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ByFT editorial

Yesterday's *Financial Times* editorial picks up the Bank of International Settlements' warning of systemic financial crisis and upgrades it to "huge crisis". Of course the prescribed course of action is some timely therapeutic bleeding of the working class - "a bit of economic pain", to be administered by central banks through monetary policy. Less orthodox is the admission that "we" - i.e. initiates of neoclassical economics - knew little about "economic processes" a few decades ago and nothing at all now. And who would have thought finance capital's chastened spokesmen would turn so mystical as to dream of "pre-emptive action" against "unknown unknowns"?!

Lots of unknowns

Healthy dose of scepticism from the central bankers' bank

It's all a bit worrying. The Bank for International Settlements, the central bankers' central bank, thinks that "our understanding of economic processes may even be less today than it was in the past." The reason is an increase in fundamental uncertainties about how the world economy works – what Donald Rumsfeld called "unknown unknowns". Pre-emptive action is needed in order to deal with them.

[...] there are also fierce debates within central banks: chief among them is the availability of money and credit, which has trebled in relation to global output over the past 25 years and which some bankers and economists argue ought to be central to monetary policymaking.

The Bank also worries about new uncertainties in the financial system brought about by innovations such as the distribution of credit risk through asset-backed securities. Sharing out risks ought to make banks more resilient but the BIS is sceptical. The recent troubles of two heavily leveraged Bear Stearns hedge funds that invested in bonds backed by US subprime mortgages is an example of the kind of unforeseen exposure that the BIS is worried may emerge.

[...] But what is really at issue is how we should respond to uncertainty. Financial markets are very good at dealing with risks – the known unknowns – but if the underlying rules have changed it is especially important to be cautious. A bit of economic pain, or a few more small failures among banks and investment funds, would be better than the huge crisis that might result if the world financial system continued to function at full throttle. Central bankers should heed the warning of the BIS.