The Stern Stewart Institute

# REVIEW ON THE ANNUAL SUMMIT 09/2008

## Managing uncertainty – the global economic framework in flux

The world's financial sector: Crisis? What crisis?

The wealth of nations

Futurology on the financial system

The next Annual Summit will take place on September 10 – 12, 2009 at Schloss Elmau.

# Impacts of the Financial Crisis on the Financial Markets, the Global Economy and Politics

an introduction by Stefan Heppelmann

The timing and choice of topics for this exchange of ideas between a panel of leading thinkers could not have been better, with the financial system only a heartbeat away from its breakdown, tremendous state aids throwing all market-belief over-board, a dramatic shrinking of "assumed" liquidity due to reduced lending activities between financial institutions and a huge swing of real liquidity between different asset classes.

The following discussions took place on September 12 and 13, 2008, just hours before the investment bank Lehman Brothers failed and was denied a government bailout, forcing it to file for bankruptcy. Although the general mood at this time was still rather positive, all participants shared their rather pessimistic view on the burgeoning financial crisis.

Is this just a financial crisis? Will it impact the "bricks-and-mortar" industries as well? And if so, what is the next round in this vicious circle? Can and should the governance issue be solved by the players within the financial industry or do we need politicians to change the market mechanics? How do we avoid future "too-big-to-fails"?

One could argue that market mechanics have no embedded memory and tend to make the same mistakes over and over again unless the underlying incentive structures and governance procedures change.

This idea is taken up and further developed by John Plender in his "Futurology on the Financial System". Plender sees a future for the financial system, but it is not a bright one. Going through different reasons for the crisis and analyzing potential next steps, one of his key arguments is that financial markets are global while regulation is not. Thus, even if investment banks would not survive (unfortunately this hypothesis proved true within several days), bankers would!

Unless there is the political will to have truly global and harmonized regulation, arbitrage opportunities would exist and be utilized by other players, such as hedge funds. On the other hand, a market for simpler, utility-style banking services would probably outlive the crisis, allowing banks to earn moderate returns.

Another group of experts is analyzing the geopolitical landscape and how it has been impacted by the crisis. China is progressing more rapidly than the US and Europe, largely due to overregulation in western countries. China's GDP is expected to be on par with the EU and US by the next generation, giving it enormous economic clout. The risk side to this is that China's social coherence is dependent on the economic growth; unfortunately given the global economic downturn, China's economy is unlikely to continue growing at the same rate as in the past. India follows a comparable track, even if it may take longer.

Finally, oil- and energy-rich countries already impact today's capital markets as the key providers of liquidity. These investments will need to be paid off, perhaps by a shift in political power. Can the G8 and the UN Security Council, in their current compositions, seriously expect to continue once the dust of this crisis has settled? All panelists agree that these issues need to be solved to preserve a state of understanding and shared wealth generation between the core regions of our world.

Stefan Heppelmann is Partner at Stern Stewart & Co.

**Dr. Dieter Wemmer**
Chief Financial Officer
Zurich Financial Services

**Prof. Dr. Edward G. Krubasik**
Member of the Supervisory Board
Dresdner Bank AG

PANEL LEADER:

**Stefan Schreiter**
Chief Executive Officer
Der Grüne Punkt – Duales System Deutschland GmbH

**Prof. Dr. h.c. Karlheinz Hornung**
Chief Financial Officer
MAN AG

**Dr. Ludger Arnoldussen**
Member of the Board
of Management
Munich Re

**Thomas Pütter**
Chief Executive
Allianz Capital Partners

# The World's Financial Sector: Crisis? What crisis?

**Schreiter:** We are facing a situation with intense corporate governance problems that has developed over the last two to four years and affects not only the financial sector, but also the industrial sector.

Let me start by asking Dr. Wemmer about risk management. How does it work? Has it failed in the past? And does corporate governance work?

**Wemmer:** Since Zurich Financial has weathered the crisis quite well, I think that risk management has been effectively implemented.

At Zurich Financial, we continuously apply four simple tools to avoid taking on investment products that we don't understand. First of all, we have an explicit capital allocation that we charge to our risk-taking. We also have a target return and don't accept the risks if we don't make our target returns. We also have a maximum risk load we take on in one investment. And finally, because of the high complexity of risk management tools that even experts concede are problematic, we use worst-case scenarios to give us insight into what the consequences for our enterprise would be if the world fell apart.

