

Round Table

“Global Financial Crisis and the Role of the G-20”, Comment

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The organisers of this conference asked me to deal with three issues.

1. How long and how deep will the global financial crisis be?

In the course of the 1980s, it became a policy of professional journals like the Journal of Finance not to accept papers based on the supposition that financial markets were perfectly competitive markets. Their informational deficiencies in particular had become common currency among specialists. Equally, by the end of the 1980s the US fiscal and current account deficits had become a serious concern. Incidentally, I worked on both issues at that time (s. Kamppeter 1988, 1990). I picked up the loose ends of those discussions and came to the conclusion that we were heading for a serious financial and economic crisis. Its causes lay on the one hand in the informational deficiencies, moral hazards and the solipsism of capital markets and, on the other, in the US double deficit problem and the corresponding global saving-investment disequilibria. I was convinced that if we did not change course, i.e. re-regulate financial markets and reverse the global macro-economic disequilibria, the world economy was heading for an ever more inscrutable problem.

South Korea at that time had just won the battle for democracy. After the former dictatorial and developmental governments had controlled the economy rather strictly, the economy too experienced a major liberalisation drive under its newly won democratic government. In a sense, after having suffered so much under its authoritarian governments, South Korea fell into the trap of considering economic freedom as an equivalent of political freedom and liberalism. As we may have learned from the present crisis, political and economic freedoms are quite different animals. Because economic freedom can be quite destructive and impose a hefty price on the public, even the most liberal democracies need to restrain the freedom of the economic actors. Precisely this is the meaning of the primacy of politics. As we know from political science and constitutional law, democratic regimes too need a State able to act effectively to safeguard the public good. Yet, because of bounded rationality, ideology, media democracy, lobbyism etc., it is not at all easy to draw the

¹ Paper presented at an international conference on “Global Financial Crisis, Future of the Dollar, and the Choice of Asia” on 31 May and 1 June 2009 in Seoul, co-organized by the North East Asia Research (NEAR) Foundation (EAMC Forum) and the Asian Development Bank Institute (ADBI).

proper line between private and public interest.²

Apparently, at that time my views were completely discordant with reality. Instead of moving toward the abyss, as I had expected, the world economy and the financial markets in particular entered a phase of much praised and seductive buoyancy. Yet, unfortunately, in the end the solipsism of estranged financial markets joined hands with the global macro-economic disequilibria (which could not have occurred without the liberalisation of capital accounts and the liberalisation of capital markets) and produced the most severe crisis since the Great Depression of the 1930s.

I was by far not the only economist to perceive those problems 20 years ago. Yet, it took more than two decades for the disastrous consequences rooted in these problems to become an undeniable reality. Should one really be surprised, if it took another 20 years to sort out the problems created by the present world economic and financial crisis? Reasons there are plenty:

- * As most observers agree, this is the most serious crisis since the Great Depression.
- * In this emergency, most major economies responded with huge increases in government expenditure and guarantees for financial institutions. Yet, government debt eventually will become a huge burden for taxpayers and put serious limits on the ability of governments, households and private enterprises to spend, consume and invest. Not least, the past and present accumulation of debt will severely restrict the future manoeuvrability of governments in weathering the present and future of crises.
- * The extremely loose monetary policies and the huge sums spent to stabilize the financial system could well cause a liquidity-driven asset bubble in financial and commodity markets in the future. Sovereign risk is bound to rise (Roubini, 2009).
- * Apparently, the political power and influence of financial and other vested interests in the failed neoliberal regime is unbroken.³
- * Even though there have been some swift reactions, it is hard to identify serious efforts to improve the existing system of global institutions. This system is fragmented, incoherent, exclusionary, largely ineffective, unaccountable and slow (Held/Young, 2009).
- * As of yet, nobody is really sure, whether we will get inflation, deflation, stagflation or a strong recovery, recession or even depression.

Thus, while this list could be expanded easily, optimism for a quick way out of the present calamities does not seem to be justified. Furthermore, we should not forget that we face larger and deeper challenges than the short-term management of this crisis and the reconstitution of economic governance structures. Just to mention two of them:

² 20 years ago, there was a general preference for more economic freedom (and competition) in Korea. Hence, when I put forward reasons for a proper regulation and re-regulation of financial markets at a workshop of the KDI (Korea Development Institute) in 1991, these were not well received.

