Learning the lessons of the financial crisis

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“Simply stated, the bright new financial system – for all its talented participants, for all its rich rewards – failed the test of the market place.” Paul Volcker, April 8th 2008

Learning the lessons of the financial crisis

- What has just happened?
- Why did this happen?
- What lessons do we need to learn?

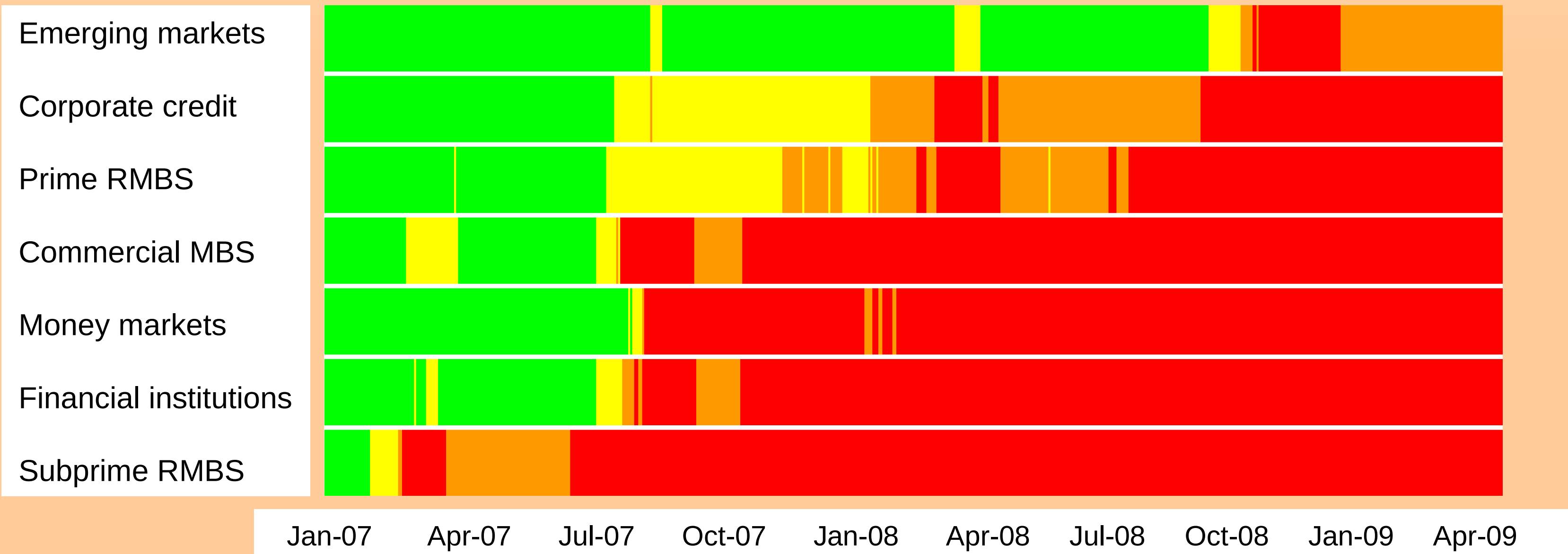
1. What has just happened?

- A global financial and economic crisis, triggered by a brutal re-rating of risk in core economies
- This re-rating revealed the under-capitalisation of the financial system
- That in turn generated a panic
- This panic triggered a collapse in credit and consumer demand, which spread the crisis worldwide
- The worst affected have been not crisis-hit economies, but exporters of manufactures and emerging economies dependent on foreign capital inflow

