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Global Imbalances, International Monetary Policy and Global Governance – their role in the financial crisis and impact on future policy framework

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Thematic Paper: Global Imbalances, International Monetary Policy and Global Governance – their role in the financial crisis and impact on future policy framework

It is understood that three of the main contributing factors to the current financial crisis are global imbalances, regulatory governance and monetary policy. The purpose of this report is to examine the effects of these factors and propose measures to bolster the financial system against a future shock of this magnitude.

This is not to suggest that the credit crisis can be attributed to deficiencies in these three areas alone. Indeed a multitude of other effects and imbalances also impacted on the situation including: fiscal policies in some countries, bank bonus structures, rating agency deficiencies and over-reliance on mathematical risk models amongst others. The interplay between all these factors is highly non-trivial *ex-post* let alone in any *ex-ante* analysis that could have preceded the crisis. Further, it would seem that it is the *combination* of deficiencies and asymmetries inherent in the financial and oversight system that drove the system to failure. For this reason we take the top down approach, examining the three areas mentioned but remain cognisant that while this is necessary, it is not in itself sufficient.

Globalisation – a key driver of the crisis?

The credit crisis of 2007/9 can be considered to be the first crisis of globalisation, attributed as such due both to its causes and to the spread of its effects. In this case it is worthwhile briefly considering the historical perspective from which this problem evolved.

1995 was the year that China joined the WTO and marked a major step forward in globalisation. Indeed from 1996 onwards China's current account surplus has increased every year up to the crisis, with the exception of the 2001/2002 recession, reflecting rapid export growth and relocation of manufacturing via foreign direct investment (FDI).

By this year, interest rate setting authorities in the most major economies had converged on the policy of using the overnight target rate as the sole control mechanism to combat inflation which was typically measured on a basket of goods and services in each economy. Previous policies, for example in the 1980's in the US, had targeted monetary aggregates which reflect credit growth or as in the UK, a target exchange rate. These had proven inadequate in stabilising inflation, considered necessary for minimising the output gap and hence optimising economic activity. This policy continued till the dawn of the current crisis where emergency measures such as quantitative easing were employed. Monetary policy was therefore a strong contributory factor to the development of the crisis.

Late 1997 saw the financial crisis of the South East Asian countries. So-called "hot money" was rapidly being withdrawn from the area and ASEAN governments spent their foreign exchange reserves trying to maintain the foreign exchange peg to the US dollar in the midst of this capital flight. When this failed and currencies were forced to float, the effect was disastrous for the area. GDP fell by over 30% in USD terms in 1998 with Thailand, South Korea and Indonesia being most affected. The

area witnessed collapsing currencies, widespread bankruptcies, plunging asset prices (particularly in real estate) and social unrest. By comparison China, which also pegged its currency to the USD at a rate of 8.3 Renminbi (RMB) to the dollar, was largely insulated from the problems of its neighbours due to two main factors. Firstly the Renminbi was not convertible and secondly, FDI into China at that time was in manufacturing facilities and not securities which could be monetised quickly. China's current position may well reflect the ruinous financial and social effects on its "tiger economy" neighbours of a combination of current account deficit, foreign currency debts and a convertible currency. The effect and contribution of China and in particular its trade surplus and portfolio investments, to the current crisis will be examined in more detail.

Late 1998 saw the Long Term Capital Management ("LTCM") crisis. In many ways this should have been considered the first crisis of globalisation and was an indication of what was to come. The similarities with the current crisis, namely high leverage being employed, forced unwinding of positions in an unfavourable market environment and a Federal Reserve Bank of New York brokered solution to the collapse, are marked. All the world's major investment banks injected capital in to LTCM to prevent forced liquidations that would trigger a domino effect to their own holdings. Merrill Lynch observed in their annual report following the collapse, that mathematical models "may provide a greater sense of security than warranted; therefore, reliance on these models should be limited." Following large losses on CDO positions, valued using complex mathematical models that failed in the stresses of the current crisis, a distressed Merrill Lynch was taken over by Bank of America in 2008. The seeds of self destruction in both the buy side and sell side mentality as illustrated here were also a major component in the crisis.

On the first of January 1999 the Euro was born in to a changing global landscape. Having met the convergence criteria at date of entry some countries have enjoyed historically low rates. It is generally accepted that the countries who benefited the most from a decrease in interest rates are Greece, Ireland, Portugal, Spain, and Italy. These are precisely the countries in the euro zone most exposed by the financial crisis because of imbalances in their economies. A correction of these imbalances has not yet happened, nor has an agreed route been found. The effect and contribution of economic imbalances within the EU need to be examined.

