it, now you don't; the nature of risk and the current financial turmoil*, BRI, 26 February, 2008.


