

July 6, 2009

ING Investment Weekly

Basel Does A Balancing Act



Jim Griffin
Economic Advisor

If you have been confused about the contradictory arguments being heard regarding financial sector reform and re-regulation, go ahead and peruse the annual report released last week by the Bank for International Settlements (BIS). A close reading should have the effect of deepening your confusion while setting it onto a more broadly informed stance.

The discussion in a chapter on near term risks and exit strategies is shot through with the equivocations, contradictions and balancing acts inherent in, first, getting out of the hole the global economy finds itself in and, second, making arrangements so that this sort of crisis is less likely to happen again.

The BIS has some criticisms of the extraordinary government actions taken around the world in reaction to the meltdown following the Lehman collapse last September. On the one hand, it admires the creativeness shown and the breadth of response around the world but, on the other, it decries indecisiveness in disposing of bad "legacy" assets and recapitalizing financial institutions. Early recognition and comprehensive intervention are critical to successful rescue and BIS regrets the uneven resolution of the financial sector's troubles. It sees shortcomings in the rescue as leading to uncertainties that hinder the effectiveness of countercyclical fiscal and monetary policies.

As if there were clear options. For example, BIS argues that restoring the flow of lending to the economy through the financial system is critical – "banks must resume lending" – but to minimize the risk that this could happen again, banks "must also adjust by becoming smaller, simpler and safer."

Huh? Get bigger! Lose weight! Which is it? How can we expect both?

I suppose this is just another of the contradictions inherent in a deep recessionary situation. Near-term recovery seems to require that we do many of the same things that got us into the mess in the first place. Easy credit to borrowers of questionable creditworthiness? Check. Runaway fiscal deficits? Check. Oodles of excess liquidity through highly accommodative monetary policy? Check. It is a fact that cycles can spiral downward as well as upward, and may still be doing so in many asset markets and in the global economy itself. Lord Keynes pointed out that in the long run we are all dead, but if the authorities don't get the global economy out of a nose-down attitude, the long run may arrive sooner than we'd prefer. Unstinting countercyclical effort is critical.

But knowing when to quit is also important. The BIS notes the heroic fiscal efforts being undertaken around the world – the U.S. federal budget deficit will expand by 8% of GDP between 2008 and 2009 – but worries that the effectiveness of this fiscal thrust is compromised by a less than fully successful restoration of financial intermediation. Moreover, it fears overshoot: "timely, targeted and temporary are attributes notoriously rare in representative democracies." Fiscal overshoot might lead to a rise in real interest rates and the crowding out of private sector investment. It might also generate a bond vigilante reaction.

Exit strategy for central banks, it notes, is likely to prove less a technical issue than a political one. Rescue efforts have tended to support some

industries at the expense of others, and weaker banks with government help may be favored over stronger banks that are going it alone. Central banks have to get out of the role of “intermediary of last resort” but beneficiaries and their political representatives may complicate the retreat.

The BIS says it straight out: “Building a perfect, fail-safe financial system – one capable of maintaining its normal state of operation in the event of a failure – is impossible.” But to mitigate the risk of failure, it is necessary to address exposures that arise in instruments, markets, and institutions.

The “opacity, complexity and sheer volume” of financial instruments, particularly innovative new ones,, can lead to systemic problems. The BIS sees another balancing act here, in that it doesn’t want to block the scope for progress in devising new financial instruments but wants limits on any capacity they may have for imperiling the system as a whole. It suggests a supervisory approach akin to that for pharmaceuticals: some may be bought by anyone, some require a professional’s judgment regarding appropriateness and a prescription, and some are simply illegal.

Regarding markets, the principal systemic hazard is illiquidity. For some instruments, the BIS suggests replacing over-the-counter markets with central counterparties, or clearing arrangements, and with organized exchanges. This should help to address the opacity issue and make prices more transparent and therefore potentially less prone to cliff-like plunges.

And for institutions, a macroprudential framework is necessary. Systemic risks can arise if institutions have similar portfolios or similar exposures to counterparties. It notes that “...a financial sector with only a few large institutions may be no more risky than one comprising many small institutions whose balance sheets all look the same.” A high level regulatory perspective that can look across these balance sheets for systemic exposures, whether they be in commercial or investment banks, or insurance companies, or hedge funds – or any other significant concentration of capital –is a necessary part of a more stable financial system.

The review by the authoritative BIS of the causes, consequences and possible remedies of this historic financial crisis might be cartooned as: Don’t stint – it might cause failure. But don’t do too much – it might cause overshoot and then relapse. Allow for progress in financial innovation – but make sure it is transparent and appropriate to the target accounts. If you’re looking for simplicity, clarity and unhedged prescriptions, the BIS 2009 annual report does not appear to be the place to find them.

Still, the central bank for central bankers may have the best vantage point for assessing the problems that have arisen in the global web of finance. The fact that it doesn’t have simple answers suggests that there simply aren’t any. ■

Copyright © 2009 ING Investment Management. This report does not make any recommendation about your investments, and this information should not be considered investment advice. Any opinions expressed herein reflect our judgment at this date and are subject to change. Certain of the statements contained herein are statements of future expectations and other forward-looking statements that are based on management’s current views and assumptions and involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. Actual results, performance or events may differ materially from those in such statements due to, without limitation, (1) general economic conditions, (2) performance of financial markets, (3) interest rate levels and (4) increasing levels of loan defaults (5) general competitive factors (6) changes in laws and regulations (7) changes in the policies of governments and/or regulatory authorities. ING Investment Management assumes no obligation to update any forward-looking information contained in this document. Past performance is not indicative of future results. This material may not be reproduced in whole or in part in any form whatsoever without the prior written permission of ING Investment Management. To obtain permission, contact stephen.easton@inginvestment.com or 860-275-2110. For all other inquiries contact David White, Publishing Manager, david.white@inginvestment.com or 860-275-2056.