**Schreiter:** If the experts don't even understand, you really have a problem. Thomas Pütter, what is your private equity point of view?

**Pütter:** This crisis may well be the worst crisis in the last 60 years, but let's put it into perspective. Even though it has wiped out an estimated two and a half years of bank earnings, the banking world hasn't collapsed yet. This crisis is so dramatic because a large part of it started as a valuation problem, not a default problem. Because the instantaneous wipe-out of significant value had to be replaced by additional capital, the old-fashioned banking way of solving these problems, namely to eat through them over a period of years and digest the difficulties slowly, is clearly impossible.

**Schreiter:** If this financial crisis is a valuation problem, then the question is if and how it affects the "real" economy.

**Hornung:** The real economy will certainly be affected by this crisis. Due to the recent high liquidity, private equity investors outbid strategic buyers and pushed acquisition prices sky high. The current, more realistic assessment of inherent investment risk will encourage increased investment in good projects, while funding is cut for some of the bad projects.

There will be a price to pay for what's been happening, however. In the real economy, the kinds of things these institutions have been doing would eventually cause you to go bust. However, the banks always trust that the government will help them if they get into trouble, allowing some money to flow in sooner or later. This is one of the reasons why banks have such a high appetite for risky investments. Another reason for the crisis is the incentive systems.

**Krubasik:** I agree that the re-pricing of assets and the recapitalization of banks will pull money out of the real economy. We will have fewer mergers and acquisitions, fewer leveraged buyouts and more expensive project financing. We will also see more efficient allocation of capital in the real world. There will be money flowing back from the less-developed economies into those that have been growth-drivers. There will also be more inflation and currency fluctuations. If the US government takes $5,000 billion on the balance sheet by absorbing the debt of all the mortgage companies, there will be an impact on currency exchange.

In addition, there will be ownership changes, both through consolidation and an increased number of strategic buyouts due to fewer private equity deals. People may even have a chance to buy back their own stock at low prices, or turn their stock into convertibles, creating ownership changes.

**Schreiter:** Does that mean banks, insurance companies and the whole financial sector is going back to the basics (i.e. to the financing of industrial companies, not virtual products)?

**Krubasik:** Transactions should be related to project financing, to company financing, to infrastructure financing and to growth financing in the real economy. The level of internal trading, with the number of complicated papers generating enormous profits without a real economic transaction, should be reduced. That automatically happens if more underlying capital is needed for highly leveraged transactions.

Also the principle that, "You can only do business that you understand," probably needs to be reinforced. Why did we rely so much on rating agencies when we knew that even they had trouble understanding what they were rating?

**Hornung:** I think we should make sure that we learn from this crisis. What can it teach us? Why did it happen? Because if we don't understand the roots of the cause, we will leave it to the politicians to create laws that will lead to more restrictions in the real economy. Somebody should sit down and analyze how this happened and how institutions like rating agencies or central banks can react earlier to prevent the crisis from becoming this extensive.

**Arnoldussen:** I think we will see a re-evaluation of corporate strategies. Munich Re was, for a long time, known as a rather conservative, maybe even a bit boring company. Now these characteristics are greatly valued because investors realize that, despite highly sophisticated risk management systems, the control that companies have over their risk differs.

In the past, we were often confronted with investment banks' high equity returns as opposed to reinsurance companies. Some of the secrecy about how they managed to do that has now been lifted. They moved so many risks off their balance sheets, creating the illusion of higher equity returns.

Investors will put more value on predictable results and they will be prepared to accept lower returns on equity.

**Pütter:** We have seen a breakdown in corporate governance. The boards of directors of these banks and others of such organizations should have been monitoring more carefully. I think what's most perverse about this crisis is that it is the result of an unprecedented period of wealth creation. Unless there is

significant regulatory interference, the behavior of the banking system is not going to change. There is going to be a period of shock for maybe two years. And since the memories of the financial world are relatively short-lived, we will do the same thing again in the next period of economic upswing. It is the inherent nature of finance because financial institutions compete with one another for their capital base, for their shareholders and for their innovations. So, it's going to happen again.

**Wemmer:** I am also not optimistic that new regulations or learning the lessons of the crisis will solve it. I think we have all seen it before. After WorldCom and Enron, the SOX [the Sarbanes-Oxley Act of 2002] was created as a formula to restore ethics to the business world. Since the SOX only managed to create increase the business for certain advisory functions, the SEC is currently working on a new SOX to bring everything back to normal.

