Global Financial Trouble: Causes, Cures, Responses

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A currency trader at the Korea Exchange Bank in Seoul, South Korea, April 9, 2009.

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The global financial crisis has eclipsed Iraq, Afghanistan, North Korea, and other crises as a topic of concern — making these critical threats to global stability seem modest by comparison. Even if our perception is myopic and too greatly focused on our pocketbooks, the global financial crisis is significant, and it has spread to many places around the world. In order to address the current crisis and to prevent future crises — if, indeed, that is possible — it is necessary to understand what caused this crisis. Diagnosis is not easy because this crisis was caused by a complex interaction of macroeconomic mismanagement, incomplete financial regulation, and defective corporate governance. For the same reason, prevention of future crises is not a simple matter.

The financial crisis began in the United States with a housing price bubble and risky mortgages. Mortgages seemed like solid investments while housing prices rose, but looked much less attractive as housing prices declined. And this decline fed on itself, as reduced willingness to lend and foreclosures on mortgages caused further reductions in home prices. Many of the original

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The currencies of the United States and China.

mortgages were securitized, and banks and other financial institutions, as well as investors, eagerly purchased and traded the resulting securities in their never-ending search for high-yielding investments. But the holders of these securities found that their value declined sharply. For financial institutions, the losses on these securities impaired their capital and their ability to do business. This reduced their ability to finance businesses, resulting in a substantial depressing effect on the real economy. The credit freeze is only now showing signs of thawing.

While the crisis began in the United States, it is now global. It became global because the financial system is global, and the financial institutions that engaged in the subprime mortgage business in the United States included both U.S. multinationals and foreign multinationals. In addition, some foreign financial institutions did similar businesses abroad, emulating the U.S. domestic experience. Financial contagion meant that as the first, mostly U.S., financial institutions were threatened with failure, their counterparts around the world were also threatened. Finally, economic contagion through trade and investment has brought a sharp reduction in exports to the United States and in investment abroad from the United States.

The Causes

No doubt, economic historians will argue for years to come about the causes of the global financial crisis. The primary causal factor was macroeconomic, but appropriate regulation might have averted or ameliorated the crisis.

Low interest rates in the United States, Japan, and elsewhere, China's exchange rate policies, and the growth of oil wealth and other wealth in sovereign wealth funds all contributed to excess liquidity, which in turn contributed to the development of an asset bubble. There was a lot of cheap money around, and it needed to be reinvested. Not only that, but because there was a lot of cheap money, investors were constantly seeking increased returns. Those who promised them higher returns could command great followings and fees.

Much of this excess liquidity flowed into U.S. housing. During the run-up to the crisis, U.S. housing had the characteristics of a classic bubble. Those who invested in housing, either as owners or as lenders, looked like financial geniuses. Mortgage lenders could not really lose money because the value of their collateral would continue to rise, forgiving lending mistakes. As legendary investor Warren Buffett has said, "It's only when the tide goes out that you learn who's been swimming naked."

Mortgage lenders were no longer the traditional local savings and loan associations, planning to hold the mortgage loans that they originated until maturity. Rather, these loans were packaged into pools and these pools were securitized, with individual investors and merchant banks trading in and investing in these securities. Therefore, the mortgage lenders often did not take a long-term view and did not worry about the ability of their borrowers to service their mortgages in a financial downturn. The amount of mortgage-backed securities issued skyrocketed beginning in late 2003. The profit model for many financial institutions had changed from one based on interest rate spreads to one based on fees and trading. This changing business model also brought with it changes in compensation — providing bonuses for executives who were able to produce these fees and trading profits.

Securitization required good pools of loans, according to the underwriting requirements specified, and it also often required credit enhancements through insurance or other backing. These mortgage-backed securities, meeting the requirements specified by rating agencies such as Moody's and Standard & Poor's, generally received top credit ratings. The rating agencies competed with one another for business and often relied on historical experience, rather than on forward-looking models that included the possibility of an asset bubble, to determine the creditworthiness of these pools.

