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THE INTERNATIONAL FINANCIAL CRISIS

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The current problem with the balance sheets of banks is that on the left side nothing is right and on the right side nothing is left.

"I will follow the lead of a restaurant that opened in an empty bank building and then advertised: 'Put your mouth where your money was'."
(Warren Buffett, NYT, 17 Oct. '08)

CAUSES AND SOLUTIONS OF THE FINANCIAL CRISIS

One should profoundly analyze the various causes of the current crisis, not primarily to blame and punish those who were responsible but to understand the real issues. This is needed to formulate the right remedies and solutions.

Fundamental crisis elements

The fundamental elements of the current crisis consist of:

1. In the USA: the decline in the residential real estate market evidenced by a) the huge amounts of non-performing 'sub-prime' mortgages, which depress the financial health of the homeowners as well as the banks and investors worldwide (through securitization) who own these 'toxic' assets and, b) the decline in American home values. These developments are interrelated.

2. Globally: shortcomings in risk management of many banks.

3. Globally: the paralysis in the interbank market. This affects the backbone of all financial markets: the short-term (one day to one year) borrowing and lending between banks all over the world, even among large and strong banks. This huge market has dried up almost entirely since summer 2007, as evidenced by the excessive interest premiums paid in the few transactions executed. In fact, the central banks felt obliged to largely take over this market, hopefully temporarily.

4. Mainly in the USA and Europe: illiquidity and/or insolvency of many individual banks and several insurers. Largely resulting from factors 1 and 2 above, many banks faced liquidity and/or solvency problems, which were aggravated by withdrawal of deposits and savings and the collapse of their share prices. Other banks are in better shape but have capital ratios that – although not inadequate – are now considered too low.

All these factors are interrelated and reinforce each other into a downward spiral.

Solutions
The solutions to the crisis are found in two areas:
1. The urgently needed emergency measures – to stop the further deterioration of financial markets and institutions; and

2. The policy remedies – both in the private and public sector – that should be taken in the medium-term to improve the financial system and to avoid a future repetition of this or similar crises. This requires a 'lesson learned' approach rather than an ideological-political debate.

Emergency measures
Governments have taken several measures to deal with the acute crisis to stop further collapse of financial markets and institutions and to restore confidence. These measures were initially taken on a country-by-country basis, by national authorities to cope with their domestic problems, without sufficient awareness that this crisis is an international issue, at least an Atlantic (USA-Western Europe) one. It requires a high degree of international cooperation. More recently this cooperation has become stronger although each decision and each financing is still made nationally, also in the EU.

Though taking different forms from one country to another and with mixed success and with mid-stream changes in national policies, such as in the USA and Germany, the following categories of emergency measures were put into effect:

1. Support by governments (with budget, that is taxpayers, money) to the financial markets by buying specific financial assets owned mainly by banks which – due to their dubious quality – were losing value and/or had become illiquid. This was the core intervention ($700 billion program) by the US government to provide a bottom to the markets. This method has not yet been executed in the United States. The Europeans decided to follow a different approach. Secretary Paulson recently changed course and used a large portion of this $700 billion to support individual banks like in Europe (see 2).

2. Support by governments to individual banks and insurers to shore up their inadequate capital base by buying shares (in most cases preferred shares) or extending loans which qualify as capital. This is solvency, not liquidity support. Conditions are always attached to protect the taxpayers (high dividend or interest rate; repayment conditions) and to achieve corporate governance or even political goals. These conditions appear to be stricter in the cases in Europe than those in the United States. However, this partial state ownership of private banks and insurers is rightly seen as a temporary emergency device rather than a real nationalization. Governments are moving from an ad hoc approach to approving a safety-net facility for an overall amount, which can be used on a case-by-case basis. In Europe a growing consensus is emerging that this is the right approach, although it is still done on a national basis. The United States has moved into this direction as well (see 1).

3. Support by governments for the non-functioning interbank market by way of state guarantees to financial institutions lending to each other. Rightly, these guarantees come at a price. It is still early to reach a final judgement, but if these unique guarantees, made available

for huge amounts, do not succeed in revitalizing the interbank markets, there will be not much else left that governments can do in this area.

4. Support by central banks to provide ample short-term liquidity support to all supervised banks that knock at their liquidity window. This is being done in most countries for huge amounts in a way that shows a growing degree of international coordination. Here, again, to avoid moral hazard, central banks should charge stiff interest rates.

5. Monetary policy measures by central banks by way of reductions in their official interest rates. This is also executed increasingly in a coordinated manner. However, these interest rate actions as such do not contribute to the solution of the financial crisis. On the other hand, as the financial crisis leads to a recession in the 'real' economy, the interest instrument can be used as a remedy against this danger, provided the other danger of inflation is under control.

