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EDITORIAL

The Financial Crises

Report by Robert Boyer, Dominique Plihon and Mario Dehove

Financial crises have become more frequent in recent years. They have also changed in nature. Most of these crises remain difficult to predict and are open to interpretation even after the fact.

The purpose of this report is to paint a comprehensive picture of crises in the banking and financial sectors, to analyse the mechanisms by which they appear and spread (contagion phenomena playing a crucial role in systemic crises) and arrive at some recommendations for economic policy.

This is an area in which the intervention of the state in the wider sense, including via independent central banks, scarcely needs justifying given the large number of externalities at play and the extent to which financial stability has, along with monetary stability, become a public good at the world scale through financial globalisation.

Some recommendations are in tune with the present institutional framework. Others, because they impinge directly on global governance, would require the framework to be transformed.

Christian de Boissieu
Executive Chairman of the CAE

Financial crises are becoming more frequent and affect all countries, at all levels of development. However, they can have a particularly serious economic and social impact on developing or emerging countries.

For our purposes, the term «financial crisis» has a very broad meaning. It encompasses stock market, bank and currency crises as well as sovereign debt crises. In fact it is difficult to view crises in isolation given the strength of contagion phenomena across sectors and countries.

Where do these crises come from? What are the underlying mechanisms? Can we do more to prevent them? These are the questions the authors try to answer. Their report leads to a number of concrete suggestions.

The report was presented at the plenary meeting held on 7th June 2004, in the presence of the Governor of the Bank of France. This letter, published under the direction of the permanent unit of the CAE, summarises the authors' main conclusions.

At the beginning of the crises: a few mechanisms at play

Both theorists and practitioners have displayed renewed interest in analysing the weakness of the financial system and the risk of a systemic crisis. This may be ascribed to various factors, including the frequency of major crises, the scale and often unexpected pattern of contagious phenomena, the difficulty in preventing their occurrence and their major impact on public finances, both in terms of growth and greater inequality.

Initially economists produced a series of models describing the currency market crises in Latin America, the volatility of exchange rates associated with self-fulfilling prophecies regarding the feasibility of European monetary integration, followed by the dual banking and currency crises after 1997 in South-east Asia. The increasing amount and diversity of research (historical, empirical, based on panel data, theoretical in terms of formalisation) brings to light a small number of constant mechanisms which trigger the crises.

The pro-cyclical nature of risk-taking represents the most important mechanism

regarding bank lending and the financial markets: agents' propensity to take risks tends to grow as the economic climate improves. Ease of access to credit represents a second factor that propagates imbalances from one market to another. This factor affects the allocation of virtually all assets, and accounts for contagion from one market to another via a mechanism similar to a financial accelerator. Given the *growing interdependence of financial markets*, speculative flows are disseminated from one country to another. Even though they are dissociated from each other they are drawn together through the involvement of financial market agents. Finally, while the theory of rational choice may account for the emergence of weaknesses in the financial system, historical and empirical evidence suggests that speculative excess is aggravated by phenomena such as *mimicry*, *loss of memory* in relation to previous crises or over-confidence in individual decisions versus those of other market players, not to mention *blindness in the face of disaster*, a typical pattern at the end of periods of speculation.

The intrinsic fragility of the financial markets turns into vulnerability in the event of the synergy of these three series of factors. The way they combine is always unusual and even idiosyncratic, to the extent that crises almost never re-occur in an identical fashion, as they always have a specific pattern... which invariably comes as a surprise even to the most observant analysts. Some imbalances do not produce crises and if they do they are resolved very quickly. Conversely under other scenarios vulnerability leads to a systemic crisis which affects the whole of the financial system, extending even to the social and political arena, as illustrated by the crisis in Argentina.

The scope of the crises crucially depends on the banking system

The difference can be ascribed to the degree of *concentration/dispersion of risks* and the degree of *resilience of the banking system*. Financial crises are particularly serious as all the risks tend to be concentrated on banks, which are vital for the continuity of the payments system and lending relationships. For example, this accounts for the fact that the Internet bubble in the United States did not reproduce the speculative bubble at the end of the eighties in Japan: the risk management implemented by American banks was relatively adequate and a large part of the risk was passed on to other agents, as opposed to the consistent under-estimation of risk and the concentration thereof on banks in Japan.