Two further events frame the environment in which the crisis was generated. The first is the stock market collapse in 2000 following the bursting of the so called "dot com" bubble. The second is the psychological effect on the US consumer of the events of 9/11, whereby family and home took on great importance. At the same time the Federal Reserve slashed interest rates to 1.75% making home affordability attractive. As a result home price growth in California, Florida and most North-Eastern states grew by 10% in 2002, the biggest annual rise since 1980. With the stock market out of vogue following the crash, much speculative money entered the housing market encouraged by skewed and existing fiscal policies.

Global Imbalances: Not always unwanted

It is important to define what we mean in the context of this report by an 'imbalance'. The word itself implies an undesirable asymmetry and an unwelcome deviation from a steady and secure state. This is necessarily not the case and we

have to distinguish between dangerous imbalances and benign imbalances as to their impact on the global financial system.

Imbalances on a small scale are manifest by imperfections that exist in all markets and are arbitrated away by market participants. Their effects are therefore transitory and the arbitrage assumption is core to most mathematical pricing and risk models and supported in theory by the 'Efficient Market Hypothesis'. Similarly, interest rate setting authorities' models assume that by fixing the overnight rate, the entire term structure of interest rates will be efficiently priced by the market. There is no scope for a structural imbalance in these situations. However it will be argued that the combination of scale and statistical 'tail events' did in fact lead to imbalances that had a direct impact on the crisis.

On a larger scale we can consider imbalances within an economy. Examples of this are: over-reliance on the financial sector (UK); over-reliance on the export sector at the expense of domestic consumption (Germany, China); consumer debt levels (UK, US); and large budget deficits/surpluses. Whilst these imbalances are not independent of the crisis, it is considered that they impact more strongly on the ability of member states and constituent countries to react to the crisis and as such fall outside the scope of this report. The exception to this, as will be considered later, is the China surplus/ US deficit situation and the accumulating surplus of oil exporting countries.

Imbalances within global financial institutions

Another large scale imbalance was found in the balance sheets of financial institutions. The major imbalance was, somewhat counter intuitively, an imbalance in diversification. This was accentuated by leverage. The mechanisms of how this situation arose are worthy of closer examination in order to propose effective legislation to avoid the situation recurring.

From the late 90's onwards there was an explosion in banking, and primarily investment banking mergers. Size was considered a necessary pre-requisite in a globalised environment for many reasons: the ability to provide a full service to an increasingly globalised client base, the ability to build market share and avoid being a marginal player, having the balance sheet to provide products and services to the biggest clients and a good credit rating thus lowering the cost of capital amongst others. The size and number of mergers can be illustrated with respect to the formation of Citigroup. In 1993 Travellers Group acquired Shearson having already owned Smith Barney. In 1997 they further acquired Salomon Brothers Inc., one of the so called 'bulge bracket' firms. In 1998 they merged with Citicorp to form Citigroup, then the largest financial company in the world. To put this in perspective, consider that the very existence of Citicorp was in doubt during the Latin American debt crisis of the 1980's due to its large exposures in the region. The bank has since bought Nikko Securities as well as many retail banking companies.

This picture is paralleled by many other firms and indeed there was market pressure on company management of smaller firms to be acquired in order to release 'shareholder value'. Of course, larger companies had to find large market opportunities to maintain profits growth (other than by acquisition) and this was

presented to them by the explosive growth in the credit derivatives area from a barely existing base.

The ability to isolate and trade credit risk dovetailed neatly with the existing sovereign, corporate and mortgage debt markets. By definition the market was huge and the number of participants very diverse in terms of funds, hedge funds, banks, insurance companies etc. One of the first credit instruments was a credit default swap ("CDS"). From modest roots as a hedging tool for e.g. convertible bond traders whereby the credit risk of an issuer can be isolated and sold to a natural buyer of credit risk (e.g. an insurance company), the use of this exploded in to a speculative trading tool. In parallel, more complex instruments were created, in part, due to the search for yield in a low interest rate environment.

One of the better known, a collateralised debt obligation ("CDO"), involved a basket of bonds in which investors bought tranches with different seniority rights in terms of the payment of coupons and principle. Complex mathematical models were developed to assess the different properties of these tranches and ratings agencies were brought on board to ostensibly "rubber stamp" them. In this way triple A products could be sold to conservative investors based on a basket of low quality credit assets. Such investors were keen buyers in the search for higher returns with a gilt edge credit rating. Further products were developed such as synthetic CDOs whereby the tranches were not backed by a physical holding in the bonds, but rather by a basket of CDSs, further compounding the model risk. Huge fees were made by creating the CDO vehicle and the margin on the sale of the tranches. A steady supply of mortgage bonds from the US were issued by government sponsored enterprises ("GSE") whose lending standards had also become much more lax under political pressure, but combined with the widely held "implicit government guarantee" view, were another route of low quality loans, dressed in the protective garments of high credit into the market. End purchasers had little or no knowledge of the makeup of the assets underlying the investment let alone any systemic risk between these assets and the assets of any other credit products.

