Reflections on the Crisis 2007-2008

Foreword
by Alberto Quadrio Curzio

This editorial note is a novelty for our Journal, since it collects the points of view of three members of the Editorial boards, one English and two Italians, on the current financial crisis, as they were expressed in articles previously published on three different important newspapers.

The previous publication venues must be stressed, because they target, and have influence on, the general public, which in these days of panic take billions of decisions that Governments try to affect, often without much success, in order to avoid a big crash in the world financial system.

The first article by John Eatwell on «Financial Regulation: So what do we do now?» appeared in a shorter version on The Guardian, the well known English newspaper, on September 19 and we are very glad to have obtained by the author the permission to republish it.

The second article by Marco Fortis on «Che cosa insegna la crisi americana (What the American crisis teaches us)» appeared in a shorter version on «Il Messaggero» on September 21; the third article, by the same author, on «Come sopravvivere al dissesto americano (How to survive the American turmoil)» appeared on «Il Messaggero» on September 27. They have been widely appreciated by the Italian public and by commentators on other Italian newspapers.

Other two articles republished here were written by myself and appeared on «Il Sole 24 Ore»: one on «Un Fondo sovrano con l’oro d’Europa (A Sovereign-wealth Fund with Europe’s gold)» on February 5 and the other «L’Europa non è solo BCE (Europe is not only ECB)» on September 24. They brought to the attention of the Italian public and Government the proposal of a European Communitarian Fund.

In the past we have¹, with other economists, raised worries on «finan-

¹ Quadrio Curzio A., D’Adda C., Marseguerra G., Beretta S. (2000), Economia e finanza
cial globalisation» and unfortunately the facts of 2007-2008 confirm now our concerns.

While we know what the Governments, the Supranational Institutions and the EU have done in the last months in order to control the disruptive effects of the financial crisis we believe also that no one knows what will happen in the financial markets now. We hope nevertheless that everyone will learn for the future the lesson that financial economy and real economy should never be split to a degree that the first one could be perceived by the public as merely «paper economy» or worst as «waste paper economy». With the wide series of consequences that we see and which include both the «panic» where very strong companies and very strong economies are hit by irrational market behaviour.

These effects call the role of Institution which must never neglected also in order to have well functioning markets.

Financial Regulation: So what do we do now?²

by John Eatwell

In April of this year the G7 finance ministers, worried about growing financial turbulence, endorsed the approach to regulation presented to them in a report from an eminent group including the Chairman of the UK’s Financial Services Authority, the President of the Federal Reserve Bank of New York, and the Chairman of the US Securities and Exchange Commission³.

The report began with an honest recognition of past failure: «A striking aspect of the turmoil has been the extent of risk management weaknesses and failings at regulated and sophisticated firms».

There followed a series of detailed recommendations, the essence of which was embodied in three core themes: greater transparency, greater disclosure, and stricter risk management by firms. In other words, nothing new. The Committee were repeating the tired trinity that has defined financial regulation for the past three decades. The trinity failed, and without a new approach the regulators will fail again.

That failure had two closely related origins: regulation failed to keep up with the institutional changes that in thirty years have transformed financial markets; and the regulators accepted that firms had the technical skills, expressed in their mathematical risk models, to manage risk better than the regulator could.

² Appeared in a shorter version on «The Guardian» on September 19, 2008.
Thirty years ago most loans, to businesses and to individuals, were made by banks, or specialist institutions such as building societies. The deregulatory fervour of the 1980s changed all that. Credit markets became «dis-intermediated», that is instead of banks acting as intermediaries between savers and borrowers, the markets took over. Borrowing is now packaged into securities that are sliced and sold through a myriad of financial intermediaries. Investment banks, like Lehman Brothers, Merrill Lynch and Goldman Sachs, are (or were) at the centre of this process, taking on massive amounts of debt relative to their capital base (i.e. becoming highly leveraged) in order to deal profitably in the complex web of markets. Guiding their operations are their mathematical risk models, statistical models that measure the riskiness of their operations against patterns of past market behaviour. The firms claimed that they could manage risky markets, and the regulators swallowed that claim. Faith in transparency, disclosure, and risk management by firms is at the heart of the financial regulation today.

