Learning Lessons? The GFC 5 years on.

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presented at COST Action IS0902, Athens.

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146 (447 & 448), June 2013, pp. 3–16, and A1–A43.

http://royalsoc.org.au/generator/assets/journal/J_Proc_RSNSW_Vol_146_1_Nos_447_448_Marks.pdf

“The Equivalent of Cardiac Arrest”

October 13, 2008, the *Financial Times* characterised the western world’s banking system as having a coronary.

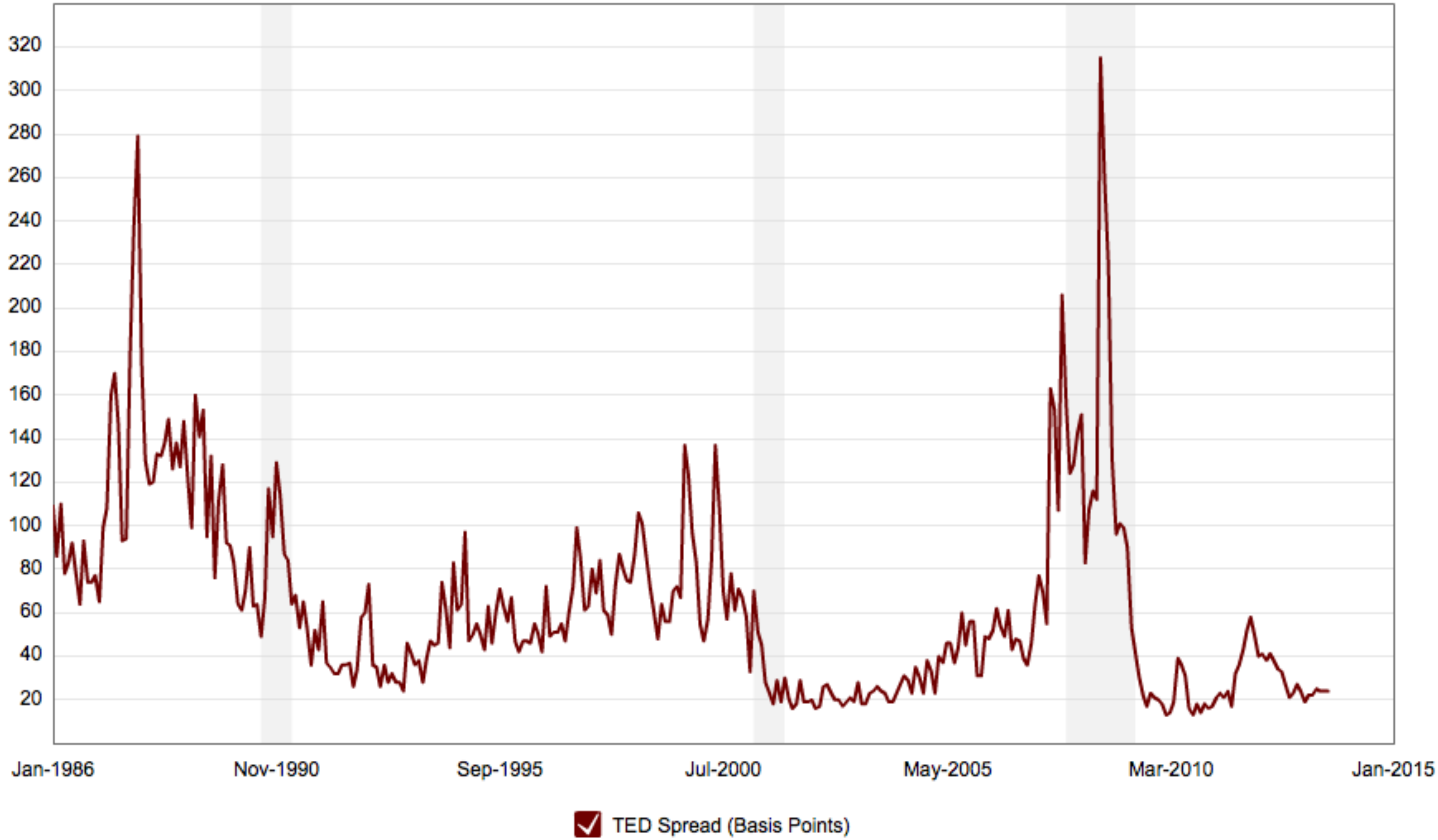
“It is now virtually impossible for any institution to finance itself [borrow] in the markets longer than overnight.”

