

## Chapter 3

# The National Boom-Bust Cycle

"We suggest that what has to be regulated is behaviour rather than particular instruments. This is the case because booms are often a result of things appearing to be safer than they turn out to be"

The current crisis has laid two economic commonplaces to rest. The first is the 'efficient markets hypothesis,' which maintains that financial prices embody the true value of their real counterparts, with price movements being a reflection of fundamental values. In such a world financial crises should be rare indeed. Given this, one of the key lessons of this crisis is that market discipline is little protection against the macro-prudential risks that come with the economic cycle. The institutions that have proved most resilient to the crisis, such as HSBC and J.P. Morgan, had lower equity 'ratings' (lower price-earnings ratios) than those that proved to be less resilient, such as Northern Rock, Bear Stearns, Fortis, and Lehman Brothers. Market discipline may have an important role to play in the efficiency of the financial sector; but it cannot be the front line of defence against crises.

The second, related and now discredited view is the proposition that if markets are 'efficient' in this way, then if crises do occur, they must be the result of policy error. That is, government, qua excessive regulation, causes financial crises.

### Risk and Volatility in Development *Diery Seck*

Many Least Developed Countries rely on external indebtedness to finance their development, at least, until they reach the stage of emerging economies and tap into more developed domestic credit markets. The frequency of sovereign debt crises affecting the poorer countries over the last decades suggests that either past interventions were mostly on the symptoms, or that measures to prevent them, if any, were unused or inadequate. My view is that volatility matters and will doom any sovereign debt architecture for developing countries, if left unaddressed. Currently, public external borrowing is the main link between developing economies and the international financial system.



Poor developing countries usually have highly volatile export earnings and, given their weak domestic credit markets, tend to rely on relatively high levels of external sovereign borrowing and long debt maturities. Their exports receipts typically follow a random walk and therefore tend not to return to a long term trend that is consistent with economic growth, and are also exponentially more uncertain over long periods. Consequently, they face a high probability of debt service difficulties which can be compounded in later periods if payment arrears lead to capitalization of unpaid interest or if they are forced to make debt service payments that hinder their development process and lessen their capacity to honor future debt service obligations. High volumes of external debt only make matters worse.

Yet, such countries need long term financing to avoid potential credit rationing that could arise from a severe national or global economic downturn, or the possibility of borrowing at high interest rates, if they need to borrow at the wrong time. These adverse events are more likely to happen if countries resort to short-term external debt and make frequent trips to the market. One remedy that could be considered is to combine external lending, even on concessionary terms, with provision of pure grants in proportions that would reflect the export volatility of developing countries. Countries afflicted with the highest levels of export volatility would receive the highest proportions of pure grant financing relative to external debt. This facility could be revised frequently to take current economic conditions into account. If properly and consistently implemented, this mechanism could result in comparable and acceptable default risk levels for all developing countries, regardless of their wealth or volatility.

The problem with the proposition that regulation causes crisis is that the historical record does not support it. From the 1940s through to the 1970s, the economic order of the

day supported merchandise trade that was seen to be welfare enhancing, while discouraging financial flows through capital controls and regulations, since these were seen to be welfare-diverting and the cause of speculative excess. In this period OECD countries experienced very few financial crises and grew strongly in comparison to what came before. Only with the deregulation of finance in the OECD countries, and later the rest of the world since the 1970s, has the incidence and severity of financial crises increased. And as the current crisis amply demonstrates, it has increased markedly.

To admit this is not to wish for a return to the supposed 'glory-days' of a limited and de-globalised financial sector. While the risks to the system have increased, and with them their attendant costs, so have the benefits. The point of regulation is to skew the balance in favour of the latter over the former. The original form of securitisation, in which long-term loans from good borrowers that were on the bank's balance sheet for some time were moved off it in order to make room for new lending, did promote the development of deeper capital markets with more access to credit for consumption smoothing (we have suggestions on how to improve risk allocation below). Derivatives have both complicated, and eased, risk management. Savers get higher returns and borrowers get lower rates and easier access – so long as the market does not dry up. Moreover, in the advanced OECD economies, as employment has moved out of manufacturing and into services, finance has become an increasingly important source of jobs, income, and taxation. Given this, we need to establish two principles.