**Arnoldussen:** Regulators need to ensure that this crisis won't repeat itself again. One issue that the regulators should really address is the issue of "too big to fail." We should ensure that those who made the wrong decisions pay the price, not the taxpayers. And the measures could be quite extreme, including limiting the size of banks, increasing regulation for bigger players or increasing capital requirements with size because of the bigger systematic impact. There are many ways to address the what the consequences should be. What's important is setting the proper incentives for everybody in the market.

**Schreiter:** So what can we do? Corporate governance is a solution, but it doesn't seem to be effective.

**Wemmer:** The problem is that we have a one-way incentive system. It only creates incentives, there are no disincentives.

**Krubasik:** We need to apply existing laws more consequently. We need to examine if the rating agencies used the appropriate analytical models and were thorough in their research or if we need to re-evaluate the ratings system to ensure a better under-

standing of specific processes. We need to figure out how good the banks were and if they blindly accepted inferior ratings. Maybe banks should be required to take on more risk to prevent repackaging and redistributing inferior loans.

**Pütter:** I think that central banks and regulators are going to increase the cost of doing business in certain areas. I also think that the central bankers and regulators got a wake up call that there were large parts of the financial market that they hadn't looked at properly. We will see some degree of regulation or at least enforced self-regulation, especially for hedge funds and private equity communities, which are involved in trillions of financial transactions.

I personally don't think this crisis is over, nor do I think that we have reached the peak yet. Two weeks ago, somebody said: "Forget subprime and forget the beginnings of some of the consumer credit crisis that we are seeing, all of which totaled about $1.2 trillion, according to World Bank estimates. There is a $65 trillion credit default swap market out there. It is perfectly conceivable that in an economic downturn, 2% of this could go bust. That alone would be larger than everything we've seen to date." Two weeks later, $500 billion of that was triggered by the bailout of Fannie Mae and Freddie Mac. Nobody knows how the credit default swap market will domino if we have a significant economic downturn. I can tell you though, that as

Though the reasons why this crisis occurred can be explored, it is the inherent nature of financial markets and participants that a similar crisis might develop in the next period of economic upswing.

Volkswagen issues a profit warning on its consumer car leasing business and as every credit card company in the world is reassessing its loss reserves, we haven't seen the end of this yet.

**Schreiter:** Do you think we've seen the end, Mr. Hornung?

**Hornung:** I think we are close to the peak of the crisis, but we need about five to six years to work it out.

**Arnoldussen:** My view is slightly more optimistic. I think we've seen maybe two-thirds of the crisis and I agree it will continue. But a lot depends on the decisions of institutional investors and how they fare during this crisis.

**Wemmer:** I also think that we're two-thirds through, but I think we will certainly see other really big name failures, so that is probably not over yet.

**Krubasik:** I agree with the five to six year recovery window, though I am surprised that we haven't heard much about credit card debt and private equity bond failures. I expect some failures by private equity-funded companies, which are at risk in a downturn because of the high leverage and the current tight conditions in a refinancing situation. We haven't heard about the refinancing wave in the industry mainly because most of the industry credit lines are fixed at five to six years going forward. So, there are some things that are still in the pipeline.

**Question from public:** The big three carmakers in the United States (US) are in big trouble. We've had a tremendous decline in the market value of real estate and shares have dropped as well. Citibank has lost $55 billion, Merrill Lynch has lost $52 billion. Economic growth has stalled; unemployment rates and bankruptcies are increasing. Past US crises were generally short-lived with consumer spending fuelling recovery. Will consumer spending be able to save the day yet again in this crisis?

**Wemmer:** Since half of our company is US-based, we've really seen the impact of this crisis. The average American family with three cars uses only two of them now because of the high fuel prices. Also, consumers significantly reduced spending on fun vehicles like jet skis and motorcycles. So, there is a real change in US consumer behavior.

Still, the US has the ability to react faster to a changing economic environment. There is also a ton of available cash in money market bonds, so as soon as there is enough trust in the financial system again, there will be an exorbitant flow of money going back into the system.

**Schreiter:** Let me briefly summarize our discussions. Having discussed so many interesting angles of the financial crisis, we all agree that the crisis is not yet over and due to the severity of the crisis it will take several years to recover. There will also be a trend back to only doing business that we understand. Though we can explore the reasons as to why this crisis occurred, it is the inherent nature of financial markets and participants that a similar crisis might develop in the next period of economic upswing. In an effort to prevent history from repeating itself, incentive structures need to be changed sustainably and we need effective corporate governance and strong regulator involvement.

