

## **NZZ Podium – February 5, 2009**

### **The Global Financial Crisis – Analysis and Prospects**

*Keynote Speech by Dr. Philipp M. Hildebrand, Vice President of the Directorate, Swiss National Bank*

*followed by comments by Herbert J. Scheidt, CEO of the Vontobel Group*

#### **The speech by Dr. Hildebrand**

“All life is problem-solving.” So said Karl Popper in a short but wonderful lecture on Technology and Progress in 1991.

Problem-solving, ladies and gentlemen, is a very precise description of my activities to date in the realm of monetary policy. I would go so far as to say that, since August 2007, we in the Swiss National Bank have been involved with particular intensity in exactly what Karl Popper was talking about.

You all know why – which brings me to the subject of today’s Podium. We are currently experiencing the most severe and complex financial crisis in many decades. Back in 1931 John Maynard Keynes wrote: “Never before has there been such a world-wide collapse over almost the whole field of money values of real assets as we have experienced in the last two years” (1). Ladies and gentlemen, unfortunately that quotation has regained its validity in many respects today.

In the current crisis environment, “problem-solving” means primarily crisis management. The Swiss National Bank is using all its resources to help combat this crisis. In doing so we have, in conjunction with government agencies at home and abroad, one overarching and clearly defined goal: to prevent a profound and long-lasting global economic crisis, or at least to soften its impact.

Permit me to cite three bits of historical data to illustrate why this objective seems to me so imperative.

Between August 1929 and March 1933, industrial production in the United States fell by about half. The unemployment rate rose to 25%, and in the course of that four-year period fully one third of all American banks had to close their doors.

I won’t elaborate on the details. Many of you know the history of the global economic crisis of the 1930s. And you all know the social and political consequences. They must both be avoided this time, at any cost. I shall devote only a few remarks to the course of the current crisis. I have done so extensively on a number of previous occasions (2).

After several years of record economic growth and what was thought to be low risk levels, the real financial crisis broke out in the summer of 2007. Price declines on the U.S. real estate market began to be reflected in bank balances via value losses in a broad range of financial instruments. The resulting uncertainty over the solidity of those banks led to several waves of losses in confidence and thus of liquidity in financial markets.

The situation worsened drastically in the autumn of 2008, with more and more financial institutions finding themselves in difficulty. This culminated in the bankruptcy of Lehman Brothers in mid-September, which prompted government agencies in various countries, Switzerland among them, to institute extraordinary support and rescue measures. The goal of those measures was to avoid a breakdown of the financial system as a whole and to limit the damage to the global economy.

Thanks to this decisive action, the global financial system has been stabilized for the present. But there is still a serious lack of confidence and further losses by international banks are likely. Moreover the financial crisis is now fully impacting the overall economy. The resulting losses of economic growth are expected to be greater than anything we have experienced in decades. The severe crisis has already affected many innocent people throughout the world. Savings, homes and jobs have been lost, and further suffering will inevitably follow.

Understandably enough, this raises the question: Who is really responsible for this entire mess? We know from history that in such a severe crisis the search for those responsible can quickly lead to public outcry and accusations. Such finger-pointing often produces more heat than light. But “light” in the sense of greater understanding is what we need most just now. I am convinced that a careful clarification of responsibility can serve as a signpost for all of us – a signpost pointing us to the path we must pursue, after overcoming the current crisis, in order to make our financial system, and thus our economy, more resistant to future crises. For this reason I venture to discuss with you today the difficult subject of responsibility.

In a purely formal sense, the question of responsibility is quickly answered. Almost without exception, and despite their astronomical levels of remuneration, the top officials of the leading international banks failed to do their jobs and meet their responsibilities.

At first glance this answer seems both comprehensive and convincing. However, it falls short of reality. As so often in life, a purely formal viewpoint results in an incomplete picture of reality.

The uncomfortable fact is that in many respects the responsibility for failure is much more broadly shared. Permit me to illustrate that contention:

- central banks, which had long been issuing warnings, not only failed to insist strongly enough to oversight agencies, but did not intervene themselves;
- heads of government and finance ministers, who for years had issued frequent warnings about global imbalances, ultimately failed to put effective corrective measures in place;
- regulatory agencies, perhaps partly inspired by the idea of self-regulation, failed in their dealings with banks to behave consistently like true organs of governmental control;
- politicians and political parties preferred to bask in the favor of banking chiefs instead of posing critical questions and resolutely strengthening the authority of the oversight agencies;
- major shareholders, their eyes hopefully fixated on stratospheric short-term yields and apparently endlessly rising share prices, helped carry constantly increasing debt loads.

