

**Comments by Charles Goodhart
at the Panel Session at the World Bank Conference
on Thursday, October 9, 2003**

In these remarks I want to make a single substantive point. This relates to the empirical procedures adopted in virtually all the papers by the World Bank and their economists in this field. This procedure is to categorise occasions of `systemic' financial crises, and then to use practical or econometric techniques to assess what worked in such crises, and what did not work. Now there is nothing wrong with such a technique by itself, but by itself I contend that such a procedure is biased. Why? It is biased because it is conditioned on the prior existence of crises, and many of the techniques of financial response to shocks are aimed at preventing a crisis occurring in the first place. Let me mention three such techniques; forbearance, deposit insurance, and liquidity provision.

If, despite such forbearance and deposit insurance, for example, a crisis occurs, then these techniques have, in some serious sense, already failed. Then continuing with an already failed technique is not likely to be productive. But such techniques do not always fail. Sometimes they succeed; and I will give a few examples in a moment.

Let me take an analogy with a medical treatment which is meant to reduce the probability of the onset of cancer. Then to test the efficacy of such a medicine by examining only the recovery rates conditioned on the cancer having already occurred is obviously misspecified.

Consider, for example, the example of forbearance from the Calomiris et al paper, which was

the S&L (savings and loan) crisis in the US in the 1980s. I agree that there was a serious failure of policy in this respect, and that the whole process was badly handled, embarrassing and expensive. Even so the crisis was local, regionalised, and of little systemic concern to the wider world. Let me contrast the S&L crisis with an occasion at roughly the same time, which was of much more potential gravity. This was the effect on the banking system of the whole world of the sudden default of Mexico, Argentina and Brazil in August 1982. This was an event which had not been well foreseen. You will remember the statement by Walter Wriston of Citibank, to the effect that, "Sovereign countries do not go bankrupt." While we have learnt better in subsequent years, this view was then widely pervasive, and all the major banks around the world had lent considerable sums to MAB, particularly the city-centre New York banks. After the MAB default, it was widely believed that Manufacturers Hanover was technically insolvent, and that many of the other major New York banks, including Citibank and Chase, had severe capital impairment. The financial situation was exceptionally fragile and dangerous; indeed this was, almost certainly, the occasion of greatest danger to the western financial system as a whole in the years since 1960, during which I have been an observer and participant in financial affairs and policy. There was a potential for the whole of the New York money market, and indeed money and financial markets around the world, to cease to function adequately. How was it handled? In practice, it was handled quite largely by a process of forbearance, that is, in effect, temporarily relaxing financial regulations, and allowing the system to recover gradually by itself. Indeed, as you will remember, the occasion that really marked the recover to normality was when Citibank was able to increase its provisions against lending to MAB to a level that reflected the underlying economic fundamentals, as I recall about three or four years later.

Let me give you another more recent example. In the summer of 2002, last year, the decline in the value of equities, had placed the life insurance companies in the UK in a difficult balance sheet position; as you know, the UK life insurance companies are more heavily invested in equities than similar companies in almost all other countries. Meanwhile, the regular solvency tests for life insurance companies, in order to allow them to continue operating, require them to undertake a regular monthly stress test, whereby they consider the effect on their balance sheet and their insolvency of a further fall in equity markets of 25%. As the equity markets fell in value, so it became more difficult for the life insurance companies to meet such solvency tests. One way of doing so, under such pressure, was to sell equities and to buy bonds, which automatically helps the company to meet such a test. But, the financial regulations were thereby in effect forcing the life insurance companies to sell equities as the market was declining. Moreover, other participants in the market were able to see this happening, and were able to position themselves by selling in advance of the forced sales by the life insurance companies. So, what we had was a classical debt-dynamic spiral, largely introduced by the regulatory procedure itself. This spiral, at last, was broken by the regulators having the good sense to relax the process of the solvency requirements themselves. A combination of this relaxation of the financial regulations, together with some, admittedly fortuitous, bottoming-out of the equity market around the same time, resulted in the debt-dynamic spiral ending, and some considerable recovery in financial conditions, without wholesale failures in the life insurance companies.

One can, of course, attribute the better outcome to the bottoming-out of the equity market, but who knows whether this would have occurred in the UK if the life insurance companies, who represent a sizeable proportion of the market, had been forced into further required sales.

Let me turn next to deposit insurance. I am fully persuaded of the econometric results obtained by several World Bank economists, including those here, that financial crises in countries which have deposit insurance have on average been worse than those without. At the same time, one must remember that from 1933 until sometime in the 1970s, there were in effect no bank failures and no financial crises in the United States at all. Many authors have attributed this absence of bank failures to the presence of deposit insurance. If deposit insurance should have the effect of reducing the probability of the occurrence of crisis, then the fact that the crisis may be worse in countries where deposit insurance, nonetheless, has been imposed, is not necessarily an indication that it is a mistaken policy in the first place.

It is, of course, extremely difficult to ascertain whether, or not, deposit insurance reduces the probability of onset of crises; but some attempt could be made to do so. Equally, it should be possible, if only by asking Central Banks for examples, to get a listing of those cases when judicious forbearance, or the provision of liquidity at an early stage and sufficiently, defused a situation which otherwise was perceived to have the potentiality for blowing up into a future financial crisis.

So what econometric and research procedures do I suggest? Crises occur because of the interaction of shocks with the existing financial structures. What I think is needed is a control group, in addition to the cases of financial crisis, where equivalent shocks occurred, but in the control group no crisis actually then arrived. Can this be done? I think that it can, in a number of ways. One way would be to ask Central Banks to assess qualitatively occasions which had the potentiality for crisis, but they managed to deal with it, in addition to those occasions when a crisis occurred which they did not manage to snuff out at an early

stage. This, of course, has the disadvantage of subjective assessment. So an alternative it to look quantitatively at occasions of extremely sharp shocks either to asset prices, or to exchange rates, or to some other aspect of the real economy, and to divide up cases in which there was on the one hand a crisis, and on the other hand no crisis, and then to try to distinguish what were the differentiating factors between the crisis and the 'no-crisis' occasions. Either way, my point is that just looking at crisis occasions and not examining those occasions when crises were prevented, introduces a bias into the empirical tests, which may lead to incorrect policy advice.