In the face of this enormous market opportunity, all major financial institutions expanded aggressively into credit derivatives. Management at these financial institutions have been accused of being lax and understanding little of the risk that they were dealing in, or in many cases, warehousing. There is substance to this view and while they cannot perhaps be expected to understand the minutiae of complex financial mathematical models, they are expected to understand the effects of a toxic mixture of low regulatory oversight, reduced capital requirements (and particularly risk capital allocated to new mathematically valued derivatives with little trading history and a large balance sheet presence), the leverage effect of these products on the balance sheet and the spiralling compensation payouts to those involved. Perversely, the market, seen as the ultimate arbiter of risk and value, would punish the share price of institutions that could not keep abreast of their peers and thus limit the incentive of management to curtail risk or make any decisions that could limit the profit growth. Indeed, it is likely that rather than "too big to fail", the main concern of management was "too big to maintain profit growth".

In this way, the balance sheet and risks of the major participants were highly aligned. The credit products were largely sold over the counter ("OTC") and so were not marked to market with margin requirements. In the wake of the crisis, and

particularly in the wake of the Lehman collapse, uncertainty as to the counterparty risk each institution had incurred as a result of no margining mechanism, led to the freezing and near collapse of the system.

This imbalance of diversification, both inter and intra company, was a major driving force in the crisis and policy recommendations follow.

Global Imbalances: the role of saver versus borrower

The other major imbalance as alluded to earlier, and key to the ensuing crisis, was the combination of the China current account surplus and the US current account deficit. The presence of an imbalance *per se* is not in itself a problem, but rather the nature of the imbalance.

On a global level, the amount of savings and the amount of lending is, by definition, a zero sum situation. It is rational and desirable that savings flow to the best investment opportunities in terms of productivity and risk adjusted return. This would broadly characterise the nature of the US deficit in the 1990's. During the technology boom which was led by the US, productivity increased and corporate profits swelled. In a benign inflation environment, and with open, liquid securities markets, the US witnessed large foreign capital inflows via portfolio investments and direct investment. This environment came to a halt with the dot-com bubble burst of early 2000. Whilst the wisdom of these investments may be questioned in hindsight, it does not invalidate the *raison d'être* for these foreign capital flows. This would constitute what we term a benign imbalance.

During the last decade significant budget surpluses have continued to amalgamate in China, and increasingly in the oil exporting countries. The reasons for the persisting current account surpluses in these countries and the policy prescriptions to address them are widely recognised. In China, fiscal policy is geared towards promoting export growth and the expense of domestic consumption. This involves domestic tax policy and a managed exchange rate regime. The provision of a welfare system, rebalancing the tax burden between corporate entities and individuals, and the enforcement of property and human rights, would all contribute to greater domestic consumption while at the same time reducing the incentive to keep saving.

Similarly, it is argued that the Renmimbi is being kept artificially low and has a distorting effect on world trade. It is beyond the scope of this report to examine this issue but it is worth mentioning that a stronger Renmimbi would not balance world trade unless Chinese domestic consumption was to increase. Hence, the effect of a strengthening would be to make other manufacturers more competitive but the extent to which other countries could compete with the established manufacturing base and a workforce without collective representation is not clear. On the other hand, as mentioned previously, authorities are likely cognisant of the effect of floating currencies in the ASEAN crisis, particularly when the depth and maturity of the currency market cannot comfortably accommodate the size and speed of speculative flows.

Whilst not a concern at the sovereign level, the build up of low interest rate foreign currency debt by consumers and corporates can be just as destabilising. Domestic stresses such as inflation pressures appear to be considered a price worth paying by

Chinese authorities and thus policy prescriptions are largely an academic exercise in the context of immediate measures that can be taken to address the current crisis.

This century another source of surplus has developed in the oil exporting countries, attributable to the huge increase in the price of oil (as an aside, confidence in monetary policy was bolstered by the weathering of the oil price shock without the recessionary consequences witnessed in the 1970's). In broad terms, these countries share the attributes of low domestic consumption, and underdeveloped societies in terms of social security; thus increasing the saving imperative. Furthermore the status of the US dollar as a world reserve currency and the fact that oil is a dollar priced commodity incentivises such savings to be held in US dollars.

