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Exit strategies from the financial crisis

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The Global Polity

Exit Strategies from the Financial Crisis

The Challenges

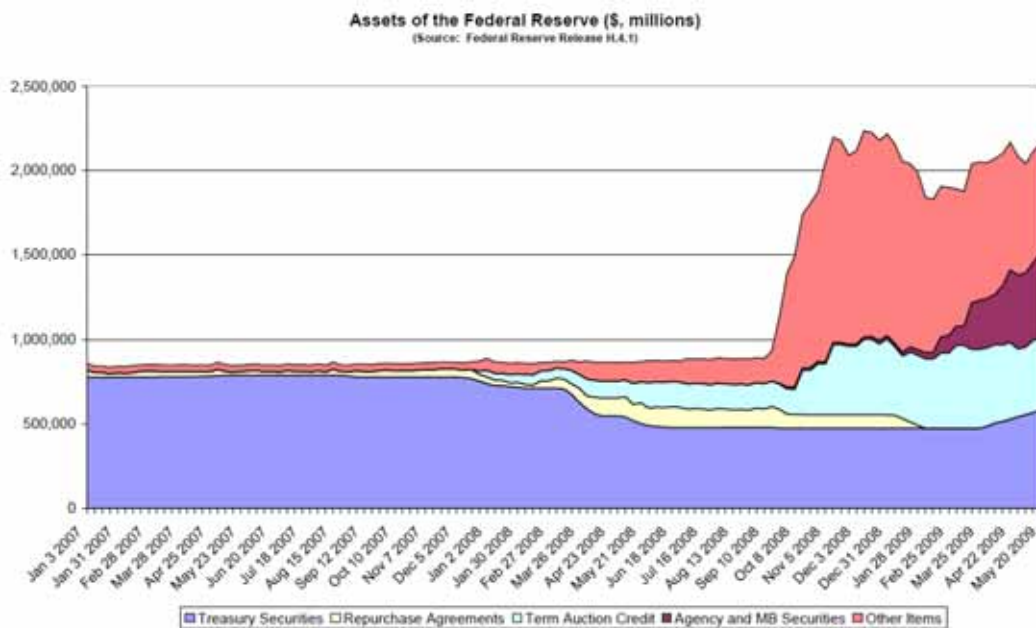
In response to the worldwide financial crisis, governments have bailed out their large banks and some of their large companies, thereby earning equity stakes in these enterprises.

In the process, these governments have accumulated massive deficits.

Several central banks no longer just provide short-term credit to commercial banks against highly rated collateral, but have also bought bank assets of dubious long-term value as well as distressed corporate bonds.

As governments have shored up local industry with loans and subsidies, often in the name of the numerous fiscal-stimulus packages, they have generated new forms of protectionism.

None of these developments is sustainable in the longer run. What are socially desirable exit strategies from these policy traps? How and when should governments return the financial industry to private sector hands? How can governments prevent their deficits from rising relentlessly relative to GDP over the business cycle? How can central banks ultimately divest themselves of problematic assets? How can they avoid the danger of inflation once the current downturn is over? How can governments avoid supporting new forms of protectionism that may be difficult to undo in better times?





Proposed Solutions

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Central bank exit strategies: the return to normalcy

Introduction

In this short paper I discuss possible exit strategies of central banks concerning their recent balance sheet policies. After reviewing these policies during the recent financial crisis, I will first present the problems involved with exit strategies of central banks in terms of reversing their “quantitative” as well as “qualitative” easing. After understanding the problem involved with reversing these positions I present several possible solutions. The quickest and most optimal solution to inject stability into the banking system is to reclassify bank creditors from secured positions to equity shareholders, thus allowing for bad assets to be revalued at market prices without exacerbating the liquidity constraints.

The origin of the problem

A strong central bank balance sheet is essential for the quality of a currency and the stability of a financial system. The financial crisis has seen substantial changes in the balance sheets of the world’s major central banks. Besides the much discussed quantitative easing, there have been substantial amounts of “qualitative easing” – which is understood to be those balance sheet policies that deteriorate the average quality of central bank assets in opposition to the more typical “quantitative easing,” understood as an expansion of a central bank’s balance sheet. Using this definition quantitative easing may imply qualitative easing if the new assets on the balance sheet are of lower quality than the average existing quality as of the assets held.

