Erkki Liikanen: Economic policy and economic theory facing challenges after the financial crisis

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland, at the Finnish Economic Association annual meeting, Tampere University, Tampere, 5 February 2010.

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The subject of this event is so wide-ranging and the time reserved to deal with it so limited that, in my short discourse, I am only able to scratch the surface. At the same time, the subject is of great importance. The financial crisis and the economic crisis that followed have forced economists and economic policymakers to reconsider some basic issues.

Only a couple of years ago the "Great Moderation" was in the headlines of numerous articles. It was once again believed that cyclical fluctuations could be managed much better than before. Many thought that increasing securitisation had helped to diversify risks and made the international financial system more stable. Although US domestic demand growth was expected to slow down gradually, it was thought that stronger growth in Asia would more than take up the slack. All in all, the outlook for world economic growth was, if not rosy, at least good.

But things turned out otherwise.

If we are to learn some lessons from the financial crisis, we must first get a grip on the elements that finally led to the crisis.

Anatomy of a crisis

Several books have already been written on the various stages of the crisis and its causes, including some good ones.[1] These provide a picture of an intricate web of profligate risk-taking, human greed, short-sightedness and policy errors. I will try to simplify this scenario by concentrating on ***four crisis elements***.

The ***first*** crisis element relates to the ***global macroeconomy and its imbalances***. Even before the financial crisis, there was much talk of global economic imbalances, and for many years the management of these was the focus of statements coming out of international economic conferences. It was debated whether Chinese export-driven growth policy or irresponsible US debt accumulation was behind the imbalances.

Even so, the fact is that, with increasing global imbalances, the demand for financial assets grew worldwide: as a result, interest rates fell, and prices in equity and property markets shot up.

Meanwhile, inflation remained subdued especially for industrial products. This was due to the low production costs of emerging Asian economies. In an environment of low inflation, monetary policy remained lax and interest rates low, from short-term money market rates to long-term government bond yields. The low interest rates had an impact on investor behaviour. In particular, many institutional investors were bound by nominal or real return objectives.

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[1] Including Acharaya, Viral V, Richardson, Matthew: Restoring Financial Stability New York 2009; Fox, Justin: The Myth of the Rational market, New York, 2009; Tett, Gillian: Fool´s Gold: London 2009;Wessel, David: In Fed We Trust, New York 2009, see also Gylfason, Holmström, Korkman, Söderström, Vihriälä; Nordics in Global Crisis, Vulnerability and resilience, Helsinki 2010.

As it was no longer possible to achieve these objectives by means of traditional investment instruments, investors began to look for higher-yielding assets. Insurance companies, pension funds and other institutional investors, public and private alike, reverted to riskier investments. As the demand for riskier investments grew, risk premia fell to historic lows.

So, money was cheap, nor was much compensation demanded for risk.

The ***second element*** underlying the crisis was ***a lack of financial market transparency***. Interest rates were low and financial markets full of money looking for higher yields. Because there was an inadequate supply of traditional, safe investment options, financial innovations – especially securitisation – came to rescue of investors. Securitisation was the Midas touch that turned even low-grade raw materials, such as subprime credits, into securities with the top ratings.

In part as a consequence of securitisation, in part on account of capital adequacy regulation, increasing use was made of another type of financial innovation, ie derecognition and transfer of securities from financial institutions' balance sheets to special purpose vehicles. The "shadow banking sector" ballooned.

Securitisation and special purpose vehicles weakened the regulation of banks' capital adequacy and the quality of available information on financial markets. Investors were unable to adequately assess the risks inherent in securitised assets, and risks were not always widely understood inside the banks either. Similarly, bank balance sheets shed less light on banks' real exposures, as the bulk of the risks had been transferred to special purpose vehicles.

