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Walking the talk: *At Davos, it was clear that progress was being made in terms of the financial sector. The biggest problem though is the debate is often bogged down by complex issues and the desire for global agreement*

Davos – realism replaces pessimism

There was caution about the near-term and about challenges facing advanced economies

By **GERARD LYONS**

THE mood at Davos last year was pessimistic. This year, it was realistic. It will have to wait until next year to become optimistic. This year's annual gathering of the great and the good at the World Economic Forum's annual event in Davos was themed, "Rethink, Redesign, Rebuild". There certainly was much rethinking and redesigning; now this needs to be followed through in the rebuilding. Sustainable recoveries certainly need sound foundations. This is particularly so with respect to the financial sector.

The realism seen at Davos was reflected in most views expressed about the world economy. In particular there was caution about the near-term and about challenges facing the advanced economies. There was also realism about addressing some of the current issues, particularly those related to the banking and financial sector.

Debate about the banking sector formed only part of Davos 2010, but it was a significant part, and was enough to steal most of the headlines. The announcement of the Volcker Plan by President Obama on the eve of this year's Davos meant the banks were even more of a hot topic than they were already likely to be.

The Volcker Plan effectively invokes the spirit of the Glass-Steagall Act that previously existed to separate commercial and investment banking. Although not aimed at reintroducing that act, the aim is to avoid a situation where taxpayers take the downside risk, whilst financial firms get the upside.

The present debate on banks appears to be following two strands. One is led by the "technocrats" or regulators, with much input from the bankers themselves. And the second is driven by politicians in response to the public mood.

There was some attempt at Davos to reconcile differences. One common theme in both debates is the desire to address systemic risk, and thus improve the workings of the financial system. Although there are many areas of overlap, the focus of both debates continues to be different, and this was evident to some extent in Davos.

The public debate has been heavily driven in recent months by a focus on compensation and the structure of banks, particularly the issue of size and "too big to fail". Both issues are important, there is no doubt about that.

Yet, the technocratic debate focuses on factors that are probably of more importance in the long run: capital and liquidity. Banks need to be well capitalised and liquid. Those that did well in the crisis were.

There is a need for risk-adjusted capital ratios that apply over the course of an economic cycle aimed at ensuring conservatism on behalf of banks as well as a buffer to cope with shocks. Trouble is, a lot is being asked of capital. More and better quality capital may thus be seen as a necessary, but not sufficient, condition to improve the future foundations of banking.

Liquidity, too, is seen as a key issue, and rightly so. But even here there are still issues, including what can be defined as liquid assets and how to reconcile the management of liquidity centrally and locally within institutions.

The announcement of the Volcker Plan also seemed to go against the desire for a common, G-20 approach. Whilst there is no doubt that countries need to be able to refine proposals to suit local circumstances – economic and political – some common international ground rules are needed, and indeed are being sought.

This is vital in the area of cross-border resolution frameworks, regulation and – an area stressed many times in Davos – international accounting standards. The financial crisis highlighted a systemic failure in the system. This needs fixing. Yet, it is often overlooked that much within the financial system did not break, even in the City of London where damage was high.

Furthermore there are probably many lessons from countries whose financial sectors appeared more intact, with Australia, Canada and even Israel and Turkey cited in this respect at Davos. One common theme – apart from conservatism – was effective supervision. Also, other economies including China, India and Hong Kong benefited from effective policy measures, such as reserve requirements or, in the case of Hong Kong, loan-to-value ratios on mortgage lending.

This is an important lesson. If the aim is both economic and financial stability – which it should be – then two policy objectives require two types of policy tools.

Monetary and fiscal policy should be directed to economic stability of ensuring growth and avoiding deflation in the West or inflation in the East. In turn, macro-prudential measures should be aimed at preventing asset bubbles.

For emerging economies, managing capital inflows or asset bubbles in this recovery will be a big challenge. Whilst the challenges facing emerging economies did not figure as a big concern at Davos, for some, myself included, many emerging markets do face a big challenge this coming year, particularly in terms of how they handle such capital inflows.

At Davos, it was clear that progress was being made in terms of the financial sector. The biggest problem though is the debate is often bogged down by complex issues and the desire for global agreement. So a sense of urgency appears missing. This has given politicians the green light to push ahead with populist measures.

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