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REGIONAL AND GLOBAL FINANCIAL COOPERATION:

SOME IMPLICATIONS OF THE GLOBAL FINANCIAL CRISIS

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INTRODUCTION AND OVERVIEW

The recent financial crisis that began in the United States ended up spreading across most of the globe. This is an important reminder that we should not allow efforts at national and regional reforms to detract from maintaining a global focus as well. Indeed any sensible approach to issues of improving macroeconomic and financial performance should always pay attention to national interactions at the regional and global levels, with the relative amount of effort devoted to each level varying on a case by case basis depending both on the magnitudes of spillovers or interdepence and prospects for securing political cooperation.

Since both regional and global cooperation are scare resources it is important to concentrate efforts in those areas that have the highest expected payoffs. Of course discerning which these areas are is a highly uncertain process over which reasonable experts may often differ, but adopting this perspective forces us to recognize the importance of taking a broad political economy approach as contrasted with just a narrow technical economics approach. From this perspective we can safely assume that a variety of nationalistic tendencies will lead to an undersupply of regional and global cooperation so that governments should allocate their efforts in these areas quite carefully.

There is a long agenda of potential issues for supranational economic and financial cooperation that are affected only modestly by the recent crisis. This list includes issues such as global imbalances, and, more arguably, regional monetary and exchange rate coordination. I include the latter because while some commentators argue that the crisis shows the benefits of common currencies there are others who argue that it has shown the benefits of flexible rates. I expect the outcome of such debates to remain inconclusive, at least for some time to come.

What is new I suggest is the realization that financial innovation and liberalization in the advanced economies was not exempt from the dangers of the creation of perverse incentives that can endanger the economic system. Such problems had become widely recognized with respect to financial liberalization in emerging market economies but had been largely overlooked by the advanced economies and the deliberations of the Basle Group and the Financial Stability Forum. It is quite

appropriate that the G-7 has been largely replaced by a revitalized G-20 and the membership broadened for the Financial Stability Board. It is now absolutely clear that developing and emerging market countries have a very strong interest in the financial strategies adopted by the advanced economies and should be active participants in the deliberations on global financial reform.

In the political arena there has been much debate about the causes of the crisis with those on the left largely blaming excessive financial liberalization and those on the right largely blaming government intervention. These chargrs are often presented in highly oversimplified form and given the sharp conflict in ideological views it is no wonder that commentators sometimes remark that more that two years after the start of the crisis we are no closer to developing a consensus on the causes of the crisis. Such a judgment is highly misleading, however.

While distressingly true with respect to many political activitsts, among serious students of the crisis there is actually a good deal of agreement about the causes. But it turns out that quite a number of factors were contributors. Given the depth and breath of the crisis this should not really be surprising. Where most of the disagreement among serious analysts occurs is about the relative importance of different factors. On this question there is likely to remain controversy for an extended period. After all there are still lively academic debates about various aspects of the Great Depression of the 1930s. This doesn't mean, however, that there isn't a good deal of consensus among economists over a number of lessons from that period.

In the same spirit it is clear that debates about regulation versus the market that have been generated by the recent crisis will be inherently unproductive. Both failed badly. Allan Greenspan's view that financial markets would discipline themselves has been clerarly falsified, but many of the worst financial excesses were generated by institutions in the United States and Europe that were subject to considerable government oversight and regulation. There was considerable regulatory as well as market failure.

Thus its not suffient just to create more regulation. We need to give considerable attention to the political economy of implementation, especially to the influence of those being regulated and the human difficulties of standing against the herd when markets (and often governments as well) become exuberant and overly optimistic. Regional and global coordination of financial reform is an especially difficult area because it involves both considerable technical complexity and strong interest group lobbying. Already we are seeing that intense lobbying from the financial sectors in the advanced economies has been leading to considerable watering down of proposals for global financial reform.

One of the types of multinational cooperation that has proved to be most feasible is the cooperative exploration of the lessons from past events and their implications for future policies. The lessons from the recent crisis for financial policies is an area where this should be especially fruitful and this conference provides an excellent

example of the value of sharing experiences widely across both different countries and experts with different types of backgrounds and perspectives.

