ESRC Economic & Social Research Council

LSE

SRC Systemic Risk Centre

CPNSS Centre for Philosophy of Natural and Social Science

Towards a Sustainable Financial System

SRC and CPNSS conference
21 March 2014

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INTRODUCTION

The Systemic Risk Centre (SRC) and the Centre for Philosophy of Natural and Social Science (CPNSS) at the London School of Economics and Political Science (LSE) organised a one-day conference *Towards a Sustainable Financial System* on 21 March 2014.

The event brought together experts in the sector to discuss the fundamental issues surrounding money creation, increased private debts and underestimated endogenous risks; whether there was more to do to avoid another severe financial crisis; and whether the financial system could operate in a way that would better support the real economy and encourage sustained growth.

The conference successfully created a dialogue between practitioners and academics on these issues and raised awareness of the remaining problems. This publication presented many of the key discussions that took place in the conference.

The event was generously supported by the Economic and Social Research Council (ESRC) [grant number ES/K002309/1]. The activities of the CPNSS and the SRC are kindly supported by Mizuho International plc.

SESSION 1: CREATING MONEY – FOR WHAT PURPOSE?

Lord Adair Turner has combined careers in business, public policy and academia. He became Chairman of the UK Financial Services Authority as the financial crisis broke in September 2008, and played a leading role in the redesign of the global banking and shadow banking regulation as Chairman of the International Financial Stability Board's major policy committee. He is now a Senior Fellow of the Institute for New Economic Thinking, and at the Centre for Financial Studies in Frankfurt.

Lord Turner's focus was on questions of lending and debt. First, there's the theory: fundamentally, banks create money and credit and, through supplying credit, they create purchasing power – in doing so they also create ongoing debt contracts.

Pre 2008 there was a widely held view that the more credit there was vis a vis GDP, the more economic growth there would be. But not only was the volume of credit far too high – too much of the wrong sort of debt was created.

"I believe that we have a system which will create too much debt and credit left to itself. And I think we have to recognize the problems with debt in both the upswing and the downswing of the cycle…we simply don't have a stable system."

In the downswing, we don't know how to get rid of leverage in the economy – it's simply shifted round, particularly into the public sector.

Lord Turner debunked the idea that the bulk of lending goes to business to invest in new projects – that accounts for only about 15 per cent of lending. The rest performs other functions, including financing consumption or investments in assets that already exist, such as houses or land. In Britain pre 2008 there was an enormous credit and asset price boom in real estate – but little new construction.

"The net result is that credit against real estate is not just part of the story of financial instability, it is – again and again and again – the central story of financial instability."

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There are several ways to tackle the problem. Inequality, which exacerbates problems of debt, has to be reduced. The issue of the wrong sort of debt has to be tackled – on a global scale – and central banks must be more concerned with the level and growth levels of debt. More constraints must be applied to both borrowers and lenders – and maybe higher rates of interest should be applied to real estate lending.

Finally, banks must devote themselves to what should be their core role – lending to business for investment projects – and not be overly involved with other functions.

A video of session 1 can be viewed here (**lse.ac.uk/newsAndMedia/videoAndAudio/channels/publicLecturesAndEvents/player.aspx?id=2356**)

SESSION 2: A ROADMAP TO RECOVERY, SUSTAINED GROWTH AND A STABLE GLOBAL FINANCIAL SYSTEM

Riccardo Barbieri Hermitte joined Mizuho International in January 2011 following a twenty-year career that saw him holding senior positions in economic research, macro strategy and proprietary trading at JP Morgan, Morgan Stanley and Bank of America.

Luca Fantacci teaches international economics and the history of financial crises at Bocconi University in Milan. His research focuses on the history of financial systems and of economic thought.

Ulf Dahlsten is a Research Associate at the London School of Economics and Political Science (LSE). Previously he held high profile positions within the Swedish Government and industry.

A video of session 2 can be viewed here (**lse.ac.uk/newsAndMedia/videoAndAudio/channels/publicLecturesAndEvents/player.aspx?id=2356**)

"I don't think the Eurozone can survive another recession within the next two to three years."

Riccardo Barbieri Hermitte noted that growth in the Eurozone was still sluggish – the most optimistic forecasts were looking at 1 per cent growth in 2014 and only 1.8 per cent in 2015. For growth to be sustained, EU structural reforms, particularly in the southern European countries and in France, had to continue.

