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Reflections on the Great Recession of 2008-2009

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As economists and policy makes ponder the lessons of the last two turbulent years, many troubling questions remain. What went wrong? Why did policy makers fail so abysmally to take preventative action? Why were economists so completely taken by surprise?

Some commentators, who consider the principal cause of the Great Recession to have been the structure of global macroeconomic imbalances, argue that economists did see the problem coming for many years, and repeatedly advocated corrective measures which political leaders did not follow. I think this view brushes over increasing and inherent weaknesses in developed financial markets, which caused them to become excessively vulnerable to collapse. When a shock came, the resulting disruption was vastly magnified by these inherent structural weaknesses.

Large macroeconomic structural imbalances did clearly impact domestic economic conditions in the United States. Whether it was the reflection of insufficient saving in the U.S or excessive saving in Asia, the current account deficit of the U.S.

[1] Remarks prepared for the Asian Economic Panel in Incheon, Korea, March 22 and 23, 2010

facilitated the maintenance of low interest rates in that country[2]. .If the U.S. had not run such a large current account deficit, and if Asian central banks had not purchased such large amounts of U.S. Treasury obligations, the U.S. authorities might have felt more pressure to correct fiscal imbalances, and interest rates might also have been higher.

In turn, a prolonged period of very low interest rates in the United States encouraged many financial professionals to take increasing risk. With interest rates so low, and debt so cheap, it was very tempting to go for a home run[3]. Indeed, low interest rates combined with a conscious push by policy makers to favor home ownership for everyone, contributed importantly to the housing boom, which became a bubble, and eventually burst.

But are these macroeconomic developments sufficient to explain what happened? Developed countries have experienced bubbles before – the tech bubble, and housing bubbles in other countries, for example. Why, in this case, when the bubble burst, did the financial system in the United States and Europe collapse so dramatically? The magnitude and success (for now) of the rescue operations tends to make one forget the depth of the abyss into which global financial markets appeared to be plunging.

When one considers the rapidity with which strains in the mortgage markets spread through the rest of the system, one can only conclude that the financial system itself had fault lines which made it vulnerable to any important failure in any sector of the

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[2] For a balanced view of the debate over underlying macroeconomic imbalances, see Maurice Obstfeld and Kenneth Rogoff, "Global Imbalances and the Financial Crisis: Products of Common Causes," paper presented to "Economic Linkages, Spillovers and the Financial Crisis," a conference in Paris, January 28-29, 2010, sponsored by the Bank of France Professorship of the Paris School of Economics, and by the IMF.
[3] See G. Rajan Raghuram, "Monetary Policy and Incentives," Address at the Bank of Spain conference on Central Banks in the 21st Century, Madrid, June 8, 2006. Raghuram discusses the motives investment managers may have for increasing the exposure to risk in their portfolios, when risk free interest rates are very low for a long time.

markets. As mortgage markets dried up, so did markets for automobile loans, credit card loans, student loans, etc. The inter-bank market froze; there was almost a run on money markets, and bank credit to the economy came to a standstill.

Why were financial markets in the United States and Europe so vulnerable? What made them so interconnected, and so susceptible individually and jointly to seizing up? The consensus answer seems to be 1) the complexity of and indeed the flaws in the structured products in which so many institutions in Europe and the United States invested so heavily, and 2) the startling extent of the use of leverage by these same institutions[4].

In any financial system in which institutions borrow short and lend long, the risk of a panic is always present. If creditors loose confidence in the ability of banks or money funds or hedge funds, they may rush for the exit, and precipitate a liquidity crisis in the institutions where they have put their money. This risk is amplified if the assets which the short term borrowings have financed are opaque, and if their valuation is extremely volatile. The story of 2008 has now been told many times. The problem was not just that mortgage loans failed, but that nobody knew how bad the RMBs and CMBs and CDO squared were, and nobody knew what the extent of exposure of their counterparties was. Financial institutions stopped lending to each other over night, because they had no way of estimating how far the problem extended. Leverage ratios of 40 and 50 to 1 exacerbated the problem many fold. An institution that has a high degree of leverage and large short term liabilities needs in a crisis to have assets that it can monetize quickly, and

[4] Some global banks concur with this analysis. In a February 2010 report, the research department of one of the 15 largest global banks identified excessive leverage and the inherent weaknesses of some structured products as the principal reasons for the failure of the financial system. See also the analysis of the French banker, Ambroise Laurent, "Le vrai défi," Commentaire, No.125, Spring 2009, pp. 25-36.

at predictable values. The simultaneous ubiquity of opaque structured products and of excessive leverage proved to be a deadly mixture.

