

## Financial Risk Management: Lessons from the Recent Turbulences

*Roberto Zahler*



# ISSUES

- (I) Causes of the Financial Crisis
- (II) Dealing with the Financial Crisis
- (III) Main Challenges

(I)

## Causes of the Financial Crisis

- Insufficient and inefficient financial regulation and supervision. And proliferation of complex and non-liquid new financial instruments, with deficient risk rating →
- Macro policies in the US led to excess spending, mostly intermediated through the financial sector:
  - 1) U.S. Current Account Deficit Balance of Payments and excess saving in EM economies →
  - 2) Low (consumer price) inflation and low real interest rates →
  - 3) Asset Price Bubbles →

(II)

## Dealing with the Financial Crisis

- Hands on supervision and close government oversight of the institutions they protect (shares and/or guarantees)
- Massive provision of Liquidity: avoid run on deposits →
- Restore Interbank Credit →
- Minimize Credit Crunch effects on the “real” economy:

(II)

## Dealing with the Financial Crisis

- Minimize Credit Crunch effects on the “real” economy:

1) Financially weak banks recapitalization by Private Sector requires prompt definition of:

- Toxic assets

- Price at which they will be bought

- Maturity, yield and marketability of new assets

- Repayment of toxic assets: time span; source of funds (% of profits?; new type of shares?)

- Opening the US economy to foreign investment (SWF)

2) “Appropriate” bank management for times of crises: recapitalized banks must maintain loans at a certain level; reprogram viable debtors and accept governmentals decision on executives compensation that encourage excessive risk-taking.

(III)

## Main Challenges

1) Financial Regulation and Supervision: prevent crises

2) Monetary Policy and Assets Prices



3) What type of Global Imbalances unwinding is best?

- For the U.S. not to export its recession, the Rest of the World principally EM, has to expand its domestic demand substantially. In other words, U.S. cannot safely diminish its excess spending if other countries don't diminish their excess saving at the same time.

4) IMF's new role?

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(III)

## Main Challenges

- Basle II reevaluation (easily circumvented by off-balance sheet SPV, where toxic assets were hidden)
- Strengthen International Supervision
- Improve Cooperation and Coordination between National Supervisors
- Supranational institutions (IMF, BIS) and National Regulators
- How to engage in a debate and design of new regulatory structures in an aggressive and negative environment so as to avoid excess and inefficient regulation?

(III)

## Main Challenges

-Rating agencies: inherent and structural conflicts of interest; report at least two ratings

-Countercyclical financial regulation: the current regulation is pro cyclical.

-Institutions and instruments to be regulated: international financial integration requires a new and dynamic look due to the systemic costs derived from non traditional financial institutions and instruments.

