

The Royal Society of Edinburgh
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The David Hume Institute
The Financial Sector after the Credit Crunch
Sir John Gieve,
Former Deputy Governor of the Bank of England

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Report by Matthew Shelley

As Deputy Governor of the Bank of England from 2006 until February this year, Sir John was responsible for financial stability and was a member of the FSA board. He was welcomed to the RSE by Jeremy Peat, Director of the David Hume Institute, and Gavin McCrone FRSE, who chaired the event. Both said the lecture was taking place at an extraordinary moment. The Chancellor of the Exchequer had just made a keynote Mansion House speech about the financial crisis, the Governor of the Bank of England had declared that sermons are not enough, and President Obama had announced far-reaching measures in the United States. Sir John emphasised that world-wide action is needed to restore the financial sector and ensure that similar problems cannot happen again. He also argued for a rethink of macro-economic strategies and argued that the greatest threat to sustainable recovery is not over-reaction but inertia.

Quoting Hume's claim that "either the nation must destroy public credit or public credit will destroy the nation", Sir John pointed to the current build-up of public debt as one of the major results of the credit crunch. Whilst hoping that the last quarter of 2008 and the first of 2009 will prove to be the low point, he added that much remains to be done to pull the economy out of its tail-spin. Pointing to similarities between the path of the current crisis and the Great Depression, he is hopeful that recovery is on the way. This is likely to be a slow process, as Western governments and consumers need to build up savings, whilst many other economies are export driven and will have continued difficulty finding markets.

Even though we are still in the midst of the crisis, Sir John argued that we already know enough to start drawing conclusions – and that these are far-reaching. He said: "This crisis calls not just for emergency measures, but for major changes in our longer-term approach to policy. And this isn't just about banking and regulation, because the financial crisis also brought the worst world recession for 80 years. This has also been a failure of macro-economic management. So we need to go back to the drawing board, not just on financial regulation, but on macro-economic policy, and, in my view, on macro economics itself."

Sir John pointed to features of the crisis which were similar to previous booms and bust. The property price boom of recent years, the ensuing rise in interest rates, the credit squeeze, and the eventual bursting of the bubble were all familiar from the 1970s and 1990s. Yet the scale was of a new order, resulting in the worst collapse of financial confidence since 1914 and the first drop in global output since World War II. Nonetheless, he said, "I still think it's a bit of a puzzle why an old-fashioned property boom and bust should lead to a global meltdown in financial markets." There was also the issue of why no-one saw it coming. Much of the problem lay in financial innovations, with the growth of derivatives obscuring real risk levels. "I think banks and their regulators thought that a lot of it was sustainable and that the hedging of their balance sheets through the use of derivatives was reducing their vulnerability to a downturn. That was a critical and shared misjudgement." The ultimate outcome was that when a downswing came, no-one could be sure of the extent of losses or where they lay. The third special feature of the crisis has been its global reach, and the speed at which it took hold after its emergence in the USA – a result of the integrated nature of the financial system. Checks and balances were in place that could cope with a certain level of instability but, like other complex networks, it had a tipping point after which it plunged into catastrophe. In this case after 'the point of no return' institutions needed government support to raise large amounts of capital very fast, and help in funding when no-one was prepared to lend.

The first lesson Sir John drew was that much greater weight must be given to the systemic links throughout the network, rather than just watching the outliers. At the same time, there is a need to recognise that there are some actions which are rational and sustainable for an individual, but not for a whole system. Sir John listed a number of necessary reforms – from ensuring the quality of capital, to tackling bonuses, and moving more trading onto exchanges – for which there is already a consensus. Yet he argued that it would be a serious mistake to implement these and return to business as usual. Instead he identified four areas for fundamental change. These were under the headings of:

- Market mood swings
- Moral hazard
- Regulatory capture and groupthink
- International inertia.

As the banking system is central to the world economy, Sir John believes it must be cushioned against market swings; something that can be achieved by insisting that banks hold greater insurance. His recipe for stability included more capital, greater liquidity and smaller balance sheets. At the same time the economy needs protection from the banks, which can be achieved by direct measures to dampen the effects of the cycle in the financial sector. “The way I believe we can most easily do that is to adjust capital and liquidity requirements as a proportion of assets in good times and reduce them in bad. That would create bigger buffers to absorb losses.” It would also dampen the pace of expansion and contraction in the banking market.

With regard to moral hazard, Sir John said the government has dispelled any creative ambiguity about how far it is willing to allow financial institutions to suffer by introducing a safety net for banks. This brings short-term gain by encouraging inter-bank lending, but it can store up problems for the next upswing by spurring rapid expansion and risk taking. Signs of problems are already emerging “with fierce competition between the investment banks ... to collect the best staff with offers that include guaranteed bonuses for several years – displaying what we thought were features of a boom.” This is happening at a time when we have just seen the failure of self-regulation by banks. There is, therefore, a need for firm public regulation and to rebuild market discipline. Sir John recommended the development of special insolvency regimes for larger and more complex banks, and higher capital and liquidity requirements for the biggest firms. If these are not enough, it may be necessary to limit the size of banks and the business they can do – though this was not his favoured option.