It is sometimes argued that the crisis demonstrated the bankruptcy of mainstream economics. You won't be surprised to hear that I believe such views are far wide of the mark. I agree, however, that the crisis illustrated that some important schools of thought within economics had become too dominant. Many economists became blinded by the theoritical beauty of models that had strayed too far from reality. Efficient markets theory in finance is a prime example. While this approach has yielded many important insights and valuable financial innovations, the tendency to dismiss critics led to far too much faith in its general applicability. As applied in the private sector and in regulatory strategies the consequences proved to be disasterous. It is now becoming increasingly recognized that substantial weight needs to be given to broader approaches such as the research going on in the fields of political economy, behavioral economics and finance, and complexity economics. I will touch on some of the implications of these approaches in the next section.

SOME KEY CONTRIBUTORS TO THE CRISIS AND THEIR IMPLICATIONS FOR FINANCIAL POLICY

While many factors contributed to the generation and spread of the recent crisis, one of the most important causes was the way in which a number of innovations in the financial sector combined to create a greatly increased set of perverse incentives for financial instituitions to take on excessive risks. When this type of issue comes

up the first response of many economists is to blame government induced moral hazard. This certainly played some role, but I believe that it was largely a supporting rather than lead factor, however. There had developed so many perverse incentives within private finance that I am confident that we would have had a major crisis even without any moral hazard or US government programs to expand home ownership. Likewise while global imbalances and accomodative monetary policies undoubtedly contributed to the magnitude of the financial imbalances that developed and consequently to the severity of the crisis, perverse incentive structures and false mental models or views such as the belief that financial engineering had virtually conquered risk would have generated a major crisis in any event.

Perhaps the easiest set of perverse incentives to see involved the ratings agencies. Since they we paid by those who recieved the ratings for the securities they issued, it does not take a PhD in economics to see the incentives to give overly high ratings to secure more business. The important role given to requirements for ratings by governments and regulatory agencies meant that these conflicts of interest could have a huge influence on the financial system. This was combined with compensation schemes and the structure of many of the new financial instruments that gave strong incentives for massive risk taking within financial institutions. At the same time excessive faith in the wonders of financial engineering and a bout of optimism generated by The Great Moderation led both borrowers and lenders to believe that they were taking only modest risks while in fact they were dangerously exposed. The "This Time Its Different" mentality held in full sway and influenced the

regulators as much as the private sector. As a result leverage was allowed to expand to dangerous levels.

Alan Greenspan believed that the major financial instituitions had much greater capacity to measure and monitor risks then did regulators and thus advocated turning over much of prudential risk management to the private sector. Indeed some wags have described Basle II as outsourcing much of risk management to the private sector through the use of risk weighted capital requirements where the large financial instituitions calculated their own risks. What this approach overlooked was that while these institutions might have greater technical capacity than their regulators, they also had incentives to game the system and this they certainly did.

On top of this problem, their risk management strategies, while in some ways highly sophisticated, were also highly flawed. Standard risk management systems such as Value at Risk grossly underestimated risks and imparted serious procyclical biases to official capital ratios and private sector strategies. Hidden from many users by their sophisticated mathematical frameworks, at the heart of these models was the simplistic assumption that recent history would continue to repeat itself. Markets were also implicitly asumed to be highly liquid and efficient and the implications of extending such sustems from one to a large number of instituitions was largely over looked. But behavior that would be prudent for one institution by itself could in some cases crash the system if undertaken by a large number of market participants at the same time. The role of portfolio insurance in the 1987 crash of the US stock

market gave an early warning of this danger, but its implications for regulatory strategies was largely missed. Financial regulation remained too focused on the micro or individual level and not enough on system interactions.

The recent literatures in behavioral finance and complexity economics pointed to many of the dangers in this approach and the recent crisis all too strongly validated these concerns. Thus it is now widely recognized that much more attention needs to be given to macro prudentional oversight. How best to do this is an important area for cooperative discussion.

One of the implications of perspectives from political economy, complexity economics, and the critiques of standard risk management systems is that where possible emphasis should be placed on the use of simple rules even though there are more sophisticated rules that can be shown to be substantially superior under some circumstances. The point is that what we need are rules that will give decent outcomes under a much wider range of circumstances and which are less open to gaming. Our watch word should be robustness. Thus there is a considerable case for using mechanisms such as simple leverage ratios despite their apparent lack of sophistication.

