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THE FINANCIAL CRISIS: IRELAND AND THE WORLD

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Introduction

"The global financial crisis was caused by a lethal combination of fear and greed?" Yes, and no. "The Irish dimension of the crisis was a consequence of our wide-open exposure to the rest of the global financial system?" Yes, and no. "At least governments have acted decisively to correct the problem?" Yes, but misdiagnosis at first meant that the early actions taken had a very limited impact. "More bank capital is a key element of the solution?" Yes, but not in the way you may have in mind.

Soundbites like these are only half-truths which require a closer look if we are to understand better the origin, transmission and policy needs of the crisis.

Like solar eclipses, system-wide financial crises are a rare occurrence in any given country. We haven't had one in Ireland for well over a century. There's a running gag in Sean O'Casey's 1942 play *Red Roses for Me* in which an eccentric character called Brennan anxiously buttonholes whoever will listen, seeking assurance that his investments, deposited in the Bank of Ireland, are safe… "as if St Peter himself had the key of where the bonds are stationed, eh?" The hilarity of this tends to escape us today, shell-shocked as we are by seeing failing banks worldwide, to the point where the Irish government felt the need to step-in with its blanket guarantee of depositors.

But, as with solar eclipses, in any one year there's usually a handful of systemic banking crises in progress somewhere in the World. Over the past thirty years or so, well over a hundred systemic crises have been documented. By studying these crises, we do get an understanding of how they can emerge and evolve. They are not all the same, of course, that's another fallacy. Indeed if they were all the same, it would be easy to step in and stop one before it got going.

And unlike solar eclipses, they are not predictable. So I won't try to pretend that I foresaw all of this mess that we are in. Of course I read the Jeremiads of Nouriel Roubini, easily the most distinguished of the recent prophets of doom. But I was inclined to discount his pessimism, because I knew him to be primarily a macroeconomist, with no particular claim to expertise in matters of bank risk management. And I had a touching belief in the capacity of the big international banks to make good use of the mathematical and statistical techniques of risk management that have been refined over the past few decades. Certainly, banks were employing risk management tools to build very complex transactions with confidence. Indeed, they adopted these powerful tools with *overconfidence*. Ironically, it was the excessive confidence placed in these tools that resulted in them becoming a Trojan Horse, destroying the system from the inside.

How did it happen?
Professor Roubini made the right call because he was not blinded by this science. The tools of risk management are powerful indeed, but (to mix metaphors) they are a two-edged sword, especially dangerous in the hands of those that do not recognize their limitations.

Thus, bankers and their regulators did *not* simply stumble into the same old trap as others had before them. It was *not* that they had failed to learn the lessons of past crises.

Of course borrowing short-term to lend long is risky. Of course bankers are constantly finding ways of circumventing onerous regulation. Of course there are skewed reward structures for bankers heads I wins, tails you lose (for example, loan officers that are rewarded for bringing new business even if the borrower subsequently defaults). Greed and fear are always with us.

In fact, it was to cope with these known sources of vulnerability that risk management tools had been refined; and at first they performed well. Certainly, by generating more accurate predictions of risk and by spreading the risk among many lenders, these systems had allowed banks to do new types of business with apparent safely. But the risk management models were pushed well beyond their true capabilities, being employed to assess the riskiness of increasingly complicated and unproven transactions and contracts.

In the hands of the *unscrupulous* – keen to close a deal that earned a fee – these models could be – and were – manipulated in hard-to-detect ways to display less apparent risk than was actually being assumed.

The Swiss bank UBS, for example, was awarded the title "Best Risk Management House in the World" in 2005. But an inquiry has shown that, only the following year, some ambitious bank officers figured out exactly how to fool the internal risk management system by tweaking the risky contracts that they were undertaking so that they would just slide in under the radar. Senior management assumed they were fully protected against such abuses. But they weren't: UBS lost $44 billion as a result of such manipulation.

In the hands of the *ignorant*, the models were equally lethal. Many lenders relied on rating agencies to do the risk assessment for them; but the rating agencies competed against each other to grant high ratings to these complex securities, constantly erring on the side of optimism in the assumptions they fed their models. Most investors did not have the time, information or expertise to second guess these specialists, and so they trusted the models.