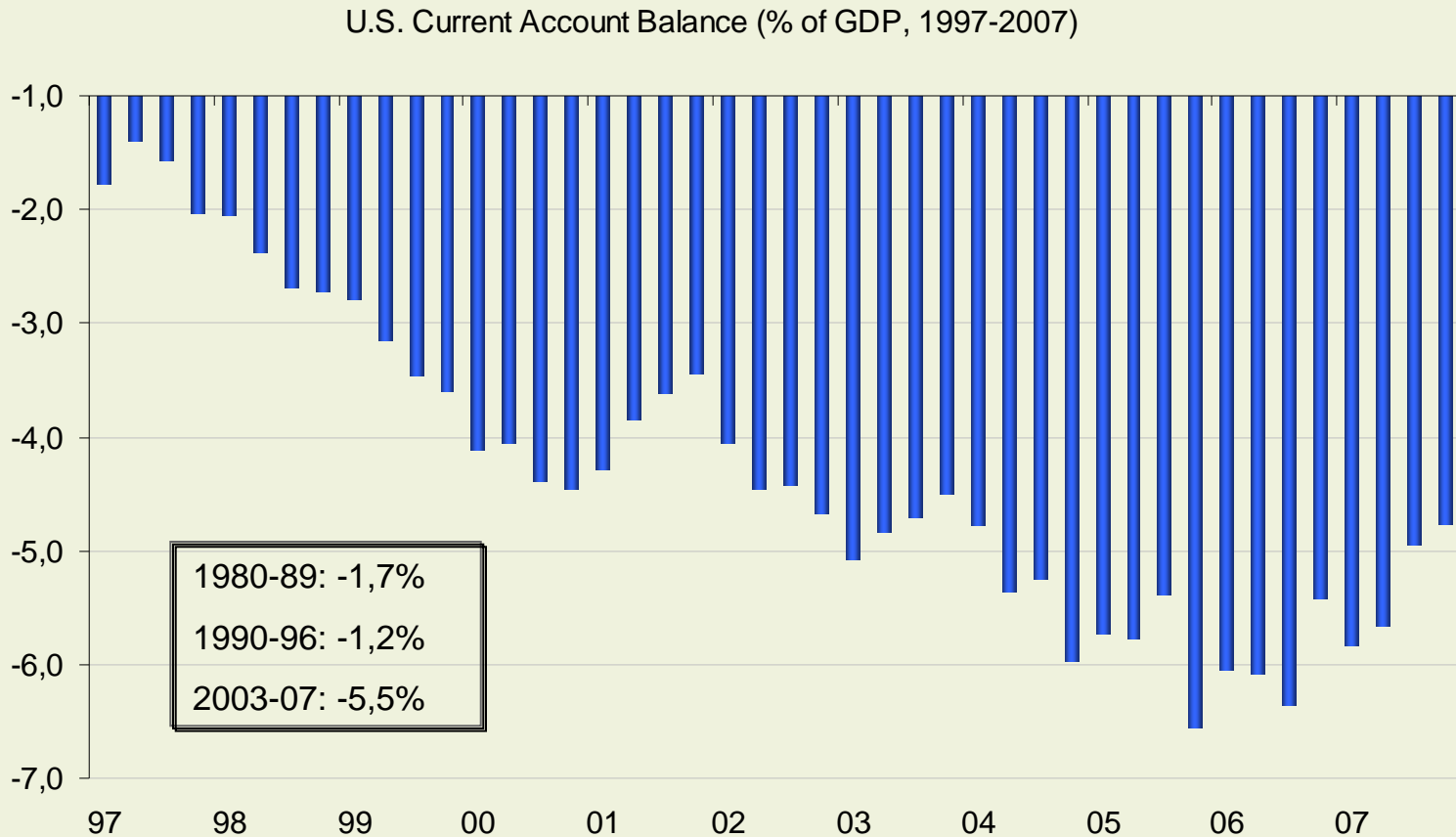
(I)

## Causes of the Financial Crisis

- The existence of Sophisticated Financial Instruments is not the problem: they contribute to better risk diversification and improve financial resource allocation.
- The problem was its explosive propagation without adequate comprehension from originators, investors, regulators and rating agencies, which ended up increasing systemic risk.
- Transparency of information and disclosure is not enough; financial markets need a type of regulation that clarifies the imperfect knowledge of those who provide assessment of financial assets.

(I)