Sir John considered the approaches taken to regulation by a variety of countries, saying no one approach was clearly better than the rest. Nonetheless, the financial crisis has demonstrated the need to be alert to the dangers of regulatory capture and “groupthink”. The problem is not that banks pull the wool over the eyes of regulators, but that they share common misjudgements. While supervisors can identify abnormal or unusual behaviour, it is difficult to question common behaviour which has built up over the years and has previously been seen as acceptable. One option is to rely less on discretion and more on rules. There is also a powerful argument for the system to be scrutinised by “a second pair of eyes” from outside the day-to-day running of the banking system.

On inertia, Sir John said: “As people feel there are green shoots, we are beginning to hear and see some reduction in the pressure for reform; there are calls for caution.” While acknowledging that a bad situation can be made worse, he added that the risks from over-reaction are outweighed by those of inertia. He cited examples of reform proposals that had become bogged down for decades, meaning that avoidable problems had been allowed to occur. Sir John praised the EU’s calls for tighter rules, a strong body to oversee systemic risk (which is separate from the regulator) and effective control of implementation by nation states (so countries don’t fear they will lose a competitive edge because others fail to follow the rules). However, he added that reforms at national or EU level are not enough, they must be implemented by the G20, or globally, to prevent financial institutions from undermining them by shifting operations to the least regulated areas.

Turning to economic policy, Sir John said in the dozen years up to 2006 we had achieved stability, growth, low inflation, low interest rates and falling unemployment; “it seemed like we had reached the Promised Land”. There was consensus between practitioners and academics that so long as a low-inflation regime was maintained, then market forces were powerful enough to haul cyclical variations back into equilibrium. Macro economics became reduced to monetary policy, and monetary policy was

just interest rates. Fiscal policy and regulation were seen as a micro-economic function. Interest rates were set according to whether inflation was above or below a target and whether economic activity was above or below sustainable levels. The “Greenspan doctrine” – from former Chairman of the US Federal Reserve, Alan Greenspan – also held sway. This stated that it was “better to mop up after asset price bubbles than to prick them in advance,” because the authorities were ill-suited to identify bubbles and pre-emptive action risked distorting a state’s entire economic policy. “The last few years have proved the limitations of that approach.” Limitations in policy were compounded by the fact that conventional indicators failed to show that trouble was on the way: accelerating inflation or the growth in the output gap gave little sign that we were heading for a precipice.

Sir John drew four conclusions for economic policy:

- New Keynesian models failed to forecast the problems.
- They also failed to cope with the challenges thrown up by the credit crunch, such as self-sustaining departures from the equilibrium.
- Inflation levels and output gaps, and mopping up when bubbles burst, do not represent an effective macro-economic policy.
- Interest rates alone cannot guarantee stability, and more than one policy instrument is needed. Liquidity provision, quantitative/credit easing, capital requirements and fiscal policy are essential factors.

On top of this, he suggested that a complete separation of roles in which central banks care for stability, finance ministries for equity and efficiency, and regulators supervise, is obsolete. Overlap and interdependence have already emerged and will continue, though Sir John warned against the concentration of functions in one pair of hands as a retrograde step. He called on university economists to help in the process of rebuilding by rethinking their most fundamental assumptions in the light of recent events, and help in the process of charting the way forward.

In summing up Sir John re-emphasised that radical measures are necessary if similar, or worse, economic crises are to be avoided. “The experience of the last few years has important lessons for regulation and the way we do economic policy and for economics itself. We must not allow the emphasis on reform to weaken and I conclude with the thought that inertia, particularly international inertia is a far greater risk than over-reaction.”

Following the lecture, Sir John was asked a wide-ranging series of questions.

Asked about the role of international economic imbalances in the crisis Sir John said that while the crisis, was made in America, the ready access to large amounts of lending from Asia and the Middle East had been an important factor. Imbalances between consumption and saving would also present obstacles for a swift and sustained recovery of the economy.

On the criticisms of the Bank of England for demanding tough terms from those asking for help, he said the approach was correct, as it was a lender of last resort, not first resort, and that required a penalty on borrowing.

Questioned on whether some banks are too big, Sir John said that the key was devising ways which enabled the authorities to close big institutions. On the other hand, he added that a global economy requires banks that can do business anywhere and that more consolidation is likely over the next 20 years.

Sir John was asked if the failures of the banks were partly due to failures in governance, with boards, and particularly non-executive directors, not fulfilling their proper roles. Whilst rejecting the idea that there was a lack of appropriate knowledge or experience on many boards, he identified two areas of concern. One was the notion that it was fine to pay a lifetime’s money in just a few years to get the top executives – this philosophy had taken some banks, along with the reputations of their chairmen and chief executives, over the cliff edge. The other was that boards need to rethink the idea that their role is just to pick a chief executive and then support him or her; they are also there to challenge.

Votes of thanks were offered by Jeremy Peat and Gavin McCrone.

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