Global Financial Crisis

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Era before the GFC, era of securitization

Securitization allowed a bank to get the risky loans off its books.

At the same time, it allowed long-term investors in the market, such as pension funds and insurance companies, to take on a small portion of the risky claims that they, by virtue of having longer horizons and holding a diverse portfolio of other assets, could hold more easily than the bank.

In theory, with the risk better spread across sturdier shoulders, investors would demand a lower return for holding the risk, allowing the bank to charge lower loan rates and expand borrowers' access to finance.

When one looks at plots of different measures of the riskiness of large U.S. banks, they suggested that banks had become, if anything, more exposed to risk over the past decade.

This was surprising, for if banks were getting risky loans off their balance sheets by selling them, they should have become safer.

Problem: assuming that everything else but the phenomenon being studied, in this case securitization, remained the same. Not the case

Most important, deregulation and developments like securitization had increased competition, which increased the incentives for bankers (and financial managers more generally) to take on more complex forms of risk.

Incentives were horribly skewed in the financial sector, with workers reaping rich rewards for making money but being only lightly penalized for losses.

That encouraged financial firms to invest in complex products, with potentially big payoffs, which could on occasion fail spectacularly.

“credit default swaps” which act as insurance against bond defaults.

Insurers and others were generating big returns selling these swaps with the appearance of taking on little risk, even though the pain could be immense if defaults occurred.

Because banks were holding a portion of the credit securities they created on their books, if those securities ran into trouble, the banking system itself would be at risk.

Banks would lose confidence in one another, he said. “The interbank market could freeze up, and one could well have a full-blown financial crisis.” This is exactly what happened in the GFC

The true sources of the crisis we have experienced are not only more widespread but also more hidden.

We should resist the temptation to round up the most proximate suspects and pin the blame only on them.

Greedy bankers can be regulated; lax government officials can be replaced.

This is a convenient focus, because the villains are easily identified, and measures can be taken against malfeasance and neglect.

It absolves the rest of us of our responsibility for precipitating this crisis. But this is too facile a response.

We should also resist the view that this is just another crisis, like every financial crisis before it, with real estate and foreign capital flows at its center.

Although there are broad similarities, this one centered on the most sophisticated financial system in the world.

What happened to the usual regulatory checks and balances? The discipline imposed by markets?

What happened to the private instinct for self preservation?

Is the free-enterprise system fundamentally broken?

These questions would not arise if this were “just another” crisis in a developing country.

The fault lines that precipitated this crisis are indeed systemic; stem from more than just specific personalities or institutions.

A much wider cast of characters shares responsibility for the crisis: it includes domestic politicians, foreign governments, economists like me, and people like you.

Furthermore, what enveloped all of us was not some sort of collective hysteria or mania. Somewhat frighteningly, each one of us did what was sensible given the incentives we faced.

Despite mounting evidence that things were going wrong, all of us clung to the hope that things would work out fine, for our interests lay in that outcome.

Collectively, however, our actions took the world’s economy to the brink of disaster, and they could do so again unless we recognize what went wrong and take the steps needed to correct it.

There are deep fault lines in the global economy, fault lines that have developed because in an integrated economy and in an integrated world, what is best for the individual actor or institution is not always best for the system.

Responsibility for some of the more serious fault lines lies not in economics but in politics.

The danger is that we will continue to ignore them.

Politicians will naturally focus only on dealing with a few scapegoats, not just because the system is harder to change, but also because if politicians traced the fault lines, they would find a few running through themselves.

Action will become particularly difficult if a more rapid recovery reinforces the incentives to settle for the status quo.

The roots of this crisis, in part, is a child of past crises.

In the late 1990s, a number of developing countries which used to go on periodic spending binges fueled by foreign borrowing, decided to go cold turkey and save instead of spend.

Japan, the second largest economy in the world, was also in a deepening slump.

Someone else in the world had to consume or invest more to prevent the world economy from slowing down substantially.

In the late 1990s, that someone else was corporations in industrial countries that were on an investment spree, especially in the areas of information technology and communications.

Unfortunately, this boom in investment, now called the dot-com bubble, was followed by a bust in early 2000, during which these corporations scaled back dramatically on investment.

As the U.S. economy slowed, the Federal Reserve went into overdrive, cutting interest rates sharply.

By doing so, it sought to energize activity in sectors of the economy that are interest sensitive.

Typically, such a move boosts corporate investment, but corporations had invested too much already during the dot-com boom and had little incentive to do more.

Instead, the low interest rates prompted U.S. consumers to buy houses, which in turn raised house prices and led to a surge in housing investment.

A significant portion of the additional demand came from segments of the population with low credit ratings or impaired credit histories

The flood of money lapping at the doors of borrowers originated, in part, from investors far away who had earned it by exporting to the United States and feeding the national consumption habit.

But how?

This is where the sophisticated U.S. financial sector stepped in.

Securitization dealt with many of these concerns. If the mortgage was packaged together with mortgages from other areas, diversification would reduce the risk.

Furthermore, the riskiest claims against the package could be sold to those who had the capacity to evaluate them and had an appetite for the risk, while the safest, AAA-rated portions could be sold directly to the foreign saver or her bank.

The U.S. financial sector thus bridged the gap between an overconsuming and overstimulated United States and an under consuming, under stimulated rest of the world.

The gravy train eventually came to a halt after the Federal Reserve raised interest rates and halted the house price rise that had underpinned the frenzied lending.

Subprime mortgage-backed securities turned out to be backed by much riskier mortgages than previously advertised: value plummeted.

The seemingly smart bankers turned out to have substantial portions of these highly rated but low-quality securities on their balance sheets, though they knew what they contained; they had financed these holdings with enormous amounts of short-term debt.

Hence, short-term creditors panicked and refused to refinance the banks when their debts came due.

Economies across the world went into a deep slump from which they are recovering slowly.

This narrative leaves many questions unanswered.

Why was the flood of money that came in from outside the United States used for financing subprime credit?

Why was the United States, unlike other economies, unable to export its way out of the 2001 recession?

Why are poorer developing countries financing the unsustainable consumption of rich countries like the United States?

Why did the Federal Reserve keep rates so low for so long?

Why did financial firms make loans to people who had no income, no jobs, and no assets?

Why did the banks hold so many of the securities for their own consumption when they knew what went into them?

There is no single explanation for this crisis, and so no single silver bullet to prevent a future one.

Any single explanation would be too simplistic.

There exist a number of fault lines that exert stresses on the global financial system

One set of fault lines stems from domestic political stresses.

Almost every financial crisis has political roots, which no doubt differ in each case but are political nevertheless, for strong political forces are needed to overcome the checks and balances that most industrial countries have established to contain financial exuberance.

The second set of fault lines emanates from trade imbalances between countries stemming from prior patterns of growth.

The final set of fault lines develops when different types of financial systems come into contact to finance the trade imbalances: specifically, when the transparent, contractually based, arm’s length financial systems in countries like the United States and the United Kingdom finance, or are financed by, less transparent financial systems in much of the rest of the world.

Because different financial systems work on different principles and involve different forms of government intervention, they tend to distort each other ’s functioning whenever they come into close contact.