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CONCLUSIONS OF THE SYMPOSIUM

« THE SUBPRIME CRISIS AND ITS INTERNATIONAL CONSEQUENCES »

(by Michel ROCARD)

What is written on the programme is clear : I am supposed to draw the conclusions of this conference. This casting is in a way a trap. It spares all economists and experts the task of concluding…. And it puts the charge on the weakest person in terms of knowledge. After all, politicians are known, and criticised for their innumerable mistakes, but these mistakes rarely affect their careers, whereas an error in the mouth of an academic has a greater price in terms of indignity…

It is therefore with some irony that I accepted this responsibility, measuring perfectly the importance of the honour made to me with this designation.

One problem appears, though, which you will discover : if my current English is supposed to be sufficient for me to be roughly understood, my acquaintance with business English is poorer… I'll do what I can.

As all of you discovered during this debate, the help we can receive from the certainties of "economic science", if ever such a thing exists, is weak. In fact I can only propose impressions, with the double risk of academic and political dispute. But it's worth playing the game.

My first impression is that, concerning the analysis of the crisis itself, we are in a large uncertainty.

First, measuring the risks is difficult. The very nature of the subprime loans, the lack of transparency, the accumulated results of the long and victorious battle conducted by operators against rules and means of control, all this makes it difficult to evaluate the size of the threat for the banking system. Evaluations vary from the simple to the quadruple in terms of tens of billions of dollars.

Uncertainty is much greater about the second step, the packages that threatened banks made by mixing subprime loans with some more reliable financial papers, but in unknown proportions, and which were sold throughout the world. At this level evaluations still vary from simple to quadruple but in hundreds of billions. The last German evaluation is 600 billions dollars. It is by far not the highest.

Secondly, the passage between financial analysis to macroeconomic analysis goes wrong, already for the diagnosis, and much worse for the prognosis. Economists are specialised, and respectful of the limits of their own knowledge. Financial analysts rarely dare to extend their conclusions to the macroeconomic sphere, and reciprocally macroeconomists hesitate to combine their analysis with detailed datas coming from the financial sphere. The result of all this is that, if no one doubts that we are in a banking crisis turning to financial crisis, there is controversy on the potential consequences of this situation on real economy.

Do we expect a deep recession or not ? For some experts, solving the liquidity problem should be sufficient to put an end to the banking crisis and to avoid any contagion from this cash flow problem to the real economy. Other experts do believe that it is now impossible to escape a significant recession. I share this last group's opinion. When banks stop lending to one another, it is clear that a long time is needed before the situation becomes normal again. Forecasters have already begun to reduce their growth estimates for 2008, and I don't think it is finished.

Thirdly, there might be some questions about economic theory. It is clear that intellectual lessons of all these events should only be drawn after the end of the process and time enough for consensual elaboration by the scientific economic community. Still, before concluding firmly, one can admit that something went wrong somewhere. When the dominant paradigm is that market equilibriums are optimal, we can probably feel authorized to consider that the degree of optimality which is presently obtained in the financial markets is a very low one and that there should probably be some good reasons to question the paradigm itself. Any theory has for a main objective to be useful, and the best ways in which theories can be useful is to help anticipation and permit forecasts. The tool for that cannot be ideal objects, but exclusively real objects. The theory must therefore deal with real markets, as they are, and not with markets supposed to be perfect. This may finally conduct to alter the conditions of the demonstration. If a market equilibrium is optimal only under the condition that the market should be perfect, the practical consequences that an operator can draw do change a lot…

After uncertainty, my second impression deals with ethics.

Let us come back to the beginning of these difficulties. The desire to possess one's own house is as old as the world. In average a house costs five years of salary. Most people have no possibility to gather such an amount of money. They have to borrow it. Mortgage loans are as old as is capitalism, they are useful and therefore respectable. An old practice conducted the banking companies to investigate on the repayment capacities of their customers, the implicit hypothesis being that their profit is included in this repayment and therefore depending on it. Some six or eight years ago a change in the way of thinking of these companies, mostly Americans but not only, appeared : they discovered that the real guarantee of their repayment, and then of their profits, did not rely, finally on the repayment capacities of their borrowers, but on the value of the houses themselves. The decisive problem, then, was no more to be correctly repaid, but was much more to recover the property of the estate and to be capable to sell it again. In the real estate markets, the long term tendency is a slow rise, a bit faster than that of the gross domestic product, at least in non crisis periods. It is then possible to multiply the number of loans.