The trouble is that the EU finds it very difficult to implement overall finance policy – policy still tends to be country specific. "This represents a big obstacle for promoting growth in the Euro zone area in general."

Mechanisms whereby countries could be given more realistic fiscal targets were also needed. And it was vital that the ECB do more to stimulate growth: maybe its mandate needed to be re-examined, allowing it to do more on the unemployment front.

"I don't think the Eurozone can survive another recession within the next two to three years."

We must understand how national problems become Euro wide problems said **Luca Fantacci** and why monetary union has not been as successful in providing unity as had been hoped.

Monetary union still needed to be established – all too often there had been divergence when convergence was what was required. Monetary union only works if there's an external balance – and there are common currency flows from the centre to the periphery. But that hasn't happened: instead there's a very clear separation between surplus and deficit countries.

"This is the original sin of monetary union."

The ECB has to reestablish external balances. There has to be an end to the big differences within monetary union, where, for instance, interest rates can be 5 per cent at the periphery but very low at the centre.

Ulf Dahlsten warned against complacency. The financial system is not fixed – it's inherently unstable.

"There are so many institutions that are too big to fail and if one of them fails, all of them will fail."

There's still a lack of transparency in the system and too many risk taking incentives. The tendency for bigger and bigger banks should be resisted: mark to market accounting systems should be put in place. And while a global monetary governance regime is probably impractical a market charter should be drawn up, with a council and NGOs and others involved to ensure transparency.

"This is the original sin of monetary union."

"There are so many institutions that are too big to fail and if one of them fails, all of them will fail."

SESSION 3: THE RMB INTERNATIONALISATION AND SUSTAINED GROWTH IN CHINA

In this session an overview of the reforms adopted to stabilise China's financial system and its currency, since the outbreak of the financial crisis, was given. These include policies and reforms to further internationalisation of the RMB and establishing it as a major currency for transactions and settlements, and as a reserve currency. A policy framework to facilitate the use of RMB in cross-border transactions is used, including pilot programs to enable cross-border trade settlement in RMB. Further measures target an increase of liquidity supply, the cutting of red tapes for the cross-border use of RMB, an upgrade of the market infrastructure, as well as sustaining a strong and stable economic growth in general.

To ensure sustainable economic growth in China, fiscal reforms are accompanied by political reforms. While China aims at developing its economy further by moving upwards on the value chain from manufacturing to service industries, the recovery of the world economy, as well as an increase in domestic consumption, will serve as a favourable environment for the Chinese economy.

BREAK OUT SESSION A: WILL THE RMB BECOME THE NEW RESERVE CURRENCY?

Alan Wheatley was global economics correspondent for Reuters until November 2013. He is the editor and co-author of "The Power of Currencies", published by the International Institute for Strategic Studies, and is editor for the London think-tank Official Monetary and Financial Institutions Forum.

Yu Yongding is a former president of the China Society of World Economics and director of the Institute of World Economics and Politics at the Chinese Academy of Social Sciences.

Alan Wheatley, describing himself as a "mere journalist" said that despite all the problems of the US – its gridlocked political system, its foreign wars – the position of the dollar as an international unit of account and a medium of exchange is unrivalled. It took centuries for the US dollar to build up its position as the reserve currency of choice.

There's a great deal of inertia built into international markets: many countries, such as Japan and Saudi Arabia – are sheltered under the US military umbrella – and, as a quid pro quo arrangement, it's natural these states hold the main part of their reserves in US dollars.

China had made some progress in broadening its financial markets and making the RMB more accessible but its money market was still governed by a system of political patronage.

"The US has unparalleled, deep, liquid financial markets underpinned by transparency, accountability and the rule of law and China, and I speak here as a friend of China, does not have any of these things."

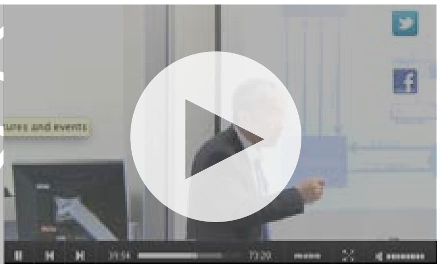
Yu Yongding, while supporting the wider use of the RMB, felt the process should not be rushed. China's attempts to build international financial markets have met with only limited success: Hong Kong was more a financial centre than

Shanghai though the government was trying to promote the latter.

The first step to internationalising the RMB is allowing allowing China's companies to pay for goods in RMB – such as imports from Hong Kong. RMB would flow into Hong Kong – and RMB holders in Hong Kong could invest in China.