Unfortunately the nature of the US deficit changed in the 21st century from a benign to a problematic situation. Rather than portfolio and investment inflows, foreign savings inflows were used to fund government, corporate and personal borrowings. The US went from a balanced and short lived budget surplus at the end of the Clinton era to record deficits at the end of the Bush presidency. The issuance of treasury debt to fund this deficit across the maturity spectrum did not result in an increase in interest rates as might be expected, but rather a *decrease*. This was largely attributable to Chinese and foreign purchases of treasuries. This mechanism is worthy of greater scrutiny as it had secondary effects on corporate and consumer debt with its effects spreading globally.

The US government debt market is the deepest and most liquid market in the world. Also by definition it is denominated in the world's reserve currency. With virtually no probability of default it represents the 'natural' home for a risk adverse investor. The problem that arises is one of scale. An efficient market theory would assume that an investor would direct investments to the best risk adjusted return. Alternatively, in the situation where an asset class becomes expensive relative either to fundamentals or other securities, other market participants would be expected to arbitrage the difference.

The Chinese purchase of US debt was ongoing and in such scale that the market was unable to stand in its way. In fact, the effect of these purchases was to push down the interest rates across all maturities. In relative value, the interest rates of other issuers, both sovereign and corporate was pushed down. Effectively, risk premium disappeared and funding became cheap.

Mortgages in the US are primarily fixed rate mortgages. The rally in the long end of the curve presaged a wave of remortgaging, freeing cash for consumer spending. Furthermore, tax relief was, and still is, available on home loans even when the proceeds were not spent on the home itself. In other words, there was a tax incentive to release equity, increase leverage and sustain the debt bubble. This was one of the drivers of the real estate boom, paralleled to varying degrees in other countries.

In the US in particular, as well as the tax incentives, government policies aimed at increasing home ownership amongst the low paid and the loosening of the credit quality of mortgages insured by the GSEs, exacerbated the boom. The lack of an appropriate risk premium in the government bond markets led investors to participate in riskier markets in the search for yield. Typically this took the form of

lending to borrowers of lower credit quality and at very high loan to value ("LTV") ratios – even exceeding 100% in some European countries. Securitising these loans either privately or via GSEs and their global distribution via credit derivative structures discussed earlier, maintained a steady source of funds to the mortgage origination market.

Interestingly, in any normal market situation one would expect the risk of a transaction to lie with the lender. However, this has not been the case in this crisis. China has largely been protected from the effects of the crisis and it is in both the US and China's interests to maintain orderly and stable treasury markets. Given the continuation of the flow of funds in this extraordinary situation, discipline on the part of the borrower is required, either through regulation or policy prescription.

A role in the crisis for global taxation?

To the extent that 'perverse' tax incentives contributed to consumer debt, debt accounting and tax issues further encouraged corporate borrowings which would have been strong in any case as a result of the low term structure of interest rates explained earlier. Debt issuance at the corporate level is an attractive funding option as the servicing costs of the debt are allowable expenses against a tax liability. There is no 'balancing effect' in the issuance of equity funding.

As a result, and as it pertains to the financial sector, the last decade witnessed a perfect storm of lowered capital requirements based on risk models that proved inadequate, typically buying back equity in the market and cancelling it as a means to improve earnings per share, and low tax efficient debt issuance to fund balance sheet leverage. A large proportion of earnings were used to purchase back shares in preference to using retained earnings for capital or distributing cash dividends to shareholders.

The cheap availability of debt, due in part to favourable tax treatment, also contributed to the explosive rise in the private equity industry, with transaction levels in individual deals and funds in the industry reaching record levels each year. Any policy prescription for the future must address not only a higher capital cushion but the asymmetry in the funding solutions available to the corporate.

To the extent that it impacts on regulation, it has been suggested that so called tax havens have had a part in the crisis. Whilst this may merit further investigation, it is not obvious that there is any connection. Often, SPEs, SPVs or funds will be domiciled in such locations as the entity itself is not taxed. However any distributions to shareholders or owners in the structures are taxable in the investor's home tax jurisdiction. The benefit of a tax free domicile for the fund or vehicle maximises the potential investor base and while tax liabilities may be deferred, they are not avoided.

It is not considered that the tax free domicile of these vehicles was the driving force behind their creation for all the reasons mentioned earlier in this report, and as such was not instrumental in the ensuing problem. The corollary of this argument would be that all the world's major financial institutions were acting in concert to construct tax avoidance schemes of global proportions, which is simply not credible. Hence this report has no recommendations to do with tax havens as it pertains to the causes

and effects of the financial crisis and any tax avoidance or tax fraud issues are better dealt with by enforcement.

It has been suggested that a financial transaction tax applied within the EU, or more beneficially on a global basis, would be a suitable response to the current crisis. However, evidence from the UK stamp duty on share trading and other examples around the world, would suggest that this would not deter behaviour in the financial markets. To modify trading activity would require a punitive rate of taxation which would be impractical and inoperable globally, across asset classes, without adversely affecting the availability of capital to the real economy.