During the financial crisis several major central banks engaged massively in qualitative easing. The Federal Reserve, until September 2008, engaged in qualitative easing with an almost constant balance sheet total (i.e., a limited quantitative expansion). The Federal Reserve swapped liquid and low-risk assets against relatively more illiquid and riskier ones held by the banking system. New credit programs appeared while US Treasury bonds were sold, supporting a faltering banking system faced with a destabilizing liquidity constraint. Thus, the granting of credits to the troubled banking system did not expand the balance sheet total but was sterilized by the sale of Treasury bonds. As a consequence, banks’ balance sheets improved and the central bank’s balance sheet commensurately deteriorated. The Federal Reserve System had become a certain type of “bad bank” that they were themselves trying to rescue.

The average quality of the assets backing the dollar (the assets held by the Fed) deteriorated at an even faster pace after September 2008. There was a substantial expansion of the balance sheet through an increase in the monetary base. The increase in emergency credit programs was financed mainly by (excess) bank reserves and by accounts of the Treasury held at the Fed. A new stage in quantitative easing was reached when in the spring of 2009 the Fed started buying government bonds, agency debts and mortgage backed securities directly.

While the Fed’s balance sheet policies certainly have been substantial, the Eurosystem’s changes are no less so, even though they may appear so at first sight if concentration is focused solely on the apparent (and oft examined) quantitative expansion of the balance sheet. The changes in the balance sheet policies of the Eurosystem are more subtle by maintaining the established programs and softening collateral rules. Thus, the ECB has also engaged in substantial qualitative easing, although a lack of full transparency has, to a large



extent, hidden the methods used to enact these policies. The central banks' balance sheet policies of changing the balance sheets' composition and totals were conducted in order to support a struggling financial system.

The problems of exit strategies

Undoing the qualitative and quantitative easing by reversing the balance sheet policies is easy only from a technical point of view as, for instance, Ben Bernanke has pointed out.

In order to reduce the size of their balance sheets, central banks could simply sell the government bonds, mortgage backed securities, end emerging programs, increase collateral standards again and discontinue the roll-over or renewal of loans to the banking system. In fact, the demand for these emergency programs will likely shrink as the economic situation improves.

The problem, however, is that the reduction of the balance sheet would undo policies enacted in order to support the financial system. By selling securities, central banks would reduce the amount of bank reserves and thereby reduce liquidity in the interbank loan market. By not renewing loans to the banking system, a liquidity constraint could reemerge. By increasing collateral standards banks might not have sufficiently high quality assets in order to sustain the level of credit they currently maintain. In sum, the quantitative tightening would decrease interbank and overall liquidity and could lead to a stronger, deflationary credit tightening. The financial crisis could become aggravated again with destabilizing effects.

However, there is another way to reverse part of the qualitative easing without reducing the balance sheet total or current levels of bank reserves. Central banks could simply undo the swap of liquid and low-risk assets against relatively more illiquid and riskier ones. The Fed, for instance, could end some of the emergency lending programs where collateral of low quality is accepted, thereby decreasing excess bank reserves. As compensation the Fed could buy government securities, thus increasing bank reserves. This would increase the average quality of the assets backing the monetary base, while the balance sheet and bank reserve totals would remain constant. However, the loans collateralized by risky and illiquid assets would be removed from the Fed's balance sheet while government securities are increased. In turn, government securities would disappear from banking system's balance sheets while the low quality assets formerly used as collateral would no longer be used to guarantee central bank loans.

Yet, when these low quality assets are fully integrated in bank balance sheets without the possibility of using them as collateral for central bank loans, the interbank lending market may seize up again. The risks regarding the value of these assets, which valued at market prices would probably endanger the solvency of many banks, would slacken the desire to lend to other banks. As the solvency of counter-party banks is unclear due to the bad assets on their balance sheets, interbank liquidity would be reduced and banks may restrict the extension of credit in order to restore their liquidity and solvency. This lack of liquidity would place negative pressure on many financial institutions, further reducing confidence in counter-parties and the system at a whole. A downward spiral of evaporating liquidity, credit contraction and bankruptcies might lead in the extreme to the collapse of the financial system.

