



BRIEFING

What Went Wrong?

An Agenda for the G20

by Miles Saltiel

Summary

Many common explanations for the economic crisis are wrong, stemming from prejudice rather than evidence. In reality, there are five key culprits that the G20 should focus on: (1) loose monetary policy; (2) hubristic social engineering in housing policy; (3) the failure of the Basel protocols on core capital; (4) banks that were 'too big to fail'; and (5) the effects of oligopoly on auditors and ratings agencies.

The scene of the crime

On 2 April the G20 leaders will meet in London's Docklands. Disobliging commentators are already trashing their host, Gordon Brown, suggesting that he wants nothing more than cover so as to buy the UK's next election. *Prospect's* Foreign Editor goes one better in the current issue suggesting that, by contrast with FDR, Obama is talking up a run-of-the-mill downturn to legitimate *dirigiste* plans never put to his electorate.

We may be sure that few attending the summit will have the candour of one of their sherpas, as reported on 14 March in the *Financial Times*. He spoke of a milieu akin to a bar-room, "You wait till a fight breaks out and then take a swing at the guy you always wanted to hit. Whether or not he had anything to do with starting the fight is not the point." It certainly looks like many are using the turmoil as an opportunity to push their pet agenda. Obama's Chief of Staff, Rahm Emanuel, made no bones of it, "You never want a serious crisis to go to waste". Hilary Clinton echoed him recently in Brussels, "Never waste a good crisis..."

They are not the first. From the outset, academics and journalists have been contorting a chaotic reality to fit the way they've always seen the world. We owe it to ourselves to look through this less than forensic analysis and attempt to glimpse what we may of the truth. Let's start with some of the leading contenders.



The usual suspects

Alan Greenspan is the former Governor of the US Federal Reserve. Last year, his testimony to Congress seemed to recant a lifetime of adherence to free markets by saying that we were wrong to rely on **the self-interest of participants**. As it happens, Mr Greenspan's reputation has suffered as the author of the post-dot.com-bust loose money, which led us to our current pass. But if we take his remarks seriously, we are in a terrible pickle as it is hard to know how better to operate. Over the last ten days both David Cameron (tactically) and Gordon Brown (grudgingly) have acknowledged their own failures of judgement. This confirms that the never-certain wisdom of the authorities provides as unhappy a compass as any. The disagreeable truth is that almost no-one is free of the instinct to herd.

Nouriel Roubini is a Professor of Finance at the Stern Business School of NYU. He has made a reputation as a latter day Doctor Doom, stressing that our problems may be laid at the door of a **vast 'shadow banking' system**. But his concept is wholly indiscriminating. It embraces the whole kit and caboodle of financial innovation, from 'special investment vehicles', an undisputed evil when they conceal risk; to 'securitization', a perfectly respectable procedure when done with sound assets and computation; to private equity and hedge-funds, the former wholly and the latter almost entirely unimplicated in our problems. Roubini's idea is catchy and offers wonderful cover for the self-interest of the French and Germans, as they attempt to curtail markets beyond their borders. But it is overstated and uninformative.

Nassim Taleb is a former trader. By his own account he finds his former occupation less admirable than writing books or his academic post. He argues that traders adhered to **erroneous risk-management arrangements**, which is so obvious it tells us nothing. Nor does his bestselling account of 'Black Swans' (unusual but costly events) help us much. Are we using the wrong maths? Or was our mistake to test good maths against roseate data from the unusually benign period of the last fifteen years? This is certainly worth examining, but is probably not a matter for the attention of the Heads of Government at the G20.

Gordon Brown remains our prime minister. He claims that it is **all America's fault**. His remarks may stem from his lifetime career objective of never getting caught out, but in this instance he is more right than wrong. The Community Relations Act, and its consequences, led to over-allocation to, and misallocation within, the US household sector, with Fannie Mae and Freddie Mac adding 50% to US broad money before they became insolvent in mid-2008. This leaves us with the question of whether he, or Obama, is qualified to correct the hubristic social engineering which underpins these failed policies.

The red herrings

There are several other wrong-headed explanations of the credit crunch.

- **"Unsustainable imbalances occurred in international trade."** It is not clear that this matters in that China is not asking for its money back, though it is very politely asking for more votes at the IMF and the expansion of Special Drawing Rights – neither being the worst idea in the world. In order to demolish the 'imbalance' theory, alter the thinking to: suppose that the US had a positive savings ratio. Why would we believe that those savings would have been exempt from the processes leading to the over-allocation to and misallocation within the US housing sector which occurred?
- **"Securities became an unintelligible alphabet soup."** This is trivially true in the sense that they are beyond lay observers. But those dealing in them had previously understood instruments much like those now in disarray; indeed so much so as to undermine the notion that the distressed securities are intrinsically beyond comprehension. It's simply that some are better than others.
- **"Glass-Steagal should never have been repealed."** In other words policy-makers erred by allowing retail banks to re-enter wholesale markets. There may be something in this, but we need to remember that it was feisty intruders from the provinces who failed in the UK: HBOS who mismanaged their assets; Northern Rock who mismanaged their liabilities; B&B

who mismanaged both; and RBS who made a disastrous acquisition. Only the last of these violated the retail/wholesale bank distinction and this was not so much a matter of a bad business model (RBS didn't get much chance to manage the businesses it bought from ABN-Amro) as buying at the top of the market.

