

CENTER ON CAPITALISM AND SOCIETY

COLUMBIA UNIVERSITY

<http://www.capitalism.columbia.edu/>

Working Paper No. 36, February 2009

A New Era: How the Crisis Will Reshape Politics, Societies and Finance

Comments Presented at the 6th Annual Conference of the CCS,
Emerging from the Financial Crisis
(Columbia University, February 20, 2009)

Josef Ackermann*

* Chairman of the Management Board and Group Executive Committee, Deutsche Bank

Ladies and Gentlemen, It is a great pleasure to be here tonight and I regret that I couldn't arrive earlier as I am sure I missed very interesting debates.

Indeed, there are plenty of issues to be discussed. "Values have shrunken to fantastic levels; [...] government of all kinds is faced by serious curtailment of income; [...] the withered leaves of industrial enterprise lie on every side; [...] the savings of many years in thousands of families are gone. More important, a host of unemployed citizens face the grim problem of existence and an equally great number toil with little return."

Interestingly, these words were spoken more than 70 years ago. They are taken from Franklin D. Roosevelt's inaugural speech in 1933 but they capture perfectly the essence of today's downturn.

Finding the right answers to these challenges is not an easy task for our political and economic leaders. Thinking about these measures in a serious and creative manner is therefore more than justified. But as we focus on the immediate crisis management we shouldn't lose sight of the longer term perspective. The West is undergoing a once-in-a-century shock, not just in the economy, but in society at large.

Allow me to point to just **three aspects** where I see **transformative powers at work**:

- **First**, the fall-out from the crisis will have a transformative impact on the role of the state in the economy. It seems that thirty years after the Reagan / Thatcher revolution the pendulum has reached its widest amplitude and will start to swing back towards interventionist policies. After decades of consensus that the state should limit itself to setting the right framework conditions but otherwise leave private actors to do the job, the state is now again being seen as a beneficial actor in its own right, one who should play an active role in the economy. Incidentally, this changed attitude towards the role of the state goes along with an apparent change in values: For instance, a more egalitarian income distribution is valued higher than the dynamic which a greater differentiation of wages can bring. Similarly, personal trust has gained greater importance, which will also have an influence on whom people are willing to do business with in the future.
- **Second**. When world leaders gathered in Washington in November 2008 to chart their response to the crisis, it was the G20 that met, not just the G7.

The Washington summit was highly symbolic in highlighting that the financial crisis will accelerate the rebalancing of economic and political power in the world. I think that the loss of credibility that the Western model of capitalism and society has suffered may, in the end, turn out to be even more important than the purely economic impact.

- **Third**, now is the moment of truth for the international community as regards the future of globalisation. Over recent years, many have said that globalisation is as inevitable as the force of gravity. I never shared that view: globalisation has always been man-made – and it is in our hands to make it or break it.

Unfortunately, it looks as though we are on course for the latter. Let me dwell a moment on this thought, as it is a matter of grave concern.

Many comparisons have been drawn in recent weeks between the Great Depression of the 1930s and our times. Most commentators have come to the conclusion that things will be different this time. The key argument for those holding this view is that we have learned the lessons from the past and will avoid the policy mistakes committed at the time. Now, I agree that this certainly holds true as far as macroeconomic policies are concerned. Central banks and governments around the world have been quick to put all of the policy tools at their disposal to work on an unprecedented scale.

But while I, along with many commentators, would laud policy makers for their actions on monetary and fiscal issues, I also feel that we must be increasingly concerned that we do not seem to have learned our history lessons on the dangers of protectionism. True, we now have a more stable institutional framework than we did in the 1930s, with institutions such as the WTO.

But in their rhetoric and policy actions, our political leaders now revert to notions long thought dead: the notion that jobs are best preserved by shutting our doors to foreign firms, capital and workers; the notion that employment and growth are best served by preserving current production patterns; and the notion that our firms must first and foremost devote their resources to their home country. These are dangerous notions, but they will only become stronger with the growing role of the state in our economies.

Ladies and gentlemen, we must quickly and forcefully reverse course on this rhetoric and these actions. We need to break this trend, before it assumes a dynamic of its own, for otherwise we will all be left considerably worse off in a few years' time. We do need powerful action that sends a strong signal. Completing the WTO's Doha Round immediately would be such a signal.

Financial sector: in for radical change

So, the crisis will be transformative for global politics, the world economy and our societies. Arguably, there is one sector in which change will be greatest – the one that lies at the heart of the crisis: the financial sector. It is not just that the reputation of bankers personally is in disarray: a recent poll indicated that bankers ranked almost at the bottom of the list of social classes that people wanted to have represented amongst their friends – ahead only of convicted felons and prostitutes. --- Incidentally, did I already thank the organisers for inviting me tonight?!

