

# **The financial crisis: The time for credibility has come!**

## **Introductory note to the contribution to be presented at the ISSA Seminar on security security in times of crisis: Impact, challenges and responses**

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After a succession of downward revisions, the IMF, in its most recent forecast dated 19 March, predicted that world growth would shrink catastrophically in 2009 to between 0.5 per cent and 1 per cent. The impact on the real economy is a direct result of the severe "credit crunch" which began in August 2007. Obviously, the shortage of credit is the result of grave doubts concerning the health of the banking sector: what is the real weight of toxic products in the banks' balance sheets? If there is still doubt about the reply to this question, it is largely because of the lack of direct credible information on the real situation of the principal banking and financial institutions. However, the lack of credibility also affects other actors: the main regulators, the central banks, and also governments. Seen in this light, the most recent meeting of the G-20 may not have been successful in removing doubts concerning the health of the world economy.

This atmosphere of uncertainty was initially the fault of the banks which hid their problems concerning liquid assets when they began to feel the effects of the subprimes crisis. Their real problems began with the securitized assets which they held in their own name or for which they provided after sales service for their clients. Their credibility was quickly undermined when successive waves of bad news broke week after week for more than 20 months, each wave contradicting previous announcements.

The main central banks and the financial regulators were also "taken by surprise" by the magnitude of the crisis. It's enough to look at the series of panic-stricken injections of funds which have been - and continue to be - fed into the interbank lending markets since August 2007. Similarly, governments reacted very slowly in providing support for the banks (from September 2008) and even when they did so it was only on a case-by case basis and under the worst conditions. Plans to provide support for the economy are produced in quick succession and only reflect the confusion of public authorities in the face of this continuing crisis. From an optimistic if slightly simplistic standpoint, this may be seen as "pragmatism" on their part, but it is obviously navigation on sight which once again undermines the credibility of their explanations concerning the current situation and thus casts doubt on the effectiveness of their actions.

In this context the IMF is probably farthest from the truth as regards the nature of the current crisis and its effects on the world economy. Since the beginning of the crisis, its quarterly forecasts on world economic growth have one by one been disproved by the facts. Similarly, the IMF estimated the losses caused by the financial crisis at 400 billion dollars in February 2008, a figure which has progressively climbed to reach 4 100 billion by 21 April 2009!

Finally, do we need to add that the "credit crunch" is aggravated by this general loss of credibility in which the banks, even if they are not alone as we have just seen, have played and continue to play a major role? This discredit is the direct cause of the lack of confidence in each other displayed by the

banks on the interbank lending markets; it also lies behind the uncertainties concerning the future which are affecting enterprise management. In concrete terms this first affects credit supply, then in a domino effect the demand for credit, finally leading to a slump in economic growth.

The most recent meeting of the G-20 will probably be unable to remove all the current uncertainties. It has certainly recognized that the world economy has suffered a considerable shock. Basically, the response to the crisis involves an increase in IMF resources and the introduction of new rules on security (with the creation of the Financial Stability Board). However, in spite of its length, nowhere does the final communiqué issued by the G-20 dare use the word “bank” to indicate the role of these institutions in triggering the current cataclysm. On the contrary, the only reference to the “banking system” is to indicate the “considerable support” provided by the G-20 countries to restore growth (point 8 of the Communiqué). This failure to provide a plausible explanation of the causes of the crisis lies behind our search for a deeper understanding of the underlying logic and thus the issues facing us.

Two series of causes are easily identified. Let us take a brief look at them:

1. Firstly monetary causes. The two-fold liberalization of the monetary and financial markets came first; liberalization of exchange rates in the early 1970s and liberalization of interest rates in the early 1980s. A financial risk hedging industry developed in order to protect the real economy from these two shocks. Firms must in fact cover themselves against risks arising from fluctuations in exchange and interest rates. This industry, which expanded rapidly in the 90s, began by providing increasingly sophisticated products to cover all sorts of risks which could be traded on the financial markets. In the late 90s, the banks had the idea of eliminating lending risks through the securitization of their debts, i.e. by transforming the debts on their balance sheets, particularly mortgage loans, into tradable financial assets.