In financial terms it is true, and intelligent. It meant that banking companies practicing mortgage loans could avoid in the future to pay for all the service of investigating the customers incomes. Sufficient is it to expropriate them. The problem is that this new financial thinking, undoubtedly correct in financial terms, completely forgets the fact that the objects of all these transactions, before being houses, are human beings, and that this new behaviour in mortgage loans mean a severe increase in human pain. The treasury crisis, however, does not come from this contempt of the clients, but of the fact that expulsions need judges and policemen, and require some sort of social acceptance, and when they come by millions, judges may hesitate, or be overcrowded, chief policemen may be reluctant, and social acceptance might be missing. The delays grow, and funds are lacking.

What does all this tell us ? Evidently that the markets are legitimate and respected when they aim at diminishing human pain, or at least at keeping it stable, but they are not legitimate anymore when they aim at aggravating it. I cannot forget here that the founders of modern economics were all moralists, such as Adam Smith, David Ricardo and the French Doctor François Quesnay. Then comes the second question : if one admits that markets should respect ethical principles not only for reasons of morality and dignity, but also for reasons of efficiency, and if one admits too that an excessive percentage of human beings are not ready to respect ethics in their conduct, in the banking profession as in any other, should we then admit that precise rules and sanctions are necessary in place of declaration of principles and codes of conduct ?

A second aspect of the present crisis aggravates the importance of this question. When many banks developing mortgage loans discovered that they had in portfolio an important volume of doubtful papers, instead of transmitting the news to regulating authorities and making provisions the face the loss, they attempted to hide it. They did so by mixing the mortgage loans certificates with more reliable financial papers in “packages” which they sold throughout the world. This is the reason why so many banks in the United States, in Europe, in Japan, and in a few other countries meet heavy difficulties today. We all know that the three main American banks are in trouble, we’ve all heard of Northern Rock, two important banks in Germany are concerned as well, and the last news quote UBS, one of the largest Swiss banks. In this issue, in some way second step issue, it is again a violation of ethical principles which is the cause of financial disequilibrium. The missing capital here is evaluated between 400 and 1.000 billions of dollars. But the main result of this diffusion of the risks is that no bank, presently, seems capable to evaluate the risk to which its usual partners are exposed. Banks now do not lend to others anymore, by lack of confidence. This blocks credit in current days economics, and this is the way the threat of recession progresses.

Do we really think that the recall of basic ethical principles will be sufficient to solve all that ? I personally don’t, and that is why my third impression is about rules.

Third impression, then : we need rules. In our present legal system, the only bodies which have at the same time the legitimacy and the legal capacity to pronounce rules, and especially constraining rules including sanctions, are national governments. Unfortunately they are not the pertinent entity. Capital circulates with no limits in the whole planet except North Korea, Cuba, and for a decreasing part China. No structure, neither the United Nations Organisation nor the International Monetary Fund, has any capacity to enforce norms. At the world level, the only way to decide prescriptions and sanctions are international treaties. In terms of law the recommendations of the Bretton-Woods international financial conference in 1945 took the form of a treaty.

I propose to the gathered wisdoms of this respectable college that this is now what we need. I suppose, for instance that nearly all of us support the courageous efforts of Henry Paulson the American Secretary for the Treasury. He has to win, and may. But his attempts are limited to the United States, and cannot concern all the subjects which need to be treated. The more I think of it, the less I can avoid the idea of convening a world financial conference, a Bretton-Woods two sort of thing. It could decide for new international rules for certain items, and press all governments to decide in the field of their competences for others.

In a miscellaneous order, without any logical priority, I think the following eight subjects should be prepared, and dealt with.

- Rules and procedures to be followed for mortgage loans.
- Redefinition and extension of the security ratios, prudential ratios, as we say in french, such as the Cook ratios and their successors, which should be imposed to all operators on the markets, banks naturally, but also funds and brokers.
- To impose rules of agreement and international taxation on tax havens
- To enforce a world-wide separation of banking activities, in the spirit of the former Glass-Steagall Act.
- To create some world wide instruments to measure the evolution of the prices of assets and real estates as it is done for consumption goods and services.
- To define strictly and limitate the possibility to create new financial products, in fact derivative products, and submit them to the control of regulating authorities.
- To allow Central Banks to discount or acquire semi-public bonds financing investment.
- To come back to a system of fixed adjustable exchange rates.