In retrospect, the important question is why did financial practices veer so recklessly into this danger zone? Where were the prudent bankers? Where was every participant's instinct for self preservation? Why didn't the owners of the capital that was being put at risk wave red flags?

Much has been written about incentives and governance. It is now widely appreciated that variable compensation schemes which depend on annual targets and feature no recapture asymmetrically favor risk taking. The message, "Heads I win, Tails you loose," is loaded. In the United States, the Fed has wisely proposed – and is confidant that it has the necessary authority – to bring compensation schemes into the purview of its surveillance. Moves are also afoot in the United States and elsewhere to increase the voice of shareholders. This is an important development for non-financial as well as financial corporations.

But incentives are not everything. When Bear Stearns was sold for $10, its CEO owned 6% of the firm. When Lehman filed for bankruptcy, Richard Fuld and other top executives had an overwhelming share of their wealth invested in the firm. In both cases, management's interests were very much aligned with those of share holders. And, nonetheless, management accelerated as it headed for the wall.

Fuld and many others firmly believed that what was happening could not happen, that their strategies were the right ones, and that the storm would pass. They were convinced that the structured products that they had promoted and invested heavily in were the wave of the future, and that their risk management procedures protected them from default[5]. One of the surprising aspects of the financial crisis of 2008 was the degree to which the principal actors, and in fact large segments of the informed public, were convinced of the intelligence, validity and soundness of the very practices that nearly brought the system to ruin.

Economists bear a large part of the responsibility for that illusion[6]. The problem was not so much that their analyses were wrong, but that they abandoned reasonable skepticism about their conclusions. Much has been made of the fact that the econometric models which investment banks, insurance companies, and rating agencies used to value complex CDOs were misleading or inadequate[7]. They did not take sufficient account of fat tails, correlations, and confidence intervals. These are serious shortfalls for a model. But more serious yet was the blind faith that the executives in charge put in the model results.

Much has also been made of the degree to which the perfect market paradigm was over sold. As hypotheses on how markets function, many of its tenets are useful tools of analysis. CAPM and its progeny have transformed the thinking of financial professionals, and increased the acumen and the logic of their analyses. In that sense, the assumption of perfect markets was not wrong; it was useful for certain purposes, but not for all purposes.

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[5] Andrew Ross Sorkin gives a gripping account of the unswerving belief of the top management of Lehman until the bitter end in the validity of its business model, in Too Big to Fail, Viking Press, 2009.

[6] The economics profession has begun to take stock of the extent to which it contributed to the Great Recession. See Daron Acemoglu, "The Crisis of 2008: structural lessons for and from economists," Centre for Economic Policy Research, Policy Insight No. 28, January, 2009; Luigi Spaventa, "Economists and Economics: what does the crisis tells us?" Policy Insight No. 38, August, 2009; Paul Krugman, "How did Economists Get It so Wrong?" New York Times Magazine, September 2, 2009. I argue that it is not so much our teachings as our loss of critical perspective which contributed to the crisis. See also Francis Fukuyama and Seth Colby, "What were they thinking? The role of economists in the financial debacle," The American Interest, Fall, 2009, for a scathing criticism by non-economists.

[7] For a critique of the pitfalls of simulation analyses of CDOs, see Joshua Coval, Jakub Jurek and Erik Stafford, "The Economics of Structured Finance," Journal of Economic Perspectives, Vol. 23, No. 1, 2009.

As every philosopher of science knows, any model is a simplification, a powerful tool for thinking through aspects of a problem, but a tool to be used with circumspection.

Some economists indeed made a leap of faith, and argued that the perfect model hypothesis was the most powerful tool the profession had for analyzing all important problems[8]. That view was not held unanimously. But the believers did convince a large fraction of opinion makers and political leaders of the power of their argument.

Our profession was also the purveyor of another, broader and more subtle message – namely that we knew how to model the world, that there were no markets, no developments that we could not, with proper care, understand and analyze.