The first is that financial crises are a recurring phenomenon of capitalist economies. Trying to avoid them altogether would require a new form of organisation of an economy, which would no longer be capitalist. Sixteenth century Germans, seventeenth century Dutch, and twentieth century Texans all managed to have financial meltdowns without credit default swaps or 50:1 leverage ratios. As such, we should not treat this financial crisis as a unique event with equally unique causes that, if we attend to them, will mean that crises cease to be a problem. This view is false.

Financial crises may differ in the details; the triggering event, the asset class involved, the identified causes and other elements, but the commonalities are there across individual cases. Some shock to the system produces a redistribution of assets across portfolios that alter profit opportunities. If this occurs in a period of relative stability banks become less risk averse and expand credit in response to demand in light of these new opportunities. This leads to price increases in the speculative asset class that in turn encourages more credit, thus fuelling the upswing. The specific signal that 'its time to get out' will vary, but when it occurs (most recently, subprime losses and the implosion of Bear Stearns) investors all try to get out of the same assets at the same time. This drops market prices below modelled prices, which in turn results in a liquidation of other previously well-performing assets to cover losses in the original portfolio. The resulting cannibalisation of assets is the bust that always follows the boom. This pattern has occurred repeatedly in the history of modern capitalism. It is the rule not the exception.

We suggest that what has to be regulated is behaviour rather than particular instruments. This is the case because booms are often a result of things appearing to be safer than they turn out to be. Securitisation was viewed as a way of making banks safer. Diversified portfolios of subprime mortgages were viewed as having low delinquency rates. Banks were so convinced of the safety of these products that they found elaborate ways to be exposed to them. Indeed, while micro-prudential regulation is certainly necessary to weed out the truly reckless institutions, instruments and behaviour, it needs to be supplemented with macro-prudential regulation as a countervailing force against the decline of measured risks in a boom and the strongly-held belief by market participants that 'this time, it is truly different'. It never is, and it is the job of the regulators to remember that singular fact.

The second principle is that, not only are they not going away, financial crises have severe real costs. Reinhart and Rogoff have recently demonstrated, across all modern (post-1977) financial crises (18 cases), asset price collapses of the order of 35 percent for housing and

55 percent for equities and unemployment increases of 9 percent above base are the norm during the bust phase of the cycle, which can last up to six years depending on the asset class. Given this, it is little surprise then that government debts surge by an average of over 80 percent of GDP as tax receipts collapse and deficits expand as the private sector deleverages and the public sector leverages-up through bail-outs to compensate.

Given all this, we must conclude that regulation to avoid the worst of both the upswing and the downswing is as inevitable as financial crises themselves. As stated above, we do not necessarily need more regulation; we need smarter regulation that enables regulators to act against financial institutions that try to capture them (we address this below). We recognise that supervisors have plenty of discretion to step in, to raise capital requirements where they feel there is too much risk and enquire about activities off-balance sheet or in other jurisdictions if they fear spill-over effects, but they find it hard to use this discretion in a boom when the political winds prevail against them. Almost everyone wants a boom to last. Politicians want to reap electoral benefit from the sense of well-being and prosperity during a boom. Policymakers convince themselves, and try to convince others, that the boom is not an unsustainable credit binge, but the positive result of structural reforms that they have put into place. Booms have social benefits. They are associated with a higher appetite for risk often making finance more inclusive (e.g. subprime mortgages). Booms are not quite a conspiracy of silence, but there are few who gain from their early demise.

In dealing with boom-bust cycles the Commission is focused upon pro-actively leaning against the wind such that crises are dampened during the upswing rather than expensively dealt with on an ad hoc basis on the downswing. An ounce of prevention really is worth a hundredweight of cure. The Commission's key ideas of counter-cyclical regulation, liquidity regulation, and 'unlevel playing fields' are of particular importance in this regard.