Systemic Subprime Crisis
Plea for Social Control of Financial Innovations

By Robert BOYER

Failure of Full Financial Liberalization

Modern financial theories and sophisticated methods for evaluating risk were supposed to have drastically reduced the frequency and severity of financial crises. Furthermore, the central banker had learnt how to deal with financial crises from the erroneous monetary policies that had converted the October 1929 Wall Street crash into a cumulative and deflationary depression. Therefore, one understands the "shocked disbelief" expressed by Alan Greenspan who is stressing the exceptional feature of the contemporary crisis that should occur only one time in each century. On one side, the securitization that was supposed to diffuse and reduce risk has been a strong incentive in the deterioration in the quality of the underlying financial assets. On the other side, the fast reaction of the Fed and other central banks that provided abundant liquidity to failing investment banks and insurance companies has not been sufficient to stop the vicious circle of asset depreciation and serial bankruptcies.

By contrast, whoever is familiar with the history of financial crises since the Tulip mania episode and more specifically the successive financial disruptions associated with financial liberalization and innovation could anticipate the current financial crisis and provide a better understanding of its novelty.

Permanent Disregard by US Authorities of Early Evidence of Coming Systemic Crisis

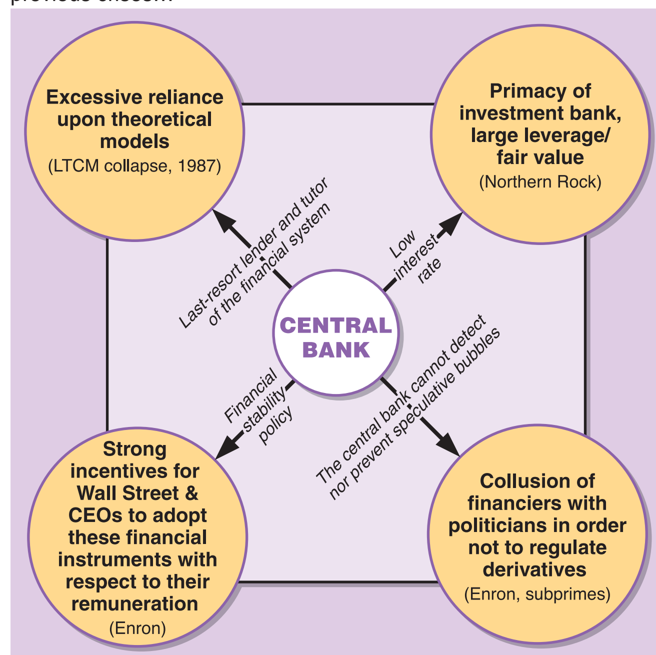
The October 19, 1987, Wall Street crash had shown the destabilizing nature of computerized routines that synchronize the strategies of traders. The collapse of LTCM was a second warning: modern statistical techniques of risk management associated with high leverage effects cannot cope with unexpected events. The Enron scandal originates in the concentration within a single corporation of the market for energy derivatives after an intense lobbying in order to prevent any regulation or surveillance procedures. The bank run against Northern Rock has recalled that mixing conventional mortgage credit with an intensive use of bonds might end up in financial fragility affecting the whole economic system. In the process of adopting fair value-accounting principles, many professionals and economists pointed out the danger of an accounting accelerator that would exacerbate the financial accelerator, typical of all major financial crises.

US authorities have interpreted all these events as pure accidents, explained by greed, irrationality, lack of transparency or the irresponsibility of CEOs and CFOs. The Sarbanes-Oxley act was supposed to overcome all the opportunistic behavior associated with the ongoing process of financialization. Simultaneously, the success of Greenspan's new monetary policy allows the permanence of low nominal and real interest rates, and the related excess of liquidity enhances a strong incentive to speculation on the stock market, real estate or more recently natural resources. The central banker had fully understood the erroneous monetary policy that led to the Great Depression and he was confident that a quick supply of liquidity to traders after a stock market crash was necessary and sufficient to prevent the repetition of an equivalent depression. *(Chart 1)*

Diffusion of Securitization Finally Destroys Responsibility of Credit Relation, Will End Finance-led US Growth

The "shocked disbelief" of the former Fed governor and the secretary of the Treasury comes from their firm beliefs that financial markets are self-equilibrating and that financial corporations have the interest, the information and tools to overcome any possible financial crisis. The first evidence of the subprime