These, ladies and gentlemen, are just a few examples. In the final analysis, they should raise the following question: In the dance around the Golden Calf, who did *not* participate somehow or at least look on benevolently?

If I have learned anything through my years of financial activity, it is this: Within the limits of established incentives, the actors in financial markets will always, and without reservation, aim their business practices at maximizing profits. And when I speak of the actors in financial markets, and their incentives, I am thinking not only of the banker and his wages and bonuses. Among others, I include the shareholders who wish to realize the swiftest and greatest possible returns on their investments. As author-playwright Friedrich Dürrenmatt formulated it in his 1959 work “Frank the Fifth: The Opera of a Private Bank”: “Where profit beckons, people’s actions are predictable.”

In other words, if incentives are conceived in such a way as to provide market players with a highway on which the desire for prosperity can degenerate into unlimited greed, then unlimited greed is what we will get.

Precisely this is the great misunderstanding of all those who dogmatically equate “the free market” with limitless freedom. The fact that this is not, and cannot be the case was recognized by the grandfather of capitalism and the free market. Adam Smith’s stated justification for forbidding certain financial transactions in the interests of system stability seems amazingly relevant today. Almost 350 years ago he wrote: “Such regulations may, no doubt, be considered as in some respect a violation of natural liberty. But those exertions of the natural liberty of a few individuals, which might endanger the security of the whole society, are, and ought to be, restrained by the laws of ... governments ...” (3).

So let us cease senselessly insisting that capitalism or the free market system does

not permit the establishment of regulations and clearly defined structures of incentive. Caution is especially imperative in the case of banks which are so large and complex that they simply cannot be permitted to fail without endangering the stability of our entire system. With such banks, incentive structures must be narrowly defined with special care.

Incentive structures, ladies and gentlemen, are not formulated by regulators alone. Investors – i.e., shareholders – should also do all they can to establish consistent incentives. Indeed, I'd like to take things one step further at this point: Society too, especially in a democracy, shares in the responsibility for the incentive structures under which our banks have operated in the past and will do so in future. In a democracy we have the power to jointly insist on clearly defined, risk-limiting incentives. If government agencies wish to impose stricter regulations to that end, we should give them our unqualified support.

From this perspective the current crisis is, among other things, definitely the result of collective failure. Faced with this collective failure, we must find the courage to take a clear stand for the future. We should never let a severe crisis pass without learning something from it. What has happened now must never be permitted to happen again.

Please do not misunderstand me. In saying this I do not wish to raise the hope that we will ever be able to prevent financial crises entirely. Between 1973 and 1997 alone, there were 139 documented financial crises around the world (4). I am convinced that we will continue to suffer financial crises in future. For that reason, we are all obliged to do everything possible to create the right incentives for our financial market. In future, our big banks should simply not be in a position to place the stability of our entire system at risk. It is for this reason that the Swiss National Bank is pushing hard to insure that the big banks are required to maintain higher levels of self-capitalization and liquidity.

Finally, it is obvious to me that future players in the financial markets will have to be more modest in their insistence on high yields. And yield systems must be structured so that risk levels are taken into account in the striving for profit. They must not be a one-way street. All of which does not add up to less success. By now it should be clear to everyone that increasing yield based on rising indebtedness and risks does not constitute a long-term strategy for success. Should you have any doubt about this, take a look at the share prices of our two big banks over the past 10 years or so.

We have been reviewing the crisis horizon and the future. Such a review is important. But at the moment, ladies and gentlemen, the efforts of our governments and central banks remain clearly focused on overcoming the current crisis. The Swiss National Bank has taken massive, decided measures to combat the symptoms of the crisis and to work against the resulting economic contraction. In conjunction with the government, we

have made an extensive contribution toward stabilizing the financial system. We have, in part, embarked on uncharted waters. Should it prove necessary, we shall similarly not hesitate to take further decisive, innovative and far-reaching measures in the realm of monetary policy.

We are quite aware that the path we are pursuing in combating this historic crisis harbors long-term risks. At the same time we are convinced that the path of “doing too little” would harbor far greater risks. And whenever it seems evident that the Swiss economy is finding its way back to its long-term course of growth, we will naturally not hesitate to alter the direction of our monetary policy accordingly.

Ladies and gentlemen, this evening I have tried to deal with the question of responsibility and not with that of guilt. The former permits a constructive approach to whatever is wrong. Above all, I have tried to look to the future, using the “signpost” as a metaphor. We must not feel guilty for making mistakes. But we would be guilty indeed if we failed to learn the necessary lessons from our mistakes. And that is precisely what we are trying to do. In terms of monetary policy, this means that we will not repeat the mistakes of the 1930s. In my opinion, the same holds true for fiscal policy. At the level of bank regulation and bank oversight it means deciding the necessary measures quickly, and applying them at the right time. The clearly defined goal is to make the banking sector resistant over the long term. That is our responsibility.

