



# **The crisis: policy lessons and policy challenges**

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**Based on joint paper with Agnès Bénassy-Quéré,  
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## Ongoing debates

- **Why the crisis?**
  - Why did the crisis occur?
  - Why did it engulf the whole financial system?
  - Why have its consequences been so severe?
- **Has the policy response been right?**
  - Short term crisis containment
  - Longer term policy reforms
- **The Queen's question: why have economists not seen it coming (and therefore are they qualified to make recommendations)?**



## Some questions are easier to answer

No surprise Europe was hit by the financial crisis, not Asia

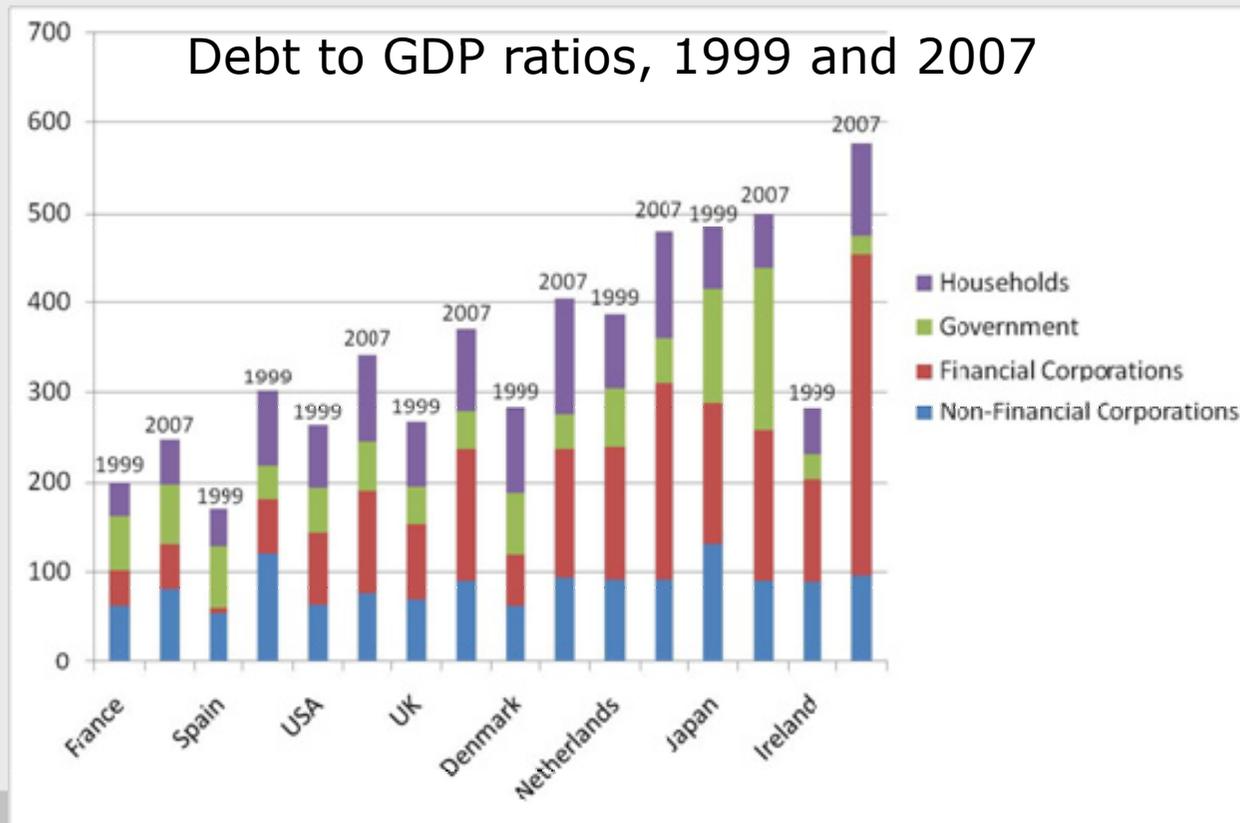
Foreign Holdings of US bonds (in % of GDP)			
	Mid 2007		
	Treasury	Agency	Corporate
Luxembourg	113%	84%	746%
Ireland	6%	12%	83%
Belgium	3%	7%	70%
Switzerland	9%	4%	22%
United Kingdom	2%	1%	15%
Netherlands	2%	3%	12%
Germany	1%	0%	3%
Japan	14%	5%	3%
France	1%	0%	2%
Korea	4%	7%	2%
China	14%	11%	1%
Russia	3%	9%	0%