Yet at the same time it is generally accepted that a core purpose of financial regulation is to mitigate systemic risks, like a global credit crunch. Such risks are externalities, their cost to the economy as a whole is greater than the cost to firm whose actions are creating the risk. But if regulators focus on risks that are recognized by firms already, and neglect systemic risk, why do we need regulation at all, other than to enforce best practice? Firms will manage their risks well enough, using systems that are inevitably (and properly) market sensitive.

The flaw is that in the face of systemic market failures even the most transparent market is inefficient. In financial markets risk is mispriced, with consequences that are all too evident today.

So what can be done to tackle «systemic» risks?

First, regulators must begin to base their approach on the system as a whole. For example, whilst financial firms are encouraged by supervisors to conduct thousands of stress tests on their risk models, few are conducted by the regulator on a system wide scale. If it possible to have system-wide stress tests on the impact of Y2K, or of avian flu, why not on liquidity? The regulator should conduct system wide stress tests of those scenarios most likely to produce systemic stress – such as a 40% drop in house prices. The information gleaned in this exercise should feed into regulatory measures that might be quite different from those suggested by the risk management of an individual firm. After all, banks end up concentrating their resources in places where their individual risk management systems tell them, erroneously, they are safe. In the past couple of months the Federal Reserve has started to run such systemic tests.

Second, financial institutions must be required to undertake pro-cyclical provisioning, raising their reserves in good times and using those reserves as a cushion in bad times, as has been proposed by Charles Goodhart and Avinash Persaud. The rules determining these reserves would be quite different from those governing the regulatory capital that financial institutions
are required to hold today. That capital is a charge, not a buffer. Since the firm must hold a certain capital reserve to be allowed to operate, it cannot use that reserve to tide it over in bad times. The provisioning requirements should be based on the health of the economy as a whole, so capturing systemic strength and weakness. A policy like this has been pursued in Spain, where, despite the massive real-estate crisis the banks have so far remained strong. Astonishingly, the Spanish system is being dismantled because it is not in accord with market based international financial accounting standards.

Third, financial regulation must escape from its present focus on the nature of institutions – commercial banks are regulated differently from investment banks, hedge funds are not regulated at all – and concentrate instead on function. Willem Buiter’s proposal that regulation be targeted on highly leveraged institutions, whatever their formal legal status, is an important step in this direction. Many years ago the only significant highly leveraged institutions were commercial banks. Today, leverage is a characteristic of firms throughout the financial system, whether they are deposit taking banks, investment banks, hedge funds, mutual funds, private equity firms or insurance companies. There is no such thing as safe leverage. It is this leverage that threatens market gridlock in a disintermediated financial system. Regulation must switch from an institutionally-defined approach to a functionally-defined approach as a vital component of systemic regulation. It’s the potential spread of pollution that matters, not the legal entity of the polluter.

The fact that the FSA is a comprehensive regulator means that the UK is particularly well placed to implement these changes. In the US, with its segmented regulators, it will be more difficult. Perhaps an overarching Federal Regulatory Commission would be the answer. But most important of all, domestic and international regulators must abandon the tired trinity, and focus now on the systemic risks generated by today’s financial markets. The next time you hear a regulator arguing that greater transparency is the answer, you will know that he or she doesn’t understand the question.

Save the markets, rewrite the History4
by Marco Fortis

The worldwide financial crisis, caused in the US by the uncontrolled rise of subprime loans and derivatives, has become really serious by now, after being denied and underestimated for a long time.

It is also evident the need to face it with giant public markets supports, also because, as Paolo Savona clearly pointed out on «Il Messaggero» on September 2, interventions, that would have been extremely cheaper if taken in time, have been guilty delayed. Now a plan like the one announced

4 Appeared in a shorter version on «Il Messaggero» on September 21, 2008.
by the American Treasury Secretary, Henry Paulson, aimed at gathering all
the «toxic» assets engendered by the financial insanity into a Federal Fund,
should hopefully stop the dramatic drop of the world stock exchange, even
if this plan would have been considered awkward in normal times. But once
having saved the markets from the crash, History will have to be urgently
rewritten. If History is «magistra vitae», we cannot allow that tomorrow our
children will study what we have been erroneously told in these years, also
in Italy, by economists, columnists, intellectuals, politics that made a solemn
blunder. This mistake was to believe that American economy grew faster
than the European one (and the Italian one) because it was more modern,
innovative, globalised. Because it left the yet mature manufacturing industry
to China and aimed at advanced services, info-telecommunication, finance,
more than our old and not updated continent did (except Great Britain, that
followed «cleverly» the American path). This History has been revealed as a
fairy tale without happy-ending.

