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Turner is asking the right questions on finance

September 11, 2009 3:07am by Martin Wolf

I like and admire Lord Turner, chairman of the UK's Financial Services Authority. He is more than an acute analyst. He is also brave. He showed that in his struggle with Gordon Brown, then chancellor of the exchequer, over plans for pension reform published in 2005. He is showing that again today in the lively debate he has initiated on the future of financial regulation.

This financial crisis was no minor blip, to be forgotten as quickly as possible. On the contrary, the UK (and other significant countries, not least the US) have just received a monstrously expensive warning. That is why Lord Turner's willingness to raise unpalatable questions is both welcome and refreshing. **His report for the FSA** is among the best analyses of the crisis. Now, in a discussion for the British journal Prospect, he has **taken the debate into even more controversial territory**.

I will address five of the issues raised there: the case for moving the responsibilities of the FSA over banking into the Bank of England; the supposedly excessive size of the financial sector, particularly in the UK; the levels of capital required of banks, particularly on their trading activities; the possible role of taxes on financial transactions – the so-called "Tobin tax"; and, finally, the vexed question of bankers' pay.

The remainder of the article can be read here. Debate from our panel of economists appears below. September 11, 2009 3:07am in Central banks, Monetary policy | 5 comments from our expert contributors

Comments

I slightly disagree on one of Martin Wolf's remarks in his very interesting article where he argues that Lord Turner's report is among the best analyses of the crisis.

In my view, the report's analysis of macro-imbalances in Chapter 1 is weak. In a nutshell, it presents a very simplistic interpretation of causal relationships, namely that declines in US and UK real long-term government bond yields to historically low levels in the early part of the current decade were driven by huge investments in US (does Lord Turner mean to include UK in this respect?) government and government guaranteed bonds by China and other current account surplus countries and they in turn contributed to rapid domestic credit expansion in the US and the UK. I do not argue that this kind of causality had not existed at all, for the US at least, as the US dollar was heavily managed by a number of its trading partners intervening to resist dollar depreciation, and making the US dollar effective exchange rate a residual of other countries' policies in their own interest. On the other hand, the pound was floating and, so far as I am aware, no one was trying to manage it. The Turner report should have more carefully assessed the importance of global macro imbalances relative to other, domestic macro and micro factors as a root cause of the crisis in the UK, without mixing the UK with the US.

In this connection, Exhibit 1.2 in the report shows the foreign-ownership of marketable US Treasury bonds as percentage of total amounts outstanding, but no equivalent data for the UK are shown (Exhibit 1.26 on the composition of UK capital flows, 2000-2007, does not appear to distinguish foreign investors' purchases of UK government debt instruments from their investments in UK private debt instruments). More curiously, Exbit 1,3 shows UK real interest rates in terms of long rates only, with no information provided on UK short rates and equivalent rates in the US. In fact, the report does not assess the influences of domestic monetary policy and other macro factors on the UK non-bank sector's lower overall costs of borrowing, both short and long, and credit availability as well as the effects of domestic fiscal policy indirectly working on non-banks' long-term borrowing costs through its direst influences on (nominal and real) long-term government bond yields. Huge increases in UK household debt ratio to GDP cannot be explained in connection with low real long-term government bond yields alone, as a significant part of household debt has been in the forms of short-term borrowings and longer-term borrowings at variable short rates. According to a report by Darren Williams of Global Economic Research, short-term household borrowing in the UK amounted to 17 per cent of total debt and 16 per cent of GDP in 2005, much higher than in the euro area. Moreover, in addition to about 30 per cent of UK mortgages at short-term fixed rates, some two-thirds is long-term borrowing at variable rates with only less than 10 percent at long-term fixed rates, in contrast to Germany where most mortgages are at long-term fixed rates. The report should have added at least an exhibit for short-term money market rates which, in the UK, fell from 6.1 per cent in 2000 to 3.7 per cent in 2003 and rose only modestly to 4.6 per cent in 2004 and 4.8 per cent in 2005 (and, in the US, declined from 6.5 per cent in 2000 to 1.2 per cent in 2003 and rose only slowly to 1.6 per cent in 2004 and 3.5 per cent in 2005).

Moreover, while the report appears to argue that the major cause of a decline in the UK real long-term government bond yields (by about a half percentage point or so) from 2000 to 2006 was high domestic savings in external surplus countries like China, it did not examine reasons why a far sharper (some 2 percentage points) decline in the UK real long-term government bond yields from 1990 to 1999 (shown also in Exhibit 1.3) occurred with smaller combined current account surpluses of Asian and other countries in that period than between 2000 and 2006, a period in which the fall in long rates was far more moderate in the face of larger current account surpluses of Asia and oil exporting countries.

In short, the report’s analysis of macro imbalances as causes of domestic private credit excess in the UK is inadequate. (A similar comment can be made about the British Academy’s letter to the Queen.)

In addition to the issues Lord Turner recently raised in the British journal Prospect, useful policy lessons can be drawn only from deeper analysis of the macro-prudential aspect of the UK crisis. This said, I completely agree with Lord Turner on his two recommendations concerning macro-prudential analysis in the section “Actions required to create a stable and effective banking system” of his report (page 8).

19. Both the Bank of England and the FSA should be extensively and collaboratively involved in macro-prudential analysis and the identification of policy measures. Measures such as counter- cyclical capital and liquidity requirements should be used to offset these risks.

20. Institutions such as the IMF must have the resources and robust independence to do high quality macro-prudential analysis and if necessary to challenge conventional intellectual wisdoms and national policies.

Posted by: Kumiharu Shigehara | September 16 9:17am