CSIS | CENTER FOR STRATEGIC & INTERNATIONAL STUDIES | Simon Chair in Political Economy

ISSUES IN INTERNATIONAL POLITICAL ECONOMY

October 2008, Number 106

Thoughts on the Credit Crisis

Sidney Weintraub

The purpose of this essay is to get some thoughts on the credit crisis into the public domain.

1. Questionable incentives. The earnings incentives of employees in the financial sector played a large role in creating the problems of investment banks. The larger the short-term profits of these banks, the higher the bonuses handed out to employees at the end of the year. The idea of credit default swaps (CDS) was seen as an easy way to make money with little perceived risk. Packaging subprime mortgages into the asset-based securities sold to investors was so profitable that the downside was ignored. The debt-to-capital ratios were reported to be 30-to-1 when the house of cards collapsed. It is not clear who suggested taking these operations off the regular books, but this contributed to the lack of knowledge of investors and even of the CEOs of financial institutions about the extent of even their own troubled assets. But this combination—risky underlying paper, outrageous leverage, and lack of transparency—was highly profitable while the party lasted. As each bank saw how much profit its competitors were making, it became hard to resist what was essentially making large profits and putting up minimal capital to do this. The profits were unbelievable and, because of the incentive systems, the bonuses to employees kept pace.

2. Where were the grown-ups? Given the rewards young people at the banks received for financial innovation, I find their behavior understandable. My main problem is with the top management and CEOs of these financial institutions who consented to go full-speed ahead with what many of them surely realized were risky asset-based securities. What were the experienced adults doing? They were receiving outsized rewards.

3. Exacerbating the housing bubble. Who devised subprime mortgages in the first place? This lending continued to prosper even after it became clear that a bubble was developing in the housing market. The explanation for this must be that mortgage bankers knew that these mortgages would be sold to other banks that were prepared to include questionable loans in the credit-based asset packages that were being issued. The financial alchemists thought they had a good thing going. Indeed, original alchemists who sought to convert base metals into gold were small-time players compared to the current-day variety of financial alchemists.

4. Future mistakes will not mimic past errors. The lack of oversight for subprime lending and packaging these risky mortgages in asset-based securities can be corrected in new banking regulations, but new rules will not prevent managers and employees of financial institutions from devising other innovations in the future. That is why I find it important for the government to oversee what new incentive systems will be put in place in the financial sector.

5. It took time, but Congress did finally act. The troubled assets relief program (TARP) of up to $700 billion, even if it is well administered, will not correct many problems in the housing and credit markets. Its weakest point always was how the toxic assets would be priced and how reverse auctions might work. Secretary Paulson has now said that the U.S. Treasury will use part, perhaps most, of the $700 billion to take preferred equity positions in the banks. Housing prices have not yet reached bottom, and further steps will be needed to stanch the continuing decline.

6. Uninformed politicians sneer at informed government experts. I don't know how long it will take for politicians to stop berating Washington, D.C., as the cause of many economic problems. It is clear that the politicians in Congress paid excessive attention to criticisms of overregulation; the problem in the financial sector evidently turned out to be inadequate regulation. The horrors this time were created by the private sector, and the government, just as in the great depression of the 1930s, had to come to the rescue. I have never forgiven some of our recent presidents and legislators for sneering at government "bureaucrats" who generally understood the fundamental economic issues better than they did.

7. Don't downplay the destruction of pension funds. Pundits kept repeating that the key problem was in the credit markets, the reluctance of banks to lend to each other or to creditworthy business and personal borrowers. This undoubtedly is an accurate observation. But, as they did this, many commentators said specifically that the large declines in the stock market were a side show. They have now stopped doing this as they realized that retirement and pension funds declines bring suffering to millions of people. Stock price declines are one aspect of the total consequences of the financial excesses of recent years.

8. Not yet as bad as the Great Depression, but bad enough. Many talking heads remind us that the economic consequences of what is going on in the financial and credit markets today are not as bad as what happened during the Great Depression. This is true, at least so far, but this is cold comfort. We live in the here and now and the situation is quite bad enough.

9. We need real experts in the next administration. It has been clear in the U.S. presidential debates that the two major candidates have not been able to come to grips with or to state publicly how their policy positions will have to be altered by the current credit and pension problems. Each candidate recognizes this intellectually, but then repeats the positions enunciated before the seriousness of the current economic severity became clear. I can only hope that the next U.S. president realizes how important it will be to be surrounded by solid financial experts and not merely by successful business persons.

10. Politicians have not yet learned all the lessons from the Great Depression. We may never replicate the horrible outcomes of the Great Depression because today's financial policymakers learned much from that experience. The level of deposit insurance, which was born at that time, has already been increased. Injecting capital directly into the banks is about to begin. The federal funds rate for interbank lending was lowered, and this was done in conjunction with other central banks lowering their key interest rate. However, many politicians have not fully grasped the lessons of the Great Depression. Today's protectionists seem to have forgotten the high cost imposed on the world economy by the Smoot-Hawley protectionism of the 1930s. Many ideologues who believe that the market should be left to work out its own solutions to today's problems are unwilling to take into account how long and how high a price this will inflict on the U.S. and global population.

11. Moral hazard is being overplayed. We have heard much in recent months about moral hazard and how rescuing financial institutions will only promote more risk taking in the future. The consequences of moral hazard are by no means identical in all situations. Deposit insurance is an example of moral hazard, but it also stimulates saving. Rescuing Fanny Mae and Freddie Mac is a form of moral hazard, but this may accelerate a return to sensible mortgage lending. The refusal to practice moral hazard by allowing Lehman Brothers to declare bankruptcy was popular at the time, but has had adverse results in credit markets around the world. The people who ran AIG deserve little public sympathy, but the moral hazard involved in government control of the company is clearly safer than the alternative of dealing with it as the Secretary Paulson dealt with Lehman Brothers.

12. Europe's inability to act as a unit. The inability of the European Union countries to work out common rescue measures has made clear that there is a great difference between a single country such as the United States and a grouping of 27 different countries. However, the countries that use the euro as their currency did finally agree to follow the example of the United Kingdom and add capital to the banking system and to guarantee repayment of interbank lending. The United States has not announced this kind of credit guarantee, but it may. It has always been intellectually evident that a common currency of many EU members and a single central bank is not the same as a single treasury department, but the initial disarray in Europe has made this practically clear as well; and even the revised European position will be carried out country by country.

13. We need all the ideas we can get. The world has many experts who are prepared to comment on the current financial problems that the world must address. However—and I will close on this point—none of them has had any practical experience in dealing with a situation in which credit markets have almost completely shut down. Therefore, thoughtful ideas—like those that came from the United Kingdom—on how best to restore confidence and stimulate credit markets to work efficiently are most welcome.

Sidney Weintraub holds the William E. Simon Chair in Political Economy at the Center for Strategic and International Studies.

Issues in International Political Economy **is published by the Center for Strategic and International Studies (CSIS), a private, tax-exempt institution focusing on international public policy issues. Its research is nonpartisan and nonproprietary. CSIS does not take specific policy positions. Accordingly, all views, positions, and conclusions expressed in this publication should be understood to be solely those of the author.**

© 2008 by the Center for Strategic and International Studies. All rights reserved.