Free market is certainly the best model of socio-economic organization,
but it can have many versions: it goes from the prudent Italian household
model, with a debt of 70% on the available income to the one of American
and British household, with a debt, respectively, of over 140% and 170% on
the available income.

We observe a context that includes the Italian small and medium enter-
prises (today the commercial surplus of the typical sector of «made in Italy»
is $113 billion dollars) and the so admired, but then degenerate paradigm of
US investment banks: among these, quoting the last events, one went bank-
ruptcy (Lehman Brothers), one (Merrill Lynch) escaped bankruptcy by the
skin of one’s teeth melting with another banking institute (Bank of Amer-
ica), other two (Goldman Sachs and Morgan Stanley) will be saved just in
time by Paulson’s Plan before crashing in Wall Street. Not to mention Bear
Stearns’ crack, AIG’s rescue, Fannie Mae and Freddie Mac’s nationalization,
the US trade deficit for more than $800 billion dollars and 5 million Ameri-
can home-owners in difficulty because of the loans crisis. It would be as if
the entire Finland population risked to become homeless.

What has not to be remembered is the fact that an economy like the
American of these last years could represent a «model», because it is not
conceivable to dismantle and delocalize their own productive activities to
Asia, to grow by debt, to build houses without money, to count on Wal-
Mart department stores for their own national growth (Wal-Mart imports
from China much more than the entire Great Britain does), to infect the
world with derivatives, to loan money to anyone without guarantee in order
to maintain the high level of domestic consumptions. All this caused a fake
added value and spread on the market an «insane euforia», as the Emeritus
Italian Republic President Carlo Azeglio Ciampi said on «Il Messaggero» on
September 17, 2008.

As already mentioned, American public debt, if market rescue measures
will be adopted, will reach percentages of the US GDP extremely high, simi-
lar to those in the early Fifties or worse. Although, it would be useful to add a further reasoning to complete the re-interpretation and re-writing of the History. Differently from 2003, from 2004 to 2007 the US GDP grew at current cumulative value of 26%, a very praised increase according to globalised financial innovation supporters, almost 40% higher than the European GDP, equivalent to 18.6%. This determined an increase in absolute terms of the US GDP of about $2.800 billion dollars in four years. In other words, it is about $1.100 billion dollars more than a hypothetical different background were America would have been satisfied with growing like the slow Euro Area. Practically, in just more than a year of financial crisis (far more to be ended), the worsening of American national budget, caused by the mere stop-gap measures adopted (bank rescues, supports to household consumptions, etc.), has already «burned» almost the half of the larger economic growth of the US than the Euro Area one realized in 2004-2007. If the great Paulson’s Plan starts, US will probably «burn» other $500-1.000 billion dollars. At that point, maybe markets will be rescued, but the true History to teach will consist in the fact that the real growth in Euro Area during the first decade of this century has been more sound and stronger than the «virtual» one in the US.

Europe should aim at a political union that can allow to overcome the present difficulties and to support its development, Italy, on the other hand, has to bring about the necessary reforms to hold up the growth of the healthy part of the country, that is enterprises of its manufacturing industry.

How to survive the American financial troubles

by Marco Fortis

In the dramatic speech of the president George W. Bush aired on Wednesday to the American nation, there is the giant dimension of the economic-financial crisis that hit the first world power. Wishing and almost implore the Congress for the approval of Paulson’s Plan of $700 billion dollars (aimed at erase the «toxic» assets that the globalised American finance produced in these years), Bush said also:

America could slide into a financial panic… Many banks could go bankruptcy, including the ones in your community. The stock exchange could drop more deep, reducing the value of your pensions, your home could go down in value, foreclosures increase unrestrainedly, a lot of enterprises could close and millions of Americans lose their employ. You could not find easily the credit to buy a car or to let your children attend the college.

