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Financial Market Turbulance

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Moderator's Introduction

Welcome to the session on Financial Turbulence. We have five very distinguished panelists representing a broad spectrum of views. The OECD deserves our thanks for that, and let me begin by offering some questions as moderator. We want to allow time for questions, so we are asking our panelists to limit their remarks to eight minutes, and I will try to set a good example by holding my own introductory remarks to four.

I am working on a book titled Globalization and the Good Society. I have been meeting with senior people in Europe this spring to seek views from government, business, finance, NGOs, trade unions, and academic experts, on the challenge of how we maximize both economic dynamism and social decency in a global economy.

The current financial turmoil is at the very center of this issue. The idea that markets are by definition efficient, that nearly everyone can benefit from the fruits of that efficiency, has been central to the recommendations of the OECD, the Commission of the EU, the Washington Consensus, and the efforts of the WTO and its member nations to remove obstacles to global trade. These recommendations have generally urged greater liberalization of both labor markets and capital markets, perhaps complemented by social buffers, in the name of economic innovation, efficiency, and growth.

The financial crisis suggests that market liberalization may have its limits. No sensible person believes that the financial innovations that caused the subprime collapse added to economic efficiency. The losses will total on the order of a trillion US dollars, and it was only the intervention of central banks, not institutions of the free market, that prevented the losses of a credit crisis caused by market excesses from causing a general depression.

But of course, there are deep divisions over the remedy. Some believe that codes of conduct, industry self-regulation, and the wisdom of committees of eminent persons can limit the excesses, and that financial innovation and enrichment can then continue pretty much as before. Others believe that only direct government regulation can remove temptations that are bad for both efficiency and equality, as well as stability.

The recent report of the former Danish Prime Minister Poul Nyrup Rasmussen, to the Committee on Economic and Monetary Affairs of European Parliament, proposes in four succinct pages, strong remedies that use direct government regulation. These include capital requirements for all kinds of financial institutions including non-bank institutions that are now basically unregulated, limits on leverage, greater transparency, prohibitions of conflicts of interest, creation of an EU credit-rating agency and financial supervisor. This overlaps in some respects the views of the Financial Stability Forum, except that Rasmussen's version goes further and his constraints would be mandatory.

In my role as a financial journalist, I have interviewed many former and current officials who consider this regulatory approach is not just sound, but necessary. But to hear the reaction of much of the private financial community, you would think that this kind of thinking represented the second coming of Karl Marx.

So my first question to the panel: is which reforms do we need; which should be mandatory; where can we trust self regulation, and to what degree is the sub-prime crisis and its spillover effects a broader impeachment of the premises of financial laissez-faire?

This raises my other question. It is interesting that the same Mr. Rasmussen is also the leader who is the father of the widely acclaimed Danish model of flexicurity. This is a model that relies heavily on free markets for entrepreneurship, places no restrictions on hiring and firing workers, maintains a fully open economy, the world's third most open according to the World Economic Forum, but uses very substantial social protections, generous outlays on human capital, and genuine social partnership with trade unions to make sure that flexibility is truly balanced with security.

Now, why did Mr. Rasmussen, with his belief in markets complemented by social outlays, also become a crusader for robust regulation of finance? Because as prime minister, he perceived that the Danish flexicurity model could co-exist from free trade, and could benefit handsomely from free trade, but that it was under assault from financial engineering—because financial engineers want quick returns, engage in excessive leverage, and have no interest in the kind of real social partnership that is the heart of the Danish model, except perhaps as public relations.

So my broader question is this. Should we consider excess financial engineering as something dangerous that needs to be harnessed, not just for financial stability and efficient allocation of capital, but also for the OECD objective of social balance? Is there a paradox--that to retain free trade, we need to constrain totally free finance, as my friend Jagdish Bhagwati who is speaking next door has long argued?

Is it accidental that the period of increased liberalization of speculative finance has also been a period of not just regulatory arbitrage, but also of tax arbitrage and wage arbitrage, and during this period that economic security and economic distribution have become far unequal in nearly all of the OECD countries except the Nordics? So, does extreme financialization threaten not just economic stability, but also does it undermine the instruments that we need to build secure societies? In sum, what is the connection between the appropriate regulation of finance and the broader goal of social balance?

And so with that well balanced introduction, now to the panel