# U.S. Bal. of Payments Current Account Balance

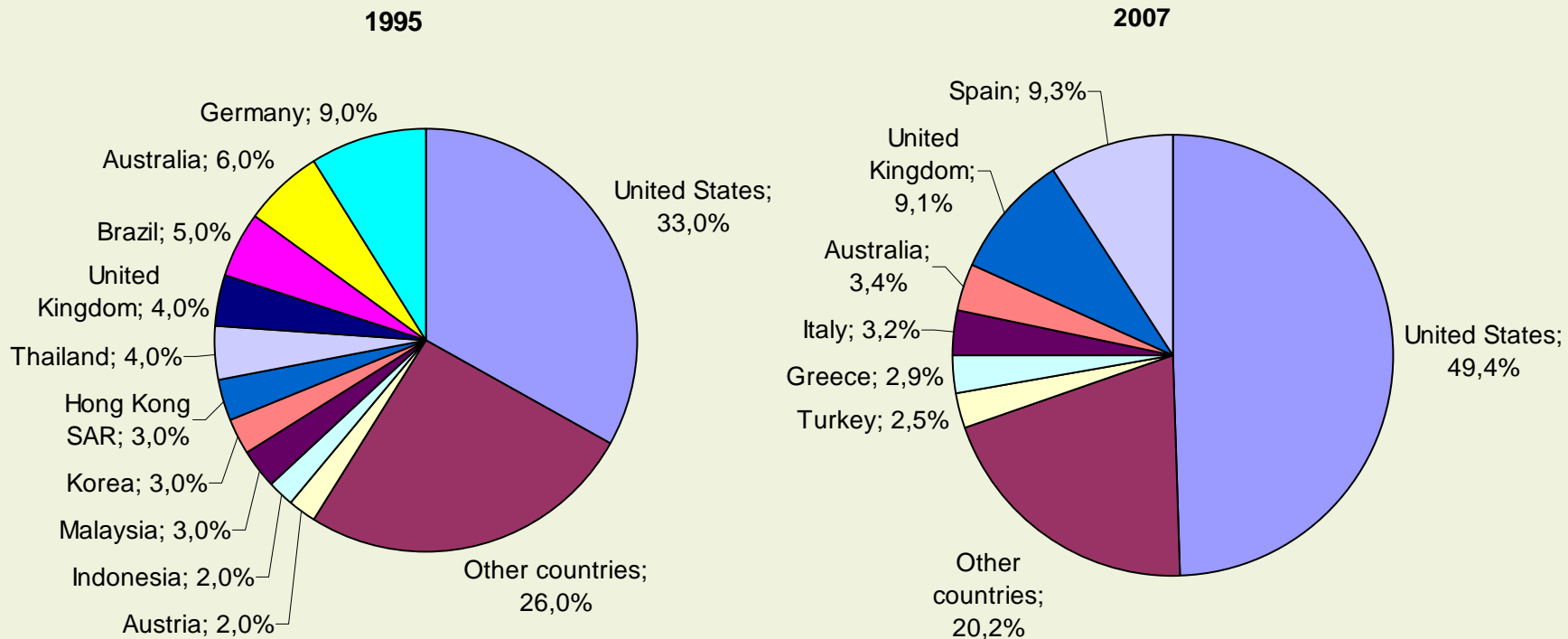


Source: Bloomberg.

(I)

# Countries that Import Capital

(As measured by countries' current account deficit)



Source: IMF, Zahler&Co.

(I)

## Current Account Balance in 2007

(US\$ billions)

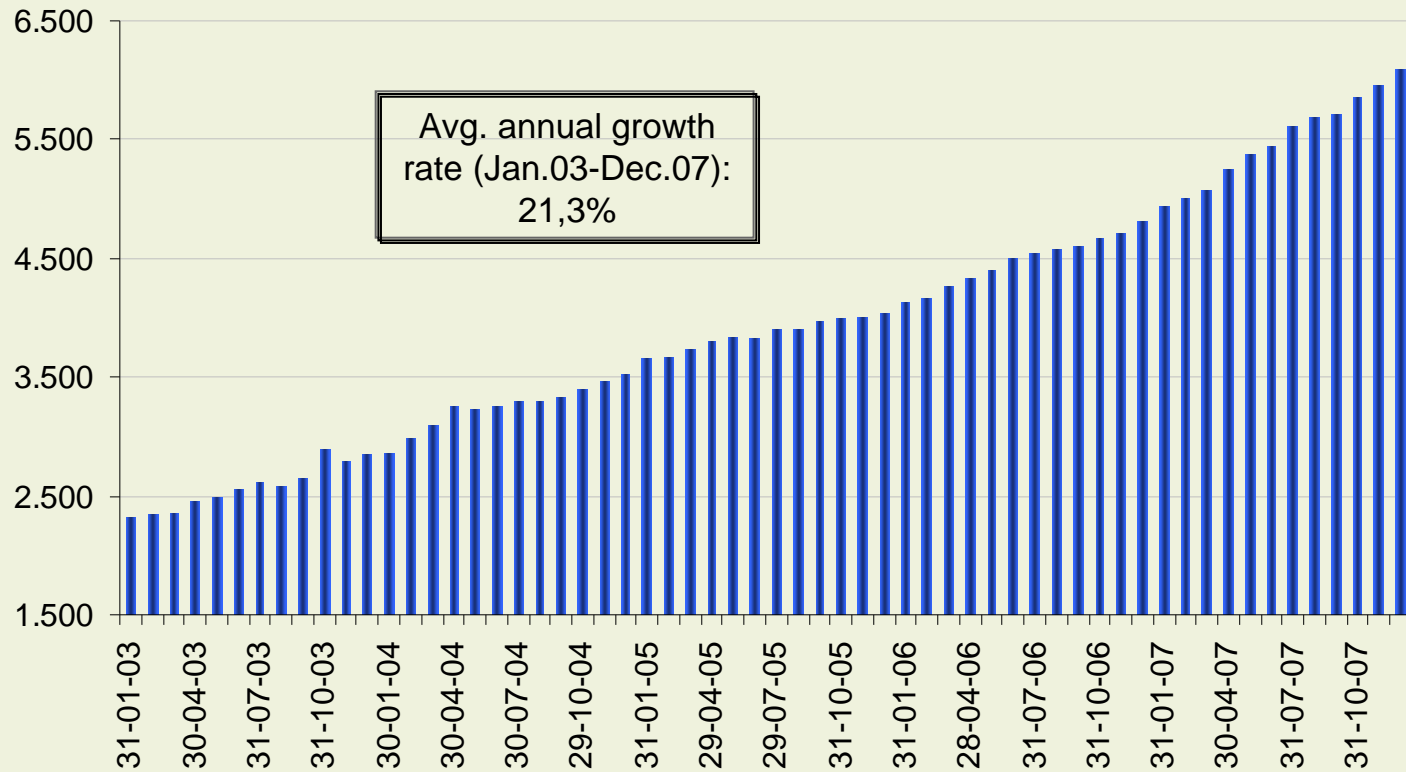
<b>Advanced Economies</b>	<b>-368,8</b>
United States	-731,2
Euro Area	29,3
Japan	211,0
Other advanced economies	122,1
<b>Emerging and developing countries</b>	<b>634,2</b>
Developing Asia	403,4
Middle East	257,0
Commonwealth of Independent States	74,3
Western Hemisphere	16,2
Africa	4,0
Central and Eastern Europe	-120,7