Monetary Policy – the low interest era

The monetary response of interest rate setting bodies to all of these developments has been central to events globally. It has been suggested, and it is quite likely the case, that interest rates in many countries were kept too low but this is not to suggest that central bankers did an inadequate job. The problem lies in the strict mandate of price stability. To take the UK as an example, this meant targeting an inflation rate of 2%. As mentioned before, the inflation rate was measured with respect to price movements on a basket of goods and services in the economy (CPI the consumer price index). It is necessary to define the basket in terms of 'sticky' prices, which have inertia in their response to the monetary climate, so that policy does not erratically respond to short term movements in volatile prices such as energy.

Deutsche Bank Research quotes the Bank of England as stating that 25% of the CPI basket is comprised of imported goods on which monetary policy would have little effect. Globalisation, through lower prices of imported goods, effectively imparted price deflation on the goods component of the basket. The policy response of low interest rates to maintain a 2 % inflation target meant that services inflation was running too high and that the economy was therefore running faster than it should have been. This in turn contributed to the asset price, primarily real estate, inflation witnessed in the UK.

The ECB by contrast has a two pillar strategy where it also assesses the risks to price stability. It should be recalled that the ECB was consistently criticised during the last ten years for too hawkish a stance on monetary policy, particularly by financial sector economists. Even so, a tighter monetary policy was not in itself sufficient to prevent asset price booms in some member states. The conclusion would be that monetary policy is necessary but not sufficient to ensure price stability. However, the failure to manage other monetary indicators such as M2/M3 monetary aggregates and exchange rate targeting suggest that targeted policies with regard to interest rates may be needed to work alongside monetary policy.

Monetary Policy: Subject to Inherent Modelling risks

The issue of modelling flows directly into the econometric models used to establish the appropriate overnight interest rate. As has been documented extensively, such models do not explicitly use inputs such as asset prices in their calculations or indeed other indicators of imbalances specific to this crisis. Other important inputs such as the output gap, the difference between the actual and optimal economic output,

are not observable. However, it is not suggested that central bankers blindly follow the output of a model, and in general it is considered better to work with a well understood and simpler model, where the deficiencies are known and qualitatively accounted for, than a complex model, with more and uncertain inputs. It has been suggested by many that the success of monetary policy in stabilising inflation over the past decade has owed more to the benign economic environment than to policy success. This is not the view of this report and would recommend that monetary policy continues to be conducted in the same established framework.

There is however a suggestion that the inflation target should be increased. A recent IMF paper suggests that a higher target inflation rate, provided it is well communicated and kept stable, would not affect the output gap but would mean higher average nominal interest rates. This would provide more room for manoeuvre in a crisis using only interest rates as a tool. It has been suggested for example, that in the absence of a zero rate floor to interest rates, the correct policy rate in the US currently, would be 3 to 5 percentage points lower. According to research from Deutsche Bank, a higher target inflation rate would be accompanied by higher deviations from the target if the same standard deviations were observed over the economic cycle. Whilst mindful of this, we would recommend that further research be done to decide whether a higher target rate, potentially in the 2.5% - 3.5% range would be warranted, practical and implementable, without negative consequences to economic growth or investor confidence in the euro region.

Fiscal Policy as a tool of last resort

Fiscal policy is a tool of last resort in a crisis. As a general rule, recessions caused by crises are relatively short lived and the time lag for the approval and implementation of policy is not consistent with crisis. Even in the current crisis it took the US congress 12 months to pass the stimulus bill. Furthermore, domestic fiscal policy recommendations as they pertain to states with large deficits or surpluses are well documented, as are the political difficulties with implementation, consequently it is recognised that these are unlikely to be implemented in the short term and so fall outside the scope of recommendations in this report.

One exception to this would be the rise in the current account surplus of the oil exporting countries. If one accepts that the Chinese surplus is a problem, then the combined surplus of the oil exporting countries cannot be ignored. The difference is that the Chinese surplus has grown in a free trade environment (with the caveat of exchange rate disagreements) whereas the price of oil is largely manipulated by the OPEC syndicate. In any other market this would be viewed as monopolistic behaviour and the *raison d'être* is to maintain a stable oil price. Whilst the range of oil prices in the last decade from \$10 to \$150 per barrel may give cause to question this, it must be recognised that pricing power should come with responsibilities. The surpluses being accrued are a potential source of future instability and our willingness to accept an OPEC pricing policy should be accompanied by political pressure to invest the proceeds in establishing a social framework and stimulating domestic demand in the OPEC countries.