— The freezing of the interbank credit market, less than a month after Lehman Brothers collapsed.

Counterparty risk was seen as prohibitive to prospective lenders, at any price.

See the spike in the TED spread = Libor − US bond yield.
The London Interbank Borrowing Rate

Macrotrends.org_TED_Spread_Historical_Chart.pdf



320
300
280
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240
220
200
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160
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120
100
80
60
40
20
Jan-1986
Nov-1990
Sep-1995
Jul-2000
May-2005
Mar-2010
Jan-2015
TED Spread (Basis Points)

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2. How can we attempt to avoid other such crises in future?

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Five and a half years ago I started a timeline of the crisis, for my own purposes: things were happening too fast.

Go to the link on the cover page to see the Timeline (from June 1720 to March 2014) and to read a discursive version of this talk, at

`http://www.agsm.edu.au/bobm/papers/marksfinal.pdf`

Necessity and Sufficiency

Ideally, want to identify the *necessary* conditions for the GFC — factors without which the GFC would not have occurred.

But instead we identify a number of plausible *sufficient* conditions
— those factors that preceded, accompanied, and followed the GFC.

From these, which are the most important?

To avoid future crises, this is vital.

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6. and at least six changes in corporate behaviour.

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1997 October 1: Northern Rock floats as a demutualised building society.
In 2007, it suffers the first bank run in the UK since 1866.

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1983 June: Larry Fink (now of BlackRock) is the co-inventor, for Freddie Mac, of the collateralized mortgage obligation (CMO).

An example from Goldman Sachs

In August 2006 the best tranche in the residential mortgage pool (known as GSAMP 2006-S5) was rated (twice) at AAA. (The pool holds $338 million of second mortgages to sub-prime (SP) borrowers.)

A year later Moody's downgrades this to Baa, the lowest investment-grade level.

Four months later it is downgraded to "below investment level."

In April 2008 it is downgraded to "junk" rating.

By December 2008, it is no longer traded.

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The U.S. borrows (& sells bonds) while China & Asia saves.

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2008 October 7: Before the congressional Committee on Oversight and Government Reform, the former chief accountant at the SEC reveals that the SEC's Office of Risk Management was cut back to a single employee.