The U.S. regulatory structure may be accused of both sins of commission and sins of omission. The

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Former Fannie Mae chief executives testify before U.S. congressional committees, December 2008.

Bush administration sought to extend home ownership to lower-income people through zero-equity lending. Increased capital requirements imposed on U.S. mortgage giants Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation) opened the home financing market to securitization by other institutions. The Basel capital requirements provided incentives for securitization, and the expected reduction in capital requirements relating to mortgages under Basel II induced U.S. banks to increase their holdings of mortgage-backed securities. Investment banks were permitted to increase their leverage. All of these regulatory changes may be said to have been driven by the available liquidity and to have accentuated the growth of the mortgage-backed securities market and of its risks. While individual regulators may have seen some of the problems growing, the authorities lacked the political will to intervene strongly.

The corporate governance of many financial institutions was placed under severe stress by the fee and trading-based model, the drive to promote businesses that produced greater profits, the competitive pressure resulting from other firms' risky activities, and the inability to develop a persuasive model of long-term risk. Under these circumstances, shareholders, boards of directors, and senior management were unable to assess and curtail the risk that their institutions absorbed. In congressional testimony in October 2008, Alan Greenspan, former chairman of the U.S. Federal Reserve Bank, stated that "those of us who have who looked to the self-interest of lending institutions to protect shareholder's equity — myself especially — are now in a state of shocked disbelief." This is a stunning indictment of American corporate governance: The mechanisms of corporate governance are insufficient to ensure that executives will manage in the long-run interests of shareholders, rather than in their own short-run interest.

The Cures

Each of the causes of the financial crisis will merit careful consideration in order to prevent future crises. Of course, we need to remember that mere retrospective prevention of crises like those we have already experienced, such as the French military's Maginot Line in World War II, will not prevent future crises. Rather, we must understand the types of structures that cause crisis, and seek to establish mechanisms to see new crises coming and to restructure our regulation to respond.

First, macroeconomic management must be able to identify asset bubbles and to muster the political will to respond. Second, we must be careful to recognize that regulatory reforms often have pro-cyclical motivations: accentuating dangerous phenomena. As we engage in regulatory reform, we must be careful to ask the Warren Buffett question: Will we be seen to be naked when the tide goes out? Third, financial regulation must be understood as a special response to the particular incentive incompatibilities of financial institutions. We must recognize that corporate governance alone can be inadequate to restrain short-sighted management. We also must recognize that shareholders of financial institutions may themselves have inadequate incentives to ensure that financial institutions avoid excess risk: The rest of us may, through deposit insurance and government bailouts, absorb significant components of the risk. This moral hazard often requires a regulatory response.

Required Responses

Domestic regulation is often needed when firms do not bear all the risks of their actions or when the people who control firms do not bear all the risks of their actions. Furthermore, international regulation is needed when states do not bear all the risks of their regulatory actions. International externalities may occur through contagion: Financial institutions maintain dense international webs of interbank relationships, and the failure of one bank may hurt others. International externalities may also

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As homeowners default on mortgages, "For Sale" signs pop up on the street.

occur through regulatory competition: When one state reduces its standards, it may increase the short-term competitiveness of its financial institutions, imposing competitive harm on foreign financial institutions. Finally, a U.S. economic slump has repercussions around the world through the mechanism of trade and investment.

What kind of international regulatory response is required? States must take greater responsibility for the solvency regulation of their financial institutions in order to limit the risk of contagion. It may be appropriate for states to agree on the scope of this responsibility.

But this will not be enough. Corporate governance problems that induce firms to take excessive risk must be addressed, either through regulation or through self-regulation by the financial industry. An international regulatory response will be needed to ensure that states do not have incentives to reduce regulation in order to promote the competitiveness of their own firms. The Basel capital regulation was partially motivated by this concern, but much more work needs to be done.

Finally, greater sobriety and humility in macroeconomic management, and greater attention to the concerns of other states regarding national macroeconomic management, will be needed in order to avoid the conditions for asset bubbles or other macroeconomic-based crises. ■

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