For the twenty years that preceded the Great Recession, this view of the world seemed to be confirmed by global macroeconomic developments. The United States and Europe experienced, with short interruptions, steady non-inflationary growth. In Asia, the financial crisis of 1997-1998 was a more transformational experience. But if one steps back and looks at global trends, what one sees is that stock markets occasionally crashed, but each time non-inflationary growth recovered quickly in the United States and Europe. These were the decades of the Great Moderation[9]. In these Panglossian times, it was only too easy to accept the assurances of our profession that there were no economic problems that could not be solved, and that depressions and inflations were a thing of the past. Rational leaders who understood economics could be counted on to ensure growth and stability.

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[8] The strongest statement of this view is that of Michael Jensen in 1978, "…there is no proposition in economics which has more solid empirical evidence supporting it than the Efficient Markets Hypothesis." "Some Anomalous Evidence Regarding Market Efficiency," Journal of Financial Economics, June/September, 1978.

[9] For a discussion of the drop in macroeconomic volatility from 1985 through 2007, see Roger W. Ferguson, Jr., Philipp Hartmann, Fabio Panetta and Richard Portes, International Financial Stability, ICMB and CEPR, Geneva Reports on the World Economy, No. 9, 2007, particularly chapter 5.

The problem with this rosy view is that it allows and encourages people to put down their guard. If macroeconomic stability could be taken for granted, if the world was indeed becoming increasingly less risky, then previous precaution could be neglected. If all bets could be expected to succeed, there was no downside to taking on more leverage. And the complex instruments designed by the technicians of modern finance could be initiated, sold and purchased without hesitation. Thus did economists themselves contribute to the excesses which eventually caused the system nearly to crash. There were a few nay sayers – Cassandra's like Nouriel Roubini[10], but also a few hedge fund managers like John Paulson, who saw the dangers, and in Paulson's case, made bets on the collapse which eventually came through. The global economy and the reputation of the economics profession would be stronger today if there had been more actors like Roubini and John Paulson.

Now that roughly a year and a half has passed since the crash and the Great Bailout, where do we stand? Economic conditions and policy issues are radically different in the developed and developing worlds. The balance of this essay will address first the situation in the United States and Europe, and then, in conclusion, the situation in emerging Asia.

In the United States and Europe, the legacy of the Great Recession of 2008 and 2009 is one of asset destruction, fear, massive public deficits and unprecedented levels of

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[10] "On Sept. 7, 2006, Nouriel Roubini, an economics professor at New York University, stood before an audience of economists at the International Monetary Fund and announced that a crisis was brewing. In the coming months and years, he warned, the United States was likely to face a once-in-a-lifetime housing bust, an oil shock, sharply declining consumer confidence and, ultimately, a deep recession." Stephen Mihm, "Dr. Doom," New York Times Magazine, August 15, 2008.

public debt. The crisis may not in fact be over. The destruction of private asset values remains so massive that it is difficult to see where the demand – without which there cannot be a durable recover – will come from. The public authorities, which through their interventions forestalled a worse crisis, are now themselves struggling with excessive debt. The tension surrounding the debt of Greece is a potential harbinger of worse things to come. Budgetary consolidation is an urgent priority around the world. If political resistance causes delay, a public debt crisis may become inevitable. Consolidation may not begin in earnest until there has been another panic, this one focused on the state of public finances.

Given this depressed outlook, there is no chance that any major financial institution in the developed world will soon repeat the excesses of the beginning of this century. Neither Citibank, nor Bank of America, nor Royal Bank of Scotland, nor even Deutsche Bank is likely to take uncalculated risks anytime in the next decade.

So do we need regulatory reform? The question is rhetorical, because political pressures are such that reform is going to happen whether we need it or not. There is irresistible political mileage to be made in every country in the developed world from bashing financial institutions. The question should perhaps rather be: since we are going to have regulatory reform, what should its focus be?

Regulatory reform is certainly needed at a minimum to ensure that existing rules are not thwarted. Our present structure of competing jurisdictions, both nationally and internationally, is characterized by gaping loopholes through which many of the villains of 2008 – 2009 blithely charged. The AIG catastrophe is an example of a US based insurance company avoiding US insurance regulations by developing what proved to be a very risky business in London, where it slipped through the cracks. Another example is Lehman's ability to use the Repo 105 rule artificially to raise its apparent liquidity, by getting a London law firm to approve what no US lawyers were willing to approve[11]. In 2004, the threat of regulatory arbitrage helped the investment banks of Wall St., among them Lehman and Merrill Lynch, to convince the SEC to raise their ceilings on leverage to what subsequently proved to be dangerous levels[12]. Within the European Union, the jurisdictional obstacles to financial surveillance are surrealistic.

