

Viewpoints

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Lessons from the Crisis

By Dr. A. Michael Spence

The current financial crisis has complex origins and will require complex solutions. The crisis response has focused on unlocking credit and preventing extensive damage to the global economy. In the longer term, I see a number of potential regulatory approaches, including changes that dramatically improve market transparency as well as coordination among global authorities, and potentially a more effective supranational agency. A global commission could address the challenge of creating an early warning system that would better alert market participants and governments to growing risks of impending financial crisis.

But first, let's take a very brief look at where we stand currently, and what led us here. The measurable effects of the crisis thus far are dramatic; substantial damage has already been done. Major financial institutions are gone or transformed. Equities have declined in value globally by \$25 trillion. Banks have been seized and sold overnight. Emerging market equities have on average lost half their value. Growth is slowing in the developed economies, which still account for 70% of global gross domestic product, and therefore also in the rest of the world. The estimates of the costs of recapitalizing the financial sector are between \$1 trillion to \$2 trillion and continue to rise. Private flows of capital into the financial sector have dried up, capital is pulling out of emerging markets, many currencies are falling and there is credit tightening. Just as pressing, concerns about the viability of major financial institutions caused interbank lending to dry up, and the channels via which short-term credit is delivered to businesses and municipalities failed completely. This credit lockup threatened damage outside the financial sector.

In any market-based economy there are a few sectors that can damage the whole economy, or worse, bring it grinding to a halt. The most important are energy, transportation, financials and, in the modern era, telecommunications. The financial sector has many parts and functions: processing transactions, intermediating the supply of credit, financing investment and distributing risk. All of these functions are important, but processing transactions and supplying short-term credit are a mandatory day-to-day requirement. Protecting those functions is essential.

Even when these sector risks are internalized – and in the current crisis they don't appear to have been – external risks to the financial system always will be present. The magnitude of these risks can rise and fall with the stability and capitalization of the financial sector, debt levels and the accuracy of asset values. They represent a permanent liability on the public-interest balance sheet, and in practice this always means that they represent a liability on the government's balance sheet. Some believe that in a properly functioning financial sector these liabilities rarely become too large because the system has a self-regulatory capacity, but this view has not been borne out by the evidence. The current crisis and a long sequence of such events in developed and developing countries suggest public liabilities can become very large. At the very least it seems safe to say that we have not yet discovered a mode of regulation that curtails these spillovers to the “real” economy. The need for regulation

Viewpoints

November 2008

and oversight is clear, and in a tradeoff between efficiency and stability, a bias in favor of stability is appropriate.

Asset bubbles like the one that helped fuel the current financial market crisis are not new, and seem very likely to recur. In the present case we have an asset bubble in housing and other areas fueled by leverage and encouraged by the semi-invisibility of an increase in systemic risk.

However, it is one thing to have an asset bubble and excessive leverage in the housing sector, and quite another to have the balance sheets of all the major financial institutions, including banks, damaged to the point that interbank lending dries up, channels for underwriting commercial paper and short municipal paper vanish, and the payments system (which in its current form requires stability and confidence in the major financial institutions) malfunctions. Failures of the payments system and the inability to obtain rollover financing for governments and businesses are the main channels through which distress in the financial system spreads quickly to the whole economy. Then, slowing growth, rising unemployment and declining consumer and business confidence can further damage asset values and the financial sector. This is all part of the downward spiral in which we now find ourselves.

To ease the credit lockup and related payment-system problems, the authorities have had to invent new channels on the fly. This is reasonable, in fact crucial, as an emergency response mechanism, but to have reached a state where such ad hoc solutions are needed is unacceptable. It is crucial that channels for performing essential day-to-day functions are never destabilized or broken by distress elsewhere.

What are the longer-term solutions?

I see two complementary approaches. One is to segregate a sector of financial services through regulation, restricting its lines of business and setting capital requirements to ensure that the likelihood of an inability to function in processing transactions and channeling short-term capital is minimal. This would be a sector that is in effect a regulated public utility.

The second approach is to anticipate that emergency channels will occasionally be needed when there is widespread distress in the rest of the financial sector, and set up such channels in advance. Then deployment would be automatic and not a source of risk to the real economy. Of these two options, the first is likely to be perceived as preferable.

British Prime Minister Gordon Brown recently said the global financial system needs an early warning system – continuous oversight and monitoring to anticipate and head off crises. The idea appeared to gain traction among world leaders at the G-20 meetings in Washington. This is a good idea, but acting on it will require a nontrivial extension of our current knowledge and capabilities. We have been operating with indicators that, while relevant, do not add up to a complete picture of systemic risk – they set off alarm bells but lack authority.

Viewpoints

November 2008

Systemic risk escalates in the financial system when formerly uncorrelated risks shift and become highly correlated. When that happens, then insurance and diversification models fail. There are two striking aspects of the current crisis and its origins. One is that systemic risk built steadily in the system. The second is that this buildup went either unnoticed or was not acted upon. That means that it was not perceived by the majority of participants until it was too late. Financial innovation, intended to redistribute and reduce risk, appears mainly to have hidden it from view. An important challenge going forward is to better understand these dynamics as the analytical underpinning of an early warning system with respect to financial instability.

One approach is to bet on information and the market participants' learning. The focus would be a major regulatory overhaul to fix or dramatically improve transparency problems, with the hope or expectation that market participants armed with much better information would detect and manage risk better, especially with the benefit of applying lessons learned from experience. To be honest, I wouldn't want to bet global financial stability on this pillar alone. We are dealing with fat-tailed risks where the endogenous dynamics are causing the correlated risks to rise over time. While that happens, the system throws out very little data about the rising risk until the system becomes unstable. Absent very accurate and sophisticated models of the dynamics, expectations and beliefs about risk will lag behind the shifting reality (as they clearly did in this case) and the natural circuit breakers associated with risk avoidance by market participants and regulators won't work.

I therefore think we need a commission of top industry professionals and academics to address the challenge of measuring and detecting systemic risk and provide the underpinning of an effective "early warning" system. Progress in this area would provide a sounder basis for monitoring global financial stability and protecting the public interest.

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Viewpoints

November 2008

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