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Catastrophic Failures in Risk Management, 2:
The Never-Ending Global Financial Crisis

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With increasing frequency comments on the ongoing sovereign debt crisis in Greece and the euro zone include a reference to the need to avoid a repeat of the collapse of the investment bank Lehman Brothers in September 2008. The basis for this otherwise puzzling comparison is the concept of "contagion," that is, cascading failures in the financial sector – the "falling dominos scenario" – which once started with a single "event" cannot be halted, by any means currently at our disposal, until other (perhaps many other) large losses occur. Here is an account from today's *Globe and Mail* (Eric Reguly, "French banks seek support for Greek debt rollover plan, pp. B1, B14):

"The [debt rollover] plan is voluntary, though euro zone governments are putting enormous pressure on their banks to contribute to the rescue package for fear that Greece's inability to pay its debt charges would trigger a second financial crisis. 'If it wasn't voluntary, it would be viewed as a default, with huge risk of catastrophic results,' [French President Nicolas] Sarkozy said.... Josef Ackermann, chief executive officer of Deutsche Bank AG, said [that the] Greek debt crisis, if not contained, would reverberate through the European and global economies. 'If it's Greece alone, that's already big,' he said. "But if other countries are drawn in through contagion, it could be bigger than [the 2008 collapse] of Lehman,..."

How did we get ourselves into this mess? In my 2010 book, *The Doom Loop in the Financial Sector, and Other Black Holes of Risk*, I sought to show that the 2008 global financial crisis had its roots in three key developments:

(1) a quarter-century of systematic deregulation of the banking sector, primarily in the U. S. and the UK;
(2) a failure to oversee the markets in novel financial instruments (derivatives and securitization) as they exploded in size and global reach during the first decade of this century;
(3) a deeply flawed conception of risk management in the financial sector, which failed to recognize and assess systemic risk.

In addition, I referred to an accompanying serious policy mistake, namely, the erroneous belief (motivated by ideological principles) that "asset bubbles" – in this case, soaring valuations in home values in the U. S., Ireland, and Spain – could not be controlled, a belief shown to be false in the book by George Cooper (2008), *The Origin of Financial Crises.*

As a result of these errors, the countries of the developed world were "blindsided by risk" in 2007-2008, and those countries have suffered immense and, to some extent,

immeasurable levels of losses that are still ongoing. They have also added huge new quantities of sovereign debt to their national balance sheets. The major institutional actors in the banking sector maintain that no one could have foreseen these consequences and thus that they could not have been prevented. This is a self-serving lie and has been exposed as such. Those who doubt this should read, among other good sources, Richard Bookstaber's *A Demon of our own Design* (2007) and Gillian Tett's *Fool's Gold* (2009).

The fact of the matter is that these selfsame actors in the banking sector, along with their friends in the political sphere, had colluded in the dismantling of essential regulatory structures that had been put in place after the experience of the Great Depression. They destroyed the career of a woman who foresaw the disaster of failing to regulate the derivatives markets. The result was to unleash a decade of reckless risk-taking that enriched them enormously and left huge bills to pay for future generations.

The European sovereign debt crisis is Round 2 of the unravelling of this reckless risk-taking. It illustrates a fundamental fact about our newly-globalized economic and financial sectors: namely, that as risks in some sectors (such as environment and health) are more strictly regulated, we continue to simply overlook emerging risks in other sectors, with catastrophic results. What were the brilliant minds at the European Central Bank, and in the finance ministries of the dominant European economies, thinking when they created a monetary union unsupported by a fiscal union? What were they thinking as they watched smaller countries such as Greece, Ireland, and Portugal run up enormous new levels of debt – at the same time as their economies were falling behind in economic productivity terms (on the basis of which the debt has to be repaid at some point)? What were they thinking when, through the new monetary union, they foreclosed the option for single nations in Europe to default on their sovereign debt (as Argentina did in 2002) without threatening a larger cascade?

Others helped, to be sure, especially Goldman Sachs, which made hundreds of millions in fees aiding the Greek government hide the true level of its sovereign debt: see Louise Story and others, "Wall Street helped to mask debt fueling Europe's crisis," *The New York Times,* 13 February 2010.

Now a grand game is being played out, one which will not have a happy ending. The Europeans cannot allow Greece to default because of the contagion risk. But the Greeks themselves will *never* be able to repay the full value of the debts they have already accumulated, much less those they expect to incur with the second EU bailout later this year and next. The game being played is to pretend that Greece is solvent; it is not solvent and cannot become solvent again with the remedies that are on the table. Even if the Greeks accept the medicine that has now been offered to them (wage cuts, privatization of national assets, etc.), and even if they were to actually able to carry out these measures (a highly dubious proposition), they still will never be able to repay their debts. But the European game is to pretend that the Greeks can and will, so that their national banks, holding great quantities of this paper, can avoid recognizing the huge losses they are sitting on.

The global financial crisis that erupted in 2007/8 may run for a decade or more, piling up catastrophic levels of losses for many nations and peoples. (One part of the economic fallout is the high levels of permanent unemployment of young people in the U. S. and many European countries.) By the time it runs its course most of the world's developed economies will be up against the wall in terms of debt-to-GDP ratios, which will severely constrain both their future economic growth and their ability to fund essential social programs. And the worst part of it is, none of this needed to happen.

This was a preventable tragedy. Any rational assessment of risk in the banking and financial sectors at the end of the last century, using techniques that were well in hand more than a decade ago, would have concluded that imprudent levels of risk-taking were being contemplated. But the powers that be, in the political and economic sectors, decided to roll the dice. They did so without having the faintest notion of the real risks they were running. And so, despite all the sophistication in risk management that we have developed in the past 50 years, once again we were blindsided by risk.

Many citizens around the world are paying a high price for this irresponsibility, and will continue to pay for a very long time. If we go on acting like this, future generations will have plenty of time in which to contemplate the ruination of the economic wealth once possessed by their predecessors, because they will have little else to do.

For ongoing expert commentary on the global financial crisis, two indispensable Internet resources are:

(1) "The Baseline Scenario," by Simon Johnson and James Kwak: http://baselinescenario.com/

(2) Commentaries by Christopher Whalen: http://www.rcwhalen.com/

See also the accompanying PPT: William Leiss, "Blindsided by Risk" (2011).