Institute of Policy Studies

IPS Lunch Dialogue:
Sir Paul Tucker on Crisis Contagion – Post Global Financial Crisis
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Introduction

Sir Paul Tucker was Deputy Governor at the Bank of England during the tumultuous aftermath of the global financial crisis which began in 2007. As Deputy Governor, he was on the steering committee of the G20 Financial Stability Board and chaired its Committee on the Resolution of Cross-Border Banks in order to solve the problem of "too big to fail" banks.

In March, Sir Paul, now a Senior Fellow at Harvard Kennedy School and Harvard Business School, visited Singapore as a guest of the Lee Kuan Yew School of Public Policy (LKYSPP), National University of Singapore. He gave a speech as part of the ST Lee Lecture on 17 March, and spoke to the Institute of Policy Studies (IPS) Corporate Associates over lunch later that week to round off his trip. Chairman of Ascendas Pte Ltd, Dr Teh Kok Peng, a former Singapore central banker, chaired the dialogue, which was attended by leaders from the banking, financial advisory and shipping sectors. After brief opening remarks from Sir Paul, dialogue participants launched into a series of questions and sought his views on the current financial system, the culture in the banking sector and the role of the central bank. A selection of his responses from the lively, hour-long dialogue is summarised below.

Continued Reforms Are a Must

Sir Paul commented that as reforms to the financial system are implemented, responsibilities would shift from the jurisdiction of banking regulators to securities regulators. But in most places, securities regulators are focused on honesty and efficiency, which are important qualities but insufficient to ensure the stability of the financial system, he said. Sir Paul remarked that unless institutions underwent reform, there would still be weaknesses in the global financial system.

He further described how the landscape in which central banks operate has changed drastically over the years. For one, emerging market economies now have to grapple with uncertainties such as short-term capital flooding in — pushing up exchange rates and asset values, and loosening internal credit conditions — and subsequently withdrawing due to fluctuating expectations of the timing and principles of the US Federal Reserve's move to taper its monetary stimulus programme.

"While the world distracts itself with the debate of achieving symmetric adjustments to global account balances, it did not focus on the more important question of what can be done when the US eases monetary policy and dollar-denominated capital flies around the world to wherever it takes to make a return," Sir Paul said. He added that the international community has been too slow to think about the flow of "hot money" (i.e., funds or capital that flow from one country to another so as to earn short-term profits on interest rate differences). Since the Asian Financial Crisis, many Asian countries have deepened their capital markets, which he said is sensible, but by doing so they expose their economies to such flows.

One possible solution is to use capital controls. There are leading academics and economists who suggest that the benefits from trade, goods and services are high but the benefits from completely free capital are not so high. However, Sir Paul noted that it is impossible to have a world where capital protection does not slip into trade protection. Instead, regulators should ensure that most of such hot money is held in liquid form as resources to meet withdrawals if there is an exodus of capital.

Sir Paul pointed out that in creating a stable global financial system, the world would be pushed towards better co-ordination and co-operation in monetary policies. "The lesson the world has taken from this crisis is that no one is insulated," he said, and while international policy is a slow process with many conflicting voices, it is necessary.

Too-big-to-fail

A member of the audience asked if the problem of too-big-to-fail banks could be solved. Sir Paul said he is optimistic about the matter, but he believes that the problem cannot be solved purely by structural policies that break up the banks. "Yes, the laws to break big banks into smaller entities will solve the problem temporarily, but those laws will get repealed eventually. We are not trying to develop policies for the next 10 years; we are trying to develop policies for the next 70 or 80 years. If we reintroduce the Glass-Steagall Act, it will [probably] be repealed before the end of my natural lifetime," he said.

Instead, a system that controls spillovers from bank insolvency via bank-resolution regimes and is capable of operating across national borders is necessary.[1] However, for that to happen, the right legislative powers are required. In the US, the Dodd-Frank Act confers the Federal Insurance Deposit Corporation those powers. Sir Paul said that the objective is not about containing order — if Goldman Sachs or Barclays fails, the world would inevitably spiral into a mess — but about containing the cataclysmic price decline in assets so that the economy does not collapse.

[1] See Financial Stability Board, (2013), "Guidance on developing effective resolution strategies", 16 July, https://www.financialstabilityboard.org/publications/r_130716b.htm; and Paul Tucker, (2003), "Resolution and the future of finance", speech delivered at the INSOL International World Congress, The Hague, 20 May, http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech658.pdf.

Risk from Shadow Banking

Asked for his opinion about the risk posed by the shadow banking system, Sir Paul replied that not all shadow banking is bad. Bad shadow banking "mainly replicates the materiality of liquidity mismatch in the banking sector," he said. He explained that the risk of these activities exists because while the shadow banking system promises increased liquidity, many of the underlying assets are illiquid. Central bankers therefore have to ask themselves what the chances are of these activities running into a position where harm is inflicted upon the system. Sir Paul reckoned regulators and central bankers should engage more with big accounting companies to identify existing and potential risks.

Sustainability of the UK's Economic Recovery

One participant asked if the UK economy was going into another housing bubble. The participant questioned the resilience of its economy and the financial system to tighter monetary policies that the market expects to begin within this year. He also expressed concern towards the potential adverse consequences of having regulators and central bankers with conflicting objectives.

Sir Paul noted that there are sufficient supervisory frameworks in place to insulate the UK economy against the risk of conflicting objectives. For example, within the Bank of England, there is the monetary policy committee and financial policy committee. Each committee has external members to help maintain the bank's integrity and prevent the bank from focusing on just one issue while neglecting other important issues.

Sir Paul said he and the central banking community were more concerned about the UK's economic prospects. For the past few years, monetary policy has been the only tool employed. Fiscal policy has been pulled back to nurse the damage from running years of unsustainable budget deficits. However monetary policy works by bringing forward future spending; it reduces savings and increases debt. Citing the "three arrows" programme to revitalise the Japanese economy by Japanese Prime Minister Shinzo Abe, Sir Paul said: "The third arrow of Abenomics is where all the action is. It is the arrow of structural policy that can push up the rate of growth. If that works, everyone's income is going to be higher. Then borrowing more today becomes less worrying."

He added that central bankers today have fallen into the trap of allowing society to think that they will answer all the problems of the economy. Prosperity comes entirely from the real economy, and he would like to see central bankers preach that message again, he said.

Culture in the Banking Sector

Asked if the banking culture had evolved since the financial crisis, Sir Paul said the more appropriate question would be: Are banks too big to manage? He observed that financial managers in the present world did not have the same level of social responsibility that their predecessors had. For instance, he said, financial leaders in the past seemed more aware of how their organisations were intricately tied to the economy and society because they were very much in touch with government ministers and the media. However, more financial managers today run operations that are shielded from the outside world, and the resulting

culture becomes "problematic". To really reform the banking culture, the mindset of their boards of directors towards profit-making will need to change.

Summing up, Sir Paul said that a new international regulatory order can be used to mitigate spillovers and crisis contagion in the international monetary system. There is also a need for international authorities to enrich their surveillance and co-ordination in order to keep up with changes to the financial landscape. Only through these efforts can robustness be ensured in the global financial system. Otherwise, history could repeat itself.

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