AMERICA'S FINANCIAL CRISIS: LESSONS FOR POLICY AND REGULATION

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Profound Lessons Concerning Market Economies

- Market economies are not self-regulating
  - Prone to excesses
  - With many people suffering in process
  - Market fundamentalism has no theoretical or empirical foundations
  - And the belief in market fundamentalism can be very costly

- Inadequate regulatory structures can have deep and long lasting economic and social consequences
  - Notion that regulators could rely on banks' own risk management systems and rating agencies was questionable
  - Products that were supposed to mitigate risk increased it
    - If those who were supposed to know about managing risk could do such a bad job, what about those who were not professionals?

- Ideology can not only cause problems, but can impede in their resolution
- Once again, the rich and well-off are being bailed out, but the poor are being left to manage on their own
  - Contributing to America's growing inequality and sense of social injustice

Global consequences

- Inadequate regulations in U.S.
  - But foreign regulators trusted U.S.
  - U.S. allowed to export its toxic financial products abroad
- Causing weakness in foreign financial systems
  - Mitigating impact in US of bad behavior and bad policies
- US icons bailed out by sovereign wealth funds

- Fed bail-out of Bear Stearns model of bad bail-out
  - Non-transparent
  - Bear Stearns shareholders walk away with $1.2 billion dollars, American taxpayers left facing risk—with no compensation
  - Extending lender of last resort to investment banks
  - JP Morgan got free valuable options
    - Not just credit risks
    - Interest rate risk
  - Large distributive consequences
  - Increased moral hazard
  - There were alternatives

Slowdown in US will have global consequences

- US still largest economy in world
- No such thing as decoupling
  - Though effects may be reduced by new sources of growth
- But US is exporting its downturn
  - Similar to “beggar thy neighbor” policies of Great Depression
  - But this time through competitive devaluation

Flawed Proposal to Strengthen Bank Regulation

- Basle II relies on risk management systems of major banks and risk assessments of rating agencies
  - Both have been shown to be highly flawed
  - Both seemed to have believed in **financial alchemy**
  - Securitization converted low-grade loans into AAA rated financial products
- Ultimate example of market fundamentalism: relying on market to regulate itself
- Attention should have been focused on systemic properties of system—does it exacerbate or dampen fluctuations
  - Concern that it exacerbated fluctuations

FAILURES

- INCENTIVES
  - BANKERS HAD INCENTIVES FOR EXCESSIVE RISK TAKING
  - RATING AGENCIES HAD INCENTIVES TO PLEASE THOSE THAT THEY WERE RATING
  - STOCK OPTIONSPROVIDED EXECUTIVES WITH INCENTIVES TO PROVIDE DISTORTED INFORMATION

FAILURES--INCENTIVES

- REGULATIONS PROVIDED INCENTIVES FOR REGULATORY ARBITRAGE
- INADEQUATE ACCOUNTING SYSTEMS
  - PROVIDED INCENTIVES FOR "ACCOUNTING DECEPTION"
  - Accounting "management" — à la Enron? (off/on balance sheet arbitrage)
- SECURITIZATION CREATED NEW ASYMETRIES OF INFORMATION, WITH PERVERSE INCENTIVES
  - AND NEW CONSTRAINTS ON RENEGOTIATION
  - HAD FOCUSED ONLY ON BENEFITS OF SECURITIZATION, NOT ITS COSTS
  - With securitization, mortgage brokers got their money up front

FAILURES--INCENTIVES

- GLASS STEAGALL REPEAL OPENED UP NEW CONFLICTS OF INTEREST
- STANDARD MORAL HAZARD FOR BANKS
  - NOW GREATLY EXACERBATED
- INCENTIVES/OPPORTUNTIES FOR FRAUD
  - MORTGAGE ORIGINATORS OWNING APPRAISALS
  - ESPECIALLY GIVEN COMPENSATION SYSTEM FOR MORTGAGE BROKERS

Failures--MODELING

- Failure to understand risk
  - Products were so complicated that neither originators nor borrowers nor regulators could adequately measure the risk
    - Clearly not designing products to meet specific risks
- Failure to understand correlated risks
  - And how banks, using similar models, can give rise to correlated risks
  - Failure to understand systemic risk has systemic consequences
    - Including risks facing market insurers
- Failure to understand fat-tailed distributions
  - With “once in a hundred years” events occurring every decade!