In fact, the financial crisis has been caused by solvency problems that led to a liquidity constraint. Central banks tried to fight this by increasing liquidity availability and buying or loaning against the same bad assets that caused the solvency problems. If central banks sell those assets again or stop accepting them as collateral as loans, the same solvency problems will reemerge, along with the preexisting liquidity issues.

Paradoxically, the central banks by buying and accepting bad assets did not solve the solvency problem; they merely delayed the inevitable. The bad loans did not turn "good" by changing hands or being accepted as collateral by central banks. Hence, the problem remains and exit strategies can only be successful if the quality of these assets change or their quality



is acknowledged and banks are recapitalized accordingly. Therefore, we are faced with two possible solutions for exit.

On the solvency of central banks

Before turning to these solutions let me first address another problem related to the solvency of central banks. Central banks may be forced to realize losses when reversing qualitative and quantitative easing policies by selling assets. When banks start to use their excess reserves and expand credits, central banks might increase interest rates putting pressure on prices of mortgages backed securities and government bonds. The central banks in this situation might want to sell these assets in order to reduce liquidity. In other words, there may be losses when these assets are sold to restrain liquidity.

Do these losses pose a problem for the solvency of central banks? First of all, provided central banks do not have substantial foreign liabilities, as has been the case of Iceland, they will never face insolvency in the sense that they can pay their liabilities simply by creating money. In fact, base money of central banks' might not be considered as "true" liabilities as they do not imply any obligation to pay in the present or the future. However, central banks can become insolvent in the sense that the capital on their balance sheet is consumed by losses. In fact, both the Fed and the Eurosystem have very low equity ratios of 2 and 4 percent respectively. Small losses of their assets could easily consume these central banks' capital. In this case, there are several possibilities. The first consists in using hidden reserves in the balance sheets to recapitalize. Thus, the Fed could revalue its gold reserves at market value and the Eurosystem could use its position "revaluation account" to boost its capital. In this case, both equity ratios would increase to approximately 13 percent.

Yet, even the increased capital might be consumed by potential losses. In this case, as a solution there remains a recapitalization by the government, which would be easier in the case of the Fed and pose political problems for the Eurosystem as independent European governments would have to agree how to share the considerably burden. Another possibility would be to post a negative capital on the balance sheet. Central banks can have a negative capital and be technically "insolvent" without being "economically" insolvent, i.e., being unable to fulfill their obligations. Yet, the negative capital would be detrimental for the quality of the currency and market participants might lose confidence in the currency. In this case, market participants might regard a central bank with negative capital as not being able to defend the value of the currency externally and maintain its value internally. The negative capital would be a signal that the assets backing the currency have lost in value and that the net worth of the central bank that is installed to inspire confidence in the banking system and the currency has become negative.

Solution number one: asset price inflation

The first solution to the exit problem consists in simply waiting for the bad assets to become good assets. Yet, there is no reason why the majority of these assets will turn good except that nominal prices (housing prices, etc.) re-inflated again to their pre-bust levels. Therefore, the central bank can actively try to improve the quality of their assets and accepted collateral by increasing the money supply causing prices to rise. Moreover, price inflation causes the real debt burden of the loans to decrease, thereby increasing the possibility of an improvement in the performance of bad loans. Thus, central banks can pursue a policy of increasing the money supply in order to inflate (for example, housing) prices again. Central banks could also buy directly troubled assets to bid their prices up (the Fed has already commenced this policy when it started to buy mortgage backed securities). When housing prices increase, the value of mortgage backed securities will also increase improving the solvency of the banking system. Thus, a solution for the reversion of the qualitative easing and the increase in the quality of the central banks' assets is price inflation.



Yet, this solution has several disadvantages. First, it is only a partial exit strategy. It is true that it can undo the compositional changes of qualitative easing. For instance, central banks could buy good assets thus increasing the money supply and causing prices to rise sufficiently. Thus, central banks could not undo the quantitative easing as an exit strategy but would have to engage in significant additional quantitative easing to rectify the newly created problems. In other words, one cost of quantitative easing is that central banks may reverse the previous episodes of qualitative easing. By reversing the qualitative easing central banks would create an even bigger exit problem for the quantitative easing that this would imply.

The new quantitative easing would only be reversible with a significant credit contraction. This credit contraction, however, would cause marginal companies and investments depending on the existing volume of credit to suffer liquidity difficulties. These bankruptcies would aggravate problems for the financial system developing a downward spiral of credit contraction, bankruptcies and falling prices. Thus, the quantitative easing as a solution to the qualitative easing could not be reversed without risking the collapse of the financial system.

