After the Crisis: In Search of the New Normal

Tenth Annual International Seminar on Policy Challenges for the Financial Sector
Towards a Brave New World – Reshaping Financial Regulation

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Context

• Thanks to the success of government stimulus packages, the global financial crisis that erupted in September 2008 the world economy continues to show signs of recovery.

• However, rising government and household debt still threatens to stir up another crisis and is serving as a drag on recovery. Further, a surge in liquidity is escalating concerns over inflation, giving greater credence to arguments for pushing ahead with an exit strategy.

• What is the proper course for responding to the biggest crisis since the Great Depression and reviving the global economy? And what should the new global economic architecture look like?
Questions

• How well has the global economy navigated through the storm of the past two years and what economic policies should be taken on at this point?

• What is the 'new normal' that will govern subsequent financial market initiatives and innovations?

• What now for the post-crisis world? What visions must policy makers formulate for its future and how can they make full use of its opportunities?
How well has the global economy navigated through the storm of the past two years?

• Overall, the policies have managed to stabilize the situation, but with considerable long term costs

• The most obvious is the increase in government debt
  – According to the IMF, government debt for advanced G-20 countries would reach 118 percent of GDP on average by 2014. Among them, only Australia, Canada, and Korea would have debt ratios well below 90 percent*.
    => Witness Greece, Portugal, Spain, Ireland,
  – Countries that are as highly indebted as the UK and US will, at the end of the crisis, grow at sub-par rates

• Other implications are more subtle
  – The moral hazard and costs of blanket guarantees on the system
  – Zero interest rate policy: Treatment may be as expensive as the crisis FT Economists’ Forum October 15, 2009 By Andrew Sheng and Michael Pomerleano
  – The consequences of nationalizing private sector losses FT Economists’ Forum January 15, 2010 By Michael Pomerleano

Europe’s General government consolidated gross debt

The impact of fiscal adjustment with simplistic Keynesian multipliers

<table>
<thead>
<tr>
<th>Country</th>
<th>Keynesian multiplier: $1/(1-c+m)\cdot 1/(s+m)$</th>
<th>Primary balance adjustment required to offset snowball effect (% GDP)</th>
<th>Impact of fiscal adjustment on output relative to baseline, in %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greece</td>
<td>2.5</td>
<td>9.9</td>
<td>-24.8</td>
</tr>
<tr>
<td>Ireland</td>
<td>1.3</td>
<td>7.4</td>
<td>-9.6</td>
</tr>
<tr>
<td>Portugal</td>
<td>1.7</td>
<td>3.1</td>
<td>-5.3</td>
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<tr>
<td>Spain</td>
<td>2</td>
<td>4</td>
<td>-8</td>
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Five financial reform policies for a crisis-wracked world - a scorecard*

- **Global policy challenge 1**: The global Imbalances. Looking ahead, there is widespread agreement that achieving macro-financial balances is essential to reduce the risks of future crises.

- **Global policy challenge 2**: Financial stability-While financial supervisors deemed each individual institution to be sound, risks were building in the system. Therefore the need for macro-prudential approach

- **Global policy challenge 3**: Recapitalization of banking systems and removal of toxic assets.

- **Global policy challenge 4**: Recognition and acceptance of financial regulation as a benefit and not as a cost of doing business

- **Global policy challenge 5**: Conduct of monetary and fiscal policy. With ZIRP huge risks ahead

Global imbalances 1996-2008: What can not go on will not go on

Source: The financial crisis and its international transmission: selected lessons Gian Maria Milesi-Ferretti International Monetary Fund, Research Department
Opportunities for the US, G-20

• It is imperative to use the crisis to lead to real global reforms with respect to Domestic and Global financial stability*. However, the results to date are not encouraging.

• Public Information Notice (PIN) No. 10/52 of the IMF dated April 22, 2010: Executive Board Discusses Modernizing the Surveillance Mandate and Modalities and Financial Sector Surveillance and the Mandate of the Fund" is indicative of the slow progress on macro-prudential surveillance.

• I recently wrote an article for Carnegie “Waiting for Godot: The Elusive Quest for a Financial Stability Framework”. Indicative of my assessment re. the progress.

Domestic Stability Reforms – criteria*

• A multidisciplinary, multi-agency function is essential
• Both central banks and fiscal authorities need to be involved in three key competencies related to financial stability: liquidity provision; prescriptions and proscriptions for the behavior of financial actors; and solvency support.
• Third, to be effective, the stability regulator must be independent of political considerations and separate from the micro-supervision of individual banks.
• Accountability requires clear regulatory objectives, a clear mandate, and clear processes for preventing, managing, and resolving crises.
• A stability regulator needs binding powers and the ability to impose measures on other regulators and financial institutions.

EU- This approach has glaring limitations: It does not take a multidisciplinary, multiagency approach to systemic risk. Central banks are heavily over-represented, and there is no clear distinction between the European Central Bank and the ESRB. Given the dominance of central bankers, the ECB dominates the other views and expertise on the ESRB in the decision-making process. The process is unwieldy (more than 61 members), and the ECB dominates the process with analytical support and voting rights.

US- regulator conceived as a reputational body with Sect. of Treasury chairing

* What international experience tells us about financial stability regulatory reforms By Michael Pomerleano December 21, 2009 FT
Glaring lack of progress at the international level

*  

-Criteria of legitimacy, independence and expertise  
-During the crisis the G20 policymakers rightfully rushed to assemble the present hodgepodge of entities to respond to urgent financial stability concerns. The Financial Stability Forum hosted by the BIS was reestablished as the Financial Stability Board on April 3, 2009 with a broader representation of the national financial authorities (central banks, regulatory and supervisory authorities, and ministries of finance) from the G20 and other countries, international financial institutions and the standard-setting bodies. It has a sweeping mandate to address vulnerabilities and to develop and implement strong regulatory, supervisory, and other policies in the interest of financial stability.  
-The G20 elected to accept existing entities that were established due to historical reasons (and accidents). Now the G20 needs to unravel the spaghetti bowl and establish an organization with legitimacy, accountability and expertise for the world at large.

* International financial stability architecture for the 21st century  
By Masahiro Kawai and Michael Pomerleano August 1, 2009 FT
Financial Stability and Development Council in India

The task of maintaining financial stability in India, at the moment, lies with an informal inter-regulatory body—the High Level Coordination Committee on Financial Markets (HLCCFM), which is chaired by the governor of the central bank and is composed of representatives of other regulatory agencies. The present arrangements are informal, and the mandate, authority, resources, and tools are not explicitly vested by law in the HLCCFM.

In his budget speech, The Minister of Finance addressed Financial Stability “The financial crisis of 2008-09 has fundamentally changed the structure of banking and financial markets the world over. With a view to strengthen and institutionalize the mechanism for maintaining financial stability, Government has decided to setup an apex-level Financial Stability and Development Council. Without prejudice to the autonomy of regulators, this Council would monitor macro prudential supervision of the economy, including the functioning of large financial conglomerates, and address inter-regulatory coordination issues. ...”
Comments? Suggestions?

Thank you.

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