

**BACK TO THE DRAWING BOARD – REGULATION  
AND ECONOMIC POLICY AFTER THE CRISIS<sup>1</sup>**

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1. I am delighted to be given the opportunity to speak today to the heirs of David Hume whose wonderful clarity and open mind has been the model for philosophers to this day. He was also an important economist. In one essay he commended the classical approach of building up war chests in advance to the modern preference for public borrowing at the cost of future generations. He warned that “either the nation must destroy public credit or public credit will destroy the nation”<sup>2</sup>. Today’s level of public borrowing and money creation would certainly have sent him back to the writing table.
2. That huge increase in public debt has been one notable result of the economic crisis of the last two years. I want today to draw some lessons from that experience for the way we approach regulation of the financial sector and economic policy.
3. Of course, for the moment the focus must remain on pulling the economy out of its tailspin. Recent months have brought a recovery in financial markets and there are also some welcome signs that the wider economy may be beginning to stabilize. There will no doubt be further swings in markets ahead. Equity prices rose by more than 2% on 15% of trading days between 1929 and 1932 (Chart 1)<sup>3</sup>. And, as the ECB pointed out a few days ago<sup>4</sup>, many of the losses facing EU banks have still to crystallize (and the same is true in the US where the full effects even from the housing market are still working through).
4. Nevertheless, there is reason to hope that the last quarter of 2008 and the first quarter of this year will turn out to have seen the biggest falls in output of this recession and that we will now see a steady departure from the path of the Great Depression which we have followed so closely over the last year (Chart 2). That does not mean that the world economy will bounce back quickly. Indeed, recovery is likely to be slow given the need for governments and households to rebuild savings in the US and UK and the continuing reliance on net exports in many other leading economies.

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<sup>1</sup> This is based closely on a lecture at the David Hume Institute on 18 June 2009 but expanded to reflect the subsequent questions and answers.

<sup>2</sup> “Of public credit” in “The essays moral, political and literary of David Hume” first published in 1742

<sup>3</sup> I owe the chart and figures to a presentation by Niall Ferguson

<sup>4</sup> June 2009 ECB Financial Stability Review

5. It is too early to reach final conclusions about the causes and effects of the crisis (indeed no doubt they will be the subject of dispute among economists and historians for as many decades as the causes and consequences of the Great Depression). But I think we know enough to conclude that it calls not just for emergency measures but for major changes in our longer term approach to policy. And this is not just about regulation. For the financial crisis has blossomed into the worst world recession for over 50 years. This has been a failure of macroeconomic management too.
6. So we need to go back to the drawing board not just on financial regulation but on macroeconomic policy and on macroeconomics itself.

### **What went wrong**

7. There is no need to go over familiar ground again. But I do want to point to three special features of the crisis of the last two years.
8. First, its scale. This is certainly not the first financial crisis or recession<sup>5</sup>. And much of the story is familiar from earlier episodes. In the US (and UK) there was too much consumption and too much borrowing particularly for property. That produced a boom in prices which for a long time seemed to justify more lending on ever more dubious propositions. Eventually as interest rates rose and prices stopped rising, defaults began to increase and banks faced losses and funding difficulties. They responded with a credit squeeze which compounded the cycle of defaults. All this was true in the early 90s and the 70s too.
9. But this has not been just another crisis. It has been on a grand scale. The major banks in all the leading industrial countries have had to be supported by explicit government guarantees and many have required government funding. We have not seen a collapse of financial confidence on this scale since 1914. In economic terms, we have seen the level of world trade and world output fall for the first time since the war. And that despite some of the most dramatic policy measures ever taken in peacetime.
10. The boom that preceded the bust was also on a large scale. At its root was the property boom especially in the US (Chart 3). The rise in house prices in the US exceeded not just the average for banking crises in advanced economies but the average of the five worst such crises. Moreover those “big 5” were in Spain, Norway, Sweden, Finland and Japan; this time it was in the US – the world’s dominant economic and political power. (The UK was the tail and not the dog in this world cycle, but we were doing our part as can be seen in Chart 4.)

