# Containing a Systemic Crisis: Is There a Playbook?

Masahiro Kawai
Michael Pomerleano

- The paper exudes wisdom as if we just read Kierkegaard and concluded that “Life must be lived forward, but can only be understood backward.”

- **But…we are trying**

# Key messages

- Major policy blunders lead to significant structural vulnerabilities
- Markets are forgiving, but eventually the unsustainable runs its course
- Domestic stability regulators , equipped with adequate tools, are an essential part of the solution
- The international financial stability architecture is not suited for the 21st century

# Policy blunders

# Virtually all the countries made serious policy mistakes that lead to significant structural vulnerabilities.

- **Korea 1997**
  - The liberalization of the short term capital account lead to a high level of external short-term debt and the low level of usable international reserves. It made the economy increasingly vulnerable to shifts in market sentiment. Equally, there were latent problems with the high leverage and poor profitability of the chaebols, reflected in the financial sector.

- **Thailand 1997**
  - Pegged exchange rate regime. An unsustainable current account deficit, a significant appreciation of the real effective exchange rate, rising short-term foreign debt, and deteriorating fiscal balance.

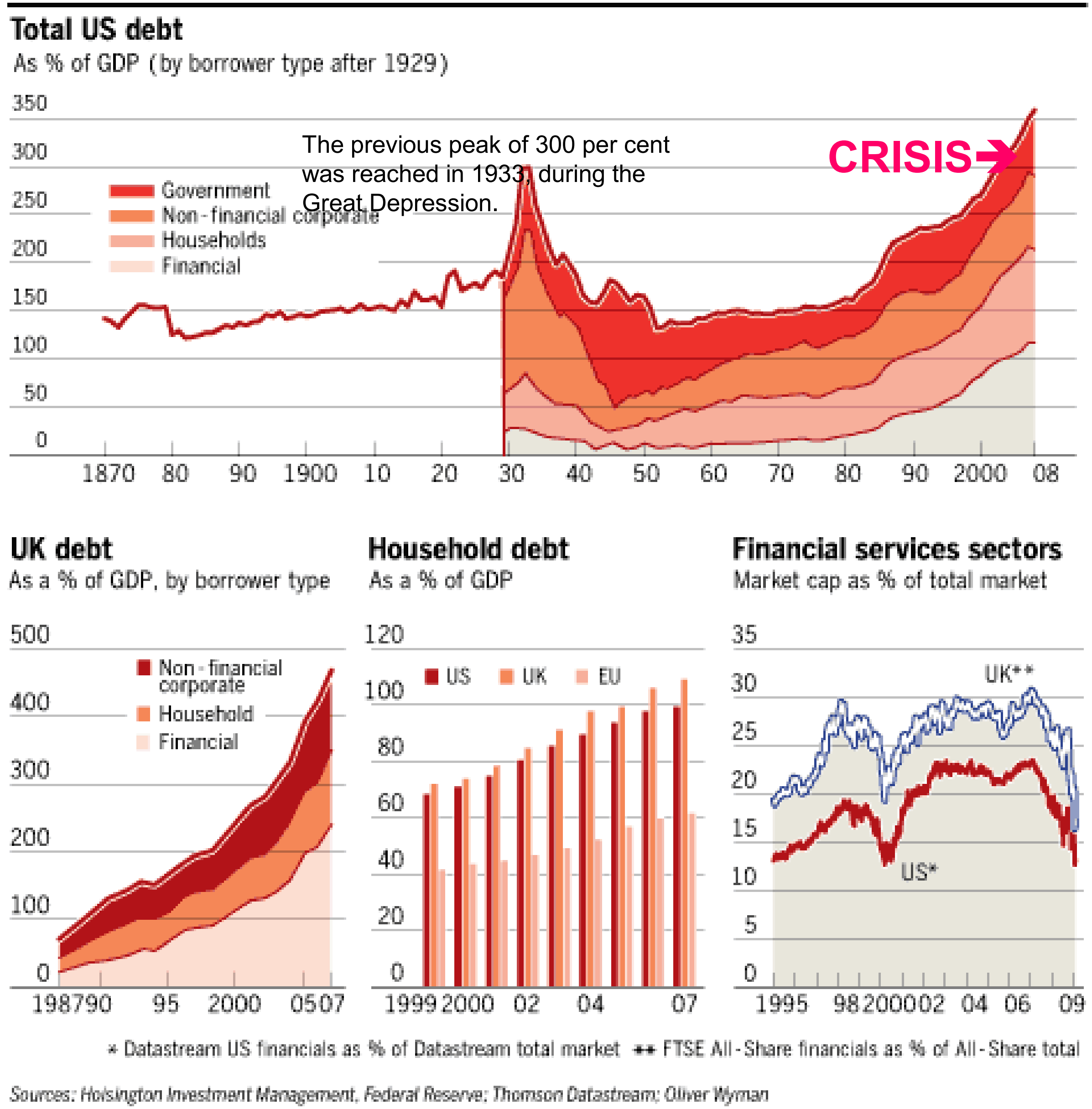
# Blowing bubbles in the 2007-9 crisis

# Major policy blunders leading to this crisis: rapid credit growth, etc

- Bernanke: “ the Fed cannot reliably identify *bubbles* in *asset prices”* . ..... Aftermath: *Implications for Monetary* Policy," NBER working paper 8992, June 2002. www.federalreserve.gov/BoardDocs/Speeches/.../default.htm
- Taylor rule ignored: Getting Off Track: How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis
- Greenspan on imbalances in the Per Jacobsson Foundation Lecture - Balance of Payments Imbalances .. http://www.iadb.org/intal/intalcdi/PE/2009/02532.pdf
  - “ policymakers have been focusing too narrowly on foreign claims on U.S. residents rather than on all claims, both foreign and domestic, that influence economic behavior and can be a cause of systemic concern”.
  - “part of a long-term updrift in this broader swath of unconsolidated deficits and mostly offsetting surpluses of economic entities has been persistent but gradual for decades, probably generations”

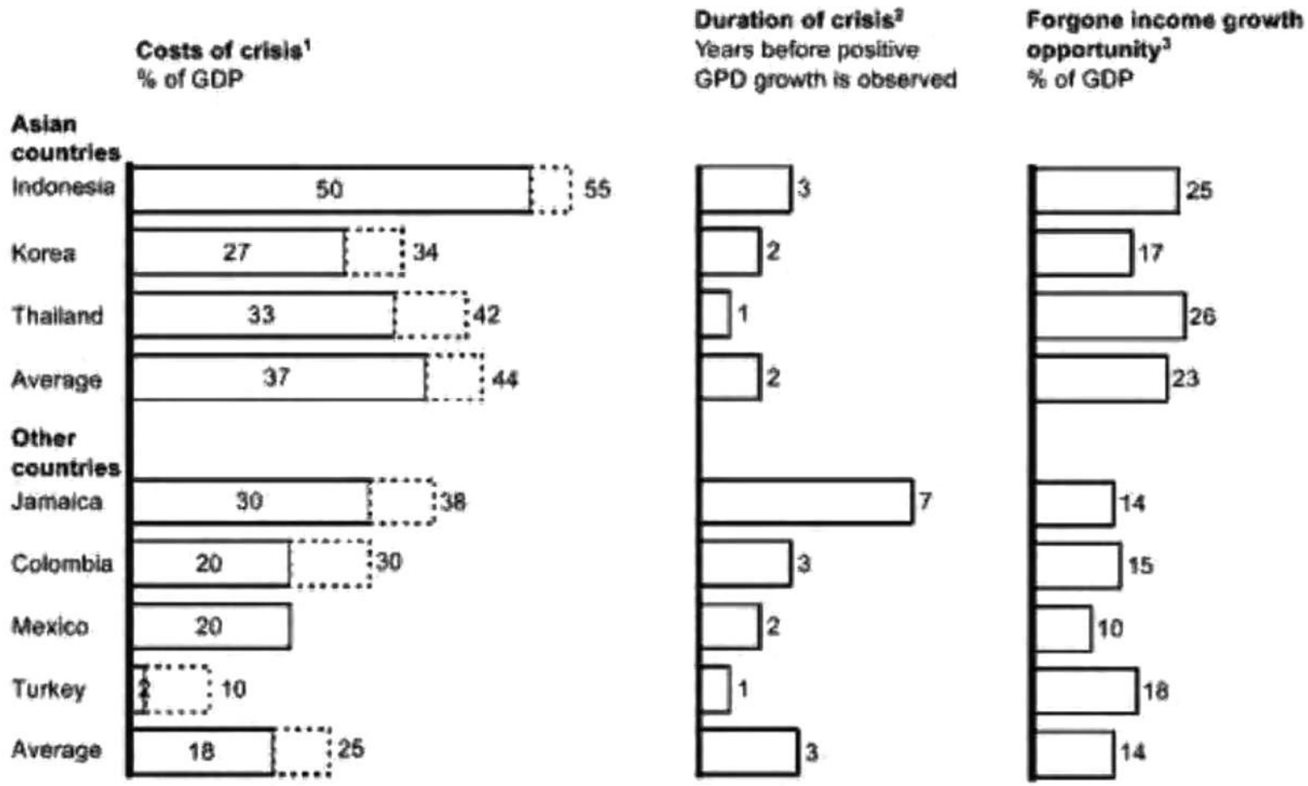
Example: The ratio of US public and private debt to gross domestic product reached 358 per cent in the third quarter of 2008.