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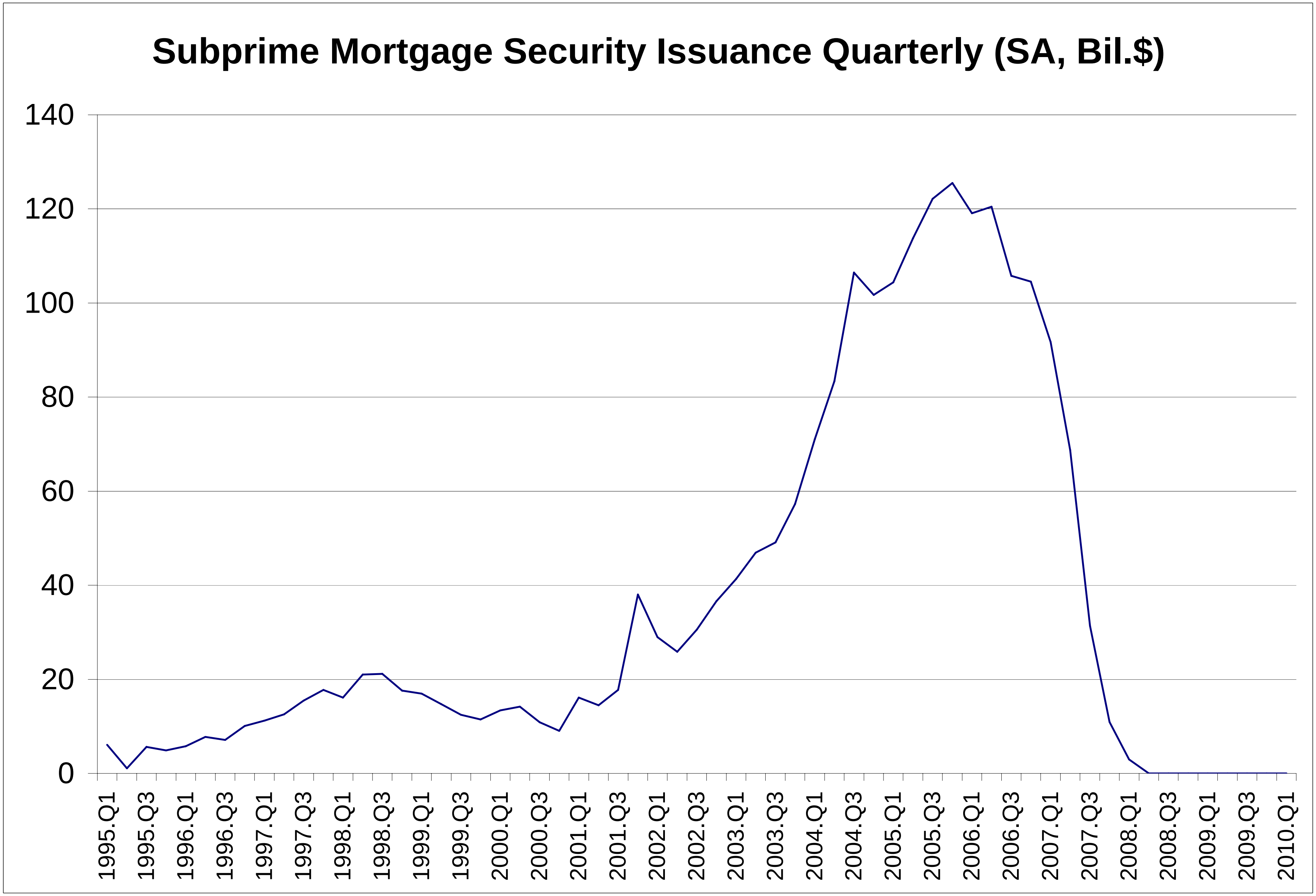
2006: In Q4 2005 the issuance of SP mortgages peaked at $125 bn.

[Greenspan Exhibit 4: 53.pdf]

Exhibit 4



Source: Inside Mortgage Finance

4/15/2010

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Executives in the U.S. financial sector successfully lobbied to ease the restrictions their firms faced — to change the incentives they operated under: see the successive easing of restrictions above, both legislative and regulatory.

