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You Have to Do Something!

Remarks at AEI's "Conference on the 10th anniversary of the financial crisis"
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Thanks, Peter. It's a pleasure to be in a panel with such distinguished colleagues.

I'd like to begin by pointing out that, in addition to being the instructive 10th anniversary we have been discussing, today is also a notable 11th anniversary: On Sept. 14, 2007, Northern Rock bank, a major British mortgage lender, could no longer fund itself in wholesale markets, and an emergency lender-of-last-resort facility from the Bank of England was announced. That day, long lines of depositors began to form outside branches of Northern Rock, its website collapsed and its phone lines were jammed.

The first bank run in England since the days of Queen Victoria was underway. So was the first bailout of the 2007-2009 financial crisis. The crisis reached its peak panic just one year later, as Lehman Brothers went down.

Let's review a few of the events as the ultimate panic approached.

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In June 2008, Larry Lindsay wrote an article for AEI entitled, "It's Only Going to Get Worse." He was so right.

In July, Congress passed the law authorizing the Treasury to put money into Fannie and Freddie. Secretary Paulson said he wouldn't need to. "Nervous calls" from officials of foreign countries to the U.S. Treasury were urging that their large investments in the securities of the tottering Fannie Mae and Freddie Mac be protected by the U.S. government.

On Sept. 7, Fannie and Freddie were put into conservatorship along with their Treasury bailout. Fannie's common stock had closed at $7 a share Friday, Sept. 5. On Monday, Sept. 8, it was 73 cents.

A week later, Friday, Sept. 12, Lehman's common stock closed at $3.65 a share. By Monday, Sept. 15, it was 21 cents.

On Sept. 16, losses on Lehman commercial paper forced the Reserve Primary money market fund to "break the buck"; also the Federal Reserve loaned AIG $85 billion.

On Sept. 20, the Bush administration submitted TARP legislation to Congress.

The times were frightening, to be sure, and obscured by the "fog of crisis." As Secretary Paulson later wrote, "We had no choice but to fly by the seat of our pants, making it up as we went along."

Imagine you are a Treasury secretary, finance minister or head of a central bank. You are in the fog of crisis, but you can see that you and your colleagues are standing on the edge of a cliff, staring down into the abyss of potential debt deflation. Will you choose to risk the eternal obloquy of being the one who did nothing? Of course not. You will intervene and keep intervening with whatever bailouts seem necessary. Your only objective will be to survive the crisis. That's what you would do, if you were in office, and so would everybody else, just as is always done.

Only, of course, in 2008, they didn't bail out Lehman. Would you have done so, under the circumstances of the time?

But more fundamentally, the panic was the climax of more than a decade of a long buildup of leverage and risk, and much of this, as has been rightly said, was promoted by the U.S. government. How had the long increase in risk seemed at the time?

Well, the central bankers believed they had created the "Great Moderation," which turned out to be the "Great Leveraging." Tim Geithner, then-president of the Federal Reserve Bank of New York, thought in 2006 that "[f]inancial institutions are able to measure and manage risk more effectively," a belief common at the time.

But: "The reality is that we didn't understand the economy as well as we thought we did," as Fed Vice Chairman Don Kohn candidly reflected. "Central bankers, along with other policymakers, professional economists and the private sector failed to foresee or prevent a financial crisis."

That is reasonably close to a mea culpa, although he sweeps in a lot of other people in his confession. Does the Fed understand the economy any better today than it did in the 2000s? Is it ever, as Peter Fisher has asked, "candid about the uncertainty" it always faces?

The government promoted housing debt. Most notoriously, the "National Home Ownership Strategy" of the Clinton administration pushed for "innovative" – that is, poor credit quality – mortgage loans. It goes without saying that the government promoted excess housing debt and leverage though Fannie and Freddie, as it continues to do today. These debt-promotion strategies never have been rejected by the U.S. government.

The crisis ended in the spring of 2009, after the Fed had the very good sense to replace mark-to-market tests with "stress tests." That was an ingenious way out of a problem. Whether by cause or coincidence, the stock market started back up on its long bull run. The S&P Bank Index, which had been at 281 on Sept. 12, 2008, bottomed at 77 on March 5, 2009, after a loss of more than 70 percent. It has since then gotten up over 500.

In the boom, it seems like the boom will last forever. In the bust, it seems like the bust will last forever. Of course, neither is the case, but it feels that way.

By midyear 2009, it was clear we had survived the crisis. Now, it was time for the inevitable political reaction to it, as happens in every financial cycle. Now was the hour for the politicians, including those who had pushed the policies that made things worse, to show how they could fix the problems.

Imagine you are a politician. What would you do in the wake of a huge crisis and bust?

First of all, you certainly have to Do Something! You can't just stand there, any more than the central bankers and regulators could during the panic.

Some of us, including Peter Wallison, Ed Pinto, Chairman Jeb Hensarling and me, thought it was a great opportunity to restructure U.S. housing finance into a primarily private, market system, with private capital bearing the risk of its actions.

In 2010, I proposed, in a piece called "After the Bubble," a list of reform actions which included these:

-Create a private secondary market for prime, middle-class mortgages;
-Design a transition to having no government-sponsored enterprises;
-Stop using the banking system to double-leverage the GSEs, should they survive;
-Facilitate credit-risk retention by mortgage originators;
-Develop countercyclical loan-to-value discipline;
-Create bigger loss reserves in good times;
-Use a one-page key mortgage information form focused on whether the borrower can afford the loan;
-Address the banking system's overconcentration in real estate risk; and
-Rediscover savings as an explicit goal of housing finance.