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| John Plender | Prof. Hans-Werner Sinn | PANEL LEADER: Prof. Dr. A. Stefan Kirsten | Dr. Hans-Joachim Körber | Iyad Malas |
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| Columnist | President | Chief Financial Officer | Chief Executive Officer | Chief Executive Officer |
| Financial Times | Ifo Institute for Economic Research | Majid Al Futtaim Group LLC | Metro Group (until 2007) | Majid Al Futtaim Asset Management LLC |

# The wealth of nations

**Kirsten:** First off, let's ask ourselves a couple of questions: Can we and the OECD countries expect to dominate the global economy in the future as we did in the past, even though developing countries consistently grow at three to five times our pace? If 8 billion people want to fulfill their demand for goods and services, why were we surprised by the onset of a commodity boom? Are sovereign funds bad per se? Do rich countries have to be democracies? To organize the subsequent discussion, let's summarize the key topics in this panel with currency, competitiveness, regulation and sovereign funds.

The news is full of salary caps for managers, minimum wages, codetermination and EU and national regulation. Do we deserve our level of stagnation, are we losing our competitiveness, do we over-regulate and are we losing our grip?

**Körber:** There is a simple answer: Yes. We are world export champions and we benefited a lot over the years from the fall of the iron curtain. We were successful because we had been very competitive. What we really did is export high wage jobs to Eastern Europe and increase that competitiveness.

The question is how we deal with India and China. Based on my frequent visits to China, I think there is a misperception in the West about China. It is not so much about what the Chinese are doing, but the speed at which they are tackling their problems. When we have a problem, it is a serious one because it takes us 10 years to fix. In China, the same problem takes about six months to a year to fix.

So I think we are over-regulated, but we don't realize it. We don't understand the real issues. And there is only one solution: We need to create a common market, because that's the only way to stay competitive.

**Kirsten:** Do you think that protectionism will generally increase?

**Malas:** The large amount of money that is generated by oil producing countries and countries with natural resources implies that there will be a race between China, India, Russia, the US and the EU to be the main power in the world.

The race for the world's energy resources is aimed at securing and controlling a country's future. There will be a wealth transfer from energy-consuming countries to oil-producing, mineral-rich countries, causing some backlash. Many countries will move to protect their own markets, increasing the level of protectionism.

Wealth funds like the Abu Dhabi Investment Authority have invested on a global basis for many years. As the magnitude of investment has increased, some countries, particularly the US, have grown wary about the money source. With the recession that we are seeing in the West, you are going to hear more and more politicians getting worried about the source of money. Also, there is a need for greater transparency with sovereign funds.

**Kirsten:** So why does the media love to hate the state-backed funds?

**Plender:** All I can say is that they shouldn't. Americans cannot be protectionist about capital flows while they have a current deficit of 7% of GDP. They can't afford that attitude towards sovereign wealth funds when their banking system is troubled and desperately short of capital; they depend on sovereign funds to maintain the solvency of the banking system.

If you try to integrate these emerging markets into the global trading system, there are bound to be stresses and strains. Overall trade is a positive-sum game, but of course there are winners and losers as this process takes place. And those losers have political clout. It's going to be very difficult to avoid rising protectionist pressure in the US and Europe, particularly when some of the emerging markets, like China, peg their currencies to the dollar in a dirty float to maintain the valuation. With the overvalued euro, we are feeling the strain from the integration of these developing countries into the global trading system.

**Kirsten:** Mr. Plender expects a higher long-term growth rate, higher productivity and a more favorable demographic profile for the US than for Europe. Prof. Sinn, how does that fit with your notion that Europeans will weather the current recession better than the US?

**Sinn:** The reason for the opposing opinions lies in different time spans. The high population growth in the US compared to a shrinking European population puts the US in a favorable position for the long-term. In the mid-term beyond the current recession situation, however, Europe is doing quite well and better than the US.

The problem in the US is serious. They have to get rid of the current account deficit and there are only two possibilities: 1) the stagnation of the economy will decrease imports or 2) a devaluation of the dollar.

**Kirsten:** How fast will emerging markets like China, India and Russia be able to reach a dominant position in the world? Will they need five years, 10 years or 100 years?