Failures

- Failure to understand the economics of securitization
  - Understood advantages of diversification
  - Failed to understand problems of information asymmetries associated with securitization
    - Including possibilities of “bad actors”, i.e., distorted appraisals
  - Failed to understand problems of re-negotiation
  - Contrast with “old model” where banks originated loans, kept them, and re-negotiated if necessary

Intellectual incoherence

- Thought new products were creating a “new world,” yet used data from earlier periods to assess risk
  - Ultimate refutation of rational expectations
- Believed in “spanning” (basis of pricing models), which suggested limited benefits to new products—yet argued that there were large benefits
- Problems had been pointed out earlier
  - And some were seen in earlier crises

FAILURES--MODELING

- FAILURE TO DETECT PONZI SCHEME
  - ABILITY TO SERVICE LOANS DEPENDED ON PRICES GOING UP
  - BUT NOT LIKELY—GIVEN THAT REAL INCOMES OF MOST WERE GOING DOWN
  - INCREASING RISK OF BUBBLE—AS PRICE SOARED BEYOND HISTORICAL LEVELS
- FAILURE TO DETECT SYSTEMIC LEVERAGE

EACH BANK SHOULD HAVE BEEN WORRIED ABOUT THESE

REMARKABLE THAT ALMOST NONE OF THEM DID

FAILURE OF REGULATORS

- REGULATORS SHOULD HAVE DETECTED THAT SOMETHING WAS
  - something was strange—giving away money to poor people (option)
    - Pyramid scheme — borrowers were told not to worry, home prices would continue to rise, they could refinance (with large transaction costs)
      - The more you borrowed, the more you “made”
  - Should have been suspicious of financial alchemy
  - Many of these modeling problems and perverse incentives had occurred/been recognized before

Lobbying activities should have heightened suspicions

- Lobbyists worked hard to prevent legislation intended to restrict predatory lending
- New bankruptcy legislation gave lenders confidence that they could squeeze borrowers
- Incentives/opportunities for fraud
  - Over-valuation of residential real estate

Regulators were part of the problem

- Regulators drawn from investment community had incentive to keep the party going
- Fed encouraged people to take out variable rate mortgages *just as interest rates reached lows*
- Encouraged reckless lending
  - Said that it would lead to more home ownership
  - Real result is just the opposite – more foreclosures
  - Should have recognized that there was something wrong gong on
    - Some mortgages were made with no money down
    - With borrowers able to walk away, like giving away money
    - But normally, banks do not give away money

- Said that if there was a problem, they could manage it
  - But didn't say that they would put at risk taxpayers
- Part of strategy to keep the economy going
  - Especially important in light of high oil prices
  - And drag on economy from the Iraq War

DEEPER ANALYSIS

- FINANCIAL SYSTEM FAILED MISERABLY TO PERFORM CRITICAL FUNCTIONS
  - MANAGE RISK
    - CREATED PRODUCTS THAT INCREASED RISK
    - DID NOT CREATE PRODUCTS THAT WERE NEEDED
  - ALLOCATING CAPITAL EFFICIENTLY
    - SMALL FRACTION OF INDUSTRY INVOLVED IN VENTURE CAPITAL
- AND YET THEY WERE AMPLY REWARDED
  - 40% OF CORPORATE PROFITS
  - EVIDENCE OF DISCREPANCY BETWEEN SOCIAL AND PRIVATE RETURNS
  - NOT WAY ECONOMIC SYSTEM IS SUPPOSED TO FUNCTION

MACRO-PROBLEM

- HIGH LEVELS OF LIQUIDITY, LOSE REGULATION WERE "NEEDED" TO KEEP THE ECONOMY GOING
  - Iraq war led to rising oil prices
    - Rising oil prices meant that hundreds of billions of dollars were being spent to buy oil rather than to buy American made goods
    - Iraq expenditures did not stimulate economy in the way that other expenditures might have
  - 2001-2003 tax cuts were not designed to stimulate the economy, and did so only to a limited extent
- Question: Why did the economy seem as strong as it did?
  - Answer: America was living on borrowed money and borrowed time
- There had to be a day of reckoning
- That day has now arrived…

- FAILURE OF UNDERLYING MACRO-MANAGEMENT
  - EXAMPLE OF MYOPIC POLICIES
  - FREQUENT PROBLEM ELSEWHERE
  - REMARKABLE GIVEN WEAK DOLLAR
  - IN PART, RESULT OF LONG RUN POLICIES
- THERE WERE ALTERNATIVES
  - GOVERNMENT EXPENDITURES THAT WERE MORE EXPANSIONARY (ESPECIALLY THAN IRAQ WAR)
  - TAX POLICIES THAT WERE MORE EXPANSIONARY
  - ENERGY POLICIES THAT WOULD HAVE REDUCED IMPORTS OF OIL

