Book review:

Reviewer: Sten Jönsson

This book contains the best, clear and pedagogic, account of the financial crisis so far. It also discusses what policy measures were taken by the US government and agencies to stop the downward spiraling and return confidence to the financial system in the USA. And it charts a way ahead.

Everyone who wants to be able to participate in an informed discussion about policy matters in the area should first read this text. One can disagree with some arguments and be annoyed by the nonchalant style at times, but this guy knows what he is talking about. He learned from the inside, practices as well as theories.

Part I of the book gives us an overview history of the crisis. It is aptly called “What is a nice economy like you doing in a place like this?” It tells the story in plain English and with a skillful use of a limited number of “clean” diagrams. How could we build such a fragile House of Cards?, Bilnder asks, and answers with giving a list (with comments) of 7 villains. The first one is the “double bubble” (housing financing and a bond bubble). The clarity of exposition helps us see how the bond bubble multiplied the effects of the mortgage bubble popping. There is a picture (p.77) of boxes and arrows showing how all the financial instruments of “Modern Finance” hang together. Then came the failures. First Bear Stearns that was judged (by the FED) necessary to save by “persuading” JP Morgan to take it over at 2 USD per share. There was critique, Volcker questioned whether it was legal for FED to deviate from central banking principles to this extent. Bernanke was grilled in Congress hearings. The “Too big to fail” doctrine will generate “moral hazard”. The argument (in FED and Treasury) for not letting Bear Stearns go bankrupt was its interconnectedness. There were too many counterparties that would be struck in unforeseen ways. This is interesting because it shows how the idea of “markets” is blurred by OTC deals with financial instruments that tie counterparties together over periods of time. (This, in turn, is an argument for setting up an oversight agency with the task of tracking “system critical” bonds between actors in financial
markets. Assuring that actors have capital to weather the storm when it comes is another matter.)

Then came Fanny Mae (born 1938) and Freddie Mac (born 1971), the government sponsored vehicles for securitizing home mortgages. There were no guarantees for their bonds, but the impression was that they were backed up by something like guarantees. Several factors contributed to their early fall. These companies were allowed to operate with very high leverage (thus vulnerable to declining values), they were not allowed to diversify outside the mortgage market, and they were pressured by the Housing Department as well as by competition from Wall Street to take on lower quality paper as the bubble neared burst. Paulson saw it coming and asked Congress for authority to inject new capital in July 2008. By September 7 Fanny Mae and Freddie Mac were placed under conservatorship. This was a week before the ship hit an iceberg in the form of Lehman Brothers. As Bears went down Fuld, the CEO of Lehman, said that his company had plenty of capital and liquidity, but he knew that his firm would be the next target for speculators in default. He asked the Fed to turn his company into a holding company for protection but this was rejected. Paulson told his subordinates that he did not like being called "Mr Bailout". Aides leaked this to the press and it was clear that there would be no bailout for Lehman. Speculators and strict calls for increased collateral sealed Lehman’s fate. One aspect that made the decision to let Lehman fall was the opinion that Lehman was less interconnected than Bears – a false belief.

Panic broke and the next victim was AIG, Blinder calls the section on AIG “The uninsured insurer”. In the bubble AIG had expanded its subsidiary AIG Financial Products (managed by the notorious Joseph Cassano) very rapidly by massproducing Credit Default Swaps (CDS). This could be done on the basis of AIG’s excellent balance sheet and on the fact that AAA ratings were given as a matter of routine by the rating firms to sub-prime mortgage based securities. Cassano was forced to resign in February 2008 but was retained as consultant at the nice fee of 1 million USD a month. AIG was saved by a massive injection of taxpayers’ money giving the Fed ownership of about 80 % of the equity. Blinder points out that shareholders and most of the executives paid a high price for the bailout, but the moral hazard rests with the creditors who seemingly had not watched the creditworthiness of AIG were bailed out to 100 %. (The moral hazard and reckless gaming with other peoples’ money is on the credit side, while the rhetoric focuses “shareholder value” side!)
Then came the run on the money funds, and then Merrill Lynch had to be saved, and we heard of WaMu and vachovia. (p. 166f shows a table with all the “victims” and their fate). Gradually authorities switched from saving institutions to saving markets. Blinder gives a rather detailed account of the travail of Paulson and company in designing TARP (Troubled Assets Relief Program) and is quite critical of Paulson’s efforts to pressure everybody to accept to receive TARP contributions in order to avoid “stigma” on any particularly reckless institution. Also the shift in purpose from buying troubled assets to injecting capital is commented upon. Instead of lifting “toxic” assets off the balance sheet of banks they were provided with equity-like injections to manage the toxic themselves. TARP worked.

