Anticipating Crises in Markets and Government – Plenary Session at ANZSOG Conference, 3rd September 2009

Introductory remarks by Saul Eslake, Program Director, Grattan Institute

Strictly speaking, 'anticipate' has a deeper meaning than 'foresee', even though they have become almost synonyms in common usage. 'Anticipate' conveys the sense of taking some kind of action based on foresight.

Thus defined, financial market crises of the kind that have been experienced repeatedly over the last three decades and most recently and dramatically over the past two years are very difficult to 'anticipate'.

In particular, these crises are difficult to foresee with sufficient confidence, especially as regards their timing, to make politically and administratively practicable the kind of policy, regulatory or other actions which may 'head off' the onset of a crisis.

The reality is that very few people saw the most recent crisis (or the 'tech wreck, or the Asian financial crisis, or the 'Tequila' crisis of 1994, etc.) coming; and of the few that can credibly claim that they did, most had seen a crisis of some sort or another coming for a very long time – too long for their foresight to have been of much value in making a practical case for the adoption of measures which *might* have forestalled the crisis.

It is sometimes suggested that more use should be made of market-based indicators – share prices, credit spreads on debt instruments and the like – in order to gain a more 'forward looking' view of risks. For example, in its most recent 'Article IV' report on the Australian economy the IMF uses what it calls 'contingent claims analysis' to derive measures of 'distance to distress' and probability of default for the Australian non-financial corporate sector. However, as Ben Bernanke noted in his comments at this year's Jackson Hole Conference, most market-based measures of default risk were declining in the weeks immediately preceding the collapse of Lehman Brothers.

It's perhaps worth emphasizing that crises invariably occur after extended periods of euphoria which in turn have at least some tangible foundation – such as an extended period of economic growth, the development of some significant new technology, the discovery of new mineral or energy resources, or a 'paradigm-shifting' policy change.

Hence, almost any measures which might be taken with a view to reducing the risk on an ensuing crisis will have the character of (in McChesney Martin's famous phrase) 'taking the punchbowl away just as the party gets going', and thus will encounter formidable opposition. Such measures would in effect call for an agency such as a central bank or a prudential supervisor to impose its judgement as to the sustainability of an upward trend in real or financial assets over that of those whose decisions have largely driven that trend: and this is, as Alan Greenspan was trying to say in his 'irrational exuberance' speech of December 1996, not an easy decision to justify and implement.

This is especially so in the Australian context where a large segment of the population has a vested interest in rising asset prices and where the setting of monetary policy is more politically sensitive than in any other advanced economy (because of the preponderance of variable mortgage interest rates).

Hence, even if the nascent debate between Phil Lowe and Guy Debelle at the Reserve Bank (which mirrors an ongoing debate in academic and central bank circles around the world) as to the desirability of using interest rates to 'lean against' asset price bubbles were to be resolved intellectually in the former's favour, doing it in practice would be another thing entirely.

The conclusion I'm leading to is thus that attempts to 'anticipate' financial crises are probably not going to be especially helpful; and that the intellectual effort involved may be better expended in seeking to reduce the likelihood of crises occurring at all, and in devising (in advance) more effective ways of responding to them when they nonetheless do occur.

On the latter score, I would argue that Walter Bagehot's advice – that in a crisis central banks should 'lend early and freely, to solvent firms, against good collateral, at penalty interest rates' – is as sound today as it was when first given in 1873. That advice was spurned by, in particular, the US Federal Reserve, with calamitous results in the early 1930s; it was followed, by and large, by the Federal Reserve and (on a smaller scale, given a much less pressing need) by the RBA, in the current crisis with considerably more favourable results.

As to the former task, I think we have to recognize four points.

First, the succession of financial crises over the past couple of decades strongly suggests that de-regulated, globally integrated financial systems are less stable, and more prone to crises, than most of us realized. As a result, and without endorsing assertions that the most recent financial crisis was wholly, or even largely, caused by 'neo-liberalism' or 'free market fundamentalism', I think there is an almost unarguable case for stronger regulation and supervision of financial markets and the behaviour of financial market participants than has been generally regarded as appropriate hitherto, or might still be regarded as appropriate for most other markets.

Second, the most recent financial crisis demonstrates that the task of financial system supervision cannot rely solely on the regulation or supervision of individual financial institutions or intermediaries, but also has to take explicit account of the myriad linkages among the various participants in the financial system and the resulting vulnerabilities of the system as a whole. It has to incorporate the presumption that the requirements for financial system stability are likely to vary over the course of the cycle. And it perhaps needs to take a broader view than has hitherto seemed appropriate as to where the boundaries of the financial system are drawn.

Third, more attention needs to be given to the supervision of liquidity at banks and other systemically-important financial market participants. As the Bank of England's Andrew Haldane says, liquidity has been the 'poor relation' of the regulatory world for the past several decades. Yet it may be that liquidity regulation provides the most practical tool for 'macro-prudential' supervision of the financial system with a view to reducing the incidence of crises.

Fourth, the experience of the global financial crisis suggests that supervisors and regulators need to take a judiciously sceptical view of the capacity of participants in the financial system to measure, manage, price and distribute risk. In particular, market-based measures of risk are likely to under-state the 'true' amount of risk in booms and over-state it in busts, leading to a strong probability that at any point in time risk will be mis-priced. And some measures of risk are themselves the object of speculative activity, rendering them unhelpful and potentially dangerous if given excessive weight in risk assessment procedures.

As a final observation, the global financial crisis should also serve to remind us that inappropriately or excessively low interest rates can be as damaging and dangerous as inappropriately or excessively high interest rates. I have no doubt that one of the reasons why the financial crisis was less severe in Australia than in the US or Britain is that the Reserve Bank was one of very few central banks not to have made the mistake of keeping interest rates too low for too long in the aftermath of the 'tech wreck' and the ensuing mild (as it turned out) downturn at the beginning of this decade. More generally, Japan's experience of the past two decades should serve as a warning to politicians and others who regard low interest rates as a virtue in and of themselves.