# Can a Collapse of the Global Financial System Be Prevented?

*Campbell Harvey is J. Paul Sticht Professor of International Business at Duke University's Fuqua School of Business. After studying economics and political science at the University of Toronto and MBA studies at York University, he chose the University of Chicago for his formative Ph.D. studies. Harvey's Ph.D. research examining the effect of interest rates on the United States' business cycles enabled him to predict the recessions of 1990, 2001, and 2008. He also pointed out that standard approaches and finance theory in developed markets should not be applied to the analysis of many developing countries, proposed new ways of dealing with the special challenges of emerging markets, and examined how opening financial markets to foreign investors can lower the cost of financing and increase investment and GDP growth in developing economies.*

by **JOHN MILLIGAN-WHYTE**

At the World Economic Forum in 2005 Professor Campbell Harvey warned Senator Richard Shelby, chairman of the U.S. Senate Banking Committee, "We're going to have a massive crisis unless you do something." Harvey told him, "These banks are incredibly profitable and because they're running like hedge funds. They're using these cheap deposits to finance incredibly risky activity."

Harvey emphasizes, "A large part of this crisis is what we call in economics moral hazard where you have got the incentive to take a huge bet." "The U.S. government has lent, spent or guaranteed as much as US$12.8 trillion to rescue the economy" according Bloomberg News. He warns that low interest rates, which allowed banks to make huge profits, now only exacerbate the global financial crisis.

### Reenact Glass-Steagall Act

On December 2, 2013 Senator Elizabeth Warren warned, "The four biggest [American] banks are 30 larger than they were five years ago. And the five largest banks now hold more than half of the total banking assets in the country." Senator Warren and John McCain have called for a reenactment of the Glass-Steagall Act. It's repeal in 1999 allowed depository institutions to undertake risky securities trading."

According to the Atlantic article, "A parade of former high-ranking executives has called for bank breakups, tighter regulation, or a return to the Depression-era Glass-Steagall law, which separated commercial banking from investment banking.

### Implement and Enforce the "Volcker Rule"

The Wall Street Journal reported on December 9, 2013 that, "The so-called Volcker rule will put in place new hurdles for banks that buy and sell securities on behalf of clients, known as market making, and will restrict compensation arrangements that encourage risky trading. Five U.S. financial regulatory agencies are expected to approve the rule, which bans banks from making bets with their own money and limits their ability to invest in certain trading vehicles." It is urgently needed.

### Implement Derivative Regulation Globally

Before the financial crisis, from within government, Brooksley Born, head of the Commodity Futures Trading Commission warned of the potential for economic meltdown and campaigned for the regulation of the multi-trillion-dollar derivatives market whose crash helped trigger the financial crisis. But, Federal Reserve Chairman Alan Greenspan, Treasury Secretary Robert Rubin, Assistant Treasury Secretary Larry Summers advising President Clinton and Congress succeeded in preventing such regulation.

"Without significant regulatory reform, our financial system will be exposed to continuing dangers and repeated crises. No federal or state regulator has market oversight responsibilities or regulatory powers governing the over-the-counter derivatives market or indeed has even sufficient information to understand the market's operations. The market is totally opaque and is now popularly referred to as 'the dark market.' "

### Seek Truth in Facts

Alan Greenspan says, "Why was virtually every economist and policymakers of note so blind to the coming calamity? I have come to see that an important part of the answers to those questions is a very old idea: 'animal spirits'.... The trouble is that such behavior is hard to measure and stubbornly resistant to any systematic analysis."

Harvey was able to foresee the financial crisis by using his interest rate model. The Duke/CFO Magazine Global Business Outlook Survey has been polling thousands of CFO's worldwide and assembling the survey results economic, financial and business indicators.

### Can the "Once Bitten, Twice Bitten Problem" be Solved Before the Second Bite?

William White warned Greenspan and other central bank heads of the coming financial crisis since 2003. White was the chief economist of the Bank of International Settlements owned by fifty-five central banks that meets in Basel every two months. "White wanted central bankers to take things a step further by preventing the development of bubbles and taking corrective action. He also advised the banks to beef up their reserves during a recovery so they would be in a position to lend money in a downturn. If White's model had been applied, it might have been possible to avoid the collapse of the financial system, " according to an article Der Spiegel Online.

Warnings from bright stars about the black holes of finance in the parallel universes of regulation and politics were not strong enough to prevent the financial crisis. The horrible economic impact of the crisis on billions of people is not strong enough to prevent the now foreseeable catastrophic implosion of the global financial system. That has to change. So what happens now?