Broadly speaking, the history of major speculations and the attendant financial crises show that the latter *are due to innovative measures* that either affect the financial sector itself or the real economy via both product and process innovation. In recent history, *financial liberalisation* has played this role as banks have been compelled to adopt high-risk strategies, and especially as innovation requiring stringent checks and supervision on the part of the public authorities has extended to countries with a weak financial

system. This accounts for the contrast between the surprising resilience of the countries with a well-established financial tradition and the increasing number of crises in the most vulnerable countries. Significantly, the scale of the actual imbalances created by the speculative excess of the New Economy has produced a sharp but orderly decline in the stock market. Conversely, imbalances that seem relatively minor with hindsight, led for example in Korea to the deepest crisis and institutional restructuring undergone by the country since the end of the Second World War.

Public intervention is justified

Are financial crises triggered by the insufficient role attributed to market mechanisms... or should they on the contrary be ascribed to the intrinsic vulnerability of financial markets that leads willy nilly to regular intervention by the public authorities? A large amount of research material reflects the view that the financial markets are fairly efficient in macro-economic terms, insofar as they reduce relatively minor anomalies; however they are unable to prevent periods during which their allocation of capital in sector and macro-economic terms is highly inefficient. This is one of the reasons –but not the only reason– for public intervention. Financial markets can generate for *externalities*, both in terms of strategies at a given time and inter-temporal strategies; this is one of the main reasons given for intervention by the public authorities. Finally, maintaining *financial stability* is all the more vital as part of the social benefits structure –for example defined-contribution pension schemes– is processed via the markets. Another crucial consideration is the devastating impact on well-being and investment of a *disruption in the continuity of payment and lending channels*. Ultimately the growing number of regulations governing financial activity are the direct *consequence* of the intrinsic instability of the relevant markets, rather than the main reason for the latter.

However intervention by the public authorities is likely to create various moral hazard problems which also has an impact on the source of the crises. For example, compulsory insurance of bank deposits may lead to excessive risk exposure in lending and therefore to cause a run on the banks. Nevertheless the appropriate solution is not to discontinue this type of insurance but rather to design and implement *prudential rules* governing lending, which should itself be based on increasingly sophisticated risk assessment procedures.

In light of the successive financial crises since the eighties, how can the public authorities intervene both at a national and international level? The report suggests six avenues to be explored, both for countries with a well-established financial tradition and those which only recently embarked on the modernisation of their banking and financial system.

The quality of information must be improved

The first proposal concerns the improvement in the quality of the information required for the proper functioning and the *credibility* of the financial markets. After the growing number of financial scandals (such as Enron, Worldcom, etc.), the accounts submitted to financial market participants clearly have to provide more reliable information. This requirement is highly necessary for investors governed by less stringent rules than the banks in terms of submitting information to regulatory bodies and the markets. Furthermore the fact that the rating agencies operate as an oligopoly requires intervention on the part of the competition authorities. This would ensure greater independence in terms of ratings and a quicker response to developments at corporation and government level. In the era of transparency of economic units in relation to rating agencies, the latter should specify their assessment principles and methods.

However we cannot expect these measures to ensure that stock

market crises either cease or become milder. History shows that accounting irregularities become frequent during periods of speculative excess of which they are the expression rather than the cause. Moreover, the Internet bubble showed that the publication of huge losses would not in itself elicit vigilance on the part of financial market participants since there was a widely held belief in an unprecedented increase in return on capital. Finally we should not forget that banks and financial intermediaries justify their existence and generate their profits through the use of regular access to information. It is therefore futile to seek to remove them altogether as this would imperil the very existence of the financial systems.

Public authorities have a role to play as reminders

The second recommendation may seem paradoxical as it entrusts to historians/economists and to the public authorities the task of reminding the private agents that both real and financial innovation may create speculative excess that will lead to financial crises of varying magnitude. Given the generation transition, private agents tend to forget the sequence of events that led to previous crises. The belief in a new era in which the previous criteria of financial assessment and prudence no longer apply periodically re-emerges. Economists have to draw on financial history in order to remind financial market participants of similar instances of speculative excess. The public authorities –central banks, banking and financial market supervisory bodies, international bodies– should also publish their diagnosis of the likelihood of a period of speculation and therefore of *financial vulnerability*. This role derives from the fact that the public authorities are entrusted with ensuring financial stability and preventing systemic crises.

Redefining the Central Banks' objectives

The third proposal draws on the second recommendation regarding the policy of the central

bank. The development of the financial sector produces an unusual situation requiring a redefinition of the objectives and tools of monetary policy. In the sixties, *the Keynesian central banker* was required to strike the best possible balance between inflation and *full employment*, thereby emphasising the latter to the detriment of the former. The eighties saw the emergence of a *conservative central banker*, i.e. almost wholly dedicated to preventing inflation and maintaining *monetary stability*. Under this scenario victory could mean maintaining low interest rates, thereby stimulating continued expansion, but also an excessive rise in equity markets, bank lending and often commercial and residential real estate prices. Whether he recognises it or not, the central banker thereby favours the emergence of speculative bubbles, as suggested by the Japanese experience of the eighties, followed by the American experience of the nineties. The analyses of this report tend to suggest that this is far from inevitable.

