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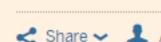
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Lesson I learnt tackling financial crisis that never was

Ed Balls



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Sometimes the biggest potential risks are staring you in the face, writes Ed Balls



ne of the stranger experiences you can have as a Treasury minister is engaging in a tense discussion with the governor of the Bank of England about a problem that does not exist.

My contretemps with the governor came during a three-hour meeting in early 2007, as we decided what action to take to tackle a purely theoretical banking crisis at the end of a 10-day simulation exercise. As the UK's financial services minister, I had decided that we should conduct that exercise to test our systems. Little did we know that the real thing was just around the corner.









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If Bank of England officials are holding similar drills today — and I hope they are — they will not struggle for plausible scenarios. In the past year, fears of tighter US monetary policy have triggered enough jitters in the equity and commodity markets to warrant the simulation of a full-blown transatlantic stock market correction.

Set aside the crisis engulfing Greece. Officials could wrestle with the impact of a sharp slowdown in China or Brazil, or a further escalation of hostilities in eastern Europe or the Middle East. If they wanted to look at a narrower market that is worryingly overheated, they would be spoilt for choice — from London housing to subprime US car loans. If they wanted to try out a scenario similar to the 2007 crisis, they might look beyond the formal banking sector, where rules are now much tougher, and focus on the frothier end of asset management and shadow banking.

In retrospect, the current economic situation apparently healthy growth but with plenty of downside risks - contains some disconcerting echoes of the situation in 2006, a year before the global financial crisis began. Back then, with inflation and interest rates historically low, the consensus was that economies were still recovering from the oil and dotcom shocks of the early 2000s.

Economists debated whether continued loose monetary policy was necessary to maintain that recovery, or whether it was simply serving to fuel the

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next, bigger crisis. But in both the US and UK, central banks were inclined to believe the "great moderation" was delivering a more benign cycle, with lower household savings the result.

While at the time, I remember spending hours in the European Council listening to the German finance minister lecturing Britain about "irresponsible" hedge funds, even while German banks were falling over themselves to buy US subprime mortgages and Greek debt. It was in that uncertain environment that I decided to initiate our simulation.

It envisaged a lender collapsing after an unexpected legal ruling, and a large UK clearing bank being exposed to huge liabilities as a result, turning a local difficulty into a

systemic event. The simulation ended with my tough meeting with the governor of the Bank of England and the chairman of the Financial Services Authority. We debated the risk that stepping in might send the wrong message and encourage recklessness by signalling that institutions could expect rescue if they ended up on the rocks. But we decided that the failure of a clearing bank would cause immense damage. So we opted to arrange a takeover.

When the real crisis struck later in the year, it did help that officials had been through that simulation — although I know many of the same arguments resurfaced. Here are three long-term lessons, relevant today, that I learnt from that exercise.

First, if weaknesses are exposed, they must be fixed quickly. Our simulation at the start of 2007 revealed that our deposit insurance system was old and creaking, and that EU state aid rules could obstruct decisive action to find an acquiring bank. The Treasury agreed a plan with the BoE to sort out those problems. But only on an 18month timetable — too slow to help when Northern Rock foundered eight months later.

Fortunately, the structural reforms recommended by the international Financial Stability Board are happening much more urgently, particularly in the UK.

Second, procedures really matter. Even in a simulation exercise, our three-hour meeting was arduous. It helped greatly that there were three institutions in the room, able to debate the issues and hammer out an agreement.

Of course, the tripartite system did not spot the real crisis coming. Almost nobody did. But I am concerned that, under the new arrangements which replaced that system, the equivalent discussion would now take place exclusively within the Bank of England, with just one principal at the top.

In my view, the head of the Prudential Regulation Authority must also have a direct line to the chancellor, underpinned by proper structures for crisis decision-making which currently do not exist.

My third lesson is that sometimes the biggest potential crises are staring you in the face. In our simulation, the lending institution that collapsed was, in fact, a northern building society. And when a buyer was needed for the large clearing bank, who did the FSA propose? ABN Amro. Just a few months later, we were still taken by surprise

when Northern Rock collapsed for real; while the misplaced confidence in ABN Amro's stability was doubtless one of the reasons Royal Bank of Scotland was allowed to go ahead with its disastrous takeover. Policymakers need to be alive to all the distant threats to stability, from emerging market slowdowns to new financial activities beyond their regulatory reach, as they

make the difficult and delicate judgment about whether and when to tighten monetary policy. But, while continuing to scan the horizon, they must always keep one careful eye on

The writer is a senior fellow at Harvard Kennedy School and a former shadow

chancellor and cabinet minister





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