Another salient problem consists in the danger of hyperinflation. When central banks increase the money supply to the extent that housing prices increase back to their pre-bust levels, people may lose confidence in their currency's long-term stability. Relative housing prices must adjust and fall relative to other prices. Increasing them nominally to their pre-bust levels (and possibly higher) would require a substantial increase in the money supply. This substantial monetary inflation could lead to a loss of confidence and possibly hyperinflation. A further problem consists in the question of proportionality. If the central bank fails to increase the money supply sufficiently, bad assets will remain bad leading to solvency problems. If the central bank increases the money supply excessively, a hyperinflation becomes probable.

Solution number 2: exit and recapitalization of the banking system

The second and only viable solution consists in a consequent exit from the qualitative and quantitative easing and thoroughly addressing the problems involved. Central banks would return to balance sheets similar to that before the crisis broke out which is technically not difficult to achieve, as has been stressed by Ben Bernanke and a multitude of fellow central bankers. Bad loans and assets would be returned to banks' balance sheets. Valued at market prices this would result in the insolvency of at least some main financial institutions. While this might be considered as problematic and harmful, it is the best and only viable option at hand. The alternative would be to continue the existing policies with the danger of an enduring recession, not unlike Japan has experienced.

The insolvency of a large part of the banking system would only acknowledge a fact that has been concealed and whose consequences have been delayed causing important moral hazard problems. Banks knowing they are too big to fail will have a tendency to behave more recklessly. The real challenge to this exit strategy is a way to orderly solve the insolvency problems of banking institutions without causing, or exacerbating, future moral hazard problems.

There are several solutions to the looming insolvency problem of banks. First is recapitalization by the market. Banks would compete to receive new capital on the market. This solution will probably result in limited success as its success depends on finding investors willing to fund insolvent companies.

Second is a recapitalization by the government. The disadvantage of this option is that scarce resources are shifted to help the banking system at the expense of other areas of the economy. As these resources are needed in other places in order to restructure the economy the situation in other industries could consequently worsen, leading to more bad loans and additional problems for the banking system. Moreover, the recapitalization by the government would instigate further moral hazard problems to be bred.



Third, the most radical solution would be a conventional insolvency process for the banks (i.e., bankruptcy filings in court). This bankruptcy process – during which creditors would take over the assets of the banks – would, however, likely take a long time to implement via the conventional legal channels. Hence, even though a takeover of the banks by their creditors in a regular bankruptcy process would solve the present problems and enable a reversal of the current balance sheet policies, it would entail some transaction costs due to lengthy legal proceedings.

Fourth, the better solution might be to turn bank creditors directly into equity holders by legal decree circumventing the legal system. More specifically, the real value of the assets of many banks is currently lower than their outstanding liabilities giving rise to the insolvency problem that triggered the financial crisis. The qualitative and quantitative easing has not solved the problem but only delayed the solution. It will only be possible to reverse the previous easing when the insolvency problems are solved. This can be done by acknowledging the real value of the assets on the books of the banks and turning creditors of the banks into shareholders pro rata. Depending on the speed at which a reclassification of stakeholders can be achieved, this option will likely be the much swifter than an ordinary bankruptcy filing. Banks could start operating and trusting each other immediately and the easing could be undone accordingly. Existing shareholders will lose via a dilution of their current holdings through new share issuances, while secured creditors and liabilities will be reduced accordingly.

Conclusion

The root of the problem of the current financial crisis has been an artificially induced boom in the real economy and asset price markets that subsequently turned to bust. The bust led to a reduction in the values of many assets owned by banks. Thus, the banking sector found itself crippled by insolvency problems consequently causing liquidity problems. The readjustment of the economy and relative asset prices cannot be solved by increasing the quantity of money or shifting bad assets from banks' balance sheets to central banks' balance sheets. The problem is only solved by acknowledging and assuming it. Turning bank creditors into equity holders would solve the banks' solvency problems and would increase confidence in the financial sector, thus, also improving the liquidity situation. If this is done, the balance sheet policies of quantitative and qualitative easing can be reversed by selling the bad assets, buying back the goods assets and refusing to roll-over emergency loans. Otherwise, the policies cannot be undone without instigating the breakdown of the financial system or a possible hyperinflation.