Maintaining *financial stability* should be added as a further role in addition to monetary stability, and of course the central banker should be provided with an additional tool: the possibility to publicly warn that in all likelihood the excessive rise of lending and asset prices signals the beginning of a speculative phase requiring dual action: firstly, an interest rate hike as a signal to the financial community and not only a tool for managing demand; secondly, intervention on asset prices via an existing or specially established government body. In France, the Caisse des Dépôts has in the past played the role of stabilising stock market prices. Property agencies may also fulfil the same role regarding the price of land and, via a knock-on effect, commercial and residential real estate.

Complementing Basel II by macro-prudential provisions

As is the case for transparency of information, the need to produce

a highly accurate assessment of risk should not be underestimated. American banks have hitherto withstood the bursting of the Internet bubble remarkably well, whereas the Japanese banking system has still not overcome a crisis that emerged a decade ago: the difference is mainly due to better assessment of risks and to the quality of prudential management, both of which were introduced in Japan at a much later date. Against this backdrop, the report emphasises the usefulness of the provisions established under the Basel II agreements. On the one hand, the procedures are meant to extend to all countries, thereby responding to financial globalisation. On the other hand, these new agreements address some of the shortcomings of the previous one in that it uses far more sophisticated methods for assessing and measuring risk depending on the type of loan and financial asset.

However the report emphasises some of the risks arising from the provisions of Basel II, reflecting a widely held view among specialists and researchers. First of all, while the assessment only takes into account contemporary risk, the heightened sensitivity of bankers to risk could accentuate the *pro-cyclicality of lending* which is one of the main sources of financial crises. Above all, the increase in capital requirements will have redistributive effects detrimental to categories of players viewed as representing greater risk (particularly small and medium-sized companies and developing countries). Finally, Basel II implicitly assumes market efficiency if micro-prudential legislation is taken into account, against a backdrop of heightened systemic risk.

The report recommends a revision of Basel II and a drive towards *macro-prudential provisions*. Risk management should emphasise the smoothing of cycles through early provisioning of credit risks. Ideally the risk premium should increase as the expansion phase persists and should on the contrary decline sharply once the economy enters into a recession. In a way this

implies redeploying the forms of competition in order to prevent the struggle for market share in the banking sector from reducing the risk premium during a period of growth.

In macro-prudential terms, the authorities should develop tools enabling them to analyse the capacity of the financial system to withstand the synchronisation of some weaknesses or the impact of a major macro-economic shock simultaneously affecting the banks (currency crisis, sharp rise in interest rates, recession...). Finally some public agencies may rate players and countries that have not been covered by the private rating agencies.

The report expresses its concern, similarly to the regulatory bodies and most of the French banks, regarding the threat represented by some aspects of international accounting normalisation (IASB). This is particularly true of the implementation of the *«fair value»* principle which would accentuate the instability of banks' accounts and the pro-cyclical behaviour of the latter.

Controlling capital flows in the most vulnerable countries

The last two recommendations relate more to the prevention and handling of financial crises in countries that have opened up most recently to international capital flows. Virtually all recent research converges towards the same conclusion: the frequency of financial crises in these countries is due to premature opening to financial liberalisation, in the absence of further reforms improving the strength of the banking system and the conduct of macro-economic policies aimed at stability. The critical reassessment of the benefits of liberalisation relate to two other points.

First of all, financial capital flows do not have any clear link with performance in terms of growth or even well-being as measured by child mortality rates and life expectancy. It is therefore wrong to view opening up to international trade and accepting the full

mobility of capital flows as identical policies: the former very often contributes to growth, whereas the latter accentuates macro-economic instability, increases the magnitude of fluctuations and does not stimulate growth. Finally and more importantly, instead of playing a contra-cyclical role, capital inflows and outflows further accentuate internal instability.

This does not apply to foreign direct investment which ensures technological modernisation without introducing specific macro-economic imbalances, provided it is disseminated to the rest of the economy.

In light of these results and the change in the intellectual climate regarding financial liberalisation, the report suggests three types of measures. In order to avoid a destabilising inflow of capital, the establishment of *required reserves* or, as an alternative to the latter, of a taxation system, seems to have proved its efficiency in adjusting economic performance, without introducing any major productive inefficiency, as illustrated by the Chilean experience. This principle has been made clear to the financial community and the reserve ratio or the tax rate are determined on the basis of the situation in the domestic economy.