Soon most of the world's largest banks were operating in this way. The temptation to turn a blind eye was great when the fees being earned were so high.

But the banks were playing with fire. They took ever larger bets, especially on securities tied to the US sub-prime mortgage industry. These bets were out of proportion both to the cushion of shareholders' capital available to absorb losses and also to banks' own customer's deposits – so they were financed through short-term borrowings by the banks from other pools of investment.

In particular, the huge flows of lending for house purchase – for rich and poor alike – drove house prices in many parts of the US to unsustainable levels.

As soon as house prices started to slide from these unrealistic heights, the shortcomings of the risk models began to be revealed by losses and defaults on a scale that threatened the solvency of some banks.

Quite suddenly, a revulsion set in. And here is where the Trojan horse proved most lethal.

For now it began to dawn on each bank in turn not only that its own risk management systems were deeply-flawed, but that the same was true of all of its fellow banks with which it was doing business on a daily basis.

Interbank lending collapsed, meaning that each bank might not be able to borrow cash when needed. Hoarding ensued. Normal channels of credit dried up as the solvency of would-be borrowers and of their suppliers and customers all fell under suspicion.

As has happened so often in the long and episodic history of systemic financial crises, the downward spiral of confidence has been feeding on itself. Investors have postponed new activities, putting pressure on the viability of their suppliers. Even when they have firm orders, exporters have found it difficult to get credit because of lenders' fears that someone along the financing chain might fail. Now the global crisis has spread beyond the purely financial, and reached into almost every country to a greater or lesser extent.

The Irish banks are hit

Most acutely hit at this stage were countries and firms which had been relying on inflows of funds from abroad. Like others, Ireland had been enjoying a house-price and construction bubble. This had nothing to do with the financial innovations that drove the subprime boom in the States, but it had been fuelled by huge amounts of bank borrowing from abroad. Between 2003 and 2007 Irish banks increased their *net* borrowing from abroad by an astonishing 50 per cent of annual GDP. (Even the Icelandic banks didn't import funds on that scale).

Here is where globalization plays a significant part in the Irish strand of the crisis: funding of such loans would not have been so effortless in the past. Furthermore, it was euro membership – another aspect of growing openness to the rest of the world -- which had driven down Irish interest rates so sharply in 1998 and helped trigger the demand for credit to buy houses.

Such high levels of foreign borrowing did leave the Irish banks vulnerable to a change of foreign sentiment. As the months wore on, after the Irish house price bubble burst in early 2007, it became increasingly difficult for the banks to roll-over these funds and it seems that, on September 29th, one of them was unable to do so. The fear that the same fate would befall others was behind the Irish Government's decision announced the following morning, to guarantee all of the borrowings of the Irish-controlled banks.

But it would be a mistake to suppose that the Irish banks' difficulties derived solely from the freezing of the world's credit markets and the sudden stop which it imposed on their borrowing. Their enthusiastic willingness to use those foreign funds to finance an unsustainable housing bubble had, certainly by 2004, resulted in unaffordable prices and building far in excess of national needs.

The Irish banks are thus left with a very lopsided portfolio of assets, relying heavily on property-related assets at a time when house prices were falling by almost one per cent per month, and with unemployment rising, making it difficult for borrowers to service their loans.

The banks have made estimates of the sizable likely loan losses they will incur: but full provision for these foreseeable losses has not yet been made in the bank's accounts, which is why their capital is widely thought to be inadequate despite seeming to satisfy regulatory requirements.

There has been a lot of confusion about bank capital and why it is good to have a lot of it. Recall that capital is essentially the excess of a bank's assets over its customer liabilities, and it serves as a buffer to absorb any unexpected losses. Without an adequate buffer, a big shock could trip a bank into insolvency, or in our case a call on the government's guarantee. Moreover, experience around the world also confirms that banks with little or no capital are inclined to take big risks – after all, the shareholders have little to lose (the government will pay if the gamble fails).