China had made considerable progress towards internationalizing its currency and reforms had been implemented. There was still a need to create a deep and liquid money market and to liberate the exchange rate – but this had to be done carefully or else China would suffer rather than benefit from RMB internationalization.

"The US has unparalleled, deep, liquid financial markets underpinned by transparency, accountability and the rule of law and China, and I speak here as a friend of China, does not have any of these things."



A video of breakout session A can be viewed here (**lse.ac.uk/newsAndMedia/videoAndAudio/channels/publicLecturesAndEvents/player.aspx?id=2356**)

BREAK OUT SESSION B: ARE WE HEADING TOWARDS A NEW FINANCIAL CRISIS?

Jon Danielsson is a Director of the Systemic Risk Centre at the London School of Economics. Having published his work extensively, his two latest books are Financial Risk Forecasting and Global Financial Systems.

Charles Goodhart, CBE, FBA is Emeritus Professor of Banking and Finance with the Financial Markets Group at the London School of Economics. Previously he worked at the Bank of England for seventeen years as a monetary adviser, becoming a Chief Adviser in 1980. In 1997 he was appointed one of the outside independent members of the Bank of England's new Monetary Policy Committee.

Lars Jonung is senior professor at Lund University, Lund, Sweden. He was chairman of the Swedish Fiscal Policy Council 2011-13, and Research Adviser from 2000-2010 at DG ECFIN, European Commission, Brussels, focusing on issues related to the euro.

A resounding "Yes" was the verdict of **Jon Danielsson**.

Inevitably, regulators are looking backwards not forwards – "fighting the last war." Also the regulators are under pressure from politicians who, on one hand, caution against risk taking but then on the other encourage, in the name of economic growth, the exact opposite.

"The focus should be on easily verifiable and likely to succeed rules and not on trying to match the complexity of the financial system."

Charles Goodhart said regulations don't bring about crises – they happen when classes of assets come to be considered as far safer than they actually are by both regulators and markets, as happened with residential property in the last crisis.

There is still the potential for a Eurozone crisis but a financial crash in China is unlikely – you pay a high price for failure in China.

"The focus should be on easily verifiable and likely to succeed rules and not on trying to match the complexity of the financial system."

In the UK a pattern has emerged, with a financial crisis occurring every 17 years. So, the next crisis – "again associated with property lending and an overly competitive banking system" is due in 2025!

In the UK a pattern has emerged, with a financial crisis occurring every 17 years. So, the next crisis – "again associated with property lending and an overly competitive banking system" is due in 2025!

Yes, of course there'll be another financial crisis said **Lars Jonung**. The financial system is becoming more and more unstable.

The next crisis is likely to happen in countries which have not recently had one – Sweden and Norway for example. Prices in both have been rising.

"You can buy a small shack on the top of a Norwegian mountain where you can only basically spends two months a year, at a price twice as much as you can buy an estate or vineyard in France."

The best way to achieve financial stability is to restrict growth in credit, relative to income. We must draw lessons from crises.

"I think we're wasting the present financial crisis but I would say don't waste the next financial crisis."

A far more macro based approach is needed if another crisis is going to be averted said **Malcolm Knight**.

"Reform relies far too much on strengthening micro prudential regulation and not enough on macro prudential regulation."

"I think we're wasting the present financial crisis but I would say don't waste the next financial crisis."

The system is still far too interconnected – there's a great risk of contagion. At the same time it's crucial that regulatory reform is harmonized across jurisdictions and is made international. And the whole process has to be monitored.

A video of breakout session B can be viewed here (**lse.ac.uk/newsAndMedia/videoAndAudio/channels/publicLecturesAndEvents/player.aspx?id=2356**)

BREAK OUT SESSION C: WHY WE NEED NEW MODELS OF THE ECONOMY

Sheri Markose is a Professor of Economics at the University of Essex and is also a Senior Consultant at the Financial Stability Unit of the Reserve Bank of India.

Sheri Markose advocated developing "agent based models" – computer programmes that can interact with each other. Through them you can see the way disasters unfold. There is a need for multi agent financial network models or micro-nets – to be used for macro-prudential policy.

"The reason we sleepwalked into this crisis is because risk-management was studied at the level of individual institutions."

The future will be how we deal with large data – we need to work towards making models that work in a similar way to Google maps.

No one is really examining the system in its entirety and questioning where it's all going. Risk might be sent elsewhere but it not only destroys things at the periphery, it also eats away at the hub. Threats come from various segments and we need to make all the network models encompass global flows.