Only now could attention be directed to the loss of jobs. Stimulus was a forbidden word now that the Republican party had been shanghai-ed by the Tea Party zealots. The room for Fiscal (Keynesian) stimulus was minimal due to the huge budget deficit and extremely large national debt. The USA had to be inventive in using monetary policies to stimulate the economy. But even there the traditional weapon of lowering interest rates was nearly exhausted. One interesting tool was to make verbal commitments to maintain a certain policy “for some time”, “for an extended period”, “at least through mid-2013”, all in order to keep intermediate-term interest rates down. Another innovation was the kinds of “Quantitative easing” Fed used. The purpose is to influence interest rates by changing the composition of assets held on Fed’s balance sheet, i.e., selling short term Treasury bills and buying an equal amount of long term ones. The introduction of “stress tests” was a good move. It served to show that most banks were able to take adversity and it put pressure on (actually ordered) GMAC (the car financing company that had gone awry) to double its capital. FED’s tools were exhausted.

With this a new look at a fiscal stimulus package was required. We should remember that president Obama was inaugurated in the middle of it all. It was president Bush who “gave” the 700 billion USD to “the bankers” now a quite inexperienced politician (two years in Congress), and a new transition team to support him, had to negotiate a stimulus package with Republicans after having stated that he sought “bi-partisan” solutions. Republicans, however, were set on limiting Obama’s tenure to one term from
the start. The resulting package (cost 787 billion USD) was 1/3 tax cuts, 1/3 new spending, and 1/3 support to state and local governments. The Act was passed without a single Republican vote. Symbolic rhetoric from the Republican side, made "stimulus" a dirty word (waste, pork, socialism), and there was soon a mix-up between the two packages that started with the figure 7 (TARP and the Recovery Act). Furthermore, there was a fundamental error by the economists that wrote the report on the likely job effects of the stimulus package (Romer & Bernstein) saying that the unemployment rate would be 1.8 % better with the package, but also saying the rate would never exceed 8 % with the package (in an economy in free fall at 7.8 % in January 2009). The actual rate peaked at 10 % in 2010:4 (with the stimulus). Republicans could use this as proof of the futility of increased government spending. A grave mistake by the economists! Lesson to learn: Do not overstate effects of fiscal policy; underestimation that is surpassed is much better, politically. With the benefit of hindsight, we can see that the seeds of the current problems (October 2013) were sown with that recovery Bill.

Now to the unconventional monetary policies that came into use to remedy the crisis. It is then necessary to focus on the spreads. The spread is the difference between the interest on a riskless asset (a treasury bill) and the rate of some other asset that carry some risk. That difference, the risk premium, for that asset is called the spread.

Conventional textbooks tell us that the spread is fairly stable since the market will determine the relevant prices. If, then, the central bank increases the base rate the cost of other borrowing will increase and this will control inflation (provided that the "spread" is the same). But during the period of the crisis “spreads” increased. When spreads rise too much (“blow out”) borrowing becomes too expensive. To reduce spreads central banks will have to rely on unconventional monetary policy (now called “quantitative easing”) to avoid that markets turn illiquid. It is mostly about influencing risk perceptions. Part of this is “verbal commitments” like the intentions for “an extended period” as mentioned above. Another ingredient may be to change the target for inflation – the idea being that inflation expectations is included in the market’s fixing of the interest rate. (negative real interest). This did not work in Japan in the 1990s because it is quite difficult even for a central bank to deliver inflation in a depressed economy. A third policy that also has not been used in the USA is to lower the interest rate paid for bank reserves. This is important since these reserves are deposits from
banks into the central bank. FED in the USA requires banks to hold 10% of their customers’ transaction deposits in reserve. Normally banks keep the reserves in excess of the 10% close to zero. But since the end of 2008 banks have amassed huge excess reserves at FED instead of increase their lending to real economy projects (that could create jobs). Banks are afraid of the risks of lending. One way of encouraging them to do so would be to lower the rate paid for bank reserves. FED has rejected this option. A fourth option is to peg the interest rate to a fixed figure (say 1.0% for 2-year Treasury notes) and buy or sell such assets as market rates move. This would stabilize expectations to that fixed figure. What FED has done in “quantitative easing”, and with obvious success, is to change the composition of assets in its balance sheet (between government securities and private commercial paper, and in size) as the situation requires.