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<sup>5</sup> Ken Rogoff and Carmen Reinhart have analysed 18 post war crises in “Is the 2007 U.S. Sub-Prime Financial Crisis So Different? An International Historical Comparison”.

- 11.** But, the similarities of this to other booms and busts raise two puzzles: why did an old-fashioned credit and property boom lead to global meltdown and why didn't someone see what was coming and prevent it? The answers are connected and reflect two other new feature of this crisis.
- 12.** The first was the role of credit derivatives. Their explosive growth not only financed a good deal of the bad lending but also did so in a way which helped to obscure the scale of the risks being taken from banks, investors, rating agencies and regulators during the upswing. The doubling of gross bank leverage in UK banks after 2000 seems an obvious warning sign now (Chart 5); but much of the lending was within the financial sector and it was not easy to tell how much was cyclical and how much reflected sustainable structural change. The banks and their regulators thought that the hedging of their balance sheets through the CDS market and securitization was reducing their vulnerability to a downturn. It was a critical and shared misjudgement.
- 13.** Even more important, the complexity of structured credit and the shadow banking sector greatly amplified uncertainty and fear among banks and investors in the downswing. No-one could be sure which institutions would bear the emerging losses on sub-prime assets; nor was it obvious which would run out of finance first as funding markets tightened. So everyone hoarded liquidity and thus compounded the very pressures they were guarding against. This first closed the mortgage - backed securities market and then squeezed the interbank markets savagely (Chart 6). The loss of funding and the asset sales it forced then compounded the losses, slowed down the wider economy, and developed into a damaging downwards spiral.
- 14.** And that spiral did not develop just in the US. The third major new feature of this crisis has been its global reach. Of course any crisis in the US is bound to affect others but the speed and scale of the impact has been transformed as the financial system has become truly global. Like other complex networks, it is much more than the sum of its parts. Like other complex networks it has proved self stabilizing within bounds but liable to catastrophic failure beyond a tipping point. The way that the loss of confidence in one market spread to others had similarities with the spread of epidemics or the breakdown of ecological systems as Andy Haldane has shown in a recent article.<sup>6</sup> Thus the worries about US sub-prime mortgages ricocheted onto markets for all mortgage securities and then to the money markets across the world. The first victims were not the banks with greatest exposure to the sub-prime sector but those, like Northern Rock, which needed to raise a lot of money quickly from wholesale money markets. When Lehmans failed last September the loss of confidence spread from financial markets to confidence in trade and investment across the world.

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<sup>6</sup> [Rethinking the Financial Network](#) Speech delivered at the Financial Student Association in Amsterdam on 28 April 2009

15. Again, both markets and their regulators misjudged how far globalisation had increased the risks of contagion across different national markets.

### **The lessons for regulation**

16. There is now a wide consensus that the biggest failure of regulation was to give too little weight to these systemic links. The crisis has brought home again that it is not enough to ensure that each institution – taken alone - is sound, to spot outliers and rein them back. We need also to identify and reduce vulnerabilities which arise from their interaction and from behaviour which may be rational for one firm but, when replicated many times, can lead to self reinforcing booms and busts.
17. The G20 summit in April showed also a wide agreement on some of the key areas for reform. For example we need to increase capital and liquidity requirements overall and in particular for trading books and for off balance sheet commitments, increase the proportion of equity which is real equity as opposed to subordinated debt, widen the regulatory net to capture big funds and mortgage originators, reduce the prominence of bonuses tied to short term performance, and move more trading onto exchanges ( to increase transparency) and through central counterparties (to reduce counterparty uncertainty).
18. There is less clarity on how radical those reforms need to be. Is it enough to plug these gaps, adjust the dials in the risk models and then get back to business as before? Or is something more fundamental needed?
19. In my view there are four problems which do call for more fundamental changes: “mood swings” in financial markets, moral hazard, regulatory capture, and regulatory arbitrage.
20. *Mood swings in markets* The last two years have brought out as never before the dangers of the swings from mania to depression in financial markets. In part this is genuinely “irrational exuberance” phrase<sup>7</sup>. But a boom doesn’t require irrationality. In markets the prizes do not only or mainly go to the person with the best understanding of fundamental values but to the person who correctly forecasts what others will be willing to pay. It can be rational for investors to follow a trend even when they believe an asset is over-valued on the fundamentals.
21. When exuberance affects credit, the bounce back is much more dangerous than when it is confined to equity markets because the banking sector is highly geared and is so central to the smooth working of the wider economy.

