

**İftiharla sunar**  
İçeriği olan konular ve konuşmacılar

## Insolvent banks should feel market discipline

Nouriel Roubini



**“Kriz kahini” olarak tanınan, İndeks - Leigh Bureau konuşmacısı Nouriel Roubini, Financial Times’ta dünya ekonomisini değerlendirdiği yazıları yayımlanıyor. Roubini’nin son iki ayda yayınlanan ekonomik değerlendirmelerini siz İndeks takipçileri için derledik.**

**J**oseph Schumpeter famously argued that the essence of capitalism was creative destruction, by which new economic structures are born from the rubble of older ones. The government stress tests on the 19 largest US banks, the results of which are due to be announced on Thursday, could have facilitated this process. The opportunity looks likely to be missed.

The tests, which measure how viable banks are under adverse economic conditions, have no “failed” category, even if as many as 10 are reported to need additional capital. But, given that the economic environment already reflects the tests’ worst-case scenario and that recent estimates by the International Monetary Fund of financial sector losses have doubled in six months, the stress test results will not be credibly interpreted as a sign of bank health. Instead, market participants will conclude that banks requiring extra capital have, in fact, failed. As a result, these institutions will not be able to raise outside capital and will immediately require government help.

Once again, the question will be how the near-insolvent banks can be kept afloat, to avoid systemic risk. But the question we really should be asking is: why keep insolvent banks afloat? We believe there is no convincing answer; we should instead find ways to manage the systemic risk of bank failures.

Schumpeter’s biggest fear was that creative destruction would lead capitalism to collapse from within, because society would not be able to handle the chaos. He was right to be afraid. The response of governments worldwide to the financial crisis has been to give the structure of private profit-taking an ever-growing scaffolding of socialised risk. Trillions of dollars have been thrown at the system, just so that we can avoid the natural process of creative destruction that would take down these institutions’ creditors. Why shouldn’t the creditors bear the losses?

One possible reason is the “Lehman factor” – the bank runs that would occur as a result of a big failure. But we have learnt from the Lehman collapse and know not to leave the sector high and dry when a systemic institution fails. Just being transparent about which banks clearly passed the stress tests would alleviate many of the fears. Another reason is counterparty risk, the fear of being on the other side of a transaction with a failed bank. But unlike with Lehman, the government can stand behind any counterparty transaction. This will become easier if a new insolvency regime for systemically impor-

tant financial institutions is passed on a fast-track basis by Congress. Problem nearly solved.

That leaves the creditors – depositors, short- and long-term debt-holders and preferred shareholders. For the large complex banks, about half are depositors. To avoid runs on these deposits, the government has to provide a backstop. But it is not clear it needs to cover other creditors of a bank, as the failures of IndyMac and Washington Mutual attest.

Even if systemic risk were still present, the government should protect the debt (up to some level) only of the solvent banks, not the insolvent ones. That way, the risk of the insolvent institutions would be transferred back from the public to the private sector, from the taxpayer to the creditors.

The government may be able to avoid the mess by persuading long-term creditors to swap their debt for equity, at a loss. The recent failed effort with Chrysler suggests this will not be easy. But a credible threat of bankruptcy could scare creditors into negotiation, to avoid bigger losses.

Suppose the systemic risk problem is solved. The other argument against allowing banks to fail is that after a big loss by creditors, no one would be willing to lend to banks – which would devastate credit markets. However, the creative-destructive, Schumpeterian, nature of capitalism would solve this problem. Once unsecured debtholders of insolvent banks lose, market discipline would return to the whole sector.

This discipline would force the remaining banks to change their behaviour, probably leading to their breaking themselves up. The reform of systemic risk in the financial system would be mostly organic, not requiring the heavy hand of government.

Why did creditors not prevent the banks taking excessive risks before the crisis hit? For the very same reason creditors are getting a free pass now: they expected to be bailed out. For capitalism to move forward, it is time for a little orderly creative destruction.

By Matthew Richardson and Nouriel Roubini – FT  
07.05.2009

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## The Almighty Renminbi?

**T**HE 19th century was dominated by the British Empire, the 20th century by the United States. We may now be entering the Asian century, dominated by a rising China and its currency. While the dollar's status as the major reserve currency will not vanish overnight, we can no longer take it for granted. Sooner than we think, the dollar may be challenged by other currencies, most likely the Chinese renminbi. This would have serious costs for America, as our ability to finance our budget and trade deficits cheaply would disappear.

Traditionally, empires that hold the global reserve currency are also net foreign creditors and net lenders. The British Empire declined – and the pound lost its status as the main global reserve currency – when Britain became a net debtor and a net borrower in World War II. Today, the United States is in a similar position. It is running huge budget and trade deficits, and is relying on the kindness of restless foreign creditors who are starting to feel uneasy about accumulating even more dollar assets. The resulting downfall of the dollar may be only a matter of time.

But what could replace it? The British pound, the Japanese yen and the Swiss franc remain minor reserve currencies, as those countries are not major powers. Gold is still a barbaric relic whose value rises only when inflation is high. The euro is hobbled by concerns about the long-term viability of the European Monetary Union. That leaves the renminbi.

China is a creditor country with large current account surpluses, a small budget deficit, much lower public debt as a share of G.D.P. than the United States, and solid growth. And it is already taking steps toward challenging the supremacy of the dollar. Beijing has called for a new international reserve currency in the form of the International Monetary Fund's special drawing rights (a basket of dollars, euros, pounds and yen). China will soon want to see its own currency included in the basket, as well as the renminbi used as a means of payment in bilateral trade.