Source: U.S. portfolio surveys, Milesi-Feretti (2009), Bruegel calculations



## Some questions are easier to answer (2)

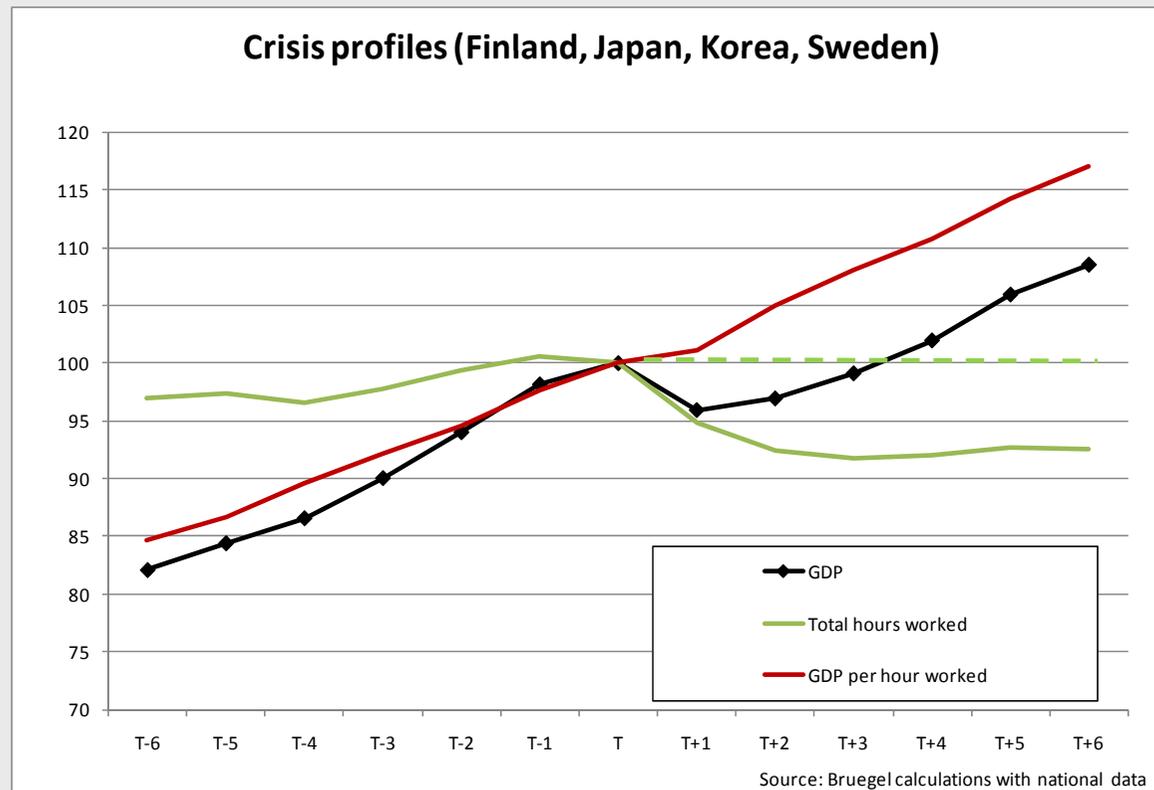
No surprise many countries now need to deleverage





