Title	*Global Governance and Regulation - why?*
Description	In this podcast, Ngaire Woods, Christina Ward and Jeni Whalen discuss the causes of the current recession and asks why governments, financial regulators and banks failed to act responsibly and how we can act now to prevent the next financial crisis
Presenter(s)	Ngaire Woods, Christina Ward and Jeni Whalen
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Interviewer So what caused this global financial crisis?

Respondent Well let's think about the four groups we could blame for this crisis. We'll start with the banks and financial services sector firms whose corporate government, pay, remuneration, work practices lead them to disaster, there is one cause right there. But then we need to look at regulators and so why were regulators not doing their job in the United States, in Britain, in Europe? Why were regulators not looking at the banks and saying "You guys are acting dangerously."

So the regulators, both their regulation and to the extent they were actually enforcing the regulatory instruments they had at their disposal needs fixing. Then you've got to ask why where the politicians, the governments not standing over the regulators and making sure the regulators did their job, that's the job of governments. And those governments weren't not least because in Britain and the United States you had a perfect storm. The politicians were happy that so many people had access to mortgages; they were not going to stop that party

And then finally you've got economist call the global imbalances driving this crisis. In other words the fact that some countries of the world were building up massive deficits like the United States and Britain and other countries of the world were building up massive surpluses.

So the $3 trillion of reserves that China was building up but also other emerging economies were building up massive reserves. Reserves partly so that they could protect themselves in the event of a financial crisis but the fact that they were building up all these reserves created a huge pressure, the search for yield, which meant that there was more and more money that financial services firms were trying to find ways to invest in ever more innovative forms and structures.

So some would like to say the whole crisis was caused by the global imbalances and that if we don't solve the global imbalances, if we don't have an international agreement that prevents countries building up huge surpluses for example that forces China to revalue its exchange rate that we are not going to solve the core of the crisis.

We have to be careful of that argument because it's being used by some to take our eyes off the fact that the regulatory structures where inadequate and inadequately enforced. In other words we shouldn't imagine that we can solve the global imbalances problem and not do more regulation and therefore prevent a crisis, that's not going to happen. The regulatory structure has to be in place to prevent the next crisis and for one very simple reason. That is that at the core of any economists understanding which is a concept of moral hazard.

In other words if you think that when you gamble you will and you take the prize, you loose and you don't have to pay up, your incentive to gamble increases many fold. What's happened in this crisis is the banks have been bailed out. The lesson they will take from this crisis is that no matter how large they are and no matter how riskily they gamble, they will be bailed out and that is a serious moral hazard and that's another reason why regulation has to happen very quickly and it has to be global.

Interviewer What's the job of a regulator in that context?

Respondent So even the most free market economist would agree that you need certain kinds of regulation in any economy. You need regulation to set up the very things that make a market a free market work. The rule of law, the enforcement of the rule of law, property rights and so forth. But then you need regulation to deal with market failures and there are two big kinds of market failure that economist look at.

One is externalities. The fact that markets structure transactions that have spin over's on third parties an obvious one is pollution. Like pollution is a negative externality that you need regulation to deal with, so too is the kind of financial crisis that we've just seen.

Another market failure is information. All of our, a free market vision of the economy assumes that all of actors have perfect information that is timely and accurate and of course that is never true and so you need regulation to deal with the effects that some have very imperfect information and that this then creates havoc in the actions in the market. I think there is increasingly a consensus on another reason why you regulation which is market irrationality, which has been highlighted in this crisis in Shiller's excellent new book "Animal Spirits" this notion of animal spirits catches the irrationality of actors in the market.

The irrational exuberance that we saw in financial sector markets over the last decade which is part of the story of this huge bubble that we've just seen burst. And finally you need regulation for fairness and justice. You need regulation to ensure that you have enough buy in within a society and across the international society of all countries because they believe that the system is producing some modicum of fair and just results and I think all those reasons we are seeing in the public debate about what regulators should do today. That there is a real sense of questioning about whether bankers for example should earn several hundred fold what others in society earn or whether you want to have a society or not that has that kind of inequality.

People are starting to ask those questions, economists are doing very interesting work about the consequences of that kind of inequality for crime, for happiness, for welfare within societies. So these are being probed all as a basis for thinking about what regulators should do.

In the financial sector what regulators need to do is ensure that banks don't pose the systemic risk that we've just seen, we are just living through now and it is hard in banking because banks are in a way the oil of the machine that is the economy and you can't afford to simply let large banks collapse.

So there is no market discipline in banking, the minute you say we can't afford to let this bank collapse you are saying that market discipline will not self regulate this bank. In other words you are saying regulators have to step in and do all the things that you might have expected market competition to do because left to its own devices there is no discipline. The bank knows it can't be left to fail, the government knows the bank can't be left to fail, you have a huge moral hazard problem.

Interviewer So you mentioned before that this is a bubble but the economy has seen many bubbles. Why have we not had the regulations that are being discussed now before?

Respondent I think this crisis began with the sub-prime mortgage crisis in the Untied States and in Britain and to me there is a clear sort of perfect storm story about that which is that it seemed at the time to be in everyone's interests.

Home buyers wanted to have access to loads of easy credit to buy houses, banks found it extremely profitable lending to so many home buyers wanting to buy houses. Regulators found themselves under no pressure from politicians more heavily to regulate this expansion of mortgage lending and the politicians found it convenient that they were presiding over a very happy, contented population of voters, comfortable in their fancy new houses having taken out these huge mortgages.

So you sort of had a perfect storm and you had to ask the question that a famous American central banker asked "Who was going to take the punch bowl away at the party?" and this was a big party that everyone seemed to be enjoying themselves at. Who was going to actually come and lock the wine cabinet and say that's enough stop and what we saw was that there was really nobody in the system that had a strong enough incentive to do that and that's what the new system is going to have to rectify.