³ Which has a direct effect on government action: "I think the Obama administration has succumbed to political pressure and scare-mongering by the big banks. As a result, the administration has confused bailing out the bankers and their shareholders with bailing out the banks. ... this is a form of ersatz capitalism, in which the losses are socialized and the profits privatized ... America has expanded its corporate safety net in unprecedented ways ... The rich and powerful turn to the government ... while the needy individuals get little social protection" (Stiglitz 2009). Thus, "corporate welfarism" underrates social welfare. In the same vein, John Sweeney (2009) complained at the OECD Council on June 24, 2009, "...the fiscal stimulus packages to date are not sufficiently focused on employment and social protection."

- a. Environmental destruction and the wretched poverty of most human beings on this planet surely are much more demanding long-term challenges – and they are bound to become more serious through this crisis.
- b. After decades of stimulating economic growth through government deficits, we have not seen a significant reduction in the levels of unemployment. Instead, the superfluous population outside the formal market economy (who would not remember Arthur W. Lewis “surplus labour” concept?) has increased remarkably, nationally as well as globally. Even in OECD countries a steadily increasing number of people, i.e. citizens of democratic regimes that rely on notions of social justice, fill the ranks of the *precariat*, trying to edge out a modest living on the fringes of the prosperous core of the market economy or relying on public transfers. We are bound to wonder whether economic growth can really be the basic rationale/ideology for economic policymaking.

Unfortunately, the present economic and financial crisis not only diverts attention from these deeper problems, but tends to see the only solution in the ideology of economic growth – varnishing it with newly popular, yet old-fashioned neo-Keynesian growth packages, “bastard Keynesianism” as Joan Robinson would have said.⁴

2. Main achievements and limits of the G-20 Summit in London

As I cannot claim to any deeper knowledge about the front-door results and back-door dealings of that summit, I would want to limit myself to one comment: In all financial crises since the Latin American debt crisis in the early 1980s, short-term capital movements played a major role. Just think of the East Asian financial crisis ten years ago.⁵ Unbelievably, the problematic role of short-term capital movements is not discussed at all in any one of the documents of the G-20 summit (verbal communication by Eric Helleiner).

I recognise the conceptual and practical problems in limiting short-term capital movements, yet I am firmly convinced that they need to be regulated seriously. Some economist might be able to argue convincingly that foreign direct investment offers net benefits for the recipient countries (I do not deny some scepticism). However, referring to an argument frequently made by Jagdish Bhagwati, as of yet nobody has been able to demonstrate, in contrast to the case of free trade, that unrestricted international capital movements lead to higher levels of welfare.

3. Strengthening of financial regulation

“Banking is the industry that failed. Banks are meant to allocate capital to businesses and consumers efficiently ... Banks are supposed to make money by skilfully managing the risk of transforming short-term debt into long-term loans; instead, they were

⁴ In the final chapter of his *General Theory*, Keynes deals with the limits of accumulation and economic growth and makes proposals on how to maintain full employment under conditions of a saturation of investment. See also Keynes 1980 (orig. 1943).

⁵ This disastrous experience did not induce the Korean authorities to hold in check the movement of short-term capital. At the beginning of the present crisis short-term debt, in particular through the Yen carry trade, was higher than the considerable reserves of the Korean central bank. Additionally, there was a huge outflow of portfolio capital because of the liquidity problems of their (mostly US owners), which were a result of the crisis itself. The awareness of these problems is growing again. See, for example, Kim Kyung-soo, Opening up to capital flows poses challenges. Prudential regulation of banks needs to be improved to prevent rapid increase of short-term debt, *The Korea Herald*, Dec. 31, 2008.

undone by it. They are supposed to expedite the flow of credit through the economies; instead, they ended up blocking it.” (Economist, May 16, 2009).

Looking at this disaster and its horrible sequels, one cannot avoid becoming normative. There is after all a difference between private and public interest. It is the task of laws and regulations to safeguard public interest vis-à-vis private interests – and, one might add, to protect the latter against their own madness.

From a normative point of view, the right of existence of financial intermediaries can only be based on their usefulness for the real economy and of the public interest in general. The financial markets ought to serve dutifully the needs of the real economy (Kampeter 1993).

For the real economy, financial intermediaries have four basic functions:

1. mobilisation of savings;
2. allocation of savings to investment in terms of profitability and risk;
3. facilitation of financial transactions between economic actors;
4. inter-temporal allocation of liquidity.