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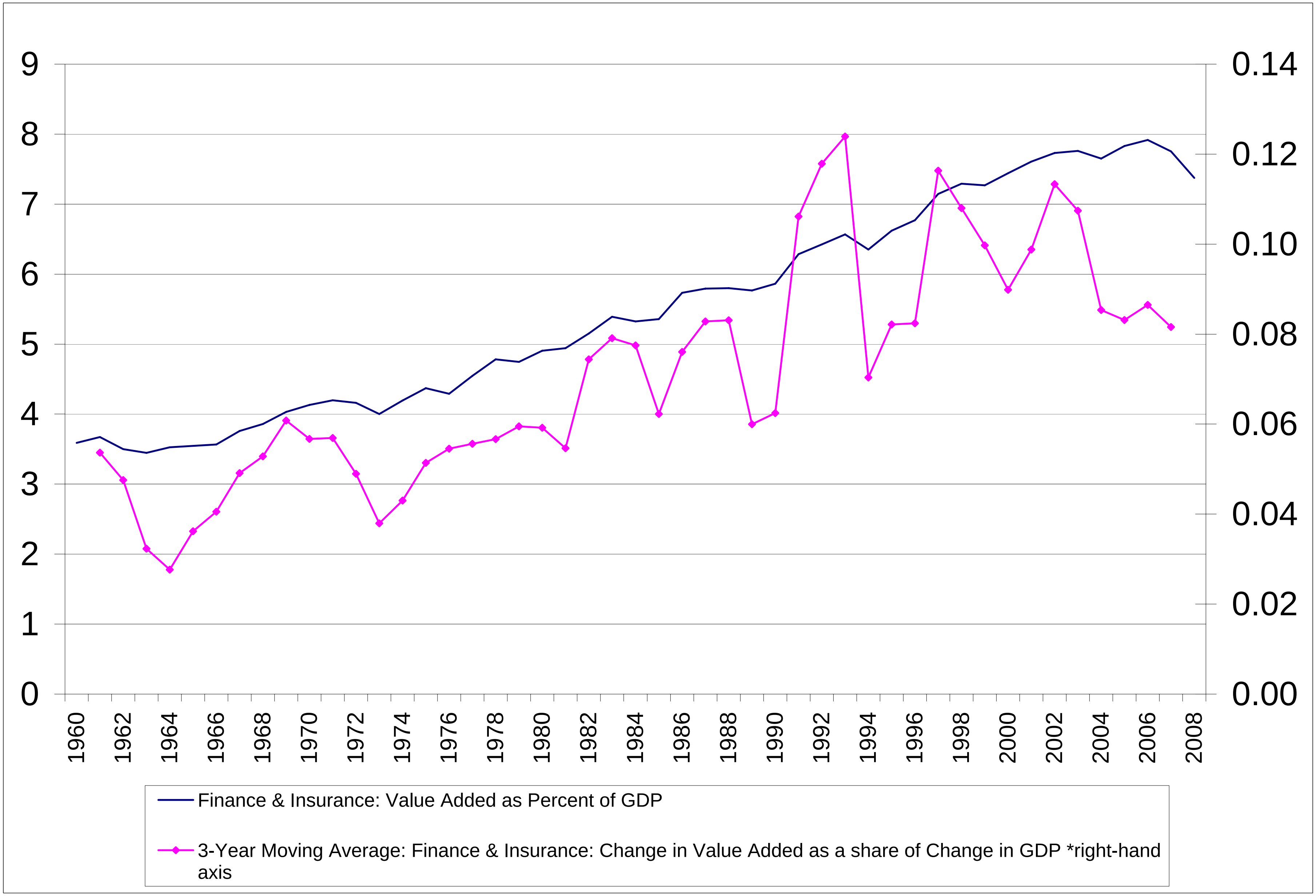
Institutions too big to fail?

(Greenspan 2010, Exhibit 7) 56.pdf

Exhibit 7



Source: Bureau of Economic Analysis

4/15/2010

Big is Beautiful?

Was there a corresponding increase in the contribution of the U.S. finance sector to the real economy? Paul Volcker doubts it. Others might too.

But a belief in the efficiency of real-world markets and the absence of such market failures as uncertainty, asymmetric information, increasing returns (although not apparently for banking) will allow one to look at Greenspan's Exhibit 7 and say, There you are!

But TBTF results in *moral hazard*, which accelerates the disparity in market sharer: lower risk-adjusted cost of capital, greater lobbying power.

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Failures of regulation, not acts of venality. (This raises the question: *how* did these changes occur?)

Simple to say, but so what, or what now?

The Economist's Causes

1. The financiers' irrational exuberance: risk was lost track of, not banished.
2. The negligence of the regulators.
3. Complacency from the low inflation and growth during "The Great Moderation."
4. The "savings glut" in Asia, and global imbalances.
5. The European banks' borrowings of questionable U.S. securities (after 1986).