Harold Stieber said he's fighting to gain recognition for such modeling techniques in the work of the European Commission. He feels there's a new found unity developing in science, where, for instance, computer science and economics are developing algorithms to build and analyse large data related to cancer.

New, multi layered models for monitoring the monetary system should be introduced: the problem is that there's not only a skills

gap but also considerable technological challenges in implementing change – and communicating why it's necessary.

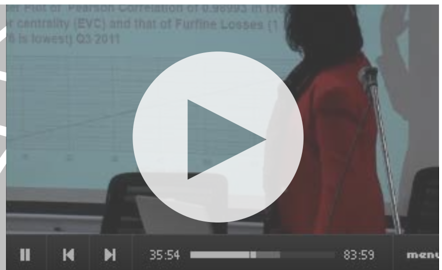
Central banks are facing particularly big challenges according to **Eric Beinhocker** with "one foot on the monetary gas and one foot on the macro-prudential brake."

"The reason we sleepwalked into this crisis is because risk-management was studied at the level of individual institutions."

We need a system to control contagion and what is present day 'wild horse' economics – a situation similar to where one horse in a herd starts getting jumpy and then transfers that uneasiness to the entire pack.

Agent based modeling is "ideally suited to model these kind of disaggregated, interacting systems." This would include banks, households, big and small companies – and central banks.

Work on this is still at an early stage: everyone is excited about big data but the question is what do we actually do with it?



A video of breakout session C can be viewed here (**lse.ac.uk/newsAndMedia/videoAndAudio/channels/publicLecturesAndEvents/player.aspx?id=2356**)

SESSION 4: TOWARDS A MORE BALANCED GROWTH MODEL: THE CASE OF JAPAN

Haruhiko Kuroda was appointed Governor of the Bank of Japan in March 2013 after serving for eight years as President of the Asian Development Bank. Throughout his career at the Ministry of Finance in Japan, which began in 1967, Mr Kuroda's responsibilities encompassed fields including international finance and national and international tax, as well as duties in the finance minister's office. From 1999 to 2003, he represented the Ministry at a number of international monetary conferences as Vice Minister of Finance for International Affairs, and from 2003 to 2005 Mr Kuroda was Special Adviser to the Cabinet of Prime Minister Junichiro Koizumi.

Haruhiko Kuroda, Governor of the Bank of Japan, says his country's extended period of deflation had been very unlike the Great Depression of the 1930s. In Japan, deflation had gone on for an extended period and had been very gradual.

Price declines had been moderate – on average about 0.3 per cent per year – while unemployment, at its worst, had been 5.5 per cent.

"Japan's deflation had come to show symptoms akin to a chronic lifestyle disease."

Yet while Japan's economy was in deflation it was not in recession. There have been periods of steady economic growth – in fact the longest post war economic recovery period in the country was over the years 2002-2008. But the economy had lost its vitality.

Several factors caused this extended deflationary period: when the economic bubble burst in the early 1990s, serious adjustments had to be made to cope with excess capacity and employment. Prices of imports from emerging economies were low, corporates were pursuing low price strategies. There were also serious non performing loan problems, there was uneasiness in the financial system and excessive appreciation of the Yen.

Perhaps most important of all the idea that prices would not rise became entrenched in people's minds. Deflation became self fulfilling.

"We have to dispel such sentiment. We have to convince people that a situation in which prices will increase by about 2 per cent every year is nothing special and

"Japan's deflation had come to show symptoms akin to a chronic lifestyle disease."

"The day that Japan's economy can contribute more and more to the world economy is at hand."

change the economy to one in which people make decisions and behave based on that assumption."

Decisive action was needed. Soon after Mr Kuroda was appointed BOJ Governor in early 2013 "the unprecedented, large scale monetary easing policy of QQE – quantitative and qualitative easing – was introduced.

"To combat people's deflation expectations and to raise their expected rate of inflation, it is necessary to demonstrate the Bank's strong resolution and commitment towards overcoming deflation and to implement decisive policy that is sufficient to achieve that goal."

QQE means the doubling of the monetary base over two years with the aim of achieving a 2 per cent price stability target: the BOJ has said it will maintain QQE for "as long as it is necessary for maintaining the target in a stable manner."

The results of QQE had been beyond people's expectations. Inflation had increased by more than 1 per cent in less than a year. Japan was on course to reach its targets – inflation expectations continue while long term interest rates have been hovering in a stable manner at lower levels.