In particular, with respect to the first two functions financial intermediaries have failed blissfully. We have learned the hard way that most financial markets are inefficient in allocating future risk, are highly volatile and are driven by expectations on expectations on expectations, if not by sheer greed and recklessness.

- a. Instead of mobilising savings, the business of financial intermediaries expanded based on credit and liquidity creation and extremely high leverage ratios. They did so largely outside the regulated sphere of their businesses and far beyond what their equity positions would be able to bear.
- b. Instead of mobilising savings for real investment, financial intermediaries carelessly expanded consumer credit and, in particular in the US, mortgage finance, generating furthermore a real-estate bubble.
- c. Even banks, which really should have known better, engaged in excessive maturity transformation (as in conduits and SIVs), which then contributed to the liquidity crash.
- d. A 25% rate-of-return benchmark for leading banking institutions implied that there was something seriously wrong: Either these institutions engaged in too much risk taking or competition did not work the way it should. There was a frantic search for yield, *yield panic* as Martin Hellwig put it, which contributed to the mania of markets and financial institutions.
- e. Governance was flawed in multifarious ways. System-stabilising incentives were either absent or wrong or ineffective. Regulators, central banks, governments, politics and international regulating bodies turned, to say the least, a blind eye and, worse, literally did not know what was going on in the markets. For example, for worse than better, *Basel II* was based on the risk models of the banks and encouraged along with *Basel I* the formation of conduits outside of balance sheets. *Basel I* and *II* made it possible for banks to treat assets under certain conditions with a zero-risk weight; this was a recipe for disaster.

Another flaw pointed out by Charles Goodhart is that it was difficult for the guardians of the financial system to take measures that will reduce economic growth in the short

term in the interest of fending off a recession no one thinks will happen while the good times still roll (Plender 2009).

- f. Bankers and managers did not know much better. The parameters of behaviour were set by bonuses, peer pressure, career concerns, fears of being ostracised and, alas, the self-fulfilling promises of their deficient models.⁶ Internal risk control was not comprehensive, yet distorted and weak.
- g. Neither did rating agencies know – or they knew, but were afraid to hurt their consulting business. Yet, when things became tough, they triggered and accelerated the implosion of markets and the difficulties of intermediaries.
- h. Systemic and pro-cyclical interdependencies and risks were almost completely ignored.
- i. Some pieces of regulation exacerbated the difficulties of financial institutions and thus became an important source of systemic risk. Among them are *mark-to-market (fair-value) accounting* and capital-adequacy regulations (Basel Accord), which in times of difficulties increased the solvency problems of banks. Both pushed financial institutions onto a downward spiral of equity losses and shrinking balance sheets (Hellwig, 2008).

Challenges of regulation

It has become increasingly clear that effective regulation is in the interest of not only the real economy, but also safeguards the stability of the financial system itself – as well as that of the individual financial institutions themselves (Griffith-Jones, 2009).

1. Purpose

The financial sector ought to be seen as a means to an end; it should serve the real economy, and thus the needs of households, enterprises and governments to consume and invest. Finance is an intermediate good that does not produce utility directly (Kamppeter 1992).

Questions:

- * Which financial intermediaries are minimally necessary to satisfy the needs of the real economy?
- * Role of stock markets: In most countries, only a fraction of new investment is financed through the emission of new stock. Therefore, stock markets are largely a secondary/second-hand market dealing with stocks that have served their investment purposes already. These markets for second-hand stocks are driven by expectations on expectations on expectations, not to say on euphoria and panic. Therefore, against what would expect on theoretical grounds, they are much more volatile and unstable than real economic activity. However, because the price movements of the stock market are perceived as an economic barometer or even a divine judgment on firms and governments, they generate a lot of noise and tend to have a destabilising impact on economic activity and the financial markets themselves.

⁶ One serious defect of these models was that they underestimated tail risks “that with our present knowledge cannot be quantified” (de Grauwe, 2008). Interestingly enough, these models, through their specifications and interactions have a strong if not decisive impact on markets. Schulmeister (1987) has shown that this for the use chart models in foreign exchange trading.

As has been known for a long time, shareholders are not able to impose transparency and market discipline. Instead, for already many decades, the stock company has served as a camouflage for managerial capitalism. These informational asymmetries were further enhanced by wrong incentives like stock options and other nice devices. With disastrous consequences as we could see again.

