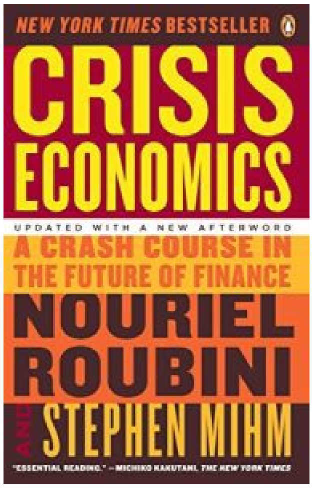

Book Crisis Economics

A Crash Course in the Future of Finance

Nouriel Roubini and Stephen Mihm
Penguin Group (USA), 2011

Recommendation

Nouriel Roubini is the rare economist who, in the midst of a speculative bubble, accurately warned that the financial crisis of 2008 was coming. His bona fides established – and his "Dr. Doom" nickname well earned – Roubini and economics professor Stephen Mihm offer an insightful, entertaining look at the history and future of crashes. Get ready, Roubini warns: After a period of relative calm after the 1930s Great Depression, financial markets are in for a wild ride. He expects financial crashes to continue and offers advice for mitigating the damage, such as restructuring Wall Street bonuses and reining in big banks, although you may suspect that his recommendations will go unheeded. *BooksInShort* recommends this book to investors and business leaders seeking a deeper understanding of the markets' gyrations.

Take-Aways

- The 2008 crisis upset the dominant economic orthodoxy of rational, efficient markets.
- A new school of thought – "crisis economics," which says investors are unpredictable but crashes aren't – offers a more realistic portrayal of economic reality.
- Wall Street should stop paying bankers and traders bonuses for success without punishing failure.
- Collateralized debt obligations are so risky and toxic that regulators ought to ban them.
- Congress needs to break up big banks so they can no longer become "too big to fail."
- US lawmakers should restore the Glass-Steagall separation of commercial banking and investment banking, and they should ban investment banks from proprietary trading.
- The Federal Reserve must act to prevent asset bubbles, rather than responding only after a bubble bursts.
- Government bailouts, while unseemly in some respects, prevented the 2008 crisis from deepening into a depression.
- Stopping markets' free fall proved an easier task than nurturing a sustained recovery.
- In a global and interconnected world, financial crises will grow more common.

Summary

"Crisis Economics" Replaces the "Efficient Markets Hypothesis"

If you think the "Great Recession" of 2008 and 2009 was unique, think again. It was strikingly similar to a long list of financial meltdowns, from the South Sea Bubble of 1720 and the crash of 1825 to the Great Depression, the 1980s US savings and loan debacle, and the Japanese Lost Decade of the 1990s.

> "The same forces that gave rise to the Great Depression were at work in the years leading up to our...Great Recession."

While the details change from crisis to crisis, the broad outlines are the same. In the run-up, easy credit abounds. Consumers, investors and business owners embrace optimism and leverage themselves recklessly. Negligent regulators, asleep-at-the-wheel central bankers and enabling politicians prime the pump of speculative excess as financial innovation creates new ways to invest in the craze of the moment. After the most recent crisis, details emerged about bankers' and traders' outsized paychecks as well as about arcane derivatives, imprudent securities backed by subprime mortgages. Believing that Wall Street greed has reached new levels is tempting, but, in fact, the greed level hasn't changed. Instead, a new breed of bonuses based on short-term profits raised greed's payoff. The more-interconnected nature of global markets also contributed to the spread of the contagion.

"That the recent crisis bears so many eerie similarities to a catastrophe that unfolded decades ago is not a coincidence."

For decades, economists have been devoted to explaining and reinforcing the genius of free markets. The orthodox view says economic participants behave rationally and markets are efficient and logical. University of Chicago economists led this school of thought. After World War II, they advanced the Efficient Markets Hypothesis, contending that the free market always values assets accurately, and overvaluation or undervaluation don't exist – only perfect valuation. However, crises such as the 2008-2009 debacle poke giant holes in the idea that the markets are always right. If the market always reflects fair, rational pricing, what explains the rapid run-up and sudden crash in the value of US homes or of shares in Lehman Brothers?

"The best way to understand crises is to see them as part of a broader continuum of causes and effects, extending long before and long after the acute phase of the crisis."

Despite the long dominance of the University of Chicago theory, some major economists have come to grips with the reality that irrational optimism can affect markets on the way up just as abject panic can affect them on the way down. From John Stuart Mill and Karl Marx in the 1840s to Robert Shiller in the 1980s, some thinkers reject the perfect markets idea. They say financial market crises are inevitable. Offering a particularly bleak view, Marx predicted that economic calamity would lead to a workers' revolt. Now economists must embrace a new idea about markets and their stability, or lack thereof: the theory of crisis economics, which recognizes that panics and meltdowns are part of capitalism. Crises are likely in an ever-riskier financial world.