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<sup>7</sup> Alan Greenspan in “ the challenge of central banking in a democratic society” 1996 Federal Reserve bank

- 22.** Part of the answer is to “protect the banks (and other financial intermediaries) against the economic cycle” by making them hold bigger buffers of capital and liquidity on which they can call when defaults rise. In effect, each institution needs more insurance cover.
- 23.** But the financial sector is not a passive victim of a cycle in the wider economy, it is a major driver of that cycle. So we need also to “protect the economy against the banks” through measures which directly dampen the cycle in the financial sector. One way to achieve that would be to adjust capital and liquidity requirements as a proportion of assets in good times and reduce them in bad. That would not just create bigger buffers to absorb losses when they arise but should also lower the peaks of the booms, raise the troughs and make the cycle less fierce.
- 24.** “*Moral hazard*” The Bank of England was criticized for worrying too much about moral hazard at the outset of the crisis in 2007. Our timing was poor but the issue was real then and is much more significant now that ambiguity, constructive or otherwise, about the State’s willingness to let banks’ creditors suffer has been largely dispelled.
- 25.** Markets provide banks considered “too big to fail” with more and cheaper credit than others and thus enable them to expand more quickly and take bigger risks. In the short term, of course, that is part of the cure, but it could make the next cycle even more damaging. For market pressures will push all banks, not just the reckless, to make use of that easier credit. I gather that, even while most are still dependent on government support, investment banks are competing fiercely for good staff with offers of guaranteed bonuses and share options which rival pre-crisis patterns.
- 26.** Of course, banks have had a terrible shock. They don’t need telling that sub-prime mortgages can damage their health. They know only too well that their sophisticated risk management systems prepared them only for showers not for hurricanes. And if they show signs of forgetfulness, at least for the next few years, their investors will remind them. But, improving private sector risk controls only takes you so far.
- 27.** Chuck Prince (the ex CEO of Citi) has been widely condemned for saying: ‘as long as the music is playing, you've got to get up and dance.’<sup>8</sup> But in a provocative way he was only stating the obvious. Banks need to make profits if they are to survive. Their ideal risk management system is one which lets them take profits when they are available and close out risks at the last minute (or, even better, go short and profit from their competitors’ exposures). The investment banks which did best in recent years were not those which stepped back from structured finance and the property

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<sup>8</sup> Financial Times interview in July 2007.

market well in advance but those which reacted most quickly and cohesively when the trouble started.

