

June 2009 Editorial

A recent article in the New York Review of Books contained a symposium with at least 6 wise men about our recent "Financial Crisis" [not including Ben Bernanke Hank Paulsen or Tim Geithner].

Bill Bradley: How far are we along in a recovery? When the market price of Citicorp drops from 60 to 1, and then comes back to 3, I don't think that's a recovery. Warren Buffett buys Goldman Sachs, and after he buys, the price drops 45 to 50 percent, and if he's going to break even on the investment he's got to earn 9 percent for the next twelve years, I don't think that's a recovery. The administration has put in place measures that, if they were to work, could offer some hope.

Niall Ferguson: This is the end of the age of leverage, which began, I guess, in the late 1970s, and saw an explosive rise in the ratio of debt to gross domestic product, not only in this country, but in many, many other countries. Once you end up with public and private debts in excess of three and a half times the size of your annual output, you are Argentina. You know, it's funny that people refer all the time back to the collapse of Lehman last September. Let's remember that this crisis actually began in June 2007. It fully became clear in August of 2007 that major financial institutions were almost certainly on the brink of insolvency to anybody who bothered to think about the impact of subprime mortgage defaults on their balance sheets.

But we were in denial. And we stayed in denial until September, more than a year later, of last year. Then we had the breakdown. Notice how psychological terms are very helpful when economics fails as a discipline. After the breakdown, we came out of denial and we realized that probably more than one major bank was insolvent. Then in September and October the world went into shock. It was deeply traumatic.

Now we're in the therapy phase. And what therapy are we using? Well, it's very interesting because we're using two quite contradictory courses of therapy. One is the prescription of Dr. Friedman—Milton Friedman, that is—which is being administered by the Federal Reserve: massive injections of liquidity to avert the kind of banking crisis that caused the Great Depression of the early 1930s. I'm fine with that. That's the right thing to do. But there is another course of therapy that is simultaneously being administered, which is the therapy prescribed by Dr. Keynes—John Maynard Keynes—and that therapy involves the running of massive fiscal deficits in excess of 12 percent of gross domestic product this year, and the issuance therefore of vast quantities of freshly minted bonds.

Paul Krugman: Let me respond to that a bit. Let's think about what is actually happening to the global economy right now. On the one side there has been an abrupt realization by many people that they have too much debt, that they are not as rich as they thought. US households have seen their net worth decline abruptly by \$13 trillion, and there are similar blows occurring around the world. So the people, individual households, want to save again. The United States has gone from approximately a zero

savings rate two years ago up to about 4 percent right now, which is still below historical norms; but suddenly saving is occurring.

That saving ought to be translated into investment, but the investment demand is not there. Housing is flat on its back because it was overbuilt; housing bubbles collapsed not only in the United States, but across much of Europe. Many businesses cannot get access to capital because of the breakdown of the financial system. But even those that do have access to capital don't want to invest because consumer demand is not there. Between the housing bust and the sudden decision of consumers to save, after all, we have a world with lots of excess capacity. The GDP report that just came out says that business-fixed investment, non-residential fixed investment, essentially business investment, is falling at a 40 percent annual rate.

George Soros: There are two features that I think deserve to be pointed out. One is that the financial system as we know it actually collapsed. After the bankruptcy of Lehman Brothers on September 15, the financial system really ceased to function. It had to be put on artificial life support. At the same time, the financial shock had a tremendous effect on the real economy, and the real economy went into a free fall, and that was global.

The other feature is that the financial system collapsed of its own weight. That contradicted the prevailing view about financial markets, namely that they tend toward equilibrium, and that equilibrium is disturbed by extraneous forces, outside shocks. Those disturbances were supposed to occur in a random fashion. Markets were seen basically as self-correcting. That paradigm has proven to be false. So we are dealing not only with the collapse of a financial system, but also with the collapse of a worldview.

That's the situation that President Obama inherited. He's faced with two objectives. One, he must arrest the collapse and, if possible, reverse it. Second, he has to reconstruct the financial system because it cannot be restored to what it was. This is a new situation. When people see this crisis as being the same as previous financial crises, they're making a mistake.

Bill Bradley: As we look at the future, we also have to look at the mistakes policymakers made in the last ten years. It's not news that people are greedy. But we made conscious decisions not to put limits on that natural human impulse. What were the mistakes? In 1999, we allowed investment banks, banks, insurance companies to combine: we eliminated the Glass-Steagall Act, which prohibited commercial banks from operating as investment banks. Why was Glass-Steagall put into law? Because the last time we didn't limit greed we got into trouble, the Great Depression.

The second mistake was in 1999, the explicit decision by the Clinton administration and Congress not to regulate derivatives, in particular credit default swaps. In 2002 they were worth \$1 trillion and today they're worth \$33 trillion, and that decision not to regulate derivatives created the following sequence: you have mortgages; then a thousand mortgages are packaged and sold as a mortgage-backed security; a thousand mortgage-backed securities are packaged and sold as a collateral debt obligation

[CDOs]; then a thousand collateral debt obligations are packaged and sold as a CDO squared; and insuring each one of those bundles are credit default swaps, which are a part of that \$33 trillion. And our government deliberately decided not to regulate this chain of investments.

One result was that the 374 people in the London office of AIG who were responsible for AIG derivatives destroyed a company that had 116,000 employees in 120 countries. Why? Because there was no regulation at all.

The third decision was in 2004. The SEC allowed banks to go from 10 to 1 leverage to 30 to 1 leverage. And guess what? Once they were allowed to do it, they did it. So if we're going to look at the future, we might think of undoing those three mistakes.

Finally, we might want to remember that the chairman of the Federal Reserve is supposed to remove the punch bowl from the party when the party gets out of control. And that did not happen in the Greenspan years. The opposite happened.