A "Once-in-a-Century" Financial Crisis—

Mortgaging the Future

How We Got in This Mess & Why It Could Happen Again

By Robert MADSEN

Overcoming the present financial crisis – which Alan Greenspan recently described as "a once-in-a-century" disaster – and shoring up the foundations of the world economy will doubtless require several years. In the meantime, the recriminations have already begun. Most of the criticism justifiably centers on the United States, whose poorly regulated real estate and mortgage markets precipitated the trouble and whose investment banks, hedge funds, and other institutions almost instantaneously transformed it into a worldwide phenomenon. It would be a mistake, however, to limit the scope of the inevitable scrutiny to just the United States or even the global financial system, for many other institutions also played significant roles in these tragic events. The purpose of this paper is to put the present crisis in its historical context, contending that there are underlying dynamics in the international economy that for perhaps two decades have gradually increased the scale and frequency of financial shocks. Among those dynamics are changes in international price patterns, an expansionary bias in central bank policy, acceleration in the pace of financial innovation, and flaws in the national and global regulatory regimes. If not remedied, these shortcomings could contribute to even more traumatic episodes of financial and economic distress in the future.

I. The Changing Historical Pattern

Since every financial disturbance is unique, it is difficult to compare such events or to argue that they comprise a single trend. Yet there is no denying that changes in the structure of commercial and credit markets affect the timing, size, and international ramifications of what are ultimately unavoidable occasional shocks. In this sense, the tendency in recent decades of most countries to move ever closer to the capitalistic norms of advanced industrial economies is very important. For during the Bretton Woods period, the barriers between national economies and monetary systems usually mitigated, and often precluded, the danger of financial contagion. There is still prophylactic value in such restrictions, as evidenced by China's and Malaysia's comparative immunity, conferred by their strict capital controls, to the Asian financial crisis of 1997. But these late cases are really the exceptions proving the rule – again demonstrated by Beijing – that in the name of faster GDP growth, greater efficiency and higher standards of living, virtually all nations have been committed to dismantling the breakwaters between their domestic markets and the world economy and hence have unintentionally become more susceptible to adverse developments abroad.

II. Price Inflation & Asset Values

Another implication of global liberalization has been a partial breakdown in the pre-existing linkage between the prices of goods and services on the one hand and of assets on the other. It would be wrong to suggest that that relationship was ever fixed but for long stretches of time in the post-World War II era, it was reasonably constant. This meant that a loosening of monetary policy generally led to stronger GDP growth and rising goods prices, which in turn persuaded central banks to raise interest rates in a manner that suppressed inflation while also collaterally preventing the spillage of too much surplus liquidity into asset bubbles. Thus, official vigilance regarding wholesale and retail price inflation almost automatically discouraged the accumulation of serious financial imbalances.

This serendipitous mechanism broke down somewhat in the 1990s and 2000s. Perhaps the most significant factor here was the entrance into the global economy of China and a number of other developing countries, which effectively doubled the capitalist world's workforce and thereby suppressed wage hikes. At about the same time, a surfeit of capital emerged in the international markets, engendered initially by the expansion in the size of high-saving age groups in many advanced industrialized countries and later by the massive current-account surpluses run by oil exporters and many developing nations. This greater supply of capital led to a reduction in long-term interest rates and in the cost of capital to businesses and households. Cheaper labor and money thus combined to stimulate stronger GDP growth in countries that enjoyed net aggregate demand – Japan, with its vast excess capacity and deflation, being the most salient counterexample – while simultaneously moderating the concomitant upward pressure on the prices of goods and services. The Federal Reserve and other central banks consequently registered less inflation than in the past and were freed to keep interest rates lower during prolonged periods of economic expansion. This is one of the reasons for the halcyon days of the 1990s and early 2000s, although it also explains, more regrettably, much of the upward momentum in price/earnings ratios and other measures of asset values that characterized those years.

III. Inflating Crises Away

The divergence between the patterns of goods and asset prices also affected the behavior of central bankers in the event of systemic financial distress. Historically, monetary authorities had to be careful when easing policy because keeping rates too low for too long would cause inflation. So rather than reacting to every crisis by aggressively expanding the money supply, central banks sometimes had no choice but to force the economies they oversaw into painful periods of adjustment, even recession. The need for caution decreased markedly, however, in the relatively benign environment of the 1990s and early 2000s. In these circumstances, the Federal Reserve and its counterparts abroad had less to fear in terms of inflationary danger and hence could react to economic and financial shocks by applying the accelerator somewhat more quickly and for a longer period of time than they might otherwise have done. The personal and political advantages of this bias towards loosening were compelling and may be seen in the sympathetic, sometimes even hagiographic, treatment that these men received in the press.