- 28.** For the individual firm the aim is come first. But, in a competition, someone always comes last. And, as we saw in the autumn, the failure of the weak can start a chain reaction which threatens even the strongest institutions.
- 29.** So we need to rebuild disciplines especially on the biggest firms. That means redesigning our special insolvency regimes so they can be used for bigger and more complex banks and financial conglomerates. With the new Banking Act, the UK has caught up with the best international practice, but the US Treasury is now proposing to go further and we may well need to follow them. We should also follow the US proposals on setting higher capital and liquidity requirements for the firms which are most critical to the overall system (to offset the discount they receive on market funding).
- 30.** The arguments for limiting the overall size of banks or introducing Glass-Steagall split between commercial and investment banking are less clearcut.
- 31.** Certainly, when the dust settles we will need in the UK to examine whether the departure of most overseas lenders and the failure of so many domestic banks has left us with sufficiently competition in all our banking functions. If not we may need to restrict the shares of the UK markets that any one bank can hold. Again boards and executives of universal banks need to consider whether they have or can develop the capability to control such complexity. And, in the light of Iceland's example, countries which are home to global giants need to consider, like the Swiss<sup>9</sup>, whether they want and are able to act as lender of last resort. The one thing worse than a bank that is too big to fail is one that is too big to save.
- 32.** But as global mobility and trade increase, the market demand for banks which can offer a really global service will increase and I don't think we should prevent the consolidation of banks internationally that will drive. Indeed some of the banks that have weathered this storm relatively well, like HSBC, have done so because of the diversification that their size and global reach has allowed. Nor do I think we should prevent them hedging their risks through capital markets or offering their clients a full range of financial services.
- 33.** In my view what is critical is to establish a regime which enables the authorities to take control and wind down failing investment houses and insurance companies as well as banks. In its absence, I don't think a declaration that the State safety net is confined to a core of deposit-taking "narrow" banks will be credible. As we saw last

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<sup>9</sup> See Philipp Hildebrand's introductory remarks at the media conference at the Swiss National Bank on 18 June.

year, the failure of an investment bank can have a devastating effect even on narrow banks.

- 34.** *Regulatory capture and groupthink.* There is much discussion on both sides of the Atlantic of whether a new institutional architecture would be more likely both to identify systemic vulnerabilities and to intervene to reduce them.
- 35.** A cross-country comparison doesn't suggest there is an obvious best buy either on the style of supervision or the on the institutional set up. If the Spanish regulatory system has come out of the crisis well (with its conservative approach to provisioning and derivatives), somewhat similar models involving intrusive bank examinations didn't protect Germany or the US (with its small army of bank examiners working full time inside banks). Canada and Australia seem to have weathered the storm well with a clear separation of supervisor from central bank but the very similar system in the UK has been heavily criticized. Combining the two functions seemed to work quite well for France but not so well in the Netherlands. My conclusion is that a number of different structures can be made to work and that all involve close cooperation across institutional boundaries.
- 36.** One common danger is regulatory capture and groupthink. It is very difficult for any supervisor to avoid sharing a good deal of received market wisdom. The main problem is not that the private sector is full of clever people who can pull the wool over supervisors' eyes – although cooption is a natural tactic for any regulated firm. The greater problem is that firms and regulators tend share misjudgments (as they did for example on the risks in structured credit and wholesale funding). Where a supervisor is addressing idiosyncratic risk, she can contrast the strategies and controls of one firm against others and question outliers. But it is much harder to question common practice especially where it has grown up over several years and has been blessed, or at least permitted, by supervisors in successive incremental business plans. At that point, to raise questions about market practice is also to suggest previous errors on the supervisor's part. More generally, when good market operators not only say but believe that a business line is sustainable, it takes great confidence to insist on a contrary view.
- 37.** One lesson from that is to use rules rather discretion where that is possible – as the Spanish have on general provisioning. But in a fast changing world, judgement will also be needed on systemic risks. It seems to me valuable to have a second pair of eyes alongside the lead regulator and giving a powerful voice to a body which is not engaged in day to day supervision but has a responsibility for taking a top down view of the system as a whole. In the UK, of course, the Bank of England already plays a role of this sort but without any formal authority to give bite to its views. That is unfinished business following the Banking Act. If, as I believe, we are going to introduce a power to vary capital and liquidity requirements with the economic cycle, the Bank should have the lead responsibility for making those judgements,

after consulting the FSA. That would not just empower the Bank, but put beyond question the breadth of its role in maintaining financial stability, after five years in which that has been in question inside the Bank itself.