In addition, given the huge macroeconomic impact of oil prices, it is questioned whether a price setting regime set by the producers as opposed to all stake holders is appropriate.

Finally, on the issue of oil price, this report is sceptical on the suitability of financial market participants to speculate on this commodity. The oil market is very small in comparison to the scale of speculative capital and so very exposed to manipulation and large price movements. This is illustrated by the general acceptance that the oil price hike from *circa* \$115 to \$150 and back again was associated with the unwinding of oil futures contracts. While the author of the report is very pro free markets, it again comes down to a question of size and scale. It is proposed that the oil market is too small to easily absorb speculative capital, and too important in economic terms to be manipulated by speculative flows.

Global Governance: the role of global institutions

What has become apparent during the global financial crisis is that the interconnectedness of the world's financial markets must be reflected in the work of global institutions. Organisations need to communicate effectively in crisis times and normal times in order to ensure coordinated approaches towards regulation, monetary policy (where applicable) and financial accounting to ensure proactive measures can be taken when markets are overheating.

G20 - The expansion of the forum from the G8 to the G20 is to be welcomed, as the breadth of coverage reflects the global nature of the crisis and the required actions by governments. However, discussions need to take place to ensure that agreements reached at these summits are translated into actions agreed by all constituent members; otherwise it will become a meaningless entity very quickly. The G20 Pittsburgh summit adopted a framework for multilateral surveillance of macroeconomic policies, with the aim of making national policies consistent with balanced growth and including regular consultations on commonly agreed policies and objectives.

IMF - During the crisis the IMF's resources were tripled, however, countries still view the available funds as a last resort and have an implied stigma attached. Proposed reforms of the body should be implemented including: improved governance; the method of accessing funds available and ways of building on the new crisis prevention instruments; such as the flexible credit line and other sources of contingent financing. Beyond assisting distressed member countries with funding and expertise during crisis situations and monitoring multilateral policy dialogue, it has been tasked with acting as secretariat to the G20 forum in achieving the framework detailed above by building on its existing surveillance analysis and reporting back to the G20.

WTO -The nature of the global imbalances, particularly between the US and China would suggest that protectionist measures witnessed so far may escalate - for example the Chinese tyre ban by the US and the Chinese action on US poultry. The role of WTO needs to be strengthened as an ultimate arbitrator between competing members in arising trade disputes

IASB - The convergence of global economies, with respect to accounting standards over the past decade, is welcomed; however, the US now needs to move permanently to adopt IAS and the EU needs to ensure that it does not waiver from IAS in the post-crisis era.

BIS - The work of the BIS is respected and therefore supported by all major financial centres. The recommendations from the Basel Committee on Banking Supervision, particularly Basel II were implemented by most European Banks, although they were not fully implemented by their US counterparts ahead of the crisis. A commitment from regulators of all major financial centres needs to be made with respect to Basel III and its full implementation across all jurisdictions.

Governance Issues: within the EU

The current Maastricht cap of 60% debt to GDP ratio of member states has been systematically flouted and in the current situation has lead to instabilities in Greece with the possibility of contagion to other member states. It seems it is not the absolute size of the deficit in the context of the European economy that is problematic but rather the size compared to the domestic economy. It is critical that member states create credible and sustainable deficit reduction plans. Furthermore, it is critical that member states publish financial statements that are both credible and transparent. Off balance sheet transactions, unfunded public liabilities, labelling government spending as 'tax credits' to manipulate the balance sheet are examples of so called financial engineering by governments to deliberately mould the published public finances in a favourable light. By contrast, New Zealand has a much more transparent policy towards public finance reporting and it is recommended that an approach such as this be adopted to maintain investor confidence in the euro region and better assess a member state's ability to cope with a large magnitude shock.

It should be acknowledged that whatever steps are taken as a result of this crisis, there will be future economic shocks. The state is the insurer of last resort and, as such, consideration should be given to the fiscal room for manoeuvre in the presence of a shock. Is 60% debt to GDP - if this is adhered to - sufficiently low to withstand a future shock? An *ex-post* analysis of this crisis in the terms of the debt assumed by member states and their ability to service and reduce it needs to be carried out.

It is recognised that monetary policy within the EU is too blunt a tool, particularly in the wake of globalisation, to address problems such as asset bubbles and financial sector imbalances. However we have to acknowledge the destabilising effect of these factors in the ensuing crisis. It is the recommendation of this report that research be done to identify the most effective areas to implement a new policy to contain emerging financial imbalances. These would almost exclusively be contingent capital triggers on the balance sheet of lenders measured against e.g. gross lending, gross leverage, gross asset class exposure etc. This would necessarily involve the consolidation of all subsidiaries, branches, special purpose entities ("SPE") and special purpose vehicles ("SPV") in the calculation. This in itself is no trivial task as even within Europe, the use of branches versus subsidiaries is used for regulatory

arbitrage and it is suggested than one particular American (former) investment bank has over 7000 SPEs or SPVs.