You will, perhaps, have noticed that in describing these functions of capital, I have not mentioned its role in enabling an expansion of new lending. To be sure, a properly regulated bank is required to maintain a buffer of capital in proportion to the risks of lending. But, regulations aside, injecting capital will not increase the ability or willingness of a bank to lend in any mechanical way. There's no automatic multiplier. A nervous bank will not lend regardless of how much capital it has.

The Mexican experience in the 1990s is quite a cautionary tale in this respect. The banks there had recently been re-privatized after the earlier 1982 crisis, but this privatization was handled very poorly. In effect (and oversimplifying), much of the capital that each of the new owners injected was borrowed from the other banks. Thus as a group, the newly privatized banks had really put up very little genuine capital. That probably explains why these bankers gambled with depositor's funds, lending them to related parties, until they collapsed in so-called Tequila Crisis of 1994.

The lessons from Mexico don't stop there. After Tequila the banks were restructured and reprivatized. The new owners, including big international banks, had plenty of capital. But they were nervous, seeing what had happened before, and bank credit to the private sector shrank, and remained low and stagnant for a decade. Rebuilding the banking system's willingness to lend on a secure basis does require capital; but it is not panacea.

Containment and resolution
If the financial authorities have not prevented a systemic banking crisis, their task for the financial regulator shifts to containing the crisis, and then resolving it effectively. Learning from scores of banking crises around the world in the past three decades, the driver's manual for this task calls for prompt intervention in any *insolvent* bank that is unable to raise additional capital from shareholders; deposit insurance schemes should provide *peace of mind* to small depositors; and the central bank should make sure that *liquidity*, or loanable funds, are available to all sound banks.

With hindsight, I have to say that the performance, along these three dimensions, of financial sector policymakers in the US and Europe over the past eighteen months has been somewhat disappointing.

Deposit insurance schemes did not contribute in a positive way. The British scheme was the first to be tested. Its design features, including the fact that deposits (beyond the first £2000) were not fully covered, and the lack of any assurance that payout in the event of a failure would be prompt, these features meant that deposit insurance was not only wholly ineffective in preventing a run on Northern Rock, but in fact probably contributed to it.

Again, long-standing unresolved issues of dealing with deposit insurance where banks from different countries operated across borders came home to roost—spectacularly in the case of Kaupthing Bank. Here the bank's assets were frozen by the British Government, using an anti-terrorist law, because they doubted that Iceland would be willing or able to make the promised payouts to British depositors at another failed Icelandic bank.

The first version of the Irish government's guarantee of deposits also elicited an angry response from Britain because it discriminated against non-Irish controlled banks.

The Irish guarantee was easily the most extravagant of the various government guarantees that were introduced in September and October when governments at last reacted in a comprehensive way to the crisis. But that doesn't make it the best. Indeed, my own analysis of previous crises points to unlimited guarantees and tolerance of low capital levels as policies that tend to add to the cost of crises. Wherever in the world I have gone in recent weeks, policymakers complain that the demonstration effect of the sweeping nature of the Irish action forced their own hands into following suit--albeit with more limited guarantees that they have introduced with considerable misgiving.

Only along the third dimension, provision of liquidity, was there early and vigorous action. Certainly from early August 2007 on, central banks did make valiant efforts to preserve credit availability at their target interest rates. But they were not wholly successful in this, and the market for interbank lending has been functioning very imperfectly.

In contrast to these vigorous efforts to ensure liquidity, relatively little was done at first to deal with insolvency. What's the difference. The best way of describing the difference between these two is to say that illiquidity can be fixed with a loan; insolvency can't – it needs a grant or a gift. Providing a loan may seem a perfectly sensible solution to anyone whose closest encounter with bank failure comes from watching *Mary Poppins* or James Stewart's *It's a Wonderful Life*, in which the arbitrariness of the bank run is portrayed to be the very essence of a crisis. Unfortunately, while illiquidity is obvious, there's usually a deal of insolvency lurking in the background. This needed to be dealt with.