The inclination of central bankers to become more generous when dealing with occasional disturbances is perhaps most evident in the conduct of the Federal Reserve in the late 1990s and early 2000s. After warning the United States and the world against "irrational exuberance" in early 1996, Greenspan and his colleagues reacted to the Asian financial crisis of 1997 by easing monetary policy, which they did again in response to the Russian crisis of August 1998 and the collapse of the hedge fund Long-Term Capital Management (LTCM). The Federal Reserve was slow, however, to return rates to their normal level in the aftermath of those challenges and the result was further to inflate the incipient bubble in technology shares. Indeed, it was not until 2000 that the American monetary authorities finally started curtailing the growth in the money supply, a change which brought markets crashing down. Yet the pain was only temporary, for the 9/11 strikes on the United States soon led to another dramatic decline in interest rates. The Federal Reserve maintained its comparatively accommodative policy for several years after that tragedy in the full knowledge that the excess liquidity thus produced was flowing into the residential real estate market. Investors and speculators saw that the central bank was growing more supportive and accordingly started taking ever more risk in their business decisions. To this extent, the combination of greater price stability, lower interest rates, and less discipline among monetary authorities contributed to a pattern of ever larger, more frequent, and more dangerous asset bubbles.

IV. Innovation & Integration

Meanwhile, in the progressively deregulated world of the 1990s and early 2000s, the pace of technological and financial innovation accelerated considerably – as did the speed with which such changes spread from New York and London to other countries. These were laudable dynamics insofar as they brought greater efficiency, new ways for institutions and individuals to earn high returns while also diversifying their risks, and marginally faster national and global GDP growth. But they also entailed significant dangers. Financial institutions already tended to place the same bets in the same markets as their competitors – recall John Maynard Keynes' dictum that a wise banker is one who goes bankrupt when everyone else does because then he too can seek a bailout – in a manner that inevitably increased systemic risk. The proliferation over the last several years of securitized assets based on the US mortgage market aggravated this tendency, for those products were quickly grafted into the world economy and used by institutional investors, investment banks, and hedge funds as the basis for borrowing to finance investments in other sectors. This coincidence of rapidly increasing integration and rising leverage ratios transformed what was initially a domestic American weakness into a systemic global vulnerability within just a few years.

V. Suboptimal Regulation

Sadly, the national and international regulatory frameworks did not evolve as would have been necessary to monitor and contain the threats that emerged in this new, unprecedentedly interconnected world. The most important individual country in this regard was, of course, the United States, where so much of the innovation and increased financial leverage began. In the 1990s, the Glass-Steagall barrier between commercial and investment banks gradually eroded, letting those enterprises encroach on each other's territory even as official oversight remained divided between the Federal Reserve for the former and the Securities and Exchange Commission (SEC) for the latter. This was unfortunate both because the SEC did not adequately oversee its charges and because there were areas between and beyond the two regulatory agencies' bailiwicks that went largely unsupervised, including the purchase and financing of mortgage-backed securities and their use as collateral for investments in other markets. Yet this problem had an overseas facet as well, for other countries suffered from comparable regulatory gaps and there was little coordination between the various national systems. Hence much of the innovation of the late 1990s and early 2000s occurred in the interstices between jurisdictions and, plainly, without appropriate oversight and regulation.

VI. The New Dynamic/Pattern

The upward bias in monetary policy, the perceived availability of the "Greenspan Put" in the event of major shocks, and the faster speed of innovation interacted in a way that led to ever larger and more costly imbalances. The pattern is easiest to portray from 1997 and 1998, when the Asian and then Russian crises, respectively, occurred. The latter, in turn, produced statistical abnormalities of a magnitude that had not obtained since the Great Depression and which destroyed LTCM, the Nobel-studded investment group whose mathematical models assumed that the modern world would no longer see such enormous distortions in securities prices. Though perhaps not literally a "once-in-a-century" event, the ensuing trauma