It is recognised that some member states such as Spain had counter-cyclical balance sheet policies in place; so-called "dynamic provisioning", and it did not fully insulate them. However, as noted at the beginning of this report, it is the compounding effect of many interacting imbalances that has resulted in the crisis and no one issue in isolation would be a 'silver bullet'. Rather, it is prudent to introduce a broad range of sensible policies which together provide a safety blanket, but any one of which is not too onerous as to disrupt the financial system which it is in everybody's interests to optimise.

Global Governance: Regulation of Financial Institutions

A major deficiency in the oversight system has become evident as a result of this crisis, and opportunities for regulatory arbitrage should be minimised globally, and within the European member states they should, where possible, be abolished. It is our opinion that the case for a single European financial rule book is compelling, but that a lot of care should be taken in the implementation of such a common rulebook with the creation of new European Supervisory Authorities. In particular, the operation of these new pan-European authorities should be free of political interference and its personnel should not be political appointments. It is crucial that such a supervisor consist of leading operators in the field of financial management and regulation.

Such a supervisor should, through national regulators, have the ability to impose tough sanctions on institutions that compromise its guidelines. Too often a regulatory framework appears to be viewed as a set of boundary conditions in which products and business are financially engineered to operate within. In such a rapidly changing industry, adherence to principles rather than rules is necessary, but with penalties for non-compliance.

Financial institutions are instrumental in both the cause and propagation of the crisis, and policy recommendations need to reflect this. Global investment banks and other financial service providers operating on a global scale need to be subject to comprehensive and consistent regulation. Regulatory arbitrage opportunities need to be minimised and all G20 participants need to ensure a co-ordinated implementation of agreed measures. Loopholes, which allow foreign corporations, such as the US based insurance company AIG, to operate unregulated in European Union member states must be closed. The sharing of best practice and knowledge between financial centres globally must be encouraged. The Colleges of Supervisors for global companies must be made to work more effectively.

The size of financial institutions and their balance sheets have introduced the concept of 'too big to fail'. EU proposals to address this include:

- Banks being required to produce a so called living will to detail their orderly liquidation in the event of a crisis
- Increased capital requirements
- Remuneration policies within financial institutions
- Increased transparency and collateralisation of OTC derivatives trading

These need to be implemented on a global basis, on a contemporary timescale, to ensure better regulation of global entities which pose systemic risk to the global financial system.

The current policy proposals however, do not sufficiently scrutinise the reliance of the financial institutions and regulators on mathematical modelling. While it no doubt has a place and has contributed to the availability of new financing channels, it has proven deficient in crisis times. This should not be surprising for three reasons.

First, in a crisis we observe a herd mentality in financial market participants which results from a (usually relatively short lived in terms of an economic cycle) collapse in risk appetite. Efficient market principles, such as arbitraging market dislocations, fall by the wayside in the drive for principle safety. This would be challenging to model.

Secondly, a crisis is by definition a 'tail' event in the distribution of possible market reactions. Such tail events occur more frequently than expected by models, but are nevertheless infrequent enough that any meaningful statistical modelling information is insufficient to capture them. Indeed it is everyone's desire to avoid tail events thus making it *de facto* a rare event which cannot be modelled.

Finally, all financial institutions will use substantially the same models and where the risks on their balance sheet are aligned, these models will trigger the same hedging events, at the same time, which tests the liquidity of the underlying market and can lead to a self reinforcing downward spiral as happened with LTCM.

This is where the size of positions has a deleterious effect and needs to be constrained. It is not easy to imagine how a risk model can incorporate the market activities of your competitors in the analysis. The principal policy recommendations flowing from this would be

- (i) increased capital held on holdings whose values are not directly observable in a liquid market and rely heavily on mathematical modelling
- (ii) calculate capital on gross exposures. This would entail a haircut for net positions but would recognise the effect of large exposures in unstable market conditions.
- (iii) scenario analysis based on qualitative and industry/regulator agreed metrics as opposed model based VAR or Monte Carlo analysis
- (iv) a capital premium on mathematically valued products who have not been in existence for 2 economic cycles. One of the problems with credit derivatives is that they have not been in existence for long enough to assess their behaviour and the robustness of their valuation and risk management over a long period.

RESULTING POLICY RECOMMENDATIONS

One common thread permeating all of the recommendations outlined below is the issue of size. Size is a relative concept whether we are talking about budget deficits, balance sheet leverage, the impact of derivatives or any other aspect of a crisis. In general, the issue of size should be a primary consideration when assessing the risk to stability in any financial framework, and will no doubt impact on other developments outside the scope of this report, such as so called 'dark pools' and the impact of large hedge funds on market stability. In the recommendations that follow the role of 'size' should be considered.