6. Finally, in the same vein as 5, a new set of government actions could be envisaged in the general policy area of economic stimulus through extra spending or lower taxation. This kind of emergency measure does not, however, directly focus on the financial crisis itself but rather on the economic fall-out of a recession. Experience teaches that economic stimulus measures have a mixed record.

MEDIUM-TERM REMEDIES

The required remedies are logically linked to the causes of the crisis and should focus on both the private financial sector and the governmental/supervisory framework.

I. In the private financial sector the following action is needed.

1. Foremost: a better risk management by the seniors at most banks and insurance companies. This requires better internal oversight, governance, internal discipline and transparency of data about risks and exposures, better understanding of the risks involved in new financial products, especially derivatives and "structured" products, better understanding of exposures that are assumed to be 'stand-alone' but are in reality correlated with other exposures (the contagion-effect and the need to assess properly aggregate risk amounts).

2. Compensation. The criticized bonus-amounts are not only seen as unacceptable from a social or moral point of view (particularly for loss-making companies or for banks that apply for government support), but they also provide the wrong incentives to recipients for increasing the risk (and possible reward) profile of their business transactions. More than the absolute amounts, the bonus system requires corrections: a) to link bonuses more to the overall results of the company than to the individual performance and, b) to pay not in cash now but in deferred payments or better yet, to pay in restricted shares that vest after 3 years or later.

3. Capitalization. Although much had already been achieved through the Basel capital adequacy requirements for banks, the bar should be raised by requiring higher capital ratios to provide for more equity as a solvency buffer against losses.

4. De-leveraging (this is related to 3). In recent years banks' balance sheets have undergone an unacceptable increase in risk through higher leverage (ratio of total assets to equity or capital). This was done through massive borrowings to finance additional lending in order to increase profits. Alternatively, assets were put off-balance through SIVs (structured investment vehicles). De-leveraging has two components, which should go hand in hand:

a) Reducing assets. This shrinking of the balance sheet takes time and may create losses. The huge amounts involved will unfortunately impact the 'real' economy negatively by reducing bank credit to industrial companies and individuals.
b) Increasing capital. This is already work in progress. Additional equity should come from private sources (existing or new shareholders) and/or from government support programs depending on the solvency conditions of each bank or insurer.

II. The second category of policy change is required in the public sector to remedy the shortcomings that became visible during the crisis.

1. Supervision of financial institutions. Stricter supervision is required; it should focus primarily on the areas mentioned under point I above. In most cases there is no need for additional legislative powers to increase prudential oversight of individual banks or insurers but rather intensifying and improving the existing instruments of supervision. The major exception concerned the independent American investment banks, which did not fall under the supervision exercised over commercial banks. (Only the SEC looked after investment banks but did so inadequately in so far as risk management and capital adequacy are concerned.) However, for the past few weeks, the investment banks have no longer existed or were forced to apply for commercial bank status (bank holding company). What should be done in the USA is to clean up and streamline the ineffective labyrinth of overlapping and uncoordinated federal and state bank supervisory institutions (for insurers no federal authority even exists, only 50 separate state insurance commissioners). In Europe, the EU should accelerate actions toward integrated supervision (see below).

2. Deposit-guarantee systems. Each country applied a different mechanism. Certainly in Europe, harmonization of the national facilities is required by agreeing on a substantial level of the guaranteed amount for private savers, but with a maximum amount to avoid moral hazard, distortion of competition and irresponsible behavior by banks and depositors.

3. Credit rating agencies. Changes are required to avoid conflict of interest situations and to avoid repetition of practices in which securitized bonds based on the collateral of sub-prime mortgages, etc. obtain AAA ratings.

4. Accounting and financial reporting rules. In two areas changes have been proposed: a) increase transparency on balance sheets, especially off-balance sheet assets and liabilities of banks and b) reconsider the 'fair-value' accounting rule ("mark-to-market") for bank assets which has aggravated the crisis by weakening solvency and depressing market prices by forced sales. However, this latter issue is not easy to solve: fair-value accounting based on current (market) prices is in itself appropriate but perhaps temporary exceptions should apply if 'markets' are in disarray and illiquid.

5. Monetary policy by central banks. A different cause of the crisis related to the prolonged period of too low (in real terms) interest rates and cheap borrowing which indirectly has fuelled the crisis through unsound practices of financial institutions, especially leveraging and risk-taking. This requires adjustment of macroeconomic policy in the future.