**Körber:** A lot of experts predict that by 2030 China will have the absolute same GDP as the US. I am not so optimistic with regard to India because the infrastructure will take longer. The Chinese are far more advanced; they invest in infrastructure. The retail industry that took us 50 years to develop, the Chinese developed in 10 years. They have made rapid progress and have used the latest technology. Therefore I believe we will see a shift in growth and a shift in power.

China is advised by a board with CEOs from around the world giving recommendations for its development. Their main message is to not overheat the economy. China needs to see 10% growth and a minimum of 10 million new jobs created each year to bring young people into the workforce. As we saw in the aftermath of the Olympic Games, the Chinese have developed national pride. They don't see themselves as an emerging market anymore, but on eye level with the western countries. And that will have a big political impact.

**Audience Question:** What is the situation in the UK? Will the UK blunder along like Europe and come out of it, or has it been in a permanent state of crisis for the past 60 years?

**Sinn:** The housing crises in the UK, Spain and the US are similar, and have to be solved. The UK, however, has an additional problem, namely that they are eating up the Thatcher reforms. The government share in GDP has increased over the last 10 years, while Germany's government share in GDP fell to an even lower level then Britain's.

Through the Schröder reforms in Germany, there was a revolution in the labor market. The wage distribution widened and created 1.1 million more jobs than the normal business cycle would have created. Germany is on a good path now, while Britain is not.

**Plender:** In addition to what Prof. Sinn mentioned, the UK has a sectoral problem because it is overly dependent on the financial and business services sectors. In the long-term, if you compare our problems coming out of the housing bubble with those of Spain coming out of its construction bubble, we at least have the flexibility of currency. Our markets remain more flexible than most of the euro-zone, though the British electoral system is also more responsive when confronted with challenges.

**Audience Question:** Can Europe rebuild itself and generate enough internal demand for growth that would make Europe exciting? I conducted a study for our industry in which we identified about 100 billion (or a third of the existing market) of additional investment opportunities. I wonder whether there is a growing perspective for Europe to be a different Europe – a Europe that is remaking itself.

**Kirsten:** How do you make Europe more exciting? Between our heritage, to the way we have moved forward peacefully and prosperously over the last 50 years – Europe is exciting!

On the other hand, other people have to catch up. Considering the OECD statistic, which shows that the percentage of the world's population that wants to become rich has risen from 15% to 40%, you obviously have to take some dynamics away somewhere else.

**Audience Question:** This time last year we talked about new institutions to deal with, the rise of the GCC nations or China or India for that matter. What is the viewpoint from the Gulf or even from China? Who is going to be setting the rules for the future?

**Malas:** If we want to extend the UN system, why are there only five countries and on what basis do these five countries have veto power? Why can't a country as big as India be a member of that system? Many institutions need to accept the reality of a changing world. Unless these institutions enact reform and give emerging players an important seat at the table, we are going to have increasing friction in many parts of the world.

**Plender:** I completely agree – the whole apparatus of international cooperation needs an overhaul as emerging players begin to assert themselves economically and politically. There is a lack of legitimacy in the way many institutions operate. The problem is that whatever you look at, whether it's the G8, financial regulatory bodies or the IMF, somebody needs to be bounced out and these news players added in to make it work. It's really going to be a serious challenge to address this problem.

**Kirsten:** Let me briefly summarize our discussion. We all agree that economic power will shift away from the traditional powers – US and Europe – to fast-growing economies like China and India. In addition, oil- and energy-rich countries already significantly impact capital markets as key providers of liquidity in today's markets. This recent shift in economic power will also require an overhaul of the political apparatus to incorporate these new realities. We need to reassess the composition of the UN, the G8 and other international regulatory bodies to ensure that our regulatory systems are ready for a new future with shifted economic and political powers.

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SPEAKER

John Plender
Columnist
Financial Times

# Speech
# Futurology on the financial system

Those of you who heard my very gloomy prognosis about the credit markets last year will take heart in the title of my address this time. "Futurology on the Financial System" does, after all, imply that the financial system has a future. Some people would have you believe that that is no longer the case. I beg to differ, though it would be foolish to deny that we are still in a financial maelstrom.

In some ways my forecast last year was an easy one. If you are coming out of the greatest credit bubble of all time, it was a pretty safe bet to argue that:

- There would a protracted process of deleveraging;
- The real problem was not the subprime mortgage market, but the re-pricing of risk all across the system;
- The US housing market had a very long way to fall; and
- The benign period of low-inflationary global growth and stability was at an end. It was "goodbye" to Goldilocks and the economy that was not too hot and not too cold.