Source: IMF, WEO october 2008.

(I)

# High Liquidity Growth

World International Reserve Assets excluding gold  
(Jan 2003-Dec 2007, US\$ billions)



Source: Bloomberg, Zahler&Co.

(I)

# Low consumer price inflation

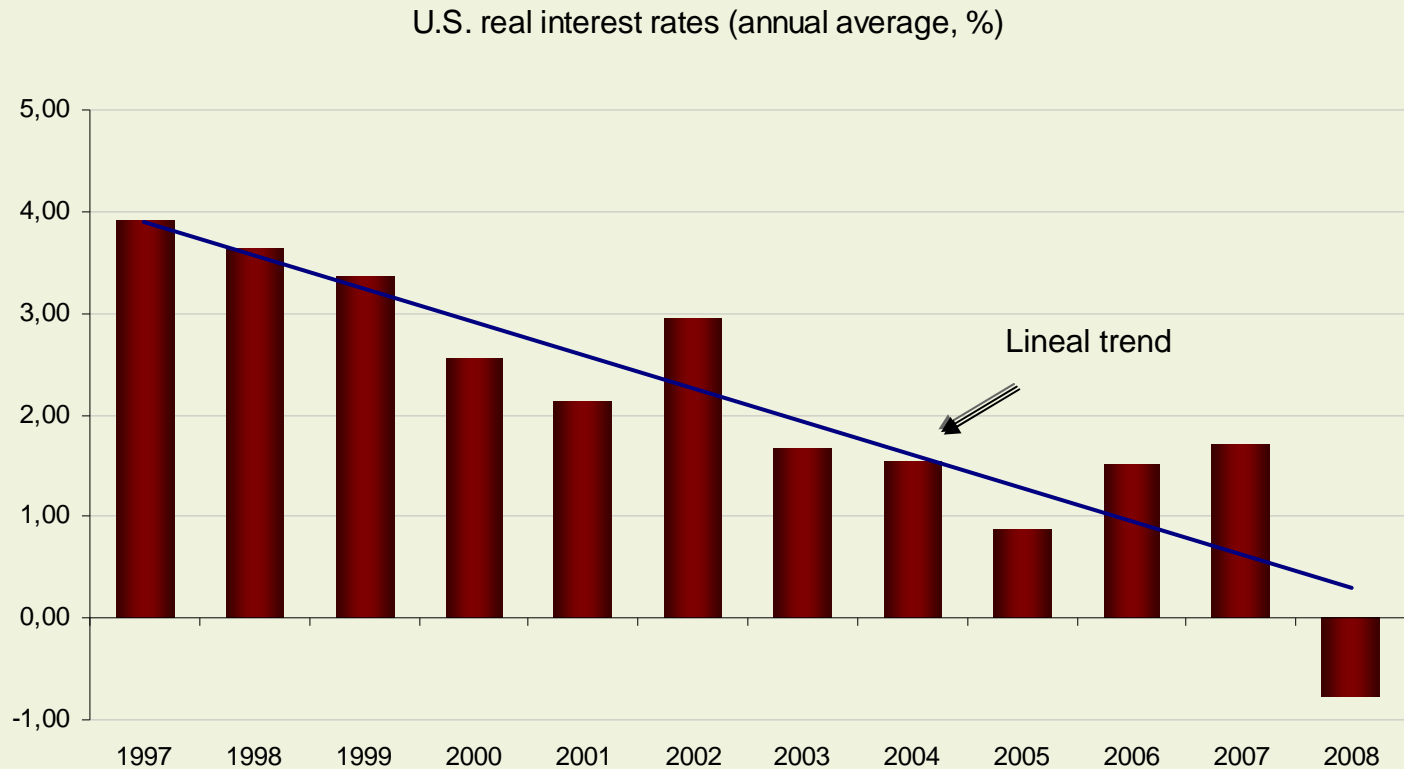
(U.S. PCE core deflator, yoy %)



