High-Risk Summer

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Summer lassitude is no guarantee against financial madness, as was illustrated last year. When the market went haywire at the beginning of August, blackberry-wielding financiers and central bankers had to get a handle on the crisis from the beach.

Since then, winter bowed out with the dramatic fall of Bear Stearns, spring was rather quiet, and tension is mounting again in this early summer time. Interbank markets have never returned to normal since almost a year ago.

It would be hazardous to forecast now about what will happen to the cost of risk, the price of oil or the future level of growth.

But among all the risks, one appears to be getting worse by the day: that of counterproductive public decisions made under intense political pressure.

Even though the worst is never certain to happen, political risk might well become a factor to be reckoned with in the next stages of a financial crisis which will be with us for some time yet.

Two recent cases illustrate this new dynamic. Both involve policymakers whom the markets had not until recently suspected of adopting ideological positions.

On 13 June, the UK Financial Services Authority unexpectedly and without prior consultation introduced disclosure requirements designed to restrict short selling of shares in the context of new rights issues, with almost immediate effect. The decision took place in an environment of tension surrounding the capital of UK banks and especially of the biggest mortgage lender, HBOS.

Three days later in Dublin, and equally out of the blue, Charlie McCreevy, the European Commissioner responsible for financial services, announced a decision to submit rating agencies to European-level regulation. This unprecedented move was made against the opinion of various groups of securities regulators, whom the Commissioner dismissed with unusually strong words.

The two initiatives may appear rather benign, especially in France where hedge funds, which do most of the short selling, are loathed across the political divide, and where rating agencies are also lambasted routinely.

But they represent a surprising doctrinal about-face from two key players of the regulation of financial markets in Europe and particularly in their now-undisputed hub, the City of London.

In 2002 the then chairman of the FSA made it clear that he saw no valid reason to restrict short selling. Commissioner McCreevy, for his part, had been consistently cultivating a brand of regulatory minimalism.

The two initiatives have other features in common. Both stem from diminished authorities: the FSA following its poor showing in the Northern Rock saga, and the Commissioner because of his scant legacy after four years of a term of office now nearing its end.

Most of all, both rushed decisions aim to give the public and the media the impression that authorities are 'doing something', but the underlying technical analysis remains unclear at best. If these decisions are designed to play to the gallery rather than being based on a proper assessment of their future impact, they are unlikely to be of any benefit to markets.

Such developments are a cause for concern, not so much for their direct and immediate consequences but on account of the change in mindset which they point up.

Public regulation is crucial to ensure the orderly operation of financial markets. As the Victorian-era journalist and businessman Walter Bagehot noted in his essay *Lombard Street*, 'Money will not manage itself.' Financial markets require public supervision in order to efficiently serve the broader economy.

But in order to fulfil its purpose, regulation must be credible and targeted. Failing this, it cannot enhance trust and play its protective role. If regulatory initiatives are conceived primarily as short-term public relations, they will only cause trouble.

In crisis periods more than ever, public authorities must avoid creating the impression that they are falling prey to a temptation to move the goalposts – whether to help particular players, such as the FSA with HBOS and other cash-strapped banks, or to respond to political pressure by identifying scapegoats, as in the case of rating agencies.

By and large, supervisory and regulatory authorities so far have reacted to the crisis in a calm and collected manner. The report published at the beginning of April by the Financial Stability Forum, consisting of the key authorities under the current chairmanship of Bank of Italy Governor Mario Draghi, succeeded in achieving a fine balance between being pro-active in its response to the crisis and at the same time sober and technically sound in its proposals for action. The same applies to the work led at the international organisation of securities commissions (IOSCO) by France's Michel Prada on rating agencies.

Continuing this measured approach will be a crucial factor in how events unfold, in spite of growing political pressure resulting from the deteriorating business cycle, a deficit of public leadership in Europe, and the US election campaign.

Markets will undoubtedly provide their share of nasty surprises in the coming months. Public authorities should aim at reducing their impact by keeping their cool, by taking account of the mid-term effects of their decisions, and by steering clear of rushed and ill-prepared moves.

As France embarks upon its six-month presidency of the European Union, one can only hope that France's leaders will have the wisdom to heed this imperative.

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