Eliminating loopholes within any one country is feasible, if the political will to do so exists. Getting national authorities to agree to coordinate their regulations is another matter. If it is one of the most important priorities for regulatory reform, it is sadly also the most difficult to achieve. One has to hope that the political momentum which seems to exist now will not be wasted.

Other specific institutions and markets call for enhanced and improved regulation. It is important that bank capital requirements be made counter-cyclical rather than pro-cyclical. Rating agencies need attention. There is a need for institutions and regulations to ensure transparency and a level playing field in the trading of some new financial products -- CDSs and other derivatives.

Beyond international coordination, the most challenging aspect of the regulatory agenda is how to deal with what has come to be known as the "too big to fail" problem.

In the last two decades, global financial markets have experienced a sequence of major crises -- the Mexican Peso crisis (1994), the Asian Crisis (1997), LTCM (1998),

[11] Meghan Murphy and Michael Peel, "Elite London law firm faces fall out from Repo 105," Financial Times, March 13, 2010. See also Jennifer Hughes, "Fooled Again," Financial Times, March 19, 2010.
[12] Stephen Labaton, "Agency's '04 Rule let Banks Pile up New Debt and Risk," New York Times, October 3, 2008.

and the current crisis – in which each time public authorities stepped in to guarantee certain institutions, provide conditional finance to others, and, nationalize still others, one way or another, avoiding the complete implosion of markets. Over time, the sums that had to be deployed grew. Private decision makers can not be faulted if what they learned from this is that there are no risks that the public authorities will not cover in order to avoid collapse.

Economists rightly focus on the moral hazard generated by these implicit guarantees. This problem haunted decision makers during the Fall of 2008. If the Fed partially guaranteed the toxic assets of Bear Stearns and saved its counterparties, what would other players think? In the case of Lehman Brothers, the authorities felt they had no alternative but to let it fail, and may also have hoped that the example would discipline institutions that had gone too far. Paradoxically, the fall out from the failure of this institution – which was neither gigantic, nor a bank – was so catastrophic that authorities in the United States and Europe had to rush to implement the biggest package of bailouts in history. And, non one should have any illusion; the survivors read between the lines that they would all be saved. I happen to have been attending the presentation of a new fund by the CEO of a major, highly leveraged and troubled private equity firm in New York shortly after the US Congress passed TARP. One of his first remarks was, "Well, now we know that we will all still be here at the end of the day." One could not invent a clearer expression of moral hazard.[13]

[13] The research department of a major, global bank estimates, in the study mentioned in n. 4,the value of the implicit guarantee which the largest banks in Europe and the United States regularly receive under current circumstances as a result of being "too big to fail." The bank's estimate is between $20 and $30 billion per year.

But the deeper problem is size and concentration. If there were hundreds of different institutions, each following a different strategy and each with a different view of the world, .the authorities would have no reason to hesitate to allow one or a few of them to fail because they had made bad bets. But if a few giant institutions dominate the markets -- or if one or more of them, not necessarily giants, have a strategically important position at a vital node in the relationships among many other participants-- then letting one of these fail is tantamount to letting the financial system as a whole crash.

Unfortunately, changing the size and the composition of the players in global financial markets is a tall order. It is almost impossible to do by any single sweep of legislation. If it is to happen, it will have to happen progressively, over time.

The Volker rule is not the answer. The idea of the rule is that commercial banks would be prohibited from engaging in high risk activities – like proprietary trading of derivatives and in house promotion of private equity or hedge funds[14]. These activities would be pushed into "casino" banks, whose liquidity would not be guaranteed by any public authorities. The trouble with the rule is that it pushes much of modern finance into the casinos, beyond the reach of the authorities. In 2008-2009, the most spectacular failures and bail-outs involved non-banks (Bear Stearns, Fannie Mae, Lehman, AIG…). Unfettered, casino finance would thrive, and the more it grew, the more one could be sure to find systemic risks among its number.

For a public body to be in a position to take actions that sanction institutions that threaten systemic stability, without itself precipitating a general collapse of markets, it must have authority over all institutions of systemic importance. It is illusory to think that

[14]Statement of Paul A. Volker before the Committee on Banking, Housing and Urban Affaires of the United States Senate, February 2, 2010.

it could allow a systemically important institution to collapse simply because that institution had excluded itself from the authority's control.