came close to meeting that definition and was described as such by more than one commentator. In any case, LTCM's collapse convinced the Federal Reserve and other central banks that they needed to embark on a new and prolonged monetary loosening. However necessary this may have been in the short term, though, the consequent growth in the money supply immediately started pouring into the world's technology markets. Through leverage and margin borrowing, the gains in these asset classes led to capital appreciation in other parts of the domestic and international financial systems as well. So when the technology bubble imploded in 2000 and 2001, the impact on the global economy was more pervasive than it would have been in previous years and decades. Indeed, the decline in the NASDAQ and some other stock indices was so steep that it invited comparisons to the 1929 crash – meaning that the world had now suffered a second "once-in-a-century" crisis.

Yet that too was mere prelude, for the deflation of the technology bubble entailed another iteration of the new pattern of innovation, expansion and crisis. By lowering interest rates in the aftermath of that shock and the 9/11 attacks on New York City and holding them at depressed levels through the middle 2000s, the Federal Reserve and other central banks fed enormous quantities of credit into the world economy – and, particularly, the American residential real estate markets – just when financiers were learning how to bundle and sell all sorts of new products as a means of moving risk off their balance sheets. Investors and speculators, confident that the world's monetary authorities would bail them out in the event of a crisis, then used the appreciation in these new securities to borrow on margin to purchase other assets in other markets. It was at this point that the absence of appropriate regulation became truly disastrous. By letting banks transfer their risk to parties that they did not supervise, the Federal Reserve and the other oversight agencies effectively surrendered their ability to monitor and influence the ratio of leverage in the overall economy. Since other countries were similarly negligent – the Europeans, for example, who despite their vehement criticism of the United States had committed many of the same mistakes – and because international regulatory coordination was largely lacking, the American problems quickly became a general phenomenon. This is why the discontinuity in the US mortgage market in 2007 and 2008 ramified throughout the entire world, precipitating a third "once-in-a-century" debacle and causing damage that will take many years to overcome.

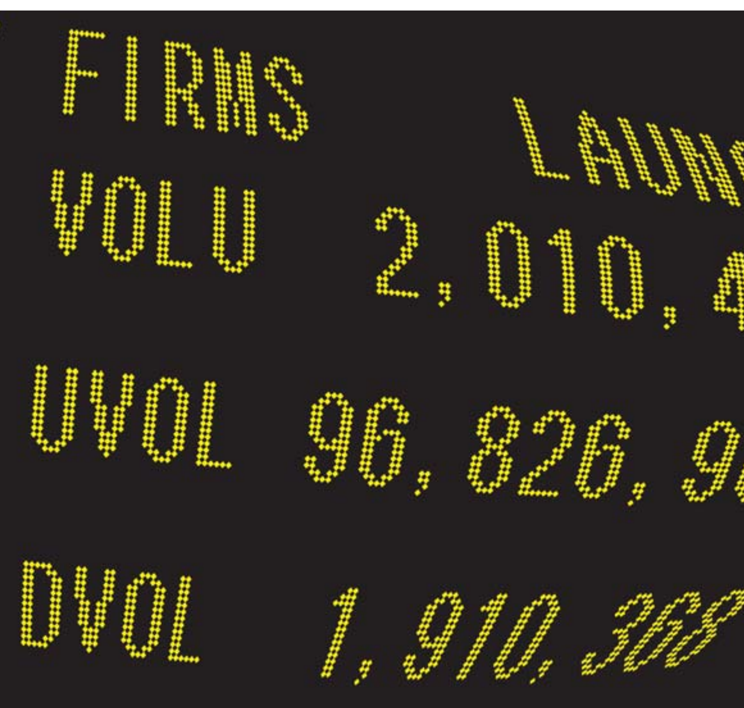
VII. Remedial Measures

Just as most of Japan's banks, chastened by their own failures in the 1990s, avoided the worst of the subprime mess, so too will most of the financial institutions that survive the 2008 disaster impose new risk-management techniques and avoid truly dangerous investments for some time to come. But history suggests that within a decade's time financiers will again be pushing the limits of prudence in their quest for higher returns. If the aforementioned problems of easy monetary policy, the implicit "Greenspan Put" and unregulated financial innovation remain unaddressed, the next crisis could be as big as, or bigger than, the last three. It would therefore clearly be worthwhile to minimize the risk factors even if one would not want to return the world to the relative safety –and low growth rates and standards of living – that obtained in the decades after World War II. Besides the obvious need for condign punishment of dishonest companies and executives, the remedial steps that may merit consideration include:

Monetary Policy: Central banks must start paying explicit attention to the level of asset prices when making their decisions about interest rates and the money supply. Some monetary experts reckon this a bad idea because it is difficult to gauge precisely when a bubble

starts to inflate, but the dangers inherent in ignoring asset markets and focusing just on goods and services are now conspicuous and compelling. Moreover, as demonstrated by Greenspan's prescient 1996 declamation against "irrational exuberance" and by central bankers' warnings about the real estate markets in 2005 and 2006, it is possible to identify at least extreme pricing distortions and therefore to resist them through moderate monetary tightening. In retrospect, even a slight increase in average interest rates from the middle 1990s through the present might have mitigated the several crises of that period, as somewhat higher reserve and margin requirements would assuredly also have done. Such measures would doubtless have caused GDP growth to slow a bit and have tarnished central bankers' image as rock stars, but from today's vantage those seem a reasonable price to pay.

National Regulation: The credit crunch casts profound doubt on the viability of the Anglo-American scheme of market oversight, for in this instance financial institutions were far from "transparent" and regulators negligent to the point of irresponsibility. Both of these flaws must be remedied if New York City is to regain international confidence and respect. Perhaps more pressing, however, is the need to reorganize the US regulatory agencies into a single authority whose ambit is coterminous with the relevant industries. It simply makes no sense that financial institutions that engage in similar businesses are subject to separate supervisors and distinct rules; nor should government agencies be able to act as if risk has simply vanished when financiers sell packaged securities to other investors. What is necessary is the establishment of a single regulatory agency



whose duty it is to monitor and manage leverage and other systemic variables throughout the economy, no matter what form they assume and where they appear. This is the only way to ensure sound regulation of industries that evolve rapidly and seek, in the name of profit maximization, to exploit every possible loophole.

International Regulation: Just as financial supervisors and central banks must close the gaps in their domestic systems of oversight, so too must governments eliminate the gulfs between their individual national regulatory schemes. One of the problems revealed by the current crisis is the degree to which seemingly unrelated financial industries, both within the United States and globally, are all connected through networks of syndication and margin borrowing. Short of reinstituting the sort of capital controls that existed decades ago, the only way to address this problem is by enhancing cooperation among regulators in all of the major economies. Countries should therefore work towards common standards that emphasize transparency, more frequent and frank communication, and the timely identification and discussion of emerging dangers. It may be difficult to persuade some governments to embrace these values now that the Anglo-American model has been so badly discredited, but there really is no alternative to better disclosure and explicit cooperation among regulatory bodies – especially if those bodies operate on different governing principles.

Political Leadership: In the short term, political leaders in the United States, Europe and elsewhere must recognize the severity of the present credit crunch and react to each successive challenge with determination and speed even if voters resist such action. As attested by both Japan's experience in the 1990s and the stunning international developments of this October, delay in today's circumstances is extremely costly. Next, governments should attempt to formulate and adopt legislation that renders regulators more accountable for market failures, perhaps tying their compensation to the quality of their performance. But these changes must be formulated carefully and implemented with the lightest possible touch. For in the aftermath of serious financial stress, politicians often overreact, imposing regulatory burdens that have little to do with the underlying problems and whose effect is to discourage the process of innovation and retard GDP growth and improvements in living standards. The world will inevitably emerge from this process with some degree of extraneous and ill-advised legislation, but hopefully such mistakes can be kept within reasonable bounds.

VIII. Conclusion

The subprime crisis that unfolded in 2007 and 2008 was triggered by the implosion of the American real estate bubble but then ricocheted with unprecedented speed around the world because of flaws in the international monetary, financial, and regulatory systems. Ultimately, these latter shortcomings are more important than the comparatively common and manageable phenomenon of distorted property values; for if they go unresolved, they will almost certainly exacerbate future shocks and cause still more pain for countries, companies and households. It would therefore make sense for governments and market participants to start considering structural improvements in the global financial architecture as soon as possible so that at least some advantage can be gleaned from the present debacle. Otherwise, the world may have to accept the unfortunate conclusion that "once-in-a-century" disasters now occur roughly every five years. JS

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