## Some questions are easier to answer (3)

No surprise financial paralysis had major consequences

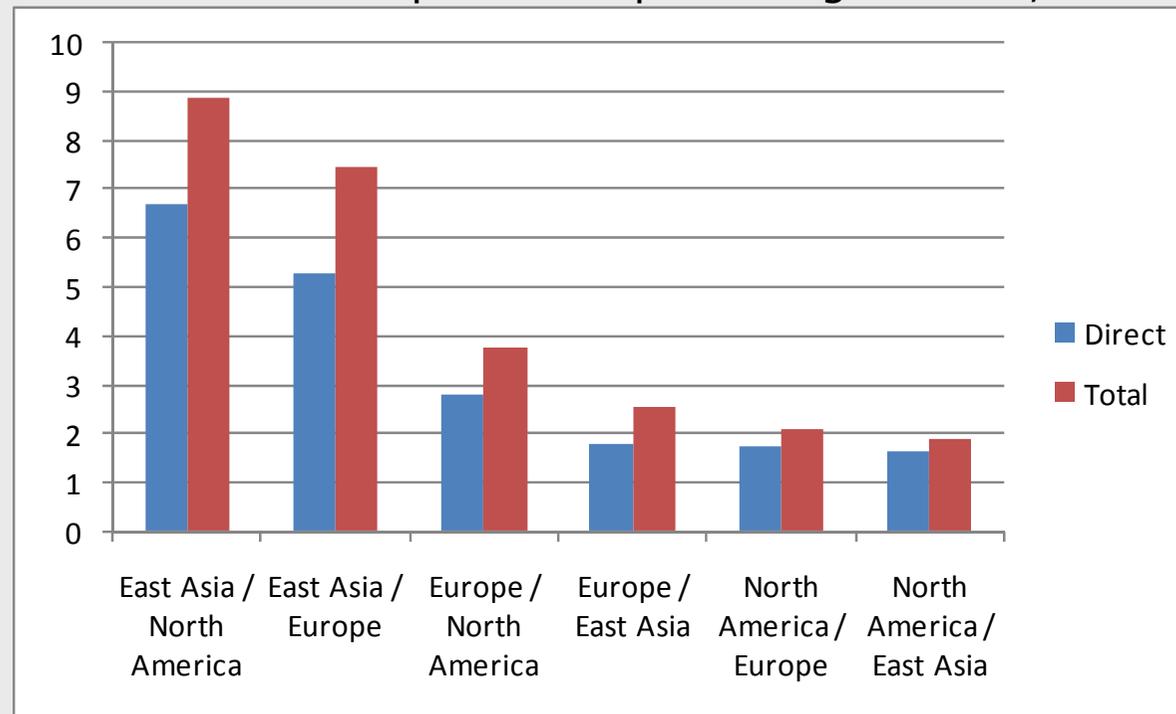




## Some questions are easier to answer (4)

No surprise Asia was hit through trade

Bilateral trade exposure as percentage of GDP, 2006





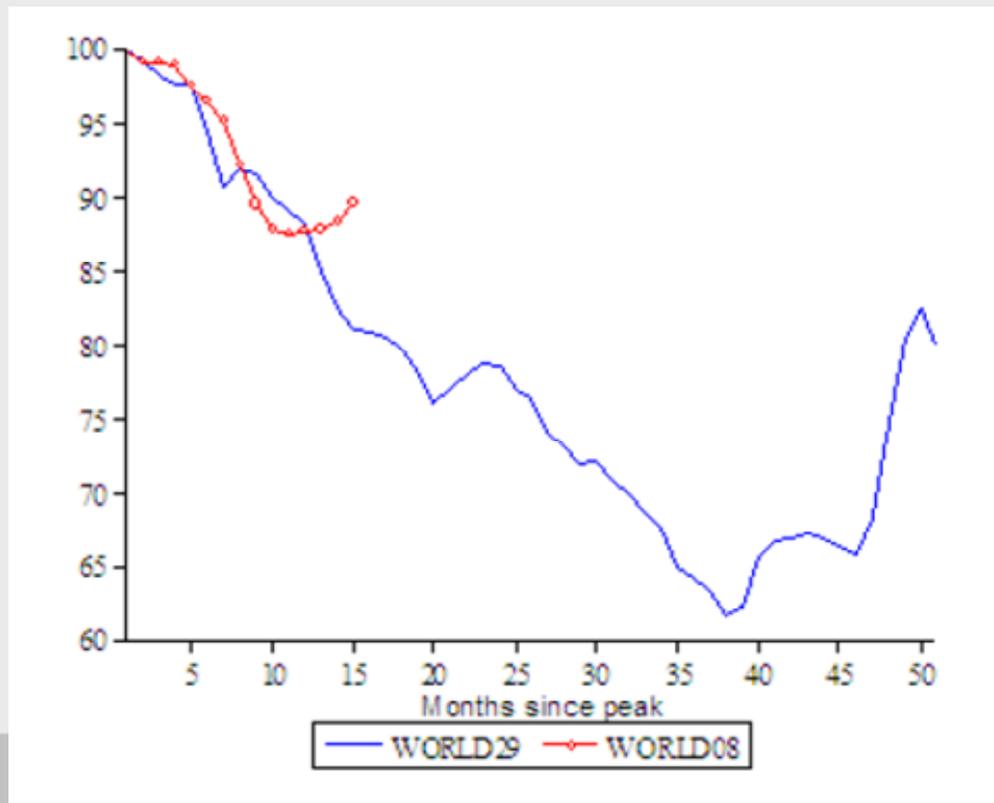
## **Some questions are easier to answer (5)**