It still seems like a good list to me, but needless to say, this wasn't the direction taken.

A different path was chosen, one always available to the legislature: to expand regulations and the regulatory bureaucracy, with orders that they are not to allow such problems again. This was in spite of the fact that "[n]o regulator had the foresight to predict the financial crisis," as Andrew Haldane of the Bank of England said, adding, "although some have since exhibited supernatural powers of hindsight."

But the most interesting question is why did regulators fail to foresee the crisis? It was not because they were not trying—they were diligently regulating away. It was not because they were not intelligent. Instead, the problem was and always is one of knowledge of the future, not of effort. The problem is the inherent uncertainty, the ineluctable lack of knowledge of the future—the mismatch between prevailing ideas and the emergent, surprising reality.

There is another problem: regulators are employees of the government and cannot be expected to stop activities the government is intent on promoting, or act against the interests of their employers. As Bill Poole so convincingly wrote in his paper for this conference:

"An obvious first observation is that the affordable housing policy and mortgage goals given to the GSEs were policies of the Congress, President Clinton and President Bush." He asks rhetorically, "Should the Fed somehow have undercut the stated policies of the president and the Congress?" The same question applies to all the other regulators.

In spite of these problems, the politicians did what they usually do in the wake of the bust: expand the regulatory bureaucracies and give them more power, renewing Woodrow Wilson's faith in "expert" bureaucracy. The resulting many thousands of pages of new rules protect the politicians who had to Do Something from the charge of not doing anything or of not doing enough. There is no doubt that the thousands of man-years that went into negotiating and writing the new rules were spent by intelligent, informed, well-intentioned people intent on making the financial system into a mechanism with less chance of failure, although we all know the chance of failure never becomes zero. This is a fine goal, but suffers because financial markets are not a mechanism. (Of course, the bureaucratic excesses of Dodd-Frank were enabled by the temporarily overwhelming congressional majorities of the Democratic Party, which only lasted until they were lost in 2010.)

In the wake of the crisis, the power of the Federal Reserve was also greatly expanded, its role in feeding the bubble and its complete failure to anticipate the collapse notwithstanding. This is the latest of numerous examples in history of Shull's Paradox, which is that the Fed always gets more powerful, no matter what blunders it makes.

Another action always available to politicians is to set up a committee and give them a big, great-sounding assignment. In this case, the committee was FSOC (the Financial Stability Oversight Council) and its assignment was to figure out, address and avoid systemic risk. There is no evidence that FSOC has the ability to do this, but creating it was a perfectly sensible action from the politicians' point of view. No one can accuse them of ignoring systemic risk!

FSOC was given the power to designate large financial firms, in addition to the big banks, as Systemically Important Financial Institutions, or SIFIs. FSOC has designated a few firms, then de-designated most of them, but it has utterly failed to designate as SIFIs the most blatantly obvious SIFIs of all: Fannie and Freddie. FSOC has not admitted, let alone acted on, a fact clear to everybody in the world: that Fannie and Freddie are systemically important. This may be politically prudent on its part, but is intellectually vacuous. I believe Fannie and Freddie should be designated as the SIFIs they so obviously are immediately. Better late than never.

The Fannie and Freddie problem displays the more general fatal flaw in FSOC. It cannot control or even point out the systemic risk created by the government itself. Its members cannot criticize their employer.

The last point I will mention here is a key one: the post-crisis political reaction insisted that there had to be more equity capital in the financial system. This was a good idea, agreed upon by almost everybody. But note that the banks' capital was able to get so small in the first place, only because the government was correctly believed to be guaranteeing the depositors. Fannie and Freddie's capital was able to get even smaller because of the correct belief that the government was guaranteeing their creditors.

In the wake of the bust, the Federal Reserve set out to create a "wealth effect" by pushing back up the prices of houses and the prices of financial assets, in order in theory to stimulate economic growth. As we all know too well, it pursued this by massive purchases of long-term Treasury bonds (while reducing its portfolio of short-term Treasury bills to zero) and of very long-term mortgage-backed securities, increasing the Fed's own balance sheet, as is well-known, up to $4.5 trillion. The Fed also kept real short-term interest rates negative for the better part of seven years.

Whatever the arguments for doing these things as short-term measures, the Fed has kept them as long-term, unquestionably distortionary programs, even now reducing its balance sheet only slightly and getting real short-term interest rates up to approximately zero. The result has been a massive asset price inflation in real estate, financial assets and other assets.

The Fed got its renewed house price boom, all right. Nominal house prices are now well over their bubble peak.

The Fed also instituted the payment of interest on excess reserves held with it by banks. This allowed it to suppress the credit expansion that would have occurred in classic banking theory, and to itself allocate credit instead. To what did it allocate credit? To housing and to the government deficit.

Where and how will the Fed-induced remarkable asset price inflation end? I don't know. The Fed doesn't know. The financial regulators don't know. That is hidden in the uncertainty of the economic future. It may be the Fed's hoped-for soft landing, but then, it might not be.

Finally, here is a reminder of some essential things not done by the politicians or the regulators or the central bank in the wake of the crisis, among others:

- They did not create a primarily private secondary market for prime mortgages.
- They did not design a transition to having no GSEs.
- They did not develop countercyclical LTV discipline.
- They did not address the overconcentration of the banking system in real estate risk.
- They did not rediscover savings as an explicit goal of housing finance.

They did get equity ratios increased, which was good.

They did preside over an efflorescence of bureaucracy and a giant asset price inflation.

What next? This is a period of uncertainty, just like every other period.