International banker points to fundamental crisis in global capitalism

By Tim Joy
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Andrew Crockett, the general manager of the Bank of International Settlements, has provided a revealing insight into the intellectual crisis at the top of the global financial system.

Delivering the third David Finch Lecture, entitled "International Financial Arrangements: Architecture and Plumbing", in Melbourne on November 15, Crockett put forward that while the "architecture" (the international monetary system based on the free market) was "superior to the alternative" of a government-led system, the problem was with the "plumbing" (the system of supervision, regulations and institutions that operate the system).

This is a fairly standard argument, but in his concluding remarks Crockett went on to raise the possibility that the system itself may be inherently unsound.

Crockett is a leading figure in the international financial system. As general manager of the Bank of International Settlements—also known as the central bankers' bank—and as chair of the Financial Stability Forum, established by the G7 Finance Ministers, he is playing a key role in attempts to deal with the global financial instability.

He began the lecture by pointing to the significance of the Asian economic crisis over and above the series of crises that preceded it. The turmoil in Asia was important because it had affected strong economies, spread rapidly, had severe economic consequences and been exacerbated by the volatility of international capital flows. These features underlined the "vulnerability of the current system and reinforce the urgency of efforts to strengthen its stability."

The problem for any market-based system, he said, was "market failures". These could arise from: information asymmetries, when some agents in the markets have better access to information than others; aggregation effects, when "individually rational behaviour" by a large number of agents produces sub-optimal social results, such as in bank run; and the inadequate supply of public goods, the lack of sufficient supervisory systems and regulations.

While he claimed that all that was needed was the right "plumbing" to alleviate these problems, he did note the failure of attempts to introduce such measures in the past and pointed out that in some cases the "plumbing" itself creates further problems.

The development of a safety net for banks through a lender of last resort facility and deposit insurance schemes could create perverse incentives, such as lenders taking on larger risks on the assumption that they would be bailed out if anything went wrong. Even where there were no such arrangements, there could still be an expectation that they would be put in place, as in the case of the enthusiasm for lending to Russia.

However, rather than an exposure of the roots of financial crises, these explanations were more a description of their common features. His inability to go any further was exemplified by a series of truisms throughout the lecture. For example, he noted that, "to function stably, markets need a stable economic environment"—in other words in order to be stable, capitalism must be stable.

But it seems that Crockett himself was not entirely satisfied, for in his concluding "thought" he raised the possibility that there might be something fundamentally wrong.

"I have sketched a world in which financial instability can be mitigated by actions designed to improve the functioning of markets. I believe this can go a considerable way toward reducing the incidence and severity of crises in the international financial system. But what if this is not enough? What if, in other words, the root of the problem lies in the inherent instability of financial markets; the tendency towards excess in optimism and pessimism and an associated excess volatility of asset prices?

"We cannot rule this out. Indeed studies of the history of financial instability... do not offer much encouragement. In such a case the choice would be an unpalatable one between accepting damaging instability and a far greater degree of administrative control over financial markets."

When asked by the author of this article whether, given that he himself had pointed to a fundamental problem with the market, we should delve more deeply into this question because no tinkering with the "plumbing" would resolve problems in the "architecture", Crockett gave a revealing reply.

"Well I have to say you have smoked out an ambivalence in my position on this and that's why I labelled it a concluding thought rather than putting it as part of the lecture. Professionally I have to believe that if we deal with the sources of market failure we will make markets work better and that that is the first best approach.

"If markets cannot be made to function stably, however much information they are provided with and however we create the incentives to be consistent with stability— and I don't believe this will in fact be the case—what do you then do? As you say, then it is a fault of the market system, a fault of the architecture.

"Then you would be confronted, as I tried to say in my concluding remarks, with a very unpalatable choice. On the one hand you would say: do we stick with the market system and periodically have these crises, which I don't think would be acceptable. I just think that public opinion would say 'something has to be done about this'. I believe that if we then tried to introduce comprehensive controls it would in fact be much worse. We wouldn't be successful in plugging the loopholes and the loss of efficiency that would result from comprehensive controls would in fact reduce welfare much more than the periodic crises would.

"So I hope that's not a choice we have to make. As I tried to say, that is why it's so important not to give up early or to look for magic solutions outside but to engage in what I call the painstaking process of looking at each of those factors that generate market failure and that leads to instability and try to deal with those.

"And I do believe—actually it's the fundamental basis of the whole subject of economics—that you can create circumstances in which an equilibrium exists and there is a tendency towards equilibrium. If we were to say that in financial markets that [was not the case] we would be taking the subject, I believe, back a considerable distance."

If the "fundamental basis of the whole subject of economics" is that markets tend towards equilibrium when in reality they do not, the fault must lie in the "subject of economics" as it stands. Crockett alluded to the problem in his lecture where he noted, "actual experience, not least in the East Asian crisis, has provided forceful empirical confirmation of the potential strength of such [destabilising] tendencies".

Warning his audience against considering "magical solutions from outside" Crockett offered his own form of mysticism—that confidence in the stability of the global financial system should be retained because this is the "professional belief" of those supposedly in charge of it.