

Anatomy of a Crisis

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Getting out of our current financial mess requires understanding how we got into it in the first place. The dominant explanation, voiced by figures as diverse as Thomas Friedman and John McCain, is that the fundamental cause was greed and corruption on Wall Street. Though not one to deny the existence of base motives in the institutional investor community, I would insist that the crisis has roots in key policy decisions stretching back over more than three decades.

At the domestic level, the key decisions in the United States were to deregulate commissions for stock trading in the 1970s and then to eliminate the Glass-Steagall restrictions on mixing commercial and investment banking in the 1990s. In the days of fixed commissions, investment banks could make a comfortable living booking stock trades for their customers. Deregulation meant greater competition, entry by low-cost brokers like Charles Schwab, and thinner margins. The elimination of Glass-Steagall then allowed commercial banks to encroach on the investment banks' other traditional preserves. (It was not only commercial banks of course, but also insurance companies like AIG that did the encroaching.)

In response, investment banks to survive were forced to branch into new lines of business like originating and distributing complex derivative securities. They were forced to use more leverage, funding themselves through the money market, to sustain their profitability. Thereby arose the first set of causes of the crisis: the originate-and-distribute model of securitization and the extensive use of leverage.

It is important to note that these were unintended consequences of basically sensible policy decisions. It is hard to defend rules allowing price fixing in stock trading. Deregulation allowed small investors to trade stocks more cheaply, which made them better, off other things equal. But other things were not equal. In particular, the fact that investment banks, which were propelled into riskier activities by these policy changes, were entirely outside the regulatory net was a recipe for disaster.

Similarly, eliminating Glass-Steagall was a fundamentally sensible choice. Conglomeratization allows financial institutions to better diversify their business. Combining with commercial banking allows investment banks to fund their operations using a relatively stable base of deposits rather than relying on fickle money markets. This model has proven its viability in Germany and other European countries over a period of centuries. These advantages are evident in the United States even now, with Bank of America's purchase of Merrill Lynch, which is one small step helping to staunch the bleeding.

Again, however, the problem was that other policies were not adapted to the new environment. Conglomeratization takes time. In the short run, Merrill, like the other investment banks, was allowed to lever up its bets. It remained outside the purview of the regulators. As a self-standing entity, it was then vulnerable to inevitable swings in housing and securities

markets. A crisis sufficient to threaten the entire financial system was required to precipitate the inevitable conglomeratization.

The other key element in the crisis was the set of policies giving rise to global imbalances. The Bush Administration cut taxes, causing government dissaving. The Federal Reserve cut interest rates in response to the 2001 recession. All the while the financial innovations described above worked to make credit even cheaper and more widely available to households. This of course is just the story, in another guise, of the subprime, negative-amortization and NINJA mortgages pushed by subsidiaries of the like of Lehman Brothers. The result was increased U.S. consumer spending and the decline of measured household savings into negative territory.

Of equal importance were the rise of China and the decline of investment in much of Asia following the 1997-8 crisis. With China saving nearly 50 per cent of its GNP, all that money had to go somewhere. Much of it went into U.S. treasuries and the obligations of Fannie Mae and Freddie Mac. This propped up the dollar. It reduced the cost of borrowing for U.S. households by, on some estimates, 100 basis points, encouraging them to live beyond their means. It created a more buoyant market for Freddie and Fannie and other financial institutions creating close substitutes for their agency securities, feeding the originate-and-distribute machine.

Again, these were not outright policy mistakes. The emergence of China is a good thing. Lifting a billion Chinese out of poverty is arguably the single most important event in our lifetimes. The fact that the Fed responded quickly to the collapse of the high-tech bubble prevented the 2001 recession from becoming worse. But there were unintended consequences. Those adverse consequences were aggravated by the failure of U.S. regulators to tighten capital and lending standards when abundant capital inflows combined with loose Fed policies to ignite a ferocious credit boom. They were aggravated by the failure of China to move more quickly to encourage higher domestic spending commensurate with its higher incomes.

Now we are all paying the price. As financial problems surface, a bloated financial sector is being forced to retrench. Some cases, like the marriage of BofA and Merrill, are happier than others, like Lehman. But either way there will be downsizing and consolidation. Foreign central banks like China's are suffering immense capital losses for their unthinking investment. As the People's Bank and other foreign central banks absorb their losses on U.S. treasury and agency securities, capital flows toward the United States will diminish. The U.S. current account deficit and Asian surplus will shrink. U.S. households will have to begin saving again. All this is of a piece.

The one anomaly is that the dollar has strengthened in recent weeks against pretty much every currency out there. (The one exception is the yen, which is being supported by Mrs. Watanabe keeping more of her money at home.) With the U.S. no longer viewed as a supplier of high-quality financial assets and the appetite of foreign central banks for U.S. treasury and agency securities falling off, one would expect the dollar to weaken. The dollar's strength reflects the reflex action of investors rushing into U.S. treasuries as a safe haven. It is worth recalling that the same thing happened in early August 2007, when the Subprime Crisis first erupted. Once investors realized the extent of U.S. financial problems, the rush into treasuries

subsided, and the dollar resumed its decline. Now, as investors recall the extent of U.S. financial problems—and even more so as they realize the U.S. treasury debt is going to rise significantly as the authorities are forced to recapitalize the banking system—we will again see the dollar resume its ongoing decline.

Emphasizing greed and corruption as causes of the crisis leads to a bleak prognosis. We are not going to change human nature. We can't make investors less greedy or to prevent them from cutting corners when they see doing so as in their self interest. But emphasizing policy decisions as the mechanism amplifying these problems into a threat to the entire financial system suggests a more optimistic outlook. Policy mistakes may not always be avoidable. Unintended consequences cannot always be prevented. But they at least can be corrected. Correcting them, however, requires first looking more deeply into the root causes of the problem.

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