Paradoxically, in Europe -- where almost all banks are universal banks, and are likely to remain so – the authorities could be in a better position to control systemic risk than in the United States, where universal banking is less firmly established, and might indeed recede if the Volker rule is implemented. Where universal banking prevails, the banking institutions which take on more risk are just as subject to regulatory control as the plain vanilla banks.

The authority which it is most important for a regulator monitoring systemic risk to have is the authority to seize and break up a problem institution. This would mean, in the case of a giant bank which had failed, to separate the pieces and require each to stand alone. The natural tendency, in the midst of a crisis, when a regulatory authority is bailing out an institution, is towards consolidation. Very often, the regulator, under pressure to stop contagion, divides up the pieces of the failed institution and distributes them to its surviving competitors. The result is more not less concentration. To resist this tendency, authorities will need a lot of imagination, will have to be prepared well in advance, and will have to display considerable political courage. Some form of pre-arranged liquidation procedures may be the answer, but they clearly should not be drawn up by the interested parties themselves[15].

Advance planning is necessary. But we should not delude ourselves. It is unlikely to be sufficient to forestall the next crisis, when it eventually comes. If the threat of being wiped out did not deter the manager-owners of the institutions that plunged to their

[15] See the discussion in Beatrice Weber di Mauro and Ulrich Kluh, "Reshaping Systemic Risk Regulation in Europe," manuscript which draws on a proposal put forward in the German Council of Economic Advisors' Annual Report of October 2009.

demise in 2008-2009, the threat of being broken up is not likely to stop them next time. What is important is that regulators be given the authority now to break up the failed giants next time. That way, and perhaps only that way, will global financial markets evolve towards more stable structures.

We should also not be under the illusion that more competitive, less concentrated global financial structures will be immune to bouts of collective excess. It is important to remember that as the current crisis developed, almost all the major actors - - including the Chairman of the Federal Reserve Board, the U.S. Secretary of the Treasury and the U.K. Chancellor of the Exchequer -- believed unconditionally in the myth that brought the house down.

In closing, I would like to comment about financial markets in emerging Asia. Emerging Asia, like Europe, is far from homogeneous, and comments which may be appropriate in one case may be completely off the mark in another. Nonetheless, there are two simple points that deserve to be made.

The first concerns initial conditions.

One can observe in the literature and in the public debate, a certain degree of backlash against the liberalization movement and the faith in markets which characterized the previous twenty years. This is in part a natural reaction to the overselling of the perfect market paradigm. It is also a response to the crisis itself. Though I have argued that regulation failure was far from the whole problem, it was clearly part of the problem. A new literature is emerging, which purports to connect the origin of the crisis and also its incidence, with openness, private ownership, and international competition in financial markets. It is still unclear how this literature relates to the older theme that financial openness may cause instability in the short term, but promotes economic development in the long term[16].

It is also factually true that financial institutions in emerging Asia were, by and large, spared direct involvement in the activities that proved so destabilizing in developed markets. They did not originate and did not purchase significant amounts of structured products. In addition, their short-term foreign currency indebtedness was moderate, and the authorities in these countries held very large foreign currency reserves, available to be used as a buffer against exogenous shocks.

The knowledge that they have averted the worst of the storm, and that opinion leaders in the developed world are questioning the merits of unbridled liberalization and openness, may easily lead decision makers in Asia to conclude that the push for financial liberalization of recent years was misguided, and should be halted or reversed.

My comment on this view is that its validity depends a lot on where you stand. If your initial conditions, particularly as relates to financial markets, are those of completely open, liberalized and deregulated markets, then, indeed, it may be wise for your authorities to pause and concentrate on effective implementation of the regulations that they have. But if your initial conditions are those of a completely closed and state-owned financial system, then some degree of prudent liberalization may be an important priority.

This leads me to my second point. It is obvious that the best way to avoid a banking crisis entirely is not to have a banking system. If volatility of any kind is to be avoided at all cost, that may be a model to pursue. One should not be surprised if it tends

[16] G.J. Caprio and P. Honohan, “Banking Policy and Macroeconomic Stability – an exploration,” Policy Research Working Paper Series, 2856, The World Bank, 2002.

to repress private consumption and encourage corruption. The most problematic aspect of the model may be that, in today's globalized world it is destined to break down.

What one hopes is that the leaders who make financial policy in emerging countries will learn from the mistakes of their peers in developed countries, without rejecting wholesale the potential benefits of free markets.