

GLOBAL GOVERNANCE IN CRISIS
Eurojess Congress 2011
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Gentlemen,

It is an honor to participate in this panel on the financial and economic crisis, its origins and the implications for the future.

I would like to address the following questions :

- 1) What were the causes of this crisis which originated in the United States in 2007 and soon engulfed Europe as well?
- 2) How was the financial system rescued ?
- 3) Where do we stand today ?
- 4) Where do we go from here ?

In addressing these issue I would like to focus on the ethical aspects of this worldwide crisis which finds its only parallel in modern times in the 1930's.

As far as the causes of the crisis are concerned, let me quote from the report of the US Senate Investigation Sub-Committee on the financial crisis, published on April 13, 2011, and submitted by Senator Carl Levin, democrat, and Senator Dr. Thomas Coburn,

republican. This is a 635-page report which being bipartisan can claim some credit for objectivity.

"The free market has helped make America great, but it only functions when people deal with each other honestly and transparently. At the heart of the financial crisis were unresolved and often undisclosed conflicts of interest. Blame for this mess lies everywhere from federal regulators who cast a blind eye, Wall Street bankers who let greed run wild and members of Congress who failed to provide oversight"

And a little further on, Senator Levin is quoted as saying *"Our investigation found a financial snake pit rife with greed, conflicts of interest and wrongdoing"*

According to this report, and in its own words, there was high risk lending for short-term profits by the banking industry, there were massive regulatory failures by incompetent, lazy and probably somewhat corrupt government agencies; there were massively inflated credit ratings by the large rating agencies that were in certain cases actually "selling" undeserved AAA ratings for money; and indeed investment banks were grossly enriching themselves by lying to their clients and let them carry significant losses.

So, yes, at the root of the financial crisis there were greedy and overpaid investment bankers and the services they provided were of marginal social value.

But they were not the only ones responsible: the United States Congress through its legislation promoted home ownership for almost everybody, leading to the so-called "NINJA" loans (no income, no jobs, no assets). The regulatory authorities (SEC and so forth) were either incompetent, understaffed or possibly corrupt

and overlooked obvious exaggerations and even fraud, such as in the Madoff case.

Also, it was the United States Congress which gave just a few rating agencies, a typical oligopoly, almost unlimited authority to decide which securities could be held by US pension funds, thus opening the way to unsupervised, unregulated potentially arbitrary judgements.

And finally, the consumer borrowed excessively on the basis of artificially inflated home values in order to spend the money in consumer goods of all kinds, casting away the most elementary rules of prudence and common sense.

In late 2008, when Lehman Brothers, a major US investment bank went bankrupt, a global financial and economic meltdown threatened. It is the great merit of the central banks, and the governments in the major financial centers to have closely coordinated their response and to have flooded the markets with liquidities, driving interest rates down to almost zero.

As a result of this unprecedented creation of money, no other bank of any significance went bankrupt. There was in effect a worldwide guarantee by governments to those banks that were declared "too big to fail".

While a major catastrophe was averted, we are not by any means facing a comfortable situation today. Huge amounts of debt have been shifted from the private sector to governments. Beyond governments, there is no one to whom these debts can be shifted further. And the massive expansion of the money supply bears longer-term considerable inflationary risks.

Though initiating in the United States, the financial crisis is now engulfing the European Union. Its banks were just as greedy and irresponsible as Wall Street and its regulatory authorities just as incompetent.

Every country has been living beyond its means; the so-called PIIGS states (for Portugal, Italy, Ireland, Greece and Spain) are highly vulnerable, and the major Euro zone banks, which lent extensively to these countries, are also at risk.

It is not my purpose today to discuss the likely evolution of the Greek crisis and the future of the Euro. But what is happening in the public squares in Athens, Madrid and soon undoubtedly in other places around Europe is full of danger for the stability of our democracies. Greece is a foretaste of what may be coming !

As you well know, civilization is as fragile as porcelain. Frightened people become tribal. Dividing lines open within and between societies and when chaos comes, the worst of human nature will almost always emerge. There have been enough sad examples in past history to make us take today's situation of many countries most seriously indeed.

