The Ongoing Financial Market Crisis: 
- How could it happen? 
- What is the appropriate response? 

Klaus Regling 
EU Fellow, LKYSSP 

17 OCTOBER 2008 

PRESENTATION OUTLINE 

1. Developments since August 2007 
2. Reasons behind the financial crisis 
3. Appropriate Responses 

E VOLUTION OF MAJOR STOCK INDICES MID-2007 TO DATE 
1 July 2007 equals 100 

Source: Ecowin, own calculations
NINE REASONS FOR THE FINANCIAL MARKET CRISIS

1. 10 years of generous liquidity creation by central banks
2. Global imbalances
3. Benign inflation environment
4. A long period of low interest rates resulted in a search for yield, low risk aversion and high leverage
5. Technological change allowed the development of new, complex financial market instruments
6. Credit rating agencies misjudged risks
7. With securitisation and the originate-and-distribute model, credit worthiness was no longer assessed
8. Incentive structure for senior managers in financial institutions encouraged short-term risk taking
9. Problems in the supervisory and regulatory framework: gaps and pro-cyclicality

Part III: Responses to the Crisis

Short-term Actions

From Central Banks
- Emergency liquidity
- Broader range of collateral
- Currency swaps
- Close international cooperation

From Supervisors
- Ban on Short-selling

From Ministries of Finance
- Nationalization
- Re-capitalization
- Guarantees
- Buying of toxic assets

Medium-term Responses

- Work of EU Finance Ministers (Ecofin), Financial Stability Forum (FSF), Bank for International Settlements (BIS), International Accounting Standard Board (IASB) closely coordinated to:
  - Enhance transparency
  - Close existing gaps in the system
  - Reduce possibilities for regulatory arbitrage
  - Reduce pro-cyclicality
  - Strengthen oversight over credit rating agencies
- Establish a common platform for trading + settlements of derivatives
- Market response from the Institute of International Finance (IIF):
  Voluntary Code of Conduct on
  - Improved risk management
  - Transparency and disclosure
  - Compensation policies
**Longer-term issues**

- Developing a stronger macro-economic policy framework:
  - Consider asset price developments in monetary policy framework
  - Avoid exchange rate policies that contribute to overheating
  - Make fiscal policy less pro-cyclical

- Developing a system of macro-prudential regulation

**Conclusions**

- Many reasons for the crisis and they are all linked.
- A comprehensive policy response is needed.
- The work has started.
- If successful, the financial system will be:
  - Smaller with less leverage
  - More transparent, less opaque
  - Less profitable
  - Less vulnerable

- But the process of de-leveraging is painful