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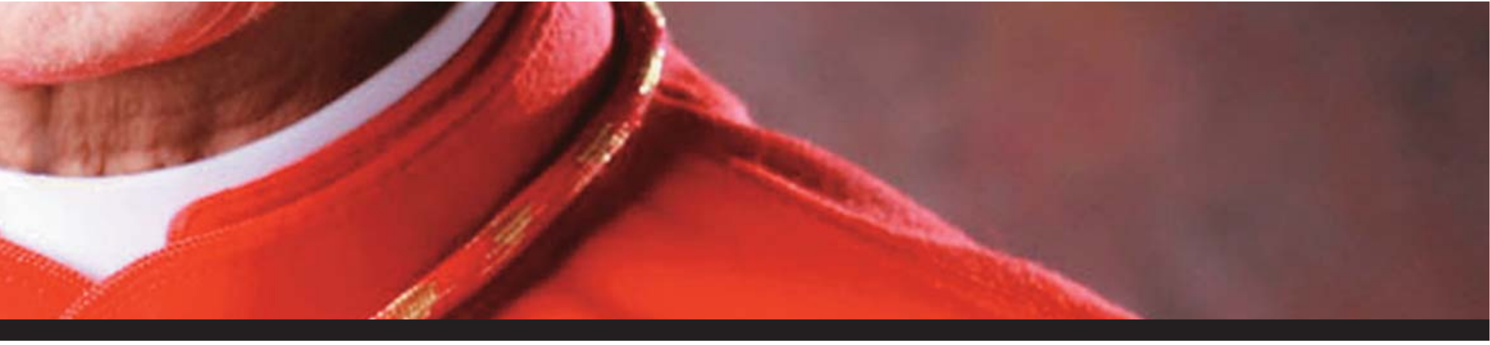
EDITORIAL

The turbulence that has shaken the international banking and financial system since August 2007 has forcibly called to mind questions which have been debated in economic history and theory for centuries: Are financial crises inevitable? Are they impossible to predict? Are they manageable? These questions today are usually answered within the context of the present phase of financial globalization, often seen as the first and sole cause of the inevitability of crises, of their unpredictability and the impossibility to manage them. Economic history teaches that crises are probably inevitable because they derive from permanent traits of human nature, such as greed and the desire to accumulate riches (the abominable hunger for gold – auri sacra fames – mentioned by Virgil in the *Aeneid*) which lead to irresponsible behavior and resulting blindness to risk. Yet, for this very reason, history makes clear that financial crises are generated independently of the structure of the banking and financial system of the day. There is no scarcity of examples; one can read Charles Kindleberger's *Manias, Panics and Crashes*, which has enjoyed five editions since its first publication in 1978, and find a vast selection: beginning with the first case of international insolvency in 1343, when King Edward III of England refused to honor the Crown's debt and thereby caused the bankruptcy of the Florentine banks of the Peruzzi and the Bardi; then there were the speculative "bubbles" of 1700; and so on to the crises of the XX Century, especially those of the 30s and 90s. Thus there have always been crises, but it is interesting to observe that after 1870 the international financial system saw two periods of overall stability, both featuring strong monetary anchors: the period of 1870-1914, which historians now refer to as "the first globalization" and coincides with the system of the gold standard, and the period from 1947-1970 which saw the operation of the Bretton Woods system of "fixed but adjustable" rates of exchange tied to the value of gold and the dollar. In comparison, there have been serious and repeated monetary and financial tensions during two periods featuring diametrically opposed configurations of the economic and financial system: the period between the two world wars (1919-1939) in which autarchy, trade restrictions and competitive devaluation of currencies signaled "the end" of pre-war globalization and spread depression and unemployment on a worldwide scale; and the period from the mid-80s to the present, that of the "second globalization", where deregulation, liberalization of capital movements and



