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GROWING OUT OF THE CRISIS THROUGH PRUDENTIAL REGULATION OF LARGE FINANCIAL INSTITUTIONS AND REDEFINED GOVERNMENT RESPONSIBILITIES

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An economic recession produces its share of negative consequences: drops in the value of retirement funds, declines in the worth of real estate assets, lower corporate profits, increases in public sector debt and in structural government deficits, and so forth. However, the most perceptible impact is unquestionably the job losses and the drop in the value of human capital that are typical, if not inevitable, results of an economic recession.

This paper covers different aspects of the financial crisis and economic recession which officially began in late 2007: the main events, an analysis of possible causes, including the loss of confidence within the financial system, particularly in interbank financial relations, which helped precipitate the financial crisis and later the economic recession. The *coup de grâce* came when interbank lending, which lies at the heart of the financial system, was thrown into disarray by the fact that the banks were no longer showing confidence in each other: bank managers suspected or found out that risks were as badly managed in other banks as they were in their own!

To re-establish confidence, four issues had to be tackled then and must again be addressed now: the manipulation-falsification of information by public organizations and private companies regarding risks; the indulgent attitude of regulators toward government-sponsored enterprises, Fannie Mae and Freddie Mac being the most notorious; major (well known) flaws in performance incentive programs; and finally, the inflexible application of the mark-to-market accounting rule.

Some facts: (1) The American economy has continued to create an impressive number of jobs (more than 6.6 million jobs on average per quarter) during the recent recession - the nine quarters from 2008.I till 2010.I - even if it lost an even larger number of jobs (more than 7.6 million on average per quarter). During the "normal" pre-crisis and post-crisis periods (more than 16 years of observations), each net job created was the result of 20 jobs created and 19 jobs lost. In comparison, the number of jobs allegedly "created or saved" by the U.S. recovery plan is relatively negligible and one can wonder if government efforts were properly oriented. (2) All the major banks and many of the smaller ones have now paid back the full amount loaned to them by the U.S. Treasury; the 10 largest banks paid the Treasury a total of $25 billion in interest, dividends and fees on the amounts disbursed. Two major ones remain on the hook: AIG with a positive outlook, and the tandem Fannie–Freddie with a negative one.

In conclusion, I offer four main recommendations. First, refocus the role of governments on rebuilding and maintaining confidence, on developing conditions favourable to creative destruction, and on building a competency in taking the economy out of a stable bad equilibrium. Second, favour the development of new institutions and instruments, mainly finance and insurance based, aimed to facilitate adjustments by firms and individuals to endogenous and exogenous shocks in their socio-economic environment, including the inclusion of clauses in mortgage or other contracts to allow for continuous adjustments to economic conditions in case of recession or crisis, thereby avoiding sudden cascading adjustments that only aggravate poor economic conditions needlessly. Third, various microprudential and macroprudential regulatory rules should be implemented over the coming years. Fourth, growing out of the crisis would benefit in the longer run also from efficiency-prone fiscal reforms (abolish income taxes on individuals and corporations in favour of generalized consumption taxes) and redesigned competency-based roles for the government sector and the competitive sector.

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