**No surprise emerging markets were hit by sudden stops**



## Some questions are easier to answer (5)

Little surprise output collapsed as fast as during the 1930s





**But some questions are hard to answer**

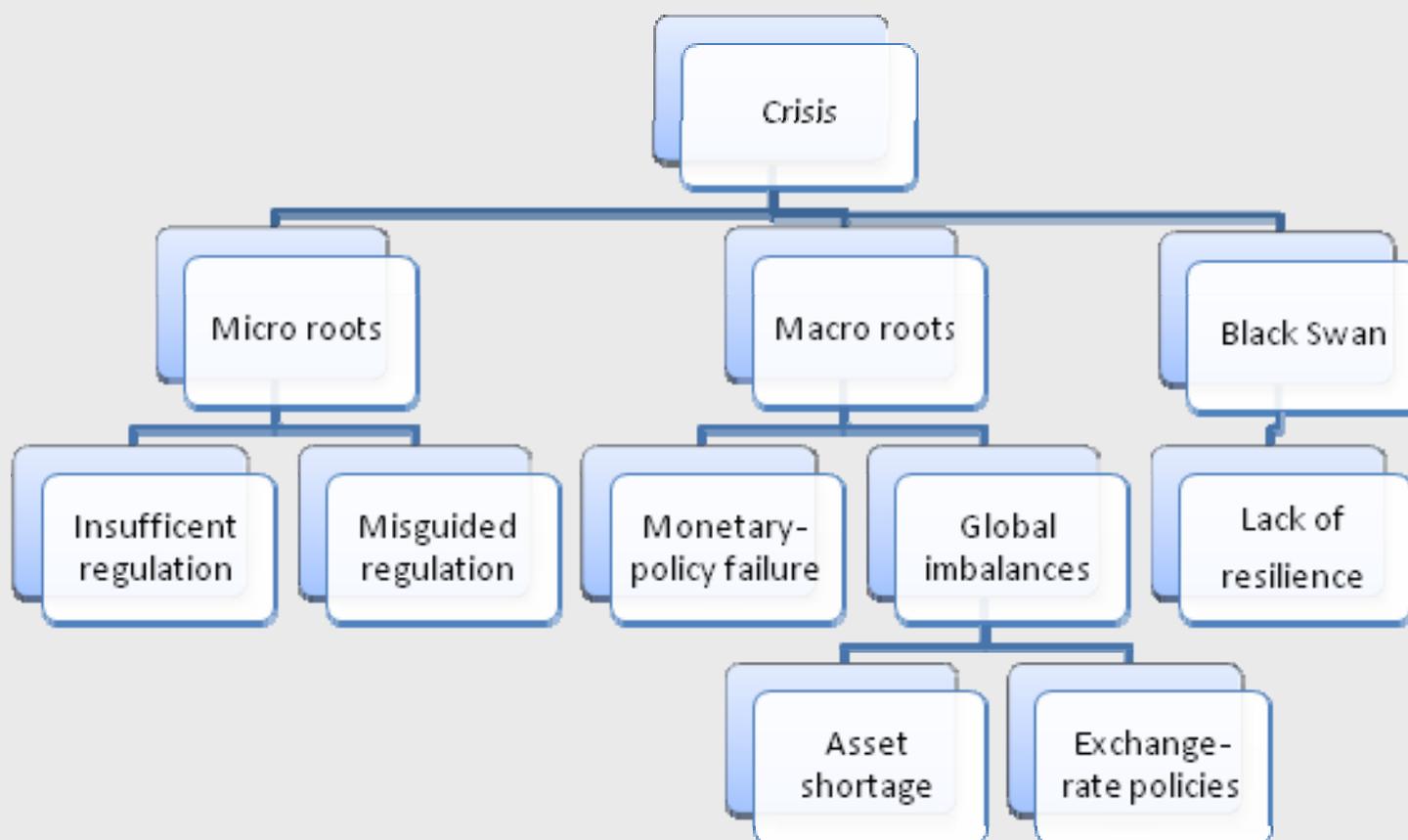
**(and they may not be answered before long: Friedman's take on the Great Depression came thirty years after, and Bernanke's fifty)**



