The Perils of Moving Too Quickly on Financial Reform

Edwin M. Truman, assessing the global economy and the agenda of the G-20 countries, cautions that overly restrictive reforms could stifle economic recovery.

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Steve Weisman: Welcome to Peterson Perspectives. This is Steve Weisman at the Peterson Institute for International Economics. Our guest is Edwin Truman, senior fellow at the Peterson Institute and an economist who has served at the Federal Reserve and the US Treasury and studied international finance and international financial architecture for many years. Thanks for joining us, Ted.

Edwin M. Truman: My pleasure.

Steve Weisman: This is a few weeks after the mid-November meeting of the world leaders of the G-20. Tell me your latest thinking about where the economy is going.

Edwin M. Truman: I think all the evidence we've had since mid-November is that the global economy is doing very badly and the prognostication is that we're going to have a global recession with global growth under 3 percent certainly. Probably it could be well under 2 percent. The prognosticators are looking pretty good if you want to grade them, and so therefore I think that issue has moved to the center stage over the last several weeks.

Steve Weisman: The G-20 called for a number of steps to deal with the economy, the markets, the financial sector, and also for the International Monetary Fund (IMF). What do you foresee happening with the IMF?

Edwin M. Truman: What we've seen in the last four weeks is that the IMF is back in the lending business. It lent more in November than in any month in its history, roughly $42 billion of commitment. And people are concerned somewhat that the Fund may run out of money, assuming that the membership of the Fund will not lend it. But I think what is becoming clear is that the Fund has been inappropriately deprived of resources. My recommendation to the G-20 when it meets again in April is that they endorse a doubling of IMF quotas, which would essentially increase its lending capacity by 200 million dollars.

Steve Weisman: Explain to me what a quota is.

Edwin M. Truman: Good question. A quota in the Fund determines three things. First, it determines how much each country has to contribute to the Fund in order for the Fund to lend to other countries. The quota is also a basis for determining how much a country can borrow from the Fund, to borrow some multiple of your quota. And it determines also the voting power within the Fund.

Steve Weisman: Do you see any problem in increasing those quotas? Is there any resistance?

Edwin M. Truman: Well, there's lots of resistance because the notion has been perpetuated by many people, the G-7 in general, that the Fund isn't needed anymore. And there was an attitude of basically "starve the beast" so that it doesn't get any money, then it won't lend, and the Fund shouldn't be in the lending business. To me, it looks like the Fund is back in the lending business. They just opened a special new short-term liquidity facility and put aside roughly $100 billion for use of that facility. That illustrates, it seems to me, that in this global financial world that we live in—and are going to continue to live in—no matter what the reforms are to go forward, we will need the Fund to help channel, on a multilateral basis, short-term financing needs and longer-term financing needs going forward. One of the amazing features of this period has been that the Federal Reserve has advanced $500 billion to foreign central banks. Now that's worked fine under these circumstances. But over a longer run, the Federal Reserve should not be in the bilateral lending business. That is the appropriate thing for multilateral institutions, and we should turn to the multilateral institutions and update them in a way that will serve us for the 21st century. That item along with the economy itself will rise to the head of the agenda when the G-20 meets again in April.

Steve Weisman: So this should be, in your view, one of the most urgent priorities for the G-20?

Edwin M. Truman: I think when they get to April things are going to look even worse than they are today. Even if they are already getting better by that time, they will look worse. And the ramifications of the global recession as it echoes through the emerging markets have just begun. So I think the focus in April is going to be on the economy and on being able to support countries that need support in principle through institutions like the International Monetary Fund. I would hope actually that the financial reform pieces of the package would be forgotten about. But set that aside. First of all, they're going to take a long time to implement appropriately. We have to clean up the mess, and there is a big risk, in my view, that this excessive attention on what went wrong in terms of the financial system is actually making things worse today.

Steve Weisman: Let's talk about that. Another priority of the G-20 was to reform the regulations of the financial system. It wasn't clear what they had in mind but is it a good idea to do that right away?