- Too often the regulatory framework has been viewed as a set of boundary conditions in which products and business is financially engineered to operate within. In such a rapidly changing industry, adherence to principles rather than rules is necessary but with penalties for non-compliance.
- A major deficiency in the oversight system has become evident as a result of this crisis and opportunities for regulatory arbitrage need to be minimised globally, through firm agreement at the G20 level, and within the European Union member states, they should, where possible, be abolished through the application of a common rule book for financial services.
- Loopholes which allow subsidiaries of foreign financial services to operate significant business in the EU, unregulated, need to be closed, whilst Colleges of Supervisors for all global firms need to ensure close supervision across all markets.
- Risks from aligned financial sector exposures need to be identified early. The people best placed to identify an emergent risk are the financial institutions themselves. In an analogy of interest rate setting committees, it is proposed that the major European financial institutions produce a bi-annual report on the current state of financial market stability and the outlook for risks to that stability. The report would be signed by the CEOs and CFOs of the institutions for which they would be held accountable, and delivered to the FSB and ESRB for consideration
- Tax incentives which favour debt financing over equity financing need to be minimised. The problems associated with over-reliance on debt financing have become evident, particularly for tax payers who have bailed the financial system out, and hence any tax incentive to the extent that it is desirable at all should be focussed on equity financing.
- Tax policies, while still exclusively remaining the responsibility of member states, may benefit from a more coordinated approach in order to ensure the operation of an effective single market in financial services.
- The size of financial institutions and their respective balance sheets have introduced the concept of 'too big to fail'. Proposals already made to address this, and supported by this report are that banks are required to produce a "living will" to detail their orderly liquidation in the event of a crisis and are required to hold increased capital.
- Senior management and Board Members at financial institutions have demonstrated lax control and little understanding of the risk that they were dealing in. Although not all non-executive directors should necessarily be

expected to understand the minutiae of complex financial mathematical models, they should be expected to understand the business model sufficiently so as to be able to provide a first stage of regulatory oversight, to question new products and their risk management and to assume responsibility for aligning investor and employee interests with respect to compensation. Regulators should be tasked with monitoring knowledge and suitability of board appointments.

- A ban on buying back and cancelling previously issued equity needs to be investigated as a mechanism for limiting the organic growth in financial firms. The inability to buy back their own shares would ensure that banks have to find genuine growth opportunities to increase earnings per share, or else retain the earnings as an increased capital cushion. They might alternatively choose to distribute dividends which are historically low compared to the capital allocated to bonus payments. This would also ensure that liquidity is left in the market for other participants. Aside from takeover opportunities, which themselves are limited by competition rules, growth in financial firms needs to be self limiting.
- Bank bonus culture has been a contributory factor in the search for profits at the expense of prudence.
- The failure to manage other monetary indicators such as M2/M3 monetary aggregates and exchange rate targeting suggest that targeted interest rate policies may be needed to work alongside monetary policy. Research needs to be done to identify the most effective areas to implement this and would necessarily involve the consolidation of all subsidiaries, branches, special purpose entities and special purpose vehicles.
- Member states should be required to publish financial statements that are both credible and transparent. Off balance sheet transactions, unfunded public liabilities, labelling government spending as 'tax credits' to manipulate the balance sheet should no longer be allowed and investigation into the merits of operating a more transparent policy towards public finance reporting along the New Zealand model is recommended in order to maintain investor confidence, particularly in the euro region, and allow better assessment of a member state's ability to cope with a large magnitude shock.
- An *ex-post* analysis of this crisis in the terms of the debt assumed by each member state and their ability to service and reduce it needs to be carried out. Each member state should determine an appropriate debt to GDP ratio and avoid reliance on a pre-set "group" criteria.
- Consideration at a global level needs to be given to the state of the oil market which is very exposed to manipulation and large price movements. Research needs to be carried out into the imbalances caused by oil producing countries and the role of global bodies such as OPEC as it is proposed that the oil market may be too small to easily absorb speculative capital and is too important in global economic terms to be manipulated by speculative flows.
- Research should be carried out to determine whether a higher inflation rate target (as proposed by IMF paper 2010) would be warranted, including whether it would be practical and implementable without negative consequences to economic growth or investor confidence in the euro region
- Recommend less reliance by financial institutions and regulators on mathematical modelling. While it no doubt has a place and has contributed

to the availability of new and novel financing channels, it has proven deficient in crisis times. Regulators and Board Members should be required to apply subjective judgement at times of market stress.



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