fluctuation of the exchange rates of major currencies prevail. If global finance is not to bear the blame for the recent financial turbulence, it is also true that innovation in finance and the revolution in information and communications technologies have contributed in multiplying and intensifying episodes of financial instability and of facilitating their spread on the international plane. In effect, thanks to the opening up of the world's commerce in goods and services, globalization has, on the one hand, helped to reduce global inflation to historically very low levels, with the consequent reduction in the rates of return of financial investments; on the other, due to increasing competition among operators in the sector, it has provided a strong push toward the reduction of margins for financial mediators. This has urged both investors and brokers to go in search of ever riskier ventures, such as those in emerging countries, of structured financial products or highly speculative operations, in the prospect of earning greater returns than those offered by the traditional instruments for managing savings. Global finance has in a certain sense facilitated these options by creating the illusion that the abundant liquidity of the markets would make it possible for anyone to opt out of an investment that had become too risky

__While global finance was not responsible for the recent financial turbulence, the interaction of financial innovation and new information and communication technology made its international spread easier

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without difficulty or loss. In reality, as the credit crisis in Latin America, Asia and Russia has shown, from the speculative bubbles in Japan and in the United States up to the recent crisis in the sub-prime mortgage markets, conditions of ample liquidity in financial markets can suddenly be transformed in situations of lack of liquidity, thus generating a "rush for the exit" in which investors and brokers suffer enormous losses.

Unpredictable crises?

Consequently, if financial upheavals constitute a kind of "natural calamity" that cannot be avoided, it should at least be possible to predict them with enough warning to allow people at least to take an umbrella when they leave the house. In fact, the predictive capabilities of financial authorities, of central banks and international institutions have grown prodigiously with the spread of globalization; it is now possible to isolate with a certain amount of precision the risk factors and the conditions that make the trends of certain economic and financial variables unsustainable over time, thus increasing the probability of an acute crisis. It would be pointless here to cite all the cases where official warnings have been voiced in various national and international venues regarding the unsustainable foreign debt of important emerging countries, the deficit in the United States balance of payments, and the boom in the prices of shares and real estate. Even in recent times all the public and private analysts agreed that the overabundance of liquidity in global markets had given rise to an undervaluation of credit risk and to its inadequate cover by the ever decreasing margins of intermediaries: the warning was aimed against the possibility of a brusque re-pricing of credit risk, alongside a brusque reconfiguration of portfolios with likely destabilizing repercussions for intermediaries and investors. Moreover it is difficult, as Governor Draghi has recently reminded us, "to predict the moment the market chooses to give way to a crisis; the exact forms this will take; and the decisive connections for its propagation". This is what happened in 2007 with the crisis sparked in the sub-prime mortgages sector.

Analysts had agreed that the deterioration of the American real estate market, already in sight at the beginning of the year, would certainly have had repercussions on the limited sub-prime sector, but they believed that this would not have created problems for the much wider mortgage market. In reality, the problem became increasingly complicated as it became clear that through the process of securitization, sub-prime securities had found their way into a wide spectrum of structured financial products, diffused in capillary fashion within investor portfolios. The perception of the risk of these instruments suddenly became very acute, and they immediately lost their liquidity and therefore became difficult to price. As often happens, this had an "alarm clock" effect on financial operators, giving way to an examination of the positions at risk over the entire range of securitizations effected by the major international banks, often through the use of "vehicles" or conduits with no legal connection with the issuing institution. This generalized reduction of the risk appetite has caused a crisis in the model of mediation that has become prevalent recently, on the basis of which the banks finance a decreasing number of risks that stay in their portfolios until expiration, but limit themselves to organizing for their clientele securitization operations in which the risk is immediately transferred to the market (originate and distribute). Under these circumstances the major banks had to face an unexpected ballooning of their balance sheets caused by the impossibility of transferring to the markets assets acquired with a view to their securitization, and by the necessity of financing the "unsold" positions of their respective conduits. The paralysis of the financial marketplace has given rise to tensions in the short-term inter-bank liquidity market where, even in the presence of not inconsiderable injections of liquidity on the part of the central banks, the operators were reluctant to grant it given the uncertainties regarding the solidity of their eventual counterparts. Although the crisis has not yet caused situations of acute lack of liquidity or insolvency on the part of important intermediaries, there is no doubt that it has spread well beyond the sub-prime sector where it began and has had vast repercussions on monetary and financial markets.