Bank lending had gradually accelerated to both big and small firms and the BOJ has expanded its lending facilities in support of financial institutions – including providing funds with a 4 year fixed rate of 0.1 per cent.

Meanwhile Japanese firms – with their cutting edge technology and their stock of human capital – had started to take new initiatives. The economy and the outlook on prices have changed dramatically.

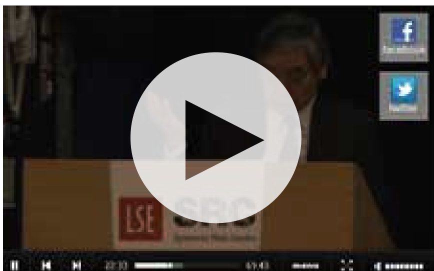
"The day that Japan's economy can contribute more and more to the world economy is at hand."

Jan Danielsson says Europe needs to spend more time studying recent Japanese history – as had been said before, in many ways Japan resembles us 10 years into the future.

"There are many lessons to be learned – both mistakes to be avoided and correct policy to be followed."

"QE, or QQE, to use recent US military terminology, is shock and awe applied to conventional monetary policy."

We have to recognize that the impact of similar monetary policy tools is quite different in Europe and in Japan. For instance the impact of QQE is very different when there's persistent deflation, as in Japan, or when it's used to stimulate the economy where there's already inflation, as was the case in Europe and the US.



A video of session 4 can be viewed here (**lse.ac.uk/newsAndMedia/videoAndAudio/channels/publicLecturesAndEvents/player.aspx?id=2356**)

SESSION 5: A CONVERSATION ON US MONETARY POLICY: FORWARD GUIDANCE – FAD OR THE FUTURE OF MONETARY POLICY?

Richard W. Fisher assumed the office of president and CEO of the Federal Reserve Bank of Dallas on 4 April 2005. In this role, Fisher serves as a member of the Federal Open Market Committee; the Federal Reserve's principal monetary policymaking group.

Richard Fisher felt one of the main questions to answer was what should be done after what had been a massive programme of quantitative easing. Countries are at various stages in their quantitative easing programmes – Japan is at a different phase in the process to the US.

In the US the efficacy of quantitative easing had been exhausted. The US balance sheet had been massively expanded – it now exceeded four trillion dollars compared to 900 billion before the crisis.

"The way this has manifested itself is that we've seen a huge build up in the reserves of the depository institutions of the US."

The US now had a monetary base which is "stout and rich and full and deep." The issue was how to tackle the next phase – of transforming from this situation to anchoring the base interest rate.

The volatility had been taken out of the market place: interest rates had been driven down to, at one stage "the lowest in 237 years of American history." But jobs hadn't been created.

Forward guidance is the "subject de jour" of central bankers. It's been described as the latest monetary fad. But it can be an important tool in analysing present developments and in looking to the future.

Leaving aside complicated language and arcane definitions, in its most simple form forward guidance has been translated by the press as "We'll see."

"I think that's pretty accurate. We are all aiming for the same objective, whether it is the Bank of Japan or the Federal Reserve Bank of the US or the Bank of England. We're all seeking to make sure that we have a sustained recovery and will conduct monetary policy accordingly."

But we're moving forward in unexplored territory. …"Basically what we have done is we have de-quantified our guidance and are seeking to provide qualitative indicators

The US now had a monetary base which is "stout and rich and full and deep."

of how we might proceed…by its very nature qualitative guidance will be a little bit sloppy, though people look to us for exact precision… you cannot expect specific quantitative guidance without mistakes being made."

Jean-Pierre Zigrand described forward guidance as "absolutely the right thing to do." The main thing was to cut through bad feedback.

"One has to cut these feedback loops that make the initial phase of a crisis much worse and so forward guidance is absolutely essential…like a painkiller after a drinking binge."

There are both short term and long term bad loops – the longer term are more difficult to identify.

Various moves had resulted in taking a large measure of volatility out of the market: this is both good and bad. Some uncertainty is needed in the market – without it there's no creativity, if we don't invent anything new companies can't make profits.

Richard Fisher agreed – it was an important point: taking volatility out of the market can lead to complacency and you both maintain and suppress rates. In such circumstances people are often driven to take greater risks. Overall policy in the US had been contradictory, with fiscal and monetary policy moving in different directions.

"We've had a disconnect between fiscal and monetary policy in that we have been stepping on the accelerator full bore while fiscal policy has been slamming on the brakes."

