The Credit Crisis and the Role of Public Policy

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A frequently heard cliché about the current credit crisis is about the powerlessness of government. When mortgage repayment delays in California trigger the collapse of banks in Düsseldorf, Leipzig and Newcastle, and threaten European with recession, the state is sometimes depicted as condemned to the role of spectator of this 'butterfly effect' in the financial system. But such a line is misleading, as the role of government is never more crucial than in times of crisis. As the US economist David Moss has demonstrated in a fascinating book (1), the state is the insurer of last resort of our market mechanisms. Government limits the liability of shareholders, organizes the management of bankruptcies, and guarantees the stability of the financial system in all developed countries. It remains the port in the storm, the buttress of collective trust in the face of mass panic, particularly destructive in financial crises.

The famous quote of Roosevelt, "The only thing we have to fear is fear itself", dates back to the 1933 banking hysteria. It has always been difficult for politicians to face up to this responsibility because they are individuals subject to constraints and incentives which may prevent them from carrying out their role as an institutional and psychological fall-back.

It is even harder today when power is dispersed. Thanks to globalization, national decision-makers no longer hold all the levers of power. We in the European Union have chosen to share sovereignty between 27 nations in a series of fields which includes financial regulation. Each person involved is pulled in several directions at once. It has become vital to play a team game, to make an effort to ensure that the numerous policymakers in a given field speak with one voice and support coherent, credible public action.

The ability to achieve this coherence is not far off constituting the litmus test of governmental responsibility in our era of multiple interdependencies. Conversely, the demonisation of foreign interests or financial innovations entails the risk of amplifying the backlash, particularly when economic actors know that it is not based on facts.

Consider the typical scapegoats. Rating agencies: but they are not responsible for incautious investor activity and, although their privileged access to information calls for public debate, nothing so far suggests that they have knowingly conveyed distorted messages to the market. International accounting standards: by pushing for the accounting of derivatives, they have reduced rather than increased uncertainty about bank balance sheets compared with the previous situation, in France as in other countries. Securitisation: while it has undoubtedly gone off the rails in some cases, this is an effective financing technique which is not about to disappear. Central banks: they have acted wisely when they flooded the market with liquidity and decided not to punish past imprudence. Hedge funds: despite having for years been fingered as big risk-bearers, they have had only a minor impact since August. Sovereign wealth funds: far from contributing to the turmoil, they are currently playing a useful stabilising role.

By picking out these scapegoats, as has recently been the practice in a number of countries to various degrees, those in power risk diminishing their own credibility and increasing doubt in the marketplace.

In times of crisis, governments must keep a tight rein on the temptations of finger-pointing and free-riding. Public authority is vital in order to provide what the market alone is incapable of delivering: public information about risks, especially about banking risks (and one of the lessons of the last few months is that this information has been lacking); credible supervisory mechanisms and the ability to intervene decisively, where necessary with taxpayers' money, when the stability of the system is in danger. In a market which is now global in scale, this implies collective discipline on the part of governments, and well-functioning supranational institutions. This puts more pressure on our policymakers, but in no way relieves them of their responsibilities.

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(1) David Moss, *When All Else Fails: Government as the Ultimate Risk Manager*, Harvard University Press, 2002