5 Appeared on «Il Messaggero» on September 27, 2008.
A very apocalyptic vision, that, on the one hand, can be used to obtain the approval of the emergency Plan, but, on the other hand, it does not encourage economic agents and citizens’ optimism. And it also makes completely understand the gravity of this historical moment. We are in front of the crisis of the «America debt empire», that, as the same Bush stated, is extremely precarious. This is due to strategic mistakes, not only in economy, that led the great American nation to a step from handing over to China the new world leadership, after the primacy in the manufacturing industry and in the exchange reserves. This situation does not cheer us up, since America has always been for Europe and Italy a fundamental reference, also and above all for its democracy, while China is not so.

Meanwhile, also on British newspapers, appeared opinions that have been already held in Italy and Europe for years, but till now they were criticized by the intellectuals too much confident on the capacities of the market mechanism. On September 24, 2008, Martin Wolf on the «Financial Times» remembered that the debt of American household arose from 50% of the GDP in 1980 to 70% in 2000 and to 100% in 2007; during the same time period US financial sector debt sprang from 21% to 80%, reaching at the end of 2007 116%.

Facing with these figures, it would be very useful that both European Central Bank and the Bank of Italy introduce promptly (if they do not have already them) synthetic debt index of the different institutional categories (household, financial sector, no-financial sector, public sector), comparing them with of the Federal Reserve System and easily comprehensible to not experts. This to explain, first of all, how Euro Area and Italy are positioned towards the weakened US economy. We know, actually, that public debt in Europe and above all in Italy is a serious problem, but it is indisputable that the entire Euro Area (including Italy) is making important efforts to restrain it into acceptable limits. On the contrary, US public debt, because of the current serious financial crisis, will explode such as the household one and the financial sector one, because among nationalizations (Fannie Mae and Freddie Mac), rescues (AIG) and interventions like Paulson’ s Plan or similar, its impact on the GDP is destined to grow quickly and dramatically. In the Euro Area and in Italy a positive aspect is undoubtedly constituted by the fact that the household and the financial sector debt is on average significantly lower than in the US. Regarding the banks, although, Daniel Gros and Stefano Micossi on «Financial Times» on September 24 sustained that the debt of some big European banks is so high yet, that eventual emergencies would need a European management and could not effectively faced by the single national authorities individually.

In this context Italy, that it was portrayed in 2005 by the «Economist» as unable to stand on its own feet, looks like a «corner of paradise». In fact, if from 1997 to 2007 American household debt rose to 51% of GDP and the one of the financial sector to 82% of GDP, bringing both over the value of the same GDP, in Italy this growth has been very moderate and both index
are largely under the GDP value. Updating these data for Euro Area and Italy and reporting them to the market and citizens could be very important, also to launch a calming message to potential new waves of panic, coming from US, shaken in the last hours by the latter bankruptcy, the one of Washington Mutual, the larger of a commercial bank in American history.

It is useless today, as many intellectuals that abandon the «ex American winner» did, to sentence from Europe that everything in US economy is a disaster and that the Plan proposed by Bush and Paulson is an aberration. While writing this article we do not still know if this Plan, that certainly can and must be improved, will be approved by the Congress. But it is certain, as Barry Eichengreen on «Il Sole 24 Ore» underlined, that in case of standby and without an intervention of the same importance the coming days can be disastrous for the markets, not only Americans but of all the world. On the same time, except of the criticisms that even the Bush Administration received (and the excesses of globalization based on the domestic and foreign debt that US capitalism has irrationally favoured), Europe and Italy have to be close in this difficult moment to America nation and economy. To acknowledge a very important alley in democracy and also to have convergent economic interests. Too many Europeans and Italians, maybe attired by the potential markets of emerging countries (first of all China) have rapidly forgotten the largest surplus of EU-27 and of our country are still the ones with US: respectively €80,4 and €13,3 billion euros in 2007.