A Closer Look at the Current Problem

- Three distinct but related problems:
  - The freezing of credit markets
  - The sub-prime mortgage crisis
  - The impending recession
- Each teaching lessons about economics
- Each interacting to exacerbate problem

The Sub-Prime Mortgage Crisis

- Loans were made to people who couldn’t afford them
  - With negative amortization
  - And “reset provisions”
  - **Bad Advice and Complicity of Regulators**

The Credit Crunch

- Lack of transparency may have been biggest culprit
  - Banks didn't know their own balance sheet
  - Knew that they didn't know balance sheet of those to whom they might lend
- Lack of transparency is what is giving rise to the credit crunch
  - Irony—given criticism from US concerning lack of transparency in Asia
  - It is clear that the losses are far greater than those revealed so far

The Problem is Huge

- Housing prices have already fallen 15%, likely 10% further decline
- 2.2 million Americans likely to lose home in next year
  - Many will lose their entire life savings
- But with decline in housing prices 14 million Americans will have mortgages exceeding house value

- Foreclosures will lead to falling home prices
  - Large real adjustment needed
  - Vicious circle
  - Blighted neighborhoods
  - May well extend beyond sub-prime mortgages
  - Problem is not just lack of liquidity, many individuals cannot afford housing
- Unless something is done, there will be huge dislocations, as people downsize, house prices get reappraised with large transactions costs, and everybody loses

Impending Recession

Growing consensus among economists that there will be a substantial gap between actual and potential GDP

- Even a 2% shortfall for one year means a loss of a quarter of a trillion dollars
- Conservative estimate of cumulative loss to U.S.--$1.5 trillion
- This is worst downturn in at least quarter century, probably since Great Depression
  - Most have been inventory cycles, or Fed stepping on brakes too strongly to stop inflation—no major structural problem
  - 1991 downturn related to S & L's, small part of financial system

Underlying Macroeconomic Problem

- *The US economy has been fueled by unsustainable consumption for the past five years:*
  - Zero or negative savings for the last two years
  - Based on “optimism” from rising home prices
    - And persistence of low interest rates
  - Financed through home equity withdrawals in the hundreds of billions of dollars
  - Much of it from sub-prime borrowers

The Game is Over

- Households will not want or be able to continue taking out more money from their homes
  - Housing prices down 7% from peak
  - New regulations
    - Closing the barn door after the cows are out
    - May have adverse short-run effects (the standard trade-off)
  - Securitization game which started it all is also over
    - Increased scrutiny on valuations
    - Increased scrutiny on rating agencies
    - Increased scrutiny on CDO's and other instruments
- If savings returns to "normal" rate of 4 to 6%, it will create a major drag on aggregate demand
  - If adjustment is quick, downturn may be deep
  - If adjustment is slow, downturn may be prolonged

What will Replace Consumption?

- Probably not investment
- Net exports have so far played an important role
  - But unlikely to be sufficient
  - And will have global ramifications
- Can government action save the day?
  - Given lags, it may already be too late

What is needed

- Monetary policy can only prevent things from getting worse
  - Bail-outs need to be better designed
- Fiscal policy that stimulates—and addresses long run problems
- Dealing with foreclosure problems
- Regulatory Reform

Can Monetary Policy do the Trick?

- Probably not — Keynes' view: pushing on a string
  - Will lenders be willing to lend, and households be willing to borrow, to continue unsustainable consumption?
    - Probably not
    - And this would just be postponing the day of reckoning
      - Making eventual adjustments even more difficult
      - In politics, timing is everything
- Long-term interest rates may even increase as inflationary expectations mount
  - They didn't rise as short term rates rose ("conundrum")
  - This is just the reverse

Flawed Fed **Bail-outs**

- Is preventing a rapid melt-down
- But is creating reinforcing moral hazard problem
- There was an alternative
  - Put quarter of billion dollars paid to Bear Stearns shareholders in escrow, to be used if problems are as bad as market believes they are
    - Tax payers should not be asked to pay out anything so long as Bear Stearns shareholders walk away with anything
    - And their shareholders should be charged an insurance premium
    - Unconscionable give-away

Unconscionable give-away

- Bail-out done in a non-transparent way
- Magnitude of gift to JP Morgan still not apparent
  - Credit risk put
  - Interest rate put

Fiscal Stimulus?