It wasn't. In the first year of the crisis, intervention in weak banks in Europe and the US was slow. The authorities reacted only to acute distress as one bank after another lost the confidence of market participants, saw its equity price collapse to almost nothing and ran out of cash in a pattern of increasingly rapid death spirals.
This piecemeal and dilatory approach ended only with the fall-out of the Lehman Brothers collapse in mid-September. The delay mattered. Had there been an earlier recognition that the problem of capital inadequacy and near insolvency was widespread, combined with decisive action, including the use of public funds where necessary, the disastrous and protracted slide of confidence which has been experienced through most of 2008 could have been stemmed.

Preventing global recession
Soon borrowing firms and borrowing countries all over the world began to encounter difficulties in getting loans or rolling over loans. The heavier the reliance, the more acute the squeeze. Turkey, Hungary, Pakistan and the Ukraine were early victims and worried policymakers were feeling the pressure even in large countries such as Brazil, India, Indonesia and Russia, whose economies had recently been doing so well. In contrast to what we have experienced in Western Europe and the US, the problems in these countries did not stem from their financial systems. A few medium-sized banks have got into trouble, but these were in the category of "the usual suspects", their woes revealed rather than caused by the downturn. But developing countries have been affected by the global credit squeeze that has begun to hit borrowers everywhere, victims of the desire of international financiers to pull back their resources and hold them in a safer and more liquid form. Prices on emerging stock markets have fallen as sharply as elsewhere; interest rates on emerging market debt has soared, their exchange rates have come under pressure. Thus the tsunami waves from the rich countries have been affecting an ever-growing number of countries as I speak.

So what happens now? Some things will have to change for stability to be restored. For the world as a whole, the losses that have been experienced, and the upward re-assessment of risk, mean that the ratio of debt to equity in the world is now much too high. In effect, firm promises need to be replaced with risk-sharing agreements. Put another way, current financing arrangements are too fragile to be supported. This imbalance will gradually have to be resolved one way or another. Some of the debt will default. But default and bankruptcy can be a most destructive form of resolution to be avoided where possible by renegotiation involving debt-to-equity conversions.

Lower share prices are already beginning to encourage wealth holders to convert some of their cash into equity.

Much of the correction will fall to governments around the world, which have indeed begun to purchase equity stakes in banks on a large scale, and to provide backstop guarantees on large blocks of loans, thereby reducing banks' need for capital. This process will place pressure on governments' finances, potentially undermining their ability to provide improved services in other areas. As time goes on, housing markets will settle at lower but sustainable price levels, and the fog surrounding the recoverability of mortgage loans will gradually clear.

The challenge is to engineer this inevitable rebalancing without overshooting and with the minimum of disruption to production and employment. If poorly managed, the rising unemployment, failing firms and generally depressed economic conditions that we now see could be protracted. I am somewhat optimistic that the current political configuration in major economies will deliver what is needed – but let me not digress.

The financial system and society: winners and losers
Of course a massive systemic failure such as that which we are experiencing calls for a reassessment of the policy framework for preventing future crises. Probably it is too early for this: when the house is on fire it's not the moment to be pricing sprinkler systems. As it happens, a brand new regulatory framework for banks, called Basel 2, is just being introduced following a 10 year debate. Alas, far from providing a solution, the Basel 2 approach entrenches the very features that have contributed to weak policy in that it envisages the regulators as relying on each bank's own assessment of risk, and on the rating agencies, to make the main determination of how much of a cushion of capital a bank should hold. Basel 2 is in effect the embodiment of the overconfidence in mechanical risk management tools, a personification of the Trojan horse. It is now being treated by many commentators as "dead on arrival".

Instead, the most thoughtful scholars are looking to other regulatory changes: much higher capital requirements (perhaps 5 times as much as now, especially in boom times), an outlawing of complex and opaque transactions in the core banking system, and some way of clawing back – even after some years – bonuses already paid to senior executives when the decisions they made turn out to have been loss-making.

There are side effects to the measures needed to stabilize the financial system and the wider economy. Many of them are adverse.

Crisis response measures tend to bail out the undeserving along with the needy, and can have the effect of encouraging reckless behaviour. Some of this moral hazard has to be accepted in times of crisis. And it is only fair to notice that plenty of fat cats have lost out in this crisis: uninsured depositors or bond-holders of several banks have lost considerable sums of money, as have shareholders in all of the weak banks, including the Irish banks. Top management lost their jobs in most of the banks rescued around the world, at least up to early October.