There are good reasons to ask, whether the stock company and the stock market have outlived their 19th century purposes of financing large-scale industrial investments.

- * What contribution do international short-term capital movements, for instance portfolio investments and the Yen carry trade, make to real investment and employment? They have been a major vehicle for transmitting boom and bust across borders. They have produced dramatic exchange rate movements and destabilised real economic activities.
- * More generally, if movements in the capital account determine exchange rate movements (as they have for quite a number of years), then exchange rates cannot fulfil their real-economy function as a central price for balancing trade and allocating resources. Hence, free-trade arguments of whatever description become invalid. It certainly is not very far-fetched to argue that free-trade ideology (the only thing left once its theoretical justification loses stringency) has basically served to discipline labour and governments (for example, through the Washington consensus).
- * The speed with which financial markets move is excessive and has negative repercussions for the real economy. How can it be for example that the exchange rate, which is supposed to reflect the average of myriads of price movements, is one of the most unstable and volatile prices? Surely, there is a need to dampen the speculative mood in these markets through transaction taxes or otherwise.
- * Securitisation: Is it intended to circumvent statutory regulation or does it indeed re-allocate and provide a better sharing of risks? Does it reduce the risks for real economic actors?

2. Rational for statutory prudential regulation

Limit the risk implications of financial intermediaries' strategic choices for their creditors and the financial system as a whole.

Create a regulatory framework, which generates stability even when mistakes are made (Lee Dukhoon; verbal communication).

"... the notion that there is a difference between private interests and the public interest in risk management and risk control of banks seems to have been lost." (Hellwig, 2008, 54-5)

3. Decentralised global system

- * The system ought to be based on general principles and a minimum set of international guidelines. There is a strong presumption in favour of a separation of commercial and investment banking ("narrow" banking).
- * The system ought to be comprehensive, in the sense that prudential regulation and control are extended to all major participants in the financial system (micro-prudential regulation), while systemic risks are observed and acted upon (macro-prudential regulation). Comprehensiveness requires that financial institutions be banned from operating in regulation- and law-free offshore financial centres.

- * The system ought to be differentiated to account for the differences in the roles and liability structures of financial institutions. The homogenisation of market participants reduces the resilience of the financial system (Hellwig, 63).
- * The system should locate the responsibility for regulation and supervision at local, national, regional and international levels. The basic point of reference is the nation-state, which must assume this responsibility within a framework of general rules and guidelines (similar to the Bretton Woods system). This is necessary
 1. because the real world possesses a large variety of capitalist-type economies;
 2. because the specific needs of regulation and supervision vary with the level of economic development;
 3. because the improvement in living and conditions in the least developed and developing countries should not be impeded by systems of control and supervision not appropriate to their needs and their levels of development;
 4. because economic cycles do not coincide among countries;
 5. because it cannot be expected that powerful countries in particular will cede sovereignty to international agencies;
 6. because in any case, whatever some experts and technocrats might say, any sort of regulation and control is politics. Political decisions need legitimacy. Legitimacy largely is a matter of national constitutions and laws. The present crisis indicates that it might be worthwhile to reconsider the case for independent central banks.
- * Macro- and micro-prudential risks and problems can take different shapes between and within countries, and between multi-nation regions. Functionally, there should be a preference for supervision and control at the most appropriate and lowest level (subsidiarity). The concept of subsidiarity is different from the concept of equivalence, which links benefits with costs at the level of jurisdictions. Both principles can be useful in the design of systems of control and supervision.
 1. If the system is developed and put into practice in a top-down manner, the whole system is likely to be a poor and ineffective compromise and to be poorly enforceable.
 2. The *home-country principle* (which restricts the supervision of banks to the one of their home country and allows no additional supervision by authorities of other countries, in which they are active) needs to be revised. This principle is one of the reasons why today's big private banks are "global in life but national in death" (Mervyn King, Governor, Bank of England), with the burdens of their failure falling onto the countries where they happen to reside.
- * The system should allow for capital controls, i.e. limits on capital account transaction. As Jagdish Bhagwati has argued repeatedly, the liberalisation of international capital movements has not produced the promised benefits, very much to the contrary. In particular, developing countries have to be able to protect themselves from financial turbulences originating elsewhere (Helleiner, 2009, 7).
- * There is a need to reduce the pressure to accumulate reserves for future crises (one of the reasons for the present macroeconomic disequilibria and, obviously, an aim impossible for all country to realise). Therefore it is suggested that
 1. swap agreements among central banks are extended, while
 2. SDR-type credit facilities are created at the central level (e.g. IMF) and regional level (e.g. a Asian Regional Monetary Fund).