If a balance of payments crisis proves inevitable, *control over capital outflows* should be seriously considered. Broadly speaking, the permanent establishment of this kind of measure would enable a higher portion of domestic savings to be retained, thereby encouraging local intermediation in national rather than international currency.

In light of the successive dual banking and currency crises, we should highlight the threat arising from the coexistence of a national currency and a hard currency that can only appreciate. Even though it is paroxysmic, the Argentine example warrants analysis by the leaders of countries that have recently opened up to international finance. Pegging the national currency to another currency may forestall an acute phase of hyperinflation and/or mistrust of

the national authorities... however it cannot be considered as an irreversible measure that defines banks' lending policy and corporate and individual borrowing policy. *Liberalisation of the internal financial system* should ensure a better balance between savings and national investment, thereby avoiding subjecting each country to the uncertainty and mishaps of international financial intermediation.

Improving the functioning of the IMF

The last proposal relates to the architecture of the international financial system. Financial globalisation limits national central banks' capacity to act in isolation and seems to require the establishment of a lender of last resort (LOLR). From this standpoint, it would suffice to extend to an international level the process via which the national central banks have emerged in order to overcome the successive banking crises throughout the 19th century and in the early 20th century. Given the drastic scale of IMF intervention required to overcome the Mexican, Russian, Turkish and other crises, it would appear necessary to transform this international institution into a lender of last resort.

However this solution is far from straightforward as the role of lender of last resort relates to a national framework. The IMF is not empowered to issue currency as it merely redistributes the reserves contributed by member states, even if the relevant amounts are increased through the use of Special Drawing Rights.

Furthermore it does not always intervene as quickly as necessary and its strategy is facing a fierce challenge. Moreover given the coexistence of a large number of currencies, liquidity injections may prove ineffective as they are immediately converted into hard currency. The establishment of a LOLR therefore requires a procedure for blocking capital outflows, as discussed in one of the previous proposals.

Finally it is far from certain that the IMF has access on a real time basis to the financial information available to the national central banks in order to manage national crises. This would tend to suggest that the LOLR should be the Bank for International Settlements or an association of the central banks of the main countries. However neither one nor the other have the required resources to implement this type of policy, especially as in many cases, providing the banks with liquidity goes hand in hand with re-capitalisation using public funds.

Ultimately reinforcing international financial regulation requires sweeping reform of the IMF in three main areas. In terms of organisation, representation of the main member state groups should be more balanced at the level of the governing bodies. Furthermore, the resources that can be used by the IMF and the SDR credit facilities should be increased. It would also be appropriate to review the principles underlying its actions as the effectiveness and legitimacy of the latter have been fiercely challenged as a result of the handling of recent financial crises.

Comments

Antoine d'Autume agrees with the report's main conclusions: the free movement of capital has not fostered growth in developing countries; herd behaviour tends to precipitate crises; a robust banking system is a key element of prevention, etc. The pro-cyclicity

of lending is well argued, but the authors develop a personal interpretation: not only does the pro-cyclicity of lending accentuate the cyclicity of the economy, but it increases in response to imitative behaviour, which may lead to an overt crisis. The case of the Argentinean crisis is well presented. However, it is not certain, as the authors claim, that the currency risk associated with dollar-denominated debt was unhedged. Ultimately, it was the economic slowdown in conjunction with a drop in tax revenue that caused the system to collapse. Antoine d'Autume does not dispute that the spontaneous operation of markets is unsatisfactory and that regulation is required. The problem is that government intervention is subject to the same imperfections as those it is trying to tackle. While he believes that adding macro-prudential supervision to micro-prudential regulation is an appropriate solution, he has reservations about the role of central banks, which are incapable of largescale intervention.

Gilles Étrillard contests the report's conclusions. As far as he is concerned, the issue is not so much one of describing and predicting financial crises, or even of preventing them – which the models have proved incapable of doing – since they are inevitable. Instead, we should be examining the role of crises in the dynamics of growth and taking steps to encourage their resolution. Crises are healthy in that they correct past excesses and bring market participants back to simple value equations, such as the difference between the inverse of the price-earnings multiple and the general level of interest rates, excessive monetary creation and excessive asset/liability mismatch or leverage outside of the banking sector, etc. The bursting of the dot.com

bubble, which corrected a period of collective derangement, is significant from this point of view. Gilles Étrillard also argues that financial innovation has increased the markets' capacity to absorb crises by allowing a greater spread of risk and better diversification of portfolios. In this sense, the recent ability of developed economies to withstand financial crises is precisely due to financial deregulation. Finally, he believes that the idea that externalities justify government intervention is meaningless.

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