Together with my colleagues at the Swiss National Bank, I shall devote myself to that responsibility unconditionally and with everything in my power in the years ahead. But today I also direct an appeal to you. As I have tried to explain, the responsibility in this crisis is widely shared. In the final analysis we must together make sure that in future here will be no dancing around the Golden Calf, no placing the stability of our entire system and ultimately our economy at risk. I am hoping for your support, and I look forward to our discussion.

#### *ENDNOTES*

- (1) John. M. Keynes: “The Consequences to the Banks of the Collapse of Money Values,” August 1931; reprinted in: “Essays in Persuasion. The Collected Writings of John M. Keynes ” Vol. IX, London 1972, p. 153.
- (2) cf, for example: “Einleitende Bemerkungen, Halbjahres- und Jahresend-Mediengespräche” for the years 2007 and 2008.
- (3) Adam Smith: “An Inquiry into the Nature and Causes of the Wealth of Nations,” Glasgow 1776, II, ii, p. 94.
- (4) Barry Eichengreen and Micharel D. Bordo: “Crises now and then: What lessons from the last era of financial globalization?”, NBER working paper 8715, January 2002.

**Comments by Herbert J. Scheidt, CEO of Bank Vontobel AG**

(Some thoughts on the global financial crisis)

**Premise 1:**

**Small is beautiful**

1. The argument “too big to fail” has led to a kind of global “original sin” in system policy. We find ourselves now on the slippery slope from needed support via government guaranties to nationalization (examples: Anglo-Irish, RBS, to a certain extent also Commerzbank). This path became necessary because the size of certain banks had become a systemic risk. Government then intervened to prevent a systemic breakdown.

*Question:* How can we in future avoid situations in which the systemic risks of *one* bank become so large that the social market economy can no longer absorb those risks? My answer to that question is: We must limit the absolute size of banks so that the risks can be borne and digested by the market.

2. The subject “too big to fail” goes hand-in-hand with the subject “too big to manage.” The volume of risk on the books of the leading banks is horrifying. Equally disturbing is the length of the time-axis across which ever more risks burden the bank balances of the big global players. For example: In January the Deutsche Bank made a surprise announcement that it had suffered extensive losses in the 4<sup>th</sup> quarter of 2008. That resulted in an overall loss for the year of 5.7 billion pre-tax euros. This came as a surprise to all market players.

*Question:* Did top banking officials not know precisely what was going on in their banks? Or have their globally operating mega-banks become too complex to be manageable?

Hypothesis 1: After the kind of concentration we have experienced in recent months (e.g., Merrill Lynch absorbed by Bank of America, Bear Stearns by J.P. Morgan Chase, etc.), and another period of bank nationalizations, we will experience a huge process of transformation and restructuring. Big banks will become substantially smaller and will concentrate on what they do best. First example: Citi splits off the brokerage Smith Barney and merges it with Morgan Stanley, creating America’s largest, pure-bred brokerage house. A good example of increased focus.

Hypothesis 2: The financial crisis and the phenomenon of “too big to fail” will serve as the trigger for a fundamental process of transformation and far-reaching structural change in the real economy and the financial system. This structural change will be driven by:

- I. drastically reduced asset prices;
- II. strongly reduced multiples (e.g., price/earnings ratio);
- III. an altered attitude with regard to risk.

In my opinion, Anglo-Saxon-style investment banking – based on high outside financing (high leverage) – is unlikely to survive in its present form as an integrated service model.

In that process of change, those who will profit will be the ones that are flexible and can adapt well to new situations – i.e., medium-sized enterprises which have a clear strategy and know just what they want and what they can digest.

Conclusion: Small is beautiful – as was proposed by German economist E. F. Schumacher.

**Premise 2:**

**Global financial oversight, properly understood, is unavoidable.**

1. Straightforwardly put: We – the financial industry, regulators, central banks and politicians – all of us are faced with the alternative of either globalizing financial oversight or de-globalizing the financial industry – and with it the real economy as well.

As we have long observed, both positively and painfully, the banking world is globally interconnected. The best and most painful example of this are the so-called CDOs (collateralized debt obligations), in which, crudely put, high-risk high-yield sub-prime loans were bundled so that they could be spread all over the world. Thus Swiss, Chinese and Indian investors all purchased equally bad mortgage debt from America. And in that way America's sub-prime mortgage crisis was globalized.

