The hard lessons of the global financial crisis

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The downgrading of sovereign debt by the rating agencies may yet trigger another financial crisis. **Jean-Paul Fitoussi** explains what governments must now do to stop them from sapping the confidence of financial markets
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Oscar Wilde said experience is the name we give to our mistakes, and we have just experienced not only a crisis but also a number of attempts to fix it. Last year we tried to analyse the errors that led us into the crisis, and this year it is time to analyse the mistakes we made when trying to sort it out.

The many factors involved make it hard to judge how the crisis was managed, but it's nevertheless worth looking at how the various players interacted. When the scale of the problem became clear last year, many thought the crisis was certain to be managed badly, so perhaps we should be grateful that it was managed at all. Unlike in the 1930s, decisionmakers acted quickly, ignoring those dogmas that warned against rapid intervention. They knew that in contrast to the inter-war period, close international co-ordination was needed, even if some of the relevant institutions lacked legitimacy. Between 2008-2009, the influence of the G20 grew as the power of the G8 declined. People became aware of the need for governance that is truly global. And at long last, a number of proposals have emerged aimed at making this kind of global governance a reality. The ideas now being tabled include the report by a Commission that was initiated by the President of the UN General Assembly and chaired by Joseph Stiglitz, whose Working Group on macroeconomic issues was headed by myself.

EW BACKGROUND BRIEFING

Taming the rating agencies is not so straightforward

Rating agency Standard & Poor's plunged the Greek government even deeper into crisis in April when it downgraded its paper to "junk" bond status, and then downgraded Spain and Portugal too wreaking havoc on European markets. "Who is Standard and Poor's anyway?" retorted an EU spokesperson Altafaj Tardio.

In spite of their undoubted influence, the recent track-record of rating agencies suggests there is good reason to ignore them. In the run-up to the mid-2008 financial crisis, they often gave high ratings to suspect collections of loans called Collateralised Debt Obligations (CDOs) as well as to mortgage bank securities. Investors who put faith in their ratings lost heavily.

The rating agencies themselves have blamed their mistakes on scarce resources, yet their balance sheets show resources weren't a problem. Moody's, one of the three main agencies, saw its profits rise from $425mn in 2004 to $753mn in 2007. The real reason for their mistakes is thought by analysts to reflect conflicts of interest. Banks pay agencies to rate their debt, and agencies try not to upset their biggest clients. Politicians on both sides of the Atlantic have since tabled proposals to break the bank-agency link, even though these proposals risk creating more problems then they solve.

The most obvious proposal is to make the investor and not the issuer pay for a rating. But if an investor were to become a big agency client it could then influence ratings to its advantage. As could governments too if they were to be the main funders of the rating agencies.

A solution would seem to be for the U.S. rating agency watchdog, the Securities and Exchange Commission (SEC) to approve more agencies. As matters stand, only three are officially sanctioned, in the U.S., Standard & Poor's, Moody's Investors Service and Fitch Ratings. If there were more, the argument goes, investors could shop around. The downside is that if many different agencies were giving out conflicting ratings, that could destabilise financial markets.

If governments decide they can't replace the rating agencies' business model, perhaps the best they can do is increase their transparency. In the EU, the Committee of European Securities Regulators is now demanding that a rating agency should "disclose its models, publish an annual transparency report and create an internal function to review the quality of its ratings." The idea of an exclusively European agency has also been put forward. As to the U.S., it seems the SEC will be granted more power over the agencies, but is unlikely give the green light to create more of them. That means agencies will continue to rely on banks for their funding; if so, the conflicts of interest won't go away.

As well as being the name we give to our mistakes, experience is also the process that enables us to raise our level of understanding and ultimately to envisage a new world. The question I want to raise in this article is simple. Does our experience now afford us a glimpse of that new world? This financial crisis will not be over until we have understood its causes, and it seems to me that this has not really happened yet. The crisis is therefore not over, and the spectacle we are witnessing now also has some truly surprising features; the fire-starters have become the prosecutors, and are now accusing the fire-fighters of having provoked flooding.

Although the crisis was managed well initially, the measures put in place were at best stop-gap solutions. Those who may have hoped for a Keynesian-style revolution were to be disappointed, and in a worrying development for both the macro-economy and the environment many banks, governments and international institutions went back to "business as usual." The Obama administration recognised the severity of the situation, but wasn't apparently willing to take the measures needed to tackle it. Macroeconomic researchers in the Administration, all of whom were well versed in Great Depression economics, came up with a quick and initially successful response, but they didn't produce a proper long-term strategy that addresses financial regulation, inequality and global governance.