"Crises wane before waxing anew; a period of calm may precede even worse outbreaks of panic and disorder."

Before the Great Depression, financial calamities and bank runs were common in the United States. As wrenching as it was, the Great Depression, with its high unemployment and bread lines, ushered in decades of stability in US markets. When the 2008-2009 recession struck – "a 19th-century panic moving at 21st-century speed" – it surprised investors since risk seemingly had disappeared from financial markets. Chicago adherents dismissed this recession as an unpredictable, unexpected event. In retrospect, though, the warning signs were obvious. Clearly, real estate had become overvalued and banks were overleveraged. In Dubai, home prices more than tripled from 2003 to 2007. In Spain and Australia, home prices more than doubled from 1997 to 2005, making the United States's 73% rise seem relatively pedestrian. Investment banks' leverage ratios soared. In 2008, Barclays had a leverage ratio of 61:1 and Deutsche Bank's ran 53:1.

"China is underwriting US wars in Afghanistan and Iraq, never mind the bailout of the financial system."

Panic set in with astonishing speed. After the bubble burst, banks stopped taking giddy risks and flooding homeowners with easy credit. They hoarded cash, creating a "liquidity trap" that hampered economic growth even as the Federal Reserve – transforming from "lender of last resort" to "investor of last resort" – cut interest rates to nearly zero. The Fed's balance sheet swelled from $900 billion in 2007 to $2.3 trillion in 2009 as it took ownership of assets ranging from Fannie Mae and Freddie Mac's debts to home loans, car loans and credit card debt. This dramatic departure from its normal role left many observers uneasy about the Fed manipulating markets. Amid the crisis, the federal government also underwrote large automakers.

"The fall of the pound took three-quarters of a century, and we may reasonably hope that the dollar's decline will also proceed at such a leisurely pace."

As the US government began to play such an outsized role, the ideas of British economist John Maynard Keynes returned to prominence. He theorized that during economic crises, governments could be pivotal in alleviating suffering and spurring growth. While a balanced budget was fine in good times, he argued, fiscal discipline during a crisis would sabotage a recovery. Indeed, Franklin D. Roosevelt's New Deal spending in the 1930s helped decrease unemployment by putting people to work building roads, hospitals, airports, bridges, schools and sewer lines.

"Unfortunately, for all the obstacles that policy makers encountered, rescuing the financial system may prove easier than fostering a genuine recovery."

Seven decades later, the government of the United States embarked on a new round of Keynesian stimulus – some of it wise, some misguided. Income tax rebates in 2008 and 2009 failed to spur spending since taxpayers preferred to sit on their money. A cash-for-clunkers incentive spurred new car sales in the short term but sapped future demand. Raising bank deposit insurance limits to $250,000 from $100,000 stemmed anxiety but made bank failures more costly. The government injected capital into banks, an aggressive response that created good news and bad news. To the good, the United States averted an all-out financial collapse. To the bad, the rescue was costly. Debt as a share of gross domestic product doubled. While US regulators and lawmakers made some arguable decisions, the ultimate result was that their quick, expensive actions saved the global economy. The Fed couldn't ignore the fiscal crisis just because solving it by government intervention struck its bankers as unseemly.

Preventing the Next Crisis

Some economists think that politicians, regulators and central bankers went overboard scrambling to contain the recession. The intellectual heirs of Carl Menger and other Austrian economists of a century ago are deeply skeptical of government market involvement. They believe easy monetary policy causes bubbles, and the post-bubble regulatory surge will only exacerbate future crises. They take issue with the federal government's crisis reaction. While the regulatory response was imperfect, it kept the recession from deepening into a depression. If it had failed, poverty and misery would have exploded, and Americans would be clamoring for changes to the financial system. Instead, they've shown scant political will to push for reform. That's too bad. Here are a few changes that could prevent future crises:

- **Rein in compensation** – Over the past two decades, Wall Street salaries and bonuses have been perverted to reward good performances without punishing poor ones. This has led bankers and traders to act recklessly, since they get incentives for risk. Curing this problem is simple. For starters, require employees who receive stock bonuses to hold the shares for at least a decade, and ideally until retirement. Base bonus payouts on three years of performance, not one. The policy of rewarding good bets but not punishing bad ones means a trader receives a bonus for a good year, but nothing for a bad year. Institute a "clawback" forcing bankers to repay a previous year's bonus if they lose money the next year. Finally, bonuses for bankers and traders who invent new financial instruments should be in those securities, not cash. If traders know they'll hold collateralized debt obligations in their portfolios, they'll be more interested in the instrument's long-term prospects. Credit Suisse already is trying this concept. At the end of 2008, it moved $5 billion in toxic debt into an employee bonus fund.
- **Standardize esoteric securities** – The boom years saw the rise in securitization of risky assets, a process that resembled financial sausage making, since customers weren't sure what they were buying. Each issue of asset-backed securities came with multiple details and disclosures. Regulators should make sellers

disclose a standard set of data. Transparency would give investors a better handle on the quality of the loans underlying asset-backed securities and would remove some of the risk from esoteric instruments.

