# *Recipe* for Financial Order

*A rule-based system for future prosperity.*

**BY HORST SIEBERT**

We are in a crisis which has two faces: a severe disruption of the financial industry and a stark recession. How do we get out of this situation? For the long run, we need a reliable institutional arrangement that will prevent getting into a similar financial distress again. In the short run, we have to move out of the present recession.

It has long been a tradition of Germany's Freiburg school that a market economy—Americans speak of capitalism—needs rules. A prime example is a rule system guaranteeing competition against endogenous market tendencies to form monopolies, if these tendencies remain uncontrolled.

Institutional arrangements, including norms of behavior, laws, and other rules draw from negative historical human experience, mostly historical disasters. Some came into existence after the Thirty Years War ending in 1648 and after other wars and internal turmoil. Rules evolve in order to prevent human hardship and misery. Without rules, life would indeed be "solitary, poor, nasty, brutish, and short," in the words of philosopher Thomas Hobbes.

On a global scale, rules refer to the institutional arrangements among states. In specific areas and to a certain extent, sovereign states cede sovereignty. This leads to

*Horst Siebert is the Heinz Nixdorf Professor, Bologna Center, Johns Hopkins University, Italy; President-Emeritus, Kiel Institute for the World Economy, Germany; and Member of the Group of Economic Policy Analysis (GEPA) of the European Commission, advising President José Manuel Barroso. His most recent book,* Rules for the Global Economy *(Princeton University Press) discusses the ideas in this article at greater length.*

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the establishment of a multilateral rule system, binding sovereign states and their citizens. In the economic sphere, we have accumulated experience with the institutional set-up that affects all aspects of the international division of labor, mostly in the World Trade Organization. We now are in the process of finding new rules for global environmental scarcity.

After our negative experience with the recent financial crisis, what are the essential elements of a rule system for financial stability? Here are some crucial aspects.

Inflation and hyperinflation can be avoided by an adequate institutional arrangement for the central bank and by an adequate monetary policy. A basic rule is that public budget deficits must not be financed by printing money. The independence of the central bank is of utmost importance. The position of the central bank must be strong enough to resist political pressure for an easy money policy and for simply financing the public budget.

In order to develop rules for the soundness of the financial system, one needs to look at the functions that the financial system has to perform: allocate savings to investment; finance transactions, investment and infrastructure; transfer, reduce, and manage risks; perform maturity transformation within reasonable limits; and send reliable signals through prices. These functions should be performed without causing financial disturbances.

Balance sheet truth is essential. The Enron case in the United States in 2001 has made clear that stock markets cannot successfully intermediate between savings and investment if the balance sheets of firms are false.

*In the bonanza of national political rescue plans, central banks must be vigilant that these activities do not erode their position of political independence.*

*Rules evolve in order to prevent human hardship and misery.*

Under such conditions, share prices are distorted; when the fraud is revealed, stocks are depreciated, stock owners are betrayed and the reputation and credibility of the financial market—a crucial precondition for market economies—is devastated. Financial markets cannot function correctly if they do not provide reliable information.

Balance sheet truth also applies to the banking sector. Bank balances should reflect risks adequately. Risks should not be put off the balance sheet. In securitization, the originator of a loan should retain part of the original risk, say 10 or 20 percent.

The bank's risk management has to ensure the sustainability of the institution. It has to anticipate how the bank's environment will change, including the probability distribution of risks. It has to be aware of risks in the tails of a probability distribution with low probability, but large damage, also known as "black swans." Capital adequacy requirements—a bank's capital in terms of shareholders' equity and retained earnings as a percentage of its risk weighted credit exposure—must take into account the long-run sustainability of a financial institution. A value of 10 percent seems appropriate.

Such requirements need to adjust to adverse situations in the business cycle and in the interconnectedness of risk positions within the financial industry. They also have to be set higher for more risky activities. Ratios between debt and equity should be limited to 12:1, a ratio in force in the United States before 2004.