At the moment, though, the renminbi is far from ready to achieve reserve currency status. China would first have to ease restrictions on money entering and leaving the country, make its currency fully convertible for such transactions, continue its domestic financial reforms and make its bond markets more liquid. It would take a long time for the renminbi to become a reserve currency, but it could happen. China has already flexed its muscle by setting up currency swaps with several countries (including Argentina, Belarus and Indonesia) and by letting institutions in Hong Kong issue bonds denominated in renminbi, a first step toward creating a deep domestic and international market for its currency.

If China and other countries were to diversify their reserve holdings away from the dollar – and they eventually will – the United States would suffer. We have reaped significant financial benefits from having the dollar as the reserve currency. In particular, the strong market for the dollar allows Americans to borrow at better rates. We have thus been able to finance larger deficits for longer and at lower interest rates, as foreign demand has kept Treasury yields low. We have been able to issue debt in our own currency rather than a foreign one, thus shifting the losses of a fall in the value of the dollar to our creditors. Having commodities priced in dollars has also meant that a fall in the dollar's value doesn't lead to a rise in the price of imports.

Now, imagine a world in which China could borrow and lend internationally in its own currency. The renminbi, rather than the dollar, could eventually become a means of payment in trade and a unit of account in pricing imports and exports, as well as a store of value for wealth by international investors. Americans would pay the price. We would have to shell out more for imported goods, and interest rates on both private and public debt would rise. The higher private cost of borrowing could lead to weaker consumption and investment, and slower growth.

This decline of the dollar might take more than a decade, but it could happen even sooner if we do not get our financial house in order. The United States must rein in spending and borrowing, and pursue growth that is not based on asset and credit bubbles. For the last two decades America has been spending more than its income, increasing its foreign liabilities and amassing debts that have become unsustainable. A system where the dollar was the major global currency allowed us to prolong reckless borrowing.

Now that the dollar's position is no longer so secure, we need to shift our priorities. This will entail investing in our crumbling infrastructure, alternative and renewable resources and productive human capital – rather than in unnecessary housing and toxic financial innovation. This will be the only way to slow down the decline of the dollar, and sustain our influence in global affairs.

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By NOURIEL ROUBINI - NYT  
15.05.2009

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## Latvia's currency crisis is a rerun of Argentina's

**A**fter a recent failed public debt auction, the authorities in Latvia are desperately trying to prevent a depreciation of the currency, the lat. The country's predicament is similar to the one that faced Argentina in 2000-01: a severe recession driven by global financial shocks, a sudden drying up of capital inflows and the need to reduce a large external deficit worsened by an unsustainable currency peg. As in Argentina, the International Monetary Fund initially went along - somewhat uncomfortably - with the authorities' strong preference for not letting the currency depreciate, in spite of its significant overvaluation. But a real exchange rate depreciation is necessary to restore the country's competitiveness; in its absence, a painful adjustment of relative prices can occur only via deflation and a fall in nominal wages that will take too long and exacerbate the recession.

Draconian cuts in public spending will be required if Latvia is to improve the current account. But this is becoming politically unsustainable. And while fiscal consolidation is needed - as Argentina found in 2000-01 - it will make the recession more severe in the short run. So it is a self-defeating strategy as long as the currency remains overvalued.

Of course, as in Argentina, letting the currency depreciate would lead to massive negative balance-sheet effects. The large foreign liabilities of households, companies and banks are in foreign currency; the real value in local currency of such debts would increase sharply after a devaluation. Devaluation may therefore lead to default by many private sector agents - and as the country's banks are local subsidiaries of Swedish banks, a financial meltdown in Latvia could prove damaging for its neighbours.

Nonetheless, devaluation seems unavoidable and the IMF programme - which ruled it out - is thus inherently flawed. The IMF or the European Union could increase financial support for Latvia but, as in Argentina, this would be throwing good money after bad. International resources are better used to mitigate the collateral damage of depreciation.

An introduction of the euro immediately after devaluation could help prevent the exchange rate from overshooting, although it would require the eurozone to admit a country that does not yet satisfy the

formal criteria for membership. Euroisation after depreciation is a more credible strategy for Latvia than dollarisation would have been for Argentina, as Latvia was on its way to membership and its business cycle is highly correlated with that of the EU. Euroisation without depreciation will not work, as a real depreciation is necessary to restore competitiveness. Of course, any depreciation - with or without euroisation - will make many foreign currency debts unsustainable and will require a forced debt restructuring, as in the case of Argentina.

To minimise the risk of contagion, the best strategy may be: depreciate the currency, euroise after depreciation, restructure private foreign currency liabilities without a formal "default", and augment the IMF plan to limit the financial fallout. It is a risky strategy but - as in Buenos Aires nine years ago - when plan A does not work it is time to move to plan B sooner rather than later. Delaying plan B would only cause a bigger blowout when the unavoidable currency crisis eventually occurs. It is to be hoped the lessons of Argentina in 2001 have been learnt.

Latvia's authorities are trying desperately to prevent depreciation by intervening in the foreign exchange market. While the very thin interbank market slows down the rate at which domestic and foreign financial institutions can short the Latvian currency and put pressure on the central bank reserves, the country is bleeding forex reserves at an alarming rate. Only a miracle or some draconian and credible fiscal adjustment (that does not exacerbate the recession) could restore the peg's credibility and lead to a growth recovery.

At this point, a currency and financial crisis is pretty much unavoidable; the issue is how to minimise the domestic and international costs of the needed change in the policy regime. As the experience with Argentina suggests, procrastinating will make the unavoidable crash - and the regional contagion - even more -dramatic and costly.

By Nouriel Roubini - FT  
11.06.2009