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A simpler way to solve the “dollar problem” and avoid a new inflationary cycle

When China's Premier Wen Jiabao recently expressed concerns about the future of the US dollar, the currency in which most of his country's official reserves are denominated, his remarks provoked contrasting reactions among US economists.

Some, like Fred Bergsten of the Institute of International Economics, exhorted the US government to take Mr. Wen's concerns seriously and listen to Beijing's suggestion to create a substitution account in the IMF, which would allow Fund members to exchange unwanted dollar balances for SDRs, as part of a gradual process to replace the dollar with a supra-national reserve currency over the long run (Mr. Bergsten was particularly enthusiastic about the substitution account idea since it matched a similar proposal he had made in 2007, see Fred



Bergsten, "We should listen to Beijing's currency idea," FT April 8, 2009, and "How to solve the problem of the dollar," FT December 11, 2007).

Other US economists, including last year's Nobel laureate Paul Krugman, were less enthusiastic. According to Mr. Krugman (Paul Krugman, "China's Dollar Trap," New York Times, April 2, 2009), China had fallen into a trap of its own making due to its reluctance to adopt a more flexible exchange rate policy in the past. Since any attempt by China or any other country to diversify away from the dollar too much or too quickly would be self defeating, there was no immediate threat to US or world financial stability, hence no need for the US government or the IMF to intervene on China's behalf.

In our opinion, Mr. Krugman's view is very simplistic for it fails to take into consideration the effect that a large amount of unwanted dollars and dollar assets will have on inflation once recession fears dissipate. It is possible that Mr. Krugman believes that some increase in inflation is a good thing, as it could help cure the "dollar overhang." If so, he is not alone. Kenneth Rogoff, the former chief economist of the IMF, has recently written that "a sudden burst of inflation would be extremely helpful in unwinding today's epic debt morass" (Kenneth Rogoff, "Embracing inflation," The Guardian, UK, December 2, 2008). Put in other words, by increasing inflation, the US would "solve" two problems at once. On the one hand, it would debase the value of its national debt, hence preventing it from growing too much relative to GDP. On the other, it would reduce the real value of the debt (unsecured and secured) of financial institutions and other US corporations, hence diminishing the need for explicit haircuts or public bailouts.

The problem with this "solution," aside from the reputational problems it creates for the US government, is that once the inflation genie is out of the bottle, it will be very difficult to put it back in. As for the solution proposed by the Chinese central bank and Mr. Bergsten, there are, unfortunately, several problems. First, the plan requires a complex multilateral negotiation, including a change in the IMF's Articles of Agreements, which is unlikely to be supported by the US, if anything because the SDR will compete with the dollar as a reserve currency unit. Second, the proposal restricts the menu of potential dollar substitutes to the SDR, itself a basket of currencies with a predominant dollar share. Third, a substitution account in the IMF makes the IMF rather than the US government liable for losses resulting from the depreciation of the dollar vis-à-vis the SDR, a condition likely to be opposed by other Fund members.

However, the most important drawback of the China/Bergsten proposal is that it does not really protect US official creditors from a persistent fall in the dollar. This is because in the event of a protracted dollar depreciation, it is highly unlikely that the central banks of Europe, Japan, and the UK will stay put and let their currencies appreciate. More likely, these countries will resist appreciation by engaging in a process of competitive devaluations, the end result of which will be an increase in global inflation. If so, the reserves of China and other emerging markets will lose real value whether they are in dollars or SDRs. More importantly, inflation will be high everywhere in the world, and it will take years of high real interest rates and low growth to bring it down.

Fortunately, there is an easier and better way to protect the value of emerging market reserves while reducing the risk of a resurgence in world inflation. This is to reduce the incentive of the US government to "inflate its way out of debt." For this to happen, all US creditors need to do is demand that the US government swap nominal US Treasury bills, notes, and bonds for inflation-adjusted instruments (TIPS) on demand. Since, at present, the supply of TIPS is very small in relation to the rest of the US national debt, bilateral coordination would be necessary to avoid distorting their value.