Edwin M. Truman: You're right. It isn't clear what they have in mind. There's a long laundry list. Actually the Financial Stability Forum put out a report this spring, more than nine months ago, listing 67 things that need to be done. They are all in the right areas. They may not be for the right things, it may not be as much as is needed, but the problem I think we have now is that the threat of reform is actually discouraging lenders. One of the issues, ironically, in thinking about the financial system and how it's worked over the last decade or so is that the regulation has been procyclical. So when there haven't been mechanisms that pull back the system from lending more when the steam gets too hot out of the kettle, you want to have a more counter-cyclical regulatory and supervisory environment to try to curb the natural excesses of the financial system.

So here we are in a deep downturn where the financial system has gone into reverse and we're plodding on and saying, "Yeah, put on the brakes, put on the brakes, put on the brakes." It's not quite clear what you do about it at this stage, because the people who are talking about these things and working on these issues are working hard. But the actual practitioners, whether they are lenders or rating agencies or whatever it might be, are saying, "Well, they're looking over our shoulders and things are going to get a lot worse. The rules are about to change and they're going to be much tougher, and we might just as well adjust to those things now and change the way we do business because that's how it's going to be going forward."

Steve Weisman: But you don't see any harm in talking about reform. You just see a concern that reform becomes implemented at a time when it could dampen the prospects for a recovery. Is that right?

Edwin M. Truman: It's a delicate problem, it seems to me. At one level, one needs to talk and think and try to learn the lessons and draw up a blueprint for what you want to do going forward. On the other hand, it is true that many of the things that are likely to be on that blueprint—and appropriately should be on that blueprint to control the situation when the economy and the financial system are getting too hot—are, by talking about them now, operating in reverse. So it's not an easy problem. An example, I think, is this question about the role of rating agencies. There's no doubt that the rating agencies underperformed and there are lots of things that could be done and should be done probably to fix that situation, though it's not an easy thing to do.

You had, just this week, the SEC put in place some new regulations for rating agencies, though they've stepped back from doing some of the more draconian measures. I was told the story by a senior CEO of a major corporation just this week, that his rating agency that looks over his firm, which has had, for many years, a finance subsidiary. The rating agency told him that he had to consolidate that finance subsidiary into the firm itself and then to demonstrate that it had one year of liquidity and cover its obligations for one year, which would add $35 million to his financing needs going forward. This is an example of a rating agency reacting to the criticism that it has heard and basically saying, that firm can either not advance as much credit as it has before or the price of it doing that would be increased to the firm itself until that would be $35 million that couldn't be used on other things like expanding the plant.

So I think that's an example of how even just to talk about this stuff unfortunately can make things worse. It's hard to say with a straight face that you're in favor of widespread forbearance, but indeed in some sense that's what we're talking about.

Steve Weisman: When you say forbearance, do you mean not implementing these requirements or reforms too severely, right?

Edwin M. Truman: Yes, the problem is, just think about banks. Banks made loans that they shouldn't have made, right? So now they're not making loans that they should make to creditworthy borrowers. So the trick for the banking supervisor actually is to say, in terms of the macroeconomy, "We actually are going to forbear on you. We're not going to beat up on you right now for the mistakes that you made in the past, and in fact, we want you to go the other way and to make all the loans that you can make to creditworthy borrowers." That's part of what the whole process in the United States is about: to get the credits flowing whether it's to the housing or car industry or to any of the other industries in the United States, because everybody is being super cautious and risk-averse, as the economists put it. It's not that the secretary of the Treasury, new or old, or chairman of the Federal Reserve, can stand up, in words of one syllable and say, "All is forgiven. Go right ahead." Indeed, they actually need to try to convey that notion as much as they can and that they're not about to lower the boom the day after tomorrow on all aspects of credit extension in the United States.

Steve Weisman: So, in conclusion, your expectation would be that the G-20 leaders will probably forbear in their spring meeting and focus more on some of the other more urgent matters.

Edwin M. Truman: That would be my hope and expectation. And my guess is that these are all urgent matters that have risen further up the agenda because of the economy and the need for financing for the International Monetary Fund. And, also on the other side, I hope they recognize that there is some downside to talking about reforms. Moreover those reforms are all going to take years to put into place, and the loss of six months in that process is not going to set back the growth of the global economy over the next century.

Steve Weisman: Ted Truman, thank you very much for walking us through that. We'll have you back as the process heads forward. Thanks again.

Edwin M. Truman: My pleasure.