When the United States housing market collapsed at the end of 2006, and the interest rates rose, the securities based on mortgage loans to the most vulnerable American householders began to become toxic. The phenomenon became even more important because these securities could in turn become part of the composition of more complex "structured" securities which, in return, also became toxic.

On the eve of the subprime crisis, the financial sector had become hypertrophic because of the number of these hedge products and the volume of trading in them; nearly 40 times higher than the volume of trading in the real sector. However, hedge products cannot exist without a speculative counter balance. Speculation feeds on both an expanding bubble and a bubble which bursts and shrinks. The excesses linked with the hypertrophy of global finance could not have developed without the leverage of the gigantic debts which were often made possible by the banks themselves, particularly as a result of their off-balance-sheet operations.

However the G-20 has left the causes behind the formation of hedge products and thus of speculative funds intact. And yet, when you see the composition of these derivatives (mostly hedge products for exchange and interest rates), it would be enough to backtrack on the two-pronged liberalization of the money market to shrink the financial sector in one fell swoop, and enable the actors to return to long-term planning for international trading and finance. In concrete terms, this implies the construction of a new international monetary system with rules based on the evolution of exchange and interest rates. In other words, the conception of money as something which belongs to humanity as a whole. It also implies the end of the dollar standard.

2. The other factor which is undermining and destabilising the world economy, is revealed by shareholder value practices. Arising out of American tax legislation (ERISA Act, 401K plans) the administration of pension funds based on capitalization changed completely in the 80s. It became

much more aggressive as a result of competition between the principal fund administrators to capture retirement saving. This led to the birth of the 15 per cent financial norm for return on investment as a measure of their efficiency. This norm implies that fund administrators must become over-demanding, as shareholders when they invest, for example, the resources in their care in listed firms.

Behind the terms "shareholder value" or "added value for shareholders", lies the increasing influence of institutional investors on the management of an enterprise and its financing. This led to the "New governance" of firms which appeared in Great Britain in the early 90s and thereafter in the rest of Europe. Shareholder value practices have completely changed the image of the firms, their management and their organization. In fact, the need for a fixed financial profit level *a priori* implies a massive transfer of risk to the management of the enterprise which from that moment on is thus obliged to produce results. And what's more, at an incredible level.

The impact on labour relations is considerable. The organization of labour and the labour market is disrupted. Flexible working, out-sourcing and relocation become increasingly frequent. Financial pressure on the world of work reaches such levels that health expenditure increases significantly; this is followed by redundancy plans in spite of the fact that firms are making a profit or by "stock exchange redundancies". Profit-making is no longer sufficient. The norms imposed by the new shareholders must be achieved. As you can see, these new practices are untenable; their origin lies in the distortion of added value to the detriment of employees in the 90s. They led to the flagrant inequalities in earnings which can be observed today. These issues do not figure in the final communiqué of the G-20.

The practices connected with shareholder value and new governance of firms affect all those firms listed in the various financial centres throughout the world. Major investors are now looking more and more closely at non-listed enterprises. However, higher risk brings the need for much higher profit, around 25 per cent. ...

What means can be used to combat this infernal logic? The response to this question is unpalatable, for there are no miracle solutions. Certainly, the United States would have to accept to backtrack on their tax legislation, but there is every likelihood that the lobby of major investors would oppose this with all their might. Other avenues merit exploration. Let us take a quick look at them. First of all; the consolidation of the mutual trust, cooperative and associative sectors by helping them to regain their fundamental principles of solidarity. After that, the transformation of current joint stock companies into genuine firms based on alternative partnerships, which would mean drawing up principles for their governance, ownership rights and the distribution of profits. And also, why not, the political consolidation of the nationalisation of banks in order to forge the tools needed to serve a long-term vision. This is becoming increasingly vital in order to meet the enormous challenges which face our planet at several levels: the environment, energy and nutrition.