- Any stimulus should be **timely** and **targeted** to **maximize impact** (bang for buck--especially important given high level of U.S. deficit), and **address long-term problems**
- Most effective excluded from package
  - Unemployment insurance
    - America probably has worst unemployment insurance system of advanced industrial countries
  - Assistance to states and localities
    - Tax revenues about to plummet
    - Forcing them to cut back on spending
    - Leading to deepened downturn

Other Features of Stimulus

- Tax rebates
  - May be less effective than normal: uncertainty may lead many to use refunds to pay credit card bills, etc.
  - Exacerbates fundamental problem — *excessive consumption*
- Business incentives
  - Mostly for investment that would have occurred anyway
  - Very low bang for the buck

Fiscal Policy: What Else Should Have Been Done?

- Marginal investment tax credit — strong incentives for *additional* investment
- Infrastructure investment
  - America's infrastructure is in bad shape
    - Not a single one of the top ten global airports is in U.S.
    - Not enough public transportation
    - Other green investments necessary to achieve global warming targets
- R & D
    - Public R & D has high return on investment
    - Underlies America's economic strength
    - Cut backs in recent years
- Strategies that stimulate in the short-run while providing basis for long-run growth
  - What China did in 1997/1998 crisis

Dealing with the Foreclosure Problem

- Should begin at the *bottom*—the source of the problem, the large number of households who will lose their homes
  - A home-owners' Super chapter 11
    - Write down mortgages to 80/90% of current market value
    - Homeownership assistance for poor—we already give it to rich through tax system
  - Government program to purchase foreclosed homes, prevent community blight
  - We subsidize home ownership for rich. Why not for poor
    - Conversion of tax deduction into cashable tax credit

Dealing with the Foreclosure Problem

- Can restructure debt to reduce foreclosure threat
  - Government assuming 20% of debt, recourse
  - Would ensure that even those underwater would not strategically default
  - But would be a big gift to lenders, unless done in the right way

New regulatory structures

- NOT sufficient to rely on self-regulation
- More **transparency**
  - Reducing scope for conflicts of interests
  - Repeal of Glass Steagall was a mistake
    - Exacerbated conflicts of interest
      - Evidenced in Enron, Worldcom
    - And extended government bail-outs
      - Bear Stearns unprecedented
  - But this is not enough

- **Regulating incentives**
  - *At least when it comes to those dealing with regulated institutions (banks, fiduciaries)*
- **Regulating behaviors**
  - **Speed bumps**

Financial product safety commission

- What risks are products supposed to manage?
- Are the products “safe”?
- Do they do what they are supposed to do?
- Presumption that there is no such thing as a free lunch
  - Presumption that markets are relatively efficient
- Help identify risks that are not being deal with well
- There may be a cost—delay in introduction of new products—but the benefits far exceed the costs
  - And new products can be tried out in the unregulated parts of the financial system

Financial Markets Regulatory Commission

- Need to look at markets as a whole
- But have expertise required to deal with each sector
- Look at systemic leverage
- Are risks being managed well? Identify gaps
- Encourage standardization of products—moving to futures markets

regulatory capture

- Attention to regulatory capture
  - Not just a matter of money
  - But of ideas
- Worthwhile to have duplication—cost much lower than cost of mistake
- Making sure that those who are likely to lose are involved in regulation
  - Not just those reflecting ideology and interests of regulated

General Principles

- Proposals to give Fed more power peculiar—given that they were part of problem, and had not used their regulatory powers before
- Any reform of regulation has to begin with an analysis of market failures—why is regulation required—
  - Externalities
  - Herding behavior
  - Imperfections of market from imperfect information
  - Imperfections of markets from imperfect risk markets
  - Imperfections of markets form imperfect competition
  - Government inevitably bears risk, provides some insurance—has to make sure insured against events are less likely to occur

Principles of Regulation

- and the objectives of regulation
  - Safety-soundness of system
  - Competition
  - Consumer protection
  - Access to finance
  - Systemic (cyclical) properties
- And recognize the risks of regulatory capture

Sovereign Wealth Funds

- Not a surprise that they had to rescue America's premier financial institutions
  - Large redistribution of global (liquid) wealth
- America has not been saving
  - America has become consumer of last resort, living beyond its means
- High oil prices have created huge reserves of liquid funds in the Middle East
- Mismanagement of 1997-98 crisis has led developing countries to say "never again" will they allow loss of economic sovereignty
  - To prevent history from repeating, they have accumulated massive reserves