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Unmanageable crises?

Since crises are inevitable and unpredictable, it is an increasingly difficult and ungrateful task for those called to anticipate and manage them. After the debtor crises in emerging countries, which had resulted in repercussions even for financial markets in the most advanced countries – particularly with Russia's default in 1998 – the international community undertook a process of robust reforms of the so-called "international financial architecture". With the political support of the G-7, the International Monetary Fund (IMF), the World Bank (IBRD) and the International Regulations Bank have created a far-reaching program of technical and financial assistance aimed at adjusting the internal and external imbalances and at strengthening banking and financial systems in developing countries. In 1999 the

G-7 also set up a coordination round-table – the Financial Stability Forum (FSF) – among finance ministers, central banks and market watchdog authorities in the Group countries and tasked them to identify the structural weakness and vulnerability of the global financial system. Participating in the work of the FSF, headed by the Governor Draghi of the Bank of Italy, also took part the European Central Bank and the central banks of Australia, Hong Kong, Holland, Singapore, Switzerland , and the representatives of the major international institutions (IMF, IBRD, OCSE, BRI) and of the international financial regulatory committees (BCBS, IOSCO, IAIS, IASB).

The initiatives have certainly contributed positively to international financial stability. The overall situation of developing countries has clearly improved both with regards to reorganization of the imbalances, and the strengthening of banking and financial systems. In addition to the extraordinary performances of China and India, there has also been considerable improvement in crises stricken countries like Mexico, Brazil, Korea, Thailand and Russia. Fears that Argentina's default in 2001 might pave the way for a series of unilateral defaults involving the foreign debt of developing countries have proved to have been unfounded. Nor does it seem that these countries have been affected by the turbulence coming from the sub-prime sector.

Regarding the functioning of the global financial system, the FSF involvement initially centered on the analysis of the role of hedge funds in the monetary and financial turbulence of the 90s; the hedge funds have often been accused of having mounted speculative operations against countries with fixed rates of exchange; the FSF has further intensified its monitoring of off-shore financial centers, which were held to be responsible for hosting the speculative operations, including recycling and tax evasion. These endeavors also brought overall positive results in this sector, as demonstrated by the fact that the recent turbulence sparked in the sub-prime market has no connection whatsoever with the operations involving hedge funds and off-shore centers. In any case, the analysis of the exposure of banking systems with regard to hedge funds has permitted a closer view of the counterparty risks and of their management by credit intermediaries, as well as increased the focus on issues relevant to an examination of the implications for monetary and financial policies raised by the present phase of turbulence.

Despite these improvements in the institutional architecture of analysis, of supervision and of regulation, the capacity of the international community to forestall crises has once again proven inadequate with regards to the tensions that surfaced last August

and that now have been spread through unpredictable channels with unusual modalities. This posed an immediate challenge to the structures set up to manage the crisis, and from the very start called for the central banks of the major monetary and financial centers to guarantee markets the liquidity necessary to continue functioning as usual. By a closely concerted effort, the American Federal Reserve, the European Central Bank, and the central banks of Japan, England and Switzerland have effectively fought the risk of lack of liquidity of the global inter-bank market thus preventing the process of reorganization of portfolios and the re-pricing of risks from degenerating in situations of insolvency with implications for the stability of the global financial system. These measures were particularly needed to overcome the traditional need for liquidity toward year-end which risked being exacerbated by the uncertainties of the impact of the crisis on the balance sheets of the major banking and financial intermediaries. The uncertainties can only be wholly dispelled in the coming months, when the corporate balance sheets for 2007 are certified and approved. This process is complicated by the difficulties of arriving at a fair valuation of complex financial products for which there is no available mark-to-market method, considering their lack of significant market quotations.
On the strictly regulatory plane, as of last October the FSF has been given a mandate to carry out a complete analysis of the cause of these tensions, to point out the weaknesses requiring corrective measures and to make the necessary proposals for measures to strengthen market discipline and the solidity of institutional structures. One special working group chaired by

