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IS THERE A DANGER OF A VICIOUS CIRCLE DEVELOPING?

The world economy is facing an extremely serious situation. It is quite obvious, particularly in the case of Europe, that there is a danger of a vicious circle developing. A vicious circle in which weakness in sovereigns leads to doubts about the adequacy of the capitalization of banks. It can be translated into calls for provisioning which would effectively mark the sovereign assets of banks. It does not require an enormous amount of astuteness to understand that this puts further strains on the sovereigns themselves, because it requires recapitalization of the banks. This recapitalization, in the first instance, needs to be carried out through the private sector. However, it is clear that the recapitalization may not be fully available from private sector sources, in which case, if we need to reach for sovereign backstops, we have extra burdens placed on the position of sovereigns themselves. We also have a clear feedback loop, which can continue feeding on itself in a vicious circle.

Furthermore, there are indications that there will also be effects, resulting from this situation, on the availability of term-lending in the banking system. Some of the solutions that have been proposed are in the area of sovereign guarantees to term-lending. These would clearly impose further strains on the sovereigns.

There is an interesting story about the Great Depression, that may come useful here. It states that the real problem began when somebody from one of the US supervisory institutions came up with a bright idea that it would be prudent to

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send inspectors to the banks and check how the great Wall Street crash of 1929 had affected their capital. Of course, once this had been done it turned out that the banks' capital positions were dramatically worse than had been previously assumed. This is not necessarily true and does not confirm that that was really the source of the banking crisis which followed a year or two after the Wall Street crash. Nevertheless, it shows the kind of consequences that we could have, if the above mentioned vicious circle was allowed to develop.

One of the problems is the fact, that over the last twenty or thirty years, a system of supervision control support over the financial, particularly banking, system has been built. There are supervisors, who are separate from the central banks, in the European Union, particularly in the Eurozone and there are very strong and strict limits on what the central banks are allowed to do. The net result and the reason for building up these systems, was essentially twofold. The first was that the main threat was seen to be the threat of inflation. It was believed that this kind of fragmentation of responsibility was likely to make inflation less probable. One of the aspects of this fragmentation was the creation, or rather strengthening of the independence of the central banks. The other aspect, or reason lying at the source of such fragmentation, was that by fragmenting, creating and imposing rules for the fragmented parts of the supervisory system, the hope was that one would reduce the expectation of bailout, and therefore reduce moral hazard.

All this is well known to everybody, and was absolutely sensible and correct at the time. The unfortunate thing is that we are in a situation similar to the one before the fall of Singapore in 1941. There are the most wonderful defences, the most massive cannons facing out to sea, well prepared for an attack by the imperial navy. Unfortunately, the threat that we are actually facing, is the imperial army coming through the jungle from the rear. In other words, we are facing a completely different set of challenges, and the institutions that we have built correctly to face one set of challenges actually find it extremely difficult, for extremely sound, legal reasons of institutional culture, to face the challenges that we now have. This is particularly true in Europe, where, in order to achieve a single currency, certain strong concerns about moral hazard had to be laid.

Therefore, the challenge is of an especially grave kind, because with the fragmentation of responsibility comes a natural tendency for bureaucracies to essentially stick to their mandates, to say "This is not our responsibility", to play, what in England is called 'pass the parcel', meaning 'pass the parcel of responsibility'. We have to realize just how dangerous this situation is, because the institutions and political systems have been lagging behind the curve. From that point of view, another analogy is that of Tarquin and the Sibyl, who was willing to sell Tarquin the Sibylline books for vast amounts of money and when he refused, she burned half of them and then insisted on the same amount of money, then she burned another half, and finally he bought the remains for the original amount of

money. We are finding ourselves always moving too late, and in the end getting to where we do not want to be without the effect that we were hoping to have.

It is worth pondering for a minute about what will happen, if we continue in this direction. The threat we are facing today should not be underestimated. The longer we behave in the way we have been behaving, the greater will be the cost in terms of undermining the fundamental, liberal and free market order that we have been creating over the last sixty years. We are in serious danger of finding that more and more of what we have taken for granted in terms of free markets, free capital movements, and so on and so forth, will be under threat, unless we are willing to behave in ways that today seem to be extremely unconventional. We have to save what we can. We have to act in ways that we may find, at the moment, to be unpalatable in terms of what we have developed as far as structures, cultures and rules are concerned, in order to save the rest.