Debt reached an all-time high of 294 per cent of GDP in 2007, a rise of 105 percentage points over the previous decade. Nearly all the increase was in the financial and household sectors.




Source: Martin Wolf, Financial Times

# Why do we care? Output loss , fiscal cost are staggering . Long duration of crisis




[1]Ranges represent differing estimates from two reports cited

[2]For those crises that have not yet subsided (Indonesia, Korea, Jamaica, Colombia, and Turkey) duration is calculated through 2002.

[3]Difference between average GDP's growth rate during crisis period and steady-state growth rate; economic literature suggests that in steady-state economic growth should be equivalent to population growth

*Sources:* Caprio, Gerard and Daniela Klingebiel, "Episodes of Systemic and Borderline Financial Crises," World Bank, October 1999. Hogarth, Glenn, Ricardo Reis, and Victoria Saporta,

# The nature of the current crisis

- Several excellent reviews of what went wrong in financial regulation& how to remedy the situation. These would include reports by the Group of Thirty , the Geneva Group and the recent report by the De Larosiere Group.
- The IMF analysis: “ macroeconomic policies – which did not take into account building systemic risks”
- Supervisors / examiners were “mis-educated”: "A key failure during the boom was the inability to spot the big picture threat of a growing asset price bubble. Policymakers only focused on their own piece of the puzzle, overlooking the larger problem."
- Realization that regulation and supervision have to be top-down as well as bottom-up. It should be “macro-prudential”, monitoring the financial system as a whole, as well as “micro-prudential”, keeping an eye on individual firms
- Instituting a macro-prudential approach to supervision and assigning a clear mandate to a systemic stability regulator

International Monetary Fund: *Initial Lessons of the Crises*, February 2009

http://www.imf.org/external/pubs/ft/survey/so/2009/pol030609a.htm

# Today’s financial regulation

- Founded on a fallacy of composition-- assumption that making each bank safe makes the system safe.
- Goes a long way towards explaining how global finance became so fragile without sounding regulatory alarm bells.
- Mitigating the costs of financial crises necessitates taking **a macroprudential approach** to complement the existing microprudential rules.

# Domestic stability regulators

# The elements of a broad policy agenda to address systemic risk

- Charging a governmental entity with express responsibility for **monitoring and addressing systemic risks** in the financial system
- **Consolidated** supervision of all systemically important financial firms
- The development of an **orderly resolution of systemically important nonbank** financial firms
- Uniform and robust authority **for the prudential supervision of systemically** important payment and settlement systems

# Stability regulator

- Regulatory objectives, i.e., what the stability regulator expects to achieve, in particular whether its objectives should include the responsibility of “spotting” and/or managing the crisis;
- Regulatory structure, i.e., the stability regulator should be a single entity pulling the collective effort of different regulatory authorities, each with a different specific responsibility to carry out the delegated financial stability oversight;
- Regulatory resources, i.e., the political backing, and legal and financial resources to enable the stability regulator to carry out its duties effectively; and
- Regulatory implementation, i.e., the instruments, tools, and techniques that the stability regulator will use to achieve its objectives.