CHART 1
Origins of subprime crisis
The spillover of all destabilizing mechanisms not corrected during the previous crises…

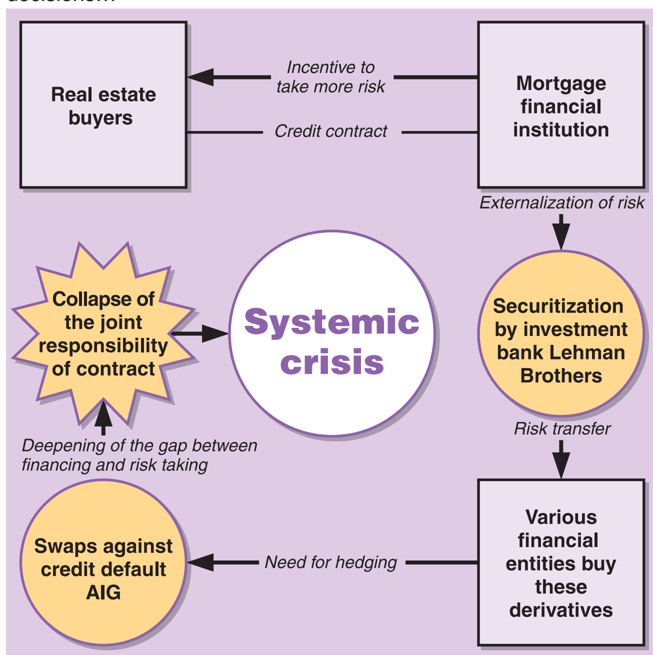


Source: author

crisis dates back to March 2007, but it was interpreted as a coming limited and not too severe a crisis. Unfortunately, this was a drastic simplification of the complexity of the crisis that mixes three inter-related processes.

1. Nothing new under the sun: the excess of credit is associated with major overproduction of housing and the subprime crisis is no more than the repetition of the savings and loan episode in the 1980s-90s on a larger national scale.
2. But the multiplication of financial innovations has generated a whole pyramid of derivatives, swaps, options, insurance contracts and derivatives of derivatives that have been very profitable for quite any entity of the financial system. When the underlying financial instruments run into problems, the whole US financial system is affected and progressively paralyzed. The mark-to-market practice exacerbates capital losses, whereas the mark-to–model method becomes totally obsolete when the permissive conditions of their relevance vanish. The subprime derivative market is frozen and by progressive spillover this affects interbank credit and the credit to the real economy. This shows the limits and the open crisis of the dominant strategy of the 2000s: "originate and redistribute," i.e. the progressive complete de-connection of financial flows and risk taking. This generalization of the irresponsibility of the credit contract ends up in the inability of financiers themselves to value their highly sophisticated derivatives and they can no more respond to the very basic question of a market economy: "who owes what to whom?" The novelty of this microeconomic origin of the blocking of the financial system explains why the quasi-unlimited access to central bank liquidity and the first Henry Paulson rescue plan failed to restore confidence, the recovery of everyday trading and credit activities. In a sense, the quasi-nationalization associated with the recapitalization of banks is the last-resort – but quite crude indeed – response to this violation of the core principle of a market/monetary economy. *(Chart 2)*

CHART 2
Hidden origin of subprime crisis: perverse division of labor within finance
At the core of the crisis: the erosion of direct responsibility for credit decisions…



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3. From March 2007 to September 2008, the deflation of assets remains internal to the financial system but since October 2008, the first adverse consequences for the real economy have become evident: slowdown of household consumption, lower-than-expected profits of nonfinancial corporations, fast reduction of employment…The second round of this structural crisis begins and it will definitely affect the core of the US growth regime since the mid-1980s: its dynamism was closely linked to recurring financial innovations entitling households to get access to one form or another of credit in the context of a moderate growth of real disposable income. The foreclosures and the reappraisal of credit risk already imply a contraction of the stock of credit granted to US households. It is prudent to anticipate that this trend will continue during the next year and will imply a drastic slowdown in US growth. Similarly, nonfinancial corporations will be very careful in extending production capacities, and therefore the only two sources of recovery will be the dynamism of net exports and public deficits.