Source: Bloomberg.

(I)

## ...and low real interest rates

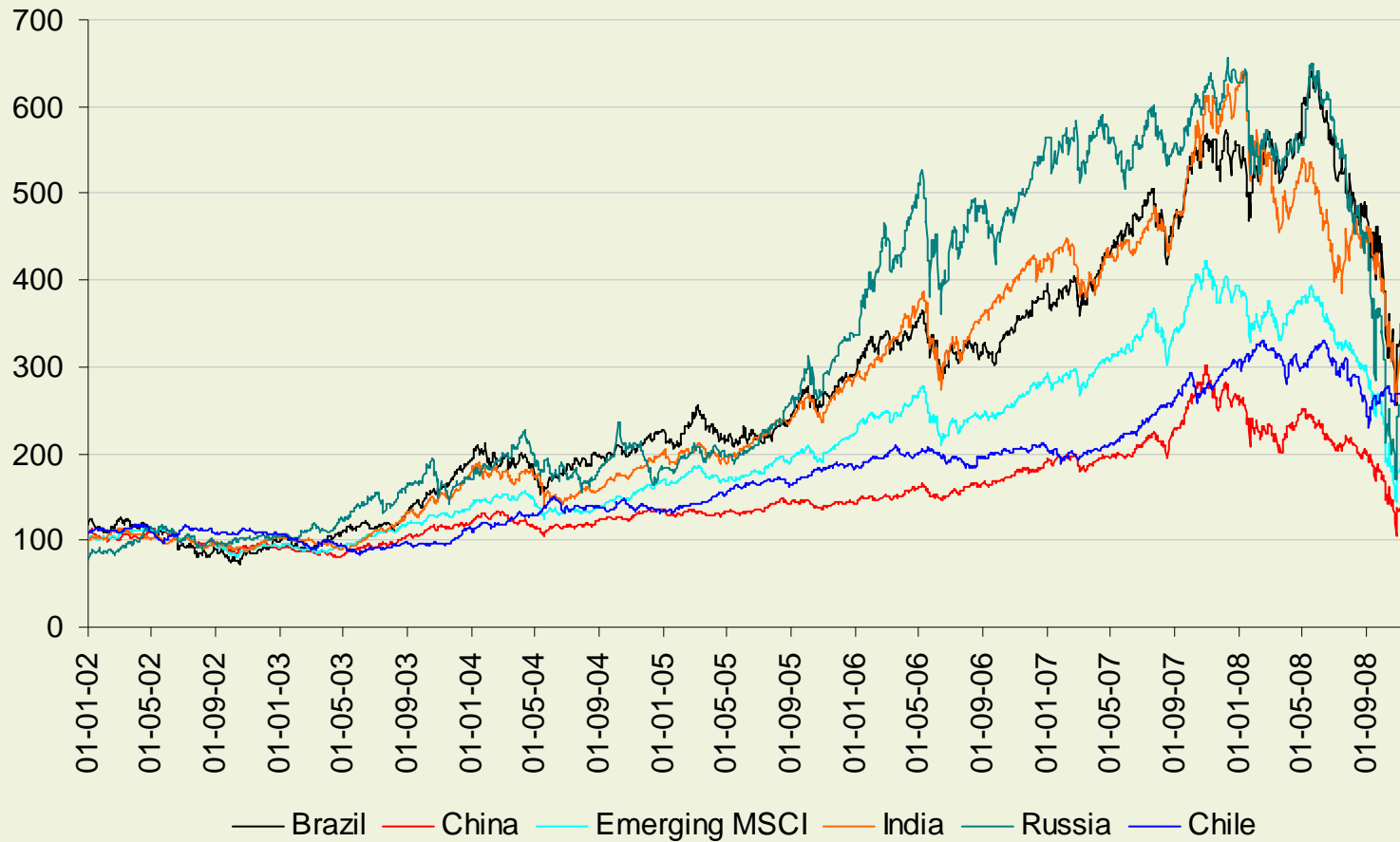


Source: Bloomberg, Zahler & Co.

(I)

# Asset Price Bubbles

Emerging stock markets (index avg. 2002=100)