# What are the functions of a stability regulator?

- Monitoring
- Analyzing
- Identifying regulatory gaps,
- Curtailing systemic risks
- Feeding findings into regional and global stability forums
- Issuing periodic reports

# Monitoring: A crisis is not the “unknown unknown” -- it builds up overtime, until the unsustainable runs its course

- Macro overlay. Leverage in the economic system. Was possible to recognise the toxic combination of rapid credit expansion and financial innovation dealing with the deleveraging of a huge debt overhang is hard
  - Households
  - Financial institutions
  - Corporate sector ..(neglected in recent discussions)
  - Government
- Sectoral soundness
  - Corporate ..(neglected in recent discussions)
  - Banks
  - Households
- Large and persistent current-account deficits funded by short term debt.
  - Excessive reliance in short term international bank
- Under pricing of risk

# Curtailing systemic risks

- **Macro prudential standard setting** . Setting of standards for capital, liquidity, and risk-management practices for financial firms, given the importance of these matters to the aggregate level of risk within the financial system. Examples  Mitigate pro-cyclicality with counter-cyclical provisioning
  - Automation rules vs. discretion: Automatic rules desirable
  - Automatic, such as a form of dynamic provisioning
  - Manage Loan to Value ratios: In some jurisdictions maximum loan-to-value (LTV) restrictions for mortgages
  - Limits on sectoral exposure:  limits on consumer borrower indebtedness
  - Tax measures should , but are not used adequately
  - E.g., Deductibility of interest on debt
- **Legislative initiatives** insolvency regime to cover non bank financial institutions
- **Monetary policy**

# Recent global, regional, and country, reform initiatives to address systemic risks

- Country initiatives to manage systemic risks
  - EU, UK, US,
- Regional initiatives
  - EU
- Global initiatives
  - FSF, IMF

# The international financial stability architecture

# Global initiatives to manage systemic risks

- FSB ‘s role
  - Financial Stability Forum (FSF) was re-established as the FSB with an expanded membership (G20) and a broader mandate to promote financial stability.
  - The FSB is a secretariat with 10 staff members that facilitates a community of practice
  - It does not have independent capacity for analysis; relies on the members insights, analysis and input
  - No country authority will report adversely on itself; therefore the discussions will be innocuous such as “offshore centers”
  - Highly unlikely that  members will share sensitive detrimental domestic information
- IMF‘s role
  - ?
  - The IMF has formally dropped exchange rates surveillance ,

# The Financial Stability Board
mandate

- Assess vulnerabilities affecting the financial system;
- Identify and oversee action needed to address them;
- Promote coordination and information exchange among authorities responsible for financial stability;
- Monitor and advise on market developments and their implications for regulatory policy;
- Advise on and monitor best practice in meeting regulatory standards;
- Undertake joint strategic reviews of the policy development work of the international standards setting bodies;
- Set guidelines for and support the establishment of supervisory colleges;
- Manage contingency planning for cross-border crisis management; and
- Collaborate with the International Monetary Fund (IMF) to conduct Early Warning Exercises.

# Who is going to do the heavy-lifting?

- The FSF “deafening silence” re the growing risks in eastern Europe and US
- The present  voluntary cooperative efforts are not adequate
- The FSF and IMF have done little more than issue statements of principle since the start of the crisis
- The stumbling blocks:
  - Weak cross-border framework for crisis management The prospects for such an accord are slim.
  - The Westphalian principles governing international financial oversight are not suited to address an inextricably interconnected global financial system (TLTF)
- The international financial community needs to make progress with a binding post-Westphalian global financial order, but prospects are dim.

# The stumbling block: national champions and weak provisions for cross border bank restructuring

- Weak cross-border framework for crisis management and for the resolution of cross-border banks (CBRG).
- The wind down of a large cross border institution is complex
  - Asymmetries of exposures across jurisdictions
  - Risk of asset grab discourages sharing of information/collaboration
  - Legal form does not follow function
  - Multiple (conflicting) proceedings and competencies
  - Existing resolution tools do not work when markets are not functioning
  - Practical constraints (need for speed, time zones)
- Domestic policy makers are left with ad-hoc half-measures…such as guarantying banks' obligations, direct capital support, direct liquidity support, blanket deposit guarantees, and forbearance
- Until this issue is solved, it will be impossible to reach a binding global financial order

# In conclusion

- Qualifier: Yogi Berra about the future “It's tough to make predictions, especially about the future” …the next crisis will be different