_Working in close contact with each other, the ECB (under president Trichet) and the Japanese, UK and Swiss central banks countered recent crises at the global level

Governor Draghi has already identified the principal lines of involvement:

1. the management of risk on the part of intermediaries, with particular reference to liquidity and counterparty risk;
2. the principles and practice of the valuation and capitalization of complex financial products, with special reference to posting obligations and risks outside the balance sheet;
3. the role of rating agencies in the development and commercialization of structured financial products, with particular attention to possible conflicts of interest.
4. the need for prompt implementation of the Basel 2 principles, so as to permit a complete evaluation of the opportuneness of modifications in light of the recent tensions.

In mid-February the FSF will present its provisional report on the situation to the G-7, while the final report will have to wait for the IMF spring meetings in mid-April.

What lesson

It is difficult to predict how the global monetary and financial conditions will evolve in coming months. While it is true that tensions have been relaxed somewhat in the inter-bank market, especially in the United States we are beginning to see signs of the repercussions of the financial and real-estate market crisis on the real economy. Some observers take it for granted that the American economy will enter into recession in the second and third quarters of 2008, and this would have a negative impact on growth in Europe and in the rest of the world economy. Notwithstanding sustained growth in developing countries, headed by China and India, the gap in their respective dimensions makes it improbable that the developing economies can grow at rates such as to compensate for the slowing down of industrialized economies. The management of the crisis will be rendered even more complicated by the risk of inflation pressures, mostly generated by the increase in the price of petroleum, of raw materials and foodstuffs. Central banks both in the United States and Europe cannot ignore this factor in the formulation of their monetary policy. With regard to banking systems, we can assume an increase in the need for capital on the part of intermediaries which have experienced an unexpected ballooning of balance sheet assets and/or have suffered significant losses on account of the crisis. In these circumstances, we have seen an unexpected source of support in some cases from investment funds controlled by sovereign States, which have poured into these new agents their excess currency reserves accumulated by the surplus in their current balance of payments. In many cases these are operators whose investment strategies are far from clear and who lack transparency and accountability. The tensions of the moment must not be allowed to obstruct the continuing dialogue among these operators and international monetary and financial authorities for the purpose of stipulating adequate standards for management and communications. In any case, needed relief for the lack of capital may come from the prompt activation of the risk management strategies called for by the Basel 2 accords.

The uncertainty still oppressing the development of the international economic and financial system makes it difficult to draw the final lessons of this new and complex period of crisis. Nevertheless, we can anticipate two orders of considerations:

– On the macroeconomic scale, the crisis developed within a context characterized by an excess of liquidity on the monetary and financial markets that fed an excessive expansion of credit, especially in the real estate sector. These trends developed against a background of imbalances in the payments of the major world economic zones, in particular with respect to the United States and China that gave rise to uncertainties in the exchange relationships of the major currencies. In the future the monetary and financial authorities must inevitably pay greater attention than in the past to the implications of the credit cycle with respect to monetary and financial stability. Though there may be stability in the prices of goods and services, an excessive growth of credit may foment a rise in the price of financial and real estate activity with destabilizing effects for the financial system and long term risks of generalized inflation. Recent increases in gold and petroleum prices reflect fears of the resumption of inflation and of an unstable dollar. In perspective there is a need to reinforce the analysis of the impact of the effects of monetary policy by the central banks of major countries on the orientation of the global financial market. This will necessitate both increased cooperation among central banks and market watchdog authorities, and more effective supervision on the part of the IMF over international streams of liquidity and on the evolution of exchange rates among the major currencies.

– On the level of financial regulation, to deal with predictable requests for the introduction of new restrictions and controls, it will be important instead to follow up on what has already been accomplished and ongoing work by the FSF. It will also prove necessary to strengthen cooperation among watchdog authorities and banking and financial operators at the level of individual countries. In a global financial context, only a constant and detailed dialogue among regulators and those who are regulated can result in rules that will not stifle the operability of markets, and can at the same time make it possible to identify market failure situations in a timely manner, so that the authorities can intervene and provide for the "public benefit" of monetary and financial stability.