Today, more than a year into the crisis, financial futurology is much harder, especially putting a date on when equity and housing markets will bottom out. We have had a huge amount of government and central bank intervention, but the liquidity problem in the interbank market has not gone away and there is still a phenomenal lack of trust.

We have seen bailouts all over the place – Northern Rock, Bear Stearns, Freddie Mac and Fannie Mae, even banks here in Germany. But the markets, after a positive initial response to the de facto nationalization of Fannie and Freddie – which makes George W. Bush's US look like the world's most socialist economy outside North Korea – are back in a funk. Will Lehman Brothers be the next to go? How quickly confidence evaporates after government intervention!

The logic of the US Treasury's intervention in Fannie and Freddie cannot be questioned. On any realistic basis, they are insolvent. There was an absolute need to maintain the confidence of America's foreign creditors, who had invested in the agencies' debt, as well as to shore up confidence at home. Securitization, remember, was a vehicle, among other things, for recycling the excess savings of Asia and the petro-economies. With securitized markets in a state of seizure, it became all the more important that these semi-state entities remain in business.

I doubt that the various measures proposed will have the immediate effect of stabilizing the housing market and mortgage-related securities. They will certainly reduce borrowing costs and add some liquidity to the mortgage market, but as I argued in Wednesday's *Financial Times*, there is a problem of debt exhaustion among US households. People borrowed up to the hilt and ran down savings to rock bottom levels during the bubble.

Hank Paulson is now asking households to borrow more when:

- House prices are still falling and there remains a huge overhang of supply;
- Unemployment and the cost of living are rising; and
- Bank capital remains desperately short, leaving the overall system still heavily credit constrained.

Big changes in government policy, or big u-turns, often signal turning points in the market. I don't think this is it, but I also think it is fruitless to try to predict the precise timing of markets bottoming out. So what I will try to do now is:

- Offer some thoughts on what the turmoil and the official responses imply for economic growth;
- Look at how economic policymaking will be different in the future;
- Ponder the future shape of the financial system; and
- Raise one or two wider points on the business climate.

First, the Fannie and Freddie intervention confirms what I argued here last year. The Americans will do absolutely everything that is needed to ensure that there is no deflation, no lost decade of the kind that afflicted Japan in the 1990s.

On the monetary front, they have the latitude because of the Federal Reserve's dual mandate to protect the price level and ensure economic growth. Under the present circumstances, that means that growth takes precedence over curbing inflation. The Americans also have in Ben Bernanke, the Fed's chairman, a man who has studied the deflation of the 1930s in-depth over the course of his academic career. He also spent a great deal of time studying the Japanese banking crisis.

On the fiscal front, I believe the Americans have the political will to do everything that may be needed to avert depression. In rescuing Fannie and Freddie they have already demonstrated a readiness to take risks on the side of fiscal profligacy. Both presidential candidates will be budget-constrained upon taking office, but neither will want to go down in history as a new version of President Hoover. The starting point for fiscal activism in the face of this crisis is admittedly dreadful. The cyclically adjusted deficit in 2008 is likely to be over 5% of the GDP even before the cost of rescuing the two big agencies.

In fact, a new era of fiscal activism is dawning all across the world. There have been recent expansionist budget packages in Japan and the UK and there is enough room to maneuver in much of the euro-zone. China, which has been an important driver of global growth during this present cycle, has a lot of headroom. It has a budget surplus and the level of public sector debt is very low.

That means that a global recession is avoidable. Provided the politicians keep their heads, fiscal activism can and probably will offset the relative impotence of monetary policy, which the credit crunch rendered ineffective in the US and elsewhere.

All this comes at a longer-term cost, however: The risk of return to an era of higher inflation. This could, paradoxically, be exacerbated if central banks seek to counteract loose fiscal policy; politicians will then be tempted to re-establish control over operationally independent central banks.

There has been a tendency to take the independence of central banking for granted in recent years. Under the current circumstances, that is complacent. There has also been a tendency to take the competence of central bankers for granted. That, too, is dangerous when you have today's combination of inflationary pressure and credit contraction. The scope of monetary policy errors is great, and their effects can last for a very long time.