One of the advantages of this idea is its simplicity. For starters, it can be executed bilaterally rather than multilaterally. This not only makes it easy to implement, but also gives the US government leverage to extract concessions from the other governments. For example, in the case of China, it would be possible for the US to negotiate a quid-pro-quo, whereby China



commits to reforms geared to reducing its structural current account surplus – including, but not limited to, a more flexible exchange rate policy. For this reason, it would be preferable that the swap proposal comes from the US rather than from its creditors.

But, more important than the practical advantages are the beneficial long term effects of such a policy, particularly in averting the specter of global inflation. By substituting TIPS for nominal bonds, the US government would be sending a strong signal that it does not plan to “inflate its way out of debt,” as disingenuously suggested by Mr. Rogoff but, to the contrary, will commit itself to adopting a more disciplined monetary and fiscal policy going forward.

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I. Introduction

The global financial crisis has involved unprecedented government actions in several regions around the world, but most notably in the advanced economies. Such actions have been aimed at stabilizing financial markets and restoring bank confidence, as well as at mitigating the effects of the crisis on the real economy. Responding to the challenges posed by the global turmoil, governments have displayed a wide array of traditional as well as new monetary, fiscal, and banking policy actions. As the global financial crisis starts to subside, new challenges will be faced by policymakers as regards the unwinding of the emergency measures and the management of the longer-term consequences of the crisis as well as of the governments' response to it.

In what follows, we deal briefly with exit strategies in the areas of monetary, banking, and fiscal policy.

II. Exit Strategies: Proposed Solutions

As regards monetary policy, the exceptional measures adopted by central banks in the advanced economies have resulted in a significant expansion of their balance sheets. In the US case, for instance, two aspects are worth noting. First, the expansion on the asset side of the balance sheet has been associated with a significant acquisition by the Fed of mortgage-backed securities and other lower-credit-quality assets. Second, on the liability side of the balance sheet, the commensurate expansion in the monetary base was reflected in a build up of financial institutions' deposits at the Fed. The latter characteristic also applies to other advanced economies, such as the Euro area, the UK, and Switzerland. In the Fed's case, there has been also a significant increase of Treasury deposits at the Fed.

In this context, unwinding of the exceptional monetary measures entails two different (but possibly interrelated) problems: 1) how to respond to an upcoming reduction in the demand for monetary base (which would reflect a decrease of deposits held at the central bank), and 2) how to dispose of the stock troubled assets owned by the central bank.

In our view, the unwinding of the monetary expansion should in principle be carried out with open market operation using government bonds. Alternatively, central banks could impose (transitory) reserve requirements that would be gradually reduced over time, so as to ensure that the reduction in the demand for base money does not compromise price stability. In addition, the unwinding of rediscounts and central-bank emergency lending to banks will be automatic, and poses no significant risks.



As regards the second problem, we propose that the disposal of (potentially) troubled assets be undertaken at a much more gradual pace. In this respect, we do not favor using acquired private-sector assets in monetary sterilization operations. Emphasis should be placed on ensuring the return to normality in the valuation of such assets. Asset disposal at distressed valuations would only undermine the recovery of markets and result in unnecessary losses to the central bank.

In addition to the expansion of their balance sheets, central banks have adopted a number of measures that affect bank behavior. These include the provision of guarantees to bond issues, the sale of tail-risk insurance on certain segments of bank assets, and the provision of capital injections. As markets return to normality, central banks should place the highest priority on ending measures that distort incentives and the pricing of risk at financial institutions.

Although unwinding the monetary expansion entails only moderate risks in our view, challenges in the fiscal area will be major, and carry the highest risks over the medium term. Current estimates of post-crisis public-debt levels place most of the advanced economies with ratios of public-debt-to-GDP close or in excess of 100% (with Japan exceeding 200%).

In our view, emphasis placed on fiscal stimulus has been excessive, compared to the emphasis placed on actions directed at resolving banking problems more directly. While we do not expect significant inflationary pressures from the unwinding of the monetary expansion, for which central banks dispose of adequate instruments, inflationary risks may well arise in connection with increasing uncertainty about debt sustainability.

Historical experiences show that inflation has played a significant role in reducing large public debts, even in the advanced economies. The crucial variable to watch will be the interest rate paid by advanced-economies' governments on their debts issues. Recent IMF projections on debt sustainability and required fiscal adjustments are in our view too optimistic, as interest rates on government paper could rise significantly as debt burdens climb.