- 38.** In the US of course there are many more than two pairs of eyes involved but they have come from overlapping and competing supervisory remits. The new proposals from the US Treasury would leave most of that in place and add some new players. It would give the Fed the systemic oversight responsibility but would add that to its frontline supervisory responsibilities. Big groups would still have several supervisors with the risks that brings of overlap and underlap. These are disadvantages compared to the British system but there also some interesting pointers for the UK for example on the role of the Central Bank in supervising not just payment systems but clearing and settlement as well.
- 39.** *Regulatory competition and arbitrage* Lehmans' closure would have been difficult in any circumstances, but working under different national insolvency regimes without a shared understanding among its national supervisors of corporate structure or the pattern of interlocking assets and liabilities made it devastating. The G 20 agreement to establish stronger international colleges of supervisors and agreed contingency plans for global firms is therefore important.
- 40.** Indeed we need to address all the regulatory problems on an international basis including increasing liquidity and capital buffers, introducing counter cyclical requirements, widening the regulatory net, sanctioning breaches of the rules, moving more transactions onto exchanges, moving to a single set of accounting standards.
- 41.** This is a formidable agenda but it should not be seen as a hopeless quest. These are technical areas, not issues like taxation or criminal justice which raise political passions. The main thing holding back international agreement is worry about competitive advantage. This is largely defensive at least among major countries and is based on a lack of confidence (on behalf of both national authorities and their industries) that everyone will keep to the rules and a fear that any national measures will be subject to arbitrage – a classic collective action problem. In my view, the EU has identified most of the right answers here: tighter rules coupled with an effective international quality control on national implementation, a tie breaker in cases of dispute, and a powerful body to monitor and make recommendations on the stability of the system. However it is not sufficient and may be counter-productive to pursue these for the EU alone. They need to be global (at least G20) measures. It doesn't make sense to look at Barclays, Santander, or Deutschebank on an EU basis or to apply a regime to them which does not apply to their main competitors from the US or Asia.

**42.** The main to this programme is a loss of political focus. As acute fears of depression subside, we are already beginning to see some reduction in the pressures for reform. There are calls for caution and against haste. Of course it is always possible to make a bad situation worse by ill judged reforms, but in my experience inertia is a much greater risk than over-reaction, especially in international policy. In the 80s, when the Basel Committee of bank regulators started its work on capital, the plan was to produce guidelines for liquidity as well. But we were still discussing non binding and high level principles when we were hit by the liquidity crisis of 2007. Again, in the wake of the failure of LTCM, a Basel working group reviewed the dangers from a failure of a large global institution and called for a wide range of sensible reforms – nearly all of which remained undone 10 years later. We must avoid repeating those mistakes.

### **Economic policy - the consensus in 2006**

- 43.** The lessons for economic policy are no less far reaching than for regulation.
- 44.** I joined the Civil Service in 1974, just in time to witness the miserable death of the post war “consensus” model. It was a low point for Britain and British Government, when the “management of decline” was widely seen as the best we could do. The 80s and 90s saw the struggle political and economic to build a new market-based model for the economy and a framework for policy that would keep it stable.
- 45.** And in the dozen years leading up to 2006 we appeared to have found it. We achieved not only a long period of stable growth and low inflation which had seemed so elusive but an unusual consensus among policy makers and professional economists on how best to manage a modern economy.
- 46.** Macroeconomic policy should be left to an independent Central Bank, acting through interest rates, which would take politics out of economic management and whose commitment to low and stable inflation would anchor inflation expectations. While that would not iron out cyclical variation in the real economy, it would set the best possible basis for sustained growth. Beyond that, market forces could be relied on to respond to shocks and bring the economy back to equilibrium.
- 47.** Fiscal policy was too slow and uncertain to use for macroeconomic purposes and should be put on auto pilot – allowing some swings in response to the cycle around a sustainable long term path for public debt. Its main impact was on incentives and thus the longer term growth potential of the economy and on the distribution of income and wealth.
- 48.** Regulation too was seen as a microeconomic instrument whose function was to correct or mitigate specific market failures. In the financial sector it addressed, in particular, the imbalances of information between consumers and producers, the

collective interest in maintaining open and competitive markets, and the collective interest in the resilience of key institutions and the risk that, left alone, they would underinsure against failure.