In the reform process we should not turn our backs on all financial liberalization and innovation. But we likewise have no basis for believing that they are always good. A much more careful case by case approach is needed with careful attention paid to incentive structures abd the possibilities of unintended consequences.

Financial engineering has developed many useful concepts and products which can make positive contributions if used appropriately, but which proved to be highly dangerous when misunderstood and consequently misused. While such criticisms have been widely acknowleged, regulatory frameworks have generally still not been revised sufficiently in light of these problems.

Also put to the dust bin by the crisis is the belief that financial markets can rely sufficiently on internally generated discipline to require little official oversight. Adam Smith's invisible hand only works under certain conditions and this were notably absent from many segments of the financial sector. In many areas such as housing finance and the generation of asset back securities, perverse incentive structures kept competition from playing its normal positive role. Indeed under these conditions instead of promoting prudent behavior, heavy competition increased the pressure to take excessive risks in order to increase one's bonuses and maintain the firm's market share. In the future both private and public sector managers and regulators need to look much more carefully at incentive structures within the financial sector.

In the international arena a particular implication of this conclusion that financial markets do not always behave efficiently is that the case for strong prudential oversight of international financial flows has been greatly strengthened.
The best ways of providing such oversight are far from clear, however, and should be the focus of continuing discussions at the national, regional and global level.

While I'm opposed to general taxes on financial transactions I am quite simpathetic to arguments that higher capital or reserve requirements should be applied to more risky activities. In this approach emphasis should be placed on activities whose social or systemic risks substantially exceeds their private risks. Because of political economy considerations I am not highly optimistic that the creation of living wills and other resolution mechanisms will be sufficient to eliminate the moral hazard of too big to fail. In this case higher capital, leverage, and liquidity requirements for systemically important instituitions are certainly in order.

Large international surges of financial capital into emerging market economies is another category of activity that surely meets this criteria of substantial devergencies between private and social risks. Part of any sensible response to such surges is to accumulate additional international reserves. But since this is costly, standard welfare economics would call for imposing some of this cost on the international flows themselves. It is also quite important that national authorities monitor quite closely the influences of international financial flows and reserve accumulations on domestic financial conditions. Even when inflation in goods and services prices is kept in check, recent crises have show that excess liquidity can generate bubbles in asset prices. This is not an argument against inflation targeting, only against making it the only objective of policy.

There is considerable controvery among economists about how much weight, if any, should be put on the behavior of asset prices in setting monetary policy. What is clear, however, is that one policy instrument cannot successfully target two

policy objectives, financial regulation is needed as an additional type of policy instrument to guard against financial and asset market excesses. The recent crack down by the Chinese government on off balance sheet lending by banks is a good example of the value of using multiple policy instruments.

Until the recent Greek crisis I would have argued that concerns with the consequences of international financial flows was a relevant issue just for emerging markets, but I now think it is worthy of consideration with respect to European countries as well. And indeed also with respect to the United States, although its large reserve currency role adds an additional layer of complications.

Such strategies can be adopted unilaterally at the national level. but there are advantages for coordinating such strategies across larger groupings. There are also strong advantages to multilateral discussions of the advantages and disadvantages of various ways to implement such strategies and of appropriate ranges for the technical paramaters involved such as what types of capital flows should be included and by how much should international reserves should be increased to keep the country at its initial risk level. Jie Li and I and some of our colleagues have been working on such issues and have produced research that we think is of relevance, but it is far from the last word . There is much more to be done, as there is on the issue of how much reserves should be drawn down during crises. These are examples of areas in which I believe greater cross national dialogues can be of considerable value.

It is especially useful, if difficult, for us to learn from others' experiences. The Asian crisis of 1997-98 illustrated the dangers of many of the risk management techniques that contributed to the recent crisis. Many Asian countries took sound lessons from the crisis and developed much stronger financial systems. There was much less learning in Europe and the United States. Let us hope that with this crisis we can have much broader learning and resulting improvement in financial policies. The recent agreement on proposed new capital requirements by the Basel Committee is a hopeful sign, but many of the most difficult issues are yet to be addressed. We have much work still to do.

Note: Several of the themes in this address are covered in more detail and with extensive references in my paper " Some Lessons for Economists from the Financial Crisis" Indian Growth and Development Review(forthcoming) and my study The Global Crisis and Korean International Financial Policies (Korean Economics Institute, 2009).