Source: Bloomberg, Zahler & Co.

(I)

# Asset Price Bubbles

S&P index (avg. 2002=100)

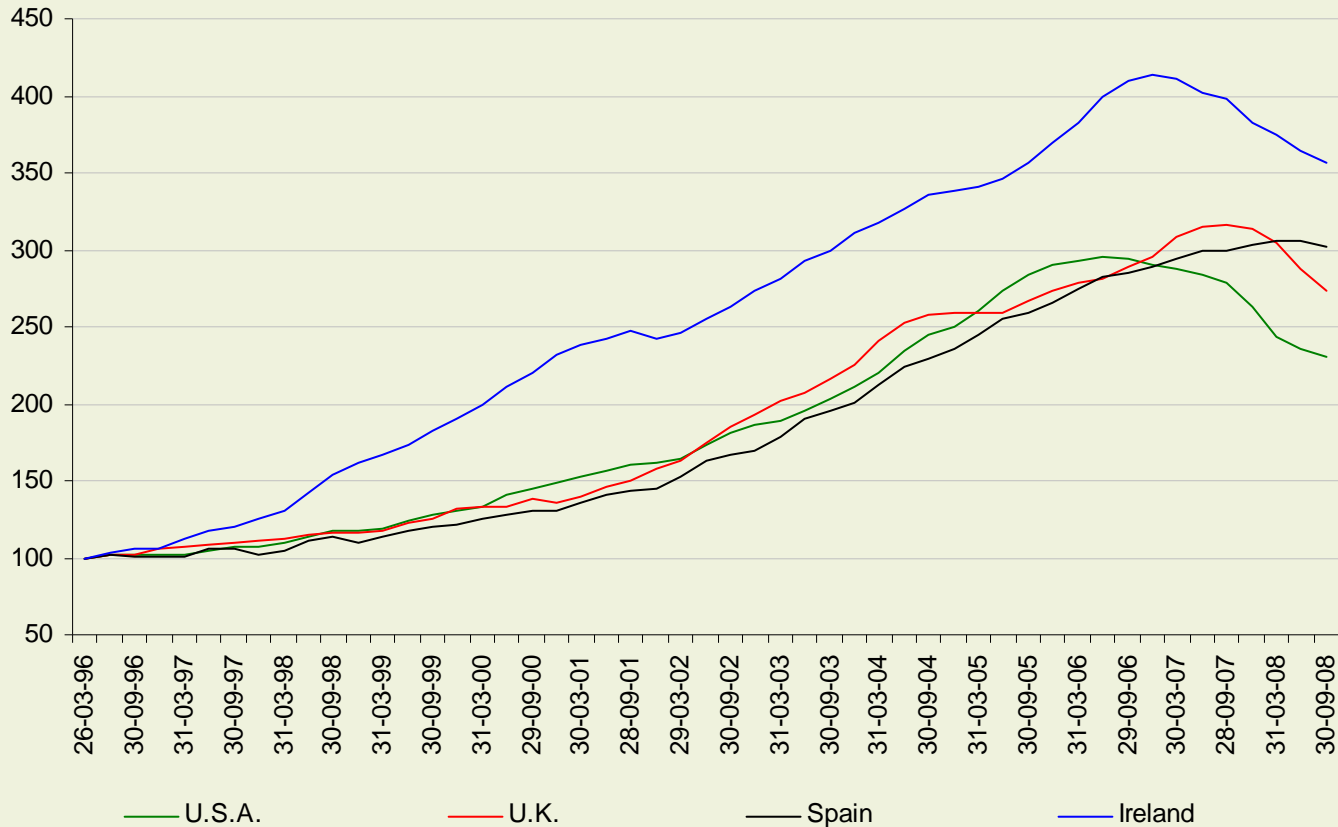


Source: Bloomberg, Zahler & Co.