6. Liquidity support by central banks. Contrary to 5, this is an area where central banks acted as lender of last resort in an alert way by correctly providing huge short-term liquidity to banks to prevent the crisis from further deteriorating. Central banks even substantially softened the requirements for borrowing banks to provide adequate collateral by accepting all kinds of low-quality bank assets. Over time, this practice should return to normal.

Financial supervision in the EU

Whereas supervision of financial institutions was executed in the past on a purely national basis, the EU countries have gradually increased coordination among national supervisors. The financial crisis has added strength to the arguments in favor of integration of supervision by way of one European supervisory institution. Whether this role should be entrusted to the ECB or to a new and separate body is an important but subsidiary decision. Several member states are not yet willing to agree to such a change for reasons of retaining national sovereignty in this financial area. This argument is less convincing if one takes into account that they already had – rightly – agreed to give up their financial sovereignty by establishing the euro and the ECB. The structure could follow the ECB in that the EU adopts a ‘federal’ supervisory model in which the national supervisors continue to handle the many smaller domestic banks. Supervision of the +/- 40 large and European or cross-border banks should be given to the central EU supervisor where one governing body makes the decisions.

The current proposals aim at intensification of the coordination but it remains a fragmented structure of national supervisors who can make their own decisions. Whereas it is true that – fortunately! – we have not yet faced a serious problem around one of the large, international financial institutions based in the EU, Europe should stand ready to cope with such a major issue. Proposals for a ‘college’ of national supervisors or one ‘lead’ supervisor (of the country of the head office of the bank involved) are probably insufficient. One European supervisor can not be created soon, but this is the time to act.

IMF

Until a month ago the International Monetary Fund was regrettably almost absent from the global economic-financial stage: no lending to deficit countries and no impact on macroeconomic policies of its member countries. This situation is likely to change. Many countries did not need IMF financial support because they could easily finance their deficits, if any, in the private capital markets. A growing number of mainly emerging countries is now expected to borrow large amounts from the IMF. The IMF should stand ready to serve both emerging and developed countries provided it attaches the appropriate doses of conditionality on macroeconomic policies. For the time being, the IMF is sufficiently liquid to do so. If the demand for its resources continues it can resort to its members with surpluses.

The more difficult question is whether its members will allow the IMF to resume its role as a major player to influence the global economic-financial system and the macroeconomic policies, especially of its larger members, through multilateral surveillance, early warning systems, etc. For many years many countries – especially the G7/G8 and more precisely the USA – wanted to decide the course of macroeconomic policies among themselves and did not like (public) IMF criticism and proposed corrective measures of their own domestic policies. A reinvigorated role of the IMF is needed in the coming years, with the likelihood of a global recession and balance- of-payments financing problems for many countries.

Regulation and deregulation; economic system

Since 1980, the world has experienced a wave of deregulation and liberalization, particularly for financial markets and institutions. These developments have contributed substantially to economic growth. One element is financial innovation. Important examples are securitization of assets and derivative products. On the one hand they provide advantages such as instruments (like credit derivatives) that enable banks and investors to hedge certain risks and transfer these risks to other institutions, as an appropriate defensive device of risk management. On the other hand, it is true that excessive use of these innovative instruments by those who aggressively applied them to increase their risk profile for short-term profit opportunities, acted as one of the causes of the financial crisis.

We should take the needed corrective actions to curtail this excessive use, but we should also avoid overreacting by a backlash of aggressive regulation or re-regulation.

It would be a misunderstanding to assume that deregulation and liberalization equal less supervision by authorities over financial institutions. The contrary is more accurate: deregulation should be accompanied by strict supervision.

In recent weeks voices are heard saying that the financial crisis is evidence of the failure of capitalism, free markets and 'laissez-faire' economies. Particularly, the American or Anglo-Saxon type of capitalism is being blamed, including the 'Washington-consensus' as the policy recipe for emerging and other countries. The other view holds that our capitalist economic system as such is not at stake – as still being the best, or the least bad one – but that a number of dangerous and unacceptable elements have developed in recent years which should be corrected. One of the arguments presented by the latter group is that the financial crisis was made possible by mistakes not only in the private financial sector, but also by governments. The cost of a financial crisis is unacceptably high, but the cost of incompetent actions by governments to deal with financial crises in several countries in the past has not been trifle either.

There exists a risk that the necessary actions by governments to address the current crisis may lead to a swing too far to the other side, in the direction of: protectionism, nationalism, de-liberalization, interventionism, state aid, over-regulation and *étatism*. Measures with short-term appeal may have longer-term adverse consequences. State intervention in the longer run implies risks of moral hazard, distortion of competition and discrimination.