Worries about Sovereign Wealth Funds

- Partially reflect old-fashioned protectionist sentiment
- Partially reflect worries about inadequacy of our regulatory structures
  - Both competition (can a firm be so large that its actions become “relevant”?)
  - And regulations concerning conduct
  - Though most of the potential problems could arise with any form of private ownership, whether foreign or domestic

G-7 Solutions Not Well Thought Out

- Transparency
  - Fashion of the day
  - Cure-all for all problems
  - Part of long-standing strategy of diverting attention (used in 1997-98 crisis)
- But what *information* would *guarantee* that they behave “well”?
- So long as there are unregulated, secret hedge funds, they could always buy ownership through hedge funds

- Ownership can matter
- But so can private ownership
- Need to identify what potential behaviors one is worried about, and proscribe them
  - Anxiety over sovereign wealth funds suggests that we believe our regulatory system is inadequate
  - But natural solution is improve regulatory system
  - But this is not being emphasized
  - Suggests what is really going on is an attempt to divert attention

Global Financial Integration

- The world has become increasingly integrated
  - Implying that there is more interdependence
- Problems in one part of the global economic system have ramifications for the entire system
  - Implying that there is more need for global collective action

Need for Global Collective Action

- But we have neither the institutions, nor the mindsets, with which to do this effectively, and democratically
  - There is greater need for institutions, like the IMF, to regulate the global international financial markets
  - But confidence in these institutions has never been lower
    - Failed to do anything about global imbalances
    - Failed to do anything about inadequate regulations
      - Flawed proposal to strengthen bank regulation

Global Imbalances

- Massive U.S. borrowing from abroad
  - $850 billion in 2006 alone
  - U.S. blames China (undervalued yuan)
  - But even if China revalued its currency and completely eliminated its trade surplus, and even if China's surplus translated dollar-for-dollar into a reduction of U.S. trade deficit, the U.S. trade deficit would still be massive, reduced to "only" $720 billion
  - More likely scenario is that the deficit would be little changed, as U.S. buys textiles from Bangladesh and other countries
    - US simply trying to shift blame
- Genuine worry is potential disorderly unwinding

Making Globalization Work

- Failure of IMF not a surprise
- U.S. major source of global imbalances
- Inadequate regulation in U.S. having global consequences
- But U.S. has veto power at the IMF
  - IMF not likely to be aggressive in criticizing U.S.
  - Contributes to undermining credibility of IMF

Other Institutions Also Not Working

- G-8 most important informal institution
- Major issues:
  - Global imbalances
    - Blame China, but China is not there
  - Sovereign Wealth Funds
    - But sovereign funds are not there
  - Global warming
    - Blame developing countries
    - But developing countries are not there
- Not good enough just to invite them to lunch
  - Without consulting on agenda or communiqué
  - Especially when communiqué is issued before lunch

Need Better Cooperation in Global Financial Markets

- Macroeconomic cooperation
- Cooperation on regulation
- But voices of developing countries have to be heard
  - Reform institutions
  - Reform governance
  - Current structures increase risk in periphery relative to center (pro-cyclical policies in periphery, countercyclical policies in center)—with obvious implications for global efficiency and equity
- Will need some more fundamental reforms

Fundamental Reforms

- After 1997-98 global financial crisis, discussion of fundamental reform in global financial architecture
  - Nothing came of it
  - Consistent with suspicions at time that U.S. did not want any change
- What kinds of policies exacerbate “contagion,” contribute to “automatic destabilizers”?
  - Many of IMF and banking regulatory policies may contribute to instability

Fundamental Reforms

- Developing countries still bear brunt of interest and exchange rate risk
  - International institutions should bear larger share of risk
- No mechanism for restructuring sovereign debt
- Global reserve system

Global Reserve System

- Dollar-based system is fraying
  - US has been consumer of last resort
  - US has been debtor of last resort
- Contributes to instability and cannot work in the long-run
  - As dollar debts accumulate, confidence in dollar erodes
- Inequitable
  - Developing countries lending U.S. huge amounts of money at low interest rates
  - Net transfer to U.S. is greater than foreign aid U.S. gives to developing countries
- Dual (dollar/euro) reserve system may be even more unstable

- We CAN make globalization work
- Or at least work much better
- Both for the developing and the developed world

But if we are to do this

- We have to learn the lessons of the current economic crisis
  - Market fundamentalism does not work
  - Need to have good regulatory structures
- We have to have fundamental reforms in the governance of the global economic system