## **A shortlist of hard questions**

- 1. Underlying causes of the crisis**
- 2. Reform priorities**
- 3. Lessons for policy economists**

## Underlying causes





## Pure micro roots

- **Compelling evidence of micro failures**
  - O&D model and moral hazard
  - Conflicts of interest in the rating business
  - Compensation practices and risk-taking
  - Procyclicality of capital ratios
- **However regulatory failures did not start in the mid-2000s**
- **Need for macro story?**

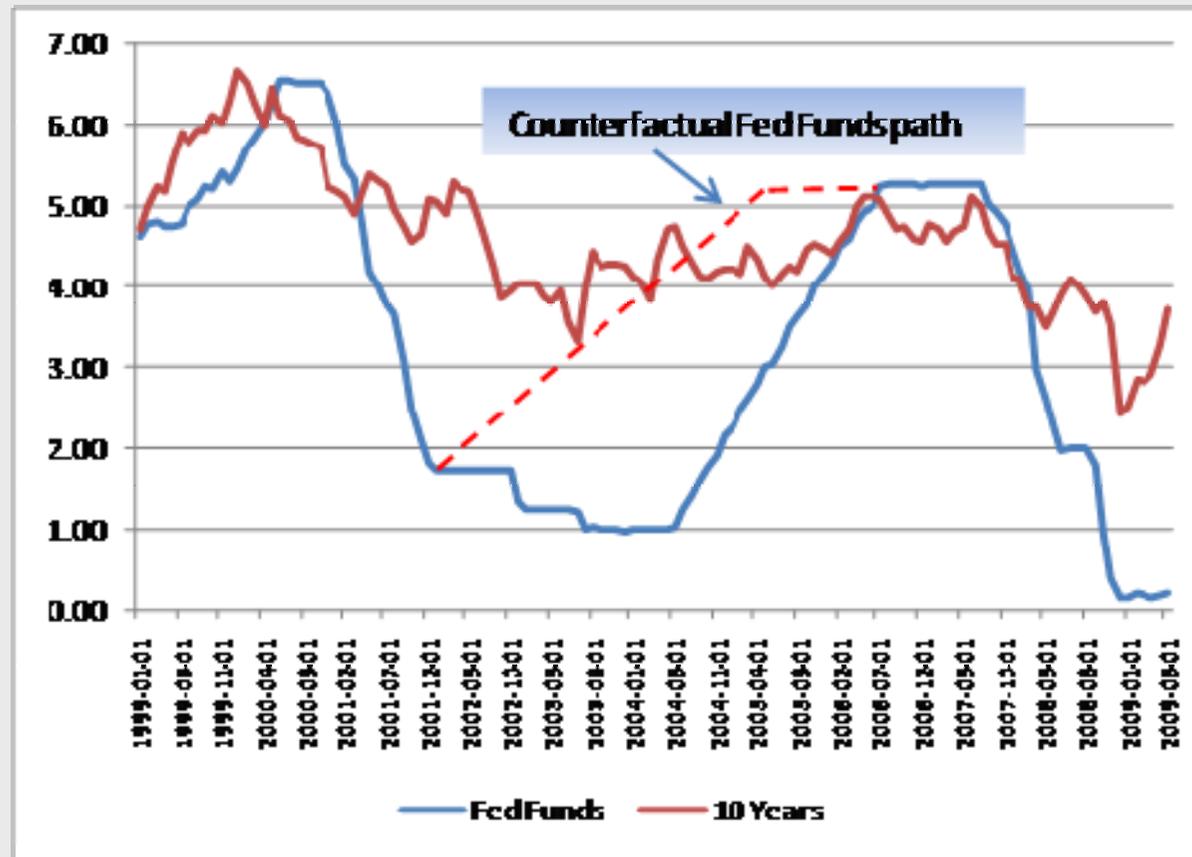
*“At the core of the crisis lay an interplay between macro-imbances which had grown rapidly in the last ten years, and financial market developments and innovations”.*