A Sovereign-wealth Fund with Europe’s Gold6

by Alberto Quadrio Curzio

Throw the heart beyond the hurdle. In front of the international financial crisis, which risks to affect seriously the European real economy – in spite of her being structurally solid – a courageous and not ordinary answer, from political and economic institutions, is needed. There is, for instance, something tired and repetitive in the current debate on the monetary policy of European Central Bank (ECB): as if reducing or increasing of a quarter of point interest rate could change the economic trend. But there is the possibility for European Union (EU) to strongly intervene, also respecting the markets rules. How? By creating a European Sovereign-wealth Fund with a financial endowment, made of the mobilization of the Central banks gold reserves.

The issue of countries that accumulated large exchange reserves with oil and manufacturing exports and conveyed them into sovereign-wealth fund in order to do investments also abroad, has been urging for US Government, European Commission, European states and international organizations. Ren-

6 Appeared on «Il Sole 24 Ore» on February 5, 2008.
ato Ruggiero on «Il Sole 24 Ore» on January 26, 2008 questioned about EU position. Now as we mentioned on «Il Sole 24 Ore» on the last August, EU could create its own European Sovereign-wealth Fund (ESF) especially in order to invest in European enterprises and banks with global capacities.

It could be hazarded that ESF could intervene in stock exchange during hard times of dropping prices of very good European enterprises, cut down by panic and eventually sold off. For a Community who founded the European Investment Bank, the ECB and the Euro, it could not be an impossible innovation. On the contrary, it would be an important complement for a global economic power as EU is, that in this phase appears stronger than US for its value, for the substantially balancing of payments on current accounts, respecting to the enormous US deficit, for a «traditional» manufacturing industry that engenders large surplus from exports, for a ECB that shows greater governance ability than Federal Reserve System, for a banking system less damaged, by now, than the American one.

If EU had a greater political-institutional strength, the often sarcastic opinion of an irreversible European decline would be altered. To strengthen EU, it would be useful a European Sovereign-wealth Fund able to compete with export countries sovereign-wealth funds (Middle East, China, Russia, etc…), whose available funds are about $2.500 billion dollars, and as esteemed, they could reach $1.2000 billion dollars in a decade. At the beginning of December 2007 European Commission opted for not obstructing with protectionist policies sovereign-wealth funds of export countries, who have to be persuaded by international organizations to accept soon, by the half of this year, voluntary behaviour codes on governance and transparency. France and Germany positions are determined to introduce a protective legislation for enterprises considered strategic. Both solutions appear weak.

Our proposal of European Sovereign-wealth Fund is stronger than the European Commission one, who as usual shows deference towards a world market considered in a competitive system, which actually does not exist (while it exists and has to be increase in the European market), since there is a competition between geo-economic powers. And it is far more correct than the protectionist legislative proposal of France and Germany, which would damage the entire EU in long run. European Sovereign-wealth Fund should be founded on the contribution of a real assets, made by the official gold reserves of European countries. The same would not be sold but put under guarantee in a fund to attract credit liquidity (that today banks keep in order to no provoke sufferings to counterparts) and financial liquidity to invest. Official gold reserves of Eurosystem countries are 355 million ounces, with a very prudential price of $800 dollars per ounce, they have an equivalent in dollars of about $285 billion dollars. Thanks to this huge assets, it would not be difficult to attract credits and fundings in order to reach an availability of a $1.000 billion dollars to invest in interest bearing activities without worrying about the short-term, considering also the levers used by many societies. It would be soon the larger sovereign-wealth fund, followed by the Ara-
Bahrain Emirates with $875 billion dollars. With a further difference in terms of economic-financial security: the Arabian Emirates sovereign-wealth fund is 461% of its GDP, with risks of slides and unexpected liquidations, while the European Sovereign-wealth Fund could be 8.4% of Euro Area GDP.

We know that there would be many problems to solve to create a similar European Sovereign-wealth Fund: the «Central banks gold agreement», that includes also other Central banks with remarkable gold reserves (Switzerland and United Kingdom, who could prefer to adhere to European Sovereign-wealth Fund instead of incurring into the uncertainties of foreign sovereign funds); Eurosystem statutes; the determination of the juridical status of the fund and the participations into it, that could involve also private capitals. However, unless old nationalism or dogmatic economic liberalism intervene (oriental funds can appear more attractive), euro-democracy could build the European Sovereign-wealth Fund, considered the innovative force showed with the Euro.