Impaired information quality led to the ***third element*** of the financial crisis, ***a variety of agency problems and moral hazard***. Because of the inability to assess the risks of securitised loans, the discipline needed to enforce credit criteria was weakened. Meanwhile, banks' executive management and risk management staff were in a weaker position to evaluate and control the operations of portfolio managers. Ratings assigned by rating agencies to exotic products were not called into question, despite the raters' own agency problems.

Supervisors were also less able to scrutinise bank balance sheets and understand the risks. Overall, controls in financial markets slackened and risk-taking at others' expense flourished. Distorted incentives sped up the process. Later, in depths of the crisis, when financial institutions encountered problems, the same lack of transparency prevented an understanding of the scope and nature of the systemic links between financial institutions. Decisions on rescue operations had to be made in a hurry and often in blindfolds.

The ***fourth and final element was a permissive supervisory environment***, which allowed all this to happen. One factor was international competition: more lax regulation with the aim of strengthening the competitive position of a country's own financial centre. A tighter supervisory regime would impair a country's position in global competition for the location of financial institutions and securities trading.

Another, perhaps even more important factor was the general atmosphere. There was a widespread belief in the markets' ability to manage risks. Advocates of this view included many economists, economic and monetary policy decision-makers and even supervisors. Even if an individual supervisor would have seen a built-up of risks, the threshold for concrete measures was high, with no other supervisor seemingly aware of problems in the offing.

As a consequence, supervision of financial institutions in key financial centres was too often limited to passive application of the rules. People did not know how – or were unwilling – to ask whether the rules provided adequate safeguards in the new circumstances. Behind this passiveness were many quite understandable factors. One was supervisors' uncertainty of their legal powers to intervene in the operations of financial institutions on a discretionary basis.

Macroeconomic imbalances, the increased complexity of the financial innovations and weaker transparency, disincentives and agency problems, including a permissive supervisory environment, together created an explosive situation that eventually set off the financial crisis. The ultimate trigger was the reversal of the uptrend in US housing prices in 2006. In August 2007, confidence in the markets for bonds based on securitised housing mortgages collapsed and the crisis began. But it took well over a year before the crisis hit the real economy with full force, after the banking sector problems surfaced in autumn 2008. Although international cooperation helped to keep the banking system operational, world trade shrank by 20–30% within a few months and unemployment and government deficits went on the rise.

The challenges for economic policy and economic thinking

The financial crisis forced economists and economic policymakers to reconsider some basic issues: how to get through the crisis, and how to avoid a replay. The challenges are many, but I will pick upon just three of them. The first is to correctly understand the root causes of the financial crisis and to prevent their recurrence. The second challenge is to repair the damage the crisis has done to the public finances, and the third relates to the need to draw the right conclusions for economic analysis.

So, the first challenge is to prevent similar crises in the future. The financial crisis taught policymakers many things – perhaps most importantly the holes in our understanding of systemic risk. The concept of systemic risk is not new as such, but the crisis revealed some new dimensions of systemic risk. Before the crisis, it was not understood how multifaceted the links are between the global financial markets and that a sufficiently wide disruption could paralyse the markets. Global financial markets did not collapse in October–November 2008. But the collapse was so near that such a risk could no longer be tolerated.

Efforts are now under way on numerous fronts to get systemic risk under control. On one hand, important revisions to the supervision of financial institutions are in process. The Basel Committee on Banking Supervision recently published its first consultation papers on the matter. These are truly significant initiatives – as evidenced by the scale of resistance to the proposed changes on the part of banks.

Another lesson from the crisis is that supervision of individual financial institutions is not enough. Financial markets must also be supervised and regulated at the systemic or macro level. Macroprudential supervision has already been under discussion for some 20 years, but it is only now that the tools and institutions for macroprudential supervision are being set up for the first time. The EU Council has reached an agreement on the establishment of the European Systemic Risk Board, and the European Parliament is expected to consider the matter before next summer. There has been lively debate in various fora on the best instruments for controlling systemic risks.

