

FINANCIAL CRISIS: THERE IS A NEED FOR ECONOMIC GOVERNANCE

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The world-shattering burst of the American financial bubble in 2008-2009 is still so close and the economic shock caused is still so paralyzing that it will take probably years to scientifically assess the lessons learnt. My point is that the evaluation of the unprecedented financial and economic collapse depends mainly on the economic philosophy attitudes. The true followers of neo-liberalism find that this could be one of the new manifestations of Schumpeter's „creative destruction”. Meaning that the self-regulating market is doing just that: adjusting itself. Nevertheless, American researchers found that altogether 38 financial crisis were registered from 1945 to the seventies. This number increased significantly to 139 ever since the neo-liberal line started to dominate from the seventies until the end of the century. That is why it is also advisable to listen to those, who say that seeing the current financial crisis, we must rethink even the axiom-like theories. Such as, for instance, if we deregulate the financial markets, they would always become a place for a noble competition for the customers. The state should be small and cheap. Can we apply this well-known requirement when the states had to compensate for thousands of millions of market losses, from public funds? We could see this all in the 2009 bank rescue packages. Nobel Laureate J.E. Stiglitz at the Davos Summit blamed those American financial leaders, who tried to make themselves look like victims. In his opinion they were actually perpetrators who threatened with economic collapse. And this way they successfully blackmailed the governments for the enormous rescue packages. What is more: the new funds were often not used to facilitate lending, necessary for economic re-start. A number of stories went around in the global media telling cases about bonuses and dividends that „disappeared” from the system.

If we try to summarize the main reasons of the collapse, we can say that the Anglo-Saxon type of basically security-based financing practice, the extreme deregulation of the financial markets and the higher demand for liquidity in the global economy all together caused the formation of this record size „bubble”. It is known from many analyses that external funds from ventures are financed in the Anglo-Saxon countries mostly from securities, issued on the capital markets. This means a much liberal „external control” over company management compared to the mostly bank-financed continental practice. That is why the main, almost the only proof of successful company-management for a capital market investor is a return, achievable on the short run. The large part of the American bankruptcies prove that financial managers chased after financial products promising higher returns, but with higher risks - as it turned out later - because their salaries and bonuses depended mostly on quarterly sales indicators. We would call this manager motivation a „Kornai-paradox” because this is a denial of Harvard Professor Janos Kornai's theory. Kornai said in his famous work of 1980

„The Economics of Shortage” that under private ownership conditions „tough budgetary restrictions” always work. These restrictions prevent irresponsible decisions of capital investments. Unfortunately the bank collapses indicate that these restrictions did not work at all. What is more: many decision makers were not risking their own money, but rather that of their depositors. These motivations could also explain to some extent why the American Government and financial supervision authorities failed to resist the constant pressure of powerful deregulation lobbies. Since the first deregulation campaigns of the Reagan Administration, they managed to bring financial market regulations down to a minimum. So the highly complex and ever more risky electronic „financial products” could fly high in the last couple of years. The institutional risk and vulnerability also grew since banks could increase their high leverage to an extreme level, because restrictions were lifted too, often they reached a 30 or even a 60 index. The heavy growth of the global economy since the mid-90’s increased the liquidity demands as well. Countries accumulating huge commercial surpluses against the US (such as China and Saudi Arabia) put their significant reserves into reliable, but low return American Treasury bonds. Paradoxically, this also increased the demand for more liquid real estate or other asset-based securities, promising extra high returns.

The real effects of the extreme financial market deregulation can be seen clearly in the 2007-2008 „bubble formation”. The key factor was that the security-packages of the American mortgage debtors were bought and sold by the financial institutions without any form of control in hundred billion dollar lots. Because of the shortcomings of financial regulation and supervision, the financial rating companies were allowed to rate these „products” at the highest reliability category, AAA. These companies misled not only the investors, but the leaders of the banking sector as well. It must not be a surprise, knowing that these rating companies were remunerated mostly by the issuers of such tools. Then in the last several years American financial institutions heavily involved in the risky „derivative business”, tried more and more to foreclose on the mortgaged properties, which led to the collapse of the real estate market. This is how the famous securities became „toxic”, to put it mildly, meaning worthless. The „derivative bubble” burst, forcing the bank system to write off losses, in a value of thousand billion dollars, which in turn first led to the collapse of international lending, then to the collapse of the real economy, which unfortunately still lasts today.

Analyzing these failures we have to come to the conclusion that - due to the globalization of finances - the current bank and capital market supervisions working within national frameworks are not suitable to handle the financial crisis of this magnitude. This is even more true for the international supervisory institutions. The greatest contradiction made visible by the financial crisis is that the international supervisory bodies have practically insignificant capital and organizational power as compared to the financial conglomerates with huge amounts of capital and global scale of activities. The makers of the De Larosiere Report disclose rather sincerely and realistically the dimensions of the problem: Such financial giants are so vast and complex that, they are, to some extent, ’too big to manage’, and ’too big to fail’; in some instances these institutions can even be ’too big to save’. The global financial supervision system would naturally not be some supranational „super authority”; probably

this has neither professional, nor political foundations. International experts look for the way out of the current crisis more in the direction of trying to convince the leading economic powers of the world of the need to globally coordinate financial regulation.

The realistic goal could be putting an early warning system in place, which would warn decision makers about international financial stability risk factors. A so-called international risk map and an international credit register would be part of the system. These latter tools would provide an up-to-date registry of data on interbank and retail banking, so most risks would be much easier to identify. Ongoing registration would cover all financial sectors and institutions and major financial products. However, the early warning system would be more than just a mere registration of the „danger zones". For example IMF could make recommendations to decision makers on specific preventive measures, too. But for this IMF member states would need to pledge that they would accept the analyses given by the system. They should publicly justify if they do not comply with the recommendations (comply or explain procedure).

A promising step toward the globally coordinated „economic governance" is that the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision announced a substantial strengthening of existing capital requirements. In addition, banks will be required to hold a significant capital conservation buffer to handle future periods of stresses. Another important element of the strengthening of global supervision is that regulations would also cover the poorly regulated or „non-cooperative" off-shore areas that significantly increase risks. The idea is that global supervision bodies could require substantial extra regulatory capital from institutions that keep their assets in such areas. Many experts say that the challenges are enormous and our responses so far, are weak, with many uncertainties. But looking at the destruction caused by the current crisis, we must be firm and determined to find solutions.