Another example of the financial industry's high level of interconnectedness are the trading books of banks, which are regularly transferred to the time-zone in which trading is going on at the moment. There are also the financial products and innovations offered all over the world via the Internet.

*Clear insight:* The financial markets and financial institutions are very closely intertwined *globally*. By contrast, the regulatory framework for overseeing the globally operating financial institutions is in most cases purely national. Moreover, the national regulatory authorities tend to focus their attention on legal entities, such as banks operating in one jurisdiction, rather than on economic activities that are global in nature. The challenge here is to get a grip on the phenomenon "too

interrelated to fail.” That is to say, when it comes to the oversight of financial risk, we need a greater degree of global coordination among national regulatory agencies. Those agencies need to operate with globally coordinated international risk standards in order to prevent, among other things, regulatory arbitrage among countries in the realm of risk policy.

Along the lines of the “prisoner’s dilemma,” each bank and each country has an incentive to issue softer regulations – e.g., inadequate leverage ratios – in order to gain an advantage. Thus the defining and enforcing of suitable, globally harmonized regulations for risk management (e.g., adequate debt postings on balance sheets) is in everyone’s best interest. Some progress has been made in this area, such as the Basle II regulations, but there is still some way to go.

2. The call for adequate regulation of risk management, however, is not the same as the general call for more government. It is government’s task to set the regulations and conditions under which economic actors can achieve socially desirable results while best serving their own self-interest. In the process, care must always be taken to insure that the “public good” of *global* stability on the financial market is protected. What is needed to that end is not necessarily *more*, but rather more *efficient* regulation.

**Premise 3:**

**The desire for the “honest merchant” requires a discussion about fundamental principles of policy in a globally interconnected economy.**

- Bernard Madoff with his \$5-billion fraud;
- Jérôme Kerviel, the notorious trader who made off with some 5 billion euros from the Société Générale;
- manipulated corporate balance sheets;
- scandals over greed at top corporate levels.

All these things explain the serious loss of trust in the financial system and its actors. Society’s disgruntlement with the financial industry has become so pervasive that people are forgetting the reasonable advice about not judging an entire flock because of a few black sheep.

Just as swiftly as the public image of the financial industry has deteriorated, the general longing for the “honest merchant” has grown in our society. That longing calls for a broad-based discussion of the necessary general principles which must guide policy in a globally interlinked economy.

What are we talking about in broad general terms? Among other things, I am referring to

the following two questions:

1. To what extent is self-interest positive as an engine of economic activity in a free market economy, and where lies the border between self-interest and greed? I do not believe that systematically drawing the line between these two is possible, although we all think we know what greed is.

But in contrast to greed, self-interest is an important driving force in human activity. People motivated by self-interest are constantly testing the limits of the possible and in so doing contribute greatly to progress. Our current levels of prosperity would be inconceivable without such individuals.

In order to limit the risk attendant on self-interest, there is a need for regulatory policies which balance self-interest and the interests of society as a whole. The establishment of clear and simple rules is the primary task of government. That provides the maximum long-term benefit to both the economy and society.

2. The second question is linked to the establishment of rules: Are laws, regulations and corporate-government structures sufficient to insure value-based, ethically “clean” dealings in the business world? In other words: Is everything permitted that is not forbidden?

I believe that laws and regulations can only establish a framework for socially acceptable coexistence. In order to do good business over the long term, our actions must adhere to the maxim that we should act in such a way as to create a maximum of trust in our own sphere. The trust of our clients in us, in our services and products, and also the trust of our colleagues in our joint endeavors, is essential. Trust is a fundamental basis of human relations – very much along the lines of the Hanseatic “honorable merchant” of the 16<sup>th</sup> century. His basic idea was value-oriented enterprise; his word was his bond, and his clients were always at the center of his concern. That did not prevent him from sober calculation, tough negotiation and honest reckoning. In all this he took the long view, often spanning generations. Naturally, he also did his best for the public good without demanding any special recognition.

The values of the “honorable merchant” serve as a model in the corporate structure of Vontobel.

The question remains open of how we are all to anchor those values in a globally interlinked economic order. The various initiatives to insure consistent practices were the first steps in that direction. Much remains to be done.

**Conclusion:**

If we wish to emerge from the present crisis strengthened, despite all the damage done, we must use new-old virtues as the guidelines for our actions. If solidity, integrity, transparency and consistency again become the determining maxims of our market activities, we will truly have learned something from the current crisis.

In that sense, I see my remarks as a plea for a “moral economy” in the financial world – and thus a plea for the reconciliation of two spheres which have seemingly seldom been in harmony in recent years.

I look forward to a lively discussion.