SCENARIO ANALYSIS

CIRANO Note written by Bryan Campbell, March 2010

Good initiatives are worth repeating. The centerpiece of an evening on the Financial Crisis hosted a year ago at CIRANO was an analysis of the origin of the crisis by Robert Amzallag, former President and CEO of BNP Paribas (Canada), and currently a CIRANO Invited Fellow. In addition to his considerable banking experience that equips him well to share his insights on the financial crisis, we should note that Mr. Amzallag has been a staunch supporter of the Finance Group. Retired from BNP, he now divides his time between London and North America with a winter stay near Montreal. All the while, he continues to offer suggestions and propose~~s~~ initiatives to our Group on current events relating to the Montreal financial market. He has been a valuable asset in difficult times.

Our evening last January on the crisis was a signal success, so we invited Mr. Amzallag to offer a self-appreciation of his previous observations one year later. We have used this assessment as part of a web retrospective available at http://www.cirano.qc.ca/crisis.

Our web retrospective has various elements all accessible from this address:

- The Burgundy Report containing Mr. Amzallag's presentation from last year;
- The centerpiece, a crisis update, in which Mr. Amzallag addresses which of the three scenarios offered a year ago best describes the current world. Laurence Allaire Jean, CIRANO Research Professional, interviews Mr. Amzallag to explore further his current views;
- Our Web chronology of crisis events, now covering the past year's events. We have also updated the time series of relevant financial and economic variables; see below.

Last year, with a forward-looking perspective, Mr. Amzallag explored the implications of three scenarios and responses linked to the crisis. *The first scenario* considered a quick and painless rebound. Here, based on the huge amount of liquidity injected by the authorities, a rapid recovery in equities occurs followed by other markets. As confidence returns, governments recoup some of the bail out money and pressure on politicians lessens. All participants: banks, hedge funds but also central banks, lawyers, accountants, rating agencies and regulators, are eager to revert to previous conditions before structural damage is done to their usual way of conducting their affairs.

The second scenario explored the possibility of a deepening recession and serious market weakness. As a consequence, governments get further involved in supporting, regulating and even running the financial system to the point where they put themselves at risk. The *dirigiste* intervention into the financial world stifles innovation, entrepreneurship and ultimately the economy creating a further downward spiral.

The third scenario (where reason prevails) described a balanced approach where a reasonable short term recovery leaves enough leeway for the main actors to coordinate the appropriate measures addressing the real causes of the crisis.

In his current update, Mr. Amzallag, after a review of the key elements of the three scenarios, gives his perspective on the events of the past year. In response to the near collapse of the financial system, treasuries around the world "rose to the challenge and acted with the appropriate speed, decisiveness and coordination on a global scale." Moreover, when the crisis extended from the financial sector to the real economy, governments spent massive amounts of money to save certain institutions from bankruptcy. In this context, Mr. Amzallag worries about the ultimate effectiveness of these initiatives contrasted with the huge resulting indebtedness. Finally, he underscores the reality that the recovery in equity markets was based to a large extent on the reality of near zero interest rates.

In sum, rather extraordinary measures have won a certain breathing space during which it is to be hoped that appropriate regulatory measures could be crafted to avoid further occurrences of extreme crises. The following sub-title of the presentation nicely summarizes Robert Amzallag's assessment: *Key players adopt self-serving and somewhat misguided approach.* The key players in this account of the events of the past year are governments, central bankers, regulators, financial institutions and corporate directors. For instance, governments have seemed overly pre-occupied with the bonus question and have created an "antagonistic" atmosphere with the financial sector; in creating huge amounts of liquidity, central banks may have set the scene for further inflation and are in a "delicate situation" with respect to the ultimate transition to higher interest rates; on the regulatory side, there has been a disconcerting lack of focus; financial institutions have adapted a siege mentality; finally, the appropriate relationship between the management and boards of financial institutions has yet to be adequately resolved.

Mr. Amzallag ends his update with an assessment of the relative prospects of the three scenarios now conditioned on the events of the past year. Here it is best to consult what he has to say.

An important aspect of the CIRANO evening on the crisis held last year was the presentation by Mr. Michel Magnan, a CIRANO Fellow and Professor at the John Molson School of Business, Concordia University. He presented an overview about the controversy surrounding the marked-to-market pricing, an important aspect of the crisis. Professor Magnan reworked his presentation into a self-contained paper available at http://www/pdf/publication/2009s-27.pdf. According to our principle that *Good initiatives are worth repeating,* the Finance Group has asked Michel Magnan and a colleague at Queen's University, Dan Thornton (recently invited to be a CIRANO Fellow) to put together an afternoon workshop on marking-to-market of derivative products. This event will be held at CIRANO on April 29. Further information will soon be available on our web site.