(I)

# Asset Price Bubbles

House price index (1Q96=100)

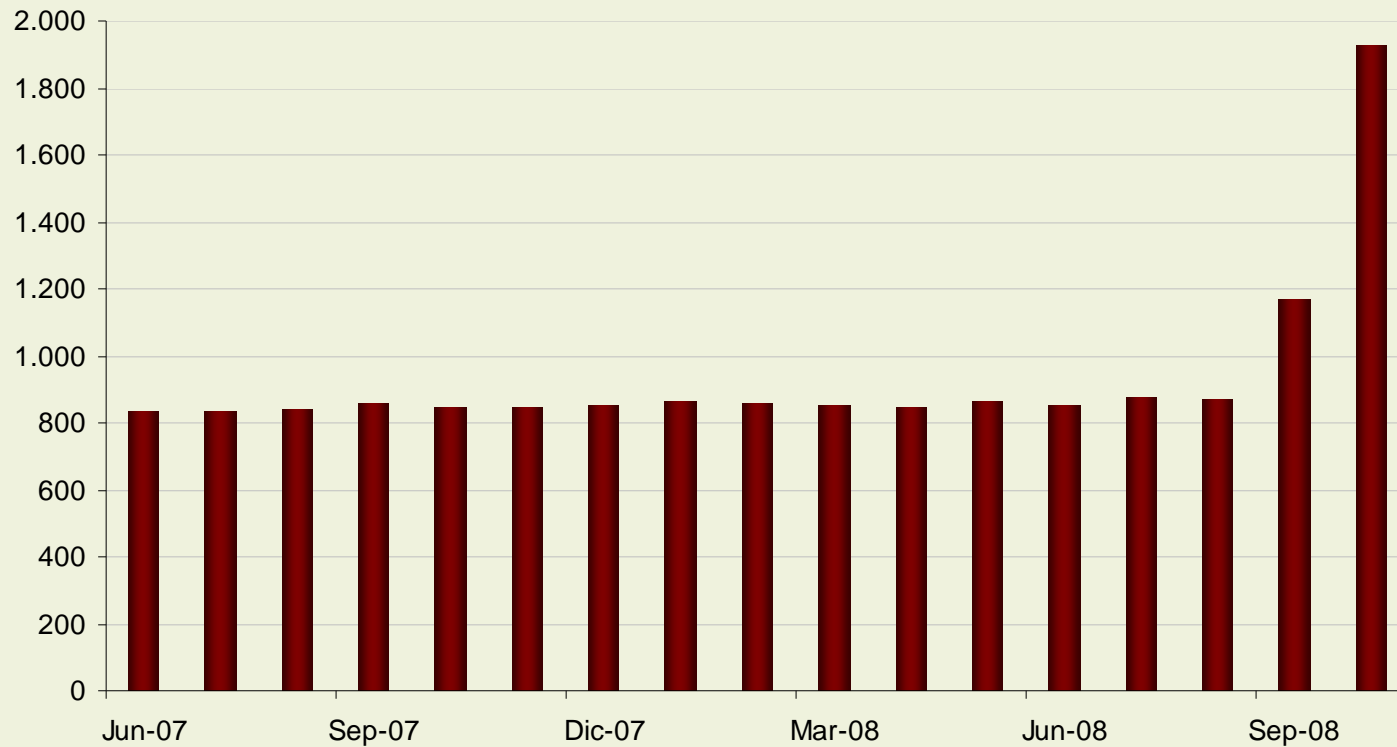


Source: Bloomberg, Zahler & Co.

(II)

## Massive Provision of Liquidity

Federal Reserve Total Liabilities (US\$ billions)



Sources: U.S. Federal Reserve, Zahler&Co.

(II)

# TED Spread

(LIBOR 3m - T-bill 3m, basis points)