We're also in a period when the liberalizing / privatizing ideo logy of the Reagan / Thatcher era is giving way to a less pro-market ethos. The world suddenly looks more neo-Keynesian. The legitimacy of the Anglo-American model of capitalism, with its heavy financial bias, is seriously and rightly in question. When the best and brightest in investment banking have made personal fortunes out of wrecking the financial system, questions should indeed be asked. The trouble is there are no other compelling alternative models of capitalism around.

So what kind of financial system is likely to emerge from the wreckage? The answer hinges, to a large extent, on the regulatory response to the crisis.

The striking thing is how difficult it will be for politicians to grasp this nettle, largely because of the sheer complexity of the system. Lord George, the former governor of the Bank of England, recently admitted having difficulty understanding securitized instruments. If he had difficulty, what hope have the politicians when considering how to re-regulate the system?

Much of what went wrong is due to leadership and governance failures, flawed incentive structures in banks and flawed risk models. These are not easy issues for politicians to address. What do they know about risk management or internal control? As a result, I think they'll address the easy things, like bashing the credit rating agencies, imposing tougher penalties for fraudulent selling of mortgages and so forth. They'll have to leave the substantive work to people in Basel, to the Basel Committee.

Having just got to Basel Two, we are now condemned to a Basel Two and a Half, which will have a much strengthened liquidity component. Because the politicians are restricted in what they can do more directly, they will apply immense pressure for exceptionally tough capital requirements to address excessive leverage. Capital will be the catchall solution, *faute de mieux.* I suspect capital requirements, when they are incorporated into national legislation, will be quite draconian. Proprietary trading by banks will be especially hard hit.

The implication is that we may return to a 1950s-style financial system that performs a utility-style function. Profits will be commensurately lower. "Respectable" forms of securitization – simple mortgage backed securities and credit card securitization – will survive in this system, complex-structured products will not.

You may ask, "Why not go down that route? That would be infinitely preferable to the investment bankers' financial version of Dante's *Inferno.*" But there is, alas, a snag. A utility-style banking system is a very dull, un-remunerative place for investment bankers. All the clever, ambitious, greedy ones will be tempted to jump ship. They will move to hedge funds and other

less-regulated vehicles that lend themselves to regulatory arbitrage. It won't take long before one of them becomes "too big to fail" in the next episode of monetary laxity – a systemic threat emerging from a new shadow banking system.

I doubt there is any escape from regulatory arbitrage. Capital flows have been comprehensively globalized, while regulation has not. The international regulatory bodies and networks are a patchwork and proliferation of unwieldy committees of varying degrees of effectiveness.

One of the ironies of the present crisis is that the big bailouts have required little cross-border cooperation. Yet, despite this lack of a complicating international dimension, cooperation failures between domestic institutions turned the Northern Rock bailout into a fiasco.

But at some point there will be a bank failure where the deposit base is larger outside the home country than within and where the systemic threat exists outside the home country. There will then be a fearsome haggle between politicians in different jurisdictions over burden sharing. In other words, the debate will be over whose taxpayers should meet the cost of the failing bank's insolvency.

For all the severity of the present crisis, this tells you it could be worse – and could yet become worse!

That underlines a fundamental problem that explains the frequency of financial crises in the modern world: moral hazard. Persistent bailouts encourage excessive risk-taking. Only when politicians can be persuaded to allow large financial institutions to go bust will this vicious cycle come to an end. However, politicians have no incentive to do this; it is not their money that supports lender of last resort operations and bank bailouts. No regulatory system, however well-devised, can be proof against this morally hazardous set of incentives.

So what is my conclusion?

With regard to the global economy, there will be no depression and there is no need for recession. We're not out of the woods yet, however, and have to beware of shocks. Anything could happen.

In terms of financial imbalances, the nationalization of Fannie and Freddie ensures the recycling of excess savings in Asia and that the petro-economies can continue as imbalances unwind over time.

We are back in a neo-Keynesian, less market-friendly world where the Anglo-American capitalism is discredited, and there may be some general collateral damage in terms of the legitimacy of business.

The most depressing of my conclusions, though, is there is no likelihood that we will find a way of putting the financial system back together again that will reduce the incidence of crises and bailouts. The political will to address moral hazard does not exist. So while the global economy will muddle through, it is only a matter of time before we confront the next bubble and the next financial crisis.

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**The Stern Stewart Institute**

Salvatorplatz 4 · D-80333 Munich, Germany

T +49.89.242071.0 · F +49.89.242071.11

E info@sternstewartinstitute.com · I www.sternstewartinstitute.com