At the peak of the crisis, governments had an opportunity to create a new global financial infrastructure. But they then let it slip between their fingers. The fact that many western economies last year got out of recession should not fool us into thinking that the crisis was only a brief interlude, and that the post-crisis world can return to the way things were before. There is tremendous pressure to re-write the history of this crisis by depicting effects as if they were causes, and to hold the governments who managed the crisis responsible for starting it.

Last year governments' attempts to ward off the crisis were met with widespread disapproval. Although these governments in fact achieved a lot, they were generally accused of extravagant spending and of running up levels of debt that might well lead to another crisis. The European Commission remained mute when the storm peaked, but eventually hit back by criticising many EU member states for creating large public deficits. The Commission now claims that 20 of the 27 EU's member states are too deeply in debt and should return as soon as possible to the "reasonable" limits set out in the Growth and Stability Pact. But if European member states follow the Commission's recommendations we will be brought to the brink of another crisis. There was nothing rational in the sequence of events that brought us to this point, and there is nothing reasonable about the situation we are currently in.

A low point – perhaps one should say the height of ridiculousness – was reached last year when rating agencies intensified their surveillance of government debt, and the markets who had become the victims of the agencies' incompetence became fixated on their evaluations. Investors and financial institutions had in many cases already made the mistake of trusting the rating agencies and purchasing dodgy securities that the agencies had pronounced safe. Lehman Brothers had been awarded a high rating on the very eve of its collapse, yet somehow the rating agencies still exert considerable power and fuel the public securities market. Now, though, if the risks of holding public securities are exaggerated any further by them, the crisis may deepen and governments with downgraded ratings may be compelled to dismantle precisely those measures that contained the crisis when it was at its most threatening.

The situation today, therefore, is that many of those who helped sort out the crisis have now become accused of causing it. Financial markets and rating agencies were among the causes of collapse, and were also to blame for the subsequent rise in public debt and deficits. Yet by a curious turn of events the governments that prevented market forces from pushing the global economy into an abyss have since found themselves criticised for violating accounting principles. Are rating agencies and the markets really so ill-informed about public ratios? According to the International Monetary Fund, G20 countries earmarked an average 17.6% of their GDP to giving support to banking systems, although in the end in 2008 they spent only 0.5% of their GDPs, 1.5% in 2009 and probably 1% this year. In total, the recovery plans of EU members came to only 1.6% of EU GDPs, compared with 5.6% in the U.S.

Governments took the right measures to save the banks, but ignored the political consequences. By doling out vast sums of money to save the financial system, without asking for genuine guarantees in return, they showed a lack of foresight. And acknowledging that rating agencies were incompetent without doing anything to regulate them was also inexcusable. As a result, taxpayers may be asked to pay twice, once for the bailout and then once more because the debt they have incurred during the bailout is considered low quality. Paradoxically, the growing sense that a catastrophe has been averted has been paralleled by a growing demand for governments to cut public and social spending and to refrain from proposing investment programmes for the future. People are racing back to the policies which caused the crisis in the first place.

But in spite of what the European public may think, governments are not guilty of gross public deceit; if anything they acted naïvely and are now paying a heavy price for that. They nevertheless still have a choice to take their responsibilities and exert power, even though this may entail swimming against the tide of public opinion. If that means that they can help alleviate the social suffering brought on by the crisis, then governments really have no choice.

What are the most obvious lessons of the crisis? The first lesson is that the financial markets have a tendency to go completely awry, making it essential to regulate the financial system so that bankers and rating agencies can't behave recklessly with other people's money.

We should also remember that growth was sustainable only in countries with highly-developed social welfare systems, like France. Yes, these countries will recover at a slower pace than elsewhere, but countries that have fallen into a deep hole need to work harder than those who have fallen into much shallower ones.

The drive to become more competitive regardless of the cost will only aggravate the crisis. After all, export-led growth policies can succeed only if other countries are willing to run a deficit. And given that it was global imbalances that led to the crisis, it is clear that increased competitiveness makes for only a Pyrrhic victory.

It is clearly now advisable to speed up the reform of global governance to deal with global macroeconomic instability, so that developing countries no longer need to hoard their reserves to protect themselves. And perhaps the most important lesson of the crisis is that we need to break the vicious circle in which rising inequality means that demand has to be propped up to deal with it, with both inequality and demand fuelling speculative bubbles. If any one thing is now certain it is that the impact of the crisis on unemployment, social injustice and poverty means that there is greater inequality today than before.