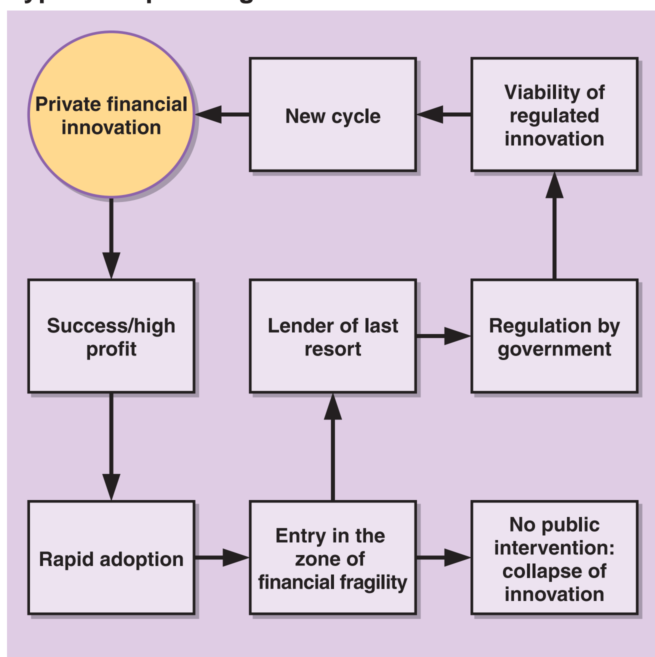
Thus, the US economy will have to search for a new growth regime governed by innovation and competitiveness and it will take time just to remove the major current macroeconomic imbalances, i.e. the twin external and public deficits.

No Radical Financial Innovation Successful Without Pragmatic Approach to Regulation

The present systemic crisis manifests the conjunction of three ruptures with respect to the 1990s and 2000s.

1. First of all, public authorities as well as financiers and economists have to recognize that financial markets are far from efficient. Their informational efficiency is especially problematic since securitization and complex derivative products have lost the precise content of the risk associated with basic financial instruments, at odds with the ideal of full transparency. Some key actors in the mortgage market have developed an opportunistic behavior, beneficial to their own remuneration but detrimental to financial stability and social welfare. The costs of direct finance have proven to be quite high, contrary to the initial expectations about the superiority of financial markets over bank intermediation. Finally, real capital has been badly allocated to the real estate sector, precisely in response to this deterioration in the quality of information generated within the entire US financial system.
2. More basically, the idea that financial markets are self-equilibrating and that sophisticated statistical methods designed by financiers eliminate the need for public surveillance and regulations has proven quite dangerous indeed. The erroneous extrapolation of transitory statistical regularities to the medium and long term, the excessive leverage effects in order to get an unprecedented rate of returns, and the belief in the permanent liquidity of all financial markets have led to the present crisis. By contrast, the commercial banks that have been kept under relatively tight control by federal regulations and institutions have until now resisted quite well to the near-complete financial meltdown. Therefore, relevant financial regulations may limit the degree of freedom in terms of innovation but sustain long-term viability of the financial system. The long-term comparative analyses of financial crises from the 17th century to the present days convincingly show that radical financial innovations have finally delivered the expected good results only after major crises that have been triggering countervailing regulatory and surveillance mechanisms. *(Chart 3)*
3. The hegemony of Wall Street over the US financial system and economy is now totally challenged. In the past, the financiers had been orienting the whole of monetary and financial regulatory policies and they enjoyed an explosion of their own remuneration out of scope with the rest of the economy. Nowadays, in order to repair the financial chaos they contributed to create, they are urgently demanding to be bailed out by the state. The public opinion is not especially happy to be asked to support this socialization of the losses, whereas the past profits have been appropriated by a very small minority. The arrogance of Wall Street is over, its implicit business model has failed and investment banks have become holding companies.

CHART 3
Typical sequencing of financial crises



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Thus it is time for polity to reassert control by society upon financial innovations in order to check that they do fulfil real economic objectives and enhance welfare.

Collapse of Free Financial Market Paradigm

Some free market fundamentalists continue to argue that any constraint upon the private sector to design new financial products would mean the end of US dynamism and prosperity. Actually, if in the past some basic financial innovations have been definitely contributing to a more efficient allocation of capital and alleviation of business cycles, it is not at all proven that the cluster of contemporary innovations (securitization, derivatives of derivatives, fair value, mark to model…) had a clear and positive contribution to the efficiency of the real economy and the improvement of the standard of living. Quite to the contrary, the economic and social costs of the subprime crisis might be quite high, superior to those observed during the previous banking crises elsewhere, for example in Sweden or Japan.