2. What has just happened?

RISK AVERSION SPREAD

Figure 1.2. Heat Map: Developments in Systemic Asset Classes



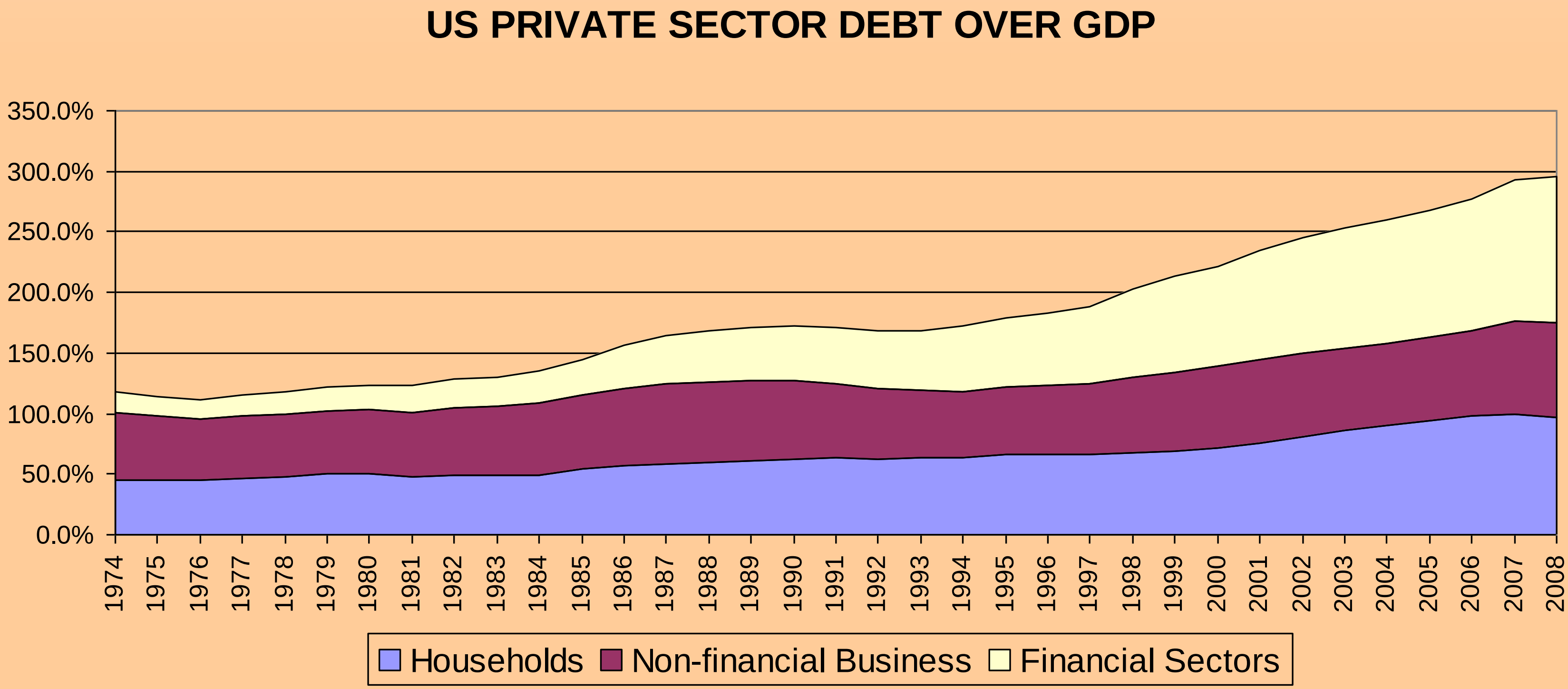
Source: IMF staff estimates.
Note: The heat map measures both the level and 1-month volatility of the spreads, prices, and total returns of each asset class relative to the average during 2004-06 (i.e., wider spreads, lower prices and total returns, and higher volatility). The deviation is expressed in terms of standard deviations. Green signifies a standard deviation under 1, yellow 1-4 standard deviations, orange 4-7, and red greater than 7. MBS = mortgage-backed security; RMBS = residential mortgage-backed security.

2. Why did this happen?

- The late Hyman Minsky produced a canonical model of financial instability, based on a simple idea:
  - Confidence, then euphoria, then the “Ponzi game” and, finally, revulsion;
  - We have been in the revulsion stage – flight to quality and dramatic increases in spreads
- <u>Success breeds excess and excess breeds collapse</u>

2. Why did this happen?

US PRIVATE DEBT BOOM



2. Why did this happen?

- So what lay behind this particular episode?
  1. The “great moderation” and resulting complacency among policymakers and investors;
  2. Emergence of huge global imbalances and extraordinary reserve accumulations in the late 1990s and early 2000s;
  3. Low real and nominal interest rates and the “reach for yield”;
  4. Accommodative monetary policy aimed at inflation;
  5. Innovation in the financial sector, to provide apparently safe, high-yielding assets; and
  6. De-regulation and mal-regulation of the financial system

3. Lessons for financial regulation

- Lesson One - the financial system is inherently fragile:
  - Term transformation and pervasive asymmetric information;
  - Such systems are prone to serious errors;
  - They are also prone to “runs”;
  - Securitisation did not, to many people’s surprise, make this better, but worse.

3. Lessons for financial regulation

- Lesson Two – governments will always try to rescue the financial system:
  - The risk-bearer of last resort is the taxpayer;
  - The regulator is, de facto, a representative of the ultimate provider of risk capital;
  - That capital is provided nationally;
  - This is why regulation can never be truly global;
  - But it is also why, in a crisis, the financial system will cease to be global, as we have seen.

3. Lessons for financial regulation

- Lesson Three - banks and markets are inextricably interconnected:
  - The financial system is a system;
  - Risk is shifted where it is least visible and onto people who least understand it;
  - The banks are always at the heart of the system; and so
  - The system must be regulated as a system.

3. Lessons for financial regulation

- Lesson Four: regulation must be changed in fundamental ways:
  - It must be comprehensive;
  - It needs to charge *ex ante* for publicly provided insurance;
  - It needs to recognise that institutions will not only mismanage risk, but will never take full account of the systemic dangers they create; and
  - It needs to be consciously countercyclical