This discussion includes the possible role of monetary policy. There is talk about “leaning against the wind”. This idea meets with two types of opinions within the central banking community. On one hand, there is wide agreement that monetary policy should take greater account of certain monetary phenomena, such as sharp rises in asset prices and credit stock, as well as the pricing of risk.

On the other hand, there is concern that monetary policy is being burdened with responsibilities it is unable to bear. Central bankers are generally sceptical as to how effectively monetary policy can curb excesses in the financial markets. A particular concern is whether effective leaning against the wind is possible without jeopardising the anchoring of inflation expectations.

The name of the former chairman of the Federal Reserve Board, Alan Greenspan, is often attached to a doctrine according to which the identification of asset bubbles, ie their separation from price rises that are warranted in terms of the real economy, is so difficult that they should not be suppressed by interest rate policy – especially considering that, when a bubble finally bursts, the damage can always be repaired by monetary policy action.

This view has also been severely criticised, because it is assumed to lead to asymmetric monetary policy which is too expansionary on average: it does not constrain asset price rises, but is expansionary when these prices decline. Following the crisis, there are naturally more advocates of the idea that monetary policy, besides regular monitoring of inflation, should also pay increasing attention to asset prices. But if this is to be done without weakening the control over inflation, new monetary policy tools will be needed. As the well-known Tinbergen rule states, the simultaneous pursuit of two objectives requires at least two separate instruments.

Partly for this reason, central banks have actively participated in discussions on the development of macroprudential guidance. The more effective the tools in place for the control of financial risks, the less the pressure on monetary policy. These discussions may at best significantly alter the economic policy toolkit. It has been proposed, for example, that we need to create an instrument that works like interest rate policy in regulating financial sector incentives for balance sheet expansion. As signs of overheating appear and systemic risks increase, the instrument could be adjusted so as to tighten lending possibilities. This is an interesting thought. However, more research and analysis are needed before a final stand can be taken.

One basic problem in the current discussions is that economics does not provide clear guidance as to what types of instruments could be used to conduct this type of stability policy. While the traditional toolkit of monetary policy, namely interest rate policy and money supply analysis, is firmly entrenched at the core of the economics discipline, the integration of financial markets and financial mediation into macroeconomic analysis is still in its infancy, and the relevant approaches are not yet established. This presents a definite challenge for economics in the coming years.

The second major economic policy challenge is the repair of the crisis damages to public finances. Following the financial crisis and resultant economic crisis, public finances have generally deteriorated and unemployment has increased, in some countries quite sharply. The weakening of general government finances partly reflects the effects of financial system support, automatic stabilisers and various stimulus measures, but perhaps even more the fact that the collapse of GDP levels has led to a marked erosion of the public revenue base. The revenue base is expected to remain smaller than previously envisaged in many countries, as the crisis is estimated to have reduced their output potential.

The condition of public finances has rapidly deteriorated, in Finland as elsewhere. According to the Bank of Finland's forecast in September last year, Finland's budget balance is weakening considerably, by almost 10 percentage points relative to GDP in the period 2008–2011. The budget balance is projected to be about 5% of GDP in 2010–2011. Meanwhile, general government debt will grow by about 20 percentage points relative to GDP, to more than 55% in 2011.

The pronounced and rapid weakening of our general government finances is a tough challenge for economic policy. The situation is made increasingly difficult by population ageing, the effects of which begin to be gradually felt more broadly in pension expenditure, demand for publicly subsidised health and care services and in the labour supply. Accordingly, the present trend in public finances and the adjustment required cannot be reviewed in isolation from the ageing issue.

Long-term plans have been put in place in Finland to deal with the expenditure pressures of population ageing. This has been reflected not only in public expenditure planning, but also in the pension reform and public-sector productivity programmes. The aim has been to reduce central government indebtedness and thereby to provide room for the short-term costs of structural reforms and for the long-term upward pressures of expenditures. Other goals have been to extend the number of years people spend in working life and to raise productivity in the provision of basic public services.

