Carlos Gustavo Cano: On the crisis

Speech by Mr Carlos Gustavo Cano, Co-Director of the Bank of the Republic, at the Universidad del Rosario School of Economics graduation ceremony, Bogotá, 25 April 2012.

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An important body of literature has come to light on occasion of the latest international financial crisis, known as the Great Recession, which began to form in 2007 and had the mortgage market in the United States at its core. Produced by the most prestigious economists in academia, this literature focuses on the etiology of that crisis and the suggested courses of action to prevent its reoccurrence. Several documentary films have been produced as well, which help to illustrate and stir the debate.

One of the most valuable exercises is that developed by Carmen Reinhart and Kenneth Rogoff (2009). Its title carries the ironic essence of one of its central messages: *This Time Is Different,* thereby reflecting the typically arrogant attitude often assumed by those responsible for economic policy, and particularly for financial regulation in the affluent world, when confronted with phenomena of this type, which have been recurrent, at least throughout the last two centuries.

Excessive exposure to financial risk, above all during the so-called “good times,” has been the main cause of these crises. During the last 25 years, this exposure was exacerbated by the much celebrated and lauded “financial revolutions,” which provoked the largest bubbles and “manias” in the real estate and securities markets.

The term “manias” suggests a loss of contact with reality and is akin to the idea of “mass hysteria”. Indeed, during a boom, people over-borrow in order to invest. The longer the euphoria provoked by the boom lasts, the more risks lenders take. And, so it goes until the income generated by the assets acquired by borrowers is no longer enough to repay their debts. Creditors then tend to demand loans be paid immediately, forcing over-indebted investors to sell their speculative assets precipitously to pay back their loans, causing the prices of those assets to drop sharply.

The hard lessons derived from these experiences – forewarned by eminent scholars who are no longer with us, such as Charles Kindleberger (2005) and Hyman Minsky (1992, 2008) – and regrettably often ignored but fortunately reiterated and recalled by a group of other learned contemporary writers and central bankers, such as Paul Krugman (2009a, 2009b), Nouriel Roubini (2010), Charles Goodhart (2005) and Paul Volcker, show investors do not respond to the “efficient market” theory, based on the false assumption of absolute rationality on the part of economic agents.

On the contrary, in the real world, false illusions and collective insanity tend to outweigh rationality. As a result, investors very often are exposed to “herd behavior,” attacks of “irrational exuberance” or unwarranted panic. If we were truly rational and the markets were indeed efficient and perfect, unemployment would be voluntary and recessions, natural and therefore desirable, as noted by Krugman (2009b), the 2008 Nobel Laureate in economics.

Moreover, to fulfill the objective of their mission, financial intermediaries raise funds from the public, which generally lacks the knowledge and sufficient means to assess the solvency and liquidity of those intermediaries, and to understand the nature and scope of the risks involved in how those funds ultimately will be used.

Therefore, the State must assume a fundamental responsibility to fill this delicate vacuum. It can do so primarily by educating, guiding and protecting the consumer, by reinforcing – through regulation and oversight – the confidence savers and depositors have in the broader financial system, by ensuring its social effectiveness, by promoting competition among its agents and avoiding dominant positions in the market, by minimizing the risks and the costs of crises, by ensuring the smooth operation of payment systems, and by giving rise to and preserving the faith citizens have in the constituted authority that is responsible for monetary policy, regulation and oversight.

Ultimately, what is at stake are the criteria for deciding who may or may not use the public's savings and for what purposes; who may or may not undertake new businesses; and who may or may not preserve or increase their positions of economic power.

As to the constitutional duty of the country's monetary authority, which is essentially to secure and maintain low and stable levels of inflation through controls on demand and on growth of the amount of money in circulation, the efforts of today's central bankers could easily end up being offset by new and very near substitutes for the latter.

I am talking about some of the latest credit and financial "innovations." Their development has paralleled that of the so-called "shadow banking system," with a capacity to issue currency by virtue of those innovations that goes beyond the reach of the central bank's monopoly or control over that function.

Clearly, the regulation of classic and new financial intermediation, rather than supplementary, must be an essential and urgent part of the management of the monetary base in all its accepted forms and varieties.

Rather than distorting the use of a traditional instrument such as the interest rate to achieve that second objective, what we need is a second instrument with counter-cyclical features of the kind that make it possible to exercise effective control over growth in the loan portfolio during asset price booms, such as those involving real estate and securities. Obviously, the issue at hand is one of regulation and oversight.

The appearance of new non-bank intermediaries with a strong appetite for risk – hedge funds, private equity funds and venture capital funds, among others – is the most formidable contemporary challenge the authorities now face. Within the "broader financial system," in most of the planet and especially in the United States, duly supervised banks occupy an increasingly reduced space, as indicated by another of today's most noted experts, Raghuram Rajan (2005, 2010). At the time, he was labeled as backward by the heads of the financial conglomerates and their counterparts in the public sector. Yet, ultimately and because of deregulation, it was they who sparked the crisis.