Europe is not only European Central Bank

by Alberto Quadrio Curzio

US Treasury Secretary asked G-7 countries for a greater contribution to solve the crisis and Ministers of Finance and Central bankers of the Great Seven shared US measures. We can be glad but not satisfied because G-7 intends to continue as it did till now. But it could not be enough.

As it is not enough that euro-sceptics are re-considering «old Europe» and that European Union (EU) is more sounder for the greater relationship between savings, credit and finance on one hand and real economy and manufacturing industry on the other.

During the crisis Europe too much upon European Central Bank (ECB), who did well but it is not a substitute for a (economic) policy. Moreover it is worrying that at G-7, as it happens in other cases, every country acts individually. It is fundamental, in fact, that Europe appears with one voice, giving worth to its economic and financial weight in this current phase, where financial markets structure has to be redrawn in terms of precautionary measures, accounting rules and transparency.

Among the possible proposals to consolidate unitary European position we want to remember the creation of a European Sovereign-wealth Fund «similar but different» from the sovereign funds of emerging countries.

Many people considered the latter as useful means of management to relieve US crisis. There is something true in this opinion, but cautions are need because these funds are not lenders of last resort or charitable institutions to relief. So European Commission did well, when at the end of February 2008

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it issued lines of actions to the definition of a common European approach, safeguarding international opening of markets, but reaffirming member countries right to apply communitarian or national rules, if necessary, to prevent from foreign investments not transparent.

That is why German government, after Singapore sovereign-wealth fund had activated to take over Hapag-Lloyd of Hamburg, approved in August a bill that will allow Germany, from January 2009, to block the acquirement of holdings of «strategic» German societies from non-European investors for more than 25% of capital.

The European strategy to «nationalize» decisions is not convincing, anyway, for two reasons. First of all because the sovereign-wealth fund theme is a worldwide matter and not only because their assets, now of about $3.200 billion dollars could reach in a decade $17.000 billion dollars; in second place because an eventual relevance on «national» could damage also the home market with «protectionisms» – both intra-European and toward other countries with a fair behaviour in the world economy – stealing flexibility (that does not mean anarchy) to the international system.

So we propose a European Communitarian Fund with a critical mass to oppose the current crisis and to support the economic recovery. This idea, already proposed on «Il Sole 24 Ore» February 5, 2008 and in other writings at the beginning of this year, would be much better than a national protective laws.

The fund should therefore invest, acting on market, into EU both in infrastructures and in enterprises with continental or worldwide role, also for innovative profiles and returns in medium-long term. Without excluding the possibility to give guarantees to selected private enterprises, involved in long-term transactions or in restructuring. The European Communitarian Fund could have as assets the official gold reserves of the European system of Central banks, equal to 355 million ounces that at a price of $900 per ounce are worth now $320 billion dollars. Central banks would have a say in a matter but should not manage the Fund. Today, with Euro, gold reserves are uselessly frozen.

Attracting with this kind of guarantee a loan capital and/or risk capital of $1.000 billion dollars would not be difficult. The returns would come from medium-long term investments and restructuring. A similar proposal was put forward also for Japan by using a part of official reserves of its Central bank.

For Europe the creation of a European Communitarian Fund would demonstrate creativity and courage, as successfully happened with the launch of the Euro.

To conclude. Market laws are essential but they have to be set in a context of long-term development that has to be drawn by institutions and it can not be always delegated to single agents, particularly in crisis moments where trust volatilizes.

Moreover the lack of initiative of the European Council and of the European Commission since the beginning of the crisis, fifteen months ago, is
worrying. As it has been with Ecofin meeting (and Eurogroup) some days ago in Nice, where an extension of the European Investment Bank fundings to small-medium enterprises of some billion euros has been valued but innovative proposals of Giulio Tremonti have received a tepid welcome. It is useless to talk about international financial system reforms without taking the initiative. It seems that Nicola Sarkozy is working, as current EU President, at reform proposals: Italy should co-operate since now also because it will be G-8 President in 2009. Hopefully, EU, by reinforcing (economic) European institutions, could contribute also to reform the international ones\(^8\).

\(^8\) The translation of the articles of Marco Fortis and Alberto Quadrio Curzio have been made by Ilaria Pasotti.