For the debt crisis is not limited to the so-called "Club Méditerranée" states: The United States itself has a ratio of debt to Growth National Product which, if unchecked, will be close to the ratio we find in Belgium, Italy and Portugal in just a few years' time. President Clinton left sound finances behind when he turned over the presidency to George W. Bush. Under the latter's presidency, because of two major wars, massive tax reductions and an inefficient expansion of Medicare, the United States is in a serious financial predicament.

Bernard Madoff paid off his original investors with "new investors" money; but the United States Treasury is getting dangerously close to paying the interest on its debt out of newly raised debt provided courtesy of the People's Republic of China !".

What should be done ? What can be done ?

There is no doubt that the near-term debt picture is ugly, but the longer-term outlook is extremely unfavorable owing to the impact of the rapidly aging population, of entitlement spending (medicare, social security) and of interest payments,i.e the cost of servicing an exploding debt.

There are basically three possible solutions to this predicament:

- 1) By far the most favorable and pleasant solution would be a resumption of significant economic growth which one could perhaps hope for if there were major technological innovations We can hope, but there are no indications that this will happen.
- 2) Less palatable, but potentially effective, would be forceful and coordinated action. This would involve
 - a) a major tax reform;
 - b) significant cuts in most spending programs, including of course armed forces.

But the United States Congress is hopelessly polarized and divided on major issues. This would have to change significantly, as such action would require tough decisions and a lot of political courage plus a will to collaborate beyond party lines for the good of the country.

- 3) Clearly, the least palatable solution but maybe inevitable: The markets will force changes and will compel the politicians to do what they were unable to do in calmer times.

How do the markets force change ? Well, the handwriting will be on the wall when the US Treasury experiences difficulties in selling its debt ! When that happens, it will have to raise interest rates at the worst possible time and that may cause a depression, which would be economically disastrous and politically dangerous.

Beyond what governments can and should do, it is quite clear that the banking sector must be more tightly regulated to avoid to the extent possible a repeat of the last crisis, which the world could not possibly afford.

Most everybody agrees on what should be done, but there are important difficulties in implementing these regulations.

Competition between key financial centers (New York, London, Frankfurt, etc) makes it quite hard to agree on strict rules which can only be effective and acceptable in a so-called level playing field where the rules apply to everyone worldwide. And the banks resist what they call "excessive regulation". The bank-lobby is rich and powerful and has already exercised its influence in the United States Congress to water down some of the initial proposals for increased regulation. Most investment banks are back to full profitability, still extracting large profits from trading activities that were described by top regulators as inherently useless... and dangerous.

As a former banker, I would like to express here a personal opinion that does not necessarily reflect the views of my friends in the profession.

Over the last 30 years, finance's share of the economy, has multiplied by a factor of 6 achieving today a power position that is simply not in line with its economic and social usefulness. We should revert to a more modest and reasonable definition of finance as a provider of services to governments, industry and individuals, not as a large casino that works for the greater benefit of its own kind who have been, as Mr. Paul Volcker said "Pushing the rent around" among themselves for too long. The motto should again be "clients first", and not year-end bonuses, stock options, golden handshakes and golden hellos!

The finance sector should be cut down to a reasonable size through coordinated and effective regulation in a level playing field. As a result, employment in finance should shrink and there should be in future hopefully fewer PHDs in finance and more in engineering and natural sciences, for example.

In conclusion, I would like to say that the world is certainly facing an extended period of low growth while massive deleveraging of private and public debt takes place.

The resulting adjustment process bears significant political risks. Let us hope that somehow the world will once more "muddle through" and avoid major disruptions.

If history is a guide, I would say that in the past humanity has moved after all rather successfully from one unsustainable equilibrium to another !

There is, I believe, overall a tendency towards progress in human affairs in spite of many ups and downs, some of which were catastrophic, such as the period between 1914 and 1945.

Thank you for your attention.

Jacques Rossier