Note: One of the expected benefits from regimes of flexible exchange rates was that the pressure of accumulating reserves of the Bretton Woods system would be eliminated. We nowadays know how wrong this expectation was – and we know too that systems of flexible exchange rates and unrestricted movements in the capital account are not compatible.

4. Characteristics

- * Transparency

Nobody knew about the systemic risk from conduits and SIVs before July 2007, because these, as well as hedge funds, did not have to provide information about their positions.

- * Simplicity

- Unbundling of universal banks; separation of commercial from investment banking and restricting “casino banking” to potential benefits for the real economy. Not least, such a separation can be expected to significantly reduce maturity problems.
- A general preference for national financial intermediaries, as prudential regulation and supervision can be extremely complicated when they fall under various jurisdictions. The massive injection of government funds in any case has “de-globalised” finance (Martin Wolf, FT, 20.5.2009).
- Prohibition of all off-balance sheet activities.
- Limiting the issuance of complex, customised, often non-tradable instruments (Eatwell, 2009).

Such measures will be beneficial to the public’s, journalists’ and politicians’ understanding of what is going on in financial markets.

- * Limits on size and market shares of financial intermediaries through competition and administrative procedures – lest these intermediaries gain political power and influence, and become too big to fail.
- * Taking proper account of systemic interdependences and risks (Hellwig, 2008); stress testing for the system as a whole (Eatwell, 2009)
- * Implement anti-cyclical regulation: for instance, financial institutions should raise capital reserves in good times and use them as a cushion in bad times.

5. Specific measures

1. Oblige rating agencies to divest from consulting business (if not create public bodies instead).
2. Do not allow higher stages of securitisation (like MBS CDOs, MBS CDO²s).
3. Limit total leverage of financial firms.
4. Develop comprehensive and properly conceptualised models of private and public risk, taking account of the correlation of risks between markets and market participants.
5. Develop robust and simple procedures for unwinding positions when a financial institution becomes insolvent (Hellwig, 63).
6. Revise capital adequacy regulation: The present regime has a number of drawbacks and disadvantages, which among other things give it a pro-cyclical bias.

7. Institutionalise for traders a quota for women in order to dampen the influence of the overzealous testosterone-driven investment managers on markets and risks.

6. Limitations

1. There is only so much one can do through regulation and control. In the final analysis, control can only come from self-restraint and the recognition of the public purpose of our deeds by institutions and the individual actor.

Within the limits of the law, behaviour can be legal, yet at the same time selfish, irresponsible and immoral.

Surely, there is a need to take consciousness and pride in the public purpose and in public virtue and to give it a central place in society, politics, economics and education.

2. We do not only face the challenges of the present financial and economic crisis, which in the face of the (momentary?) self-destruction of neo-liberalism has bestowed upon us the “state socialism for the rich and the neoliberalism for the poor” (Ulrich Beck, 2009).

The much more difficult challenges are the ones of the destruction of our own and the habitats of most other living beings; the excessive consumption levels of some 15-20 percent of the world’s population; the existence of surplus labour that capitalism and the market economy generates or cannot absorb, along with the enormous levels of inequality and impoverishment both nationally and internationally; the scandalous misallocation of resources through military expenditure and the killing fields that follow in their wake; the rising number of failed states; high population growth in the poorer countries and the challenges of shrinking populations and ageing in the more advanced ones; the widespread disenchantment with politics and the declining legitimacy of democratic government, as well as the lack of confidence in our economic and political elites and their governance ... Potentially, covered only by a thin veneer of crisis management, capitalism and politics suffer a severe crisis of legitimacy.

These challenges are extremely difficult to meet. It is quite clear that capitalism and the market economy cannot be a panacea for answering any of them. It is more of a cause than a cure, as capitalist modernisation contributed mightily to the pathologies we observe today (Habermas). These challenges will require a thorough readjustment of the relationship between State, market, politics and citizens at the local, national, regional and global level.

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