

Welt am Sonntag
"Für die Finanzmärkte war diese Korrektur gesund"
August 5, 2007

Economics professor John Taylor does not believe in an expansion of the credit crisis.

“For the financial markets this correction was healthy”

John Taylor teaches economics at Stanford university, California and is known in the financial world for the “Taylor rule”. It describes the criteria according to which central bankers set short term interest rates. Between 2001 and 2005 he was the state secretary in the U.S. Treasury. His latest book deals with this time and speaks of the “global financial warriors”.

Welt am Sonntag:

The U.S. credit crisis disconcerts financial markets. How great is the danger of global contagion?

John Taylor:

We have experienced a correction in the past days. The return on risk has been too low until now. It has normalized now, although the risk premium is even now lower than in the 90s. Thus for the financial markets this correction has been healthy.

Welt am Sonntag:

The market turbulences, bankruptcies of hedge funds and U.S. mortgage banks as well as difficulties of the German IKB speak a different language, however.

John Taylor:

In particular, institutions which have continued to bet on an extremely low return on risk with second class U.S. mortgage financing, should have lost a lot of money. It is indeed possible that they need additional financial injections like the IKB. But as long as the economic environment stays robust, the risk of experiencing a similar crisis like in the 90s stays relatively limited.

Welt am Sonntag:

The turbulences have been caused by hedge funds, which have over-speculated. Should they be further regulated?

John Taylor:

No, we do not need that. Transparency is enough.

Welt am Sonntag:

But exactly this is lacking. Nobody knows what the hedge funds are actually doing.

John Taylor:

One should encourage them to more transparency. But investors, who invest in hedge funds, know exactly what they are doing. These are rich people, who make great profits, but who also assume a high risk. When they over-speculate their money is just gone. But it should not be our task to protect these investments.

Welt am Sonntag:

It is difficult to see through the network of hedge funds, banks and other financial institutions.

John Taylor:

If several hedge funds would go bankrupt and pull the credit giving banks after them, this would actually be a problem for the whole system. However, even in this case there are effective counter measures such as central banks ensuring adequate liquidity. By no means should the state become active. This would be counter productive.

Welt am Sonntag:

You have given your latest book the menacing title of “The Global Financial Warrior”. Who is a financial warrior?

John Taylor:

When the protection of stability in the global world is concerned, the first thing that comes to mind is foreign and defense policy. Financial policy as a third pillar is often forgotten. However, it is also important today. In order to express this definition clearly, I have consciously chosen the analogy with the military. Central bankers and financial politicians represent such “financial warriors” for me.

Welt am Sonntag:

As U.S. financial state secretary you have been one of them. It has been one of your tasks to cut off the money for terrorists after September 11. Has that worked?

John Taylor:

It was the easiest undertaking to block the accounts in the United States. The security services have provided the names of the suspects. The coordination with other countries was more complicated. It was and is even more difficult to undermine the unofficial financial flows such as private money transfer systems. They are certainly difficult to control. One will never be able to stop such money flows completely. But one can collect information. And this is even more important.

Welt am Sonntag:

How likely do you consider an attack on the financial system?

John Taylor:

This is by all means possible. For example, an attack on the payment systems or on the big stock markets. However, a lot has been done after September 11. In addition to that, central banks have showed after September 11 that in an emergency they can provide

adequate liquidity in order to solve problems.

Welt am Sonntag:

Then what is momentarily the greatest risk for the world economy?

John Taylor:

The biggest risk is a return of inflation. There is such a danger, if one takes a look at the world wide utilization of production capacities. Rising inflation would require higher interest rates than desirable, and this in turn could cut off business activity. On the other hand, it is amazing in which excellent condition the world economy is at the moment. There has seldom been a better time.

Welt am Sonntag:

Even good times don’t last forever.

John Taylor:

Central banks today deal with the topic of inflation differently than in the 70s or 80s. The emerging economies have large foreign exchange reserves and therefore, enjoy a lot of confidence. Only if one of the reasons for good business activity disappears, for example if inflation rises, we will have problems again.