A video of session 5 can be viewed here (**lse.ac.uk/newsAndMedia/videoAndAudio/channels/publicLecturesAndEvents/player.aspx?id=2356**)

"We've had a disconnect between fiscal and monetary policy in that we have been stepping on the accelerator full bore while fiscal policy has been slamming on the brakes."

THE RESEARCH CENTRES

Systemic Risk Centre

The **Systemic Risk Centre (SRC)** was set up in 2013 to study the risks that may trigger the next financial crisis and to develop tools to help policymakers and financial institutions become better prepared.

Based at the London School of Economics and Political Science (LSE), the Centre is generously funded by the Economic and Social Research Council (ESRC).

The primary goal of the SRC is to build up research findings across the broad area of systemic risk and to use these to construct practical tools for policymakers and private institutions to achieve a better understanding of the risks they face. The unifying principle of the Centre's agenda is endogenous risk – the notion that financial risk is created by the interaction of market participants.

The SRC is rooted in a multidisciplinary approach, bringing together experts from computer science, law, political science and the natural and mathematical sciences, as well as from finance and economics. This enables our researchers to investigate how risk is created through feedback loops within and between the financial, economic, legal and political systems.

The SRC runs frequent conferences, seminars, masterclasses and other events to facilitate and enhance collaborations and exchange of ideas.

Centre for Philosophy of
Natural and Social Science

The **Centre for Philosophy of Natural and Social Science (CPNSS)**, established in 1990, aims to promote research into philosophical, methodological and foundational questions arising in the natural and the social sciences, as well as their application to practical problems.

The Centre seeks to achieve this aim by supporting interdisciplinary and inter-institutional endeavours of different kinds and maintaining international collaborations and partnerships. It is home to a number of research projects bringing together academics from different backgrounds, and it hosts researchers pursuing individual research initiatives. A Visitors' Programme gives philosophers of science from all over the world the opportunity to reside in the Centre for a term or an academic year, to participate in existing projects and to pursue their own research.

The Centre supports several seminar series, hosts public lectures, organises conferences and workshops, and hosts events of professional societies, among them the regular meetings of the British Society for the Philosophy of Science. All these activities contribute to a lively intellectual environment with a full calendar of events.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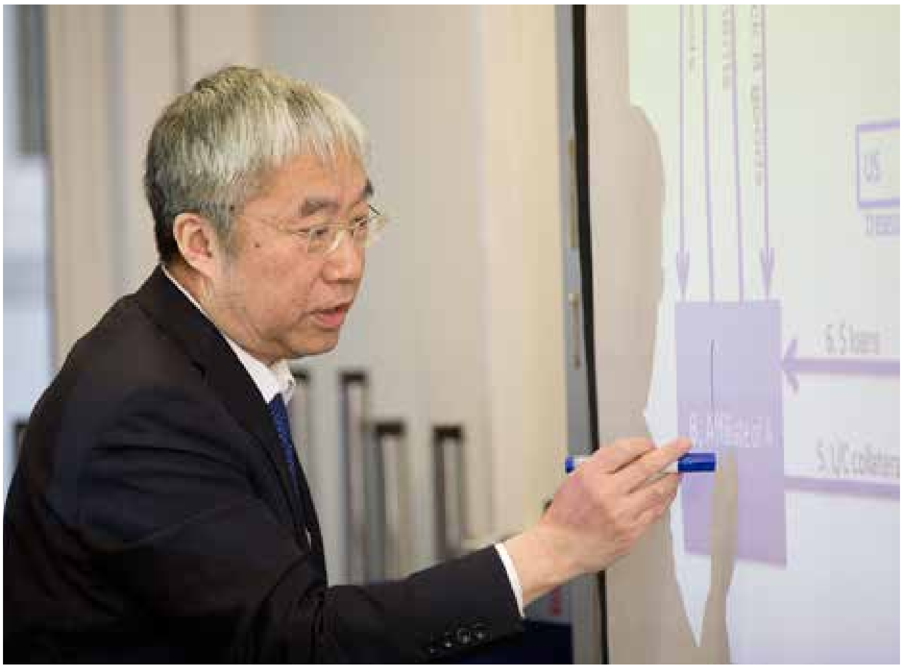

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Freedom of thought and expression is essential to the pursuit, advancement and dissemination of knowledge. LSE seeks to ensure that intellectual freedom and freedom of expression within the law is secured for all our members and those we invite to the School.

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