Therefore, it is urgent to start thinking about possible new regulations that would drastically reduce the frequency and severity of financial crises. The ineluctability of a systemic crisis by the very fact that smart innovators will always overcome any regulations, however sophisticated, is a myth. First, banking crises nearly disappeared in OECD countries during the Golden Age, precisely because public interventions have checked that capital allocation was governed by the search of economic efficiency and financial stability. Second, real estate bubbles have been observed in many other countries, but where public regulations

have maintained reasonable criteria in the allocation of mortgage credit, the bursting of the bubble has not triggered financial turmoil equivalent to that observed in the United States. For instance, in Spain, the central bank dissuaded daring bankers from implementing the equivalent of US subprime mechanisms: this decision has benefited the stability of the Spanish financial system, however acute other emerging economic disequilibria might be.

This is an invitation to disciplined finance in order to be sure that innovation benefits society. All other economic activities (medicine, transport, durable goods, food…) are subject to such an *ex-ante* public control of innovations that are potentially dangerous for security or welfare. Why should the financial community benefit from any derogation to this quite logical requirement? The public good at stake is no less than world financial stability and prosperity.

Governments Must Discipline Financial Innovations

Every piece of new information about the strategy of financial entities during the subprime bubble confirms that the severity of the crisis derives from the conjunction of three major components: the belief in the efficiency of financial markets, the inability of public authorities to detect and then prevent speculative bubbles and finally the role of the central banker as lender or even rescuer of last resort (LLR or RLR). The collapse of this "Wall Street consensus" opens a debate about the possibility of significantly reducing the frequency and severity of financial crises. *(Table 1)*

1. The basic trick of collateralized debt obligations (CDOs) and mortgage-backed securites (MBSs) has been to hide bad credit within a mix of better-quality financial assets. Thus investment banks voluntarily distorted the relevant information for other investors… and ultimately themselves! Such dangerous products, highly profitable in the short run for the issuers, should be forbidden by public authorities in charge of the transparency and equity of financial markets because they imply afterwards huge economic and social costs for society.
2. The last two US speculative bubbles were so spectacular that they were easy to detect. During the dot-com bubble, the quotation on Nasdaq of newly founded ICT firms was frequently implying the doubling of profits and sales *ad infinitum:* within a decade they would have represented all the US economy! Similarly, the unexpectedly large profits shown by Wall Street investment banks and hedge funds were clearly implying huge leverage effects and high risks of collapse…that finally manifested itself after four or five years of exhilarating profits.

TABLE 1
Two options concerning financial crises: curing them or preventing them?

	Ex-post	*Ex-ante*
Merits	• Legitimacy in response to the need to restore financial stability • No interference with private profit strategies during a boom	• Possible reduction of bail-out by the central bank since crises would be less frequent and acute • Less volatility, less inequality
Drawbacks	• The more severe the crisis, the more passive public authorities • Large economic and social costs • Moral hazard will make next crisis more severe	• Clear interference with private right to manage • Possible erroneous policy by central bankers • Lack of adequate instruments
Means	• The central bank as a lender of last resort • Public entity in charge of buying back non-performing loans • De facto nationalization of some banks or insurance companies • Restructuring within the financial community	• Monetary policy should take into account financial asset inflation and financial stability • Common regulation and surveillance for all financial entities • Ex-ante agreement by FSA or SEC of financial innovations, potentially dangerous for macroeconomic stability

Source: author

3. Consequently, the central bank should build a new inflation index that would measure not only the prices of goods and services but also those of financial and real estate assets. The central bank would then have in hand the stabilization of inflation via the evolution of the nominal interest rate and periodic statements announcing the probability of the occurrence of a financial bubble and the next move for interest rates to curb it.

It is time to discuss the relative merits of a mere repetition of the 1990s and 2000s – financial laissez-faire and the lender of last resort and their huge social and economic costs – versus a redesign of the responsibility of public authorities. This would imply uniform control of all financial entities by an integrated regulatory agency, the use of simple but efficient surveillance mechanisms, and *ex-ante* certification and standardization of new financial instruments.

If one follows the basic hint of Karl Polanyi, *financial innovation* should not be the favorite tool used by *predatory finance* but be the *servant of society welfare.*

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