- **Ban CDOs** – Issuing exotic securities responsibly is possible, but not CDOs – also known as "Chernobyl Death Obligations." CDOs are "preposterously complicated"; CDO-squared and CDO-cubed investments are even more so. No amount of disclosure could help an investor analyze the millions of loans backing a CDO-squared. Just how toxic are CDOs? One example: A 375-person branch of AIG insured enough of the poisonous instruments to bring down a 100,000-employee company.
- **Reform the rating agencies** – Standard & Poor's, Moody's Investor Service and Fitch Ratings grade corporate bonds, mortgages and government debt. The government should not allow these ratings agencies to do anything else, but their business model has morphed to include selling consulting and modeling services to the very banks whose issues they rate. What's more, issuers pay the rating agencies to grade their investments. Both practices create a conflict of interest akin to professors selling services to students at the same time they're grading the kids' class work. Issuers should stop paying ratings agencies directly; instead, the fees should go into a pool run by regulators, who would then assign responsibility for the rating to a rating agency.
- **Toughen up the regulators** – Because of the United States's patchwork of rules, banks essentially can choose their regulators. A financial institution's decision to operate under a state or federal charter essentially amounts to choosing which regulatory agency it wants overseeing it. With regulators competing with each other for institutions to supervise, the financial industry underwent a "race to the bottom" during the boom. Though US bankers and lawmakers are unlikely to agree, Britain uses the wisest model: The Financial Services Authority oversees all types of financial institutions under one regulatory roof.
- **Break up the big banks** – The Federal Deposit Insurance Corporation (FDIC) routinely closes small and mid-sized banks whose balance sheets are out of control. Yet the largest institutions enjoy a free pass known as "too-big-to-fail." The government has allowed such giants as Citigroup, Fannie Mae, Goldman Sachs and AIG to grow so huge that their demise would wreak havoc on the economy. One solution would be for big institutions to write "living wills" that would let regulators step in and wind down their affairs in a way that minimizes disruption. The United States also needs an alternative to Chapter 11 bankruptcy designed for financial conglomerates, perhaps modeled after the government's conservatorship of Fannie Mae and Freddie Mac. The real solution is to break up too-big-to-fail institutions. Citigroup and Goldman Sachs, to name two financial giants, repeatedly have pushed themselves to the brink of collapse over the decades, only to be saved by taxpayer bailouts. Abolishing too-big-to-fail would solve this problem.
- **Bring back Glass-Steagall** – From 1933 to 1999, the Glass-Steagall Act erected a wall between commercial banking and investment banking. Its repeal allowed Citigroup and others to play a variety of roles – commercial banker, broker, insurer, proprietary trader and hedge fund manager. This set the stage for the "too-interconnected-to-fail" model that played a role in the recession. The law should again separate commercial banking and investment banking, and should prohibit investment banks from proprietary trading. Such risky activity should be the purview of hedge funds. Investment banks should stick to their basic business of raising capital and underwriting securities. Instead of simply reviving Glass-Steagall, Congress and President Barack Obama should create "Glass-Steagall on steroids."
- **Get the Fed out of the bailout business** – In bubble after bubble, the Federal Reserve has behaved as responsibly as a doctor who doesn't tell a patient to stop smoking – but leaps into action after the patient develops lung cancer. By setting rock-bottom interest rates after the Sept. 11 terrorist attacks, the Fed played a key role in the recessionary bubble. The Fed did nothing to slow the bubble's inflation, but it took drastic steps to rescue the economy after the crash. This pattern does not convince investors to rein in risk. Why should they, if the Fed is going to bail them out?

> "While some fiscal actions were wasteful and some bailouts not warranted, the fiscal stimulus and the back-stopping of the financial system prevented the Great Recession from turning into another Great Depression."

What's next for the world economy? The hangover from the 2008-2009 crisis is likely to linger for a long time. Preventing a crisis proved easier than getting the US economy back on a trajectory of steady growth. China, with its huge surpluses and high personal savings rate, was already poised to unseat the United States's position as world's largest economy and issuer of the globe's reserve currency. The flaws illustrated by the recession seem likely to accelerate that changing of the guard. Just as the dollar usurped the pound, the renminbi will usurp the dollar. The latest bubble involves gold, the "barbarous relic" that has soared in value amid financial uncertainty. Typically, gold acts as a hedge against inflation, but inflation looks unlikely, so gold has been rising solely in reaction to financial uncertainty. As a result, gold will top out at $2,000 an ounce.

About the Authors

New York University economics professor **Nouriel Roubini** founded Roubini Global Economics and served in the White House from 1998 to 2000. University of Georgia history professor **Stephen Mihm** writes about economics and history for *The New York Times Magazine*.