20130907Economist.pdf


INSIDE THIS WEEK: TECHNOLOGY QUARTERLY
The Economist
SEPTEMBER 7TH–13TH 2013
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Obama's Syrian cliffhanger
Xi's party purge in China
Mobile telecoms' two big deals
Rebellion v reform in Mexico
Farming as rocket science
Five years on
Where's the next Lehman?
RUPEE TOWERS
BRITISH HOUSING
CHINA PROPERTY
STUDENT LOANS
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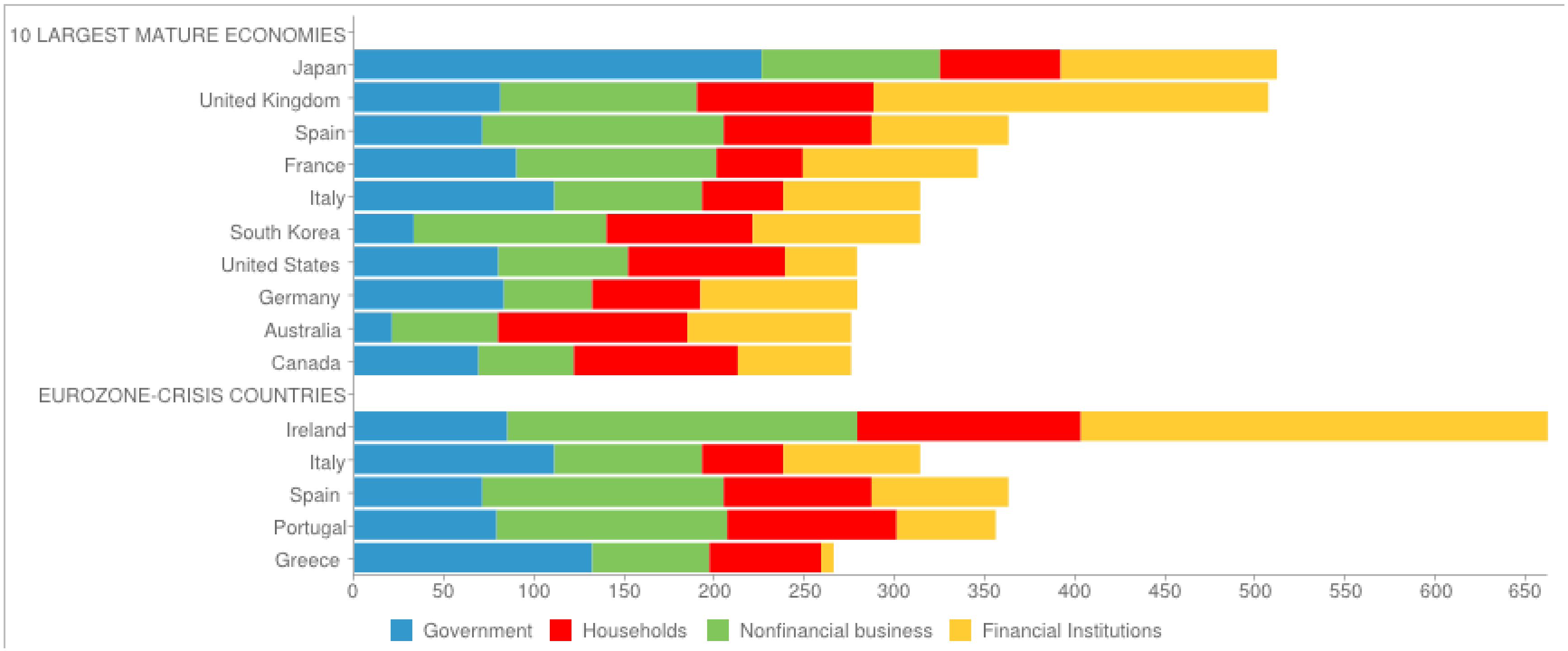
Remember: post-Lehman, TBTF might result in greater risk-taking, not less.

Page from Paul Krugman

Debts as % of GDP



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2. **Greed? or Envy? (At the Agency level.)**

   Gordon Gekko (1987): "Greed is good."
   $\longrightarrow$ collusion, me and my $$

   But Veblen (1899): envy, not greed.
   $\longrightarrow$ competition: me against others

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In the future, a need to look beyond the nostrums (and mathematical elegance) of the General Equilibrium Model, to a real world in which asymmetric information, incentives to lobby to change incentives, uncertainty (rather than risk) is pervasive mean that there are no simple answers, even ignoring distributional issues, to questions of efficiency in the financial sector.