The ongoing deep recession, however, is forcing a rethink of the present strategy for ensuring the sustainability of general government finances in the future. In the context of increasing indebtedness, expenditure growth and a decline in the output level , the capacity of general government finances to meet the expenditure and other pressures of population ageing is much weaker than earlier anticipated. The challenges of sustainability of public finances have been analysed comprehensively in the recently published report by the Ministry of Finance[2] Calculations of the long-term trend in public finances carried out at the Bank of Finland[3] reinforce the outcome of the Ministry of Finance's analysis: there is now a pressing need to readjust the public finances. Estimates made at the Bank also indicate that the extent of the adjustment will depend largely on the types of policy measures taken to reduce the deficit. Of the various possible alternatives, policies that impact the labour market will be particularly expensive. A notable tightening of earned income taxation would weaken the employment situation and increase the costs of public service provision, and thereby their GDP contribution.

From the perspective of the economy, it is not irrelevant how public finances are consolidated and how their long-term sustainability is secured. One particularly effective means of reducing the adjustment required for public finances would be an enhancement of public-sector productivity. This is also confirmed by the Bank of Finland calculations I mentioned earlier. Productivity performance should, however, materially change from the trends of the last few decades.

Besides boosting productivity, other measures are also needed. They concern, among other things, the need to extend the number of years people spend in working life. Particular attention should be focused on measures that would induce young people to complete their educations and enter working life earlier than at present. Older employees' later retirement is another effective way of reducing the adjustment in public finances. These effects are, however, channelled mainly via central and local government finances. Because the funding of the pension scheme is weighted towards the final years of working life, the effect of these years on the scheme's sustainability will be minor.

In addition to improving productivity in public services and extending the number of years people spend in working life, other measures are needed to bring about the necessary adjustment. It will probably be impossible to avoid higher taxes and a reassessment of public expenditure.

The third challenge relates to basic issues in economics. In early autumn last year, Paul Krugman asked in his already popular column: "How did economists get it so wrong?"[4] Krugman's central argument was that the economics profession had gone astray. The fascination for analytical elegance and mathematical acrobatics had locked economics into an ivory tower of frictionless markets and rational economic agents while marginalising attempts to understand the economy as it actually is.

Some esteemed economists defended Krugman. Others hastened to explain that there was no problem, as Krugman had simply overlooked the economic analysis of the last couple of decades. Without taking a stand on who is right here, the dispute that ensued from Krugman's column shows that he managed to raise an important issue. It could be that

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[2] Finland's Public Finances at a Crossroads, Ministry of Finance, 1 February 2010.

[3] Kinnunen, H. & Kostiainen, J.: Julkisen talouden kestävyys taantuman jälkeen: tarkasteluja politiikkavalinnoista (Sustainability of public finances after the recession: policy choices under scrutiny). BOF Online , 4 February 2010.

[4] Krugman, Paul: How did the economists get it so wrong?, 6 September 2009, New York Times.

economists and economic policymakers have lost touch with their own science and need a more humble approach to their own expertise. And it could also be that achieving a balance between mathematical elegance and understanding real economic phenomena will indeed require reconsideration.

The “Great Depression” of the 1930s gave birth to Keynesian economics. In March 2008, I asked Federal Reserve Governor, Professor Rick Mishkin about his long-standing research colleague Ben Bernanke and Bernanke’s important research collection “Essays on The Great Depression”[5]: “Is it so that the Great Depression and the experiences gained from it provide the key frame of reference against which Bernanke’s research work and activity at FED should be assessed?” “Not his work alone, but the work of all of us”, was Mishkin’s reply.

The stagflation experience of the 1970s, in turn, put expectations at the core of economics and laid the basis for modern macroeconomics.

Does the current “great recession” give a new direction to economics? One thing is for sure: economics once again faces interesting challenges for years to come.

[5] Bernanke, Ben: Essays on the Great Depression, Princeton, New Jersey, 2000.