- 49.** In the UK this consensus was embodied in the tripartite division of roles between the Bank of England, the FSA and the Treasury (Chart 7). But the underlying thinking went a lot wider than the UK. The division of roles was even clearer in the Euro area with a split between a supra-national monetary authority and national fiscal and regulatory institutions.
- 50.** And the dominant school of monetary economics showed that Central Banks should be guided in setting interest rates above all by two factors : the gap between consumer price inflation and its target and the gap between output and its equilibrium level. The prevailing wisdom – which seemed to be confirmed by the LTCM crisis and dotcom bubble – was that it was difficult to identify bubbles in advance, probably counterproductive to try to prick them early, and - most important - possible to limit any damage to the wider economy if and when they did burst.
- 51.** The last two years have shown the limitations of the approach. It has proved effective in “fighting the last war” – preventing the type of inflationary boom we experienced in the 70s and 80s. But it had little place for the long build up of global imbalances and of the credit and asset price bubbles in the West which have exploded with such devastating force. Neither the modest estimates of the output gap (Chart 8) nor the stable inflation rates (Chart 9) warned us we were on the verge of disaster. Since then they have offered little guidance on how to respond to the crisis itself. Indeed, they were still pointing to a tightening of policy right up to the summer of 2008, while the global financial system seized up. We have learned the hard way that we need to prevent the build-up of chronic imbalances and asset price bubbles; mopping up after they burst won't do.
- 52.** The crisis has also brought close coordination of monetary, fiscal and regulatory policy (Slide 10). Central Banks and Finance Ministries have been drawn into decisions on the appropriate levels of capital and liquidity for individual banks. At the same time, regulators' requirements (and expected requirements) have become drivers of bank lending and thus of the broader economy. Fiscal policy has returned to a central place in macroeconomic policy both through traditional tax and spending measures and through the recapitalisation of the banks. As Central Banks have turned to quantitative measures and inflated their balance sheets, they have required government underwriting for their risks (especially in the UK where the Bank of England's own capital is so limited).
- 53.** That close coordination will remain essential as the crisis subsides. We have learned that interest rates and inflation targets are not enough to secure stability. Policy

needs also to address asset prices, credit expansion, and imbalances between sectors and between economies. That requires more than one policy instrument. Fiscal policy will remain centre stage. Japan's experience shows how difficult it is to get the mixture right between monetary and fiscal measures as central banks wind down their balance sheets and governments come under pressure to reduce the burden of debt. There are risks of snuffing out recovery and of allowing inflation to reignite.

54. We need also to dampen the credit cycle in future by varying capital requirements and that will require cooperation between monetary authorities and regulators.
55. Yet, in different ways, the US, UK and Euro-area all lack clear frameworks for this coordination. We have had to make it up as we go along.
56. No major country manages these functions with less than three institutions and most have more. So we need a clear framework for coordination which specifies the separate remits and powers but also places a clear duty on each to cooperate to achieve joint objectives and sets up a process which helps it happen.
57. Macro and monetary economics
58. Finally this is a challenge to the profession as much as to policy makers. The influence of professional economists on economic policy has probably never been greater than in the last 10-15 years. The thinking in universities and institutes has been reflected both in policy frameworks and in policy decisions. For most of that time, policy was successful but the reverses of the last two years call for some new thinking. The failings of the orthodoxy with its focus on general equilibrium models, based on near perfect markets and rational expectations, have been exposed. We need a paradigm shift in economics as well as in policy.

## **Summary**

59. To summarise, there are some signs that the global crisis ignited in the US housing market two years ago may have past its most acute phase even though it is too early to announce recovery let alone judge how sharp and robust that will be.
60. But the experience has important lessons for our approaches to regulation and economic policy and for economics itself. And, as fears subside, we must not allow the impetus for reform to weaken. Inertia, particularly in international policy, is a far greater risk than over-reaction.