The New Financial Order

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Introduction

- Although the World has had it fair share of crisis in the past, the current global financial exuberance stands out as exceptional.
- Unlike many previous economic setbacks it is not caused by external shocks (such as the oil crises of the 1970s).
- It is the consequence of a long series of misguided policy decisions by legislators, governments, central bankers, surveillance authorities, and others.
- The failed policies involve:
  - large trade imbalances of major economies,
  - excessively low interest rates,
  - misguided deregulation of deposit money banks (pushing them towards universal banking),
  - inadequate regulation of hedge funds,
  - various new financial instruments, such as credit default swaps, that are still poorly understood.

The Second Wave

- The crisis started out as a banking crisis but has now turned to a severe debt crisis.
- This second wave is much a result of sovereigns bailing out their banks in a desperate move to avoid a complete meltdown of their financial systems.
- Trillions of US dollars have been transferred from the ordinary taxpayer to the banking system in this extraordinary and desperate move to save the financial system.
- The government has in fact lost two times over as the results are fragile banks that barely can support the real economy and heavily indebted sovereigns that face raising taxes and cutting services to be able to service this new debt.

Stagnation—Stagflation

- The current debt crisis is likely to be followed by stagnation in the West.
- Debt of households, firms, and governments will out of necessity result in less consumption, and investment as these agents have to service the debt burden.
- Consequently, economic growth will be suppressed.
- Increased demand for commodities in emerging markets and the less developed world will most probably also increase inflation the West.
- The only way to avoid this scenario is for creditors to forgive some of both private and public debt.
- Only by cutting the losses can we avoid a scenario of stagnation that would eventually hurt the creditors more than forgiving part of the debt now.
- This has to be followed by re-haul of public finances and the international financial architecture otherwise mistrust will arise.

Banks as Weapons of Mass Destruction

- The experience from the US and Europe show that universal banking, cross-border banking and badly designed supervision can pose danger to the financial health of a sovereign as it increases systemic risk.
- An extreme example is Iceland, my native country, were the banking system dwarfed the capabilities of the central bank and the sovereign, leading to one of the most spectacular events of the current crisis.
- At the onset of the Icelandic collapse, the balance sheet of the banking system was more than ten times the country’s GDP.
- Investors have probably lost more than six times the country’s GDP from the default of the Icelandic banks.

The New Financial Order

- Due to cross-border banking is natural to ask if there is there a need for a strong supranational financial supervisory authority.
- Should deposit taking banks and investment banks be separated to lower systemic risk?
- How will we solve the deposit guarantee dilemma in a world of cross-border banking?
- Should deposit guarantee schemes be extended over borders or should be simply restrict cross-boarder banking?
- How can we quarantine systemically important banks in times of trouble in order to minimize contagion effects?
- Do we have to restrict capital flows somewhat despite the economic costs associated with limiting the flows?
- Can we design systems were the taxpayer does not have to take the bill in difficult times or will we simply abandon the idea of insuring deposits?

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- In the wake of the current financial crisis these questions, and more, need to be answered.
- We have to strive to design a financial system that does not put the sovereigns at risk due to irrational exuberance of bankers as is inherent in the current design.