In this regard, we propose that serious consideration be given to unwinding fiscal stimulus packages much sooner than later. Current views suggesting that additional stimulus in some countries may still be required appear to us as counterproductive, as fiscal risks may turn out to be seriously underestimated.

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In the financial sector, the main problem is not that of illiquidity among banks. Central banks have flooded the markets with ample liquidity. Instead, the potential insolvency of systemically relevant financial institutions has become the main challenge. Just as central banks act as "lender of last resort" in the case of illiquidity, governments should act as "buyer of last resort" in the case of insolvency, when there are no willing private buyers. In turn, bailed-out institutions need to accept tighter regulation and supervision.

Once the rescued financial institution regains strength to operate on its own, one possible exit strategy for the government is to hand over the acquired equity to a trust company. The trust company has the task of selling the shares within a given period (e.g., ten years) with the sole objective of maximizing the profit and, thereby, minimizing the taxpayers' burden.



Bondholders and shareholders of the bailed-out financial institutions or companies need to share the losses as well. Whereas the shareholders contribute automatically by putting up with the dilution of their equity, bondholders could take part in the burden sharing by compulsively accepting a debt-to-equity swap, where their bonds are converted into shares.

In the long run, improvements in financial regulation will have to take the lessons from these new experiences into account. Since modern banks cross international boundaries, improved financial regulation will entail a number of things. First of all, international policymakers will have to coordinate ways in which to let banks fail without taking economies down with them, in a manner similar to bankruptcy reorganization. This may require setting up an international deposit insurance fund for those banks which are large relative to their countries (such as those in Austria), modeled on the FDIC, or it may require breaking large banks into smaller pieces, each of which is not too big to fail.

International regulators could also increase capital requirements (thus reducing the risk of future insolvency) once the economic situation has improved. They can increase transparency by moving derivatives trades such as that in CDSs onto a centralized exchange to be cleared, as is done for futures and options. At the local level, individual countries or states could increase the (so far lax) requirements on the origination of loans, particularly subprime residential mortgages. However, caution is also needed when it comes to political decision making. Policymakers need to be careful to focus on creditworthiness in deciding on public loan allocations or new regulations, not on benefits to specific political constituencies.

Bo Lundgren

Director General of the Swedish National Debt Office

Exit and prepare for new crisis

A discussion on exit strategies should cover three major areas:

- How to phase out government support and government ownership in banks and of assets.
- How to minimize risk for and effects of future systemic financial crisis.
- How to prepare for the next crisis.

Most support schemes have an end date. If not, a date with ample time to adjust should be set when confidence returns to market. Government ownership in banks should be phased out by privatisation when market conditions so allow (a political decision which is very difficult to hand over to a trust or a subordinated organization) in order to recover all or as much as possible of the original stake. Acquired assets should be put in special asset management corporations (bad banks) with a long term perspective in order to recover as much as possible of the original value.

The best way to handle a financial crisis is to avoid it. Measures must be taken nationally and internationally to minimize risk for asset-bubbles and reckless lending. Macroeconomic stability and prudent fiscal policy are prerequisites. Asset prices could be a parameter in forming monetary policy. Regulation must be improved, not necessarily increased. There is an obvious risk for over-regulation instead of more efficient regulation. Capital adequacy rules must be tightened. Approval by Financial Regulators of remuneration schemes in at least systemically important financial institutions should be considered.

Even with precautionary actions taken future crisis in the financial sector will occur. This is an unavoidable part of market economy (a negative factor outweighed by its superiority as an economic system) so organisational and legislative preparations are necessary.

Government intervention is unavoidable in systemic financial crises. Roles for involved institutions should be defined in advance. The role of central banks should be to maintain liquidity in



the financial markets and to be a lender of last resort for solvent financial institutions. Governments or institutions under Government should handle other matters of crisis management.

When confidence in financial markets is lost it must be restored as soon as possible. Depositors and other creditors in systemically important institutions must be protected, but of course not shareholders. Crisis management must be transparent. Important institutions should undergo stresstests. These tests should be open. The capital base for lending must be restored to minimize credit crunch effects. Should it not be possible to raise capital needed from the private sector Governments has to contribute? To minimize moral hazard and taxpayer cost Government capital injections must be coupled with corresponding Government ownership.