Turner review, 2009



# A failure of monetary policy?

The Taylor critique: is it sufficient?





## **A consequence of macro imbalances?**

- **Macro thesis put forward by regulators (Turner, Larosière) and academics (Caballero et al., Rajan)**
- **Some empirical support for global savings glut – low interest rates link (Warnok and Warnok)**
- **But why?**
  - Asset shortage theory is nice rationalisation but lacks empirical backing (explains private inflows, not public inflows)
  - Bretton Woods 2 theory has empirical support but lacks analytical underpinnings
- **More research needed there**



## Channels of paralysis

- **US losses on non-prime mortgage (Oct. 2008):**  
**\$100bn = 0.7% of US GDP = 0.2% of world GDP**
- **US losses on MBS securities: \$500bn**  
**US S&L losses (early 1990s): equivalent to \$1700bn**

**Do we understand why small causes had huge effects?**

- **Pure fragility (Black Swan)**  
***"Complexity got the better of us"* (Lloyd Blankfein)**
- **Transformation of information-insensitive debt into information-sensitive debt (Gorton, 2008, 2009)**



## A Black Swan?

*"The system acts as a mutual insurance device with disturbances dispersed and dissipated. Connectivity engenders robustness. Risk-sharing – diversification – prevails.*

*But beyond a certain range, the system can flip the wrong side of the knife-edge. Interconnections serve as shock-amplifiers, not dampeners, as losses cascade. The system acts not as a mutual insurance device but as a mutual incendiary device.*

*In just about every non-financial discipline [the combination of increased complexity and reduced diversity] would have set alarm bells ringing. Based on their experience, complexity plus homogeneity did not spell stability; it spelt fragility."*

Andrew Haldane (2009)



## Conclusion

- **Superficial agreement only on the cause of the crisis:**
  - Perverse incentives
  - Lack of information
  - Regulatory heavens
  - Regulatory capture
  - Piecemeal approach to financial stability
  - Lack of an effective warning mechanism
- **All this is true but does it answer the questions?**



## Reform priorities

- **Significant G20 regulatory agenda this far:**
  - Closure of regulatory gaps
  - Incentive realignment
  - Strengthening of market infrastructures
  - Emergence of macroprudential approach
- **Not yet in place, requires some more hard work**
- **Not an easy task for large and diverse G20**



## **Some open issues however**

- **Moral hazard, 2B2F**
- **Structure and resilience of financial system**
- **Growth-stability trade-offs**
- **Size of financial sector**



## Less progress on macro front

- **Little change until Pittsburgh (no consensus on role of macro imbalances)**
- **Issues ahead:**
  - Monetary policy framework
  - International rules of the game
  - Stress-tests for policies



## Lessons for policy economists

- **Part of broader debate on the role and responsibility of the economic profession**
- **Specific issues:**
  - Data dependence
  - Information limitation
  - Reliance on models of limited scope
  - Cassandra's complex
  - Capture?



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