Therefore, if regulation and oversight are to be effective, they must apply to the conglomerates, instead of being applicable only to individual firms in a separate manner. The entire system must be covered comprehensively and seamlessly.

As illustrated by Reinhart and Rogoff (2009), there is a striking correlation between the degree of freedom in capital markets and the occurrence of crises. Clearly, the booms in capital flows have been particularly important factors in causing financial crises, as least since the 1970s when the markets began to be deregulated in a major way.

Thirty years ago, in the face of that the deregulatory wave, Minsky (1992, 2008) warned that a sophisticated, complex and dynamic financial system like ours endogenously generates destabilizing forces than end in equally serious economic depressions as a natural result of noninterventionist capitalism. "Do not allow the markets to operate freely," he said. As happened to Keynes, many accused him of being a socialist, and even a Marxist, when actually what he was trying to do was save the capitalist system. Since then, the "Minsky moment" has been popularized in economic literature to characterize the symptoms of this type of crisis.

In addition, the possibility that the effects of sharp increases in capital inflows, combined with high terms of trade, might be multiplied by the financial system through more lending, thereby generating asset price bubbles, constitutes a risk that warrants careful monitoring. Similar scenarios could trigger the formation of bubbles, and equally unusual increases in current account deficits and excessive vulnerability of the financial system.

The behavior of asset prices, although not included in conventional indicators of inflation, also should be an issue of concern to the monetary authority, namely the central bank, because of its impact on the solvency and stability of the financial system.

The idea is to steer regulation towards dealing with the systemic risks in the financial sector as a whole, as opposed to addressing isolated parts. This means supplementing the conventional objective of monetary policy by adding the mandate to anticipate potential asset price bubbles. For that reason, regulating the supply of credit is crucial.

What is needed to do so, apart from interest rates, reserve requirements and capital controls, which must continue to be available and applied, when warranted under the circumstances, are other tools now referred to as macro-prudential regulation. These include minimum liquidity and capital requirements for intermediaries; ordinary and counter-cyclical provisions; leveraging limits; criteria on risk management and investment portfolio diversification; limits on loan-to-value and loan-to-income ratios for housing and other consumer durables , as well as limits to financing securities through "margin accounts"; prevention of currency and maturity mismatches between leveraging by intermediaries and their loan portfolios; counter-cyclical capital requirements for intermediaries, according to credit performance; and separation of commercial banking activity from proprietary trading.

In short, the task at hand is essentially to prevent excesses caused by financial and credit innovations, to offset the formation of asset price bubbles and to prevent them from bursting, and, above all, to protect the consumers of financial services.

Colombia can proudly show off its sold and transparent institutional system in the realm of monetary policy and regulation and oversight, which is recognized and respected both at home and abroad.

The severe crisis the country suffered at the end of the 1990s taught us some harsh lessons. Fortunately, they were learned well and assimilated by our central bank, which is known for its outstanding and proven technical capacity.

Since then, coordination with the Finance Ministry and the Office of the Superintendent of Financial Institutions in the area of regulation and oversight has been particularly close and fruitful. Nevertheless, in my opinion and regardless of how suitable and responsible management fortunately has been, this last agency should have a degree of independence and autonomy similar to what the central bank (Banco de la República) enjoys, with a Board of Directors and fixed terms for its members and for the Superintendent. Its public credibility would be further strengthened through such reforms, as would its harmony and coherence with the Board of Directors of Banco de la República, which is essential.

James Madison, the foremost architect of the United States constitution and the foundations of its public institutions, wrote the following in the fifty-first edition of the *Federalist Papers*:

> "If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself."

Inspired by Madison's judgment, in an excellent book just published by MIT entitled *The Guardians of Finance*, the authors, who almost certainly are the leading experts on these topics at present – James Barth, Gerard Caprio and Ross Levine (2012), added:

> "If men had only angelical intentions and the markets were perfect, there would be no need for government or financial regulation. But people are not angels, nor are the markets perfect."

On this particular point, United States Senator Carl Levin, who is quoted in the book, said:

> "The recent financial crisis was not a natural disaster. It was an economic assault perpetrated by men. People did it…and it will happen again unless we change the rules."

The moral of these considerations leads us to recognize that history is the master inspiration of economics; psychology, the language by which it can be understood; and ethics, its cradle.

Those who disregard history, like Sisyphus, will never cease to wrongly believe "this time is different".

Those who ignore psychology will never be able to understand that economic is essentially a science of human behavior. Were it not so, then how can one explain the fact that the 2002 Nobel Prize for Economics went to the most celebrated psychologist of our time, Daniel Kahneman (2011)?

Finally, let us not forget the first great work written by Adam Smith, the pioneer of modern economics, was *The Theory of Moral Sentiments*, followed by *The Wealth of Nations,* which is better known to us for having concentrated on the specific object of our profession as economists. But the order in which these works appeared is not coincidental. Clearly, the former provided the underpinnings for the latter; hence, their contents are bound essentially by cause and effect.

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