As many representatives of the banking industry, including myself, have acknowledged in recent months, banks have committed grave mistakes in the run-up to the crisis. Weaknesses in business models, in incentive structures and infrastructures were exposed. Having said this, fairness requires to also acknowledge that not only banks were at fault: Monetary policy had been too loose for too long, allowing the building up of severe imbalances. More generally, our regulatory systems – especially capital requirements and accounting standards – amplified rather than dampened the procyclical tendencies of the financial system. Similarly, our supervisory systems were insufficient for modern, global financial markets.

Work to rectify these deficiencies is underway. Major regulatory changes will emerge from the G20 process, even if the term “new financial architecture” is probably too grand a term for these proposals.

- Banks will be required to hold more capital and more liquidity.
- In particular, rules on regulatory capital requirements for trading book assets will be tightened by raising the incremental risk charge and, more importantly, by addressing the procyclical effect of the use of VaR-models for capital charges in the trading book.

These may create an incentive to shift assets to the trading books in a prolonged boom period, reducing the amount of capital held at a time when systemic risk, in fact, rises.

- Procyclicality will be addressed by modifications to fair value accounting, such as the rules on reclassifications, and to capital requirements, building on concepts like dynamic provisioning.
- Authorities will coordinate more closely in their supervisory activities of globally active financial firms and instruments for this will be aligned.
- Efforts will be made to increase transparency on the distribution and extent of risk in the financial system. The German government has captured this in the idea of a “global risk map”.
- Systemically important institutions, irrespective of whether they are regulated or not, will come under supervision – which will inter alia change the face of the hedge fund industry.
- Incidentally, the latter two changes would probably help to prevent the re-emergence of a shadow banking system like the one that contributed to the current crisis.

Clearly, we underestimated how much this shadow banking system added to regulatory arbitrage and the inflation of the bubble and how large the contractional impact would be if the demand from these investors evaporated.

At the same time, substantial changes will be made by banks to their business models, their risk managements and the way they conduct their business. To name but a few:

- Gone is the business model of the independent investment bank, financed on wholesale markets, operating with high leverage and putting its own capital at risk.
- The limits of quantitative risk models will be acknowledged. Blind trust in numbers (and ratings, for that matter!) will be complemented by sound judgement and comprehensive risk assessment.
- Internal capital allocation will be subject to stricter rules. Specifically, trading activities must and will no longer be inflated on the back of cheap capital gathered through deposits and asset management and the favourable rating that comes with such stable business lines.
- The era of high bonuses will give way to pay structures that are geared to long-run, sustainable profitability and are subject to greater transparency and closer scrutiny by shareholders.
- Gone also is the business model of a complex, large financial institution which is active in many business lines around the globe – not primarily because this business model has fallen out of favour with analysts, but mainly because new regulation will on balance aim at keeping banks “small and simple enough to fail”.
- After decades of deregulation, privatisation and liberalisation, the involvement of the state in the financial sector – both as an owner and as a regulator – will stage a huge comeback.

Ladies and gentlemen, the financial industry is used to change. In fact, the ability to innovate is the key to success in our industry. I have little doubt that the industry will be able to reinvent itself this time, too. In fact, although it may not be entirely obvious in the heated debate, banks have been extremely active over the past 20 months or so in drawing their lessons from the crisis.

We have revamped compensation regimes, risk management methods and processes, product approval and management, not least in the area of securitisations, and our corporate governance structures.

In doing so, we have acknowledged our responsibility for the developments that brought us here, but also our willingness to be part of the solution. I can assure you that we will continue to do our best to improve our processes.

Academic support

In times of uncertainty, in times of transformative breaks, it is a natural human tendency to seek refuge in what we know best. This may be the psychological reason why we can observe a resurgence of nationalism these days. It may also be the reason why we seem to struggle to find the right tools to tackle the crisis, because tools that may have been perfect for the last crisis may not be effective in this one.

In any case, while seeking refuge in the familiar is an understandable reaction, it will not get us very far in our efforts to find the right solutions to the challenges that our interconnected, intertwined and interdependent countries face.

Hence, now – more than ever – is the time that we need the vision and support of our best and brightest minds. If you allow, I would explicitly point to the role of academia here.

It is in academia where new ideas can and should be generated, where the luxury exists to build innovative concepts from scratch – unencumbered by corporate and institutional legacies, independent of electoral cycles and free from the tyranny of day-to-day crisis management that has pre-occupied key personnel in administrations and firms for many months now.

It is conferences like this one to which we look for inspiration in our daily struggle; it is centres of excellence like Columbia University on which we pin our hopes for enlightenment in these days.

And since most of you – like myself – are economists by training, let me close by observing: eternal fame and glory await the one who will provide the silver bullet to the two trillion dollar question. Now, that should be incentive enough to prove to the world that the times may be dismal, but our profession is not!

Thank you for your kind attention.