Don't throw out the baby with the bathwater

The world is in quite a state. Financial markets have been distressed for the last year and a half. It started in the United States. The *All American Dream*— everybody owning his own home— should become achievable also for low-income families. Betting on a further surge in house prices, banks were prepared to grant them loans, and with the benefit of hindsight we have seen that few bankers and intermediaries seemed to observe the rules for prudence and decency in pursuit of profit. In the end, the dream vanished under the collapse of house prices.

What started as a small fire evolved into in worldwide firestorm. The 'firemen' that worked overtime until the 15th of September (when Lehman Brothers announced bankruptcy) have since then simply been unable to supply the hours. Banks failed, stock markets collapsed. And European banks turned out to be all but immune to these problems. The flammable materials that needed only a sparkle to ignite this fire are known: faulty incentives for rating agencies and bank managers, the originate-and-distribute model, overly complex financial products traded on over-the-counter derivative markets, and unregulated hedge funds. Their precise interaction in the spread of the fire will remain subject to debate for some time.

In meantime, however, the world is desperately seeking somebody to bear the blame for this disaster. The prime suspect is obvious: markets, in general— and the financial market, in particular. They weren't popular, anyway, in major parts of the world, which makes things easy. Let there be no misunderstanding: financial markets are the source of this crisis. Banks have an inherent tendency toward excessive risk taking, a tendency that must be curbed by supervision. This supervision hasn't delivered what it was supposed to do— either in the United States or in Europe. Improvement is urgently needed.

However, this does not mean that we can do without financial markets. The market may currently be closed, but after a while we'll be looking for some new investment projects. Otherwise, technological innovation will come to a complete standstill. These projects require capital for take-off— capital that somebody has to provide. Cross-country research clearly shows the importance of capital markets for innovation and growth. Projects can get funding on various segments of this market: bank lending, venture capital, stock markets, or private equity. All of these have their pro's and con's. If our recent experience leads us to distrust one segment, we can to some extent substitute another. For example, if de-leveraging is needed, as many observers claim, then the role of bank lending must decline. But then, inevitably, stock markets and perhaps private equity will become more important— and they don't seem to be very popular today, either.

Sooner or later, the worst of the dust will settle and capital markets will slowly begin once again to fund new projects. But first we've got to repair the damage, develop some new rules and improve international supervision of financial markets. Financial markets, with all of their unpleasant, even negative, aspects, will always be with us. We can't do without them. In the midst of all of our zeal for reform, let's take care that we don't throw the baby out with the bathwater.

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