Nevertheless, I find it sickening to see banking executives walking away with tens of millions despite having run their bank into the ground. This is especially so when one considers how little help has been given to poor and gullible borrowers in the US who had unaffordable loans foisted on them by unscrupulous and dishonest mortgage brokers keen to get their fee even on a loan they knew would default. As in the past, it is times of crisis which often most clearly reveal the heartlessness of capitalism and the opportunities it provides for hucksters.

Just because it is the most effective system that we know for lowering poverty and generating income growth does not mean that the market system is as good as some cheerleaders have noisily proclaimed it to be.

While it appears to have, from the distance, a certain formal elegance in the way it matches supply to demand and in its capacity for self-organization, capitalism is raw, inegalitarian and lacking in compassion. For that reason the intermittent crisis episodes of capitalism – and we are in one of the most acute – often trigger a populist response that is worse.

It will be clear by now that the financial system, lifeblood of capitalism, "lost the run of itself" in recent years. But it would be a mistake to throw out the baby with the bathwater. Numerous studies show that, most of the time, a well-developed financial system contributes strongly to sustainable economic growth. If we are to take the latest official macroeconomic forecasts for the world economy at face value, the losses due to this crisis will take away only some of the sheen of this longer-term success.

Furthermore, while we may think of finance as representative of the most conservative elements in society and to be focused on the interests of the rich, it can be subversive despite itself. While the past few decades of free-market capitalism have been associated with concentrations of income and wealth in the advanced economies, it is far from clear that the financial system has been the culprit. On the contrary, pursuit of profit can induce bankers and other financiers to make resources available to promising ventures, regardless of where they come from, thereby limiting the power of incumbent businesses and expanding opportunities for hitherto excluded groups (including ethnic or religious groups otherwise suffering from discrimination). This is probably why countries with large financial systems tend, on my reading of the empirical literature, to have less poverty for any given level of average income.

It might be thought that nationalizing the banks and requiring them to pursue government objectives instead of profit would produce even greater equality. But paradoxically, the evidence from around the world is that private for-profit banking systems have, in normal times, contributed more to reducing poverty than government-controlled ones (which, responding to political pressures, tend to keep large but faltering borrowers afloat for much longer than is healthy for the economy as a whole).

That's the funny thing about economic systems. Going about things directly is not always the most effective approach. With all of the leading governments purchasing shares in their country's banks, these days, and with the popular mood turning sharply in favour of strict controls over unpopular bankers, it remains to be seen if the new shape of bank management that results will generate the anticipated benefits for society.

Not that Irish banks played a particularly important part in the Celtic Tiger period of the 1990s. It was only after our living standards had converged on those of the leading economies that the banks' lending went into overdrive, a gear shift which we – and they – have reason to regret. Indeed, that observation highlights the delicate nature of the financial adjustments which is now called-for. We wish the banks hadn't lent recklessly for property; but now we don't want them to freeze out viable firms in the rest of the economy or the sort of borrower whose plans will help the economy to recover its rapid growth on a sustainable basis.

For there are good reasons for believing Ireland's medium-term growth potential to be high, given all we have learnt about coping with and indeed prospering in the globalized world economy over the past quarter century. If we handle the recession well, we can get back on that growth path quickly. Korea and Malaysia did, after their V-shaped crashes in 1997-8. But others did not recover so quickly, not least because banks (even though they had been recapitalized) remained pessimistic and risk-averse. Indonesia has only just re-achieved its average living standards of a decade ago. As I have already mentioned, Mexico experienced almost a decade of credit famine following its Tequila crisis in 1994.

Getting the policy package just right will be demanding. It will require the sort of collective shared understanding of what needs to be done, and collective measures to ensure that it happens, that was achieved in Ireland in the mid-1980s. It is a political as much as a technical financial policy issue – in Ireland as elsewhere – and the actions required on wages and salaries, on taxation and public spending, range well beyond the narrowly financial. As such, this calls for a much more wide-ranging discussion, that would take us too far afield today.