- **“A destructive cult of proprietary trading emerged.”** Financial institutions were committing too much of their own money to speculation. There is no doubt that prop trading has come to be more prominent in financial services, contorting the business model of former fee-earning investment banks like Goldman Sachs and insurance companies like AIG. But this would not have been a problem had there not been too much money in the system.
- **“The ‘originate and distribute’ model proved disastrous.”** In other words, banks engineered risky securities in the knowledge they would pass them on to others. This is most often heard from former financiers complaining about the changes that derailed their careers. In truth the ‘originate and distribute’ model proved productive and innovative. Sadly, it was up-ended by loose money and government mandated laxness on credit. The notion that risk was introduced recklessly is trumped by the humbling truth that it was simply miscalculated.
- **“Excessive risk was promoted by the bonus culture.”** The complaint is that bonuses are paid on deals as they close rather than after they prove successful in subsequent operation. This misses the point. Despite the most forensic due-diligence and the most extensive modelling, no one can be certain of what's going to work *ex ante*. It serves our economic purposes that bankers propose innovations to their clients and that they be rewarded if their offers are accepted. Those with whom the banks do business are grown-ups, often themselves bankers, responsible for saying no to bad ideas and making those they accept work.
- **“US regulators (and regulators in general) succumbed to the folly of light touch.”** Sadly, this is a reinvention of history. In the event,

US banks were bullied by government into making the disastrous loans that underpin the disarray. On both sides of the Atlantic regulatory regimes devoted themselves to detailed scrutiny of processes. This failed, demonstrating not that there was insufficient regulation but that it was misconceived.

- **“The UK’s tripartite system failed.”** Regulation failed all over the world, providing little evidence that the UK’s system was singularly awful. Though it is hard to imagine that the old Bank of England would have overlooked the follies of Northern Rock, B&B or HBOS.
- **“We have become too reliant on banks.”** In the general climate of ‘let’s lynch the bankers’, the UK seems to have surrendered to one of its customary outbreaks of economic nostalgia. But US data tells us that economies with strong financial service sectors are more prosperous than those devoted to manufacturing. The top ten manufacturing states in the US have an annual income of \$33.9k per head; the top ten financial services states have an annual income 25% higher at \$42.4k per head.

The real criminals

None of the above should claim the attention of policy-makers next week, but we fear they might. Other contentions have more of the ring of truth about them, and should be added to the policy errors of loose money and hubristic social engineering.

- **“Insurers were unregulated.”** In fact they are regulated in a particularly fragmented fashion – state by state in the US. It is to no-one’s credit that AIG’s Financial Products Unit slipped through the cracks, and such failures certainly warrant further examination. The G20, however, is probably not the appropriate venue.
- **“The Basel protocols on core capital failed.”** These concepts are based on ‘risk-adjusted’ ratios. The adjustments opened the door for European banks, in particular, to proffer imperfect assets to regulators as core capital. This has been destabilizing and needs urgent re-examination.

- **“The banks got too big to fail.”** Not everyone sees this as a problem, with some arguing that the financial system could tolerate oligopolistic retail banks, provided they were restricted to simple deposit-taking and loans. Others argue that reserve requirements for large banks should be more onerous, since they pose greater systemic risk. The classical solution would be to break up oligopolistic retail banks to reintroduce competition. Whether or not this occurs, universal banks (and insurance companies) ought to qualify for break-up, if the scale of their wholesale business poses systemic risk.
- **“The rating agencies and auditors failed.”** The small number of rating agencies and top-drawer auditing practices do seem to act as monopolists, with evidence of rent-seeking rather than competition — in this instance cosyng up to the customers — often themselves quasi-monopolists — whom they should be scrutinizing. But this may be too dull for the G20.

In a few days time the final communiqué will be issued from Docklands and the G20 Heads of Government will disperse, no doubt congratulating themselves on having committed themselves to little. But the fear is that they will feel obliged to throw out a few bones by way of ill-judged policy. Let us hope that they avoid the errors set out in this paper and pay attention to the real issues it identifies.

Miles Saltiel read PPE at Oxford and wrote his MA dissertation on Japanese business and government at Sussex. In 1979, he joined GEC-Marconi, where he worked for seven years on corporate finance and recoveries. In 1986 he went into investment banking, joining the WestLB Group in 1996 to become Head of Equity Research for emerging markets. In 1998, he assumed responsibility for London-based Tech Research, and in 2000 was voted one of the UK's top 50 in the New Economy. In July 2002 he left the WestLB group, where he was the senior tech banker, to found the Fourth Phoenix company to provide research and associated services. He has written extensively for London think-tanks on the credit crisis.