And this list is naturally not exhaustive.

I cannot finish this intervention without confessing a great worry, which is my fourth impression.

Outside the financial crisis we live in, and in the pure field of real economy, my feeling is that the financial crisis happens in a period in which real economy is weakened. After the second world war, capitalism in developed countries (North America, Western Europe, Japan) grew for twenty-five years at a rhythm of 4,5 to 5 % a year, regularly, without any international financial crisis, and with full employment in all countries. The main engine seemed to be consumption, permitted by the policies of high income distribution which were practiced in quasi all developed states.

A great change has occurred. In the same developed countries, growth is now diminished by half, financial crises of a continental or worldwide dimension happen every half dozen years or more, and a quarter of all our populations, in variable proportions according to local traditions or structures but with the same total, is either unemployed, or working in precarious jobs, or just poor. In these conditions the resistance capacity of our societies, in political or in social terms, is deeply affected.

There is some mystery behind this huge intra-capitalist revolution, which happened in roughly thirty years.

A first question is to determine whether this has any importance, or none, in the capacity of our real economies to thwart the negative signals they receive from the financial sphere. I have no qualification to answer this question. I can just underline that the general lack of dynamism which is our common share now aggravates the situation rather than help to solve it.

The second question is why are we there?. Investigation is difficult, and there are few attempts to answer. One hypothesis comes from the fact that in all our countries, throughout the last thirty years, though at different rhythms and periods, the incomes coming from salaries and social protection systems have diminished by approximately ten per cent in share of gross national product. Resources for consumption are therefore limited, and logically the speed of growth weakened. It seems not to be the revenues of taxation which have substituted this share of GNP, they remained roughly stable, but the last category, imprecisely defined as profits, a sum in which industrial profits and dividends represent a large half. The reason for that could be the main change which has occurred in the shareholders position in the system. When peace came again after the Second World War, they were unorganised and therefore weak. For long time they just received the dividends the managers accepted to distribute, after having secured research funds and large wages for their employees. But then, in the seventies and eighties, came the pension funds, the investment funds, and the hedge funds. In thirty years they became present, in significant positions, in all large companies throughout the world. Management could no more, in boards and assemblies, try to build complicity with isolated share holders but had to face an organised front, aiming at more dividends and refusing to share the companies objectives in terms of research budgets or fidelity to the employees. Externalisation of as many jobs as possible has been the main result of this new pressure, transmitted through redundancy of managers and take over bids. Millions of workers of large and secured companies found themselves members of small and medium enterprises, with smaller salaries, and hardly any unions to defend them.

There is in this evolution an evident capitalistic rationale. But we should consider thresholds. The preservation of a minimal social order should be an objective of the system, as well as the equilibrium in which the dynamism of consumption is maintained.

For me the main danger of this situation is in politics before being in the economy. The loss of social confidence, the development of extremist or populist behaviours, with for instance the Dutch and French refusal of the proposal of a constitutional treaty for Europe, the increase in voter’s abstention, all this is announcing growing dangers of social unrest. Economists cannot ask us to remain performing in political management if the system they produce creates growing social unrest.

But we should care for the purely economic consequences. Not only do companies loose their identity and vision of the future, but restructurations become more and more difficult, and the global resilience of our economic and social systems is dangerously diminished. This should be considered by economic theory. Our societies can no longer accept to live in a system which theory describes as perfect under the condition that politics in general and police in particular are in charge of managing the human and social consequences of their prerequisites.

Once again, ethics is in question: the main factor of this new state of things is the rapacity of the share holders. This rapacity is a normal economic instinct, it is even the engine of capitalism. But it should meet counterweights. Many economists consider this change in the share of GNP as non important because they believe in a counter evolution and in the return towards an equilibrium position. I am respectful of this vision, but doubtful: it lasts since some thirty years, which is long for a cycle, and no signal, not the slightest sign of a change in the tendency can apparently be observed here and now. What about the financial crisis turning into a deep recession just because of the bad health of the real economic system?

We still have food for thought!

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