The final tool, and one that Blinder is quite satisfied with is the “stress test” where the major banks are subjected to a severe scenario covering, say, two years, and are asked for their response to estimated credit loss rates etc. After some back and fro, the FED may declare that the banks are robust and the markets may relax by reducing risk premiums. That first test was the one that exposed the vulnerability of GMAC and the consequent requirement to double its equity mentioned above.

It is broke – let’s fix it!

Next Blinder moves into the discussion of needed reforms to come (Part IV). First he takes up some of the usual reform proposals. One such idea is to reinstate the Glass-Steagall act of 1933. The last time there was fundamental changes in the regulation of banking was after the Crash of 1929. The Glass-Steagall Act was part of that reform package (together with the a. a. SEC and the FDIC), and it separated banking, investment banking and commerce. There are many who believe that the repeal of that act and replacing it with the Gramm-Leach-Bliley (GLB) act in 1999 (allowing those two branches of banking to be joined again) that set the stage for the Crisis. Usually lobby pressure put on Congress to allow the announced merger between Citibank and Travelers by accepting the GLB is mentioned and that the act allowed Citibank to rush into speculative activities are mentioned. Some truth in this, says Blinder, but fact is that “Citibank has been a central player in virtually every banking disaster of the last several decades.” (p. 266). Blinder does not draw the conclusion that Citibank might harbor
some managerial flaw that made it jump into unknown waters, even if that seems close at hand. No, reinstating Glass-Steagall does not find support in Blinder. He claims that the crisis did not stem from investment banking mistakes, but from a dangerous mix of high leverages and disgraceful lending practices.

Another approach to limiting the size and thereby the system effects of managerial failures in banks would be to break up the financial giants into smaller units, none of which would be “too big to fail”. Others long for the good old days when investment banks were organized as partnerships (bankers had to risk their own money). Blinder thinks that it is politically impossible to stuff the sprawling corporate genies back into partnership bottles. No, the road towards reform will be long and complicated.

He then embarks on a discussion of a host of problems, introducing different approaches and weighing the arguments; the “too-big-to-fail” problem, systemic risk regulation, capital requirements, proprietary trading, the regulatory structure, protecting the consumer, regulating derivatives, hedge funds, compensation, rating agencies and more. Then we are guided through the process of getting reform proposals through Congress. The list of reform proposal issues presented by the Ministry of Finance (Treasury) in 2009 take up two full pages (299f). Work in Congress started and resulted in the Dodd-Frank act of 2010 (a 2,319-page reform law - the issues/provisions list takes up 3 pages (307 – 309)). Blinder points out that at this stage the finance lobby is by far the biggest contributor to re-election campaigns of both parties. The battle goes on.

Even if the rescue of the financial sector by providing liquidity (the different “easing” programs) was successful there were at least two secondary effects of the crisis that are troublesome; the foreclosure problem (millions of people having to leave their homes) in spite of several attempts by the Obama administration to do something about the problem. Foreclosure has the nasty effect that people in the financial sector who set up the tricky deals can benefit again by acquiring foreclosed assets at very low prices. The other secondary effect is anti-government backlash that we have witnessed lately. Libertarian ideologues aiming to reduce the influence of the state, which they see as a home of inefficiency, and rednecks that have lost jobs or homes due to faulty government policies, join forces in the tea party movement to obstruct the government machinery at any cost. Blinder is in a dark mood “Historians will ponder …..the paradox of backlash against government success – forever” (p. 364).
The final part of the book looks ahead. How can we get the FED back to normal and how can the USA solve its huge government deficit and debt problem (getting back to “normal”). The first issue is that the FED now holds very large amounts of securities as a consequence of the easing initiatives after 2008. These assets cannot be liquidated without effects. Also the banks, benefitting from the infusion of liquidity in the markets, have chosen to deposit excessive reserves with the FED, much more that is justified by risk management reasons. (These resources could do much good if lent to real economy firms for job-creating projects).

When it comes to “sovereign debt” and the budget deficit we have recently witnessed the difficulties between president and congress. The matter is not resolved, just postponed. Blinder seems to favor a solution like the one proposed by Simpson – Bowles (but rejected) of committing congress to reduce the deficit by a fixed amount annually for a period of 10 or more years. Blinder labels the European debt crisis “the European Aftershock”.

Finally Blinder summarizes his views on financial regulation reform in “ten commandments”. He seems to stress communication with the public more than economists usually do.

Summary evaluation: This book is written in a lucid and everyday language with shaded boxes that explain pertinent concepts and phenomena. Now and then there are indications that banks have been poorly managed, but this aspect is not discussed. Blinder is of the opinion that that it is futile to try to prevent bubbles and future crises (he does not say the Minsky was right, though), but focuses on reforming the financial sector policy and management tools. A useful book.