Bubbles are part of our historical experience. When the herd is running, those in charge have to stay outside the turmoil and remind everyone of the equilibrium that will be sustainable in the long run. Limits need to be respected. Such a prudent outlook would have prevented such bubbles as the Tulipmania in Holland in the seventeenth century, and it could have avoided the similar financial exuberance demonstrated in the U.S. housing bubble.

While risk transformation and consumption smoothing are important aspects of the banking industry and the capital market, institutional arrangements should not artificially favor over-consumption which can be the root cause of future financial crises. Over-consumption in the United States in constructing new homes did not have a foundation in savings; in that sense, it was artificial. The housing bubble led people to expect that their mortgages could be financed through the increases in wealth from rising house prices. Many factors contributed to the bubble such as the low interest rate of one percent during some years, a result of the Federal Reserve's expansionary policy. Of course, politicians liked that their voters could live up to the American dream of owing their home. A number of buyers were lured into taking out excessive mortgages, and predatory lending prevailed. These false incentives were exacerbated by Fannie Mae and Freddie Mac, the government-sponsored organizations created to purchase and securitize mortgages.

Prudent supervision has to become more effective. It must be in a position to prevent systemic risk, and it must have the instruments to avert systemic risk, for instance through stress tests. Risk assessment ratings need to be improved, but at the same time, regulators should not rely automatically on ratings. All in all, the financial sector should not distance itself too much from the real economy.

Regulation failed in the United States and in Europe. The regulatory regime for Fannie Mae and Freddie Mac, established by Congress, proved to be insufficient. The institutional arrangement for Fannie Mae and Freddie Mac was flawed from its beginning in 1968; their accounting scandals in 2003 and 2004 were covered up by Congress. In Europe, meanwhile, regulators did not recognize that EU banks had contracted the disease by taking in the bad loans of U.S. banks.

The subprime crisis shows that regulation per se is not a guarantee that financial crises are prevented. On the contrary: Since regulations set incentives, they may well set the wrong incentives and cause moral hazard. An example is the failures of the 747 savings and loan associations in the United States in the 1980s and 1990s. The origin of these failures was a government regulation providing special protection to risky loans of these institutions—which amounted to an incentive to go into more risky lending. New regulations, introduced with the best intentions, may have hidden incentive effects which may represent new moral hazards so that the institutional arrangement is not improved.

One major reason regulation often fails is that the regulator does not have the appropriate information. It is also the Hayekian problem that the regulator possibly cannot have all the necessary information on future economic conditions; most specifically he cannot have all information on product innovation within the industry.

Another major reason regulation fails is capture, that is, that the interest of the regulated seizes the institutional arrangements and dominates the interest of the public. That is why I am skeptical of the proposal by Joseph Stiglitz, former World Bank chief economist and Nobel laureate, to include those affected by financial products in a regulatory body. The body then may well be captured by its members and politics.

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After all, we should not forget the progress we have made in distancing politics from institutional arrangements, such as in the realm of central banks. Moreover, time inconsistency of political decision-making with shifting preferences is an important factor affecting the regulatory framework and causing its instability.

Yet a further important aspect of a financial rule system is that international spillovers are typical for the financial industry. Coordination among national regulatory authorities is needed similarly as among competition authorities. This can be done under the umbrella of the Financial Stability Forum, which should attempt to open membership to emerging market economies to ensure that it does not resemble too strongly a rich men's club. Cross-border banks especially require some form of cooperation among regulators, for instance within regulatory colleges. The Bank for International Settlements would be well-suited to playing the role of a standard setter. Standards should refer to the economic situation and the structure of the banking industry. They do not have to be completely uniform across countries.

Along another avenue, there is demand in some countries of Europe for an increased role for the International Monetary Fund in establishing financial stability. Of course, the IMF's surveillance function can monitor financial stability and the situation of the financial sector. Its Financial Sector Assessment Program, voluntary up to 2008, should become mandatory for its members. However, the IMF has no sanctions at its disposal to stop national banking systems from running into trouble. To cede sovereignty in the area of prudential supervision, including concrete sanctions against a financial "polluter," to an international body is unlikely to happen. Countries with memories the IMF's approach to the Asian currency crisis are reluctant to cede any sort of sovereignty to the Fund.

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